Winter Federal Tax Summit with Ron Roberson

Individual Update

2024

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IPE 1031 is an active member of the Federation of Exchange Accommodators (FEA), the only trade organization and governing body of the qualified intermediary industry. IPE 1031's President previously served on the FEA's Board of Directors, as Chair of its Ethics Committee, as Co-Chair of its Government Affairs Committee, and as the FEA's 2013 President.

The FEA established a Certified Exchange Specialist (CES) certification program to enhance professionalism and expertise of its exchange industry members. The FEA advises property owners considering a like-kind exchange not to proceed with a transaction without first consulting with a CES. IPE 1031 currently has four Certified Exchange Specialists on staff.

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- Improvements will be built on replacement property.
- A planned event to increase time flexibility by removing pressures from delayed exchange replacement property identification deadlines.

Meet Our Professionals

David A. Brown *President*

A graduate of the University of Iowa College of Business and Drake University Law School, Dave is a member of the Iowa State Bar Association and served as a past Chair of its Tax Committee; the Iowa Commercial Real Estate Association; and the Realtor's Land Institute. Dave serves on the Federation of Exchange Accommodators Government Affairs Committee. He previously served on its Board of Directors, as Chair of its Ethics Committee, and as its 2013 President. He holds the designation of Certified Exchange Specialist ("CES®") and lectures on the subject of Section 1031 for events sponsored by the Iowa State Bar Association, Drake University Law School, the University of Iowa College of Law, the University of Nebraska, the Realtors Land Institute, the Iowa Association of Realtors, and various other accounting, legal and real estate associations. Dave is a contributing editor to the Iowa State Bar Association Income Tax Manual.

M. Kathleen Brown *Vice President*

Katie received her undergraduate degree from Saint Mary's College, Notre Dame, Indiana and her law degree, with honors, from Drake University Law School in 1999, where she was a Note Editor for the *Drake Law Review*. She is a member of the Iowa State Bar Association, the Federation of Exchange Accommodators, the Iowa Commercial Realtors Association and the Realtor's Land Institute. Prior to joining IPE 1031 in 2007, she practiced law as a partner with a private law firm. Katie holds the designation of Certified Exchange Specialist ("CES®").

Becky J. Petersen *Assistant Vice President*

Becky received her law degree, with honors, from Creighton University and served on the *Creighton Law Review*. Becky holds a bachelor's degree in finance from the University of Northern Iowa. Prior to joining IPE 1031 in 2011, she served as Field Operations Director and Commercial Underwriting Counsel for Iowa's Title Guaranty program and managed escrow operations for Title Guaranty's Commercial Services Department. Becky is a member of the Iowa Commercial Real Estate Association; the Realtor's Land Institute; the Iowa State Bar Association, where she previously served on the Real Estate Section Council; and the Federation of Exchange Accommodators. She holds the designation of Certified Exchange Specialist ("CES®") and regularly lectures on the subject of Section 1031 for accounting, legal and real estate associations. Becky is also President of IPE Closing & Escrow.

Chet A. Mellema *Exchange Officer*

Chet received his juris doctor from the University of Iowa College of Law, where he served as a student writer and Note & Comment Editor for the *Journal of Corporation Law*. Chet also holds a bachelor's degree in finance from Drake University and a Business Leadership Certificate from Drake's College of Business and Public Administration. Chet is a member of the Iowa State Bar Association, serving several terms on the Real Estate & Title Section Council; the American Bar Association; Iowa Commercial Real Estate Association; and the Federation of Exchange Accommodators. He brings over 20 years of private practice and corporate legal experience to IPE 1031, with concentrations in real estate, business and debtor/creditor law. Chet is a contributing editor to the Iowa State Bar Association Income Tax Manual, holds the designation of Certified Exchange Specialist ("CES®"), and regularly speaks on the topic of Section 1031 for realtors, accountants, attorneys and similar professionals.

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Notes-You should take 2 types of notes during this seminar. The first type (margin notes) should be your notes to yourself in the pertinent manual topic area that helps you understand the material. The second type (specific notes) requires specific, immediate duties as soon as you return to the office.

Specific Notes	**Client**	**Page**

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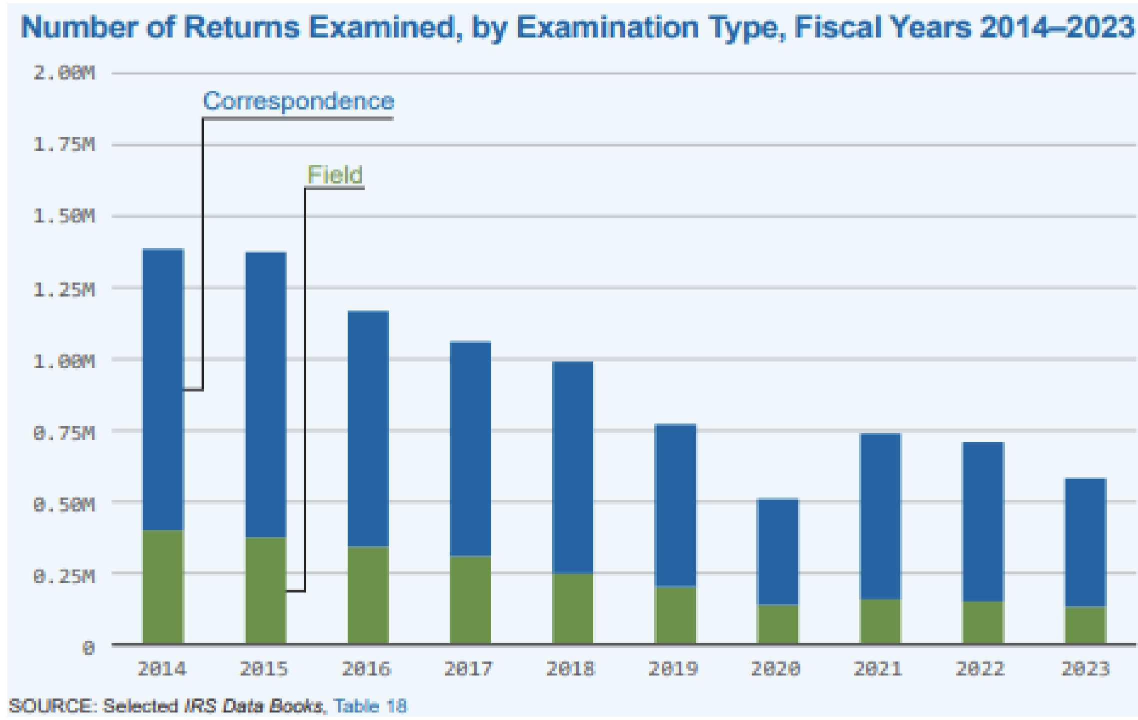
IRS Changes and Update

IRS Data Fast Facts (2023 IRS Data Book)

Audit Update

For tax years 2013 through 2023, the IRS audited 0.44% of all individual returns filed. They audited 8.7% of taxpayers who reported income greater than $10 million.



Audits of individual tax returns have decreased more than 50% since 2014. In FY 2023 the IRS employed 82,990 FTEs (79,070 in 2022), down from 94,711 FTEs in 2010, but steadily climbing.

2023 and 2022 IRS Audits of Individual Tax Returns (2021 Tax Returns)		
Taxpayer Income	**2022**	**2023**
Up to $100,000	.26%	.26%
$100,000 to $1,000,000	.14%	.11%
$1,000,000 to $10,000,000	.44%	.57%
More than $10,000,000	2.4%	2.9%
Returns with Earned Income Credit	0.9%	0.68%
Total percentage of returns audited in 2023	0.24%	0.21%
NOTE – 77.25% of audits are correspondence audits, 22.75% are field audits.		

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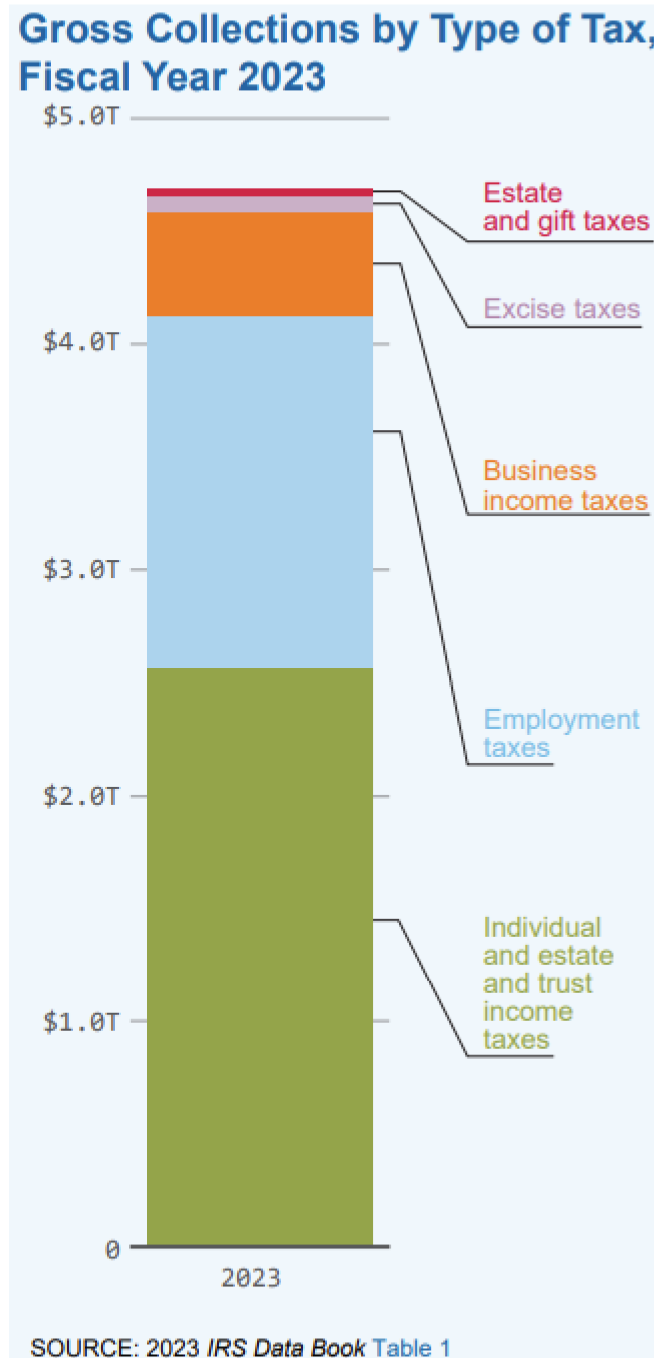
Fast fact – of the 560,009 returns audited in FY 2023, only 13,482 (2.3%) taxpayers disagreed with the IRS adjustments.

Where does the Federal government revenue come from?



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Office of Professional Responsibility (OPR) – The Conversation

The author had the opportunity to have a conversation recently with Jim McElligott, Legal Administrative Specialist, and Nellie Allen, Legal Administrative Specialist, from the Washington DC Office of Professional Responsibility. The OPR representatives passed along recent developments in the tax preparation world and how Circular 230 interacts with these developments. As our world continues to evolve, it is critical that we, as practitioners, continue to update our practices and procedures to ensure our evolving environment continues to comply with the requirements of Circular 230. Our conversation specifically addressed changes in the world of remote workers, artificial intelligence, technological competency, and social media interaction and marketing. Below is a summary of the more important and interesting points we discussed.

Reach of Circular 230 oversight. Circular 230 governs the practice of taxation before the IRS. In other words, it only applies to those who may represent taxpayers before the IRS – audits, notices, installment agreements, etc. Circular 230 does not govern those who merely prepare tax returns. This means the irony is that Circular 230 only applies to those tax professionals who are already licensed (i.e., CPAs, EAs, attorneys, tax related appraisers, etc.) and to select unlicensed preparers who voluntarily agree to be governed by its provisions. Any other unlicensed preparer is not covered by the rules of Circular 230. One could argue those that need it most may ignore Circular 230.

Establishing best practices by not ignoring the client. The IRS team advised that implementing "best practices" avoids having OPR get involved. Some of the procedures to ensure best practices include:

- It is each professional's responsibility to ensure that there are adequate procedures in place to ensure employees, associates, contractors and anyone else with access adhere to Circular 230's rules and guidelines. This cannot be outsourced.

- Professionals are required to take reasonable steps to ensure employees and others understand and follow their responsibilities under Circular 230. Establishing controls on data, oversight of employee work product, ensuring competency in areas worked, acting if Circular 230 isn't followed, are all examples of steps that must be taken. This can be accomplished by implementing mentoring and CPE programs to allow those who need it the knowledge required.

- Tantamount in this area is timely communicating with clients. One of the common complaints OPR receives is that the practitioner stopped communicating with the taxpayer. We've all had that client, but OPR's advice is to continue to communicate until you can get the relationship to the point where you can disengage, assuming that is the goal. If you just stop talking to them, the chance for an OPR complaint rises dramatically.

- Ensure the person assigned to a task has the knowledge, skill and competency to perform the engagement. This can be done by research and education. Don't be afraid to say no – sometimes it's the best answer!

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Client file security. OPR made it clear this is taken very seriously. Professionals need to implement and regularly review procedures to ensure client data is safely secured. This is done for physical files as well as electronic files. Tax offices need to have the technological expertise to ensure electronic data is properly backed up and is as safe as is reasonably possible from theft. Paper files may not be left in the open for others to see (e.g. janitorial staff, maintenance staff, etc.). If operating in a shared workspace, steps are needed to ensure confidential information isn't made available to those without need.

Remote workers bring unique challenges. Many firms have continued to embrace remote working environments even with the COVID pandemic well in the rearview mirror. From a Circular 230 standpoint, having staff work remotely brings unique challenges, including:

- Proper supervision, training, and mentoring of the remote worker to ensure competence and due diligence.

- Maintaining document management procedures that protect client data: including policies on software updates, encrypting sensitive data, other people in the remote location, electronic drop-boxes, etc. Data safety is both physical and electronic. For example, do you have a policy that states how isolated the remote office needs to be? Can others at the remote location hear confidential conversations? Policies need to be in place to mitigate the risks. Consider establishing a policy for minimum standards at a remote location.

- Consider smart technologies and their impact. Alexa, Siri, etc. record everything.

- Remote employee training should include data security and other technology related training as well as technical training.

Ensure entire staff has technological competence. Technological competency ensures:

- Deadlines are met;
- Client confidences are maintained;
- Relevant information is communicated safely;
- Client property and information are safeguarded; and
- Practitioners can provide competent representation.

Other technology related best practices:

- Assess risks in electronic systems (e.g., server locks, guidance on phishing/malware schemes, laptop and mobile security).
- Conduct computer network surveys to determine potential security issues (e.g., antivirus software, firewalls, security patches, scan engines).
- Install anti-malware/anti-virus security software on all devices (e.g., computers, routers, tablets, phones) and set software to update and perform deep scans automatically.
- Back up sensitive data to a secure external source not connected full-time to a network.
- Develop email policies (including encryption) that comply with federal and state laws.

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- Wipe clean or destroy old computer hard drives, printers, copiers, etc.
- Use strong passwords composed of 8 or more characters (special and alphanumeric characters) or a phrase, different passwords for each account, password protect wireless devices, and consider a password manager program
- Use the IRS's Tax Pro Account to create and sign authorization forms (e.g., POA, TIA) and encourage clients to create IRS Online Accounts to access their account information.
- Create a written information security plan (WISP) – see below.

Artificial Intelligence (AI) challenges. Artificial intelligence is going to have an extraordinary impact on our profession. The author personally thinks AI will result in the biggest change to our profession since the internet. And with AI right now, we are about where the internet was in the early 1990s, just in its infancy. As AI develops, we must consider the Circular 230 impacts. One thing we know for sure is that AI cannot be used as a substitute for our competency. Our competency (e.g., knowledge, skill, thoroughness, and preparation) is to advise and assist people in presenting their cases before the IRS. While AI cannot do this yet, it can write letters from scratch. If you are using an AI program (Chat GPT is the most well-known) and ask it to draft a letter about a specific topic, it will.

That said, one of the big issues with using AI is what is commonly referred to as "AI hallucinations." This happens when AI makes content up, including citations. In a few recent examples:

- A Colorado judge reported an attorney to the state bar for using ChatGPT to complete and file a document containing several fake case citations with the court.
- A Manhattan judge imposed a $5,000 fine on two lawyers who submitted a legal brief "full of made-up cases and citations," all generated by ChatGPT.
- A California judge penalized a law firm for submitting a legal brief citing "fake" cases. Per the firm, a young, newly hired lawyer used "online research" to write the motion.

It's up to us to ensure these types of mistakes don't happen. The other thing to keep in mind, if you use an app like ChatGPT, it is an open app, meaning any confidential information you provide is kept in the app and everyone on the other side has access.

Social media and tax practice. Tax professionals must be aware of the potential legal and compliance risks associated with their online presence and exercise caution when using social media. Social media best practices include:

- Separate personal and professional social media profiles, maintain strict privacy settings and regularly review and update privacy settings.
- Firms should develop and implement clear social media policies and educate all employees on these policies, the potential risks associated with social media, and the importance of discretion.
- Avoid sharing personal financial information, client details, or sensitive tax-related information on social media. Be mindful of what you post or comment, as seemingly innocuous information can be used against you or your clients.
- Limit those who may post to the Firm's social media to a select few well-trained staff.

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- Before accepting connections or engaging with individuals or organizations on social media, verify their authenticity and be selective about accepting friend or connection requests.
- Avoid offering specific tax advice or endorsing products or services without the appropriate qualifications and disclosures. Ensure that your online activities adhere to the ethical and legal standards established by your professional organizations and regulatory authorities.
- Regularly monitor your online presence by setting up Google Alerts or using social media monitoring tools to track mentions of your name, firm, or relevant keywords. This can help you stay informed and promptly address any potential issues.

Final wrap. The OPR representatives were asked what the most common disciplinary action is that is taken against tax professionals. They advised that number one and two actions were:

1. **Failure to file.** Tax practitioners who don't file their own tax returns. This includes personal, business, and employment tax returns.

2. **Contemptuous conduct.** Acting unprofessionally towards the IRS – threatening them, cussing them out, etc. The OPR team was clear that you must be well over the line to get in trouble, but they have a lot of folks who cross the line.

Preparer note. The latest version of Circular 230 is from June 2014. The Publication can be downloaded from the OPR website:

https://www.irs.gov/tax-professionals/office-of-professional-responsibility-and-circular-230

Supreme Court Says the Courts are the Ultimate Interpreters of Law, Not Administrative Regulators (Loper Bright Enterprises v. Secretary Raimondo, Dept. of Commerce, S Ct. No. 22-451, June 28, 2024). The Supreme Court greatly reduced the power of Federal agencies to interpret the laws they administer and ruled that courts should rely on their own interpretation of laws. The decision overturns the 1984 landmark decision in Chevron v. NRDC, which gave rise to the doctrine known as the Chevron doctrine. Under that doctrine, if Congress had not directly addressed a specific provision of a law, the courts were required to give deference to the regulatory interpretation of the statute, if the court deemed the interpretation as reasonable. In our world, this meant that IRS regulations, revenue rulings, revenue procedures, and notices were to be considered authoritative guidance and that, generally, the courts were required to defer to this guidance. This was true, even if the law didn't specifically give the IRS the authority to write guidance.

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Loper Bright – It's a whole new world. In the Loper Bright case, the Department of Commerce agency created an oversight plan for the herring fishing industry and then required the fishing industry to pay for it. Fishing boats were required to pay for the costs of carrying observers on their vessels, whose job was to collect data about fish caught and to monitor overfishing. Industry representatives sued, arguing nowhere in the law did it require the industry to pay the cost of the Department's oversight program and the regulations requiring the industry to do so were regulatory overreach and unconstitutional. The Court ruled that the Chevron doctrine is inconsistent with the Administrative Procedure Act (APA) and ruled the Chevron doctrine was overreach. Chief Justice John Roberts noted, the APA directs courts to "decide legal questions by applying their own judgment" and therefore "makes clear that agency interpretations of statutes – like agency interpretations of the Constitution – are not entitled to deference. Under the APA it thus remains the responsibility of the court to decide whether the law means what the agency says." Effectively, this ended the Chevron doctrine.

Okay, Chevron is gone, now what. What the ultimate impact will be from the overturning of the Chevron doctrine remains to be seen. At a minimum, we can expect many more challenges to IRS notices, rulings and regulations. In fact, unless the IRS is specifically given authority in the law to make regulatory decisions, it is likely we will see many more court challenges to regulatory decisions made by the IRS. Stay tuned!

IRS Protect Your Client; Protect Yourself Series

Tax professionals are one of the most likely targets of scammer and cyber thieves. We have all the identity data that thieves crave so they will continue to try to find ways to attack our systems and procedures. We are bound by our professional standards to protect client data. The IRS spearheaded the creation of a coalition that includes most state tax agencies and multiple private-sector tax industry companies (e.g. Intuit, Thomson Reuters, Drake, H&R Block, etc.). The purpose of the coalition is to educate the tax professional community about the risks of identity theft and cyber-attacks, and to provide guidance to help everyone in the tax professional community, including smaller practices, stay current on the latest developments to keep their systems safe and to protect client data. The group conducts a summit each year in the summertime. The year's summit, titled Protect Your Clients; Protect Yourself, featured eight weeks with a different core topic each week:

Week 1 – Trending Threats - New and Old Scams and Schemes. Beware of the "new client" scheme, where the tax professional receives spear phishing email from someone pretending to need help with their taxes. They use emails to try to get sensitive information or gain access to a practitioner's client data. In these fake "new client" schemes, the fraudster can send a malicious attachment or include a link to a site that the tax professional thinks they need to access to obtain the supposed new client's tax information, but the site is collecting information from the tax pro, such as their email and password, or loading malware onto the tax pro's computer. While this threat is not new, the IRS continues seeing activity. Also watch phone, text and correspondence schemes, where identity thieves use phone calls and text messages to get Social Security numbers, birth dates and banking information from victims. Several of these schemes are common right now that can target not just taxpayers, but potentially tax professionals and their clients.

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Week 2 – Evolving Threats. One of the most common threats facing tax pros are phishing and related scams. These are designed to trick the recipient into disclosing personal information such as passwords, bank account numbers, credit card numbers or Social Security numbers. Tax professionals and taxpayers should be aware of different phishing terms and what the email scams might look like:

- Phishing/Smishing – Phishing emails or SMS/texts (known as "smishing") attempt to trick the recipient into clicking a suspicious link, filling out information or downloading a malware file.
- Spear phishing – A specific type of phishing scam that bypasses emailing large groups at an organization, but instead identifies potential victims and delivers a more realistic email known as a "lure." These types of scams can be trickier to identify since they don't occur in large numbers. They single out individuals, can be specialized and make the email seem more legitimate.
- Clone phishing – A newer type of phishing scam that clones a real email message and resends it to the original recipient pretending to be the original sender. The new message will have either an attachment that contains malware or link that tries to steal information from the tax professional or recipient.
- Whaling – Whaling attacks are very similar to spear phishing, except these attacks are generally targeted to leaders or other executives with access to secure large amounts of information at an organization or business. Whaling attacks can also target people in payroll offices, human resource personnel and financial offices.

Week 3 – Identity Theft Red Flags. Tax pros should be on the lookout for critical warning signs from their clients, including:

- Clients receive notice that an IRS Online Account was created without their consent or that someone accessed their IRS Online Account without their knowledge.
- Tax pro clients receive a tax transcript they didn't request.
- Balance due or other notices from the IRS are received that are not correct based on the tax return filed.
- Clients reach out to the tax pro about calls or emails the tax pro didn't make.
- Clients receive refunds without filing a tax return.

Tax professionals should also watch for these red flags when their business experiences these situations:

- Slow or unexpected computer or network responsiveness such as:
- Software is slow or actions take longer to process than usual.
- Computer cursor moves or changes numbers without touching the mouse or keyboard.
- Unexpectedly being locked out of a network or computer.
- Client tax returns are being rejected because their Social Security number was already used on another return.
- IRS authentication letters (5071C, 6331C, 4883C, 5747C) are being received even though a tax return hasn't been filed.
- Getting more e-file receipt acknowledgements than the tax pro filed.
- The IRS disabled the tax professional's online account.
- Transcripts are being delivered to the tax pro's Secure Object Repository (SOR) that they did not order.

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- Notification from the IRS regarding a client that they do not represent.

Week 4 – Special Protection Tools. The IRS currently provides the IP Pin program and online accounts to help counter identity theft. Both are discussed below.

Week 5 – Strengthening Account Security. Multi-factor authentication is now more than an important protection for businesses and their clients – it's now a federal requirement. All tax professionals are required under the Federal Trade Commission's safeguards rule to use multi-factor authentication (MFA) to protect clients' sensitive information. The MFA mandate is meant to strengthen account security by requiring more than just a username and password to access any system, application or device containing client data.

Week 6 – Tips that Tax Pros Can Take. The IRS announced that there is a new and updated Written Information Security Plan (WISP) designed to help protect tax professionals against continuing threats from identity thieves and data breaches. See further discussion below.

Week 7 – Security Six" – Six Steps to Increase Data Security. The "Security Six" protections offer a relatively simple but important starting point for tax pros to protect their offices, computers and data. These best practices include:

1. **Anti-virus software.**
2. **Firewalls** provide protection against outside attackers.
3. **Multi-factor authentication** adds an extra layer of protection beyond a password.
4. **Backup software or services** should be routinely used by tax pros to back up critical files on their computers and hard drives to external sources.
5. **Drive encryption:** Because tax professionals keep sensitive client data on their computers, users should consider drive encryption software, which transforms data on the computer into protected files that are unreadable to outsiders.
6. **Virtual Private Network (VPN):** Because many tax firms' employees must occasionally connect to unknown networks or work from home, the office should establish an encrypted virtual private network (VPN).

Week 8 – Commit to Data Protection Steps. Tax professionals must commit to maintaining strong safety measures to protect themselves and their clients against evolving data security threats. Time and other resources are necessary to ensure data is protected and professional standards are met. Without committed management this won't happen. Rest assured the bad guys are committed and investing resources.

IRS Security Bookmarks. The IRS has created a list of bookmarks on its webpage that provide access to helpful data security related information. These bookmarks include:

- Identity Protection: Prevention, Detection and Victim Assistance – Main identity theft page.
- Data Theft Information for Tax Professionals – How to report client data loss to the IRS.
- Protect Your Clients; Protect Yourself – Awareness campaign and scam alerts for tax pros.
- Taxes. Security. Together. – Awareness campaign for taxpayers.
- Identity Theft Information for Tax Professionals – An overview.

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- Report Phishing and Online Scams – How to report IRS-related scams.
- How IRS Identity Theft Victim Assistance Works – What clients can expect.
- Maintain, Monitor and Protect Your EFIN – Protect your IRS-issued identification numbers.
- Secure Access – How to authenticate your identity to access IRS online tools.
- Security Summit – Track safeguards enacted by IRS, states and industry.
- Newsroom – Stay in the know by subscribing to IRS News Releases.
- Stakeholder Liaisons Local Contact – find your local contact to report data losses.

Written Information Security Plan (WISP) requirement. The Gramm-Leach-Bliley Act (GLBA, passed by Congress and administered by the FTC, requires financial institutions, ***including tax professionals,*** to keep customer data safe and to implement a written information security plan (WISP). The 2024 Security Summit introduced a newly updated WISP and the related documents, including Publication 5708, Creating a Written Information Security Plan for your Tax & Accounting Practice. This Pub includes a 28-page template designed to help tax pros, particularly smaller practices, create a WISP. The new template includes several new best practices updates, including implementing multi-factor authentication. The IRS also reminded tax pros that they are required to report a security event affecting 500 or more people to the FTC no later than 30 days after the date of discovery. This is in addition to reporting the incident to an IRS Stakeholder Liaison and state tax authorities.

Multiple resources to assist with data protection. The IRS has issued multiple practice aids to assist tax professionals comply with the data security requirements. All these items are new or have been updated in 2024 or late 2023 and include:

- IRS Pub 5708 – Creating a Written Information Security Plan for Your Tax & Accounting Practice
- IRS Pub 5709 – How to Create a WISP for Data Security
- IRS Pub. 4557 – Safeguarding Taxpayer Data
- IRS Pub. 1345 – Authorized E-File Providers of Individual Income Tax Returns
- IRS Pub. 5293 – Data Theft Resource Guide for Tax Professionals
- IRS Identity Theft Central
- FTC Data Breech Guide
- FCC Interactive Custom Security Planning Tool

Requirements of a WISP. There are 7 requirements of a WISP, regardless of firm size, according to the FTC.

1. Designate at least one qualified individual to coordinate the information security program.

2. Identify and assess the risks to customer information in each relevant area of the company's operation and evaluate the effectiveness of the current safeguards for controlling those risks.

3. Design and implement a safeguards program, and regularly monitor and test it.

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4. Select service providers that can maintain appropriate safeguards by ensuring your contract requires them to maintain safeguards and oversee their handling of customer information.

5. Evaluate and adjust the program considering relevant circumstances, including changes in the firm's business or operations, or the results of security testing and monitoring.

6. Implement multi-factor authentication for any individual accessing any information system, unless your qualified individual has approved, in writing, the use of reasonably equivalent or more secure access controls.

7. Report a security event affecting 500 or more people to the FTC as soon as possible, but no later than 30 days from the date of discovery.

Developing a WISP

A security plan should be appropriate to the company's size, scope of activities, complexity, and the sensitivity of the customer data it handles. There is no one-size-fits-all WISP. For example, a sole practitioner can use a more abbreviated and simplified plan than a 10-partner accounting firm. A good WISP should focus on three areas:

1. Physical Safeguards – keep data protected from physical threats.
2. Technical Safeguards – ensure that your device(s) and network are not compromised.
3. Administrative Safeguards – manage and train staff.

We suggest making the WISP a document presented to all employees and owners at a mandatory scheduled annual training course and at hire for new employees. There should be a requirement that everyone, including the owners, sign the document in the presence of all other employees. Maintaining a copy in a common employee-accessible file and online provides knowledge and compliance. ***The initial implementation of the WISP should occur at an attendance-mandated employee/owner security meeting.***

Maintaining a WISP

WISPs should be reviewed at least annually, and the program updated for equipment, software, and operational changes. An annual employee mandated update training should remind and inform all employees of the plan, its existence, and its requirements.

Anyone can be a target of cybercriminals and scammers. Unfortunately, tax professionals can seem like the big fish in a sea of potential targets because of how much financial data they use to conduct their business. Even a careful, prepared tax pro may fall victim to a crime. If that happens, there are several key things they should do to protect their clients and their business.

It is required by law that tax professionals inform all their clients of a breach and encourage them to apply to the IRS for an Identity Protection Personal Identification Number, or IP PIN. The Electronic Tax Administration Advisory Committee called the IP PIN, "The

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number one security tool currently available to taxpayers from the IRS." Info on reporting a data breech is available in the FTC Data Breech Guide cited above.

Review security measures used to protect client data. Data protection is key in helping avoid data breaches. To help tax pros protect their clients and their business, the IRS, state tax agencies and the tax industry partners who make up the Security Summit created a Taxes-Security-Together Checklist. Whether a one-person shop or partner in a large firm, everyone can take several relatively simple steps to protect their clients and their business data.

Practical tips for keeping your office safe. What should the tax professional do to protect their office and clients? Here are some ideas:

1. Never respond directly to emails or phone calls requesting information.
2. Always check the sender's reply-to address or ask IT before replying to a suspicious message.
3. Never respond to emails or texts (particularly texts), instead go to the supposed website, and call the number to check if it is authentic and do not call the number if provided within the email as, most likely, it is fake also.
4. Any text, email, WhatsApp message, or any communication that creates a time-sensitive situation should be a red flag.
5. Educate all employees and owners about the risks and to these alert items. Share details of actual problematic messages with the team to keep them aware.
6. Implement and enforce a firmwide "No-Click" policy for emails as shown on the next page.

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Here is a summary of receiving client information when you are using a no-click policy, in order. The author has used a no-click policy combined with the client information system below for five tax seasons. Tax season 2023 saw nearly 85% of clients using upload features because of security concerns, the pandemic, and US Postal Service issues.

1. **Clients should upload data to our secure portal; or**
2. **Clients may physically deliver hard copies to our office; or**
3. **Clients may utilize physical mail systems to send hard copies to our office; or**
4. **Clients may take a picture of a document and text it to us, where we will print it directly to a physical document using our HP AirPrint app; or**
5. **Clients may fax us a document, or as a last resort.**
6. **Clients may email us a document, with a confirming phone call noting date, time, telephone number and person confirmed with, the document name and size.**

Any exception to this system jeopardizes the firm, the clients and the employees and may not be tolerated. Do not expose your very existence to 1 client who will not conform to this system, instead you need to send the client elsewhere. A client who says they "waive" the risk does not understand the risk is to every client, not just them.

Keeping EFIN up to date. Tax professionals should update their EFIN application within 30 days of any change, including if there are new personnel, telephone numbers, addresses or email addresses. Keeping the application up to date means any correspondence from the IRS will go to the correct person and the correct address. EFINs can only be obtained from the IRS. They are not transferable should a business be sold. Also, new office locations may need their own EFIN if the new location files tax returns.

Tax pros should make a weekly check of their EFIN to determine how many returns were filed under their number. Practitioners should select "EFIN status" from their EFIN application within e-Services. If the number is too large, tax pros should contact the IRS e-Help Desk to make a report.

Additionally, tax pros who are attorneys, CPAs, enrolled agents, or participants in the Annual Filing Season Program and who file 50 or more returns also can check the number of tax returns with their PTIN processed by the IRS in the current year. The information is updated weekly and can be located by going to their online PTIN account and selecting "View Returns Filed Per PTIN." Both the EFIN and PTIN status checks can help quickly identify any unusual activity.

The IRS launched the "Identity Theft Central" webpage (https://www.irs.gov/identity-theft-central) to collect its information on identity theft and data security. The Identity Theft Central main page is an easy starting point to access IRS resources for individuals, tax

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professionals, and businesses, along with links to the Security Summit and reporting phishing and online scams.

The IRS concludes the warnings with this statement: "avoiding phishing emails, which cybercriminals commonly use to trick practitioners into disclosing sensitive information."

Document Upload Tool Catching On (IR-2024-155)

The IRS announced in June 2024 that its Document Upload Tool has officially accepted its one millionth taxpayer submission. Use of the Document Upload Tool, sometimes referred to as DUT, has continually grown since its launch in 2021. DUT offers taxpayers and tax professionals the option to respond digitally to IRS notices by securely uploading required documents online through IRS.gov. For anyone with a smart phone or computer, this means that replying to IRS notices is now often as easy as scanning required documents and uploading them to the tax agency. Since 2022, average monthly use of the DUT has more than doubled every year, from around 16,000 in 2022, to around 37,000 in 2023 and finally almost 84,000 so far in 2024. The document submissions cover a wide range of tax issues, including responding to IRS Notice CP2000, where the agency notifies taxpayers of potentially underreported income. The IRS estimates that more than 94% of individual taxpayers will have the option of communicating only digitally with the IRS.

IRS Makes Online Business Accounts Available

The IRS expanded its online features to its Business Tax Account (BTA), an online self-service tool for business taxpayers who may view and make balance-due payments. Launched in late 2023, BTA is eventually expected to allow many types of business taxpayers to check their tax history, make payments, view notices, authorize powers of attorney and conduct other business with the IRS. The latest changes allow business taxpayers to pay Federal Tax Deposits (FTDs) and see and make a payment on balances due.

Who can use BTA and what can they do? Business taxpayers who can use the IRS business tax account services include:

- Sole proprietors who have an Employer Identification Number (EIN). LLCS that report business income on Schedule C cannot access BTA at this time.
- Individual partners or shareholders who have a Social Security number (or an individual tax ID number), and a Sch. K-1 on file (for partners, from 2012-2023; for shareholders, from 2006-2023).
- Currently there is no BTA access for other entities, including tax-exempt organizations, partnerships, C corporations and S corporations.

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What can business taxpayers use BTA to do? Within BTA, business taxpayers can now:

- View and make payments for balances due by using a bank account. This includes payments on returns filed for the current and prior years and Federal Tax Deposits.
- Schedule payments for any business day for up to a year and cancel a scheduled payment.
- View recently processed payments, including payments made through EFTPS, online, wire transfers, checks or money orders, and see if any payments were returned or refused.
- Store multiple bank accounts in their online "wallet" to manage tax payments.
- Request a tax compliance check.
- View the business name and address on file.
- Give account access to employees of the business.
- Register for clean energy credits (if eligible).
- View and download transcripts for various payroll, income and excise tax returns.
- Sole proprietors can now download business entity transcripts, which show entity information like business name, mailing address, location address and more for the EIN on file.
- View and download select digital notices including:

    - CP080: Reminder - We Have Not Received Your Return, Credits May be on Your Account.
    - CP136: Annual Notification of Federal Tax Deposit (FTD) Requirements (Forms: 941, 941-SS).
    - CP216F: Application for Extension of Time to File an Employee Plan Return – Approved.

What new features are planned for BTA in the future? Future capabilities will enable access by all business and organizational entities. To set up a new business tax account, or for more information visit Business Tax Account.

Direct File Program Here to Stay

Direct File is a web-based service that works on mobile phones, laptops, tablets or desktop computers. It guides taxpayers through a series of step-by-step questions to assist them to prepare their Federal tax return. Approximately 140,000 taxpayers filed return with Direct File in 2024 and thousands received help from IRS customer service representatives through a live chat feature. Once taxpayers completed their Federal tax return, the Direct File system automatically guided them to state tools to complete their state tax filings. In May 2024, the IRS announced the Direct File program is being made permanent.

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IRS Direct File set to Expand for 2025 Filing Season (IR-2024-258). The IRS announced in October 2024 that it is expanding the Direct File program that started as a pilot program earlier in 2024. The program was expanded to 24 states in 2025, up from 12 in 2024. During the pilot last year, Direct File was available in Arizona, California, Florida, Massachusetts, Nevada, New Hampshire, New York, South Dakota, Tennessee, Texas, Washington State and Wyoming (very happy the included income tax states!). For the 2025 tax filing season, Direct File will also be available in Alaska, Connecticut, Idaho, Kansas, Maine, Maryland, New Jersey, New Mexico, North Carolina, Oregon, Pennsylvania and Wisconsin. Several other states have expressed interest or announced that they will participate in Direct File in 2026.

More complex tax situations will be covered in 2025 filing season. In addition to doubling the number of states where Direct File will be available, the service will also cover a wider range of tax situations for the 2025 filing season. During the pilot last year, Direct File covered limited tax situations to those taxpayers with wage income reported on a W-2 form, Social Security income, unemployment compensation and certain credits and deductions. For 2025, Direct File will support 1099's for interest income greater than $1,500, retirement income and the 1099 for Alaska residents reporting the Alaska Permanent Fund dividend. Additionally, Direct File supported taxpayers claiming the Earned Income Tax Credit, Child Tax Credit and Credit for Other Dependents in 2024. This year, Direct File will also cover taxpayers claiming the Child and Dependent Care Credit, Premium Tax Credit, Credit for the Elderly and Disabled, and Retirement Savings Contribution Credits. In addition to covering taxpayers claiming the standard deduction and deductions for student loan interest and educator expenses, this year, Direct File will support taxpayers claiming deductions for Health Savings Accounts. The IRS expects that Direct File will gradually expand to support most common tax situations, focusing on tax situations that impact working families.

IRS Withholding Estimator Available on Website (IR-2024-27)

The IRS encourages taxpayers to use the IRS Tax Withholding Estimator to ensure they're withholding the correct amount of tax. This digital tool provides workers, self-employed individuals and retirees with wage income a user-friendly resource to effectively adjust the amount of income tax withheld from their wages. The Tax Withholding Estimator is available on the IRS's website at irs.gov.

Avoiding Taxpayer and Preparer Penalties

Overview (§6662). Taxpayers who report a substantial understatement of income on their tax return are subject to an underpayment of tax penalty equal to 20% of the understated tax. The penalty increases to 40% in the case of gross valuation misstatements, nondisclosed noneconomic substance transactions, or undisclosed foreign financial asset understatements. There is a substantial understatement of income tax if the understated tax[1] exceeds the greater of:

[1] An understatement is the excess of the amount of tax required to be shown on the return for the taxable year over the amount of the tax that is shown on the return reduced by any rebate (§6662(d)(2)).

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- 10% of the amount of tax required to be shown on the return for the taxable year, or
- $5,000 (see §6662(d)(1)(B) for special rules that apply to C corporations).

Preparers also subject to penalties (§6694). Tax return preparers who prepare a return that reflects an understatement of liability due to an "unreasonable position" which the tax return preparer knew (or reasonably should have known) about. The preparer penalty is the greater of $1,000 or 50% of the income derived by the preparer for the respective return. If the IRS determines the understatement was due to willful neglect or reckless conduct, the penalty is equal to the greater of $5,000 or 75% of the income derived.

Example. Evan and Sarah Green hired MJ to prepare their 2024 tax returns. During their interview, Evan and Sarah advised MJ they want to deduct auto and travel expenses of $50,000 on Sarah's Schedule C. They also say they don't have any contemporaneous documentation to prove the deductions. MJ decides to allow the Greens to claim the deductions on their tax return. She charges the Greens $1,500 to prepare the return.

The IRS audited Evan and Sarah's tax return and determined the auto and travel expenses were not deductible and added $50,000 to taxable income. Green's 2024 income tax increased $15,000 and the IRS assessed a substantial understatement penalty of $3,000 ($15,000 x 20%) and a preparer penalty of at least $1,000 for MJ (greater of $1,000 or 50% of $1,500). If the IRS determines MJ willfully ignored the law – she did – the preparer penalty would be increased to $5,000 (greater of $5,000 or 75% of $1,500).

Using disclosure to avoid taxpayer and preparer penalties. The understatement penalties do not apply if the taxpayer and/or preparer has a reasonable basis for the tax treatment (and the item in question is not a non-tax shelter or reportable transaction[2]). A tax position is generally treated as reasonable if:

1. There is or was substantial authority for taking the position, or
2. The position was adequately disclosed (per §6662(d)(2)(B)(ii)(I)) and the taxpayer and preparer had a reasonable basis for taking the position.

What is adequate disclosure? Rev. Proc. 2020-54 revised the procedures required to provide adequate disclosure and avoid taxpayer and preparer penalties. The Rev. Proc. requires the taxpayer to furnish all required information in accordance with the applicable forms and instructions in a clear manner and in accordance with the form instructions. For example, in the example above, Evan and Sarah's tax return needed to include Sch. C, and all expenses deducted were supported with proper documentation. Additionally, Form 8275 or Form 8275R must be included with the return. Finally, Rev. Proc. 2020-54 has general and specific disclosure requirements for specific types of tax return income and deduction. The general disclosure requirements are:

[2] If the position is with respect to a tax shelter (§6662(d)(2)(C)(ii)) or a reportable transaction to which §6662A applies, the position is treated as unreasonable unless the position would more likely than not be sustained on the merits (Notice 2009-5).

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1. All amounts entered on forms must be verifiable (i.e., taxpayer can prove the origin of the amount, even if the IRS does not accept the number) and the taxpayer can show good faith in entering that number on the applicable form.

2. The disclosed amounts are not related party transactions (disclosure is not adequate when the understatement arises from a transaction between related parties (defined at §267(b)).

3. For amounts and items shown on a line that do not have a preprinted description (e.g., Sch. C other deductions) the taxpayer clearly describes the item on the line. For example, to disclose a bad debt for a sole proprietorship, the words "bad debt" must be written or typed on the line of Schedule C that shows the amount of the bad debt, not say "Other expense." If space limitations on a form do not allow for an adequate description, the description must be continued on an attachment.

4. Even if the taxpayer meets the literal disclosure requirements, the disclosure has no effect if the item or position: 1) doesn't have a reasonable basis; 2) is attributable to a tax shelter; or 3) is not properly substantiated due to inadequate books and records.

Example - variation. Assume the same facts as described above except this time Evan and Sarah agree when MJ suggests they include Form 8275 with the return to meet the disclosure requirements of Rev. Proc. 2020-54. Assuming they meet all the requirements, Evan and Sarah will not be subject to substantial underpayment penalties and MJ will not be subject to preparer penalties.

Final Note – Line by line instructions available. Rev. Proc. 2020-54 has specific disclosure guidelines for specific return items (e.g., medical expenses, charitable contributions, trade or business expenses, repair expenses, etc.). Specific details for each line are too voluminous to cover here. Refer to the Rev. Proc. for more detailed discussion.

IRS Continues to Encourage Use of IP PINs to Cut Down Identity Theft (Pub 5367)

The Internal Revenue Service expanded the Identity Protection PIN Opt-In Program to include all taxpayers who can verify their identities. The IP PIN is a 6-digit number assigned to eligible taxpayers that is required to be submitted with the tax return, in addition to the taxpayer's name and Social Security number, to verify the taxpayer's identity. Bottom, the IP Pin helps prevent identity thieves from filing fraudulent tax returns with stolen Social Security numbers (SSNs).

IP PIN is available to all taxpayers, not just those subject to ID theft. For more than a decade the IRS issued IP PINs to identity theft victims. That process is unchanged. What's new is that any taxpayer who wants an IP PIN, even if they are not victims of identity theft, may now obtain one to protect against potential identity theft. Here's what you need to know before applying for your IP PIN:

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1. This is a voluntary program.
2. You must pass a rigorous identity verification process.
3. Spouses and dependents are eligible for an IP PIN if they can verify their identities.
4. The IP PIN is valid for one year. Each January, the taxpayer must obtain a newly generated IP PIN.
5. You must obtain a new IP PIN each filing season, using the online IP PIN tool.
6. The IP PIN tool is unavailable generally mid-November through mid-January each year.
7. Correct IP PINs must be entered on electronic and paper tax returns to avoid rejections and delays.
8. The IRS plans to offer an opt out feature to the IP PIN program in 2022 if taxpayers find it is not right for them.

The easiest way to get an IP PIN is to use the “Get an IP PIN”’ online tool on the IRS website. The steps are:

1. Go to IRS.gov/IPPIN, select the Get an IP PIN tool, verify your identity, and create an account.
2. Once you have a username, password, and security code, enter the Get an IP PIN tool.
3. Your IP PIN will be revealed to you.

Can’t pass online identity proofing? There are alternatives for those who cannot pass the online ID proofing but there will be a delay in obtaining an IP PIN. These taxpayers will have to:

1. File Form 15227 for those with a valid SSN or ITIN, an AGI of $72,000 or less, and access to a telephone. An IRS assistant will call you, validate your identity and ensure that you receive an IP PIN in the next filing season.
2. Those ineligible to file Form 15227 will have to call the IRS for in-person options.

Bottom line – obtaining an IP PIN and renewing it each year will no doubt be somewhat of a hassle. However, it is the best way to protect yourself from tax related identity theft and fraud.

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<u>Preparer Penalties under the Law: Reference is to Internal Revenue Code Section</u>

§6694 – Understatement of taxpayer's liability by tax return preparer.

§6694(a) – Understatement due to unreasonable positions. The penalty is the greater of $1,000 or 50% of the income derived by the tax return preparer with respect to the return or claim for refund.

§6694(b) – Understatement due to willful or reckless conduct. The penalty is the greater of $5,000 or 75% of the income derived by the tax return preparer with respect to the return or claim for refund.

§6695 – Other assessable penalties with respect to the preparation of tax returns for other persons.

§6695(a) – **Failure to furnish copy to taxpayer**. The penalty is $50 for each failure to comply with IRC § 6107 regarding furnishing a copy of a return or claim to a taxpayer. The maximum penalty imposed on any tax return preparer shall not exceed $26,500 in calendar year 2020.

§6695(b) – **Failure to sign return**. The penalty is $50 for each failure to sign a return or claim for a refund as required by regulations. The maximum penalty imposed on any tax return preparer shall not exceed $26,500 in calendar year 2020.

§6695(c) – **Failure to furnish identifying number**. The penalty is $50 for each failure to comply with IRC § 6109(a)(4) regarding furnishing an identifying number on a return or claim. The maximum penalty imposed on any tax return preparer shall not exceed $26,500 in calendar year 2020.

§6695(d) – **Failure to retain copy or list**. The penalty is $50 for each failure to comply with IRC § 6107(b) regarding retaining a copy or list of a return or claim. The maximum penalty imposed on any tax return preparer shall not exceed $26,500 in calendar year 2020.

§6695(e) – **Failure to file correct information returns**. The penalty is $50 for each failure to comply with IRC § 6060. The maximum penalty imposed on any tax return preparer shall not exceed $26,500 in calendar year 2020.

§6695(f) – **Negotiation of check**. The penalty in calendar year 2020 is $530 for a tax return preparer who endorses or negotiates any check made in respect of taxes imposed by Title 26 which is issued to a taxpayer.

§6695(g) – **Failure to be diligent in determining eligibility for certain tax benefits**. This penalty is for failure to determine eligibility or the amount for earned income credit, child tax credit, additional child tax credit, other dependent credit, American opportunity credit and/or the head of household filing status. The penalty for returns filed in 2020 is $530 for each failure on each return.

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§6700 – Promoting abusive tax shelters. The penalty is for taxpayers who organize or sell abusive tax shelters. The penalty is calculated differently depending on the taxpayer's conduct. If the taxpayer makes false statements regarding the tax benefits of the transaction which he knows or has reason to know is false, the penalty is equal to 50 percent of the gross income derived from the activity. If the taxpayer provides a gross valuation overstatement the penalty is $1,000 for each organization or sale (or, if lesser, 100 percent of the income derived from the activity).

§6701 – Penalties for aiding and abetting understatement of tax liability. The penalty is $1,000 ($10,000 if the conduct relates to a corporation's tax return) for aiding and abetting in an understatement of a tax liability. Any person subject to the penalty shall be penalized only once for documents relating to the same taxpayer for a single tax period or event.

§6713 – Disclosure or use of information by preparers of returns. The penalty is $250 for each unauthorized disclosure or use of information furnished for, or in connection with, the preparation of a return. The maximum penalty on any person shall not exceed $10,000 in a calendar year. If a disclosure or use is made in connection with a crime relating to the misappropriation of another person's taxpayer identity, whether such crime involves any tax filing, the penalty increases to $1,000 for each use or disclosure, with a maximum of $50,000 per person per calendar year. This penalty applies to disclosures or uses that are made on or after July 1, 2019.

§7206 – Fraud and false statements. Guilty of a felony and, upon conviction, a fine of not more than $100,000 ($500,000 in the case of a corporation), imprisonment of not more than three years, or both (together with the costs of prosecution).

§7207 – Fraudulent returns, statements, or other documents. Guilty of a misdemeanor and, upon conviction, a fine of not more than $10,000 ($50,000 in the case of a corporation), imprisonment of not more than one year, or both.

§7216 – Disclosure or use of information by preparers of returns. Guilty of a misdemeanor for knowingly or recklessly disclosing information furnished in connection with a tax return or using such information for any purpose other than preparing or assisting in the preparation of such return. Upon conviction, a fine of not more than $1,000, imprisonment of not more than 1 year, or both (together with the costs of prosecution).

§7407 – Action to enjoin tax return preparers. A federal district court may enjoin a tax return preparer from engaging in certain proscribed conduct, or in extreme cases, from continuing to act as a tax return preparer altogether.

§7408 – Action to enjoin specified conduct related to tax shelters and reportable transactions. A federal district court may enjoin a person from engaging in certain proscribed conduct (including any action, or failure to act, which is in violation of Circular 230).

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Other IRS Updates and Developments

IRS Ends Policy of Unannounced Revenue Officer Visits (IR-2023-133).

The IRS discontinued unannounced visits of revenue officers to taxpayers except in a few unique circumstances effective July 2023. The change reverses a decades-long practice by IRS revenue officers, the unarmed agency employees whose duties include visiting households and businesses to help taxpayers resolve their account balances by collecting unpaid taxes and unfiled tax returns. Effective immediately, unannounced visits will end except in a few unique circumstances and will be replaced with mailed letters to schedule meetings. The visits were replaced with mailed letters to schedule meetings. IRS Commissioner, Danny Werfel, noted “we have the tools we need to successfully collect revenue without adding stress with unannounced visits.” “The only losers with this change in policy are scammers posing as the IRS.”

Cash Transaction Reporting Must be E-filed Starting 2024 (IR-2023-157).

Businesses that receive cash payments greater than $10,000 may only file Form 8300, Report of Cash Payments Over $10,000 Received in a Trade or Business, electronically starting in 2024. Businesses are allowed to create an account with FinCen's BSA E-Filing System to e-file Forms 8300, which normally must be filed within 15 days of receiving the cash payment.

Businesses must keep copies of each Form 8300 it files, along with any supporting documentation and the required statement it sends to customers, five years from the date the form was filed with FinCen. The email confirmation alone verifying the filing of a Form 8300 is insufficient documentation. Filers also must save a copy of the filed form – either electronically or on paper – before finalizing the submission and should associate the confirmation number they receive with the copy.

Taxpayer Qualified for Reasonable Cause Exception (Donald Tracy v. Comm., TC Summary 2023-30).

Attorney Don Tracy, age 92, operated as a sole proprietor for almost 60 years. Don did not timely file returns or timely pay his employment tax liabilities for the periods from 2017through 2019. During this time, Don was winding up his law practice because of his declining health and advanced age. Don had an assistant help him with daily business operations and another attorney worked on his remaining cases. He also employed a part-time aide to assist with his daily living activities. He was also the primary care giver for his dying wife. Don asked his assistant to take care of filing and paying his payroll taxes during the time at issue. When he later realized the returns weren’t done and the taxes weren’t paid, Don promptly filed the returns and paid the taxes. He did not pay the penalties and asked the IRS to abate them.

The IRS granted a partial abatement of the failure to pay penalties, but they did not forgive the failure to file penalties. Don went to court to ask for relief. The Court agreed that Don was diligent in exercising ordinary business care and prudence in providing for payment of his tax liabilities but filed late due to his poor health and advanced age. He had effective systems in place that failed in his final year only because he was unable to supervise his assistant properly. The Court ruled Don had reasonable cause and abated all penalties.

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Substantiation Penalties for Disorganized Taxpayer (A.G Mulu v. Comm., T.C. Summary 2023-2).

The Court held that a taxpayer, who worked as a pharmacist, was liable for penalties for failing to substantiate deductions taken with respect to rental real estate. In addition, the court concluded that the taxpayer did not have reasonable cause and good faith for the resulting underpayment of tax because he relied on a tax return preparer who did not have a preparer tax identification number (PTIN) and who electronically submitted the taxpayer's return as though it had been self-prepared by the taxpayer.

IRS Sets PTIN Fee at $19.75 for 2024 Renewals (§300.12)

After much back and forth between the IRS, the tax preparation profession, and the courts, the U.S. Court of Appeals for the District of Columbia ruled Federal agencies that provide services that confer benefits on identifiable recipients are allowed to charge user fees to recover the full cost of providing the service. The Court further ruled that the PTIN program provides benefits to tax professionals (*Brittany Montrois* v. U.S., D.C. Cir. No. 17-5204, March 1, 2019). Accordingly, for the first time in several years, tax professionals were required to pay a fee to renew their 2021 PTINs. After conducting the required biennial review of the PTIN program, the IRS set the 2024 user fee at $11 plus $8.75 processing fee (paid to third-party contractor) for a total cost of $19.75.

Who needs a PTIN? Anyone who prepares or assists in preparing any federal tax return for compensation is required to have a PTIN. All enrolled agents must have a PTIN. For 2023, the IRS has issued more than 781,000 PTINs.

Personal Blogs Allowed into Evidence (Sydney Ann Thomas v. Comm., USTC No. 12982-20, Feb. 2023)

Thomas and her husband filed joint returns for 2012, 2013 and 2014 but did not pay the full amounts of tax due. Thomas's husband passed away in 2016 and Thomas sought relief from joint and several liability under the innocent spouse rules (§6015(f)). After being denied relief, in part due to postings from her personal blog, Thomas tried to argue that a technicality made her blog inadmissible. The Court disagreed and allowed the blog to be admitted.

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IRS and Tax Related Contact Phone Numbers

Service	Description	Phone #	Comments
Practitioner Priority Service	Practitioner's first point of contact for account-related issues - *for tax preparers ONLY*	(866) 860-4259	Monday–Friday, 7:00 a.m.–7:00 p.m., Local Time
e-Help Desk	For questions on e-file, EFTPS, and e-services	(866) 255-0654	Monday- Friday 6:30 a.m.–6:00 p.m., Central Time
Business and Specialty Tax Line	For Small Businesses, Corporations, Partnerships, and Trusts	(800) 829-4933	Monday–Friday, 7:00 a.m.–7:00 p.m., Local Time
IRS Tax Help Line for Individuals	Procedural or tax law information to help file	(800) 829-1040	Monday–Friday, 7:00 a.m.–7:00 p.m., Local Time
Refund Status	Check the status of the current year's return. When you call, you will need your Social Security number, your filing status, and the refund amount shown on your return.	(800) 829-1954	Automated service is available 24/7
IRS Debt	Taxpayers can use the IRS Tax Help line.	(800) 829-1040	Monday–Friday, 7:00 a.m.–7:00 p.m., Local Time
FMS Debt	*Treasury Offset Program*	(800) 304-3107	
Social Security Administration		(800) 772-1213	Automated service is available 24/7 Monday–Friday, 7:00 a.m. – 7:00 p.m.
IRS Disaster Hotline	Help with disaster losses.	(866) 562-5227	Monday–Friday, 7:00 a.m.–10:00 p.m., Local Time
Employer Identification Number (EIN)	EIN applications and changes (Business and Specialty Tax Line). **EIN applications can also be submitted online.**	(800) 829-4933	Monday–Friday, 7:00 a.m.–7:00 p.m., Local Time

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Service	Description	Phone #	Comments
Tax Exempt and Government Entities (TEGE) Help Line	Tax Exempt or Government Entities, Bonds, Pension Plans, Tribal Agreements	(877) 829-5500	Monday–Friday, 7:00 a.m. – 7:00 p.m., Central Time
Form 706 or Form 709	For questions related to Form 706 and Form 709	(866) 699-4083	
Excise Tax and Form 2290 Help Line	***Heavy Vehicle Tax issues***	866) 699-4096	Monday–Friday, 8:00 a.m.–6:00 p.m., Eastern Time
Criminal Investigation Informant Hotline	Report Tax Fraud	(800) 829-0433	
Electronic Federal Tax Payment System (***EFTPS***)	Business or individuals who want to pay taxes through electronic transfer of funds	(800) 555-4477 (800) 733-4829 (TDD) (800) 244-4829 (SP)	24/7
Pay by credit card - phone	**See list of IRS providers**	(888) 555- 4477	
Pay by credit card - online			
Forms and Publications	For IRS forms, instructions, tax publications	(800) 829-3676	Monday–Friday, 7:00 a.m.–7:00 p.m., Local Time
National Taxpayer Advocate	For tax problems that have not been resolved through normal channels	(877) 777-4778	
Telephone Device for the Deaf	For hearing-impaired taxpayers or practitioners	(800) 829-4059	Monday–Friday, 7:00 a.m.–7:00 p.m., Local Time

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Form 1040 – Filing Issues, Filing Status and Dependents

Brief History of the Income Tax in the United States (*Source: Tax Foundation.*)

The nation had few taxes in its early history. From 1791 to 1802, the United States government was supported by internal taxes on distilled spirits, carriages, refined sugar, tobacco and snuff, property sold at auction, corporate bonds, and slaves. The high cost of the War of 1812 brought about the nation's first sales taxes on gold, silverware, jewelry, and watches. In 1817, however, Congress did away with all internal taxes, relying on tariffs of imported goods to provide sufficient funds for running the government.

Congress passed the Revenue Act of 1862, the nation's first income tax law, to support the Civil War effort. The law also established the office of the Commissioner of Internal Revenue. The Commissioner was given the power to assess, levy, and collect taxes, and the right to enforce the tax laws through seizure of property and income and through prosecution. This law was a forerunner of our modern income tax in that it was based on the principles of graduated, or progressive, taxation and of withholding income at the source. During the Civil War, a person earning from $600 to $10,000 per year paid tax at the rate of 3%. Those with incomes of more than $10,000 paid taxes at a higher rate. Additional sales and excise taxes were added, and an "inheritance" tax also made its debut. In 1866, internal revenue collections reached their highest point in the nation's 90-year history—more than $310 million, an amount not reached again until 1911.

In 1868, Congress again focused its taxation efforts on tobacco and distilled spirits and eliminated the income tax in 1872. It had a short-lived revival in 1894 and 1895. In the latter year, the U.S. Supreme Court decided that the income tax was unconstitutional because it was not apportioned among the states in conformity with the Constitution.

In 1913, the 16th Amendment to the Constitution made the income tax a permanent fixture in the U.S. tax system. The amendment gave Congress legal authority to tax income and resulted in a revenue law that taxed incomes of both individuals and corporations. In fiscal year 1918, annual internal revenue collections for the first time passed the billion-dollar mark, rising to $5.4 billion by 1920. With the advent of World War II, employment increased, as did tax collections—to $7.3 billion. The withholding tax on wages was introduced in 1943 and was instrumental in increasing the number of taxpayers to 60 million and tax collections to $43 billion by 1945.

Enrolled agents were established after the Civil War to present damage claims from property seized during the War. After the 16th amendment was passed, EAs influence was extended to include claims for US citizens against income tax issues and taxpayer representation, culminating in Circular 230 during World War II. In contrast to attorneys and CPAs that are state-licensed, enrolled agents are federally licensed and obtain their license through either testing or IRS enrollment. They remain the only tax professionals in America licensed by the Federal government and required by law to take annual, federal income-tax specific continuing education.

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Form 1040 – Filing Issues, Filing Status and Dependents

2024 Reference Table – Inflation Adjustments (Rev. Proc. 2023-34)	
Tax Item	**2024**
Kiddie tax unearned income	$ 1,300
Adoption credit (also Employer Adoption Assistance Limit)	$ 16,810
Refundable child tax credit	$ 1,700
Educator deduction	$ 300
Transportation fringe	$ 315
Cafeteria Plan FSA	$ 3,200
Max Cafeteria Plan FSA carryover to following year	$ 640
Qualified Relative Gross Income Limit	$ 5,050
§179 Limit	$ 1,220,000
§179 Phaseout begins	$ 3,050,000
§179 SUV limit	$ 30,500
QBI phase out – MFJ	$ 383,900
QBI phase out – all others	$ 191,950
Cash method limit	$30,000,000
Foreign earned income exclusion limit	$ 126,500
Late filing penalties – Form 1065/Form 1120S – per owner per month	$ 245
Gift tax exclusion	$ 18,000
QSEHRA maximum – single	$ 6,150
QSERHA maximum – family	$ 12,450

2024 Rates, Brackets, etc. (Rev. Proc 2023-34)

2024 Tax Brackets by Filing Status				
Tax Rate	**Single**	**HOH**	**MFJ**	**MFS**
10%	**$0 - $11,600**	**$0 - $16,550**	**$0 - $23,200**	**$0 - $11,600**
12%	**$11,601 - $47,150**	**$16,551 - $63,100**	**$23,201 - $94,300**	**$11,601 - $47,150**
22%	**$47,151 - $100,525**	**$63,101 - $100,500**	**$94,301 - $201,050**	**$47,151 - $100,525**
24%	**$100,526 – $191,950**	**$100,501 – $191,950**	**$201,051 - $383,900**	**$100,526 – $191,950**
32%	**$191,951 - $243,725**	**$191,951 - $243,700**	**$383,901 - $487,450**	**$191,951 - $243,725**
35%	**$243,726 - $609,350**	**$243,701 - $609,350**	**$487,451 - $731,200**	**$243,726 - $365,600**
37%	**$609,351 or more**	**$609,351 or more**	**$731,201 or more**	**$365,601 or more**

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2024 Estate and Trust Tax Brackets	
Tax Rate	**Bracket**
10%	**Up to $3,100**
24%	**$3,101 - $11,150**
35%	**$11,151 - $15,200**
37%	**$15,201 or more**

2024 Capital Gain Tax Brackets			
Filing Status	**0%**	**15%**	**20%**
Single	**$0 - $47,025**	**$47,026 - $518,900**	**$518,901 or more**
HOH	**$0 - $63,000**	**$63,001 - $551,350**	**$551,351 or more**
MFJ	**$0 - $94,050**	**$94,051 - $583,750**	**$583,751 or more**
MFS	**$0 - $47,025**	**$47,026 - $291,850**	**$291,851 or more**
Estates/trusts	**$0 - $3,150**	**$3,151 - $15,450**	**$15,451 or more**

2024 Standard Deduction	
Filing Status	**Standard Deduction Amount**
Single	**$14,600**
HOH	**$21,900**
MFJ	**$29,200**
MFS	**$14,600**
Additional Standard Deductions	
Individual claimed as a dependent - unearned income only	$1,300 *or* $450 + earned income up to Std. Ded.
Additional blind or disabled or over 65	$1,950 Single, $1,550 MFJ

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Huge Tax Changes on the Horizon

As most are aware, most provisions of the Tax Cuts Jobs Act (TCJA), which passed at the end of 2017, expire at the end of 2025. This, along with many other provisions that were temporarily enacted in various tax bills over the past few years, means we are going to have to be on the lookout for these expiring provisions. While Congress is likely to address some or most of these expiring provisions in 2025, tax advisors must at least consider the impact of the expiring provisions while tax planning for clients now. Below is a summary of the more significant tax provisions expiring soon.

Tax Provisions Expiring December 31, 2025	
IRC §	**Description**
§1	Modification of individual income tax rates
§24(h)	Child tax credit increase and other modifications
§36B(b)/(c)	Premium assistance credit enhancements
§45D	New markets tax credit
§45S	Family and Medical Leave credit
§51(c)	Work opportunity credit
§55	Increased AMT exemption amount and phaseout threshold
§63(c)	Increased standard deduction amounts
§67(g)	Suspension of miscellaneous itemized deductions
§68(f)	Suspension of the overall itemized deduction limitation
§108(f)(5) - §127(c)	Student loan forgiveness and employer paid student loans no longer tax exempt
§132(f)	Suspension of tax-free bicycle commuting expenses
§151(d)	Suspension of the personal exemption deduction
§163(h)	Reduction of the mortgage interest deduction and home equity debt
§164(b)	Limit on SALT tax deduction
§170(b)	Increased percent of AGI allowed for charitable gifts
§199A	Qualified business expense deduction
§217(k)	Suspension of moving expense deduction
§274(o)	Deduction for de minimis meals and meals for the convenience of the employer
§529A	Saver's credit and QTP rollovers to ABLE accounts
§1396	Empowerment Zone employment credits
§2010(c)	Increased estate and gift exemption amounts
Additional provisions expire at the end of 2026 and beyond.	

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We will discuss these expiring provisions in more detail in the Tax Planning chapter. Stay tuned!

2024 Form 1040

IRS ceases annual changes for Form 1040, at least at press time! At the time the manual was being finalized, the 2024 draft Form 1040 has little or no changes from the 2023 version. As last year, filers are required to file either: 1) Form 1040, or 2) Form 1040SR. To file Form 1040SR, the taxpayer, or if applicable, the spouse, must be age 65 or older as of December 31, 2024. Form 1040 and Form 1040SR have a box in the taxpayer information section confirming whether the taxpayer, or spouse if applicable, was age 65 at year end.

Form 1040SR - The Form 1040-SR is identical to Form 1040 except the fonts are larger. There are no other differences.

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Form **1040** Department of the Treasury—Internal Revenue Service
U.S. Individual Income Tax Return **2024** OMB No. 1545-0074 IRS Use Only—Do not write or staple in this space.

For the year Jan. 1–Dec. 31, 2024, or other tax year beginning ______, 2024, ending ______, 20 ____ See separate instructions.

Your first name and middle initial	Last name	Your social security number
If joint return, spouse's first name and middle initial	Last name	Spouse's social security number
Home address (number and street). If you have a P.O. box, see instructions.	Apt. no.	**Presidential Election Campaign** Check here if you, or your spouse if filing jointly, want $3 to go to this fund. Checking a box below will not change your tax or refund. ☐ You ☐ Spouse
City, town, or post office. If you have a foreign address, also complete spaces below.	State / ZIP code	
Foreign country name	Foreign province/state/county / Foreign postal code	

Filing Status Check only one box.

- ☐ Single
- ☐ Married filing jointly (even if only one had income)
- ☐ Married filing separately (MFS)
- ☐ Head of household (HOH)
- ☐ Qualifying surviving spouse (QSS)

If you checked the MFS box, enter the name of your spouse. If you checked the HOH or QSS box, enter the child's name if the qualifying person is a child but not your dependent: ______

☐ If treating a nonresident alien or dual-status alien spouse as a U.S. resident for the entire tax year, check the box and enter their name (see instructions and attach statement if required): ______

Digital Assets At any time during 2024, did you: (a) receive (as a reward, award, or payment for property or services); or (b) sell, exchange, or otherwise dispose of a digital asset (or a financial interest in a digital asset)? (See instructions.) ☐ Yes ☐ No

Standard Deduction **Someone can claim:** ☐ You as a dependent ☐ Your spouse as a dependent
☐ Spouse itemizes on a separate return or you were a dual-status alien

Age/Blindness **You:** ☐ Were born before January 2, 1960 ☐ Are blind **Spouse:** ☐ Was born before January 2, 1960 ☐ Is blind

Dependents (see instructions): If more than four dependents, see instructions and check here ☐

(1) First name Last name	(2) Social security number	(3) Relationship to you	(4) Check the box if qualifies for (see instructions): Child tax credit	Credit for other dependents
			☐	☐
			☐	☐
			☐	☐
			☐	☐

Income

Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld. If you did not get a Form W-2, see instructions.

Line	Description	Box
1a	Total amount from Form(s) W-2, box 1 (see instructions)	1a
b	Household employee wages not reported on Form(s) W-2	1b
c	Tip income not reported on line 1a (see instructions)	1c
d	Medicaid waiver payments not reported on Form(s) W-2 (see instructions)	1d
e	Taxable dependent care benefits from Form 2441, line 26	1e
f	Employer-provided adoption benefits from Form 8839, line 29	1f
g	Wages from Form 8919, line 6	1g
h	Other earned income (see instructions)	1h
i	Nontaxable combat pay election (see instructions) 1i	
z	Add lines 1a through 1h	1z

Attach Sch. B if required.

Line	Description	Box		Description	Box
2a	Tax-exempt interest	2a	b	Taxable interest	2b
3a	Qualified dividends	3a	b	Ordinary dividends	3b
4a	IRA distributions	4a	b	Taxable amount	4b
5a	Pensions and annuities	5a	b	Taxable amount	5b
6a	Social security benefits	6a	b	Taxable amount	6b

Standard Deduction for—
- Single or Married filing separately, $14,600
- Married filing jointly or Qualifying surviving spouse, $29,200
- Head of household, $21,900
- If you checked any box under *Standard Deduction*, see instructions.

Line	Description	Box
c	If you elect to use the lump-sum election method, check here (see instructions) ☐	
7	Capital gain or (loss). Attach Schedule D if required. If not required, check here ☐	7
8	Additional income from Schedule 1, line 10	8
9	Add lines 1z, 2b, 3b, 4b, 5b, 6b, 7, and 8. This is your **total income**	9
10	Adjustments to income from Schedule 1, line 26	10
11	Subtract line 10 from line 9. This is your **adjusted gross income**	11
12	**Standard deduction or itemized deductions** (from Schedule A)	12
13	Qualified business income deduction from Form 8995 or Form 8995-A	13
14	Add lines 12 and 13	14
15	Subtract line 14 from line 11. If zero or less, enter -0-. This is your **taxable income**	15

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11320B Form **1040** (2024)

DRAFT AND OMB USE ONLY DRAFT July 8, 2024 DO NOT FILE

TaxSpeaker

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Form 1040 (2024) Page **2**

Section	Line	Description		
Tax and Credits	16	**Tax** (see instructions). Check if any from Form(s): 1 ☐ 8814 2 ☐ 4972 3 ☐		16
	17	Amount from Schedule 2, line 3		17
	18	Add lines 16 and 17		18
	19	Child tax credit or credit for other dependents from Schedule 8812		19
	20	Amount from Schedule 3, line 8		20
	21	Add lines 19 and 20		21
	22	Subtract line 21 from line 18. If zero or less, enter -0-		22
	23	Other taxes, including self-employment tax, from Schedule 2, line 21		23
	24	Add lines 22 and 23. This is your **total tax**		24
Payments	25	Federal income tax withheld from:		
	a	Form(s) W-2	25a	
	b	Form(s) 1099	25b	
	c	Other forms (see instructions)	25c	
	d	Add lines 25a through 25c		25d
If you have a qualifying child, attach Sch. EIC.	26	2024 estimated tax payments and amount applied from 2023 return		26
	27	Earned income credit (EIC)	27	
	28	Additional child tax credit from Schedule 8812	28	
	29	American opportunity credit from Form 8863, line 8	29	
	30	Reserved for future use	30	
	31	Amount from Schedule 3, line 15	31	
	32	Add lines 27, 28, 29, and 31. These are your **total other payments and refundable credits**		32
	33	Add lines 25d, 26, and 32. These are your **total payments**		33
Refund	34	If line 33 is more than line 24, subtract line 24 from line 33. This is the amount you **overpaid**		34
	35a	Amount of line 34 you want **refunded to you.** If Form 8888 is attached, check here ☐		35a
Direct deposit? See instructions.	b	Routing number c Type: ☐ Checking ☐ Savings		
	d	Account number		
	36	Amount of line 34 you want **applied to your 2025 estimated tax**	36	
Amount You Owe	37	Subtract line 33 from line 24. This is the **amount you owe.** For details on how to pay, go to *www.irs.gov/Payments* or see instructions		37
	38	Estimated tax penalty (see instructions)	38	

Third Party Designee

Do you want to allow another person to discuss this return with the IRS? See instructions ☐ **Yes.** Complete below. ☐ **No**

Designee's name | Phone no. | Personal identification number (PIN)

Sign Here

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Your signature	Date	Your occupation	If the IRS sent you an Identity Protection PIN, enter it here (see inst.)
Spouse's signature. If a joint return, **both** must sign.	Date	Spouse's occupation	If the IRS sent your spouse an Identity Protection PIN, enter it here (see inst.)
Phone no.	Email address		

Joint return? See instructions. Keep a copy for your records.

Paid Preparer Use Only

Preparer's name	Preparer's signature	Date	PTIN	Check if: ☐ Self-employed
Firm's name			Phone no.	
Firm's address			Firm's EIN	

Go to *www.irs.gov/Form1040* for instructions and the latest information. Form **1040** (2024)

TREASURY/IRS AND OMB USE ONLY DRAFT July 3, 2024 DO NOT FILE

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Filing Issue - Military Spouses Choice of Domicile (Veterans Auto and Education Improvement Act (VAEIA)

The Veterans Auto and Education Improvement Act changed the domicile laws for military families. Where a military member or spouse lives, the amount of property they have, or the amount of income they earn has no impact on the service member's or spouse's residency for tax purposes. Military spouses, regardless of the date of marriage to the service member, may elect to base their state of residency on either:

1. The residence or domicile of the service member, or
2. The residence or domicile of the spouse, or
3. The permanent duty station of the service member.

This change will most importantly impact tax planning for state tax purposes.

Example. Roy is a pilot in the USAF and is stationed at Nellis AFB in Nevada. Roy married Cindy, a CPA from California, in Dec. 2022. Roy was deployed for most of 2024, so Cindy worked in Nevada but often stayed with family in California. Given the circumstances, California would likely argue Cindy is a California resident and tax 100% of her income. However, when Roy and Cindy file their 2024 tax return, Cindy chooses Nevada, Roy's permanent duty station, as her resident state. None of her income, other than anything she actually earned in California, is taxable in California.

Military Members Protected by Servicemembers Civil Relief Act (SCRA).

Originally enacted in 2003, the SCRA provided extra protections for service members in the event that legal or financial transactions adversely affect their rights during military or uniformed service. The law was intended to enable service members to devote their entire energy to the defense needs of the Nation and to reduce stress on the service member's family. SCRA's provisions apply to:

- Active-duty members of the Army, Marine Corps, Navy, Air Force, and Coast Guard;
- Members of the Reserve component when serving on active duty;
- Members of the National Guard component mobilized under Federal orders for more than 30 consecutive days; or
- Active duty commissioned officers of the Public Health Service or the National Oceanic and Atmospheric Administration.

SCRA rights may also be exercised by anyone holding a valid power of attorney for the service member. Some SCRA protections also apply to dependents.

Most common benefits. The five most common protections sought and received under SCRA by service members are (per the Consumer Financial Protection Bureau):

1. Reduction of interest rates on pre-service loans to a maximum of 6%;
2. Protections against default judgments in civil cases;

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3. Protections against foreclosure on service member homes;
4. Protections against repossession of service member property; and
5. Termination of residential housing and auto leases without penalty.

New protections provided to service members and their spouses. Congress has periodically updated SCRA to protect service members and their families from challenges unique to their service. In the latest change to the SCRA, Congress added a provision that ensures professional license portability for military service members and their spouses. Professionally licensed service members and their spouses may rely on any existing licensing to work in the same capacity in the same field as they were working where they obtained the license. If they change residences to a state or jurisdiction due to military orders, the new state or jurisdiction is required to accept the member or spouse's licensing credentials. The existing professional license must be considered valid for a similar scope of practice in the jurisdiction of such new residency for the duration of such military orders. The law defines "covered license" as a professional license or certificate that is in good standing with the authority that issued it, the license holder "has actively used the license during the two years immediately preceding the relocation, and it is not a license to practice law.

Counselor helps Texas Department of Education understand SCRA law (Hannah Portee v. Mike Morath, Ed Comm. TX Ed Agency, USDC, WD, Austin, 1:23-CV-551-RP, Nov. 20, 2023). Hannah Portee was a licensed school counselor in Ohio (July 21, 2021) and Missouri (July 7, 2022). Hannah married David Portee, an active-duty Air Force Officer, in July 2022 while working as a school counselor in Missouri. David was transferred to Laughlin AFB in Texas in January 2023. Hannah left her job and moved to Texas with David.

Hannah applied to be licensed to be a school counselor in Texas so she could seek employment in her field. Her license application was denied because Texas requires a school counselor with an out of state license to either:

1. pass a Texas license examination; or

2. have worked full-time for two academic years in a public or private school.

The Texas Dept. of Ed also argued that SCRA did not apply because Hannah did not use her counseling license continuously for two years before she moved to Texas. The Court ruled that SCRA explicitly states the existing license ***must be used within the past two years, but not continuously*** and allowed Hannah to be licensed to provide school counseling services in Texas.

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2024 Filing Requirements

U.S. citizens and residents (including residents of Puerto Rico) are required to file (or should file) an individual tax return if they meet any of the following criteria:

- Individual taxpayers (including those living outside the U.S.) whose income exceeds the standard deduction for the type of return (e.g., $14,600 if single, $29,200 if MFJ, etc.). But taxpayers who are 65 and over or blind may add the additional exemption amount they receive.
- Net earnings from self-employment are $400 or more.
- Children under age 24 who are subject to the Kiddie Tax unless their parents include their unearned income on the parent's return.
- Person was a resident alien for the entire year.
- Federal income tax was withheld from pay.
- Qualify for the earned income or the additional child tax credit.
- Qualify for the health coverage, AMT minimum, American Opportunity, fuel, adoption, or other refundable credit.

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Dependents (§152)

Fun Fact – Each year the Social Security Administration releases its list of the most popular baby names for the year.

2023 Most Popular Baby Names

Rank	Male name	Female name
1	Liam	Olivia
2	Noah	Emma
3	Oliver	Charlotte
4	James	Amelia
5	Elijah	Sophia
6	Mateo	Mia
7	Theodore	Isabella
8	Henry	Ava
9	Lucas	Evelyn
10	William	Luna

Back to Work!

The 2017 Tax Cuts and Jobs Act (TCJA) repealed the deduction for a dependency exemption. However, there are multiple other Internal Revenue Code sections that continue to rely on the definition of a dependent (e.g., EIC, Child Tax Credit, etc.).

Two dependent definitions and related tax attributes. A dependent for tax purposes must meet one of two definitions: a qualifying child or a qualifying relative. Different tax attributes apply for each definition.

- Qualifying child tax attributes include:
  - Child tax credit and the additional child tax credit.
  - Earned income credit.
  - Dependent care credit.
  - Head of household filing status.

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- Qualifying relative tax attribute:
  - Additional dependent credit.
  - In limited cases, head of household filing status.

- Both custodial and noncustodial parents may claim the following benefits for a qualifying child or relative (Rev. Proc. 2008-48):

  a. Medical reimbursements (§105 plans)
  b. Health insurance (§106)
  c. Excluded fringe benefits
  d. Medical expenses
  e. MSA and HSA distributions

Qualifying child defined (§152(c)). Six tests are used to determine if a person is a "qualifying child" for a taxpayer:

1. Relationship test – must be the taxpayer's child, stepchild, foster child, sibling, stepsibling or descendent of any.
2. Age test – must be younger than the taxpayer and under age 19 (age 24 if a full-time student) or any age if permanently and totally disabled at the end of the year.
3. Abode test – lived with taxpayer more than half the year.
4. Support test – it is irrelevant who supports the child if the child does not provide more than half of her or his own support.
5. Citizenship test – must be a U.S. citizen, national, or a citizen of Canada or Mexico.
6. Joint return test – cannot file a return using the married filing joint filing status unless not required to file and filing only to collect withholding.

Qualifying relative defined (§152(d)). Four tests are used to determine if a person is a "qualifying relative" for a taxpayer:

1. Qualifying child test – the child cannot be the taxpayer's or another's qualifying child.
2. Relationship test – includes all the relationships listed for qualifying children plus parents and stepparents (and their ancestors), uncles, aunts, and son-daughter-father-mother-brother and sister-in-law. Also, an individual (other than a spouse at any time during the year) who, for the entire tax year, has the same place of abode as the taxpayer and is a member of the taxpayer's household.
3. Support test – the taxpayer provides more than half of the qualifying relative's support.
4. Gross income test – the person's gross income for the year is less than the personal exemption amount (as defined in §151(d)). This amount is $5,050[1] in 2024.

[1] The IRS issued final regs (TD 9913)) in September 2020 affirming the reduction of the exemption amount to zero required in §151(d)(5)(A) for taxable years 2018 through 2025 does not apply for purposes of the gross income limitation in the definition of a qualifying relative. The regulations also confirm the amount will be annually adjusted for inflation.

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No qualifying child means no EIC or HOH filing status (Susan Turner v. Comm., TC Memo 2024-20). Susan Turner became the court appointed legal guardian for AV, her grandchild, in 2007. For most of 2020, AV lived at a friend's house except for about 60 days, when he lived with Turner. Even when AV wasn't living with her, Turner helped pay AV's rent (while he stayed with friends), phone bills, clothing, food, transportation, and other personal expenses. As of the close of 2020, Turner was not married, and AV was a minor.

All tests must be met or the is an unqualifying child! Turner filed her 2020 and claimed AV as a dependent. She did not claim any other dependents. Turner claimed an earned income credit and used the head of household filing status based on AV being a qualifying child. The Court ruled a qualifying child of a taxpayer has to have the same principal place of abode as the taxpayer for more than one-half of such taxable year. As AV only lived in the same home as Turner for 60 days, she was not entitled to claim that AV was a qualifying child. And without a qualifying child, Turner did not qualify for the EIC or to use the HOH filing status.

Tie breaker rule (§152(c)(4); PR 1.152-2(g)). In some circumstances a child may be a qualifying child for more than one taxpayer. In such cases, the tie breaker rules state:

1. The child is the qualifying child of the parent; but
2. If neither taxpayer is a parent, the taxpayer with the highest AGI is entitled to claim the qualifying child.
3. If two parents are qualified to claim the child, either may do so. If both parents claim the child, then the following two tests are used, in order, to break the tie:
   a. First, the parent with whom the child spent the most time during the year may claim; but
   b. Second, if the time spent with each parent is a tie, then the parent who has the highest AGI may claim the child.

If the parents of a qualifying child do not claim the child, and the child is also a qualifying child of a non-parent, the child may be claimed as a qualifying child of the non-parent if her or his AGI is higher than the highest AGI of the child's parent.

Example 1. MJ is Vanessa and Robbie's daughter. Vanessa and Robbie are not married and lived together with MJ for all of 2024. MJ is a qualified child for Vanessa (AGI $52,000) and Robbie (AGI $23,000). Robbie and Vanessa may decide between the two of them which parent will claim MJ. If they do not agree, and they both claim MJ, the tie breaker rules dictate Vanessa qualifies to claim MJ as Vanessa's AGI is higher.

Example 2. Robbie lives with Vanessa, an unrelated friend, and MJ, Vanessa's 3-year-old daughter for all of 2024. Robbie pays 100% of the household bills. Vanessa is eligible to claim MJ as a qualifying child, but she has no gross income and is not required to file a Federal income tax return. Because Vanessa does not have a filing requirement and in fact does not file a tax return, MJ is not treated as Vanessa's qualifying child. Robbie may claim Vanessa and MJ as qualifying relatives. However, Robbie cannot claim to be Head of Household as neither Vanessa nor MJ are related dependents for HOH purposes.

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Dependents and Divorce (§152(e); §1.152-4). Determining which parent may claim a child when the parents are divorced is a two-step process: 1) the parent with whom the child resides for a longer period of time during the taxable year is, by regulation, the custodial parent and is allowed to claim the child as a qualifying dependent, assuming the child otherwise qualifies; and 2) once the custodial parent is established, he or she may release claim to the exemption and allow the non-custodial parent to claim the child. For the non-custodial parent to claim the child, all the following criteria must be met:

1. The parents are divorced or legally separated under a decree of divorce or separate maintenance, and
2. They lived apart at all times during the last 6 months of the year.
3. The child received over half of his or her support for the year from the parents.
4. The child is in the custody of one or both parents for more than half of the year.
5. The custodial parent signs a written declaration, Form 8332 or similar statement that he or she will not claim the child as a dependent for the year, and the noncustodial parent attaches this written declaration to his or her return.

Preparer note. §1.152-4 clarifies which parent may claim a child as a dependent where the parents are divorced or live apart. The Regs state that a parent has custody of a child if one or both parents have the right under state law to physical custody of the child for more than ½ of the calendar year. The "custodial" parent is the parent with whom the child lived for the greater part of the year, determined by where the child spent the greatest number of nights during the year. The other parent is the "noncustodial" parent. A child resides with a parent for a night if the child sleeps in the parent's residence (even if the parent is not present) or in the company of the parent when traveling, such as on vacation. A night that extends over 2 years is allocated to the year the night begins. If the parents divorced or separated during the year and the child lived with both parents before the separation, the custodial parent is the one with whom the child lived for the greater part of the rest of the year.

Release of exemption to noncustodial spouse (Form 8332). A custodial parent uses form 8332 to release a child to a noncustodial parent for the current year, a specified number of years (for example, alternate years), or for all future years, as specified in the declaration. If the child is released for more than one year, the original release must be attached to the return of the noncustodial parent for the first year, and a copy must be attached for each later year. If the noncustodial parent omits Form 8332, they are not allowed to claim the child. Form 8332 is also used to revoke a previously granted release.

Preparer Tip. A common mistake made by taxpayers and tax professionals alike is allowing a noncustodial parent to take advantage of all the tax attributes associated with a qualifying child. A noncustodial parent may only claim head of household filing status if a child lived with them more than half the year. In addition, the noncustodial parent may never claim the earned income credit nor the dependent care credit. When a noncustodial parent is allowed to claim a child, the noncustodial parent may only claim the dependency exemption and the child tax credit, education credits and medical expenses.

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Form **8332**
(Rev. October 2018)
Department of the Treasury
Internal Revenue Service

Release/Revocation of Release of Claim to Exemption for Child by Custodial Parent

► Attach a separate form for each child.
► Go to *www.irs.gov/Form8332* for the latest information.

OMB No. 1545-0074
Attachment Sequence No. **115**

Name of noncustodial parent	**Noncustodial parent's social security number (SSN) ►**	

Note: This form also applies to some tax benefits, including the child tax credit, additional child tax credit, and credit for other dependents. It doesn't apply to other tax benefits, such as the earned income credit, dependent care credit, or head of household filing status. See the instructions and Pub. 501.

Part I — Release of Claim to Exemption for Current Year

I agree not to claim an exemption for ______________________________
Name of child

for the tax year 20 _____.

______________________________ Signature of custodial parent releasing claim to exemption | ______________ Custodial parent's SSN | __________ Date

Note: If you choose not to claim an exemption for this child for future tax years, also complete Part II.

Part II — Release of Claim to Exemption for Future Years (If completed, see **Noncustodial Parent** on page 2.)

I agree not to claim an exemption for ______________________________
Name of child

for the tax year(s) ______________________.
(Specify. See instructions.)

______________________________ Signature of custodial parent releasing claim to exemption | ______________ Custodial parent's SSN | __________ Date

Part III — Revocation of Release of Claim to Exemption for Future Year(s)

I revoke the release of claim to an exemption for ______________________________
Name of child

for the tax year(s) ______________________.
(Specify. See instructions.)

______________________________ Signature of custodial parent revoking the release of claim to exemption | ______________ Custodial parent's SSN | __________ Date

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Gross Income (§61)

SCHEDULE 1 (Form 1040)
Department of the Treasury Internal Revenue Service

Additional Income and Adjustments to Income

Attach to Form 1040, 1040-SR, or 1040-NR.
Go to *www.irs.gov/Form1040* for instructions and the latest information.

OMB No. 1545-0074
2024
Attachment Sequence No. 01

Name(s) shown on Form 1040, 1040-SR, or 1040-NR | **Your social security number**

For 2024, enter the amount reported to you on Form(s) 1099-K that was included in error or for personal items sold at a loss . . .

Note: The remaining amounts reported to you on Form(s) 1099-K should be reported elsewhere on your return depending on the nature of the transaction. See *www.irs.gov/1099k*.

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Part I Additional Income

Line	Description	Sub-line	Line
1	Taxable refunds, credits, or offsets of state and local income taxes . . .		1
2a	Alimony received . . .		2a
b	Date of original divorce or separation agreement (see instructions):		
3	Business income or (loss). Attach Schedule C . . .		3
4	Other gains or (losses). Attach Form 4797 . . .		4
5	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E . . .		5
6	Farm income or (loss). Attach Schedule F . . .		6
7	Unemployment compensation . . .		7
8	Other income:		
a	Net operating loss . . .	8a ( )	
b	Gambling . . .	8b	
c	Cancellation of debt . . .	8c	
d	Foreign earned income exclusion from Form 2555 . . .	8d ( )	
e	Income from Form 8853 . . .	8e	
f	Income from Form 8889 . . .	8f	
g	Alaska Permanent Fund dividends . . .	8g	
h	Jury duty pay . . .	8h	
i	Prizes and awards . . .	8i	
j	Activity not engaged in for profit income . . .	8j	
k	Stock options . . .	8k	
l	Income from the rental of personal property if you engaged in the rental for profit but were not in the business of renting such property . . .	8l	
m	Olympic and Paralympic medals and USOC prize money (see instructions) . . .	8m	
n	Section 951(a) inclusion (see instructions) . . .	8n	
o	Section 951A(a) inclusion (see instructions) . . .	8o	
p	Section 461(l) excess business loss adjustment . . .	8p	
q	Taxable distributions from an ABLE account (see instructions) . . .	8q	
r	Scholarship and fellowship grants not reported on Form W-2 . . .	8r	
s	Nontaxable amount of Medicaid waiver payments included on Form 1040, line 1a or 1d . . .	8s ( )	
t	Pension or annuity from a nonqualifed deferred compensation plan or a nongovernmental section 457 plan . . .	8t	
u	Wages earned while incarcerated . . .	8u	
v	Digital assets received as ordinary income not reported elsewhere. See instructions . . .	8v	
z	Other income. List type and amount:	8z	
9	Total other income. Add lines 8a through 8z . . .		9
10	Combine lines 1 through 7 and 9. This is your **additional income**. Enter here and on Form 1040, 1040-SR, or 1040-NR, line 8 . . .		10

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 71479F **Schedule 1 (Form 1040) 2024**

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Schedule 1 (Form 1040) 2024 Page **2**

Part II Adjustments to Income

TREASURY/IRS AND OMB USE ONLY DRAFT June 21, 2024 DO NOT FILE

Line	Description		Amount	Line	Amount
11	Educator expenses			11	
12	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106			12	
13	Health savings account deduction. Attach Form 8889			13	
14	Moving expenses for members of the Armed Forces. Attach Form 3903			14	
15	Deductible part of self-employment tax. Attach Schedule SE			15	
16	Self-employed SEP, SIMPLE, and qualified plans			16	
17	Self-employed health insurance deduction			17	
18	Penalty on early withdrawal of savings			18	
19a	Alimony paid			19a	
b	Recipient's SSN				
c	Date of original divorce or separation agreement (see instructions):				
20	IRA deduction			20	
21	Student loan interest deduction			21	
22	Reserved for future use			22	
23	Archer MSA deduction			23	
24	Other adjustments:				
a	Jury duty pay (see instructions)	24a			
b	Deductible expenses related to income reported on line 8l from the rental of personal property engaged in for profit	24b			
c	Nontaxable amount of the value of Olympic and Paralympic medals and USOC prize money reported on line 8m	24c			
d	Reforestation amortization and expenses	24d			
e	Repayment of supplemental unemployment benefits under the Trade Act of 1974	24e			
f	Contributions to section 501(c)(18)(D) pension plans	24f			
g	Contributions by certain chaplains to section 403(b) plans	24g			
h	Attorney fees and court costs for actions involving certain unlawful discrimination claims (see instructions)	24h			
i	Attorney fees and court costs you paid in connection with an award from the IRS for information you provided that helped the IRS detect tax law violations	24i			
j	Housing deduction from Form 2555	24j			
k	Excess deductions of section 67(e) expenses from Schedule K-1 (Form 1041)	24k			
z	Other adjustments. List type and amount:	24z			
25	Total other adjustments. Add lines 24a through 24z			25	
26	Add lines 11 through 23 and 25. These are your **adjustments to income**. Enter here and on Form 1040, 1040-SR, or 1040-NR, line 10			26	

Schedule 1 (Form 1040) 2024

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Gross Income Rules (§61)

Gross income per §61 means "all income from whatever source derived". In other words, the tax code default is any ascension to wealth is income to the person receiving the income unless there is a specific exception provided in the Code. It is well established that any statutory exclusions from income are narrowly construed (see Comm. v. Schleier et. al., 515 U.S. 323, SCt, No. 94-500, June 14, 1995). Taxpayers seeking an exclusion from income must demonstrate that they are eligible for the exclusion and "bring themselves within the clear scope of the exclusion" (Pavel and Ana Dobra v. Comm., 111 T.C. Dkt. 7573-97, Dec. 29, 1998).

Social Security and the Workers Comp Offset (§86(d)(3))

Workers' compensation programs. Workers' compensation provides benefits to workers who are injured on the job or have a work-related illness. These benefits include payments for medical treatment and cash payments to partially replace lost wages. Temporary total disability benefits are paid while the worker recuperates away from work. If the work-related condition has lasting consequences after the worker heals, permanent disability benefits may be paid. In the case of a fatality, the worker's dependents receive survivor benefits.

Workers' compensation programs are designed and administered by the states and may vary in terms of who must provide insurance, which injuries or illnesses are compensable, and the level of benefits. State laws generally require employers to obtain workers' comp insurance, or otherwise prove they have the financial ability to self-insure. Workers' compensation is financed almost exclusively by employers. Employer premiums are typically based on the employer's industry, the occupational classifications of workers, and, in many cases, the employer's experience rating for prior workers' comp claims.

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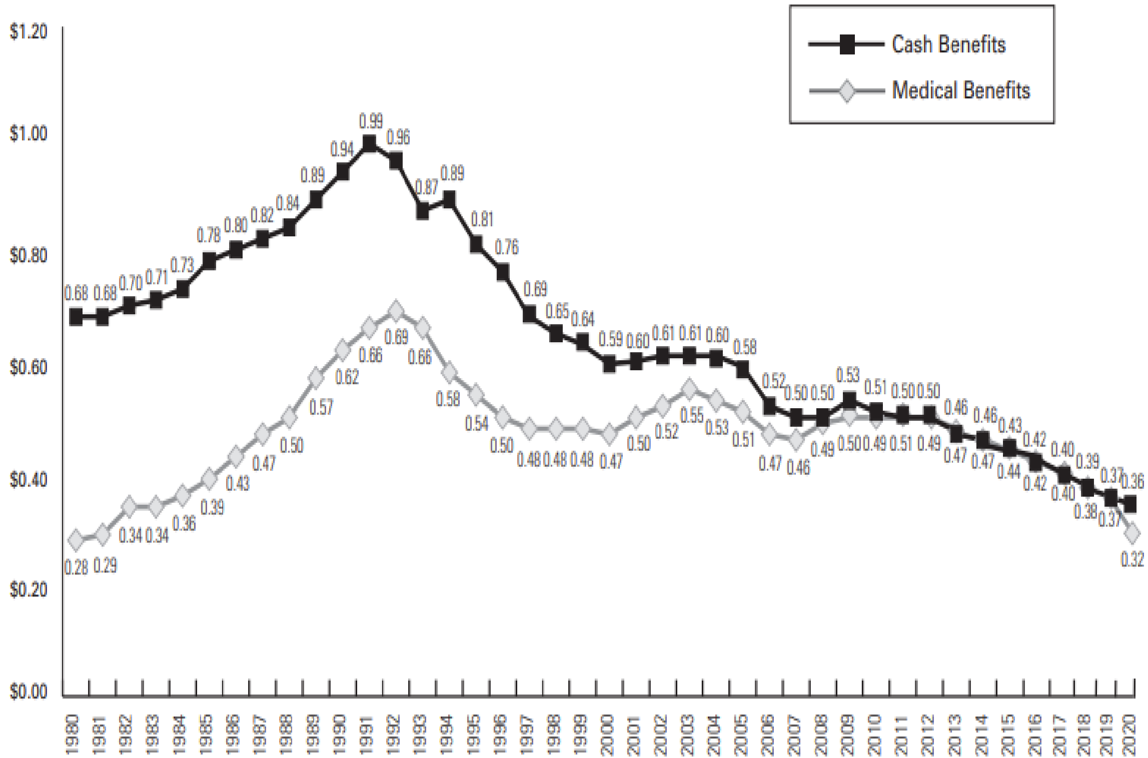
Workers' compensation costs and benefits per $100 of payroll, 1980–2020



Source: National Academy of Social Insurance estimates.

Social Security Disability Insurance. Workers' compensation in the United States is surpassed in size only by the Social Security Disability Insurance and Medicare programs in providing cash and medical benefits to disabled workers; but the workers' comp and the Social Security disability benefits programs are significantly different. Workers are eligible for workers' compensation benefits from their first day of employment, but Social Security disability benefits are paid only to workers who have a substantial work history. Workers' compensation provides benefits for short-term, long-term, and partial disabilities as long as the disability arose out of and in the course of employment. In contrast, Social Security disability benefits are only paid to workers who have long-term impairments that preclude any gainful work, regardless of whether the disability arose on or off the job. By law, the benefits are paid only to workers who are unable to engage in any substantial gainful activity by reason of a medically determinable physical or mental impairment that is expected to last at least a year or result in death. The impairment has to be of such severity that the worker is not only unable to do his or her previous work but is also ***unable to do any other type of substantial gainful work***. Social Security disability benefits begin after a 5-month waiting period. Social Security Disability is funded through employer and employee payroll taxes.

Workers Comp Offset. The Social Security Administration estimates approximately 12% of those who are collecting Social Security disability benefits are also collecting workers comp benefits. The Social Security laws include an offset provision to prevent those who qualify for both benefits from receiving double benefits. This offset has been in the law since 1965 but is still a surprise to many who are impacted. The offset requires that Social Security Disability Insurance benefits be reduced when the worker is eligible for workers'

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compensation payments. In such cases, the worker's combined amount of workers' compensation and Social Security disability benefits is limited to 80% of the worker's "average current earnings". The combined payments, after the reduction, may never be less than the amount of total Social Security disability benefits before the reduction.

Average current earnings defined (ACE). Average current earnings are defined as the highest of the average monthly:

- Wage on which the unindexed disability primary insurance amount is based,

- Earnings from covered employment and self-employment during the highest five consecutive years after 1950, or

- Earnings in the calendar year of highest earnings from covered employment during the five years ending with the year in which the disability began.

Total earnings, including those above the Social Security taxable maximum, are used to determine average current earnings. The offset of Social Security disability benefits applies to disabled workers under age 65 and their families. Benefits for a worker's spouse or dependent children are offset before the offset is applied to the worker's benefit. Other offset rules include:

Reverse offset states. Some states have adopted what is commonly referred to as a "reverse offset" policy. Essentially, if a reduction of benefits is required, these states reduce the workers comp benefits, and the Social Security disability payments are made in the full amount. The Social Security disability benefit will not be reduced. NOTE – the option to elect to use the reverse offset was discontinued in 1981 but states who'd adopted the reverse option method were grandfathered in. There are still 14 states who maintain a reverse offset today[1].

Example. Ted's average current earnings were $5,000 per month prior to becoming disabled as the result of a job-related injury. Ted, his spouse, and his two children are eligible to receive Social Security disability benefits totaling $3,200 per month. Ted is also entitled to workers' comp benefits of $2,500 a month. Ted's total benefits are $5,700 ($3,200 + $2,500). However, Ted is subject to the workers' comp offset, which means his total benefit cannot exceed $4,000 (80% of his $5,000 ACE). Ted's will receive $2,500 from workers comp and $1,500 from Social Security disability (after the workers comp offset).

Variation. Ted lives in Ohio, which is a state who has opted in to the reverse offset option. Because of the reverse option, Ted will still receive $4,000 per month, but it will be comprised of $3,200 from the Social Security Disability program and only $800 from workers comp.

[1] Reverse offset states include Alaska, California, Colorado, Florida, Louisiana, Minnesota, Montana, New Jersey, New York, North Dakota, Ohio, Oregon, Washington and Wisconsin.

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Veterans benefits not impacted. Specifically excluded from these offset provisions are all Department of Veterans Affairs' benefits; needs-based benefits; Federal, state, or local disability benefits that are based on employment that was covered by Social Security; and private pension or private insurance benefits.

Workers' comp offset impacts disabled taxpayer (Donald and Kristen Ecret v. Comm., TC Memo 2024-23). Kristen Ecret worked as a registered nurse until she was injured in 2014 and became disabled. Workers' comp paid Kristen benefits of about $42,000 per year through 2019. She also applied for Social Security Disability and was approved for benefits in 2017 retroactive back to 2015. However, the SSA determined that Kristen's entire 2017 SS benefit was subject to the workers comp offset so she didn't receive any actual payments in 2017.

Request of redetermination. Kristen believed the SSA calculated her claim incorrectly and ask for a redetermination. The SSA conceded it made an error when it calculated her disability benefits and paid her $55,248 in 2019. This amount was allocated as: $19,866 for 2019; and $35,382 for 2016 – 2018. Kristen received a check in 2019 for $6,120 net of $1,080 of Federal withholding. The remaining $48,048 ($55,248 less $6,120 less $1,080) was held as a workers' comp offset. When she filed her return for 2019, Kristen included tax Social Security benefits of $5,202 ($6,120 x 85%). The IRS audited and increased the taxable portion of Kristen's 2019 Social Security disability benefit to $16,886 ($19,866 x 85%). The Ecret's argued they never received the portion of the Social Security Disability that was part of the workers' comp offset and therefore, they were not taxed on that portion of the income reported on the 1099-SSA.

Sometimes what seems righteous isn't how the law works. The Court noted that gross income includes up to 85% of Social Security benefits, regardless if the benefits are derived via Social Security's disability or retirement program (§86(a)(1)). The benefits are treated the same. If workers' comp benefits are substituted for Social Security benefits, IRC §86(d)(3) provides that any Social Security benefit reduced by reason of the receipt workers' comp benefit, the 'Social Security benefit' includes that portion of such benefit received under the workers' compensation which equals such reduction. Thus, the amount of Kristen's total Social Security benefits received in 2019 includes the portion paid via the workers' comp payments, to the extent those payments offset Social Security benefits. Kristen must include the entire $19,866 reported on her 1099-SSA to calculate the tax portion of Social Security. Her taxable Social Security benefits were $16,886.

Tribal General Welfare Exclusion (§139E).

The General Welfare Exclusion Act (GWEA), passed in 2014, provided an income exclusion for Indian general welfare benefit payments made to Indian tribal members. For this purpose, the term "Indian general welfare benefit" includes any payment made or service provided to or on behalf of a member of an Indian tribe (or any spouse or dependent of such a member) pursuant to an Indian tribal government program, but only if the program is administered under specified guidelines and does not discriminate in favor of members of the tribe's governing body.

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IRS clarifies welfare benefit exclusion in proposed regulations (NPRM REG-106851-21). The IRS issued proposed regulations in September 2024 to clarify the exclusion available to tribal members receiving payments from Indian tribes. The proposed regulations define a "Tribal General Welfare Benefit" as a payment or service that is:

- Pursuant to an Indian Tribal Government Program;
- For the promotion of general welfare of tribal members and their families;
- Available to any eligible Tribal Program Participant;
- Not lavish or extravagant; and
- Not compensation for services (note that any items of cultural significance, reimbursement of costs, or cash honorarium for participation in cultural or ceremonial activities for the transmission of tribal culture are not treated as compensation for services).

Tribal Government Program. A program qualifies as a Tribal Government Program if it is established by an Indian Tribal Government, is administered under specific guidelines, and does not discriminate in favor of governing tribal members. Specific guidelines, at a minimum, include a written description of the program, the benefits provided, how the benefits are determined, eligibility requirements, and the process for receiving benefits.

Tribal General Welfare Benefits. "Tribal General Welfare Benefits" must be for the promotion of general welfare. For this purpose, the Indian Tribal Government determines that a benefit is for the promotion of general welfare at the time it establishes the program. Indian Tribal Governments have ***sole discretion to determine whether a benefit is for the promotion of general welfare and the IRS must defer to the Indian Tribal Government's determination***. Benefits may be provided to Tribal Participants without regard to the financial or other need and may be provided on a uniform or pro-rata basis. The benefits can be paid for cultural programs, housing assistance programs, education benefits, training or retraining to acquire new skills or to obtain better employment opportunities, provide assistance for disasters or emergency situations, funeral or burial assistance programs, legal aid programs, wellness and health-related programs, or any programs that provide benefits to specific categories of individuals, such as elderly individuals or minors.

Gaming revenue and general welfare benefits. Benefits paid to tribal members under an Indian Tribal Government Program are typically funded by net gaming revenues. Net gaming revenue payments are often paid on a per capita basis, and are defined under Indian Gaming Regulatory Act (IGRA). Such payments are subject to Federal taxation and are not excludable from gross income under §139E. Per cap payments are payments made to tribal members that are identified by the Indian Tribal Government as a per capita payment in a Revenue Allocation Plan that is approved by the Department of the Interior.

Tribal Gaming Income Included in Tribal Member's Gross Income (US v. Sally Jim, 11th CA, No. 16-17109). The Indian Gaming Revenue Act (IGRA) of 1988 permits Indian tribes to engage in gaming and to distribute the revenue from gaming activities to its members on a per capita basis - an equal payment to each member. These per capita (i.e. per cap) payments are subject to Federal taxation. Indian tribes are required to report

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the distributions to the IRS and to notify its members that they have a Federal tax responsibility for the payments. The Tribe is also required to withhold Federal taxes on the per cap payments.

Sally Jim, a member of the Florida Miccosukee Indian Tribe, received quarterly per cap payments that totaled $272,000 in 2001. She also earned wages of $26,000 in 2001. Sally Jim neither filed a tax return in 2001 nor paid federal taxes on the distributions. The Miccosukee Tribe also ignored its reporting and withholding obligations. The IRS audited Sally Jim and determined that she owed, for 2021 and other years, $267,000 of taxes and penalties. Sally Jim argued that the payments qualified as general welfare benefits under §139E and were, therefore, excludable from her 2001 income.

The IRS argued, and the Court agreed, that the per cap payments did not qualify as general welfare benefits because Congress specifically subjected such distributions to Federal taxation in IGRA. The GWEA exclusion did not apply as the payments were part of the required Revenue Allocation Plan of IGRA. The Court determined that GWEA was not meant to supplant the IGRA; that is, per capita distributions of gaming revenue remain taxable income, even if these distributions arguably promote the general welfare of a tribe.

Gambling Income and Losses in General (§61; §165(d); §1.165-10)

Under the §61 definition of income, gains from wagering transactions must be included in gross income. Mechanically, wagering (i.e., gambling) income is reported on Form 1040, Schedule 1, line 8b. Wagering expenses are deductible as a Miscellaneous Itemized Deduction on Schedule A, but only to the extent of the taxpayer's wagering income. As a result of this reporting, AGI is increased by the amount of any wagering income, which in many cases increases other AGI sensitive taxable items (e.g., Social Security, passive rental losses, QBI deduction, medical expense deductions, etc.). Oftentimes, gamblers end up with a higher tax bill even in years they suffered wagering losses or broke even.

Example. Rich is retired and lives on $20,000 of Social Security and an annual $10,000 pension. Rich enjoys going to the local casino and playing slot machines. In 2023 Rich received W-2Gs totaling $40,000. Rich has documentation to prove he had losses of more than $40,000. Because of his wagering income, Rich must report $17,000 ($20,000 x 85%) of taxable Social Security on his 2023 return. He can claim an itemized deduction of $40,000 for his gambling losses, but that does not help to reduce his taxable Social Security. Rich's 2023 tax return looks like:

	w/Gambling	w/o Gambling
Pension	$ 10,000	$ 10,000
Gambling income	$ 40,000	$ - 0 -
Social Security - taxable income	$ 17,000	$ - 0 -
Adjusted gross income	$ 67,000	$ 10,000
Itemized deductions	($ 42,000)	($ 15,700)
Taxable income	$ 25,000	$ - 0 -
Tax	$ 2,780	N/A

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Preparer note. Taxpayers who pursue gambling activities as a legitimate business endeavor report wagering income and the related wagering losses on Schedule C. Losses are only allowed to the extent of wagering income but at least both are reported pre-AGI, providing a much fairer tax result.

Players adopt session accounting to calculate wagering income. While taxpayers must report income from wagering transactions, nowhere in the tax code is the term "wagering transaction" defined. As a result, taxpayers, the IRS, and the courts have been left to figure it out. While some may argue the term "transaction" means as every play or wager. This would mean that a taxpayer would have to account for each handle pull, hand dealt, or dice throw separately to adequately account for the transaction. Decades ago, taxpayers began to utilize "session accounting" to determine how to report wagering income on their tax returns. The main premise behind session accounting is that a wagering transaction is not one pull of the handle or punch of a button on a slot machine, nor is each hand dealt in poker or blackjack, nor is it one roll of the dice. A session begins when a player sits down and ends when the player is done and walks away. At the end of the session, the player adds up all his or her wagers and his or her winnings and the net amount is a wagering transaction gain or loss.

Example. Using the same facts as in the previous example, assume that Rich kept detailed records, so he can substantiate:

- He gambled 62 days in 2023 when he spent 6-8 hours gambling with no breaks
- Of all those days, he only walked away with a profit on 5 days
- His combined profit for those 5 days was $5,000
- He had a net overall loss for 2023 of $12,000

The result is Rich has no taxable Social Security earnings and no taxable income.
AND not tax! Big difference!

Preparer note. Effectively, session accounting allows an above the line deduction for gamblers other than professional gamblers.

Courts support the concept of session accounting (Shollenberger v. Comm., TC Memo 2009-306; LaPlante v. Comm., TC Memo 2009-226). Although the IRS did not initially agree with session accounting, early adopting taxpayers found the courts to be more supportive. Repeatedly, the courts ruled that accounting for every separate wager was unduly burdensome and unreasonable (see Green v. Comm., 66 TC 538 (1976); Szkirscak v. Comm., TC Memo 1980-129). The courts have generally held that a taxpayer who plays the slots recognizes a wagering gain or loss at the time the tokens are redeemed, rather than tracking each fluctuating win or loss during the session. The IRS has conceded that the taxpayer has an accessions to wealth when chips are redeemed and amounts can definitively be calculated (CC Memo 2008-11). For example, a casual gambler who enters a casino with $100 and redeems chips for $300 after playing the slot

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machines for 4 hours has a wagering gain of $200 no matter what happened on any individual pull or the handle.

IRS concedes session accounting is appropriate for slots and provides safe harbor (Notice 2015-21). In IRS Notice 2015-21 the IRS acknowledges the appropriateness of session accounting but only for slot machine gambling and under very narrow circumstance. To meet the safe harbor, a session must:

1. Be completed at one casino. If a taxpayer leaves one casino or location for another, the session ends upon leaving the first casino.

2. Begin when a taxpayer places the first wager on a particular type of game and ends when the same patron completes the last wager on the same type of game.

3. End no later than the end of that calendar day.

Electronically tracked slot play. The Service will accept the session accounting from electronically tracked slot machine play. The term "electronically tracked slot machine play" means slot machine play using an electronic player system that is controlled by the gaming establishment (such as using a player's card or similar system) and that records the amount a specific individual won and wagered on slot machine play.

Required reporting. Taxpayers who choose to rely on Notice 2015-21 are instructed to write " Revenue Procedure 2015-X" (final Rev. Proc. has not yet been issued) on Line 21 of the Form 1040".The problem is this Notice was written prior to the TCJA so there is no longer a line 21 (other income) on Form 1040 as this is all now reported on Sch. 1. The author suggests the gross gambling winnings be reported on line 8b of Schedule 1 and then any offsetting losses be reported on Schedule 1, Part II, line 24z and include the verbiage.

Preparer note. This safe harbor appears to be an instance where the IRS provides a safe harbor that is not worth much. If the court cases on this topic are considered, it quickly becomes clear the IRS could never win a case where the taxpayer performed all that is required by the safe harbor. We are being given a safe harbor we already have! That said, at least they have formally acknowledged that session accounting is allowable.

It is important to remember that the IRS safe harbor and related Notice is in response to several court cases the IRS lost. Session accounting, when properly documented, has been upheld multiple times by the courts. And while the IRS only includes slot play in their safe harbor, the ***court cases indicate session accounting may be used for all forms of gambling, not just slots***. A good thing to keep in mind when advising clients on this issue.

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Records help save part of the day for gambler (Katherine Kalk v. Comm., TC Memo 2024-82)

Katherine Kalk was a computer programmer from Indiana who was interested in developing a digital app to provide casinos with statistical information about their customers' slot machine play. Her plan was to also allow customers to use the app to track their daily play and to view their wagering history. Kalk testified that she performed research for developing the casino app, but the only "research" expenses she was able to document were the ordinary gambling losses she incurred while playing slot machines. Kalk provided casino generated win-loss statements for 2013, 2014, and 2016. Her gambling activity for those years is summarized:

Description	2011	2012	2013	2014
Gambling income	$ 115,500	$ 299,000	$ 65,700	$ 24,000
Expenses – gambling losses	$ 109,100	$ 297,000	$ 137,800	$ 92,200
Net	$ 6,400	$ 2,000	($ 72,100)	($ 68,200)

The IRS disallowed 100% of the gambling losses and assessed tax on the gross gambling winnings.

Sch C not allowed. Neither is session accounting. But Court lenient on itemized deductions. Kalk report all of her gambling activity on Sch. C, where the only expenses she deducted were wagering expenses. She was a full-time employee for all of the years in question. The Court ruled that Kalk was not a professional gambler and that her gambling related income and expenses were not reportable on Sch. C. Additionally, Kalk testified that her casino club card tracked only "casino member card" bets and that she placed other bets without using her member card. She did not have adequate documentation to support the other bets. The Court ruled she could not use the session accounting rules.

So what's left – mercy of the Court. The Court acknowledged that it has allowed taxpayers to substantiate gambling losses with evidence such as casino ATM receipts, canceled checks made payable to casinos, credit card statements stating that cash was advanced at the casinos, etc., as well as transactions appearing on a taxpayer's bank statements, the taxpayer's lifestyle (modest or luxurious), and overall financial position. Kalk submitted casino statements for 2013 and 2014. She did not submit any such reports for 2011 or 2012. The casino statements showed losses of $52,167 in 2013 and $56,134 in 2014.For 2011 and 2012, Kalk urged that the Court estimate her gambling losses by considering her bank statements. After review, the Court determined Kalk's bank statements showed total casino ATM withdrawals for 2011 and 2012 of $210,229 and $162,199, respectively and ruled that the withdrawals adequately substantiated losses equal to those amounts for those years. At the end of the day, Kalk was allowed to claim itemized deductions equal to her gambling income.

Preparer note. The reason this case made the manual is it can be used by tax professionals to remind the IRS that bank statements can be used to substantiate gambling losses and that the courts will use common sense, at least some of the time.

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See also:

- **Jacob Bright v. Comm., T.C. No. 10095-22, May 4, 2023,** where the Court estimated the amount of gambling losses where it was obvious the taxpayer incurred losses but could not substantiate how much the amount of the losses.

Miscellaneous Gross Income Items

Public Safety Officer Health Insurance Exclusion (§402(l); Secure Act 2.0 §328).

Public safety officers who retire due to disability or after reaching normal retirement age and who pay for their health insurance in after tax dollars may exclude the lesser of the amount paid for their health insurance or $3,000 from their taxable government pension. For this purpose, a “public safety officer” includes those collecting pensions earned as law enforcement officers, fire fighters (wildland and city), first responders, and certain chaplains. Qualified health insurance includes premiums paid to cover the taxpayer, spouse, and dependents for general health coverage and long-term care insurance.

Secure Act 2.0 allows all insurance payments to qualify. Prior to enactment of the Secure Act 2.0, retired safety officers were only allowed to exclude health insurance premiums that were paid directly by the retirement plan to the insurance company. Beginning in 2023, allowable premiums will also include direct payments from the retiree to the insurance company. The $3,000 annual limit did not change. Any amount excluded is not allowed as a medical expense deduction on Sch. A and is not allowed as an SE health insurance deduction.

Workers Comp Awards Retain Tax-free Status if Converted from Lump Sum to an Annuity (§130; LTR 202416001)

An insurance company who paid out personal injury benefits on behalf of an insured requested the IRS rule if the Federal income tax treatment of an indexed annuity contract that is issued to a claimant to settle a personal injury claim. Specifically, the taxpayer asked if:

1. The periodic payments to be made under the annuity are considered “fixed and determinable as to amount and time of payment” (as is required for the payments to retain their tax-free status) within the meaning of §130(c)(2)(A), even though the dollar amount of the payments may increase (but never decrease) from an initially-determined amount; and

2. The annuity contract will continue to be a “qualified funding asset” within the meaning of §130(d), regardless of the potential increase in the periodic payments as described.

IRS confirms tax-free status retained. Based on the specific facts submitted, the IRS ruled the conversion of a lump sum benefit to an annuity contract would retain the tax-free status.

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Car Sales Employee Doesn't Get Sch. C for 1099 Income (Noah Schmerling v. Comm., TC Summary 2023-14)

Noah Schmerling sold new and used cars for McKenna Motors, a California based BMW dealership. As part of his employment, Noah also sold extended warranties. The dealership reported Noah's earnings on Form W-2 and otherwise treated him as an employee. In addition to his W-2 income, Noah received periodic bonuses or reward payments directly from BMW and Devex (the extended warranty company). These bonuses were reported on Form 1099-MISC as non-employee compensation.

Noah incurred various expenses related to his car sales job, including mileage, meals, travel, etc. When he filed his 2014 tax return, Noah reported the 1099 income on Schedule C, where he also deducted 100% of his job related expenses. On audit, the IRS argued that the 1099 income should have been treated "other income" related to his employment as a car salesman/manager, and any associated expenses must be deducted on Schedule A as miscellaneous itemized deductions. The Court agreed with the IRS.

Preparer note. The other side of this outcome is the income would not be treated a self-employment income and would not be subject to self-employment tax.

GoFundMe, Giveforward, Crowd Funding Sites

So called "crowd funding" sites are designed to raise money for individuals, businesses and charities. A person with a need can post a description of what they need money for, and people can donate for that need. The sites charge a service fee based upon the amount of money raised. There is no charitable deduction available for the donors unless the fundraiser is a qualified charity. If the fundraiser is for an individual or a non-qualified charity, the money is considered a gift and there is no deduction for the donor. If the recipient is not raising funds for a business purpose, the funds are not claimed as income. If the money is raised in connection with a business, then it must be included as business income. In summary, the three types of income generated from crowd funding are:

1. Gifts – this occurs when individuals make payments to a crowd funding page out of generosity and have no expectation of receiving anything in return. The amount given is an excludable nonreportable gift for the recipient and the payor does not report the gift anywhere on her or his tax return.

2. Charitable contributions – this occurs where the payor is paying a legitimate charitable organization amounts to be used for the organization's charitable purpose and the payor does not receive anything in return. These payments are deductible as charitable contributions for the payor and tax-free contribution receipts for the receiving organization.

3. Business income – this occurs when a business, regardless of entity type, receives payments via an online crowd funding campaign. Such payments are generally included in the taxable income of the recipient business and the payor generally gets no deduction.

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Example. Team Scott is raising money for an alternative treatment for Scott's cancer. They register with GoFundMe and raise $10,000. The money is spent for the treatment and travel expenses for Scott, after GoFundMe takes their processing fee of 7.9% and $0.30 per donation.

Scott does not report the income from gifts of the $9,200 that GoFundMe sends him. He does not have a deduction for the service fees of $800. Scott can deduct the $9,200 he spends on medical treatments.

Preparer note. The people who donate toward Scott do not have a charitable deduction, because Team Scott is not a recognized §501(c)(3) charity.

IRS releases Online Crowdfunding Fact Sheet (FS-2024-28). The IRS published a contributions and distributions online crowdfunding fact sheet on its website in August 2024. The Fact Sheet reminds taxpayers about the various sources of online crowdfunding and the related tax responsibilities. It also provides guidance to those who receive Form 1099-K.

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Adjustments to Income (§62)

Part II Adjustments to Income

11	Educator expenses			11	
12	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106			12	
13	Health savings account deduction. Attach Form 8889			13	
14	Moving expenses for members of the Armed Forces. Attach Form 3903			14	
15	Deductible part of self-employment tax. Attach Schedule SE			15	
16	Self-employed SEP, SIMPLE, and qualified plans			16	
17	Self-employed health insurance deduction			17	
18	Penalty on early withdrawal of savings			18	
19a	Alimony paid			19a	
b	Recipient's SSN				
c	Date of original divorce or separation agreement (see instructions):				
20	IRA deduction			20	
21	Student loan interest deduction			21	
22	Reserved for future use			22	
23	Archer MSA deduction			23	
24	Other adjustments:				
a	Jury duty pay (see instructions)	24a			
b	Deductible expenses related to income reported on line 8l from the rental of personal property engaged in for profit	24b			
c	Nontaxable amount of the value of Olympic and Paralympic medals and USOC prize money reported on line 8m	24c			
d	Reforestation amortization and expenses	24d			
e	Repayment of supplemental unemployment benefits under the Trade Act of 1974	24e			
f	Contributions to section 501(c)(18)(D) pension plans	24f			
g	Contributions by certain chaplains to section 403(b) plans	24g			
h	Attorney fees and court costs for actions involving certain unlawful discrimination claims (see instructions)	24h			
i	Attorney fees and court costs you paid in connection with an award from the IRS for information you provided that helped the IRS detect tax law violations	24i			
j	Housing deduction from Form 2555	24j			
k	Excess deductions of section 67(e) expenses from Schedule K-1 (Form 1041)	24k			
z	Other adjustments. List type and amount:	24z			
25	Total other adjustments. Add lines 24a through 24z			25	
26	Add lines 11 through 23 and 25. These are your **adjustments to income**. Enter here and on Form 1040, 1040-SR, or 1040-NR, line 10			26	

Schedule 1 (Form 1040) 2

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Educator Expense Deduction (§62(a)(2)(D))

Educator expenses of up to $300 in 2022 through at least 2024 ($250 in 2021 and prior years) are deductible for qualified educators for expenses related to purchases of school supplies and equipment. The amount is subject to annual inflation adjustments. For married couples where both spouses qualify, each may claim $300.

Qualifying educators – kindergarten through 12th grade teachers, instructors, counselors, principals, or aides who work at least 900 hours during the year are allowed a deduction for qualified expenses.

Qualified expenses – includes books, supplies, equipment, software, and other materials but do not include home schooling costs. Professional development classes are also included in the list of qualifying expenses.

Health Savings Accounts (§223; Form 8889; Rev Proc. 2024-25)

2024-25 HSA Limits		
Contribution Source	**2024**	**2025**
Contribution Levels	$4,150 self only $8,300 family	$4,300 self only $8,550 family
Deductible Ranges	$1,600 minimum for self only $3,200 for family	$1,650 minimum for self only $3,300 minimum for family
Max. Out-of-Pocket (Includes deductible)	$8,050 self only $16,100 family	$8,300 self only $16,600 family
Who is Eligible?	Individual must be covered under a ***qualified*** high deductible health plan, and not covered under any other health plan.	
Is there a "catch-up" contribution provision for older workers?	Individuals aged 55 or older may contribute an additional $1,000 per year.	

High deductible health insurance plan required. To qualify to make HSA contributions, the taxpayer must be covered by a qualified high deductible health plan and not have any other non-qualified insurance. A qualified high deductible health plan in 2024 is a health plan that has a deductible of at least $1,600 for singles, $3,200 for married filing joint. The plan terms must require that no medical expenses will be paid by the plan, other than minor preventative care expenses (annual physical, flu shots, etc.), until after the deductible is met.

New law extends HSA telehealth provisions through 2024 (§223(c)(2)(E)). In the case of plan years beginning on or before December 31, 2021, or in the case of months beginning after March 31, 2022, and before January 1, 2025, a qualified HDHP may pay for telehealth services and other remote care services without regard to any deductible. In such cases, the health plan retains its character as a QHDHP. This provision was extended through 2024 by the Consolidated Appropriations Act of 2022.

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HSAs combine the best features of an IRA and a Roth IRA.

- Contributions are deductible before AGI.
- Earnings accumulate tax-deferred and become tax-free if they are used to reimburse the account owner for qualified medical expenses.
- HSAs are always owned by one person – joint accounts are not allowed, even for spouses (Notice 2004-50, Question 63).
- A withdrawal from the taxpayer's HSA to pay the medical expenses of a spouse or dependent who is covered under a non-HDHP qualifies as a tax-free withdrawal (Notice 2004-50, Question 36).
- Similarly, one spouse may use his or her HSA to pay the medical expenses of the other spouse, even if the other spouse also has an HSA under Notice 2004-50, Question 38.
- Withdrawals before age 65 (for non-medical purposes) are subject to tax and a 20% penalty – transfers incident to a divorce are not taxable if the HSA continues as an HSA in the spouse's hands.

Example. Mark has a low deductible health plan through the VA. Mark's wife, Judy, has a qualified HDHP and has been contributing to her self-only HSA for many years. In 2024, Mark has major surgery and must pay $1,000 for costs his VA insurance doesn't cover. Judy withdraws $1,000 from her HSA to reimburse for Mark's out-of-pocket costs. This is a qualified HSA withdrawal and is tax free, even though Mark is covered by a low deductible health plan and Judy's HSA is a self-only plan.

Preparer note. Married taxpayers who are both age 55 or older and who wish to contribute the 2024 HSA maximum amount of $10,300 ($8,300 plus $1,000 for each spouse) must have two HSA accounts, one in each spouse's name. A minimum of $1,000 must be deposited in each spouse's HSA account. The remaining $8,300, assuming both spouses have family HSAs, may be divided in any way the spouses agree (IRS Notice 2008-59, Question 22).

HSA contributions. HSA contributions are limited (2024) to $4,150 for a self-only policy and $8,300 for a family policy and must be made by the due date of the tax return, without extensions (April 15, 2025 for 2024 contributions). Contributions are not limited based on earned income, AGI, etc. Only age and enrollment in a qualified HDHP come into play.

- Eligibility is determined on the first day of the month. In IRS Notice 2008-52 the IRS clarified guidance on late year HSAs, the annual contribution limit is limited to the greater of the sum of the monthly limits for their applicable plan (plus catch-up)

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or the annual maximum limit for their applicable plan. For calendar year taxpayers the eligibility testing period is from December 1st of the current year through December 31st of the following year. Failure to remain eligible (except for death or disability) causes the entire amount to be fully taxed and subject to a 10% penalty. Additionally, this notice provides that excess contributions to HSAs are subject to a 6% excise tax unless withdrawn by the last day of the year. The Notice also reminds taxpayers that expenses incurred prior to the establishment of the HSA are not qualified expenses for purposes of tax-free HSA withdrawals.

Medicare Lookback Issue For HSA Contributions

Overview. To participate in an HSA, an individual may only have qualified high deductible health coverage. If an individual has non-HSA qualified health insurance, they cannot contribute to an HSA. Medicare is a low deductible health plan and, therefore, those enrolled in Medicare cannot establish or contribute to an HSA.

HSA contributions at age 65 and over. Most people sign up for Medicare when they reach age 65. Once enrolled in Medicare, the person ceases to qualify to contribute to an HSA. As this happens for most people at age 65, there is a misconception that those age 65 and older no longer qualify to make HSA contributions. Turning age 65 doesn't disqualify a person from contributing to an HSA, enrolling in a non-qualifying health plan (e.g., Medicare) does. Individuals age 65 and over may continue to be covered by their employer's health coverage, which, if the coverage is HSA qualified, the person may continue to make HSA contributions regardless of age.

Medicare lookback creates a problem. For those who enroll in Medicare after turning age 65 generally receive the Medicare coverage retroactive for the six months before enrollment. But not before a person turns age 65. The problem here is that the retroactive enrollment means the person was covered by a non-qualified health plan six months prior to enrollment and is therefore not eligible to contribute to an HSA during the six-month Medicare retroactive period. The retroactive Medicare enrollment date is mandatory by statute – the person cannot opt out.

Example. Kelly worked for his employer until he retired on November 10, 2024, when he was age 67. Prior to retiring, Kelly was covered by his employer's qualified HSA health insurance. He contributed $429 monthly ($5,150 annual limit ÷ 12 months) from January through October to his HSA, for a total contribution of $4,290. When Kelly retired, he immediately signed up for Medicare, which retroactively enrolled him as of May 1st, 2024, six months prior to Kelly's enrollment. This means Kelly was only HSA qualified for 4 months in 2024 and only allowed to make HSA contributions of $1,716. Kelly has overfunded his HSA by $2,574 ($4,290 - $1,716). If Kelly doesn't withdraw his excess contributions and any related earnings, he will be subject to a 6% excise tax when he files his 2024 tax return.

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HSA Planning. In practice, HSAs offer unique planning opportunities to taxpayers on both ends of the income spectrum. Tax professionals need to stay alert to recognize situations where HSA planning opportunities exist.

Example – HSA planning for middle or low-income taxpayers. Your client, Lloyd, is a middle to low-income taxpayer with a qualified HDHP. You advise Lloyd to set up an HSA, but he says he can't afford it. So now what? Advise Lloyd to at least open the account with a minimum deposit, say $50. Why is this so important? Because only expenses incurred after the account is open may be reimbursed. Next you ask Lloyd to accumulate and bring to his tax appointment all his out-of-pocket medical expenses he pays during the year. When you finish Lloyd's return, you add up the out-of-pocket medical expenses and see that he paid medical bills of $1,500 during the tax year. You tell Lloyd if he deposits $1,500 in his HSA before April 15th the contribution will be deducted on the prior year return and he will save an additional $225 ($1,500 x 15% tax rate) of tax. Lloyd reminds you that he doesn't have the money to contribute to the HSA and thanks you for rubbing his nose in the additional tax he owes. You advise Lloyd that he doesn't have to leave the money in the HSA – he can deposit $1,500 today and take it back out tomorrow and his tax bill is reduced by $225.

Example – HSA planning for higher income taxpayers. Your high-income client, Caity, has had a qualified high deductible plan and has been contributing to an HSA since 2005. Due to Caity's substantial financial resources, you've always recommended that she annually fund her HSA and not use the HSA to reimburse herself for any out-of-pocket medical expenses she pays. Your strategy is that Caity should continue to accumulate and grow her HSA account and save it to pay her medical expenses when she retires when it is anticipated that her income will be much lower. Caity benefits not only from deducting the contribution to the HSA, but also from tax deferred growth in the account. Additionally, you advise Caity to retain her receipts for medical expenses that she pays and that are not reimbursed or deducted. Reimbursements are not required to be taken within any specified time period so Caity's out of pocket expenses may be reimbursed at any time in the future. In 2024, Caity comes to you and wants to take $25,000 out of her IRA for a European vacation. You calculate the tax on the distribution at $6,000, leaving her $19,000 for her vacation. Instead, you review the out-of-pocket medical expenses Caity has paid over the years and discover that she paid $34,200 of out-of-pocket medical expenses from 2006 through 2023 that have never been reimbursed from her HSA or otherwise deducted on her tax returns. You advise Caity to withdraw up to $25,000 from her HSA in 2024 and the entire distribution is tax free.

HSAs at death of account owner. The treatment of an HSA at the death of the account beneficiary depends on whether the designated beneficiary is the surviving spouse or someone else.

- Spouse is designated beneficiary – the HSA continues to be an HSA and the surviving spouse becomes the account beneficiary. The account merely rolls over and continues as an HSA except there is a new account beneficiary.

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- Non-spouse designated beneficiary – the account ceases to be an HSA at the date of the account owner's death. The fair market value of the HSAs assets is included in the gross income of the beneficiary or the estate of the HSA owner.

The amount included in gross income may be reduced by any qualified medical expenses incurred by the decedent before death and paid within one year.

Creditable Coverage – Prescription Drug Coverage Notification Requirements

The Medicare Modernization Act (MMA) requires entities (whose policies include prescription drug coverage) to notify Medicare eligible policyholders whether their prescription drug coverage is creditable coverage, which means that the coverage is expected to pay on average as much as the standard Medicare prescription drug coverage. For these entities, there are two disclosure requirements:

1. Provide a written disclosure notice to all Medicare eligible individuals annually who are covered under the employer's prescription drug plan. This notice should be issued prior to October 15th each year. The disclosure must also be provided to dependents, Medicare eligible COBRA individuals and their dependents, Medicare eligible disabled individuals covered under your prescription drug plan, and any retirees and their dependents. The MMA imposes a late enrollment penalty on individuals who do not maintain creditable coverage for a period of 63 days or longer following their initial enrollment period for the Medicare prescription drug benefit. Accordingly, this information is essential to an individual's decision whether to enroll in a Medicare Part D prescription drug plan.

2. Entities to must complete an Online Disclosure to CMS Form to report the creditable coverage status of their prescription drug plan. The Disclosure should be completed annually no later than 60 days from the beginning of a plan year (contract year, renewal year), within 30 days after termination of a prescription drug plan, or within 30 days after any change in creditable coverage status. This requirement does not pertain to the Medicare beneficiaries for whom entities are receiving the Retiree Drug Subsidy (RDS).

Additional information is available at www.cms.gov, including sample notification letters and other required documentation.

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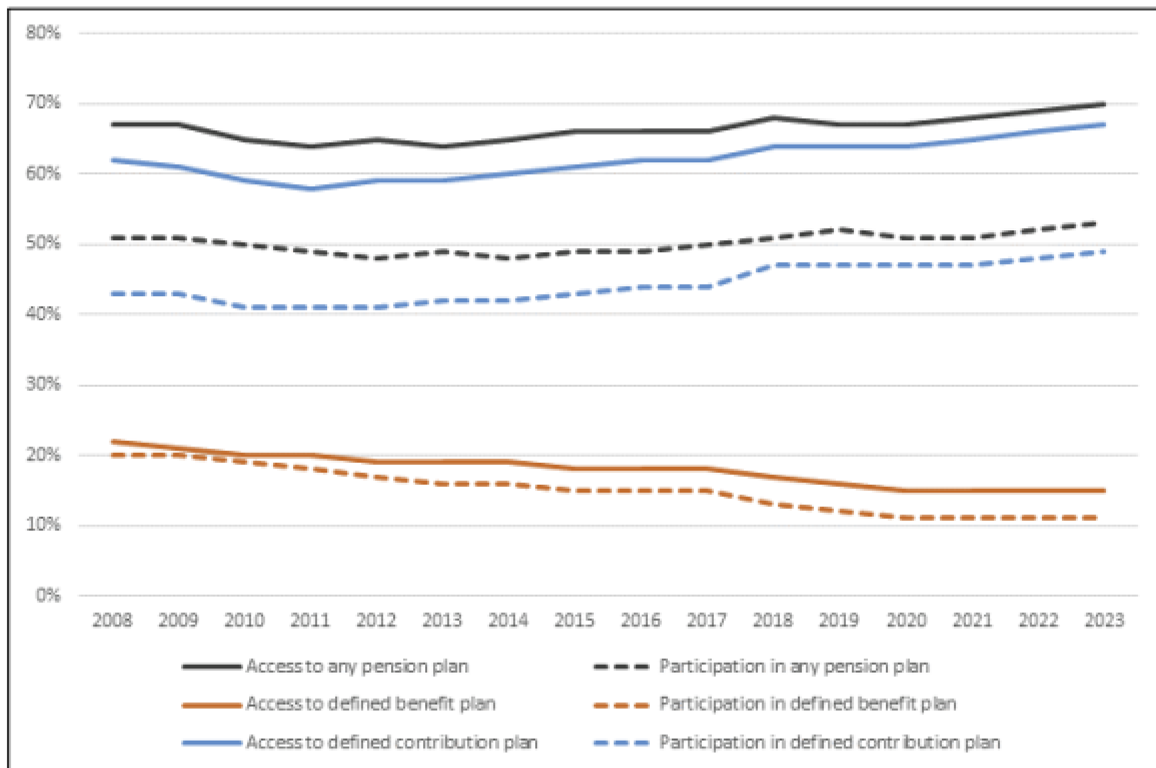
IRAs and Retirement Savings

Retirement in the U.S. in 2024

One notable trend in the U.S. retirement system over the past five decades is that private-sector employees have become increasingly less likely to be covered by defined benefit (DB) pension plans and more likely to be covered by defined contribution (DC) pension plans. Approximately 70% of private sector workers had access to either a DB or DC pension plan in 2023 (Congressional Research Service R43439). Among these workers, 15% had access to a DB plan, 70% had access to a DC plan, and some had access to both. 51% of private industry workers participated in a pension plan in 2023. Examples of private-sector DC plans include profit-sharing plans, money purchase plans, 401(k) plans, 403(b) plans, and Employee Stock Ownership Plans (ESOPs).

Figure 1. Access and Participation Rates in Employer-Sponsored Pension Plans Among All Private Sector Workers

2008-2023



Source: CRS presentation of NCS data, 2008-2023. See BLS, NCS Benefits series, "Annual Summaries of Benefit Coverage," https://www.bls.gov/ebs/publications/annual-benefits-summary.htm.

See also: US Department of Labor, Employee Benefit Security Admin (ESBA), Private Pension Plan Bulletin Historical Tables and Graphs: 1975-2022, September 2024.

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Congress takes action – no, really! Recognizing that workers can no longer rely on their employers to fully fund their retirement, Congress has been working to make it easier and more affordable to save for retirement. In 2019 the SECURE Act increased the RMD age, eliminated the age limit for IRA contributions, created new child early withdrawal penalty exception, increased the credit for employers who adopted new pension plans, and limited non-spouse beneficiary withdrawal periods to 10 years. In December 2022, Congress passed SECURE Act 2.0 as part of the Consolidated Appropriations Act, 2023. This Act made multiple law changes that will impact retirees, pensions, and IRAs for years to come. Many of these changes are being phased in over a few years, starting in 2023. The chart below highlights some of the Act's most significant changes and the year the change becomes effective. All individual retirement provisions are discussed in this chapter. The business retirement provisions are discussed in the Business Pension Plans chapter.

Secure Act 2.0 Summary. Below we've included a chart showing the major changes provided in Secure Act 2.0 and the dates the changes become effective. As we go through this chapter, we will discuss these changes in detail.

SECURE 2.0 Summary of Significant Provisions	
Contribution Changes	**Year Effective***
- Catch-up contributions indexed for inflation in $100 increments	2024
- Additional catch-up amounts for those ages 60, 61 62, and 63	2025
- Student loan payments count as employee contributions for matching	2024
- Sch. C filers w/no employees may contribute employer and employee portions to 401k up to the Form 1040 extended due date	2023
- SEP contributions allowed for domestic employees	2023
- Auto enroll generally required for 401(k) and 403(b) plans	2025
- Employer SIMPLE contributions allowed more than mandatory contributions	2024
- SIMPLE employee elective contribution limits increased 10%	2024
- De minimis gifts allowed for employees who contribute to plans	2023
- Pension-linked emergency savings account allowed	2024
- 529 Education plans may be rolled to Roth IRAs tax free	2024
- SIMPLE plans allowed to accept employee Roth contributions	2023
- Employee catch-up contributions may only be Roth contributions for those with wages more than $145,000 (originally 2024 - now 2026)	2026
- Employer contributions to 401k, 403b and 457 plans may be Roth contributions	2023
Required Minimum Distribution Changes	
- RMD age increased to 73 (75 starting in 2033)	2023
- Longevity annuities exclusion from RMD calculation enhanced	2023
- Penalties reduced for failure to withdraw RMDs	2023
Retirement Related Tax Credits	
- Small employer pension start up credit enhanced	2020
- Small employers allowed 100% credit for employer contributions of up to $1,000	2023
- Small employers who waive waiting periods for military spouse credit	2023
Other Provisions	
- Excess accumulation penalty reduced from 50% to 25%	2023
- Federal disaster distributions have new statutory benefits - ***retroactive***	2021

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SECURE 2.0 Summary of Significant Provisions	
- Auto enroll mandatory for qualified plans	2025
- Starter 401(k) plans available to small employers with no plan	2024
- Part-time workers (500 or more hours per year) must be included in 401(k) and 403(b) plans after 2 years	2024
- QCDs annual $100,000 limit indexed for inflation	2025
- Statute of limitations provided for IRA prohibited transactions	2023
- Retirement plan contributions of up to $50,000 allowed to CRTs	2023
- Early withdrawal penalty waived for victims of domestic abuse	2023
- Early withdrawal penalty waived for persons who are terminally ill	2024
	2023
*** Note that effective dates vary significantly.**	

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2024 IRA Comparison Table (Notice 2023-75)			
	Traditional IRA	**Roth IRA**	**Non-Deductible IRA**
Highlights	Excellent savings plan for those not covered by other plans but who have earned income	Great long-term plan that offers tax-free accumulations and withdrawals	Worst of the 3 IRAs but better than nothing, use for Back Door Roth, but watch taxability
Max Contribution	$7,000	$7,000	$7,000
Max Employer Contribution	N/A	N/A	N/A
Max Contribution All Sources	$7,000	$7,000	$7,000
Over Age 49 Catch-Up*	$1,000*	$1,000*	$1,000*
Tax Deduction	Yes	No	No
Withdrawals	Taxed	Nontaxable	Earnings Taxed
Earnings	Tax Deferred	Nontaxable	Tax Deferred
Penalty Exceptions (§72(t))	Death, disability, education, 1st time home, more	Death, disability, education, 1st time home, more	Death, disability, education, 1st time home, more
Contribute By	Form 1040 Due Date	Form 1040 Due Date	Form 1040 Due Date
Penalty Issues	10% before 59½	10% before 59½ on earnings only	10% before 59½
Tests	1-Earned Income 2-Not covered by another plan 3-If covered, must be below income limits	1-Earned income 2-Max Income under 153k single, 228k MFJ	1-Earned income
Distributions	Start by 4/1 of year after turning 73	None required	Start by 4/1 of year after turning 73
Bankruptcy Protection	$1,512,350 Infl. Adjusted	$1,512,350 Infl. Adjusted	$1,512,350 Infl. Adjusted
5500 Required?	No	No	No
For more information see Pub 590-A for contribution info and Pub 590-B for distribution info.			
*** Beginning in 2024, SECURE Act 2.0 provides for inflation indexing of IRA catch-up contributions. Adjustments will be in $100 increments. Previously there was no indexing.**			

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Traditional Deductible Individual Retirement Accounts (IRAs) (§219; §408; §1.408-1)

A traditional IRA contribution must be deposited by the due of Form 1040 for the year the contribution year (e.g., 2023 IRA contribution must be made no later than April 15, 2024, to allow deduction on the 2023 tax return). In addition to the contribution due date, there are three tests that must be met for a taxpayer to deduct an IRA contribution:

1. The ***earned income*** test,
2. The ***other retirement plan*** test, and
3. The ***maximum income*** test (only applicable if Test 2 is not passed).

Preparer note. There is no longer an age test to make a traditional IRA contribution. Prior to 2020, taxpayers had to be under age 70½ to contribute to a traditional IRA. As a result of the Secure Act, there is no longer any age limit for any IRA contribution (traditional, Roth or non-deductible).

Traditional IRA Deduction Income Phase-Out Ranges (Notice 2023-75)			
Year	**Single and HOH**	**MFJ – Contributing Spouse Covered**	**MFJ– Contributing Spouse Not Covered**
2024	$77,000 – $87,000	$123,000 – $143,000	$230,000 – $240,000
2023	$73,000 – $83,000	$116,000 – $136,000	$218,000 – $228,000
2022	$68,000 – $78,000	$109,000 – $129,000	$204,000 – $214,000
Married filing separate phase out is always $0 – $10,000.			

Traditional Non-Deductible IRA

The only test that applies for those wishing to make a nondeductible IRA contribution is the earned income test. No other test applies. Additionally, taxpayers who qualify to make a deductible IRA contribution may choose to treat the contribution as nondeductible. Taxpayers who make a non-deductible IRA contribution are required to file Form 8606 for the year the nondeductible contribution was made and in any year in which another contribution or withdrawal is made. The purpose of Form 8606 is to report:

- Nondeductible IRA contributions.
- Distributions from SEPs, SIMPLEs, and IRAs in which the taxpayer has basis.
- IRA, SIMPLE and SEP conversions to Roth IRAs.
- Distributions from Roth IRAs.

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What if Form 8606 is not included with the return? If the taxpayer does not file Form 8606 to report non-deductible contributions, all the contributions to the traditional IRA are treated as if they were deductible (i.e., no basis!). 100% of any distributions from the IRA are taxable unless the taxpayer can document that nondeductible contributions were made.

Preparer note. There is a $50 penalty for not filing Form 8606 in a timely manner (§408(o)(4)(C)8). The penalty may be waived for reasonable cause (§6693(c)(3)). The form may be filed by itself and is required even if a tax return is not filed.

If Form 8606 was not filed when required, we suggest the preparer immediately file a separate Form 8606 for each required year without a 1040-X. Mail all the delinquent forms in the same envelope and attach:

1. Proof of deposit and non-deduction,
2. An explanatory letter that includes a reasonable cause explanation, and
3. A request for penalty abatement due to the reasonable cause.

Pro rata rule must be used for distributions. Distributions from IRAs with basis must be prorated between the basis and the non-basis portion of the distribution. Form 8606 is used to track the basis of non-deductible accounts and help allocate basis on withdrawals.

Example. In December 2024, Steve's $20,000 IRA is comprised of $10,000 of deductible IRA contributions, $6,000 non-deductible IRA contributions, and $4,000 tax-deferred earnings. Steve's IRA is made up of 30% basis ($6,000 ÷ $20,000 total) and 70% taxable (($10,000 + $4,000) ÷ $20,000 total). Steve withdraws $5,000 from his IRA the last week of 2024. $3,500 (70%) of this withdrawal would be taxable and $1,500 (30%) would be non-taxable return of basis.

All IRAs must be aggregated when calculating the pro rata rules. Some taxpayers believe they can circumvent the pro rata rules by making deposits into separate IRA accounts – one account gets all deductible IRAs, and another account gets all nondeductible IRA contributions. Nice try! All traditional IRA accounts and related basis are aggregated, and the totals are used to calculate the pro rata allocation of basis and taxable amounts upon withdrawal.

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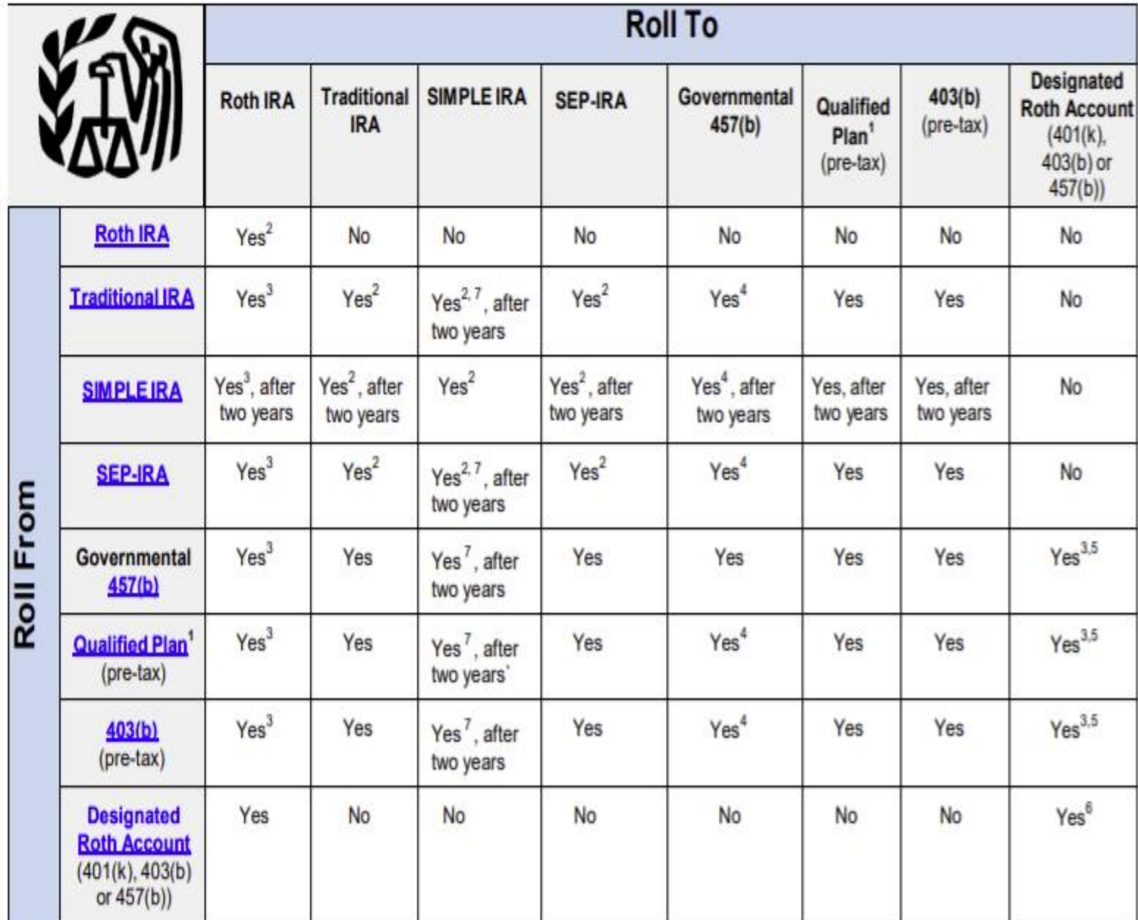
IRA Rollovers



ROLLOVER CHART

Roll From \ Roll To	Roth IRA	Traditional IRA	SIMPLE IRA	SEP-IRA	Governmental 457(b)	Qualified Plan[1] (pre-tax)	403(b) (pre-tax)	Designated Roth Account (401(k), 403(b) or 457(b))
Roth IRA	Yes[2]	No	No	No	No	No	No	No
Traditional IRA	Yes[3]	Yes[2]	Yes[2,7], after two years	Yes[2]	Yes[4]	Yes	Yes	No
SIMPLE IRA	Yes[3], after two years	Yes[2], after two years	Yes[2]	Yes[2], after two years	Yes[4], after two years	Yes, after two years	Yes, after two years	No
SEP-IRA	Yes[3]	Yes[2]	Yes[2,7], after two years	Yes[2]	Yes[4]	Yes	Yes	No
Governmental 457(b)	Yes[3]	Yes	Yes[7], after two years	Yes	Yes	Yes	Yes	Yes[3,5]
Qualified Plan[1] (pre-tax)	Yes[3]	Yes	Yes[7], after two years'	Yes	Yes[4]	Yes	Yes	Yes[3,5]
403(b) (pre-tax)	Yes[3]	Yes	Yes[7], after two years	Yes	Yes[4]	Yes	Yes	Yes[3,5]
Designated Roth Account (401(k), 403(b) or 457(b))	Yes	No	No	No	No	No	No	Yes[6]

[1]Qualified plans include, for example, profit-sharing, 401(k), money purchase, and defined benefit plans.
[2] Only one rollover in any 12-month period.
[3]Must include in income.
[4]Must have separate accounts.
[5]Must be an in-plan rollover.
[6]Any nontaxable amounts distributed must be rolled over by direct trustee-to-trustee transfer.
[7]Applies to rollover contributions after December 18, 2015. For more information regarding retirement plans and rollovers, visit Tax Information for Retirement Plans.

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Roth IRAs

Contributions to Roth IRAs are non-deductible but all future withdrawals, including earnings, are not taxable while in the Roth account or when distributed. The maximum Roth contribution for 2024 is $7,000 plus an additional catch-up contribution of $1,000 for those age 50 or older as of December 31st. To qualify to make a Roth IRA contribution, two tests must be met:

1. The taxpayer must have earned income (just like with a traditional IRA), and

2. AGI cannot exceed the limits (see below).

2024 Roth IRA AGI Limits

	Max Contribution Allowed if MAGI is Less Than:	**Contribution Amount Reduced if MAGI is Between:**	**Cannot Contribute if MAGI is Above:**
Single, H of H	$146,000	$146,001 - $161,000	$161,000
Married Filing Joint	$230,000	$230,001 - $240,000	$240,000
Married Filing Separate	$0	$0 - $10,000	$10,000

Preparer note. Although Roth contributions are not deductible, preparers must know the dollar amount of every Roth contribution and withdrawal since 1998 (the first year Roth's were allowed). Why? Because, regardless of age, withdrawals are tax free until all contribution dollars have been returned. ***When you pick up a new client from another preparer make sure to ask the client for this information which is not normally provided to the new preparer.***

Roth Conversions

Conversions are allowed from traditional IRAs, SEPs , or SIMPLEs as direct conversions. But, ***required minimum distributions from traditional IRAs may not be converted to Roth IRAs.*** Conversions are taxable but not penalized regardless of age.

Planning point. Individuals who receive Social Security or Medicare benefits should consider the impact of a Roth IRA conversion. Additional taxable Social Security income could unexpectedly result, as well as a Medicare surcharge for those with AGI in excess of $103,000 if single, $206,000 if married. These premiums usually start at about $175 per month, but with a surcharge, could increase by more than $400 per month! Conversion income is included in AGI used to calculate the surcharge.

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Backdoor Roth planning. The "Backdoor IRA" is created via a process where the taxpayer opens a nondeductible IRA and then converts it to a Roth IRA. Because the non-deductible IRA is 100% basis, there is no tax on the conversion to the Roth IRA. So why not contribute directly to the Roth and skip the extra step? As mentioned above, Roth IRA contributions are limited, or not allowed, for taxpayers whose AGI exceeds the specified thresholds. However, Roth conversions are allowed regardless of AGI. The Backdoor Roth allows taxpayers to work around the AGI rules, effectively allowing all taxpayers with earned income to contribute to a Roth IRA regardless of AGI.

Example. Kim is 40 years old, single, has wages of $150,000, and her AGI is $170,000. Kim max contributes $23,000 to her work 401k. Kim would like to also contribute to a Roth IRA but her AGI is too high. Kim contributes $7,000 to a non-deductible IRA and a few days later, before there are any earnings on the money, she converts the IRA to a Roth IRA. Kim is not subject to the Roth IRA AGI limit for the conversion. The conversion is not taxable because none of the $7,000 in the IRA was deducted when it was deposited.

Conversion caution. An issue that may arise when converting an IRA to a Roth IRA is the “common pot” rule. All IRAs are treated as one IRA when calculating IRA basis. Basis in any IRA is spread across all IRAs. The result is taxpayers with multiple IRAs must consider all IRA accounts combined and all basis combined to determine how much basis is included in any withdrawal, including Roth conversions. Any conversion in excess of basis is taxable.

Example variation. Assume the same facts as above except that Kim has $43,000 of prior year traditional, deductible IRA accounts in addition to the non-deductible contribution she made for 2024. Considering the “common pot” rule, Kim’s $7,000 Roth conversion would result:

Pre-2024 deductible IRAs – no basis	$43,000	86%
2024 non-deductible IRA contribution – all basis	$ 7,000	14%
Total pre-conversion IRAs	$50,000	100%
Roth conversion		
Basis – non-taxable	$ 980	14%
Pre-tax – taxable	$ 6,020	86%
Total conversion	$ 7,000	100%
Basis in the pre-2024 IRAs after conversion	$ 6,020	86%

Note. This means that a portion of any future withdrawals from the pre-2024 IRAs be partially attributable to basis. The basis amount is tracked on Form 8606. If the form is left out of the return, the basis will be lost.

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Serial Backdoor Roth. As discussed above, there are significant traps taxpayers need to avoid when converting an IRA to a Roth IRA. In an unusual twist, the rules are much more taxpayer favorable when qualified plans are entered into the calculation. With proper planning, and the right qualified plan rules, the "common pot" rule discussed above can be avoided. Taxpayers with pre and after-tax contributions to IRA who are allowed to make rollover contribution to qualified retirement accounts (e.g., 401k account) may choose to roll over only the pre-tax balance to the qualified plan. In reverse, a taxpayer who has both pre and after-tax contributions made to a qualified plan, may segregate the pre and after-tax balances and roll the pre-tax portion to a traditional IRA and the after-tax portion to a Roth IRA account. We call this the "Serial Backdoor Roth IRA."

Example. Harry has $500,000 in an IRA comprised of $100,000 of non-deductible IRA contributions (i.e., basis) and $400,000 in traditional deductible IRA contributions and earnings. If Harry were to convert all, or any portion of his IRA to a Roth IRA, 80% of any amount converted would be taxable under the common pot rule.

Exception to common pot rule. Harry is eligible to participate in his employer's 401k. The 401k includes a provision that allows for rollover contributions from personal IRA accounts or other employer plans. Harry may roll the taxable portion of his IRA ($400,000) to his 401k plan. If Harry chooses to do the rollover, the common pot rule does not apply. One the rollover is complete Harry's remaining $100,000 IRA balance is comprised of 100% basis. Harry could roll the remaining IRA balance to a Roth IRA completely tax free.

Note that plan sponsors may choose whether to allow rollover contributions to their retirement plans. This provision is not required.

Mega-Roth Accounts

Mega-Roth – the New Frontier. Okay, so we have the Roth IRA, the Backdoor Roth account and the Serial Backdoor Roth. Another planning option is what is commonly being referred to as the Mega-Roth Account. The Mega-Roth provides additional planning opportunities for taxpayers who are covered by a deferral pension plan through their work. They key to understanding this planning option is to understand that the annual qualified plan limits provided in the IRC are designed to limit pre-tax contributions, either made by employees or employers. Non-deferral contributions (e.g. Roth contributions) don't have near as many statutory restrictions. The Mega-Roth takes advantage of these relaxed restrictions.

To qualify. To qualify to make Mega-Roth contributions, the employee must have access to an employer qualified plan. The employer plan must allow:

1. The taxpayer to make deferral contributions (e.g. 401k or 403(b) elective deferrals);
2. Roth contributions;
3. Roth account conversions or in-service distributions to Roth IRAs; and
4. After tax contributions up to employee limits.

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After tax contributions. Almost all employees and tax professionals are familiar with general contribution rules for employer qualified deferral plans – there is an overall limit in the amount that may be contributed on behalf of an employee. This limit is $69,000 in 2024, $76,500 if the employee turns age 50 or older on or before December 31, 2024. The overall limit is typically funded via two sources:

1. Employee elective deferrals of up to $23,000 (2024) plus $7,500 for those age 50 and over.
2. Employer contributions of up to 25% of employee compensation. The maximum employer contribution in 2024, assuming the employee contributes $23,000, is $46,000.

The Mega-Roth planning concept relies on a potential third 401k/403(b) funding source. This source is allowed when the employer does not fully fund the employer profit sharing component. In such cases, the employee may make additional after-tax contributions to his/her retirement plan until the full annual limit is met. The result is the after-tax contributions create basis in the employee's plan, but any future earnings on the contributions are taxable to the employee.

Enter the Mega-Roth account. If the employer allows plan balances to be rolled over into a designated Roth account, and the employee rolls to the designated Roth account, the future earnings would not be taxable. The employer could also opt to allow in-service distributions, in which case the employee could transfer the basis to a Roth IRA, allowing all future earnings to be completely tax free. Either way, the employee is able to fully fund her/his 401k up to the employee limit for the year, not just the employee deferral limit. And they get a Roth contribution without regard to AGI.

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Example. Angie is 45 years old and her AGI is in excess of the Roth IRA limit. Angie defers $23,000 into her 401k in 2024 and her employer contributes $10,000. Both contributions were made to the tax-deferred component of the employer's 401k even though the employer plan allows for designated Roth account. The employer plan allows employees to convert after-tax contributions into the designated Roth component. Angie's 2024 plan contributions are summarized:

2024 total employee 401k contribution limit	$ 69,000
Angie's employee elective deferral contribution	($23,000)
Employer profit sharing contribution	($10,000)
Angie's remaining 2024 unfunded limit	$ 36,000

Angie may elect to make an after-tax contribution of up to $36,000 to her employer's 401k plan. Once elected and the contribution is made, Angie may elect to roll the $36,000 of after-tax contributions to the Roth component of the 401k plan. The common pot rule does not apply, allowing the entire rollover to be made on a tax-free basis (after-tax contributions).

Note – Angie would also qualify to contribute to a backdoor Roth in 2024, allowing her to contribute another $7,000.

Variation. Assume the same facts as above except the employer does not allow employees to contribute to designated Roth accounts. But, the employer does allow in services distributions. Angie distributes the $36,000 after-tax contribution to her Roth IRA.

Limited §529 Plan Conversion to Roth IRA Allowed Start in 2024 (§529(c)(3)(E)).

Overview. Qualified tuition programs (a.k.a. QTPs or 529 plans) are programs established by a state and allow a contributor to set aside large sums of money in a tax deferred account to pay for the account beneficiary's qualified higher education expenses. There is no deduction for amounts contributed but the earnings accumulate tax deferred. If the money in the account is used for its intended purpose, there is no tax on distributions, including the earnings portion. Qualified higher education expenses include expenses required for the enrollment or attendance of the designated beneficiary at any college, university, vocational school, or other postsecondary educational institution eligible to participate in a student aid program administered by the Department of Education. Costs of tuition for enrollment at an elementary or secondary public, private, or religious school (i.e., kindergarten through 12th grade) also qualify up to $10,000 per year. Qualified expenses also include required fees, books, supplies, and equipment, and, for those going to school more than half-time, room and board.

What if there's extra 529 plan money and nowhere to use it (§529(c)(3)(C)? An issue with 529 plans since inception is what to do with the money if it's not needed by the beneficiary. Historically, the only option to avoid tax and penalties was to roll the 529 plan balance to another member of the family. Rollovers may be made directly or indirectly and are treated as a gift from the original beneficiary to the new beneficiary for gift tax purposes unless the new beneficiary is the same generation as the original beneficiary and is a

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member of the beneficiary's family. For these purposes, "member of the family" is defined as the beneficiary's:

- Spouse;
- Child or descendant of a child;
- Siblings or step siblings;
- Parents or ancestors of parents;
- Stepparents;
- Nieces and nephews;
- Aunts and uncles;
- In-laws – son, daughter, brother, sister, mother, and father in-laws;
- The spouse of any individual described above; and
- Any first cousin.

While rollovers to other beneficiaries are allowed, sometimes the owner may just want to cash it in and use the money for something else. If the owner withdraws all the money and doesn't spend it on qualified educational costs, the earnings portion of the distribution is subject to tax and penalties.

Roth IRA rollover to the rescue – maybe? Beginning in 2024, 529 plan beneficiaries are allowed to roll balances from their 529 accounts to Roth IRAs tax and penalty free. Several criteria must be met to qualify, including:

- Rollover must be made via a direct trustee-to-trustee transfer. Indirect rollovers are not allowed ;
- The Roth IRA AGI limitation is waived;
- The lifetime maximum Roth rollover for any one beneficiary is $35,000;
- The annual rollover limit is equal to the Roth IRA annual contribution limits ($7,000 in 2024 if under age 50). The annual rollover limit must be reduced by any Roth or other IRA contributions for the same year;
- Only amounts contributed more than 5 years prior may be rolled over; and
- The 529 account must have been open for that specific beneficiary for more than 15 years.

Example. Ron contributed $20,000 to a 529 plan in 2004 when Evan, Ron's grandson, was born. In 2024, when the 529 plan balance was $55,000, Evan received a scholarship to play baseball at the University of Texas. The scholarship pays 100% of Evan's education expenses. Ron elects to roll the 529 plan to a Roth IRA for Evan. Ron may roll $7,000 per year for 5 years before reaching the aggregate maximum $35,000 rollover.

So here's the problem. There is still $20,000 left in the 529 plan after all the transfers to Evan's Roth IRA. Ron decides to roll the $20,000 balance into a 529 plan for Adam, Evan's little brother. For purposes of making Roth rollovers from a 529 plan, Adam's 529 plan is established the day the rollover is made. The result is a Roth rollover is not allowed for Adam for 15 years.

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IRA and Pension Plan Distributions

Excellent Sources of Additional Retirement Information

- IRS Publication 590-B
- "The Retirement Savings Time Bomb Ticks Louder" by Ed Slott (possibly the best IRA reference manual in layman's terms available)

Account Holder Retirement Withdrawals

Account owners may begin penalty free withdrawals from IRAs and retirement plans at age 59½. Once the age requirement is met, the account owner may either withdraw the entire amount prior to reaching age 73 or begin making required minimum distributions at that time.

Required Minimum Distributions (RMDs) (§401(a)(9); §1.401(a)(9)-1)

RMDs in general. Beneficiaries of retirement plans are required to take annual distributions from the retirement plan starting at "the required beginning date." RMDs are required for IRAs, SEPs, SIMPLEs, 401(k)s, 403(b)s, 457s, annuities and most other retirement plans. The amount of the distribution is calculated using account balance as of December 31st of the prior year and dividing that amount by a number provided in an IRS table (these tables and certain exceptions to the RMD rules will be discussed later). Once the RMD amount is determined, the taxpayer is required to distribute that amount during the year.

SECURE Act 2.0 Changes RMD Age (§401(a)(9)(C)(v))

"Required beginning date" defined. The requirement to take RMDs is based on the taxpayer's "required beginning date," which is when RMD must begin. Beginning in 2023, the required beginning date is the date the taxpayer reaches age 73. For the year the taxpayer first reaches age 73, the required beginning date is April 1st of the following year. If the taxpayer chooses to wait until the following year, two RMDs must be taken in that year.

Preparer note. If a taxpayer postpones their 1st RMD to April 1st the following year, two withdrawals are required, **and two calculations are required!** For example, a taxpayer who is subject to RMDs for the first time in 2024 may elect to defer the first year RMD to April 1, 2025. For the deferred 2024 withdrawal, the pension/IRA account balance at 12/31/23 is used to determine the 2024 RMD. The 2025 RMD, calculated based on the 12/31/2024 pension/IRA account balance, must be taken by 12/31/2025.

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Year	Normal First Required Payment Date	Special 1st RMD Payment Extension Option	Future Payment Date Requirement
2033 and beyond	12/31 of year turning 75	April 1st of year after turning 75	The year following turning 75 will require 2 payments: 1 for the first RMD and the normal 2nd year RMD
2023 - 2032	12/31 of year turning 73	April 1st of year after turning 73	The year following turning 73 will require 2 payments: 1 for the first RMD and the normal 2nd year RMD
2020* - 2022	12/31 of year turning 72	April 1st of year after turning 72	The year following turning 72 will require 2 payments: 1 for the first RMD and the normal 2nd year RMD
Prior to 2020	12/31 of year turning 70½	April 1st of year after turning 70½	The year following turning 70½ required 2 payments: 1 for the first RMD and the normal 2nd year RMD
*Does not consider rules revised due to the COVID pandemic related modifications.			

RMD exception for those still working (§1.401(a)(9)-2, Q-2). The required beginning date for a taxpayer who is an employee of the organization who is the sponsor of a retirement plan is April 1st of the calendar year following the year the employee retires from working for the plan sponsor. If the employee continues to work, even part time, the required beginning date is postponed. Note however, this rule does not apply to taxpayers who own 5% or more of the sponsoring organization.

Qualified Charitable Distributions from IRAs to Charity (§408(d)(8))

IRA owners aged 70½ and older may make transfers from their IRA directly to charitable organizations. The total transfers in a year cannot exceed $100,000. These “qualified charitable distributions” (QCDs) are reported on Form 1099-R as if they were distributed directly to the account owner and no special identifying code is provided. Taxpayers must report the total IRA distribution and then reduce the taxable portion to the extent of the QCD. The IRS is notified that a QCD occurred when the taxpayer enters “QCD” in the margin of Form 1040 next to the taxable amount. These rules allow qualified taxpayers to reduce their IRA income by the amount of their charitable contributions including RMDs.

Inflation adjustments coming to QCD annual maximum (408(d)(8)(G)). QCDs first became part of the Internal Revenue Code in 2006 at which time the annual maximum was limited to $100,000. The amount remained static through 2023. SECURE Act 2.0 change the law so that, starting in 2024, the annual QCD maximum contribution limit is indexed for inflation. The 2024 QCD limit is $105,000 (Notice 2023-75).

QCD benefit. QCDs qualify as an RMD for IRA withdrawal purposes. Taxpayers subject to RMD requirements reduce their taxable IRA distributions by the amount of any QCD made during the year.

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Preparer note. The QCD rules apply to taxpayers age 70½ and older even though taxpayers are not subject to RMDs until age 73. The QCD minimum age wasn't changed when Congress increased the RMD age. While QCDs prior to reaching RMD age don't have as significant of a tax impact, for those who make significant charitable contributions or who want to reduce retirement assets at death, QCDs are still an important planning tool.

QCDs and inherited IRAs. Beneficiaries of inherited IRAs who've reached the minimum QCD qualify age of 70½ may elect to make QCDs from their inherited IRA. Any QCDs made from the inherited IRA reduce the RMDs for the IRA beneficiary in the same manner as if the beneficiary was the original owner.

IRAs only – not allowed for qualified plans. The QCD rules apply only to IRAs, not to other pension plans. If it is important enough, taxpayers should consider rolling their other pensions over to an IRA. For QCD purposes, a SEP or SIMPLE IRA can be used only if the account is inactive (no contributions in the year the QCD is made).

Contributing to an IRA may result in a reduction of the deductible QCD amount. The aggregate amount of deductible IRA contributions a taxpayer makes to an IRA after turning age 70½ reduces the amount of the QCD that is excludable from gross income.

Some charities *do not* qualify for QCDs:

1. Private foundations.

2. Supporting organizations: i.e., charities carrying out exempt purposes by supporting other exempt organizations, usually other public charities.

3. Donor-advised funds, which public charities managed on behalf of organizations, families, or individuals.

Charitable documentation is still required. When making a QCD, a taxpayer must receive the same type of acknowledgement of the donation that he or she would need to claim a deduction for a charitable contribution (see Pub. 526, Charitable Contributions).

Tax-free QCDs made to split-interest entity now allowed (§408(d)(8)(F). Congress expanded the QCD provisions to allow a one-time distribution of up to $50,000 to a split-interest entity (i.e., Charitable remainder trusts). To qualify, the split-interest entity must be 100% funded by the QCD. A split-interest entity is defined as:

- A charitable remainder unitrust (aka CRUT) (§664(d)(2));
- A charitable remainder annuity trust (aka CRAT) (§664(d)(1)); and
- A charitable gift annuity (see §501(m)(5)), as long as the annuity commences fixed payments of 5% or greater within one year of funding.

Additionally, these distributions qualify as QCDs only if the amounts distributed would otherwise qualify as a deductible charitable contribution and no person holds an income interest in the entity other than the IRA account owner and/or the spouse. The interest in

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the entity cannot be assignable. QCDs to split-interest entities are allowed in taxable years beginning after 2023.

Required Minimum Distribution Calculation – the math. RMD calculations depend on a variety of factors – age of the account beneficiary, is the beneficiary the original account owner, was the account inherited, etc. All the calculations, at their core, utilize three factors: 1) value of the retirement account as of December 31st of the prior year, 2) age of the beneficiary, and 3) life expectancy derived from an IRS provided table. Factors one and two are straight forward. The complicating factor is determining which IRS table should be used as there are three to choose from:

1. **Uniform Lifetime Table –** used for all unmarried IRA and retirement plan owners calculating their own withdrawals, married owners whose spouses are 10 or fewer years younger, and married owners whose spouses are not the sole beneficiaries of their IRAs.

2. **Table I (Single Life Expectancy)** – used for beneficiaries who are not the spouse of the IRA owner.

3. **Table II (Joint Life and Last Survivor Expectancy)** – used for owners whose spouses are more than 10 years younger and are the sole beneficiary.

Uniform Life Table Updated for 2022 and Years After (T.D. 9930; §1.401(a)(9)-9)

The IRS issued final regulations that updated the uniform life expectancy table for the first time since 2002. The new table is reproduced in IRS Pub 590, Appendix B.

Inherited IRAs Distributions

Beneficiaries versus Designated Beneficiaries.

When a person with a pension or IRA dies, the person(s) or entity(ies) who inherits the decedent's pension/IRA account are referred to as the beneficiary. Such beneficiaries are categorized as either a "designated beneficiary" or "non-designated beneficiary". Designated beneficiaries are typically individuals who are specifically named in the plan documents. Non-designated beneficiaries are typically the decedent's estate/trust or an entity (e.g. charitable organization).

Non-designated beneficiaries – the 5-year rule. Beneficiaries who are not "designated beneficiaries" look to the decedent's age at death to determine distribution options. For decedents who die before reaching RMD age, the non-designated beneficiary has until December 31st of the fifth year after the year of the decedent's death to distribute 100% of inherited account. Annual RMDs are not required. For decedents who die after reaching RMD age, the beneficiary must withdraw annual RMDs. The RMDs are based calculated using the single life annuity table and decedents age at date of death. The account balance as of December 31st of the year of death is divided by the single life annuity table factor. This establishes the RMD in the year after the year of death. For subsequent years, one year is subtracted from the first-year factor.

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Example. Sharon's estate is the beneficiary of her IRA when she dies at age 71 in 2024. Sharon's may wait until 2029 to withdraw the entire IRA amount. There is no requirement to make any annual distributions before 2029.

Variation. Assume the facts as above except Sharon was age 79 when she died. Sharon's estate must make RMDs starting in 2025 that are calculated by dividing the IRA balance as of December 31, 2024 by 11.9, the life expectancy factor from the single life annuity table. For each succeeding year, the estate will subtract 1 from the original life expectancy factor to calculate the required distribution (e.g. 2025 distribution factor 11.9 – 1 = 10.9 for 2026, 9.9 for 2027, etc.). This formula would be continued until the IRA balance is zero.

IRS Issues Final RMD Regulations SECURE Act Rules (TD 100001).

The IRS issued final regulations in 2024 to address RMDs as changed by the SECURE Act. The Regulations are effective as of January 1, 2025. Prior to 2025, taxpayers may continue to rely on the proposed regulations.

The final regulations define retirement plan/IRA beneficiaries (for brevity we will refer to both as "accounts" for the remainder of this section unless a distinction is necessary) as one three types of beneficiaries:

1. **Eligible designated beneficiaries** - may use their own life expectancy to calculate RMDs from inherited accounts; and

2. **Designated beneficiaries** – generally must use a 10-year distribution period for inherited accounts.

3. **Undesignated beneficiaries** – all beneficiaries other than a designated beneficiary.

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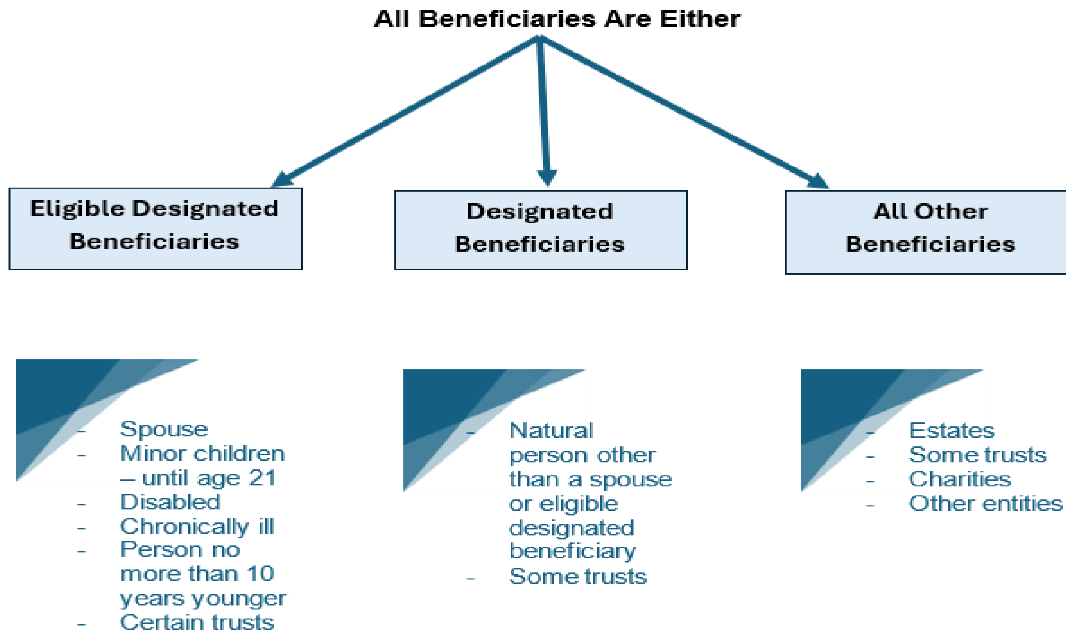

Clarification of 10-year withdrawal for inherited accounts provided. The IRS formalized the rules for inherited accounts and the 10-year rule in its regulations. The Secure Act changed the rules for withdrawals by beneficiaries for deaths occurring after 12/31/2019 by mandating that designated beneficiaries are generally required to distribute the entire account balance by December 31st of the year containing the tenth anniversary of the owner's death (i.e., the end of the 10th year starting the year after the year of the owner's death). The requirement for annual withdrawals depends upon the age of the decedent at date of death:

- **Death occurs prior to owner reaching RMD age.** For account owners who die prior to reaching RMD age, beneficiaries are not required to make annual withdrawals from the inherited account but 100% of the account balance must be withdrawn by the end of year that includes the tenth anniversary of the decedent's death.

- **Death occurs after required beginning date is reached.** If the decedent died on or after reaching RMD age, the beneficiary(ies) must take a distribution each year beginning the year after the year of the decedent's death. For years 1 through 9, the distribution must equal at least what the beneficiary would be required to take based on his or her single life expectancy. The entire account would has to be withdrawn no later than December 31st of the 10th year.

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Example. Carly inherits a traditional IRA from her 71-year-old mother, who died early in 2024. Carly must distribute 100% of the account balance (what is in the account at date of death plus any earnings thereafter) no later than December 31, 2034, but she is not required to distribute anything from the account in 2024 through 2033 as her mother passed away before reaching age 73 (RMD age).

Variation. Let's say Carly's mother was age 77 when she passed away, well beyond her required beginning date. Carly must make annual IRA distributions starting in 2025 and continuing through 2033 from the inherited account. The amount of the RMDs are calculated based on Carly's life expectancy, not her mother's. The single life annuity table found in IRS Pub. 590-B would be used to calculate the required amount. In 2034 Carly must withdraw any remaining balance in its entirety.

Example 2: What if Carly's mother in example 1 had a Roth IRA instead of a traditional IRA? Since there is no required beginning date for a Roth IRA (no RMD's required), Carly is treated as inheriting an IRA from someone who died before the required beginning date. Carly may make distributions at any time and in any amount as long as she distributes the entire account balance by December 31st, 2034 (year 10).

IRS waived excess accumulation penalties for 2021, 2022, 2023 and 2024 for inherited account RMDs (Notice 2024-35; (Notice 2023-54; Notice 2022-53). The IRS concurred that there was significant confusion about whether beneficiaries of inherited accounts were required to make RMDs during the 10-year withdrawal period. In response, the IRS has waived the excise tax that normally applies for failing to make RMDs for 2021, 2022, and 2023. The IRS further extended this relief with Notice 2024-35 to 2024. Excess accumulation penalties will apply starting in 2025. No catch up distributions need to be made for 2021-2024. Taxpayers who've already paid an excise tax are entitled to refunds.

"Eligible Designated Beneficiary" (EDBs) definition clarified. Eligible designated beneficiaries have more advantageous withdrawal rules than all other beneficiaries. Mainly, EDBs may are subject to RMDs using their own life expectancy rather than that of the decedent. In some cases, this can significantly slow the distribution process. The regs divide "eligible designated beneficiary" into two main categories:

1. **Minor children.** The decedent's minor children are eligible designated beneficiaries until they reach the age of majority. The regs clarify the "age of majority" as used here is age 21, not age 18. Additionally, the regs make clear if the decedent died on or after reaching age 72, the minor child is required to take annual distributions in years 1-9 based on her or his own life expectancy using the single life annuity table. If the decedent hadn't reached the required beginning date at the date of death, then no annual withdrawals are required.

2. **Other EDBs.** Eligible designated beneficiaries also include the decedent's spouse, disabled/chronically ill persons, and anyone no more than 10 years younger than the decedent. These EDBs may use their own life expectancy and the single life annuity table to calculate annual RMD. The 10-year rule does not apply to them.

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> **Preparer Tip.** The first step any beneficiary should take upon inheriting an IRA that they do not immediately cash is to name a beneficiary and contingent beneficiary to the account.

Surviving spouse is the beneficiary. If an IRA or qualified plan is inherited from a spouse, the surviving spouse has the option to:

1. Leave it in the deceased spouse's account and add their name as survivor. This option is only available if the spouse is the sole heir with unlimited withdrawal rights. This option allows the surviving spouse to use the life expectancy of the deceased for withdrawal calculations and ***allows the withdrawal of the funds without penalty at any time, regardless of age***. This is particularly valuable if the surviving spouse is older than the deceased or underage 59½. Note:

    - No additional contributions may be made to this account since the account holder is deceased.
    - The surviving spouse must begin taking RMD's by the later of 12/31 of the year after death or 12/31 of the year the owner would have turned 73 (if deceased after 2019).

2. Treat the deceased spouse's IRA as their own IRA by rolling it over into their own traditional IRA. This option is only available if the spouse is the sole heir with unlimited withdrawal rights. As the surviving spouse owns the IRA, they can make additional contributions if otherwise qualified. The surviving spouse is the owner of the rollover IRA for all purposes including:

    - Using their own life expectancy for withdrawal calculations, and
    - Becoming subject to early withdrawal penalties for any pre-age 59½ distributions.

3. Withdraw the full amount and pay tax, but no penalty regardless of age.

4. Elect to take the entire balance by December 31st of the 10th year after the year of death. No distributions are required at any point within the 10 years. The IRA remains in the name of the decedent. Any amount withdrawn is taxable but not subject to penalty regardless of age.

5. Elect to be treated as the employee pension plan owner (§401(a)(9)(B)(iv); Secure Act 2.0 §327). Secure Act 2.0 added an option for a surviving spouse to allow her or him to elect to be treated as the employee for RMD purposes starting in 2024.

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Non-spouse beneficiaries

If an IRA is inherited by an individual other than a spouse, the IRA may not: 1) be rolled over into the beneficiaries account, 2) receive contributions, or 3) be treated as the heir's IRA. Non-spouse beneficiaries have the option to:

1. **Disclaim the IRA.** The beneficiary can always elect not to claim the account at all.

2. **Withdrawal and pay tax.** Withdraw the entire amount immediately and pay the related tax.

3. **Distribute within 10 years.** Non-spouse beneficiaries must withdraw 100% of the inherited IRA within 10 years beginning the year following the year the participant or IRA owner died. Unlike prior law, the 10-year period applies regardless of whether the plan participant or IRA owner dies before or after reaching RMD required age 72. However, as discussed above, if the owner had reached his or her required beginning date for RMDs, the heir must make RMDs in years 1 – 9 and then completely liquidate the account by December 31st of year 10. This applies to distributions to non-spouse beneficiaries from qualified retirement plans, IRAs, and Roth IRAs. All withdrawals are taxable without penalty, regardless of the beneficiary's age.

Preparer Trap. In no event may a non-spouse beneficiary roll an inherited IRA into and IRA in their own name. Only spouses have that option!

Undesignated beneficiaries. Undesignated beneficiaries are everyone or everything else other than a designated beneficiary. The most common beneficiary here is an estate, trust, or charity. Undesignated beneficiaries are subject to the pre-Secure Act distribution rules, which means the entire account must be distributed by the end of the fifth year beginning the year after the decedent's death.

Certain trusts may qualify as a designated beneficiary. To qualify as a designated beneficiary for IRA distribution rules, a trust must:

1. Be a valid trust under state law, or would be but for the fact that there is no corpus;
2. Is irrevocable or will, by its terms, become irrevocable upon the death of the IRA owner; .
3. Have trust beneficiaries who are identifiable from the trust instrument.
4. Provide documentation to the IRA administrator no later than October 31st of the year following the year of the IRA owner's death. Documentation is provided by providing either:

    a. A final list of all beneficiaries of the trust (including contingent and remainder beneficiaries with a description of the conditions on their entitlement); and
    b. Certify the list is correct and complete; and
    c. The other three requirements of naming a trust as beneficiary are satisfied: and
    d. Agree to provide a copy of the trust instrument to the IRA administrator upon demand.

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OR

- A copy of the actual trust document for the trust that is named as a beneficiary under the IRA as of the owner's date of death.

Recent PLR provides insight when Trust is named beneficiary (LTR 202404003). John Doe and Jane Doe established Trust as part of their estate plan. John and Jane were named as trustees, each of whom could act independently of the other to exercise any powers granted to a trustee. Either trustee could withdraw or distribute any property from Trust at any time. The trust assets included John's IRA. John passed away at 68, when Jane was age 67. The trust rolled John's IRA to an inherited IRA, with the Trust listed as beneficiary. After John's death, Jane was the sole trustee of Trust, and she had the authority to distribute all of the trust assets to herself during her lifetime. Based on these facts, the IRS was asked to rule on:

1. May Jane, as surviving spouse, be treated as having acquired the IRA directly from John, and not from the Trust;
2. Is Jane eligible to roll over the IRA distribution to an IRAs established and maintained in Jane's own name;
3. Is Jane required to include in gross income the amount of John's IRA in the year it is rolled from the Trust's IRA to an IRAs set up and maintained in Jane's name.

The IRS concluded that Jane may be treated as acquiring John's IRA directly from John, not from the Trust. She is eligible to roll the IRA into an IRA in her name (assuming the 60-day rollover rule is met, if applicable). Jane is not required to pay tax on the rollover of John's IRA to her IRA.

New Regs Make Significant Change to Documentation Rules (TD 10001). In determining whether the documentation requirements are met (to determine whether a trust is a see-through trust), the trust documentation above no longer will be required to be provided to IRA trustees, custodians, or issuers. Only trust administrator will require the documentation. This means trustees will no longer have to argue with investment companies!

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Preparer Tip. The number one mistake that taxpayers make is failure to designate a beneficiary (designated beneficiary). When the IRA holder dies without a designated beneficiary, the beneficiary is known as a named beneficiary. A named beneficiary does not get the benefits of stretching the withdrawals or payments over the ten-year period normally available to a designated beneficiary.

Prepare Tip 2. Today, now, RIGHT NOW name both a designated beneficiary as well as contingent beneficiaries for all retirement accounts. The number two mistake taxpayers make is failure to name a contingent beneficiary in the event of the primary designated beneficiary's death or disclaiming of the retirement accounts. Failure to name a contingent means that if the primary dies before the account holder, then all options are lost.

Preparer Tip 3. A designated beneficiary is defined as an individual. Not an estate, not a trust, not a corporation, and not passing through the will (treated as an estate). DO NOT ALLOW THE RETIREMENT ACCOUNT TO PASS VIA WILL TO THE ESTATE. ESTATES ARE ALWAYS UNDESIGNATED BENEFICIARIES.

Form 5329 – Additional Taxes On Retirement and Other Tax-Favored Accounts (§72(t); (Form 5329)

Taxpayers who take distributions from IRAs or qualified plans prior to reaching age 59½ are potentially subject early withdrawal penalties in addition to any tax due. There are multiple exceptions that result in the penalty being waived. The Secure Act 2.0 added several additional exceptions and clarified some of those already on the books. The discussion below focuses on these exceptions.

Early Distributions – 60-day Rollover Rule Doesn't Apply So Now What?

Distributions prior to reaching age 59½ is an early distribution and is usually subject to a 10% penalty tax that is disclosed on Form 5329. The distribution is also taxable for regular tax. Note the age 59½ rule means the taxpayer must be 59½ or older ***on the day of withdrawal.***

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Exceptions to 10% Additional Tax (§72(t)			
Description	**Qualified Plans (401(k), etc.)**	**IRA, SEP, SIMPLE IRA* and SARSEP Plans**	**IRC Section(s)**
Age			
Participant or IRA owner reaches age 59½ or older	Yes	Yes	§72(t)(2)(A)(i)
Auto-Enrollment			
Permissive withdrawals from a plan with auto enrollment features	Yes	SIMPLE IRAs and SARSEPs	§414(w)(1)(B)
Beneficiary Death			
Beneficiary after death of the participant/IRA owner	Yes	Yes	§72(t)(2)(A)(ii)
Disabled			
Total and permanent disability of the participant/IRA owner	Yes	Yes	§72(t)(2)(A)(iii)
Substantially Equal Payments			
Series of substantially equal payments	Yes	Yes	§72(t)(2)(A)(iv)
Separation from Service			
Separates from service when employee reaches age 55 (age 50 or 25 years of service for public safety employees)	Yes	No	§72(t)(2)(A)(v), §72(t)(10)
ESOP Dividends			
Dividend pass through from an ESOP	Yes	n/a	§72(t)(2)(A)(vi)
IRS Levy			
Due to an IRS levy	Yes	Yes	§72(t)(2)(A)(vii)
Excess Contributions			
Corrective distributions (and associated earnings) of excess contributions, excess aggregate contributions and excess deferrals, made timely	Yes	n/a	§401(k)(8)(D), §401(m)(7)(A), §402(g)(2)(C)
Medical			
Amount of unreimbursed medical expenses (>7.5% AGI)	Yes	Yes	§72(t)(2)(B)
QDRO			
Distributions paid to alt. payee by court order	Yes	Yes	§72(t)(2)(C)
Unemployed Health Insurance			
Health insurance premiums paid while unemployed	No	Yes	§72(t)(2)(D)
Higher Education			
Qualified higher education expenses	No	Yes	§72(t)(2)(E)
First Time Home Buyer			
Qualified 1st homebuyers max $10,000	No	Yes	§72(t)(2)(F)
Military Reservists			
Distributions to qualified military reservists called to active duty	Yes	Yes	§72(t)(2)(G)
Birth or Adoption			

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Exceptions to 10% Additional Tax (§72(t)			
Description	**Qualified Plans (401(k), etc.)**	**IRA, SEP, SIMPLE IRA* and SARSEP Plans**	**IRC Section(s)**
$5,000 for 1 year from event date, ***per birth***	Yes, for all except defined benefit	Yes – each parent qualifies	§72(t)(2)(H)
Emergency Expense – New starting in 2024			
Personal or family unforeseen needs up to $1,000	Yes	Yes	§72(t)(2)(I)
Pension-Linked Emergency Savings – NEW, starts in			
Employer pension emergency distributions	Yes	N/A	§72(t)(2)(J)
Domestic Abuse – NEW, starts in 2024			
Up to $10,000 for victims of spousal/partner domestic abuse within 1 year	Yes	Yes	§72(t)(2)(K)
Terminal Illness – NEW, starts in 2023			
Terminal diagnoses of death within 84 months. Amount unlimited	Yes	Yes	§72(t)(2)(L)
Federally Declared Disasters – NEW, retroactive to January 26, 2021			
Up to $22,000 allowed if Federally Declared Disaster. May be paid back	Yes	Yes	§72(t)(2)(M)
Long-term Care Contracts – NEW, starts 2026			
Allows distributions of up to $2,500 annually to pay for LT care insurance	Yes	Yes	§72(t)(2)(N)

§72(t) Recent Developments

Clarification of substantially equal payments rules (Act §323). Congress clarified that this exception continues to apply if taxpayers roll over their retirement plans midstream. This new rule applies to rollovers and exchanges of annuities if the annual required payment is made from one or both accounts or annuities. This provision is effective in 2024 except annuities, which are effective beginning in 2023.

Federally Declared Disasters exempts withdrawals from early withdrawal penalties (§72(t)(2)(M); FS-2024-19 FAQs). Congress implemented provisions related to declared disasters related distributions. An taxpayer is qualified if the taxpayer's principal place of abode is in a qualified Federally declared disaster area, ***and*** the taxpayer suffered an economic loss because of the disaster, then:

1. The taxpayer may make a penalty free distribution from an IRA or pension plan of up to $22,000.
2. The distribution may be made anytime withing 180 days of the disaster declaration.

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3. The distribution may be repaid anytime within 3 years of that day the withdrawal took place.

4. The taxpayer may elect to take the distribution into income over three years instead of 100% in the year of distribution.

Qualified loss. A qualified economic loss includes, but is not limited to:

- Loss, damage to, or destruction of real or personal property from fire, flooding, looting, vandalism, theft, wind, or other cause,
- Loss related to displacement from the individual's home, or
- Loss of livelihood due to temporary or permanent layoffs.

Note that there is no dollar amount associated with the economic loss definition. There is no correlation between the loss and the plan distribution.

Employer participation optional. Employers are permitted to choose whether, and to what extent, to adopt these provisions, including the repayment provisions. For example, an employer may choose to provide for qualified disaster recovery distributions but choose not to change its plan to allow for distribution repayments.

Preparer note. Even if an employer does not treat a distribution as a qualified disaster recovery distribution, an individual may still treat a distribution as such on their federal income tax return if they are a qualified individual and the distribution meets the requirements to be a qualified disaster recovery distribution.

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Form **8915-F** (Rev. January 2024) Department of the Treasury Internal Revenue Service

Qualified Disaster Retirement Plan Distributions and Repayments

Attach to Form 1040, 1040-SR, or 1040-NR.
Go to *www.irs.gov/Form8915F* for instructions and the latest information.

OMB No. 1545-0074
Attachment Sequence No. **915**

Name. If married, file a separate form for each spouse required to file Form 8915-F. See instructions.	**Your social security number**

Before you begin (see instructions for details):

- Use Form 8915-F for 2021 and later disasters. Also, use it after 2020 for coronavirus-related and other 2020 disasters instead of Form 8915-E.
- Major Disaster Declarations at *www.FEMA.gov/disaster/declarations* provides the only qualified disasters and their FEMA numbers for item C.
- "This year" (as used on this form) is the year of the form you check in item A next. For example, if you check 2022, "this year" is 2022.

Complete items A and B below. Complete item C and check the box in item D for the coronavirus, as applicable.

A Tax year for which you are filing form (check only one box): ☐ 2021 ☐ 2022 ☐ 2023 ☐ 2024 ☐ Other ______

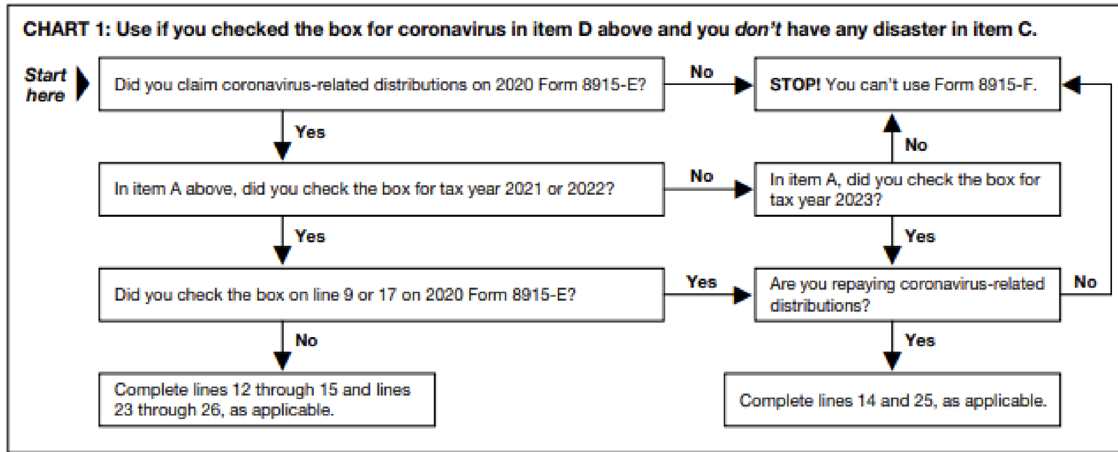
B Calendar year in which qualified disaster(s) began (check only one box): ☐ 2020 ☐ 2021 ☐ 2022 ☐ 2023 ☐ Other ______

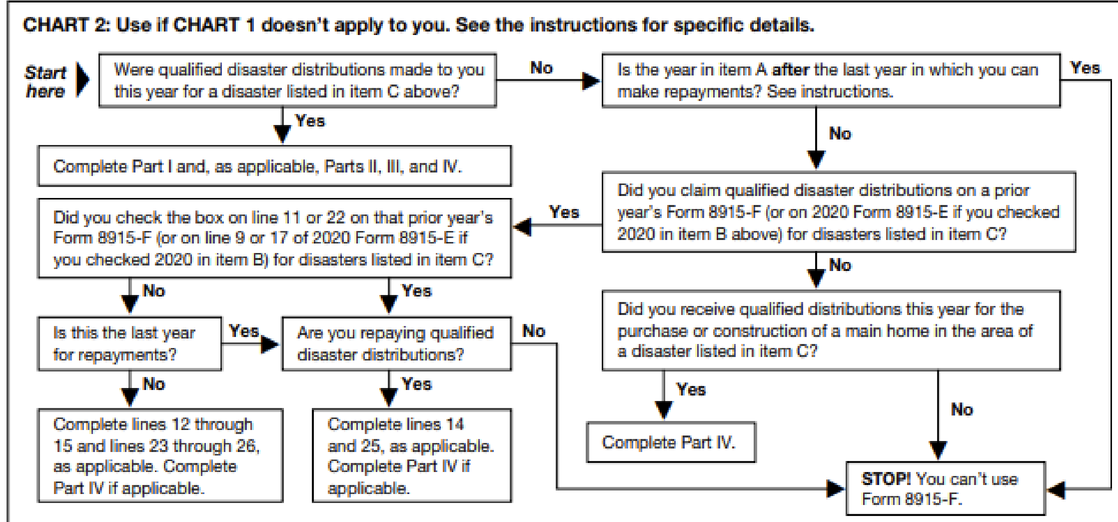
C FEMA number for each of your qualified disasters for the year checked in item B above. Use item D, **not** item C, for the coronavirus

(1) ______ (2) ______ (3) ______ (4) ______ (5) ______ (6) ______

D If your only disaster, or one of your disasters, is the coronavirus, check this box ☐ Don't list the coronavirus in item C.

Which lines on this form should I use? See CHARTS 1 and 2 below.





This provision is retroactively available to disasters dating back to January 26, 2021.

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Adoption or Birth Early Distribution Exception (§72(t)(2)(H)). Taxpayers may withdraw up to $5,000 without penalty from any IRA or qualified plan except defined benefit plans up to 1 year from the date of birth or final adoption date. The exception is limited to $5,000 for each birth or adoption. A married couple may each take a $5,000 distribution penalty-free from their respective retirement plans following the birth or adoption of a child. There is no requirement that the distributions be used for birth or adoption expenses.

New birth-adoption repayment terms (§72(t)(2)(H9)(v)). As originally enacted, any birth or adoption distribution could be repaid at any future time (re-contributed back to a retirement account). Congress changed this rule by adding a time limit for paying the withdrawals back. Repayments must be made within three years of the date the distribution was made. After this time, no repayment is allowed. Any amount repaid is treated as having qualified as an institutional transfer within 60 days of the original distribution. The taxpayer will need to file an amended tax return for the year of the withdrawal to receive a refund of any taxes paid. No deduction is allowed in the year the repayment is made.

Individual Emergency Personal Expenses (§72(t)(2)(I); Notice 2024-55). An emergency personal expense distribution is includible in gross income but is not subject to the 10% additional early withdrawal tax. For this purpose, the term “emergency personal expense distribution” means any distribution made for purposes of meeting unforeseeable or immediate financial needs such as medical care, casualty, imminent foreclosure or eviction from a primary residence, burial or funeral expenses, auto repairs, or any other necessary emergency personal expenses. An eligible retirement plan includes IRAs and employer-sponsored plans that are not defined benefit plans. Emergency personal expense distributions are subject to three limitations:

1. No more than one distribution per calendar year is permitted.
2. The annual maximum of $1,000. And
3. Subsequent emergency personal expense distributions are limited to .

Employers or plan administrators may rely on an employee's written certification that the employee satisfies emergency withdrawal conditions. Emergency withdrawals may be repaid at any time during the 3-year period beginning on the day after the date on which the distribution was received. Only one distribution is allowed per year, and, if a distribution is not repaid, no additional distributions may be paid to the same employee for three calendar years following the year of distribution.

Terminally Ill Exception (§72(t)(2)(L); Notice 24-02, Sec. F.). Distribution from IRAs or pensions plans to a terminally ill person are not subject to early withdrawal penalties. There is no limit on the amount that may be withdrawn. For this provision, the term “terminally ill individual” is defined as an individual who has been certified by a physician as having an illness or physical condition which can reasonably be expected to result in death in 84 months or less after the date of the certification. The certification must be obtained prior to the distribution and must be provided to the employer. Employers may not rely on an employee’s self-certification. The distribution can be made from almost any qualified plan or IRA, including a defined benefit plan. Employers are allowed to decide if the employer pension plan will allow terminally ill distributions. They are not required to offer such distributions.

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Preparer note. If a terminally ill individual works for an employer who doesn't allow terminally ill distributions but does allow other forms of in-service distributions (e.g. hardship distributions), the terminally ill employee can designate the distribution as a terminally ill distribution when his or her personal tax return is filed. The employee designates the distribution as a terminally ill distribution, it's not up to the employer.

Preparer note #2. Per Notice 2024-02, a taxpayer who makes a qualified terminally ill distribution may recontribute the distribution under rules like those discussed above for birth or adoption related distributions.

Domestic Abuse Victim Distribution exception (§72(t)(2)(K)(ii); Notice 2024-55). Victims of domestic abuse are allowed to receive a retirement plan distribution of up to $10,000 (indexed for inflation) within one year of date the abuse occurred without paying the additional 10% tax. For this purpose, the term "domestic abuse" means physical, psychological, sexual, emotional, or economic abuse, including efforts to control, isolate, humiliate, or intimidate the victim, or to undermine the victim's ability to reason independently, including by means of abuse of the victim's child or another family member living in the household.

Repayment is allowed. An individual may, at any time during the 3-year period beginning on the day after the date on which the distribution was received, repay any portion of a domestic abuse victim distribution, up to 100% of the amount withdrawn.

Optional for employer. Employers are not required to offer this provision as part of their qualified plans.

Public Safety Officer Early Retirement exception (Act §§329). Public safety officers (e.g., police, fire fighters, first responders, etc.) who retire and start collecting a pension at age 50 or older are exempt from the early withdrawal penalties (§72(t)(10)). Secure Act 2.0 made changes to these provisions including:

- The penalty exception applies to public safety officers who've reached age 50 OR have 25 years of public safety service.
- In addition to "public" safety officers, these provisions apply to private sector firefighters.

Additionally, first responders' service-connected disability pensions are excluded from gross income for years beginning after 2026 (Act §309).

Preparer note. The Secure Act 2.0 added state and local correctional officers to the list of public safety officers (Act §330).

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Pension-linked Emergency Savings Accounts (PLESA) Allowed Started in 2024 (§402A(e); Notice 2024-22)

Overview. According to Congress, a recent study found that, in the past year, almost 60% of retirement account participants who lack emergency savings tapped into their long-term retirement savings, compared to only 9% of those who had at least a month of emergency savings on hand. In response, Congress included PLESAs in Secure Act 2.0. These accounts allow employers the option to offer to their non-highly compensated employees pension-linked emergency savings accounts. The accounts cannot have a minimum balance requirement. And PLESA accounts are NOT retirement accounts.

PLESA contributions. Employers may auto enroll employees into the PLESA up to 3% of an employee's salary. Employee contributions must stop when the account balance applicable to employee contributions reaches the lesser of $2,500 or lower as set by the employer. Any excess PLESA contributions may be redirected to an employee's Roth defined contribution plan (if such accounts are part of the employer plan) or stopped until the balance attributable to contributions falls below the cap. PLESA contributions are made on a Roth-like basis and are treated as elective deferrals for purposes of retirement matching contributions with an annual matching cap set at the maximum account balance (i.e., $2,500 or lower as set by the plan sponsor).

Withdrawals. Secure Act 2.0 states that withdrawals from PLESAs are for emergencies, but nowhere is the word "emergency" defined. It is expected the IRS will provide guidance at some point, but for now, from the employer perspective, there is nothing required for the employee to request and receive a withdrawal. The law does not even have a requirement for the employee to self-certify they are having an emergency. The first four withdrawals from the PLESA each plan year may not be subject to any fees or charges solely based on such withdrawals. At separation from service, employees may take their emergency savings accounts as cash or roll it into their Roth defined contribution plan or an IRA.

Other PLESA rules. PLESAs are 100% discretionary for the employer. They are not required to offer them. Administrative burdens include:

- Maintaining and monitoring the accounts.
- Ensuring accounts limits aren't exceeded.
- Accounts would have to be set up and investments need to be monitored (only cash investments such as CDs, savings accounts, etc. are allowed).
- Participants will need notice of the PLESA availability.
- And more!

Provisions of Secure Act and Secure Act 2.0 cannot be applied retroactively (Caren Kohl v. Comm. TC Summ. 2024-2. Caren Kohl, who was in her early 50s, received a taxable retirement plan distribution of $10,342 in 2018. Kohl. withdrew the money to pay past-due rent and to avoid being evicted. She did not include the distribution in income on her 2018 Form 1040 and her only argument was that withdrawals made for economic hardship are exempt from it from early withdrawal penalties. To support her claim, Kohl highlighted §72(t)(2)(I), which exempts withdrawals made for emergency expenses from the additional tax. The Court ruled the exception is only for distributions made after

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December 31, 2023, not for 2018. She owed the additional tax and related early withdrawal excise tax.

No relief for criminal forfeiture (Lonnie W. Hubbard v. Comm., TC Memo 2024-16). Lonnie Hubbard was a Kentucky pharmacist that was convicted of various crimes related to the distribution of controlled substances. As part of his conviction, much of Hubbard's personal assets, including his IRA, was condemned and forfeited to the United States government. Hubbard was also sentenced to twelve years in prison, which he began serving in 2017. T. Rowe Price, Hubbard's IRA administrator, issued Hubbard a Form 1099R for $427,518, the amount forfeited, for the 2017 tax year. Hubbard did not file a tax return for 2017 and made no tax payments. The IRS filed a substitute 2017 return for Hubbard and assessed tax and penalties of $66,141. Hubbard argued the fact that he was incarcerated, his wife divorced him, and he wasn't getting his mail, all contributed to his non-filing of his 2017 tax returns. He asked the Court to consider that all of prior year tax returns, from 2002 through 2016, were filed timely and the related taxes were timely paid.

Court says incarceration no excuse. Citing multiple precedential cases, the Court ruled that being incarcerated was no excuse for not filing or paying on time. The fact that Hubbard had historically filed on time indicated he knew his responsibilities for filing, even if he didn't receive a 1099 or other documents in the mail. He owed the $66,000.

Excess Accumulation Penalty

50% penalty reduced to 25%/10% (SECURE Act 2.0, Section 302). Taxpayers who fail to take an RMD use Form 5329 to calculate the related penalty. Historically the penalty amount has been a very onerous 50% of the undistributed RMD. Congress reduced the penalty to either 25% or 10% beginning in 2024. Generally, the penalty is 25% but it is reduced to 10% if the taxpayer takes the required RMD by the end of the second year following the year it was due.

Waiving the penalty for failure to take an RMD. Taxpayers who fail to take the required minimum distribution must fill out Form 5329 to calculate the applicable penalty. Taxpayers may use Form 5329 to request penalty abatement, which is regularly granted. The taxpayer should attach proof that they have "caught up" any missed RMD's and a statement explaining the amounts, the causes, the term "reasonable cause" and that the mistake has been rectified. A separate 5329 is required for each missed year. Attach the required documentation but do not amend the returns for those years – the missed RMD's are not taxable until received so those years technically are not amendable.

Part IX of Form 5329 must be completed. Enter the RMD on line 52 for the year, enter distributions taken, if any, on line 53. Enter "RC" (reasonable cause) and amount to be waived in parentheses on the dotted line next to line 54. Calculate the penalty on line 55 after reducing the amount be any relief requested.

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Example. Due to some health issues and her advanced age, Lucy forgot to take her $10,000 required minimum distribution in 2024. Lucy completes her Form 5329 as shown below to request penalty abatement and attaches it to her 2024 tax return. Lucy also includes a statement explaining how the mistake happened and documentation to show the excess accumulation has been withdrawn.

Part IX **Additional Tax on Excess Accumulation in Qualified Retirement Plans (Including IRAs).** Complete this part if you did not receive the minimum required distribution from your qualified retirement plan.

52	Minimum required distribution for 2022 (see instructions)	52	$ 10,000
53	Amount actually distributed to you in 2022	53	$ 0
54	Subtract line 53 from line 52. If zero or less, enter -0- RC ($10,000)	54	$ 0
55	**Additional tax.** Enter 50% (0.50) of line 54. Include this amount on Schedule 2 (Form 1040), line 8	55	$ 0

Preparer note. In 2024, the maximum penalty is 25%. If Lucy from the above example, failed to take her 2024 RMD, and assuming she makes the correction no later than December 31, 2026, the penalty would only be 10%. It will be interesting to see if the IRS changes its attitude toward waiving the excess accumulation penalties when the penalty drops from 50% to 10%.

IRS Not Always so Forgiving (Clair R. Couturier Jr. v. Comm., USTC No. 4, Dkt. No. 19714-16, Feb. 28, 2024)

Background. Clair Couturier was a corporate executive who held 4,586 stock shares of his employer inside of an ESOP, a qualified retirement plan. In 2004, as part of a corporate reorganization, Couturier accepted a $26 million "buyout" of his interest in the ESOP and various other non-qualified deferred compensation programs he participated in. The $26 million was paid in installments – first a $12 million cash payment made to Couturier's IRA in 20024 and the remaining $14 million was made via a promissory note payable to his IRA. The promissory note was paid in full in 2005. Couturier timely filed his 2004 tax return, on which he reported the $26 million as a nontaxable "rollover contribution" to his IRA. Form 5329 was not included with the return and the line on the Form 1040 for "Additional tax on IRAs, other qualified retirement plans, etc." was left blank. Upon audit, the IRS concluded that $25,133,000 of the $26 million received by Couturier's IRA was attributable to the non-ESOP deferred compensation plans, not eligible for tax-free rollover. The remaining $867,000 was a payment for ESOP shares and qualified for rollover to his IRA.

Excise tax is assessed annually until the excess contribution is removed. The 6% excise tax applies to any "excess contributions" to a taxpayer's IRA. Prior to 2022, a taxpayer's failure to file Form 5329, Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts, generally caused the statute of limitations for this excise tax to remain open indefinitely. The IRS conceded that the statute of limitations had closed for the income tax should have been pain on the taxable deferred compensation that was ineligible for rollover. However, the IRS argued the statute was still open for assessment of the excise tax. And, as Couturier made the excess contribution of $25,133,000 to his IRA in 2004, the excise tax is equal to 6% of $25,133,000 per year and continues to apply

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for future years, until such time as the original excess contribution is distributed to the taxpayer and included in income. The IRS assessed an excise tax of $8,477,000 plus interest and penalties for years 2004 through 2014.

Taxpayer's statute of limitations argument times out. Couturier argued that the deficiencies for the tax years 2004 through 2008 were barred by the statute of limitations on assessment. He also argued that the Consolidated Appropriations Act, 2023 changed the statute of limitations to a maximum of six years. The Court ruled that prior to the statute changes in 2023, the limitations period for the assessment for the excess contribution excise tax remained open indefinitely (§6501(c)(3); Paschall v. Comm.). For tax years 2004–2008, Couturier timely filed his Forms 1040, but he did not file Form 5329 for any year. Therefore, the statute of limitations never began to toll. Additionally, Congress specified that the December 2022 amendment it made to §6501 took effect on the date of the enactment, which was December 29, 2022. Couturier owed the excise tax and related interest and penalties.

Secure Act 2.0 limits excess accumulation and contribution penalties (Act 313). The most troubling thing about this penalty is the statute of limitations only starts when the taxpayer files Form 5329. Often the taxpayer is unaware they are supposed to file the form, making the penalty never ending. Congress changed the statute effective for returns filed in 2023 and after so the statute of limitations now begins as soon as the Form 1040 is filed, with or without Form 5329. For excess accumulations, this makes the statute three years and for excess contributions six years. There is also a six-year statute of limitations for bargain sales to an IRA.

Prohibited Transactions (§4975)

Qualified plan penalties. If a "disqualified person" and a qualified plan enter a "prohibited transaction" a two-tiered excise tax may apply. Tier 1 is a tax equal to 15% of the amount of the prohibited transaction and is due for each year (or part thereof) in the taxable period. After the 1st tier tax is assessed, if the transaction is not corrected within the taxable period the 2nd tier tax of 100% of the amount involved is assessed. These excise taxes are collected from the disqualified person(s) who participated in the prohibited transaction.

IRA rules and related penalties are different (§4975(c)(3); §408(e)(2)). IRA account owners are exempt from the two-tiered excise tax discussed above. Historically, if an IRA owner entered a prohibited transaction with her/his IRA, the account ceases to be an IRA as of the first day of the taxable year in which the prohibited transaction occurred. Effectively, this made the entire balance in the IRA immediately taxable and, if the owner didn't meet an exception, the distribution was also subject to the 10% early withdrawal penalty.

Prohibited transactions defined (§4975(c). Prohibited transactions between a disqualified person and a plan include any direct or indirect:

1. Sale, exchange, or lease of property;
2. Loan or extension of credit;
3. Furnishing of goods, services, or facilities;
4. Transfer to or use by or for the benefit of the disqualified person of the income or assets of the plan;

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5. Use of plan income or assets by fiduciaries for their own benefit; or
6. The receipt by a plan fiduciary of consideration for his or her own account from a party who is dealing with the plan in connection with plan income or assets.

Preparer note. The list above is not all inclusive or mutually exclusive. A transaction may fall within the parameters of more than one of transaction types. The list illustrates examples of the kind of self-dealing and participation that is prohibited. The quality of an underlying investment or other validation efforts are of no consequence. If the transaction is prohibited it cannot be saved with documentation or other business purposes.

Disqualified person. A disqualified person is a person with a close relationship to the plan, including:

1. A fiduciary;
2. A person providing services to the plan;
3. An employer or employee organization whose employees or members are covered by the plan;
4. An owner, direct or indirect, of 50% (or more) of:
   a. The combined voting power of all classes of stock;
   b. The capital or profits interest of a partnership; or
   c. The beneficial interest of a trust or unincorporated enterprise, which is an employer or employee organization, whose employees or members are covered by the plan;
5. A member of the family of any individual disqualified person, including spouses, ancestors, lineal descendants, and spouses of lineal descendants;
6. A corporation, partnership, trust, or estate, 50% or more of which is owned by persons described in (1) through (4), above;
7. An officer, director, 10% (or more) shareholder or highly compensated employee (earning 10% or more of the annual compensation of an employer) of any person described in 3, 4 or 6 above; or
8. A 10% (or more) partner or joint venturer of a person described in 3, 4 or 6 above (§4975(e)(2)).

Secure Act 2.0 eases prohibited transaction penalties for IRAs (§408(e)(2)(A); Act §322). The Secure Act 2.0 changed the penalty rules so that, if an IRA engages in a pr9ohibited transaction, only the balance in that IRA account ceases to be an IRA. If the IRA owner has multiple IRAs, then any other IRAs retain their IRA status and are not taxable. In other words, only the amount involved in the prohibited transaction will be treated as no longer qualifying as an IRA.

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Itemized Deductions

SCHEDULE A (Form 1040)
Department of the Treasury
Internal Revenue Service

Itemized Deductions

Attach to Form 1040 or 1040-SR.
Go to *www.irs.gov/ScheduleA* for instructions and the latest information.
Caution: If you are claiming a net qualified disaster loss on Form 4684, see the instructions for line 16.

OMB No. 1545-0074
2024
Attachment Sequence No. 07

Name(s) shown on Form 1040 or 1040-SR | **Your social security number**

TREASURY/IRS AND OMB USE ONLY DRAFT July 17, 2024 DO NOT FILE

Section	Line	Description	Box	Total
Medical and Dental Expenses		**Caution:** Do not include expenses reimbursed or paid by others.		
	1	Medical and dental expenses (see instructions)	1	
	2	Enter amount from Form 1040 or 1040-SR, line 11 [2]		
	3	Multiply line 2 by 7.5% (0.075)	3	
	4	Subtract line 3 from line 1. If line 3 is more than line 1, enter -0-		4
Taxes You Paid	5	State and local taxes.		
	a	State and local income taxes or general sales taxes. You may include either income taxes or general sales taxes on line 5a, but not both. If you elect to include general sales taxes instead of income taxes, check this box ☐	5a	
	b	State and local real estate taxes (see instructions)	5b	
	c	State and local personal property taxes	5c	
	d	Add lines 5a through 5c	5d	
	e	Enter the smaller of line 5d or $10,000 ($5,000 if married filing separately)	5e	
	6	Other taxes. List type and amount:	6	
	7	Add lines 5e and 6		7
Interest You Paid **Caution:** Your mortgage interest deduction may be limited. See instructions.	8	Home mortgage interest and points. If you didn't use all of your home mortgage loan(s) to buy, build, or improve your home, see instructions and check this box ☐		
	a	Home mortgage interest and points reported to you on Form 1098. See instructions if limited	8a	
	b	Home mortgage interest not reported to you on Form 1098. See instructions if limited. If paid to the person from whom you bought the home, see instructions and show that person's name, identifying no., and address	8b	
	c	Points not reported to you on Form 1098. See instructions for special rules	8c	
	d	Reserved for future use	8d	
	e	Add lines 8a through 8c	8e	
	9	Investment interest. Attach Form 4952 if required. See instructions	9	
	10	Add lines 8e and 9		10
Gifts to Charity **Caution:** If you made a gift and got a benefit for it, see instructions.	11	Gifts by cash or check. If you made any gift of $250 or more, see instructions	11	
	12	Other than by cash or check. If you made any gift of $250 or more, see instructions. You **must** attach Form 8283 if over $500	12	
	13	Carryover from prior year	13	
	14	Add lines 11 through 13		14
Casualty and Theft Losses	15	Casualty and theft loss(es) from a federally declared disaster (other than net qualified disaster losses). Attach Form 4684 and enter the amount from line 18 of that form. See instructions		15
Other Itemized Deductions	16	Other—from list in instructions. List type and amount:		16
Total Itemized Deductions	17	Add the amounts in the far right column for lines 4 through 16. Also, enter this amount on Form 1040 or 1040-SR, line 12		17
	18	If you elect to itemize deductions even though they are less than your standard deduction, check this box ☐		

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Standard Deduction (§63(c))

	2023	2024
Single	**$13,850**	**$14,600**
Head of Household	**$20,800**	**$21,900**
Married Filing Joint	**$27,700**	**$29,200**
Married Filing Separate	**$13,850**	**$14,600**

Medical Expense Deduction (§213)

Overview. Taxpayers are allowed a deduction for expenses paid during the taxable year, not compensated for by insurance or otherwise, for medical care of the taxpayer, the taxpayer's spouse, or the taxpayer's dependent. Only expenses taken together that exceed 7.5% of the taxpayer's, or both taxpayers' if filing jointly, adjusted gross income (AGI) are deductible on Schedule A.

Only medical expenses actually paid during the taxable year are deductible, regardless of when the expense was incurred, and regardless of the method of accounting used by the taxpayer for filing income tax returns (§1.213-1(a)(1)).

Medical care defined (§213(d)(1); §1.213(e)). The Code defines "medical care" as amounts paid for:

- Diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body,
- Transportation primarily for and essential to obtaining medical care,
- Qualified long-term care services; or
- Insurance covering medical care and transportation, including supplementary medical insurance for the aged (Medicare Part B), and any qualified long-term care insurance contract.

Medical deductions are limited to amounts paid for expenses incurred primarily for the prevention or alleviation of a physical or mental defect or illness and for operations or treatment affecting any portion of the body. Thus, medical care payments include a) hospital services; b) nursing services; c) medical, laboratory, surgical, dental, and other diagnostic and healing services; d) obstetrical, therapy, and X-ray expenses; e) prescribed drugs or insulin; and f) artificial teeth or limbs. Expenditures which are merely beneficial to the general health of an individual, such as an expenditure for a vacation, do not qualify. Illegal operations or treatments also do not qualify.

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IRS Adds FAQs To Website to Clarify Medical Expense Deductions (IR-2023-47)

The specifics of what is and what is not a deductible medical expense, both for deduction purposes and for reimbursement from HSAs, FSAs, HRAs, etc., are often debated between taxpayers and the IRS. To provide some clarity, in March 2023 the IRS added an FAQ page to its website with some interesting content. We've summarized a few of the most interesting questions and answers below:

- **Therapy: FAQ #7** – Is the cost of therapy a medical expense that can be deducted or paid or reimbursed by HSAs, FSAs, MSAs, etc.? Yes, if the therapy is treatment for a disease. For example, an amount paid for therapy to treat a diagnosed mental illness is a medical expense, but an amount paid for marital counseling is not.

- **Nutritional counseling: FAQ #8** – Is the cost of nutritional counseling or weight-loss program a medical expense that can be deducted or paid or reimbursed by HSAs, FSAs, MSAs, etc.? Yes, but only if the nutritional counseling or weight-loss program treat a specific disease diagnosed by a physician (such as obesity or diabetes). Otherwise, the cost of nutritional counseling is not a medical expense.

- **Gym memberships: FAQ #10** – Is the cost of a gym membership a medical expense that can be deducted or paid or reimbursed by HSAs, FSAs, MSAs, etc.? Yes, but only if the membership was purchased for the sole purpose of affecting a structure or function of the body (such as a prescribed plan for physical therapy to treat an injury) or the sole purpose of treating a specific disease diagnosed by a physician (such as obesity, hypertension, or heart disease). Otherwise, the cost of a gym membership is for the general health of the individual and is not a medical expense.

- **Exercise: FAQ #11** – Is the cost of exercise for the improvement of general health, such as swimming or dancing lessons, a medical expense that can be deducted or paid or reimbursed by HSAs, FSAs, MSAs, etc.? No, because exercise, even if recommended by a doctor, is only for the improvement of general health.

- **Food and beverages: FAQ #12** – Is the cost of food or beverages purchased for weight loss or other health reasons a medical expense that can be deducted or paid or reimbursed by HSAs, FSAs, MSAs, etc.? Yes, but only if 1) the food or beverage does not satisfy normal nutritional needs, 2) the food or beverage alleviates or treats an illness, and 3) the need for the food or beverage is substantiated by a physician. The medical expense is limited to the amount by which the cost of the food or beverage exceeds the cost of a product that satisfies normal nutritional needs. If any of the three requirements is not met, the cost of food or beverages is not a medical expense.

- **Non-prescription medicines: FAQ #13** - Is the cost of nonprescription (over the counter) drugs and medicines a medical expense that can be deducted or paid or reimbursed by HSAs, FSAs, MSAs, etc.? The answer to this question is yes and no. First yes, the cost of over-the-counter medicines and menstrual care products may be paid or reimbursed by HSAs, FSAs, MSAs, etc... But, no, the cost of medicines that aren't prescribed by a physician are not a deductible medical expense deduction on Schedule A. for these products. The exception to this general rule is insulin, which is always a deductible medical expense.

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- **Nutritional supplements: FAQ #14** – Is the cost of nutritional supplements a medical expense that can be deducted or paid or reimbursed by HSAs, FSAs, MSAs, etc.? Yes, but only if the supplements are recommended by a medical practitioner as treatment for a specific medical condition diagnosed by a physician. Otherwise, the cost of nutritional supplements is not a medical expense.

Preparer note. While FAQs on the IRS website are not authoritative, they do provide insight into what the IRS may be thinking about a particular issue at a point in time. Additionally, website information may be used to boost a reasonable cause argument when fighting penalties. If IRS website information is relied upon while preparing returns, practitioners should consider printing the website information to the file to ensure it is still available if needed.

IRS Reminds Taxpayers To Beware of Misleading Advertising for Medical Reimbursement Products (IR-2024-65).

The IRS is concerned that some overly aggressive companies are mistakenly claiming that a doctor's note based merely on self-reported health information can convert non-medical food, wellness and exercise expenses into deductible medical expenses make such expenses reimbursable under flexible spending arrangements, health savings accounts, health reimbursement arrangements or medical savings accounts (FSAs, HSAs, HRAs and MSAs). The IRS notes that such a note would not establish that an otherwise personal expense satisfies the requirement that it be related to a targeted diagnosis-specific activity or treatment; these types of personal expenses do not qualify as medical expenses.

Example. Avery is a diabetic who attempts to control her blood sugar by eating low carb foods. Avery sees an advertisement stating that she can use pre-tax dollars from her HSA to purchase healthy food if she has a doctor's note. The ad says that if Avery pays a fee to the advertiser, it will provide her with a 'doctor's note' that will make her low carb food expenses reimbursable from her HSA. The IRS warns this is likely a scam advertisement as a mere doctor's note based only on the taxpayer's self-reported information does not make the food expenses deductible or reimbursable.

Medical insurance deductions (§213(d)(1)(D)). Medical insurance expenditures are included as medical care to the extent amounts paid for insurance for:

- Covering the diagnosis, cure, mitigation, treatment, or prevention of disease;
- The purpose of affecting any structure or function of the body; or
- Transportation primarily for and essential to medical care.

Policies that contain premium waivers in the case of certain events do not qualify. In the case of an insurance contract that includes non-medical provisions (e.g., a policy providing an indemnity for loss of income or for loss of life, limb, or sight):

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1. No amount may be treated as paid for medical insurance unless the charge for such insurance is either separately stated in the contract or furnished to the policyholder by the insurer in a separate statement,
2. The amount treated as paid for medical insurance may not exceed such charge, and
3. No amount may be treated as paid for medical insurance if the amount specified in the contract as the charge for such insurance is unreasonably large in relation to the total charges under the contract.

Proposed regulations expand medical care definition in response to executive order (NPRM REG-109755-19). The Secretary of the Treasury released proposed regulations in June 2020 that would allow expenses related to certain types of direct primary care arrangements and healthcare sharing ministries to be eligible medical expense deductions under §213(d). ***Unfortunately, at our publishing date, no further action has been taken on these Proposed Regulations.*** The Regulations specifically state that they cannot be relied on until they become final. According to the U.S. Government website regulation.gov, they Regs are due to become final sometime in December 2023. Believe it when you see it!

"Direct primary care arrangement" (aka: concierge medicine) defined (PR §1.213(e)(1)(v)(A)). The proposed regulations define a "direct primary care arrangement" as a contract between an individual and one or more primary care physicians under which the physician or physicians agree to provide medical care for a fixed annual or periodic fee without billing a third party (i.e., insurance company). The proposed regulations define a "primary care physician" as an individual who has a primary specialty designation of family medicine, internal medicine, geriatric medicine, or pediatric medicine. The IRS is considering adding nurse practitioners, clinical nurse specialists, and physician assistants as primary care providers, although it hasn't been done so yet.

Proposal to treat direct primary care arrangements as payments for medical care. While direct primary care arrangements may encompass a broad range of facts, a payment for a direct primary care arrangement may be a payment for medical care or as a payment for medical insurance. For example, payments for a direct primary care arrangement that solely provides for an anticipated course of specified treatments of an identified condition, or solely provides for an annual physical examination, are payments for medical care. However, so long as a direct primary care arrangement meets the definition set forth in the proposed regulations, amounts paid for the arrangement will qualify as an expense for medical care, regardless of whether the arrangement is for medical care or medical insurance.

"Health care sharing ministry" defined (PR §1.213(e)(2)). Health care sharing ministries do not provide medical treatment or services. Instead, membership entitles members to share their medical bills through the ministry and potentially receive payments from other members to help with their medical bills. The membership payments historically have not been allowed as payments for medical care. The proposed regulations define a "health care sharing ministry" as a charitable tax-exempt organization:

- Whose members share a common set of ethical or religious beliefs and share medical expenses among members in accordance with those beliefs and without regard to the State in which a member resides or is employed,

- Whose members retain membership even after they develop a medical condition,

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- Which (or a predecessor of which) has always been in existence since December 31, 1999, and medical expenses of its members have been shared continuously and without interruption since at least December 31, 1999, and

- Which conduct an annual audit performed by an independent certified public accounting firm in accordance with generally accepted accounting principles and which is made available to the public upon request.

Proposal to treat payments to Health Care Sharing Ministries as health insurance. The proposed regulations determined that payments for membership in a health care sharing ministry that shares expenses for medical care are payments for medical insurance. The purpose of a health care sharing ministry is for members to share the burden of their medical expenses with other members. Members assist in the payment of other members' medical bills, and possibly receive reimbursement for their own medical bills in return. Whether this is done by making membership payments to the ministry or by sending the payments directly to other members, the substance of the transaction is the same. Like traditional medical insurance premiums, amounts paid for membership in a health care sharing ministry allow members who incur expenses for medical care to submit claims for those expenses and potentially receive payments to help cover those expenses.

HRA or HSA reimbursements. Amounts paid for direct primary care arrangements are eligible for reimbursement from HRAs, QSEHRAs, and HSAs. Amounts paid to health care sharing ministries are considered payments for insurance and are eligible for reimbursement from HRAs and QSEHRAs. However, as these payments are for insurance, they are not reimbursable from HSAs. In addition, participants in both direct primary care arrangements and health care sharing ministries are considered to have low deductible health plans that would preclude the taxpayer from qualifying to make contributions to HSAs.

Medical (and other) Mileage (Notice 2024-08)

Mileage Type	2023	2024	2025
Medical/moving	22¢	21¢	
Business	65½¢	67¢	
Charity	14¢	14¢	

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Qualified Long-Term Care Premiums (Rev. Proc. 2023-34)

The amount that is deductible as qualified long-term care premiums is annually adjusted for inflation. The annual deductible amounts per person are:

Age at close of tax year	2023	2024	2025
40 or less	$ 480	$ 470	
Over 40, not over 50	$ 890	$ 880	
Over 50, not over 60	$1,790	$1,760	
Over 60, not over 70	$4,770	$4,710	
Over 70	$5,960	$5,880	

Taxes (§164)

Overview. Historically §164(a) allowed a deduction for the payment of certain taxes, including:

- State, local, and foreign real property taxes,
- State and local personal property taxes, and
- State, local, and foreign income, war profits, and excess profits taxes.

A deduction has also been allowed for taxes not described above that were paid or accrued within the taxable year in carrying on a trade or business or an activity engaged in to produce income (§212). Additionally, taxpayers have been allowed to elect to deduct State and local general sales taxes in lieu of State and local income taxes (§164(b)(5)).

State and local tax deductions limited to $10,000 (SALT limit) (§164(b)(6)). The TCJA made two significant changes to taxes allowed as an itemized deduction for tax years 2018 through 2025:

1. Foreign real property taxes are no longer allowed as an itemized deduction.
2. The deduction for State and local taxes (SALT) is limited to $10,000 ($5,000 for MFS). Any excess amounts expire and do not carry forward. Business deductions for Schedules C, E and F activities were not changed.

Capitalization of tax and interest allowed (§266; §1.266-1). Taxpayers who own unimproved investment, non-income producing land should consider making a §266 election whenever they are subject to AMT. This election allows the real estate taxes, interest, and other charges to be added to the cost of the land under §1.266-1(b)(1)(i) rather than be currently deducted. The taxpayer may elect to capitalize one of these costs and deduct the others if deductible and of a different category such as capitalizing taxes and deducting interest.

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The election is made annually and requires a statement in the taxpayer's return setting forth the description of the property and the expenses to which the election applies. In addition, if the property produces income each year, the election is not available. The election must be made by the due date of the return. In PLR201105014 the taxpayer was granted the ability to make the election on an amended return.

Home Mortgage and Investment Interest (§163)

Where to Deduct Interest Expense

TYPE OF INTEREST	WHERE TO DEDUCT	MORE INFORMATION
Student loan interest	Form 1040, Sch. 1, Line 21	Pub. 970
Home mortgage interest & points on Form 1098	Schedule A, Line 8a	Pub. 936
Home mortgage interest and points **not** on Form 1098	Schedule A, Line 8b	Pub. 936
Deductible points **not** on Form 1098	Schedule A, Line 8c	Pub. 936
Investment interest for raw land	Form 4952	Pub. 550
Investment Interest for stocks & taxable bonds	Form 4952	Pub. 550
Investment interest for S corporation stock	Schedule E, Page 2, Part 2, Line 28 as "Business Interest"	Notice 89-35
Non-farm business interest	Schedule C, Line 16	Pub. 535
Farm business interest	Schedule F, Line 21	Pub. 225
Rent/royalty related interest	Schedule E, Line 13	Pub. 527
Oil & gas working interest	Schedule C, Line 16b if direct, Schedule E, Line 13 if indirect	Pub. 550
Other personal interest	Non-deductible	§163(h)

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Charitable Contributions (§170)

Taxpayer Certainty Act make changes to contribution rules.

AGI limit of charitable giving modified (§170(b)(1)(G)). Historically, deductions for donations to charitable organizations was limited, in most cases, to 50% of the taxpayer's AGI. For years beginning in 2018 through 2025, the TCJA increased the AGI limitation percentage to 60%. Contributions more than the 60% AGI limitation may be carried forward and deducted as a charitable contribution in the five succeeding years.

Charitable Contribution Deduction Substantiation Requirements (§170(f)(8))

All cash and non-cash charitable contributions must be substantiated to be deductible (§170(f)(8)). Substantiation may be a receipt or cancelled check, but for donations greater than $250, the taxpayer must get a written contemporaneous acknowledgment (no later than when return is timely filed) from the donee organization. This rule applies regardless if the donation is cash or other property.

For non-cash contributions of more than $500 the taxpayer is required to attach to Form 1040 Form 8283 to provide additional information about the donation. The taxpayer must also keep the same records required for contributions valued at less than $250, plus information documenting how and when the property was acquired, and its basis or cost (§1.170A-13(b)(3)).

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Contribution Documentation Summary

Amount	Non-Cash	Cash
<$250	Receipt Required	Receipt Required
>$249 and <$500	Receipt required ***and*** contemporaneous written acknowledgement from the charity	Receipt required ***and*** contemporaneous written acknowledgement from the charity
>$500 and Sold by Charity	Receipt required ***and*** Form 1098-C showing charity's sales price, ***and*** attach 1098-C to Form 1040, ***and** deduction limited to 1098-C amount*	Receipt required ***and*** contemporaneous written acknowledgement from the charity
>$500 and <$5,000 and retained for use or improved by charity	Receipt required ***and*** Form 8283 ***and*** contemporaneous written acknowledgement meeting certification of non-sale requirements, *deduction allowed at fair market value using private party sales pricing guidelines in used vehicle pricing guides*	Receipt required ***and*** contemporaneous written acknowledgement from the charity
Over $5,000 and retained for use or improvement by charity	Receipt required ***and*** written appraisal ***and*** signed Form 8283 ***and*** contemporaneous written acknowledgement meeting certification of non-sale requirements, *deduction allowed at fair market value using private party sales pricing guidelines in used vehicle pricing guides*	Receipt required ***and*** contemporaneous written acknowledgement from the charity
Over $500,000	All of the above, plus attach the appraisal to the tax return.	Receipt required ***and*** contemporaneous written acknowledgement from the charity

CPA charity documentation doesn't include date or "no goods or services" wording ([Anthony Aulisio, Jr. v. Comm., TC Memo 2024-29]). California CPA Anthony Aulisio claimed a charitable cash deduction of $500 to the Friends of the Los Angeles Philharmonic. The receipt from the charity did not have the required language and was not dated. The deduction was denied.

The rest of the story. As you might imagine, there were major issues brought up in the audit of Aulisio's return that had nothing to do with his charitable contribution deduction. The Court also found Aulisio had underreported income from Sch. C income of $11,000 and Sch. B of $22,000. The IRS also argued Aulisio claimed excess auto expenses of $18,600 and office expenses of $20,500, which the Court disallowed. Aulisio claimed an

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NOL of $437,000 on an amended return, for which he had no documentation. Yep, that was denied as well.

See also:

Duncan Bass v. Comm., TC Memo 2023-41, where the taxpayer attempted to argue that his non-cash charitable contribution deductions of $18,999 on his 2017 tax return were the result of multiple, separate donations and, therefore, were not subject to the reporting rules for donations greater than $250 and Form 8283 wasn't required. The Court noted that Bass would have to have made more than 170 trips to the charities (more than 3 a week) for his claims to be true. The Court ruled the Regulations mandate aggregating similar items of property donated to one or more charitable organizations to determine whether the donation exceeds the thresholds (§170(f)(11)(F); §1.170A-13(c)(1)(i)) and disallowed his charitable donations due to lack of substantiation.

Volunteer Expenses as Charitable Contributions

Volunteers who incur expenses while providing volunteer services to charitable organizations may, subject to certain limitations, deduct these expenses. Expenses incurred on personal, living and/or family expenses are excluded. Other specific guidelines include:

- A deduction of $50 per month is allowed for each full month that a foreign or American exchange student (12th grade or lower, full-time) lives with the taxpayer, under a written agreement between the taxpayer and a qualified organization as part of a program of the organization to provide educational opportunities for the student. (15 days or more counts as a full month).
- Auto mileage at mileage 14¢ per mile, plus tolls and parking.
- Travel costs (including meals) performing services for a charitable organization where there is no significant element of personal pleasure.
- The cost and upkeep of uniforms are not suitable for everyday use and that must be worn while performing donated services for a charitable organization.
- Foster care providers designated by a qualified organization, who have no profit motive in providing foster care, may deduct unreimbursed expenses for food, clothing, and care.
- Taxpayers chosen to attend a convention of a qualified organization as the organization's representative may deduct unreimbursed expenses for travel and transportation, including a reasonable amount for meals and lodging, while away from home overnight in connection with the convention.

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Volunteers' Questions and Answers

Question	Answer
I volunteer 6 hours a week in the office of a qualified organization. The receptionist is paid $10 an hour for the same work. Can I deduct $60 a week for my time?	No, you cannot deduct the value of your time or services.
The office is 30 miles from my home. Can I deduct any of my car expenses for these trips?	Yes, you can deduct the costs of gas and oil that are directly related to getting to and from the place where you are a volunteer. If you don't want to figure your actual costs, you can deduct 14 cents for each mile.
I volunteer as a Red Cross nurse's aide at a hospital. Can I deduct the cost of uniforms that I must wear?	Yes, you can deduct the cost of buying and cleaning your uniforms if the hospital is a qualified organization, the uniforms are not suitable for everyday use, and you must wear them when volunteering.
I pay a babysitter to watch my children while I volunteer for a qualified organization. Can I deduct these costs?	No, you cannot deduct payments for childcare expenses as a charitable contribution, even if you would be unable to volunteer without childcare.

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Conservation Easements Continue to be Hot Button for IRS (§170(h))

Background. Charitable deductions for those making conservation easement donations have steadily grown since the Pension Protection Act was passed in 2006. The PPA enacted several provisions to encourage conservation contributions. Explaining how a conservation easement works is best described in an example.

Example. Mike and Julie own a 500-acre ranch in a growing area of Montana. Mike and Julie want to ensure that their ranch continues to conform to its agriculture roots and is not developed as a housing tract in the future. Mike works with an attorney and has an easement drawn up that he then attaches it to his ranch property. The easement requires that the ranch property always be used for agriculture purposes, preferably a horse or cattle ranch. Mike records the easement with the County and makes it official.

Mike has his ranch appraised as a ranch and the appraiser determines the value to be $1,400,000. Mike asked the appraiser to do another appraisal assuming the ranch property was available to be developed into residential housing lots. The appraiser determines the value to be $1,800,000 in this case. Mike and Julie place the value of the conservation easement at $400,000, the difference between the two appraisals.

Soon after the appraisals are completed, Mike and Julie donate the easement that protects the ranch for agricultural use to the Montana Land Conservancy, who agree the value is $400,000. Mike and Julie take a charitable deduction on their return for $400,000.

The above example is simplistic, but it exhibits the basic concepts surrounding conservation easement deductions. Most notable, the quality of the appraisals is the most important aspect of the entire process. If the appraisals are bad, then the whole thing will be tossed out.

Conservation Easement Final Regulations Officially Add Syndicated Conservation Easements (SCEs) to Listed Transactions (TD 10007)

IRS reported problems with conservation easements. Since the very beginning the IRS has waged an uphill battle against defective conservation easements. The IRS and the Courts have seen abuses by taxpayers, often encouraged by promoters armed with questionable appraisals and who take inappropriately large deductions for easements. Taxpayers have sometimes used or developed these properties in a manner inconsistent with §501(c)(3). In other cases, the charity has allowed property owners to modify the easement or develop the land in a manner inconsistent with the easement's restrictions. Another problem arises in connection with historic easements, particularly façade easements. Here again, some taxpayers have been found to take improperly large deductions. After agreeing not to modify the façade of their historic house giving an easement to this effect to a charity, some taxpayers claim a deduction even though the façade was already subject to restrictions under local zoning ordinances. In response, the IRS issued Notice 2017-10, which made many conservation easement transactions listed transactions.

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Final regulations aim to correct problems with Notice 2017-10. Notice 2017-10 designated syndicated conservation easement (SCE) transactions as presumptively tax-avoidance listed transactions and required reporting by taxpayers. However, the courts held that that Notice 2017-10 was promulgated unlawfully because Congress did not expressly authorize its issuance without notice and comment (Green Rock LLC v. Comm., 11th Circuit CA, No. 23-11041, June 4, 2024). The 6th Circuit reached a similar conclusion with respect to Notice 2007-83, which identified certain trust arrangements claiming to be welfare benefit funds and involving cash value life insurance policies as listed transactions (Mann Construction, Inc. v. U.S., 27 F.4th 1138 (6th Cir. 2022).

Final regulations provide Court ordered comment period. While the IRS disagrees with both opinions discussed above (see Announcement 2022-28), it chose to issue regulations that included a comment period, thereby remedying the Courts' requirement for public comment. The final regulations were issued in October 2024 and, much the same as Notice 2017-10, identify certain syndicated conservation easement transactions as "listed transactions" – abusive tax transactions that must be reported to the IRS. The IRS has pursued both legislative (see Secure Act 2.0 changes discussed below) and regulatory changes to combat perceived abuse. Under the new regulations, participants and material advisors will need to report their participation in syndicated conservation easement transactions on Forms 8886 and 8918, respectively. This includes any transactions that were completed in taxable years that are still open.

New holding periods required for some conservation easements (§170(h); Secure Act 2.0 §605). Since 2016 IRS has identified certain syndicated conservation easement transactions involving pass-through entities as "listed transactions" carrying a high potential for abusive tax avoidance. In response, Congress used the Secure Act 2.0 to implement new restrictions on charitable deductions related to conservation easements. Starting in 2023, a charitable deduction for a qualified conservation contribution is not allowed if the deduction claimed exceeds 2½ times the sum of each partner's relevant basis in the contributing partnership. There is an exception if:

- The contribution meets a 3-year holding period test;
- Substantially all the contributing partnerships are owned by members of one family; or
- The contribution relates to the preservation of a building that is a certified historic structure (new reporting requirement applies).

While the new law provides taxpayers opportunities to correct certain defects in an easement deed (excluding easements involved in abusive transactions), it also gives the IRS additional enforcement provisions including:

- Makes conservation easement valuation misstatements subject to the 20% penalty under §6662;
- The reasonable cause exception provided under §6664(c) does not apply to conservation easement valuation misstatements;
- No deduction is allowed unless the donating partnership discloses the donation in its return; and
- If the donation is not properly disclosed, the statute of limitations does not toll.

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In perpetuity requirement and related regulation (§1.170A-14(g)(6)). One of the requirements for conservation easement deduction is the easement's conservation purpose must be guaranteed to extend in perpetuity (§170(h)(5)(A)). On occasion, unforeseen developments occurring after the easement donation is completed may make it impossible for the taxpayer to comply. Contemplating such scenarios, the IRS Regulations addresses situations in which unforeseen changes to the surrounding land make it “impossible or impractical” for an easement to fulfill its conservation purpose. In such events, the conservation purpose may still be protected in perpetuity “if the restrictions are extinguished by judicial proceeding and all of the donee’ s proceeds … from a subsequent sale or exchange of the property are used by the donee” to further the original conservation purpose. This regulation is referred to as the “proceeds regulation.”

But we win one once in while (Buckelew Farm, LLC v. Comm., TC Memo. 2024-52). Bucklelew Farm (aka Big K Farms) was an LLC located in Atlanta, Georgia and owned by John Smoltz (50%) and Ryan Klesko (50%). Between 1998 and 2006 the LLC acquired 1,562 acres of land in Georgia for $4,014,000. The LLC purchased the land for its timber value and for various recreational uses including hunting, fishing, and other outdoor sporting activities. It continued the recreational use until 2012. During the period from 1999 to 2012, the 1562 acres was appraised and multiple local real estate offered opinions as to value. These various valuations ranged from $3 million to $9 million. The property was listed for sale for $9 million but it didn’t sell.

Here comes the experts. Jim Adams, real estate attorney and investor, presented a conservation easement plan to Klesko and Smoltz where Big K Farms, LLC (a newly formed LLC) would purchase the property for $6 million. Adams organized BKF Management, LLC (BKF Management), to act as the managing member of Big K Farms. BKF Management was owned by Adams, Carlton Walstad, Pete Powell, and Klesko, each owning 25% interest in the LLC. In an email to John Smoltz’s advisor, John Dodd, Adams opined that the properties’ true value was about $3 million, but that Adams was willing to pay $6 million because of the “value of the potential tax deductions and tax credits.” In February 2012, Adams, on behalf of Big Knoll Farms, purchased the property from Smoltz and Klesko.

Adams hired an appraiser, Jim Clower, to ascertain the fair market value of the property “before” and “after” granting a conservation easement. Clower’s appraisal report determined the value of the property “before” the granting of the conservation easement to be $60 million, and the value of the property “after” granting the conservation easement to be $4,130,000. Adams hired a second appraiser to help determine the value of the conservation easement. This appraiser, Dale Hayter estimated the amount of a potential conservation easement deduction to be $47,570,000.

In December 2013 Big K filed the Conservation Easement and Declaration of Restrictions and Covenants (conservation easement deed), which granted a conservation easement over the 1,545 acres in perpetuity to protect the conservation values, which refer to natural open space and scenic and educational values. The conservation easement deed identifies five conservation purposes: (1) water quality protection, (2) natural habitat protection, (3) open space protection, (4) scenic enjoyment of the public, and (5) public conservation education. The LLC’s timely filed 2013 Form 1065 reported a charitable contribution deduction of $47,600,000, including Form 8283, Noncash Charitable Contributions; a supplemental letter; and Hayter's 2013 appraisal. Form 8283 was signed

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by Hayter and clearly identified the property as a "conservation easement under IRC 170(h) on land in Macon, Georgia."

Win some, lose some The Tax Court held that Big K's donation was made in perpetuity and that it had the proper donative intent. Said another way, Big K made a charitable contribution under the law and regulations. So, they win! But the Court addressed the valuations, before the donation and after. Based on these differences and the IRS appraisals, the Court allowed a conservation easement donation of $4,595,000.

See also:

- Oakbrook Land Holdings, LLC v. Comm., 6th Circuit CA, No. 20-2117, March 14, 2022, where Oakbrook Land Holdings, LLC (Oakbrook) challenged the validity of the proceeds regulation, contending that Treasury violated the notice-and-comment requirements of the Administrative Procedure Act (APA). Oakbrook also argues that the IRS's interpretation of §170(h)—the statute that the rule implements—is unreasonable. Finally, they argued that the proceeds regulation is arbitrary or capricious. The Court ruled against Oakbrook and the Appeals Court affirmed.

- David and Tammy Hewitt v. Comm., 11th Circuit CA, No. 20-13700, Dec. 29, 2021, where the Hewitts made almost the same argument as Oakbrook above, that the proceeds regulation was arbitrary and capricious and it violated the Administrative Procedures Act, but the 11th Circuit Court ruled in the Hewitt's favor. As these two courts disagree, we now wait to see if the Supreme Court will take on one of these cases to bring clarity to the law.

- *U.S. v. Nancy Zak et al.*, USDC Georgia, ND, CIV 1:18-cv-05774-AT, where two persons were found to promote an abusive syndicated conservation easement and were to be tried for fraud.

- *Railroad Holdings, LLC v. Comm.*, TC Memo 2020-22, *Oakbrook Land Holdings, LLC v. Comm.*, TC Memo 2020-54, and *Maple Landing, LLC v. Comm.*, TC Memo 2020-104, where the conservation easement included an extinguishment clause that provided for any proceeds from a sale of the property to be split between the taxpayer and the charity. The Court ruled the extinguishment clause prevented the conservation easement from being "protected in perpetuity" as required by §170(h)(5)(A).

- *Theron Johnson v. Comm.*, TC Memo 2020-79, where Theron Johnson donated a conservation easement to create a private wildlife reserve in Colorado and claimed a charitable deduction of $610,000. The Court determined the appraisals used by Johnson to determine the amount of the deduction were incorrect and reduced the value of the easement to $373,000.

- CCA 202020002, where the IRS Chief Counsel discusses more than 100 cases and the impact of those cases on IRS enforcement efforts for conservation easements.

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Penalties may be avoided. Taxpayers may avoid the imposition of penalties relating to improper contribution deductions if they fully remove the improper contribution and related tax benefits from their returns by timely filing a qualified amended return or timely administrative adjustment request.

Taxpayers are not the only ones in the IRS sights. In addition to auditing participants, the IRS is pursuing investigations of promoters, appraisers, tax return preparers, etc. who assist with these deductions. Further, the IRS is evaluating numerous referrals of practitioners to the IRS Office of Professional Responsibility. The IRS will develop and assert all appropriate penalties, including penalties for participants (40 percent accuracy-related penalty), appraisers (penalty for substantial and gross valuation misstatements attributable to incorrect appraisals), promoters, material advisors, and accommodating entities (penalty for promoting abusive tax shelters and penalty for aiding and abetting understatement of tax liability), as well as return preparers (penalty for understatement of taxpayer's liability by a tax return preparer).

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Credits, Other Taxes, Withholding, and Estimated Tax Payments

SCHEDULE 2 (Form 1040)
Department of the Treasury
Internal Revenue Service

Additional Taxes

Attach to Form 1040, 1040-SR, or 1040-NR.
Go to *www.irs.gov/Form1040* for instructions and the latest information.

OMB No. 1545-0074
2024
Attachment Sequence No. 02

Name(s) shown on Form 1040, 1040-SR, or 1040-NR | **Your social security number**

TREASURY/IRS AND OMB USE ONLY DRAFT August 16, 2024 DO NOT FILE

Part I Tax

1	Additions to tax:		
a	Excess advance premium tax credit repayment. Attach Form 8962	1a	
b	Repayment of new clean vehicle credit(s) transferred to a registered dealer from Schedule A (Form 8936), Part II. Attach Form 8936 and Schedule A (Form 8936)	1b	
c	Repayment of previously owned clean vehicle credit(s) transferred to a registered dealer from Schedule A (Form 8936), Part IV. Attach Form 8936 and Schedule A (Form 8936)	1c	
d	Recapture of net EPE from Form 4255, line 2a, column (l)	1d	
e	Excessive payments (EP) from Form 4255. Check applicable box and enter amount. (i) ☐ Line 1a, column (n) (ii) ☐ Line 1c, column (n) (iii) ☐ Line 1d, column (n) (iv) ☐ Line 2a, column (n)	1e	
f	20% EP from Form 4255. Check applicable box and enter amount. See instructions. (i) ☐ Line 1a, column (o) (ii) ☐ Line 1c, column (o) (iii) ☐ Line 1d, column (o) (iv) ☐ Line 2a, column (o)	1f	
y	Other additions to tax (see instructions):	1y	
z	Add lines 1a through 1y	1z	
2	Alternative minimum tax. Attach Form 6251	2	
3	Add lines 1z and 2. Enter here and on Form 1040, 1040-SR, or 1040-NR, line 17	3	

This Section is all new in 2024

Part II Other Taxes

4	Self-employment tax. Attach Schedule SE	4	
5	Social security and Medicare tax on unreported tip income. Attach Form 4137	5	
6	Uncollected social security and Medicare tax on wages. Attach Form 8919	6	
7	Total additional social security and Medicare tax. Add lines 5 and 6	7	
8	Additional tax on IRAs or other tax-favored accounts. Attach Form 5329 if required. If not required, check here ☐	8	
9	Household employment taxes. Attach Schedule H	9	
10	Repayment of first-time homebuyer credit. Attach Form 5405 if required	10	
11	Additional Medicare Tax. Attach Form 8959	11	
12	Net investment income tax. Attach Form 8960	12	
13	Uncollected social security and Medicare or RRTA tax on tips or group-term life insurance from Form W-2, box 12	13	
14	Interest on tax due on installment income from the sale of certain residential lots and timeshares	14	
15	Interest on the deferred tax on gain from certain installment sales with a sales price over $150,000	15	
16	Recapture of low-income housing credit. Attach Form 8611	16	

(continued on page 2)

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Schedule 2 (Form 1040) 2024 Page 2

Part II Other Taxes *(continued)*

17	Other additional taxes:				
a	Recapture of other credits. List type, form number, and amount:	17a			
b	Recapture of federal mortgage subsidy, if you sold your home see instructions	17b			
c	Additional tax on HSA distributions. Attach Form 8889	17c			
d	Additional tax on an HSA because you didn't remain an eligible individual. Attach Form 8889	17d			
e	Additional tax on Archer MSA distributions. Attach Form 8853	17e			
f	Additional tax on Medicare Advantage MSA distributions. Attach Form 8853	17f			
g	Recapture of a charitable contribution deduction related to a fractional interest in tangible personal property	17g			
h	Income you received from a nonqualified deferred compensation plan that fails to meet the requirements of section 409A	17h			
i	Compensation you received from a nonqualified deferred compensation plan described in section 457A	17i			
j	Section 72(m)(5) excess benefits tax	17j			
k	Golden parachute payments	17k			
l	Tax on accumulation distribution of trusts	17l			
m	Excise tax on insider stock compensation from an expatriated corporation	17m			
n	Look-back interest under section 167(g) or 460(b) from Form 8697 or 8866	17n			
o	Tax on non-effectively connected income for any part of the year you were a nonresident alien from Form 1040-NR	17o			
p	Any interest from Form 8621, line 16f, relating to distributions from, and dispositions of, stock of a section 1291 fund	17p			
q	Any interest from Form 8621, line 24	17q			
z	Any other taxes. List type and amount:	17z			
18	Total additional taxes. Add lines 17a through 17z			18	
19	Recapture of net EPE from Form 4255, line 1d, column (l)			19	
20	Section 965 net tax liability installment from Form 965-A	20			
21	Add lines 4, 7 through 16, and 18. These are your **total other taxes**. Enter here and on Form 1040 or 1040-SR, line 23, or Form 1040-NR, line 23b			21	

TREASURY/IRS AND OMB USE ONLY DRAFT August 16, 2024 DO NOT FILE

No significant changes in 2024

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SCHEDULE 3 (Form 1040)
Department of the Treasury Internal Revenue Service

Additional Credits and Payments

Attach to Form 1040, 1040-SR, or 1040-NR.
Go to *www.irs.gov/Form1040* for instructions and the latest information.

OMB No. 1545-0074
2024
Attachment Sequence No. 03

Name(s) shown on Form 1040, 1040-SR, or 1040-NR | Your social security number

Part I Nonrefundable Credits

Line	Description		
1	Foreign tax credit. Attach Form 1116 if required		1
2	Credit for child and dependent care expenses from Form 2441, line 11. Attach Form 2441		2
3	Education credits from Form 8863, line 19		3
4	Retirement savings contributions credit. Attach Form 8880		4
5a	Residential clean energy credit from Form 5695, line 15		5a
b	Energy efficient home improvement credit from Form 5695, line 32		5b
6	Other nonrefundable credits:		
a	General business credit. Attach Form 3800	6a	
b	Credit for prior year minimum tax. Attach Form 8801	6b	
c	Adoption credit. Attach Form 8839	6c	
d	Credit for the elderly or disabled. Attach Schedule R	6d	
e	Reserved for future use	6e	
f	Clean vehicle credit. Attach Form 8936	6f	
g	Mortgage interest credit. Attach Form 8396	6g	
h	District of Columbia first-time homebuyer credit. Attach Form 8859	6h	
i	Qualified electric vehicle credit. Attach Form 8834	6i	
j	Alternative fuel vehicle refueling property credit. Attach Form 8911	6j	
k	Credit to holders of tax credit bonds. Attach Form 8912	6k	
l	Amount on Form 8978, line 14. See instructions	6l	
m	Credit for previously owned clean vehicles. Attach Form 8936	6m	
z	Other nonrefundable credits. List type and amount:	6z	
7	Total other nonrefundable credits. Add lines 6a through 6z		7
8	Add lines 1 through 4, 5a, 5b, and 7. Enter here and on Form 1040, 1040-SR, or 1040-NR, line 20		8

Part II Other Payments and Refundable Credits

Line	Description		
9	Net premium tax credit. Attach Form 8962		9
10	Amount paid with request for extension to file (see instructions)		10
11	Excess social security and tier 1 RRTA tax withheld		11
12	Credit for federal tax on fuels. Attach Form 4136		12
13	Other payments or refundable credits:		
a	Form 2439	13a	
b	Section 1341 credit for repayment of amounts included in income from earlier years	13b	
c	Net elective payment election amount from Form 3800, Part III, line 6, column (j)	13c	
d	Deferred amount of net 965 tax liability (see instructions)	13d	
z	Other refundable credits (see instructions):	13z	
14	Total other payments or refundable credits. Add lines 13a through 13z		14
15	Add lines 9 through 12 and 14. Enter here and on Form 1040, 1040-SR, or 1040-NR, line 31		15

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Consolidated into one page – most lines are the same as in 2023.

TaxSpeaker

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Credits

Individual federal tax credits apply against income and other taxes on the return. Credit may be either refundable or nonrefundable. Refundable credits first offset any income tax and then any remaining credit is refunded to the taxpayer. Nonrefundable credits may only be used against the current year tax balance. Any unused portion either expires immediately or carries forward to a future year depending upon the type of credit. Most individual tax credits are nonrefundable.

Refundable credits include:

- Credit for excess Social Security or Railroad Retirement tax withheld (Form 843)
- Child tax credit – partially refundable (Form 8812)
- Education (partial) credits (Form 8863)
- Earned income credit (Form 1040, Sch. EIC)
- Premium assistance credit (Form 8962)

Nonrefundable credits include:

- Adoption credit (Form 8839)
- Alternative motor vehicle credit (Form 8910)
- Alternative fuel vehicle refueling credit (Form 8911)
- Child and dependent care credit (Form 2441)
- Credits to holders of tax credit bonds (Form 8912)
- Disabled access credit (Form 8826)
- Foreign tax credit (Form 1116)
- Mortgage interest credit (Form 8396)
- Other dependent credit (Form 8812)
- Residential clean energy credit/Energy efficient home improvement credit (Form 5695)
- Retirement savings contributions credit (Form 8880)

Energy Efficient Home Credit (§25C)

The Inflation Reduction Act (IRA) modified the energy efficient home improvement credit for years after 2022, including increasing the annual credit up to $3,200. The credit amount is equal to 30% of the sum of amounts paid by the taxpayer for certain qualified expenditures, including: 1) qualified energy efficiency improvements, 2) residential energy property expenditures, and 3) home energy audits. There are limits on the allowable annual credit and on the amount of credit for certain types of qualified expenditures. The credit is nonrefundable and continues through 2032. Below, we've provided a summary of all the various rules, so you have them in one place.

Credit criteria. The credit breaks eligible expenses into 3 separate and distinct categories:

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1. **Qualified energy efficiency improvements (§25C(a)(1))** – includes building envelope components installed on a taxpayer residence and expected to last at least five years. This includes insulation materials, air sealing material, exterior windows and doors, and skylights (if certified by the manufacturer to qualify as an energy efficiency improvement). This property must be reasonably expected to last 5 years at the time of installation.

2. **Residential energy property expenditures (§25C(a)(2))** – includes heat pump water heaters, electric or gas heat pumps, central air conditioners, natural gas, propane or oil water heaters, and natural gas, propane or oil furnace or hot water boiler the meet the highest efficiency tier established by the Consortium for Energy Efficiency. Some biomass (wood) stoves or boilers used to heat a residence also qualify.

3. **Home energy audits (§25C(a)(3); Notice 2023-59).** The home energy audit must include an inspection and a written report for taxpayer's principal residence (as defined §121). The audit must identify the most significant and cost-effective energy efficiency improvements, including an estimate of the energy and cost savings for each improvement. It also must be conducted and prepared by a "qualified home energy auditor".

Additional documentation required beginning in 2025 (Notice 2024-13). Beginning January 1, 2025, taxpayers claiming the energy efficient home credit are required to provide a PIN for certain categories of products. Under this requirement, an item will only qualify for the energy efficient home improvement credit if the item is produced by a qualified manufacturer, and if the taxpayer includes the qualified PIN of the item on their tax return. The IRS plans to issue proposed regulations to provide guidance on how the PIN reporting is supposed to work. The IRS has requested comments from the tax community about the implementation of the PIN program. The proposed regulations will be issued after the IRS has reviewed the feedback. See Notice 2024-13 for additional detailed information.

Qualifying improvements. Qualifying costs must be made for a dwelling located in the U.S. and used as a residence by the taxpayer. For Residential Energy Property, the dwelling is ***not*** required to be the taxpayer's principal residence (§25C(d)(1)). The improvements must be made to an existing home, not to a newly constructed home. With some exceptions, the credit is effective for qualified improvements placed in service from January 1, 2023 through December 31, 2032.

Preparer note. The "residence" requirement allows Residential Energy Property improvements, unless otherwise stated, to be completed on a second or vacation home. The only requirement is that the taxpayer use the home as a residence, not as an investment or trade or business property. For example, these credits would not apply for a landlord who made improvements to a rental property.

That said, there is ***no ownership requirement***. A tenant who makes qualifying improvements to the home they live in, but don't own, would qualify for the credits.

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Homes used personally and for business. Taxpayers who use property solely for business purposes do not qualify for the credit. But taxpayers who use an otherwise qualified residence for business purposes no more than 20% (e.g., home office) may claim the full credit. Taxpayers who otherwise qualify for the credit, but whose use of the qualified property for business purposes exceeds 20%, the taxpayer is required to prorate the credit between business and the personal portions.

Other credit conditions include:

- The rate of the credit is 30%.

- The credit is generally limited to $1,200 ***annually***. but:

    - Exterior doors – 30% of costs up to $250 per door, maximum of $500;
    - Windows and skylights – 30% of costs up to $600; and
    - Other residential energy property – 30% of costs (including labor) up to $600. Includes:
        - Central air conditioners;
        - Natural gas, propane, or oil water heaters;
        - Natural gas, propane or oil furnaces and hot water boilers; and
        - Electric improvements.

    - Energy efficient (electric or natural gas) heat pumps, heat pump water heaters, biomass (wood) stoves and boilers – 30% of costs up to $2,000.

Preparer note. The $2,000 limit is in addition to the $1,200 overall limit for the other energy efficient improvements discussed above. Thus, the maximum annual credit would be $3,200.

- Home energy audits – 30% of cost up to a maximum of $150, which is included in the $1,200 overall limit.

Preparer note. Roofs (metal and asphalt) and ceiling fans no longer qualify for any credit.

- The property must be installed to claim the credit – paying in advance won't qualify.

Documentation required (Notice 2024-13). Starting in 2025, taxpayers claiming these credits will be required to provide a "product identification number" (PIN) with their return to document their home improvements qualify. The IRS issued Notice 2024-13 requesting comment on how this portion of the law should be implemented. The Notice was issued December 29, 2023 and the comment period ended February 24, 2024. Yep, not even two months to respond and right at the start of tax season. They really needed out help!

Credit is nonrefundable. The Energy Efficient Home credit is nonrefundable and **may not be carried forward to future years**. Basis is reduced by any credit claimed (§25C(g)).

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Example 1. All in 2024, Kai purchases and installs the following:

- Three exterior doors at a cost of $1,000 each
- Windows and skylights at a total cost of $2,200
- One central air conditioner at a cost of $5,000.

To calculate the credit, first the door credit is 30% x $1,000 ($300) x 3 = $900. However, the limit per door is $250 and the total door credit maximum is $500. The door credit is recalculated at 3 x $250 = $750, but the max is $500.

Next, 30% of the taxpayer's total $2,200 of expenditures for windows and skylights is $660, but the overall windows and skylights limit of $600 applies.

Finally, 30% of the taxpayer's $5,000 paid for the central air conditioner is $1,500, but the $600 per item limit for energy property applies, which limits the credit to $600.

Adding all these credit amounts added together gives Kai a total credit of $1,700 ($500 + $600 + $600). But there is an aggregate credit limit of $1,200 which caps what Kai may claim. His 2024 Energy Efficient Home credit is $1,200.

Planning pointer. If Kai in the previous example split the expenses between 2024 and 2025, he may have been able to increase his credit by $500 or more. For example, if Kai installed the new air conditioner in 2024, his 2024 credit would only have been reduced to $1,100, but he would then qualify for a full credit of $600 for the air conditioner in 2025. His total credit for the two years would be $1,700.

Example 2. Assume all the same facts as in Example 1 above, except that instead of purchasing the central air conditioner, Kai purchases and installs an electric heat pump for $5,000. In this case, 30% of the heat pump cost $1,500. Since the heat pump is in a category of energy property exempted from both the $600 per item limit and the $1,200 aggregate limit, Kai may claim a of $1,500 for the costs of the heat pump in addition to his Efficient Home Improvement Credit of $1,100 ($500 for the exterior doors + $600 for the windows and skylights). Kai's total credit is $2,600 ($1,500 + $1,100).

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Example 3. Assume all the same facts as in Example 1 except that instead of purchasing the central air conditioner, Kai purchases and installs an electric heat pump that costs $8,000. Also assume Kai spends $600 to have a qualified home energy audit prepared. Kai gets a credit of 30% of the home energy audit cost, but only to the $150 max. Adding this credit amount to the credit amounts for the doors, windows, and skylights makes the total credit $1,250, but the $1,200 aggregate limit applies so Kai gets $1,200.

For the electric heat pump, the credit is calculated at 30% x the $8,000 cost = $2,400. But the heat pump is subject to the separate $2,000 aggregate limit, which means the heat pump credit is cap0p0ed at $2,000.

Kai's total credit for 2024 is $3,200 ($1,200 + $2,000) for the doors, windows, skylights, and home energy audit and heat pump.

Guidance on Tax Treatment of Rebates for Energy Efficiency Property (Announcement 2024-19)

The Inflation Reduction Act included rebate programs for owners of residential property who purchase energy saving appliances for their homes. These programs are administered by the US Department of Energy and rebates are paid directly from retailers at the time of purchase. The IRS has clarified that individuals who receive these rebates are not required to report anything on their tax returns. Any rebates received are treated as a reduction of basis in the appliance, not as income for the recipient. Additionally, information reporting (e.g. Form 1099) is not required by the issuer of the rebate. Any amounts paid to a business (e.g. to a contractor) is taxable income for the business.

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Energy Efficient Home Credit Summary (§25C)				
30 % of Cost	Windows	Doors	Insulation	Total Energy Efficient Home Improvement Credit
Maximum Annual Credit	$600	$250 per door $500 total	$1,200	$1,200
Effective Period	2023 - 2032	2023 - 2032	2023 - 2032	2023 - 2032
Does labor qualify?	No	No	No	No
New construction qualify?	No	No	No	No
2nd home qualify?	No	No	No	No
Ownership requirement?	Yes	Yes	Yes	Yes
Rental home qualify?	No	No	No	No
Refundable?	No	No	No	No
Unused Carryover?	No	No	No	No
30 % of Cost	Central A/C	Natural gas, propane or propane water heaters or boilers	Panel board & electric upgrades	Electric or gas Heat Pumps & Heat Pump Water Heaters, Wood stoves & Wood boilers
Max Annual Credit	$600	$600	$600	$2,000
Effective Period	2023 - 2032	2023 - 2032	2023 - 2032	2023 - 2032
Does labor qualify?	Yes	Yes	Yes	Yes
New construction qualify?	No	No	No	No
2nd home qualify?	Yes	Yes	Yes	Yes
Ownership requirement?	No	No	No	No
Rental home qualify?	No	No	No	No
Refundable?	No	No	No	No
Unused Carryover?	No	No	No	No
Form	5695	5695	5695	5695
Note	Included in $1,200 limit	Included in $1,200 limit	Included in $1,200 limit	Up to $2,000 Additional Credit

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Residential Clean Energy Credit (§25D; IRS Fast Facts)

The residential clean energy property credit is a 30% credit for qualified residential energy efficient property. IRA extended the credit though 2034, modified the applicable credit rates, and added battery storage technology as an eligible expenditure. Qualified property includes installations on new **OR** existing homes that are used as a residence of the taxpayer (not only the primary residence).

Preparer note. The same rules for homes used personally and for business that were discussed above apply to the residential clean energy credit as well (i.e., business use less than 20% take full credit, business use more than 20% allocate). The big difference is that the residential clean energy credit is available on NEW or existing homes.

Applying the credit. The credit percentage rate phases down to 26% for property placed in service in 2033, 22% property placed in service in 2034, and no credit is available thereafter. The credit is equal to 30% of amounts paid for qualified:

- Solar electric (panels);
- Solar water heating (not to heat pool water);
- Fuel cell ($500 maximum for each ½ kilowatt of capacity);
- Small wind energy property;
- Geothermal energy generating systems; and
- Battery storage technology.

Storage systems qualify starting in 2023. Prior to IRA 2022, energy storage systems (batteries) did not qualify for the credit unless the storage system was paired with an energy generating system. Under the new rules, stand-alone energy storage systems also qualify for the credit. Batteries installed to store the electricity must be at the residence of the taxpayer and have at least 3 kilowatt hours of storage.

Other credit details. While there is no maximum credit, the credit is nonrefundable. Any ***unused credits are carried forward*** for use in future years. Expenses qualify when installation is completed or, in the case of a new home, when the taxpayer begins using the home. Basis is reduced by the credit amount.

Residential Clean Energy Credit Summary (§25D)			
Qualifying Property	**Credit Percentage**	**Maximum Credit**	**Excess Credit**
Solar electric	30% 2022 - 2032	No limit	Carried forward
Solar water heating	30% 2022 - 2032	No limit	Carried forward
Battery storage	30% 2022 - 2032	No limit	Carried forward
Fuel Cell	30% 2022 - 2032	$500 per ½ kilowatt	Carried forward
Wind energy	30% 2022 - 2032	No limit	Carried forward
Geothermal	30% 2022 - 2032	No limit	Carried forward

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IRS Provides Early Statistics for 2023 Tax Returns and Home Energy Credits (IR-2024-202)

The IRS reported that more than $6 billion of residential clean energy investments and more than $2 billion for energy efficient home improvements were claimed on 2023 personal tax returns filed through May 23, 2024. The data is summarized:

Residential and Energy Efficient Home Improvement Credit

Credit	Number of returns	Credit value
Residential Clean Energy Credit	1,246,440	Total: $6.3 billion, Average per return: $5,084
Rooftop solar	752,300	Up to 30% of cost
Batteries	48,840	Up to 30% of cost
Energy Efficient Home Improvement Credit	2,338,430	Total: $2.1 billion, Average per return: $882
Home insulation	669,440	Up to 30% of cost[c]
Windows and skylights	694,450	Up to 30% of cost or $600[c]
Central air conditioners	488,050	Up to 30% of cost or $600[c]
Doors	400,070	Up to 30% of cost, $250 per door, or $500 total
Heat pumps	267,780	Up to 30% of cost or $2,000
Heat pump water heaters	104,180	Up to 30% of cost or $2,000

IRS Warns Taxpayers of New Scams Targeting Energy Credits (IR-2024-182)

The IRS issued a news release describing instances where its seen tax return preparers misrepresenting the revised energy credit rules. The credit transferability provisions of IRA enable the purchase of eligible clean energy tax credits to offset a buyer's tax liability. The IRS has seen taxpayers file returns claiming purchased clean energy credits that the taxpayer is not entitled to claim. The scammers target Form 1040 filers where the credits are used to offset income tax from sources such as wages, retirement account withdrawals, etc. Most cases these purchased tax credits are subject to the passive activity rules, meaning they can only be used to offset income tax from a passive activity, which most taxpayers do not have.

Other credit related scams also on the IRS radar (FS-2024-24). The IRS also issued an alert (IR-2024-139) about a series of scams and inaccurate social media advice, which they claim led to thousands of inflated refund claims during the 2024 filing season. Specifically, the IRS noted questionable claims involving:

- Fuel Tax Credit (Form 4136).
- Sick and Family Leave Credit for Self Employed Individuals (Form 7202).
- Overstated withholding.

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- Schedule H, Household Employment Taxes including Qualified Sick Leave Wages.

The IRS promises extra scrutiny for returns claiming these items in the future.

Clean Vehicle (CV) Credit (§30D; TD 9995; Form 8936)

Newly revised clean vehicle (CV) credit began January 1, 2023. The nonrefundable New Clean Vehicle Credit applies to vehicles placed in service beginning Jan. 1, 2023, and continues through 2032. The maximum credit is $7,500.

Qualifying vehicle (Rev. Proc. 2024-26; Notice 2023-1; Notice 2023-16; Rev. Proc. 2023-33; IRS Fact Sheet FS-2024-14 - FAQs). To qualify for the credit, a vehicle must:

1. Be a new, not used, vehicle;
2. Have an MSRP under $80,000 for vans, SUVs, and trucks and under $55,000 for all other vehicles. The amount actually paid is irrelevant. Only the MSRP is considered;
3. Not be acquired for resale;
4. Have at least 4 wheels and is designed primarily for use on public streets;
5. Be powered by an electric motor which draws electricity from a battery with at least seven kilowatt hours of capacity;
6. Be capable of being recharged from an external power source;
7. Have a GVWR of less than 14,000 lbs; and
8. Final assembly occurs in North America (U.S., Canada, and Mexico) by a qualified manufacturer.

Preparer note. The credit is available for qualified plug-in hybrid vehicles if they fulfill all the requirements including a battery over seven kilowatts. Additionally, fuel cell vehicles also qualify if 1) the original use begins with the taxpayer, 2) the final assembly is in North America, and 3) the seller of the vehicle provides a qualifying report to the taxpayer and the IRS.

Qualified manufacturer (Rev. Proc. 2204-26). A qualified manufacturer is one that performs final assembly in North American for qualifying autos built after Aug. 16, 2022. The manufacturer must also enter into a written agreement with the IRS to file periodic reports with vehicle identification numbers (VINs) and other information for each vehicle they manufacture. Additionally, a qualified manufacturer ensures the auto's materials and "critical minerals" in the battery are sourced from the U.S. or a country with a free trade agreement with the US (starting in 2024). Taxpayers are allowed to rely on manufacturer's certification.

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Preparer note. There is a list of qualified manufacturers and qualified vehicles is available at www.fueleconomy.gov/newtaxcredit, a Department of Energy webpage.

The Department of Energy also has an online interactive VIN search that will provide specific build information for any vehicle for which you have a VIN. See this tool at:

https://afdc.energy.gov/laws/electric-vehicles-for-tax-credit

Qualifying taxpayer. Only taxpayers with modified AGI below $150,000 (single), $225,000 (HOH), and $300,000 (MFJ) qualify to claim the credit. For the AGI test, taxpayers may choose to use the current or the previous tax year's AGI. Taxpayers who claim the credit at the time of purchase with the dealer, and later fail to meet the AGI requirement, will have to recapture the excess credit on their tax return for that year and pay the credit back. Modified AGI includes AGI from the tax return plus foreign earned income and foreign housing exclusions.

Preparer note. This credit is non-refundable and may not be carried forward for personal use vehicles. The result was lower income taxpayers who purchased CVs would end up losing some or all the credit. This new option allows any taxpayer to benefit from the credit by claiming it at the point of purchase.

BUT, the credit is available for vehicles purchased for business use. In such cases, if the credit exceeds tax for the year of purchase, the taxpayer may include the excess credit in the general business carry forward (§30(c)(1)).

2-wheel and 3-wheel vehicle credit repealed. While previous law included credits for 2-wheel electric vehicles, the new law struck these provisions down. There currently are no credits for any 2- or 3-wheeled electric vehicles.

Qualified dealer required?(FS-2024-14). Beginning January 1, 2024, buyers will only be able to claim credits if the seller has registered with the IRS and successfully submits a seller report through IRS Energy Credits Online. This submission is done at the time of sale through IRS Energy Credits Online, and the seller must provide a copy of the successfully submitted seller report to the buyer. Dealers will submit seller reports electronically to the IRS. The IRS's acceptance of this seller report means a qualified manufacturer has submitted the VIN listed in the seller report to the IRS as an eligible vehicle. Eligible buyers can rely on a seller report that a seller has submitted electronically to the IRS, that the IRS has accepted, and that the seller has provided to the buyer, as confirmation that the vehicle is eligible.

Form 8936. The Clean Vehicle Credits are claimed on Form 8936.

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Summary of Qualifications for the Clean Vehicle Credit			
	2022		2023 - 2032
	Pre-8/16	Post 8/15	
Total # units sold by manufacturer	Yes	Yes	No
Final assembly in North America	No	Yes	Yes
Battery restrictions apply	No	No	Yes
Income limitations	No	No	Yes
Vehicle purchase price limit	No	No	Yes
Credit for business EVs*	No	No	Yes
Credit for leased vehicles	No	No	Yes
Credit is transferable	No	No	2024 & beyond
2 and 3 wheeled vehicles	Yes	Yes	No
* Note purchase price and income limits do not apply.			

Used Clean Vehicle (UCV) Credit (§25E; TD 9995; Form 8936)

IRA 2022 established a new credit for qualified buyers of used clean vehicles which is effective Jan. 1, 2023 through 2032. The credit equals the lesser of $4,000 or 30% of the purchase price of the qualified vehicle. Like the CV credit discussed above, this credit is limited based on the taxpayer's modified AGI. The modified AGI limits for 2023 are, in the current or previous year: $75,000 (single), $112,500 (HOH) and $150,000 (MFJ). Note that the AGI limits are much lower than they are for new CV credits. Modified AGI is calculated the same as it is for the CCV credit.

Qualifying UCV purchase. To qualify for the UCV credit:

- **Previously-owned clean vehicle** – is defined as a motor vehicle, the model year of which is at least 2 years earlier than the year of acquisition and the original use commenced with someone other than the taxpayer. The vehicle's GVRW is less than 14,000 pounds. The vehicle must meet all the requirements of §30D other than it being new.

- **Qualified sale** – means a sale of a motor vehicle by a dealer ***(no private party purchases)*** for a sale price which does not exceed $25,000. The transfer must also be the first ownership transfer since August 16, 2022, to a qualified buyer other than the person who originally purchased the vehicle.

- **Qualified buyer** – means an individual (who is not a dependent of another taxpayer) who purchases a qualified vehicle to use (not resell) and who has not been allowed a UCV credit for the 3-year period ending on the date of the purchase

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of the qualified vehicle. The individual must meet the AGI limitations discussed above.

> **Preparer note.** Notice 2023-33 makes it clear the used clean vehicle credit applies to an individual. Accordingly, it appears that each spouse in a joint return is allowed the credit. In other words, the "no UCV claimed in prior three years" rule would apply individually to each spouse, thus allowing each spouse their own three-year period.

- **VIN number requirement** – the vehicle identification number (VIN) is required to be reported in the buyer's tax return the year the credit is claimed.

Other UCV rules. Most other rules for the used clean vehicle credit follow the CV rules. Basis is required to be reduced by the amount of any credit received. The credit is effective started January 1, 2023 and continues through 2032.

Transferability of new and used clean vehicle credits (§30D(g); §25E(f); Rev. Proc. 2023-33). The new and used clean vehicle credits are nonrefundable and do not carry over to future years unless the vehicle is a business vehicle. The result is taxpayers who qualify for either credit, but for whatever reason do not have enough tax liability to absorb the entire credit would receive reduced, or potentially no, credit benefit. To avoid this situation, Congress provided that taxpayers may, instead of claiming the CV credits on her or his tax return, elect to transfer the credit to the dealer seller in exchange for a lower purchase price for the vehicle. This provision takes effect in 2024.

> **Preparer note.** Transfers of partial credits are not allowed. It is an all or nothing election.

IRS clarifies transfer rules (FS-2024-14). The IRS issued guidance to clarify how the CV credit transfer is completed. The transfer of either credit is initiated when the buyer elects to transfer the credit to an eligible vehicle dealer. These procedures apply to credit transfers beginning January 1, 2024. To facilitate the advance payments, the IRS created a CV credit portal for dealers to communicate and file credit claims with the IRS. At the time of sale, the dealer is required to provide the buyer with:

- The MSRP of the new clean vehicle or the sale price of the previously owned clean vehicle.
- The maximum amount of credit allowable and any other incentive available for the purchase of such vehicle.
- The amount provided by the dealer to you as a condition of you making the transfer election.
- The modified AGI limitations, as applicable.
- For previously owned clean vehicles, certification that:
    - The model year of the vehicle is at least two years prior to the calendar year of sale; and
    - That the transfer is the first transfer of the vehicle since Aug. 16, 2022, to a person other than the person with whom the original use of such vehicle commenced.

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Alternative Fuel Vehicle Refueling Property (AFVRP) Credit (§30C; Notice 2024-20)

This energy credit (AFVP credit) has been in the law off and on since 2006. The Inflation Reduction Act brought it back to life retroactively to January 1, 2022 through the end of 2032.

Changes to AFVRP credit in 2023 and beyond. The credit was originally 30% of the cost of the vehicle refueling property for individuals or businesses. IRA 2022 reduced the credit rate to 6% for businesses but increased the maximum credit to $100,000 (previously $30,000). The credit applies primarily to electric car charging devices.

Non-business credit is also available. Individuals are allowed to claim an AFVRP credit for 30% of the cost of adding AFVRP to their property. But the maximum credit for non-depreciable property (personal property) is only $1,000.

Census tract specific locations only (Notice 2024-20). The IRA added a requirement that qualified alternative fuel vehicle refueling property must be placed in service in an eligible census tract. An eligible census tract is any population census tract that is a low-income community as described in §45D(e) or that is not an urban area. Notice 2024-20 specifies how taxpayers can verify that a location satisfies the geographic requirements.

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Premium Assistance Credit (§36B; IRS FS-2024-30)

Summary of old law. The Affordable Care Act included tax credits to subsidize health insurance costs for qualified taxpayers who purchase health insurance through the Marketplace, a Federal or State-run website where health insurance is sold. Taxpayers who qualify may receive the tax credits in advance and use them as a direct offset to insurance costs. The amount of the subsidy varied depending on the taxpayer's AGI in relation to the Federal Poverty Level (FPL). For 2020 and before, the following chart summarizes the percentage of income a taxpayer is expected to spend on health insurance:

Applicable Percentage Table for Pre-2021 and Post-2025		
As a % of the Poverty Level	**Initial Premium %**	**Final Premium %**
Up 133%	2.07%	2.07%
133% to 150%	3.10%	4.14%
150% to 200%	4.14%	6.52%
200% to 250%	6.52%	8.33%
250% to 300%	8.33%	9.83%
300% to 400%	9.83%	9.83%

Example. Jordan purchased health insurance through the Marketplace in 2020. When he applied for the insurance Jordan estimated his annual income at $25,520, 200% of the FPL. Jordan's monthly health insurance premiums were $600, which was paid with a premium assistance credit of $461 per month ($5,532) and Jordan paid $139 a month (6.52% of his income). During 2020, Jordan received a raise at work, so his actual income was $31,900, 250% of the FPL. Jordan's actual premium assistance credit was $379 per month ($4,543). Jordan owed the IRS $989, difference between his estimated premium assistance credit and the actual credit, for premium assistance recapture when he filed his 2020 tax return.

Changes for years 2021 through 2025 (Notice 2024-35). ARPA 2021 changed the formulas used to calculate the premium assistance credits and the credit recapture to do two things:

1. Reduce or eliminate the premium assistance credit recapture; and
2. Allow more people to qualify for the premium assistance credit.

Applicable Percentage Table for 2021 and 2025		
As a % of the Poverty Level	**Initial Premium %**	**Final Premium %**
Up 150%	0%	0%
150% to 200%	0%	2.00%
200% to 250%	2.00%	4.00%
250% to 300%	4.00%	6.00%
300% to 400%	6.00%	8.50%
400% or higher	8.50%	8.50%

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2024 Federal Poverty Levels							
Family Size	**100% FPL**	**138% FPL**	**150% FPL**	**200% FPL**	**250% FPL**	**300% FPL**	**400% FPL**
1	$15,060	$20,783	$22,590	$30,120	$37,650	$45,180	$60,240
2	$20,440	$28,207	$30,660	$40,880	$51,100	$61,320	$81,760
3	$25,820	$35,632	$38,730	$51,640	$64,550	$77,460	$103,280
4	$31,200	$43,056	$46,800	$62,400	$78,000	$93,600	$124,800
5	$36,580	$50,480	$54,870	$73,160	$91,450	$109,740	$146,320
6	$41,960	$57,905	$62,940	$83,920	$104,900	$125,880	$167,840
7	$47,340	$65,329	$71,010	$94,680	$118,350	$142,020	$189,360
8	$52,720	$72,754	$79,080	$105,440	$131,800	$158,160	$210,880

Example using new table. Jordan purchased health insurance through the Marketplace in 2024. When he applied for the insurance Jordan estimated his annual income at $30,120, 200% of the FPL. Jordan's monthly health insurance premiums were $805, which was paid with a premium assistance credit of $755 per month ($9,060) and Jordan paid $50 a month (2% of his income). During 2024, Jordan received a raise at work, so his actual 2024 AGI was $37,650, 250% of the FPL. Jordan's actual premium assistance credit was $679 per month ($8,154 total). Jordan owed the IRS $904, difference between his estimated premium assistance credit and the actual credit, for premium assistance recapture when he files his 2024 tax return.

Preparer note. For 2021 through 2025, the 400% of AGI premium assistance cliff no longer exists. Taxpayers who receive premium assistance credits and whose AGI is greater than 400% of AGI are required to pay 8.5% of their income towards their health insurance premiums. Anything over 8.5% of AGI that is needed to cover the cost of the health insurance is paid via premium assistance credits. There is no longer an overall income limit.

Example – variation. Assume the same facts as in the previous example except Jordan got a new job that increased his 2024 AGI to $65,000, well more than 400% of the FPL. Prior to 2021, if Jordan's AGI exceeded 400% of the poverty level he would have been ineligible for a PAC and he would have been required to pay back any advance credit he received. But, for 2021 through 2025, Jordan is only required to pay $5,525 (8.5% x his $65,000 income) for his health insurance. As his insurance cost was $9,660, he would still qualify for a PAC of $4,135 ($9,660 total premiums less his $5,525 share of cost). The fact that Jordan's AGI is more than 400% of the FPL is no longer relevant.

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Premium Assistance Credit (PAC) – Planning Note (Form 8962 Instructions)

Occasionally a taxpayer may purchase health insurance through the Marketplace that covers two (or more) adults who file separate tax returns. This situation is most common where a non-dependent child is still receiving health insurance coverage on the parent(s)' health plan. This situation allows a unique planning opportunity for the taxpayers.

Allocation allowed in any fashion taxpayers agree to. Under the rules in this section, the taxpayers may agree to allocate the premiums and any related PAC between the taxpayers. The on any allocation of the policy amounts. Taxpayers may use the same percentages for each month during the year, or they may agree on different percentages for different months. Essentially, almost anything goes if the allocations are consistent across all aspects of the policy (i.e., taxpayer share of costs, advance premium assistance credit, etc.).

Example. Anna is 55 years old and earned $65,000 in 2024. Anna's son, Justin, is 23 years old and earned $21,000 in 2023. Justin is not a full-time student at any time in 2024 and Anna does not claim him on her tax return.

Anna purchased her health insurance through the Marketplace and Justin was included in the policy. When Anna originally signed up through the Marketplace, she estimated her income at $35,000, which qualified her for a 2024 advance PAC of $12,324. The significant increase in Anna's income was due to a one-time taxable payment from her ex-husband's pension.

When Anna prepared her 2024 tax return, she calculated she owed a PAC recapture of $4,020. Using the rules for allocation, Anna and Justin decided to report 100% of the advance PAC and related health coverage on Justin's return instead of Anna's. As a result, Justin's 2024 PAC is $13,797, $1,473 more than the advance PAC Anna already received. This additional credit is refundable on Justin's return and Anna doesn't owe anything to the Marketplace. Win – win for sure!

Author note - Pushback on this example. I first put this example in the book in 2023 and since then I've received some push back from some who've attended my class. The question being raised is that the Federal Poverty Level and the related percentage of income payment requirement is based on "household income". Therefore, if an adult, non-dependent child is still living at home, his or her income must be included in the calculation of household income, meaning the parent(s) and the non-dependent child(ren)'s income would both need to be included to properly calculate household income. In the Anna and Justin example above, each of them would have to claim AGI of $86,000 ($65,000 from Anna plus $21,000 from Justin).

Household income defined (§1.36B-1(d) and (e)). Household income is the sum of the taxpayer's modified AGI plus the aggregate modified AGI all other individuals who are included in the "taxpayer's family" and are required to file a return. The "taxpayer's family" means **individuals the taxpayer properly claims a personal exemption deduction**

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under §151. The IRS Form 8962 instructions reflect these regulations where they explicitly state:

"Household income. For purposes of the PTC, household income is the modified adjusted gross income (modified AGI) of you and your spouse (if filing a joint return) plus the modified AGI of each individual ***whom you claim as a dependent*** (emphasis added) and who is required to file an income tax return."

While there is no dependent deductions currently available, the definition of a dependent is still used where applicable in the tax law. This certainly includes the PAC calculations and the related household income.

Other Planning Opportunities Revolving Around PAC, Savers Credits and IRAs.

We have noticed additional planning opportunities for taxpayers due to the interaction of the tax rates, PACs, Savers Credits and a few other items. This is best illustrated by a couple examples form the author's office for 2023.

Example 1. Taxpayer is a 60-year-old single woman who has a part-time job, a small side business, some interest income and dividends. She uses the standard deduction.

When we completed her return, we initially assumed that due to her relatively low income and low tax rates there was no way she'd want to contribute to an IRA. However, we ran her return both ways and were very surprised to learn she would save $2,835 (40.5%) if she contributed $7,000 to her IRA. The large change was due to a reduction in taxable Social Security and an increase in her PAC ($1,123), a Retirement Savings Credit ($200), and a tax reduction ($1,512). She found a way to fund the IRA!

Description	Without IRA	With IRA
Income		
Wages	$ 17,079	$ 17,079
Interest and dividends	$ 11,223	$ 11,223
Taxable Social Security	$ 9,587	$ 3,993
Business income	$ 349	$ 349
Total income	$ 38,238	$ 32,644
Adjustments to income		
IRA	($ - 0 -)	($ 7,000)
Adjusted gross income	$ 38,238	$ 25,644
Standard deduction	($ 13,850)	($ 13,850)
Taxable income	$ 24,388	$ 11,794
Tax before credits	$ 2,687	$ 1,175
Credits		
Retirement savings credit	($ - 0 -)	($ 200)
Premium assistance credit – (additional) or repayment	$ 1,019	($ 104)
Tax after credits	$ 3,706	$ 871

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Example 2. Taxpayers are a relatively high income married couple who use the standard deduction. Both are retired but the husband received a final payment from his former job which was reported as wages of $5,500.

While preparing the return we noted the taxpayer was eligible to make a deductible IRA contribution of up to $5,500 as he was no longer an active participant in his former employer's pension plan. The IRA contribution lowered his AGI, which not only reduced their taxable income, but it also reduced the excess Premium Assistance credit and the NII tax. The total Federal tax savings was $1,575 (28.7% of the IRA contribution).

Description	**Without IRA**	**With IRA**
Income		
Wages	$ 5,500	$ 5,500
Interest and dividends	$ 54,799	$ 54,799
Pension	$154,513	$154,513
Taxable Social Security	$ 10,185	$ 10,185
Rents,	$ 38,731	$ 38,731
Total income	$263,728	$263,728
Adjustments to income		
IRA	($ - 0 -)	($ 5,500)
Other AGI adjustments	($ 1,083)	($ 1,083)
Adjusted gross income	$262,645	$257,145
Standard deduction	($ 29,200)	($ 29,200)
QBI Deduction	($ 7,728)	($ 7,728)
Taxable income	$225,717	$220,217
Tax before other taxes	$ 36,440	$ 35,230
NII tax	$ 481	$ 272
Total tax before credits	$ 36,921	$ 35,502
Credits		
General business credit	($ 80)	($ 80)
Premium assistance credit – repayment	$ 2,108	$ 1,952
Tax after credits	$ 38,949	$ 37,374

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Savers Match Credit (§25B)

Credit for IRA and pension contributions often overlooked (§25B). Taxpayers who meet required AGI thresholds are allowed a credit of 10% to 50% (based on a sliding AGI scale) of contributions to IRAs and retirement plans, including Roth IRAs. The maximum credit is $1,000 ($2,000 contribution x 50%) per person ($2,000 for MFJ returns). To qualify:

- The taxpayer must be at least 18 and not a full-time student.
- The taxpayer cannot qualify as a dependent by another taxpayer.
- The taxpayer's 2024 AGI must be under $73,000 for MFJ, $54,750 for head of house or $36,500 for single or MFS.
- Contributions must be made to traditional or Roth IRAs, 401k, 403b, 457, SIMPLE, or SARSEP plans.

The credit is non-refundable and is calculated and reported on Form 8880.

2024 Saver's Credit			
Credit Rate	**Married Filing Jointly**	**Head of Household**	**All Other Filers***
50% of your contribution	AGI not more than $46,000	AGI not more than $34,500	AGI not more than $23,000
20% of your contribution	$46,001 - $50,000	$34,501 - $37,500	$23,001 - $25,000
10% of your contribution	$50,001- $76,500	$37,501 - $57,375	$25,001 - $38,250
0% of your contribution	more than $76,500	more than $57,375	more than $38,250

Example. James was laid off from his job at the end of 2023 leaving Cheri, his spouse, the sole family earner. At the end of 2024 the couple's only taxable income is Cheri's $40,000 W-2. James and Cheri have some extra cash in savings from the severance payment James received last year and are considering making a Roth IRA contribution.

Based on James and Cheri's AGI, they would qualify for a saver's credit of 50% their IRA contributions. If they both deposit $2,000 into their own IRA, they will each receive a $1,000 credit (the maximum) for a $2,000 total. If instead they contributed $4,000 to Cheri's IRA and nothing for James, the credit would only be $1,000. Also note there is no tax benefit to contributing more than $2,000 each as the credit is maxed out at $1,000.

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Secure Act 2.0 makes big changes to Savers Credit (§6433; Notice 2024-65). Congress has been disappointed with the lack of participation in the Savers Match Credit since its inception in 2001. In response, Secure Act 2.0 repeals the Savers Match Credit (§25B) after 2026, and reinstates the credit as significantly revamped under §6433. Highlights of the new Saver's Match Credit include:

1. The maximum credit is $2,000.

2. Credit equals up to 50% of the amount a taxpayer contributes to an IRA or pension plan.

3. The 50% credit phased out as a taxpayer's AGI exceeds:

    - MFJ and surviving spouse - $41,000 and the phase out range is $30,000 (i.e., no credit is allowed for a MFJ taxpayer once AGI exceeds $71,000).

    - Single and MFS - $20,500 and phase out range is $15,000.

    - HOH - $30,750 and phase out range is $22,500.

4. Credits more than $99 may only be made as a matching contribution to an IRA or retirement plan. Amounts less than $100 may be treated as a tax credit on the taxpayer's return.

Any credit payment subsequently withdrawn will be subject to penalties including repayment of the contribution to the IRS.

IRS requests comments (Notice 2024-65). The newly revised Saver's Match contributions significantly changes the approach to promoting retirement savings. In an effort to ensure a successful rollout of the new rules, the IRS is seeking comments across a variety of topics, including:

A. Saver's Match Credit eligibility.

B. Claiming the Saver's Match Credit.

C. Designating the destination for the Saver's Match contributions.

D. Recovery Tax on specified early distributions.

E. Reporting and disclosures.

F. Other miscellaneous issues.

Comments are due by November 4, 2024, but will be considered as long as there is no delay in the issuance of related guidance.

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Other Taxes

Net Investment Income Tax (NII Tax)

The 3.8% net investment income surtax is a 3.8% surtax on a filer's income from sources like interest, dividends and capital gains that applies if adjusted gross income, or AGI, is above $200,000 for most single filers or $250,000 for most married couples. It affects one-time spikes as well as recurring income, so taxpayers who typically earn less can owe it on a windfall.

When lawmakers enacted it to help fund the Obamacare health-coverage expansion, they chose not to adjust the $200,000/$250,000 thresholds for inflation to collect more tax.

As a result, NIIT revenue has more than tripled since the tax took effect in 2013, rising from $16 billion to more than $60 billion in 2021, according to the Internal Revenue Service's latest data. Over that period the number of taxpayers owing it more than doubled, from about 3 million to about 7 million. Had the $200,000/$250,000 thresholds been inflation indexed, the thresholds would be closer to $264,000 and $330,000.

Surtax Guide SELECTED Business Items			
Type of Income	**Subject to .9% Medicare Tax**	**Subject to 3.8% NII Tax**	**Exempt from both surtaxes**
Capital Gains: 1231 gains from active business			X
C Corp Dividends-Closely Held, even if actively involved		X	
C Corp Stock Sale-Closely Held, even if actively involved		X	
Dividends-Qualified or Not		X	
Expense reimbursements-Accountable Plan			X
Fringe Benefits-Qualified			X
Guaranteed Payments	X		
Installment sales-current or deferred portion *if active and either RE professional, S Corp or 1065 when sold*			X
Interest Income		X	
Interest income on company accounts receivable			X
Partnership K-1 Income-Actively Involved	X		
Partnership K-1 Income-Passive		X	
Real estate professional income			X
Rental Income-Normal		X	
S Corporation K-1 income-actively involved			X
S Corporation K-1 income-passive		X	
Sale of active S corp stock or partnership/LLC interest			X
Self-Rental Income			X
Self-Charged Interest Income			X
Self-Employment Income	X		

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Investors, Landlords, and K-1s – Sch. D and Sch. E

Sales and Capital Gains

Schedule D is used to summarize the net transactions of capital asset sale details reported on other forms. It is used to report:

- Flow through items from other forms:

    a. Form 4797 – Sales of Business Property
    b. Form 6252 – Installment Sale Income
    c. Form 8949 – Sales and Other Dispositions of Capital Assets
    d. Form 1099-DA – Digital Asset Proceeds from Broker Transactions

Asset sales that are not reported on Schedule D via Form 8949 include:

1. Business equipment sales, (reported on Form 4797)
2. Rental property sales, (reported on Form 4797)
3. Assets sold inside of retirement plans, (not reported)
4. Inventory sales (reported on business schedule)
5. Gifts to individuals (reported on Form 709)

Capital asset defined (§1221). The Code defines capital assets as generally everything owned by the taxpayer for personal, pleasure, business or investment purposes including:

- Stocks, bonds, mutual funds (Investment).
- Personal and secondary residences and furnishings.
- Vehicles and personal property.
- Coins, stamps, jewelry, gems, gold, silver, paintings, sculptures (collectibles).
- Gains and losses on investment assets are taxable or deductible.
- Gains on personal and pleasure assets are taxable but losses are not deductible.

The Code (**§1221**) further defines capital assets by listing what are NOT capital assets (i.e., ordinary income on sale):

- Inventory for resale, including homes bought to flip, mobile homes and cars on “buy here, pay here” car lots).
- Personally, created copyrights, musical or artistic compositions.
- Depreciable business property.
- Business accounts and notes receivable.

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Schedule D Review

Short term capital gains are taxed as ordinary income tax rates. While the TCJA retained the 0%, 15% and 20% long term capital gain rates for 2018 through 2025, these rates have their own brackets that are ***not*** tied to the ordinary income brackets. Below are the brackets for long-term capital gains and qualified dividends. Those with AGI more than $250,000 ($200,000 for unmarried taxpayers), pay an additional tax of 3.8% on nonbusiness capital gains.

2024 Capital Gain Tax Brackets*			
Filing Status	**0%**	**15%**	**20%**
Single	**$0 - $47,025**	**$47,026 - $518,900**	**$518,901 or more**
HOH	**$0 - $63,000**	**$63,001 - $551,350**	**$551,351 or more**
MFJ	**$0 - $94,050**	**$94,051 - $583,750**	**$583,751 or more**
MFS	**$0 - $47,025**	**$47,026 - $291,850**	**$291,851 or more**
Estates/trusts	**$0 - $3,150**	**$3,151 - $15,450**	**$15,451 or more**
*** Gains for those with AGI in excess of $250,000 (MFJ), $200,000 (single, HOH), are generally subject to the additional 3.8% NII tax**			

5 Capital Gain Planning Ideas

1. Consider effects of rate brackets and surtaxes and installment sales.

2. A 1031 exchange without tax may not be the wisest move this year – consider selling the asset and lock in a 0 – 15% capital gains rate, buy the new asset with the new basis and the client receives a stepped-up depreciation basis with a lock-in of the current low capital gains tax rates.

3. Accelerate (maybe discount) installment sales to lock in the current low rates.

4. Utilize the 0% capital gain rate for lower income taxpayers. Coordinate with §179, bonus deprecation and other discretionary deductions.

5. Sell appreciating stock now, lock in the low rates, and re-purchase the same stock. The wash sale rules do not apply to gains!

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Planning pointer. For clients who are supporting or helping support aged parents, transferring stock to the parent for the parent's sale can capture the 0% rate. But watch to make sure it doesn't make Social Security taxable.

Retirees with invested assets may also wish to investigate the sale of capital gains assets to benefit from the 0% rate, again keeping in mind social security and Medicaid.

Where to Report Sales		
Type of Sale	**Form 8949**	**Form 4797**
Stocks & Bonds	X	
§1244 qualifying stock losses		X
Personal assets	X	
Personal involuntary conversions (not casualty)	X	
Nonbusiness bad debts	X	
Personal residence sales	X	
Business bad debts		X
Business property		X
Digital asset sales	X	
Oil, gas & mineral property		X
Business involuntary conversions (not casualty)		X
Flow through 1231 items from K-1		X
Section 179 recapture		X
Depreciable property		X
Capital gain distributions	On Sch. D directly	
Stock sales where both cost and sales price are reported to IRS and there are no basis adjustments	On Sch. D directly	

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Basis & Holding Periods

Type of Acquisition:	Basis	Holding Period
Gift	Lesser of donor's basis plus gift tax ***or*** FMV (if sold at gain use donor's basis, if sold at loss use lesser of donor's basis or FMV)	Donor's holding period unless valued at FMV then use gift date
Inheritance	FMV date of death or alternate valuation date	Always long term-of sold show acquisition date as "inherited"
Inherited by spouse in joint tenant state	½ of cost basis plus ½ of FMV at date of death (but use full estate tax value for property purchased by decedent before 1977)	Same as above on inherited value
Divorce	Transferor's basis	Transferor's holding period

I. Purpose and Use of Form 4797

A. To report the sale or exchange of business assets under §1231 and its related subsections.

1. Form 4797 is used rather than Schedule D because of several differences between the sale of personal assets reported on Schedule D and the sale of business assets, primarily:

a. **The sale of business assets at a profit gives rise to capital gains**, as with personal assets, but some portion of the profit may be recaptured at ordinary or other income tax rates.

1. If the §1231 asset is held less than 1 year (2 years for horses and cattle) any gains are ordinary, not capital.

b. **The sale of business assets at a loss gives rise to ordinary loss** deductions without regard to the $3,000 annual capital loss limit applied to personal assets.

B. Business assets fall under §1231, which has many subsections (§1245, §1250, §1252 and §1254) with different rules.

1. §1231 includes the following activities:

a. Sales or exchanges of real or depreciable property used in a trade or business and held for more than 1 year.

b. Cutting of timber if the special election was made.

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c. Disposal of timber, coal, or iron ore under special rules [§631(c)]

d. Sale or exchange of cattle and horses used in a trade or business for draft, breeding, dairy, or sporting purposes and held for 24 months or more from acquisition date.

e. Sales or exchanges of livestock other than cattle and horses, regardless of age, used in a trade or business for draft, breeding, dairy, or sporting purposes and held for 12 months or more from acquisition date.

   1. Livestock does not include poultry, chickens, turkeys, pigeons, geese, other birds, fish, frogs, politicians, or other reptiles, etc.

f. Sales or exchanges of unharvested crops

g. Involuntary conversions of trade or business property or capital assets are held for more than 1 year in connection with a trade or business, or a transaction entered for profit.

2. §1231 does not include inventory.

3. §1245 property includes all personal property, as well as certain types of real property, subject to an allowance for depreciation, amortization, or special first-year expensing including:

   a. §197 intangible asset (goodwill, customer lists, etc.) that is subject to amortization [§197(f)(7)]

   b. Other intangible assets such as patents, inventions, copyrights, models or designs, contracts, recordings, non-compete agreements films or tapes, etc.

   c. Poultry, racehorses, cattle, hogs, sheep, goats, horses, as well as mink and other fur bearing animals.

   d. Drain tile (Rev. Rul. 83-13*)*

   e. Single purpose agricultural structures [§1245 (a)(3)(D)]

   f. Any other property eligible for §179 deductions

   g. Any property on which a deduction for the disabled access barrier removal cost was taken.

   h. Commercial real property placed in service between 1981 and 1986 on which an accelerated depreciation method was used.

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1. Note that this rule does not apply to residential real property placed in service during this period.

2. Further note that, as §1245 property, all depreciation is recaptured as ordinary income in the year of sale. **Watch out for this tax trap on installment sales of older buildings**!

4. §1250 property generally includes all real property subject to the allowance for depreciation.

5. §1252 property is farmland on which conservation expenses (§175) had been deducted and owned less than 10 years.

6. §1254 property is oil, gas, or geothermal property.

7. §1255 property is farmland on which exempt cost sharing payments were received.

C. Recapture rules

1. The table below summarizes the depreciation recapture rules. In general, any gain over and above depreciation is subject to capital gains rates, and any loss is deductible in full.

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Form 4797 Recapture Rules

Type of Property and Code Section	Recapture all depreciation in full in year of sale as ordinary income	Recapture excess depreciation over straight-line in full in year of sale	Recapture straight-line depreciation ratably as payments are received at 25% maximum rate	Notes
Personal Property §1245	X			Watch the tax trap on installment sales
Real Property §1250		X	X	Generally taxed at a 25% maximum rate, rare sales may include excess depreciation
Farmland Conservation §1252	X			Only a percentage is recaptured based on a 10-year recapture period
Oil & Gas §1254	X			
Farmland Cost Sharing Payments §1255	X			Only a percentage is recaptured based on a 20-year recapture period

2. Generally, an asset sale triggers recapture. Several additional actions may also trigger recapture.

    a. A gift of property with a mortgage more than its adjusted basis is a taxable disposition for recapture purposes.

    b. The Tax Court has held that a third party's assumption of a partner's share of partnership liabilities triggers recapture.

3. A tax-free like-kind exchange generally does not trigger recapture if the exchange meets the like-kind requirements (§1031).

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a. However, if the exchange is partially taxable to the extent of boot, the boot is taxable as ordinary income to the extent of recapture and capital gain for any excess.

b. If depreciable real property is exchanged for non-depreciable real property and the deferred gain exceeds the FMV of the new property, then recapture is triggered [§1250(d)(4)(A)].

4. An involuntary conversion generally does not trigger recapture if replaced in the specified amount of time.

5. A transfer of property at death forgives all recapture amounts.

   a. If, at the date of death, payment had not been received for property sold prior to death, the recapture provisions may apply to payments received for that property. This is because the exception for transfers at death does not include gain from income in respect of a decedent.

6. When both §§1245 and 1250 property are disposed of in the same transaction, the amount realized is allocated to both types of property in proportion to their respective market values [Reg. §1.1250-1(a)(6)].

7. The recapture amount can never exceed the total gain on disposition.

8. §1245 recapture amounts are taxed in full as ordinary income (to the extent of depreciation allowed or allowable) **in the year of sale**.

9. Amounts recaptured as ordinary income are added to basis in installment sales to reduce future capital gains income while recording current year ordinary income.

Example 1 of §1245 Installment Sale
Worksheets courtesy of www.TaxTools.com

Ernie owns equipment with an original cost of $200,000 and $50,000 of accumulated depreciation ($150,000 basis). He sells the equipment on installment for $300,000 ($150,000 gain), payable in 6 annual payments of $50,000 (plus interest) beginning 7/1/24. 50% of all payments represent profit and 50% is a return of basis.

Date	Payment Amount	Ordinary Income	Capital Gain
7/1/24	$50,000	$50,000	$16,667
7/1/25	$50,000	0	$16,667
7/1/26	$50,000	0	$16,667
7/1/27	$50,000	0	$16,667
7/1/28	$50,000	0	$16,667
7/1/29	$50,000	0	$16,667
Total	$300,000	$50,000	$100,000

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Name: Ernie ID#: 123-45-6789

Year: 2024

Property Description: Personal Property

Date Acquired: 01/10/2021 Date Sold: 07/01/2024

Line				
1. Gross Sales Price			$	300,000
2. Mortgages Buyer Assumed	$			
3. Subtract line 2 from line 1	$	300,000		
4. Cost or Basis of Property Sold	$	200,000		
5. Depreciation Allowed or Allowable	$	50,000		
6. Adjusted Basis. Subtract line 5 from line 4	$	150,000		
7. Expenses of Sale	$			
8. Ordinary Income Recaptured in 2024	$	50,000		
9. Add lines 6, 7 and 8			$	200,000
10. Realized Gain. Subtract line 9 from line 1			$	100,000
11. Excluded or Deferred Gain			$	
12. Gross Profit. Subtract line 11 from line 10			$	100,000
13. Excess Mortgage Over Basis. Subtract line 9 from line 2			$	0
14. Contract Price. Add line 3 and line 13			$	300,000
15. Gross Profit Percentage. Divide line 12 by line 14				33.33%
16. For Year of Sale, Excess Mortgage Over Basis from line 13			$	0
17. Payments Received for 2024			$	50,000
18. Add line 16 and line 17			$	50,000
19. Payments Received in Prior Years	$			
20. Installment Sale Income for 2024 . Multiply ln 18 by ln 15			$	16,665

The amount on line 20 can be reported in the following places:
- -Capital gain to Sch D.
- -Sec 1231 gain to Form 4797.
- -Sec 1252, 1254 & 1255 ordinary income recapture to Form 4797.
- -Sec 1245 & 1250 ordinary income recapture from sales before 6/8/84 to Form 4797.

21. Ordinary Income for 2024 from line 8 . . . . $ 50,000

The amount on line 21 should be reported as follows:
- -Sec 179, 1245 & 1250 ordinary income recapture to Form 4797.

22. Total Income Reported for 2024 . Add line 20 and 21 . . . . $ 66,665

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Example 2 of §1245 Installment Sale
(analysis below – CFS Tax Tools)

Ernie owns equipment with an original cost of $200,000 and $80,000 of accumulated depreciation ($120,000 basis). He sells the equipment on installment for $300,000 ($180,000 gain), payable in 6 annual payments of $50,000 (plus interest) beginning 7/1/24. 60% of all payments represent profit and 40% is a return of basis; however, for tax purposes, all ordinary income is recognized in the year of sale, basis is increased for the installment by the ordinary income portion, and payments are recalculated as paid on the new gain.

Date	Payment Amount	Ordinary Income	Capital Gain
7/1/24	$50,000	$80,000	$16,667
7/1/25	$50,000	0	$16,667
7/1/26	$50,000	0	$16,667
7/1/27	$50,000	0	$16,667
7/1/28	$50,000	0	$16,667
7/1/29	$50,000	0	$16,667
Total	$300,000	$80,000	$100,000

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Name: Ernie ID#: 123-45-6789

Year: 2024

Property Description: Personal Property

Date Acquired: 01/10/2021 Date Sold: 07/01/2024

Line				
1. Gross Sales Price			$	300,000
2. Mortgages Buyer Assumed	$			
3. Subtract line 2 from line 1	$	300,000		
4. Cost or Basis of Property Sold	$	200,000		
5. Depreciation Allowed or Allowable	$	80,000		
6. Adjusted Basis. Subtract line 5 from line 4	$	120,000		
7. Expenses of Sale	$			
8. Ordinary Income Recaptured in 2024	$	80,000		
9. Add lines 6, 7 and 8			$	200,000
10. Realized Gain. Subtract line 9 from line 1			$	100,000
11. Excluded or Deferred Gain			$	
12. Gross Profit. Subtract line 11 from line 10			$	100,000
13. Excess Mortgage Over Basis. Subtract line 9 from line 2			$	0
14. Contract Price. Add line 3 and line 13			$	300,000
15. Gross Profit Percentage. Divide line 12 by line 14				33.33%
16. For Year of Sale, Excess Mortgage Over Basis from line 13			$	0
17. Payments Received for 2024			$	50,000
18. Add line 16 and line 17			$	50,000
19. Payments Received in Prior Years	$			
20. Installment Sale Income for 2024 . Multiply ln 18 by ln 15			$	16,665

The amount on line 20 can be reported in the following places:
- -Capital gain to Sch D.
- -Sec 1231 gain to Form 4797.
- -Sec 1252, 1254 & 1255 ordinary income recapture to Form 4797.
- -Sec 1245 & 1250 ordinary income recapture from sales before 6/8/84 to Form 4797.

21. Ordinary Income for 2024 from line 8	$	80,000

The amount on line 21 should be reported as follows:
- -Sec 179, 1245 & 1250 ordinary income recapture to Form 4797.

22. Total Income Reported for 2024 . Add line 20 and 21	$	96,665

10. Real estate recapture amounts are taxed in three ways (§1250):

    a. Depreciation more than straight-line amounts is taxed as ordinary income, in full, in the year of sale as §1250 recapture. (**Note: After 2012 it is impossible in most situations to have excess depreciation because the excess ACRS rates have all now exceeded their assigned lives.)**

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b. Any other depreciation is taxed at ordinary tax rates limited to a maximum 25% rate as §1250 gain, not as recapture income.

c. All other gains are taxed at capital gain rates.

In an installment sale, all the ordinary rate recapture is taxed in full in the year of sale. Additional recapture amounts taxed at a maximum 25% rate are taxed as payments are received, and any remaining gain taxed at capital gains rates is also taxed as payments are received, but after all other gain amounts have been recorded.

Example of §1250 Installment Sale

Ernie owns a building with an original cost of $200,000 and $80,000 of accumulated depreciation ($120,000 basis).

He sells the building on installment for $300,000 ($180,000 gain), payable in 6 annual payments of $50,000 (plus interest) beginning 7/1/23. 60% of all principal payments represent profit and 40% represent a return of basis.

Date	Payment Amount	Ordinary Income	25% Income	Capital Gain
7/1/23	$50,000	0	$30,000	$0
7/1/22	$50,000	0	$30,000	$0
7/1/24	$50,000	0	$20,000	$10,000
7/1/25	$50,000	0	0	$30,000
7/1/26	$50,000	0	0	$30,000
7/1/27	$50,000	0	0	$30,000
Total	$300,000	$0	$80,000	$100,000

11. §1252 Conservation expense recapture on farmland

a. These rules require a recapture of conservation expenses deducted on farm returns if the land is sold within 10 years of purchase **(Note: This is not the same as within 10 years of taking a conservation expense deduction).**

b. This is the reason why conservation expenses must be entered into depreciation schedules and then expensed as conservation expenses to keep track for recapture purposes.

c. This rule does not apply in the event of gift or transfer at death.

d. Ordinary income is the lesser of the:

1. Entire gain, or

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2. Total deductions allowed for soil and water conservation expenses are multiplied by the applicable percentage.

   a. The applicable percentage in the first 5 years of ownership is 100%, in years 6-9 the percentage amount is reduced by 20% each year after the 5th year. If the land is disposed of 10 or more years after purchase, then the entire gain is capital.

Example: Bert acquired farmland on January 19, 2016. On October 3, 2023, he sold the land at a $30,000 gain. Between January 1 and October 3, 2023, he made soil and water conservation expenditures of $15,000 for the land that are fully deductible in 2023. The applicable percentage is 40% since he sold the land within the 8th year after he got it. $6,000 (40% of $15,000) of the gain is ordinary income and the $24,000 balance is §1231 gain.

12. §1254 applies recapture on natural resources property assets, such as oil, gas, or geothermal property.

    a. Recapture as ordinary income (limited to the total gain) all expenses deducted as intangible drilling costs, depletion, mine exploration or development costs if placed in service after 1986.

13. §1255 Cost sharing payment recapture

    a. When a farmer excludes cost-sharing payments from income and then sells the land within 20 years of receiving the payments, a percentage of the payments may need to be recaptured as ordinary income under §1255.

    b. The gain is the lesser of the:

       1. Total gain, or

       2. Applicable percentage of the total excluded cost-sharing payments.

    c. Note that if the farmer elected to include the payments in income as received that no recapture is required.

    d. The applicable percentage of the excluded cost-sharing payments to be reported as ordinary income is based on the length of time the property is held after receiving the payments. If the property is held less than 10 years after receiving the payments, the percentage is 100%. After 10

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

14. Recapture of net §1231 losses

    a. A taxpayer who has a net §1231 gain in the current year must review the 5 preceding years for possible recapture of net §1231 losses in any of those prior years as ordinary income in the current year.

Example of §1231 Recapture Rules

In 2024, Travis has a $2,000 net §1231 gain. To figure how much he must report as ordinary income and long-term capital gain, Travis must first determine his §1231 gains and losses from the previous 5-year period. From 2019 through 2023, Travis had the following §1231 gains and losses:

Year	Amount
2019	-0-
2020	-0-
2021	($2,500)
2022	-0-
2023	$1,800

Using this information, figure Travis's net §1231 gain for 2024.

1) Net §1231 gain (2024) $2,000
2) Net §1231 loss (2021) ($2,500) (used $1,800 in 2023, balance carried forward)
3) Net §1231 gain (2023) $1,300 (applied $700 from 2021 – thus ordinary)
4) Remaining net §1231 loss at start of 2024 ($700)

2024 gain treated as ordinary income $700
2024 gain treated as long-term capital gain $1,300

Travis's remaining net §1231 loss of $700 from 2021 is recaptured in 2024. Nothing carries forward into 2025.

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Reporting Business Asset Sales on Form 4797

Where To Make First Entry for Certain Items Reported on This Form

	(a) Type of property	(b) Held 1 year or less	(c) Held more than 1 year
1	**Depreciable tangible trade or business property:**		
	a Sold or exchanged at a gain	Part II	Part III (1245)
	b Sold or exchanged at a loss	Part II	Part I
2	**Depreciable real trade or business property:**		
	a Sold or exchanged at a gain	Part II	Part III (1250)
	b Sold or exchanged at a loss	Part II	Part I
3	**Farmland held less than 10 years upon which soil or water expenses were deducted:**		
	a Sold at a gain	Part II	Part III (1252)
	b Sold at a loss	Part II	Part I
4	**Real or tangible trade or business property which was deducted under the de minimis safe harbor**	Part II	Part II
5	**All other farmland used in a trade or business**	Part II	Part I
6	**Disposition of cost-sharing payment property described in section 126**	Part II	Part III (1255)
7	**Cattle and horses used in a trade or business for draft, breeding, dairy, or sporting purposes:**	**Held less than 24 months**	**Held 24 months or more**
	a Sold at a gain	Part II	Part III (1245)
	b Sold at a loss	Part II	Part I
	c Raised cattle and horses sold at a gain	Part II	Part I
8	**Livestock other than cattle and horses used in a trade or business for draft, breeding, dairy, or sporting purposes:**	**Held less than 12 months**	**Held 12 months or more**
	a Sold at a gain	Part II	Part III (1245)
	b Sold at a loss	Part II	Part I
	c Raised livestock sold at a gain	Part II	Part I

III. Other Form 4797 Issues

A. Mark-to-market election

1. A trader in securities or commodities may elect under §475(f) to use the mark-to-market method to account for securities or commodities held in connection with a trading business.

2. Under this method of accounting, any security or commodity held at the end of the tax year is treated as sold (and reacquired) at its FMV on the last business day of that year.

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3. The election must be made by the due date (not including extensions) of the tax return for the year prior to the year for which the election becomes effective, except in the case of new traders who make the election with the first return.

4. The following special rules apply:

    a. Gains and losses from all securities or commodities held in connection with the trading business (including those marked to market) are treated as ordinary income and losses, instead of capital gains and losses. As a result, the lower capital gain tax rates and the limitation on capital losses do not apply.

    b. The gain or loss from each security or commodity held in connection with the trading business (including those marked to market) is reported on Form 4797, Line 10.

    c. The wash sale rule does not apply to securities or commodities held in connection with the trading business.

B. Recapture of pre-productive expenses

1. If the taxpayer elected out of the uniform capitalization rules of §263A, any plant that was produced is treated as §1245 property.

C. Partnerships and S corporations do not report §179 recapture transactions on Form 4797, 4684, 6252, or 8824. Instead, all details of the sale or other disposition must be separately reported on Schedule K-1.

D. Small business investment company stock

1. Report on Form 4797, Line 10, ordinary losses from the sale or exchange (including worthlessness) of stock in a small business investment company operating [Small Business Investment Act of 1958 (§1242)].

2. Also, attach a statement that includes the name and address of the small business investment company and, if applicable, the reason the stock is worthless and the approximate date it became worthless.

E. Small business stock (§1244)

1. Report ordinary losses from the sale or exchange (including worthlessness) of §1244 (small business) stock on Form 4797, Line 10.

F. QBI deduction (§199A)

1. Q&A #21 issued by the IRS says to increase qualified business income by §1231 gains and reduce it by §1231 losses.

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G. Recapturing §179 deductions

1. If business use drops to less than 50%, §179 must be recaptured as SE income.

2. If the asset is disposed of prior to its recovery life period, a proportionate portion of §179 must be recaptured as non-SE income.

3. Dispositions include transfers at death (non-SE income).

4. Un-deducted carryover §179 amounts may not be utilized by the transferee (no SE effect).

5. The recapture income is included as ordinary income on Form 4797, Part IV, but also increases the basis of the property. Note that Part IV recapture amounts are added into ordinary income on the form which contained the original deduction; thus, SE tax may apply.

Example of §179 Recapture Rules

In January 2021, Kent, a calendar year taxpayer, bought and placed in service $10,000 of §179 3 -year property (with no bonus depreciation). The property is not listed property. He elected a $5,000 §179 deduction for the property. He used the property only for business in 2021 and 2022. In 2023, Kent used the property 40% for business and 60% for personal use. Figure his recapture amount as follows:

§179 deduction claimed (2021)		$5,000
Minus: Allowable depreciation (instead of §179 deduction):		
2021	$1,667	
2022	2,223	
2023 ($741 × 40% (business))	296	4,186
2023 — Recapture amount		$ 814

Clark must include $814 in income for 2023.

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Rentals of Mini Storage Facilities

The Storage and Warehouse Leasing industry rents and leases space for self-storage to individuals and businesses. This industry has been one of the fastest-growing sectors of commercial real estate since its inception in the 1960s. The industry is in a unique position in that it generally thrives even during downturns in the economy. The theory is that as people gain more disposable income, they purchase more things that then need storage. On the other hand, a recession often forces businesses to close their doors and people to downsize, increasing demand for storage.

Operations. Ten-by-ten storage spaces are generally the most popular. They can store enough goods to fill two complete bedrooms or three rooms, which is equal to half of a typical one-car garage. Competition in the industry is not just based on size/price but also on security and security systems as consumers are more likely to choose the safest, affordable facility. Computerized kiosks at storefronts, as well as websites and apps, allow customers to access their storage spaces, pay bills, control climate and more, all with a click of a button. Vacancy and bad debt rates in the industry average about 20%, but many states give landlords eviction and possession rights unheard of when the tenant resides on-site or otherwise occupies the building.

Income is passive for all, but real estate pros. Self-storage unit operators rent non-residential commercial real estate property. The lack of services provided makes the income passive and reportable on Sch. E. Net profit is subject to the 3.8% NII surtax if applicable. It appears that self-storage activities would qualify for the §199A QBI deduction as a passive trade or business.

Incidental income is still passive rental income (Hopper v. Comm., USTC 94 T.C. 542). This court case involved an attorney who owned two self-storage facilities and determined the activity was a rental real estate activity. The Court ruled that any ancillary income (e.g., soft drink machine income, pest control, contents insurance, and sales of locks, packing materials, and pallets) were provided for the convenience of the tenants and were minor and incidental. All income was passive rental real estate income.

Self-storage rental reporting. Self-storage activities operated by individuals and disregarded SMLLCs are reported on Sch. E, and on Form 8825 for flow-through entities. Because the provision of services determines whether the activity is a trade or business, or real estate rental, the court in the above Hopper case also stated (emphasis added by court) "THE FURNISHING OF HEAT AND LIGHT, THE CLEANING OF PUBLIC ENTRANCES, EXITS, STAIRWAYS AND LOBBIES, THE COLLECTION OF TRASH, AND SO FORTH, ARE NOT CONSIDERED SERVICES RENDERED TO THE OCCUPANT... We see no distinction between the nature of these services and those such as cleaning, sweeping, painting, and other general maintenance and grounds work which were provided."

Deprecation and related issues. Normally, the buildings themselves are 39-year life commercial buildings. Because self-storage facilities are composed of many shorter-life assets, operators should carefully allocate construction costs, or if purchasing, purchase price. Existing operators may greatly benefit from cost segregation studies. Here are the depreciation life reminders. Remember, items in the 3–10-year categories qualify for §179, 3–20-year categories for qualify for bonus depreciation, and a few other special categories

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such as qualified improvement property (QIP) and qualified real property (QRE) (roofs, HVAC, sprinklers) qualify for §179 as well.

Building	39 years
A/C or heat	39 years, but qualifies for 179 as QRE
Sprinklers & fire systems	39 years, but qualifies for 179 as QRE
Interior remodeling	15 years, qualifies for 179 and bonus as QIP
Fences & gates	15 years, qualifies for bonus
Landscaping	15 years, qualifies for bonus
Parking lot, roads	15 years, qualifies for bonus
Portable, movable storage units	7 years, qualifies for 179 and bonus
Cameras, computer systems	5 years, qualifies for 179 and bonus
Gate motors and arms	5 years, qualifies for 179 and bonus
Check-in kiosk	5 or 7 years, qualifies for 179 and bonus

Operating Statistics

IRS published data from 2019 revealed that there were about 60,000 self-storage operators in 2019 who operated as sole proprietorships. We presume (and hope!) that the majority of these are disregarded single member LLCs (SMLLCs).

Average annual revenue per operator	$ 51,000
Average expenses per operator	50,000

Expense percentage per operator:

Material Costs (locks, boxes, pallets)	14%
Depreciation	14%
Other business expenses	14%
Interest Expenses	9%
Repairs	8%
Taxes paid	7%
Car and truck expenses	6%
Utilities	5%
Contract labor	3%
Salaries and wages	3%

Determining Facility Rates of Return (Cap Rate)
Cap Rate = (Net Operating Income)/(Current FMV)

Estimating value. Buyers and sellers of real estate typically use cap rates as a starting point for establishing value when a property is being considered for sale or purchase. For example, if a facility is for sale for $2,000,000 and has a NOI of $100,000, the Cap Rate is 5% ($100,000÷$2,000,000). Another way to look at this is, if a taxpayer paid $2,000,000 for the facility in cash, he or she would expect to get a 5% return in annual cash flow for the $2,000,000 investment. The author has typically seen real estate investors use a variation of EBITDA to calc cap rates, eliminating depreciation, amortization, and interest from the formula. If the taxpayer is the facility owner and wants to get a sense of what the property might be worth, he or she would take the NOI, modify as desired, and then divide the result by the local cap rate for the area and the quality of the facility.

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Example. Dennis owns a storage facility that he is thinking of selling. His annul net profit on the facility is typically $100,000 and is reported on Sch. E. The buildings have no debt, and Dennis claims deprecation of $10,000 per year. Dennis uses modified NOI of $110,000 ($100,000 plus $10,000 deprecation) for the facility in a rural market, where the cap rate might be 10% vs. 4% for a new class A facility in Manhattan. The facility in this example might be valued at $1,100,000 ($110,000/10%).

Delaware Statutory Trusts (DSTs)

Overview. Delaware Statutory Trusts (DSTs) are legally recognized trusts that are set up to conduct business. The DSTs offers an entity through which investors can hold fractional ownership in underlying assets, including real estate. While corporations own assets, are run by managers, and are owned by shareholders, a DST is managed by a trustee and the trust itself holds title to the investment properties, with investors purchasing beneficial interests in the trust. Rev. Rul. 2004-86 determined that a beneficial interest in a DST that owned real estate assets is considered a "direct interest in real estate" and, thus, may qualify as a real estate investment for §1031 tax-deferral purposes. At the completion of a DST investment, beneficial owners can engage in a §1031 exchange by purchasing beneficial interests in another DST or another eligible real estate investment, even a REIT. Likewise, an investor who sells a tax-deferrable real estate investment may purchase beneficial interests in a DST as a like-kind replacement property to complete their §1031 exchange.

DST ownership structure. A DST is a private placement real estate ownership structure where multiple investors each hold an undivided fractional interest in the holdings of the trust. The trust is established by a professional real estate company, referred to as a “DST sponsor”, who first identifies and acquires the real estate assets. As individuals invest in the DST, their investments displace the capital used by the DST sponsor to acquire the property until it is eventually wholly owned by the investors. Investors own a beneficial interest in the trust, meaning that they hold a percentage of the ownership, and no single owner can claim exclusive ownership over any specific aspect of the real estate.

DST requirements. All Delaware Statutory Trusts have a consistent DST structure and share the following seven requirements (Rev. Rul. 2004-86):

1. No additional capital contributions are allowed after the DST offering closes.
2. Trustees cannot renegotiate DST loan terms.
3. Trustees cannot reinvest DST sales proceeds.
4. Capital expenditures are limited to standard repairs.
5. Cash reserves must be invested in short-term debt.
6. Cash must be distributed to beneficiaries on a current basis.

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7. Trustees cannot renegotiate leases.

DSTs are complex. DSTs are sophisticated investments, and generally require investors to be accredited, which the SEC typically defines as an individual with a net worth (excluding one's primary residence) of $1 million or an average annual income more than $200,000 for the last two years for an individual or $300,000 for a couple filing jointly.

DST structural advantages. The legal structure of a DST allows for several advantages, including limited liability for its investors. Additionally, the DST structure facilitates easier management and transferability of investment interests, making it an attractive option for investors looking to pool resources and invest in larger, potentially more lucrative properties. Its most common use is for an individual investor wishing to invest or even defer current capital gains into professionally-managed, income producing commercial real estate as well as REITs.

Other DST facts and figures. DSTs typically require a minimum investment of $100,000, and an investor can acquire or exchange into ownership in one or multiple DSTs. DST real estate is generally held for 3 to 10 years. Upon the sale of the property, the investors receive all sales proceeds, including gains from potential appreciation, which can then be exchanged again to continue deferring tax. Nearly all commercial real estate property types are held as DST properties, including the four major property types – multifamily, office, industrial and retail – as well as niche property types, like senior housing, medical office and self-storage. National institutional real estate firms, referred to as "DST Sponsors," are responsible for vetting, acquiring, and managing the properties included within each DST they put forward. Once the DST property has been acquired, several parties perform due diligence on the property and trust structure. The DST sponsors ultimately package the DST offering for investors and bring it to market through independent brokers who carry the necessary securities licenses to transact DSTs on behalf of clients.

DST real estate ownership. A DST can own one or multiple properties and each DST will generally own a single property type. Typically, DSTs own high-quality institutional property, which may allow for greater income and appreciation potential. For example, one DST may own a portfolio of Class A multifamily apartments, while another may own an industrial building like an Amazon Distribution Center or net lease real estate with corporate guaranteed retail tenants like Walgreens or Whole Foods. The biggest challenge of investing in a DST may be in finding one. Not all DST investments can be marketed directly to the public because of SEC regulations. DST sponsors work directly with securities broker-dealers and 1031 Exchange Advisors to make offerings available to accredited investors. Although DSTs can contain multiple properties, they typically focus on a single property type. To diversify across different property types, an investor can invest in multiple DSTs.

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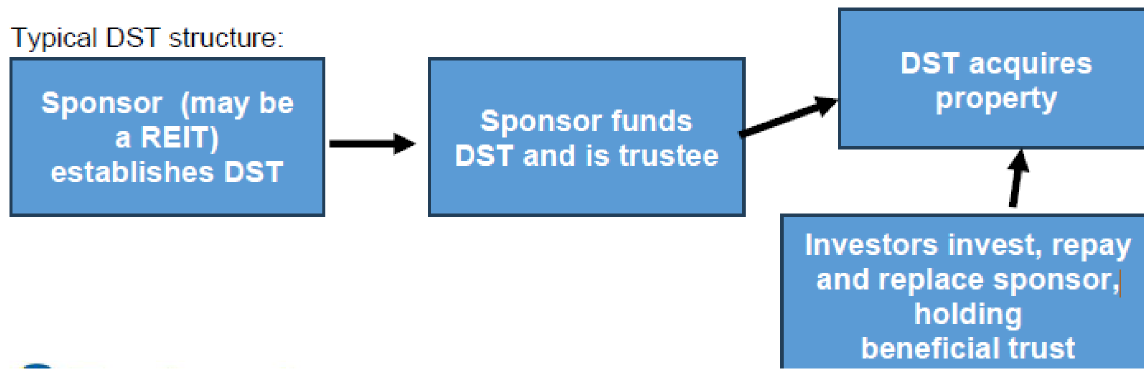

Role of DSTs in Like-Kind Exchanges. Under §1031, investors are allowed to defer paying capital gains taxes on the sale of a property if the proceeds are reinvested in a similar property in a like-kind exchange. A §1031 exchange may be directly reinvested in a DST as a qualified §1031 deferral. DSTs have become a popular vehicle for facilitating exchanges, primarily because they allow investors to reinvest the proceeds from the sale of their property into fractional interests in a diversified portfolio of properties without taking direct management responsibilities. This is particularly appealing for investors looking to step back from day-to-day management of rental properties or those seeking to diversify their investments across different types of real estate or geographical locations. By investing in a DST, an investor can effectively exchange a single property for shares in a portfolio of properties, deferring capital gains taxes and potentially benefiting from economies of scale and professional management.

To successfully complete a tax-deferred §1031 exchange involving a REIT, a taxpayer cannot directly exchange out of his or her property and into a REIT security since they are not like-kind assets. To defer tax, the proceeds from the sale of the relinquished property must be reinvested into another "like-kind" replacement property of equal or greater value within 180 days of the closing date of the relinquished property. In this context, "like-kind" simply means exchanging one investment property for another, regardless of property type. Tax deferral allows DST investors to preserve all the equity from the sale of their relinquished property so it can continue working for them in their new DST replacement property. The basics for a 1031 exchange work the same way for every property type, including DSTs. However, DSTs typically close within 3 to 5 business days following the sale of the relinquished property – a significant advantage considering strict §1031 exchange rules and deadlines.

Conversion of DST ownership to REIT ownership. The taxpayer can transition from being a property owner to a REIT investor by first exchanging his or her real property assets for shares of the DST. The starting point is §721 that provides a favorable tax rule when property is contributed to a tax partnership in exchange for interest in the partnership. Under §721, there is no taxable gain to the contributor (the property owner DST) or partnership (the recipient of the property or new OP). The contributor's tax basis carries over and the taxable gain is deferred. This is very similar to the operation of §1031 governing tax-deferred exchanges of real estate.

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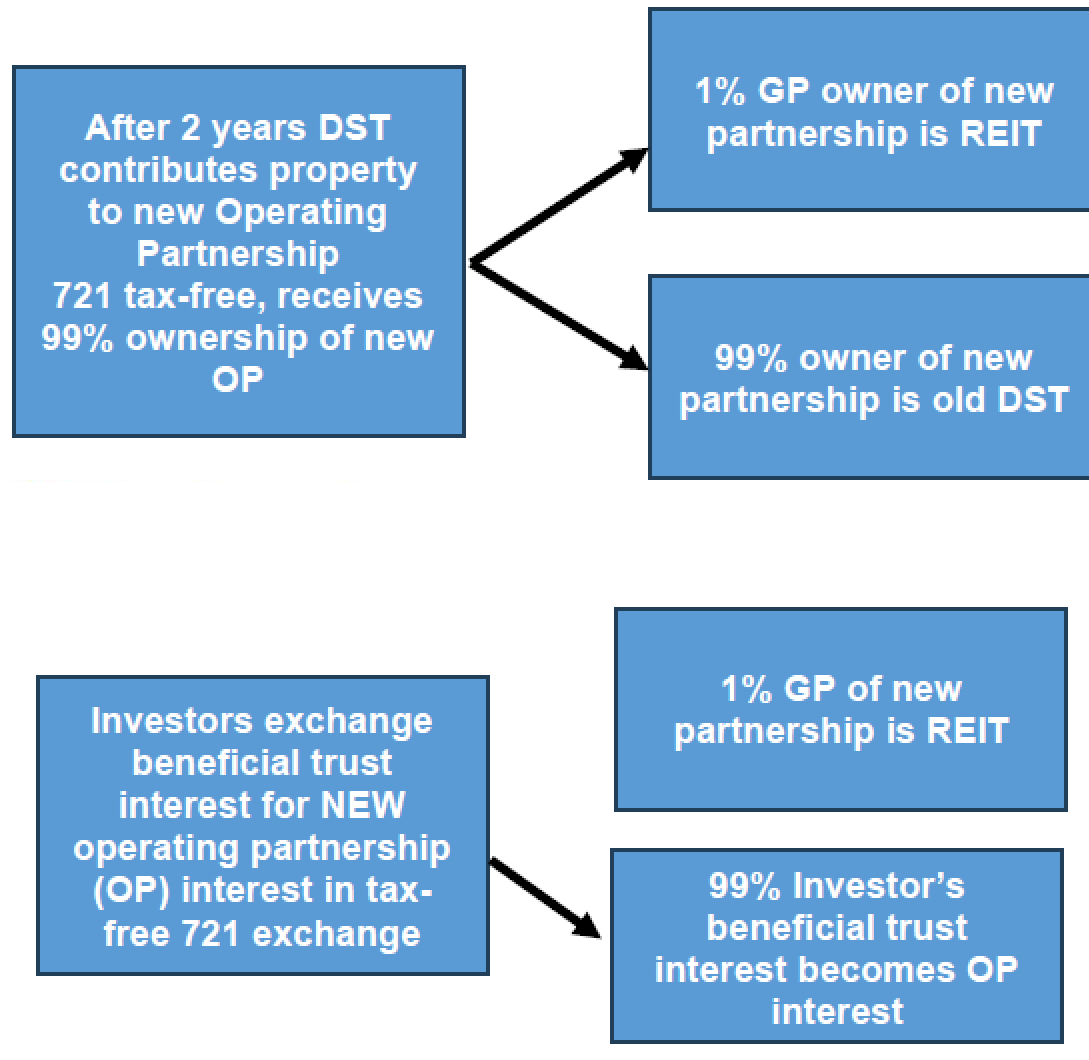

Conversion to REIT mechanics. Here is how a property sale, using §1031 deferral rules, can be reinvested indirectly into a publicly traded REIT.

1. To successfully complete a tax-deferred §1031 exchange involving a REIT, the taxpayer can't directly exchange out of his or her property and into a security since they aren't like-kind assets.

2. Typically, a sponsor places an institutional-grade asset from a REIT or an acquisition into a newly formed DST.

3. The DST offers §1031 exchangers and direct investors a predetermined amount of equity during the syndication period. A pool of investors acquires a beneficial interest in the trust and earns distributions similar to those found in a standard DST investment.

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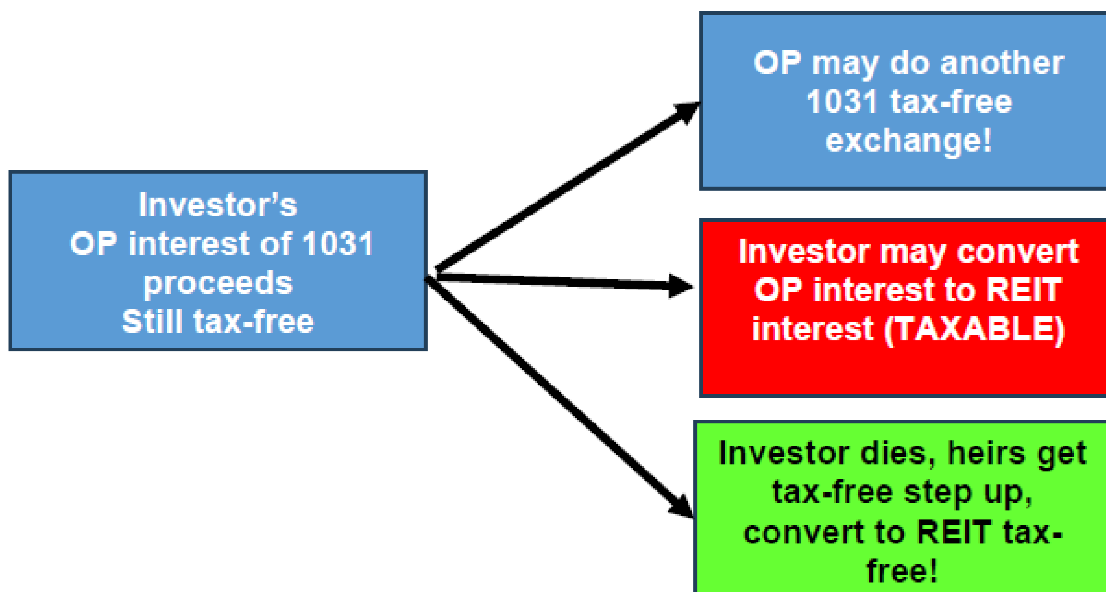
4. After a two to three-year holding period, which satisfies the IRS safe-harbor guidelines for investment properties, the sponsor executes a §721 UPREIT on the property held under trust. Investors then exchange their DST beneficial interests for operating partnership (OP) units in an entity that the REIT owns in a non-taxable transaction.

5. UPREITS generally allow the investor to further exchange the OP units to conventional REIT shares at any time, but that is a taxable transaction. Usually, the UPREIT also allows conversion for any portion of the OP units, so there is no rush for the investor to do so. Frequently, OP holders are given tax protection: the operating partnership agrees not to sell the contributed property for a given period in a manner that would trigger recapture to the contributors. Note that the operating partnership can always §1031 exchange the contributed property without recapture.



6. If the OP units are held by the individual at death, he or she receives a step-up in basis to FMV, and the heirs can then convert tax-free to conventional REIT shares for immediate liquidity or income generation.

Many REITs offer UPREITs as a way for DST investors to convert their DST interests into OP units within an UPREIT. Since this conversion is being made into a partnership, the taxpayer still can defer capital gains taxes – unless he or she decides to convert the UPREIT OP units into REIT shares. Advantages of this indirect transaction to an operating partnership ownership interest in a REIT brings REIT advantages to the owner, including:

- Professional management
- Passive income in diversified real properties
- REIT-equivalent consistent cash flow rates of return

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Preparer note. However, once the exchange has been made into a UPREIT, it precludes further §1031 exchanges on that investment since a REIT does not qualify for a §1031 exchange.

DSTs - Advantages and Disadvantages. The use of DSTs in like-kind exchanges offers several advantages, including tax deferral, access to institutional-quality real estate, diversification, and the possibility of a professional management structure.

DSTs are typically illiquid investments with a predefined holding period. As long-term, income-focused investments, DST performance is largely dependent upon the tenants' ability to pay rent. This presents a few notable DST risks including lack of liquidity, interest rate risk, and changing market conditions. Additionally, while the trustee manages the DST, investors have limited control over the investment decisions. When a DST directly invests in a publicly traded REIT, or indirectly through a UPREIT, liquidity is excellent.

Moreover, investors should conduct thorough due diligence when selecting a DST, considering factors such as the trust's property portfolio, the track record of the trustee, and the terms of the investment.

As an example of a current DST offering, we found one at https://acretrader.com/dstcentral-washington-farmland-trust that illustrates the following. Please note again, we are not investment advisors and offer no comment on this project; it is just an example of a real-life offering from the internet.

We have reprinted below some of the investment information. An accredited investor may buy a direct DST interest for a minimum of $100,000, or do a §1031 exchange into the DST for any amount between $100,000 and the maximum limit.

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The aggregate equity investment for all of the Interests is $6,210,000. The minimum equity investment (the "**Minimum Investment**") is $100,000 for all Investors, including Investors acquiring an Interest by means of an exchange (each, an "**Exchange Investor**") pursuant to Section 1031 ("**Section 1031**," and such an exchange a "**Section 1031 Exchange**") of the Internal Revenue Code of 1986, as amended (the "**Code**"). An equity investment of $100,000 is approximately equal to a 1.61% beneficial interest in the Trust, assuming in all cases that the aggregate equity investment for all of the Interests is $6,210,000. The Trust may waive these Minimum Investment requirements in its discretion. The Trust will only cancel subscription payments in the event: (i) a subscription is rejected by the Trust in its sole discretion; or (ii) the Offering is terminated or canceled in the Trust's sole discretion. The Trust will utilize North Capital Private Securities as "**Escrow Agent**" and funds in connection with this Offering will be remitted to the Escrow Agent. This offering is being made on a "best efforts" basis; there is no minimum amount of Offering proceeds that must be raised and no minimum number of Investors required before the Trust may utilize the proceeds of the Offering in its business operations. In connection with the acquisition of the Interests, each Investor will execute and deliver such documents as may be required by the Sponsor. See "HOW TO PURCHASE," and "SUMMARY OF THE PURCHASE AGREEMENT."

The Trust acquired two parcels of real estate on or about December 9, 2022. The first parcel contains approximately 1,908 gross acres of land situated in Adams County, State of Washington, as more particularly described in the exhibits to this Memorandum (the "**Hirst Farm**"). The Trust purchased the Hirst Farm from **Central Washington Farms, LLC**, a Delaware limited liability company (the "**Depositor**"), for a purchase price of $2,200,000.[1] The second parcel contains approximately 298 gross acres of land situated in Grant County, State of Washington, as more particularly described in the exhibits to this Memorandum (the "**WAE Farm**", and together with the WAE Farm, the "**Properties**"). The Trust purchased the WAE Farm from WAE LLC, for a purchase price of $3,200,000. The Trust financed the acquisition of the Properties by obtaining a long-term, non-recourse bank loan in the original principal amount of $2,700,000 (the "**Loan**") from **Bank Iowa**, an Iowa bank (the "**Bank**"), along with a short-term, non-recourse bank loan from the Bank in the original principal amount of $1,350,000 (the "**Short Term Loan**") and an equity injection from the Depositor of $1,406,472 (the "**Equity**"). The Loan is secured by the Properties and evidenced by a promissory note, a mortgage on each of the Properties and other typical financing agreements (collectively, the "**Loan Documents**"). The Loan and the Short Term Loan will be paid off out of the proceeds of the Offering and there will be no debt allocated to Investors as part of the Offering. The Equity will be repaid to the Depositor out of the proceeds of the Offering.

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Example. Harold bought 640 acres of real property in 1960 solely in his name for $1,000. He always held the property as an investment with minimal income. Harold is considering an offer of $6,400,000 from a huge real estate development company in 2024. Harold doesn't need the money, and he really does not want to pay tax. Sadly, due to an illness Harold is not expected to live more than 1-2 years. As an astute investor and long-time developer, Harold conveys the following goals to his accountant:

1. Sell the property and pay no tax., but sell the property, and
2. Invest the entire amount in income producing, professionally managed real property for his widow.
3. At his death, provide a step-up in basis for his heirs, presumably his spouse. And
4. Have the acquired property be much more liquid than the bare land he has now.

Harold's accountant talks with a §1031 advisor who advises Harold and the accountant to sell the property, and at closing, utilize a §1031 qualified intermediary (QI) to accept and hold the funds. The QI then approaches ProLogis, who has set up a new DST to acquire a midwestern warehouse. The QI then exchanges Harold's $6.4 million proceeds into the DST interest (being sure to meet the 45-day and 180-day LKE rules). Harold's basis in the DST is $1,000.

The DST is professionally managed by ProLogis and has a written restriction not to sell the property before at least 5 years passes. For the next 2 years, Harold receives about $450,000 annually in passive rent (fully taxable) from the DST. At the end of 2 years, ProLogis rolls the DST into a new operating partnership, tax-free under §721 and exchanges Harold's DST interest for operating partnership interests. The new partnership allows Harold, or his heirs, to exchange part or all his partnership interest for stock in the ProLogis REIT at any time.

A year later, Harold passes away and his OP interest transfers to his wife at FMV, so that her basis is now $6,400,000. She immediately converts to ProLogis publicly traded REIT stock tax-free (because of basis step-up), but does not sell anything. This allows her to sell off stock in pieces as needed, all at once, or pass to her heirs, while retaining all the benefits of the REIT.

Summary:
1. No tax paid on sale of the original land by Harold.
2. Entire $6,400,000 amount invested, generating $450,000 of annual income prior to Harold's death.
3. No management required of Harold or his heirs (spouse).
4. At Harold's death, his wife receives a complete tax-free step up in basis (state rules may apply). And
4. His wife has a liquid, professionally managed, income-producing property with a FMV basis!

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Other Operating and Tax Issues

- A DST is considered neither a business nor a hobby. It is treated as an investment asset generating portfolio income. It may be owned inside an IRA or Roth IRA but if it has debt, it could generate UBIT if owned in an IRA.

- DST income is generally passive income or loss. If income, it could be used to free up passive losses from other sources. The DST investor will receive a grantor trust letter explaining line-item amounts to be reported on Form 1040. Depreciation adjustments to the amount reflected by the DST may be required if non-cash assets were contributed (very rare).

- Investor basis is equal to the basis of their initial investment, plus future investments, plus retained taxable income, less non-taxable return of capital distributions and losses.

- Operating income and expenses are reflected in the grantor letter issued by the DST to the investor. If the investor borrowed money (other than against their principal residence) to invest in the DST, the interest is usually included as an investment interest expense deductions on Form 4952.

- DST income is not subject to self-employment tax.

- DST income is not subject to the 0.9% Medicare surtax, but it is considered investment income subject to the 3.8% NII surtax.

- DST income generally does not qualify for the §199A QBI deduction unless an amount is reflected in the grantor letter. Any such amounts are subject to other §199A requirements for wages, assets, AGI limits, or specified services.

- Income received from a DST is taxed at ordinary tax rates and does not qualify for capital gain rates. Capital gain distributions will qualify for capital gains rates, while any recapture income will usually be taxed at ordinary rates limited to a maximum of 25%. The sale of an ownership interest in a DST is subject to capital gain rules.

- DST planning could include:

    - a. §1031 like-kind exchanges;
    - b. §1031 like-kind exchange for leftover equity from a sale and purchase of business real property;
    - c. Diversification of investment and income types; or
    - d. Serial §1031 exchanges continuing prior LKEs.

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Example grantor trust cover letter.

FSC INDUSTRIAL III, DST
2019 GRANTOR TRUST LETTER

This letter provides Federal income tax information to Beneficial Owners of the FSC Industrial III, DST (the "Trust") in accordance with the First Amended and Restated Trust Agreement dated July 12, 2019. The attached Grantor Statement of Income/(Loss) (the "Statement") is intended to provide tax information that a Beneficial Owner is required to include in the Beneficial Owner's federal income tax return for the tax year ended December 31, 2019. You will not be issued a 2019 Form 1099-MISC or 1099-INT. However, under IRS regulations, your share of the gross rents and interest income has been reported to the IRS.

This letter and a complete statement of income/loss of the Trust, as well as other information about the Trust, can be found on the Trust's website, www.fsctrust.com.

Status of the Trust

The Trust purchased assets to hold in trust for the Beneficial Owners in accordance with the terms of the First Amended and Restated Trust Agreement. The Trust commenced operations July 12, 2019. In 2019, the Trustee conducted activities consistent with the Trust purposes and in doing so realized certain income and incurred certain expenses, which are reflected on the attached Statement.

General Tax Information

For Federal income tax purposes, the Trust is treated as a "grantor" trust. As such, the Trust itself is not subject to Federal income tax. Instead, each Beneficial Owner will be treated as having a direct interest in an allocable, pro rata share of all items of the Trust's income, deductions and credits. A Beneficial Owner's allocable share of the Trust's income, deductions and credits must be reported on the Beneficial Owner's income tax return(s). The attached Statement has been prepared based upon the Beneficial Owner's ownership percentage during the year.

The tax information in this letter is for general informational purposes only and does not address all possible tax considerations that may be material to a Beneficial Owner and does not constitute legal or tax advice. For instance, each Beneficial Owner may need to calculate depreciation expense as it relates to their basis in the underlying asset as a result of their respective IRC §1031 like-kind exchange transaction. Moreover, it does not deal with all tax aspects that might be relevant to a Beneficial Owner, in light of personal circumstances, nor does it deal with particular types of Beneficial Owners that are subject to special treatment under the federal income tax laws. The state, local and foreign tax consequences of any items of income, gain, loss, deduction or credit of the Trust may be treated differently for state, local and foreign tax purposes than for federal income tax purposes. To ensure compliance with requirements imposed by the Internal Revenue Service, any tax information contained in this letter is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein.

The Trustee cannot and does not provide income tax advice or guidance; Beneficial Owners are urged to consult with their tax advisers as to their individual tax consequences.

If you have any questions, please refer to the Trust's website at www.fsctrust.com.

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Monetized Installment Sales to be Added to IRS List of Reportable Transactions (NPRM REG-109348-22)

The IRS issued proposed regulations that will make "monetized installment sales" and substantially similar transactions listed transactions. These rules will take effect when the proposed regulations become final. Taxpayers and advisers to ensure these transactions are properly disclosed or face relevant penalties, which include 75% of the tax decrease reported on the return because of the reportable transaction. The minimum penalty amount is $5,000 in the case of a natural person and $10,000 in any other case. For a listed transaction, the maximum penalty amount is $100,000 in the case of a natural person and $200,000 in any other case.

IRS says they are aware of abusive monetized installment sales programs. The IRS are aware that promoters are marketing transactions that purport to convert a cash sale of appreciated property by a taxpayer (seller) to an identified buyer (buyer) into an installment sale to an intermediary (who may be the promoter) followed by a sale from the intermediary to the buyer. In a typical transaction, the intermediary issues a note or other evidence of indebtedness to the seller requiring annual interest payments and a balloon payment of principal at the maturity of the note, and then immediately or shortly thereafter, the intermediary transfers the seller's property to the buyer in a purported sale of the property for cash, completing the prearranged sale of the property by seller to buyer. In connection with the transaction, the promoter refers the seller to a third party that enters into a purported loan agreement with the seller.

The intermediary generally transfers the amount it has received from the buyer, less certain fees, to an account held by or for the benefit of this third party (the account). The third party provides a purported non-recourse loan to the seller in an amount equal to the amount the seller would have received from the buyer for the sale of the property, less certain fees. The "loan" is either funded or collateralized by the amount deposited into the account. The seller's obligation to make payments on the purported loan is typically limited to the amount to be received by the seller from the intermediary pursuant to the purported installment obligation. Upon maturity of the purported installment obligation, the purported loan, and the funding note, the offsetting instruments each terminate, giving rise to a deemed payment on the purported installment obligation and triggering taxable gain to the seller purportedly deferred until that time.

The promotional materials for these transactions assert that engaging in the transaction will allow the seller to defer the gain from the sale of the property under §453 until the taxpayer receives the balloon principal payment in the year the note matures, even though the seller receives cash from the purported lender in an amount that approximates the amount paid by the buyer to the intermediary.

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Digital Asset Developments (§1012(c))

Final Digital Asset Regs Issued (§1.1012(h) and (j); Rev. Proc. 2024-28)

The IRS issued final regulations generally describe how cost basis, amounts realized and other gain or loss calculation determinations upon disposition of digital assets, specifically crypto currency. The final regulations mostly follow the proposed regulations with the additional detail provided for those wishing to use the specific identification method of accounting for cost basis.

Simultaneously with the issuance of the regulations, the IRS also issued Rev. Proc. 2024-28. This Rev. Proc. provides a safe harbor for those taxpayers who wish to allocate unused digital asset basis to digital assets held within each wallet or account of the taxpayer as of January 1, 2025.

New Form Coming for Digital Asset Sale Reporting, but Not for 2024 (Form 1099-DA)

The IRS has been working on a reporting form for brokers who provide services to those who buy and sell digital assets such as digital currency (e.g., Bitcoin). The IRS released a draft form in 2024, but it won't be used for 2024 sales. The reporting will start in 2026 for sale transactions that occur in 2025. Basis reporting is not required until 2027 for 2026 sales or transfers. A digital asset is any digital representation of value that is recorded on a cryptographically secured distributed ledger (such as a blockchain or any similar technology) without regard to whether each individual transaction involving that digital asset is actually recorded on that distributed ledger, and that is not cash (that is, U.S. dollars or any convertible foreign currency issued by a government or central bank).

Penalty provisions delayed. Form 1099-DA has been delayed until 2025 and basis reporting has been delayed to years beginning in 2026. The IRS officially waived penalties for earlier years in Notices 2024-56 and 2024-57.

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Form 1099-DA — Digital Asset Proceeds From Broker Transactions (OMB No. 1545-XXXX, 2025)

Copy 1 — For State Tax Department

Field	Label
Filer	FILER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no.
	Applicable checkbox on Form 8949
	FILER'S TIN
	RECIPIENT'S TIN
	RECIPIENT'S name
	Street address (including apt. no.)
	City or town, state or province, country, and ZIP or foreign postal code
	Account number
	CUSIP number
1a	Code for digital asset
1b	Name of digital asset
1c	Number of units
1d	Date acquired
1e	Date sold or disposed
1f	Proceeds $
1g	Cost or other basis $
1h	Accrued market discount $
1i	Wash sales loss disallowed $
2	Check if basis reported to IRS ☐
3a	Reported to IRS: ☐ Gross proceeds ☐ Net proceeds
3b	Check if proceeds from: ☐ Reserved for future use ☐ QOF
4	Federal income tax withheld $
5	Check if loss is not allowed based on amount in 1f ☐
6	Gain or loss: ☐ Short-term ☐ Long-term ☐ Ordinary
7	Check if 1f is only cash ☐
8	Check if broker relied on customer-provided acquisition information ☐
9	Check if digital asset is a noncovered security ☐
10	Digital asset is a noncovered security because: ☐ Broker did not provide custodial services for it ☐ Broker provided custodial services and it was transferred in to broker ☐ Broker provided custodial services and it was acquired prior to 2026
11a	Check if gross proceeds reported in 1f is an aggregate amount for: ☐ Qualifying stablecoins ☐ Specified NFTs
11b	If 11a checked, number of transactions
11c	For aggregate reporting of specified NFTs, aggregate gross proceeds reported in 1f that are attributable to first sales by creator or minter $
12a	Number of units transferred in
12b	If transferred in, provide transfer-in date
13	
14	State name
15	State identification no.
16	State tax withheld $ $

Form **1099-DA** www.irs.gov/Form1099DA Department of the Treasury - Internal Revenue Service

TREASURY/IRS AND OMB USE ONLY DRAFT September 9, 2024 DO NOT FILE

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Landlords and Schedule E

SCHEDULE E (Form 1040)
Department of the Treasury Internal Revenue Service

Supplemental Income and Loss
(From rental real estate, royalties, partnerships, S corporations, estates, trusts, REMICs, etc.)
Attach to Form 1040, 1040-SR, 1040-NR, or 1041.
Go to *www.irs.gov/ScheduleE* for instructions and the latest information.

OMB No. 1545-0074
2024
Attachment Sequence No. 13

Name(s) shown on return | **Your social security number**

TREASURY/IRS AND OMB USE ONLY DRAFT July 1, 2024 DO NOT FILE

Part I **Income or Loss From Rental Real Estate and Royalties**
Note: If you are in the business of renting personal property, use **Schedule C**. See instructions. If you are an individual, report farm rental income or loss from **Form 4835** on page 2, line 40.

A Did you make any payments in 2024 that would require you to file Form(s) 1099? See instructions . . . ☐ **Yes** ☐ **No**
B If "Yes," did you or will you file required Form(s) 1099? . . . ☐ **Yes** ☐ **No**

1a	Physical address of each property (street, city, state, ZIP code)
A	
B	
C	

1b	Type of Property (from list below)	**2** For each rental real estate property listed above, report the number of fair rental and personal use days. Check the QJV box only if you meet the requirements to file as a qualified joint venture. See instructions.		**Fair Rental Days**	**Personal Use Days**	**QJV**
A			**A**			☐
B			**B**			☐
C			**C**			☐

Type of Property:
1 Single Family Residence
2 Multi-Family Residence
3 Vacation/Short-Term Rental
4 Commercial
5 Land
6 Royalties
7 Self-Rental
8 Other (describe)

			Properties:		
			A	**B**	**C**
Income:					
3	Rents received . . .	**3**			
4	Royalties received . . .	**4**			
Expenses:					
5	Advertising . . .	**5**			
6	Auto and travel (see instructions) . . .	**6**			
7	Cleaning and maintenance . . .	**7**			
8	Commissions . . .	**8**			
9	Insurance . . .	**9**			
10	Legal and other professional fees . . .	**10**			
11	Management fees . . .	**11**			
12	Mortgage interest paid to banks, etc. (see instructions)	**12**			
13	Other interest . . .	**13**			
14	Repairs . . .	**14**			
15	Supplies . . .	**15**			
16	Taxes . . .	**16**			
17	Utilities . . .	**17**			
18	Depreciation expense or depletion . . .	**18**			
19	Other (list)	**19**			
20	Total expenses. Add lines 5 through 19 . . .	**20**			
21	Subtract line 20 from line 3 (rents) and/or 4 (royalties). If result is a (loss), see instructions to find out if you must file **Form 6198** . . .	**21**			
22	Deductible rental real estate loss after limitation, if any, on **Form 8582** (see instructions) . . .	**22**	( )	( )	( )

23a	Total of all amounts reported on line 3 for all rental properties . . .	**23a**	
b	Total of all amounts reported on line 4 for all royalty properties . . .	**23b**	
c	Total of all amounts reported on line 12 for all properties . . .	**23c**	
d	Total of all amounts reported on line 18 for all properties . . .	**23d**	
e	Total of all amounts reported on line 20 for all properties . . .	**23e**	
24	**Income.** Add positive amounts shown on line 21. **Do not** include any losses . . .	**24**	
25	**Losses.** Add royalty losses from line 21 and rental real estate losses from line 22. Enter total losses here	**25**	( )
26	**Total rental real estate and royalty income or (loss).** Combine lines 24 and 25. Enter the result here. If Parts II, III, and IV, and line 40 on page 2 do not apply to you, also enter this amount on Schedule 1 (Form 1040), line 5. Otherwise, include this amount in the total on line 41 on page 2 .	**26**	

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Purpose of Schedule E. Schedule E is used to report income or loss from rental real estate, royalties, partnerships, S corporations, estates, trusts, and residual interests in REMICs. Regarding rental activities, real estate rentals are reported on Schedule E. Losses associated with real estate rental activities are deductible up to a maximum of $25,000 if the taxpayer's AGI is no more than $100,000. For taxpayers whose AGI is greater than $150,000, rental losses are passive and generally not currently deductible (see real estate professional exception later). And for those with AGI between $100,000 and $150,000, the $25,000 loss limitation is prorated.

Rental activity defined (§1.469-1T(e)(3)). Rental activities result when the gross income from the activity is received primarily for the use of real property by customers pursuant to a lease or other arrangement. However, there a several specific exceptions to this general rule, including:

1. Average period of customer use is 7 days or less (e.g., vacation rentals or Airbnb).

2. Average period for customer use is 30 days or less and significant personal services are provided (e.g., hotels).

3. Extraordinary personal services are provided regardless of length of stay (e.g., hospitals).

4. Property rental is incidental to nonrental activity (taxpayer is holding property for appreciation and the rents are less than 2% of the lesser of:

   - The unadjusted basis of the property, or
   - The FMV of the property.

5. Property is regularly available for nonexclusive use by various customers.

6. Self-rentals.

7. Other situations based on facts and circumstances.

Common errors on Schedule E. The two most common errors on Schedule E are:

1. Improperly reporting short-term rentals on Schedule E when they should be reported on Schedule C and vice versa. Schedule E has a property type – "vacation/short-term rental" so short term rentals are reported here, right? Not so fast. Short-term rental activities are sometimes properly reported on Schedule C and other times properly reported on Schedule E. The distinction is the level of services provided by the landlord. For situations where the only services provided are incidental services (e.g., cleaning service upon departure, trash collection, heating, electricity, cleaning public areas, etc.) the rental activity should be reported on Schedule E. For activities where more robust services are provided (e.g., daily maid service, concierge service, room service or other meals, etc.) the activity is reported on Schedule C. The determination of where to report a specific activity is a facts and circumstances case by case decision.

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Example. Michelle owns a townhome in Hawaii that she rents out to vacationers for 7 – 14 days at a time. Michelle maintains a website where tenants can make reservations and pay by credit card. Michelle has a cleaning service she is contracted with in Hawaii. The cleaning service ensures the home is clean when new tenants arrive and will coordinate with local contractors if any maintenance issues arise during a tenant stay.

Michelle reports rents and all related expenses on Schedule E.

Example – variation. Assume the same facts as above except Michelle lives in Hawaii and rents a guest cottage at her home. Michelle provides daily maid service and breakfast each morning for guests. The additional services Michelle provides would require her to report the rental income and related expenses on Schedule C.

Preparer note. Why do we care? If the activity is properly reported on Schedule E, Michelle is not required to pay SE tax on any rental profit. If the activity is properly reported on Sch C., Michelle is not allowed to deduct the $25,000 passive loss provided to landlords.

2. Personal property rentals are not reported on Schedule E. Real property rentals are the only rentals that are reported on Schedule E. Personal property rentals (trucks, tools, equipment, etc.) are generally reported on Schedule C. In cases where the personal property rentals do not rise to the level of a trade or business the rent income is reported on Line 8k of Schedule 1 (Form 1040) and the related expenses are reported on Schedule 1, Part II, line 24b.

Example. Phil owns 100% of the stock of PAN, Inc., a construction company. Phil has a separate LLC in which he owns construction equipment that he rents to PAN, Inc. Phil does not rent equipment to any other organizations and spends little time administering the rental LLC as the lease terms with PAN require it to provide all maintenance and repair services on the equipment. The rental of the property to PAN does not rise to the level of a trade or business. Phil reports the rental income in Part I of Schedule 1 and reports his rental related expenses (depreciation, interest, property taxes) in Part II.

IRS weighs in on SE tax for rental activities (CCA 202151005)

1. Home rented with substantial services provided. The IRS Chief Counsel was asked about a taxpayer who directly owned and rented a fully furnished vacation property via an online rental marketplace (e.g., Airbnb). The taxpayer provided linens, kitchen utensils, and all other items to make the vacation property fully habitable for each occupant. The taxpayer also provided daily maid services, including delivery of individual use toiletries and other sundries, access to dedicated Wi-Fi service for the rental property, access to beach and prepaid vouchers for ride-share services between the rental property and the nearest business district. The average period of customer use of the vacation property was seven days, so the rental was not considered a rental activity for §469. The taxpayer was able to meet the material participation test, so the rental was not a passive activity.

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Level of service provided means SE tax is owed. The IRS Chief Counsel determined the services provided by the taxpayer were substantial services beyond those required to maintain the space in a condition suitable for occupancy. The rents received by the taxpayer were in large part for the convenience of the property's occupants and went beyond those clearly required to maintain the space in a condition for occupancy and are of such a substantial nature that a material portion of the rent received was compensation for the services. As such, SE tax applies to the net rental income. The characterization of the activity as passive or not passive has no impact.

2. Partial home rented. The Chief Counsel was also asked about a taxpayer who directly owned and rented a fully furnished bedroom and bathroom in their home via an online rental marketplace. Occupants only have access to the common areas of the home to enter and exit the room and bathroom and have no access to other common areas such as the kitchen and laundry room. The taxpayer cleans the room and bathroom in between each occupant's stay. The average period of customer use is seven days, so the rental was not considered a rental activity for §469. The taxpayer was able to meet the material participation test, so the rental was not a passive activity.

No services, no SE tax. The Chief Counsel determined the services provided in this scenario were not substantial services beyond those required to maintain the space in a condition suitable for occupancy. The services provided were not furnished primarily for the convenience of the property's occupants and, what services were provided, were not substantial. As such, no SE tax is due. The characterization of the activity as passive or not passive has no impact.

Real Estate Professionals (§469(c)(7))

Overview. Taxpayers who meet real estate professional rules may deduct the full amount of any losses they realize from rental real estate activities. Such losses are deductible regardless of the taxpayer’s AGI and regardless of how much the rental losses are.

Example. Russ is a qualified real estate professional who realizes real estate rental losses of $150,000 in 2022 when his AGI is $350,000. Because Russ is a qualified real estate professional, he may deduct the entire $150,000 real estate rental losses on his 2022 Form 1040. The rental real estate related passive activity rules do not apply to Russ.

Qualifying to be a real estate professional. Taxpayers must meet two rules to qualify as a real estate professional:

- More than half of the personal services performed by the taxpayer in all trades or businesses during the tax year must be performed in real property trades or businesses.

- More than 750 hours of services during the tax year must be provided in real property trades or businesses.

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- For both tests, the taxpayer may combine hours spent in multiple real estate trade or business activities rather than test each activity separately. The taxpayer may not include any time spent by a spouse to meet these tests.

- For these tests, a real estate trade or business includes:

  a. Real estate brokers and agents
  b. Landlord activities
  c. Property management
  d. Construction contracting
  e. Real estate developers

Example. Russ is trying to determine is he qualifies as a real estate professional in 2022. The total hours he worked in 2021 were:

Managing rentals	365 hours
Part time construction contractor	520 hours
Part-time work as a carpenter	690 hours
Total hours worked	1,575 hours

Russ worked 885 hours in real estate related activities (365 hours managing rentals plus 520 hours contracting) so he meets the first test. In addition, because his total real estate related activity hours is greater than 750 hours, Russ meets the second test. Russ is a real estate professional.

IRS targets time tests as vulnerable when auditing real estate professionals. The IRS has audited dozens of taxpayers over the past decade regarding the real estate professional rules. The IRS regularly targets the two-time tests in audit. Specifically, the IRS attacks whether the taxpayer met the either the 750 hour or 50%-time test and whether the documentation the taxpayer prepared is adequate.

Preparer note. The IRS has regularly argued that the taxpayers must prepare a contemporaneous log to justify the claimed real estate professional hours. Neither the law nor the regulations require contemporaneous recordkeeping, and the courts have often sided with the taxpayer on this issue. However, if contemporaneous recordkeeping is not prepared, the courts have consistently held that it is the taxpayer's responsibility to produce credible documentation to prove the hours worked.

Other items to note for tests:

- Personal services performed as an employee of a real property trade or business do not count unless the taxpayer owns 5% of more of the employer.
- Hours spent as an investor, such as studying and reviewing financial information or summaries or managing finances do not count towards this test.
- Detailed time records should be maintained for the material participation and the 750-hour test because most cases are lost by failing the time requirement.

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- It is difficult for an employee with a job in a non-real estate field to meet this test. In TC Memo 2013-88 (Hassanipour), TC Summary 2015-47 (Escalante) and TC Memo 2016-193 (Lee) the taxpayers had outside jobs in fields unrelated to real estate, estimated their real estate hours and lost their arguments.

Implausible testimony not enough (Timothy Foradis and Jessica Moore v. Comm., TC Summary 2024-13). Tim Foradis and Jessica Moore filed married jointly in 2020 when they both worked as employees approximately 40 hours per week. During 2020, Tim constructed second home on the same property where he and Jessica lived. The second home was rented once construction was complete. Tim and Jessica's AGI was well more than $150,000 in 2020, when they deducted rental losses of $22,000 on their return. The IRS audited and disallowed the deduction for rental related losses. Tim argued that he was a real estate professional as he spent about 2,500 hours constructing the second home. The Court found it implausible that Tim would work 40 hours each week at a full-time job and then work an additional 48 hours each week constructing the second house. The Court also noted it is not required to accept the self-serving testimony of a taxpayer as gospel and ruled that Tim failed the 50% test. The rental losses were not deductible.

See also:

- *Greg and Rachel Teague v. Comm.,* TC Summary 2023-16, where a married couple failed to show that either spouse qualified as a real estate professional because the time requirements couldn't be met by combing the time spent by each spouse. To be a real professional, one spouse or the other must meet the 50% and the 750 hours test by themselves.
- *Christian and Francine Sezonov v. Comm.,* T.C. Memo 2022-40**,** where Ohio HVAC wholesaler claimed to be a real estate pro to claim losses from two Florida single family homes. Long-distance land-lording with a full-time business makes it almost impossible to have the required hours to be a RE professional.
- *Zaid Hakkak v. Comm.,* TC Memo 2020-46; where attorney claimed to be a RE professional, but his records did not support his claim.

Taxpayer is a real estate professional – so what?

The general passive activity rule under §469 is an activity is passive unless the activity's owner can establish material participation. Rental activities, however, are passive by definition – owners are not allowed to even test for material participation. But that still means the taxpayer must materially participate in the underlying activity to deduct losses. Without material participation, the rental real estate activity reverts to a non-deductible passive activity.

Real estate professionals get to test – that's it. Taxpayers who qualify as a real estate professional are allowed to test for material participation. If they able to substantiate their material participation, the rental losses are treated as non-passive activities, the same as any other business, and are fully deductible assuming the taxpayer has adequate basis. There are seven ways to prove material participation:

1. Taxpayer participates in the activity for more than 500 hours a year.

2. Taxpayer is the only person that performs any services in the activity.

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3. Taxpayer participates more than 100 hours during the tax year and participated at least as much as any other individual (including individuals who did not own any interest in the activity) for the year.

4. The activity is a significant participation activity (SPA), and the taxpayer participated in all significant participation activities for more than 500 hours. A significant participation activity is any trade or business activity in which you participated for more than 100 hours during the year and in which you did not materially participate under any of the other material participation tests.

5. Materially participate in the activity for any 5 of the preceding 10 years.

6. The activity is a personal service activity in which the taxpayer materially participated for any 3 (whether consecutive) preceding tax years.

7. Based on all the facts and circumstances, the taxpayer participated in the activity on a regular, continuous, and substantial basis during the year.

The first three tests are most used in the real estate professional environment.

Spousal participation counts. Participation by a spouse during the tax year in an activity owned by the taxpayer may be counted as the taxpayer's participation in the activity even if the spouse did not own an interest in the activity and whether the taxpayer and the spouse file a joint return for the tax year. However, you cannot count the spouse's hours for work not normally performed by an owner.

Example. Nita is a full-time real estate agent who also owns six rental homes. The rental homes generate combined losses of $52,000 in 2022. Nita has no other trade or business activities.

Nita clearly meets the real estate professional tests – she spends 100% of her working time on real estate related activities and she worked more than 750 hours in 2022. The next hurdle is material participation. Nita needs to spend 500 hours on each rental, spend 100 hours on each rental and no one spends more time, or be the only one ever to work on each rental. The problem is Nita hired a property manager who collects rents, takes applications, and arranges for repairs to be made. Nita cannot meet any of the material participation tests so she cannot deduct the losses even though she is a real estate professional.

Preparer note. The IRS and the courts have held numerous times the material participation test is per activity, not for activities combined. Real estate professionals have an aggregation election available to them that combines all rentals together as one activity. But absent that election, the material participation test must be met by each property.

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Grouping Activities

You can treat one or more trade or business activities, or rental activities, as a single activity if those activities form an appropriate economic unit for measuring gain or loss under the passive activity rules. To do this the taxpayer must make an appropriate grouping election provided later, or a similar aggregation election for rental real estate.

Grouping is important for several reasons. If you group two activities into one larger activity, you need to only show material participation in the activity. But if the two activities are separate, you must show material participation in each one. On the other hand, if you group two activities into one larger activity and you dispose of one of the two, then you have disposed of only part of your entire interest in the activity and are unable to deduct any suspended passive losses until the remaining group components are sold. But if the two activities are separate and you dispose of one of them, then you have disposed of your entire interest in that activity.

Grouping is also important to avoid the NII 3.8% surtax on rental income by, in certain instances grouping active trade or business activities with passive rental activities to avoid passive treatment and the resultant 3.8% net investment income surtax for higher income individuals.

Appropriate economic unit. To determine if activities form an appropriate economic unit, you must consider all the relevant facts and circumstances. You can use any reasonable method of applying the relevant facts and circumstances in grouping activities. The following factors have the greatest weight in determining whether activities form an appropriate economic unit. All the factors do not have to apply to treat more than one activity as a single activity.

Grouping factors to consider include:

- The similarities and differences in the types of trades or businesses,
- The extent of common control,
- The extent of common ownership,
- The geographical location, and
- The interdependence between or among activities, which may include the extent to which the activities:
    - Buy or sell goods between or among themselves,
    - Involve products or services that are generally provided together,
    - Have the same customers,
    - Have the same employees, or
    - Use a single set of books and records to account for the activities.

Real property rentals and personal property rentals cannot be grouped together. However, if personal property is provided in connection with the real property or the real property in connection with the personal property then grouping is appropriate.

Certain activities may not be grouped. In general, if you own an interest as a limited partner in one of the following activities, you may not group that activity with any other activity in another type of business:

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- Holding, producing, or distributing motion picture films or video tapes.
- Farming.
- Leasing any section 1245 property.
- Exploring for, or exploiting, oil and gas resources.
- Exploring for or exploiting, geothermal deposits.

If you own an interest as a limited partner in an activity described in the list above, you may group that activity with another activity in the same type of business if the grouping forms an appropriate economic unit.

Once grouped, activities may not be regrouped in a later tax year. Disclosure requirements must be met when activities are first grouped and whenever activities are added or disposed of from your group. A new grouping election is required to add new purchases to an existing group.

Grouping election. Historically grouping did not require any special election or form, except in the case of a real estate professional. In 2010 Rev. Proc. 2010-13 was issued requiring written grouping elections for activities grouped together for the first time on or after 1/25/2010. The election must:

- Be filed with the tax return for the year,
- Disclose the names, addresses and EIN's of trade, business or rental activities that are grouped, and
- Include an attestation that the activities together form an appropriate economic unit for purposes of Sec. 469

Any groupings before 1/25/2010 do not require disclosure (except for real estate professionals) unless changed or added to, in which case the above election must be made and attached to the return. This election also requires that the taxpayer attach justification for any change in grouping. The IRS allows taxpayers a “fresh start” where they may regroup their activities in tax years beginning in 2013. The regrouping must comply with the disclosure and reporting requirements of Reg. §1.469-4(e) and Revenue Procedure 2010-13.

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Grouping Election Example

Grouping Election for New or Modified Activities on or after 1/25/2010

<CLIENT> <FEIN>

"In accordance with Reg. 1.469-4, the taxpayer hereby states that the grouped activities listed below constitute an appropriate economic unit for the measurement of gain or loss for purposes of section 469."

Name/Address and/or EIN: ____

Name/Address and/or EIN: ____

Name/Address and/or EIN: ____

Name/Address and/or EIN: ____

Grouping for active treatment. In general, rental activities cannot be grouped with trade or business activities. However, you can group them together if the activities form 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 ownership interest in the rental activity, in which case the part 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.

In CCA 201411025 the IRS advised that when grouping a taxpayer's trade or business activities and rental activities for purposes of applying the passive activity loss and credit limitation rules of section 469, the "activities of a taxpayer" include only activities in which the taxpayer possesses an ownership interest.

In TC Memo 2017-16 (Hardy) The Tax Court held that a doctor was correct in recategorizing income from non-passive to passive and the IRS could not regroup the doctor's plastic surgery activity with his investment in a business entity that rents out surgical space. The grouping election is a positive election, and the IRS may not make it for a taxpayer unless an existing election (there was none here) is incorrect. However, because the issue was not previously raised, the doctor was not entitled to use that recharacterized passive income to offset prior year passive losses from dead years, holding that the losses should have been claimed against the re-characterized income at the time.

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Example. Maui and Moana are married and file a joint return. Arendelle, an S corporation, is a grocery store business. Maui is Arendelle's only shareholder. Sven, an S corporation, owns and rents out the building. Moana is Sven 's only shareholder. Sven rents part of its building to Arendelle. Sven 's grocery store rental business and Arendelle's grocery business are substantial in relation to each other so that Maui & Moana do not meet either of the first two tests.

Maui and Moana are treated as one taxpayer for purposes of the passive activity rules. The same owner (Maui and Moana) owns both Arendelle and Sven with the same ownership interest (100% in each). If the grouping forms an appropriate economic unit Maui and Moana can group Sven 's grocery store rental and Arendelle's grocery business into a single trade or business activity.

Aggregation Election (§1.469-4) for Real Estate Professionals

The aggregation election is only available for real estate professionals and is therefore different from the grouping election because the aggregation is all or none, but grouping elections are flexible as to inclusion. New properties purchased are automatically included in the aggregation election for real estate professionals, but they are not automatically included in grouping elections. Non-rental activities are not allowed to be included in the aggregation election (Bailey v. Comm. T.C. Memo 2001-296).

Late aggregation election allowed (Rev. Proc. 2011-34). The IRS established a special procedure to make a late election to treat all real estate activities as a single activity for the material participation rules (real estate professional test). To request this relief, the taxpayer must attach the statement required by Reg. §1.469-9(g)(3) to an amended return for the most recent tax year and mail it to the IRS service center where the taxpayer will file a current-year income tax return. The statement must contain the declaration required by Treas. Reg. § 1.469-9 (g)(3); explain the reason for the failure to file a timely election; state that the taxpayer meets the eligibility requirements set out in the revenue procedure; identify the tax year for which the late election is sought; and reference the revenue procedure in a heading. It also must contain the declaration prescribed in the revenue procedure and be dated and signed by the taxpayer.

Taxpayers are eligible for relief under Revenue Procedure 2011-34 if they:

- Failed to make the election solely because they failed to timely meet the requirements in Treas. Reg. § 1.469-9 (g) and have reasonable cause for the failure.
- Filed consistently with having made the election on any previous return that would have been affected if they had timely made the election.
- Have reasonable cause for failure to previously file the election.
- Have filed all required federal income tax returns consistent with the requested aggregation for all the years including and following the year they intend the election to be effective, and no tax returns containing positions inconsistent with the request have been filed by or with respect to the taxpayer during any of those years.

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- Have timely filed each return (within six months of its due date, not including extensions) that would have been affected by the election if it had been timely made.

Because real estate professionals must make the aggregation election for the current year on a timely filed return but are able to make the election retroactively with this procedure, the procedure has value, but also calls attention to the activity. It may be wiser when the taxpayer has poor time records for prior years and does not want to risk being audited on a retroactive election using this procedure.

IRS allows 120-day extension to make aggregation election (LTR 202223011). The IRS granted an extension of time to a real estate professional to aggregate all real estate rental activities. The taxpayer said that his tax professional never advised him to aggregate the rentals, so he didn't know he needed to do so. The IRS gave him 120 days to make the election. See also LTR 202226003 and LTR 202223011, where the IRS also granted 120 extensions to taxpayer to make the aggregation election.

Aggregation procedures. When aggregating rental activities into appropriate economic units, you may not regroup those activities in a later tax year. You must meet any disclosure requirements of the Internal Revenue Service when you first group your activities and when you add or dispose of any activities in your aggregations. However, if the original aggregation is clearly inappropriate or there is a material change in the facts and circumstances that makes the original aggregation clearly inappropriate, you must reaggregate the activities and comply with any disclosure requirements of the IRS.

The election to treat all interests in rental real estate as a single rental real estate activity is binding for all future years unless there is a material change in a taxpayer's facts and circumstances. If in an intervening year the taxpayer fails, the real estate professional rule the aggregation election still applies unless the taxpayer revokes the election because material facts and circumstances changed (§1-469-9(g)(3)). The aggregation has no bearing if the taxpayer is not a real estate professional, but the election doesn't go away and will be in force in any future year where the taxpayer is again a RE pro.

Election procedure. The taxpayer makes the election by filing a statement with his or her original income tax return. The failure to make the election in one year does not preclude the taxpayer from making it in another year. The statement must contain a declaration that the taxpayer is a qualifying real estate professional taxpayer for the taxable year and is making the election pursuant to §469 (c)(7)(A) [Reg. § 1.469-9 (g)].

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Aggregation Election for Real Estate Professional

<CLIENT> <FEIN>

"In accordance with Reg. § 1.469-9 (g)(3), the taxpayer hereby states that he (or she) is a qualifying real estate professional under IRC §469 (c)(7) and elects under IRC §469 (c)(7)(A) to treat all interests in the real estate listed below as a single rental real estate activity."

Property Description/Address: ____
Property Description/Address: ____
Property Description/Address: ____
Property Description/Address: ____

No grouping election means each property looked at individually (*Sidney Shaw v. Comm., TC Memo 2002-35*). Sid Shaw failed to attach an election to treat multiple interests in rental real estate as a single rental real estate activity. As a result, he was required to prove material participation for each activity, which he failed to do, and was not allowed to deduct his real estate losses, regardless if he was a real estate professional. (Also see *William C. Fowler v. Comm.*, TC Memo 2002-223; *Mohammad Hassanipour v. Comm.*, TC Memo 2013-88).

Good records save rental deductions for stockbroker (*Patricia Windham v. Comm., TC Memo 2017-68*). Patricia Windham, a part-time stockbroker, owned eleven rental properties. The Court ruled she met the material participation, 750 hours and 50% of work hour rules because her meticulous recordkeeping proved it. Patricia managed all aspects of the rentals and documented the time she spent on them. According to the Court, she materially participated ***in each rental property*** and spent 889 hours on real estate activities.

Example - variation. Returning to our example with Nita, remember the problem for her was she had six rental homes, and she used a property manager. Nita couldn't meet the 500 or the 100-hour test for each rental.

Assume Nita makes the aggregation election to treat all six rental properties as one rental activity. Now she need only meet the 500-hour test once or work 100 hours total and ensures no one else works more. It is much easier test to meet than each property individually.

Preparer note. This is the most litigated area in the passive activity and rental real estate area. Each year there are several court cases specifically on point. Taxpayers (and sometimes their preparers) classify themselves as real estate professionals to deduct rental losses, often without knowing or understanding the rules.

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Final note. Even though a taxpayer is a real estate professional, real estate rental activities are still reported on Schedule E and any net profit is still exempt from self-employment tax.

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FinCEN 114 (Report of Foreign Bank & Financial Account (FBAR))

Congress enacted the BSA in 1970 "to require certain reports or records where such reports or records have a high degree of usefulness in criminal, tax, or regulatory investigations or proceedings." A primary purpose of the BSA was to curb the "serious and widespread use" of foreign financial accounts to evade taxes. The FBAR is required because foreign financial institutions may not be subject to the same reporting requirements as domestic financial institutions. The FBAR is also a tool used by the U.S. government to identify persons who may be using foreign financial accounts to circumvent U..S law. The form is available through the BSA E-Filing System.

Information contained in FBARs can be used to identify or trace funds used for illicit purposes or to identify unreported income maintained or generated abroad. ***The FBAR does not report income****, which is taxable and required to be reported elsewhere on the return.* ***It reports the existence and value of certain overseas assets****; therefore, asset reporting is required even if the assets are not generating income.*

Filing Requirements

The FBAR is a calendar year annual report and must be filed on or before April 15th of 2024 for 2023 by any individual with ownership, joint ownership, or signature authority over one or several accounts, investments, foreign pension or mutual fund, or foreign life insurance policies when the aggregate total value of all the accounts is over $10,000 on any day of the year**.** Because there is no tax due, but the failure to file penalties are incredibly high, when in doubt, file!

A. File electronically - The FBAR must be filed electronically through FinCEN's BSA E-Filing System. If you are an attorney, CPA, or an enrolled agent (EA) filing the FBAR on behalf of a client, ***you must register to Become a BSA E-Filer*** and file as an institution rather than an individual.

B. No extension - The FBAR is not filed with a federal tax return. When the IRS grants a filing extension for a taxpayer's income tax return, it does not extend the time to file an FBAR. There is no provision for requesting an extension of time to file an FBAR. **Returns are automatically extended to October 15th.**

C. Deadline - The FBAR filing deadline follows the Federal income tax due date guidance, which notes that when the Federal income tax due date falls on a Saturday, Sunday, or legal holiday, a return is considered timely filed if filed on the next succeeding day that is not a Saturday, Sunday, or legal holiday.

D. Children - Generally, a child is responsible for filing his or her own FBAR report. If a child cannot file his or her own FBAR for any reason, such as age, the child's parent, guardian, or other legally responsible person must file it for the child. If the child cannot sign his or her FBAR, a parent or guardian must electronically sign the child's FBAR. In Item 45 Filer Title, enter "Parent/Guardian filing for child."

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IRS Chief Counsel reiterates corporations have an FBAR reporting responsibility (CCA 202225008). Just in case there was any doubt, the IRS confirmed in a recent Chief Counsel Advice that corporations have an FBAR filing requirement.

Delinquent Filings

Taxpayers who have not filed a required FBAR and are not under a civil examination or a criminal investigation by the IRS, and have not already been contacted by the IRS about a delinquent FBAR, should file any delinquent FBARs according to the FBAR instructions and include a statement explaining why the filing is late. Select a reason for filing late from the drop-down list or "other".

A. Reasonable cause – U.S. persons who inadvertently failed to file FBARs, but the IRS determines that the FBAR violation was due to reasonable cause, may not be subject penalty. More information on penalties will be discussed later.

B. Streamlined Compliance Procedures
   a. Not willful
   b. Specific procedures for Foreign Offshore and Domestic Offshore
   c. Need TIN
   d. Consider IRS Criminal Investigation Voluntary Disclosure Practice
   e. If using streamlined procedures, then not eligible for Offshore Voluntary Disclosure Program (OVDP)

Form 1040, Schedule B reporting

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

Part III Foreign Accounts and Trusts

Caution: If required, failure to file FinCEN Form 114 may result in substantial penalties. Additionally, you may be required to file Form 8938, Statement of Specified Foreign Financial Assets. See instructions.

You must complete this part if you (**a**) had over $1,500 of taxable interest or ordinary dividends; (**b**) had a foreign account; or (**c**) received a distribution from, or were a grantor of, or a transferor to, a foreign trust.

		Yes	No
7a	At any time during 2023, did you have a financial interest in or signature authority over a financial account (such as a bank account, securities account, or brokerage account) located in a foreign country? See instructions		
	If "Yes," are you required to file FinCEN Form 114, Report of Foreign Bank and Financial Accounts (FBAR), to report that financial interest or signature authority? See FinCEN Form 114 and its instructions for filing requirements and exceptions to those requirements		
b	If you are required to file FinCEN Form 114, list the name(s) of the foreign country(-ies) where the financial account(s) is (are) located:		
8	During 2023, did you receive a distribution from, or were you the grantor of, or transferor to, a foreign trust? If "Yes," you may have to file Form 3520. See instructions		

Preparer Trap. The rules dramatically increased the filing instances of this form. The IRS is saying that you must ask clients this question during your tax interviews!

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B. Check the "Yes" box on Line 7a if:
   The taxpayer owns more than 50% of the stock in any corporation that owns one or more foreign bank accounts. At any time during the year the taxpayer had an interest in or signature or other authority over a financial account in a foreign country (such as a bank, brokerage, savings, checking, demand, options, commodities, cash surrender value life or annuity policy, mutual fund, securities account, or other financial account).

C. **This rule does not apply to foreign securities held in a U.S. account. A financial account is in a foreign country only if the account is physically located outside of the United States. An account maintained with a U.S. physically located branch of a foreign bank is NOT a foreign financial account.** Do not file the report if the assets are with a U.S. military banking facility operated by a U.S. financial institution or if the combined assets in the account(s) are $10,000 or less during the entire year.

D. Enter the name of the foreign country or countries in the space provided on Schedule B.

   IR-2015-70 noted that a monetary threshold does not exist for Line 7a, Question 1. The mere existence of a foreign account requires the taxpayer to check "Yes" *"even if you are not required to file FinCEN Form 114, Report of Foreign Bank and Financial Accounts (FBAR)."*

E. Schedule B instructions include additional examples of financial accounts that go beyond the traditional notions of financial accounts. Thus, a financial account is also "a commodity futures or options account, an insurance policy with a cash value (such as a whole life insurance policy), an annuity policy with a cash value, and shares in a mutual fund or similar pooled fund.

Who is United States Person?

A "United States person" is a(n):

- Citizen or resident of the U.S.
- Entity created or organized in the U.S. or under the laws of the U.S. The term "entity" includes but is not limited to, a corporation, partnership, and limited liability company (LLC).
- Trust formed under the laws of the U.S.
- Estate formed under the laws of the U.S.

A. Disregarded entities - Entities that are U.S. persons and are disregarded for tax purposes may be required to file an FBAR. The federal tax treatment of an entity does not affect the entity's requirement to file an FBAR. FBARs are required under the Bank Secrecy Act provision of Title 31 and not under any provisions of the Internal Revenue Code.

B. United States resident - A U.S. resident includes aliens residing in the United States. To determine if the filer is a resident of the U.S., apply the residency tests in 26 U.S.C. §7701(b). When applying the §7701(b) residency tests use

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the following definition of United States: United States includes the States, the District of Columbia, all U.S. territories and possessions (e.g., American Samoa, the Commonwealth of the Northern Mariana Islands, the Commonwealth of Puerto Rico, Guam, and the United States Virgin Islands), and the Indian lands as defined in the Indian Gaming Regulatory Act.

Example. Armen is a citizen of Argentina. He has been physically present in the U.S. every day of the last three years. Because Armen is considered a resident by application of the rules under 26 U.S.C. §7701(b), he is required to file an FBAR.

Example. Jasmin is a citizen of the United Kingdom who is a permanent legal resident of the U.S. Under a tax treaty, Jasmin is a tax resident of the United Kingdom and elects to be taxed as a resident of the United Kingdom. Jasmin is still required to file an FBAR. Tax treaties with the U.S. do not affect FBAR filing obligations.

"Financial Accounts" defined.

A financial account includes the following types of accounts:

1. Bank accounts such as savings accounts, checking accounts, and time deposits.
2. Securities accounts, such as brokerage accounts and securities derivatives or other financial instruments accounts
3. Commodity futures or options accounts
4. Insurance or annuity policies with cash value (such as a whole life insurance policy)
5. Mutual funds or similar pooled funds (i.e., a fund that is available to the public with a regular net asset value determination and regular redemptions)
6. Any other accounts maintained in a foreign financial institution or with a person performing the services of a financial institution.

Example. A Canadian Registered Retirement Savings Plan (RRSP), Canadian Tax-Free Savings Account (TFSA), Mexican individual retirement accounts (Fondos para el Retiro) and Mexican Administradoras de Fondos para el Retiro (AFORE) are foreign financial accounts reportable on the FBAR because they are controlled by the individual.

Preparer Tip. Foreign hedge funds and private equity funds are not reportable on the FBAR. The FBAR regulations do currently not require the reporting of these funds.

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A. Foreign account - A financial account is foreign when it is located outside of the United States, which includes the following places: U.S., including the District of Columbia; U.S. territories and possessions; Indian lands as defined in the Indian Gaming Regulatory Act.
Typically, a financial account that is maintained with a financial institution located outside of the U.S. is a foreign financial account.

Examples. An account maintained with a branch of a U.S. bank that is physically located in Spain is a foreign financial account.

An account maintained with a branch of a Spanish bank that is physically located in Arizona is not a foreign financial account.

Example. Alvin, a U.S. citizen, purchased securities of an Italian company through a securities broker located in Maine. Alvin is not required to report these securities because he purchased the securities through a financial institution located in the U.S.

Case Law. In July 2016 the Ninth Circuit, in an unpublished per curium opinion (*United States v. John C. Hom*; No. 14-16214), held that an individual was required to file foreign bank account reports for his FirePay account located in the United Kingdom because it was used to transfer funds, but he was not required to report two online gambling accounts that were only used to play poker. This case reverses the 2014 results that a lower court determined that Hom had to report the accounts as foreign accounts. The Court determined in this case that online poker accounts were not held by a "financial institution."

B. Maximum account value - The maximum value of an account is a reasonable approximation of the greatest value of currency or nonmonetary assets in the account during the calendar year. Periodic account statements may be relied upon to determine the maximum value of the account, provided that the statements fairly reflect the maximum account value during the calendar year. The account's value is the value that appears on a statement issued quarterly or more often. If there are no periodic statements, the value is the largest amount at any time during the year.

C. Maximum value of a foreign financial account - Determine the maximum account value in the currency of the account. After the maximum value of the account is determined, convert the maximum account value for each account into U.S. dollars using the exchange rate on the last day of the calendar year.

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Example. A foreign financial account that is in Switzerland would typically be valued in Franc. Determine the maximum value of the account in Franc. Next, convert the maximum value of the account into U.S. dollars.

D. Conversion rate - When converting between a foreign currency and U.S. dollars, use the Treasury Reporting Rates of Exchange for the last day of the calendar year. If no Treasury Financial Management Service rate is available, use another verifiable exchange rate and provide the source of that rate. In valuing currency of a country that uses multiple exchange rates, use the rate that would apply if the currency in the account were converted into U.S. dollars on the last day of the calendar year.

Example. Max, a U.S. person, owns foreign financial accounts X, Y, and Z with maximum account values of $300, $14,000, and $5,000, respectively. Max is required to file an FBAR because the aggregate value of the accounts is $19,300. Max must report foreign financial accounts X, Y, and Z on the FBAR even though accounts X and Z have maximum account values below $10,000.

Example. Deana, a U.S. person, owns foreign financial accounts A, B and C with account balances of $2,000, $1,000, and $9,000, respectively. Deana is required to report accounts A, B and C because the aggregate value of the accounts is over $10,000. It does not matter that no single account exceeded $10,000.

Example. Lawson, a U.S. person, owns a foreign financial account with a maximum value of $16,000 but the account does not produce income. Lawson is required to file an FBAR to report the account.

Preparer note. Whether or not an account produces income does not affect the requirement to file an FBAR.

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Financial Interest

A U.S. person has a financial interest in the following situations:

- The U.S. person is the owner of record or holder of legal title, regardless of whether the account is maintained for benefit of the U.S. person or for the benefit of another person, including non-U.S. persons.

- The owner of record or holder of legal title is a person acting as an agent, nominee, attorney, or a person acting on behalf of the U.S. person with respect to the account.

> **Example.** Marcus is a U.S. citizen. His brother, Lucas, maintains bank accounts in Portugal on behalf of Marcus. The accounts are held in Lucas's name, but Lucas only accesses the accounts in accordance with his brother's instructions. Marcus has a financial interest in the Portuguese bank accounts for FBAR reporting purposes. If his brother Lucas is a U.S. citizen or resident, he also has an FBAR reporting requirement with respect to the accounts.

- The owner of record or holder of legal title is a corporation in which a U.S. person owns directly or indirectly:
    - (i) more than 50% of the total value of stock shares or
    - (ii) more than 50% of the voting power of all shares of stock

> **Example.** A Kansas corporation that owns 100% of a French company that has foreign financial accounts must file an FBAR because the corporation is a U.S. person, and it directly owns more than 50% of the total value of the shares of stock of the French company that is the owner of record or holder of legal title.

> **Example.** A U.S. person who owns 75% of the Kansas corporation in the previous example must file an FBAR because he indirectly owns more than 50% of the total value of shares of stock of the foreign corporation that owns foreign financial accounts.

- The owner of record or holder of legal title is a partnership in which the U.S. person owns directly or indirectly:

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- (i) an interest in more than 50% of the partnership's profits (distributive share of partnership income considering any special allocation agreement) or
- (ii) an interest in more than 50% of the partnership capital.

- The owner of record or holder of legal title is a trust of which the U.S person:
  - (i) is the trust grantor and
  - (ii) has an ownership interest in the trust for U.S. federal tax purposes.

Example. Sal, a U.S. citizen, is a grantor of a Foreign Asset Protection Trust but does not control trust assets nor does he receive distributions from the trust. Sal, as grantor and deemed owner of the trust assets for federal tax purposes, is required to report the trust's foreign financial accounts.

- The owner of record or holder of legal title is a trust in which the U.S. person has a greater than 50% present beneficial interest either directly or indirectly in more than 50% of the assets or income of the trust for the calendar year.

Example. Evelyn, a U.S. citizen, has a remainder interest in a trust that has a foreign financial account. Evelyn is not required to report the trust's foreign financial account because a remainder interest is not considered a present beneficial interest for FBAR purposes.

- The owner of record or holder of legal title is any other entity in which the U.S. person owns directly or indirectly more than 50% of the voting power, total value of equity interest or assets, or interest in profits.

Signature Authority

Signature authority is the authority of an individual (alone or in conjunction with another individual) to control the disposition of assets held in a foreign financial account by direct communication (whether in writing or otherwise) to the bank or other financial institution that maintains the financial account.

Example. Mimi, a U.S. resident, has a power of attorney (POA) on her elderly parents' accounts in China, but she has never exercised the POA. Mimi is required to file an FBAR if the POA gives her signature authority over the financial accounts. Whether or not the authority is ever exercised is irrelevant to the FBAR filing requirement.

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Case Law. In *U.S. v. James A. Simon*, CA-7, 11-1837, August 15, 2013; 2013-2 USTC ¶50,480, the Court convicted James A. Simon, a CPA and a professor of accounting who was the managing director of three foreign corporations with signature authority over the corporations' foreign bank accounts, of four counts of filing false income tax returns because he failed to check the "yes" box on his Forms 1040, Schedule B, Part III. He also had numerous other tax investigations in process.

A foreign bank account requires that the Schedule B, Part III, be completed. Although Mr. Simon had signature authority over foreign bank accounts, he did not properly complete the Schedule B on his Form 1040.

Case Law. In *Moore v US,* the U.S. (4/1/2015) District Court in Seattle held that the taxpayer's failure to check the boxes at the bottom of Schedule B was not enough to apply the "reasonable cause" penalty exception for failure to file the FBAR form. The taxpayer was then required to pay a $40,000 penalty for failure to file the form.

Reporting Jointly Held Accounts

If two persons jointly maintain a foreign financial account, or if several persons each own a partial interest in an account, then each U.S. person has a financial interest in that account and each person must report the entire value of the account on an FBAR.

A. Limited joint filing by spouses - The spouse of an individual who files an FBAR is not required to file a separate FBAR if the following conditions are met:

   1) All the financial accounts that the non-filing spouse is required to report are jointly owned with the filing spouse;
   2) The filing spouse reports the jointly owned accounts on a timely filed FBAR electronically signed (PIN) in item 44; and
   3) The filers have completed and signed Form 114a, Record of Authorization to Electronically File FBARs (maintained with the filers records).

Otherwise, both spouses are required to file separate FBARs, and each spouse must report the entire value of the jointly owned accounts.

Modified Reporting Requirements

A. A financial interest in 25 or more foreign financial accounts - A U.S. person with a financial interest in 25 or more foreign financial accounts should check the Yes box in Part I, Item 14a, and indicate the number of accounts in the space provided. The U.S. person should not complete Part II or Part III of the report but maintain records of the information. If the group of entities covered by a consolidated report has a financial interest in 25 or more foreign financial

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accounts, the reporting parent corporation need only complete Part V (for consolidated reporting), Items 34 through 42, for the identity information of the account owners, but need not complete the account information.
A U.S. person who has a signature or other authority over 25 or more accounts follows similar instructions as above with the appropriate lines.

B. U.S. persons employed and residing outside of the U.S. - A U.S. person who is an officer or employee employed and residing outside of the U.S. and who has signature authority over a foreign financial account that is owned or maintained by the individual's employer is only required to complete Part I and Part IV, Items 34-43 of the FBAR, as well as the signature section of the FBAR.

Example. McKayla is a U.S. person who lives in Italy and is employed by an Italian company. She is only required to complete Part I and Part IV, Items 34-43, and the signature section of the FBAR to report her signature authority over the foreign financial accounts of her employer.

Filing Exceptions

The following people are excepted from the FBAR filing requirement:

- Consolidated FBAR - A U.S. person that is an entity and is named in a consolidated FBAR filed by a greater than 50% owner.

- IRA Owners and Beneficiaries - An owner or beneficiary of an IRA is not required to report a foreign financial account held in the IRA.

- Participants in and Beneficiaries of Tax-Qualified Retirement Plans - A participant in or beneficiary of a retirement plan described in §§401(a), 403(a), or 403(b) is not required to report a foreign financial account held by or on behalf of the retirement plan.

- Trust Beneficiaries – A beneficiary of a trust in which the beneficiary has a financial interest does not need to report the trust's foreign financial accounts on an FBAR if the trust, trustee of the trust or agent of the trust is a U.S. person and files an FBAR disclosing the trust's foreign financial accounts.

- Signature or Other Authority - Individuals who have signature authority over, but no financial interest in, a foreign financial account are not required to report the account in the following situations:

    - An officer or employee of a bank that is examined by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, or the National Credit Union Administration is not required to report signature authority over a foreign financial account owned or maintained by the bank.

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- An officer or employee of a financial institution that is registered with and examined by the Securities and Exchange Commission or Commodity Futures Trading Commission is not required to report signature authority over a foreign financial account owned or maintained by the financial institution.

- An officer or employee of an Authorized Service Provider is not required to report signature authority over a foreign financial account that is owned or maintained by an investment company that is registered with the Securities and Exchange Commission.

  Authorized Service Provider means an entity that is registered with and examined by the Securities and Exchange Commission and provides services to an investment company registered under the Investment Company Act of 1940.

- An officer or employee of an entity that has a class of equity securities listed (or American depository receipts listed) on any U.S. national securities exchange is not required to report signature authority over a foreign financial account of such entity.

- An officer or employee of a U.S. subsidiary is not required to report signature authority over a foreign financial account of the subsidiary if its U.S. parent has a class of equity securities listed on any U.S. national securities exchange and the subsidiary is included in a consolidated FBAR report of the U.S. parent.

- An officer or employee of an entity that has a class of equity securities registered (or American depository receipts in respect of equity securities registered) under section 12(g) of the Securities Exchange Act is not required to report signature authority over a foreign financial account of such entity.

The following types of foreign financial accounts are **excepted** from the FBAR filing requirement:

- Certain Accounts Jointly Owned by Spouses. The spouse of an individual who files an FBAR is not required to file a separate FBAR if certain conditions are met as previously discussed.

- Correspondent/Nostro Account. Correspondent or nostro accounts (maintained by banks and used solely for bank-to-bank settlements) are not required to be reported.

- Governmental Entity. A foreign financial account of any governmental entity is not required to be reported by any person.

Example. A state administered college or university is not required to file an FBAR because it is a governmental entity.

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> **Example.** A government employee retirement or welfare benefit plan is not required to file an FBAR because it is a governmental entity.

- International Financial Institution. A foreign financial account of any international financial institution (if the U.S. government is a member) is not required to be reported by any person. Examples are the World Bank and the International Monetary Fund (IMF).
- U.S. Military Banking Facility - A financial account maintained with a financial institution located on a U.S. military installation is not required to be reported, even if that military installation is outside of the U.S.
- Held in an IRA or retirement plan of which the taxpayer is an owner, participant, or beneficiary.

Recordkeeping

Generally, keep records of accounts required to be reported on the FBAR for five years from the due date of the report, which is April 15 of the year following the calendar year being reported.

The records should contain the following:

- Name maintained on each account.
- Number or other designation of the account
- Name and address of the foreign bank or other person with whom the account is maintained.
- Type of account
- Maximum value of each account during the reporting period

Retaining a copy of the filed FBAR can help to satisfy the record-keeping requirements. An officer or employee, however, who files an FBAR to report signature authority over an employer's foreign financial account is not required to personally retain records regarding these foreign financial accounts.

FBAR Penalties

Failure to file an FBAR when required to do so may result in civil penalties, criminal penalties, or both. As originally enacted, only willful violations were subject to penalties. Congress added penalties for non-willful violations in 2004.

Penalty amounts. Different penalties attach to non-willful and willful violations. For non-willful violations, the penalty amount cannot exceed $10,000. The non-willful penalties are waived if the account owner can establish the failure to file was due to a reasonable cause. For a willful violation, the maximum penalty increases to the greater of $100,000 or 50% of "the amount of the transaction" (when a violation involves a transaction) or "the balance

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in the account at the time of the violation" (when a violation involves "a failure to report the existence of an account"). There is no reasonable cause relief for willful violations.

Penalties are assessed per report (FinCen Form 114) not per account (U.S v. Alexandru Bittner). Alexandru Bittner, who was born in Romania in 1957, immigrated to the U.S. in 1982 and became a U.S. citizen in 1987. In 1990 Bittner returned to Romania where he acquired multiple businesses, making him a millionaire several times over. To help manage his growing wealth, Bittner opened dozens of numbered bank accounts in several European countries. Bittner was unaware of the FBAR reporting laws and never filed with FinCen.

Bittner returned to the US in 2011, which is when he learned of his FinCen reporting responsibilities. He hired a CPA to help him file the delinquent FBARs. However, the submitted FBAR reports were incomplete and contained errors. Bittner hired a new CPA and filed revised FBARs in 2013 that included lists of every bank account with the current balances. After review, the IRS assessed $2.72 million of FBAR penalties in 2017, the non-willful penalty for failing to report interests in more than 40 foreign bank accounts on FinCen Form 114 from 2007 through 2011. The district court upheld the IRS assessment and denied Bittner's reasonable-cause defense. But the district court also reduced the penalty assessment to $50,000, ruling that the $10,000 maximum penalty attaches to each failure to file an annual FBAR, not to each failure to report an account.

Supreme Court gets involved. The IRS appealed the district court ruling and the Fifth Circuit Court of Appeals reversed (US v. Bittner, CA 5th, No. 20-40597, Nov. 30, 2021), holding that the penalty should be assessed ***per account, not per FBAR report*** and reinstated the $2.72 million of penalties. However, the 9th Circuit had previously ruled that the FBAR penalties should be assessed ***per FBAR report, not per account***. Due to the split in the circuits, the Supreme Court accepted the case and sided with the 9th Circuit. Bittner was ultimately assessed penalties of $50,000, $10,000 per report for 2007 – 2011.

FBAR is late, now what? When a U.S person learns that an FBAR should have been filed for the previous year, the filer should electronically file the delinquent FBAR report using the BSA E-Filing System website. The system allows the filer to enter the calendar year reported, including past years, on the online FinCEN Form 114. It also offers an option to "explain a late filing" or to select "Other" to enter up to 750-characters within a text box where the filer can provide a further explanation of the late filing or indicate whether the filing is made in conjunction with an IRS compliance program. If the foreign financial account is properly reported on a late-filed FBAR, and IRS determines that the FBAR violation was due to reasonable cause, no penalty will be imposed. For additional guidance when circumstances, such as natural disasters, prevent the timely filing of an FBAR, see FinCEN guidance, FIN-2013-G002.

Filing Amended Returns After You've Been Caught Not Much Help (Johannes and Linda Lamprecht v. Comm., USCA DC, No. 22-1308, April 23, 2024).

Johannes and Linda Lamprecht were Swiss citizens who lived in the US in in 2006 and 2007. For each year, the Lamprechts underreported their taxable income and failed to report to the IRS that they foreign bank accounts. In fact, they had millions of dollars in Swiss bank called UBS. In 2010 UBS agreed to give account holder information to Switzerland, which agreed to give it to the United States. Shortly after the agreement with

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UBS, Switzerland and the U.S. was made public, the Lamprechts amended their tax returns for 2006 and 2007, reporting the income from undisclosed UBS accounts, and paid tax of $2.5 million.

IRS says thanks for the tax, but we want a penalty for the undisclosed foreign accounts. The IRS sent Lamprechts a notice in 2014 assessing FBAR penalties of $500,000. The couple challenged those penalties in Tax Court, where they argued that the IRS didn't follow the tax code's procedures when the IRS first decided to penalize them; that they deserved protections for voluntarily fixing their own mistakes before the IRS acted; and that in any event, the statute of limitations for assessing accuracy penalties had run on the two tax years.

Court say pay up. The US Court of Appeals affirmed the Tax Court and let the entire $500,000 penalty stand. They noted that the Lamprechts arguments lacked merit and that they were attempting to find technicalities where they didn't exist. The IRS showed that a supervisor preapproved the Lamprechts' penalties in writing, the couple did not protect themselves from penalties by filing "qualified amended returns," and the statute of limitations did not bar the assessment of those penalties. The Lamprechts owed the penalties.

Other case law:

- In U.S. v. Est. of Danielson, 2020 PTC 352 (M.D. Fla. 2020), a district court granted the government's request for a default judgment against a decedent's estate for civil penalties and fees of more than $6.4 million because of the decedent's failure to file FBARs. The Court noted that the decedent had filed FBARs in 1994 and 1995; thus, proving that he knew of his obligation to file an FBAR in subsequent years, but had, under penalty of perjury and with knowledge of his bank accounts in Lichtenstein and Canadian, checked "no" on his tax returns when asked if he had a foreign bank account. This, the court said, proved that he acted willfully in failing to report his ownership and interests in his foreign bank accounts.

- The Court of Federal Claims held that a taxpayer who failed to file with the IRS a timely FBAR to report a Swiss bank account was liable for a penalty equal to 50% of the balance of the foreign account because he willfully failed to report the account. The Court found that, as the owner of record of the account, the taxpayer was required to file the FBAR even though he claimed to hold the account for the benefit of his family, and the court rejected the taxpayer's argument that the penalty is an excessive fine under the Eighth Amendment [*Landa v. U.S.*, 2021 PTC 114 (Fed. Cl. 2021)].

Penalties

	Non-Willful Maximum	Willful Maximum
Civil	$15,611 (adjusted for inflation)	Greater of $156,107 or 50% of account balances
Criminal – Knowingly and Willfully Filing False FBAR	N/A	$10,000 or 5 years or both
Criminal – Failure to file FBAR or retain required records	N/A	$250,000 or 5 years or both

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FinCEN 114

Home | Filer Information | Financial Account Owned Separately/Jointly | No Financial Interest Account Information | Consolidated Report | Signature Informatio

1 This report is for calendar year ended 12/31 [ ] Amended ☐ Prior Report BSA Identifier [ ]

Part I Filer Information

2 Type of filer

3 U.S. Taxpayer Identification Number

3a TIN type

4 Foreign identification

a Type

b Number

c Country of issue

5 Individual's date of birth

6 Last name or organization's name

7 First name

8 Middle name

8a Suffix

9 Address

10 City

11 State

12 ZIP/postal code

13 Country

14a Does the filer have a financial interest in 25 or more financial accounts?

☐ Yes Enter number of accounts [ ] **If "Yes" is checked do not complete Part II or Part III, but retain records of this information**

☐ No

14b Does the filer have signature authority over but no financial interest in 25 or more financial accounts?

☐ Yes Enter number of accounts [ ] **If "Yes" is checked Complete Part IV items 34 through 43 for each person on whose behalf the filer has signature authority.**

☐ No

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Part II **Information on Financial Account(s) Owned Separately 1 of 1**

15 Maximum account value

15a Maximum account value unknown ☐

16 Type of account

17 Financial institution name

18 Account number or other designation

19 Address

20 City

21 State

22 Foreign postal code

23 Country

Part III **Information on Financial Account(s) Owned Jointly 1 of 1**

Account Information

15 Maximum account value

15a Maximum account value unknown ☐

16 Type of account

17 Financial institution name

18 Account number or other designation

19 Address

20 City

21 State

22 Foreign postal code

23 Country

24 Number of joint owners

Principal Joint Owner Information

25 Taxpayer Identification Number (TIN)

25 a TIN type

26 Last name or organization name

27 First name

28 Middle name

28a Suffix

29 Address

30 City

31 State

32 ZIP/postal code

33 Country

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Other Foreign Investor Reporting (§6038; §6046; Form 5471)

The intent of this section is not to make anyone an expert in international taxation. However, there are some traps out in the foreign reported world that may catch an unsuspecting U.S. taxpayer. U.S. persons, who are officers, directors, or shareholders in certain foreign corporations, in many cases may be required to provide additional information about the foreign corporation they are involved with. Form 5471 is a 6-page form used to satisfy these additional reporting requirements.

Who must file. Generally, all U.S. persons (includes US citizens or residents, domestic partnerships and corporations, or estate or trust that is not a foreign estate or trust) who own directly or indirectly, 10% or more of the combined voting power or value of shares of all classes of stock, of an applicable or specified foreign corporation must complete Form 5471 and related schedules and statements.

Preparer note. A separate Form 5471 and all applicable schedules must be completed for each applicable foreign corporation.

Non-filing penalties. Failure to file Form 5471 and related Schedule M when required typically generates two types of penalties:

1. A $10,000 penalty for each annual accounting period of each foreign corporation for failure to furnish the information required by §6038(a) (Form 5471) within the time prescribed. If the information is not filed within 90 days after the IRS has mailed a notice of the failure to the U.S. person, an additional $10,000 penalty (per foreign corporation) is charged ***for each 30-day period***, or fraction thereof, during which the failure continues. The additional penalty is limited to a maximum of $50,000 for each failure.

2. Any person who fails to file or report all the information required within the time prescribed will be subject to a reduction of 10% of the foreign taxes available for credit under §§901 and 960. If the failure continues 90 days or more after the date the IRS mails notice of the failure to the U.S. person, an additional 5% reduction is made for each 3-month period, or fraction thereof, during which the failure continues after the 90-day period has expired.

3. When a schedule is required but all amounts are zero, the schedule should still be filed with one or more zero amounts.

Farhy, admitted tax cheat, argues Form 5471 penalties not enforceable (Alon Farhy v Comm., USTC Dkt. #1064721L, April 3, 2023). Alon Farhy owned 100% of the stock of both Katumba Capital and Morningstar Ventures, both foreign corporations. Farhy admitted the purpose of the two foreign corporations was to illegally evade US income tax. For the years 2003 through 2010, eight years in total, Farhy intentionally didn't file the required Forms 5471 disclosures for either corporation and the IRS assessed penalties of $60,000 for each year for each corporation. The total assessment was $960,000.

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Farhy challenges IRS's authority to assess penalties. Farhy argued that there is no law giving the IRS authority to assess Form 5471 related penalties (nor under §6038(b)). Farhy further argued that, while the U.S. may be able to collect liabilities for these penalties through a civil action, they may not be collected by the IRS via assessment or administrative action. Finally, Farhy contended that, unlike a bevy of other penalty sections in the Code, there is no provision authorizing assessment of these penalties – it is not an assessable penalty. The Court agreed with Farhy that the IRS assessed penalties that it had no statutory authority to assess and ruled the IRS could not pursue any further collection action.

Court of Appeals Sides with IRS – Let's Penalties Stand (Alon Farhy v. Comm., USCA DC, No. 23-1179, May 3, 2024)

The Court of Appeals overturned the Tax Court's decision and reinstated the non-filing penalties assessed by the IRS. The Court held that the absence of the penalty from Chapter 68 and the lack of either a cross-reference to Chapter 68 or explicit language directing that the penalty "shall be assessed" is not determinative. "Congress can make a penalty assessable by implication, and it did so here." Based on the statute's text, structure, and function, that penalties imposed under section 6038(b), like the related penalties under section 6038(c), are assessable. This conclusion is buttressed by more than forty years of congressional acquiescence to the IRS's practice of assessing section 6038(b) penalties. "It is well established that when Congress revisits a statute giving rise to a longstanding administrative interpretation without pertinent change, the 'congressional failure to revise or repeal the agency's interpretation is persuasive evidence that the interpretation is the one intended by Congress.

So, the penalty stands, right? Not so fast. Farhy's legal team has asked the Court of Appeals to rehear the case due to errors perceived in its opinion. If the rehearing is granted, it will be interesting to see if the issue of the reversal of the Chevron Doctrine is brought up as an additional argument. So, sit tight as we continue to track this one!

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Tax Planning in 2024 and Beyond

Author note. When it's time for me to write the FTU manual, I always start the process by asking myself "What's keeping me up at night?" in my practice. I believe if there are issues causing me heartburn then the same issues are probably doing the same to some of you. I next decide if I have anything of value to pass along and, if so, I add the issue to the manual. This year, an area that I feel strongly about is improving our tax planning processes to enhance our value in our clients' eyes. I firmly believe there is a fundamental shift going on in the world of tax planning and tax practitioners who do not embrace new planning strategies are going to be left behind by competitors. What follows are my best recommendations to not only keep up with the changes, but maybe present some strategies to get ahead of the changes coming our way.

Private equity firms (PE) are looking to invest in CPA firms. It is astounding the amount of interest being shown to our industry by private equity firms. And the interest is not just in large CPA firms, but in smaller firms as well. Traditionally, private equity investors focused on industries like technology, healthcare, and manufacturing. However, since 2021 PE firms have aggressively pursued CPA firm investments, including pouring billions of dollars into five of the top thirty accounting firms. In 2024 PE firms Hellman & Friedman and Valeas Capital Partners teamed up to make a $1 billion investment in Baker Tilly. So why all the recent PE interest? While there are multiple factors, the major reason is CPA firm clients are often underserved and great potential contacts for wealth management, insurance, and other financial services. This is in addition to the fact that CPA firm revenue streams are typically stable and recurring. The PE firms also see ***growing demand for specialized services due to increasingly complex regulatory environment***. PE firms believe they can help CPA firms provide more value to clients and improve profitability. Bottom line, they believe we underserve our clients, and, with their help, we can provide more services and increase profits. Andrew Kenney wrote an excellent article on the topic titled "Private Equity Eyes Accounting Firms Large and Small" that was published in the Journal of Accountancy, February 2023.

Employee retention credit (ERC) and revealed potential. The ERC debacle is indicative of how good and bad things can go for clients when it comes to complex tax areas. Many CPA firms were overwhelmed by the complexity of ERC and chose not to get involved or offer ERC services. Once others figured out how lucrative filing ERC claims could be, an entire cottage industry popped up to help taxpayers file refund claims. These so-called "expert consultants" quickly figured out that those getting ERC refunds did not care at all how much it cost to file a refund claim. They stayed focused on the amount of the refund they would receive.

ERC is not the end; it is the beginning of outside consultants offering our clients finance and tax services. For many years, there have been a few specialized areas where outside consultants have created a niche business to assist with one or more complex areas of tax law. The most common were:

- Cost segregation analysis.
- Research and development tax credits.
- Like-kind exchange consultants and advisors.
- 179D energy efficient building consultants.
- Tax exposure reduction and planning.

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Everyone's an expert if you don't get audited (Kunjlata and Jalandar Jadhav v. Comm., TC Memo 2023-140). Jalandar Jadhav worked as a sales and marketing executive Mobile Rosin Oil Co., Inc. His salary ranged from $150,000 to $160,000. Jadhav also operated a sole proprietorship, KJ Marketing, which earned commissions on sales of products sold for chemical products. Mrs. Jadhav worked part-time as a substitute teacher. KJ Marketing maintained a 401k retirement plan for the benefit of Jadhav and his three employees – his spouse and two adult children who were college students.

Consultant hired to provide "Income Tax Plan." The Jadhavs hired Capital Protection Services, LLC (CPS) to "evaluate their organizational structure, facilitate succession planning, and reduce their tax exposure." Jadhavs paid CPS $50,000 for a 183-page "Income Tax Plan" (Plan). CPS estimated that the Jadhavs' effective tax rate (ratio of tax to taxable income) of 37% could be reduced to 9% if the Jadhavs followed the plan's recommendations. These recommendations included: 1) convert KJ Marketing to an S corporation, and 2) rent their residential properties to the S corporation for business purposes at a reasonable per day rate up to a maximum of 14 days per year, deduct the expense on the S corp return, and exclude the corresponding rental income (§280A(g)). Although saying they should get an independent appraisal to determine the rent amount, CPS indicated a daily rent of $2,000 - $2,500 would be possible. CPS also recommended Jadhavs form a C corporation to provide "marketing" services to the S corporation. Then the S corporation would pay the C corporation a yearly marketing fee, and the C corporation would pay and deduct: 1) deferred compensation plan payments, 2) tuition for Jadhavs' sons, 3) medical expenses and disability plans for the family, 4) overtime and weekend meals for the employees, 5) meals for the family "for the convenience of the employer," and 6) salaries to Jadhav's children.

IRS says no deal and Court agrees. The Court agreed with the IRS that most of the deductions and strategies of the Tax Plan were either inappropriate or unsubstantiated and disallowed everything except the pension contributions for Jadhav's two sons. The Court found the sons were more likely than not employees and, therefore, the pension contributions were reasonable.

How Does Tax Planning Fit Into All This?

Bottom line is taxpayers are going to get tax advice and strategies. If they do not get these strategies from us, they will listen to anyone who tells them they are paying too much tax. For many of us, the concept of tax planning means preparing a tax projection for the current and/or future year(s), and maybe presenting a strategy or two to help reduce the projected tax. The strategies are often in response to client questions or their specific tax situation. Often, strategies beyond the current situation are ignored.

Tax planning process. It is time for us to look at tax planning as much more than an annual tax projection. Tax planning should be broken into at least two different and distinct levels of service:

1. Projecting tax for the current or future years; and

2. Offering tax planning strategies that may benefit the client in the current or future years. For 2024 and 2025, we also must take into consideration the possible expiration of the TCJA provisions in our planning.

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Preparer note. Especially right now, but more likely for the long term, tax planning is a long-term strategic planning process that requires much stronger relationships with taxpayers. Practitioners are going to need to communicate more often with clients and stay ahead of coming tax law changes. Good policy will call on us to:
- Timely update clients about potential changes and their impacts;
- Provide advice about how to avoid negative impacts;
- Help clients establish and achieve financial goals; and
- Help clients navigate their financial world in the constantly changing tax environment.

Tax Changes on the Horizon

We assume we all know how to do a tax projection so the rest of this discussion will focus on #2 – offering and implementing tax planning strategies. We'll first discuss the expiring provisions of the TCJA and the related planning strategies and then we will look at multiple tax planning strategies and how to implement them for your clients.

Most provisions of the Tax Cuts Jobs Act (TCJA) expire at the end of 2025. This, along with many other provisions that were temporarily enacted in various tax bills over the past few years, means we are going to have to be on the lookout for how these expiring provisions will impact clients' tax returns. While Congress is likely to address some or many of these expiring provisions in 2025, proactive communication with clients is more imperative now than ever. If we don't get ahead of this the clients will. Below is a summary of the more significant tax provisions expiring soon.

Tax Provisions Expiring December 31, 2025		
IRC §	**2025 Rules**	**2026 Rules**
§1	7 tax brackets – 10, 12, 22, 24, 32, 35 and 37%	7 tax brackets – 10, 15, 25, 28, 33, 35, and 39.6%
§24(h)	Child tax credit $2,000, phase out starts $400,000/MFJ, $200,000/S, HOH	Child tax credit $1,000, phase out starts at $110,000 MFJ, $75,000 S, HOH
§24(h)	$500 credit for dependents	$500 credit expires, personal exemption deductions return
§36B(b)/(c)	100%l premium assistance credit up to 150% AGI poverty level, no upper limit	Lower income gets lower PAC, those over 400% of poverty level excluded
§45S	Family and Medical Leave credit up to 25% of wages for 12 weeks	Expires
§51(c)	Work Opportunity Credit available for qualified hires	Expires
§55	AMT phase out increased to $133,000 for MFJ, $84,500 for singles	AMT phase out lowered to approx. $85,000 MFJ and $55,000 for singles
§63(c)	Standard deductions double pre-TCJA	Standard deduction cut in half
§67(g)	Misc. itemized deductions not allowed	Misc. itemized deductions greater than 2% of AGI deductible
§68(f)	100% of itemized deductions allowed	Pease limits returns to limit itemized deductions
§108(f)(5)/ §127(c)	Student loan forgiveness and employer paid student loan payments are tax exempt	Expire – any such amounts are taxable

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Tax Provisions Expiring December 31, 2025		
IRC §	**2025 Rules**	**2026 Rules**
§132(f)	Tax free bicycle maintenance suspended	Employer bicycle expense reimbursement tax free
§151(d)	Personal exemptions not allowed	Personal exemptions deductible – expected to be approximately $5,300
§163(h)	Mortgage interest limited on loans up to $750,000, no equity interest allowed	Mortgage interest allowed up to $1million of debt, interest deduction allowed for up to $100k of equity debt.
§164(b)	SALT deduction is capped at $10,000	No cap on SALT tax – but AMT applies
§168(k)	Bonus depreciation extended	2026 bonus depreciation reduced to 20% of cost, 0% after 2026
§170(b)	Higher % of AGI (60%) allowed for charity	Higher AGI limits expire – return to pre-TCJA limits (50%)
§199A	QBI 20% deduction allowed	QBI expires
§217(k)	Moving expense deduction not allowed except for military members	Moving expenses allowed for job related moves
§529A	QTP rollovers to ABLE accounts allowed	Expires – rollovers no longer allowed
§1396	Empowerment Zone employment credits available	Empowerment zone credits expire
§2010(c)	Increased estate and gift exemption amount is $13.61 million	Estate and gift exemption amount expected to be approx. $7.15 million

Excess business losses (§461(l)). Noncorporate taxpayers are limited to the amount of business losses that may be claimed on their tax returns for tax years beginning after December 31, 2020, and before January 1, 2029. For 2024, the limit is $305,000 ($610,000 for MFJ). While this provision was part of the TCJA, the expiration date has been deferred to 2029 so there is no additional discussion here.

Multi-year, multi strategy planning is key. Obviously, we will not have all the answers anytime soon. My plan is to start with a scenario that all the expirations will happen and then consider at least 2025 and 2026 to highlight the before and after results of all the expiring provisions. Then various scenarios will be added based on our knowledge and judgement to accommodate planning ideas. Lastly, the plans will be updated regularly as legislative changes come into focus.

Expiring provisions – the basics. The tax planning strategies for all these changes can be very complex and numerous. What follows are several strategies highlighted through practical examples.

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Rate changes.

2018 – 2025 Tax Rates		Tax Rates in 2026	
Rate	Bracket Ends – Single/MFJ	Rate	Bracket Ends – Single/MFJ
10%	$11,600 / $23,200	10%	$9,325 / $18,650
12%	$47,150 / $94,300	15%	$37,950 / $75,900
22%	$100,525 / $201,050	25%	$91,900 / $153,100
24%	$191,950 / $383,900	28%	$191,650 / $233,350
32%	$243,725 / $487,450	33%	$416,700 / $416,700
35%	$609,350 / $731,200	35%	$418,400 / $470,700
37%	N/A	39.6%	N/A

Standard deduction.

2025 – 2026 Standard Deduction		
Filing Status	2025	2026
Single	$14,600*	$8,300*
HOH	$21,900*	$9,350*
MFJ	$29,200*	$16,600*
MFS	$14,600*	$8,300*
* Amounts are estimated based on 2024 and 2017 actuals		

<u>TCJA Planning Strategies</u>

- Look for opportunities to accelerate income into 2024 or 2025.
    - Business sales, rental sales, stock sales etc.

- Elect out of installment sale treatment.

- Delay equipment purchases or use depreciation instead of expensing options.
    - Consider ADS depreciation methods.
    - Consider capitalizing repairs.

- Consider accounting method changes and the related timing. Consider timing of any §481(a) adjustment.

- Defer operating expenses into 2026.

- Delay SALT payments to 2026 (utilize PTE when possible).

- Bunch deductible items where appropriate.

- Consider qualified opportunity funds.

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- Consider Roth conversions before 2026.
- Consider maximizing deferred comp plans in 2026 and after.
- Consider C corporation structures – no QBI. Do the numbers!
- Consider the impact of expiration on state taxes.

Planning example

MFJ w/2 kids ages 8 and 10

Scenario	1	2	3	4
Wages	150,000	250,000	500,000	1,000,000
Interest	1,500	1,500	1,500	1,500
Dividends	2,000	2,000	4,000	8,000
Cap Gains	15,000	15,000	25,000	50,000
RE Tax	8,500	8,500	12,500	20,000
IL tax w/h	7,425	12,375	24,750	49,500
Mtg Int	22,500	22,500	30,000	45,000
Contribs	2,500	2,500	7,500	15,000

2025 Tax incl AMT	14,286	37,272	108,390	291,371
2026 Tax incl AMT	14,402	39,017	124,206	304,766
Tax increase in 2026	116	1,745	15,816	13,395
2025 AMT	-	-	-	-
2026 AMT	-	-	5,472	-
2025 Child tax credit	4,000	4,000	-	-
2026 Child tax credit	-	-	-	-

Overall Strategy – ABD for sure! Accelerate, bunch and delay income and deductions. Overall, rates are going to be higher in 2026, making deductions more beneficial. In general, strategies such as accelerating income, delaying deductions and choosing the best year to bunch deductions should all be analyzed.

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Scenario 1. Mike and Maggy have three kids under age 17, gross income of $200,000, and $26,000 of itemized deductions, comprised of $12,000 of state and local tax, $8,000 of mortgage interest and $6,000 of charitable contributions. Mike and Shawn haven't itemized their deductions on their tax returns since 2018. Without any changes or strategies, Mike and Maggie's returns would be:

	2025	2026
Adjusted gross income	$200,000	$200,000
Itemize or standard deduction	(29,200)	(26,000)
Personal exemptions (estimated at $5,300 in 2026)	$ - 0 -	(26,500)
Taxable income	$170,800	$147,500
Tax	$ 27,682	$ 28,353
Child tax credit (AGI limited in 2026)	(6,000)	(- 0 -)
Net income tax	$ 21,682	$ 28,353

Variation. After meeting with their CPA, Mike and Maggie decide to delay $4,000 of 2025 SALT tax payments to 2026 and to push $4,000 of charitable contributions from 2025 to 2026. The result is Mike and Maggie will have SALT expenses of $8,000 in 2025 and $16,000 in 2026. They will have charitable contributions of $2,000 in 2025 and $10,000 in 2026. Also, Mike annually spends about $4,000 on job related expenses. He decides to delay $3,000 of his 2025 expenses and pay them in 2026, giving him total employee business expenses of $7,000 in 2026. The results are:

	2025	2026
Adjusted gross income	$200,000	$200,000
Itemize or standard deduction	(29,200)	(37,000)*
Personal exemptions (estimated at $5,300 in 2026)	$ - 0 -	(26,500)
Taxable income	$170,800	$136,500
Tax	$ 27,682	$ 25,603
Child tax credit (AGI limited in 2026)	(6,000)	(- 0 -)
Net income tax	$ 21,682	$ 25,603

Preparer note. Mike and Maggie save $2,750 by moving some of the deductions between years. In some cases, this can only be done if it is started in January 2025.

*Comprised of $16,000 SALT, $8,000 mortgage interest, $10,000 charity and $3,000 ($7,000 less 2% of AGI) employee business expenses.

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Scenario 2 – §179 in 2025. Assume the same facts as the Mike and Maggy example above, except that Maggie's share of the family income is from her Sch. C business profit of $90,000. During 2025 Maggie buys some 5-year equipment for $60,000 for her business. Maggie normally chooses to use 179 to expense any equipment purchases. Also assume that Maggie and Mike use the bunching strategies discussed above so there is no difference between the 2025 standard deduction and the 2026 itemized deductions.

Variation #1 – equipment purchased in 2025 or 2026, 179 taken when purchased.

	2025 w/o equip.	**2025 with equip.**	**2026 w/o equip.**	**2026 with equip.**
AGI (net of SE tax & 179)	$193,642	$137,881	$193,642	$137,881
Itemize or standard	(29,200)	(29,200)	(29,200)	(29,200)
QBI deduction	(16,728)	(5,576)	(- 0 -)	(- 0 -)
Personal exemptions	$ - 0 -	$ - 0 -	(26,500)	(26,500)
Taxable income	$147,714	$103,105	$137,942	$ 82,181
Tax (includes SE tax)	$ 35,319	$ 17,027	$ 38,680	$ 16,262
Child tax credit	(6,000)	(6,000)	(- 0 -)	(- 0 -)
Net income tax	$ 29,319	$ 11,027	$ 38,680	$ 16,262

Result:

- If equipment is bought and expensed in 2026, the total 2025 and 2026 tax is $45,581.
- If equipment is bought and expensed in 2025, the total 2025 and 2026 tax is $49,707.

There is a $4,126 tax savings if the equipment purchase is delayed to 2026.

Estate and Gift strategies. Another area of great concern with the TCJA expiration is the area of estate and gift taxation. Under the current rules, including the expiration of the TCJA, the estate/gift 2025 basic exclusion amount (BEA) amount will be about $13,610,000 and then decrease to approximately $7 million in 2026. The IRS recently issued regulations that provide that any BEA used during 2018 through 2025 to reduce the taxable amount of any post-1976 gifts, to the extent such BEA amount is greater than the BEA in years after 2025, may be added to the post-2025 BEA to calculate the taxable amount, if any, of gifts or the donor's estate. In other words, if the gifts are made before the TCJA sunsets and were not taxable at the time of the gift, then taxpayers will not have to pay tax on the gifts, even if the BEA is lower at death. Effectively, this means that a taxpayer can permanently use the increased exemption amounts allowed under the TCJA by making gifts before TCJA expires. This strategy not only takes advantage of the higher BEA, but also shelters future appreciation of the gifted assets.

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Scenario 1. Harry made a $12,000,000 gift to an irrevocable trust in 2025, all of which were sheltered by Harry's $13,610,000 BEA. Harry passed away in 2028 when his BEA is $7,200,000. The gifted assets in the trust increased in value to $15,000,000. Harry's estate is allowed to use BEA of $12,000,000, the amount of gifts given in 2025. In addition, the $3,000,000 of asset appreciation is excluded from Harry's estate. There is no claw back.

Preparer note. Obviously, most estates are well below the lower BEA amounts expected if TCJA sunsets, especially after taking portability into account. This gifting strategy is only applicable to very high net worth clients. Additionally, taxpayers should be cautious about making large gifts to family members or irrevocable trusts. In the author's experience, more clients have issues with premature gifting than they do with estate tax. To comply with all the gifting rules, it is likely the donor will lose substantial control of the assets. And the assets lose the ability to be stepped up at death. The additional capital gain tax, in combination with the loss of control, may make large gifts less desirable. This could result in significant capital gains tax liability for beneficiaries. And of course, the estate BEA is likely to be a hot topic of negation by Congress and no one knows for sure where it will end up.

Irrevocable trust considerations. An in-depth discussion of all the various irrevocable trusts is beyond the scope of this manual. However, we want to provide a list of some of the more common irrevocable trusts that may apply to preserve the full BEA.

- **Spousal Lifetime Access Trust (SLAT).** Similar to an A/B trust at death, these trusts are used to move assets irrevocably pre-death to a trust for the benefit of the grantor's spouse. Often both spouses set up a SLAT to allow all income to stay with the two spouses, but the assets are transferred out of the estate.

- **Charitable remainder trust (CRT).** CRTs allow the grantor to transfer assets to an irrevocable trust for the benefit of a charitable organization. Normally these trusts provide an income stream to the grantor for a specified period or for the grantor's lifetime and the remainder is paid directly to the charity. The grantor receives a charitable contribution deduction for the estimated value the charity will eventually receive.

- **Qualified personal residence trust (QPRT).** Irrevocably transfers residence from grantor to the trust. This removes the residence from the estate and allows the grantor to keep a retained interest that allows them to stay in the home. Once the retained interest period ends, the residence transfers to the beneficiaries via a remainder interest. Like other trust transfers, there is no stepped-up basis on the house.

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- **Intentionally defective grantor trusts (IDGT**). An intentionally defective grantor trust (IDGT) allows assets to be transferred out of the estate to a trust, which prevents the assets from being included in the estate. For income tax purposes, any income generated by the assets is still taxed on the tax return of the grantor(s). Effectively, the grantor pays income tax on any generated income, but the estate does not incur any estate taxes when the grantor dies.

- **Charitable lead trusts (CLT).** CLTs are an irrevocable trust designed to provide payments to one or more charities over a period of time. Any remaining assets go to family members or other beneficiaries. Charitable lead trusts are often considered to be the inverse of a charitable remainder trust.

Tax Planning Strategies

Next, we would like to provide you with multiple tax planning ideas and strategies. We start off with an example of a tax planning letter that is directly from our office. After the letter we have provided dozens of tax planning ideas in the form of checklists that are specific for Taxpayers in General, W-2 Employees, Employee Fringe Benefits, Business Owners, Low Income Years, Retirement Planning, and Estates and Trusts.

Tax Planning Letter – Practical Example

Below is the tax planning letter Ron Roberson uses in his firm to communicate tax planning strategies to clients. Obviously, every strategy does not apply to every client. When a tax planning engagement is initiated, this document is opened in Word and then any strategies that are not applicable are deleted until only applicable strategies remain. The process generally takes only 10 – 15 minutes to end up with a final letter. The goal in our office is to have at least three and no more than eight strategies. If there are more strategies that are applicable, we save some for future meetings.

[Enter Date Here]

Dear [**Client name**],

Enclosed is a detailed report of your projected income and related tax information for [**insert year**]. Your taxable income is estimated at [**$Enter Amount**][1] which will generate Federal tax of [**$Enter amount**] and state tax of [**$Enter amount**][1].

Please notify us of any changes in the information contained in this report immediately so we can make appropriate modifications and update your projected tax liability. The Internal Revenue Service will assess a penalty if payment of tax is not timely paid, so it is important to ensure we've closely approximated your tax liability.

[1] Amounts presented are projections using estimated amounts. Actual tax liability can vary significantly and is highly dependent upon changes that may occur throughout the year.

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In addition to your tax projection report, we've included tax planning strategies that may help to reduce your overall tax burden. Please review these strategies and then meet with us so we can assist in the implementation of the chosen strategies. The strategies include:

- **Take advantage of the zero percent capital gain tax rates.** Married filing joint taxpayers do not pay tax on capital gains if adjusted gross income (AGI) does not exceed $123,250, $61,625 for single taxpayers. The taxpayer could recognize additional capital gains and pay no tax in this tax year.

- **Recognize capital losses to increase basis.** Capital losses may be deducted in full against capital gains and any excess losses are deductible up to $3,000 per year. Any further losses must be carried forward to future years. Taxpayers with large excess capital losses should consider recognizing gains to the extent of the losses. If the taxpayer wants to continue to own the stocks with gains, they can sell them and then buy them right back. The result is the gain from the sale is not taxable due to the capital losses. When the stocks are re-purchased, the taxpayer has a stepped-up basis.

- **Accountable plan expense reimbursements.** Most employers use accountable reimbursement plans to reimburse employee business expenses such as auto expenses, cell phones, travel, licenses, dues, meals, tools, etc. Payments made under an accountable plan are nontaxable to the employee and fully deductible for the employer.

- **Dependent Care Assistance program.** Employers may offer employees the option to reduce their taxable wages and be reimbursed tax free for out-of-pocket dependent care expenses. This makes a non-deductible expense tax deductible because it is not taxed when received. The reimbursement may only be made for care provided for the employee's child(ren) and provided to allow the employee to work.

- **Health Savings Accounts (HSAs).** Qualified HSA contributions are fully tax deductible and qualified distributions from HSAs are tax-free. HSA rules effectively allow a full tax deduction for medical expenses.

- **Premium assistance credits**. Premium assistance credits are allowed for taxpayers who purchase health insurance from the Covered California Insurance Exchange or another marketplace exchange. Credits are determined based on the taxpayer's adjusted gross income and may be quite substantial.

- **Employer cafeteria plan.** Depending on what cafeteria plan the employer establishes, the plan may offer benefits including dependent care assistance, adoption, health care, HSAs, and group term life insurance. The most used cafeteria plan benefit is health care.

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- **Medical and charitable deduction bunching.** Most taxpayers do not have enough itemized deductions to receive a tax benefit. Sometimes bunching medical expenses and/or charitable contributions will allow the taxpayer to exceed the standard deduction and thus receive a tax benefit. For example, making two or three years of charitable contributions all in one year.

- **Donor advised funds (DAFs).** A donor-advised fund is a charitable vehicle housed within a §501(c)(3) public charity that allows a donor to make a gift, take an immediate charitable deduction, and recommend, typically with strong persuasive authority, future grants made from funds in the DAF. Donor-advised funds can be used to help with bunching charitable contributions. Locally, Sonora Area Foundation is happy to work with those wishing to establish a DAF.

- **Donating appreciated stock.** Taxpayers who donate highly appreciated assets to charitable organizations receive two tax benefits. First, the taxpayer is allowed a charitable contribution tax deduction equal to the market value, not the original cost, of the donated asset. Second, the taxpayer is not required to claim taxable income at the disposition for the difference between the market value and the original cost basis of the donated asset.

- **Qualified charitable distributions.** Taxpayers age 70½ and older may transfer directly from an IRA to a charity. Transfers of up to $105,000 (2024) annually are tax free and reduce the required minimum distributions for the year. While no charitable contribution deduction is allowed, there is no taxable income from the IRA distribution. QCDs may only be made from IRA, not from §401(k)s or other pension plans.

- **Municipal bond investments.** Generally, interest earned from municipal bond investments is Federally income tax free. In addition, municipal bonds from a California municipality are also tax free for California tax purposes, providing a double tax benefit.

- **Coverdell Education Savings Accounts (ESAs).** Coverdell ESAs allow up to $2,000 annual contributions for each beneficiary. Any investment growth is tax-deferred and becomes tax-free if withdrawals are used to pay for grade school, high school costs and college costs.

- **§529 plans (aka Qualified Tuition Plans).** §529 plans are like Coverdell ESAs except the annual contribution limits exceed $100,000. Tax is deferred on earnings on monies held inside a §529 plan and are not taxed when withdrawn if the money is spent on qualified education expenses. Originally 529 plans could only be used to fund college expenses but may now be used for high school and elementary school tuition.

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- **IRA and Roth IRA contributions.** IRA contributions may be fully tax deductible and may provide a tax credit of up to half the amount contributed. From 2020, taxpayers who've reached their required minimum distribution (RMD) age are allowed to contribute to an IRA. Qualified taxpayers may also contribute to a Roth IRA, which prevents future taxation and no RMDs.

- **Back door Roth IRA.** There is an AGI limit for those who wish to contribute to a Roth IRA. High AGI taxpayers can get around this rule by contributing to a back door Roth IRA. The taxpayer contributes to a non-deductible IRA, which is allowed regardless of AGI. The taxpayer then rolls the non-deductible IRA to a Roth IRA, which is allowed regardless of AGI.

- **Convert an IRA to a Roth IRA.** Taxpayers experiencing a financially down year should consider converting an IRA or 401k to a Roth IRA or Roth 401k. Such conversions, while taxable, are not subject to penalties at any age. Any amount converted would be eligible to be withdrawn tax and penalty free five years after conversion. This applies to the account owner and heirs.

- **Qualified Longevity Annuity Contracts (QLACs).** IRA owners may exclude investments in QLACs from RMD calculations until the taxpayer is age 85. This is a strategy that is most useful for individuals with an extremely long expected lifespan and relatively high RMDs. The maximum amount that may be invested in a QLAC is $200,000 per account owner. All IRAs are treated as one IRA for this purpose.

- **Gifting and the gift tax exclusion.** Gifts are not considered for tax purposes if:

    - The total annual amount is no more than $18,000 (2024) to any one individual. Gifts to charities and political organizations are ignored. Gifts to a spouse.
    - Gifts made to spouses who are not U.S. citizens that are no more than $185,000 (2024).
    - Payment of educational expenses is unlimited if the individual makes a direct payment to the educational institution for tuition only for someone else. Books, supplies and living expenses do not qualify.

- **Charitable remainder trusts.** Charitable remainder trusts (CRTs) are irrevocable trusts that allow the taxpayer to donate assets to a charity or charities but retain the income for a specified period including the life of the donor. A charitable remainder trust may be funded with cash, publicly traded securities, regular C Corp closely held stock (but not S corporation stock), real estate and other types of assets.

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- **Charitable gift annuities.** A charitable gift annuity is a contract between a charity and a donor where the annuity begins paying an income stream to the donor immediately, at a fixed future date, or at a flexible future date. A charitable gift annuity provides the donor:
    - A charitable tax deduction for a portion of the gifted assets;
    - A fixed stream of income for the life of up to two annuitants (the donor and/or beneficiaries designated by the donor); and
    - A legacy gift donated to the charity upon the passing of the annuitants.

- **§1202 qualified small business stock (QSBS) exclusion**. Shareholders who hold QSBS of a C corporation for at least five years may be eligible to exclude up to 100% of the capital gains from their income when they sell their stock. The maximum gain eligible for the exclusion is the greater of $10 million or ten times the adjusted basis of the stock.

- **§1244 stock loss.** Owners of qualified §1244 stock may treat any losses at the stock's disposition as ordinary losses rather than capital losses, up to certain limits. The annual limit is up to $100,000 on a joint return or $50,000 for single filers. This contrasts with the standard capital loss deduction limit of $3,000 per year.

- **S corporation conversion.** Sole proprietors may enjoy significant tax advantages by operating as an S corporation. **Attached is a brief analysis of how your tax situation would change if you changed the form of your business entity.**

- **Accelerate payment of deductions and delay receipt of income.** Taxpayers using the cash method of accounting report income in the year when the income is actually or constructively received. If income isn't received, it isn't taxable. Similarly, expenses for cash basis taxpayers are deductible when actually paid, even if paid up to twelve months in advance.

- **Maximize self-rental for real estate and personal property.** Renting to an entity the taxpayer owns will save self-employment tax and may allow deductions not otherwise deductible. Net rents are not subject to the net investment income surtax (NIIT) for both net rental income and capital gains upon the sale of the building or other property.

- **Like kind exchange/§1031 exchanges.** The §1031 tax deferred treatment of capital gains is one of the best real estate investor vehicles for preserving and building real estate wealth. A like-kind exchange allows property owners to sell real estate and exchange the property sold for other real estate without recognizing any taxable capital gains. It makes it possible to transfer the financial gain that is realized from the sale of real estate into another real estate property without Federal capital gains tax at the time of the sale.

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- **Augusta Rule.** The so-called Augusta Rule (§280(A)(g)) states that "if a dwelling unit is used during the taxable year by the taxpayer as a residence and such dwelling unit is actually rented for less than 15 days during the taxable year, then…the income derived from such use for the taxable year shall not be included in the gross income." In other words, if a property is rented out for 14 nights or less in a year, the income is not taxable. The rent can be paid to a related party (e.g., paid by a corporation to its 100% owner).

- **Real property improvements.** Improvements to nonresidential qualified real property (QRE & qualified improvement property QIP) placed in service after the date the building was originally placed in service may qualify for §179. Such improvements include:

  - Qualified improvement property (QIP)
  - Commercial property roofs (QRE)
  - Heating, ventilation, and air-conditioning property (QRE)
  - Fire protection and alarm systems (QRE)
  - Security systems (QRE)

- **Solar energy improvements.** Tax credits equal to 30% of expenditures are available for taxpayers who install solar energy systems, including batteries, to provide electricity to residential (including personal residence) and to commercial properties, including residential rentals.

- **Hiring the business owner's spouse.** Hiring the owner's spouse, in a valid employment situation, allows the business to provide the spouse with all fringe benefits available to any other employee, including health insurance. If the employee-spouse is the only employee (or the only full-time employee), the owner is allowed to offer the employee spouse tax free medical reimbursements for any out-of-pocket medical expenses for the entire family. However, any such fringe benefits will also reduce the QBI deduction.

- **Hiring minor children.** Payments made to a child under age 18 who works for his or her parent in a trade or business are not 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 or her parent in a trade or business are also not subject to Federal Unemployment Tax Act (FUTA) tax. This allows income from a sole proprietorship or spouse owned partnership to be shifted to a minor child and then taxed at the child's tax rates. The child must be paid a wage that is reasonable for the services provided.

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- **Credits available to small businesses.** Congress established several tax credits for small businesses. These credits include:
    - **Small business pension plan start-up credit.** Qualified employers who establish a new pension plan are eligible for a tax credit for costs paid to establish and maintain the new pension plan. The credit is available each of the first 3 years the plan is in place.
    - **Small business pension contribution credit.** Employers who contribute to employee pension plan accounts may be allowed a credit for amounts contributed for the first five years after the plan is established.
    - **Auto-enroll credit.** Small businesses are allowed an additional $500 tax credit by adding an automatic enrollment feature to a new or existing pension plan. The credit is available for each of the first 3 years the feature is effective.
    - **Work opportunity credit.** The Work Opportunity Tax Credit (WOTC) is a general business credit administered by IRS and the Department of Labor (DOL). It is available for wages paid to certain individuals who begin work on or before December 31, 2025. The WOTC may be claimed by an employer that hires and pays or incurs wages to qualified individuals who are certified as being a member of one of ten targeted employee groups (e.g., veterans, long-term unemployed, etc.). The credit may be up to $2,400 per qualified employee.
    - **Employer tip credit.** This is a special credit designed specifically for restaurants. The credit is equal to the employer's portion of Social Security and Medicare taxes paid on tips received by employees of the food and beverage establishment where tipping is customary. The credit is not available on tips used to meet the federal minimum wage rate that applies to the employee under the Fair Labor Standards Act.
    - **Commercial clean vehicle credit**. Businesses and tax-exempt organizations that buy a qualified commercial clean vehicle may qualify for a clean vehicle tax credit of up to $40,000 ($7,500 for vehicles with GVRW of less than 14,000lbs).
    - **Employer provided childcare facility.** The credit is up to 35% of the cost of setting up and/or operating an employee childcare facility (annual maximum $150,000). Qualifying expenses include the cost of buying a building, training employees, scholarship programs, and providing increased compensation to employees with higher levels of childcare training.
    - **Disabled access credit.** This credit is equal to 50% of expenses incurred to provide disabled access, such as wheelchair ramps, assist bars in restrooms, interpreters, sign-language, closed captioning and more. The maximum amount considered annually is $10,250. The maximum tax credit is $5,000.

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- **Qualified small employer health reimbursement plan (QSEHRA).** A QSEHRA allows qualified employers to reimburse up to $12,450 families ($6,150 individual) in 2024 in medical costs for qualified employees. This is particularly helpful for employers who want to help employees with medical costs but also want the employer cost limited.

- **Retirement plans.** Small businesses without an employer provided retirement plan may want to consider retirement plan options. SEPs, SIMPLEs, 401(k)s, etc. are all employer sponsored retirement plans and each plan is appropriate in different circumstances.

- **§ 179 and bonus depreciation.** Both §179 and bonus deprecation allow immediate or accelerated tax deductions for assets that are otherwise deducted over a period of years. It is particularly important in high income years.

- **Cost segregation studies.** A cost segregation study is a professional analysis to identify a business's assets that qualify for shorter depreciable lives (e.g., 5, 7 or 15 year lives). Without a cost segregation study, all building related costs are depreciated as buildings over 27½ or 39 years. The cost segregation study allows faster deprecation, creating higher deductions early in the life of a building.

We hope you find some or all these suggestions beneficial to your overall strategic planning process. Please reach out with any questions you may have or for any other follow-up you wish to pursue.

Very truly yours,

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Low Income Year Checklist	
Completed and Notes	Idea
	Maximize 0% capital gain rate
	Convert to Roth IRA
	Accelerate retirement withdrawals
	Utilize savers credit with retirement contribution
	IRA or HSA contribution to drop a tax bracket
	Elect out of bonus
	Do not take Sec. 179
	Do not make $2,500 de minimis election
	Avoid new equipment purchases
	Close business and recapture income (increasing asset basis)
	Delay year end bill payments
	Accelerate billings
	Offer early payment discounts
	Offer year end “cash only” sale pricing

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W-2 Employee Planning Checklist

Checklist for Employee Fringe Benefit Availability and Participation

Employer: ______________________________________

Employee Name: Date:

Benefit:	Information Source: H-Handbook I-Interview O-Other W-W-2	Employer Offers?, if Yes, Provide Short Summary Notes	Plan $ limits	Employee Participates?	Employee Dollars of Participation current year
Accountable Expense Plan					
401-K Plan					
403-B Plan					
Simple Plan					
Adoption Assistance					
Dependent Care					
Education Assistance					
HSA Contribution					
Health Insurance					
Long Term Care Insurance					
Mileage Reimbursement					
No Addt'l Cost Fringe (i.e. Cable, plane tickets, etc)					
Retirement Planning					
Scholarship					
Stock Options					
Term Life					
Cafeteria (125) Plan Options:					
125-Dependent Care					
125-Health Insurance					
125-Health Savings					
125-Health Costs-FSA					
125-Term Life					
125-Other					

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Retirement Planning Checklist	
Completed and Notes	Idea
	Qualified IRA Charitable Distributions
	Utilize RMD's to pay quarterly estimates
	Transfer IRA portion to qualified longevity annuity
	Waive 60 day rollover penalty
	Utilize Roth IRA for aggressive investments
	Utilize backdoor Roth for higher income Americans
	Utilize stock distribution tool of RMD
	Make IRA contributions late in life
	Utilize savers credit
	Utilize refund to fund IRA deposit
	Utilize working spouse's income to make IRA contribution for non-working spouse
	Fund a Roth with Social Security
	Fund a Roth for children and grandchildren
	Utilize double back door Roth for 401-k's with post tax money
	Convert IRA to Roth
	Convert 401-k to Roth
	Accelerate IRA withdrawals
	Make IRA contribution when just above bracket change
	Remember 10% early withdrawal exceptions on next page

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Planning for Every Taxpayer Checklist	
Completed and Notes	Idea
	10-T home mortgage interest election
	Sec. 266 real estate tax election
	Donate collectibles to charity
	Municipal bonds
	Coverdell accounts
	Minor children as beneficiaries of retirement accounts
	Check life insurance beneficiaries
	Installment sale of real property or small business stock or capital account
	Accelerate deferred gains
	Deducting legal fees
	Utilize accountable expense plans
	Utilize statutory employee tax benefits
	Invest in rental real estate
	Like kind exchange for business or investment real property
	Utilize donor advised funds
	Establish 529 education plans
	Donate appreciated stock
	Utilize 0% capital gains rates
	Utilize Lifetime Learning Credit for adult students
	Utilize trusts
	Make IRA contributions late in life
	Rent residence for less than 15 days
	Bunch medical and charity deductions in 1 year to exceed standard deduction
	Purchase tax planning software
	Consider changing state of residency
	Recognize capital losses
	Make HSA deposit for another family member

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Employer Fringe Benefit Plan Checklist	
Completed and Notes	Idea
	Sec. 104 Injury and sick pay
	Sec. 105 Health and accident payment plan
	Sec. 105 Qualified small employer HRA
	Sec. 105 Excepted individual HRA
	Sec. 106 Health insurance
	Sec. 117 Qualified tuition reductions
	Sec. 119 Employer provided lodging
	Sec. 119 Employer provided meals
	Sec. 125 Cafeteria plan
	Sec. 127 Educational Assistance plan
	Sec. 129 Dependent care assistance plan
	Sec 132 No additional cost benefits
	Sec. 132 Qualified employee discounts
	Sec. 132 Working condition fringe
	Sec. 132 De minimis benefits
	Sec. 132 Transportation benefits
	Sec. 132 Moving reimbursements
	Sec. 132 On premise athletic facility
	Sec. 132 Qualified retirement planning
	Sec. 137 Adoption Assistance
	Sec. 139 State of emergency fringe

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Business Owner Checklist	
Completed and Notes	Idea
	Analyze choice of entity
	Determine tax advantage accounting method
	Maximize self-rental
	Prepay 12 months of operating expenses
	Delay year end billings
	Buy collectibles for business use
	Make tax advantaged Sec. 179 real property improvements
	Hire sole proprietor's spouse
	Establish Small employer HRA if qualified
	Reimburse S corp shareholder home office
	Deduct unreimbursed partner expenses
	Hire sole proprietor's minor children
	Reimburse at mileage rate for shareholder auto expense
	Consider making "S" election
	Special Small Business Tax Credits:
	New Pension Plan
	Fuel tax credit
	Work opportunity credit
	Employer tip credit
	Business energy credit
	Employer provided childcare credit
	Disabled access credit
	Analyze retirement plans and establish
	Maximize Sec. 179 by looking for exceptions
	Know and utilize short depreciation lives
	Cost segregation study for real property
	179 for qualified real property improvements
	Implement bonus depreciation rule prior to 12/31/2022
	Make $2,500 de minimus annual election
	Utilize 754 election for partnership owner changes
	Utilize Sec 338 election for s corp stock purchases
	Utilize S Corp QSub election
	Establish individual coverage HRA
	Utilize common paymaster rule
	Establish fringe Benefit Program from Next Checklist

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Estate and Trust Developments

2024 – Estates by the Numbers (Form 706 Instructions)

Description	2023	2024	2025
Basic exclusion amount (BEA)	$12,920,000	$13,610,000	
Special-use valuation ceiling	$ 1,310,000	$1,390,000	
Maximum 2% estate tax installment	$ 1,750,000	$1,850,000	
Basic credit amount	$ 5,113,800	$5,389,800	

Estate Tax Rates

Table A—Unified Rate Schedule

Column A Taxable amount over	Column B Taxable amount not over	Column C Tax on amount in column A	Column D Rate of tax on excess over amount in column A
$0	$10,000	$0	18%
10,000	20,000	1,800	20%
20,000	40,000	3,800	22%
40,000	60,000	8,200	24%
60,000	80,000	13,000	26%
80,000	100,000	18,200	28%
100,000	150,000	23,800	30%
150,000	250,000	38,800	32%
250,000	500,000	70,800	34%
500,000	750,000	155,800	37%
750,000	1,000,000	248,300	39%
1,000,000	----	345,800	40%

Gifting Rules

The annual gift limit was increased to $18,000 in 2024, up from $17,000 in 2023. Other gifting rules:

- Unlimited gifts may be given to charities and political organizations.
- Gifts to a spouse who is a U.S. citizen are unlimited. Gifts made to a spouse who are not U.S. citizens are limited to a $185,000 (2024) gift tax exclusion.
- Payment of tuition expenses are unlimited if the individual makes the payment directly to the educational institution. Books, supplies and living expenses do not qualify.
- Payment of medical expenses are unlimited as long as they are paid directly to the medical facility/care provider.

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Gift-splitting. If an individual or his or her spouse makes a gift to a third party, the gift can be considered as one-half made by the individual and one-half by the spouse. This is known as gift-splitting. Both individuals must agree to split the gift. If in agreement, each individual can take the annual exclusion for his or her part of the gift. In 2024, gift-splitting allows married couples to give up to $36,000 to one person without making a taxable gift. However, in a year in which a spouse dies or the couple divorce, an individual can split gifts with his or her spouse only during the time they are married to each other. If an individual splits a gift, each individual must file a gift tax return to show that the individual and his or her spouse agree to use gift-splitting in most situations.

Estate and Gift Tax Developments

Value of Life Insurance Included in C Corp Value for Estate (Connelly, as Executor v. US, US SCt 23-146, June 6, 2024)

Mike (77%) and Tom (23%) Connelly owned 100% of Crown C Supply, Inc., a small building supply corporation. The brothers entered into an agreement to ensure that Crown would stay in the family if either brother died. The agreement stipulated that the surviving brother would have the option to purchase the deceased brother's shares. If the surviving shareholder declined, Crown itself would be required to purchase the shares from the decedent’s estate. To provide cash for the share purchase, Crown obtained $3.5 million in life insurance on each brother. After Mike died, Tom elected not to purchase Mike's shares, thus triggering Crown's obligation to do so.

What is the value of the business? Mike's son and Tom agreed the value of Mike's shares was $3 million, which Crown paid to Mike's estate. As the executor of Mike's estate, Tom then filed Form 706 reporting the value of Mike's shares as $3 million. The IRS audited the Form 706 return and challenged the valuation of Crown. During the audit, Tom obtained a valuation from an outside accounting firm that determined Crown's FMV at the date of Mike's death was $3.86 million. The value of $3.86 million x Mike’s estate ownership percentage made the Crown stock value $3 million for the estate. The accounting firm excluded the $3 million in life insurance proceeds from the valuation, arguing the life insurance proceeds were offset by the redemption obligation. In other words, there was no net benefit to Crown. The IRS disagreed, arguing that Crown's redemption obligation did not offset the life-insurance proceeds and increased Crown’s stock valuation to $6.86 million ($3.86 million + $3 million). The IRS then calculated the value of Mike's shares as $5.3 million ($6.86 million x 77%) and determined that Mike’s estate owed additional tax of $890,000.

Supreme Court analyze chicken and egg dilemma. For valuation purposes, Mike’s estate argued that if the life insurance proceeds were included in the value of the estate, the stock redemption obligation must be considered as well. The Supreme Court agreed with the lower-level courts that the life insurance proceeds receivable to a corporation are an asset that increases the corporation's FMV. However, the Court also ruled that the FMV of the redemption has no effect on any shareholder's economic interest. At the time of Mike's death, Crown was worth $6.86 million comprised of $3.86 million in assets and income-generating potential, plus $3 million in life-insurance proceeds. Anyone purchasing Mike's shares would acquire a 77% stake in a company worth $6.86 million, along with Crown's obligation to redeem those shares at FMV. A buyer would therefore pay up to $5.3 million for Mike's shares ($6.86 million x 77%), the value the buyer could expect to receive in exchange for Mike's shares when Crown redeemed them at FMV. Crown's promise to redeem Mike's shares at FMV did not reduce the value of those shares.

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Valuation based on pre-redemption value. The Supreme Court determined Tom viewed the relevant inquiry as what a buyer would pay for shares that make up the same percentage of the less-valuable corporation that exists after the redemption. For calculating the estate tax, however, the whole point is to assess how much Mike's shares were worth at the time that he died – before Crown spent $3 million on the redemption payment. A hypothetical buyer would treat the life-insurance proceeds that would be used to redeem Mike's shares as a net asset. Tom's argument that the redemption obligation was a liability cannot be reconciled with the basic mechanics of a stock redemption. He argues that Crown was worth only $3.86 million before the redemption, and thus that Mike's shares were worth approximately $3 million. But he also argues that Crown was worth $3.86 million after Mike's shares were redeemed. Both arguments cannot be right – a corporation that pays out $3 million to redeem shares should be worth less than before the redemption.

Final Regulations Issued for Basis Reporting Rules (TD 9991)

The Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 required that the basis of assets inside of an estate must be consistent with the basis used by beneficiaries for the same assets. The law also requires estates to furnish basis information to the IRS and to the property recipients (§6035(a)). The IRS initially released proposed regulations in 2016 to assist with the implementation of the new law. After gathering comments, and a very long delay, the final regulations were issued on September 17, 2024. The final regulations modified the proposed regulations most notably:

- **Zero basis rule** – the proposed regulations provided that property discovered after Form 706 was filed or assets that were otherwise omitted from Form 706 would have a zero basis. The final regulations do not include this zero-basis rule. Assets discovered later still have basis in the hands of the beneficiaries.

- **Basis notification statements due date** – The proposed regulations required a basis statement to be furnished to beneficiaries no later than 30 days after the Form 706 was filed. The problem brought up by commenters was that, often, an estate may not have made final asset distributions within 30 days of filing Form 706. As a result, the estate would be required to provide basis statements to beneficiaries, not only for distributed assets, but also for assets that may or may not be distributed in the future, leaving beneficiaries completely confused. The final regulations provide that Form 8971 must be filed to report assets distributed to a beneficiary prior to the filing of Form 706 within 30 days Form 706 being filed. For assets distributed after Form 706 is filed, the beneficiary must receive a basis statement no later than January 31st of the calendar year following the year of acquisition by the beneficiary.

- **Subsequent gifts**. The proposed regulations provided any beneficiary who subsequently gifted inherited property was required to report basis to the IRS and the gift recipient. The final regulations provide that only trustees are required to report this information when they distribute inherited property from a trust.

Form 8971. Form 8971 is required to be filed by an estate that is required to file Form 706. The form reports basis of the underlying assets to the IRS. Form 8971, Sch. A is used to report basis for each asset to each separate beneficiary and the IRS. One Schedule A is provided for each beneficiary receiving property from the estate. Form 8971 is only provided to the IRS. Form 8971 and related Sch. A(s) are filed directly with the IRS.

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SCHEDULE A—Information Regarding Beneficiaries Acquiring Property From a Decedent

▶ Information about Form 8971 (including Schedule A) and its separate instructions is at *www.irs.gov/form8971*.

Check box if this is a supplemental filing ☐

Part 1. General Information

1 Decedent's name	2 Decedent's SSN	3 Beneficiary's name	4 Beneficiary's TIN

5 Executor's name	6 Executor's phone no.

7 Executor's address

Part 2. Information on Property Acquired

A Item No.	B Description of property acquired from the decedent and the Schedule and item number where reported on the decedent's Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return. If the beneficiary acquired a partial interest in the property, indicate the interest acquired here.	C Did this asset increase estate tax liability? *(Y/N)*	D Valuation Date	E Estate Tax Value *(in U.S. dollars)*
1	Form 706, Schedule ________ , Item ________ Description —			

Preparer note. Commenters asked for a mechanism allowing a beneficiary to challenge the estate's valuation. Although the final regulations do not provide for such a mechanism, the IRS is considering future guidance to address this issue.

No Basis Step Up for Assets Owned by Irrevocable Trust (Rev. Rul. 2023-2)

The IRS was asked to rule on whether assets transferred into an intentionally defective grantor trust (IDGT) receive a basis step-up at death of the grantor. In the case at hand, an individual we will call Adam established irrevocable trust (IDGT) and funded it with assets in a transfer that was a completed gift for gift tax purposes. Adam retained power over IDGT that caused Adam to be treated as the owner of IDGT for income tax purposes. Adam did not hold power over IDGT, which would result in the inclusion of IDGT's assets in Adam's gross estate. By the time of Adam's death in 2030, the FMV of IDGTs assets had appreciated. The IRS ruled that the assets did not receive a stepped-up basis upon transfer to the heirs. To receive the step-up, the beneficiary must receive property from the decedent. In this case, the beneficiaries received a transfer from the IDGT, not from the decedent so no step up.

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Sham Trusts with no Economic Substance – Taxpayers Pay (James and Shirley Aldridge v. Comm., TC Memo 2024-24)

At the time this case was tried, Missouri residents James and Shirley Aldridge were living in the Englewood Federal Correctional Facility and the Carswell Federal Medical Center, respectively. That is all you need to know about how this one ends up!!

James Aldridge worked as the head of sales, marketing, and training for CMI, a multilevel marketing company that sold American Silver Eagle coins. While working at CMI, the Aldridge couple attended a two-day seminar held by National Trust Services to learn how to use multiple trusts to "control the amount of tax they would pay and convert their living expenses to business expenses." After the workshop, the couple placed all their business and personal assets in a multi-tiered trust arrangement. They formed the Aldridge Family Trust, Concept Marketing International Trust, Lorbert & Co. Trust, and Excalibur Trust to own all of he and his spouse's interests in all real and personal property, including all clothing, furniture, household items, personal effects, and their residence. In addition, Aldridge conveyed all his "rights, title, and interest" in the exclusive use of his lifetime services, including all if his earned remuneration accruing therefrom. As a result: Aldridge:

1. Failed to report business income of $186,000, $135,000, $462,000, $503,000, $195,000, and $155,000 in 1999, 2000, 2001, 2002, 2003, and 2004, respectively. And

2. Failed to report pension income of $98,000 in 2000.

Court says whole scheme was a sham. The Tax Court held that the trusts were sham entities with no economic substance. The income of the trusts was attributable to the taxpayers who owed tax. The Court also found that Aldridges were subject to civil fraud penalty under §6663(a). The total assessments were:

Year	Tax	Penalty	Total
1999	$ 73,000	$ 55,000	$128,000
2000	$ 93,000	$ 70,000	$163,000
2001	$177,000	$133,000	$310,000
2002	$190,000	$143,000	$333,000
2003	$ 62,000	$ 47,000	$109,000
2004	$ 51,000	$38,000	$ 89,000

More than money at stake. In May 2007, following a lengthy criminal investigation by IRS CID and a trial, James and Shirley Aldridge were convicted of filing false tax returns and aiding and abetting the filing of false tax returns for tax years 2000 through 2004. James Aldridge served nine years in prison, and Shirley Aldridge served five years and three months in prison.

Uncashed Checks are Still Part of Decedents Estate (Estate of DeMuth v. Comm'r, 2023 PTC 187 (3d Cir. 2023)).

The Third Circuit affirmed a Tax Court decision that a decedent's gross estate included the value of checks the decedent gave as gifts to his children because the checks were delivered before the decedent's death but not paid until after he died and therefore were not completed gifts. The Court found that under Reg. §25.2511-2 and applicable state law, the delivery of the checks alone did not

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complete the gifts because the decedent had the power to revoke them until the time the checks were deposited or cashed.

Disclosure Required for Recipients of Large Gifts from Foreign Persons

When a U.S. individual receives a gift of money totaling more than $100,000 from a foreign person or estate, while it is not taxable, must be disclosed on Form 3520. Failure to report the gift results in failure to report penalty. Additionally, reporting may be required on the questions at the bottom of Schedule B, FinCen 114 and Form 8938. The penalty for filing a delinquent Form 3520 is 5% of the value of the unreported gift for each month it is late, with a maximum penalty of 25%.

Accrued Savings Bond Interest is Income in Respect of a Decedent (Anthony Hitchman v. Comm., T.C. Summary 2023-18).

Tony Hitchman inherited savings bonds from his father's estate that had accrued but unpaid interest. Tony changed the bonds into his name and later cashed most of them in. Tony only included interest in his return for the interest that accumulated while the bonds were in his name. However, he was unable to show or prove that his father paid tax on the bond interest while he was alive. Noting that accrued interest is income in respect of a decedent, the court ruled. Tony had to pay the tax (§691(a)).

Estate Closing Letters

Process for obtaining estate tax closing letter (TD 9957). An estate tax closing letter is a form letter that the IRS sends to the estate executor or administrator after Form 706 is reviewed and accepted as filed. Prior to June 2015, the IRS issued estate closing letters (Letter 627) to all estates that filed Form 706. Since July 2015, estate closing letters have only been issued when requested by the estate representative. The IRS has now determined that an estate closing letter only provides benefit to the requesting estate and not to the general public. The IRS further determined that as there is no benefit to the public then estates should pay a fee to receive the letter. Final regulations established an estate closing letter user fee of $67 for those requesting the letter.

Those wishing to obtain a closing letter are now required to go to Pay.gov, search for "estate tax" or "closing letter" and select the Estate Tax Closing Letter User Fee from the results. Paying the fee also requires the letter. The fee can be paid via credit card, ACH, debit card or through your Amazon or PayPal account.

For more information see Frequently Asked Questions on the Estate Tax Closing Letter.

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Transcript Delivery

Transcript Delivery Service (TDS) Now Available for Estate Tax Accounts. The Transcript Delivery Service (TDS), which provides authorized practitioners with the ability to view and print instant account transcripts for estate tax returns, is now available on IRS.gov. To register for TDS, access e-Services - Online Tools for Tax Professionals and:

1. Select "GO" under Transcript Delivery System (TDS).
2. Sign up or log in.

If you have difficulty registering online via Secure Access, or you are an existing e-Services user and need exception processing, call the e-Help desk at 1-888-841-4648 between 7:30 a.m. and 7 p.m. Eastern time.

Preparer note. For step-by-step instructions on securing an estate tax transcript, access Transcripts in Lieu of Estate Tax Closing Letters on IRS.gov.

Portability Election Changes

Portability Overview. The portability election is available to the estate of a personal who was married at the time of death. The election allows the surviving spouse to apply the deceased spouse's unused exemption (DSUE) amount to the surviving spouse's own transfers during life and at death. The election was made a permanent part of the law in 2013. The law provides that the estate of a deceased spouse must elect portability of the DSUE amount on an estate tax return (Form 706) that is timely filed including extensions.

Estates not required to file Form 706. For estates that are not required to file an estate tax return, the Regulations clarify that the due date of an estate tax return required to elect portability is nine months after the decedent's date of death or the last day of the period covered by an extension (if an extension of time for filing has been obtained). In 2017 the IRS issued Rev. Proc. 2017-34, which provided estates which are not required to file an estate tax return additional time to file the portability election. The simplified method provided was to be used in lieu of the letter ruling process and was available for a period extending to the second anniversary of the decedent's date of death – so two years instead of the regular 15 months.

Even with simplified procedures, IRS continues to field numerous late election requests. One of the IRS goals when it issued Rev. Proc. 2017-34 was to eliminate most, if not all, of the PLR requests for additional time to file portability elections. Unfortunately, that did not happen as the IRS continues to have a considerable number of late election relief requests.

Late portability election rules changed again (Rev. Proc. 2022-32). The IRS issued Rev. Proc. 2022-32 which includes new simplified procedures for estate administrators to elect portability. The simplified method is used in lieu of the letter ruling process and no user fee is required. Additionally, the simplified procedure extends the period during which an estate may make a portability election to the fifth anniversary of the decedent's date of death. No letter ruling is required. To use simplified procedures an estate must meet four requirements:

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1. The decedent:

    a. Was survived by a spouse;
    b. Died after December 31, 2010, and
    c. Was a US citizen or resident at the date of death.

2. The estate is not required to file an estate tax return as the estate value is below the filing threshold.

3. The executor did not in fact file an estate tax return within the original due date.

4. The executor:

    a. Is a person permitted to make the election on behalf of the decedent;
    b. Is a person who files Form 706 on or before the 5th anniversary of the decedent's date of death.
    c. Ensures the phrase "FILED PURSUANT TO REV. PROC. 2022-32 TO ELECT PORTABILITY UNDER §2010(c)(5)(A) is included at the top of page 1 of Form 706.

Example 1. Curt died on January 10, 2020, and was survived by his spouse Charlene. Curt's estate included $4,500,000 of cash in bank accounts held jointly with Charlene who had right of survivorship. Neither Curt nor Charlene made any taxable gifts during their lifetime. The estate exemption amount in 2020 was $11,580,000. Curt's executor is not required to file an estate tax return per §6018(a) because his estate is well below the filing threshold and no return was filed.

Story continues. Charlene died January 29, 2023, when her estate value was $17,000,000. The executor of Charlene's estate filed Form 706 on October 29, 2023, and claimed an applicable exclusion amount (AEA) of $12,920,000. The executor reported a taxable estate of $4,080,000 and paid estate tax of $1,632,000 with Form 706. Had Curt's executor filed Form 706 and made the portability election, Charlene's applicable exclusion amount would have been $24,500,000 ($12,920,000 of her AEA plus DSUE of $11,580,000 from Curt's estate tax would have been due. Unfortunately, it was too late to file a late portability election under Rev. Proc. 2017-34 so the only option available to Charlene's estate is to file a PLR (extremely expensive) and ask the IRS for permission to make a late portability election.

Example 2. Assume the same facts as in Example 1. Rev. Proc. 2022-32 allows the executor of Curt's estate to make the portability election any time before January 10, 2025, 5 years from the anniversary of Curt's death. The executor filed Form 706 to make the late portability election on November 1, 2024, and transferred the DSUE to Charlene's estate. As the tax was already paid, the executor of Charlene's estate must file a claim for credit or refund of tax. This is allowed even though the portability election was not filed on behalf of Curt's estate at the time Charlene's estate filed its Form 706.

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Refund claimed on Form 843, Claim for Refund and Request for Abatement. The refund claim for estate tax already paid is filed on Form 843. The refund claim may be filed in anticipation of the filing of Form 706 and making the DSUE election. If Form 843 is filed on or before October 29, 2024, in our example above, the IRS can consider and process that claim for credit or refund of tax once the estate is deemed to have made a valid portability election.

Subsequent determination that executor is required to file a return under §6018(a). If late election relief is provided and it is subsequently determined the estate's value is more than the AEA, so the executor is required to file an estate tax return, the extension granted under Rev. Proc. 2022-32 is retroactively deemed invalid.

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Form **843** (Rev. August 2011) Department of the Treasury Internal Revenue Service

Claim for Refund and Request for Abatement

▶ See separate instructions.

OMB No. 1545-0024

Use Form 843 if your claim or request involves:

(a) a refund of one of the taxes (other than income taxes or an employer's claim for FICA tax, RRTA tax, or income tax withholding) or a fee, shown on line 3,

(b) an abatement of FUTA tax or certain excise taxes, or

(c) a refund or abatement of interest, penalties, or additions to tax for one of the reasons shown on line 5a.

Do not use Form 843 if your claim or request involves:

(a) an overpayment of income taxes or an employer's claim for FICA tax, RRTA tax, or income tax withholding (use the appropriate amended tax return),

(b) a refund of excise taxes based on the nontaxable use or sale of fuels, or

(c) an overpayment of excise taxes reported on Form(s) 11-C, 720, 730, or 2290.

Name(s)	Your social security number
Address (number, street, and room or suite no.)	Spouse's social security number
City or town, state, and ZIP code	Employer identification number (EIN)
Name and address shown on return if different from above	Daytime telephone number

1 Period. Prepare a separate Form 843 for each tax period or fee year.
From ______ to ______

2 Amount to be refunded or abated:
$

3 Type of tax or fee. Indicate the type of tax or fee to be refunded or abated or to which the interest, penalty, or addition to tax is related.

☐ Employment ☐ Estate ☐ Gift ☐ Excise ☐ Income ☐ Fee

4 Type of penalty. If the claim or request involves a penalty, enter the Internal Revenue Code section on which the penalty is based (see instructions). IRC section:

5a Interest, penalties, and additions to tax. Check the box that indicates your reason for the request for refund or abatement. (If none apply, go to line 6.)

☐ Interest was assessed as a result of IRS errors or delays.

☐ A penalty or addition to tax was the result of erroneous written advice from the IRS.

☐ Reasonable cause or other reason allowed under the law (other than erroneous written advice) can be shown for not assessing a penalty or addition to tax.

b Date(s) of payment(s) ▶

6 Original return. Indicate the type of fee or return, if any, filed to which the tax, interest, penalty, or addition to tax relates.

☐ 706 ☐ 709 ☐ 940 ☐ 941 ☐ 943 ☐ 945

☐ 990-PF ☐ 1040 ☐ 1120 ☐ 4720 ☐ Other (specify) ▶

7 Explanation. Explain why you believe this claim or request should be allowed and show the computation of the amount shown on line 2. If you need more space, attach additional sheets.

Signature. If you are filing Form 843 to request a refund or abatement relating to a joint return, both you and your spouse must sign the claim. Claims filed by corporations must be signed by a corporate officer authorized to sign, and the officer's title must be shown.

Under penalties of perjury, I declare that I have examined this claim, including accompanying schedules and statements, and, to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Signature (Title, if applicable. Claims by corporations must be signed by an officer.) Date

Signature (spouse, if joint return) Date

Paid Preparer Use Only	Print/Type preparer's name	Preparer's signature	Date	Check ☐ if self-employed	PTIN
	Firm's name ▶			Firm's EIN ▶	
	Firm's address ▶			Phone no.	

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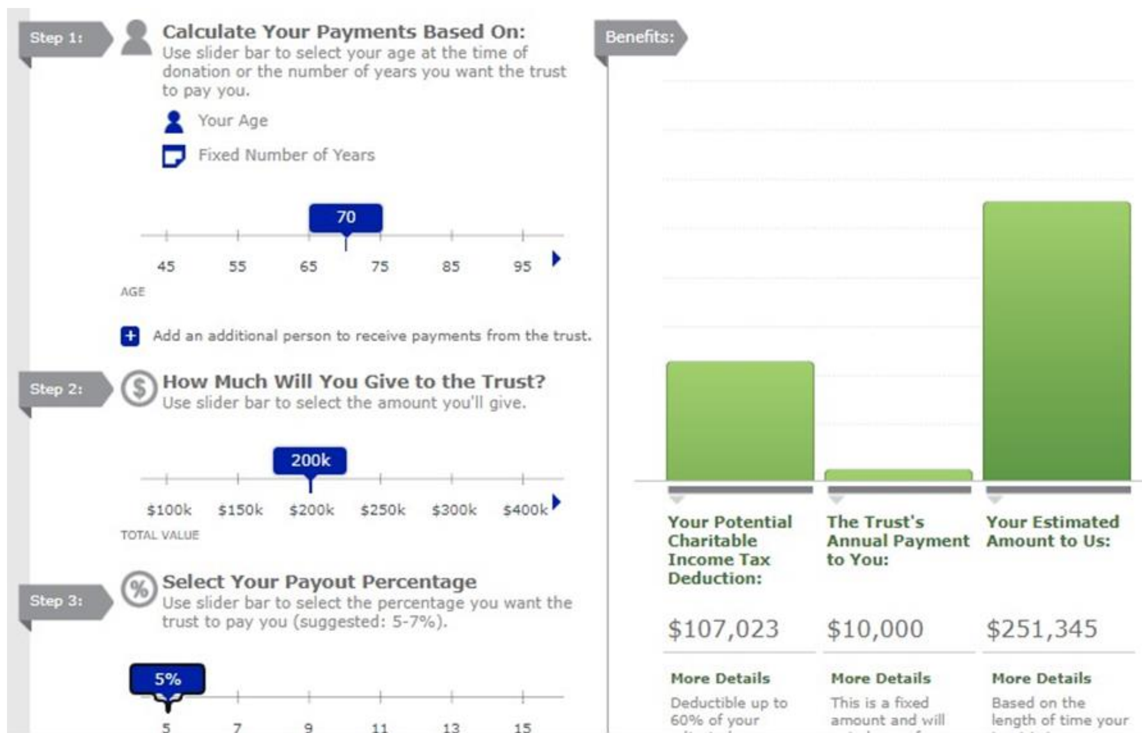
Charitable Remainder Trusts – CRUTs, CRATs (§664)

Charitable remainder trusts (CRTs) are irrevocable trusts that allow a taxpayer to donate assets to a charity (or charities) and retain income from the donated asset for a specified time, including the life of the donor. The charitable beneficiary incudes public charities or private foundations. Depending on how the CRT is established, the trustee may have the power to change the CRT's charitable beneficiary during the lifetime of the trust. A charitable remainder trust may be funded with cash, publicly traded securities, regular C Corp closely held stock (not S corporation stock), real estate, and some other types of assets.

Two types of CRTs. There are two types of charitable remainder trusts, differing in how benefits are paid to the beneficiaries: charitable remainder unitrusts and charitable remainder annuity trusts:

1. A charitable remainder unitrust (CRUT) pays a percentage of the value of the trust each year to noncharitable beneficiaries. The payments generally must equal at least 5% and no more than 50% of the fair market value of the assets, re-valued annually, so there is flexibility in payments. Additional assets may be added to the trust at later dates.

2. A charitable remainder annuity trust (CRAT) pays a specific dollar amount each year for up to 20 years. The amount is at least 5% and no more than 50% of the value of the corpus (property in the trust) when the trust is established. Additional contributions to the trust are not allowed.



Reasons to create charitable remainder trusts.

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- Help plan major donations to desired charities,
- Provide a predictable income for life or over a specific time,
- Allow the deferral of income taxes on the sale of assets transferred to the trust,
- Future asset growth is inside the trust, avoiding estate tax issues,
- Because beneficiaries may be anyone, it can allow children to receive an income stream for a fixed period or even their lifetime,
- The CRT's investment income is exempt from tax. This makes the CRT a good option for asset diversification. You may consider donating low-basis assets to the trust so that when sold, no income tax is generated to you, and you eliminate the capital gains tax on the sale of the asset. However, the named income beneficiary will pay income tax on the income stream received.
- For those with significantly long-term appreciated assets, including non-income- producing property, a CRT allows you to contribute that property to the trust and when the trust sells it is exempt from tax. By donating the assets in-kind to the CRT, you'll preserve the full fair market value of the assets rather than reduce it by large capital gains taxes, allowing more money for the income and charitable beneficiaries,
- Allows a current partial charitable deduction based on the value of the charitable interest in the trust. The partial income tax deduction is based on the type of trust, the term of the trust, the projected income payments, and IRS interest rates that assume a certain rate of growth of trust assets. An example tax deduction calculator is available at https://giftplanning.uff.ufl.edu/charitable-remainder-trusts#:~:text=An%20Example%20of%20How%20It%20Works&text=Susan%20creates%20a%20charitable%20remainder,first%20year%20from%20the%20trust.

Reasons not to create charitable remainder trusts.

- Irrevocable,
- Fixed income does not protect against inflation.
- All remaining funds must be distributed to a charitable organization, or multiple charities, of a donor's choosing at the end of the CRTs term.
- There are costs to establish and maintain the trust.

In a charitable remainder trust:

- A donor transfers property, cash, or other assets into an irrevocable trust,
- The trust's basis in the transferred assets is carryover basis, which is the same basis that it would be in the hands of the donor, for assets transferred to the trust during the lifetime of the donor,

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- A designated trustee (appointed by the donor) may sell the assets, paying no capital gains, and reinvesting the proceeds,

- The trust pays income to at least 1 living beneficiary. If the noncharitable beneficiary is anyone other than the taxpayer or their spouse, gift taxes may apply.

- The payments continue for a specific term of up to 20 years or the life of 1 or more beneficiaries,

- At the end of the payment term, the remainder of the trust passes to 1 or more qualified U.S. charitable organizations,

- The remainder donated to charity must be at least 10% of the initial net fair market value of all property placed in the trust.

Taxes on charitable remainder trusts. Payments from a charitable remainder trust are taxable to the non-charitable beneficiaries and must be reported to them on Schedule K-1 (Form 1041). The payments to a non-charitable beneficiary are taxed as distributions of the trust's income and gains in the following order:

1. **Ordinary income.** Payments are considered ordinary income first to the extent the trust had ordinary income for the year and undistributed ordinary income from prior years. If the trust has enough ordinary income to cover all payments, the entire payments are taxed as ordinary income. Beneficiaries must report payments as ordinary income as reported to them on Schedule K-1.

2. **Capital gains**. Once the trust's ordinary income is exhausted, payments are taxed as capital gains based on the sale or disposition of the trust's capital assets. These payments are taxed as capital gain to the extent of the capital gain of the trust for the current year and any undistributed capital gain income from prior years.

3. **Other income.** Once all ordinary income and capital gains in the trust are fully distributed, payments are characterized as other income to the extent of the trust's current year and accumulated other income. This includes tax-exempt income.

4. **Corpus.** After all current-year and accumulated income and gains are fully distributed, payments would lastly be considered corpus or "principal" of the trust not subject to tax.

Charitable remainder trusts file Form 5227, Split-Interest Trust Information Return annually. Beneficiaries may not borrow from the trust or pay personal expenses with trust funds. Charitable remainder trusts will likely require a greater minimum contribution to establish than a charitable gift annuity (below), typically $250,000.

Deductions for assets contributed to the trust. Upon formation of the trust, the taxpayer may generally take an immediate charitable deduction for the "remainder interest," which is a rough calculation of what will remain of the original donation after the annuity portion has been paid out. The remainder interest – which helps offset the income tax on annual distributions – is calculated using the duration of the trust and:

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- The IRS' §7520 rate at the time of the trust's creation, and
- The IRS' actuarial Table B.

Example. Kerry, a 60-year-old widow in the top tax bracket, owns an investment property with a fair market value of $1 million and a cost basis of $250,000. If Kerry sells the property, she will owe $178,500 in taxes ($750,000 x her capital gains rate of 23.8%). If instead, Kerry transfers the property to a CRAT, and the CRAT then sells the property, Kerry could receive a $50,000 annuity (5% of the trust's value at creation) for 20 years and receive an income tax deduction on the charitable portion of the trust. The charitable deduction is calculated:

1. Kerry created the trust in August 2022, which, use rates as described in §7520, the rate is 3.8%. The annuity term of 20 years is used to determine the present value factor, which is found in the IRS' actuarial Table B. In this case, the PV factor is 13.8342.

2. Multiply the $50,000 annual annuity amount times the 13.8342 PV factor = $691,710. This is the value of Kerry's annuity.

3. Finally, subtract the value of the annuity from the value of the CRAT assets to determine the value of the charitable deduction: $1,000,000 – $691,710 = $308,290.

CRAT annuity payments taxable (Gerhardt v. Comm'r, 160 T.C. No. 9 (2023). The Tax Court held that members of a family who contributed appreciated property to charitable remainder annuity trusts (CRATs), which then sold the properties and purchased single premium immediate annuities with the proceeds, could not exclude the annuity payments from income because the payments were taxable as ordinary income under §664 and §1245. The Court also held that §1245 precluded deferral of gain realized from the disposition of property in a §1031 like-kind exchange.

Charitable Gift Annuities (CGA)

A charitable gift annuity (CGA) is a contract between a charity and a donor where, in exchange for an irrevocable transfer of assets to the charity, the donor receives:

- An immediate income tax charitable deduction for a portion of the gifted assets,
- A *fixed* stream of income for the lifetime of up to two annuitants (the donor and/or beneficiaries designated by the donor), and
- A legacy gift donated to the charity upon the passing of the annuitants.

Charitable gift annuities can be designed to begin paying an income stream to the donor immediately, at a fixed future date, or at a flexible future date, providing the donor with the opportunity to leverage "after tax" income.

Contributing assets to a charitable gift annuity qualifies the donor for an income tax charitable deduction of a portion of the original gift for the year the annuity is established. If the charitable gift annuity is funded with appreciated securities or real estate owned more than one year, and the donor

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is receiving the annuity payments, part of the annuity payments received by the donor will be taxed as ordinary income, part as capital gain, and part may be tax-free. Annuity payments made to annuitants are fixed, and do not fluctuate or become adjusted for inflation. These payments are guaranteed to continue for the lives of the annuitants, and as obligations of the charity, they are backed by the charity's assets. Compared to a traditional, non-charitable annuity, though, rates of return may be lower because the primary purpose of a charitable gift annuity is to benefit the charity.

CGA terms fluctuate. Charitable gift annuity rates vary from charity to charity and are based on several factors, including the amount of the gift and the donor's age(s) at the time of the gift. Younger donors may often see significantly lower rates based on the longer expected term. For example, a 60-year-old donor who donates $100,000 may receive a rate of 4.4% (paying $4,400 annually) while an 85-year-old who also donates $100,000 will see a rate of 7.8% ($7,800 annually). Some charities offer higher rates for donors who agree to wait a number of years before starting to receive payments.

Secure Act 2.0 makes CGA contributions available to IRAs. Starting in 2024, taxpayers 70½ and older may make a one-time election of up to $53,000 to fund a CGA with a QCD from an IRA. While the gift does not qualify for an income tax deduction, it does escape income tax liability on the transfer and count toward all or part of required minimum distributions. Bottom line, it is a way to support a charity, get an income stream, and avoid tax on an IRA distribution.

CRT or CGA – What's The Right Choice?

Choosing between a CRT and CGA comes down to a matter of the gift amount and the level of bureaucracy the taxpayer donor is willing to endure. Payments made by a CGA are guaranteed by the charity, but CRT payments are subject to the availability of trust assets. Charitable remainder unitrust (CRUT) payments will likely change each year based on fluctuations in the trust's value. This means the income beneficiary and remainder charity share in any trust asset value fluctuations. For those looking for certainty, CGAs are a better option.

A CRT is a separate legal entity governed by the terms of a trust document. A trustee (may be the donor, beneficiary, or the remainder charity) is required to administer the trust. The trust is required to file an annual tax return, which includes a K-1 for the beneficiary. CGAs are not required to have a trust or tax return so the CGA costs much less to set up and administer. CGAs are typically used for smaller gifts and CRTs for larger gifts or more complex assets. In most cases, experts agree that CRTs begin to make sense once contributed assets equal or exceed $250,000.

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Form 706 – U.S. Estate Tax Return General Issues

Executors use form 706 to report and compute the Federal estate tax and the Federal generation-skipping transfer (GST) tax. The IRS uses the information on the form to enforce the estate and GST tax provisions of the Code and to verify the taxes have been properly computed.

No significant changes to 2024 version of Form 706. The last time Form 706 was significantly changed was 2019, which is the version still in use today. Each year the IRS makes minor changes to the Form 706 instructions. The 2024 changes only include new inflation adjusted amounts. See Form 706 instructions.

Schedule R-1, Generation Skipping Tax is a separate form. Schedule R-1 of Form 706 is a payment voucher where the Generation Skipping-Transfer Tax is computed and reported. The form acts as a payment voucher to accompany payment of the GST tax. Historically Sch. R-1 was imbedded in Form 706. Starting in 2019, the form was no longer included Form 706. Taxpayers now need to obtain a separate Schedule R-1, complete it, and then file it with Form 706.

Final Regulations Coordinate Provisions of the Tax Cuts Jobs Act (TCJA) and the Estate Rules After TCJA Expires (T.D. 9884; §20.2010-0; T.D. 9918 etc.)

Background. TCJA amended the Internal Revenue Code to provide that, for decedents dying and gifts made after December 31, 2017, and before January 1, 2026, the basic exclusion amount (BEA) was increased from $5 million to $10 million as adjusted for inflation after 2011 (increased BEA). On January 1, 2026, the BEA is to revert to $5 million, also adjusted for inflation after 2011.

After enactment of TCJA, the big question was what happens in 2026 when the BEA reverts to $5,000,000. Specifically, if a taxpayer made taxpayer made gifts equal to all or some portion of the increased BEA provided by TCJA, was there a claw back in 2026 when the BEA is reduced. Also, if the estate of a married decedent elected portability, passing $11,000,000, for example, of deceased spouse unused exemption (DSUE) to a surviving spouse, what happens to the DSUE in 2026?

Regulations clarify interaction of estate limits during and after the TCJA (§20.2010-1(c)). The IRS has used authority given to it by the TCJA to address the issues described above. In the regulations, the IRS finalized three important clarifications:

1. BEA includes inflation adjustments from 2011 and beyond for both the $5,000,000 BEA applicable before 2018 and after 2025 and the $10,000,000 BEA applicable for years 2018 through 2025. For example, the BEA for 2020 is $11,580,000.

2. Any BEA used during 2018 through 2025 to reduce the taxable amount of any post-1976 gifts for gift tax purposes, to the extent such BEA amount is greater than the BEA in years after 2025, may be added to the post-2025 BEA to calculate the taxable amount, if any, of gifts or the donor's estate.

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Example 1. Harry, a single man, made cumulative post-1976 taxable gifts of $9 million, all of which were sheltered from gift tax by the $11,580,000 BEA. Harry died in 2027 when the BEA was $7,000,000.

Question – Is Harry required to “claw back” any of the gifts he made more than $6,800,000 BEA in the year of his death ($2,200,000 in this example)?

Answer – Because the BEA used to offset the gifts made by Harry was $9,000,000 exceeds the $7,000,000 BEA at the time of his death, the regulations provide that Harry’s estate may use a BEA of $9,000,000 when computing the amount of the taxable estate.

Example variation – Assume the same facts as in Example 1 except Harry made only $4,000,000 of cumulative post-1976 taxable gifts. Because the total of the amounts gifted was less than the $7,000,000 BEA at Harry's date of death, the regulations do not apply. Harry’s estate tax is based on the $7,000,000 BEA in effect at the time of his death.

3. Any deceased spouse unused exclusion (DSUE) amount is retained in its entirety, regardless of the BEA at the time the second spouse dies. However, if the surviving spouse makes any taxable gifts during his or her lifetime, any such gifts are offset first by DSUE and then by the individual’s own BEA.

Example 2. Harry and Dorothy are married when, in 2023, Harry unexpectedly dies when the BEA was $12,000,000. Prior to his death Harry had not made any taxable gifts during his lifetime. The executor for Harry’s estate elects to have the $12,000,000 DSUE transferred to Dorothy. Dorothy makes no taxable gifts in her lifetime and did not remarry before her death in 2027 when the BEA was $7,000,000. Dorothy’s estate has a BEA of $19,000,000 ($12,000,000 DSUE plus her BEA of $7,000,000). She can utilize the entire DSUE amount to offset its taxable assets.

Example variation – Assume the same facts as above except after Harry died, Dorothy made taxable gifts $14,000,000 in 2025, when her BEA was $24,000,000 ($12,000,000 DSUE plus her own BEA of $12,000,000). The ordering rules for these gifts require Dorothy to apply the DSUE to the gifts first and then use her own BEA, as necessary. Dorothy would first use the $12,000,000 DSUE from Harry’s estate and then use $2,000,000 of her own BEA to avoid tax on the gifts. This would leave her BEA of $10,000,000 for the remainder of 2025 but reverts to $7,000,000 in 2026.

Miscellaneous Deductions Allowed for Estates and Non-Grantor Trust (§1.67-4)

Prior to TCJA, miscellaneous itemized deductions were allowable for individuals, estates and trusts to the extent the total of such deductions exceeded 2% of AGI (§67(a)). For this purpose, miscellaneous itemized deductions is defined as itemized deductions other than those listed in §67(b). The TCJA changed the law to prohibit individuals, estates, and non-grantor trusts from claiming miscellaneous itemized deductions for taxable years beginning after Dec. 31, 2017 and before Jan. 1, 2026 (§67(g)).

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Where does this leave estates and trusts (§1.67-4)? When the TCJA was enacted, a question arose about whether estates and non-grantor trusts would continue to be allowed deductions similar to miscellaneous itemized deductions but deductible directly against the estate or trust's AGI (i.e. expenses defined under §67(e). The recently finalized regulations make clear the deductions allowed under §67(e) are NOT itemized deductions and are therefore still deductible for estates and non-grantor trusts. The fully deductible miscellaneous deductions include:

- Costs paid or incurred in connection with the administration of an estate or non-grantor trust that would not have been incurred if the property were not held in the estate or trust[1],
- The personal exemption of an estate or non-grantor trust,
- The distribution deduction for trusts distributing current income, and
- The distribution deduction for estates and trusts accumulating income.

Excess Deductions on Termination of an Estate or Trust (§642(h); §1.642(h)-2)

Historically, when an estate or trust is terminated any excess deductions upon termination are passed through to the beneficiaries of the estate or trust and deducted on their return. The TCJA created some uncertainty as to whether these deductions would still be allowed and Notice 2018-61 did not address the issue.

Final regulations solidify the rules (1.642(h)-2). Final regulations (T.D. 9918) clarify a terminated estate or trust that has: 1) a net operating loss carryover or a capital loss carryover, or 2) for the last taxable year of the estate or trust, deductions (other than the deductions relating to the personal exemption or charitable contributions) in excess of gross income for the final year, the carryover or excess is allowed as a deduction to the beneficiaries of the estate or trust. This includes estates, non-grantor trusts (including the S portion of an electing small business trust), and their beneficiaries. Excess deductions passed to a beneficiary retains its character (specifically, as allowable in arriving at adjusted gross income, as a non-miscellaneous itemized deduction, or as a miscellaneous itemized deduction) while in the estate or trust and remains subject to any limitation applicable under the Code in the computation of the beneficiary's tax liability.

Example #1. The Smith Family trust distributes all its assets to Betty and terminates on December 31, 2024. As of December 31, 2024, the Smith Family trust has excess deductions of $18,000, all characterized as allowable in arriving at AGI. Betty reports on the calendar year basis and claims the $18,000 as a deduction in arriving at her 2024 AGI. If, however, the deduction (when added to other allowable deductions that Betty claims for the year) exceeds Betty's gross income, the excess may not be carried over to 2025 or beyond.

[1] Such expenses are defined in §1.67-4(b) and include tax preparation, additional investment advisory fees due to assets being held by and estate or trust, appraisal fees, certain fiduciary fees, etc.

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Decedent Filing Issues

Claiming refunds for deceased taxpayers. When filing a decedent's return and claiming a refund, Form 1310, Statement of Person Claiming Refund Due a Deceased Taxpayer, must be filed with the return to claim the refund unless:

- The person claiming the refund is a surviving spouse filing an original or amended joint return with the decedent, or
- The person claiming the refund is a personal representative filing an original Form 1040, Form 1041A, Form 1040EZ or Form 1040NR for the decedent and a court certificate showing the appointment is attached to the return.

When preparing Form 1310:

- Line A. Check the box on Line A if a refund check was received in the surviving spouse's name and the deceased spouse's name. The surviving spouse returns the joint name check with Form 1310 to the local IRS office or the Internal Revenue Service Center where the return was filed. A new check will be issued in the surviving spouse's name and mailed to her or him.
- Line B. Check the box on line B if the personal representative is claiming a refund on a Form 1040X, US Individual Income Tax Return, or Form 843, Claim for Refund and Request for Abatement. The personal representative must attach a copy of the court certificate showing their appointment. If the court certificate was already sent to the IRS, then write 'Certificate Previously Filed' at the bottom of the form.
- Line C. Check the box on Line C if an individual claiming the return is not a surviving spouse and there is no court-appointed personal representative. Part II must also be completed and a copy of the death certificate or formal notification from an appropriate government office (for example the Department of Defense) informing the next of kin of the decedent's death.

Preparer note. A death certificate or other proof of death is not required to be attached to Form 1310. The documentation should be kept the records and provided if requested.

Example. Charles Bronson died on January 31, 2020. Vince Majestyk is Bronson's nephew and sole heir. Bronson did not have a will, and the court did not appoint a personal representative for his estate. Vince prepares Bronson's final tax return and calculates a refund of $4,000. Vince is entitled to the refund if he files the final Form 1040 for Bronson and completes and attaches Form 1310. Vince checks box on Form 1310, line C, answers all the questions in Part II, and signs his name in Part III.

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Form **1310** (Rev. August 2019) Department of the Treasury Internal Revenue Service

Statement of Person Claiming Refund Due a Deceased Taxpayer

▶ Go to *www.irs.gov/Form1310* for the latest information.
▶ See instructions below and on back.

OMB No. 1545-0074
Attachment Sequence No. **87**

Tax year decedent was due a refund:

Calendar year 2020, or other tax year beginning , 20 , and ending , 20

Please print or type			
Name of decedent. If filing a joint return and both taxpayers are deceased, complete a Form 1310 for each. See instructions. Charles Bronson	Date of death 12/31/2020	**Decedent's social security number** 123-45-6789
Name of person claiming refund Vince Majestyk		**Your social security number**
Home address (number and street). If you have a P.O. box, see instructions. 123 W Hwy 31		Apt. no.
City, town or post office, state, and ZIP code. If you have a foreign address, see instructions. Rocky Ford Colorado 81111		

Part I **Check the box that applies to you.** Check only one box. **Be sure to complete Part III below.**

- **A** ☐ Surviving spouse requesting reissuance of a refund check (see instructions).
- **B** ☐ Court-appointed or certified personal representative (defined below). Attach a court certificate showing your appointment, unless previously filed (see instructions).
- **C** ☑ Person, **other** than A or B, claiming refund for the decedent's estate (see instructions). Also, complete Part II.

Part II **Complete this part only if you checked the box on line C above.**

		Yes	No
1	Did the decedent leave a will?		✔
2a	Has a court appointed a personal representative for the estate of the decedent?		✔
b	If you answered **"No"** to 2a, will one be appointed?		✔
	If you answered **"Yes"** to 2a or 2b, the personal representative must file for the refund.		
3	As the person claiming the refund for the decedent's estate, will you pay out the refund according to the laws of the state where the decedent was a legal resident?	✔	
	If you answered **"No"** to 3, a refund cannot be made until you submit a court certificate showing your appointment as personal representative or other evidence that you are entitled under state law to receive the refund.		

Part III **Signature and verification. All filers must complete this part.**

I request a refund of taxes overpaid by or on behalf of the decedent. Under penalties of perjury, I declare that I have examined this claim, and to the best of my knowledge and belief, it is true, correct, and complete.

Signature of person claiming refund ▶ **Date ▶**

Phone no. (optional)

Allocation of Decedent's Income

The income and deductions included on a decedent's final return is generally determined as if the person was still alive except that the taxable period is shorter because it ends on the date of death. The method of accounting regularly used by the decedent before death also determines the income includible on the final return. Some anomalies include:

- Cash method taxpayers include only items actually or constructively received before death.
- Checks received but not cashed prior to death are constructively received and are income taxable on the decedent's final 1040.

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- If the decedent used an accrual method (Sch. C income), only the income items normally accrued before death are included in the final return.

Wages. Only wages received prior to death are reported on the final return. If a paycheck was received, but not cashed, prior to death, the payroll check should be returned, and a new check should be issued to the estate. The entire amount of wages or other employee compensation earned by the decedent but unpaid at the time of death is income in respect of a decedent (IRD) and is included as an asset in Form 706. If the income is $600 or more, the employer should report it in box 3 of Form 1099-NEC, Non-Employee Compensation, and give the recipient a copy of the form or a similar statement. Wages paid as IRD:

1. Are not subject to federal income tax withholding.

2. During the calendar year of death are subject to withholding for Social Security and Medicare taxes. These taxes should be included on the decedent's Form W2 along with the taxes withheld before death. The wages are ***NOT*** included in box 1 of Form W2.

3. After the year of death generally are not subject to withholding for any federal taxes, Social Security or Medicare taxes.

Interest and dividends. Interest posted and subject to withdrawal before decedent's death (last statement prior to death) is includible in the final return. Interest posted on a monthly or quarterly statement issued prior to the decedent's death is the benchmark for calculating interest to be includible.

Example. Richard Stone died on July 21. The interest to be included in Richard's final 1040 is the interest earned to date through the last statement, which was June 30. The interest accrued after June 30 is includible on as income on the estate's Form 1041.

Joint ownership. For an account or security titled in the name of the decedent and another as joint owners with right of survivorship, interest earned after the date of death is reported on the joint tenant's income tax return. There will be no income earned and reported by the estate.

Dividends. Declared but unpaid dividends paid after death are not included on the decedent's final return. These dividends are reported as an asset of the estate and considered as IRD.
Form 1099 matching problems. If Form 1099-INT or 1099-DIV are received and it includes income earned both before and after the date of death, the preparer should show the reported amount on Schedule B on the final 1040, subtotal all amounts reported on Form 1099, and then show any interest or dividends (including amounts received as a nominee) belonging to another recipient separately and subtract it from the subtotal. Identify the amount of the adjustment as 'Nominee Distribution' or other appropriate designation. For example:

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RECONCILIATION OF INTEREST AND DIVIDEND INCOME

CONRAD GRAYSON ESTATE

CONRAD GRAYSON

	Total Amount Shown On Form 1099	Amount Included in Decedent's Form 1040 **111-22-3333**	Amount Included on Estate Income Tax Return **20-6677556**
Interest Income			
BB&T Bank	517	374	143
Bank of the Ozarks	2,965	2,259	706
Capital One Bank	1,312	887	425
Fifth Third Bank	1,127	1,127	0
PNC Bank	357	297	60
SunTrust Bank	962	650	312
Wachovia Bank	363	241	122
Totals	7,603	5,835	1,768
Dividend Income			
Florida Power & Light	3,400	1,700	1,700
Publix Supermarkets, Inc	2,200	1,200	1,000
Walt Disney Corporation	2,500	1,300	1,200
Totals	8,100	4,200	3,900

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SCHEDULE B (Form 1040A or 1040)
(Rev. January 2017)
Department of the Treasury Internal Revenue Service (99)

Interest and Ordinary Dividends

▶ Attach to Form 1040A or 1040.
▶ Information about Schedule B and its instructions is at *www.irs.gov/scheduleb*.

OMB No. 1545-0074
2016
Attachment Sequence No. 08

Name(s) shown on return: CONRAD GRAYSON
Your social security number: 111-22-3333

Part I Interest

(See instructions on back and the instructions for Form 1040A, or Form 1040, line 8a.)

Note: If you received a Form 1099-INT, Form 1099-OID, or substitute statement from a brokerage firm, list the firm's name as the payer and enter the total interest shown on that form.

1 List name of payer. If any interest is from a seller-financed mortgage and the buyer used the property as a personal residence, see instructions on back and list this interest first. Also, show that buyer's social security number and address ▶

Payer	Line	Amount
BB&T BANK	1	517
BANK OF THE OZARKS		2965
CAPITAL ONE BANK		1312
FIFTH THIRD BANK		1127
PNC BANK		357
SUNTRUST BANK		962
WACHOVIA BANK		363
REPORTED BY 20-6677556 - CONRAD GRAYSON ESTATE		-1768
2 Add the amounts on line 1	2	5835
3 Excludable interest on series EE and I U.S. savings bonds issued after 1989. Attach Form 8815	3	
4 Subtract line 3 from line 2. Enter the result here and on Form 1040A, or Form 1040, line 8a ▶	4	5835

Note: If line 4 is over $1,500, you must complete Part III.

Part II Ordinary Dividends

(See instructions on back and the instructions for Form 1040A, or Form 1040, line 9a.)

Note: If you received a Form 1099-DIV or substitute statement from a brokerage firm, list the firm's name as the payer and enter the ordinary dividends shown on that form.

5 List name of payer ▶

Payer	Line	Amount
FLORIDA POWER & LIGHT	5	3400
PUBLIX SUPERMARKETS, INC.		2200
WALT DISNEY CORPORATION		2500
REPORTED BY 20-6677556 - CONRAD GRAYSON ESTATE		-3900
6 Add the amounts on line 5. Enter the total here and on Form 1040A, or Form 1040, line 9a ▶	6	4200

Note: If line 6 is over $1,500, you must complete Part III.

Part III Foreign Accounts and Trusts

(See instructions on back.)

You must complete this part if you **(a)** had over $1,500 of taxable interest or ordinary dividends; **(b)** had a foreign account; or **(c)** received a distribution from, or were a grantor of, or a transferor to, a foreign trust.

		Yes	No
7a	At any time during 2016, did you have a financial interest in or signature authority over a financial account (such as a bank account, securities account, or brokerage account) located in a foreign country? See instructions		✔
	If "Yes," are you required to file FinCEN Form 114, Report of Foreign Bank and Financial Accounts (FBAR), to report that financial interest or signature authority? See FinCEN Form 114 and its instructions for filing requirements and exceptions to those requirements		✔
b	If you are required to file FinCEN Form 114, enter the name of the foreign country where the financial account is located ▶		
8	During 2016, did you receive a distribution from, or were you the grantor of, or transferor to, a foreign trust? If "Yes," you may have to file Form 3520. See instructions on back		✔

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 17146N Schedule B (Form 1040A or 1040) 2016

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Other items of income.

- **Capital gains and losses** – the date of sale (or transaction date) and not the settlement date is date to report the sale. Capital loss carryovers not used on the final 1040 are lost. If the capital loss was a joint capital loss; 50% of the carryforward is lost.

- **Schedule C and Schedule F** – income earned by businesses owned by the decedent will be income of the estate as of the date of death as calculated using the decedent's accounting method.

- **Partnership income** – the death of a partner closes the partnership's tax year for that partner. Subsequently the estate would become a partner at least until the estate is settled. The decedent's distributive share of partnership items must be figured as if the partnership's tax year ended on the date the partner died. To avoid an interim closing of the partnership books, the partners can agree to estimate the decedent's distributive share by prorating the amounts the partner would have included for the entire partnership tax year. Self-employment income would be prorated through the end of the month of the date of death.

Example. Shari O'Leary was a partner in the Green Ptomaine Restaurant, a partnership, and reported her income on a tax year ending December 31. The partnership uses a tax year ending December 31. Shari died August 31, 2020. Her estate established its tax year through August 31, 2021.

The distributive share of partnership income based on the decedent's partnership interest is reported as follows:

- **Final return for the decedent** – January 1 through August 31, 2020, includes Green Ptomaine's Restaurant partnership items from January through August 31, 2020.

- **Income tax return of the estate** – September 1, 2020, through August 31, 2021, includes Green Ptomaine's Restaurant partnership items for the period September 1, 2020, through December 31, 2020.

- **S Corporation income** – shareholders in S corporations include the decedent's share of the S corporation's items of income, loss, deduction, and credit on the decedent's final return for the following periods:

  1. The corporation's tax year that ended within or with the decedent's final tax year (the year ending on the date of death).
  2. The period, if any, from the end of the corporation's tax year in (1) to the decedent's date of death.

- **Community income** – if the decedent was married and domiciled in a community property state, half of the income received and half of the expenses paid during the decedent's tax year by either the decedent or spouse may be considered the income and expenses of the other.

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- **Trust income** – if decedent was the beneficiary of a non-grantor trust (often a bypass trust), the income paid by the trust and received by the decedent prior to death is reported on the final Form 1040. Income received after the DOD is reported on Form 1041.

    1. All income earned prior to death by a grantor trust (revocable living trust) is reported on the final return. If the grantor retained control of the trust, serving at least as a co-trustee, the trust status will be ignored for income tax purposes.

    2. Upon death, grantor trusts become irrevocable, and income earned is reported on a Form 1041. A Schedule K-1 may be issued to each beneficiary.

1. **US Savings Bonds** – If the savings bonds are Series EE or I savings bonds and are transferred because of death and were owned by a cash method individual who had chosen **NOT** to report the interest each year and had purchased the bonds entirely with personal funds, interest earned before death is reported:

    1. The person who is required to file the decedent's final income tax return elects to include **ALL** the interest earned on the bonds before the decedent's death on the decedent's final return. The estate or beneficiary then includes as taxable income only the interest earned after the date of death on its return.

    2. If the election to include the interest is not made, the interest earned to the date of death is IRD and is not included in the decedent's final return. Instead, all the interest earned before and after the decedent's death is taxable income to the estate or beneficiary. Cash method beneficiaries may choose to forgo annual reporting of the Savings Bond interest until the earlier of when the bonds are cashed or reach the date of maturity. In the year the interest is reported, the transferee may claim a deduction for any federal estate tax paid that arose because of the part of interest (if any) included in the decedent's estate.

Preparer note. When U.S. savings bonds are cashed that were acquired from a decedent, the bank or other payer that redeems it must give the redeemer a Form 1099-INT if the interest part of the payment received is $10 or more. The Form 1099-INT should show the difference between the amount received and the cost of the bond. The interest shown on the Form 1099-INT will not be reduced by any interest reported by the decedent before death, or, if elected, by the personal representative on the final income tax return of the decedent, or by the estate on the estate's income tax return. The redeemer's Form 1099-INT may show more interest than they must include in their income.

The redeemer must make an adjustment on their tax return to report the correct amount of interest. They report the total interest shown on Form 1099-INT on Schedule 1 (Form 1040A) or Schedule B (Form 1040). Enter a subtotal of the interest shown on Forms 1099-INT, and the interest reportable from other sources for which Forms 1099-INT were not received. Show the total interest that was previously reported and subtract it from the subtotal. Identify this adjustment as "U.S. Savings Bond Interest Previously Reported."

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Table B. **Worksheet To Reconcile Amounts Reported in Name of Decedent on Information Returns (Forms W−2, 1099−INT, 1099−DIV, etc.) (Keep for your records)**

Name of Decedent	Date of Death	Decedent's Social Security Number		
Name of Personal Representative, Executor, or Administrator		**Estate's Employer Identification Number (If Any)**		

Source (list each payer)	A Enter total amount shown on information return	B Enter part of amount in column A reportable on decedent's final return	C Amount reportable on estate's or beneficiary's income tax return (column A minus column B)	D Part of column C that is *income in respect of a decedent*
1. Wages				
2. Interest income				
3. Dividends				
4. State income tax refund				
5. Capital gains				
6. Pension income				
7. Rents, royalties				
8. Taxes withheld*				
9. Other items, such as social security, business and farm income or loss, unemployment compensation, etc.				

* List each withholding agent (employer, etc.)

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Allocation of Decedent's Deductions

Medical expenses. Medical expenses paid before death by the decedent are deductible, subject to limits, on the final income tax return if deductions are itemized. This includes expenses for the decedent, as well as for the decedent's spouse and dependents. Medical expenses that were not paid before death are liabilities of the estate and are shown on Form 706.

Election allows post death medical expenses to be deducted on decedent's final return. An election is available to treat all, or part of the decedent's medical expenses paid out of the estate during the one-year period beginning with the day after the decedent's death as paid by the decedent ***at the time they were incurred***. If the election is made, all or part of the expenses are claimed on the decedent's final Form 1040 rather than on the Form 706.

The election is made by attaching a statement to Form 1040 and Form 706 stating that these amounts were not claimed on Form 706 and that the estate waives the right to claim these expenses as deduction on Form 706. This election only applies to expenses incurred for the decedent, not to expenses incurred to provide medical care for dependents.

Preparer note. Insurance reimbursements of previously deducted medical expenses due a decedent at the time of death are includible as income on the Form 1041 of the estate and will be included as an asset on Form 706.

Example. Graham Hess, a minister, used the cash method of accounting and filed his income tax return on a calendar year basis. Graham died on June 1, 2020, after incurring $8,000 in medical expenses. Of that amount, $5,000 was incurred in 2019 and $3,000 was incurred in 2020. Graham itemized his deductions when he filed his 2019 income tax return. The personal representative of the estate paid the entire $8,000 of medical expenses in August 2020.

The personal representative may file an amended return (Form 1040X) for 2019 claiming the $5,000 medical expense as a deduction. The $3,000 expense incurred in 2020 can be deducted on the final tax return if deductions are itemized.

The personal representative must file a statement in duplicate with each return stating that these amounts have not been claimed on the federal estate tax return (Form 706) and waiving the right to claim such a deduction on Form 706 in the future.

Medical expenses of decedents and HSAs (§223(f)(8)). HSAs that have a balance remaining in the account at the time of the account owner's death may be transferred to another person with two different results:

1. If the decedent's spouse inherits the HSA, he or she may treat the HSA as their own HSA.
2. If someone other than a spouse inherits the HSA, account shall cease to be an HSA as of the date of death, and the fair market value of the assets in the account are includible in the income of the beneficiary who inherited the account.

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Example. Jeannie dies on March 1, 2020, at which time she owned an HSA with an account balance of $27,600. Jeannie has three children, Richard, Jose, and Alyssa named as beneficiaries of the HSA. The HSA ceases to be an HSA on March 1, 2020, the balance of the account is distributed to the beneficiaries each must pay tax on $9,200.

Taxpayer friendly HSA third option exists (§223(f)(8)(B)(ii)). The death of the HSA owner does not preclude additional distribution from the HSA to reimburse for medical expenses of the decedent. In fact, the executor or trustee may make withdrawals from an HSA to reimburse for qualified medical expenses incurred by the decedent before the date of death for up to 12 months after the date of death.

Qualified medical expenses defined for this purpose (§223(d)(2); Notice 2004-2; Form 8889). The term "qualified medical expenses" means amounts paid by the HSA owner for medical care (as defined in §213(d)) for such individual, their spouse and their dependents (as defined in §152), to the extent such amounts are not compensated for by insurance or otherwise. The qualified medical expenses must be incurred after the HSA was established and may be reimbursed at any time up to 12 months after the account owner dies. Form 8889 is completed:

- Enter "Death of HSA account beneficiary" across the top of Form 8889.
- Enter the name(s) shown on the beneficiary's tax return and the beneficiary's SSN in the spaces provided at the top of the form and skip Part I.
- On Part II, line 14a, enter the fair market value of the HSA as of the date of death.
- On Part II, line 15, for a beneficiary other than the estate, enter qualified medical expenses incurred by the account beneficiary before the date of death that were paid within 1 year after the date of death.
- Complete the rest of Part II.

Example - variation. Assume the same facts as the last example, except Jose is the executor of Jeannie's estate and he is familiar with the HSA rules. After Jeannie's death, the estate receives medical bills of $9,000 for medical services Jeannie received during the last 3 months of her life. Jose uses the HSA to pay the medical bills, reducing the account balance by $9,000 and saving he and his two siblings some tax. However, Jose doesn't stop there. He reviews statements of the HSA account for the past 5 years and notes that Jeannie never made any withdrawals. He also notes that she paid medical expenses more than $30,000, not including her Medicare supplemental plan, over that 5-year period. Jose withdraws the remaining balance from the HSA in December 2020 (within the one-year time limit) and records it as a qualified medical distribution on the Form 8889 he files with Jeannie's final return. There is nothing left to distribute to he or his siblings and no tax is paid on the distribution. Jose reports the distribution as a qualified distribution on Form 8889 and saves the tax on the distribution of the entire HSA account balance.

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Sample Election
Ray Kinsella (Deceased 12/31/20)
111-22-3333

Election to Expense Decedent's Medical Expenses

Under IRC §213(c) and Regulation §1.213-1(d)(2), the taxpayer hereby elects to deduct the following expenses, paid within one year of the decedent's death, on Form 1040 for the year ended December 31, 2020 These expenses have not been claimed under IRC §2053 on Form 706; and further, the taxpayer hereby waives the right to deduct the expenses at any time for estate tax purposes under IRC §2053.

Doctors and hospitals	$ 7,625
Prescriptions	1,222
Total	$ 8,847

Deductions in respect of a decedent. Items such as business expenses, income-producing expenses, interest, and taxes, for which the decedent was liable but that are not properly allowable as deductions on the final return will be allowed as a deduction when paid either by the estate or by the person who inherited the property subject to the liability.

Deduction for losses. A decedent's net operating loss deduction from a prior year and any capital losses (including capital loss carryovers) can be deducted only on the decedent's final income tax return. Unused NOLs or capital losses cannot pass through to the beneficiaries, including the surviving spouse. Such losses also cannot be deducted on the estate's income tax return.

1. **Passive activity losses** – Generally, accumulated unused passive activity losses are allowed as a deduction against the decedent's income in the year of death. However, such loss deductions are limited to the extent the loss is greater than the excess of the beneficiary's basis in the property over the decedent's adjusted basis in the property immediately before death (i.e., the amount the basis is stepped up). The part of the accumulated losses equal to the excess is not allowed as a deduction for any tax year.

Example. At the time of his death, Bill Poole owned a passive activity with a basis of $30,000. The FMV of the activity at the DOD was $45,000. Bill had suspended passive losses from the activity of $25,000.

A loss of $10,000 would be deducted on Bill's final return calculated:

Suspended passive loss	$ 25,000
Less step up in basis	($15,000)
Loss deductible	$ 10,000

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Unrecovered investment in pension or annuity. If decedent owned an annuity or pension contract which ended at death, the amount of any unrecovered investment in the contract may be deducted on the decedent's final return. Such amounts are deducted on Schedule A, NOT subject to the 2% limit.

Mortgage loan costs. Any unamortized mortgage loan costs are deductible on the final return.

Request for Prompt Assessment (§6501(d); Form 4810).

IRS ordinarily has 3 years from the date an income tax return is filed, or its due date, whichever is later, to charge any additional tax that is due. Fiduciaries may request the IRS perform a prompt assessment, which reduces the time for making the assessment to 18 months from the date the written request for prompt assessment was received. The request can be made for any decedent's income tax return and for any estate tax return.

Making the request. The request may only be filed after the return it covers has been filed and it must be filed separately from all other forms. The request is typically made by filing Form 4810, but taxpayers can substitute a letter or statement which clearly states that a request for prompt assessment is being made and the year(s) involved. The requester must verify her or his authority to act for the taxpayer (e.g., letters testamentary or letters of administration, etc.). The request is made at the same IRS Service Center where the returns were affected returns were originally filed. It may be beneficial to include copies of the returns for which the request(s) is made. If so, be sure to write "COPY – DO NOT PROCESS AS ORIGINAL" at the top of the copy. An executor can request prompt assessment of any of the decedent's taxes for any years for which the statutory period for assessment is open.

Request for Discharge From Personal Liability (§2204; §6905; Form 5495).

IRS ordinarily has 3 years from the date after an income tax, gift tax, or estate tax return has been filed to assess tax and demand payment of any deficiency. The executor representing a decedent's estate, or a fiduciary of a decedent's trust, may request a discharge from personal liability for a decedent's income, gift, and estate taxes before the 3-year period expires. Requests can be made for 9 months (6 months in the case of a fiduciary's request) after the IRS's receipt of the request for discharge, or the earlier payment of any amount determined by the IRS to be owed. If the IRS agrees, the executor or fiduciary will be discharged from personal liability for any deficiency in such tax thereafter found to be due.

Making the request. The request must be made on Form 5495 after the returns for those years are filed. The fiduciary must attach all information and documents required to accompany Form 5495. Even if the executor is discharged from personal liability, the IRS will still be able to assess tax deficiencies against the executor to the extent that he or she still has any of the decedent's property.

Don't Agree to be the Executor if you Don't Have the Time (Kwang Lee, Estate, Anthony Frese, Executor v. Comm. TC Memo 2021-092. Kwang Lee died testate on September 30, 2001, and Mr. Frese, a licensed attorney and municipal court judge, was named executor of the estate. Frese filed a Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return, on behalf of the estate on or around May 21, 2003. From July 2003 to February 2007, Mr. Frese made distributions

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to estate beneficiaries totaling $1,045,000 (distributed amounts), of which $640,000 was distributed on February 28, 2007 (February 2007 distribution).

The IRS audited the estate's return determined a $1,020,000 deficiency in estate tax and penalties of $459,000 for untimely filing and accuracy-related penalty. The trial occurred in 2010, and the Court ruled there was a tax deficiency of $536,000 in 2010 and no penalties applied.

Executor must make sure the tax is paid before making distributions. By 2013 Frese still hadn't paid the estate tax due and the IRS filed a tax lien. Frese then timely Form 12153, Request for a Collection Due Process or Equivalent Hearing with the IRS Office of Appeals. He also asked that an Installment Agreement and "Offer in Compromise" (OIC) be considered. The IRS suspended collection action until 2016. In December 2016, the estate submitted Form 433-A, Collection Information Statement for Wage Earners and Self-Employed Individuals, which showed that the estate's only asset was a checking account with a balance of $182,941. The estate also submitted an OIC in the same amount. In reviewing the estate's OIC the IRS determined it would collect the distributed amounts from Frese and from the beneficiaries and rejected the estate's OIC.

The Court ruled Frese could be held personally liable under for the unpaid estate tax that remained due ($536,000) because of the February 2007 distribution and entered a summary judgement on behalf of the IRS. OUCH!!!

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Glossary

Agricultural Chemicals Security Credit

30% credit available for eligible agricultural businesses for the costs of protecting certain agricultural chemicals

Alcohol Fuel Credit

Comprised of the straight alcohol credit, the alcohol fuel mixture credit, the small ethanol producer credit, and the cellulosic biofuel producer credit; qualifying alcohol includes methanol and ethanol

Alternative Fuel Motor Vehicle Credit

A nonrefundable credit covering five distinct areas of motor vehicles – qualified hybrid vehicles, qualified fuel cell vehicles, qualified alternative fuel motor vehicles and heavy hybrids, advanced lean-burn technology vehicles, and the plug in conversion credit

Biodiesel and Renewable Diesel Credit

Comprised of the straight biodiesel credit, the biodiesel mixture credit, and the small agri-biodiesel producer credit

Business Energy Credit

Available for businesses with costs incurred for alternative energy sources; 30% of costs for solar, fuel cells, and small wind turbines, and 10% of costs for geothermal systems, microturbines, and combined heat and power

Disabled Access Credit

A nonrefundable credit available for small businesses that incur costs to provide access to disabled persons under the 1990 ADA Act

Employer Provided Child Care

A 25% credit for qualified childcare facility expenditures plus 10% of resource and referral expenditures up to a maximum of $150,000 per tax year

Federal Renewable Electricity Production Credit

A per-kilowatt-hour tax credit available for those generating electricity through qualified energy resources and sold by the taxpayer to an unrelated person during the tax year

Fuel Tax Credit

Tax is paid on fuel to provide funds for repairing and replacing highways damaged by the vehicles using the fuel; this credit is typically for those using fuel for off-road purposes (i.e. farming) whose vehicle use does not damage roadways

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Full Time Equivalents

The number of full time employees an employer would have if based upon the hours worked by every employees (up to a maximum of 2,080 per employee) during the year; the hours worked, excluding owners family members, and seasonal employees, is divided by 2,080 to determine the full time equivalents for purposes of the small business health care credit

Indian Employment Credit

Designed to encourage businesses to hire certain individuals who live on or near an Indian reservation

New Hire Credit

Available for businesses that hire unemployed workers that meet certain qualifications; designed to speed of the hiring of the unemployed

New Markets Tax Credit

Available for businesses that made Qualified Equity Investments to acquire stock/capital interest in designated Community Development Entities whose proceeds are invested in qualified low-income community developments

Qualified Plug-In Vehicle Credit

Available for vehicles with GVW under 14,000 lbs, is designed for highway use, and which is propelled significantly by an electric motor drawing power from a battery with a capacity of at least 4 kilowatt hours; you must be able to recharge the battery from an external source

Rehabilitation Credit

A credit available for the rehabilitation or reconstruction of certain buildings; 10% of costs for building place in service before 1936 and 20% of costs for certified historic structures

Research Activities Credit

A complex credit available to businesses that increase their research activities during the year

Small Business Health Care Credit

Credit designed to assist employers with less than 25 employees with providing their employees health insurance; the credit begins to phase out at 11 employees and is completely gone at 25 employees; wage restrictions also apply

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Small Employer Pension Plan Startup

Designed for small businesses to offset the costs of setting up and administering a new qualified employer plan

Tip Credit

Available to food and beverage establishments where tipping is customary; equal to the employer's portion of social security and Medicare taxes paid on tips received by employees

Work Opportunity Credit

Credit to reduce the federal tax of private-for-profit employers; many states also offer similar credits for state taxes

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General Business Topics

IRS Industry Specific Info for Businesses (Industry and Professions Tax Centers)

The IRS continues to add information to its website to provide industry specific guidance to taxpayers and business owners. The IRS now has Business Tax Centers and Industry Specific Tax Centers webpages, which contain useful information such as tax tips, forms, financial resources, industry trends and statistics. Its Business Tax Centers include:

1. Small Business and Self-Employed Tax Center.
2. Self-Employed Individual Tax Center
3. Tax Professionals
4. Large Business and International Tax Center
5. Disaster Assistance and Emergency Relief for Individuals and Businesses

The IRS Specified Industry Centers include:

1. Agriculture Tax Center
2. Cannabis Industry Tax Center
3. Child and Adult Care Tax Center
4. Gig Economy
5. Indoor Tanning Services Center
6. Industries Where Tips are Customary
7. Money Services Information Center
8. Payroll Professionals Tax Center
9. Real Estate Tax Center
10. Trucking Tax Center

The Industries/Professions Tax Centers also includes a link to all of the IRS's current industry specific Audit Techniques Guides (ATGs).

Revised Audit Technique Guides issued. The ten most recent ATGs issued by the IRS include:

1. Attorneys – 53 pages (January 2022)
2. Capitalization of Tangible Property - 239 pages (September 2022)
3. Child Care Providers – 36 pages (January 2022)
4. Cost Segregation – 268 pages (June 2022)
5. Entertainment Industry – 134 pages (March 2023)
6. Golden Parachute – 13 pages (May 2024)
7. Low-Income Housing Credit – 214 pages (January 2024)
8. Non-qualified Deferred Comp – 23 pages (March 2024)
9. Oil and Gas – 312 pages (June 2022)
10. Split Dollar Life Insurance – 5 pages (April 2024)

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Research & Experimental Costs and Related Changes (§174)

Historical overview. Enacted in 1954, §174 was added to the IRC to provide taxpayers assurances regarding the tax treatment of research or experimental (R&E) expenditures. Before §174 was enacted, taxpayer's research and experimentation expenditures were normally capitalized and held in suspense until the taxpayer could determine if the research was a success or failure. And, if a success, was there a determinable useful life. §174 gave taxpayers with qualified R&E expenditures three options:

1. Elect to currently deduct R&E expenditures paid or incurred in connection with a trade or business, or
2. Capitalize such expenses and amortize them over at least 60 months, or
3. Simply capitalize such expenditures.

TCJA makes major change to R&E rules (§174; Notice 2024-12; Notice 2023-63). For years beginning after December 31, 2021, ***specified research and experimentation (SRE) costs*** are required to be capitalized and amortized over 5 years (for domestic expenditures) or 15 years (for foreign SRE[1] expenditures). Taxpayers are no longer allowed to expense SRE as they are incurred. Amortization of SRE expenditures begins at the "midpoint" of the tax year the SREs were incurred. Midpoint is defined:

- The 1st day of the 7th month of a 12-month taxable year.

- For a short taxable year, the amortization deduction is based on the number of months in the short year. The midpoint of a short taxable year is the 1st day of the midpoint month.

IRS busy issuing guidance. The IRS has kicked the new rules regarding SRE and other aspects of research and experimentation expenses into high gear since late in 2022. The timeline of the developments of the revised §174 are:

- December 2022 – Amended §174 enacted.
- December 2022 – Rev. Proc. 2023-8 – guidance to obtain automatic consent to change accounting method for SRE expenses.
- December 2022 – Rev. Proc 2023-11 – modifies and supersedes Rev. Proc. 2023-8.
- June 2023 – Rev. Proc. 2023-24 – adds SRE accounting method change to list of automatic changes.
- September 2023 – Notice 2023-63 – provides guidance of how the new SRE rules will be implemented.
- December 2023 – Rev. Proc. 2024-9 – modifies and enhances Rev. Proc. 2023-24 for accounting method changes.
- December 2023 – Notice 2024-12 – modifies and enhances Notice 2023-63.

[1] Foreign research is any research conducted out of the U.S., Puerto Rico or any U.S. territory or possession of the U.S. Where the SRE activities are performed determines whether corresponding SRE expenditures are domestic or foreign.

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Preparer note. The IRS plans to issue proposed regulations to address the changes from the TCJA. In the meantime, taxpayers may rely on Notice 2024-12 and Notice 2023-63 for guidance.

SRE expenditures defined (Notice 2023-63, Sec. 4; §1.174-2). SRE expenditures are paid or incurred in connection with the taxpayer's trade or business for research or experimental activities or for the development of any computer software regardless if such expenditures are research or experimental expenditures. SRE activities are:

- Activities in the experimental or laboratory sense intended to discover information that would eliminate uncertainty concerning the development or improvement or appropriate design on a product or a component or subcomponent of a product (§1.174-2)
- Software development activities which generally include but are not limited to:
    1. Planning the development of the computer software (or the upgrades and enhancements to such software) including identification and documentation of the software requirements.
    2. Designing the computer software (including upgrades and enhancements).
    3. Building a model of the computer software (including upgrades and enhancements).
    4. Writing source code and converting it to machine-readable code.
    5. Testing the computer software (including upgrades and enhancements) and making necessary modifications to address defects identified during testing, but only up until the time that:
        a. The computer software is placed in service (in the case of computer software developed for use by the taxpayer in its trade or business), or
        b. Technological feasibility has been established, product master(s) have been produced and the computer software is ready for sale or licensing to others (in the case of computer software developed for sale or licensing to others).

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Preparer note. Training, maintenance, data conversion activities and installation of computer software developed by a taxpayer for use in its own trade or business are not SRE activities. Also, marketing and promotional activities, maintenance activities that do not give rise to upgrades and enhancements, distribution activities such as making software available via remote access and customer support activities that occur after software is made available for sale or licensing to others *are not* SRE activities.

6. Production of the product master(s) – for computer software developed for sale or licensing to others.

SRE expenditures ***include*** the following costs which are incident to SRE activities:

- Labor of full-time, part-time and contract employees and independent contractors who perform, supervise, or directly support SRE activities including all elements of compensation other than severance pay.
- Attorney fees related to filing and completing patent applications.
- Materials and supplies including tools and equipment that are not depreciable.
- Cost recovery allowances (depreciation, amortization, and depletion) for property used in connection with R&E.
- Patents.
- Certain operation and management costs such as rent, utilities, insurance, taxes, security, and similar overhead with respect to facilities, equipment and other assets used in the performance or direct support of SRE activities.
- Travel.

SRE expenditures ***DO NOT include***:

- Costs for acquisition or improvement of land or depreciable property used in connection with the R&E.
- Exploration expenses incurred for ore or other minerals including oil and gas.
- Management studies and consumer surveys.
- Costs paid or incurred by general and administrative service departments that only indirectly support SRE activities (e.g., payroll department personnel services).
- Interest on debt used to finance SRE activities.
- Costs to input content into a website.

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- Cost for general website hosting.
- Costs to register an Internet domain name or trademark.
- Amortization amounts of SRE expenditures.
- Amortization amounts of R&E expenditures paid or incurred in taxable years before Jan. 1, 2022.

Allocation of costs. Taxpayers must use a consistent method to allocate costs to SRE activities. The allocation method used for one type of cost may be different than the allocation method used for another type of cost.

Research under contract (Notice 2024-12; Notice 2023-63, Sec. 6). The performance of services must be at the *research recipient*'s (the party who contracts with the research provider who performs research services) order and they must bear the risk of loss for such costs to be SRE expenditures. If a *research provider* bears financial risk or has a right to use any resulting SRE product in its trade or business or otherwise exploit any resulting SRE product through sale, lease, or license, then incurred costs for performing research activities are SRE expenditures of the research provider.

Example. Profit Pleaser (U.S. company) hires PatentPro (U.S. research provider) to develop an SRE product for use in Profit Pleaser's business. Profit Pleaser gives instructions on what they want and PatentPro makes no guarantees for the developed product, nor does it have any rights to use or sell the product. Profit Pleaser paid $20,000 of R&E costs in 2023 and paid PatentPro $100,000. The entire $120,000 is SRE expenditures that Profit Pleaser must amortize over 5 years. The RSE amortization begins on July 1, 2023, the midpoint of Profit Pleaser's calendar tax year.

Further clarification provided (Notice 2024-12, Sec. 4). The IRS acknowledged that Notice 2023-63 could be interpreted to require a research provider that does not bear financial risk under the terms of the contract with the research recipient to improperly treat as SRE expenditures the costs paid or incurred by the research provider to perform SRE activities on behalf of the research recipient under such contract if the research provider obtains an SRE product right that: 1) is separately bargained for (that is, an SRE product right that arose from consideration other than the cost paid or incurred by the research provider to perform SRE activities under that contract), or 2) was acquired for the limited purpose of performing SRE activities under that contract or another contract with the research recipient. Notice 2024-12 clarifies that if a research provider that does not bear financial risk under the terms of the contract with the research recipient obtains an "excluded SRE product right" (that is, an SRE product right described in section 2.04(3) of this notice) but does not obtain any other SRE product right under the terms of such contract, then the costs paid or incurred by the research provider to perform SRE activities on behalf of the research recipient under such contract are not SRE expenditures.

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No acceleration of amortization for dispositions, retirements, or abandonments (Notice 2023-63, Sec. 7). Taxpayers who dispose of, retire, or abandon capitalized SRE property may not accelerate or otherwise write off the RSE's unamortized balance. Any unamortized SRE expenditures continue to be amortized over the remaining amortization period. If a corporation ceases to exist due to a corporate acquisition under §381(a), the *acquiring corporation* will continue to amortize the transferor corporation's unamortized SRE expenditures over the applicable §174 amortization period beginning the month of transfer.

Corporate liquidation exception. If a corporation ceases to exist (and §381(a) does not apply) the corporation is allowed to deduct the unamortized SRE expenditures in its final taxable year. This provision does not apply in cases where the principal purpose of getting rid of SRE associated property is to claim a deduction for the unamortized SRE expenditures. The above provisions also do not apply to property that is contributed to, distributed from, or transferred from a partnership.

Example: Rummy Inc., a calendar-year taxpayer, pays $150,000 in SRE expenditures in 2023 for research performed in the U.S. In 2023, Rummy deducts amortization of $15,000 (10% x $150,000 due to mid-point calculation) of such SRE expenditures. On Oct. 1, 2024, Rummy is acquired by Spade Inc. under §381(a). In 2024, Rummy deducts amortization of $22,500 (9/12 x 20% x $150,000) while Spade deducts amortization of $7,500 (3/12 x 20% x $150,000). In 2025-2028, Spade ratably amortizes the remaining $105,000 ($150,000 - $15,000 - $7,500 - $22,500).

Long-term contracts (§1.460-4(b)(2)(iv); Notice 2023-63, Sec. 8). There is currently a mismatch in the tax law due to the changes regarding SRE expenditures over the past few years. Under the percentage-of-completion method (PCM), a taxpayer deducts allocable contract costs as they are incurred. provides an increase in the percentage of the contract price to be reported is matched by deduction of the incurred costs that cause the increase. The current §460 regulations were drafted when a taxpayer could currently deduct R&E expenses. As a result of the TCJA changes which require amortization of SRE expenditures, the contract price is increased by the R&E expenses; however, §174(a) prevents a corresponding current deduction.

The Notice provides that costs allocated to a long-term contract accounted for using the PCM include the PCM amortization deduction associated with SRE expenditures (not the total amount of SRE expenditures incurred during the tax year). The Notice indicates that the IRS intends to issue proposed regulations that would amend the existing §460 regulations.

Cost sharing. Cost sharing transaction (CST) payments between participants in a cost sharing arrangement (CSA) are made to ensure that each controlled participant's share of intangible development costs is in proportion to its share of reasonably anticipated benefits from exploitation of the developed intangibles (RAB share) (§1.482-7(j)(3)(i)).

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Notice 2023-63, Section 9 anticipates that proposed regulations will revise §1.482-7(j)(3)(i) to provide that CST payments owed to a controlled participant reduce the amount of the category intangible development costs borne directly by that participant that are required to be charged to the capital account. In addition, such payments also reduce the amount of the category intangible development costs borne directly by the participant that are deductible.

Example. Uncle Sam (U.S. parent corporation) and its wholly owned foreign subsidiary, Holidayz, form a CSA to develop a longer lasting firework, known as Longlast. Based on RAB shares, Uncle Sam agrees to bear 40% and Holidayz agrees to bear 60% of the IDCs incurred. Uncle Sam incurs $100,000 of IDCs to conduct research in the U.S. annually and Holidayz incurs $100,000 of IDCs to conduct research in its country annually. Uncle Sam's IDCs are required to be charged to a capital account and amortized over the 5-year amortization period [§174]. Holidayz IDCs incurred are required to be charged to a capital account and amortized over 15 years.

Uncle Sam's share of the total IDCs is $80,000 ($200,000 x 40%) and Holidayz share is $120,000 ($200,000 x 60%); therefore, Holidayz must make a payment to Uncle Sam of $20,000 ($120,000 - $100,000).

The CST payment reduces Uncle Sam's IDCs in the U.S. that are required to be charged to a capital account by $20,000. Thus, Uncle Sam is required to capitalize $80,000 which is required to be amortized over 5 years. Holidayz is required to capitalize $120,000 with $100,000 amortized over 15 years and $20,000 amortized over 5 years.

All or nothing no longer required (Notice 2024-12). Under Notice 2023-63, taxpayers were required to rely on all provisions of the Notice, or they were not allowed to rely on any of the provisions. Notice 2024-12 changed this provision so that taxpayers may rely on one provision and not another. The real benefit here is a taxpayer is still protected under the provisions of the Notices they do follow, even if they inadvertently did not follow a separate provision.

Accounting method change required (Notice 2024-09; Notice 2023-63; Rev. Proc. 2023-24)

Any change by a taxpayer from expensing SRE to amortizing SRE is a change of accounting method and is subject to §481. Taxpayers who made the switch and began amortizing SRE costs in their first tax year that began after Dec. 31, 2021 could simply include a statement with originally filed return indicating they are amortizing §174 expenses (Rev. Proc. 2023-11]. These taxpayers are not required to do anything else (i.e., Form 3115 and §481(a) adjustments are not required).

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All other taxpayers must file Form 3115 and calculate any applicable §481(a) adjustment. IRS intends to issue procedures for taxpayers to obtain automatic consent to change their method of accounting but has not yet done so. In Notice 2023-63, the IRS states that taxpayers may rely on Sec. 7.02 of Rev. Proc 2023-24 to automatically change their accounting method to comply with the new §174 rules. If Form 3115, is required, the taxpayer should include a statement that includes:

- A description of the type(s) of expenditures included as SRE expenditures.
- Taxable year(s) in which the SRE expenditures subject to the change were paid or incurred.
- Declaration that the applicant is changing its method of accounting for SRE expenditures to capitalize such expenditures and amortize over the applicable 5 or 15-year period beginning with the midpoint of the tax year in which such expenditures are paid or incurred, as well as state the applicant is making the change with a modified §481(a) adjustment that takes into account only SRE expenditures paid or incurred in taxable years beginning after Dec. 31, 2021.
- Use automatic change number 265.

State tax considerations. Treatment of §174 varies from state to state. Be sure to consider stater tax implications on any of your R&E planning and decisions.

Final note – change coming? Congress has been making noise since 2021 about repealing the SRE capitalization requirements. Some argue the new rules have greatly reduced the amount of research and development activities in the U.S. Stay tuned and we will let you know the minute Congress gets something done.

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Auto and Travel Expenses

Standard mileage rates update (Notice 2024-08). Taxpayers use the standard mileage rate to compute the deductible costs of operating an automobile for business, charitable, medical, and moving expenses. Each year the IRS reviews the standard mileage rate used to establish the current rates. These rates are summarized:

	2023	2024	2025
Business rate	65.5¢	67¢	
Medical/moving	22¢	21¢	
Charity	14¢	14¢	

Standard mileage rate and depreciation recapture (Notice 2023-03; Notice 2019-46)). Taxpayers who use the business standard mileage rate to compute an auto deduction for an automobile for any year must reduce basis in the vehicle using an allowance per-mile amount, which is treated as the depreciation claimed by the taxpayer. The amount of the business standard mileage rate treated as depreciation is:

2019	26¢ per business mile
2020	27¢ per business mile
2021	26¢ per business mile
2022	26¢ per business mile
2023	28¢ per business mile
2024	30¢ per business mile

Example. Sarah, a self-employed sales rep, purchased a Ford Mustang for business and personal use in 2020 for $56,000. Sarah used the standard mileage rate to calculate her annual business auto deduction. Sarah sold the Mustang in 2024 for $20,000 and assumed she need not report the sale on her tax return because the Mustang was never depreciated. The total and business miles for the Mustang while Sarah owned it were:

Year	Total Miles	Business Miles	Recapture Rate	Depreciation
2020	26,000	19,000	27¢	$ 5,130
2021	29,000	21,000	26¢	$ 5,460
2022	24,000	17,000	26¢	$ 4,420
2023	22,000	16,000	28¢	$ 4,480
2024	12,000	9,000	30¢	$ 2,700
Totals	113,000	82,000		$ 22,190

Business use % = 72.57% (82,000 business miles ÷ 113,000 total miles)

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Example – continued. Gain/loss calculation upon sale of Mustang.

Continuing with the same facts, when Sarah sells her Mustang in 2024, she calculates the related gain or loss:

Sale price - business portion	$14,514 ($20,000 sales price x 72.57%)
Less Mustang's business basis	(18,449) – (see calculation below)
Deductible loss from sale of Mustang	($ 3,935)

Mustang basis calculation:

Mustang's original cost	$ 56,000
Business use percentage	x 72.57%
Business cost basis	$ 40,639
Accumulated depreciation	($22,190)
Remaining business basis	$ 18,449

Farm Land and Fertilization (§180; §1.180-1; §1.180-2).

§180 overview. Generally, fertilizer, lime, etc. applied to farmland that provides benefit for substantially more than one year must be capitalized and amortized over the period of the fertilizer's effectiveness. However, farmers may annually elect to deduct the cost of fertilizer, lime, and other materials applied to enrich, neutralize, or condition farmland. The election is made by simply deducting the relevant costs (§1.180-2). Once the election is made, IRS approval is required to change to capitalize the cost of previously deducted items. If the farmland on which fertilizer or lime has been applied is sold, and the sale price includes part or all the cost of the fertilizer or lime, the seller reports the sale amount attributable to the fertilizer or lime separately as ordinary income.

Preparer note. There isn't a default life for fertilizer that benefits multiple years. The author has most often seen a 3–4-year life for such costs and over some declining balance method estimated based on the current year usage of the fertilizer, lime, etc.

Residual soil fertility (RSF). Those who acquire farmland (e.g., buyers, heirs, etc.) that has been fertilized or otherwise treated to improve productivity, benefit from "residual soil fertility" – the excess fertilizer, lime and other materials that have been used in prior to ownership that are still providing benefit to the current year. RSF costs are generally allowed the same tax treatment as any other purchased asset (e.g., fencing, drain tiles, irrigation equipment, etc.), deducted as allowed for that particular asset when acquired. To qualify to deduct RSF, the new owner must establish:

1. Beneficial ownership of the residual fertilizer supply,
2. The presence and extent of the residual fertilizer, and
3. That the residual fertilizer supply is actually being exhausted.

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Caution. If the new owner previously rented the land, she/he now owns, no deduction is allowed since the cost of the nutrients were deducted by the renter when the expenses were originally applied. In other words, they cannot be deducted twice.

Retroactive benefit allowed. Farmers may benefit from residual soil fertility deductions in the year the land is acquired, or at a point in the future. If the deductions are not claimed by the end of the statute of limitations, the farmer may still claim the deductions by filing Form 3115 for an accounting method change.

Third party consultant may be needed. Note that the new owner is only allowed a deduction for "excess" (i.e., more than normal) fertility, not 100% of the soil nutrients. The new owner must be able to document the existence of residual fertilizer to claim the deduction. This will typically require a valid, third-party assessment of the nutrient levels of the farmland. Consultants, similar to cost segregations specialists, may be used to provide the proper reports and to meet other requirements to claim the deductions. services to help the famer meet the three requirements.

Example. George inherits farmland valued at $3,000,000 from his parents in November 2024. George hires SAG, a farmland soil consultant, who determines the value of the RSF is $300,000 and that the RSF will be a benefit through 2027. George uses the §180 election to expense the $300,000 of RSF in 2024 on Sch. F.

Variation. Assume the same facts as above except George skips the expense election and capitalizes the $300,000 RSF. When SAG completed its soil analysis it determined that the RSF would provide benefit to George's farm soil through 2027. Furthermore, SAG's report estimated that the annual benefit would be 5%, 65%, 20%, and 10% in 2024, 2025, 2026 and 2027, respectively. George amortizes the $300,000 RSF proportionately.

What about rangeland/pastures. Unfortunately, guidance in this area is sparse. The only guidance other than the Code and Regs is limited to a 1991 PLR (PLR 9211007) and a MSSP for Grain Farmers. There is currently no guidance addressing the applicability of §180 to range/pastureland. Absent guidance to the contrary, the same three criteria discussed above would seem to apply. The big hurdle would be establishing value as the use of nutrients in range/pastureland is vastly different than row crop farmland. But, to the extent a value can be identified, the same rules of deduction would seem to apply. ***NOTE – there is a lot of opinion rather than documented law in this paragraph!***

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Home Office and Related Deduction (Pub 587; Form 8829; §280A)

Overview. Form 8829 is used to claim a deduction for expenses related to use of an office in a home. The office can be in anything that otherwise qualifies as the taxpayer's residence (e.g., house, trailer, boat, etc.). The home office deduction is generally limited to the net income of the underlying business activity. Expenses that are otherwise deductible may be deducted in excess of the business activity profit. The most common examples are mortgage interest and property taxes, which may create or increase a loss if the taxpayer itemizes their deductions. Any remaining expenses are suspended and carried forward to a year when the business activity has net income.

Example. Natasha claims itemized deductions on Sch A when she files her tax return. Natasha's Sch C home office measures 350 square feet of her 3,500 square foot home, making her home office 10% of her total home. Her 2024 expenses were:

Mortgage Interest	$10,000
Property Taxes	$ 2,000
Utilities	$ 1,500
Depreciation	$ 1,000
Total home expenses	$14,500
Max home office deduction = 10% (350÷3500) of total	$ 1,450

Natasha's Sch. C income before deducting home office expenses was $500. She will be able to claim a deduction on Form 8829 for the mortgage interest and property taxes of $1,200, creating a $700 Sch C loss if she is itemizing her deductions in 2024.

The remaining $250 of home office expenses ($150 utilities plus $100 deprecation) will be carried forward to 2025, added to her 2025 home office expenses, and tested against her 2025 business profit.

Preparer note. Any reasonable method is allowed to allocate housing expenses between business and personal. Square footage is the most used allocation method, but it is not required.

Excess property taxes and mortgage interest. Form 8829 in some cases requires taxpayers to distinguish between mortgage interest and property taxes and excess mortgage interest and property taxes.

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Part II	**Figure Your Allowable Deduction**				
8	Enter the amount from Schedule C, line 29, **plus** any gain derived from the business use of your home, **minus** any loss from the trade or business not derived from the business use of your home. See instructions.				8
	See instructions for columns (a) and (b) before completing lines 9–22.		**(a)** Direct expenses	**(b)** Indirect expenses	
9	Casualty losses (see instructions)	9			
10	Deductible mortgage interest (see instructions) .	10			
11	Real estate taxes (see instructions)	11			
12	Add lines 9, 10, and 11	12			
13	Multiply line 12, column (b), by line 7			13	
14	Add line 12, column (a), and line 13				14
15	Subtract line 14 from line 8. If zero or less, enter -0-				15
16	Excess mortgage interest (see instructions) . .	16			
17	Excess real estate taxes (see instructions) . . .	17			

Those who do not file Sch. A to itemize their deductions may only claim mortgage interest and property taxes on Form 8829 Lines 16 and 17, respectively. Nothing is reported on lines 10 and 11 for non-itemizers. Additionally, there is no limit on the loan amount for home office related interest expense. For example, if the proprietor's home mortgage is $1.5 million, the portion allocable to the home office may be claimed, regardless of the personal mortgage interest loan limit of $750,000. Any mortgage interest paid on debt that does not qualify as a deduction on Sch A is reported on line 16 of Form 8829. Taxpayers who itemize and whose total Sch. A tax deduction exceeds $10,000 (the SALT limit) are required to complete a worksheet in the Form 8829 instructions to calculate the amount of property taxes that are reported on line 11 and as excess real estate tax on line 17.,

Safe Harbor home office deduction (Rev. Proc. 2013-13). To provide a simpler home office deduction calculation, the IRS provided a safe harbor Simplified Method to calculate a home office deduction. The safe harbor amount is calculated by multiplying $5 times the square footage of the home office. Nothing other than the square footage is required to be calculated – no utilities, mortgage interest, insurance, etc. Three hundred square feet is the maximum square footage that may be included in the safe harbor calculation. The Simplified Method includes all costs of ownership of the house, such as depreciation, mortgage interest, property taxes, utilities, insurance, repairs, and maintenance. There is no depreciation recapture if the underlying property is sold. While this may sound like a great idea, the safe harbor also prohibits any carryover of any excess home office deductions to future years. Any excess deduction dies in the year claimed.

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Example – continued. Natasha, from the last example, had a pre-home office Sch C profit of $500 and a 350 square foot home office. Natasha calculates her 2024 home office deduction:

Simplified method calculation - 350 sq. ft. x $5	$1,500 (maximum)
Actual expense home office deduction from above	$1,450
Maximum safe harbor home office deduction	$ 500 (Sch C income)
Maximum home office deduction for actual expenses	$1,200
Carryover to 2025 – actual expenses only (C/O not allowed under safe harbor)	$ 250

Home office – additional requirements (§280A-(c). In addition to the requirements outlined above, a home office may only be claimed as a deduction if part of the home used regularly and exclusively:

1. As the principal place of business for a trade or business, or
2. As a place of business used by patients, clients, or customers to meet or deal with the taxpayer in the normal course of business, or
3. In connection with the trade or business if it is a separate, non-attached structure, or
4. Used for storage of inventory or product samples (if the home is the only fixed location of the trade or business). The structure does not have to be the principal place of business or a place where the taxpayer meets patients, clients, or customers, nor does the "exclusive use" rule apply, **but the home must be the only fixed location of the business**.
5. As a daycare – a daycare facility in the taxpayer's home will normally not meet the exclusive use test. However, the home office deduction is allowed if the taxpayer is in the business of providing day care for children, aged or mentally or physically disabled persons and has a valid business license (or is specifically exempt) or approval as a daycare center or home under state law.

Case Law: Employee renting office-in-home to employer does not work. §280A specifically disallows the deduction of any expenses incurred other than mortgage interest, taxes and casualty losses when an employee rents a personal residence to his employer for business purposes unless it is a separate structure (*Leslie A. Roy*, TC Memo 1998-125). Therefore, even a home office deduction is barred when an employee leases a portion of his or her home to the employer at fair market value (FMV). This rule also extends to an independent contractor who attempts to lease to the party for whom he or she performs services (e.g., a real estate agent should not lease office space located at home to his or her broker/owner).

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Principal place of business. Factors used to determine the location of the principal place of business include:

- The relative importance of the activities performed at each place where the taxpayer conducts business, and
- The amount of time spent at each place where the taxpayer conducts business.

A home office qualifies as the principal place of business if:

- It is used exclusively and regularly for administrative or management activities of their trade or business (e.g., billing customers, keeping books and records, ordering supplies, managing calendars, etc.), and
- There is no other fixed location where substantial administrative or management activities of their trade or business are conducted.

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Chart from IRS Pub. 587, Business Use of Your Home

Can You Deduct Business Use of the Home Expenses? Do not use this chart if you use your home for the storage of inventory or product samples, or to operate a daycare facility. See *Exceptions to Exclusive Use*, earlier, and *Daycare Facility*, later.

Specialized home office circumstances (Pub 587). Taxpayers may need to claim deductions for home office related expenses but are not allowed to use Form 8829. Form 8829 is for use with Sch. C only.

Form **8829** | **Expenses for Business Use of Your Home** | OMB No. 1545-0074

File only with Schedule C (Form 1040). Use a separate Form 8829 for each home you used for business during the year.

Go to *www.irs.gov/Form8829* for instructions and the latest information.

Department of the Treasury
Internal Revenue Service

2024
Attachment Sequence No. **176**

Name(s) of proprietor(s) | **Your social security number**

The most obvious taxpayers not allowed to file Form 8829 are partners in partnerships and Sch F filers. These taxpayers use a worksheet from IRS Pub 587 to calculate the home office deduction if they are using actual expenses. See worksheet below.

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Worksheet for Schedule F, Partners, and Employees to Determine Home Office Deduction

Line	Description	(a) Direct Expenses	(b) Indirect Expenses	Amount
	PART 1—Part of Your Home Used for Business:			
1)	Area of home used for business			1) ________
2)	Total area of home			2) ________
3)	Percentage of home used for business (divide line 1 by line 2 and show result as percentage)			3) ________ %
	PART 2—Figure Your Allowable Deduction			
4)	Gross income from business (see instructions)			4) ________
5)	Casualty losses	5) ________	________	
6)	Deductible mortgage interest	6) ________	________	
7)	Real estate taxes	7) ________	________	
8)	Total of lines 5 through 7	8) ________	________	
9)	Multiply line 8, column (b), by line 3		9) ________	
10)	Add line 8, column (a), and line 9		10) ________	
11)	Business expenses not from business use of home (see instructions)		11) ________	
12)	Add lines 10 and 11			12) ________
13)	Deduction limit. Subtract line 12 from line 4			13) ________
14)	Excess mortgage interest	14) ________	________	
15)	Excess real estate taxes	15) ________	________	
16)	Insurance	16) ________	________	
17)	Rent	17) ________	________	
18)	Repairs and maintenance	18) ________	________	
19)	Utilities	19) ________	________	
20)	Other expenses	20) ________	________	
21)	Add lines 14 through 20	21) ________	________	
22)	Multiply line 21, column (b), by line 3		22) ________	
23)	Carryover of operating expenses from prior year (see instructions)		23) ________	
24)	Add line 21, column (a), line 22, and line 23			24) ________
25)	Allowable operating expenses. Enter the **smaller** of line 13 or line 24			25) ________
26)	Limit on excess casualty losses and depreciation. Subtract line 25 from line 13			26) ________
27)	Excess casualty losses (see instructions)		27) ________	
28)	Depreciation of your home from line 40 below		28) ________	
29)	Carryover of excess casualty losses and depreciation from prior year (see instructions)		29) ________	
30)	Add lines 27 through 29			30) ________
31)	Allowable excess casualty losses and depreciation. Enter the **smaller** of line 26 or line 30			31) ________
32)	Add lines 10, 25, and 31			32) ________
33)	Casualty losses included on lines 10 and 31 (see instructions)			33) ________
34)	Allowable expenses for business use of your home. (Subtract line 33 from line 32.) See instructions for where to enter on your return			34) ________
	PART 3—Depreciation of Your Home			
35)	Smaller of adjusted basis or fair market value of home (see instructions)			35) ________
36)	Basis of land			36) ________
37)	Basis of building (subtract line 36 from line 35)			37) ________
38)	Business basis of building (multiply line 37 by line 3)			38) ________
39)	Depreciation percentage (from applicable table or method)			39) ________ %
40)	Depreciation allowable (multiply line 38 by line 39)			40) ________
	PART 4—Carryover of Unallowed Expenses to Next Year			
41)	Operating expenses. Subtract line 25 from line 24. If less than zero, enter -0-			41) ________
42)	Excess casualty losses and depreciation. Subtract line 31 from line 30. If less than zero, enter -0-			42) ________

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Daycare facility allocations. The big issue with daycare facilities is there are very few areas in a typical home used as a daycare facility where the exclusive use test is met. The entire home is often used to provide daycare services on a nonexclusive basis. The IRS approved an alternative allocation method for daycare facilities:

Step 1 – the daycare facility figures:

a. Calculate exclusive use area percentage (same formula as described above – exclusive use square footage ÷ total square footage).

b. Calculate the total square footage for areas used part of the day for daycare. Then use an hourly factor to arrive at the home office percentage. The hourly factor is derived by calculating the total number of hours used as daycare divided by the total hours in a year (8,760).

Step 2 – add the two percentages together to arrive at the total indirect home office percentage.

Step 3 – direct expenses are multiplied by the total percentage derived in Step 2.

Step 4 – indirect expenses are multiplied by the exclusive use percentage derived in Step 1.a.

Example. Dawn Jones used her basement to operate a children's daycare facility. Dawn determined her home's square footage and the daycare's square footage was:

Square footage of the basement	1,600 (50%)
Square footage of her home	3,200 (100%)

Dawn used the basement for daycare an average of 12 hours a day, 5 days a week, for 50 weeks a year. During the other 12 hours a day, Dawn's family could use the basement. Dawn figures the percentage of time the basement was available for use:

Number of hours used for daycare (12hrs x 5 days x 50 weeks)	3,000 (34.25%)
Total number of hours in the year (24hrs x 365 days)	8,760 (100%)

Dawn can deduct 34.25% of any direct expenses for the basement. However, because her indirect expenses are for the entire house, she can deduct only 17.13% (34.25% x 50%) of the indirect expenses.

Daycare provider meal allowances. Each year, the IRS publishes meal allowances in Pub 587 that may be used instead of reporting the actual cost of each meal or snack a child eats. For 2024, the allowances are – Breakfast: $1.65, Lunch and Supper $3.12, and Snacks $0.93. See chart for tracking below.

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Exhibit A. **Family Daycare Provider Meal and Snack Log**

Name of Provider ______________________________

Week of ____________________________ Year_____________

Keep For Your Records

Child's Name	Monday	Tuesday	Wednesday	Thursday	Friday	Saturday	Sunday	Totals
	Hours of attendance: _____ ☐ Bkfst ☐ Snack ☐ Lunch ☐ Snack ☐ Dinner ☐ Snack	Hours of attendance: _____ ☐ Bkfst ☐ Snack ☐ Lunch ☐ Snack ☐ Dinner ☐ Snack	Hours of attendance: _____ ☐ Bkfst ☐ Snack ☐ Lunch ☐ Snack ☐ Dinner ☐ Snack	Hours of attendance: _____ ☐ Bkfst ☐ Snack ☐ Lunch ☐ Snack ☐ Dinner ☐ Snack	Hours of attendance: _____ ☐ Bkfst ☐ Snack ☐ Lunch ☐ Snack ☐ Dinner ☐ Snack	Hours of attendance: _____ ☐ Bkfst ☐ Snack ☐ Lunch ☐ Snack ☐ Dinner ☐ Snack	Hours of attendance: _____ ☐ Bkfst ☐ Snack ☐ Lunch ☐ Snack ☐ Dinner ☐ Snack	Number served: _____ Breakfasts: _____ Lunches: _____ Dinners: _____ Snacks: _____
	Hours of attendance: _____ ☐ Bkfst ☐ Snack ☐ Lunch ☐ Snack ☐ Dinner ☐ Snack	Hours of attendance: _____ ☐ Bkfst ☐ Snack ☐ Lunch ☐ Snack ☐ Dinner ☐ Snack	Hours of attendance: _____ ☐ Bkfst ☐ Snack ☐ Lunch ☐ Snack ☐ Dinner ☐ Snack	Hours of attendance: _____ ☐ Bkfst ☐ Snack ☐ Lunch ☐ Snack ☐ Dinner ☐ Snack	Hours of attendance: _____ ☐ Bkfst ☐ Snack ☐ Lunch ☐ Snack ☐ Dinner ☐ Snack	Hours of attendance: _____ ☐ Bkfst ☐ Snack ☐ Lunch ☐ Snack ☐ Dinner ☐ Snack	Hours of attendance: _____ ☐ Bkfst ☐ Snack ☐ Lunch ☐ Snack ☐ Dinner ☐ Snack	Number served: _____ Breakfasts: _____ Lunches: _____ Dinners: _____ Snacks: _____
	Hours of attendance: _____ ☐ Bkfst ☐ Snack ☐ Lunch ☐ Snack ☐ Dinner ☐ Snack	Hours of attendance: _____ ☐ Bkfst ☐ Snack ☐ Lunch ☐ Snack ☐ Dinner ☐ Snack	Hours of attendance: _____ ☐ Bkfst ☐ Snack ☐ Lunch ☐ Snack ☐ Dinner ☐ Snack	Hours of attendance: _____ ☐ Bkfst ☐ Snack ☐ Lunch ☐ Snack ☐ Dinner ☐ Snack	Hours of attendance: _____ ☐ Bkfst ☐ Snack ☐ Lunch ☐ Snack ☐ Dinner ☐ Snack	Hours of attendance: _____ ☐ Bkfst ☐ Snack ☐ Lunch ☐ Snack ☐ Dinner ☐ Snack	Hours of attendance: _____ ☐ Bkfst ☐ Snack ☐ Lunch ☐ Snack ☐ Dinner ☐ Snack	Number served: _____ Breakfasts: _____ Lunches: _____ Dinners: _____ Snacks: _____
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Direct and indirect expenses. To properly calculate the home office deduction, expenses must first be classified as direct or indirect expenses as each are allocated differently.

Directly expenses are expenses that **only** benefit the business portion of the home and are fully deductible, subject to income limits:

- Painting in the office area
- Repairs in the office area
- Specific utilities just for the office area

Indirect expenses are expenses paid for the entire residence, both business and personal portions. Such expenses typically include:

- Insurance, rent, repairs & maintenance.
- Depreciation based on basis (or FMV if less) times the home office percentage divided by 39 years (non-residential rental life).

Other expenses may be deductible on other schedules in the tax return and are partially allocated to Form 8829. These represent deductible mortgage interest, property tax and casualty losses.

Preparer note. If the taxpayers claim the standard deduction, none of any mortgage interest or property taxes are allowed as a deduction on Form 8829, Lines 10 and 11; instead, claim the entire business use of the home portion of those expenses using Lines 16 and 17.

Part II Figure Your Allowable Deduction

Line	Description		(a) Direct expenses	(b) Indirect expenses		
8	Enter the amount from Schedule C, line 29, **plus** any gain derived from the business use of your home, **minus** any loss from the trade or business not derived from the business use of your home. See instructions.				8	
	See instructions for columns (a) and (b) before completing lines 9–22.		(a) Direct expenses	(b) Indirect expenses		
9	Casualty losses (see instructions)	9				
10	Deductible mortgage interest (see instructions)	10				
11	Real estate taxes (see instructions)	11				
12	Add lines 9, 10, and 11	12				
13	Multiply line 12, column (b), by line 7			13		
14	Add line 12, column (a), and line 13				14	
15	Subtract line 14 from line 8. If zero or less, enter -0-				15	
16	Excess mortgage interest (see instructions)	16				
17	Excess real estate taxes (see instructions)	17				

ONLY DRAFT May 16, 2024

Home Office and Corporate Shareholders (§280A(c)(6)). While many S corporation shareholders incur home office expenses to enable them to accomplish the many bookkeeping or management tasks that cannot be performed at a retail store, construction site, warehouse or similar workplace environment, rental related deductions are limited only to items otherwise deductible (i.e., mortgage interest, property tax and casualty losses). S corporation shareholders are prohibited from deducting any expenses related to the rental of a dwelling unit (or any portion thereof) to his/her employer during any period in which the taxpayer uses the dwelling unit (or portion) in performing services as an employee of the employer.

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Example. Les Roy operates Roy Farms, Inc., the family farm, as an S corporation. Les routinely performs all his farm related administrative duties in an office in his home. The home office represents 10% of the total square footage in Les's home so he charges Roy Farms $12,000 per year rent. Les incurs the following expenses related to the home office:

	Total	Home Office
Insurance	$ 2,500	~~$ 250*~~
Mortgage interest	$12,000	$1,200
Property taxes	$ 3,000	$ 300
Utilities	$ 6,500	~~$ 650*~~
Total	$24,000	$1,500

*Expenses are disallowed due to the restrictions of §280A(c)(6).

Les must report the entire $12,000 of rent income on Sch. E but is only allowed to deduct $1,500 of expenses – mortgage interest and property taxes. Deprecation is not allowed.

S Corp renting home office from shareholder (Thomas Conrad v. Comm., TC Memo 2023-100). Thomas and Margaret Conrad were 51.25% owners of Financial Management Corporation (FMC), a subchapter S corporation. During 2008 and 2009, the Conrads rented a portion their 7,500 square foot Florida condo to FMC that they used as a home office. FMC paid the Conrads rent for use of this space. However, this space was never exclusively used by FMC. The Conrads' extended family would occasionally visit the Conrads and they made personal use of the portions of the condo set aside for FMC's office use. FMC paid the Conrads rent of $144,000 in 2008 and $104,000 in 2009. They reported the 2008 payment as Rent Income on Sch. E with no offsetting expenses. Conrad did not report anything on Sch. E in 2009. In 2008 and 2009, Conrad reported income from FMC of $222,000 in 2008 and $369,000 in 2009 as Sch C independent contractor income. He reported home office expenses of $222,000 in 2008 and $288,000 in 2009.

What a mess! The Court ruled that the home office deductions were not allowed because the area used as a home office was not used exclusively for business. However, the Court did allow Conrad to deduct the allocable share of mortgage interest and property taxes as applicable to the rental of the residence. The rules under 280A(c)(3) do not require exclusive use – that rule is specific to the home office deduction. Of course, my question would have been how can you be an independent contractor to your own corporation but that's a lesson for another day!

Why not an accountable plan reimbursement (§62(a)(2); §1.62-2(c))? Another option, or a parallel option, is to have the S corporation reimburse the shareholder-employee for the nondeductible expenses properly allocable to the business use of the home under an accountable plan employee expense reimbursement policy. The §62 regulations clarify that out-of-pocket business expenses should be documented and reimbursed on a current and regular basis. The S corporation's Board of Directors should approve this policy in its formal board meetings and not it in the minutes of the corporation.

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Convenience of the employer. An employee's home office must be for the convenience of the employer, not for the convenience of the employee. This means the home office is required as a condition of employment, and it is necessary for the business to function, or it is necessary for the taxpayer to properly perform duties as an employee. If there is no other place of business, such as a rented office or storefront, the home office should qualify, or if there is no other suitable place available for sales calls, client meetings and phone calls and client service at an existing facility the home office should also qualify.

Combining the safe harbor and accountable plan. When using the safe harbor method rather than the actual expense method, the taxpayer using an accountable plan reimbursement approach would merely keep track of that space used regularly and exclusively, multiple it times $5.00 per square foot (limited to 300) and submit the amount to the corporation for reimbursement.

C corporation shareholders renting a home office (Greatest Common Factor v. Comm., TC Memo 2023-39). Greatest Common Factor (GCF) was a C corporation owned by Glenn and Rhonda Fyfe, each owning 50%. During 2013 and 2014 Glenn Frye provided consulting services through GCF as an independent defense contractor. GCF reported home office expense deductions on its Forms 1120 of $13,747 and $13,615 for 2013 and 2014, respectively. The IRS disallowed these deductions on audit.

Court acknowledges §280A does not apply, but still denies deductions. As previously discussed, §280A disallows deductions related to a dwelling used by a taxpayer as a residence if the taxpayer is an individual or an S corporation. However, as GCF was a C corporation, the Court noted that §280A is inapplicable. C corporations "may deduct payments made to lease home office space from an employee (or from its owner) as rent if they are ordinary and necessary expenses. However, neither GCF nor Frye could produce any records indicating that there was any rental agreement or other evidence that funds were spent on a home office. The Court ruled there were no grounds to allow GCF to deduct expenses related to Fyfe's home office. The Court further noted that even if Fyfe were the taxpayer, he would not be entitled to home office deductions because the dwelling was not exclusively used on a regular basis as the principal place of business for any trade or business of the taxpayer.

Tax Free De Minimis Fringe Benefits (§132, §1.132-1)

Overview. Certain fringe benefits are excluded from gross income. Many of these excluded items are listed in §132(a), which includes:

1. No-additional cost services – service is offered for sale to customers in the ordinary course of the employer's business and the employer incurs no substantial additional cost (including forgone revenue) in providing the service to the employee (e.g., hotel room or air flight in an empty seat);

2. Qualified employee discounts – where the discount does not exceed the gross profit percentage of the product or no more than a 20% discount for services;

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3. Working condition fringe – any property or services provided to an employee to the extent that, if the employee paid for such property or services, the payment would be allowable as a trade or business deduction;

4. De minimums fringe – any property or service the value of which is so small as to make accounting for it unreasonable or administratively impracticable. This also includes the employer's operation of any eating facility for employees if the facility is located on or near the business premises of the employer and revenue derived from the facility normally equals or exceeds the direct operating costs of the facility;

5. Qualified transportation fringe – includes transportation in a commuter highway vehicle if such transportation is in connection with travel between the employee's residence and place of employment, transit passes, and qualified parking.

6. Qualified moving expense reimbursement for members of the U.S. Armed Forces;

7. Qualified retirement planning services – includes any retirement planning advice or information given by an employer who maintains a qualified retirement plan (including SIMPLE and SEPs) if the service is provided on a nondiscriminatory basis ; and

8. Qualified military base realignment and closure fringe.

Other rules impacting de minimis fringe benefits. The IRS has also identified other specialty areas that may, or may not, qualify for tax free fringe benefit treatment. These special rules include:

1. Highly compensated employees – exclusions for no-additional cost services and employee discounts apply to highly compensated employees only if the benefits are offered in a non-discriminatory fashion.

2. Auto sales associates – qualified demonstration autos provided to full time auto sales associates is a qualified working condition fringe benefit if the demo auto is used in the area of the dealership and the auto is provided to facilitate the salesmen's services for the dealership. Substantial restrictions must be applied to prohibit excessive personal use.

3. On premises gyms and athletic facilities operated by the employer qualify. The IRS recently announced that "work-life referral services" qualify as a de minimis fringe benefit described in 132(a)(4) (IRS Fac Sheet 2024-13).

4. Services provided to an employee of another employer shall be treated as provided by the employer of the employee if any service provided is pursuant to a written agreement between the employers and neither employer incurs any substantial additional costs (including foregone revenue) in providing the service. These are called reciprocal agreements and are common in the travel industry.

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Example. Michelle works for Twilight Air, which has a written agreement with Best Eastern Hotels that allows each other's employees to fly or stay cost free if there is excess capacity. Michelle flies to her Bahama's vacation for free on Twilight Air. While in the Bahamas, Michelle stays at the Best Eastern Hotel, also for free as the hotel had extra capacity.

Michelle is an employee of Twilight Air, so she pays no tax on the value of her free flight as the flight was a no additional cost service. Because of the written agreement between Twilight and Best Eastern, Michelle is treated as an employee of Best Eastern Hotels and she pays no tax on her free hotel room. Any housekeeper or other services are considered de minimis.

Work life referral programs (FS 2024-13). The IRS recently released a Fact Sheet that now includes work-life referral (WLR)services as an additional non-taxable de minimums fringe benefit under §132(a)(4). A WLR program is an employer-funded fringe benefit that provides WLR services to eligible employees. WLR services are restricted to informational and referral consultations that assist employees with identifying, contacting, and negotiating with life-management resources for solutions to personal, work, or family challenges.

What is included? WLR services include assistance with completing paperwork and basic administrative tasks that help direct the employee to appropriate providers of life-management resources. WLR programs work with subject-matter specialists who are trained in helping employees navigate work-life challenges involving access to and eligibility for child and elder care, health care, government and employer-provided benefits, and legal and financial issues. More specifically, WLR services offer employees guidance, support, information, and referrals in connection with:

- identifying appropriate education, care, and medical service providers,
- choosing a child or dependent care program,
- navigating eligibility for government benefits, including Veterans Administration benefits,
- evaluating and using paid leave programs offered through employer or a state or locality,
- locating home services professionals who specialize in adapting a home for a family member with special care needs,
- navigating the medical system, including private insurance and public programs, and utilizing available medical travel benefits, and
- connecting the employee with local retirement and financial planning professionals.

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Business Meals and Entertainment (§274;TD 9925)

Overview. The TCJA amended §274 to clearly state no deduction is allowed for any entertainment, amusement, or recreation expense or for any facility used in connection with entertainment, amusement, or recreation (§274(a)). When the TCJA was originally signed there was concern that the IRS may interpret this change to include meals as an entertainment expense and prohibit any meal deductions as well. However, the IRS has since clarified that meals are separate from entertainment expenses and are deductible as long as all other meal deduction substantiation requirements are met and the meal is properly documented (Notice 2018-76). For meal expenses taxpayers must be able to prove that: 1) the meal was directly related to the active conduct of the taxpayer's business (e.g., business meeting occurred while eating), or 2) the meal directly preceded or followed a substantial and bona fide business discussion (including business meetings at a convention or otherwise). These are most often referred to as "directly related to" or "associated with" tests. Meals are subject to the enhanced documentation requirements of §274(d) and §274(k) which require taxpayers to document:

- Amount of expenditure;
- Time and place of meal;
- Business purpose; and
- Business relationship between the taxpayer and the person having the meal.

Additional guidance helps clarify meals and entertainment after TCJA (TD 9925). Final regulations provide clarity primarily in two areas: 1) clarifying the definition of entertainment, and 2) clarifying when a meal is a deductible business meal.

Entertainment further defined (§1.274-11(b)). No deduction is allowed for any expenditure that is generally considered entertainment or for any facility used in connection with an entertainment activity. This includes dues or fees to any social, athletic, or sporting club or organization and any amounts paid or incurred for membership in any club organized for business, pleasure, recreation, or other social purposes. The term entertainment is further defined as any activity which is entertainment, amusement, or recreation. This includes entertaining at bars, theaters, country clubs, golf and athletic clubs, sports events, vacations and on hunting, fishing, and similar trips. These activities are treated as entertainment, subject to the objective test, regardless of whether the expenditure for the activity is related to or associated with the active conduct of the taxpayer's trade or business. Seems clear the IRS does not want anyone deducting any type of entertainment!

Entertainment and meals together (§1.274-11(b)(1)(ii)). Entertainment does not include food or beverages unless the food or beverages are provided during or at an entertainment activity, which generally are treated as part of the entertainment activity. However, if food or beverages are provided during an entertainment activity, the food or beverages are not considered entertainment if they are purchased separately from the entertainment, or the cost is stated separately from the cost of the entertainment on one or more bills, invoices, or receipts. If the food or beverage costs are not separately stated on the invoice or receipt, the taxpayer cannot allocate. The amount is a nondeductible entertainment expense.

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First test to determine if an expense is entertainment (§1.274-11(b)(iii)). The Regulations set an objective test that holds an activity that is generally considered to be entertainment is treated as entertainment, ***regardless of whether the expenditure can be described otherwise by the taxpayer*** (eliminates the "It wasn't entertaining to me" argument). The taxpayer's trade or business will be considered when applying this test. For example, while attending a movie is generally considered an entertainment activity, it would not be considered entertainment for a movie critic attending in a professional capacity. These provisions are best explained using examples:

Example 1. Pete invites Penny, a business associate, to a baseball game to discuss a proposed business deal. Pete bought tickets for the game. The cost of the game tickets is a nondeductible entertainment expense.

Example 2. Assume the same facts as in Example 1 except that Pete also buys hot dogs and drinks for him and Penny. The cost of the hot dogs and drinks, which are purchased separately from the game tickets, is a meal expense, not entertainment. If the meal expense otherwise meets the rules for deductibility Pete may deduct 50% (maybe 100% in 2022) of the cost of the meal.

Example 3. Jesse invited Brandon, a business associate, to play on her team in a golf tournament. The $500 tournament fee included green fees, a cart, beverages on the course and dinner at the end of the day. Once on the course, Jessi and Brandon spent most of the day discussing ways to improve the profitability of Jessi's business. The round of golf and the related cart are entertainment expenses. In addition, because the cost of the food and beverages were not separately stated or separately purchased, those costs are also nondeductible entertainment expenses. None of the $500 is deductible.

Example 4. Assume the same facts as in Example 3 except the fee to play in the golf tournament was $450 and an extra $50 was required if Jessi and Brandon stayed for dinner. Because the meal costs were separately stated, if the meal otherwise meets the deductibility requirements, the meal is deductible because the meal meets the "associated with" test.

Example 5. Yep, I see the wheels turning and the answer is no! Assume the same facts as in Example 4 except the tournament sponsor charges Jessi a tournament fee of $50 and charges her $450 for dinner. Would this make the $450 deductible? No. The regulations specifically state that the amount charged for food or beverages must reflect the venue's usual selling cost for such items and must approximate the reasonable value of those items.

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Final regulations impose additional rules for deductible meals (§1.274-12). All business expenses must be ordinary, necessary, and directly connected with, or pertaining to, the taxpayer's trade or business (§1.162-1). Additionally, no deduction is allowed for any food or beverage expense (meal expense) unless:

- The expense is not lavish or extravagant under the circumstances;
- The taxpayer, or an employee of the taxpayer, is present at the furnishing of such food or beverages; and
- The food or beverages are provided to a business associate.

50% limitation to meal deduction. In most circumstances the deduction for business meals is limited to 50% of what was spent (see exceptions below). Deductible meals include any expense for food or beverages provided by the taxpayer, or an employee of the taxpayer, to a business associate that meets the requirements previously discussed.

Preparer note. "Business associate" means a person the taxpayer could reasonably expect to engage or deal in the active conduct of the taxpayer's trade or business such as the taxpayer's customer, client, supplier, employee, agent, partner, or professional adviser, whether established or prospective. Note the definition does not include those with whom the taxpayer is attempting to generate goodwill. It also does not include the taxpayer's spouse!

Special rules for travel related meals paid for spouse, other family. Trade or business-related meal expenses incurred while traveling away from home are generally deductible, provided the meals meet the substantiation requirements discussed above. However, travel related meal expenses of spouse, dependent, etc. are not deductible unless:

- The spouse, dependent, etc. is an employee of the taxpayer;
- The travel of the spouse, dependent, or other individual is for a bona fide business purpose of the taxpayer; and
- The expenses would otherwise be deductible by the spouse, dependent or other individual.

Exceptions to the 50% business meal limitation (§274(e); (§1.274-12(c)). Certain meal expenses are 100% deductible, rather than 50%. This includes meal expenses:

1. To the extent the cost of the meals, including travel related meals, are included in an employee's wage compensation subject to Federal income tax withholding.

2. To the extent the cost of the meals, including travel meals, are included in the income of persons who are not employees (e.g., independent contractors). Note, however, that this exception does not apply if the taxpayer is required to report the amount on Form 1099 and fails to do so.

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Example. Furlong has a company cafeteria where employees may eat at no charge. The food and beverages provided are not a de minimis fringe (§132(e)). Furlong includes the value of the food and beverage expenses in the employees' wages. The food and beverage expenses are 100% deductible.

Variation. Assume the same facts as above except the meals provided to employees are provided for the convenience of Furlong employees and are ***excluded*** from their wages under §119. Because the entire value of the employee meals was excluded from employee wages Furlong may only deduct 50% of the food and beverage expenses.

3. Paid by the taxpayer in connection with the performance of services for another person under an expense reimbursement or allowance arrangement (accountable plan reimbursement). For a reimbursement or allowance plan to qualify, it must require an adequate accounting from the recipient and provide that any excess reimbursements are returned to the payor.

Preparer note. An arrangement is not treated as a reimbursement or other expense allowance arrangement if it: 1) does not require the employee to substantiate the covered expenses, or 2) allows the employee to retain any amount in excess of the substantiated expenses (§62(c)). A good rule of thumb for designing an accountable plan reimbursement program is the 30-60-120 accountable plan. Allowances or other payments are not made more than 30 days before the expense is expected to be incurred. Within 60 days of the expense being incurred the employee/contractor accounts for the expense to the employer. Within 120 days of the expense, the employee/contractor returns any excess reimbursement.

If a reimbursement plan does not meet these requirements, all amounts paid under the arrangement are treated as paid under a nonaccountable plan and are **included in an employee's wage income** and must be reported on the employee's Form W-2.

4. For recreational, social, or similar activities (including facilities) primarily for the benefit of employees (other than highly compensated employees per §414(q)). For example, expenses paid for holiday parties, annual picnics, summer outings, etc. are 100% deductible.

Example 1. Boomers CPAs invites all its employees to a tax season end party in a hotel ballroom that includes a buffet dinner and an open bar. The cost of the party, including food and beverage expenses, is 100% deductible because the party is a recreational, social, or similar activity primarily for the benefit of non-highly compensated employees.

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Example 2. Assume the facts as above except Boomers excludes rank and file employees and only invites partners to the tax season end party. The hotel's invoice lists the costs for food and beverages separately from the cost of the rental of the ballroom and the costs reflect the venue's usual selling price for food or beverages. Because the food and beverages are separately stated they are deductible, but only 50% as the party was for highly compensated persons. The cost of the ballroom rent is not deductible because the party is entertainment, and it is a facility rented for entertainment.

Example 3. Maverick, Inc. provides free coffee, soda, chips, donuts, etc. in an office break room for its employees. The snack expenses are only 50% deductible because the break room is not a recreational, social, or similar activity primarily for the benefit of the employees.

Example 4. Nuance LLC provides emergency medical services and has a written policy that employees must be available for emergency calls during work hours. Because emergencies can and do occur during meal periods, Nuance furnishes food and beverages to employees without charge in a cafeteria on its premises and excludes the food and beverages from employees' income as meals provided for the convenience of the employer (§119). Nuance may only deduct 50% of the employee cafeteria expenses.

5. For goods, services, and facilities the taxpayer makes available primarily to the public, including any amount provided to employees.

Example 1. Phyllis is a real estate agent who provides refreshments at an open house for a home available for sale to the public. The refreshments are consumed by Phyllis's employees, potential buyers of the property, and other real estate agents. If more than 50% of the refreshments were consumed by potential buyers and other real estate agents (i.e., not employees), 100% of the refreshment costs are deductible.

Example 2. Q Star is an automobile service center that provides refreshments in its waiting area. Q Star's employees and customers consume the refreshments. The costs of the refreshments are 100% deductible for Q Star if over 50% of the refreshments are consumed by customers. Otherwise, only 50% is deductible.

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Example 3. Hour Game operates a youth summer camp open to the public. Breakfast and lunch are provided for campers as part of the fee to attend camp. Employees (counselors, supervisors, etc.) are also allowed to eat. There are 20 camp employees and 100 camp attendees, who consume more than 50% of the food and beverages. The costs of the meals are 100% deductible as more than 50% of the food and beverages are consumed by camp attendees.

6. For goods or services (including the use of facilities) which are sold by the taxpayer in a bona fide transaction for an adequate and full consideration in money or money's worth (e.g., restaurant).

Example. T Squared operates a restaurant where food and beverages are provided at no cost to food service employees before, during, and after their shifts. The expense of meals provided to employees is 100% deductible (i.e., 100% included in cost of goods sold) because the restaurant sells food and beverages to customers in the ordinary course of its business.

Per Diems for Meals, Lodging, and Incidental Expenses (Notice 2024-68)

As discussed above, the TCJA amended §274 for entertainment, amusement, or recreation for amounts paid after December 31, 2017. Rev. Proc. 2011-47 contained rules for the use of per diems rather than actual expenses for meals, travel and incidental expenses for amounts paid prior to January 1, 2018. To coordinate the changes required by the TCJA with the use of per diems, the IRS issued Rev. Proc. 2019-48. It is important to remember that taxpayers can substantiate actual expenses rather than use per diems, but if per diems are used, the substantiation requirements of §274 and §1.274-5 must be complied with.

Per diem amounts. Separate per diem amounts are available for meals, lodging, and incidental expenses. In addition, there are several different meal per diem amounts based on industry type (transportation industry meal per diem is higher than the general meal per diem) and lodging per diems fluctuate based on location. The US Government annually publishes a list of localities and the relative lodging per diem. The published rates are applicable from October 1st through September 30th the following year. If a town or city is not on the list the general lodging per diem is used. Rates are also adjusted if the travel is in the U.S. (CONUS) or outside the U.S. (OCONUS). Taxpayers may choose to adopt the rates on a calendar year basis instead of using the Federal fiscal year. Additionally, taxpayers may choose to use the high-low per diem average rates. In this scenario, all localities in the US are categorized as high or low cost and the appropriate per diem rate is used accordingly.

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Partial day per diems (Rev. Proc. 2024-68). The full meal and incidental per diem rate is available for a full day of travel (12:01 a.m. to 12:00 midnight). For purposes of determining the per diems for partial days of travel away from home, a payor may use either of the following methods:

1. Prorate the daily per diem using three-fourths of the applicable rate to each partial day of travel; or
2. Prorate using any method that is consistently applied and is consistent with reasonable business practice.

Most Common Current Per Diem Rates (Notice 2024-68; GSA Update)		
Type	**Oct. 2023 – Sept. 2024**	**Oct. 2024 – Sept. 2025**
Meals CONUS – general	$ 59	$ 68
Meals partial day (75%)	$ 44.25	$ 51
Meals OCONUS – general	Varies by Location	Varies by Location
Meals – US transportation	$ 69	$ 80
Meals – non-US transportation	$ 74	$ 86
Incidental – Both	$ 5	$ 5
Lodging – general rate	$107	$110
Lodging – other locations	Varies by Location	Varies by Location
High Low Average – Low	$ 309 ($74 meals)	$ 319 ($86 meals)
High Low Average – High	$ 214 ($64 meals)	$ 225 ($74 meals)

When can per diem rates be used (Rev. Proc. 2019-48)? Per diem rates are used by businesses and others to reimburse employees or contractors for travel and other costs. In such cases, the employee/contractor need only substantiate that they were away from home to receive the per diem payment. Once received, the per diem payment is not taxable to the employee/contractor and is fully deductible for the paying entity. Per diems are also used to substantiate the amount of deduction for travel related expenses. But there are strict rules that dictate when the per diem rates may substitute for actual expenses and who can use them:

- **Meal per diems** – Meal per diems may be used by businesses to reimburse employees and contractors who substantiate they are out of town overnight for business related travel. These per diem may also be used by a business owner to calculate the amount of deductible meal expenses while the owner is out of town for business related travel. Note that regardless of the per diem amount, if the per diem is paid or deducted for meals, only 50% is deductible.

- **Lodging per diems** – Lodging per diems may only be used to reimburse employees for out-of-town travel related lodging. They cannot be used for tax free reimbursements for independent contractors, and they may not be used to calculate a deductible amount for owners.

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- **Incidental per diems.** Incidental per diems are used by employees and contractors in lieu of deducting fees and tips given to porters, baggage carriers, bellhops, hotel staff, etc.

Hobby Losses (§183)

Trade or business defined. Although "trade or business" is one of the most widely used terms in the IRC, neither the Code nor the Treasury Regulations provide a specific definition. The definition of a "trade or business" comes from common law, where the concepts have been developed and refined by the courts. In Comm'r v. Groetzinger, 480 U.S. 23, 35 (1987), the Supreme Court ruled that the determination of whether or not an activity is carried on as a trade or business must be made for each activity using the specific facts and circumstances of that activity - there is no bright line test. When analyzing a specific activity, the Court further held the four most key factors to be considered are whether the activity is carried on:

1. A full-time basis;
2. With regularity;
3. Continuously; and
4. To make a profit.

While all four of these factors are not required, the more factors that are met the more likely the IRS will accept that an activity is a trade or business.

Deductible expenses (§162(a)). To be deductible, a trade or business expense must be both "ordinary" and "necessary" in relation to the taxpayer's trade or business. In Welch v. Helvering, 290 US 111 (1933), the Supreme Court determined the words "ordinary" and "necessary" have different meanings, both of which must be satisfied for the taxpayer to benefit from the deduction.

- The word "ordinary" is defined as customary or usual and of common or frequent occurrence in the taxpayer's trade or business.

- The word "necessary" is defined as appropriate and helpful for development of the business.

For an expense to be tax deductible, in addition to being ordinary and necessary, the expense must be reasonable in amount (Lincoln Electric Co. v. Comm'r; 162 F.2d 379 (1947)). In Lincoln, the 6th Circuit Court of Appeals ruled the element of reasonableness is inherent in the phrase "ordinary and necessary" as it was not the intent of Congress to automatically allow expenses incurred or paid by the taxpayer in an unlimited amount (see also Rev. Rul. 58-112 where the IRS stated a trade or business is an activity carried on for a livelihood or to make a profit in a regular, frequent, and continuous manner).

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Who gets to decide whether an expense is ordinary, necessary, and reasonable? It is up to the taxpayer to show all deduction requirements are met and must keep books or records that substantiate the expenses are maintained (§6001; E. Jan Roberts v. Comm., 62 T.C. 834, 836 (1974)). Failure to keep and present such records counts heavily against a taxpayer's attempted proof (John E. Rogers v. Comm., TC Memo 2014-141). In determining whether an expense is “ordinary and necessary,” Courts have focused on the taxpayer's primary motive for incurring the expense and on whether there is a reasonably proximate relationship between the expense and the taxpayer's occupation (Colleen J. O'Connor/Mark Tracy v. Comm., 653 F. App'x 633, 638 (10th Cir. 2016), aff'g on this issue T.C. Memo. 2015-155; James B. Walliser v. Comm. 72 T.C. 433, 437–38 (1979); Andrew M. Berry v. Comm., TC Memo 2021-42).

So, no deduction for hobby related expenses (Carl and Leila Gregory v. Comm., USCA 11th Circuit, No. 22-10707, May 30, 2023)?

Overview. Carl and Leila Gregory chartered their yacht, Lady Leila, in 2014 and 2015. They conceded that the yacht charter activity was a hobby, not a business. Though the hobby generated income, it also incurred sizeable expenses each year. The Gregorys deducted some of those expenses “above the line” to reduce their gross income, arguing such treatment was allowed under §183(b)(2). The IRS disagreed, arguing that any expenses associated with a hobby activity were only deductible to the extent of income generated from the activity, and then, only as miscellaneous itemized deductions subject to the 2% of AGI limitation. The Gregorys reported taxable income of $19,666,000 and $80,154,000 for 2014 and 2015, respectively. After subtracting 2% of AGI from the yacht rental expenses, the remaining expenses were zero. Effectively, the IRS disallowed all yacht related deductions.

Court concludes expenses were miscellaneous itemized deductions. The Tax Court concluded, and the 11th Circuit affirmed, that §183 does not dictate how hobby losses are treated. Instead, the Court ruled that provisions in §§62, 63, and 67 are controlling. These provisions establish that §183(b)(2) deductions are below-the-line and must exceed 2% of a taxpayer’s AGI before they become deductible.

Absurdity doctrine no help. A court may “disregard or judicially correct” a statutory provision “if failing to do so would result in a disposition that no reasonable person could approve (absurdity doctrine). The Gregorys argued that applying the 2% floor to their deductions created an absurd result because a taxpayer would only benefit if they had either a very low income or very large hobby losses (and hobby income) to benefit from the allowed deductions. The Court held that, while the consequence may be unfavorable, it is not absurd. The absurdity doctrine should “correct obviously unintended dispositions, not . . . revise purposeful dispositions.” Here, Congress deliberately devised the complained-of result by imposing the 2% floor on miscellaneous itemized deductions. The Gregorys owed $267,000 in additional tax.

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Preparer note. The TCJA, passed in late 2017, disallowed all miscellaneous itemized deductions of whatever amount, rendering them useless for 2018 – 2025. This makes the result worse than ever for taxpayers who engage in a hobby or quasi hobby activities.

Example. David has a part-time fishing guide business that he does when he's not working at his normal financial advisor job. During 2024, David receives fishing guide income of $8,000 and has related expenses of $12,000. David's tax return looks like:

	Hobby	**Sch C***
Financial advising income	$150,000	$150,000
Schedule C/Other income – net	$ 8,000	$ - 0 –
Standard deduction	($ 14,600)	($ 14,600)
Taxable income	$143,400	$135,400

*Assumes verifiable deductions equal income. No loss generated.

Final note. The point to note here is there is no difference in the income David received but there is an $8,000 difference in taxable income. The difference is due solely to how the income is reported on the return, nothing else.

What about the Cohan Rule (Cohan v. Comm., US Ct of Appeals, 2nd, 39 F.2d 540 (1930))? The Cohan rule is one of "indulgence" established in 1930 by the 2nd Circuit Court of Appeals. The court held that business expense deductions which were not adequately substantiated can be approximated, but any estimates should be weighed heavily in favor of the Commissioner as the inexactitude is of the taxpayer's own making. The Cohan rule cannot be used where the Code specifically mandates enhanced substantiation requirements such as §274(d), which requires adequate records or sufficient evidence to establish the amount, time, place, and business purpose.

Hobby v. Business Activity (§183; §1.183)

Activities of an individual, S corporation or partnership where no profit motive exists are generally treated as a hobby under the Internal Revenue Code. Income generated from a hobby activity must be reported on Form 1040 as Other Income and any related expenses are not deductible[2]. The IRS analyzes 9 factors to determine if an activity is a trade or business or a hobby (§1.183-2(b)):

1. **Manner in which the taxpayer carries on the activity.** Is the activity carried on in a businesslike manner? Are complete and accurate books and records maintained? Has a business plan been prepared?
2. **Expertise of the taxpayer or advisors.** Has the taxpayer extensively studied the business aspects of the activity or engaged others who are experts? Study includes business, economic, and scientific practices.

[2] Prior to 2018 hobby related expenses were deductible as miscellaneous itemized deductions subject to the 2% of AGI limitation and only to the extent of reported hobby related income. The TCJA eliminated the deduction for most miscellaneous itemized deductions, including those related to hobby activities.

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3. **Time and effort expended by the taxpayer.** The more time and effort the taxpayer puts in the more likely the activity is engaged in for profit. A taxpayer's withdrawal from another occupation to devote most of his energies to the activity may also be evidence that the activity is engaged in for profit.
4. **Expectation that assets used in activity may appreciate.** The term "profit" encompasses appreciation of the value of assets, such as land, used in the activity. Taxpayers may intend to derive a profit from the operation of the activity even if no profit from current operations is derived but an overall profit is anticipated to result when appreciation in the value of assets used in the activity are realized.
5. **Success of the taxpayer in carrying on other similar or dissimilar activities.** The fact that the taxpayer has engaged in similar activities in the past and converted them from unprofitable to profitable enterprises may indicate the present activity is engaged in for profit, even if the activity is presently unprofitable.
6. **History of income or losses with respect to the activity.** A series of losses during the initial or business start-up stage and explainable losses beyond the start-up period (economy, unexpected disaster, etc.) do not necessarily indicate a lack of profit motive. A series of years in which net income was realized would of course be strong evidence that the activity is engaged in for profit.
7. **Amount of occasional profits, if any, which are earned.** The amount of profits in relation to the amount of losses incurred, and in relation to the amount of the taxpayer's investment and the value of the assets used in the activity, may provide useful criteria in determining the taxpayer's intent. A substantial profit, though only occasional, would indicate an activity is engaged in for profit, where the investment or losses are comparatively small. Also, an opportunity to earn a substantial ultimate profit in a highly speculative venture indicates the activity is engaged in for profit.
8. **Financial status of the taxpayer.** The fact that the taxpayer does not have substantial income or capital from sources other than the activity may indicate that an activity is engaged in for profit. Substantial income from sources other than the activity (particularly if the losses from the activity generate substantial tax benefits) may indicate that the activity is not engaged in for profit especially if there are personal or recreational elements involved.
9. **Elements of personal pleasure or recreation.** The presence of personal motives in carrying on an activity may indicate that the activity is not engaged in for profit, especially where there are recreational or personal elements involved.

Preparer note. Meeting a simple majority of factors is not controlling nor is any one a factor. After analyzing all the listed factors, the courts and IRS weigh each as they deem appropriate.

Writer not allowed to deduct travel (research) expenses (Debra Jones-Mazotti v. Comm., TC Memo 2024-75). In 2019 and 2020, Denver resident Debra Jones-Mazotti received income from a school district, for a private employer, gambling (which she did not report), and $1,000 nonemployee compensation from Prevagen, a pharmaceutical company. During 2019 and 2020, Mazotti filed Sch. C with her tax return claiming “Writer Researcher” activities. She testified that she participated in technical writing, writing

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workshops, courses related to writing, journalism, and photography, and that she did occasional technical writing for the FBI, Western Gas Resources, etc. She also claimed to have self-published six books. Jones-Mazotti had been deducting writing-related business expenses on Sch. C since 1997. The first year she ever showed a profit from these activities was in 2022.

Other writing activities. Jones-Mazotti also told the Court she was published in numerous newspapers and online sources over the years but only able to establish one newspaper article that was published in 2008.What Jones-Mazotti, claimed were published works turned out to be letters to the editor or social media posts. One documented online post on Facebook was about Jones-Mazotti's personal travel experiences and another was an opinion review on TripAdvisor.

Income and related expenses. Jones-Mazotti reported $15 of income from her writing activities in 2019 and $1,000 in 2020. She couldn't recall where the $15 came from and she admitted that the $1,000 was received from Prevagen for her appearance in a TV commercial – not for writing the commercial as she told the IRS. She deducted numerous trips on her Sch. C for "writer-researcher" activities, including trips to California and Florida for research for her books, articles, and scavenger hunts she was creating. She traveled to Hawaii in 2020 to study macadamia nuts for her books. Some members of her family, including her husband and daughter, typically traveled with her on these trips. During these trips, Ms. Jones-Mazotti purportedly took photos of fruits, vegetables, and trees for her writer-researcher activities. As a result, she deducted expenses of $61,000 in 2018, $63,000 in 2019 and $62,000 in 2020.

Court concludes no business purpose. After analyzing the nine factors in the Regulations, the Court concluded there was no evidence Jones-Mazotti was pursuing her writing activities for the purpose of generating a profit. She didn't make any changes to reduce or minimize her losses, she never became expert at writing or engaged those who were, there were no business assets to appreciate in value, she'd never been successful in other businesses, the losses were offsetting she and her husband's retirement income, and there were significant elements of personal pleasure. Bottom line, she was 0 for 9 in the Reg factors. The Court disallowed all the writing related expenses and approved the assessment of accuracy related penalties.

Marijuana Businesses Update (§280E)

No change in controlled substance status (IR-2024-177). The Justice Department published a notice of proposed rulemaking in May 2024 to consider rescheduling marijuana under the Controlled Substances Act. If the change is finalized, marijuana would no longer be a type I controlled substance, and marijuana business would no longer be subject to restrictions under §280E. However, the IRS reminded taxpayers that until a final rule is published, marijuana remains a Schedule I controlled substance and is subject to the limitations of Internal Revenue Code Section 280E – no deductions allowed other than cost of goods sold and no credits. Although the change hasn't been finalized, some taxpayers have already begun filing amended returns. The IRS also reminded taxpayers these rules apply to businesses that sell marijuana, even if they operate in states where such sales are legal.

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IRS expands FAQs for marijuana related businesses (Cannabis industry FAQs). IRS has offered some additional insight into the taxation of marijuana related businesses. Bottom line, the news isn't good for taxpayers in the cannabis industry. Operating expenses are still not deductible, and bank accounts still aren't available. Good news – payment plans are available!

Taxpayer Asks to Claim Work Opportunity Credit for Marijuana Business (CCA 202205024)

The taxpayer operated a business whose main product was marijuana sales and is therefore subject to the restrictions imposed under §280E. The taxpayer hired and paid wages to individuals that would normally qualify the taxpayer to claim the Work Opportunity Tax Credit. The Chief Counsel was asked if §280E precludes the taxpayer from claiming the WOTC.

No WOTC for you! The wording of §280E says "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 consists of trafficking in controlled substances." Marijuana is a Schedule 1 controlled substance and, therefore, the taxpayer is not allowed to claim the WOTC for wages paid to employees working in his business.

Hemp is NOT Marijuana Sort Of (IRS Cannabis Industry FAQs)

Hemp and marijuana are both plants that derive from a cannabis plant. The big difference is hemp is a cannabis plant that has no more than .3 percent THC (the active psychoanalytic drug in marijuana. Congress passed the 2018 Farm Bill which made hemp legal in the United States. Hemp is not on the list of controlled substances that make a business subject to §280E so hemp business owners are treated the same as any other business owner for tax purposes. This includes all parts of a hemp plant including seeds, derivatives, extracts, cannabinoids, isomers, acids, salts, and salts of isomers.

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Business Pension Plans

Labor experts contend one of the greatest challenges facing young workers is the lack of pension planning. Some states are now mandating employers, even relatively small employers, provide some sort of pension plan for their employees. Employers face a multitude of choices when it comes to establishing and maintaining retirement plans for themselves and their employees. IRAs, SEP IRAs, SIMPLE IRAs, 401(k) plans, profit sharing plans, cash balance plans, defined benefit plans, and employee stock ownership plans are all options available to employers. Contribution limits, funding requirements, administrative costs, mandatory contributions to employee accounts, and many additional considerations make choosing the best retirement plan confusing at best and near impossible at worst.

DOL Reports Latest Pension Plan Statistics (DOL Private Pension Plan Bulletin Sept 2023)

For nearly a century, qualified pension and retirement plans meeting certain qualifications have received favorable Federal tax treatment with deferral of taxes on contributions and investment earnings until benefits are received in retirement. Congress has provided incentives for employers who form or maintain pension plans. These pension tax incentives are currently the largest tax expenditure, which includes defined contribution, defined benefit, and IRA plans. Yet there remains a growing concern that many millions of working Americans remain largely outside the private pension system.

Highlights from the DOL Bulletin:

- While the number of private pension plans has been going up slightly, the number of 401(k) and other employee contribution type plans have been going up much faster. Between 2000 and 2021, employer pension plans increased from 736,000 to 765,000. During the same period, the number of employers sponsored defined contribution plans increased from 687,000 to 719,000.

- The number of individuals participating (active or inactive) in any type of employer sponsored plan increased from 103 million in 2000 to 146 million in 2021. All the participant growth was in defined contribution and 401(k) plans. Participation in defined benefit plans shrank from 42 million in 2000 to 31.2 million in 2021.

- Pension plan assets grew from $5.9 trillion in 2000 to $13.2 trillion in 2021.

- Total pension plan distributions in 2021 were $1.055 trillion and total contributions were $733 billion.

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Retirement savings account balances, by age

Age	Median	Average
<25	$1.8K	$6.3K
25–34	$14.1K	$37.2K
35–44	$36.1K	$97K
45–54	$61.5K	$179.2K
55–64	$89.7K	$256.2K
65+	$87.7K	$280K

Table: Gabriel Cortes / CNBC
Source: Vanguard's How America Saves 2022 Report

Many Retirement Plan Options Available to Employers

At the core, all retirement plans are either defined contribution plans or defined benefit plans. Most private sector retirement plans, especially for small businesses, are defined contribution plans. Options available to small employers looking to implement a retirement program include:

- Payroll deduction IRA
- SEP IRA (§408(k))
- SIMPLE IRA and SIMPLE 401(k)(§408(p); §401(k)(11))
- Profit sharing plans (§415(c))
- 401(k)s, safe harbor 401(k)s (§401(k))
- Defined benefit plans (§415(b))
- Cash balance plans.

SECURE Act and SECURE Act 2.0

Congress overwhelmingly approved the Setting Up Every Community for Retirement Enhancement (SECURE Act) in December 2019 and follow it up with the passage of the Securing a Strong Retirement Act (SECURE Act 2.0) in December 2022. Both Acts passed with strong bipartisan support and each Act contains provisions that will change how Americans save for retirement. Many provisions are being phased in over several years, all the way through 2033.

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2024 Pension Comparison Summary (Notice 2023-75)				
	Simple IRA	**SEP**	**Solo 401-K**	**401-K**
Highlights	Good choice for small businesses and employers first time offering a plan. 97% employee funded.	Excellent contribution limits, 5500 not required, and annual funding 100% at employer discretion. 100% employer funded.	Higher limits than SIMPLEs but 5500 normally required. 100% employee deferral contributions allowed by owner employees.	Funded by employee & employer but top-heavy rules may apply. Safe harbor plans avoid top-heavy rules.
Max Employee Contribution	$16,000 or $17,600	-0-	$23,000	$23,000
Max Employer Contribution	$17,600	Lesser of 25% of W-2 or $69,000	Lesser of 25% of W-2 or $69,000	Lesser of 25% of W-2 or $69,000
Max Contribution All Sources	$16,000 or $17,600 + 3% of W-2 Before Deferral	$69,000	$69,000	$69,000
Over Age 49 Additional Catch-Up	$3,500 or $3,850	N/A	$7,500	$7,500
Starting in 2025 addit'l catchup ages 60 - 63	$5,000 or 150% of regular catch-up	$0	$10,000 or 150% of regular catch-up	$10,000 or 150% of regular catch-up
Tax Deduction	Yes	Yes	Yes	Yes
Withdrawals	Taxed	Taxed	Taxed	Taxed
Earnings	Deferred	Deferred	Deferred	Deferred
Penalty Exceptions	Most IRA exceptions	Most IRA exceptions	Most IRA exceptions	Most IRA exceptions
Form By (2024)	10/1/24	Due date + extension	Due date + extension	Due date + extension
Contribute By	Due date + extension	Due date + extension	Due date + extension	Due date + extension
Penalty Issues	25% 1st 2 years then 10% before 59½	10% before 59½	10% before 59½	10% before 59½
Tests	No other active plan	No other active plan	Family Only, Employer sponsored, other plans okay	Employer sponsored, other plans okay
Distributions required	Usually 73	Usually 73	Usually 73	Later of 73 or retirement
Bankruptcy Protection	Unlimited	Unlimited	Unlimited	Unlimited
5500 Required	No	No	Normally	Yes
More Information	Publications 560	Publications 560	Publications 560	Publications 560

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Simplified Employee Pensions - SEPs (§408(k); IRS SEP FAQs)

SECURE Act 2.0 adds household workers to SEP eligible list (SECURE Act 2.0 Section 118). The SECURE Act 2.0 permits household employers to provide SEP retirement benefits to domestic employees (e.g., nannies) starting in 2023.

Preparer note. Employer contributions to SEP-IRAs are in addition to the amount an individual may contribute to a Roth or traditional IRA. In addition to SEP-IRA contributions, SEP-IRAs are now allowed to accept traditional IRA contributions. Effectively, this means employees can make a traditional IRA contribution to an existing SEP-IRA account, even if the employer is making a SEP contribution for the same year.

Example. Cindy, age 45, is the owner and sole employee of JJ Investment Advisors. Cindy contributes $14,000, the maximum allowable based on her Sch. C profit, to her SEP-IRA for 2024. Cindy may also make a traditional IRA contribution of up to $7,000 and she may deposit this additional amount to her SEP-IRA account for 2024. If Cindy prefers, she also has the option of contributing to her Roth IRA instead of the traditional IRA if her total traditional IRA and Roth IRA contributions do not exceed $7,000 combined.

SEP advantages. The main advantages SEPs have over other retirement plan options are: 1) minimal administration effort and cost to establish and maintain the SEP; 2) flexibility to annually decide the amount, if any, of the SEP contribution; 3) employer's fiduciary responsibilities are minimal as the employer has no control over investment decisions; and 4), the employer has until the extended due of the return to decide whether to establish the SEP.

SEP contributions calculations and limits. Employer contributions to SEP-IRAs are completely at the discretion of the employer. There is no requirement to make contributions every year once a SEP is established and the employer has until the due date of its income tax return (including extensions) to decide what amount, if any, the employer is going to contribute and to make the contribution. Any contributions must be based on a written allocation formula and must not discriminate in favor of highly compensated employees. All contributions are 100% vested when made and employee withdrawals must be allowed at any time. Contributions are generally tax deductible for the employer and are not taxable until withdrawn.

Contribution limits and timing. Employer contributions to an employee's SEP-IRA cannot exceed the lesser of 25% of the employee's compensation ($345,000 maximum in 2024) or $69,000. Employee compensation does not include the employer's SEP contribution. The SEP plan document specifies how the employer contribution is determined and how it is allocated to participants. Catch-up contributions (for those age 50 and older) are only allowed through salary deferral contributions. As SEP-IRAs are 100% employer funded (i.e., salary deferrals are not allowed), catch-up contributions are not allowed.

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Contributions for self-employed. The annual limits on contributions to employee SEP-IRAs also apply to contributions self-employed persons make on their own behalf. Instead of wages, the self-employed person bases her or his SEP-IRA contribution on net self-employment income after subtracting any SEP-IRA contributions. This makes for a circular calculation best left up to our software! In general, a self-employed person may contribute 20% of their earnings to a SEP.

SEP IRAs contributions to Roth accounts. The Secure Act 2.0 changed the rules to allow SEP IRA contributions to be made to Roth accounts starting in 2023. Contributions are treated as made to a traditional IRA and then immediately rolled over to a Roth account. Contributions are taxable to the employee in the year of the contribution regardless of the year the SEP contribution is deducted on the employer's tax return. Any contributions made to a Roth IRA under a SEP arrangement are excluded from wages. See additional reporting rules in the SIMPLE IRA section of this chapter.

Establishing a SEP. There are three basic steps to establish a SEP:

1. Execute a formal written agreement to provide benefits to all eligible employees;
2. Give each eligible employee required information about the SEP; and
3. Establish SEP-IRA accounts for each eligible employee (typically done by the employee).

Formal written agreement (Form 5305-SEP). The requirement to execute a formal written agreement is satisfied by adopting an IRS model SEP using Form 5305-SEP. This very brief form can be filled out in just a few minutes and is available on the IRS website. If Form 5305-SEP is used, the employer keeps the original form in its files and does not file anything with the IRS. Generally, if Form 5305-SEP is used, the employer is not required to file any annual reports (Form 5500) with the IRS or the Department of Labor.

Form 5305-SEP cannot always be used. Employers may not use Form 5305-SEP as their written plan agreement if the employer:

1. Currently maintains any other qualified retirement plan other than another SEP;
2. Has any eligible employees for whom IRAs have not been set up;
3. Uses the services of leased employees who are not common-law employees;
4. Is a member of an affiliated service group (§414(m)), controlled group of corporations or businesses (§414(b); §414(c)) unless all eligible employees of all related entities participate under the SEP; and
5. Does not pay the cost of the SEP contributions.

Employers who are not allowed to use Form 5305-SEP to establish the SEP may use a prototype document. Most mutual fund companies, insurance companies, banks and other qualified institutions provide these documents. If not, employers may have to have their SEP individually designed by their legal or human resource advisors.

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For additional SEP information:

- IRS SEP webpage
- SEP Checklist – IRS Pub 4285
- SEP FAQs
- Form 5305-SEP
- SEP Fix It Guide

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Savings Incentive Match Plan for Employees or Small Employers (SIMPLE IRAs) (§408(p); §401(k)(11))

SIMPLE IRAs in general. Many employers, especially small employers, are reluctant to take on the administrative burden and cost of maintaining a retirement plan. To make it more administratively feasible, Congress adopted the Savings Incentive Match Plan for Employees IRAs (SIMPLEs). SIMPLE IRA plans are retirement plans where each employee may choose to have their employer make payments to the employee's individual SIMPLE account (over which the employee has 100% control of the investments) or to receive the payment directly in cash. The SIMPLE account is an IRA, but it is a separate and distinct IRA from other types of IRAs (i.e., SEP IRAs, traditional and Roth IRAs).

No fiscal years for SIMPLE IRAs. All calculations and testing for SIMPLE IRAs must be completed on a calendar year basis. This includes the determination of employer and employee eligibility, as well as contribution timing, matching, etc. The plan sponsor's tax year end is irrelevant.

Deadline for employers to set up SIMPLE IRA plans. A SIMPLE IRA plan may be established on any date between Jan. 1st and Oct. 1st of a year, provided the employer hadn't previously maintained a SIMPLE IRA plan. Employers who previously maintained a SIMPLE IRA plan must reestablish a plan only on Jan. 1st. New employers that come into existence after Oct. 1st and wish to establish a SIMPLE IRA plan must set up the plan as soon as administratively feasible. A SIMPLE IRA plan cannot have an effective date that is before the date the plan is adopted (Form 5304 or 5305 completed).

SIMPLE IRAs may be combined with traditional and/or Roth IRAs. As with SEPs, contributions to a SIMPLE IRA do not affect the amount an individual can contribute to a Roth or traditional IRA. Individuals may elect to fully fund a SIMPLE IRA and a traditional or Roth IRA.

Form 5304-SIMPLE and Form SIMPLE 5305-SIMPLE. Employers may use one of two IRS forms to serve as a model SIMPLE IRA plan document: Form 5304-SIMPLE or Form 5305-SIMPLE. Form 5304-SIMPLE is used when each participant is allowed to choose the financial institution where their SIMPLE account is established. Form 5305-SIMPLE is used when the employer designates the financial institution. The SIMPLE IRA plan is adopted when all appropriate boxes and blanks on the form have been completed and the employer (and the designated financial institution, if any) have signed it. The employer keeps the original form. No forms are required to be filed with the IRS.

Employee notification required. Form 5304/5305 SIMPLE include a SIMPLE IRA "Model Notification to Eligible Employees", which satisfies the employee notification requirement. The employer must be able to provide adequate proof of when the SIMPLE IRA plan was established and that employees were notified if audited.

Employee contribution limits. The 2024 employee salary reduction contributions are capped at $16,000 and employees aged 50 or older by December 31st may contribute an additional $3,500 (but see special contribution election below). Employers cannot place restrictions on the contribution amount (such as limiting the contribution percentage), except to comply with the overall limits. If an employee participates in any other qualified plan during the year and has salary reduction contributions under that plan(s), the SIMPLE

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IRA's salary reduction contributions count toward the overall annual limit for salary deferral contributions and other elective deferrals ($23,000 for 2024).

Example. Michelle is 45 years old and works for two companies in 2024 – BRC and SMC. BRC offers a SIMPLE IRA and Michelle elects to make 2024 employee SIMPLE contributions of $16,000. SMC offers a 401k. Michelle's maximum employee contribution to the SMC 401k is $23,000 (under age 50). However, Michelle must reduce her maximum 401k employee contribution by any elective deferrals made to other retirement plans. Michelle's maximum contribution to the SMC 401k is $7,000 ($23,000 less $16,000 SIMPLE contribution).

Preparer note. The one exception to this rule is that employee elective contributions to a §457 plan do not reduce elective contributions allowed to be made to qualified plans or SIMPLE IRAs. A §457 plan is a non-qualified plan, and therefore, has no impact on employee elective deferrals to qualified plan contributions.

Example – variation. Assume the same facts as above except that SMC offers a §457 plan instead of a 401k. Michelle may elect to make employee contributions of $16,000 to her SIMPLE IRA and still contribute an additional $23,000 to SMC's §457 plan.

Employee **SIMPLE contribution limits increased (§414(v)(2)(B); Notice 2024-2).** Beginning in 2024, the maximum employee deferral contributions to SIMPLE IRAs are increased. The amount of the increased deferral is determined based on the number of employees who received compensation of $5,000 or more in the prior year from the employer and whether the contribution is a regular or a catch-up contribution. The add-on contributions are calculated:

1. The elective deferral limit is automatically increased 10% for employers with 25 or fewer employees who received at least $5,000 of compensation in the preceding calendar year. This makes the 2024 maximum annual employee deferral amount $17,600 ($16,000 x 110%). The 10% increase also applies to catch-up contributions for employees aged 50 or older as of Dec. 31, 2024. The maximum catch-up contribution is $3,850 ($3,500 x 110%). This provision is 100% at the employee's discretion for employers with 25 or fewer qualified employees – employers must allow the new limits for existing SIMPLE IRA plans.

2. For employers with 26 to 100 qualified employees who made at least $5,000 in the preceding calendar year, the increased deferral amounts are elective. For these employers, the increased deferral for employees requires the employer to increase its employer SIMPLE contribution to either a 4% matching contribution or 3% nonelective employer contribution.

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Preparer note. For purposes of determining whether an employer has no more than 25 employees in the preceding year, there is a 2-year grace period. If an employer that has no more than 25 employees increases the number of employees to more than 25, the employer will still be treated as having 25 employees for two years following the last year the employer was an eligible employer (unless the increase in the employer's number of employees was due to an acquisition, disposition, or similar transaction involving the eligible employer).

Example. Sugar Shack has 24 employees in 2023 and 2024. Sugar's employees are automatically allowed to take advantage of the higher deferral limit in 2024. Sugar doesn't have to make any changes for the new limits to apply. Additionally, Sugar will remain an eligible employer in 2025 as the test is how many employees did you have in the prior year (24 in 2024) even though it had 28 employees in 2025.

Sugar Shack grows and has 28, 30 and 32 employees in 2025, 2026 and 2027 respectively. Sugar's employees may continue to use the higher deferral amounts in 2025 because the testing period is 2024. In addition, Sugar may continue to offer higher deferral limits in 2026 and 2027, the two grace period years. Starting in 2028, Sugar's employees may no longer use the increased deferral limit unless Sugar Shack agrees to increase its employer contribution percentage.

3. Catch-up contributions increase ***in 2025*** for taxpayers who've reached age 60, 61, 62 or 63 by December 31st of the tax year. The increase limit is the greater of $5,000 or 150% of the regular catch-up contribution at that time. For example, if this law were in effect for 2024, the additional SIMPLE catch-up contribution for those whose ages are 60-63 would be $5,250 (greater of $5,000 or $3,500 regular catch-up x 150%).

Example. Sean turns age 60 in November 2025. Sean's employer offers a SIMPLE IRA and consistently has fewer than 20 employees. Assuming no inflation adjustment in 2025, Sean's maximum allowable employee deferral would be:

Regular deferral	$16,000
Catch up deferral	$ 3,500
Subtotal	$19,500
Additional applicable dollar amount	x 110%
Total deferral before age 60 add on	$21,450
Age 60 – 63 add on ($3,850 x 150%)	$ 1,925*
Total allowable deferral for 2025	$23,375

*Calculated: $3,500 (catch up) + $350 (10% additional catch up) = $3,850 x 50% = $1,925.

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Other election formalities (Notice 2024-2, Q. E-4). An employer with more than 25 qualified employees must take formal written action to make an election to allow the increased limits and should maintain documentation of the election in the plan's records (there is nothing to file with the IRS). Employers (including employers for whom the increased limits apply automatically) must notify employees of the increased limits. The notice must be included in the annual employer notification that informs employees of the opportunity to enter into a salary reduction agreement or to modify a prior agreement. Employers who are required to make an election must also notify employees of the increased matching contribution or increased nonelective contribution. The employer should also:

1. Notify the SIMPLE IRA plan's or SIMPLE 401(k) plan's financial institution and payroll provider of the increased limits; and
2. Keep records of all actions concerning the increased limits.

The election remains in effect until it is revoked by the employer. The revocation must also be in writing.

SIMPLE IRA employer contributions (§408(p)(2)(A)). Employers must calculate their SIMPLE IRA plan contributions under one of two methods:

1. Employer matching contributions; or
2. Nonelective contributions.

Preparer note. Once an employer adopts a contribution method and notifies employees of the method and rate chosen, the employer cannot suspend or modify its choice midyear. The promised contributions must be made on the employees' behalf until the next calendar year.

Employer contribution options – matching or nonelective. Employers who've adopted a SIMPLE IRA plan are required to contribute to employee accounts. Employers may annually choose between making matching contributions for employees who are contributing or making nonelective contributions for all eligible employees regardless of the employee contributes.

Matching contributions. Employers who elect to match employee contributions are required to contribute on behalf of each eligible employee in an amount equal to the employee's salary reduction contributions, up to a maximum of 3% of the employee's compensation for the calendar year. The employer may elect to reduce the 3% contribution for a calendar year, but only if:

- The match percentage is not reduced below 1%;
- The match percentage is not reduced for more than 2 years out of the 5-year period that ends with (and includes) the year for which the election is effective; and
- Employees are notified of the reduced limit within a reasonable period (usually 30 days before the election period).

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Nonelective contributions. As an alternative to making matching contributions, an employer may make nonelective contributions equal to 2% of each eligible employee's compensation for the entire calendar year. The employer's nonelective contributions must be made for each eligible employee regardless of whether the employee elects to make salary reduction contributions for the calendar year. The employer may, but is not required to, limit nonelective contributions to eligible employees who have at least $5,000 (or some lower amount selected by the employer) of compensation for the year. Employers may substitute the 2% nonelective contribution for the matching contribution for a year only if eligible employees are notified that a 2% nonelective contribution will be made instead of a matching contribution and the notice is provided within a reasonable period (generally 30 days) before the election period.

Planning note. The big difference between the matching and nonelective methods is that under the matching method, if an employee doesn't contribute, or contributes less than 3%, the employer only contributes what the employee contributes. Under the nonelective method, the employer must contribute the full 2% for all eligible employees, even if the employee contributes nothing.

Preparer note. Years for which an employer chooses to make nonelective contributions are treated as a year for which the limit was 3%.

SECURE Act 2.0 allows additional *employer* SIMPLE contributions (§408(p)(2); Act Section 116). For tax years ***beginning in 2024*** employers are allowed to make ***nonelective employer contributions*** of up to 10% of each employee's compensation. These contributions are in addition to the regular SIMPLE employer matching contributions and must be made on a uniform basis. The additional employer contributions cannot exceed $5,000 for any one employee (adjusted for inflation starting in 2025).

Preparer note. Because a SIMPLE is an IRA and not a qualified plan, an employee who has reached RMD age must begin to take required minimum distributions from the account. No deferral is allowed for continuing to work.

SIMPLE IRAs and Roth Components (Secure 2.0, Section 601).

Beginning in 2023, SIMPLE IRAs, for the first time, are allowed to accept employee and employer contributions into a Roth account instead of a tax deferred account. This allows employees to elect to have their elective deferrals contributed to Roth accounts. The change also allows employer contributions to be made to Roth SIMPLE accounts. Rules unique to the Roth SIMPLE accounts include:

- Employers are not required to offer Roth SIMPLE accounts but may elect to do so at their own discretion.

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- If Roth contributions are elected, the employer must satisfy all the employee notification requirements already in the SIMPLE IRA rules.

- The employee must agree to have contributions made to a Roth account. The employer cannot elect to do so unilaterally.

- A salary reduction contribution made to a Roth IRA is includible in the employee's gross income for the taxable year that includes the date on which the employee would otherwise have received the salary reduction contribution as wages.

- Employer matching contributions to a Roth IRA are includible in the employee's income in the taxable year that the employer contribution is made to the Roth account. This rule applies even if the employer contribution is deducted in the prior taxable year of the employer.

Preparer note. The employer reports employee deferral contributions made a Roth account on Form W-2, Wage and Tax Statement, in Box 12 with a Code S (for a SIMPLE IRA), and includes the amount in Boxes 1, 3, and 5. The employer report the employer contribution on Form 1099-R, Distributions From Pensions, etc. in the same manner as the reporting that would have applied if: 1) there were no after-tax contributions made to any of the employee's IRAs, and 2) the matching or nonelective contributions were made to an IRA that was not a Roth IRA and then immediately converted to a Roth IRA. Thus, the contributions must be reported using Form 1099-R, for the year in which the contributions are made to the employee's Roth IRA, with the total reported in boxes 1 and 2a of Form 1099-R, using code 2 or 7 in box 7, and the IRA/SEP/SIMPLE checkbox in box 7 checked.

- Only the employee elective deferral contributions are subject to FICA and FUTA. Any employer contributions are exempt from payroll taxes.

See Notice 2024-2, section K for additional information.

SIMPLE IRA distributions - severe distribution TRAP – BEWARE (§72(t)(6))! Generally, the same tax results apply to distributions from a SIMPLE IRA as to distributions from a regular IRA, including the penalties for early withdrawal and the related penalty exceptions. However, a special rule applies to distributions received from a SIMPLE IRA during the 2-year period beginning the date on which contributions made by the individual's employer are deposited in the individual's SIMPLE IRA (the “2-year period”). Under this special rule, if the distribution is subject to an early distribution penalty (§72(t)), and it is a distribution within this 2-year period, the penalty is increased from 10% to 25%. If one of the §72(t) exceptions apply (e.g., for amounts paid after age 59½, after death, or as part of a series of substantially equal payments), the exception also applies to distributions within the 2-year period and the 25% - no additional tax applies.

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Rollovers can also create problems. Rollovers from one SIMPLE IRA to another are generally allowed at any time. However, rollovers from a SIMPLE IRA to another type of IRA or qualified plan during the 2-year period described above are treated as a distribution from the SIMPLE IRA subject to tax and the 25% penalty. After the expiration of the 2-year period, an amount in a SIMPLE IRA can be transferred in a tax-free trustee-to-trustee transfer to an IRA or qualified plan that is not a SIMPLE IRA.

SIMPLE and 401(k) plans allowed in same calendar year starting in 2024 (§408(p)(11); Secure Act §332). Historically the SIMPLE rules prevented employers from having any other pension plan in the same year as the employer has a SIMPLE in place. Additionally, employers were required to maintain SIMPLE contributions promised to employees prior to the start of the year. Beginning in 2024, employers who start the year with a SIMPLE IRA plan may elect at any time to terminate the SIMPLE if the employer replaces the plan with a safe harbor 401(k). Employee deferral contributions must be prorated for the portion of the year that each plan was in place.

See Notice 2024-2, Section G for rollovers from a SIMPLE to a §401(k) or a §403(b) plan info.

For additional SIMPLE information:

- IRS SIMPLE webpage
- SIMPLE Checklist – IRS Pub 4285
- SIMPLE FAQs
- Form 5304-SIMPLE
- Form 5305-SIMPLE
- SIMPLE Fix It Guide

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Qualified Retirement Plans

2024 Retirement Plans Limits (Notice 2023-75)		
Plan Type	**2024**	**2025**
Maximum Defined Contribution Plan Contribution; §415(c)(1)(A)	$ 69,000	
SEP IRA	$ 69,000	
Maximum Annual Benefit for Defined Benefit Plan; §415(b)(1)(A)	$ 275,000	
SIMPLES; §408)(p)(2)(E)	$ 16,000	
Annual Compensation Limit: §401(a)(17); §404(j); §408(k)(3)(C)	$ 345,000	
Employee salary reduction maximums: 401(k); 403(b); 457	$ 23,000[1]	
Employee salary reduction maximums: SIMPLE IRAs	$ 16,000[1]	
Age 50 and over catch-up contribution: 401(k); 403(b); 457 Plans	$ 7,500[1]	
Age 50 and over catch-up contribution: SIMPLE IRAs	$ 3,500[1]	

[1] The amount of salary deferrals that may be contributed to retirement plans is the individual limit each calendar year no matter how many plans the employee is in. This limit must be aggregated for these plan types: 401(k); 403(b); SIMPLE plans (SIMPLE IRA and SIMPLE 401(k) plans); and SARSEP. If you have access to a 457(b) plan, you have a separate limit that includes both employee and employer contributions. If you exceed the limits and the excess isn't returned by April 15th of the next year, you could be subject to double taxation: once in the year you deferred your salary, and again when you receive a distribution.

Catch up contributions allowed after other deferral contributions maxed out. Additional contributions may be made by an individual who has attained age 50 before the end of the plan year and with respect to whom no other elective deferrals may otherwise be made to the plan for the year because of the application of any limitation of the IRC (e.g., the annual limit on elective deferrals) or of the plan.

Example. Angie is 52 years old and wishes to maximize her 2024 contribution to her 401(k). Angie is allowed to defer $23,000 from her wages and her employer contributes $46,000 to her account, giving her total contributions for the year of $69,000, the maximum allowable. However, because Angie is over age 49, she may also make an additional catch-up deferral of $7,500, making her 2024 total amount contributed to her 401(k) $76,500. The $69,000 annual maximum doesn't apply to Angie as she is entitled to defer the extra $7,500 for reaching age 50 and above.

Secure Act 2.0 provides for additional catch-up contributions (Act §109). Catch-up contributions increase ***in 2025*** for taxpayers who've reached age 60, 61, 62 or 63 by December 31st. The increase is the greater of $10,000 or 150% of the regular catch-up contribution at that time. For example, if this law were in effect for 2024, the additional 401k catch-up contribution for those whose ages were 60-63 would be $11,250 (greater of $10,000 or $7,500 regular catch-up x 150%).

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Example. Sean turns age 60 in November 2025. Sean's employer offers a 401k that Sean wants to maximize. He's come to you for elective deferral advice for 2025. Assuming no inflation adjustments, Sean's maximum allowable 2025 employee deferral would be:

Regular deferral	$23,000
Catch up deferral	$ 7,500
Subtotal	$30,500
Additional applicable dollar amount	x 110%
Total deferral before age 60 add on	$33,550
Age 60 – 63 add on ($8,250 x 150%)	$ 4,125*
Total allowable deferral for 2025	$37,675

*Calculated: $7,500 (age 50 catch up) + $750 (10% additional catch up) = $8,250 x 50% = $4,125.

401(k) Plans

Overview. The most common and popular retirement plan offered by businesses today is the 401(k) profit sharing plan. In the author's opinion, once a business becomes significantly profitable and it appears those profits will be sustained for a period of time, a 401(k) plan provides an excellent retirement plan option to lower the tax bill, save for retirement, and give employees the opportunity to save substantial retirement money for themselves. All this can be accomplished at a relatively low cost to the employer.

Secure Act 2.0 Introduces the "Starter 401k Plan" in 2024 (§401(k)(16); Act §121). The Secure Act 2.0 introduced a new type of 401k plan – the Starter 401k. Employers who don't sponsor any other retirement plan may offer a starter 401(k) plan (or safe harbor 403(b) plan). A starter 401(k) plan generally requires that all employees be auto enrolled at a deferral rate of a 3% to 15% of compensation. The limit on annual deferrals is the same as the IRA contribution limit plus any age 50 catch-up deferral, if applicable ($6,500 for 2023 plus $1,000). Starter 401k plans may be established for plan years beginning after 2023.

Preparer note. Starter 401k plans are generally required to file Form 5500 unless otherwise exempt. There is no special exemption for starter 401ks from filing the annual form.

Secure Act 2.0 provides limited Top-Heavy relief (Act §310). Prior to Secure Act 2.0, qualified retirement plans had to not only pass the top-heavy test, but also other nondiscrimination tests. These other nondiscrimination tests allowed employers to test otherwise excludable employees (e.g., those who are under age 21 and have less than 1 year of service) separately. The result was employees could defer earlier than the minimum age and service conditions permitted under the law because it reduced the situations where plans would fail the nondiscrimination tests if these employees were included when performing the test. Essentially, employers were able to exclude those

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most likely to create a discrimination problem from testing but still allow the employee to participate. Win – win scenario.

Not so for the top-heavy test. The problem was that this separate testing was not allowed for the top-heavy test. Small business retirement plans often do not cover excludable employees because, if the plan is, or becomes, top heavy, the employer may be required to contribute a top-heavy employer contribution for all employees who are eligible to participate in the plan, even those who could be excluded but were not. Secure Act 2.0 changes the rules starting in 2024 by allowing employers to perform the top-heavy test separately on the non-excludable and excludable employees.

Long term part-time workers must be offered inclusion in §401(k) and §403(b) plans (NPRM REG-104194-23; Secure Act 2.0 §125). Historically employers were able to exclude employees from participating in its 401k/403(b) plan unless the worker performed 1,000 hours of services during the plan year. The SECURE Act changed the rules so that long-term, part-time employees were also eligible to participate in the 401k plan. Starting in 2025, employers are required to allow medium-term, part-time workers to participate unless the employee is covered by a collectively bargained plan. To be eligible, employees must either:

1. Complete 1 year of service of 1,000 hours or more of service; or

2. Be a part-time worker who:
    - In 2023 or 2024 worked for the employer for 3 consecutive years and provided at least 500 hours of service each year; or
    - Beginning in 2025 worked for the employer for 2 consecutive years and provided at least 500 hours of service each year.

Qualified Roth Contribution Programs Allow Employees to Designate Elective Deferrals (§402A; IRS Designated Roth Account FAQs)

What is a qualified Roth contribution program? Employers may offer employees the option to designate some or all their elective contributions to §401(k), §403(b), or §457 qualified plans to a designated Roth account. If the employer chooses, eligible participants may also roll over existing plan balances to the designated Roth portion of their accounts. Any amounts contributed to a designated Roth account are included in gross income in the year of the contribution, but eligible distributions from the account (including earnings) are generally tax-free. Employers wishing to establish designated Roth accounts as part of their qualified retirement plan must:

1. establish a separate designated Roth account for the Roth contributions and the related earnings of each participant;
2. maintain separate records for each account;
3. refrain from allocating to the designated Roth account amounts from non-designated Roth accounts unless such amounts are properly rolled over; and
4. report designated Roth account contributions separately on employee's W-2s.

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Preparer note. Prior to 2023, employee contributions to SIMPLE IRAs could only be made on a pretax basis. Roth contributions were not allowed. SECURE Act 2.0 changed the law to allow employee SIMPLE contributions to be made to Roth accounts beginning in 2023. Like other Roth deferral accounts, employers are not required to offer this option. It is elective at the employer's discretion.

Designated Roth account features. Designated Roth accounts have unique features that are different than Roth IRAs, including:

- There are no AGI limits for contributors; and
- Accounts are no longer subject to RMDs when the owner reaches RMD age.

Secure Act 2.0 mandates Roth deferrals for high income taxpayers (§414(v)(7); Act Sec. 603). Employees whose wages for the preceding calendar year from the employer sponsoring the plan exceed $145,000 may only make catch-up contributions as designated Roth contributions. In other words, the catch-up contributions cannot be made on a pre-tax basis. (as defined in section 402A(c)(1)) made pursuant to an employee election. This provision only applies to qualified plans. It ***does not apply*** to SEPs or SIMPLE plans.

IRS delays implementation of new catch-up rules (Notice 2023-62). This provision was originally set to begin in 2024. However, the IRS has noted multiple areas of confusion about how the law should be implemented. As a result, the IRS delayed the new law effective date until at least 2026 (i.e., plan years beginning after 2025). Unanswered questions include:

- How is the law applied to self-employed persons, if at all?
- May an employer unilaterally change an employee election and switch contributions to a designated Roth account?
- Is an employer required to add a designated Roth component to its pension plan if they have employees subject to catch-up contributions? We shall see.

Employer contributions to pension may be Roth contributions – includes SEPs, SIMPLEs, 401(k)s, 403(b)s and 457 plans (Act Sections 601 and 604). Historically, all plans ***other than SIMPLEs*** were allowed to accept Roth contributions from the employee deferral portion of pension plans. Employer contributions could only be made on a pretax basis – employer contributions were not allowed Roth treatment. Secure Act 2.0 made two changes to these rules:

1. SIMPLE IRAs may now accept employee Roth deferral contributions (began in 2023), and

2. Employer contributions to pension plans are no longer required to be pre-tax only. Beginning in 2023, employer contributions to SEPs, 401(k)s, 403(b)s, and 457 plans may be made on a Roth basis instead tax deferred.

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Preparer note. Employers who make Roth contributions to employee pensions report the amount contributed on Form 1099-R as a distribution and conversion. This makes the employer's contribution taxable to the employee when made and deductible for the employer in the appropriate plan year. No further reporting is required (i.e., nothing reported in wages or on W-2). The 1099R is issued the year the employer makes the contribution to the Roth account, not the year the employer accounts for it. For example, an employer who makes the employer contribution in March 2025 for the 2024 calendar year would issue the employee a 1099-R for 2025. There is no withholding required.

Preparer note. There is no AGI limit to preclude employees from making contributions to pension plans with a deferral component, regardless of if the contribution is a tax deferred or Roth contribution. The same is true for employer contributions. This change to allow employer Roth contributions will, for the first time, give high-income taxpayers the ability to contribute large sums to Roth accounts, far more than they could ever do with a back door Roth. I believe this will be very popular with many taxpayers.

Student loan payments count as employee elective deferrals for matching (§401(m)(4)(A); Notice 2024-63). This provision permits, but does not require, employers to make matching contributions to a 401(k) plan, 403(b) plan, 457(b), or SIMPLE IRA based on an employee's "qualified student loan payments" (QSLPs). Specific rules include:

- A QSLP is a payment made by an employee on an education loan incurred by the employee (employee is legally obligated on the debt) for qualified higher education expenses of the employee, employee's spouse, and employee's dependent(s).
- An employee who co-signs on a qualified loan is considered legally obligated for any payments he or she actually made.
- Employees must certify:
  - the amount of the loan payment;
  - the date of the loan payment;
  - that the payment was made by the employee;
  - that the loan being repaid is a qualified education loan and was used to pay for qualified higher education expenses of the employee, the employee's spouse, or the employee's dependent; and
  - that the loan was incurred by the employee.
- Employers may rely on the employee's certification but may also require substantiation if it deems it necessary.
- Rules are somewhat relaxed for SIMPLE IRAs as not all the rules are applicable.

Notice 2024-63 covers the QSLP rules in depth. The information contained in the Notice is surprisingly complex and beyond the scope here. At the risk of sounding cynical, the author doubts many employers will adopt this provision, at least in the short term.

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Other Secure Act and Secure Act 2.0 Changes to Pensions

- **More access to multiple employer plans (Sec. 106).** Multiple employer plans ("MEPs") provide small employers the ability to band together to obtain more favorable retirement plan investment results and more efficient and less expensive management services. The Secure Act made MEPs more attractive by eliminating outdated barriers to the use of MEPs and improving the quality of MEP service providers. Secure Act 2.0 provides that 403(b) plans (generally sponsored by charities, educational institutions, and non-profits) to participate in MEPs, including relief from the "one bad apple" rule so that the violations of one employer do not affect the tax treatment of employees of compliant employers. This provision is effective for plan years beginning after December 31, 2022.

- **Small financial incentives to encourage employee participation allowed (Sec. 113; Notice 2024-02).** Historically, employers have been prohibited from offering any immediate financial incentives (e.g., gift cards, etc.) to employees if they sign up for the employer provided pension plan. SECURE Act 2.0 added a provision that allows employers to offer minor financial incentives (value up to $250) to encourage employee plan participation. However, unless the incentive is excludable in the Code, it must be included in the employee's taxable income. Most commonly such exemptions are found in IRC §132.

Example. Gary's Suits gave Jim a $200 gift card when Jim signed up for the company pension plan. The $200 value is includable in Jim's W-2 income because a cash equivalent is not eligible for exclusion.

Amounts cannot be paid from pension plan assets and cannot count as employer matching contributions. This provision became effective beginning in 2023.

- **ESOP stock transfer tax deferral allowed for S corporations (Sec. 114).** Individual owners of non-public C corporation stock are allowed to elect to defer gain recognition for sales of stock to the corporation's ESOP. The seller is required to reinvests the sales proceeds into stock or other securities issued by a U.S. operating corporation (§1042). After the sale, the ESOP must own at least 30 percent of the employer corporation's stock. Beginning in 2028, this gain deferral provision will at least partially apply to sales of employer stock to S corporation ESOPs.

- **Emergency expense distribution to be allowed (Sec. 115).** Taxpayers will be allowed to take an early "emergency" distribution from retirement account to cover unforeseeable or immediate financial needs beginning in 2024. The maximum distribution amount is $1,000 and may only be taken once during the year. If all criteria are met, the distribution will not be subject to the 10% tax that normally applies to early distributions. Ther distribution may be repaid and, if the taxpayer decides not to repay, no additional emergency distributions may be made within 3 years.

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- **Retroactive first year elective deferrals for sole proprietors (Sec. 317)**. The Secure Act allowed employers to establish a new 401(k) plan after the end of the taxable year, but before the employer's tax filing date. The employer was allowed to treat the plan as having been established on the last day of the taxable year then fund with employer contributions up to the employer's tax filing date. Secure Act 2.0 clarifies that plans established by sole proprietors or single member LLCs after the end of the tax year may receive both employee and employer contributions up to the date of the employee's tax return filing date for the initial year.

- **Lost 401-k accounts (Sec. 303)**. A national database is to be created that will assist beneficiaries to find retirement benefits (e.g., former employer no longer in business, etc.). The retirement savings "lost and found" will be housed at the Department of Labor and be created by the end of 2024.

Other Qualified Plan Developments and Issues

Loans from Qualified Retirement Plans Subject to Amount and Time Limitations §72(p)

The law: Generally, loans from qualified employer plans are treated as distributions from the plan (§72(p)(1)(A)). Distributions from a qualified employer plan are taxable to the distributee in the distributee's taxable year in which the distribution occurs, pursuant to §72 (see §402(a); Prince v. Comm., TCM 1997-324). However, a loan will **not** give rise to a deemed distribution to the extent that the loan (when added to the outstanding balance of all other loans from the plan) does not exceed the lesser of:

1. $50,000 (reduced by the excess, if any, of the highest outstanding balance of loans from the plan during the 1-year period ending on the day before the date on which the loan was made, over the outstanding balance of loans from the plan on the date on which the loan was made); or

2. The greater of one-half of the present value of the participant's "nonforfeitable accrued benefit" under the plan *or* $10,000 (§72(p)(2)(A)).

But the above exception does not apply unless:

1. The loan, by its terms, is required to be repaid within five years (§72(p)(2)(B)); and

2. "Substantially level amortization of such loan (with payments not less frequently than quarterly) is required over the term of the loan" (§72(p)(2)(C)). One exception to the 5-year repayment requirement is when the loan proceeds are used to "acquire any dwelling unit * * * within a reasonable time * * * as the principal residence of the participant" (§72(p)(2)(B)(ii)).

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Refinancing of qualified plan loans may be trouble, trouble, trouble. In the event a loan that satisfies §72(p)(2) is replaced by a loan that has a ***later repayment date***, both loans are treated as outstanding on the date of the transaction (§1.72(p)-1, Q-20, A-20(a)(2)). If the ***sum of both*** loans, as well as all other outstanding loans, ***exceeds the limit*** of §72(p)(2)(A), then the replacement loan results in a deemed distribution in the amount that is above that limit.

Extensive Retirement Plan Resources on IRS Website (Small Business Retirement Plan Resources)

Helping Taxpayers Choose, Maintain and Operate a Plan

- Help with Choosing a Retirement Plan provides resources to help compare retirement plan options.
- Benefits to Starting a Retirement Plan helps find the right retirement plan for retirement security.
- A Plan Sponsor's Responsibilities to learn how to keep retirement plans running smoothly.
- Types of Plans to see what the rules are for SIMPLE IRA, SEP, 401(k) and other plans.
- Pension related videos - Over 30 topics
- IRS Tax Forum Presentations - retirement plan choices and rules

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Payroll and Payroll Related Tax

Employee Retention Credit (ERC) (§3134)

It's all over but the enforcement (IR-2024-78). From Sept. 14, 2023, through June 20, 2024, the IRS halted all processing of new ERC claims to give itself time to more closely review and scrutinize claims already in process. The IRS review involved months of digitizing information and analyzing data on more than one million ERC claims that totaled more than $86 billion. The IRS is using the information gathered during this review to deny improper ERC claims. When the review was completed, the IRS also began issuing payments to taxpayers with legitimate ERC claims. IRS Commissioner Danny Werfel said, "This is one of the most complex credits the IRS has administered, and we continue to ask taxpayers for patience as we unravel this complex process."

What did the IRS review reveal? During the review process, the IRS stratified ERC claims into three groups:

1. **High risk group** – Approximately 15% of ERC claims were determined to be the highest-risk group. This group's ERC documents showed clear signs of being erroneous. The IRS denied, or are in the process of denying, tens of thousands of such claims.

2. **Unacceptable risk group** – The IRS analysis concluded approximately 65% of the ERC claims showed an unacceptable level of risk. For these claims, the IRS is conducting additional analysis to gather more information – essentially, they are auditing these claims before issuing any refunds.

3. **Legitimate or low risk group** – The IRS determined the remaining ERC claims were from businesses with legitimate or low risk claims. The IRS promised to process these claims as quickly as possible, and the first payments began to go out in late summer. The IRS emphasized all future ERC payments will go out at a dramatically slower pace than payments that went out during the pandemic, and each payment will be subject to increased scrutiny.

The IRS also noted that generally the oldest claims will be worked first, and ***no claims submitted during the moratorium period*** will be processed at this time (as of August 2024).

What else did the IRS find out? The IRS claimed its ERC initiatives uncovered erroneous ERC claims of more than $1 billion and its Criminal Investigation Division (CID) initiated more than 386 criminal cases, with claims totaling almost $3 billion. Specifically:

1. More than 2,600 ERC recipients applied to the special ERC Voluntary Disclosure Program (VDP), which yielded more than $225 million erroneous ERC claims. The VDP program was suspended and was not available to those who applied after March 22, 2024 (see additional VDP info below).

2. The ongoing claim withdrawal process for those with unprocessed ERC claims led to 1,800 entities withdrawing $251 million of ERC claims. This program is available until a pending claim is processed. ***There is no expiration date.***

3. The IRS determined more than 12,000 entities filed over 22,000 improper ERC claims which resulted in $572 million in assessments. Additional audits are ongoing.

IRS Voluntary Disclosure Program (VDP) reinstated (Announcement 2024-30). The original VDP program was offered to coax taxpayers who'd incorrectly received ERC money to avoid civil and other penalties by agreeing to pay back 80% of any ERC received. This program was only in effect through March 22. Subsequently, the IRS reopened the VDP program for disclosures filed no later than November 22, 2024. To qualify, a taxpayer may only include ERC claims for 2021 for which an ERC credit or refund was received prior to Aug. 15, 2024, and:

1. Participant is not under an ERC related criminal investigation or been notified such as an investigation is pending;
2. The IRS has not received third party info alerting IRS that taxpayer is noncompliant for ERC purposes;
3. Taxpayer is not subject to an employment tax audit for any period for which ERC is claimed;
4. The IRS has not notified the taxpayer that any ERC received is subject to recapture; and
5. Taxpayer has not received any ERC repayment notice or demand.

Terms of second ERC VDP. The terms of the second round of ERC VDP are:

1. The taxpayer is not eligible for any ERC, refundable and non-refundable portions, for the periods at issue;
2. Taxpayer agrees to repay 85% of any ERC received (was 80% in the first round of VDP);
3. Taxpayers are not required to repay any interest included in any ERC payment, unless the taxpayer pays back the ERC in installments. If ERC paid back in installment, interest will be assessed as of the VDP agreement date;
4. Taxpayers who agree to pay back the ERC are not required to reduce wage expense by the claimed ERC. Amended returns or AARs are not required. Additionally, the VDP participating taxpayer does not have any taxable income regardless of only remitting 85% of the claimed ERC. The amount of the ERC not paid back is not taxable income.
5. The taxpayer must disclose the name, address, and phone number of any preparer or advisor who assisted or advised with any portion of the ERC claim. A description of the services provided must also be included.
6. The IRS will not assert civil penalties related to the underpayment of employment tax attributable to the claimed ERC against a participant of the VDP.

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The application to file for the VDP is completed using IRS Form 15434.

Preparer note. The IRS issued a series of frequently asked questions on its website to provide information about the second ERC-VDP (e.g. who can apply, how to apply, etc.). do so.

IRS shares warning signs of incorrect ERC claims (IR-2024-198). The IRS listed five new warning signs that an incorrect ERC claim has been filed. The new warning signs are:

1. Essential business claiming ERC without the required decline in gross receipts (i.e., using the government order test to claim ERC).
2. Businesses that are unable to support that a government order was in place, and if so, how it partially or fully suspended operations.
3. Businesses used family member wages to create ERC.
4. Businesses used wages to calculate ERC that were also used to avoid PPP loan payback.
5. Large employers (those with more than 100 full-time employees for 2020 and 500 full-time employees for 2021) who claim ERC for wages paid to working employees. Qualifying wages for large employers only included wages paid to employees who were not required to work.

IRS provides webpage guidance for those who receive Letter 105-C – Disallowance of ERC. Letter 105-C is used by the IRS to provide legal notice to taxpayers who've had their ERC claim disallowed or denied. The letter includes:

- Reason for the IRS decision.
- Date of the decision.
- Tax year or period for which the claim is denied.
- Appeal rights.
- Timeframe in which a lawsuit must be filed for taxpayers wishing to challenge the IRS denial in court.

Taxpayers who receive Letter 105-C are not eligible for:

- The second ERC Voluntary Disclosure Program.
- The claim withdrawal program.

The webpage also describes the process followed and the info required for taxpayers wishing to refute the IRS ERC claim denial.

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IRS says Third Party Payers(TPPs) are liable for ERC overpayments (AM 2024-001). A TPP (i.e. §3504 agent, PEO, or CPEO) is liable for any underpayment resulting from an improperly claimed employment tax credit that the TPP claimed for the client on the TPP's employment tax return filed under the TPP's EIN, where the credit was claimed based on wages paid by the TPP to the client's employees. This rule applies to the ERC as it would any other employment tax credit.

IRS Opens Process for Payroll Companies, Third Party Payers (TPPs) to Resolve ERC Claims (IR-2024-246)

The IRS opened a supplemental claim process to help third-party payers (TPPs) and their clients resolve incorrect claims for the ERC. TPPs are those who report and pay clients' Federal employment taxes under the TPP's EIN. If a TPP subsequently determined that an ERC claim was filed for an ineligible taxpayer, the TPP, not the taxpayer, needs to correct the claim. The new IRS supplemental claim process lets a TPP that filed prior claims with multiple clients "withdraw" only some clients while maintaining the claims of the qualifying clients.

Supplemental claims. A supplemental claim is an adjusted employment tax return that allows a TPP to correct and/or consolidate previous unprocessed claims that they filed on or before Jan. 31, 2024. If the claims have not yet been processed, the TPP may file a supplemental claim to ask the IRS to treat the claim(s) as if it/they were never filed. The supplemental claim process is for TPPs to which all the following apply:

- The TPP filed one or more claims aggregating ERC for itself and/or clients using the TPP's Employer Identification Number.

- The TPP made the claim on an adjusted employment tax return (Forms 941-X, 943-X, 944-X or CT-1X). And,

- The IRS has not processed any of the claims the TPP is including in the supplemental claim.

This process is not for:

- Common law employers who did not use a TPP and instead filed adjusted employment tax returns using their own EIN. These employers may be eligible for either the claim withdrawal process if their claim is pending, or for the IRS's second Voluntary Disclosure Program if they received the ERC either as a refund or a credit against tax owed.

- TPPs that received the full amount of ERC claimed on behalf of themselves and their clients – either as a refund or a credit against tax owed. They may be eligible for the IRS's second Voluntary Disclosure Program.

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Submitting supplemental claims related to ERC. A TPP must prepare one supplemental claim for each tax period filed on or before Jan. 31, 2024. Each claim must include the correct amount of ERC and any other corrections for that tax period. The TPP should use the adjusted employment tax return for their type of business – Form 941-X, Form 943-X, Form 944-X or Form CT1-X – to prepare the supplemental claim. The TPP should not include ERC amounts that were filed after Jan. 31, 2024. The amount of ERC on the supplemental claim must be equal to or less than the cumulative amount of ERC claimed on the returns the TPP is replacing by filing the supplement claim.

Due date. TPPs may submit a supplemental claim using a computer or mobile device to fax the documents by 11:59 p.m., Nov. 22, 2024.

Additional resources - see Filing a supplemental claim for the Employee Retention Credit and Supplemental claim frequently asked questions for third-party payers.

ERC Statute of Limitations (SOL)

Given how the ERC laws were enacted and how they changed over time, it should not come as any surprise that the statute of limitation laws that apply to ERC are varied and confusing. The following is a summary of the SOL rules for ERC claims.

- **3-year rule – general statute of limitations (§6501).** For most tax returns, including payroll tax returns, the general SOLs for tax assessment is three years from the date the return is filed, regardless of the return due date. For payroll tax assessments there is an exception that says any Form 941 filed by April 15th of the year after the payroll was paid, the SOL begins April 15th of the following calendar year. For example, the SOL for the four 2020 Forms 941 would generally expire on April 15, 2024. Similarly, SOL the four 2021 Forms 941 would generally expire on April 15, 2025 (§6501(b)(2) and IRC Section 6513(c)).

- **ERC special 5-year statute of limitations.** A lot has been made of the extended assessment period provided for ERC-related issues. However, this special ERC provision ***only*** applies to the third quarter of 2021. ERC was enacted through multiple tax bills, each treating ERC in a different way and each setting different ERC expiration dates. As a result, after considering all the pertinent laws, the only quarter that ended up with the 5-year assessment period is quarter 3 of 2021. This means that Q3 2021 ERC claims will stay open for assessment through April 15, 2027, while the SOL for all other quarters in 2021 will expire on April 15, 2025.

- **Treasury proposes expansion of 5-year SOL for all ERC claims.** The Treasury Department's 2024 General Explanations of the Administration's Fiscal Year 2024 Revenue Proposals (aka "Greenbook") proposes to apply the 5-year statute of limitations to all quarters the ERC was available. We will keep an eye on this one and alert you if it happens.

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- **Don't forget erroneous action civil claims (§7405(b); §6532(b)).** When considering the statute of limitations, an often-overlooked provision is the IRS's right to sue a taxpayer for a refund for up to two years (5 years in the case of fraud or material misrepresentation) after issuing an erroneous refund under any provision of the tax code. To qualify to file suit, the IRS must prove:

  - A refund was made to a taxpayer;
  - The refund was erroneously issued; and
  - The lawsuit to recover the erroneously issued refund was timely filed.

This law effectively extends the IRS's right to audit the ERC claim and collect any erroneously granted ERC refunds up to 2 years after the check was sent to the taxpayer.

Example. Golding Inc. filed an ERC refund claim for the 3rd quarter of 2021 on April 1, 2025. The IRS sent Golding an ERC refund check of $350,000 in January 2026. The IRS may file a civil lawsuit to have the $350,000 refunded at any time before January 2028, well after the Q3 2021 form 941 SOL expiration date of April 15, 2027.

Statute of Limitations Summary Table*			
When Applicable	**Taxpayer Refund Claim**	**IRS Assessment Period**	**IRS Sue for Refund**
2020 – all quarters	**April 15, 2024**	**April 15, 2024**	**Two years after refund was issued**
2021 – 1st and 2nd quarters	**April 15, 2025**	**April 15, 2025**	
2021 – 3rd quarter	**April 15, 2025**	**April 15, 2027**	
2021 – 4th quarter	**April 15, 2025**	**April 15, 2025**	
***Assumes all 941s filed by April 15th the following year.**			

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Other Payroll and Related Tax Developments

Social Security Rates and Limits			
Year	**2023**	**2024**	**2025**
Social Security Wage Limit	$160,200	$168,000	
Medicare Wage Limit	None	None	None
Social Security Rate	6.2%	6.2%	6.2%
Medicare Rate	1.45%	1.45%	1.45%
Medicare for earned income over $200k, $250k (MFJ)	2.35%	2.35%	2.35%
Quarter of Coverage	$1,640 ($6,560 for 4 qtrs)	$1,730 ($6,920 for 4 qtrs)	

Early Retirement Social Security Earnings Limit			
Year	**2023**	**2024**	**2025**
Earned income limit age 62 to year before FTA	$21,240	$22,320	
Earned income limit year of FTA	$56,520	$59,520	
Earned income limit after reaching FTA	None	None	None

Social Security Overpayments Due to Excess Earned Income

Social Security recipients who are under their full retirement age (FRA) are subject to the earnings caps listed in the above table. Recipients who hasn't reached FRA and have earned income in excess of those limits must pay some or all of the Social Security benefits back. The amount paid back is equal to:

- For those years prior to reaching full retirement age, $1 for every $2 over of earned income in excess of the limit.
- For those who've reached the year of their FRA, but they haven't reached the month of their FRA, they must pay back $1 for every $3 or earned income in excess of the limit.

Historically, the Social Security Administration (SSA) would simply withhold 100% of a beneficiary's Social Security income until the repayment was completed.

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SSA limits repayments to ease burden on recipients. The SSA began limiting recipient repayments in March 2024 to 10% of their total monthly Social Security benefit or $10, whichever is greater. Prior to this new rule, SSA collected 100% of the recipient's Social Security benefit until the entire overpayment was repaid. There will be limited exceptions to this change, such as when an overpayment resulted from fraud. Beneficiaries who had an overpayment before the new rule took effect may call Social Security (800-772-1213) and ask for the new policy to be implemented on their account.

Smaller payback amounts may be allowed. A beneficiary may request to repay benefits at a rate lower than 10% by contacting the SSA. An SSA representative will consider such a request and, if it allows recovery of the overpayment within 60 months, may approve. If the beneficiary's proposed rate would extend recovery of the overpayment beyond 60 months, the SSA representative will gather income, resource, and expense information from the beneficiary and decide.

Shark Attack Medicare Tax – IRMAA (Income-Related Monthly Adjustment Amount)[1]

IRMAA stands for "Income-Related Monthly Adjustment Amount." IRMAA requires "high-income" taxpayers to pay Medicare Part B and D premiums more than the base premiums paid by most taxpayers. Roughly 6.8 million Medicare participants (10.2% of the total) were subject to IRMAA in 2023. The amount of the IRMAA tax is based on a taxpayer's modified AGI (AGI per tax return plus tax-exempt interest) from the most recent tax information the IRS can provide, which is generally two years prior to when the premiums are paid. For example, 2025 IRMAA premium adjustments are normally calculated based on a taxpayer's 2023 tax return AGI. Those subject to IRMAA will receive a letter from the Social Security Administration notifying them they are subject to IRMAA and how much the adjustment will be. These letters are normally sent to taxpayers in the year prior to the year the adjustment takes effect.

IRMA Amounts are subject to annual inflation adjustments. The chart below shows the base Medicare Part B and D premiums, as well as the 2024 IRMAA adjustments.

	2024 Premiums (based on 2022 MAGI)	
2022 Modified Adjusted Gross Income	**Part B**	**Part D**
≤$103,000; ≤$206,000 MFJ	$174.70	None*
>$103,000, ≤$129,000; >$206,000, ≤$258,000 MFJ	$244.60	$12.90
>$129,000, ≤$161,000; >$258,000, ≤$322,000 MFJ	$349.40	$33.30
>$161,000, ≤$193,000; >$322,000, ≤$386,000 MFJ	$454.20	$53.80
>$193,000, <$500,000; >$386,000, <$750,000 MFJ	$559.20	$74.20
≥$500,000; ≥$750,000 MFJ	$594.00	$81.00
*The Part D surcharge is in addition to whatever premiums are paid to the private insurance company.		

[1] Per SSA Program Operations Manual, Section HI 01101.010.

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IRMAA exception – the "Life Changing Event." The IRMAA calculation is normally very objective – if MAGI exceeds the relevant threshold, the taxpayer pays IRMA. However, if a taxpayer had a "life-changing event" (LCE) that reduced household income in a subsequent year, they may request the Social Security Administration to reconsider the IRMAA adjustment. Life-changing events may include events such as marriage, divorce, the death of a spouse, loss of income, retirement, an employer settlement payment, etc. The taxpayer must file Form SSA-44 directly with the Social Security Administration to appeal an IRMAA determination.

Preparer note. Large capital gains are specifically excluded from the list of LCEs.

Preparer note. Taxpayers who've filed an amended return on which income was reduced may contact the SSA directly to ask for an adjustment to IRMAA. This is done by calling 800.772.1213 and explaining the reason for the amendment and the income impact.

Planning note. IRMAA is often overlooked in the tax planning process and, I can tell you from personal experience, taxpayers are not happy to find out two years later they owe additional tax. Our systems and procedures must be updated to ensure IRMAA is addressed in any tax planning engagement. Just my two cents!

Self-Employed Health Insurance Deduction (§162(l))

Medical, dental, vision and LTC Insurance premiums paid to cover the taxpayer, spouse, dependents, and for a child under age 27 who is no longer a dependent may qualify as deductible self-employed health insurance premiums. The deduction is limited to the lesser of premiums paid or net profit from the business after deducting half of the SE tax and any SIMPLE, SEP or qualified plan contribution based on the business's income. To qualify, the taxpayer must have self-employment income from:

- The taxpayer was self-employed and had a net profit (including self-employment income from a partnership). To meet the net profit test, multiple self-employment activities cannot be combined; or
- The taxpayer used an optional self-employment method to calculate SE income on Schedule SE; or
- The taxpayer received wages from an S corporation in which he/she owned more than 2% of the stock, and the S corporation reflected the premiums in Box 1 of Form W-2. This includes those who are deemed to be 2% shareholders by attribution.

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Establishing the SE health insurance under the business (Form 7206 Instructions). The SE insurance plan must be established, or considered to be established under the relevant business:

1. For Schedule C or Schedule F filers, the policy may be either in the name of the business or in the name of the individual.

2. For partners, the policy may be either in the name of the partnership or in the name of the partner. Premiums may be paid by the partner or the partnership. Premiums paid by the partnership must be reported on Schedule K-1 as guaranteed payments to be included in the partner's gross income. If the policy is in a partner's name and the partner pays the premiums, the partnership must reimburse the partner and report the premium amounts on Schedule K-1. Otherwise, the insurance plan is not considered to be established under the partnership business.

3. For 2% shareholders, a policy may be either in the name of the S corporation or in the name of the shareholder and premiums may be paid by the shareholder or the S corporation. If the shareholder pays the premiums, the S corporation must reimburse the shareholder. Amounts the S corporation pays or reimburses must be reported as Wages on Form 1120-S and included in box 1 of Form W-2 of the respective shareholder. Otherwise, the insurance plan won't be established under the business.

Preparer note. Premiums paid for another employer's group health insurance cannot be a health insurance plan established under the taxpayer's business. No SE health insurance deduction is allowed for such premium payments (e.g. COBRA payments).

Medicare qualifies as SE health insurance (Form 7206 Instructions; CCA Memo 20128037). Medicare B and D premiums qualify for the self-employed health insurance deduction, including premiums paid for the self-employed person's spouse. To qualify:

- Sole proprietors simply deduct the premiums paid to Medicare.

- Partners/members may deduct Medicare only if the partnership reimbursed the partner/member for Medicare premiums and included the reimbursement as a guaranteed payment.

- S corporation shareholders must be reimbursed by the S corporation for the Medicare premiums. The S corporation reports the premium reimbursements on the shareholder's W-2.

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SE health insurance traps. Taxpayers and tax professionals alike often overlook two important rules when claiming the self-employed health insurance deduction:

1. No premiums qualify in any month or part of the month where the taxpayer was **eligible** to participate in a **subsidized** health plan maintained by the taxpayer or taxpayer's spouse's employer.

2. Premiums paid by a retired public safety officer that are excluded from gross income, up to $3,000.

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Self-employed health insurance reporting (Form 7206). The IRS quietly introduced Form 7206 to determine the self-employed health insurance deduction beginning in 2023. The form replaces a worksheet in Pub. 535 and is now required to calculate the SE health insurance deduction. See the new form below.

Form **7206** | **Self-Employed Health Insurance Deduction** | OMB No. 1545-0074

Department of the Treasury
Internal Revenue Service

Attach to Form 1040, 1040-SR, or 1040-NR.
Go to *www.irs.gov/Form7206* for instructions and the latest information.

2023
Attachment Sequence No. **206**

Name(s) shown on return	**Your taxpayer identification number**

Note: Use a separate Form 7206 for each trade or business under which an insurance plan is established.

1	Enter the total amount paid in 2023 for health insurance coverage established under your business (or the S corporation in which you were a more-than-2% shareholder) for 2023 for you, your spouse, and your dependents. But **don't** include the following. See instructions . . . . • Amounts for any month you were eligible to participate in a health plan subsidized by your employer or your spouse's employer or the employer of either your dependent or your child who was under the age of 27 at the end of 2023. • Any amounts paid, not to exceed $3,000, from retirement plan distributions that were **nontaxable** because you are a retired public safety officer. See instructions. • Any payments for qualified long-term care insurance (see line 2).	**1**	
2	For coverage under a qualified long-term care insurance contract, enter for each person covered the **smaller** of (a) or (b). **(a)** Total payments made for that person during the year. **(b)** The amount shown below. Use the person's age at the end of the tax year. $480— if that person is age 40 or younger $890— if age 41 to 50 $1,790— if age 51 to 60 $4,770— if age 61 to 70 $5,960— if age 71 or older **Note:** The amount of long-term care premiums that can be included as a medical expense is limited by the person's age. **Don't** include payments for any month you were eligible to participate in a long-term care insurance plan subsidized by your employer or your spouse's employer, or the employer of either your dependent or your child who was under the age of 27 at the end of 2023. If more than one person is covered, figure separately the amount to enter for each person. Then enter the total of those amounts	**2**	
3	Add lines 1 and 2	**3**	
4	Enter your net profit* and any other earned income** from the trade or business under which the insurance plan is established. Don't include Conservation Reserve Program payments exempt from self-employment tax. If the business is an S corporation, skip to line 11	**4**	
5	Enter the total of all net profits* from Schedule C (Form 1040), line 31; Schedule F (Form 1040), line 34; or Schedule K-1 (Form 1065), box 14, code A, plus any other income allocable to the profitable businesses. Don't include Conservation Reserve Program payments exempt from self-employment tax. See the Instructions for Schedule SE (Form 1040). **Don't** include any net losses shown on these schedules	**5**	
6	Divide line 4 by line 5	**6**	
7	Multiply Schedule 1 (Form 1040), line 15, deductible part of self-employment tax, by the percentage on line 6	**7**	
8	Subtract line 7 from line 4	**8**	
9	Enter the amount, if any, from Schedule 1 (Form 1040), line 16, self-employed SEP, SIMPLE, and qualified plans, attributable to the same trade or business in which the insurance plan is established	**9**	
10	Subtract line 9 from line 8	**10**	
11	Enter your Medicare wages (box 5 of Form W-2) from an S corporation in which you are a more-than-2% shareholder and in which the insurance plan is established	**11**	
12	Enter any amount from Form 2555, line 45, attributable to the amount entered on line 4 or 11 above	**12**	
13	Subtract line 12 from line 10 or 11, whichever applies	**13**	
14	**Self-employed health insurance deduction.** Enter the **smaller** of line 3 or line 13 here and on Schedule 1 (Form 1040), line 17. **Don't** include this amount when figuring any medical expense deduction on Schedule A (Form 1040)	**14**	

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Form 1099-K Reporting (§6050W; Form 1099-K).

Overview. A payment settlement entity (PSE) is required to file Form 1099-K for payments made in settlement of reportable payment transactions for each calendar year. A PSE makes a payment in settlement of a reportable payment transaction, that is, any payment card or third-party network transaction. This includes payments received via apps, online merchants, and other third-party online processers (credit card processers). The 1099-K covers transactions through organizations such as E-Bay, Etsy, Craigs List, and anywhere else you may receive online payments via credit card.

1099-K reporting threshold changes – Yes, again! (Notice 2023-74; Notice 2023-10). When originally adopted, §6050W set the Form 1099-K annual filing threshold at $20,000 and 200 transactions. The 2021 American Rescue Plan reduced the filing threshold to $600, regardless of the number of transactions. The new threshold was set to be effective in 2022, but the IRS postponed its implementation until at least 2023 (Notice 2023-10) and retained the $20,000/200 transaction thresholds. In 2023, the IRS further delayed the new threshold until at least 2024 (Notice 2023-74).

Additional transition relief likely (IRS FS-2023-27). The IRS also noted that it plans to use a filing threshold of $5,000 for tax year 2024 (issued in January 2025) and then transition to the $600 threshold for tax year 2025 (issued in January 2026).

	Tax Year 2023	Tax Year 2024	Post 2024
Threshold	$20,000	$5,000	$600
Minimum # of transactions	More than 200	None	None

Of course, the revised thresholds do not mean a taxpayer won't receive Form 1099-K if not required or if not warranted – it only means Form 1099-K is not required. Third-party settlement organizations could still issue a Form 1099-K.

What to do if personal or other non-taxable income is reported on a 1099-K (IRS 1099-K FAQs; FS-2024-7). The IRS recommends that taxpayers who receive an incorrect Form 1099-K first reach out to the issuer and ask for a corrected 1099. Good luck with that! Assuming that doesn't work, the IRS recommends the income be reported as "Other Income" on Form 1040, Schedule 1, Line 8z, and then reported as an "Other Adjustment" on Line 24z. The description for each entry should be "Form 1099-K received in error."

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SECURE 2.0 Act impacts how businesses complete Forms W-2 (Notice 2024-2; IRS Fact Sheet FS-2024-29)

The Internal Revenue Service listed the new W-2 reporting requirements required because of Secure Act 2.0. The reporting provides information to employees and tax preparers about pension and profit sharing benefits that apply to a specific employee as a result of the new law. The provisions potentially affecting Forms W-2 (including Forms W-2AS, W-2GU and W-2VI) are:

- De minimis financial incentives (Section 113 of the SECURE 2.0 Act),
- Roth Savings Incentive Match Plan for Employees (SIMPLE) and Roth Simplified Employee Pension (SEP) Individual Retirement Arrangements (IRAs) (Section 601 of the SECURE 2.0 Act), and
- Optional treatment of employer nonelective or matching contributions as Roth contributions (Section 604 of the SECURE 2.0 Act).

De minimis financial incentives. These changes allow employers to offer small financial incentives (no more than $250) to employees who choose to participate in these retirement savings arrangements. If an employer offers such an incentive, it's considered part of the employee's taxable income, subject to income tax withholding, unless there's a specific exemption. Amounts received should be reported in Box 1, 3 and 5 of Form W-2.

Roth SIMPLE and Roth SEP IRAs. Employers that maintain SEP or SIMPLE IRA plans may now offer employees the option to designate a Roth IRA as the IRA to which contributions under the plan are made. This designation can be for employee salary reduction contributions and for employer matching contributions.

- Salary reduction contributions to a Roth SEP or Roth SIMPLE IRA are subject to Federal income tax withholding, FICA FUTA taxes. These contributions should be included in boxes 1, 3 and 5 (box 14 for railroad retirement taxes) of Form W-2. They are also reported in box 12 with code F (for a SEP) or code S (for a SIMPLE IRA).
- Employer matching and nonelective contributions to a Roth SEP or Roth SIMPLE IRA are not subject to withholding or any other payroll taxes. These contributions must be reported on Form 1099-R for the year in which the contributions are made to the employee’s Roth IRA. The total amounts are listed in boxes 1 and 2a of Form 1099-R with code 2 or 7 in box 7, and the IRA/SEP/SIMPLE checkbox is checked.

Designated Roth contributions. Unlike regular Roth contributions, designated Roth nonelective and matching contributions must be reported on Form 1099-R for the year in which they're allocated to an individual's account. They’re reported in boxes 1 and 2a of Form 1099-R, and code “G” is used in box 7. See Notice 2024-2, Questions and Answers L-1 through L-11.

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Form W-2 or Form 1099-R Reporting Summary

	Roth IRA under a SEP arrangement or SIMPLE IRA plan	Designated Roth account under an applicable retirement plan
Form W-2 reporting	Include salary reduction contributions in boxes 1, 3, and 5 (or box 14 if railroad retirement taxes apply) of Form W-2. Report them in box 12 using code F (for a SEP) or code S (for a SIMPLE IRA).	Include designated Roth contributions (made in lieu of elective deferrals) in boxes 1, 3, and 5 (or box 14 if railroad retirement taxes apply) of Form W-2. Report them in box 12 using code AA (for a section 401(k) plan), BB (for a section 403(b) plan), or EE (for a governmental section 457(b) plan).
Form 1099-R reporting	Report matching or nonelective contributions in boxes 1 and 2a of Form 1099-R for the year in which the contributions are made to the Roth IRA, using code 2 or 7 in box 7, and the IRA/SEP/SIMPLE checkbox in box 7 checked.	Report designated Roth matching contributions or designated Roth nonelective contributions in boxes 1 and 2a of Form 1099-R for the year in which the contributions are allocated to the individual's account, using code G in box 7.

Employee v. Independent Contractor – IRS v. DOL

Making the determination of whether a worker is an employee or an independent contractor is critical for business owners as misclassifying workers may result in significant penalties. Historically this has been a very confusing area for business owners. Contributing to the confusion is the fact that different Federal agencies may use different criteria to classify workers. For example, the Dept. of Labor (DOL) and the IRS each have their own standards for classifying workers. In 2024, the DOL withdrew its 2021 guidance and released new final regulations in March 2024.

DOL Independent Contractor regulations finalized (RIN 1235-AA43). The DOL rescinded its 2021 proposed two-factor (weighted) test it was using to determine worker status. Instead, the DOL backtracked to its pre-2021 equally weighted multi-factor standards. The DOL conceded the pre-2021 rules more properly aligned with the history of the law and the definitions used by multiple courts, including the Supreme Court, in dozens of court cases over many years.

DOL independent contractor v. employee rules. Under the final regulations, the DOL considers the following factors:

- The opportunity for profit or loss depends on managerial skill.
- Investments made by the worker and potential employer, if any.
- The degree of permanence of the work relationship.
- The nature and degree of control over the worker's duties.
- The extent to which the work performed is an integral part of the potential employee's business.
- The degree of skill and initiative involved in the work.

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IRS independent contractor v. employee rules. The IRS rules use three broad categories, and the related sub-categories, of a worker's tasks to determine if they are an employee or a contractor. These categories are:

- **Behavioral control** – does the business:
  - Dictate how, when, or where the worker works?
  - Tell the worker what tools or equipment to use and does the business provide those tools?
  - Direct the worker who to hire and how to manage employees?
  - Tell the worker where to buy tools, supplies and/or services?
  - Provide training to the worker?

Businesses have the right to direct ***what*** gets done, and, for employees, ***how*** the tasks get done. Independent contractors decide for themselves ***how*** tasks get done as long as they get done.

- **Financial control** – does the business:
  - Make significant investments in their work or is it the worker's responsibility?
  - Reimburse workers for their out-pocket business expenses?
  - Enjoy any profits made from the worker's work or do profits go to the worker?
  - Allow the worker to incur a loss?

Emphasized above is the worker's ability to earn a profit or incur a loss. If neither of those possibilities exist, it is very likely the worker is an employee. It's hard to argue that a worker is independent when they cannot earn a profit or absorb a loss.

- **Relationship dynamics.** If the behavioral and financial control are unclear, the next step is to look at the nature of the relationship between the worker and the business. It should be noted:

- Independent contractors do not receive work benefits (insurance, paid leave, retirement, etc.).
- Any work contracts between the business and the worker should reflect kind of relationship the two intended to have.

DOL FAQs for worker classification #6. 6. Does this final rule affect the analysis for determining worker classification under other laws?

No. The final rule only revises the Department's interpretation under the FLSA**. It has no effect on other laws—federal, state, or local—that use different standards for employee classification.** For example, the IRC and the NLRA have different statutory language and judicial precedent governing the distinction between employees and independent contractors, and those laws are interpreted and enforced by different Federal agencies. Similarly, this rule has no effect on those state wage-and-hour laws which use an "ABC" test, such as California or New Jersey. The FLSA does not preempt any other laws that protect workers, so businesses must comply with all Federal, state, and local

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laws that apply and ensure that they are meeting whichever standard provides workers with the greatest protections.

Last thoughts. You might ask – why are DOL rules in our manual if the IRS uses their own? We put it here to assist in the event you have a client who is assessed worker classification related penalties. In most cases, the only defense with the IRS for worker classification issues is reasonable cause. It seems to the author, if multiple Federal agencies cannot consistently define who is and who is not an employee, it is reasonable we might make classification mistakes as the area is very confusing. And if it's that hard, then we would seem to always have a reasonable cause argument.

State issues. Also note that most states have their own version of rules and tests to determine worker status. We need to make sure we are compliant with any states our workers are working in.

Remote Workers and Related Issues

Background. As long as businesses have had employees there have been tax issues for employees who live in one state and work in another. The most common result is the workers were required to file two tax returns – one for the state where they worked and another for the state where they lived. The situation becomes more complex when a worker works during the year in both states, as some form of allocation is then required – most often based on the number of days worked in each state.

Dawn of the remote worker. Although the COVID pandemic is largely in the rearview mirror, employers and employees are still trying to figure out and navigate the "new normal." Nowhere is this more evident than when it comes to employees and where they work. The US Census Bureau reported between 2019 and 2021, the number of people primarily working from home tripled from 9 million people (5.7% of the total workforce) to 27.6 million people (17.9%). As of July 2024, the US Department of Labor reported that 34.9 million workers (almost 23% of all US workers) were still working remotely. Of those, 17.4 million (11.4%) were working exclusively from home. This trend is even more evident among professional employees, where 41.2% of employees worked remotely at least some of the time. While many were hoping to never talk about "Zooming" again, the terms "zoomed", "zooming" and "zooms" were all added to the Merriam Websters Dictionary and are now part of our everyday vernacular.

> **Preparer note.** According to Flexjobs, an online bulletin board for those seeking remote job opportunities, the top three industries hiring remote workers are: #1) Computer and IT; #2) Accounting and Finance; and #3) Marketing. The number one job listing on their site is for accountants. I know we hate change, but it may be time to adapt or get left behind!

Where do we go from here? Bottom line, the remote worker is here to stay. In fact, for many industries, hiring a largely remote workforce is likely to become the norm rather than the exception. Nowhere is this truer than in our accounting world as our profession seems to be trending more towards remote workers faster than others. The trend began in earnest

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during the COVID pandemic, at which time most states passed laws to ignore remote workers when determining an employer's nexus. However, most, if not all, of these laws sunset in 2021 or 2022. Workers who have employees working in other states may have nexus, and thus income tax filing responsibilities in those states. We need to know the rules for our clients, as well as for ourselves.

Telework and tax issues. As employers and workers embrace teleworking relationships, there are at least three serious tax issues need to be considered:

1. Does the employer have a payroll tax reporting responsibility in a state other than where the employer is located?

2. Where does the employee report income from earnings earned from an employer in another state? The state where the employer is located or the state where the worker is located while performing the services (e.g. worker's home office)?

3. Is income tax nexus created for an employer who has a remote worker physically working in another state?

1. and 2. Which state does the employer report wages to and where is the employee taxed? These two questions are best discussed together as, at a minimum, consistency will be required. As you may suspect, this issue is evolving and may be different for each state. The general rule is income is taxed where you work and where you are a resident – double taxed. For example, a worker who lives in Kentucky and works in Virginia must pay tax on the income in Virginia (where it's earned) and in Kentucky (where the worker lives). To prevent taxpayers from being taxed twice on the same income, states offer a credit for taxes paid to another state. The credit is typically equal to the amount of tax that was paid to the nonresident state up to the amount of tax that is paid on the same income in the resident state.

Example. Master T's is in California, and it employs workers remotely from multiple states. Stacy works in Master T's accounting department from her home in Colorado. Master T reports Stacy's wages as California wages. Stacy files a California nonresident tax return and pays $2,500 of California income tax on the wages. Stacy also reports the wages on her Colorado resident return and pays $1,500 to Colorado for the wages she earned from Master T. Colorado allows Stacy a state tax credit of $1,500 against her Colorado tax to prevent her from being taxed twice on the same income.

Trap. So here is the problem. Stacy's Colorado tax credit on the double taxed wages is limited to the lesser of the tax actually paid to California or the amount of tax Colorado would collect on the wage income. In the above example, the credit is the lesser of $2,500 (tax paid to CA) or $1,500 (tax on the wages in CO). So even though Stacy is in a much lower tax bracket in her resident state (5.75%), she still must pay the higher CA tax rate for the CA wages. Her CO credit does not offset the entire amount of tax paid to CA.

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State reciprocity agreements – is it time? A reciprocity agreement allows residents of one state to request an exemption from tax withholding from another state. These agreements provide that workers from neighboring states will only be taxed in the state where the live, not in the state where the wages are earned. Presumably, this would eliminate the requirement to file tax returns in two or more states. There are currently thirty reciprocity agreements that include sixteen states plus the District of Columbia. Reciprocity agreements are established under one of three methodologies: 1) bilateral agreements; 2) unilateral agreements; and 3) exemptions for commuters. The states with some form of reciprocity agreements are:

Reciprocity Agreements		
You Work In	**You're a Resident Of**	**Form to File**
Arizona	CA, IN, OR, or VA	WEC
DC	Anywhere other than DC	D-4A
Illinois	IA, KY, MI, or WI	IL-W-5-NR
Indiana	KY, MI, OH, PA, or WI	WH-47
Iowa	IL	44-016
Kentucky	IL, IN, MI, OH, VA, WV or WI	42A809
Maryland	DC, PA, VA, or WV	MW507
Michigan	IL, IN, KY, MN, OH, or WI	MI-W4
Minnesota	MI or ND	MWR
Montana	ND	MW-4
New Jersey	PA	NJ-165
North Dakota	MN or MT	NDW-R
Ohio	IN, KY, MI, PA, or WV	IT-4NR
Pennsylvania	IN, MD, NJ, OH, VA, or WV	REV-419
Virginia	DC, KY, MD, PA, or WV	VA-4
West Virginia	KY, MD, OH, PA or VA	WV/IT-104 NR
Wisconsin	IL, IN, KY or MI	W-220

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> **Preparer note.** Reciprocity agreements were on the rise amongst the states through the mid-1990s, but growth has tapered off since. Given the trend of employers to hire more remote workers, it seems high time states consider expanding such agreements to reduce uncertainty and complexity for workers and employers alike. Reciprocity agreements provide a rational and much less complex method to deal with the new normal.

“Convenience of the employer” test – a unique approach. Six states (Connecticut, Delaware, Nebraska, New Jersey, New York, and Pennsylvania) adopted a “convenience of the employer” test. This test says employees are taxed where the employer is located unless an employee is working in another state for the “convenience of the employer”. Employers in these states treat wages paid to employees as wages paid in the employer’s state and the employee must file a tax return in that state to report the wages earned where the employer is located and then rely on his or her own resident state’s tax credit to avoid double taxation (as discussed above).

And then there is everyone else. For employees who are residents of states that do not have reciprocal agreements or who do not subscribe to the “convenience of the employer” test, what do we do? The most important thing to note here is that each state may have its own rules. There isn’t any overall authority in this area. That said, generally a taxpayer is taxed where services are provided. For example, if you physically work in Oregon, and you are a resident Washington, Oregon will tax the Oregon source income, regardless of the taxpayer’s residency. This tax treatment is commonly referred to as the "source rule": Oregon taxes all taxable income from sources in Oregon regardless of the taxpayer's residency. Employee W-2 income are sourced to where the services are performed, not the location of the employer.

What about nonresident remote employees who are never physically in the state? In some cases, remote workers are never physically in the state where their employer is located. They work remotely from another state 100% of the time. How is the source rule applied in such circumstances? If the employee is a nonresident who never sets foot in the employer’s state, the employee’s services are provided in the employee’s resident state, not in the state where the employer is located. There is no income sourced to the employer’s state, so no wages are reported to the state. The employer likely has a reporting responsibility to the state where the employee provides the services.

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Example. Terry lives in Vancouver, Washington and works remotely for all of 2024 for BR CPAs in Sonora, California. Terry has never been to BR CPAs office was only in California for four days in 2024 when she visited San Diego with her grandchildren. The Terry receives from BR CPA for 2024 are not subject to tax in California. She is a nonresident who never worked in California. The wages are subject to tax in Washington, where Terry earned the wages. But, as Washington has no income tax, the wages are state income tax free. BR CPA does not report the wages to California. Of course, all Federal, and if applicable, state payroll tax rules apply.

Example – variation. Instead of Washington, Terry works from her home in Portland, Oregon. In this case, Terry would report the wage income as Oregon source income and pay Oregon personal income tax on the income.

Employment tax returns. Each state has their own specific rules about filing and paying payroll taxes for out of state workers and there are far too many details than can be discussed here. Preparers will need to follow up with the specific states where employees work to ensure they stay in compliance.

Other complicating factors:

- If the employee works in the employer's state at any time during the year, then another complicating factor is how to allocate income between the states. Rules vary widely so extra caution is needed.
- Residency issues can be complex, and the states can be very aggressive about the rules, especially if the residency determination is close or if the taxpayer is sloppy in the application of the rules. This is particularly problematic for employees who live in the employer state and then choose to move to another state and establish residency. They need to truly change resident states.

3. Does the employer create income and payroll tax nexus by hiring workers who work remotely from another state? The short answer, maybe! State tax nexus is the connection between a taxpayer and a state that requires a taxpayer to file income and/or sales returns in the state because of exceeding a "business presence" threshold. Certain business activities, including having a physical presence, having employees, or reaching a certain sales threshold, may establish nexus within a state.

Multi-state Tax Commission (MTC). The Multistate Tax Commission (MTC) is an intergovernmental state tax agency established in 1966 to work on behalf of states and taxpayers to facilitate the equitable and efficient administration of state tax laws that apply to multistate and multinational enterprises. Many states incorporate the views of the Commission into their tax laws. The problem is the states cannot even agree whether to join and fully support the MTC.

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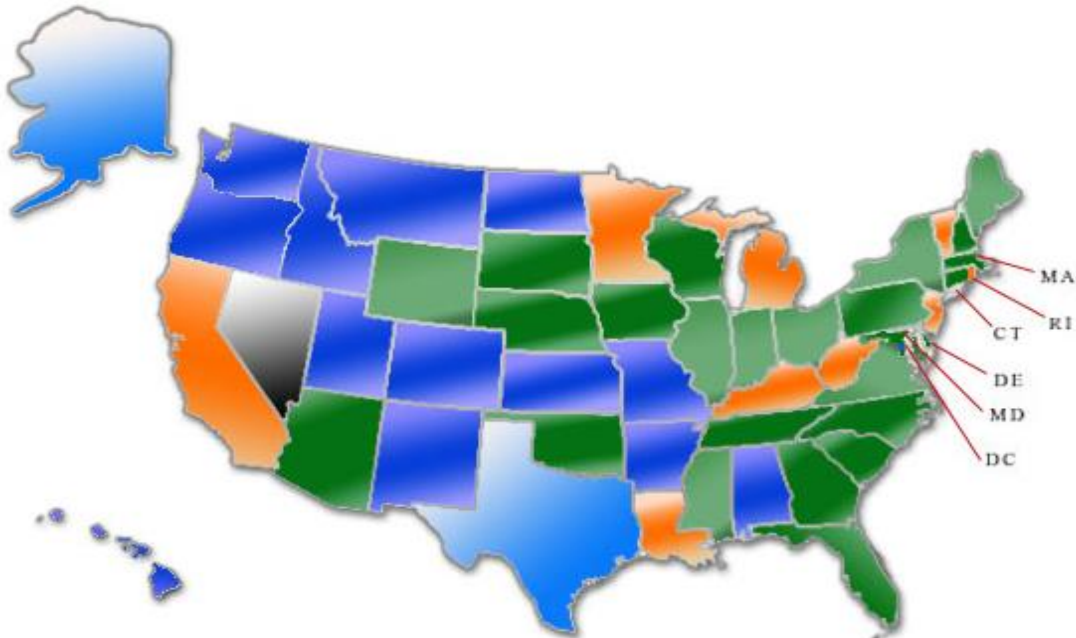

Compact Members	Sovereignty Members	Associate Members
Alabama	California	Arizona
Alaska	Delaware	Connecticut
Arkansas	Kentucky	Florida
Colorado	Louisiana	Georgia
District of Columbia	Michigan	Illinois
Hawaii	Minnesota	Indiana
Idaho	New Jersey	Iowa
Kansas	Rhode Island	Maine
Missouri	Vermont	Maryland
Montana	West Virginia	Massachusetts
New Mexico		Mississippi
North Dakota		Nebraska
Oregon		New Hampshire
Texas		New York
Utah		North Carolina
Washington		Ohio
		Oklahoma
		Pennsylvania
		South Carolina
		South Dakota
		Tennessee
		Virginia
		Wisconsin
		Wyoming

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Compact members are states that have enacted the MTC into their state law.

Sovereignty members are states that support the purposes of the MTC through regular participation and financial support but haven't enacted the MTC into their states' laws.

Associate members are states that participate in Commission meetings and otherwise consult and cooperate with MTC and its member states.

MTC nexus thresholds. The MTC established the physical presence nexus standard for income tax by using various thresholds to determine if a business presence exists for income tax purposes (note there is no "number of transactions" test). The thresholds are:

- $50,000 of property; or
- $50,000 of payroll; or
- $500,000 of sales; or
- 25% of total property, total payroll, or total sales.

If a state determines that a business exceeds any of these thresholds, then it has nexus in that state. The result is the business has an income tax reporting responsibility, and it is likely it would also have a payroll and sales reporting responsibility as well. As all states haven't signed on to the MTC criteria, the table below provides additional guidance:

State By State Remote Worker Nexus Analysis		
State	**Remote Workers Create Nexus?**	**Notes**
Alabama	Yes*	Payroll exceeds $50,000 except during COVID pandemic
Alaska	Yes	Payroll exceeds $50,000. No personal income tax
Arizona	Yes*	
Arkansas	Yes*	Payroll exceeds $50,000
California	Yes*	Payroll exceeds $71,154 except during COVID pandemic
Colorado	Yes, if other factors present	Payroll exceeds $50,000
Connecticut	Yes, if other factors present	In state sales exceed $500,000
Delaware	Yes	Case by case based on questionnaire
Dist. Columbia	Yes*	Payroll exceeds $50,000, except during COVID pandemic
Florida	Yes	No personal income tax
Georgia	Yes	Except during COVID pandemic
Hawaii	Yes	Payroll exceeds $50,000
Idaho	Yes	Payroll exceeds $50,000
Illinois	Yes	
Indiana	Yes	Except during COVID pandemic
Iowa	Yes	Except during COVID pandemic
Kansas	Yes	Payroll exceeds $50,000, except during COVID pandemic

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State By State Remote Worker Nexus Analysis		
State	**Remote Workers Create Nexus?**	**Notes**
Kentucky	Yes*	
Louisiana	Yes	
Maine	Yes*	Except during COVID pandemic
Maryland	Maybe*	Except during COVID pandemic
Massachusetts	Yes	In state sales exceed $500,000
Michigan	Yes*	In state sales exceed $350,000
Minnesota	Yes*	Except during COVID pandemic
Mississippi	Yes	Except during COVID pandemic
Missouri	Yes*	Payroll exceeds $50,000
Montana	Yes	Payroll exceeds $50,000
Nebraska	Yes	
Nevada	NA	No personal income tax
New Hampshire	Yes	No personal income tax
New Jersey	Yes*	Except during COVID pandemic
New Mexico	Yes*	Payroll exceeds $50,000
New York	Yes	In state sales exceed $1,283,000
North Carolina	Yes	
North Dakota	Yes	Payroll exceeds $50,000
Ohio	Yes, for CAT only	Payroll exceeds $50,000
Oklahoma	Yes	
Oregon	Yes*	Payroll exceeds $50,000, except during COVID pandemic
Pennsylvania	Yes*	In state sales exceed $500,000
Rhode Island	Yes	Except during COVID pandemic
South Carolina	Maybe	
South Dakota	NA	No personal income tax
Tennessee	Yes, if other factors present	Payroll exceeds $50,000, no personal income tax
Texas	Yes	Payroll exceeds $50,000. No personal income tax
Utah	Yes*	Payroll exceeds $50,000
Vermont	Yes	
Virginia	Yes, if other factors present	
Washington	NA	Payroll exceeds $50,000. No personal income tax
West Virginia	Maybe*	
Wisconsin	Maybe	
Wyoming	NA	No personal income tax
* For those that say “Yes”, this means this is a yes in the state’s questionnaire used to determine whether nexus exists.		

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Partnerships and LLCs

LLCs and Partnerships in General (§§701-761)

Overview. IRS partnership rules are generally contained in §§701-761 (Subchapter K). The term "partnership" is defined as any organization (including a syndicate, group, pool, joint venture or other unincorporated organization) through which any business, financial operation, or venture is carried on by more than one person, which is not a corporation, trust, or estate (§761(a)).

A partnership is formed when two or more "persons" agree to carry on a joint venture. A written agreement, although preferred, is not required by the IRS. But many states require partnerships to have a written agreement. Partnership agreements should cover initial capital contributions, required services, income and loss allocation terms, life of the partnership and other important items. Such agreements must always be inspected prior to preparing a partnership return. Those "persons" which may be owners in a partnership include individuals, other partnerships, estates, trusts, and all types of corporations (foreign or domestic).

The three types of partnerships that are typically seen in practice are: 1) general partnerships, 2) limited partnerships, and 3) limited liability partnerships. Over the past 30 years the number of these types of partnerships have declined significantly in favor of limited liability companies (LLCs), which provide all the flexibility of a general partnership while providing liability protection to its members.

General partnerships. A general partnership involves two or more owners conducting a business purpose. General partners share equal rights and responsibilities in connection with management of the business, and any individual partner can bind the entire group to a legal obligation. Each individual partner assumes full responsibility for all the partnership's debts and obligations. Although such personal liability is daunting, it comes with a tax advantage: partnership profits are not taxed to the business, but pass through to the partners, who include the gains on their individual tax returns at potentially lower rates and losses are deductible to the extent of basis.

Limited partnerships. A limited partnership classifies each of its partners as general partners or limited partners. Limited partners can restrict his or her personal liability to the amount of his or her business investment. Not every partner can benefit from this limitation -- at least one participant must accept general partnership status. The general partner(s) retains the right to control the day-to-day business, while the limited partner(s) does not participate in management decisions. Both general and limited partners benefit from business profits as a limited partnership is taxed in the same manner as a general partnership.

Limited liability partnerships (LLP). Limited liability partnerships (LLP) retain the tax advantages of the general partnership form but offer some personal liability protection to the participants. Individual partners in a limited liability partnership are not personally responsible for the wrongful acts of other partners, or for the debts or obligations of the business. Because the LLP form changes some of the fundamental aspects of the traditional partnership, some state tax authorities may subject a limited liability partnership

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to non-partnership tax rules. The Internal Revenue Service views these businesses as partnerships, however, and allows partners to use the pass-through technique.

Existing partnerships that wish to take advantage of LLP status do not need to modify their existing partnership agreement, though they may choose to do so. To change status, a partnership simply files an application for registration as a limited liability partnership with the appropriate state agency. Most state laws require an LLP to maintain a minimum amount of liability insurance to cover potential liability.

Limited liability company (LLC). The LLC is a separate legal entity that is not a partnership nor a corporation. LLCs are established under state law with characteristics of both entities. The LLC provides liability protection to its owners while being taxed (by default) as a partnership for Federal tax purposes when there is more than one owner. It therefore retains many of the partnership's characteristics of flow-through income, basis from debt and allowable unequal earnings allocations and distributions and the liability protections available to corporate shareholders.

IRS Small Business/Self Employed Partnership Job Aid (Pub 5800)

Occasionally, the IRS releases information that gives tax professionals insight into where the IRS will go upon an audit of a tax return. For partnership, the IRS recently produced Pub 5800, the Small Business/Self-Employed Partnership Job Aid. This Pub creates a baseline audit level for IRS field agents and guides them through the most common audit issues. Where to begin in a partnership audit, what types of issues to focus on, and why those issues are significant from an adjustment standpoint. The Pub also lists suggested Information Document Request (IDR) items, interview questions for common and recurring tax issues and provides suggested action steps, legal analyses using simple terms, and explanations as to why these steps should be taken.

Pub 5800 specifics. The Pub is divided by topic into seven separate sections and each section begins with suggested IDR items for common and recurring partnership tax issues to send to the taxpayer or taxpayer's representative at the onset of a partnership audit. The seven topic sections are:

1. Partnership agreement, legal status, and description of activity.
2. Tax allocation and substantial economic effect.
3. Partnership liabilities.
4. Partners' limits on claiming losses.
5. Self-employment tax.
6. Disposition of partnership interest and operating/liquidating distributions.
7. Reporting and withholding requirements.

Each section has subsections for:
- Why are we asking?
- What do I need to do to get the information?

Given the relative inexperience of the IRS's current audit staff, it appears this Pub will provide a roadmap for any partnership auditor you may encounter.

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Electing Out of Partnership Tax Treatment (§761(a); NPRM REG-101552-24)

Partnerships engaged in investment activities (i.e., not a trade or business), or those used for the joint extraction, production or use of property may elect out of the Subchapter K provisions (§761(a)). For example, two or more owners of a rental real estate property may elect to report their respective shares of rent income and related expenses on each owner's Form 1040, Schedule E, instead of filing Form 1065. The election must be made by the due date, including extensions, of the Form 1065 for the year the election is to be effective.

Preparer note. Taxpayers who take the position they qualify to elect out of filing Form 1065 under §761(a)(1) (not the active conduct of a trade or business) for rental real estate activities, and then also claim the net rental income qualifies as QBI seem to be contradicting themselves. An experienced IRS auditor could use this argument against the taxpayer – consider filing the 1065!

Preparer note. Be sure to check the state rules as this election may not be available for partnerships legally structured under state law as an LLC or LLP.

Making the election out of partnership treatment (§1.761-2(b)(2)). The election out of being treated as a partnership is made by attaching a statement to a properly executed partnership return, which must contain:

- The name or other identification and the address of the organization (or of the person filing the return).
- Information showing the names, addresses, and identification numbers of all the members of the organization.
- A statement that the organization qualifies to elect out under §761(a).
- A statement that all the members of the organization elect that it be excluded from all of subchapter K.
- A statement indicating where a copy of the partnership operating agreement is located. If the agreement is oral, then identify who may provide the agreement specifics.

The August 15, 2024, draft of Form 1065 includes a new line on Schedule B to make the election.

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Schedule B	Other Information *(continued)*	
b	Under the covered surrogate foreign corporation rules? . . . . If "Yes" to either (a) or (b), complete Form 7208. See the Instructions for Form 7208.	
30	At any time during this tax year, did the partnership (a) receive (as a reward, award, or payment for property or services); or (b) sell, exchange, or otherwise dispose of a digital asset (or financial interest in a digital asset)? See instructions	
31	Reserved for future use	
32	Check this box if an election out of subchapter K under section 761 is being made. See instructions . . .	☐

NOTE

What if the election is not made (1.761-2(b)(ii)? If an organization fails to make the formal election out of 761 as described above, it may still be deemed to have made the election if it can show from all the surrounding facts and circumstances that it was the intention of the members of such organization at the time of its formation to be excluded from subchapter K of the Internal Revenue Code. While this is a facts and circumstance test, the IRS has indicated the following factors indicate the requisite intent:

1. At the time of the formation of the organization there is an agreement among the members that the organization be excluded from subchapter K beginning with the first taxable year of the organization, or

2. The members of the organization owning substantially all of the capital interests report their respective shares of items of income, deductions, and credits of the organization on their respective returns (making elections as to individual items as may be appropriate) in a manner consistent with the exclusion of the organization from subchapter K beginning with the first taxable year of the organization's existence.

Why the proposed regulations? The IRS issued proposed regulations and updated Form 1065 to clarify the rules for opting out of filing Form 1065. The reason is due to the new law allowing qualified entities to treat certain credits as refundable payments to the IRS. This includes credits for qualified partnerships and S corporations. These refundable payments are discussed in detail in the Business Credit Chapter.

IRS Addresses Partnership Basis Shifting Transactions (FS-2024-21, Notice 2024-54, REG-124593-23, Rev. Rul. 2024-14)

Background. The IRS noted during multiple partnership audits repeated instances of abusive basis-shifting taking place in sophisticated maneuvers by related-party partnerships. The IRS noted these transactions employ several steps over a period of years and use sophisticated tax technology to ensure that little or no tax is paid while substantial amounts of tax basis is "stripped" from certain assets and shifted to other

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assets to generate tax benefits. In essence, these strategies allow increased depreciation deductions or reduced gain on the sale of an asset with little or no substantive economic consequence.

IRS specifically focuses on three types of transactions. The transactions most concerning are:

1. **Transfers of partnership interests to related parties** – normally involves a partner with a low "inside" tax basis and a high "outside" tax basis who transfers the partnership interest to a related person or to a person who is related to other partners in the partnership. This related-party transfer generates a tax-free basis increase to the transferee partner's share of "inside" basis.

2. **Distribution of property to a related party** – normally involves a partnership with related partners who distribute high-basis asset(s) to a related partner who has a low outside basis. Subsequently, the distributee partner reduces the basis of the distributed asset(s), and the partnership increases the basis of its remaining assets. The related partners arrange this transaction so that the reduced tax basis of the distributed asset(s) will not adversely impact the related partners, while the basis increase to the partnership's retained assets produces tax savings for the related parties.

3. **Liquidation of related partnership or partner** – normally involves a partnership with related partners that liquidates and distributes: 1) a low-basis asset that is subject to accelerated cost recovery or for which the parties intend to sell to a partner with a high "outside" basis; and 2) a high-basis property that is subject to longer cost recovery (or no cost recovery at all) or for which the parties intend to hold to a partner with a low "outside" basis. Under the partnership liquidation rules, the first related partner increases the basis of the property with a shorter life, or which is held for sale while the second related partner decreases the basis of the long-lived or non-depreciable property, with the result that the related parties generate or accelerate tax benefits.

To combat these issues, the IRS:

1. Issued proposed regulations that identify certain partnership related party basis adjustment transactions and substantially similar transactions as transactions of interest, a type of reportable transaction (REG-124593-23).

2. Intends to publish two new sets of proposed regulations to address basis-shifting transactions involving partnerships and related parties. These transactions, referred to as "covered transactions" here, involve partners in a partnership and their related parties, result in increases to the basis of property under §732, §734(b), or §743(b) of the IRC, and generate increased cost recovery allowances or reduced gains (or increased losses) upon the sale of the basis adjusted property (Notice 2024-54).

3. Notified taxpayers involved in partnership basis-shifting transactions that such transactions are subject to the economic substance doctrine rules of §7701(o) (Rev. Rul. 2024-14).

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1. IRS Proposed Regulations (REG-124593-23). The IRS proposed regulations identify certain partnership related-party basis adjustment transactions and substantially similar transactions as transactions of interest (TOI), a type of reportable transaction. Material advisors and certain participants in these transactions will be required to file disclosures with the IRS and will be subject to penalties for failure to disclose. These proposed regulations have a materiality threshold of $5 million. Only partnerships whose basis increases from related-party basis-adjustments of a partnership or partner during the year exceeds the gain recognized from those transactions $5 million or more are subject to these rules.

Preparer note. Material advisors disclose reportable transactions on Form 8918, Material Advisor Disclosure Statement. The material advisor's disclosure statement is filed with OTSA by the last day of the month that follows the end of the calendar quarter in which the advisor becomes a material advisor with respect to a reportable transaction or in which the circumstances necessitating an amended disclosure statement occur. Form 8918 must either be mailed to OTSA at the address provided in the form's instructions or faxed. If the most current version of the form (2021 version at date written) is not used, the filing will be rejected.

2. New regulations coming to address abusive basis shifting (Notice 2024-54). The IRS announced they plan to provide clarity of the rules surrounding basis shifting. They are going to issue two sets of proposed regulations that will cover basis adjustment transactions under §732, §734(b) and §743(b):

1. The first set of regulations will require partnerships to treat basis adjustments arising from covered transactions in a way that would restrict them from deriving inappropriate tax benefits from the basis adjustments.

2. The second set of regulations will provide rules to ensure clear reflection of taxable income and tax liability for consolidated groups of corporations when members of a group own interests in partnerships.

3. Basis stripping subject to economic substance doctrine (Rev. Rul. 2024-14, §7701(o)). The IRS will raise the economic substance doctrine (§7701(o)) to assess whether basis-stripping transactions are valid in cases where related parties:

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

2. Capitalize on the disparity by either transferring a partnership interest in a nonrecognition transaction or making a current or liquidating distribution of partnership property to a partner, and

3. Claim a basis adjustment under Internal Revenue Code sections 732(b), 734(b), or 743(b) resulting from the nonrecognition transaction or distribution.

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Examples for explanation. These concepts are best described using a series of three comprehensive examples. The facts are:

Crater, Inc. is a domestic corporation engaged in operating a trade or business, including through several subsidiary entities in which Crater holds controlling financial interests (Crater Subsidiaries). Crater is related to each of its subsidiaries (as defined under §267(b) or §707(b)(1)). Crater's subsidiaries include Corp 1, Corp 2, Corp 3, LLC A, LLC B, LLC C, and LLC D, each of which is indirectly owned by Crater through one or more C Subsidiaries. Crater's subsidiaries own various depreciable or amortizable assets used in, and have incurred various liabilities as part of, the conduct of Crater's operations. Crater issues financial statements for its business that reports the assets and liabilities of the Crater Subsidiaries (Crater Financial Statements).

Situation 1. Crater indirectly owns more than 50% of the stock of Corp 1, Corp 2, and Corp 3, all domestic corporations. Corp 1 and Corp 2 are the only partners in LLC A with each holding a 50% interest in the capital, profits, and losses of LLC A. Corp 1 and Corp 3 are the only partners in LLC B with each holding a 50% interest in the capital, profits, and losses of LLC B.

Prior to 2024, LLC A made a valid §754 election. Also prior to 2024, Corp 1's share of the adjusted tax basis of LLC A's property (that is, Corp 1's share of LLC A's inside basis) was $2,000,000 and the adjusted tax basis of Corp 1's interest in LLC A (that is, Corp 1's outside basis) was $10,000,000. The $8,000,000 disparity between Corp 1's inside and outside basis resulted from Corp 1 and Corp 2 making contributions to LLC A, and LLC A making distributions to Corp 1 and Corp 2, of property with specific Federal income tax attributes, and the allocation of Federal income tax items in accordance with §704(b) and (c). Such contributions, distributions, and allocations were undertaken to create a disparity between Corp 1's inside and outside basis in LLC A.

On June 30, 2024, Corp 1 transferred its interest in LLC A to LLC B in a contribution that qualified for nonrecognition of gain or loss under §721(a). The stated business purpose for Corp 1's contribution was to achieve cost savings for Crater and its subsidiaries by cleaning up intercompany accounts, reducing administrative complexity, and achieving other administrative efficiencies.

Immediately after Corp 1's contribution, LLC B's outside basis in its interest in LLC A is $10,000,000 (per §723) while its share of LLC A's inside basis is $2,000,000 (without regard to any step up under §743(b)). Under §743(b) – partnership property basis is adjusted in the case of a transfer of property – LLC A increases the adjusted basis of its property by $8,000,000 (the excess of LLC B's $10,000,000 outside basis over its $2,000,000 proportionate share of inside basis) with respect to LLC B only. LLC A allocates substantially all this $8,000,000 basis increase to its depreciable or amortizable property (§755 and §1.755-1(b)(5)). The Corp 1 contribution on June 30, 2024, was undertaken with a view to exploiting the disparity between Corp 1's share of LLC A's inside basis and Corp 1's outside basis in LLC A created before June 30, 2024, and increasing LLC B's share of LLC A's inside basis in the depreciable or amortizable property.

Cost savings are relatively minor. The cost savings resulting from Corp 1's LLC interest contribution are insubstantial in relation to the reduction in the aggregate Federal income tax liability of Crater's subsidiaries resulting from the $8,000,000 increase in LLC A's basis

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in the underlying assets. Crater reports the relatively small cost savings in the C Financial Statements.

IRS rules no economic substance (Rev. Rul. 2024-14). The IRS held that the series of transactions described above, while technically within the letter of the law, lacked economic substance under §7701(o). The transaction did not change the economic position of Crater or its subsidiaries in any meaningful way aside from the Federal income tax effects. The IRS further held that neither Crater nor its subsidiaries had a substantial purpose for entering the transactions aside from Federal income tax effects. In other words, no economic substance. The basis adjustment was disregarded, and LLC B was not entitled to a stepped-up basis. Its inside basis in LLC's assets would remain at $2,000,000.

Situation 2. Crater, Inc. indirectly owns more than 50% of the stock of both Corp 1 and Corp 2, both domestic corporations. Corp 1 and Corp 2 each own 50% of LLC C. LLC C owns 100% of the stock of Corp 3 (a domestic corporation), plus some depreciable assets, and $10,000,000 of cash in bank. Prior to 2024, LLC C made a valid §754 election. Its adjusted basis of the Corp 3 stock was $9,000,000 and the stock's FMV as of June 30, 2024 was $10,000,000. LLC C's depreciable assets had an adjusted basis of $1,000,000 and FMV of $10,000,000.

Corp 1's outside basis in LLC C was $10,000,000 and Corp 2's outside basis in LLC C was $1,000,000 as a result of Corp 1 and Corp 2 making contributions to LLC C, and LLC C making distributions to Corp 1 and Corp 2, of property with specific Federal income tax attributes, and the allocation of Federal income tax items in accordance with §704(b) and (c). Such contributions, distributions, and allocations were undertaken to create a disparity between Corp 2's outside basis and LLC C's inside basis in the Corp 3 stock.

On June 30, 2024, LLC C distributes all the Corp 3 stock to Corp 2 (not a liquidating distribution). The stated business purpose for the Corp 3 stock distribution was to achieve cost savings for Crater and its subsidiaries by cleaning up intercompany accounts, reducing administrative complexity, and achieving other administrative efficiencies. Immediately after the distribution, Corp 2's adjusted basis in the Corp 3 stock is $1,000,000, the same as Corp 2's outside basis in LLC C prior to the Corp 3 stock distribution. In addition, the Corp 3 stock distribution reduces Corp 2's outside basis in LLC C from $1,000,000 to zero. Following the Corp 3 stock distribution, LLC C increases the inside basis of its remaining assets by $8,000,000 (§734(b)(1)(B)) and LLC C increases the adjusted basis of its remaining depreciable asset from $1,000,000 to $9,000,000. The Corp 3 stock distribution was undertaken with a view to exploiting the disparity between Corp 2's outside basis in LLC C and LLC C's inside basis in the Corp 3 stock.

IRS again, says no economic substance. As in Situation 1, the IRS held that the Situation 2 series of transactions lacked economic substance under §7701(o). The transaction did not change the economic position of Crater or its subsidiaries in any meaningful way and there was no substantial business purpose for entering into the transactions aside from Federal income tax effects. The basis adjustment was disregarded, and LLC C was not entitled to a stepped-up basis. Its inside basis in LLC C's assets remained at $1,000,000.

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Situation 3 – last one! This time Crater indirectly owns more than 50% of the stock of Corp 1 and Corp 2, who are each 50% partners of LLC D. Prior to June 30, 2024, LLC D owned two assets: a depreciable asset with an adjusted basis of $2,000,000 and a FMV of $10,000,000, and nondepreciable land with an adjusted basis of $9,000,000 and FMV of $10,000,000. Prior to June 30, 2024, Corp 1's outside basis in LLC D was $10,000,000, and Corp 2's outside basis in LLC D was $2,000,000.

On June 30, 2024, LLC D liquidated by distributing the depreciable asset to Corp 1 and the nondepreciable land to Corp 2. The stated business purpose for the LLC D liquidation was to achieve cost savings for Crater and its subsidiaries by cleaning up intercompany accounts, reducing administrative complexity, and achieving other administrative efficiencies. Immediately after the LLC D liquidation, Corp 1's adjusted basis in the depreciable asset is $10,000,000, the same as Corp 1's pre-liquidation outside basis, reflecting an increase of $8,000,000 to the adjusted basis of the depreciable asset in the hands of Corp 1. Also, immediately after the LLC D liquidation, Corp 2's adjusted basis in the nondepreciable land is $2,000,000, the same as Corp 2's outside basis in LLC D prior to the LLC D Liquidation, reflecting a decrease of $7,000,000 to the adjusted basis of the nondepreciable land in the hands of Corp 2. The distribution of the depreciable asset to Corp 1 was undertaken to exploit the disparity between LLC D's inside basis in the depreciable asset and Corp 1's outside basis in LLC D.

One more time, the IRS says no economic substance. The operating cost savings resulting from the LLC D liquidation were insubstantial in relation to the reduction in the aggregate Federal income tax liability of Crater and its subsidiaries – namely increased depreciation deductions for Corp 1 and no other changes. The basis adjustment is disregarded and Corp 1's basis in the depreciable asset remains at $2,000,000.

Miscellaneous Partnership Developments

New Basis Reporting Form Required for Partner(s) Who Receive Property Distributions (Form 7217)

The IRS has introduced Form 7217, which will be used by any partner receiving a distribution of property from a partnership in a non-liquidating or liquidating distribution to report the basis of the distributed property, including any basis adjustment as required by §732(a)(2) or (b). The partner is required to attach the new form to their tax return if they receive any property distributions from a partnership during the tax year. The filing requirement applies to property distributions that take place in 2024 or after. The IRS posted draft instructions on its website in September 2024, which state that any partner receiving a property distribution from a partnership must file Form 7217, regardless of whether there is a basis adjustment in the hands of the partner because of the distribution. A separate Form 7217 must be filed for each distribution if multiple distributions are received during the year. Reporting is not required for distributions of cash or marketable securities.

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Form **7217** (December 2024) Department of the Treasury Internal Revenue Service

Partner's Report of Property Distributed by a Partnership

Attach to your tax return.
Go to *www.irs.gov/Form7217* for instructions and the latest information.

OMB No. 1545-0123
Attachment Sequence No. **217**

Partner's name	Partner's TIN
Distributing partnership's name	Distributing partnership's EIN
Date property was distributed to partner	

TREASURY/IRS AND OMB USE ONLY DRAFT August 28, 2024

Part I **Aggregate Basis of Distributed Property on Distribution Date.** File a separate form for each date a partner received distributed property.

1	Was this distribution in complete liquidation of the partner's entire interest in the partnership?	☐ Yes ☐ No
2	Was any part of the distribution treated as a sale or exchange under section 751(b)?	☐ Yes ☐ No
3	Partnership's aggregate basis in distributed property (taking into account any basis adjustments under section 732(d), 734(b), or 743(b)) immediately before the distribution. This line should equal the total of Part II, line B, column (b)	$
4	Adjusted basis of the partner's interest in the partnership immediately before the distribution	$
5	Cash and marketable securities (as defined in section 731(c)) received in the distribution	$
6	Enter the smaller of line 4 or line 5	$
7	Gain recognized. Subtract line 6 from line 5. If zero, enter -0- and go to line 9	$
8	Is U.S. tax required to be paid on the gain entered on line 7?	☐ Yes ☐ No
9	Partner's basis in partnership interest reduced by cash and marketable securities (as defined in section 731(c)) received in the distribution. Subtract line 6 from line 4	$
10	Aggregate basis to be allocated to the distributed property. For a non-liquidating distribution, enter the smaller of line 3 or line 9. For a liquidating distribution, enter the amount from line 9. Line 10 should equal the total of Part II, line B, column (e)	$

For Paperwork Reduction Act Notice, see the Instructions for Form 1065. Cat. No. 94479B Form **7217** (12-2024)

Limited Partners, LLC Members and Self Employment Tax

Background. While LLC first came on the scene in 1978, they really started to become popular in the early 1990s. With the gain in popularity came a host of tax issues. While most have been settled over the years, everyone is still trying to figure out self-employment tax and its application to LLC members. Internal Revenue Code §1402 defines SE income very broadly to include everything unless it is specifically exempt, similar to the definition of gross income per §61. Under §1402, the term net earnings from self-employment is defined as:

"…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 from any trade or business carried on by a partnership..."

Under this definition, rental real estate would be subject to SE tax, as well as capital gains, dividends and more. However, several SE tax exemptions are listed in §1402(a)(1) through (17). Of most import here, §1402(a)(13) states there shall be excluded the distributive share of any item of income or loss of a limited partner other than guaranteed payments made to that partner for services provided to the partnership.

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What's the issue? The core issue is that any taxpayer wanting to argue they have income exempt from SE tax must meet at least one of the §1402 criteria. There is no other way. When we turn to LLCs and SE tax, there are no tax laws specific to LLCs, single or multimember. The IRS says to treat single member LLCs as sole proprietors and multi-member LLCs as partnerships. For a partner's trade or business income to be exempt from SE tax, the partner must argue they meet the limited partner exception. There is no other basis for argument. This brings us to the big issue – there is no definition of a "limited partner" in the tax law. This definition is a state law definition, and while mostly consistent among the states, it is not completely consistent.

IRS acts and Congress doesn't like it. As the growth of LLCs began to grow substantially, the IRS recognized that LLCs and SE tax was going to become an issue. To get ahead of the issue, in 1997 the IRS issued proposed regulations with a specific definition of "limited partner" under §1402. Under the IRS proposed regulations, the IRS held that a partner in partnership would be a limited partner for SE tax purposes if the entity were not engaged in the business of consulting, health, law, engineering, architecture, accounting or actuarial science and the partner did not:

- Work more than 500 hours during the LLC's tax year;
- Execute contracts for the LLC; and
- Have personal liability for the debts or claims against the LLC.

Congress very forcefully lashed out at the IRS, telling them that defining who is, and who is not, a limited partner is decided by law and that Congress, not the IRS, writes law. Congress also forbid the IRS from making the regulations final. The regs are still out there as the IRS never withdrew them. Of course, no one in Congress even understands the issue so here we are, more than 20 years later, waiting for Congress to act. But that's another story!

We turn to the courts for guidance. The IRS cannot act, Congress will not act, so the tax community has watched with interest for any court developments on this issue.

Preparer note. The IRS has stated multiple times that those who follow the proposed regulations will not be attacked on audit.

Soroban provides the most comprehensive analysis yet (Soroban Capital Partners, v. Comm., USTC Dkt. No. 16217-22, 16218-22, Nov. 28, 2023).

Background. Soroban Capital Partners (SCPs) was a hedge fund that was organized as a limited partnership under Delaware law. It had one general partner and three limited partners. Each limited partner was paid guaranteed payments for services rendered to the SCP. The K-1s from SCP reported the guaranteed payments as SE income but not the limited partners' distributive shares of income. The IRS audited SCP's 2016 and 2017 returns and determined the SE tax was underreported on the K-1s and that the

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distributable profits should be included as SE income. The Court determined that the only issue was whether the partners were limited partners for SE tax purposes.

Limited partner not defined in Federal tax code. The Court noted that the Internal Revenue Code does not define “limited partner.” Looking to case law, the Court discussed Renkemeyer, where the Federal tax court applied statutory construction principles to determine whether partners in an LLP should be considered limited partners (Renkemeyer v. Comm., USTC, Feb. 9, 2011). The Court in Renkemeyer analyzed the legislative history of §1402(a)(13) and concluded that its intent “was to ensure that individuals who merely invested in a partnership and who were not actively participating in the partnership's business operations … would not receive credits towards Social Security coverage.” Further, the Court found that “[t]he legislative history … does not support a holding that Congress contemplated excluding partners who performed services for a partnership in their capacity as partners (i.e., acting in the manner of self-employed persons), from liability for self-employment taxes.” In Renkemeyer, the Court ruled that the partners were not limited partners for SE tax purposes because their “distributive shares arose from legal services … performed on behalf of the law firm” and not “as a return on the partners' investments.”

Function test at the core of the argument. The Court further noted none of the previous cases addressed whether a limited partner in a state law limited partnership must satisfy a functional analysis test to be entitled to the limited partner exception under §1402(a)(13) (Renkemeyer was an LLP, not a limited partnership). The Court found the limited partner exception under §1402(a)(13) does not apply to a partner who is limited in name only. If Congress had intended that limited partners be automatically excluded, it could have simply said “limited partner.” By adding “as such,” Congress made clear that the limited partner exception ***applies only to a limited partner who is functioning as a limited partner***. The Court effectively ruled that, to determine whether a limited partner’s income is subject to SE tax, a function test must be applied. What is the partner’s role in the partnership and, if the role is not that of a limited partner, then the SE tax applies. While the IRS 1997 proposed regulations are not enforceable, they are a place to start to determine function. The Court also noted that classification under state law has no bearing.

See also:

- Renkemeyer, Campbell & Weaver LLP v. Commissioner, 136 T.C. 137 (2011), in which the Court concluded that attorney partners who actively participated in a law firm organized as a Kansas limited liability partnership were not limited partners for purposes of section 1402(a)(13).

- Castigliola v. Comm., T.C. Memo. 2017-62, where lawyers who owned and worked in a professional LLC were limited partners for SE tax purposes. The Court ruled they were not.

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Partnership Tax Year End (§706(b); §444)

The general rule is a partnership's tax year must conform to its partners' tax years (§706(b)(1)(B)). The required year end is determined based on:

1. **Majority interest.** If one or more partners who have the same tax year own a majority interest in partnership, the partnership must use those partners' tax year;

2. **Principal partners rule.** If there are no majority interest partners, the partnership is required to adopt the same tax year as those partners who own at least 5% interest in the partnership.

3. **All other rules.** If neither of the above rules applies, the partnership must adopt a tax year that results in the least aggregate deferral of income to the partners. This is the tax year of one or more of the partners which will result in the least aggregate deferral of income to all partners. The formula to make this determination is contained in Reg. 1.706-1(b)(3) and is best explained with an example:

Example – least aggregate deferral calculation. Insider LLC has partners ATA Inc., who report income on a fiscal year ending June 30th, BSD, who reports income on the fiscal year ending Sept. 30th, CAC, who also uses a June 30th fiscal year, and DCC, who has an April 30th year end. The partners own 6%, 50%, 4% and 40% of Insider LLC, respectively. Neither the majority interest rule nor the principal partners rule apply. The least aggregate deferral for Insider LLC is calculated:

Test 9/30	**YE**	**Profits %**	**Deferral Months**	**Profit % x Deferral**
- ATA	6/30	6%	9	.54
- BSD	9/30	50%	0	0
- CAC	6/30	4%	9	.36
- DCC	4/30	40%	7	2.80
Aggregate deferral				3.70

Test 4/30	**YE**	**Profits %**	**Deferral Months**	**Profit % x Deferral**
- ATA	6/30	6%	2	.12
- BSD	9/30	50%	5	2.50
- CAC	6/30	4%	2	.08
- DCC	4/30	40%	0	0
Aggregate deferral				2.70

Test 6/30	**YE**	**Profits %**	**Deferral Months**	**Profit % x Deferral**
- ATA	6/30	6%	0	0
- BSD	9/30	50%	3	1.50
- CAC	6/30	4%	0	0
- DCC	4/30	40%	10	4.00
Aggregate deferral				5.50

The aggregate deferral for Insider LLC is April 30th.

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Exceptions to the required tax year rule (§442; Rev. Proc. 2002-39; Notice 2001-34). Partnerships, S corporations, and PSCs may adopt a taxable year other than its required taxable year. To do so, the entity must: seek IRS permission to use a natural business year, adopt a 52–53-week tax year that references its required year end; or make a §444 election.

- **Business purpose tax year (Form 1128).** A partnership may establish an acceptable business purpose for having a tax year different from its required tax year and use the different tax year. There are three natural business year tests that may be used to establish a business purpose:

  - **Annual business cycle test.** Under the annual business cycle test, the taxpayer's natural business year is deemed to end at (or soon after) the close of the highest peak period of business. A safe harbor under the annual business cycle test states that one month will be deemed "soon after" for the close of the highest peak period of business.

  - **Seasonal business test.** Under the seasonal business test, the taxpayer's natural business year is deemed to end at (or soon after) operations end for the season. Taxpayers in existence for fewer than three years can satisfy the annual business cycle or seasonal business test by giving reasonable estimates of gross receipts in place of historical gross receipts.

  - **25% of gross receipts test.** Under this test, the taxpayer may establish a natural business year using a simple formulaic approach. The taxpayer divides its last 2 months gross receipts (ending with the month requested) by its last 12 months gross receipts, and then repeats the same computation for the prior 2 years. If the results in all 3 tests equals or exceeds 25%, the test is met.

Example. UTL CPAs' gross receipts were $1,800,000, $1,700,000, and $1,500,000 for the twelve months ended April 30th, 2024, 2023, and 2022, respectively. The gross receipts for March and April of those years were $690,000, $625,000, and $520,000, respectively. Using the required formula, the result is 38.33%, 36.76% and 34.67% respectively, well above the required 25%. This test indicates that UTL CPAs satisfies the business purpose test to use the April 30th as its year end.

Form 1128 must be filed to request business tax year exception. Form 1128, Application to Adopt, Change, or Retain a Tax Year must be filed to request a year other than the required year end. The form is due no earlier than the day following the end of the first effective year and no later than the due date (plus extensions) for the first effective year. A user fee may be required.

- **§444 election (Form 8716).** A partnership may elect to use a tax year different from its required tax year if the deferral period is no longer than three months. For example, a partnership with a calendar year as its required tax year may elect under 444 to use a Sept., Oct., or Nov. year end. The election is made by filing Form 8716 with the IRS by the earlier of the 15th day of the 5th month following the

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1st day of the of the tax year for which the election is being made or the due date (without extensions) of the tax return for the 1st year the election will be effective.

- **Form 8752 required if election under §444 is made.** A partnership or S corporation must file Form 8752, Required Payment or Refund Under Section 7519 if it made a §444 election. Form 8752 and the related payment are required of any partnership or S corporation that has elected under §444 to have a tax year other than a required tax year. The partnership is required to estimate the tax on any deferred income and then make an estimated tax payment for that tax.

- **52-53-week tax year.** A partnership can use a tax year other than its required tax year if it elects a 52-53-week tax year that ends with reference to either its required tax year or a tax year elected under §444.

IRS provides relief for late §444 election (LTR 22321001). An LLC with a required December 31st year end was formed in 2020. The LLC intended to make an election under §444 to use a September 30th year end and the taxpayer's tax advisor was made aware of the desired year end. The advisor timely filed the 2020 and 2021 Form 1065 tax returns using the September 30th year end. The taxpayer also timely filed Forms 8752. However, the advisor was not aware that Form 8716 needed to be filed, which it never was. When the LLC filed Form 8752 for the third year, the IRS sent the LLC a letter advising the LLC it was not using an approved year end. The tax advisor admitted omission was his fault, not the taxpayer's fault. He reiterated that the taxpayer wished to have the September 30th year from the beginning. The IRS ruled that the taxpayer acted reasonably and in good faith and granted the late §444 election. This allowed the LLC to continue to use a September 30th year end.

Transfers in Exchange for Services (§721, Rev. Proc. 93-27; Rev. Proc. 2001-43)

Generally, neither a partnership nor its members recognize gain or loss on the contribution of property in exchange for ownership interests to the partnership (§721). This rule, however, does not apply to the contribution of services in exchange for ownership interests. Some service-like assets are considered property. This includes rights in certain assets (e.g., technical know-how, patents, goodwill etc.) (US v. Frazell, 335 F.2d 487 (5th Cir. 1964)).

Income recognition timing (§83). Taxable income must generally be recognized when property is received in exchange for services. However, if any property received is subject to a "substantial risk of forfeiture" (such as unvested rights), the recognition of any related income is delayed until the forfeiture risk period lapses. For these purposes, a transfer of an interest in a partnership in exchange for services is treated as a transfer of property.

Accounting for transfers in exchange for services. If there is a transfer of a capital interest in a partnership in return for services rendered, the partnership deducts a guaranteed payment expense for the value of the interest awarded and the offsetting entry is made to that partner's capital account. The income is recognized on the difference between FMV of assets received (the amount of income recognized by the new partner), and the basis of the property transferred (usually zero when for services). The partner records the full amount as ordinary, SE income. The partner's inside and outside basis would be equal to the amount involved. The partnership records a step-up in basis for the

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allocated purchase price, with the offsetting gain allocated to the original partners. This effectively makes the contribution by the new partner a net-deductible situation for the partnership – the partners' record gains on the buy-in on the difference between FMV and basis, offset by a deduction for the capital interest.

Example. Carol receives a 20% interest in the Coln, Dors, Gund and Fran (CDGF) partnership in exchange for services rendered to the partnership. The partnership's assets had FMV of $50,000 and basis of $30,000. As a result of the transfer, Carol receives assets with a FMV of $10,000 ($50,000 FMV x 20%) so she is allocated a guaranteed payment. The guaranteed payment is subject to SE tax. Carol's basis in CDGF is $10,000. On paper, Carol is treated as if she recontributed assets back to the partnership in exchange for the 20% ownership and CDGF is treated as if it sold her 20% for the value of the services provided.

The original CDGF partners are each allocated their respective shares of the $10,000 guaranteed payment deduction. Often forgotten at this point is that CDGF also sold/distributed 20% of the partnership interest in exchange for $10,000. The original CDGF partners must recognize income of $4,000 – the difference between the FMV of Carol's 20% interest and 20% of basis in the partnership assets. The gain is allocated to the individual partners ($1,000 each assuming equal ownership). The net deduction for the partnership is $6,000 ($10,000 guaranteed payment less $4,000 income reported).

The result is CDGF has basis in its assets of $34,000 ($30,000 original + $4,000 recognized gain).

Accounting entry.

Dr. Guaranteed Payments – Carol	$10,000	
Cr. Capital – Carol		$10,000
Dr. Asset (Step-Up Basis)	$ 4,000	
Cr. CDGF Capital		$ 4,000

Transfers for profits interest only Rev. Proc. 93-27; Rev. Proc. 2001-43). Transfers of an interest in a partnership that is a profits interest only (i.e., no interest in underlying assets is transferred) are generally not taxable. A profits interest may be used to bring on owners who otherwise cannot afford to "buy in" or even pay the tax on the value of a capital interest. However, this rule does not apply if:

- The profits interest relates to a substantially certain and predictable stream of income, or
- The service partner disposes of the profits interest within 2 years, or
- The profits interest is in a publicly traded partnership (PTP).

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Preparer note. While not required (FMV is zero for a profits only interest), if a profits interest is subject to a substantial risk of forfeiture, tax professional should consider recommending taxpayers file a protective §83(b) election. If the IRS later determines that the profits interest had value (i.e., it was a capital interest), the value used would be determined as of the date of receipt versus the date the risk of forfeiture lapsed.

Valuing partnership interests when transfers occur (§707). The IRS uses the "Liquidation Analysis" method to determine value when there is a transfer of an ownership interest in return for services provided. The liquidation analysis method assumes the partnership is liquidated immediately after the admission of the new member and all assets are sold at FMV, debts are repaid, and profits are allocated according to the partnership agreement. If the new member would receive a distribution, then a capital interest is being transferred and the new partner is taxed on the calculated amount (capital interest). If the new member would not receive a distribution, then there is no taxable income to the new partner and no deduction for the partnership (Rev. Proc. 2001-43).

Example. Nicholson & Ratchet are equal members in Cuckoo, LLC, which owns a piece of land worth $120,000, with a basis of $80,000. Nurse is awarded a 1/3 profits interest in Cuckoo, LLC in return for services maintaining the land. If the land is sold, Nurse will receive 1/3 of the proceeds in excess of $120,000.

Nurse has taxable income of $0 (Sales price = FMV $120,000, 100% of this amount is to be paid to Nicholson & Ratchet and Nurse would receive $0) on her 1/3 profits interest.

Effectively, the profits interest sets, to the members who exist when the profits interest is issued, the amount (up to the FMV) as of the date of issuance of the profits interest. Those that built the LLC up to that point as owners will share in the amounts up to the FMV without the profits interest owner sharing in these amounts.

Receipt of profits interest for services not taxable (ES NPA Holding, LLC v. Comm., T.C Memo 2023-55). The core issue in this case revolved around whether class C units received by ES NPA qualified as a profits or a capital interest in IDS, a multi-tiered partnership. The IRS argued ES NPA received a capital interest in IDS valued at $12 million. The Court, however, held that ES NPA's interest qualified as a profits interest because IDS was effectively a conduit entity and the underlying interest in ES NPA Inc. was a profits interest. Both entities (IDS and NPA, LLC) had identical liquidation rights for the class C units, which made it immaterial whether ES NPA's interest was held directly or indirectly.

The IRS also argued the FMV used was undervalued and that ES NPA received a windfall capital interest of $12,000. This was based on the IRS's "valuation expert's" opinion that the value of NPA, LLC was more than $52 million. The Court relied on the actual sale of a 70% interest that occurred simultaneously where the sale price was approximately $21 million, meaning the total valuation would be approximately $29,979,299 for NPA. Based on this valuation, the Court concluded that there was no value received by ES NPA upon receiving its class C ownership units. They were a profits interest only.

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Partnership Interest Transfers with Hot Assets – (§751, Form 8308)

Partners who sell an interest in a partnership that has underlying §751 "hot assets" (e.g., unrealized receivables, inventory or §1245 recapture items) have specific reporting requirements to ensure proper tax treatment. This applies to partners both selling and buying the partnership interest.

Seller requirements. Sellers are required to notify the underlying partnership in writing within 30 days of the sale:

- Name, address, and identification number (e.g., social security number) for the seller,
- Name, address and identification number for the buyer, and
- Date of sale.

The seller must also attach a separate statement to her or his personal income tax return for the year of the sale a statement that includes:

- The date of the sale
- The amount of any ordinary income from the sale of the "hot assets."
- The resulting capital gain or loss.

Partnership requirements. The partnership is required to file Form 8308 – Report of a Sale or Exchange of Certain Partnership Interests if hot assets are included in the transfer. The form is filed with the partnership's Form 1065 for the year of the sale and must include:

- Names, addresses, and identification numbers for the seller, purchaser, and the partnership, and
- The date of the sale.

Form 8308 is filed as an attachment to Form 1065 for the year of sale. The LLC must furnish a copy of Form 8308 to each partner whose name appears on the Form 8308.

> **Preparer note.** If the partnership fails to file Form 8308, it may face a penalty of $50 for each failure, up to a maximum of $50,000 per calendar year.

IRS releases new Form 8308. The new Form 8308 includes additional reporting in Sections I and II and new sections III and IV were added.

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Form **8308** (Rev. October 2023) Department of the Treasury Internal Revenue Service

Report of a Sale or Exchange of Certain Partnership Interests

Go to *www.irs.gov/Form8308* for the latest information.

OMB No. 1545-0123

Name of partnership	Phone number	**Employer identification number**

Number, street, and room or suite no. If a P.O. box, see instructions.

City or town, state or province, country, and ZIP or foreign postal code

Part I Transferor Information

Record holder of the partnership interest immediately before transferring that interest:

Name	**Identifying number**

Number and street (including apt. no.)

City or town, state or province, country, and ZIP or foreign postal code

Check if the transferor is foreign: ☐

Beneficial owner of the partnership interest immediately before transferring that interest:

Name	**Identifying number**

Number and street (including apt. no.)

City or town, state or province, country, and ZIP or foreign postal code

Notice to Transferors: The information on this form has been supplied to the IRS. The transferor in a section 751(a) exchange is required to treat a portion of the gain realized from the exchange as ordinary income. For more details, see Pub. 541, Partnerships.

Statement by Transferor: The transferor in a section 751(a) exchange is required under Regulations section 1.751-1(a)(3) to attach a statement relating to the sale or exchange to their return. See *Instructions to Transferors* on page 3 for more details.

Part II Transferee Information

Record holder of the partnership interest immediately after the transfer of that interest:

Name	**Identifying number**

Number and street (including apt. no.)

City or town, state or province, country, and ZIP or foreign postal code

Beneficial owner of the partnership interest immediately after the transfer of that interest:

Name	**Identifying number**

Number and street (including apt. no.)

City or town, state or province, country, and ZIP or foreign postal code

Part III Transfer of Partnership Interest

1 Date of sale or exchange of partnership interest: ____ / ____ / ____

2 Type of partnership interest transferred:

A Capital ☐

B Preferred ☐

C Profits ☐

D Other ☐

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Form 8308 (Rev. 10-2023) Page 2

Part IV **Partner's Share of Gain (Loss) Required by Sections 751(a) and 1(h)(5) and (6)**
The amounts in column (c) should be reported to the selling partner on their Schedule K-1 in box 20 using the relevant code.

		(a) Partnership-level deemed sale gain (loss)	(b1) Percentage interest in the partnership transferred	(b2) Number of units in the partnership transferred	(c) Partner-level deemed sale gain (loss)	K-1 box 20 code
1	Section 751(a) gain (loss) . . .					AB
2	Section 1(h)(5) gain					AC
3	Deemed section 1250 unrecaptured gain					AD

Sign here only if you are filing this form by itself and not with Form 1065.

Under penalties of perjury, I declare that I have examined this return, including accompanying attachments, and to the best of my knowledge and belief, it is true, correct, and complete.

Signature of partnership representative or partner or limited liability company member   Date / /

New Form 8308 instructions include BBA info. The new instructions provide guidance on coordinating Form 8308 when an AAR may be required due to the BBA rules. The instructions specifically address:

- Late or incorrect reporting of a §751(a) exchange by a partner in a BBA partnership subject to CPAR.
- Late or incorrect reporting of a §751(a) exchange by a partner in a partnership not subject to BBA.
- Non-filing of Form 8308 by the partnership.
- Incorrect reporting of a §751(a) on Form 8308 by the partnership but correct reporting of the exchange on Schedule K-1.
- Incorrect reporting of a §751(a) exchange on Schedule K-1 or K-3.

IRS Provides Form to Revoke §754 Election (Form 15254)

A §754 election may not be revoked without permission from the IRS. In the past, the only way to make that happen was via a PLR that included an $11,500 fee. A request for revocation must be filed within 30 days of the partnership year end for which the revocation is intended to be effective. Historically the IRS has been very lenient and allowed most requests for revocation.

To alleviate the cost and hassle for taxpayers going through the PLR process, the IRS introduced a new form, Form 15254, to request revocation of an existing §754 election. The partnership requesting revocation must provide a valid reason to the IRS. Some examples include:

- A change in the nature of the partnership business,
- A substantial increase in the assets of the partnership,
- A change in the character of partnership assets, or
- An increased frequency of retirements or shifts of partnership interests, so that an increased administrative burden would result to the partnership.

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Preparer note. The IRS will not approve a §754 revocation when the purpose of the revocation is primarily to avoid stepping down the basis of partnership assets upon a transfer or distribution.

Form **15254** (February 2021)	Department of the Treasury - Internal Revenue Service **Request for Section 754 Revocation** ▶ **Go to www.irs.gov/Form15254 for instructions and the latest information.**	OMB Number 1545-2297

Name of partnership	
Employer identification number	Principal business activity code number *(see instructions)*
Number, street, and room or suite no. If a P.O. box, see the instructions.	
City or town, state or province, country, and ZIP or foreign postal code	
Tax year end section 754 election was made *(MM/DD/YYYY)*	Revocation tax year begins *(MM/DD/YYYY)*
Name of contact person *(see instructions)*	Contact person's telephone number

If Form 2848, Power of Attorney and Declaration of Representative, is attached *(see instructions for when Form 2848 is required)*, check this box . . . . ☐

Caution: In order to prevent delays in processing this request, the partnership must provide all information required by Form 15254. Include any documentation in support of the request even if not specifically requested by Form 15254 and its instructions.

Part I - Information for All Requests

Question	Yes	No
1. Has the partnership previously revoked a section 754 election? See instructions	☐ Yes	☐ No
2. Does the section 754 election result in or is it expected to result in a substantial administrative burden to the partnership	☐ Yes	☐ No
a. Has the nature of the partnership's business changed, or is it expected to change	☐ Yes	☐ No
b. Has there been a substantial increase in the assets of the partnership or a change in the character of partnership assets	☐ Yes	☐ No
c. Has there been, or is there expected to be, an increased frequency of retirements or shifts of partnership interests	☐ Yes	☐ No
3. Will the revocation of the section 754 election result in an avoidance of a reduction in the basis of partnership assets under section 734(b) or section 743(b)? If yes, provide documentation of the amount. See instructions.	☐ Yes	☐ No

Part II - Reason for the Request

In the space provided below, tell us why the partnership is filing this revocation request. Attach additional statements if needed. Attach supporting documents. See instructions.

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IRS Issues Final Regulations to Combat Abusive Conservation Easements (170(f)(19); 170(h)(7); TD 9999; §1.170A-14)

The IRS has long perceived conservation easement deductions as an area of abuse. At the urging of the IRS, Congress included new rules in SECURE Act 2.0 to address these perceived abuses. Specifically, the new law included two new provisions that apply to partnerships and S corporations:

1. The partnership or S corp must include a statement with their tax return that a conservation easement deduction was made and has been claimed. The statement must contain the prescribed information.

2. There is now a disallowance provision, which effectively prevents conservation easement deductions for partnerships and S corporations unless certain specific conditions are met - the disallowance provision conditions.

Conservation easement deductions made by partnerships and S corporations without complying with the new rules are treated as tax-avoidance transactions and all related penalties apply. The IRS issued regulations to clarify how these new rules will be applied moving forward. The new regulations are effective for conservation easement deductions made after December 29, 2022.

Disallowance rule. A qualified conservation deduction will be disallowed for partnerships and S corporations if the contribution amount exceeds 2½ times the sum of each partner's or shareholder's relevant basis. For this purpose, the term "relevant basis" is defined as a partner’s "modified basis" in the partnership. Modified basis is the partner’s basis plus adjustments required under §704(c). The regulations clarify how acquisitions, dispositions, and the adjusted basis of properties affect the computation of relevant basis. See §1.170A-14(j-m) for an in-depth discussion of modified basis.

Disallowance rule exceptions. The disallowance rules do not apply to conservation easement deductions made:

1. By sole taxpayers (i.e., individuals, C corporations, etc.);
2. By family passthrough entities (i.e., 90% or more owned by family members), including family member estates and certain trusts; and
3. For preservation of any building that is a certified historic structure.

Anti-abuse rule. The regulations include a one-year holding-period rule for property ownership before a qualified conservation contribution, with exceptions for cases where contributions are limited to adjusted basis.

Amended returns and AARs. If a partnership or S corporation files an amended return or AAR, the application of the rules depends on whether the contribution amount is higher or lower than initially reported.

Allocation by upper-tier partnerships. The final regulations specify that contributions by upper-tier partnerships must be allocated among partners based on their interests in the contribution, not pro rata among their partnership interests.

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Reporting and recordkeeping. The regulations clarify the reporting and recordkeeping requirements for partnerships and S corporations who make noncash donations, not just conservation easements. The new regs require the passthrough entities to file Form 8283 with relevant basis information for noncash charitable contributions. This is required regardless of whether the contributions are of real property or other noncash property.

Partnership reporting to partners (1.170A-16(d)(3)). Partnership or S corporation donors must provide a copy of its completed Form 8283 to every partner or shareholder who receives an allocation of a non-cash charitable contribution. Similarly, a recipient partner that is a partnership or S corporation must provide a copy of the donor's completed Form 8283 (Section A or Section B) to each of its partners or shareholders and so on through any additional tiers.

Partners and S corporation shareholders reporting. Partners or S corp shareholders who receive an allocation of a noncash charitable contribution must attach a copy of each Form 8283 to its tax return when required. Form 8283 should be provided by the pass-through entity. This applies to every partner of a partnership (including a partner that is itself a partnership or S corporation) or shareholder of an S corporation that receives an allocation of a noncash charitable contribution, and, if multiple such contributions are passed through, the partner/shareholder must complete a separate Form 8283 for each. In the case of a partner that is itself a partnership or S corporation, that partnership or S corporation must provide a copy of its completed separate Form 8283 to every partner or shareholder who receives an allocation of the charitable contribution, and so on through any additional tiers.

Practitioner point. Note that these reporting requirements apply to all pass-through entity noncash contributions, not just conservation easements.

Additional reporting for conservation contributions. In the case of a qualified conservation contribution made by a partnership or S corporation, an ultimate member's separate Form 8283 must include their own relevant basis. An upper-tier partnership's or upper-tier S corporation's separate Form 8283 must include the sum of each of its ultimate member's relevant basis. This is not required for excepted entities as defined above.

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Partnership Elections Grid

Adapted from "The Tax Adviser," April 2005 updated through 2023

Election	Method of Making Election	Date for Making Election	Authority	Explanation
Initial Return Elections				
Organization Costs-**Deduction**	None Required just deduct	With return	§709(b)(1)(A)(ii)	Allows initial expensing of up to $5,000 of organizational costs by deducting them on original return
Organization Costs-**Amortization**	Capitalize the expenses and amortize-no election required	Due date of 1st return plus extension	Reg. §1.709-1(b)	Allows amortization of organization costs over 180 months
Election to be excluded from partnership rules	Statement attached to blank 1065 with entity name and FEIN, names, addresses, FEIN of all members and agreement to election, where organization documents are located	Due date of 1st return plus extension	Reg. §1.761-2(b)	Allows certain investing partnerships to be excluded from partnership rules and treat items as if owned directly
Startup Costs-**Deduction**	None required. just deduct	Due date of 1st return plus extension	§195(b)(1)	Allows initial expensing of up to $5,000 of startup costs by deducting them on original return
Startup Costs-**Amortization**	Capitalize the expenses and amortize-no election required	Due date of 1st return plus extension	Reg. §1.195-1	Allows amortization of startup costs over 180 months
Election under §444 for a tax year other than required	File Form 8716	Earlier of 15th day of 5th money following 1st day of election year, or unextended due date of return	§444; Reg. §1.444-3T	Allows taxpayer to adopt September, October, or November year end in normal calendar year entity.
Recurring item election	By deducting item on return in 1st year incurred	Due date of 1st return plus extension where applicable expenses are incurred	§461(h)(3); Reg. §1.461-4(g)(7)	Allows deduction in year expenses are fixed and determinable if performance occurs by earlier of filing date or 8 1/2 months after year end.
Accrual of property taxes	Attach statement to return	Due date of 1st return plus extension where applicable expenses are incurred	§461(c); Reg. §1.461-1(c)	Allows ratable and accrual of real property taxes over period to which they relate

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Election	Method of Making Election	Date for Making Election	Authority	Explanation
Operating Elections				
Step Up Basis Election	Attach statement from authorized partner to return	Due date, without extension, of return for year of transfer of ownership interest	§754; Reg. §1.754-1	Allows step up basis to FMV on interest transfer at purchase, death, or buyout
Adjustment to basis of distributed property	Attach statement to distributee partner's return	Due date of distributee's return, plus extension, for first tax year in which basis of distributed property is relevant	§732(d); Reg. §1.732-1	Adjusts partner's basis of distributed property following a transfer within 2 years of acquiring the property, when no §754 election is in place
Basis proration on liquidation	Attach statement to partner's return	Due date of partner's return, plus extension, for 1st year payments are received	Reg. §1.736-1(b)(6)	Allows a retiring or deceased partner to report gain evenly as opposed to recovering basis first
Designation of Partnership Representative	Form 1065, Schedule B	On timely filed tax return including extension	Reg, §301.6223-1(c)(2)	Designates PR
Termination of §444 election to use special year end	Attach statement to return for short period resulting from election	Due date, plus extension, of short period return	Reg. §1.444-1T	Allows a taxpayer to change back to a permissible tax year
Allocation of single non-recourse liability among multiple properties	None required-Allocate in any reasonable and consistent manner	N/A	Reg §1.752-3(b)	Allows a partnership to allocate a single liability among multiple properties
Grouping activities	Attach identifying statement to return when changing, additions and dispositions	Due date plus extension of first return where grouping is made	Reg. §1.469-4	Allows one or more trades, businesses, or rentals to be treated as one activity for passive loss purposes
Selection of §704(c) pre-contribution gain allocations	None required-apply the method and include it in the partnership agreement	Due date of return plus extension for 1st return with pre-contribution gain issues	Reg. §1.704-3	Determines allocation of pre-contribution gain, loss, depreciation, and amortization
Election to override interest-tracing rules	No guidance; categorization on return appears sufficient	Due date of return plus extension for 1st use of debt proceeds	§163; Reg. §1.163-8T(c)(4)	Allows a partnership to treat an expenditure from any account, within 30 days of depositing debt proceeds into that account, as a disbursement of such proceeds. The character of the interest expense is determined by the nature of the expenditure.

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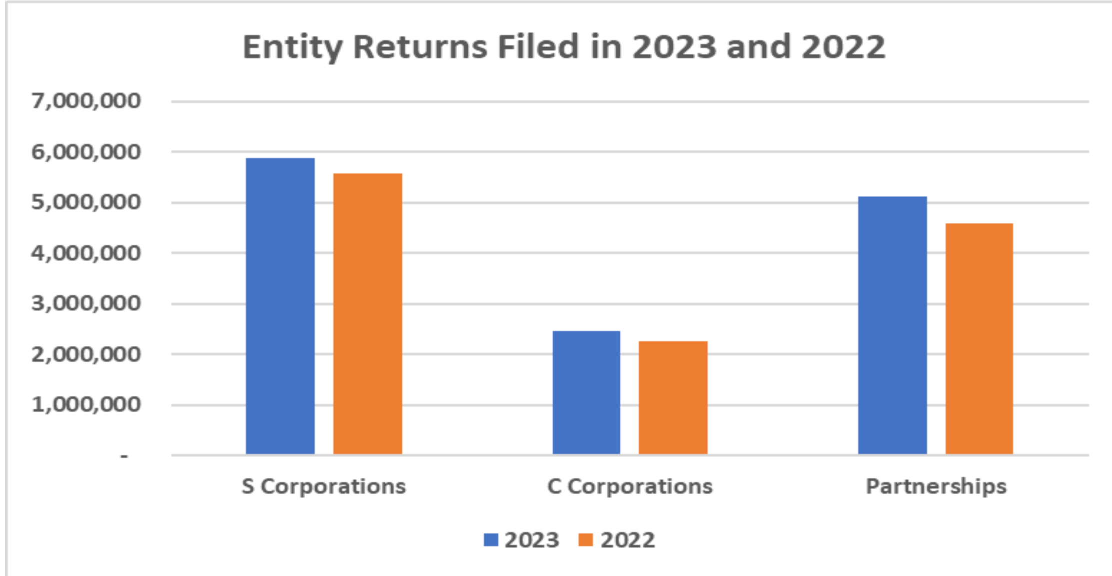
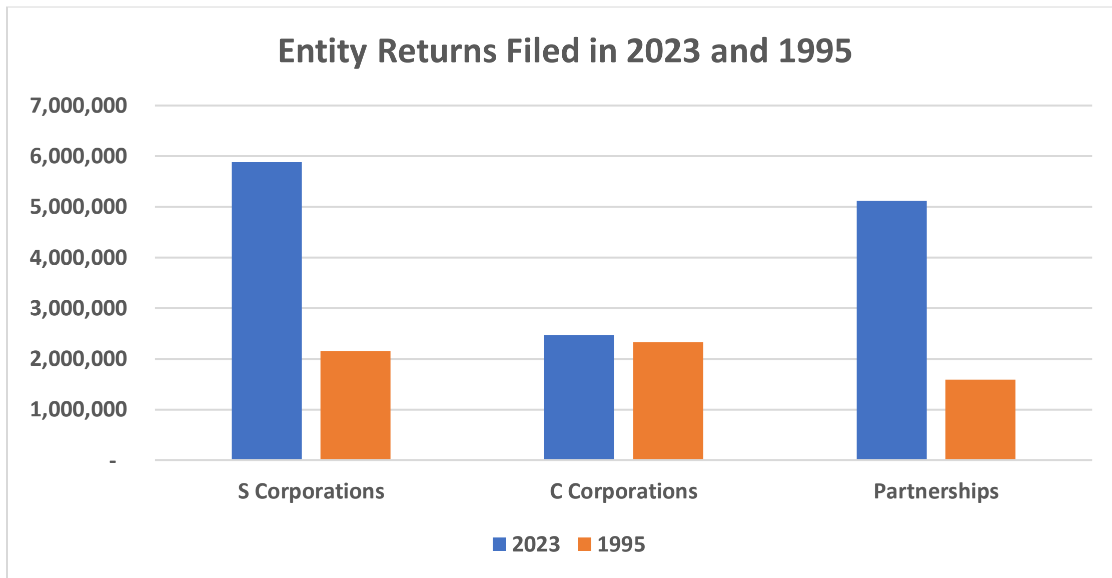
Corporations

Business Entity Filing Overview

S Corporations are by far the most common choice of business entity other than Sole Proprietorships with 5,882,000 filed in 2023 (2023 IRS Data Book). The number of partnerships increased 4,582,871 in 2022 to 5,118,000 in 2023.





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S Corp Form 1120S 2024 Preparation Checklist

Client:____Year End:______________

Note: Print all documents, support, client correspondence and workpapers to file

Accounting Work Pre-Return

	Obtain signed engagement letter
	Obtain & print entire client transaction report to PDF before adjusting
	Obtain & print client activity report of selected accounts: __ Inventory; __ Equipment;__ ***Obtain invoice copies from client*** __ Other Assets; __ Notes Payable; __ ***Obtain new loan copies from client*** __ SBA EIDL Loan info __ Common Stock and Equity Accounts __ Auto and truck __ Repairs __ Payroll tax expense and related liability account(s) __Retirement expense and related liability account (s) __ Other tax & License __ Other accounts: List: ____________________________________
	Ask client for copies of new leases
	Obtain or prepare: __ Bank Reconciliation; __ Unpaid payroll tax (look at January of next year) __ Unpaid sales tax (Look at January of next year) __ Other accounts: List: ____
	Obtain or prepare: __ Loan amortization schedules; __ Loan payoffs: __ Accrued interest if applicable
	__ Inquire and identify crypto-currency reporting items
	Obtain payroll and health insurance for officers for proper reporting
	Identify and schedule non-taxable income items and non-deductible expenses
	Identify and schedule any US interest income
	Identify rental activity separately reported interest and other expenses
	Prepare depreciation schedule __ Tie to trial balance __ Identify which assets qualify for bonus and Section 179
	Inquire as to any unpaid company pension contributions & adjust
	Adjust all accounts to match the above support and to correct mis-postings. __ Tie indexed support documents to final trial balance with tick marks.
	Inquire if other state or website activity is occurring requiring tax returns
	Inquire if there is non-US activity
	If "C" corporation in prior 5 years determine if any BIG assets disposed
	Confirm ownership changes or lack thereof with client: __ Obtain name, SSN, and address of new shareholders & date of transfer/purchase __ Verify new shareholders are qualified shareholders __ Verify new investments in ownership
	Inquire as to, and note, address of any new physical locations

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Tax Return Preparation

	Go to Secretary of State website and print "good standing" report
	Verify name and address with Secy of State to tax return and IRS
	Confirm SIC code and address with client ***based on current activity***
	Confirm current address of existing shareholders
	Confirm filing of FinCen Beneficial Ownership Interest
	Determine if $29 million average revenue test has been exceeded to require accrual method, inventory capitalization
	Obtain W-2's for officers for input
	Confirm officer reasonable compensation
	Confirm officer health insurance is correctly reported
	Obtain state allocation amounts for sales, wages, rent, assets
	Verify estimated tax payments
	Input final trial balance to tax software, noting TB accounts combined for 1 tax account and combining and presenting in same manner as prior year
	Attach K-1 Statement regarding "No K-3 to Be Issued" unless K-3 prepared
	Properly complete Schedules M-1, M-2 and K-2 noting any ownership changes, non-taxable and non-deductible items, distributions
	Review return for **required elections** or other separate disclosures: __ De minimus repairs: __ De minimus asset purchases: __ Bonus depreciation; __ Section 179; __ Tax credits (Wage, energy, foreign, etc.) __ Sec. 199A disclosures __ Specific charity information
	Final review __ Check letter for salutation, address etc. __ Confirm next year's estimated tax payments are reasonable __ Perform an analytical review of current year to prior year amounts – explain significant differences __ Clear all software diagnostics
	Send return to processing

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Corporate Transparency Act Requires New FinCen Reporting for Many Entities – or Does It?

For more than two decades, the U.S. Government has documented instances where criminals used legal entities to purchase real estate, conduct wire transfers, burnish the appearance of legitimacy when dealing with counterparties (including financial institutions), and control legitimate businesses for ultimately illicit ends. In response, Congress passed the Corporate Transparency Act (CTA) to better enable national security agencies and law enforcement to fight money laundering, terrorism, and other illicit activities by creating a national registry of beneficial ownership information for reporting companies.

What does CTA mean to our clients (FinCen 87 FR 59498, Sept. 30, 2022). FinCen issued final rules to clarify the reporting requirements for businesses because of the CTA. Bottom line is, beginning in 2024, many small and medium size businesses have new FinCen reporting requirements about their beneficial owner information. These beneficial ownership information (BOI) reports must be filed electronically using FinCEN's secure filing system. The Fin Cen rules require reporting companies to file reports that identify two categories of individuals: 1) the beneficial owners of the entity; and 2) the company applicants of the entity. As a result, every business entity formed or operating in the U.S. needs to address six questions:

1. Am I required to report beneficial owners' information to FinCen?
2. If so, who is a beneficial owner?
3. Am I required to report company applicants to Fin Cen?
4. What specific information needs to be reported?
5. When and how does the company report? And,
6. How can filed reports be amended if the original contained errors or omissions?

1. Am I required to report beneficial owner information to FinCen?

FinCen requires most corporations, LLC's and similar entities created in, or registered to do business in, the United States to report information about their beneficial owners. There are two categories of reporting companies: 1) a "domestic reporting company;" and 2) a "foreign reporting company".

A domestic reporting company is a corporation, limited liability company (LLC), or any entity created by the filing of a document with a secretary of state or any similar office under the law of a state or Indian tribe. A foreign reporting company is a corporation, LLC, or other entity formed under the law of a foreign country that is registered to do business in any state or tribal jurisdiction by the filing of a document with a secretary of state or any similar office.

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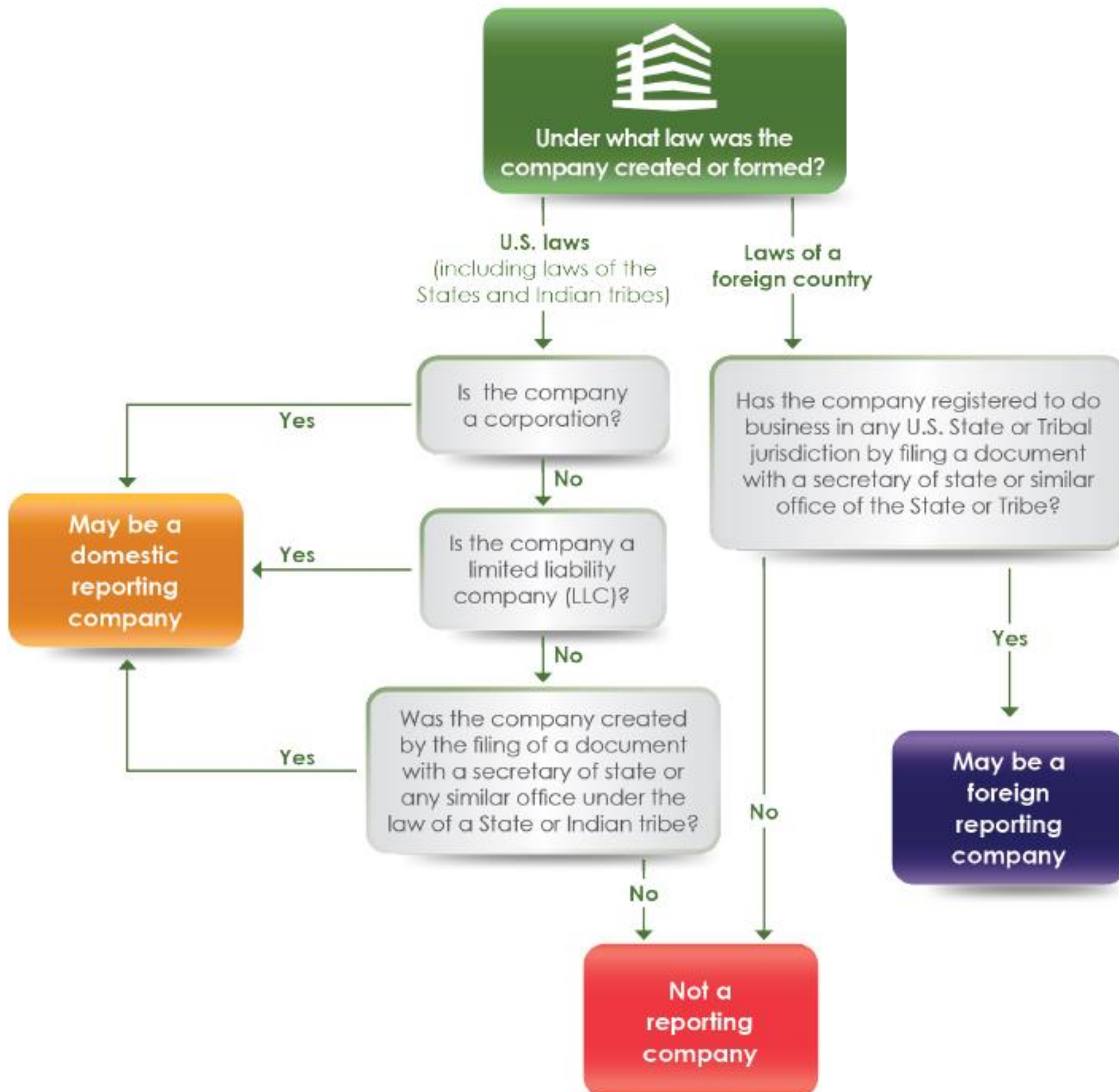
FinCEN expects that these definitions mean that reporting companies will also include limited liability partnerships, business trusts, and most limited partnerships, in addition to corporations and LLCs, because such entities are generally created by a filing with a secretary of state or similar office.

The chart below shows how to analyze whether your company is a "reporting company."



Other types of legal entities, including sole proprietors, general partnerships, and certain trusts, are excluded from the definitions to the extent that they are not created by the filing of a document with a secretary of state or similar office. FinCEN recognizes that in many states the creation of most trusts typically does not involve the filing of such a formation document.

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Specific entity exemptions. Twenty-three (23) specific types of companies are explicitly exempt from the BOI reporting requirements. They are listed below:

Exemption No.	Exemption Short Title
1	Securities reporting issuer
2	Governmental authority
3	Bank
4	Credit union
5	Depository institution holding company
6	Money services business
7	Broker or dealer in securities
8	Securities exchange or clearing agency
9	Other Exchange Act registered entity
10	Investment company or investment adviser
11	Venture capital fund adviser
12	Insurance company
13	State-licensed insurance producer
14	Commodity Exchange Act registered entity
15	Accounting firm
16	Public utility
17	Financial market utility
18	Pooled investment vehicle
19	Tax-exempt entity
20	Entity assisting a tax-exempt entity
21	Large operating company
22	Subsidiary of certain exempt entities
23	Inactive entity

#15 – Accounting firm exemption. The exemption for an "Accounting Firm" is available to any entity that is a public accounting firm registered in accordance with §102 of the Sarbanes-Oxley Act of 2002 (15 U.S.C. 7212).

#21 – Large operating company – This exemption applies to an entity that meets all three of the following criteria:

1. Employs more than 20 full time employees (those who work an average of 30 or more hours per week) in the U.S.;
2. Has an operating presence at a physical office within the U.S.;
3. Has filed a federal income tax or information return in the U.S. for the previous year and reported gross receipts greater than $5 million after subtracting gross receipts from outside the U.S.

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> **Preparer note.** An excellent resource for BOI reporting is FinCen's Small Entity Compliance Guide – BOI. The current version is Version 1.1, which was released in December 2023. It is hyperlinked and can also be found at:
>
> https://www.fincen.gov/sites/default/files/shared/BOI_Small_Compliance_Guide_FINAL_Sept_508C.pdf
>
> The Guide includes the table above and checklists for each of the 23 exemptions used to help determine whether a company meets an exemption. Companies should carefully review the qualifying criteria before concluding that they are exempt. The criteria for each exemption listed above are provided in the guide in a check-box format.

Court says CTA is unconstitutional (NSBA v. Yellen, USDC, Alabama, Case No. 5:22-cv-1448-LCB, March 1, 2024). The NSBA challenged CTA's mandate for small businesses to disclose their beneficial owners to FinCen, arguing this violates multiple amendments to the Constitution. The Court agreed with the NSBA and ruled not only was CTA unconstitutional, but also ordered that the Treasury Department, along with any other agency or employee acting on behalf of the United States, is permanently enjoined from enforcing CTA against the NSBA and its members. FinCen appealed the Court's ruling on March 11, 2024, and it is likely this will eventually end up at the Supreme Court. Until then, it appears the CTA BOI filing requirement is on hold.

Since the NSBA court case was decided, FinCEN has not slowed down its efforts to get entities to comply with the BOI reporting rules. If anything, they've increased their outreach campaign to inform businesses of their reporting responsibilities.

Okay, so now what do we do? Obviously, this will largely depend on what your client chooses to do. The options are:

1. Continue as if this Court case never happened. FinCen is still accepting BOI filings.
2. Don't do anything and wait to see what happens with the case.
3. File for new businesses formed in 2024 within 90 days and then wait until later in the year to how this develops.
4. Join NSBA and use the court case as the reason to avoid the filing requirement.

I suspect there will be much variation in how different professionals handle this. For right now, there is no wrong answer.

2. Who are the beneficial owners of my company?

FinCen defines beneficial owners as any individual who, directly or indirectly:

- Exercises substantial control over a reporting company, or

- Owns or controls at least 25 percent of the ownership interests of a reporting company.

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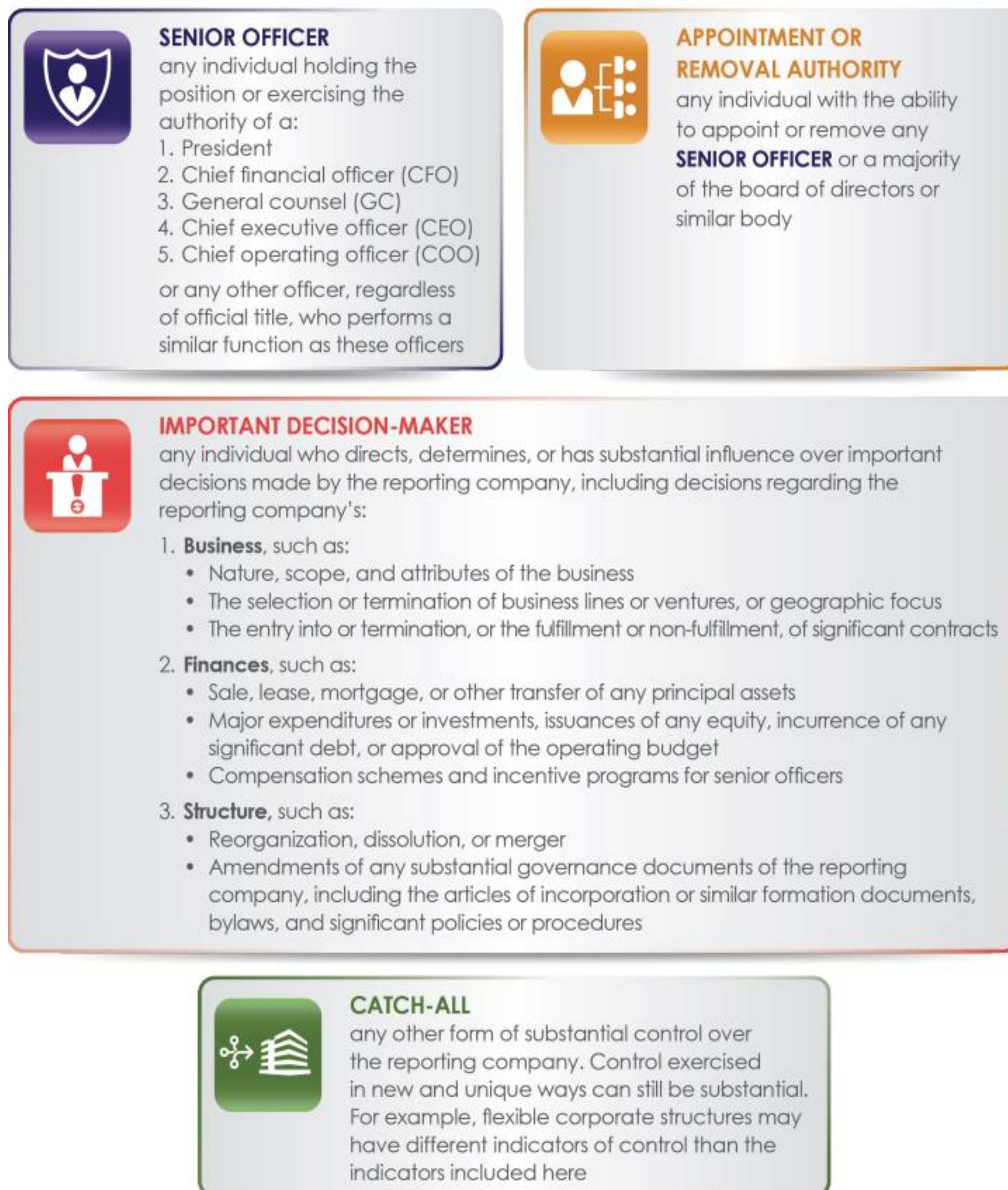
FinCen defines "substantial control." For substantial control, FinCen identified a range of activities that may constitute substantial control of a reporting company. Anyone who can make important decisions on behalf of the entity including corporate officers, board members and anyone with the authority to appoint or remove either group, stockholders, members, nominees, custodians, intermediary entity owners and other owners all would likely be deemed to have substantial control.

FinCen Substantial Control Overview



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FinCen defines "ownership interest." FinCen provided standards and mechanisms for determining whether an individual owns or controls 25% of the ownership interests of a reporting company.

Preparer note. While the FinCen adopted rules were written to the variety of ownership or control structures reporting companies may adopt, for reporting companies that have simple organizational structures it should be a straightforward process to identify and report their beneficial owners. FinCEN expects most reporting companies will have simple ownership structures.

FinCen's Small Entity Compliance Guide – BOI has multiple examples that may be used to fully understand the 25% or more ownership interest rules. FinCen has specifically identified certain individuals from the definition of "beneficial owner," including:

- Minor children (as defined under state law or Indian tribe laws where the reporting company is formed or first registered, provided the reporting company reports the required information regarding a parent or legal guardian of the minor child);
- Individuals who function as a nominee, intermediary, custodian, or agent on behalf of another individual;
- Individuals who act solely as an employee of a reporting company (excluding senior officers);
- Individuals whose only interest in a reporting company is a ***future*** interest through a right of inheritance; and
- Individuals who are creditors of a reporting company.

3. Are company applicants required to be reported?

Company applicant reporting requirement. FinCen requires companies to report its company applicants if it is either:

A. A domestic reporting company created on or after January 1, 2024; or

B. A foreign reporting company first registered to do business in the United States on or after January 1, 2024.

Companies required to report company applicants (the individual who applied to set up the reporting company) must identify and report at least one company applicant. All company applicants must be individuals. There are two categories of company applicants:

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1. **Direct filer.** This is the individual who directly filed the document(s) that created a domestic reporting company, or the individual who directly filed the document(s) that first registered a foreign reporting company. This individual would have physically or electronically filed the document with the secretary of state or similar office.

2. **Individual who "directs or controls the filing action."** This is the individual who was primarily responsible for directing or controlling the filing of the creation or first registration document. This individual is a company applicant even if the individual did not actually file the document with the secretary of state or similar office. This category not only includes shareholders and other owners, but also company agents such as the accountant or attorney.

Direct filers must be identified by all reporting companies that have a company applicant reporting requirement. The second category of company applicants is only required to be reported when more than one individual participates in the filing of the document that created or registered the company. If more than one individual participates in the filing, then two company applicants must be reported. No reporting company is required to report more than two company applicants.

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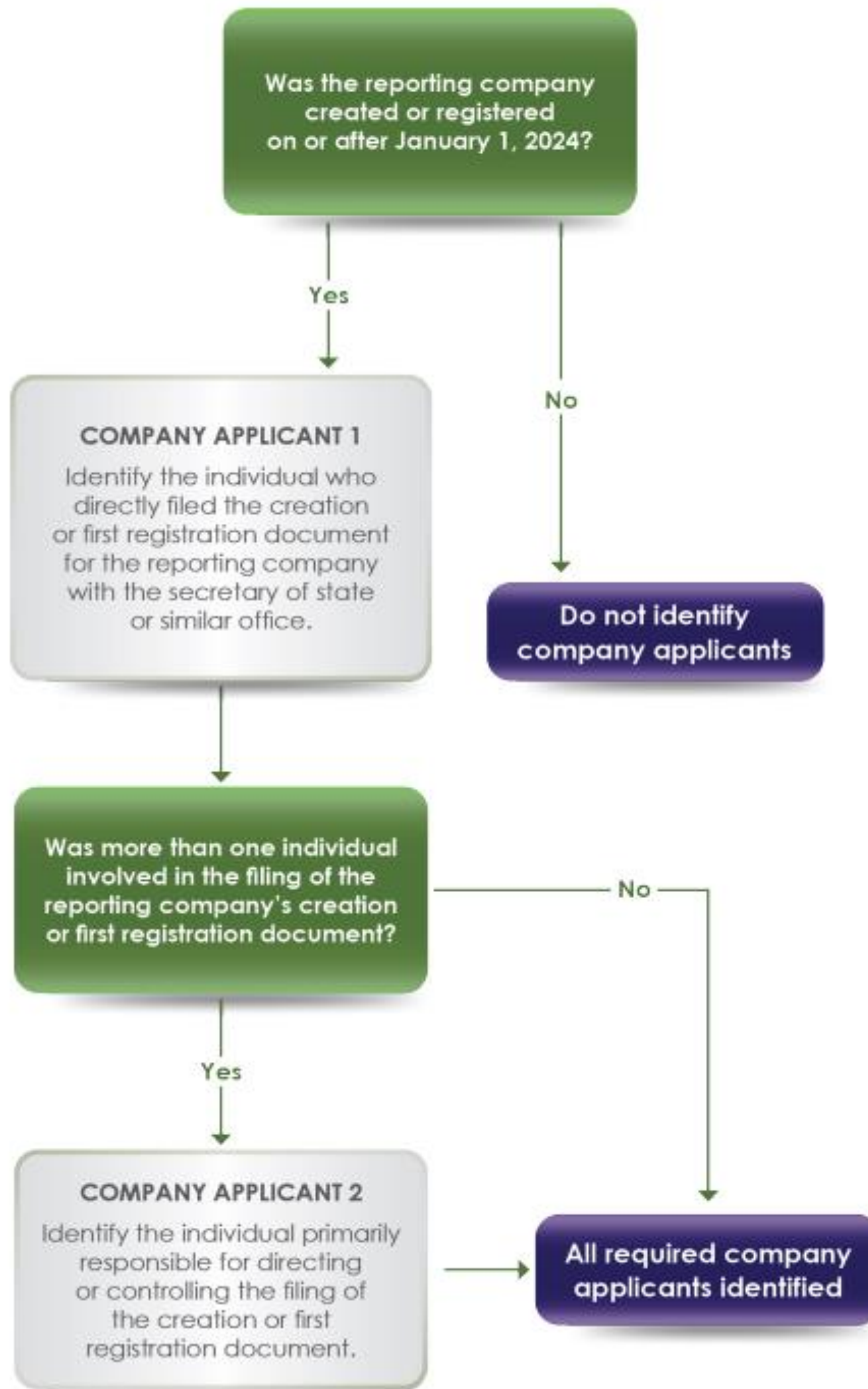
Defining Company Applicants



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4. What specific information needs to be reported?

BOI reports require specific information about the reporting company, the beneficial owners, and, if applicable, the company applicant(s). The information required is different for each report.

Reporting company info required. Information required for a reporting company's initial report includes:

1. Full legal name,
2. Any trade or "doing business as" names,
    a. A complete current U.S. address, which should be the principal place of business in the U.S., or, if the principal place of business is outside the U.S, the address of the primary location in the U.S.
3. The state, tribal or foreign jurisdiction of formation,
4. For foreign reporting companies only, the state or tribal jurisdiction where the company first registered, and
5. The IRS Taxpayer Identification Number (TIN) (including an Employer Identification Number) or, where a foreign reporting company has not been issued a TIN, a tax identification number issued by a foreign jurisdiction and the name of that jurisdiction.

Beneficial ownership information required. When filing BOI reports with FinCEN, the reporting company is required to identify itself and ***report four pieces of information about <u>each</u> of its beneficial owners***:

1. Full legal name,
2. Date of birth,
3. Complete current address, and
4. Unique identifying number and the issuing jurisdiction from one of the following documents:

    a. a non-expired passport issued to the individual by the U.S. government,
    b. a non-expired identification document issued to the individual by a State, local government, or Indian tribe for the purpose of identifying the individual,
    c. a non-expired driver's license issued to the individual by a State, or
    d. a non-expired passport issued by a foreign government to the individual, if the individual does not possess any of the other documents described.

    An image of the document from which the unique identifying number was obtained. Additionally, the rule requires that reporting companies created after January 1, 2024, provide the four pieces of information and document image for company applicants.

Unique FinCen identifier may be requested. In lieu of an acceptable identification document, FinCEN is required to offer a unique identifier (a FinCEN ID) upon request by any entity or individual who is otherwise required to report information to a reporting company. A reporting company may then report the FinCEN ID in lieu of the required identifying information.

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Individuals electronically apply for FinCEN identifiers and must provide their name, date of birth, address, unique identifying number and issuing jurisdiction from an acceptable identification document, and an image of the identification document – the same four pieces of personal information and image reporting companies submit about beneficial owners and company applicants in BOI reports. After an individual applies, the individual will immediately receive a FinCEN identifier unique to that individual. Once a beneficial owner or company applicant has obtained a FinCEN identifier, reporting companies may report it in place of the otherwise required four pieces of personal information about the individual in BOI reports. A company may request a FinCen identifier when it submits a BOI report by checking a box on the reporting form. Each FinCEN identifier is specific to the individual or company and only one FinCEN identifier can be obtained.

5. When and how does the company report?

Filing due dates. There are three different initial BOI report due dates, depending on when the entity was formed:

1. Reporting entities who exist as of Jan. 1, 2024, must file an initial BOI report no later than Jan. 1, 2025.
2. Reporting entities created or registered to do business in the U.S. in 2024 have 90 calendar days to file after receiving notice its registration is effective.
3. Reportig entities formed on Jan. 1, 2025, or after must file an initial BOI report within 30 days after receiving actual or public notice that its creation or registration is effective.

If a jurisdiction provides both actual and public notice, the timeline for when an initial BOI report is due starts on the earlier of the two dates notice is received.

Previously exempt reporting companies. If a company previously qualified for a reporting exemption (see list above) but no longer qualifies, it is required to file a BOI report within 30 calendar days of the date on which the company stops qualifying for the exemption.

How to file reports. Companies are required to file BOI reports electronically through FinCen's secure filing system, while not yet operational when this text was written, FinCEN plans for its filing system to be available Jan. 1, 2024. No BOI reports will be accepted prior to that date. FinCEN will publish instructions and other technical guidance at https://www.fincen.gov/boi when available.

Preparer note. There may be certain circumstances in which a reporting company is unable to electronically file a BOI report through FinCEN's secure filing system. In those cases, the reporting company should contact FinCEN: www.fincen.gov/contact.

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6. How are reports corrected that contained errors when originally filed?

Report changes. If there is ***any*** change to a company's required information or its beneficial owners, the company must file an updated BOI report within 30 days of when the change occurred. The same 30-day timeline applies to changes in information submitted by an individual to obtain a FinCEN identifier. A reporting company is not required to file an updated report for any changes to previously reported personal information about a company applicant. The following examples would require an updated BOI report:

- Any change to the information reported for the reporting company, such as registering a new DBA.
- A change in beneficial owners, such as a new CEO, a sale that changes who meets the 25% ownership interest threshold, or the death of a beneficial owner.
- Any change to a beneficial owner's name, address, or unique identifying number provided in a BOI report.

Preparer note. If a beneficial owner obtained a new driver's license or other identifying document that includes the changed name, address, or identifying number, the reporting company also would have to file an updated beneficial ownership information report with FinCEN, including an image of the new identifying document.

Initial report info no longer valid or inaccurate. If an inaccuracy is identified in a BOI report (either from a mistake on the original report or due to a change in the company info) the filing company must correct it no later than 30 days after the date it becomes aware of the inaccuracy or had reason to know of it. This includes any inaccuracy in the required information provided about the company, its beneficial owners, or its company applicants. The same 30-day timeline applies to inaccuracies in information submitted by an individual to obtain a FinCEN identifier.

Preparer note. There are no penalties for filing an inaccurate BOI report provided it is corrected within 90 calendar days of when it was filed. Corrected BOI reports should be filed electronically though the FinCen secure filing system.

Non-compliance penalties. The willful failure to report complete or updated beneficial ownership information to FinCEN, or the willful provision of or attempt to provide false or fraudulent beneficial ownership information may result in a civil or criminal penalties, including civil penalties of up to $500 for each day that the violation continues, or criminal penalties including imprisonment for up to two years and/or a fine of up to $10,000. Senior officers of an entity that fails to file a required BOI report may be held accountable for that failure. Providing false or fraudulent beneficial ownership information could include providing false identifying information about an individual identified in a BOI report, such as by providing a copy of a fraudulent identifying document. Additionally, a person may be subject to civil and/or criminal penalties for willfully causing a company not to file a required BOI report or to report incomplete or false beneficial ownership information to FinCEN. Penalties for failure to file or failure to correct BOI reports are $500 per day.

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> **Preparer note.** Reporting companies that need help meeting the BOI reporting obligations may consult with professional service providers such as lawyers or accountants (FAQs B.7 and B.8).

BOI authorized access. Authorized access at FinCEN's website of beneficial ownership information is being phased in 2024 and 2025. The current schedule is:

- Phase one, a pilot program, began in the spring of 2024 for a handful of Federal agency users.
- Phase two began in the summer of 2024 and extended access to Treasury offices and other Federal agencies engaged in law enforcement and national security activities that already have memoranda of understanding for access to Bank Secrecy Act information.
- Phase three, expected in the fall of 2024, will extend access to additional Federal agencies engaged in law enforcement, national security, and intelligence activities, as well as to State, local, and Tribal law enforcement partners.
- Phase four is expected in the winter of 2024 and will extend access to intermediary Federal agencies in connection with foreign government requests.
- Phase five is expected in the spring of 2025 and will extend access to financial institutions subject to customer due diligence requirements and their supervisors.

FinCEN releases FAQs (BOI FAQs). FinCEN added BOI FAQs to its website. There are currently more than 100 questions answered and more than 50 pages of information. This is an excellent source of information.

General Corporate Items

S Election Cannot Be Changed By Shareholder if S Corp is in Bankruptcy (Vital Pharmaceuticals, US Bankruptcy Court, Case No. 22-17842-PDR, Chapter 11).

Vital Pharmaceuticals was an S corporation 100% owned by John Owoc. In September 2022 Vital was subject to several adverse legal judgements, which led it to filing for bankruptcy. To pay its debts, Vital received permission from the bankruptcy trustee to sell its assets through a competitive sale and auction process. Vital eventually sold most of its assets for $370 million, $362 million of which was for cash. After paying secured debt, there was only $11.6 million of cash left for unsecured creditors and nothing for its shareholder, Mr. Owoc. But, because Vital was an S corporation, all the taxable income from the asset sale would flow through to Owoc, making him liable for the resulting taxes.

Court says owner no longer in control. To avoid paying the tax from the gain on the asset sale on his personal return, Owoc tried to have Vital's S election revoked. He asked the bankruptcy court's permission to revoke the S election and convert Vital to a C corporation, effectively moving the tax to the bankruptcy estate. The Court ruled that the right to the S election, and the right to revoke, belonged to the bankruptcy estate, not to Owoc, even though he was the 100% shareholder. The bankruptcy estate would not revoke the S election.

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FASB Requires Fuller Disclosure of Taxes Paid (FASB 2023-09, December 2023)

FASB issued new rules that require more transparency about income taxes companies pay in the U.S. and other countries. Public business entities must annually disclose a rate reconciliation presented in dollars and percentages. The following categories now require disclosure:

- State and local income tax, net of federal (national) income tax effect
- Foreign tax effects
- Effect of cross-border tax laws
- Enactment of new tax laws
- Nontaxable or nondeductible items
- Tax credits
- Changes in valuation allowances
- Changes in unrecognized tax benefits

The change was made so that users of financial statements can get better information about how the operations, related to tax risks and tax planning affect their tax rates and future cash flows. The standard is effective for annual periods beginning after December 31, 2024, and a year later for private companies.

Factors Used to Determine if Loans to Shareholders are Distributions (*Bobby Welch v. Comm.*, 9th Cir., No. 98-70930, March 1, 2000)

The courts typically use eight factors to determine whether the amount distributed was a loan, a taxable dividend, or AAA distribution:

1. Was the promise to repay evidenced by a note or other instrument?
2. Was interest charged?
3. Was a fixed schedule for repayments established?
4. Was collateral given to secure payment?
5. Were payments made?
6. Was there a reasonable prospect the borrower would repay the loan?
7. Did the lender have sufficient funds to advance the loan? and
8. Did the parties conduct themselves as if the transaction were a loan?

If these factors are not present, the “loans” will be recharacterized as distributions. For S corporations, if the recharacterized loans create unequal distributions, the S election could be voided.

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2024 Draft S Corporation K-1

Final K-1 | Amended K-1 | OMB No. 1545-0123

Schedule K-1 (Form 1120-S) **2024**
Department of the Treasury
Internal Revenue Service

For calendar year 2024, or tax year
beginning / / 2024 ending / /

Shareholder's Share of Income, Deductions, Credits, etc. See separate instructions.

TREASURY/IRS AND OMB USE ONLY DRAFT July 18, 2024 DO NOT FILE

Part I Information About the Corporation

A Corporation's employer identification number

B Corporation's name, address, city, state, and ZIP code

C IRS Center where corporation filed return

D Corporation's total number of shares
Beginning of tax year
End of tax year

Part II Information About the Shareholder

E Shareholder's identifying number

F1 Shareholder's name, address, city, state, and ZIP code

F2 If the shareholder is a disregarded entity, a trust, an estate, or a nominee or similar person, enter the individual or entity responsible for reporting:
TIN Name

F3 What type of entity is this shareholder?

G Current year allocation percentage %

H Shareholder's number of shares
Beginning of tax year
End of tax year

I Loans from shareholder
Beginning of tax year $
End of tax year $

For IRS Use Only

NOTE

Part III Shareholder's Share of Current Year Income, Deductions, Credits, and Other Items

1 Ordinary business income (loss)
2 Net rental real estate income (loss)
3 Other net rental income (loss)
4 Interest income
5a Ordinary dividends
5b Qualified dividends
6 Royalties
7 Net short-term capital gain (loss)
8a Net long-term capital gain (loss)
8b Collectibles (28%) gain (loss)
8c Unrecaptured section 1250 gain
9 Net section 1231 gain (loss)
10 Other income (loss)
11 Section 179 deduction
12 Other deductions
13 Credits
14 Schedule K-3 is attached if checked
15 Alternative minimum tax (AMT) items
16 Items affecting shareholder basis
17 Other information
18 More than one activity for at-risk purposes*
19 More than one activity for passive activity purposes*

* See attached statement for additional information.

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IRS Extends Corporate AMT Relief (§55(b)(2); Notice 2023-42)

The Inflation Reduction Act created a corporation alternative minimum tax (CAMT) equal to 15% minimum tax on the adjusted financial statement income of large C corporations for taxable years beginning after Dec. 31, 2022. CAMT applies to corporations whose three-year average annual adjusted financial statement income more than $1 billion. The CAMT does not apply to S corporations, RICs, and REITs.

IRS attempts to clarify corporate AMT (Notice 2024-10). The IRS Notice provides rules for determining the AFSI of a U.S. shareholder when a controlled foreign corporation (CFC) pays a dividend to the U.S. shareholder or another CFC. AFSI of the U.S. shareholder is determined by:

1. Disregarding any items reported on the U.S. shareholder's AFS resulting from the receipt of the covered CFC distributions; and

2. Including the U.S. shareholder's items of income and deduction for income tax purposes (considering the §959(d) exclusion (untaxed dividends) and excluding §56A AFSI rules and the §78 deemed paid foreign tax credit gross up) resulting from the receipt of covered CFC distribution.

This prevents the duplication of income that may result if the U.S. shareholder includes in AFSI, the amount of a dividend received from earnings associated with adjusted net income or loss that the U.S. shareholder includes in AFSI under §56A(c)(3).

Significant confusion leads to AMT penalty relief (Notice 2023-7; Notice 2023-20; Notice 2023-42; Notice 2024-33; Notice 2024-47; Notice 2024-66). The IRS has promised regulations to clarify the more complex areas of the CAMT since early in 2023, but the forthcoming regulations have yet to be issued. Accordingly, the IRS has issued a series of Notices to provide interim guidance and to also provide underpayment penalty relief for taxpayers subject to the CAMT who didn't make timely estimated tax payments. The relief applied for all estimated payments due in 2023 and, as of the issuance of Notice 2024-66 in September 2024, for estimated tax payments due anytime before January 1, 2025.

IRS Begins Audits on Corporate Jet Usage (IR-2024-06)

The IRS plans to begin dozens of audits focusing aircraft usage by large corporations, large partnerships, and high-income taxpayers and whether for tax purposes the use of jets is being properly allocated between business and personal use. The examination of corporate jet usage is an area of high-risk noncompliance. Use of the company jet for personal travel typically results in income inclusion by the individual using the jet personally and could also impact the business's eligibility to deduct costs related to the personal travel. These targeted audits are a part of the IRS's commitment to ensuring fairness in tax administration.

Wondering why the IRS has decided to audit corporate jet usage (Thomas Conrad v. Comm., TC Memo 2023-100)? Thomas and Margaret Conrad were 51.25% owners of Financial Management Corporation (FMC), a subchapter S corporation. FMC owned a yacht and an airplane during the years in 2008 and 2009, the years the IRS audited. FMC

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deducted depreciation for the yacht and the airplane in the total amounts of $959,000 and $281,000 in 2008 and 2009, respectively. The Court agreed with the IRS that the depreciation deductions were not allowable. However, FMC also deducted $257,000 and $21,000 in 2008 and 2009 respectively for other operating expenses including storage, maintenance, and upkeep costs for the yacht and the airplane. These expenses included the cost of flight training for Thomas Conrad to get his rating to fly the latest airplane FMC purchased. The Court allowed 100% of the operating expenses to be deductible. Go figure that one out – the assets are not business so no deprecation, but the upkeep and maintenance is deductible. Huh??

Proposed Regulations on Corporate Stock Repurchase Excise Tax (REG-115710-22)

The IRA imposed a new excise tax on stock repurchases equal to 1% of the aggregate FMV of stock repurchased by certain corporations during the taxable year, subject to adjustments, for repurchases after Dec. 31, 2022. The proposed regulations apply to publicly traded domestic corporations and certain foreign corporations that repurchase their stock or whose stock is acquired by certain affiliates. The proposed regulations would implement the statutory netting rule that reduces the aggregate FMV of stock repurchased by a taxpayer during a taxable year by the aggregate FMV of stock issued by the taxpayer during the taxable year. Additionally, the regulations would implement the statutory de minimis exception which provides that a taxpayer is not subject to the stock repurchase excise tax with respect to a taxable year if the aggregate FMV of the stock repurchased by the taxpayer during the taxable year does not exceed $1,000,000.

The regulations provide that the stock repurchase excise tax must be reported on the Form 720, Quarterly Federal Excise Tax Return, with the Form 7208 attached. The Form 7208, Excise Tax on Repurchase of Corporate Stock, would be used to figure the amount of stock repurchase excise tax owed.

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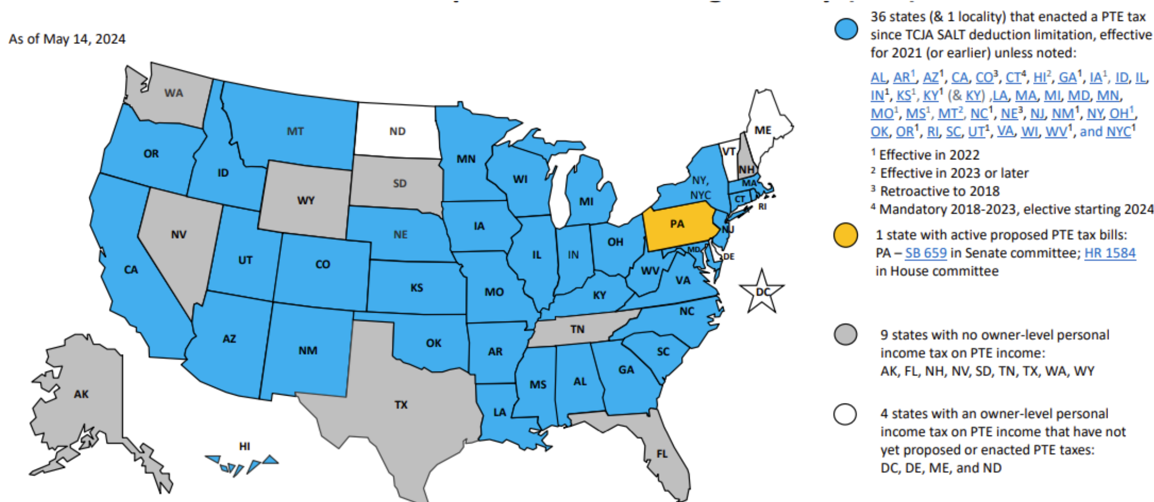
Pass Through Entity Tax - SALT Tax Deduction Workarounds

The Tax Cuts and Jobs Act (TCJA) limited the individual Schedule A deduction for state and local taxes (SALT) to $10,000 each year. Since enactment, states have tried to find a workaround to circumvent the $10,000 SALT limit. As of August 2023, of all the states that assess tax on pass-through entity income, all but 2 (and the District of Columbia) have enacted legislation to allow shareholders and partners a PTE tax deduction. North Dakota and Delaware are the lone holdouts. Not sure of any downside other than maybe the taxpayer pays the tax sooner. The AICPA produced the following chart:



Current PTE tax workarounds (36 states and 1 locality)

State	Effective Year	State	Effective Year
Alabama	2021	Minnesota	2021
Arizona	2022	Mississippi	2022
Arkansas	2022	Missouri	2022
California	2021	Montana	2023
Colorado	2018 (retroactive)	Nebraska	2018 (retroactive)
Connecticut	2018 (mandatory 2018-2023, elective starting 2024)	New Jersey	2020
		New Mexico	2022
Georgia	2022	New York	2021
Hawaii	2023	New York City	2022
Idaho	2021	North Carolina	2022
Illinois	2021	Ohio	2022
Indiana	2022 (retroactive)	Oklahoma	2019
Iowa	2022 (retroactive)	Oregon	2022
Kansas	2022	Rhode Island	2019
Kentucky	2022 (retroactive)	South Carolina	2021
Louisiana	2019	Utah	2022
Maryland	2020	Virginia	2021
Massachusetts	2021	West Virginia	2022
Michigan	2021	Wisconsin	2018

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Specified income tax payments. A "Specified Income Tax Payment" is a state or local tax income imposed on and paid by an electing partnership or S corporation and paid during a taxable year for the year in which the payment is made. Yes, that seems to read paid during 2023 for 2023.

Preparer note. It does not appear then, that this special entity-level deduction will apply for sole proprietors since they do not meet the "Specified Income Tax Payment" definition. Additionally, the state must have a law allowing or providing for the partnership or S corporation to pay the tax, rather than just requiring withholding on non-resident owners.

What taxes are included? Only state and local taxes specifically assessed against the entity qualify, not taxes assessed to the owners. This means mandatory withholding and composite tax payments would not qualify as these tax payments are mechanisms established by states to ease the collection and payment of individual tax obligations but are not specifically entity level taxes.

So, could a resident individual have the entity pay their state taxes in their own state of residency? Yes, but only if the state assesses the tax at the entity level. Could an individual have the entity pay their state estimated taxes and deduct them as a business expense? No, not unless the state tax is assessed against the partnership or S corporation directly instead of against the individual owners. Could the partnership or S corporation pay and deduct any state income tax due with the filing of the 2023 return? Only if the tax was specifically assessed against the partnership or S corporation and not if it is merely a mandatory individual withholding or comprehensive (Comp) payment.

In summary, in recent months nearly every state has modified laws now allowing the tax to be assessed to and pad at the entity level, thus in most cases the tax is deductible on the entity return as an operating expense. State-level treatment is mixed and not addressed here.

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Employee Stock Option Plans (ESOPs) (§409(a); §54.4975-11)

Background. Employee stock option plans (ESOPs) were unofficially introduced in 1958 and were formally adopted when ERISA was passed in 1974. As initially adopted, the ESOP was a very specialized form of a defined contribution retirement plan where the primary investment of the plan is the stock of the plan sponsor. Prior to 1998, ESOPs were intentionally excluded from the list of allowable S-corporation shareholders because any profits allocable to ESOP owned shares avoid Federal taxation, at least until distributed to the ESOP participants. Wanting more employee ownership opportunities, Congress changed the law to allow ESOP ownership of S corporations. Since January 1, 1998, both C and S corporations can establish ESOPs. Other important legislative milestones include:

- 2006: Pension Protection Act provided more flexibility for ESOP management and diversification of participants.
- 2018: Main Street Employee Ownership Act relaxed SBA lending rules for ESOPs to encourage ESOP ownership.
- 2021: Defense Authorization Act provides preference to ESOPs reapplying for defense contracts.
- 2022: CHIPS Act provides funding for organizations who promote employee ownership.

Bottom line – based on the legislative history, it appears that employee ownership is looked upon favorably by Congress so any future changes should be favorable to ESOPs.

Fast facts. As of the end of 2023, there were approximately 6,500 ESOPs operating in the U.S. covering about 13.9 million participants. Approximately 65% of the ESOPs were owned sponsored by S corporations[1].

Typical ESOP structure. Like other retirement plans, the ESOP is a trust subject to the Employee Retirement Income Security Act (ERISA). Strict rules must be followed to ensure the ESOP continues to operate and provide promised benefits. While ESOP structures may vary depending on circumstances, in a typical arrangement, a trust is established to hold shares of stock in the sponsoring company. Shares of the sponsor's stock are transferred to the ESOP trust in exchange for cash or a note. The sponsoring company continues to be managed by its management team, which is overseen by a board of directors. The ESOP and its participants do not manage the company. But the ESOP trustee typically approves the board of directors, and vice versa – the trustee serves at the discretion of the board of directors. The ESOP Trustee's responsibility to is to operate the ESOP for the exclusive benefit of ESOP participants in accordance with the ESOP plan document. Individual ESOP participants are not shareholders and are not entitled to the sponsor's private information.

Advantages and disadvantages of ESOPs. There are multiple reasons to do and not to do ESOPs. While not definitive, below is a list of some of the more common advantages and disadvantages of adopting an ESOP.

[1] Per information gathered from Paralign Capital Partners.

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Advantages:

- **Lower employee turnover.** ESOP participation is associated with significantly reduced turnover. An NCEO studies have shown ESOP owned companies experienced employee separation rates that are more than two times lower than national rates.

- **Younger workers attracted to ESOP benefits.** Young adults (ages 28-34) that worked at ESOPs realized a 92% higher median household net worth, 33% higher median income from wages, and 53% longer median job tenure (W.K. Kellogg Foundation ESOP study).

- **Company profits allocated to ESOP are tax free – S corps.** ESOPs are formed as tax-exempt trusts that do not pay income taxes. Any pro rata income allocated to an ESOP is not taxed. This means that 100% ESOP-owned S corporations are tax exempt (true for most but not all states)[2].

- **ESOP contributions can be tax deductible.** Like other retirement plan contributions, ESOP contributions are tax deductible. Contributions can be accelerated during the initial transaction to offset a significant taxable income in the year of adoption. Accrued contributions or contributions based on accrued compensation are not deductible.

- **§1042 may allow for capital gain deferral.** Eligible C corporation shareholders may elect to defer capital gains realized from the transfer of stock to an ESOP under §1042. See full discussion of §1042 below.

Disadvantages:

- **Costs – and this is a big one.** ESOP set up expenses typically run around 3% of company value (ranging higher for smaller companies and less for larger companies (those with more than $20mm of annual income). Additionally, annual administration fees will range $75-100,000 on the low end and go up from there. While these estimates are very broad, they show that the set up and annual costs of ESOPs are substantially more expensive than any other retirement plan available.

- **Loss of control and privacy.** Transferring control to an ESOP means there will be an ESOP trustee watching business operations. This trustee should be unrelated to the sponsor and its owners. The board of directors will become formalized and should include at least one unrelated board member. ERISA will also be keeping an eye on the plan to ensure there is true value for the participant employees. Overall, a lot of new scrutiny for entrepreneurs who are used to answering only to themselves.

- **S corporation distribution rules.** In the S corporation world, ESOPs offer the advantage that income allocated to the ESOP is not taxable. However, unless the ESOP owns 100% of the S corp stock, the S corp pro rata distribution rules apply.

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[2] District of Columbia, Louisiana, Michigan, New Hampshire, New Jersey, New York and Tennessee do not exempt from tax S corporation earnings allocated to an ESOP.

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Meaning, if there are distribution to other shareholders, say to pay taxes on their allocable share of S corp income, then the ESOP must receive pro rata distributions as well. The result is the company may end up funding the ESOP more than it wants to.

- **Disqualified shareholder could terminate S election.** Employees who leave or retire and cash in their ESOP retirement plan may not be a qualified S corp shareholder, and result in the disqualification of the corporation to be an S corp. This is often remedied by putting in the ESOP organization documents that any payouts must be made in cash, not stock.

Election to defer gains from sale of stock to ESOP (§1042; §1.1042-1T). C corporation shareholders who sell or otherwise transfer their plan sponsor stock directly to an ESOP may make an election to defer capital gains from the stock transfer. To qualify, the shareholder must purchase qualified replacement property (QRP) during the replacement period, which begins three months before and ends twelve months after the transfer of the stock to the ESOP. There is no requirement to sell the QRP at any point in the future – when to sell is 100% at the buyer's prerogative. The election is only available if the ESOP owns 30% or more of the sponsor company's outstanding stock.

QRP defined. The term "qualified replacement property" is defined as any security (preferred stock, common stock, bonds, convertible bonds, etc.) in an operating domestic corporation:

- With more than 50% of its assets in use at the time of the ESOP purchase being used in the active conduct of the trade or business;

- Whose passive income in the preceding taxable year did not exceed 25% of its total gross receipts; and

- Is not a member of the same controlled group as the plan sponsor.

Preparer note. The requirement that the QRP be acquired within twelve months limits the ability to use notes to finance the purchase of the ESOP stock.

SECURE Act 2.0 Section 114 makes some gain deferral available to S corporation shareholders. Secure Act 2.0 amended §1042 to allow S corporation shareholders to receive at least some benefit under §1042. For sales to ESOPs after December 31, 2027, S corporation shareholders will be allowed to defer capital gains from the sale of their stock to an ESOP. While C corporation shareholders may defer 100% of the gains from the sale of stock to an ESOP, S corporation shareholders will be limited to deferring only 10% of the gain. All other §1042 requirements as discussed above apply to S corporation shareholders.

Who should consider an ESOP? Given the costs involved in establishing and maintaining an ESOP, companies considering an ESOP needs to be very profitable. Industry experts suggest a net profit of at least $3 million to make the ESOP financially viable. Other criteria for choosing an ESOP include:

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- **Industry specific.** ESOPs often compare favorably to other sale alternatives in industries with traditionally limited institutional capital interest – construction and other people-centric businesses, businesses with unique assets, or assets with headline risk (e.g., firearms, political organizations, etc.), in serving as an acquirer or as a stalking horse to enhance competition.

- **Asset specific.** Asset-heavy businesses (e.g., manufacturing, equipment rental) which reach maturity and generate significant cash flows while requiring limited ongoing investment often face large tax bills. An ESOP can be used to monetize decades of investment, with the income allocated to the tax-exempt trust and cash used to repay seller notes.

Preparer note. ESOPs can be flexible and extraordinarily complex. Shareholder groups with varied timelines, risk tolerance, and objectives – whether inter-generational or otherwise – can utilize an ESOP to reduce risk and provide liquidity to select shareholders, while retaining ownership and upside for others, all on a tax-efficient basis. However, businesses considering an ESOP must remember that the ESOP is a retirement plan. As with all retirement plans, Congressional intent is that ESOPs will serve to the benefit of the rank-and-file employees, not just owners or the company itself. Plan sponsors need to remember this when considering ESOP implementation.

Gain deferral under §1042 not allowed (Edward Berman, et al v. Comm., USTC Dkt. No. 202-13, 388-13, July 16, 2024). EM Lawrence, LTD. (EML) was a family-owned New Jersey S corporation that established an ESOP on September 1, 2002, the first day of its fiscal year. EML properly filed an S corporation revocation letter with the IRS in November 2002, effectively becoming a C corporation as of September 1, 2002. Ed Berman and family sold their stock in EML to the EML ESOP in November 2002 for $8.3 million in exchange for promissory notes. No cash was received in 2002. The gain realized from the sale was $8.25 million. The Bermans elected under §1042 to defer reporting the gain from the sale of the EML stock and they purchased qualified replacement stock (QRP), which they purchased in October 2003, within the twelve-month replacement period. However, in 2003 the Bermans also engaged in purported disposition of their QRP in 2003, requiring recognition of the entire $8.25 million deferred gain in 2003. However, while the QRP was deemed disposed, the Bermans only received cash of $998,000 in 2003. The IRS assessed tax on the entire $8.25 million gain.

Installment sale rules to the rescue. The Bermans made two arguments to avoid paying tax on 100% of the gain in 2003:

1. That the original election under §1042 was invalid – the Court ruled that the election was valid and binding; and
2. If the §1042 election was valid, then the installment method of accounting should be applied to calculate the taxable gain in 2003 and later years.

The Court ruled that §1042 does not override §453. In its extensive analysis, the Court noted that the plain text of §453 provides that income from an installment sale is reported under the installment method by default. This is as sweeping as the command of §1042(e)

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that gain upon the disposition of QRP be computed and recognized pursuant to its terms. The Bermans' sales of their ESOP stock were installment sales because at least one payment for the stock was to be received after the close of the taxable year in which the sale occurred. There was no evidence the Bermans elected out of the installment method and the Court ruled they were entitled to report the gains under the installment method.

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Qualified Subchapter S Trust (QSST)

The use of trusts for ownership of S corporations has always been very restricted. The few allowed trust owners are grantor trusts while the donor is alive, testamentary and irrevocable trusts for 2 years after the donor's death, and the 2 trusts allowed by special sections of the Internal Revenue Code: the electing small business trust (ESBT) and the qualified subchapter S trust (QSST). **The ESBT and the QSST both require a special tax election discussed below.**

The QSST is specifically allowed to be a shareholder in an S corporation as a result of §1.1361-1(j). The QSST has some complex rules of formation and operation, but the first consideration is regarding the use and requirements of a QSST. A QSST treats S corporation income as a grantor trust to the beneficiary. In other words, the beneficiary is treated as if he or she owns the S corporation stock directly, at least for tax purposes. The calculation of the 20% qualified business income (QBI) §199A deduction is based on the beneficiary's taxable income and reported on the beneficiary's tax return.

This special trust is limited to one individual beneficiary who must be a US citizen or resident. All income must be distributed (or required to be distributed) annually under the trust document, but distributable income is not considered the distributive share on the Schedule K-1, but rather it is the actual cash or property distributions made similar to a trust (§1.1361-1(j)(1)). There is a special election a trustee may make to treat a distribution made in the first 65 days of the year as attributable to the prior year's income.

Under Regs. §1.1361-1(j)(3), a trust that has multiple beneficiaries can meet the QSST single-beneficiary requirement if each beneficiary has a separate and independent share of the trust, each of which is treated as a separate trust for federal income tax purposes. A special rule at Reg. §1.1361-1(j)(2) allows spouses to be beneficiaries of the trust as if they were one individual if they file a joint return during the trust's existence.

During a QSST's life, any distributions of corpus may only be made to the income beneficiary of the trust and the trust must terminate upon the earlier of the death of the beneficiary or a clause that terminates the trust prior to that date. And upon termination of the trust during the beneficiary's lifetime all the trust's assets must go to that beneficiary.

The most common usage of the QSST is for estate planning purposes, with a second use for purposes of financial planning, such as protection of assets from attachment. When the stock is transferred into the QSST, if the fair market value (FMV) is greater than the annual gift tax exclusion then a gift tax return must be filed. A common tool used with QSSTs is to transfer a minority interest of shares; thus, obtaining a minority interest discount as well as a potential discount for lack of marketability.

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Example: Fenton and Clem (2 single brothers) own a successful local furniture store operating as an S corporation and are in the highest Federal tax bracket. Their oldest nephew, Brennan, is not real bright and after losing his re-election campaign as a US Senator has come back to work in the family business, earning about $90,000 annually. None of their other family works in the business. Their estate continues to grow, and they are worried about 3 things: estate tax upon their deaths, current income tax concerns, and the transfer of the family business to the numbskull nephew. They have enough money to leave for the other family, but they want Brennan to be the owner of the furniture store.

Additionally, Fenton and Clem are concerned about losing control of the company to former Senator Simpleton.

So here is what they might consider:

Establish a QSST with themselves as donors and Brennan as the sole income beneficiary. The trust will terminate at the earlier of Brennan's death or upon the death of both Fenton and Clem. Then they will transfer some or all their stock to the QSST, potentially up front or over several years based on legal and tax advice. The stock will require a professional valuation to determine gift tax amounts and discounts.

The current year income advantages to Fenton and Clem include distributable income will now be partially or fully allocated to and reported by Brennan, the value of the stock is frozen for estate planning purposes with future appreciation in the hands of Brennan, and control is retained in the hands of the trustee of the trust rather than by their nephew.

Because Fenton and Clem's company is already operating as an S corporation, no new S-election is required. However, an election is required for the trust, and it must be made within the 16-day-and-2-month period beginning on the day that the S election is effective. Rev. Proc. 2013-30 (amplified by Rev. Proc. 2022-19) does allow extensions to the election date. An example election is included below. *The election must be made by the current income beneficiary, so trust wording should include the election requirement.*

The advantages of a QSST include:

- The ability to transfer future stock appreciation into the hands of someone else.
- Transfer current income out of the hands of high bracket shareholders and into the hands of low bracket shareholders.
- Allow retention of control of the corporation by existing shareholders and/or trustees
- Avoid trust tax.
- Obtain minority discounts for gift tax purposes.
- By using multiple QSSTs, effectuate transfer to several beneficiaries.

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> **Note:** Not all stock must be transferred to the QSST, any number or all shares may be transferred at any time. The primary disadvantage of the QSST is the requirement to have legal advisors very carefully draft the trust documents to comply with the rules and to timely file the appropriate election.

QSST Rules

A. Under §1361, these special irrevocable trusts may be shareholders of S corporations, *by election* [Reg. §1.1361-1(j)].

1. The individual beneficiary of the trust must elect to be treated as the owner of the trust and all items reported to the trust flow through on Schedule K-1 to the beneficiary's Form 1040 (PLR 9035048).

    i. The QSST must distribute all income to the beneficiary.

    ii. Required distribution income does not include flow-thru S corporation income, only cash distributions.

> **Example:** The Brennan QSST receives a Schedule K-1 from Fenton-Clem S corporation for $60,000 but only receives a $27,000 distribution from the S corporation. Brennan QSST is only required to distribute $27,000 to Brennan individual, although Brennan individual will pay tax on the full $60,000.
>
> From a tax perspective of the trust beneficiary, the trust is a grantor-type trust, which is why Brennan will pay tax individually on the full $60,000 even though he only received $27,000 cash.

2. The election is irrevocable and may apply no more than 2 months and 15 days retroactively. (See Rev. Proc. 2013-30 for the 3 year and 75-day exception).

3. Successor beneficiaries are deemed to have also made the QSST election.

4. If the QSST ceases to qualify after the beneficiary's death, the trust will continue to be an eligible shareholder for only 2 years following death.

5. If anyone has special powers of appointment during the lifetime of the income beneficiary (including even the income beneficiary), the trust will generally not qualify as a QSST.

6. If the trust is used to satisfy support obligations of the grantor, the trust will not meet QSST requirements.

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> **Example:** Frank creates a trust for the benefit of his son, George. Under the terms of the trust, all income is payable to George until the trust terminates on the earlier of George's attaining age 35 or George's death. Upon the termination of the trust, all corpus must be distributed to George or George's estate. The trust includes all the provisions prescribed by the Regulations but does not preclude the trustee from making income distributions to George that will be in satisfaction of Frank's legal obligation to support George. Under the applicable local law, distributions of trust income to George will satisfy Frank's legal obligation to support George. If the trustee distributes income to George in satisfaction of Frank's legal obligation to support George, the trust will not qualify as a QSST because Frank will be treated as the owner of the ordinary income portion of the trust.

B. A QSST is defined as:

1. Sole beneficiary is a US citizen or resident (but see above).
2. Owns stock in 1 or more S corporations.
3. Has trust terms requiring only 1 income beneficiary during the trust's life, and that corpus distributions must go to the income beneficiary.
4. The income interest must terminate on the earlier of the beneficiary's death or the date the trust terminates, and
5. Upon trust termination, all corpus must be distributed to the beneficiary; during its existence, all income must be distributed.

C. A QSST may own other assets and can generate non-S corporation income.

> **Case Law:** In CCA 200910040, the IRS determined that an error by the accountant preparing a return for a QSST did not disqualify the QSST. The accountant incorrectly reported income on the Schedule K-1 from the S corporation to the trust and had the trust pay the tax. A QSST requires that all income from the S corporation flow through to the trust beneficiary for tax purposes.

D. Upon sale of QSST stock, the gain or loss is recognized by the trust rather than the beneficiary [Reg. §1.1361-1(j)(8)].

1. However, the sale is treated as a disposition by the beneficiary to free up any suspended passive losses [§1361 (d)(1)].

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E. Making the QSST election

1. The income beneficiary (or legal representative) must make the election, not the trustee.

   a. A separate election must be made for each S corporation in which the trust owns stock.

a. It may be made on Form 2553, Election by a Small Business Corporation, if the S election date and QSST election are effective the same date and stock is transferred to the trust on or before the date of the election. (See Rev. Proc. 2013-30 for the 3 year and 75-day exception)

2. If making the election for a time after the "S" election had already been made, the Regs. require the following:

a. Send a signed statement to the Service Center where the corporation files its return that states.

b. Name, address, TIN of income beneficiary, trust, and corporation.

c. Identify the election as made under §1361(d)(2)

d. Specify the effective date.

e. Specify the date the stock was transferred to the trust.

f. Provide information to show that the trust, under local law, will have only 1 income beneficiary during its life with corpus being distributed only to that beneficiary; that the trust will terminate on the appropriate dates and distribute its assets upon termination to the beneficiary.

3. Once the election is made, it may only be revoked with IRS consent.

Two examples are provided below. The first example is a stand-alone QSST election to be used when the corporation is already operating as an S corporation The example below uses the information from the example at the beginning of this chapter. In the second example, the income beneficiary is presumed to be making the QSST election at the same time as the S election.

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Example: Blank QSST election made in years after "S" election had been made

Qualified Subchapter S Trust Election Made under §1361(d)(2)

	Current Income Beneficiary	**Trust**	**Corporation**
Name:			
Address:			
TIN:			

The current income beneficiary, _______________ TIN ___________ is making the qualified QSST election herein in accordance with Internal Revenue Code §1361(d)(2) effective ______________ to treat the trust as a qualified Subchapter S trust pursuant to §1361(c)(2)(A)(i).. ____ shares of stock were transferred to the ______Trust TIN _______________ on _________________.

The _________ Trust (TIN ____________) includes all provisions of Internal Revenue Regulation §1.1361-1(j)(6)(ii)(E) under the terms of the trust and applicable local law:

(i) During the life of the current income beneficiary, there will be only one income beneficiary of the trust (if spouses are beneficiaries, that they will file joint returns and that both are US residents or citizens);

(ii) Any corpus distributed during the life of the current income beneficiary may be distributed only to that beneficiary;

(iii) The current beneficiary's income interest in the trust will terminate on the earlier of the beneficiary's death or upon termination of the trust; and

(iv) Upon the termination of the trust during the life of such income beneficiary, the trust will distribute all its assets to such beneficiary.

(2) The trust is required to distribute all its income currently, or that the trustee will distribute all its income currently if not so required by the terms of the trust.

(3) No distribution of income or corpus by the trust will be in satisfaction of the grantor's legal obligation to support or maintain the income beneficiary.

Signed by the current income beneficiary, _________________, this ___ day of __________, 20__.

____

Current Income Beneficiary

Mail to IRS Service Center where *corporation* *files its tax return no later than the 15th day of the 3rd month after the date the stock was transferred to the trust.*

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Example: QSST election made in same year as S-election

Form **2553** (Rev. December 2017) Department of the Treasury Internal Revenue Service

Election by a Small Business Corporation
(Under section 1362 of the Internal Revenue Code)
(Including a late election filed pursuant to Rev. Proc. 2013-30)
▶ You can fax this form to the IRS. See separate instructions.
▶ Go to *www.irs.gov/Form2553* for instructions and the latest information.

OMB No. 1545-0123

Note: This election to be an S corporation can be accepted only if all the tests are met under *Who May Elect* in the instructions, all shareholders have signed the consent statement, an officer has signed below, and the exact name and address of the corporation (entity) and other required form information have been provided.

Part I Election Information

Type or Print		
	Name (see instructions) Fake Company, Inc.	A Employer identification number 12-3456789
	Number, street, and room or suite no. If a P.O. box, see instructions. 123 W. Main	B Date incorporated 01/01/2018
	City or town, state or province, country, and ZIP or foreign postal code Anywhere, Anystate 12345	C State of incorporation Anystate

D Check the applicable box(es) if the corporation (entity), after applying for the EIN shown in **A** above, changed its ☐ name or ☐ address

E Election is to be effective for tax year beginning (month, day, year) (see instructions) . . . . . . ▶ 01/01/2023

Caution: A corporation (entity) making the election for its first tax year in existence will usually enter the beginning date of a short tax year that begins on a date other than January 1.

F Selected tax year:

(1) ☑ Calendar year

(2) ☐ Fiscal year ending (mont

(3) ☐ 52-53-week year ending w

(4) ☐ 52-53-week year ending with refe

If box (2) or (4) is checked, complete Part II.

Effective S Election Date

Form 2553 (Rev. 12-2017) Page **2**

Name | **Employer identification number**

Part I Election Information *(continued)* **Note:** If you need more ro

J Name and address of each shareholder or former shareholder required to consent to the election. (see instructions)	K Shareholder's Consent Statement Under penalties of perjury, I declare ... consent to the election of the above-n... corporation (entity) to be an S corpora... under section 1362(a) and that I have examined this consent statement, including accompanying documents, and, to the best of my knowledge and belief, the election contains all the relevant facts relating to the election, and such facts are true, correct, and complete. I understand my consent is binding and may not be withdrawn after the corporation (entity) has made a valid election. If seeking relief for a late filed election, I also declare under penalties of perjury that I have reported my income on affected returns consistent with the S corporation election for the year for w... the election should have been filed (... beginning date entered on line E) a... subsequent years. Signature	Date	Number of shares or percentage of ownership	Date(s) acquired	M Social security number or employer identification number (see instructions)	N Shareholder's tax year ends (month and day)
Fenton Smith 321 W. Main Anywhere, Anystate 12345		/01/2023	40	01/01/2018	987-65-4321	12/31
Clem Smith 567 W. Main Anywhere, Anytown 12345		01/02/2023	40	01/012018	987-55-8564	12/31
New QSST Trust 678 W. Main Anywhere, Anystate 12345		01/01/2023	10	01/01/2023	35-1234567	12/31

QSST Must also sign S election if stock transferred in same year S election is

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Form 2553 (Rev. 12-2017) Page **4**

Name	**Employer identification number**

Part III **Qualified Subchapter S Trust (QSST) Election Under Section 1361(d)(2)*** **Note:** If you are making more than one QSST election, use additional copies of page 4.

Income beneficiary's name and address	Social security number
Brennan Slmpleton 890 W Main Anywhere, Anystate 12345	888-88-8888
Trust's name and address	Employer identification number
New QSST Trust 678 W Main Anywhere, Anystate 12345	35-1234567

Date on which stock of the corporation was transferred to the trust (month, day, year) . . . . ▶

In order for the trust named above to be a QSST and thus a qualifying shareholder of the S corporation for which this Form 2553 is filed, I hereby make the election under ... tify that the trust meets the definitional requirements of section 1361(d)(3) and ... , correct, and complete.

Signature of income beneficiary or signature and titl ... Date

*Use Part III to make the QSST electio ... to the trust on or before the date on which the corporation makes its electi ... be made and filed separately if stock of the corporation is transferred to the trust **after** the date on which the corporation makes the S election.

Make sure to fill in income beneficiary and trust information

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Electing Small Business Trust (ESBT) [§1361(e)]

A. This trust, an eligible shareholder, provides that income accrues for 1 or more beneficiaries. The ESBT rules were slightly modified by the Tax Cuts and Jobs Act (TCJA) in 2017. Nonresident alien individuals are now permitted to be a potential current beneficiary.

   1. The trust, rather than the beneficiaries, is **taxed at the highest individual rate** on ordinary income or capital gain rate on capital gains.

> **Preparer Tip:** Do not rule out the ESBT just because all the income is taxed at the highest rate. If the beneficiary of the ESBT is in the highest tax rate bracket, he or she is also subject to the phase out of itemized deductions and personal exemptions, something which does not affect the ESBT.

   2. The advantage the ESBT has over the QSST is the ability to have more than 1 shareholder, but to have voting control remain with the trustee, who is usually the grantor parent. The disadvantage is the high tax rate.

B. All initial ownership interests must come via gift, bequest, or transfer in trust, rather than through purchase.

C. Although current beneficiaries must meet normal S corporation shareholder requirements (as modified TCJA), beneficiaries as a result of specified events (i.e. death), may include other groups, such as political entities and most charities under§170(c)(1).

D. For income tax purposes, the ESBT is effectively divided into a "corporate trust" containing the S corporation's stock, and the "remainder" of the trust containing all other assets. Even though the entire trust must qualify to be an ESBT, only that portion of the trust consisting of the S corporation's stock is subject to special tax treatment under §641(c). The portion of the ESBT which holds the S corporation's stock pays tax on the resulting taxable income at the highest individual tax rate, subject to the limitation on rates for capital gains.

E. The ESBT election is made in the same manner as the QSST election with reference to §1361(e)(3). The election is irrevocable and may apply no more than 2 months and 15 days retroactively. (See Rev. Proc. 2013-30 for the 3 year and 75-day exception).

F. Nonresident alien individuals are permitted to be a potential current beneficiary (TCJA).

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Example: ESBT election

Qualified Electing Small Business Trust Election Made under §1361(e)(3)

	Potential Current Beneficiary	**Trust**	**Corporation**
Name:			
Address:			
TIN:			

The potential current beneficiary, ________________ TIN ________ is making the qualified ESBT election herein in accordance with Internal Revenue Code §1361(e)(3) effective ______________ pursuant to §1361(c)(2)(A)(v). _____ shares of stock were transferred to the _________ Trust TIN _______________ on _________________.

The _____________ Trust (TIN _________________) includes all provisions of Internal Revenue Regulation §1.1361-1(m)(2):

1. This election is made under Internal Revenue §1361(e)(3).

2. The stock was transferred to the trust ________________.

3. The election is to be effective _______________________.

4. The trustee represents:

(1) The trust meets the definitional requirements of §1361(e)(1); and
(2) All potential current beneficiaries of the trust meet the shareholder requirements of §1361(b)(1).

Signed by the trustee, _____________________, this ___ day of __________, 20__.

____
Trustee

Mail to IRS Service Center where corporation files its tax return no later than the 15th day of the 3rd month after the date the stock was transferred to the trust.

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QSST and ESBT Comparison

Characteristic	QSST	ESBT
Allowed beneficiaries	Individuals only	Individuals, nonresident aliens, estates, most charities
Number of beneficiaries	One	Multiple
How may interest be acquired	Any manner	Not through purchase
Who makes the election?	Current income beneficiary	Trustee
Election due date	75 days of stock receipt	75 days of stock receipt
Current income taxation	To beneficiary	To trust
Tax rates	Beneficiary rate	Highest individual rate, but if shareholder is at high rate, avoids individual phase-outs of itemized deductions and personal exemptions
Other non-S income tax treatment	Taxed to beneficiary	Bifurcated: S income taxed at highest rate; other income utilizes exemptions and graduated rates
Income distribution rules	All distributed currently	None

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Qualified Subchapter S Subsidiary (Q-Sub) [§1361(b)(3)(B)]

Generally, the ownership of stock in an S corporation is limited to individuals, a few trusts, charities, and qualified retirement plans (but not IRAs). A Q-Sub is a special tax treatment allowing an S corporation's stock to be owned by another S corporation. To qualify for the election, the Q-Sub must itself qualify to be an S corporation and ownership of the Q-Sub must be 100% in the hands of the parent.

The Q-Sub does not file its own return but files a consolidated S corporation return with the parent owner. In addition, if its stock is sold, it is treated as an asset sale not a stock sale. Q-Subs are treated as separate entities for other operating issues, such as payroll and employment taxes and filings, excise tax and fuel tax credits. The payroll separate filing issues may be avoided by using a common paymaster by the parent corporation.

Why Make a Q-Sub Election

- The same individuals or group owns two different S corporations, one which loses money and has exhausted the basis of the shareholders, and one that is profitable with substantial basis. The shareholders of the loser could transfer their stock to the profitable entity and at the same time make the Q-Sub election; thus, combining basis in both entities and allowing the losses in one entity to offset the profits in the parent.

- An S corporation owns a valuable franchise or patent, which under legal terms of the franchise or patent, may not be transferred by the existing S corporation to another owner; thus, preventing the sale of the existing S corporation. The potential new owners establish a new S corporation to purchase the old S corporation's stock and have the old S corporation make the Q-Sub election. This effectuates the sale while retaining legal ownership of the franchise or patent in the name of the original owner.

- An existing profitable S corporation wants to open a new branch in another state with existing S corporation assets and goodwill, but is concerned with liability and operational issues in the other state. The existing parent corporation could establish a new S corporation in the other state, make the Q-Sub election, transfer selected assets at cost basis (not FMV) from the parent to the Q-Sub tax-free and accomplish its goals.

The election is made using Form 8869, Qualified Subchapter S Subsidiary Election, which is due no sooner than one year in advance or 75 days after the beginning of the year of the desired effective date. (See Rev. Proc. 2013-30 for the 3 year and 75-day exception).

Q-Sub Rules

A. An S corporation may own 1 or more other S corporations if it owns 100% of the other corporation that is not treated as a separate corporation for tax purposes.

    1. All assets, liabilities and income/expense items are treated as owned by the S corporation parent company and inter-company amounts are eliminated.

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2. By maintaining separate legal entities, liability protection is maintained, while reducing compliance costs and limiting basis and at-risk tax concerns to 1 entity.

3. Only one tax return is filed, that of the parent, which consolidates all activities of the Q-Sub on the parent return. The subsidiary is deemed to have been liquidated into the parent S corporation tax-free §332. *Payroll is still maintained and reportedly* separately [Reg. §1.1361-4(a)(7)].

4. This effectively means that an S corporation **may** own the stock of another S corporation if the Q-Sub rules are met.

5. By electing Q-Sub status, the at-risk, basis and passive activity tests are only applied to the parent entity, rather than individually to each entity; a major advantage of Q-Subs.

6. In fact, a shareholder with nondeductible losses because of at-risk limitations may perform a tax-free reorganization [§368(a)(1)(D)] and contribute ownership of the shares in the loss corporation to the parent corporation and offset the losses against the parent's income, assuming that the shareholder is actively participating in both entities.

   a. Make sure that the liabilities of the old S corporation do not exceed asset basis or gain may result under §357(c) although the Q-Sub regulations specifically exempt this transaction from tax (Rev. Rul. 2007-8).

B. The Q-Sub election is made by filing Form 8869, which will specify the effective date of the election and is filed directly with the Service Center where the parent filed its most recent return.

1. The effective date may not be more than 2 months and 15 days retroactive or 12 months after the date of filing.

2. This effectively means the election must be filed within 2 and ½ months of the acquisition of the Q-Sub by the parent.

3. The election is treated as a tax-free liquidation into the parent, and making the election is treated as adopting a plan of liquidation.

4. The election may be revoked by filing a signed statement with the Service Center where the parent files its return. It is effective on the date signed or retroactively for up to 2 months and 15 days or prospectively for up to 12 months. Rev. Proc. 2013-30 also allows for an extended period to cure a late Q-Sub election.

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Two Solely Owned S Corporations without Q-Sub Election			
Activity	**Gas station Corp 1**	**Gas station Corp 2**	**Total**
Active participation?	Yes	Yes	Yes
Basis	$50,000	$50,000	$100,000
At-risk amount	$50,000	$50,000	$100,000
Current year loss	($40,000)	($60,000)	($100,000)
Deductible current year loss	($40,000)	($50,000)	**($90,000)**
Two Solely Owned S Corporations WITH Q-Sub Election			
Active participation?	Yes	N/A	Yes
Basis	$100,000	N/A	$100,000
At-risk amount	$100,000	N/A	$100,000
Current year loss	($100,000)	N/A	($100,000)
Deductible current year loss	($100,000)	N/A	**($100,000)**

With a Q-Sub election in place, only 1 return is filed, that of the parent corporation. Even carryover suspended losses from the old corporation are freed up (if basis exists) after the re-organization, under Reg. §1.1366-2(c).

Form **8869** (Rev. December 2020) Department of the Treasury Internal Revenue Service

Qualified Subchapter S Subsidiary Election

(Under section 1361(b)(3) of the Internal Revenue Code)
► Go to *www.irs.gov/Form8869* for instructions and the latest information.

OMB No. 1545-0123

Part I Parent S Corporation Making the Election

1a Name of parent | **2 Employer identification number** (EIN)

b Number, street, and room or suite no. If a P.O. box, see instructions. | **3** Tax year ending (month and day)

c City or town, state or province, country, and ZIP or foreign postal code | **4** Service center where last return was filed

5 Name and title of officer or legal representative whom the IRS may call for more information | **6** Telephone number of officer or legal representative

Part II Subsidiary Corporation for Which Election is Made (For additional subsidiaries, see instructions.)

7a Name of subsidiary | **8** EIN (if any)

b Number, street, and room or suite no. If a P.O. box, see instructions. | **9** Date incorporated

c City or town, state or province, country, and ZIP or foreign postal code | **10** State of incorporation

11 Date election is to take effect (month, day, year) (see instructions) . . . ►

12 Did the subsidiary previously file a federal income tax return? If "Yes," complete lines **13a, 13b,** and **13c** . . . ► ☐ Yes ☐ No

13a Service center where last return was filed | **13b** Tax year ending date of last return (month, day, year) ► | **13c** Check type of return filed: ☐ Form 1120 ☐ Form 1120-S ☐ Other ►

14 Is this election being made in combination with a section 368(a)(1)(F) reorganization described in Rev. Rul. 2008-18, where the subsidiary was an S corporation immediately before the election and a newly formed holding company will be the subsidiary's parent? . . . ► ☐ Yes ☐ No

15 Was the subsidiary's last return filed as part of a consolidated return? If "Yes," complete lines **16a, 16b,** and **16c** . . . ► ☐ Yes ☐ No

16a Name of common parent | **16b** EIN of common parent | **16c** Service center where consolidated return was filed

Under penalties of perjury, I declare that I have examined this election, including accompanying statements, and to the best of my knowledge and belief, it is true, correct, and complete.

Signature of officer of parent corporation ► | **Title ►** | **Date ►**

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 28755K Form **8869** (Rev. 12-2020)

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Comprehensive Q-Sub Example

Joe and Notah have been lifelong friends, graduating from college together with similar accounting degrees.

After graduation Notah was hired into the auditing department of a national firm, rising rapidly through the ranks to become an audit manager in charge of a national restaurant franchise chain account. His unusual outgoing personality combined with his brilliant mind and Native American heritage combined to accelerate Notah quickly. He constantly received job offers and promotions.

Joe went into the tax department of a different national firm and after several years left to start his own firm. He prepared Notah's personal return beginning the year after graduation and thereafter.

After managing the audit of the restaurant chain for two years, Notah was offered a job by the client and accepted the job as director of franchisee relations in the Midwest. Again, Notah advanced quickly but after two years became aware of an opportunity to buy seven of the franchises from a franchisor who was retiring. He discussed it with his tax friend, Joe, obtained financing and quickly bought the seven stores.

The restaurant chain in which Notah invested was one of the oldest and most successful franchises in America but was very structured. For example, all franchise transfers had to be approved by the franchisor corporation as part of the contract. Notah's purchase included six franchise stores which carried a formula price provided by the franchisor, plus the appraised value of real estate and equipment. In a very unusual situation, however, Notah also purchased one of the chain's seven "legacy" stores. The legacy stores were the first seven franchises established at the inception of the franchise and these were the only seven franchises available in the world which did not require pre-approval of the franchise transfer if the franchise itself was not sold.

In this legacy store, the franchise was owned by the S corporation that operated this store in a small Midwestern city. As you can imagine, this legacy store carried a high premium value because its stock could be sold to a third party to transfer the assets of the corporation (including the franchise) to an outside buyer without franchisor approval.

Notah financed 100% of the purchase with a combination of financing from the parent corporation as well as the previous franchisee. He immediately embarked on significant improvements to the store's cleanliness, employee treatment, operations, hours and management and the stores quickly rose through the ranks within the franchisor's rating system to be in the top 10% of all franchisees for overall quality within three years. Of course, this meant that Notah was working lots of hours, traveling throughout his store region regularly and reinvesting all his profits in new equipment, while trying to raise three children with his wife Diane.

As Notah's accountant, Joe met with Notah bi-weekly and had phone conferences at least once a week. Joe's firm prepared the corporate tax returns for all seven corporations, payroll, bookkeeping and assorted tax and financial planning aspects. In the third year of operations, Joe suggested to Notah that they discuss a contingency plan in the event of Notah's death or illness.

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One evening, Joe and Notah sat down together, along with Notah's wife, and discussed the always touchy topic of what to do in the event of Notah's death or illness. Diane made it very, very clear she wanted nothing to do with running restaurants and would prefer to just have life insurance to protect her and the kids since she had not worked outside of the home for many years.

Joe discussed a contingency plan with Notah, one element of which was a buy-sell agreement for the six regular franchise stores and another franchisee. This was common in the restaurant franchise Notah owned, and the franchisor even provided pricing, documents, and terms so Notah felt protected. The buy-sell on these stores would essentially wipe out debt for all six conventional franchises, plus the debt on the seventh legacy store, which Notah hoped would sell for enough money to provide for Diane and the kids for the rest of their lives.

Joe was concerned that this seemed to be a pie in the sky idea and begged Notah to enter into a buy-sell agreement for this store. Notah wanted it to be sold at fair market value (FMV) to someone he knew would run the store correctly and asked Joe how to structure the deal if the prospective buyer did not have the cash to pay off Diane for the stock.

Joe instructed Notah that the prospective buyer should buy life insurance on Notah's life, combined with a mandatory buy-sell agreement in the event of Notah's death so that if Notah died, the new owner would get the cash but would have to buyout Diane's stock for the amount of the insurance; thus, alleviating her of the need to operate and sell the store. Notah was rightfully concerned of two things: what if the buyer did not pay for the insurance premium and how would the amount of the life insurance be determined? Joe then suggested to Notah that a valuation be performed on the legacy store, and that Notah's legacy store pay for the premiums on the policy to be assured they were paid. Joe also commented that there be a bullet-proof buy-sell agreement drawn up by the attorney for this event.

The value placed on the store and land was approximately $5 million, and Notah proceeded to purchase a life policy on himself, payable to the new owner and backed up with a mandatory buy-sell agreement within 90 days of Notah's death for the new owner.

As all stories go, this one has a sad point. About 30 months after putting everything in place, Notah was killed in a car accident late one evening driving home from the legacy store. Diane was unable to deal with things and Joe and his wife immediately went to Notah's town to try to provide emotional support and to get through the financial situation.

Joe immediately notified the franchisor corporation and the buyer of the six regular stores of Notah's death, and the insurance and buyout of those six stores proceeded quickly and without a hitch. Joe was unable to determine who the other party was in the buy-sell agreement for the legacy store, and after a few days, Diane was calm enough to discuss the problem with Joe and explain things.

Diane found Notah's will and during the search also found the buy-sell and mandatory redemption agreement for the legacy store, both of which were shockingly unsigned. Even worse, she found that Notah had purchased a life insurance policy, paid the premiums, and made the other party the beneficiary of the insurance. Can you see how bad this could be? The other party is going to receive $5 million cash with no obligation to redeem Diane's stock and she has no desire, ability, or current presence of mind to run the store.

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In discussing this with Diane, Joe asked to see the life insurance policy so that he could go to an attorney immediately to protect Diane and her kids. To Joe's surprise, Joe, was the beneficiary of the policy. This was a good thing for Diane, not so good for Joe. Of course, Joe would buy out Diane's stock for $5 million; the issue was Joe had no interest in owning or running a franchise restaurant 240 miles from his office. Joe had a booming tax practice and frankly, the liability in this restaurant was not something he wanted to deal with. Spurious lawsuits were a monthly event in this industry.

Before we go further and illustrate the Q-Sub election, let's summarize the tax situation. Diane's stock has a FMV of $5 million based upon an independent valuation and buy-sell agreement, so any money she receives up to $5 million is non-taxable to her. Joe will receive $5 million cash in life insurance proceeds which are not taxable to him, but he should have reported the premium income each year, so he proceeded to amend his returns to reflect that income.

About 30 days after Notah's death Joe receives the life insurance proceeds and deposits the proceeds into his personal checking. During the interim period, Joe established several goals: first, he wanted to make sure Diane got the $5 million; second, he wanted to protect his own tax office and assets from any liability associated with the restaurant and third, he wanted to get Diane bought out and sell the restaurant since he wanted nothing to do with running a restaurant either. The sale of the restaurant's stock should be tax-free to Joe since his basis would be $5 million, and Joe's plan was to also give that money to Diane retaining a small amount for tax and similar liabilities.

Joe then proceeded to establish a new S corporation and contributed the $5 million cash to it. He then had the new corporation buy Diane's stock in the old corporation and then made a Q-Sub election by the new corporation for the old corporation, effective immediately retroactive to the beginning of the year.

Here is what has been accomplished:

<u>Diane</u>

- Enforced the buy-sell agreement on the six main stores, in which her date of death stepped-up basis removed any income tax situations.
- Used the remainder cash from the sale of the six main stores to pay off all debt of all seven stores, as well as her home and provide a small cash cushion.
- Has a stepped-up date of death FMV basis in the legacy corporation's stock of $5 million.
- Receives $5 million for the stock from Joe at no taxable gain or loss.
- Has divested herself of the store headache.
- Will receive net cash from the sale of the store when Joe sells it (a moral requirement not a legal requirement).

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Joe

- Amends two years of returns to pick up income from life insurance premiums paid by legacy corporation.
- Receives $5 million in tax-free life insurance proceeds.
- Sets up new corporation to provide liability protection from restaurant business.
- Invests $5 million in new corporation.
- New corporation proceeds buys Diane's 100% stock ownership of legacy corporation and makes Q-Sub election.
- Legacy corporation is still legally in existence so that the franchisor parent cannot step in and claim the franchise was sold outside the corporation. It was not and the legacy corporation is still in existence.
- The new corporation will file one consolidated S corporation return reflecting the operations of legacy.
- Joe now has two layers of liability protection between his personal assets and the restaurant operation: (1)Legacy is a separate legal corporation whose only stockholder is new corporation and (2) New corporation is a separate legal corporation whose only stock owner is Joe.

Postscript

After Joe's new corporation buys out Diane's stock in Legacy, Joe calls the manager of the store and tells her that he would like to have a meeting. Joe's plan is to tell the new store manager that he intends to sell the store as soon as possible to a large corporation. When Joe arrives at the store a few days later, he is surprised to see all the managers and shift leaders awaiting him. He asks the manager what is going on and she tells him she knows he wants to sell the store. She explains that she and the other employees know and trust Joe after having worked with him for several years as the accountant, payroll provider and regular meetings Joe had with Notah at the legacy store. She asks Joe not to sell to a big corporation but rather to allow her to continue running the store, promising to cause Joe no problems whatsoever because the employees do not want to work for some big corporation. Joe agrees but with a few conditions: first, that Diane must agree, second, that he have no personnel problem or management related phone calls, and third, that they will re-evaluate the situation after one year. The manager and supervisors all agree, and Diane is excited that this is occurring.

After one year, the situation is running very well, and Joe pays the profits to Diane as a salary-after all, it is really her store. Then about 18 months after the transfer, a horrible event occurs to the Legacy store. Joe is notified that his Legacy store has been leaking gas from an unknown buried tank on the property and has contaminated groundwater in the area. The result is that the assets of Joe's legacy store are used to pay for cleanup costs. The state can go to one level of ownership to assess the assets of the owners for cleanup costs. The owner of the stock of Legacy corporation is New corporation, which has insignificant assets that are also forfeited. Joe himself has been protected from the liability because of the two layers of ownership.

So, there you have a real-life case illustrating the legal, asset AND tax benefit of the Q-Sub, a simple election with unbelievable characteristics.

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Potential Planning Idea

The question has come up in a situation like this as to whether New Corporation could have made a §338 election. In a §338 election, the buyer's new corporation buys the stock of the seller's old S corporation to ensure transfer of any contracts without legal ramifications, but the IRS treats it as an asset purchase to avoid disqualifying the new S corporation. (Check with an attorney).

Reg. §1.338(h)(10)-1(c) permits corporations making a qualified stock purchase of a target S corporation to make an election under §338(h)(10) jointly with the S corporation shareholders. When this election is made, for tax purposes, the sale of the stock by the selling shareholders is ignored. Instead, the S corporation is deemed to sell its assets to the buyer (in the form of new target) and to liquidate, generally under §331 and §336. Because the target's S status remains in effect throughout this deemed sales process, any gains or losses recognized on the deemed sale flow through to the shareholders (and adjust their stock bases for purposes of determining gain or loss on the deemed liquidation).

There is no question that New Corporation could make the §338. The advantage to New Corporation would be that the $5 million paid for the stock of Legacy Corporation would be allocated to the assets of Legacy Corporation based on FMV. This would give New Corporation a huge depreciation and amortization write off annually. Without the election, New Corporation steps into the depreciation life, method, and remaining book value of Legacy Corporation's assets, receiving no current tax benefit or deduction for paying FMV.

What about Diane, the only shareholder of Legacy Corporation? Diane must agree to the §338 election (as do all shareholders of both corporations), which means she would be treated as having sold the assets of Legacy Corporation at FMV rather than the stock. Does this make a difference? It could. Diane's stock has clearly received a step-up in basis at Notah's death to FMV of $5 million, and she would have no tax on the stock sale for that amount. If she agrees to the §338 election, she is treated not as having sold the stock, but rather as having sold the assets at FMV.

Diane's stock basis is $5 million, but the assets in the hands of Legacy remain at their book value. Let's say that they have a book value of $1 million.

If Diane sells the stock and agrees to the §338 election, the sales price will be allocated to the assets and will reflect a $4 million gain in the hands of Legacy, which will then serve to increase Diane's basis by the same $4 million, making her basis $9 million. She then is treated as having sold her stock for the cash she will receive ($5 million) resulting in a $4 million capital loss.

Diane can then use the $4 million capital loss and offset it against the capital gains that Legacy Corporation realized upon the deemed sale of its assets under §338. Since that gain was $4 million, it appears that the gain is offset by the loss. However, any of the gain that Legacy recognizes from depreciation recapture (§1245 gain) is taxed as ordinary income which will not be offset by the capital loss on the sale of her stock. This could result in a nasty shock for Diane tax-wise and must be considered.

From Joe's point of view, particularly if he is planning to continue to operate the restaurant, the §338 election is almost a mandatory election. Again, if we assume that the Legacy

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Corporation's asset basis was $1 million, that is what Joe will continue to use for depreciation without the §338 election. With a §338 election, the equipment cost (and goodwill) will have a basis of $5 million and will utilize all new depreciation lives, methods, and if qualified, raid depreciation elections.

Forgotten Forms To Keep in Mind

There are multiple forms that corporations are required to use but, in some cases, may be overlooked or forgotten completely. This section is a reminder of what some of these forms are and when they need to be filed.

Form 8925 – Report of Employer Owned Life Insurance. This form is used to report employees covered by employer owned policies issued after 8/17/2006. It applies to both employer-owned term and whole life policies. It keeps any proceeds received by the employer tax-free to the employer (failure to report may make part or all the death benefit taxable as ordinary income to the employer). There are 4 safe harbors, at least one of which must be met to retain tax-free treatment for employer-received proceeds:

1. Key person policy (Director/Owner or highly compensated), or
2. Employee at any time in the 12 months prior to death, or
3. Benefit is paid to heirs, or
4. Proceeds are used to buy the deceased's ownership interest.

Form **8925**
(Rev. September 2017)
Department of the Treasury
Internal Revenue Service (99)

Report of Employer-Owned Life Insurance Contracts

▶ Attach to the policyholder's tax return. See instructions.
▶ Go to *www.irs.gov/Form8925* for the latest information.

OMB No. 1545-2089
Attachment Sequence No. **160**

Name(s) shown on return	**Identifying number**
Name of policyholder, if different from above	Identifying number, if different from above
Type of business	

1	Enter the number of employees the policyholder had at the end of the tax year	**1**	
2	Enter the number of employees included on line 1 who were insured at the end of the tax year under the policyholder's employer-owned life insurance contract(s) issued after August 17, 2006. See *Section 1035 exchanges* on page 2 for an exception	**2**	
3	Enter the total amount of employer-owned life insurance in force at the end of the tax year for employees who were insured under the contract(s) specified on line 2	**3**	
4a	Does the policyholder have a valid consent for each employee included on line 2? See instructions ☐ **Yes** ☐ **No**		
b	If "No," enter the number of employees included on line 2 for whom the policyholder does not have a valid consent	**4b**	

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Form 1120-H – U.S. Income Tax Return for Homeowner Associations annual election. Homeowners' associations are allowed to annually choose between filing Form 1120 or Form 1120-H. If the association chooses to file Form 1120, all the normal C corporation tax laws apply, and any profits are taxed at 21%. This annual election is made by simply filing Form 1120-H rather than the normal Form 1120. Generally, the election must be made by the due date, including extensions, of the income tax return. HOAs are allowed a 12-month extension to elect to use Form 1120-H if corrective action is taken within 12 months of the return due date, including extensions (§301.9100-2).

HOAs that qualify to file Form 1120-H. There are three kinds of homeowner's associations eligible to file Form 1120-H:

- Condominium management associations organized and operated to acquire, build, manage, maintain, and care for the property substantially all whose units are homes for individuals.

- Residential real estate management associations organized and operated to acquire, build, manage, maintain, and care for a subdivision, development, or similar area substantially all whose lots or buildings are homes for individuals.

- Timeshare associations other than above organized and operated to acquire, build, manage, maintain, and care for property that has members who hold a timeshare right to use or timeshare ownership in real property of the association. This association cannot be a condominium management association.

Qualifying as an HOA. Qualifying homeowner's associations must:

1. Receive 60% or more of its gross income from exempt function income (i.e., dues, assessments, maintenance fees, membership fees, etc.).

2. Have at least 90% of its expenses for the year incurred for acquisition, building, managing or maintenance of associated property.

3. Prevent any private individual from profiting from the HOA earnings except for amounts used to manage, acquire, build, maintain or operate the association.

Tax treatment of qualifying homeowner association entities (§528(d)(3)). The big difference for HOAs filing the 1120-H instead of the 1120 is that member related income (dues, fees, assessments, etc.) are not included in taxable income on Form 1120-H. Only investment income is subject to tax. In addition:

- Any non-exempt income is taxed at a 30% flat tax rate (not the 21% flat C corp rate). For timeshare associations, the rate goes up to 32%.
- NOL deductions are not allowed on Form 1120-H.

Form 4466 – Corporation Application for Quick Refund. Form 4466 is used to receive a faster refund of overpaid estimated tax payment. The form may be filed on the 1st day after year end and any time before the due date of the return, but in either case before the corporate tax return is filed. When Form 4466 is filed the IRS promises the refund will be issued within 45 days. If filed, the Form 4466 must be attached to Form 1120 when filed.

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Form 1122 – Authorization and Consent of Subsidiary… and Form 851, Affiliation Schedule. Corporations planning to file a consolidate return must include Form 1122, Authorization and Consent of Subsidiary Corporation with the consolidated income tax return the first year of consolidation. The subsidiary corporation must also complete Form 1122 and provide it to the parent corporation. Additionally, the parent company must attach Form 851, Affiliations Schedule to its return. The parent must include a schedule (not Form 1120) that shows income, balance sheets and reconciliations of book to tax and retained earnings (RE) for the entities included in the consolidated return. Check the "consolidated return" box on Page 1 of Form 1120 in Section A.

Form 8822-B – Change of Address or Responsible Party – Business. This form is used to notify the IRS of an address change or change in responsible party during the year. If the IRS must reach out to follow up on a filed return, and if no other return has been filed and the Form 8822-B has been submitted, then the IRS has met its notification responsibilities under the law, even if their notices have been sent to an old address.

Cash distributions from corporate entities may require three forms. The tax treatment of cash distributions from a corporation can be reported on Form 1099-DIV, Dividends and Distributions, Form 5452, Corporate Report of Nondividend Distributions, and/or Form 8937, Report of Organizational Actions Affecting Basis. Each form is discussed below.

1. **Form 1099-DIV – Dividends and Distributions.** All taxable dividends are reported on Form 1099-DIV, whether taxable, capital gain, non-taxable or liquidating. The amount of a distribution is generally the amount of any money paid to the shareholder plus the FMV of any property transferred to the shareholder. However, this amount is reduced (but not below zero) by:

    - Any liability of the corporation the shareholder assumes in connection with the distribution.
    - Any liability to which the property is subject immediately before, and immediately after, the distribution.
    - The FMV of any property distributed to a shareholder becomes the shareholder's basis in that property.

A corporation recognizes gain on the distribution of property to a shareholder if the FMV of the property is more than its adjusted basis. This is generally the same treatment the corporation would receive if the property were sold. However, for this purpose, the FMV of the property is the greater of the following amounts:

- Actual FMV.
- Amount of any liabilities the shareholder assumed in connection with the distribution of the property.

If the property was depreciable or amortizable, the corporation may have to treat all or part of the gain as ordinary income from depreciation recapture.

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Preparer note. Generally, Form 1099-DIV is only issued by C corporations. However, if an S corporation was previously a C corporation and it still has prior C corporation earnings and profits, these distributions would require the S corporation to file Form 1099-DIV.

PAYER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no.

1a Total ordinary dividends $

OMB No. 1545-0110

Form **1099-DIV**

(Rev. January 2022)

For calendar year 20____

Dividends and Distributions

1b Qualified dividends $

2a Total capital gain distr. $

2b Unrecap. Sec. 1250 gain $

Copy 1

For State Tax Department

PAYER'S TIN

RECIPIENT'S TIN

2c Section 1202 gain $

2d Collectibles (28%) gain $

2e Section 897 ordinary dividends $

2f Section 897 capital gain $

RECIPIENT'S name

3 Nondividend distributions $

4 Federal income tax withheld $

Street address (including apt. no.)

5 Section 199A dividends $

6 Investment expenses $

7 Foreign tax paid $

8 Foreign country or U.S. possession

City or town, state or province, country, and ZIP or foreign postal code

9 Cash liquidation distributions $

10 Noncash liquidation distributions $

11 FATCA filing requirement ☐

12 Exempt-interest dividends $

13 Specified private activity bond interest dividends $

Account number (see instructions)

14 State

15 State identification no.

16 State tax withheld $ $

2. **Form 5452 – Corporate Report of Nondividend Distributions.** Cash distributions more than E&P are reported on Form 5452. The corporation does not generally recognize gain or loss on cash distributions. They are treated as nondividend distributions and must be accounted for when the shareholder calculates her/his basis in the corporate entity. Distributions reported on Form 5452 represent a return of capital and are non-taxable to the extent of the shareholder's basis. Distributions more than basis are treated by the shareholder as a capital gain. Also note:

   - Form 5452 does not need to be filed for corporate distributions of tax-free stock dividends, distributions exchanged for stock in liquidations, or in stock redemptions.

   - Form 5452 is attached to the corporate return for the tax year. Also, include this amount in Box 3 of Form 1099-DIV issued to shareholders.

Preparer note. S corporations must file Form 5452 when distributions are made during or after an S corporation's post termination transition period or in any year when distributions fully exhaust accumulated earnings and profits.

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Form **5452** (Rev. October 2018) Department of the Treasury Internal Revenue Service

Corporate Report of Nondividend Distributions

▶ For calendar year ending December 31, ________
▶ Attach to the corporation's income tax return.
▶ Go to *www.irs.gov/Form5452* for instructions and the latest information.

OMB No. 1545-0123

Name | **Employer identification number**

A Has the corporation filed a Form 5452 for a prior calendar year? . . . ▶ ☐ **Yes** ☐ **No**
If "Yes," enter the applicable year(s) ________

B Are any of the distributions part of a partial or complete liquidation? . . . ▶ ☐ **Yes** ☐ **No**
If "Yes," attach explanation.

C Are any of the distributions from an S corporation's accumulated adjustments account? . . . ▶ ☐ **Yes** ☐ **No**
If "Yes," enter the balance at the beginning of the tax year ________

D **Earnings and Profits** (See **Supporting Information** in instructions.)

- Accumulated earnings and profits (since February 28, 1913) at the beginning of the tax year . . . ▶ $ ________
- Actual earnings and profits for the current tax year . . . ▶ $ ________

E **Shareholders at Date of Last Dividend Payment**

- Number of individuals . . . . ________
- Number of partnerships . . . . ________
- Number of corporations and other shareholders . . . . ________

F **Corporate Distributions** (see instructions)

Date Paid	Total Amount Paid (Common (C), Preferred (P), Other (O))	Amount Per Share	Amount Paid During Calendar Year From Earnings & Profits Since February 28, 1913			Percentage Taxable	Amount Paid During Calendar Year From Other Than Earnings & Profits Since February 28, 1913	Percentage Nontaxable
			From the Current Year	Accumulated	Total			
	$	$	$	$	$	%	$	%
Totals	$		$	$	$		$	

For Paperwork Reduction Act Notice, see the instructions. Cat. No. 11881T Form **5452** (Rev. 10-2018)

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Example. Seminars, Inc., a C corporation, has $10,000 in E&P and one shareholder, whose stock basis is $5,000. Seminars makes a $20,000 dividend distribution to its sole shareholder, taxed as follows to its shareholder:

Dividend income (to extent of E&P)	$10,000
Return of capital (to extent of basis)	5,000
Capital gain distribution (amount more than basis)	5,000
Total	$ 20,000

Seminars would issue a Form 1099-DIV with a Box 1 amount of $10,000 reflecting the E&P balance. The other $10,000 would be entered in Box 3 of Form 1099-DIV.

Seminars would also file Form 5452 for $10,000 with its corporate return and Form 8937 directly with the IRS and shareholders.

3. **Form 8937 – Report of Organizational Actions Affecting Basis of Securities.** Form 8937 is used by C corporations that issue distributions more than E&P or shareholder basis in any non-taxable return of basis manner, whether cash, non-cash, or stock, including stock splits. **Taxable dividends reported on Form 1099-DIV are never reported on Form 8937.**

   a. Form 8937 must be filed with the IRS on or before the 45th day following the organizational action or, if earlier, January 15 of the following calendar year of the organizational action. The return may be filed before the organizational action if the quantitative effect on basis is determinable.

   b. If required to file Form 8937, a copy must be given to each security holder of record as of the date of the organizational action and all subsequent holders of record up to the date a copy of Form 8937 was given.

   c. Give holders or nominees an issuer statement on or before January 15 of the year following the calendar year of the organizational action. An issuer statement may be given before the organizational action if the quantitative effect on basis is determined. If filing a corrected Form 8937 with the IRS, give a corrected issuer statement by the later of the January 15 due date above or 45 days after determining the facts that result in a different quantitative effect on basis from what was previously reported.

   d. Send Form 8937 to Department of the Treasury, Internal Revenue Service, Ogden, UT 84201-0054.

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Form **8937** (December 2017) Department of the Treasury Internal Revenue Service

Report of Organizational Actions Affecting Basis of Securities

► See separate instructions.

OMB No. 1545-0123

Part I — Reporting Issuer

1 Issuer's name			2 Issuer's employer identification number (EIN)
3 Name of contact for additional information	4 Telephone No. of contact		5 Email address of contact
6 Number and street (or P.O. box if mail is not delivered to street address) of contact			7 City, town, or post office, state, and ZIP code of contact
8 Date of action	9 Classification and description		
10 CUSIP number	11 Serial number(s)	12 Ticker symbol	13 Account number(s)

Part II — Organizational Action Attach additional statements if needed. See back of form for additional questions.

14 Describe the organizational action and, if applicable, the date of the action or the date against which shareholders' ownership is measured for the action ►

15 Describe the quantitative effect of the organizational action on the basis of the security in the hands of a U.S. taxpayer as an adjustment per share or as a percentage of old basis ►

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C CORPORATION NON-LIQUIDATING DISTRIBUTIONS

	E&P Distributions	Distributions in Excess of E&P
Corporate Form to File	Form 1099-DIV	Form 5452
Due Date	01/31	04/15
Notes	Box 1	File with corporate return
Form 1040 Reporting	Schedule B	Form 8949, Part II as long term
Form 1040 Other Actions & Notes	None	Calculate and reduce basis if basis drops to zero the remainder goes to Form 8949
Additional Corporate Forms to File	None	Form 8937
Due Date		File within 45 days of distribution or 1/15 of calendar year following distribution, whichever is earlier
Notes		File directly to IRS, Ogden Provide copy to shareholders
Form 1040 Reporting	N/A	Already reflected through Form 5452 above

Form 966 – Corporate Dissolution of Liquidation. Form 966 is filed when a corporation (or a farmer's cooperative) adopts a resolution or plan to dissolve the corporation or liquidate any of its stock. Form 966 should be filed within 30 days after the resolution or plan is adopted to dissolve the corporation or liquidate any of its stock. If the resolution or plan is amended or supplemented after Form 966 is filed, another Form 966 should be filed within 30 days after the amendment or supplemental plan is adopted.

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Deprecation - §168

Basis (IRC Section 1011)

All depreciation calculations begin with the basis of the asset involved. The basis of property is its cost, plus amounts paid for items such as sales tax, freight charges, and installation and testing fees. The cost includes the amount paid in cash, borrowed money, assumed debt, FMV of old asset allowed on trade-in, or services.

The basis of real property also includes certain fees and charges paid in addition to the purchase price. These generally are shown on the settlement statement and include the following:

- Legal and recording fees.
- Abstract fees.
- Survey charges.
- Cost of an option to purchase property.
- Owner's title insurance.
- Amounts the seller owes that the buyer agrees to pay, such as back taxes or interest, recording or mortgage fees, charges for improvements or repairs, and sales commissions.
- On self-constructed assets, interest incurred during the building phase plus capitalizable Section 263A costs will be added to basis rather than expensed.

Costs incurred to put an asset into service after purchase but before it is usable will also adjust the cost basis. This would include installing special electrical or utility lines, pouring special bases for equipment, zoning, legal and title costs, and receiving rebates. The allocated basis and cost to demolish a building are added to the cost of the land under IRC Sec. 280B.

When a taxpayer converts property from personal use to business use, the basis for depreciation is the lesser of the original basis (reduced by any casualty loss deductions or tax credits that reduced the basis of the property) *or fair market value on conversion date*.

If the purchase is not obtained through an arm's-length contract and is not at fair market value, i.e., a bargain purchase, the basis is, for depreciation purposes, the greater of the purchase price or the seller's adjusted basis in the property, plus any increase under §1015(d) for gift tax paid.

Property received as a gift has a basis equal to the donor's adjusted basis. However, if the donor's adjusted basis exceeds fair market value at the time of the gift, the property has a basis equal to fair market value for purposes of determining loss. Any gift tax paid with respect to the appreciated portion of the property's value is added to determine the basis, but the total basis may not exceed fair market value.

Inherited property has a basis equal to the date of death fair market value of the decedent (or alternate valuation date if elected by the estate).

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Ownership & Qualification

Depreciation may only be deducted on property legally owned by the taxpayer. This may seem basic, but when leasing is involved, it becomes a more difficult question. If you lease property to someone, you generally can depreciate its cost even if the lessee (the person leasing from you) has agreed to preserve, replace, renew, and maintain the property. However, if the lease provides that the lessee is to maintain the property and return to you the same property or its equivalent in value at the expiration of the lease in as good condition and value as when leased, you cannot depreciate the cost of the property.

More commonly the business owner IS the lessee and must determine if they meet the incidents of ownership rules. If they do, then the lessee can deduct depreciation, even though the contract may be called a lease. Incidents of ownership includes:

- The legal title to the property,
- The legal obligation to pay for the property,
- The responsibility to pay maintenance and operating expenses,
- The duty to pay any taxes on the property,
- The risk of loss if the property is destroyed, condemned, or diminished in value through obsolescence or exhaustion.

Generally, if you hold business or investment property as a life tenant, you can depreciate it as if you were the absolute owner of the property.

You cannot depreciate inventory because it is not held for use in the business. Inventory is any property you hold primarily for sale to customers in the ordinary course of business. If you are a rent-to-own dealer you usually depreciate the items over three years.

To be depreciable, the property must have a determinable useful life. This means that it must be something that wears out, decays, gets used up, becomes obsolete, or loses its value from natural causes. You also cannot depreciate property purchased and sold in the same year.

What about land? You cannot depreciate the cost of land because land does not wear out, become obsolete, or get used up. The cost of land generally includes the cost of clearing, grading, planting, and landscaping. Although you cannot depreciate land, you can depreciate certain land preparation costs, such as landscaping costs, incurred in preparing land for business use. These costs must be so strongly associated with other depreciable property that you can determine a life for them along with the life of the associated property.

What about land prep costs? Land preparation costs, however, may be depreciable if they are directly associated with the construction of a depreciable building (Rev. Rul. 65-265. 1965-2 CB 52). Thus, in Rev. Rul. 65-265, costs attributable to excavation, grading, and removing soil necessary to the proper setting of buildings were added to the depreciable basis of the buildings in an industrial complex. The cost of general grading, not directly associated with the construction of the building, however, was added to the basis of the land. See, also, for example, Eastwood Mall Inc., DC Oh., 95-1 USTC ¶50,236 (aff'd, CA-6, unpublished opinion, 59 F3d 170 (1995)), which concludes that the cost of clearing, grubbing, blasting, filling, and grading 100 acres of uneven land into an earthen

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plateau used for the construction of a shopping mall was not depreciable since these improvements were permanent and would not be re-incurred if the mall building was rebuilt or replaced. The IRS did not argue that depreciation of costs paid to dig spaces and trenches for the mall building's foundations, utilities, and the cost of installing utilities, sewers, and paving roads and parking lots.

The cost of clearing, grubbing, cutting, filling, and rough and finish grading necessary to bring land to a suitable grade for the development of a mobile home part was non-depreciable and added to the basis of the land. However, the cost of excavation and backfilling required for the construction of laundry facilities and a storm sewer system that would be destroyed when those assets were replaced was included in the depreciable basis of those assets (Rev. Rul. 80-93, 1980-1 CB 50).

Costs incurred for fill dirt that is used to raise the level of a building construction site are inextricably associated with the land and, therefore, are not depreciable. Costs incurred for fill dirt used to set the foundation of a building are depreciable, as are earth-moving costs incurred for digging spaces and trenches for a building's foundations and utilities (IRS Letter Ruling 200043016, July 14, 2000).

Example. Megan constructed a new building for use in her business and paid for grading, clearing, seeding, and planting bushes and trees. Some bushes and trees were planted right next to the building, while others were planted around the outer border of the lot. If Megan replaces the building, the bushes and trees next to it would be destroyed, giving them the same useful life as the building. Megan can depreciate them. The remaining bushes and trees are added to the other land preparation costs to the basis of the land because they have no determinable life.

Placed in service requirement. Depreciation begins when the underlying property is placed in service for use in a trade or business or for the production of income. Depreciation stops when the property is either the cost or basis is fully recovered or when the property is retired from service, whichever happens first. Property is placed in service when it is ready and available for a specific use, whether in a business activity, an income-producing activity, a tax-exempt activity, or a personal activity. Even if you are not using the property, it is in service when it is ready and available for its specific use.

Example 1. Fred bought a new Massey tractor in December of 2024 for $140,000. He received the tractor on December 23rd, but did not receive the special quad wheels needed to use the tractor in the fields until January 11, 2025. The tractor was not "available for its specific use" in 2024, so depreciation (and Section 179) will not begin until 2025.

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Example 2. Chris bought a rental home in March 2024 for $160,000. The property needed substantial repairs before it could be rented. Chris spent $50,000 to complete the repairs in November of 2024 but did not obtain a "Certificate of Occupancy" from the County until January of 2025. The property will not begin to be depreciated until it is legally able to be occupied, January of 2025.

Example 3. Chris bought a building and renovated it to accommodate equipment she plans to use for her business. The building renovations were completed on November 1, 2024, but the equipment wasn't installed until January 2025. Chris may begin depreciating the building in November 2024, when she received her certificate of occupancy. It doesn't matter that the equipment was installed until later.

Example 4. Roy buys thirty, three-month old Hereford heifers for $5,000 on July 1st, 2024, to develop breeding stock. Roy expects the heifers to reach breeding age in late March 2025. He will begin depreciating them at that time.

Calculating depreciation – the Big 3. The Federal tax rules of depreciation tell us that depreciation is allowed for property used in a trade or business. Deprecation is calculated using three variable factors:

1. The applicable life (3, 5, 7, 10, 15, 27½, 39);
2. The applicable method (200DB, 150DB or straight-line); and
3. The applicable convention (mid-month, mid-quarter, or half-year).

Applicable life. §168(c) lists the following life periods:

ADR Class Life	The applicable GDS recovery period	Tax Depr. Life
4 or less	**3-year property**	**3 years**
>4, <10	**5-year property**	**5 years**
10 -15	**7-year property**	**7 years**
16-19	**10-year property**	**10 years**
20-25	**15-year property**	**15 years**
25 or more	**20-year property**	**20 years**
Qualified Improvement Property		**15 years**
Water utility property		**25 years**
Residential rental property		**27½years**
Nonresidential real property		**39 years**
Any railroad grading or tunnel bore		**50 years**

Most assets will be depreciated using the GDS life because it provides for a shorter life for depreciation than the ADS method.

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3-year property. *(Bonus Mandatory & 179 Qualified)*

- Tractor units for over-the-road use.
- Any racehorse over 2 years old when placed in service. (All racehorses placed in service after December 31, 2008, and before January 1, 2022, are deemed to be 3-year property, regardless of age.) (2020 CAA Act),
- Any other horse (other than a racehorse) over 12 years old when placed in service.
- Qualified rent-to-own personal property held by a rent-to-own dealer, but not boats, planes, motor vehicles, trailers, or real estate.

5-year property *(Bonus Mandatory & 179 Qualified)*

- Automobiles, taxis, buses, and trucks.
- Computers and peripheral equipment.
- Office machinery (such as typewriters, calculators, and copiers).
- Any property used in research and experimentation.
- Breeding cattle and dairy cattle.
- Appliances, carpets, furniture, etc., used in a residential rental real estate activity.
- Certain geothermal, solar, and wind energy properties.
- Agricultural machinery or equipment purchased *new* and placed in service in years beginning after 12/31/2017.

7-year property *(Bonus Mandatory & 179 Qualified)*

- Office furniture and fixtures (such as desks, files, and safes).
- Used agricultural machinery and equipment as well as new or used grain bins and fences purchased after 12/31/2017, or purchased new or used prior to that date,
- Railroad track.
- Any property that does not have a class life and has not been designated by law as being in any other class.
- Certain motorsports entertainment complex property placed in service before January 1, 2026 (2020 CAA Act),

10-year property *(Bonus Mandatory & 179 Qualified)*

- Vessels, barges, tugs, and similar water transportation equipment.
- Single purpose agricultural or horticultural structures.
- Any tree or vine bearing fruits or nuts.

15-year property *(Bonus Mandatory)*

- Certain improvements made directly to land or added to it (such as shrubbery, fences, roads, sidewalks, parking lots, and bridges).
- Any retail motor fuels outlet such as a convenience store.
- Qualified Improvement Property *(179 Qualified)*

20-year property *(Bonus Mandatory)*

- Farm buildings

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25-year property

- Water utility property

27.5-year property

- Residential rental property. This is any building or structure, such as a rental home (including a mobile home), if 80% or more of its gross rental income for the tax year is from dwelling units. A dwelling unit is a house or apartment used to provide living accommodations in a building or structure. It does not include a unit in a hotel, motel, or other establishment where more than half the units are used on a transient basis.

39-year property

- Nonresidential real property
- Office in home property unless in a building owned by the taxpayer that is a residential rental building, then use 27.5 years.

Table A-1. **3-, 5-, 7-, 10-, 15-, and 20-Year Property Half-Year Convention**

Year	Depreciation rate for recovery period					
	3-year	5-year	7-year	10-year	15-year	20-year
1	33.33%	20.00%	14.29%	10.00%	5.00%	3.750%
2	44.45	32.00	24.49	18.00	9.50	7.219
3	14.81	19.20	17.49	14.40	8.55	6.677
4	7.41	11.52	12.49	11.52	7.70	6.177
5		11.52	8.93	9.22	6.93	5.713
6		5.76	8.92	7.37	6.23	5.285
7			8.93	6.55	5.90	4.888
8			4.46	6.55	5.90	4.522
9				6.56	5.91	4.462
10				6.55	5.90	4.461
11				3.28	5.91	4.462
12					5.90	4.461
13					5.91	4.462
14					5.90	4.461
15					5.91	4.462
16					2.95	4.461
17						4.462
18						4.461
19						4.462
20						4.461
21						2.231

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The questions about depreciation have become common enough that we think it is time for a central reference chart for the changes from the TCJA (9/2017), the Secure Act (12/2019), the Families First Act (3/2020) and the CARES Act (3/2020).

Description	TCJA Effective after 2017	2019 Secure Act Retroactive after 2017	2020 CARES Retroactive after 2017	Effective Lives
Bonus Depreciation - 100%	X			3-20
Bonus - Qualified Improvement Property			X	15
Bonus - Used Property	X			3-20
Computers No longer listed property	X			5
Farm Equipment-New-Using 5-year life	X			5
Farm Equipment – New – use 200% DB instead of 150DB	X			5
Motorsports complex 7-year recovery period		X		7
Qualified Improvement Property retroactive to 2018 life change from 39 years to 15 years – Depreciation recapture applies as if Sec. 1245 equipment if bonus or 179 is taken			X	15
Racehorse Lives – 3 Years		X		3
Sec. 179 $1,000,000 annual deduction floor	X			3-10 +QIP+ QRE
Sec. 179 $2,500,000 deduction phaseout floor	X			3-10 +QIP+ QRE
Sec. 179 Commercial Roofs – depreciation recapture applies as if Sec. 1245 equipment if bonus or 179 is taken	X			39 (QRE)
Sec. 179 HVAC, Security & Fire Systems – depreciation recapture applies as if Sec. 1245 equipment if bonus or 179 is taken	X			39 (QRE)
Sec. 179 Permanent	X			3-10 +QIP
Sec. 179 Qualified Improvement Property	X			15
Sec. 179 Rental Personal Property Qualifies	X			5-7
Sec. 179 TV/Films/Theatre-Initial Production		X		

*QRE-Qualified Real Estate is 39-year property which qualifies for Sec. 179.
*QIP-Qualified Improvement Property is 15-year property which qualifies for Sec. 179 as well as bonus depreciation

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Applicable methods. MACRS utilizes the following methods for depreciation:

- 200% declining balance applies to assets in the 3-10-year property category.

- ***Farm equipment placed in service in years beginning after 12/31/2017 and before January 1, 2026, use 200% declining balance (was 150% declining balance).*** Farm assets with 15-20 year lives use the 150% declining balance method unless the farmer elects straight-line.

- 150% declining balance applies to 15 and 20-year life property except qualified real estate improvements, which use straight-line.

- 150% declining balance applies, ***by election***, to nonfarm assets in the 3-10-year property category.

- Straight line applies to most other assets.

Applicable convention. Taxpayers must choose the proper convention when placing the property in service. There are three options:

1. **Mid-month convention** – applies to real property and treats all property placed in service or disposed of during a month as placed in service or disposed of at the midpoint of the month. This means that a one-half month of depreciation is allowed for the month the property is placed in service or disposed of.

2. **Mid-quarter convention** – applies to all other assets when more than 40% of the total current year asset purchases (other than real property) are placed in service in the last 3 months of the year. Under this rule, 1½ months of depreciation is allowed for the quarter the property was placed in service or disposed.

3. **Half-year convention** – applies to all other assets, and ½ of one year's expense is allowed in the year placed in service or disposed.

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In Service Date MACRS Depreciation Lives & Issues

Description	MACRS Life	Qualify for 179?	Qualify for Bonus	Authority
Asbestos Removal	39 Years	No	No	PLR 9240004
Autos & Light trucks	5 years	Yes	Yes	Section 168 (e)(3)
Drainage Tile	15 Years	Yes	Yes	IRS Publication 225
Entertainment services equipment (bowling alleys, theaters, concert halls, miniature golf, amusement parks, coin-operated games	7 Years	Yes	Yes	Revenue Proc. 87-56
Gas Pump Canopies	5 Years	Yes	Yes	Revenue Ruling 2003-54
Golf Course Greens	15 Years	No	Yes	Revenue Ruling 2001-60
Gaming furniture & Equipment	7 Years	Yes	Yes	Coordinated Issue Paper-Gaming Industry 4/10/2000
Home used for adult day care	27.5 Years	No	No	CCA 201049026
Farm Buildings	20 Years	No	Yes	Section 168 (e)(3)
Fences-Agriculture	7 Years	Yes	Yes	IRS Publication 225
Heating & HVAC	5-39 Years	Yes	Yes	2017 Tax Cuts Act
Improvement-Building Qualified	15 Years	Yes	Yes	2020 CARES Act
Lease Termination Payment	39 Years	No	No	PLR 9607016
Leasehold Improvements-Qual.	15 Years	Yes	Yes	Section 168 (e)(3)
Mobile Homes	27.5-39 Years	No	No	IRS Pub 946
Racehorse <2 through 12/31/21	3 Years	Yes	Yes	Section 168 (e)(3)
Racehorses if at least 2 YO	3 Years	Yes	Yes	Section 168 (e)(3)
Residential Rental Property	27.5 Years	No	No	Section 168 (e)(3)
Rental Property Furniture & Appliances	5 Years	No	Yes	Announcement 99-82
Rent to Own Property	3 Years	Yes	Yes	Section 168 (e)(3)
Retail/Restaurant Real Property	39 Years	Yes	Yes	Section 168 (e)(3)
Retail Motor Fuel Outlet	15 Years	Yes	Yes	Section 168 (e)(3)
Solar & Wind Energy	5 years	Yes	Yes	Section 168 (e)(3)
Trees & vines bearing fruit & nuts	10 Years	Yes	Yes	Section 168 (e)(3)
Video Cassettes/DVDs	Expense if <1year life documented	N/A	N/A	Revenue Ruling 1989-62
Vineyard irrigation & wells	20 Years	No	Yes	Trentadue v. Comr
Vineyard Trellises	10 Years	Yes	Yes	Trentadue v. Comr
Wells	15 Years	No	Yes	IRS

IRS Depreciation Information and Guides

General Depreciation Guidance: IRS Publication 946
Cars: IRS Publication 463
Residential Rental: IRS Publication 527
Home Office: IRS Publication 587
Farm Assets: IRS Publication 225

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Section 179 Expensing (§179)

§179 was established by Congress to allow taxpayers to elect to immediately expense of a limited amount of asset purchases each year. The Tax Cuts and Jobs Act, passed in 2017, increased the maximum of §179 expense to $1,220,000 (2024). This amount is indexed for inflation for years beginning after 2018. The election to claim §179 is made by completing the Part I of Form 4562.

Part I **Election To Expense Certain Property Under Section 179**
Note: If you have any listed property, complete Part V before you complete Part I.

1	Maximum amount (see instructions)	1	
2	Total cost of section 179 property placed in service (see instructions)	2	
3	Threshold cost of section 179 property before reduction in limitation (see instructions)	3	
4	Reduction in limitation. Subtract line 3 from line 2. If zero or less, enter -0-	4	
5	Dollar limitation for tax year. Subtract line 4 from line 1. If zero or less, enter -0-. If married filing separately, see instructions	5	

6	(a) Description of property	(b) Cost (business use only)	(c) Elected cost
7	Listed property. Enter the amount from line 29	7	

8	Total elected cost of section 179 property. Add amounts in column (c), lines 6 and 7	8	
9	Tentative deduction. Enter the **smaller** of line 5 or line 8	9	
10	Carryover of disallowed deduction from line 13 of your 2014 Form 4562	10	
11	Business income limitation. Enter the smaller of business income (not less than zero) or line 5 (see instructions)	11	
12	Section 179 expense deduction. Add lines 9 and 10, but do not enter more than line 11	12	

The amount of the allowable deduction is reduced on a dollar-for-dollar basis when a business purchases more than $3,050,000 (for 2024) of qualified Section 179 property in a tax year. The election may also be made or revoked timely filed amended return (§1.179-5(a)).

§179 Limits. As mentioned above, the annual limits for 179 expensing and for the purchase of 179 assets are annually adjusted for inflation. The chart below summarizes the current limits.

Year	Max 179 Expense	Max 179 For SUV/Truck*	Max 179 Asset Purchase
2017	$ 500,000	$ 25,000	$2,000,000
2018	$1,000,000	$ 25,000	$2,500,000
2019	$1,020,000	$ 25,500	$2,550,000
2020	$1,040,000	$ 25,900	$2,590,000
2021	$1,050,000	$ 26,200	$2,620,000
2022	$1,080,000	$ 27,000	$2,700,000
2023	$1,160,000	$ 28,900	$2,890,000
2024	$1,220,000	$ 30,500	$3,050,000
*There is no limit on bonus depreciation for SUVs and trucks.			

§179 rules in general. The §179 deduction is available to individuals and regular corporations, and as a pass-through from S corporations and partnerships, but not ***to estates and trusts (***§179(d)(4). Married couples who file separate returns can use the same total limit as those filing married jointly. Married filing separate filers allocate the deduction limit 50/50 unless they elect otherwise (§179(b)(4)). Controlled groups of entities are only allowed the same maximum deduction in a year as one entity, and they may allocate that total in any way desired.

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Other §179 rules to note include:

- There is no requirement for qualifying property to be new, but it must have been purchased (rather than received by gift or inheritance). Property purchased from a related party does not qualify, including spouses, ancestors, descendants, and entities of which the taxpayer owns more than 50%.

- When property is purchased during the year there is no part-year proration of the expense, the full amount still qualifies if all the other requirements are met. Similarly, short tax years do not require expense pro-ration as the full amount qualifies (§1.179-1(c)).

- The qualifying cost of property does not include the basis of property that is determined by reference to the basis of another property held at any time by the taxpayer.

Example. Ice Corporation purchases a drill press for $10,000 from Sharp Tools. Sharp grants Ice a trade-in allowance of $2,000 on an old drill press. The old drill press had a basis of $1,200. The cost basis of the new drill press is $9,200 (basis of old drill press of $1,200 plus $8,000 cash). However, for purposes of §179, the cost basis is only $8,000; the remaining $1,200 is not part of the cost because it is determined by reference to the basis of the old drill press (§1.179-4).

Planning note. The TCJA changed §1031 by adding the "real" in front anyplace the IRC says property. The title of §1031 now reads "Exchange of Real Property Held for Productive Use or Investment". Accordingly, it is no longer possible to conduct a like-kind exchange as described in the previous example. Taxpayers are now required to treat the trade of any like-kind personal property as a fully taxable sale of the relinquished property and a new purchase of the replacement property. While the IRS has yet to rule on this subject, it is the author's opinion that basis of an asset acquired in a transaction that includes a trade in of an already owned asset does NOT include any amount determined by reference to the basis of another asset and, therefore, §179 would be allowed on the entire amount of the new asset's purchase price.

Example variation. Using the same facts as in the above example but applying the TCJA rules precluding like-kind exchanges of personal property, Ice would report the sale of its old drill press for $2,000 and recognize a gain of $800 ($2,000 less basis of $1,200) and cost of the new drill press as $10,000. As none of the cost basis is determined by reference to the old drill press, Ice would be allowed to claim §179 expense deduction of the full $10,000.

Caution. The 2018-2023 versions of IRS Pub. 946, How to Depreciate Property, contains an example on page 18 that follows the rules of the first example above (trade in basis not allowed for §179), even though TCJA changed the like-kind exchange rules beginning in 2018. While the author believes the example used in Pub. 946 may be wrong, it is clear the example represents the IRS's current position on assets acquired via a trade-in. Tax practitioners need to alert clients of possible conflict with the IRS down the road.

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§179 Qualifying property (§179(d)(1)). Only tangible, depreciable §1245 or qualified real property used *in the United States* in an active trade or business qualifies. Specifically, qualifying property must meet the following requirements ***and not be excluded:***

- It must be tangible personal property in the 3, 5, or 7-year MACRS class life including machinery, equipment, non-structural property attached to a building such as cabinets and signs, livestock, gas storage tanks and air conditioners or heaters, or
- A single purpose agricultural or horticultural property in the 10-year class, or
- Off-the-shelf computer software, or
- Qualified improvement property, or
- Commercial roofs and HVAC systems

TCJA adds to list of §179 qualified assets. The 2017 Tax Cuts & Jobs Act added the following assets as newly qualified for §179 starting in 2018 (§179(d)(1) and (e)(1)):

- Depreciable tangible personal property used predominantly to furnish lodging, or in connection with furnishing lodging, including any facility where sleeping accommodations are rented (§50(b)(2)).

- Other newly qualified assets include the following improvements to nonresidential real property placed in service after the date the building was originally placed in service:

    - Qualified improvement property (§168(e)(6));
    - Roofs;
    - Heating, ventilation, and air-conditioning property;
    - Fire protection and alarm systems; and
    - Security systems.

Non-qualifying property at §1.179-4(c)(ii) and elsewhere includes:

- Property used outside the United States,
- Property acquired by gift or inheritance,
- Property acquired from a related party,
- Property in the 15, 20, 27.5 or 39-year life categories *except qualified real estate improvement property and commercial roofs/HVAC (see below),*
- Rental property (commercial and residential), except for meeting facilities, hotels, motels, and similar transient-rentals (like Airbnb), and certified historic structures,
- Energy property such as most solar property,
- Leased property except for corporations (with exceptions),
- Property used by tax-exempt organizations,
- Property used by governmental agencies or foreign entities except with leases < 6 months,
- Land and improvements *except qualified real estate listed below*.

The business use part of property used partially for business and partially for personal use qualifies if the business portion is >50% (§1.179-1(d)).

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Preparer note. When a taxpayer has §179 from a flow-through entity K-1, the low-through amount reduces the allowable §179 for the year. If the taxpayer's flow-through amounts (plus any self-employed amounts) exceed the $1,220,000 limit, the excess amount is not deductible, ***does not carry-forward, reduces basis, and is lost forever.*** In this situation, reduce any Schedule C or F §179, or contact the flow-through entities to see if the amount of §179 can be reduced at the entity level.

Business income limit. §179 is limited to the taxpayer's total business income for the year. For pass-through entities, the business income test is first done at the entity level and then flows through to the individual for another round of tests. For a pass-through entity, the elected amount of §179 for the year may not exceed the entity's taxable income for the year. For an S corporation, the calculation is based on taxable income at the 1120S level, and for a partnership, at the 1065 level. Then, at the individual level, another income limit applies which adds together income of all trades and businesses. In all three activities, taxable income is adjusted for assorted items, as illustrated below.

Taxable Income Adjustments for §179 Income Deduction Limit			
	S Corporation	**Partnership**	**Individual**
Taxable Income	X	X	X
+Section 1231 gains	X	X	X
+NOL's			X
+½ of SE Tax			X
+Tax Credits	X	X	X
+Tax exempt income	X	X	X
+Guaranteed Payments		X	X
+Wages of shareholder-employees	X		X
+ Wages from all other sources			X
+Spouse wages (joint return) from all other sources			X
+ Active income from other activities			X
- Section 1231 losses	X	X	X

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Carryovers of §179. A §179 deduction limited because of reaching the dollar maximum deduction limit for the year does not carryover. A §179 deduction limited because of reaching the taxable income ceiling carries forward for an unlimited number of years (§1.179-3(a)). Any unused §179 carryovers expire at death of the taxpayer.

Example. Carl has $50,000 of Sch. C profit from his excavation business before depreciation in 2024. Carl bought a backhoe for $70,000 in 2024. If he expenses the backhoe using §179, Carl's 2024 deduction is limited to his earned income - $50,000 Sch C profit. The $20,000 excess §179 expense is carried forward to 2025. Carl pays no income or SE tax in 2024, and he then deducts the $20,000 excess §179 expense from 2024 on his 2025 return, saving both ordinary income and SE tax.

§179 Recapture. To claim §179, the underlying property must be used predominantly for trade or business. This generally means that the underlying assets is used more than 50% of the time for trade or business purposes during its entire MACRS life. If, at any point during an asset's life, it ceases to be used predominantly for trade or business, 179 recapture is required. An asset ceases to be used predominantly for trade or business if:

1. The business use of the asset drops to 50% or less;
2. The property is disposed of in a transaction other than a disposition to which §1245(a) applies (ordinary gain on sale); or
3. The property is converted from business to personal or investment use.

Recapture is difference between a) the amount expensed under §179, and b) the deprecation that would have been claimed, including bonus depreciation, using the GDS (MACRS) method. The difference between the two calculations is treated as ordinary income and is reported on Part IV of Form 4797 and the form or schedule where the deprecation was originally claimed (e.g., Sch. C., Sch. F, etc.).

Part IV **Recapture Amounts Under Sections 179 and 280F(b)(2) When Business Use Drops to 50% or Less** (see instructions)

			(a) Section 179	(b) Section 280F(b)(2)
33	Section 179 expense deduction or depreciation allowable in prior years	33		
34	Recomputed depreciation. See instructions	34		
35	Recapture amount. Subtract line 34 from line 33. See the instructions for where to report	35		

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Example. Assume Carl, from our last example, decides to close his excavation business in May 2026. Carl owns the 20 acres that surrounds his residence, so he decides to keep the backhoe to use around his house. Unfortunately, Carl will have to recapture a portion of the §179 expense he claimed on Sch. C for the backhoe. The amount of recapture is the difference between the §179 depreciation he claimed, and the depreciation allowed under MACRS. Assume for this example that bonus depreciation was not allowed. The recapture is calculated:

§179 deprecation claimed		$ 70,000
MACRS depreciation (5-year property)		
- 2024 (20%)	$14,000	
- 2025 (32%)	$22,400	
- 2026 – zero	$ - 0 -	
Total MACRS accumulated depreciation		($36,400)
Net amount – recapture amount		$ 33,600

What about the fact that Carl carried part of the 179 expense forward? Because Carl was able to use then entire §179 expense in 2024 and 2025 (i.e., there is no longer any carryforward in 2026), the full recapture applies. However, while not specifically addressed in the regulations, it appears that the recapture included in income would be reduced for any remaining §179 expense still being carried forward.

Preparer note. Autos and other listed property require ADS (mostly straight line) depreciation to be used to calculate the accumulated depreciation. The result is a much higher recapture when vehicles are involved.

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Bonus Depreciation (§168(k))

Bonus depreciation is a term created by Congress many years ago to describe an immediate deduction of a percentage of the cost of a qualified asset in the year of purchase. Currently bonus depreciation is 100% of cost for new and used assets purchased in the 3, 5, 7, 10, 15 and 20-year life categories.

Additional bonus depreciation rules began in 2018, including:

1. The applicable bonus rate is:
   - 100% for assets placed in service in 2022;
   - 80% for assets placed in service in 2023;
   - 60% for assets placed in service in 2024;
   - 40% for assets placed in service in 2025; and
   - 20% for assets placed in service in 2026.
   - Aircraft, certain plants and grafted plants, and longer production period assets use 1/1/2024 as the cutoff for 100% bonus.

2. Qualifying property includes used property (previously new property only).

3. Allows bonus depreciation for qualified film, television, and live theatrical productions all of which are considered placed in service at the time of the initial release, broadcast, or live staged performance.

Qualified Improvement Property (QIP) defined. Prior to enactment of the TCJA, bonus depreciation, §179 expensing and 15-year depreciable lives could apply to four diverse types of real property improvements: 1) “qualified leasehold improvement property”, 2) “qualified restaurant property”, 3) “qualified retail property” and 4) “qualified improvement property”. Each of these definitions had its own separate criteria, often leaving taxpayers confused as to which, if any, of the deprecation provisions a specific improvement would qualify for.

Noting the confusion, Congress repealed IRC definitions of qualified leasehold improvement property, qualified restaurant property, and qualified retail property when it passed the TCJA and replaced all of them with one definition – “qualified improvement property” (QIP). QIP is defined as any improvement to the interior portion of a non-residential building if such improvement is placed in service after the date such building was first placed in service. QIP does not include enlargements, elevators, escalators, or interior structural framework (§168(e)(6)).

Preparer note. As a result of the new QIP definition, several provisions of the previous definitions no longer apply including the lease requirement, the requirement that building be at least 3 years old, restrictions on building owners and landlords, etc. The new definition is quite simple and straight forward and a vast improvement over the menagerie of prior definitions.

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"Internal structural framework" defined. The term "internal structural framework" for bonus depreciation purposes has the same definition as the term is defined in the regulations under §48 Qualified Rehabilitated Buildings (§1.168(k)-1(c)(3)(v)). Internal structural framework includes all load-bearing internal walls and any other internal structural supports, such as columns, girders, beams, trusses, spandrels, and all other members that are *essential to the stability of the building* (§1.48-12(b)(3)(i)(D)(iii)).

Preparer note. There is nothing in the QIP definition that precludes non-structural improvements such as plumbing, electrical, security systems, flooring, etc. from being included as QIP. It is the author's opinion that these costs qualify for the tax attributes afforded QIP and we will be treating such improvements as such until either the courts or authoritative guidance say otherwise.

Example. Mike spends $10,000,000 to build a 50,000 square foot commercial building shell. The building is completed and approved for occupancy on June 1, 2024. On June 15, 2024, Mike agrees to rent 20,000 square feet to Randy for his use as a small manufacturing plant. Mike and Randy agree to split the $500,000 cost converting the shell into a finished plant (adding bathrooms, lighting, walls, wiring, etc.). No load-bearing walls were moved or added, and no other structural components were added or changed.

Result. The entire $500,000 Mike and Randy spent to improve the space is QIP, even though the building was only two weeks old when the improvements were begun. Mike and Randy may each claim §179, bonus depreciation and/or 15-year depreciable lives for their share of the expenses ($250,000 each).

§179, bonus deprecation and MACRS ordering rules. The depreciation rules require that §179 expense is taken first, then bonus depreciation, and lastly MACRS depreciation.

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Bonus Qualifying Assets

Description	**Class Life**	**Other Requirements**
Semi Tractors	3 Year	None
Rent to Own Property	3 Year	None
Vehicles	5 Year	None
Computer Equipment	5 Year	None
Office Equipment	5 Year	None
Appliances & Furniture in residential rental	5 Year	None
Farm Equipment	5 Year	None
Office furniture	7 Year	None
Single purpose ag structure	10 Year	None
Trees & Vines	10 Year	None
Convenience store selling gas at retail	15 Year	< 1,400 square feet, ≥50% of gross from fuel sales and ≥50% of property square footage for fuel sales
Land Improvements	15 Year	None
Qualified Improvement Property	15 Year	None-retroactively changed after 12/31/17 with 2020's CARES Act
Farm Buildings	20 Year	None

Non-qualified property (§168(f)). Property that does not qualify for bonus depreciation includes property converted from business to personal use in the year of purchase, ***listed property used 50% or less for business***, used property acquired before September 27, 2017, and property required to be depreciated under the ADS method, such as that property financed with tax exempt bonds.

Bonus deprecation recapture. Bonus depreciation is treated the same as any other GDS/MACRS depreciation deduction – it is included in the calculation of regular depreciation. Accordingly, there is no recapture of bonus depreciation for assets that cease to be predominantly used for trade or business.

Watch out for listed property. This is the big exception! While bonus depreciation is generally not required to be recaptured, that is not the case listed property – vehicles. Listed property have their own depreciation recapture rules that apply to §179, bonus depreciation, and any other accelerated depreciation (aka anything but straight line). If any of these accelerated methods are used, and the asset ceases to be used predominantly for trade or business, the recapture calculation must be made, and any recapture reported the same as discussed for 179 above.

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Class Life a Question – ATG Has the Answer (Cost Segregation ATG – June 1, 2022)

The IRS updated and released an Audit Technique Guide for Cost Segregation studies. The ATG includes a detailed description of the essential elements of an acceptable cost segregation study, acceptable methodologies for completing a study, and the supporting documentation necessary to support the study's findings. Additionally, the ATG provides in-depth analysis of:

- Specific industries including:
  - Casinos,
  - Restaurants,
  - Retail businesses,
  - Pharmaceutical/Biotechnology,
  - Auto Dealerships, and
  - Auto Manufacturing.
  -
- Proper procedures for analyzing Electrical Distribution Systems and Open-Air Parking Structures.

Luxury Automobile Deprecation (§280F)

Annual depreciation is limited for "luxury" automobiles. For this purpose, a "luxury automobile" is defined as "*any 4-wheeled vehicle manufactured for use on public roads which is rated at 6,000 pounds unloaded gross vehicle weight (curb weight) or less*". For trucks, vans, or SUVs the definition uses *gross vehicle weight rating (GVRW)* (maximum loaded weight including passengers, fuel, etc.) (§280F(d)(5)(A)). Most full-size pickups, vans and SUVs are over the 6,000-pound limit and not subject to the luxury auto depreciation limits. In addition, the term "luxury automobile" does not include vehicles that, by design, do lend themselves to personal use. Such vehicles include clearly marked police vehicles, cargo trucks with GVRW over 14,000 pounds, ambulances, hearses, bucket trucks, cement mixers, delivery trucks with only one seat, dump trucks, flatbed trucks, refrigerated trucks, vehicles used by the taxpayer in the trade or business of transporting persons or property for hire, etc. (§1.274-5(k)). The luxury auto deprecation limits are:

Luxury Auto Deprecation Limitations (Rev. Proc. 2024-13)			
	2023	**2024**	**2025**
Year 1	$12,200*	$12,400*	
Year 2	$19,500	$19,800	
Year 3	$11,700	$11,900	
Year 4 and after	$ 6,960	$ 7,160	
*Luxury autos placed in service are allowed an additional $8,000 of bonus depreciation.			

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Example. Dennis, a real estate agent, purchases a new BMW sedan for $98,000 in June of 2024. Assuming he uses the sedan 100% for business, Dennis expects to claim a depreciation deduction of $19,600 under the regular MACRS rules ($98,000 x 20%). However, the luxury auto rules limit Dennis's 2024 deprecation deduction (ignoring §179 and bonus depreciation) to $12,400. His car will not be fully depreciated until 2034 - 11 years after he buys it!

2024	$12,400
2025	$19,000
2026	$11,900
2027 – 2033	$ 7,160
2034	$ 3,780

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Listed Property Rules (§274)

IRC §274 defines certain disallowed deductions related to entertainment, recreation, travel, fringe benefits and provides additional substantiation requirements for property that lends itself to personal use including vehicles. Specifically, §274(d) provides that no deduction is allowed for any listed property unless the taxpayer substantiates with adequate records or sufficient corroborating evidence a) the amount of such expense, b) the time and place of the travel or use, c) the business purpose of the expense, and d) the business relationship to the taxpayer of the person receiving the benefit. With respect to vehicles, many incorrectly believe that only vehicles that also meet the definition of a luxury auto under §280F are subject to these substantiation requirements. The enhanced substantiation requirements of §274(d) apply to *any pickup truck or van, unless the truck or van was specially modified with the result that it is not likely to be used more than a de minimis amount for personal purposes*. For example, removing a pickup bed and installing a flatbed. Merely painting a sign on the door of the truck or van is not enough! Almost all pickups and vans are subject to these rules.

Depreciation and Reporting Requirement Summary			
	<6000 lbs. Luxury Auto	**6000 – 14000 lbs truck or van**	**>14000 lb truck or van**
Listed property?	Yes	Yes	No
Logbook required?	Yes	Yes	No
Depreciation limited	Yes	No	No
Bonus depreciation allowed?	Yes – limited	Yes	Yes
179 allowed?	Yes – limited	Yes – SUVs limited	Yes
Mileage method allowed?	Yes	Yes	No

Business purpose supported. An adequate record of business purpose must be in the form of a written statement. However, the amount of detail necessary to establish a business purpose depends on the facts and circumstances of each case. A written explanation of the business purpose will not be required if the purpose can be determined from the surrounding facts and circumstances. For example, a salesperson visiting customers on an established sales route will not normally need a written explanation of the business purpose of his or her travel.

Business use supported. An adequate record contains enough information on each element of every business or investment use. The amount of detail required to support the use depends on the facts and circumstances. For example, a taxpayer who uses a truck for both business and personal purposes and whose only business use of the truck is to make customer deliveries on an established route can satisfy the requirement by recording the length of the route, including the total number of miles driven during the tax year and the date of each trip at or near the time of the trips.

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Although you must prepare an adequate written record, you can prepare a record of the business use of listed property in a computer memory device that uses a logging program.

Business use does not include the use of property for pay of any 5% owner or related party. It does include the use of property included in the W-2 of unrelated, non-owner employees. Business use also does not include property used for investment purposes, except for depreciation.

Substantial compliance. If you have not fully supported an element of an expenditure or use but have complied with the adequate records requirement for the expenditure or use to the satisfaction of the IRS director for your area, you can establish this element by any evidence the IRS director for your area deems adequate. If you fail to establish to the satisfaction of the IRS director for your area that you have substantially complied with the adequate records requirement for an element of an expenditure or use, you must establish the element as follows.

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FIXING THE ERROR – HOW DO WE SOLVE DEPRECIATION MISTAKES?
Depreciation errors are corrected by either filing an amended return or filing a change in accounting method form. Depreciation errors that are NOT subject to the accounting method change filing requirements require amended returns and include:

Amended Returns:

- You claimed the incorrect amount because of a mathematical error made in any year.
- You claimed the incorrect amount because of a posting error made in any year.
- You claimed the incorrect amount on property placed in service by you in tax years ending before the statute of limitations has expired.
- You are changing the amount of Section 179 claimed or not claimed.
- Election to apply the $2,500/$5,000 de minimis safe harbor rules (within its own time requirements of return due date plus extension).
- Election not to claim bonus depreciation under 168k (within its own time requirements of return due date plus extension).

Amending returns will only correct depreciation errors that have occurred in the last three years. Errors that have occurred before cannot be “caught up” on current or amended returns and will only be “caught up” when the asset is sold using Form 3115 and Code 107 as discussed below.

Change in Accounting Method Form 3115:
Form 3115, Change in Accounting Method, is used to correct most other depreciation errors, including the omission of depreciation. If you forget to take depreciation on an asset, the IRS treats this as the adoption of an incorrect method of accounting, which may only be corrected by filing Form 3115. ***When changing methods of accounting from not taking depreciation (incorrect method) to taking depreciation (correct method) use Code 7 on Form 3115 if the asset is still in use, code 107 if disposed.***

The IRS's automatic consent procedures for taxpayers who have adopted an impermissible method of accounting for depreciation (or amortization) and have either claimed no allowable depreciation, less depreciation than allowable, or more depreciation than allowable is provided in the guidance at Rev. Proc. 2015-13 and 2018-31.

Generally, Form 3115 must be attached to the taxpayer's tax return for the year of change by the original due date (including extensions). A copy must also be filed with the IRS no later than when the original is filed with the taxpayer's return.

Taxpayers who qualify under the automatic procedure are permitted to change to a method of accounting under which the allowable amount of depreciation is claimed. The unclaimed depreciation from years prior to the year of change is considered as a net negative (taxpayer favorable) adjustment in the year of change, generally effective for tax years ending on or after December 31, 2001, and are deducted ***in full on the return for the year of change***.

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Changes that are a change in accounting method are:

- Changing from not taking depreciation to taking depreciation. ***(Because this is a change from an impermissible method to a permissible method use Code 7 on Form 3115)***

- Changes in methods or conventions, ***(Because this is a change from one permitted method to another, use Code 8 or 200 if MACRS on Form 3115)***

- Changes to or from a required life, ***(Because this is a change from one permitted method to another, use Code 8 on Form 3115)***

- Correcting depreciation on leasehold improvements from using the incorrect life of the lease term to the correct life of the asset (generally 39 years). ***(Use Code 199 on Form 3115)***

Rev. Proc. 2015-13 is also used to correct depreciation after an asset has been sold and the 12/30/03 regulation changes correct other depreciation errors. The Procedure's additional primary value is to recover depreciation deductions mistakenly overlooked, for which, under the "allowed or allowable" rule the taxpayer had to reduce basis in the asset. ***This Revenue Procedure effectively makes the "allowed or allowable" penalty disappear! Code 107 on Form 3115 is used to "catch up" omitted depreciation on an asset when it is sold.***

Changes that do not require Form 3115 because they are not changes in an accounting method include, and which may only be made on an amended return:

1. A change in computing depreciation because of a change in the use by the same taxpayer,

2. Changes in placed-in-service dates.

3. A change in useful lives,

4. Making a late depreciation election or revoking a timely valid depreciation election (including the election not to deduct bonus depreciation). If you elected not to claim any bonus, a change from not claiming to claim bonus is a revocation of the election and is not an accounting method change. You must get IRS approval to make a late depreciation election or revoke a depreciation election. You must submit a request for a letter ruling to make a late election or revoke an election.

Other depreciation corrections still qualify for the automatic change provisions of Rev. Proc. 2015-13***.***

- Rev. Proc. 2015-13 allows the use of one Form 3115 to correct mistakes on more than one asset.

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Explanation of the 2-year rule.

The use of an incorrect method of depreciation, which would include taking no depreciation, is an incorrect accounting method. Once an incorrect accounting method is used for two years, a Form 3115 is required to change accounting methods back to a correct method, or in this case, since not taking depreciation is incorrect, to begin taking depreciation a Change in Method form must be filed. To change to the correct method, meaning to take the overlooked or correct depreciation requires the filing of the change in accounting method form, Rev. Proc. 2015-13 in most cases. (Instructions to Form 3115)

If no depreciation is taken and only one year has passed the return may be corrected via amendment because the incorrect method had only been used for one year.

Examples of depreciation change in accounting methods:

a. Using an incorrect method (or no method, which is also impermissible!),

b. Changing a method or convention, (like 200DB to S/L)

c. Change to or from a recovery period assigned by the Code,

d. Changing from non-depreciable to depreciable, or vice-versa.

Form 3115 will have to be filed, with the entire amount of incorrect or overlooked depreciation deducted in full in the year of correction via this Form 3115. The total depreciation adjustment is called a Section 481(a) adjustment, which***, if negative may be deducted in full in the year of change.***

If positive, it is added ratably over 4 years, or if positive but less than $50,000 in total the taxpayer may elect to add it in to income in full in the year of change.

The form may be filed at any time for any year, and if for a prior year sale, is accompanied by an amended tax return, effective for a Form 3115 filed for taxable years ending on or after 12/30/2003.

- Use Code 7 as the Code number of change on Page 1 of Form 3115 if correcting an error while the asset is still owned by the taxpayer.

- Form 3115 will use Code 107 as the Code number of change on Page 1 of Form 3115 if the asset has been sold and Rev. Proc. 2007-16 applies.

Rev. Proc. 2015-13 requires that a signed copy of Form 3115 be filed to the IRS office. No advance IRS approval is required to correct the error, as this is an automatic approval change in most cases. There is no user fee.

An original of the Form 3115 should be included with the tax return filed for the year of change. The original must be filed by the due date of the return, plus extension. There is a 6-month automatic extension of this due date providing the return was timely filed, and an amended return (with this change) is filed within 6 months.

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When filing Form 3115, the additional statements listed below must be attached:

- A detailed description of the former and new methods of accounting,
- A statement describing the taxpayer's business or income-producing activities,
- A statement of the facts and law supporting the new method of accounting, new classification of the item of property, and new asset class,
- A statement identifying the year in which the item of property was placed in service.

Example. Taylor James is a new client who inherited a house when her mother died on January 1, 2020, when the house was valued $275,000, not counting land of $50,000. Taylor rented the house since January 2020 but when she asks you for help with her 2024 tax return you discover she's never claimed depreciation on the rental home. The unclaimed depreciation is $40,000 ($275,000 ÷ 27½ = $10,000 x 4 years = $40,000).

Form 3115 must be filed for the 2024 tax year to calculate the §481(a) negative adjustment at $40,000 and a copy must be attached to Taylor's 2024 tax return. The §481(a) adjustment will be listed as a separate expense item Taylor's 2024 Schedule E, subject to normal deduction and passive activity rules.

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Businesses Tax Credits

Business Tax Credits – Overview

The Inflation Reduction Act (IRA), the Secure Act, Secure Act 2.0 and other recently enacted legislation introduced multiple new and revised energy related credits. Most of the discussion of these credits focuses on the credits available on personal tax returns for individual taxpayers. However, there were also many new and enhanced credits applicable to businesses and entities. Most of the new business credits relate to massive projects that include solar, nuclear, and hydrogen power used to produce electricity and are mostly claimed by large businesses. However, there are a few credits that apply to small and medium-size businesses, and we will cover those in depth. The purpose of this chapter is to put all the credit changes for businesses in one place for easy reference. And we will also review a few credits that have been around a while but may be overlooked. So, let's do this!

Pension Plan Credits – Four Credits Available for Qualified Employers (Form 8881)

The Secure Act and Secure Act 2.0 added or changed incentives meant to encourage small businesses to adopt an employer sponsored pension plan and to make at least a small employer contribution to employee accounts. Eligible small businesses may claim tax credits for adopting a new pension plan, making employer contributions to employee accounts, for adding an auto enroll feature to a new or existing plan, and for allowing military spouses to bypass normal vesting rules. We will look at each available credit in detail below.

Credit #1 – Qualified Pension Start Up Credit (§45E; Notice 2024-2). Employers who establish a new pension plan, including SEPs, SIMPLEs, 401(k)s and 403(b) plans, and who have had no other plan in place for the prior 3 years, qualify for this credit. The credit amount is equal to ***100% of the cost of establishing the plan*** (50% for employers with more than 50 employees) plus annual administrative costs. The credit is available for three years – the year the plan was established plus two more. Prior to 2020 the annual limit was $500. The credit was revised to increase the credit limit to the greater of:

1. $500 or
2. The lesser of:
    a. $250 multiplied by the number of non-Highly Compensated Employees (non-HCEs) eligible for plan participation, or
    b. $5,000.

NOTE - the deduction for pension admin costs must be reduced by the credit amount.

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Employer qualifications. To qualify, a "qualified small business" must meet three tests:

1. It must have 100 or fewer employees that earned at least $5,000 in wages the prior year (***credit decreases to 50% of costs if the employer has more than 50 employees***), and

2. The plan must cover at least one employee who is not a highly compensated employee (e.g., does not work for solo 401k's), and

3. In the three tax years before the first year of eligibility, the employees were not the same employees who received contributions or accrued benefits in another retirement plan sponsored by the employer, a member of a controlled group that includes the employer, or a predecessor.

HCE defined. For test 2, a HCE is an individual who owned more than 5% of the interest in the business at any time during the current or preceding year, regardless of how much compensation that person earned or received; or, for the preceding year, received compensation from the business of more than $155,000. ***Note that costs paid attributable to HCE's still qualify for the credit.***

Preparer note. The taxpayer may take the credit in the first year of the plan *or may elect to take the credit in the preceding year (§45E(d)(3)(B)).* For example, a calendar-year eligible small employer whose eligible plan is first effective on January 1, 2024, may elect to treat 2023 as the first credit year and claim the credit on its 2023 tax return for any costs incurred to establish the plan.

Qualified pension startup costs defined. Qualified startup costs include the ordinary and necessary costs incurred to set up and administer a qualifying retirement plan and to educate employees about the plan. This could include fees paid to investment advisors, actuaries, administrators, and accountants. The plan must have at least one individual who is eligible to participate and is not an HCE.

Preparer note. Secure Act 2.0 clarifies that the pension start up credit is available to employers who join a multi-employer plan if the employer otherwise meets the credit rules (e.g., no plan in past 3 years).

Credit #2 – Employer contribution credit (§45E(f)). This relatively new provision provides a credit to employers who contribute to employees' pension accounts during the first 5 years of the plan's existence. Employers must meet the same eligibility rules as outlined for the pension start up credit above (i.e., at least one non-HCE, new plan, etc.). The maximum annual credit is $1,000 per employee. The actual credit received is dependent on how many employees the employer has and how many years the credit has been claimed. The chart below summarizes the credit amounts.

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Year	Credit %*
First year plan established	100%
2nd year	100%
3rd year	75%
4th year	50%
5th year	25%
Thereafter	0%
*Note – these percentages decrease ratably for employers with 51 – 100 employees.	

Wage limit applies. The credit does not apply to pension contributions for any employee whose wages (as defined under §3121(a) exceed $100,000 (adjusted for inflation starting in 2024).

Planning note. The employer contribution credit applies to all contributions, even those for owners if the total owner's wages do not exceed $100,000. This means the employer may receive a tax credit for the first $1,000 they put into their own pension account.

Planning note #2. A pension plan is treated as being established, for purposes of determining the first (and subsequent) employer contributions credit taxable years during the 5-year employer contributions credit period, on the date the plan becomes effective with respect to the eligible employer. This is the first plan year for the contribution credit purposes. Employers are going to want to plan the start up of any new pension plan carefully to ensure they can take full advantage of the contribution credit. For example, starting a plan in December would leave little time for the employer to make contributions that would qualify for the credit.

Credit #3 – Automatic Enrollment Credit (§45T) – Employers may earn an additional $500 tax credit by adding an automatic enrollment feature to its new or existing deferral pension plan such as a 401(k) or SIMPLE IRA. The credit is available for each of the first three years the feature is effective. To qualify, the employer must meet the same requirements listed under Employer Requirements for the new pension plan start up credit. Additionally, the employer must annually distribute a notice to eligible employees that explains the feature, including the employee's right to make their own deferral election, and withholding from wages for automatically enrolled participants at the plan's default deferral rate.

Mandatory auto-enroll coming. For plan years beginning after Dec. 31, 2024, the Secure Act 2.0 has mandated that all new §401(k) and §403(b) participants be auto enrolled in employee deferrals. As employees become eligible to participate in the plan, employers will automatically sign the employee up to defer plan contributions from their wages. The employer chooses the deferral percent, but it must be between 3% and 10% of each employee's wages. Employees will be able to opt out of deferrals or to change the deferral percentage. Certain employers and plans are exempt from mandatory auto-enroll, including:

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1. SIMPLE IRAs plan sponsors;
2. Small businesses with ten or fewer employees;
3. Churches and government employer plans:
4. Businesses that have been in existence less than 3 years; and
5. Plans that were in existence before the date of enactment.

Preparer note. This definition of employers for mandatory auto-enroll leaves many employers to still qualify for the auto-enroll credit (e.g., SIMPLE IRA plans, grandfathered in plans, employers with 10 or fewer employees).

Comprehensive example. Jimmy and Rachael own Wildflower Landscaping, Inc., which established a 401(k) plan in 2024. The plan includes an automatic enrollment feature. Wildflower has 12 employees, including Jimmy and Rachael. All employees earn wages less than $100,000 in 2024. Wildflower spent $5,000 in 2024 to set the plan up – plan administrator fee of $2,500 and $2,500 to their accountant to advise on the appropriate plan. Wildflower committed to contribute $1,000 for each employee for 2024. Wildflower calculates its 2024 pension credits:

New plan startup cost credit ($2,500 max = 10 non-HCE emp. X $250)	$ 2,500
Per employee credit ($1,000 x 12) – includes Jimmy and Rachael)	$12,000
Auto enroll credit	$ 500
Total 2024 credit	$15,000

Result - Wildflower spends $17,000 to establish, administer and fund its pension plan in 2024, and it receives a tax credit of $15,000 in return. Additionally, Jimmy and Rachael each have at least $1,000 in their 401k plan.

Credit #4 - Military Spouse Retirement Credit (§45AA; Notice 2024-2) – The relatively new military spouse retirement plan credit was added to the IRC for years beginning after 2022. There are two components to this credit that eligible small employers (no more than 100 employees who made more than $5,000 during the preceding tax year) may receive:

1. A credit of $200 for each military spouse who is an employee of the employer and who participates in the employer's defined contribution plan at any time during the tax year, and;

2. A $300 per employee credit for employer contributions made to the plan on behalf of the military spouse.

Both credits are limited to 3 successive tax years, beginning with the first tax year the military spouse began participating in the plan and the plan was eligible for the for the credit.

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Eligible defined contribution plan is any defined contribution plan (as defined under §414(i), including §401k, SIMPLE IRA, etc.) of an eligible small employer. The employer must make military spouses eligible to participate in the plan:

1. Not later than 2 months after the military spouse begins employment; and,

2. Upon such participation, the military spouse is immediately eligible to receive the same amount of employer contributions that a similarly situated participant who is not a military spouse would be eligible to receive after 2 years of service; and

3. Provides the military spouse immediately has a non-forfeitable right to her/his accrued benefit derived from employer contributions under the plan.

Military spouse defined. For this provision, a military spouse is an employee who is not highly compensated (§414(q)) and, as of the first date that the employee is employed or rehired by the employer, is married to a member of the uniformed services (defined in U.S. Code Title 10, §101(a)(5)) serving on active duty. Employers may rely on an employee's certification if the certification includes the name, rank, and service branch of the spouse.

Preparer note. Contributions made by an employer to an employee's retirement account cannot be used for both the Military Spouse Credit and the Employer Contribution Credit. You cannot double dip.

Qualified Commercial Clean Vehicle Credit (§45W; Notice 2022-56)

Overview. Businesses and tax-exempt organizations who purchase qualified commercial clean vehicles after December 31, 2022, and before January 1, 2033, may qualify for the Commercial Clean Vehicle (CCV) nonrefundable tax credit of up to $40,000. The credit amount equals the lesser of:

- 15% of the basis in the vehicle (30% if the vehicle doesn't have gas or diesel engine).

- The incremental cost of the vehicle.

The maximum credit is $7,500 for qualified vehicles with gross vehicle weight rating (GVWRs) of under 14,000 pounds and $40,000 for all other vehicles. The credit is allowed per qualified vehicle purchased and placed in service with no limit. For example, a taxpayer who purchases ten qualifying vehicles all over 14,000 pounds could potentially qualify for a credit as high as $400,000. Any unused credit is carried forward as a component of the general business credit until used. Qualifying vehicles must be for use primarily on public roads or highways.

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Incremental cost safe harbor (Notice 2024-5; Notice 2023-9; DOE Incremental Purchase Cost Report). The incremental cost of the vehicle is defined as the difference in cost for the qualified vehicle and the cost of a comparable vehicle powered solely by an internal combustion engine. Obviously, the big question here is how to determine the vehicle's incremental cost. The Department of Energy (DOE) produced an incremental cost analysis for commercial clean vehicles and comparable internal combustion engine vehicles. The Treasury Department reviewed the DOE report and found the incremental cost of all street vehicles under 14,000 pounds, except compact Plugin Hybrid Electric Vehicles (PHEVs), is greater than $7,500 in 2024 and in 2023. The IRS provided two safe harbors for taxpayers claiming the CCV credit in 2024 and 2023.

1. For compact PHEVs, including subcompact and mini-compact cars, taxpayers may use the DOE analysis to calculate the incremental cost amount, which is $7,000 for 2024; and

2. For all street vehicles (other than compact PHEVs) with a gross vehicle weight rating of less than 14,000 pounds, the IRS will accept a taxpayer's use of $7,500 as the incremental cost, which maximizes the 2024 credit.

Qualifying commercia clean vehicle (§45W(c). To qualify, a vehicle must be acquired for use or lease by the taxpayer and:

- Be made by a qualified manufacturer (§30D(d)(1)(C)). The IRS maintains a list of qualified manufacturers on its website.
- Be for use in a business (subject to depreciation) and not for resale.
- Be for use primarily in the United States.

The vehicle must also either be a plug-in electric vehicle that draws significant propulsion from an electric motor with a battery capacity of at least:

- 7 kilowatt hours if the gross vehicle weight rating (GVWR) is under 14,000 pounds;
- 15 kilowatt hours if the GVWR is 14,000 pounds or more; or
- A qualified fuel cell motor vehicle.

Other items to note regarding CCV credit. Qualifying taxpayers must provide the qualifying vehicle's VIN along with the amount of the credit. The depreciable basis of the vehicle must be reduced by the amount of the CCV credit.

No double benefit – but choice allowed. No credit is allowed under §45W with respect to any vehicle for which a credit was ***allowed*** under §30D. Note that the rule says "allowed", not "allowable." This indicates that a taxpayer may choose which credit to claim if the vehicle qualifies for under §45W and §30D. The business credit under 45W has the advantages of:

- There is no AGI limit.
- There are no limitations on vehicle cost or manufacturing.
- Multiple vehicles may qualify per year, not just one.
- Any excess credit is carried over as part of the General Business Credit.

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Basis is required to be reduced for any credit claimed.

Example. Jessi's 2024 AGI is $210,000 and she files as a single person. Jessi bought a new Alset SUV in 2024 for $75,000. The new car qualifies for an EV tax credit under both §45W and §30D and is well under the 14,000 lb. threshold. Jessi's mileage log shows the EV was used 60% for business and 40% for personal purposes in 2024. Jessi's tax credits are calculated:

Credit type	**Business**	**Personal**
Maximum credit	$ 7,500	$ 7,500
AGI limit	N/A	$ - 0 –
Net credit	$ 7,500	$ - 0 –

The AGI limit does not apply to the business version of the credit so clearly Jessi would be better off using the business credit. Otherwise, her AGI would preclude her from claiming any credit.

Variation. Assume the same facts as above except Jessi's AGI is $120,000 and she bought two vehicles in 2024, the previously mentioned SUV and a small electric powered delivery truck. The delivery truck cost $60,000. Jessi's tax credits are calculated:

Credit type	**Business**	**Personal**
Maximum credit (2 vehicles)	$ 15,000	$ 7,500
AGI limit	N/A	N/A
Net credit	$ 15,000	$ 7,500

Again, the obvious option is to claim the credits under §45W.

What about recapture. While recapture is not specifically addressed §45W, it does say that the rules of §30D(f) apply. §30D(f)(5) authorizes the IRS to promulgate regulations to address recapture for "any property which ceases to be property eligible for such credit." When such guidance is issued, it is anticipated it will require recapture if a vehicle ceases to meet one or more of the requirements, including failing to be used primarily (more than 50%) in a trade or business during the vehicle's useful life (like the §179 recapture rule). Also, it remains to be seen how dispositions in the normal course of business to other commercial users would be treated. In the meantime, we are on our own.

Leased vehicles. Only the owner of the vehicle may claim the CCV credit. For leased vehicles, taxpayers will have to analyze if, under the circumstances, the vehicle owner is the lessee or lessor. This determination is based on whether the lease is respected as a lease or recharacterized as a sale for Federal income tax purposes. For tax purposes, the determination of whether a transaction constitutes a vehicle sale or lease is a question of fact. Features of a vehicle lease agreement that would make it more likely to be recharacterized as a sale of the vehicle for tax purposes include, but are not limited to:

- A lease term that covers more than 80% of the economic useful life of the vehicle.

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- A bargain purchase option at the end of the lease term (that is, the ability to purchase the vehicle at less than its fair market value at the end of the term) or other terms/provisions in the lease that economically compel the lessee to acquire the vehicle at the end of the lease term.

Terms that result in the lessor transferring ownership risk to the lessee, for example, a terminal rental adjustment clause (TRAC) that requires the lessee to pay the difference between the actual and expected value of the vehicle at the end of the lease.

Elective Payment and Credit Transferability (§6417; §6418)

The Inflation Reduction Act provided two new options for those who qualify for certain energy related credits: 1) an election to treat the credits as a payment of tax, making any excess credit refundable, and 2) the ability to transfer the credits to another taxpayer, even if paid cash to do so. Both provisions use the same definition of an "applicable credit:

"Applicable credit." The term "applicable credit" includes:

1. Alternative fuel vehicle refueling property credit – Form 8911, Part II (§30C);
2. Renewable electricity production credit – Form 8835 (§45(a));
3. Carbon oxide sequestration credit – Form 8933 (§45Q(a));
4. Zero-emission nuclear power production credit – Form 7213 (§45U(a));
5. Production of clean hydrogen credit – Form 7210 (§45V(a));
6. ***In the case of U.S. based tax-exempt entities, the credit for qualified commercial vehicles – Form 8936 (§45W);***
7. Advanced manufacturing production credit – Form 7207 (§45X(a));
8. Clean electricity production credit (§45Y(a));
9. Clean fuel production credit (§45Z(a));
10. Energy credit – Form 3468, Part VI (§48);
11. Qualifying advanced energy project credit – Form 3468, Part III (§48C); and
12. Clean electricity investment credit – Form 3468, Part V (§48E).

Preparer note. More detailed information about these credits is available in IRS Pub 5817-G, at IRS.gov/cleanenergy, and at the IRS FAQs for Elective Pay.

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Elective Payment of Applicable Credits – Elective Payment Election (§6417; T.D. 9988, March 11, 2024; IRS FAQs for Elective Pay Transferability)

Background. An applicable entity that makes an elective payment election is treated as having made a payment against Federal income taxes for the taxable year with respect to which an applicable credit was determined, in the amount of such credit. For example, if an applicable entity has any remaining Federal income tax liability, then the amount of the credit first offsets that tax liability and the rest is refunded to the applicable entity. If the applicable entity has no Federal income tax liability, the applicable entity's refund will be equal to the full amount of the applicable credit. Final regulations issued in March 2024 clarify how taxpayers may elect to treat the tax credits listed above as a direct payment against Federal income tax (i.e., direct pay election) rather than as a credit against its Federal income tax liability. This election allows taxpayers who otherwise would not receive any tax benefit from these credits (e.g., tax-exempt organizations) to receive cash refunds equal to the credit amount.

"Applicable entities." To qualify, an "applicable credit" must be earned by an "applicable entity" and the applicable entity must elect to treat the applicable credit as a direct tax payment or what the IRS is calling an elective pay election. There are six "applicable entities" in the law:

- Any organization exempt from Federal income tax described in §501 through §530 (e.g., charitable organizations, social welfare organizations, homeowners' associations, private foundations, etc.);
- Any state or political subdivision (e.g., cities, counties, school districts, water districts, etc.);
- The Tennessee Valley Authority;
- Indian Tribal governments;
- Any Alaska Native Corporations; and
- Any corporation operating on a cooperative basis that is engaged in furnishing electric energy to persons in rural areas.

Applicable entity exceptions. While the general rule is only applicable entities may make the election, there are special rules for three of the clean energy tax credits. Specifically, taxpayers that are not "applicable entities" may make an election to be treated as an applicable entity for elective pay with respect to applicable credit property giving rise to:

1. §45Q credit for carbon oxide sequestration,
2. §45V credit for production of clean hydrogen, or
3. §45X advanced manufacturing production credit.

The entity must own the property that generates the credit to make the elective pay election. Ownership includes arrangements where the taxpayer directly owns the property, owns the property through a disregarded entity, or owns an undivided interest in an

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ownership arrangement treated as a tenancy-in-common or pursuant to a joint operating arrangement.

Amount of credits eligible for elective pay. The amount of certain applicable credits can vary based on several factors. Certain applicable credits offer higher credit amounts to projects that:

- Pay prevailing wages and use registered apprentices,
- Are in low-income communities or energy communities, or
- Meet certain domestic content requirements.

Starting in 2024, if the domestic content requirements are not met, the applicable credit amount may be reduced (for the §§45, 45Y, 48, and 48E credits).

Steps necessary to make the elective pay election. There are several steps required to successfully make the elective payment election. The steps are (not all steps need to occur in the order displayed below) are:

1. Identify the qualifying project or activity, including which credit is applicable and for which the elective pay election will be made.

2. Determine the tax year to which the credit applies.

3. Ensure all eligibility requirements for the tax credit have been satisfied and for any applicable bonus credits, if applicable. For example, to claim the energy credit on a solar energy generating project, the taxpayer needs to first place the project in service before making the elective payment election.

4. Complete pre-filing registration with the IRS. This will include providing information about the taxpayer, which credits are applicable, and each eligible project/property that will contribute to the applicable credit. Upon completing this process, the IRS provides the taxpayer with a registration number for each applicable credit property. The registration number must be provided on the tax return as part of the elective pay election.

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

Mechanics of making the elective pay election. The direct pay election is available beginning in 2023 and may only be made on a timely filed original tax return (including extensions). The election cannot be made or revised on an amended return or by filing an administrative adjustment request. The election is made in the manner prescribed by the IRS, along with any required form(s) (source credit forms). A completed Form 3800, General Business Credit, and any additional required information, including supporting calculations, required in instructions to the relevant forms should be attached. Note that entities normally not required to file a tax return must file to make the elective pay election. The election is made annually and is irrevocable once made.

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Pre-filing requirement (IRS Pub 5884 – IRA and CHIPS Pre-Filing Registration Guide). Taxpayers wishing to make the election are subject to pre-filing registration rules that require obtaining a registration number for each eligible property. The online pre-filing registration process may be completed as soon as all the required information is available, including the date your applicable credit property was placed in service. The IRS will review the information and issue a separate registration number for each applicable credit property. The registration number would only be valid for one year and would be included on the taxpayer's tax return. See FAQ #32 for more pre-registration info. An elective pay election cannot be validly made without first completing the pre-filing process.

Preparer note. Partnerships and S corporations may make an elective payment election with respect to §§45Q, 45V, or 45X and will receive a payment directly from the IRS equal to the amount of the applicable credit. This payment will be treated as tax-exempt income for purposes of §§705 and 1366 and will be allocated to the partners or shareholders based on their share of the otherwise applicable credit. A partner may not make an elective payment election with respect to any applicable credit determined with respect any facility or property held directly by a partnership or S corporation.

Credit Transferability Clarified (§6418; TD 9993; Credit Transferability FAQs)

In addition to claiming energy related credits as a Federal tax payment, the law also allows qualifying taxpayers to transfer credits to other taxpayers. Credit transfers under §6418 permit eligible credits (i.e., certain clean energy tax credits) to be transferred from an eligible taxpayer to an unrelated third-party transferee in exchange for cash. In such transactions, the transferor ("seller") and transferee ("buyer") negotiate and agree to the terms and pricing. Effectively, this provision allows the buyer to step into the shoes of the seller for purposes of claiming the tax credit on the buyer's return.

Preparer note. Any amount paid by a transferee taxpayer to the transferor taxpayer is required to be paid in cash. The payment is not includible in the gross income of the transferor and is not deductible by the transferee (§6418(b)).

Entities eligible to transfer credits (the everybody else rules!). A taxpayer eligible to make credit transfers is any taxpayer that ***is not*** an "applicable entity" (as defined above). In other words, any entity other than any tax-exempt organization, State or political subdivision (e.g., cities, counties, school districts, water districts, etc.), the Tennessee Valley Authority, an Indian tribal government, any Alaska Native Corporation, or any corporation operating on a cooperative basis that is engaged in furnishing electric energy to persons in rural areas is an eligible taxpayer under §6418.

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Credits eligible for transfer. All the credits subject to the direct pay election (see list above) are eligible for transferability other than the qualified commercial clean vehicle credit (§45W). The taxpayer may transfer, at its discretion, all or a portion of its eligible credit(s) generated from a single eligible credit property. They may also sell credits generated from a single eligible credit property to multiple unrelated parties in the same tax year.

Eligible taxpayers may transfer all or a portion of an eligible credit generated from a single eligible credit property. They may also transfer portions of an eligible credit generated from a single eligible credit property to multiple unrelated parties in the same tax year.

Mechanics of making a credit transfer (FAQ #4). There are several steps required to make a transfer of eligible credits (or a portion of a credit):

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

2. Satisfy all the steps to qualify for the applicable credit.

3. Complete electronic pre-filing registration with the IRS, including providing taxpayer information, the intended eligible credits, and the eligible credit project. Upon completing this process, the IRS provides a registration number for each eligible credit property. This step should be completed in sufficient time to allow the transferor to receive the registration number by the time the tax return is filed. See the IRS registration page and FAQ #4.3.

Preparer note. A separate pre-registration number is required for credits subject to the elective pay election and the credit transfer election. The same registration number cannot be used for them both.

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

5. Provide the transferee (i.e., buyer) with the registration number and all other information necessary for the transferee to claim the credit.

6. Complete a transfer election statement with the transferee.

7. Timely file the tax return and indicate the credit was transferred to a third party. Include the transfer election statement and other information as required. The tax return must include the registration number for the relevant credit property and be filed no later than the due date (including extensions) for the tax return.

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

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Mechanics of receiving a credit transfer (FAQ #5). For a credit buyer, the steps to claim the credit include:

1. Purchase an eligible credit from an unrelated party in exchange for cash.
2. Obtain from the transferor seller the registration number of the credit property and all other information necessary to claim the eligible credit transferred.
3. Complete a transfer election statement with the transferor.
4. File a tax return for the year the credit is considered. Include the transfer election statement and other information as required. The tax return must include the registration number for the relevant credit property.

Transfer election statement required. The transfer election statement must include the name, address, and taxpayer identification number for both the transferor and transferee, a description of the type and amount of the tax credit transferred, the timing and amount of cash paid for the eligible tax credit transferred and the registration number related to the eligible credit property. The transfer election statement should also include statements and/or representations from the transferor and transferee as described in future IRS guidance. Attach the statement to the tax return of the transferor the year the transferor becomes entitled to the eligible credit. The transferee should attach the statement to its tax return the year the transferee takes the eligible credit into account.

Note that there is no ordering rule for which entity must file its tax returns first or last.

What if the IRS doesn't send my registration number in time to file the return?

Registration numbers provided by the IRS must be included on the entity's tax return for an elective payment election to be effective. If the taxpayer submitted a pre-filing registration package and the:

- Extended due date for the taxpayer's tax return is approaching (60 days or less) and
- Registration package was submitted more than 90 days ago and
- Status of your registration package has not changed within the last 30 days.

Contact the IRS! The IRS prefers that contact be made by email at irs.elective.payment.or.transfer.of.credit@irs.gov and the following information be provided:

- Subject line: Where's My Registration
- Name, last four digits of EIN and address of the registering entity.
- Date the registration package was submitted (or an estimate if you aren't sure of the exact date)
- Name and telephone number for a contact person (if we need to talk to you about your submission).

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POA required if taxpayer isn't the one reaching out. The contact person must be authorized to receive private taxpayer information about the registering entity (e.g., be an officer, trustee, or representative (IRS Form 2848, Power of Attorney) of the registering entity.

Additional info is available at:

- Register for elective payment or transfer of credits | Internal Revenue Service (irs.gov) and
- IRS.gov/cleanenergy

What happens if there is a subsequent audit? For transferred eligible credits under §§48, 48E or 48C or transferred carbon sequestration tax credits under §45Q, the transferee bears the financial responsibility for a recapture event and is required to recapture an amount of previously claimed tax credits based on the timing and amount of the recapture event. The transferor is required to notify the transferee if a recapture event occurs. For other eligible credits, recapture is not relevant.

Other credit transfer info. Individuals, estates and trusts closely held C corporations and personal service corporations may all purchase and claim credits through transferability. These types of taxpayers must consider the passive activity rules for any purchased credits.

Form 3468 updates (Form 3468, Form 3468 instructions). IRS Form 3468 has been redesigned to support new provisions in the IRA of 2022 and the CHIPs of 2022. The instructions include a requirement that separate information and computation of investment tax credit for each facility or property placed in service in 2023 or after. Additionally, the revised form includes reporting for applicable entities (such as certain tax-exempt and governmental entities) who elect to treat certain investment credits as a payment of income tax, or which are transferred to other taxpayers.

Preparer note. Under either 6417 or 6418, an S corporation would report the direct payment or the sale price as tax-exempt income that would increase shareholder(s)' basis. The amounts would be reported in the OAA – other adjustments account – on Schedule M-2 rather than the AAA – accumulated adjustments account. For an S corporation that purchases a credit from another entity, the purchase cost is a nondeductible expense that passes through to the shareholders. This pass through would reduce shareholder basis.

Proposed Regs Define Energy Property (Reg-132569-17)

New proposed regulations update rules for the investment tax credit (ITC) (§48) that have been unchanged since 1987. Such updates address changes in the energy industry, technological advances, and updates from the Inflation Reduction Act (IRA) of 2022. The proposed regulations provide that energy property includes units of energy property and property owned by the taxpayer that is an integral part of an energy property. They further provide that power purchase agreements, goodwill, going concern value and renewable energy certificates are not energy property as well as electrical transmission equipment,

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equipment beyond the electrical transmission state and additions or modifications to an existing energy property. Also, energy property generally does not include any property that is part of a qualified facility for which production is allowed as a §45 (renewable electricity production) credit for the current or a prior tax year.

The proposed regulations clarify various energy property definitions such as expanding the definition of geothermal production equipment from earlier rules but still disallows costs incurred to drill failed or nonproducing wells. Additionally, the proposed regulations define what qualifies as energy storage property confirming that the definition would not use a technology-specific definition but rather provide a broader definition based on capabilities of energy storage technology.

They also formally adopt the 80/20 rule in prior IRS guidance for purposes of repower projects. The proposed regulations clarify that the 80/20 rule is applied in ITC projects to each unit of energy property, meaning that all functionally interdependent components owned by the taxpayer or related parties would be tested in the aggregate. For example, if a taxpayer claims an ITC on a wind farm, the 80/20 test is applied to the entire wind farm rather than to each turbine or other piece of equipment separately.

Lastly, the proposed regulations revise the dual use rule to reduce the minimum qualifying energy requirement from 75% to 50%. This requires energy property to derive a minimum of 50% of energy from a qualifying source during annual measurement periods. If at least 50% of the energy is used from qualifying sources, a proportionate amount of the eligible basis of the energy property will be considered to calculate the ITC.

Research Credit (§41; Form 6765)

Historical overview. The research & development tax credit, also known as the research & experimentation (R&E) credit, incremental research credit or simply research credit was first introduced in 1981 as a 2-year incentive but is still in the IRC today. Its purpose is to reward U.S. companies for increasing R&E investments. It allows eligible businesses to claim a tax credit for a percentage of their qualified research expenses (QREs) related to developing or improving products, processes, software, or other innovative technologies. In most cases, the research credit equals 20% of the QREs over a base amount plus 20% of the basic research payments plus 20% of amounts paid to an energy research consortium.

The 2015 PATH Act made the research credit permanent and made it available to offset AMT liability for eligible small businesses. The PATH Act also allowed certain businesses to utilize the credit against payroll taxes. The Inflation Reduction Act (IRA) of 2022 increased the amount of the research credit that can be used against a qualified small business's (QSB) payroll tax liability. For amounts paid or incurred in tax years beginning after 2021, the TCJA requires that expenses be SREs as discussed earlier.

Inflation Reduction Act makes additional changes to R&D credit. Qualified small businesses (QSBs) may elect to apply R&D credits against the employer share of Social Security and Medicare taxes rather than income tax (§41(h)). For this purpose, a QSB is a business with less than $5 million of gross receipts for the current tax year and no gross receipts before the 5 tax-year period ending with the current year. Effectively, this provision is only available to start-up businesses that have been around for 5 years or

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less. IRA 2022 increased the limit that may be claimed against FICA to $500,000 starting in 2023. The previous limit was $250,000.

A QSB that files *annual* employment tax returns claims the research payroll tax credit on its annual employment tax return that includes the 1st quarter beginning after the date on which the business files the return reflecting the election (Notice 2017-23). When a QSB claims a research payroll credit on its employment tax return, it must complete Form 8974, Qualified Small Business Payroll Tax Credit for Increasing Research Activities, and attach it to the return. The election may be made for no more than 5 years and may not be revoked without IRS consent (§41(h)(4)(B)(ii)).

Preparer note. The research payroll tax credit under §3111(f)(1) is not considered for purposes of determining any amount allowable as a payroll tax deduction. In other words, the employer payroll taxes which the research payroll tax credit portion was credited can be deducted as a §162 business expense!

Qualified Research Expenditures

The research credit can be claimed for qualified research expenditures (QREs) conducted as a part of the taxpayer's trade or business. QREs are the sum of in-house research expenses and contract research expenses (§1.41-4). *In-house research expenses* are:

- Wages paid to employees engaged in qualified research or in the direct supervision of qualified research.
- Supplies (tangible property other than land or improvements to land and property subject to depreciation) used to conduct qualified research.
- Amounts paid for the use of computers for the conduct of qualified research.
    - Certain in-house software if a QRE and satisfies the high threshold of innovation test which means the software is innovative, development involves significant economic risk and it is not commercially available for use by the taxpayer (§1.41-4(c)(6)).

Contract research expenses are 65% of amounts paid to persons other than employees for qualified research (75% for payments made to a qualified consortium) regardless of the success of the research.

- Qualified research consortium for research credit purposes is a tax-exempt nonprofit scientific organization under §501(c)(3) that is organized and operated primarily to conduct scientific research and is not a private foundation (§41(b)(3)(C)(ii)).

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Qualified research – four requirements (§41(d)). Qualified research consists of research and development in the experimental or laboratory sense that meets all four of the following tests (§41(d)):

1. Expenditures qualify as specified research or experimental expenditures per §174 (paid or incurred by the taxpayer during the tax year in connection with the taxpayer's trade or business in an experimental or laboratory sense).

> **Preparer note.** While the IRC §174, which requires capitalization of SRE expenses, and §41, which defines qualifying expenses for the R&D tax credit, each has its own definition of qualifying R&D expenses, it is important to note that the definition under §41 begins with the §174 definition. Only after the §174 rules are met, are the remaining requirements of §41 considered.

2. Research must be undertaken to discover information that is technological in nature. Technological in nature means the process of experimentation fundamentally relies on principles of the physical or biological sciences, engineering, or computer science.

    a. A taxpayer may use existing technologies and may rely on existing principles of the physical or biological sciences, engineering or computer science to satisfy this requirement (§1.41-4(a)(4)).

    b. If the process of experimentation used in the research relies on other principles, such as economics, the information is not treated as technological in nature.

3. Substantially all the research must contain elements of a process of experimentation relating to a new or improved function, performance, reliability, or quality.

    a. Substantially all is satisfied if only at least 80% of a taxpayer's research activities are elements of experimentation (§1.41-4(a)(6)).

    b. Use the quotient of:

        Research activities that constitute elements of a process of experimentation
        ____

        Research activities not specifically excluded and whose expenses are deductible under §174.

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Case Law: In *Norwest Corp & Subsidiaries*, (1998), 110 TC 454, the Tax Court determined that activities involved in the attempted development of a strategic banking computer software system (consisting of a customer-based system that could integrate with other banking systems and handle large volumes of data) were a process of experimentation. Substantially all the activities consisted of developing, testing, and analyzing various approaches.

But Norwest was also denied the research credit for seven other types of internal use software which failed to meet research credit requirements due to relating to style, taste, cosmetic or seasonal design factors.

See also *Little Sandy Coal v Comm*. TC Memo 2021-15.

4. The application of the research is intended to be useful in the development of a new or improved *business component* of the taxpayer. This includes techniques, formulas, and/or inventions to be sold by the taxpayer. This does not include research related to style, taste, cosmetic or seasonal design factors does not satisfy this requirement (§1.41-4(a)(5)(ii)).

Preparer note. All four tests must be applied to each project or business component separately. There is no crossover from one component to another.

Example. Tidua, a retail and distribution company, wants to upgrade its warehouse management software. The company evaluates several different warehouse management software products available from vendors to determine which product will best serve Tidua's technical requirements and ultimately selects PaBrand software.

Tidua's activities to select the software are not QREs because it did not conduct a process of evaluating alternatives to eliminate uncertainty regarding the development of a business component. In addition, Tidua's evaluation of products available from vendors is not a process of experimentation (§1.41-4(a)(8), Ex. 5).

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Example. Cheesehead Inc. currently manufactures a large shred version of Packer cheese. Cheesehead wants to modify its current production line to be able to manufacture both a large and fine-shred Packer cheese. They have looked far and wide and are unable to find a thinner shredding blade capable of producing a fine-shred version. Thus, Cheesehead must develop a new shredding blade that can be fitted onto its current production line. Cheesehead analyzes various blade designs and materials to determine whether the new blade must be constructed of a material different from its existing shredding blade.

Cheesehead's activities to modify its current production line to develop a new shredding blade meets the requirements of qualified research because substantially all Cheesehead's activities constitute elements of a process of experimentation. Alternatives and the appropriate design were uncertain at the beginning of Cheesehead's research activities.

Non-qualified expenses. QREs for the research credit **DO NOT** include costs for:

- Research conducted after the beginning of commercial production.
- Research related to adapting an existing product, process, or other business component to a particular customer's need.
- Duplication of an existing product or process – any research related to the reproduction of an existing business component (in whole or in part) from a physical examination of the business component itself or from plans, blueprints, detailed specifications, or publicly available information with respect to such business component.
- Efficiency surveys, management activities studies, market research or testing, routine data collection, or routine or ordinary testing or inspection for quality control.
- Computer software, except any research with computer software which is developed by (or for the benefit of) the taxpayer primarily for internal use by the taxpayer.
- Research conducted out of the U.S., Puerto Rico, or a U.S. possession.
- Research in the social sciences, arts, or humanities.
- Research to the extent funded by any grant, contract, or otherwise by another person (or governmental entity).

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Agreement for payment must exist. An expense is paid or incurred for the performance of qualified research only if it is paid or incurred under an agreement that (§1.41-2(e)(2)):

1. Is entered into before the performance of the qualified research.
2. Provides that research be performed on behalf of the taxpayer.
3. Requires the taxpayer to bear the expense even if the research is not successful.

Example: Brite N Better develops and manufactures gizmos. Brite N Better wants to change the color of the gizmos from red to blue. Brite N Better obtains various shades of blue paint from several suppliers. Brite N Better paints several sample gizmos and surveys customers to determine which shade of blue is preferred.

Brite N Better's activities to change the color of its gizmo are not QREs because substantially all of BNB's activities are not undertaken for a qualified purpose since they only related to style, taste, cosmetic and design factors (§1.41-4(a)(8), Ex. 4).

Preparer note. Since §41 is a subsection of §174, more expenses may end up capitalized under §174 than qualify for the §41 research credit.

Possible Expenses for Research Credit	
Industry	**Type**
Agribusiness	Hybridizing during the development of new strains of crops, plants, or livestock
	Improving harvesting techniques to increase yield or production efficiency
	Developing or implementing automated processes
	Developing or implementing new ways to protect crops from disease or insects
Apparel	Developing new clothing innovations that could be eligible for utility patents
	Designing and developing product and performance specifications for new fabric and material construction technologies
	Developing a new manufacturing process
	Manufacturing, evaluating, and testing samples and prototypes
Automotive	Developing aftermarket performance products
	Researching improved materials for component parts, such as polymers, alloys, and composites

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Possible Expenses for Research Credit	
Industry	**Type**
	Designing and developing vehicle performance improvements, such as for fuel efficiency and handling
	Making improvements to automotive components, i.e., to increase safety
Clean Technology	Pursuing advances in products, materials and processes to increase efficiencies in energy generation
	Development of alternative fuels
	Development of waste treatment and remediation processes
	Designing and developing hydroelectric or another type of clean energy facility or system
Construction	Designing unique, energy-efficient infrastructure items
	Designing renewable energy infrastructure
	Developing new or improved construction techniques
Food & Beverage	Developing new product flavors, textures, or health benefits
	Developing methods to extend shelf life
	Producing prototype product samples for testing and validation of new recipe formulations
	Designing and developing specialized tools or prototype machines
Healthcare	Software to better manage customer relationships through improved analysis techniques
	Testing to satisfy domestic or foreign regulatory requirements
	Developing new or improved devices, equipment, or technology as well as product improvements
Media	Developing telecommunications networks to serve customers, i.e., integrating voice capabilities into a mobile application
	Developing software and technology to improve transmission capacity
	Developing network tools to monitor and/or measure network performance
	Designing and constructing physical network improvements
Retail	Researching appropriate materials to account for strength, durability, and cost among other details
	Designing and developing retail fixtures, i.e., displays
	Engineering of new assembly methods
	Prototyping of displays, such as mannequins, etc.
Technology	Developing code for new software
	Developing specialized technologies such as artificial intelligence applications
	Developing functional enhancements for existing applications designed to create a competitive advantage

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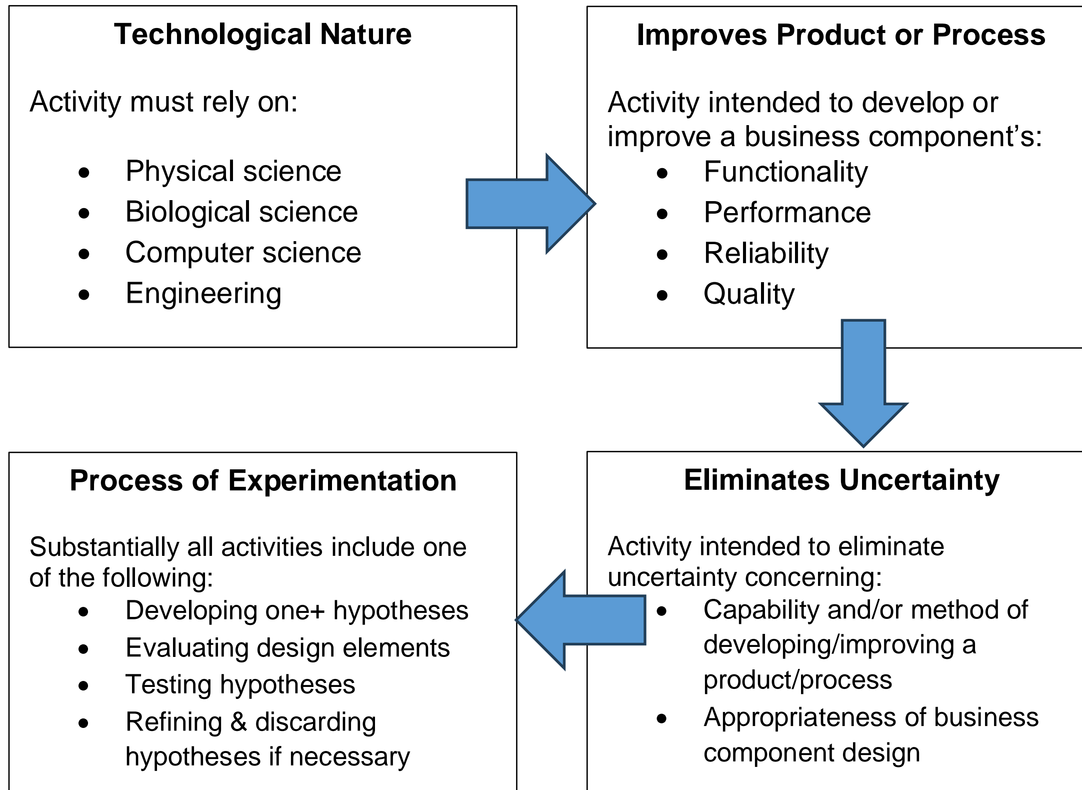
Research Credit 4-Part Test



Contract engineering expenses not QRE (Meyer, Borgman, & Johnson, Inc. v. Comm., 8th USCA No. 23-1523, May 6, 2024). Meyer, Borgman, & Johnson, Inc., was a structural engineering firm that created construction documents of the structural design for building projects. MBJ claimed research tax credits for its expenses in creating the designs. Over a three-year period, MBJ claimed $190,000 of R&D tax credits for 2010, 2011, and 2013. The IRS noted that any research funded by any grant, contract, or otherwise by another person (or governmental entity) is expressly excluded from the definition of qualified research (§41(d)(4)(H)) and argued that all MBJ's research was funded as defined in the regulations. The IRS denied the entire R&D tax credit.

General economic risk does not make contract a contingent fee contract. MBJ claimed its payments were not guaranteed but were contingent on the success of its research because each contract required MBJ to create a design that complied with all the pertinent codes and regulations and would result in a structurally sound building without being so over-engineered as to compromise the construction budget. Additionally, the agreements could be terminated by either party should the MBJ fail to perform in accordance with the terms of the agreement.

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The Court ruled that MBJ's contracts lack the express terms that courts have identified as important to establish payment was contingent on the success of the research. The contract did not include rejection language; nor did it limit payment to work the customer accepted. The R&D credits was disallowed.

Taxpayer got a lot wrong (Mark and Christine Betz, Dennis and Julia Lincoln v. Comm., TC Memo 2023-84). Catalytic Products International, Inc. (CPI), an S corporation owned by Betz and Lincoln, designed and supplied air pollution control systems. CPI had extensive institutional knowledge and experience in supplying exhaust systems that met the specifications of customers in manufacturing industries. CPI claimed a research credit on its 2014 1120S for research performed on nineteen of its projects. CPI included the costs of producing the systems it supplied and the wages it paid to certain of its employees for activities performed in connection with the projects as SRE when calculating its research credit. As a result, Betz and Lincoln claimed passthrough research credits of $501,000 on their individual tax returns for 2014.

Documentation problems proves costly. CPI did not use a time-tracking system for its employees' activities and thus estimated the amounts of employee time spent performing qualified services. The Court ruled, for all nineteen projects, CPI failed to establish that the wages claimed as SRE were incurred in connection with the performance of qualified services. The Court also ruled that CPE failed to prove that the products being modified were not existing products and determined CPI's purported QREs for costs of production failed to satisfy the requirement of §41(d)(1)(A) and were not creditable. The entire $501,000 of R&E credits were disallowed.

Documentation not the only problem. The Court also took issue with CPI's claim that the outcome of its activities was uncertain. CPI argued that the ultimate success of its research was not verifiable until final on-site testing was completed. The Court, however, determined expenditures did not qualify as research because there were instances where customers had received similar products with the relatively same design – nothing new was added or adapted. The Court determined there was no technical uncertainty.

Alliantgroup provided consulting services. It is noteworthy that Alliantgroup prepared the original R&D tax credit study for CPI and agreed to provide audit defense. CPI and the related shareholders consulted with Alliantgroup LP to perform the initial credit calculations, and the study was prepared after Alliantgroup personnel made a site visit to CPI and interviewed multiple employees. The study concluded that CPI had credit qualified wages of $1,983,647 and $5,732,211 of qualified supplies. The result was an R&D credit in a gross credit of $771,586 and a net credit of $501,531 being claimed.

See also:

- Ramesh Kapur v. Comm., USTC No. 14017-21, March 12, 2024, where the taxpayer's consultant, Alliantgroup LP, argued unsuccessfully that the R&D credit could be calculated for all projects based on a sampling of most of the projects. The Court noted that "absent an agreement between the parties, project sampling improperly relieves the taxpayer of its burden of proving entitlement to the research credit claimed." Betz v. Comm, T.C. Memo. 2023-84, (citing Bayer, 850 F. Supp. 2d at 538, 545-46). The Court ruled the IRS's requests were reasonable to determine Kapur's eligibility for the research credits and concluded that the

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significance and necessity of the info outweighed the expense to Kapur. Lastly, to the extent that Kapur believed that the expenses related to providing additional information was disproportionate to any potential benefit to the IRS, the Court advised Kapur he was welcome to eliminate his claim to research credits for QREs relating to the projects he felt did not need to be included in the sample! ***BOOM!! Oh no he didn't!!***

- Robert Eustace et al. v. Comm., 7th USCA No. 02-1367, is an IRS oft cited case where Applied Systems, Inc. (ASI), an S corporation, developed and improved software products for sale to independent insurance agencies. Robert Eustace was a shareholder of ASI who claimed a pass-through research and development tax credit on his personal tax return. The IRS determined that this research tax credit is not available for those software development expenses for two reasons:

  1. The "qualified research" was not undertaken to discover information that went beyond the current state of knowledge in the computer science field. No research was undertaken by ASI to develop software programs, and neither was anything done through process of experimentation. Simply debugging a computer program does not represent a process of experimentation.

  2. ASI did not present sufficient evidence to establish that its activities met the requirements for the research credit. It did not undertake research to discover information beyond the current state of knowledge in the computer science field, and it did not conduct a process of experimentation aimed at eliminating uncertainty about the technical ability to develop the software.

  The court ruled in favor of the IRS, noting that the mere industrious development of software through a process of trial-and-error does not constitute "qualified research" as defined in §41(a).

R&D Credit Computation

The R&D credit is the composite of three different component calculations: 1) the incremental research credit; 2) basic research credit; and 3) energy research consortium credit. There are two methods that may be used to calculate the credit – 1) regular credit method and 2) the alternative simplified method.

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Regular R&D Credit Calculation

In general terms, the credit equals 20% of the QREs for the current tax year exceeding the "base amount" (also known as the incremental research credit) for that year, plus 20% of the basic research payments to universities and other qualified organizations (also known as the university basic research credit), plus 20% of amounts paid to energy research consortiums (§41(a)).

1. **Incremental research credit** – The incremental research credit equals 20% of the current year QRE more than the base amount. The base amount equals:

    a. Fixed base percentage[1] x average annual gross receipts of the taxpayer for the four years preceding the credit tax year.

    b. The "base amount" cannot be less than 50% of its QREs for the year (minimum base amount). Thus, no more than half of the current year QREs qualify for the research credit.

Example. Roco began incurring QRE in 2020. Roco has gross receipts of $8,000,000 and QRE of $900,000 in 2024. Its prior years amounts were, Roco had:

	Gross Receipts	**QRE**
2023	$ 7,000,000	$1,000,000
2022	$ 5,000,000	$ 800,000
2021	$ 3,000,000	$1,500,000
2020	$ 2,000,000	$1,200,000
Total	**$17,000,000**	**N/A**
Number of years	**÷ 4**	
Average annual gross receipts	**$ 4,250,000**	**N/A**
Fixed base % (3% in first 5 years)	**x 3%**	
Calculated fixed-base amount	**$ 127,500**	
Minimum fixed-base amount(50% of QRE)	**$ 450,000**	
2024 qualifying QRE ($900,000 - $450,000)	**$ 450,000**	
Incremental credit %	**x 20%**	
2024 Incremental credit	**$ 90,000**	

Assuming Roco did not have any payments to consortiums or universities, the credit is $90,000.

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[1] The fixed-base percentage depends on whether the entity is an "existing" company or a "start-up" company. A "start-up" company is a taxpayer that had both gross receipts and QRE either: 1) for the first time in a tax year beginning after 1983, or 2) for fewer than 3 tax years beginning after 1983 and before 1989. For this purpose, this means all taxpayers formed after 1988 are start-up businesses. The fixed-base percentage for start-up business up to 5 years old is 3%. For those in existence more than 5 years, there is a formula to calculate the fixed-base percentage (see the Form 6765 instructions). The fixed-base percentage for an existing company (any company that isn't a start-up company) is figured by dividing the aggregate QRE for the tax years beginning after 1983 and before 1989 by the aggregate gross receipts for those tax years. The fixed-base percentage for all companies (existing and start-up) must be rounded to the nearest 1/100th of 1% and can't exceed 16%.

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2. **Basic research credit.** The university basic research credit is equal to 20% of basic research payments expenditures paid by corporations (except S corporations, PHCs or service organizations) for basic research if such payment is pursuant to a written agreement, and such basic research is performed by a qualified organization (educational institutions, scientific research organizations, scientific research organizations or grant organizations) over the sum of the minimum basic research amount and the maintenance-of-effort amount (§41(e)(1)(A)). For this purpose, the "minimum basic research amount" is the greatest of:

    a. 1% of the average amount paid for in-house and contract research expenses during the *base period* (3 years before first tax year beginning after 1983),
    b. Contract research expense for the base period, or
    c. 50% of the basic research payments if the taxpayer was not in existence for a full year in the base period.

Preparer note. Any qualified clinical testing expenses (QCTEs) taken into account when computing the Orphan Drug Credit (§45C) for a tax year may not be taken into account for purposes of computing the research credit. However, any QCTEs which are QREs, are taken into account in determining the base amount research expenses for purposes of applying the research credit to later years (TAM 201740018).

3. **Energy research consortium.** 20% of amounts paid to an energy consortium for energy research. Qualified research consortium for research credit purposes is a tax-exempt nonprofit scientific organization under §501(c)(3) that is organized and operated primarily to conduct scientific research and is not a private foundation (§41(b)(3)(C)(ii)).

Alternative Simplified Credit (ASC) (§41(c)(4)).

Taxpayers may elect to calculate the incremental research component of the R&D credit using an Alternative Simplified Credit (ASC) method instead of the regular credit calculation described above. Under the ASC, the incremental research portion of the R&D credit equals:

- 14% of the amount by which the taxpayer's QRE for the current tax year exceeds 50% of its average QRE for the three preceding tax years; or

- For taxpayers who do not have QRE in all of the three preceding tax years, 6% of its QRE for the current tax year.

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Example. GNR had $75,000 of QRE in 2024. GNR's QRE was $50,000 (2021), $50,000 (2022) and $65,000 (2023), for an average of $55,000 over the prior three years. Assuming GNR didn't make any payments for University Basic Research or Energy Consortium, GNR calculates its R&D using the ASC:

2024 QRE	$ 75,000
Base amount ($55,000 average x 50%)	($27,500)
Allowable QRE	$ 47,500
Credit %	x 14%
2024 R&D credit	$ 6,650

Planning note. The ASC may result in an allowable R&D credit even if QRE is not increased in the current year. This would occur if QRE in the current year exceeds the base average for the three prior years, even if it wasn't increased over the prior year.

Example. Using the same facts as above, assume that GNR's 2024 QRE was $45,000, less than what was paid in all three prior years. The R&D credit is calculated:

2024 QRE	$ 45,000
Base amount ($55,000 average x 50%)	($27,500)
Allowable QRE	$ 17,500
Credit %	x 14%
2024 R&D credit	$ 2,450

Preparer note. The ASC replaces the Incremental Research component of the credit. If applicable, those who choose to use the ASC may still add the University Basic Research credit and the Energy Consortium credit components to determine the total R&D credit.

Election to use ASC. The election to use the ASC is made by filing Form 6765 and completing the ASC section. Once made, this election applies for the tax year made and all following tax years unless revoked with IRS consent. The IRS automatically revokes the election if Form 6765 is completed and a method other than ASC is used. The ASC may be claimed on an amended return if the taxpayer has not previously claimed a §41 credit for that tax year on an original or amended return (§1.41-9). The IRS will not allow the ASC election to be revoked on an amended return.

R&D Limitations. The research credit is a component of the general business credits (§38). Use of the general business credit is limited to net income tax (regular tax reduced by most non-refundable non-business credits), less the larger of 1) the tentative minimum tax or 2) 25% of the net regular tax more than $25,000 (§38(c)). Any unused portion of the research credit may be carried back one year and forward twenty years (§39(a)(1)). If any

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research credit remains unused at the end of the 20th year, 50% of the unused amount can be deducted in the 21st year, subject to special rules pertaining to the reduced credit (§196(d)).

Recordkeeping
A taxpayer claiming the research credit must retain records in sufficiently usable form and detail to substantiate that the expenditures claimed are eligible for the credit (§1.41-4(d)).

R&D Credit requires documentation (Scott and Gayla Moore v. Comm., 7th Circuit, USCA No. 23-2681, April 30, 2024). Nevco, Inc., an S corporation, made scoreboards and related gear for athletic events. In 2014 and 2015 Nevco claimed it engaged in research to improve its products and claimed an R&D credit that was passed through to Scott Moore and Gayla Moore, the sole shareholders. When calculating the R&D credit, Nevco included the salary and bonus of Gary Robert, the firm's President and COO, as qualified §41 expenses. However, Nevco was unable to provide any documentation to substantiate that Robert was engage in research activities.

Lack of documentation dooms the R&D credit. At court, Nevco's payroll records only showed how much time employees worked, not the tasks that were performed. Robert, during testimony, was unable to estimate, even approximately, how much of his time was devoted to "qualified" research. And Robert conceded he did not engage in either "direct supervision" or "direct support" (§41(b)(2)(B)(ii)) of Dave Paslay, Nevco's director of engineering, whose salary the IRS allowed as a "qualified research" expense. The IRS also conceded that Robert likely devoted much of his time to conducting or supervising research, but there was evidence to show the time was spent on "qualified" research. The IRS argued if the time was spent on qualified research, there was no record of how much time he spent. Without answers to those questions, the R&D credit cannot be accurately calculated. The Court ruled that none of the evidence showed what fraction of the research involved "experimentation." Without knowing how much of Robert's research was "qualified," the Court could not determine how much it had increased over a base amount. And because the Moores bore the burden of production and persuasion, the Court ruled against them and the R&D credit was disallowed.

Reporting. Form 6765 is used to claim the research credit. As mentioned above, Form 6765 is also used to elect the reduced research credit and to elect to claim a certain amount of the research credit as a payroll tax credit. If there is a GBC in addition to the RC (or a carryback or carryforward of the GBC), the research credit is carried to Form 3800, General Business Credit, and if necessary, to Form 8810, Corporate Passive Activity Loss and Credit Limitations. Partners and S corporation shareholders use Schedule K-1 information to prepare their own Form 6765.

2024 Form 6765 Draft version – The IRS is proposing to make significant changes to the 2024 Form 6765. Because of their, the IRS sought input from taxpayers and tax professionals about the changes. Specifically, the IRS is proposing to change:

- **New Section E Line 48** is being considered because of consistency requirements in the credit calculation. If you include any new categories or recharacterized any categories of expenditures in the current year compared to the base year(s), those expenditures must be included in any base year when computing the credit.

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- **New Section F Section F** includes lines 50 through 57 and requires the reporting of information as stated for each business component generating the credit. This provides a consistent and predefined format for reporting information. Lines 58, 59, 60 and 61 will be the sum of all wages, supplies, rental/lease cost of computer, and contract research, respectively. All basic research payments will be entered separately on line 62. Section F will be able to accommodate as many lines as necessary to allow for the reporting of all business components. Lines 58, 59, 60, 63, and 64 are the business component totals for the specific expense and will be entered on either lines 5-9, Section A, or lines 24-28, Section B, as applicable.

- **Section F response options** for lines 50(e) through 50(h).
    - For 50(e) the responses are new or improved.
    - For 50(f) the responses are product, process, computer software, technique, formula, or invention.
    - For 50(g) the responses are sale, lease, license, or used by the taxpayer in a trade or business.
    - For 50(h) there are options a through j and include:
        - IUS (internal use software).
        - DFS (dual function software)–no third-party subset identified dual function software safe harbor not applied.
        - DFS–third party subset(s) identified (remaining dual function subset subject to High Threshold of Innovation test) Preview of Proposed Changes to Form 6765, Credit for Increasing Research Activities.
        - DFS–dual function software safe harbor applied (25% of expenditures that meet all conditions).
        - Non-IUS–developed to be commercially sold, leased, licensed, or otherwise marketed to third parties.
        - Non-IUS–developed to be used internally by the taxpayer but not in any G&A (general & administrative) function(s) of the taxpayer.
        - Non-IUS–developed to interact with third parties but not to be used in any G&A function(s) of the taxpayer.
        - Excepted from IUS Treatment–developed for use in an activity that constitutes qualified research (other than the development of the internal use software itself).
        - Excepted from IUS Treatment–developed for internal use by the taxpayer for use in a production process to which the requirements of section 41(d)(1) are met.
        - Excepted from IUS Treatment–A new or improved package of software and hardware developed together by the taxpayer as a single product (or to the costs to modify an acquired software and hardware package), of which the software is an integral part, that is used directly by the taxpayer in providing services in its trade or business. In these cases, eligibility for the research credit is to be

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determined by examining the combined hardware- software product as a single product.

Form **6765** (Rev. December 2024) Department of the Treasury Internal Revenue Service

Credit for Increasing Research Activities

Attach to your tax return.
Go to *www.irs.gov/Form6765* for instructions and the latest information.

OMB No. 1545-0619
Attachment Sequence No. **676**

TREASURY/IRS AND OMB USE ONLY DRAFT June 20, 2024 DO NOT FILE

Name(s) shown on return	Identifying number

A Are you electing the reduced credit under section 280C? See instructions . . . ☐ Yes ☐ No

B Are you a member of a controlled group or business under common control? . . . ☐ Yes ☐ No

If "Yes," complete and attach the required statement. See instructions for required attachment.

Section A—Regular Credit. Skip this section and go to Section B if you are electing or previously elected (and are not revoking) the alternative simplified credit.

Line	Description				
1	Certain amounts paid or incurred to energy consortia (see instructions) . . .			1	
2	Basic research payments to qualified organizations (see instructions) . . .	2			
3	Qualified organization base period amount . . .	3			
4	Subtract line 3 from line 2. If zero or less, enter -0- . . .			4	
	Note: Complete Section F before going to line 5.				
5	Total qualified research expenses (QRE). Enter amount from line 48 . . .	5			
6	Enter fixed-base percentage, but not more than 16% (0.16). See instructions	6	%		
7	Enter average annual gross receipts. See instructions . . .	7			
8	Multiply line 7 by the percentage on line 6 . . .	8			
9	Subtract line 8 from line 5. If zero or less, enter -0- . . .	9			
10	Multiply line 5 by 50% (0.50) . . .	10			
11	Enter the smaller of line 9 or line 10 . . .			11	
12	Add lines 1, 4, and 11 . . .			12	
13	If you elect to reduce the credit under section 280C, then multiply line 12 by 15.8% (0.158). If not, multiply line 12 by 20% (0.20) and see instructions for the statement that must be attached . . .			13	

Section B—Alternative Simplified Credit. Skip this section if you are completing Section A.

Line	Description				
14	Certain amounts paid or incurred to energy consortia (see the line 1 instructions) . . .			14	
15	Basic research payments to qualified organizations (see the line 2 instructions)	15			
16	Qualified organization base period amount (see the line 3 instructions) . . .	16			
17	Subtract line 16 from line 15. If zero or less, enter -0- . . .			17	
18	Add lines 14 and 17 . . .			18	
19	Multiply line 18 by 20% (0.20) . . .			19	
	Note: Complete Section F before going to line 20.				
20	Total qualified research expenses (QRE). Enter amount from line 48 . . .	20			
21	Enter your total QRE for the prior 3 tax years. If you had no QRE in any 1 of those years, skip lines 22 and 23 . . .	21			
22	Divide line 21 by 6.0 . . .	22			
23	Subtract line 22 from line 20. If zero or less, enter -0- . . .	23			
24	Multiply line 23 by 14% (0.14). If you skipped lines 22 and 23, multiply line 20 by 6% (0.06) . . .			24	
25	Add lines 19 and 24 . . .			25	
26	If you elect to reduce the credit under section 280C, then multiply line 25 by 79% (0.79). If not, enter the amount from line 25 and see the line 13 instructions for the statement that must be attached . . .			26	

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 13700H Form **6765** (Rev. 12-2024)

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Section C—Current Year Credit

27	Enter the portion of the credit from Form 8932, line 2, that is attributable to wages that were also used to figure the credit on line 13 or line 26 (whichever applies)	27	
28	Subtract line 27 from line 13 or line 26 (whichever applies). If zero or less, enter -0-	28	
29	Credit for increasing research activities from partnerships, S corporations, estates, and trusts	29	
30	Add lines 28 and 29	30	
	• Estates and trusts, go to line 31. • Partnerships and S corporations not electing the payroll tax credit, stop here and report this amount on Schedule K. • Partnerships and S corporations electing the payroll tax credit, complete Section D and report on Schedule K the amount on this line reduced by the amount on line 36. • Eligible small businesses, stop here and report the credit on Form 3800, Part III, line 4i. See instructions for the definition of eligible small business. • Filers other than eligible small businesses, stop here and report the credit on Form 3800, Part III, line 1c. **Note:** Qualified small business filers, other than partnerships and S corporations, electing the payroll tax credit must complete Form 3800 before completing Section D.		
31	Amount allocated to beneficiaries of the estate or trust (see instructions)	31	
32	Estates and trusts, subtract line 31 from line 30. For eligible small businesses, report the credit on Form 3800, Part III, line 4i. See instructions. For filers other than eligible small businesses, report the credit on Form 3800, Part III, line 1c	32	

Section D—Qualified Small Business Payroll Tax Election and Payroll Tax Credit. Skip this section if the payroll tax election does not apply. See instructions.

33a	Check this box if you are a qualified small business electing the payroll tax credit. See instructions ☐		
b	Check the box if payroll tax is reported on a different EIN ☐		
34	Enter the portion of line 28 elected as a payroll tax credit (do not enter more than $500,000). See instructions	34	
35	General business credit carryforward from the current year. See instructions. Partnerships and S corporations, skip this line and go to line 36	35	
36	Partnerships and S corporations, enter the smaller of line 28 or line 34. All others, enter the smallest of line 28, line 34, or line 35. Enter here and on the applicable line of Form 8974, Part 1, column (e). Members of controlled groups or businesses under common control, see instructions for the statement that must be attached	36	

Section E—Other Information. See instructions.

37	Enter the number of business components generating the QRE on line 5 or line 20	37	
38	Enter the amount of officers' wages included on line 42	38	
39	Did you acquire or dispose of any major portion of a trade or business in the tax year? ☐ Yes ☐ No		
40	Did you include any new categories of expenditures as current year QRE? ☐ Yes ☐ No		
41	Did you determine any of the QRE on line 5 or line 20 following the ASC 730 Directive? ☐ Yes ☐ No		
	If "Yes," enter the amount from Appendix C Line 19 (you may attach your Appendices A, B, C, and D here)	41	
	This ASC 730 Directive only applies to taxpayers with assets equal to or greater than $10,000,000 who follow U.S. GAAP to prepare their Certified Audited Financial Statements showing the amount of currently expensed Financial Statement R&D. See instructions.		

Section F—Qualified Research Expenses Summary. See instructions.

A Are you required to complete Section G? See instructions to determine if you are required to complete Section G, and how to complete Section F if you are not required to complete Section G ☐ Yes ☐ No

42	Total wages for qualified services for all business components (do not include any wages used in figuring the work opportunity credit)			42	
43	Total costs of supplies for all business components			43	
44	Total rental or lease cost of computers for all business components			44	
45	Total applicable amount of contract research for all business components (do not include basic research payments)	45			
46	Enter the applicable amount of all basic research payments. See instructions	46			
47	Add line 45 and line 46			47	
48	Add lines 42, 43, 44, and 47, then enter line 48 on either line 5 or line 20, whichever is appropriate			48	

Form **6765** (Rev. 12-2024)

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Section G—Business Component Information. Complete lines 49(a) through 49(f) for each business component you are required to report. See instructions. Attach additional sheets if necessary to capture all business components.

BC	49(a) EIN of the controlled group member conducting the research activities on this business component	49(b) Controlled group member's principal business activity code	49(c) Business component's name or unique alphanumeric identifier (see instructions)	49(d) Business component type (select one from available options)
1				
2				
3				
4				
5				
6				
7				
8				
9				
10				
11				
12				
13				
14				
15				

BC	49(e) Software (if applicable, select from the available options)	49(f) Describe the information sought to be discovered. Use the space provided.
1		
2		
3		
4		
5		
6		
7		
8		
9		
10		
11		
12		
13		
14		
15		

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Section G—Business Component Information *(continued)*. Complete lines 50 through 56 for each business component. If you have more than fifteen business components, see instructions.

BC	50 Direct research wages for qualified services	51 Direct supervision wages for qualified services	52 Direct support wages for qualified services	53 Total qualified wages (add line 50, line 51, and line 52)
1				
2				
3				
4				
5				
6				
7				
8				
9				
10				
11				
12				
13				
14				
15				
Total from attachments				
Total				

BC	54 Cost of supplies	55 Rental or lease cost of computers	56 Applicable amount of contract research expenses (see instructions for reporting basic research payments)
1			
2			
3			
4			
5			
6			
7			
8			
9			
10			
11			
12			
13			
14			
15			
Total from attachments			
Total			

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Amended returns – The research credit may be claimed on the original return or on an amended return. If claiming a refund or credit on an amended return or an administrative adjustment request (AAR) that includes a research credit that was not reported on the original return or is increased from the amount reported on the original return, the following information must be provided:

1. Identify all business components to which the research credit claim relates for that year.
2. For each business component, identify all research activities performed.
3. For each business component, name the individuals who performed each research activity.
4. For each business component, describe the information each individual sought to discover.
5. Provide the total qualified employee wage expenses, total qualified supply expenses and total qualified contract research expenses paid or incurred for the research credit claim. This item may be done using Form 6765.

Orphan Drug credit. If a taxpayer incurs qualified clinical testing expenses relating to drugs for certain rare diseases, elect to claim the Orphan Drug Credit on Form 8820 for these expenses, not the research credit.

Work Opportunity Credit (§51)

The Work Opportunity Tax Credit (WOTC) is available to employers for hiring individuals from certain targeted groups who have consistently faced significant barriers to employment. The WOTC is available to employers of all sizes and includes tax exempt organizations (but not for all the same target groups – see below). Given today's employment market, with most businesses facing a tight job market, it seems like a good time to review the WOTC details.

What is the WOTC? The WOTC is a general business credit provided that is jointly administered by the IRS and the Department of Labor (DOL). The credit is available for wages paid to qualified individuals who begin work on or before December 31, 2025. The WOTC may be claimed by any employer that hires and pays or incurs wages to individuals who are certified by a designated local agency (sometimes referred to as a state workforce agency or SWA) as being a member of one of ten targeted groups. In general, the WOTC is equal to 40% of up to $6,000 of wages paid to, or incurred on behalf of, an individual who:

1. is in their first year of employment;
2. is certified as being a member of a targeted group; and
3. performs at least 400 hours of services for that employer.

Maximum credit. Thus, the maximum tax credit is $2,400. A credit percentage is reduced to 25% for wages paid to individuals who work fewer than 400 but at least 120 hours for the employer. Other rules include:

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- Up to $24,000 in wages may be considered in determining the WOTC for certain qualified veterans.
- An employer cannot claim the WOTC for employees who are rehired.
- The credit is limited to the amount of business income tax liability or Social Security tax owed.
- Employers may carry the current year's unused WOTC back one year and then forward 20 years (see Form 3800 General Business Credit).

Qualified targeted groups. The targeted groups include certain veterans and recipients of various kinds of public assistance, among others. Specifically, the ten groups are:

1. Temporary Assistance for Needy Families (TANF) recipients;
2. Unemployed or disabled veterans;
3. Qualified ex-felon hired within 1 year of conviction or release from incarceration;
4. Designated community residents aged 18 to 39 who live in Empowerment Zones, Enterprise Community or Rural Renewal Counties;
5. Vocational rehabilitation referrals;
6. Summer youth employees aged 16 or 17 who live in Empowerment Zones;
7. Supplemental Nutrition Assistance Program (SNAP) recipients aged 18 to 39;
8. Supplemental Security Income (SSI) recipients;
9. Long-term (at least 18 months) family assistance recipients; and
10. Long-term unemployment recipients (unemployed for at least 27 consecutive weeks and received state or federal unemployment benefits during part or all that time).

Qualifying for the credit (Form 8850). To qualify, employers must first request certification by submitting IRS Form 8850, Pre-screening Notice and Certification Request for the Work Opportunity Credit, to their state workforce agency (SWA). It must be submitted to the SWA within 28 days after the eligible worker begins work.

Claiming the credit. Eligible businesses first figure the credit on Form 5884, Work Opportunity Credit, and then claim the credit on Form 3800, General Business Credit. Qualified tax-exempt organizations claim the credit on Form 5884-C, Work Opportunity Credit for Qualified Tax-Exempt Organizations Hiring Qualified Veterans, as a credit against the employer's share of Social Security tax. The credit will not affect the employer's Social Security tax liability reported on the organization's employment tax return.

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Form **5884** (Rev. March 2021) Department of the Treasury Internal Revenue Service

Work Opportunity Credit

► Attach to your tax return.
► Go to *www.irs.gov/Form5884* for instructions and the latest information.

OMB No. 1545-0219
Attachment Sequence No. **884**

Name(s) shown on return	Identifying number

1	Enter on the applicable line below the total qualified first- or second-year wages paid or incurred during the tax year, and multiply by the percentage shown, for services of employees who are certified as members of a targeted group.			
a	Qualified first-year wages of employees who worked for you at least 120 hours but fewer than 400 hours . . .	$ ____ × 25% (0.25)	**1a**	
b	Qualified first-year wages of employees who worked for you at least 400 hours	$ ____ × 40% (0.40)	**1b**	
c	Qualified second-year wages of employees certified as long-term family assistance recipients	$ ____ × 50% (0.50)	**1c**	
2	Add lines 1a, 1b, and 1c. See instructions for the adjustment you must make to your deduction for salaries and wages		**2**	
3	Work opportunity credit from partnerships, S corporations, cooperatives, estates, and trusts (see instructions)		**3**	
4	Add lines 2 and 3. Cooperatives, estates, and trusts, go to line 5. Partnerships and S corporations, stop here and report this amount on Schedule K. All others, stop here and report this amount on Form 3800, Part III, line 4b		**4**	
5	Amount allocated to patrons of the cooperative or beneficiaries of the estate or trust (see instructions)		**5**	
6	Cooperatives, estates, and trusts, subtract line 5 from line 4. Report this amount on Form 3800, Part III, line 4b		**6**	

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 13570D Form **5884** (Rev. 3-2021)

Preparer note. The credit is available to tax-exempt organizations but only for hiring qualified veterans.

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Tax Exempt Organizations

Public Charities and Private Foundations

All charitable organizations are classified as either a private foundation or a public charity. Private foundations and public charities are distinguished primarily by the level of public involvement in their activities. An organization is presumed to be a private foundation unless it requests, and qualifies for, a ruling or determination as a public charity. Organizations that qualify for public charity status include churches, schools, hospitals, medical research organizations, publicly supported organizations (i.e., organizations that receive a specified portion of their total support from public sources), and certain supporting organizations.

Private foundation. A private foundation is typically controlled by members of a family or by a small group of individuals and derives much of its support from a small number of sources and from investment income. Because they are less open to public scrutiny, private foundations are subject to various operating restrictions and to excise taxes for failure to comply with those restrictions. Limits on deductions are lower for donors to private foundations.

Public charities. Public charities generally receive a greater portion of their financial support from the public or governmental units and have greater interaction with the public. A public charity must file an application for recognition of exemption with the IRS (see discussion below). The law provides limited exceptions to the filing requirement.
To qualify as a public charity, a charitable organization (§501(c)(3) must meet one of two public support tests:

1. The 33-1/3% public support test requires at least one-third of the organization's support over a five-year period to be "public support", including contributions from other public charities and contributions by other donors up to 2% of the charity's overall support during that five-year period; or

2. The 10% facts-and-circumstances test requires at least 10% of the charity's total support over the five-year measuring period to be "public support" and the other facts and circumstances to indicate it is a public charity.

Charities unable to pass one of these two public support tests would be reclassified as a private foundation. This test is an annual test.

Unusual grants or donations may cause charity to fail public support tests. Occasionally a public charity may receive a gift, grant, or bequest from one source that is large enough that it threatens the charity's status as a public charity. Fortunately, the IRS contemplates such events and provides relief if specified rules are met (§1.170A-9(f)(6)(ii); §1.509(a)-3(c)(4)). These rules allow public charities to exclude qualifying unusual gifts, grants, or bequests from both the numerator and denominator of its public support calculation. To qualify, the donation must be from a disinterested party whose contributions are:

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1. Are attracted by the publicly supported nature of the organization;
2. Are for an unusual or unexpected amount; and
3. Would, because of its size, adversely affect the organization's publicly supported status?

The regulations requires pertinent facts and circumstances to be taken into consideration to determine whether a contribution is excludable from the public support calculation; no single factor, however, will necessarily be determinative. Factors to be considered include whether:

- The contribution was made by a person who: created the organization; has contributed a substantial part of the organization's support or endowment; was in a position of authority in the organization (e.g., foundation manager); exercised direct or indirect control over the organization; or was in a relationship described in §4946(a)(1)(C) through (G) with one of the people described in this sentence.

- The contribution was a bequest (less favorable) or an inter vivos transfer (more favorable).

- The contribution was for cash, readily marketable securities, or assets that further the organization's tax-exempt purpose.

- The organization had solicited and attracted a significant amount of public support and had carried on tax-exempt activities before receiving the contribution.

- The organization is reasonably expected to attract significant public support after receiving the contribution at issue.

- The organization met the one-third public support test before receiving the contribution.

- The organization has a representative governing body (per §1.509(a)-3(d)(3)(i)).

- The transferor has imposed material restrictions or conditions on the transferee in connection with the transfer.

Form 8940 required - IRS lenient with charitable recipients of occasional large donations (Form 8940; LTR 202349019; LTR 202344020). Public charities who receive a large or unusual donation should consider filing Form 8940, Request for Miscellaneous Determination. The Form can only be filed electronically through Pay.gov. The user fee is $600 (as of July 1, 2024). The good news is that the IRS is typically very lenient in this area as long as they do not detect any ulterior motives at play. In both current letter rulings, and numerous older letter rulings as well, the IRS waived the public support tests and allowed recipients of large or otherwise unusual donations to retain their public charity status.

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Various Types of Charitable Organizations

There are several types of organizations that may be exempt from paying income tax, the most common of which are:

Charitable Organizations. Organizations organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, educational, or other specified purposes and that meet certain other requirements are tax exempt under §501(c)(3).

Churches and Religious Organizations. Churches and religious organizations, like many other charitable organizations, qualify for exemption from federal income tax. The significant difference is that qualified churches and religious organizations are not required to file annual information returns (i.e., Form 990 or 990EZ) to retain their tax-exempt status. No filing is needed.

Private Foundations. Every organization that qualifies for tax-exempt status under §501(c)(3) is classified as a private foundation unless it meets one of the exceptions found in §509(a). Private foundations typically have a single major source of funding (usually gifts from one family or corporation) rather than funding from many sources and most have as their primary activity the making of grants to other charitable organizations and to individuals, rather than the direct operation of charitable programs.

Political Organizations. A political organization is a party, committee, association, fund, or other organization (whether incorporated) organized and operated primarily for the purpose of directly or indirectly accepting contributions or making expenditures, or both, for an exempt function. Such organizations are tax exempt under §527.

Other Nonprofits. Organizations that meet specified requirements may qualify for exemption under subsections other than §501(c)(3). These include social welfare organizations, civic leagues, social clubs, labor organizations and business leagues.

Exempt Organizations Developments

Tax Exempt Client Hasn't Filed Returns – Now What?

Form 990, 990-EZ, Form 990-N, or 990-PF must be filed by the 15th day of the 5th month after the end of an exempt organization's year end (e.g., for a calendar year taxpayer, the due date is May 15th of the following year). Entities who fail to file tax returns for three consecutive years will have their tax-exempt status automatically revoked as of the due date of the third unfiled return. The revocation is done by operation of law, and not by a determination made by the IRS. There is no process in the law to allow any kind of appeal for automatic revocations.

Effect of automatic revocation. An organization that has lost its tax-exempt status through automatic revocation may be required to file one of the following federal income tax returns and pay any applicable income taxes:

- Form 1120, U.S. Corporation Income Tax Return, due by the 15th day of the 3rd month after the end of an organization's tax year, or

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- Form 1041, U.S. Income Tax Return for Estates and Trusts, due by the 15th day of the 4th month after the end of an organization's tax year.

In addition, a §501(c)(3) organization that loses its tax-exempt status cannot receive tax-deductible contributions and will not be identified in the IRS Business Master File extract as eligible to receive tax-deductible contributions, or be included in Tax Exempt Organization Search.

Reinstatement once revocation has occurred. Once revoked, the organization must file a new application (i.e., Form 1023, 1023-EZ, 1024 or 1024-A to request exemption. This is effectively starting over from scratch, even if the return filing requirement was for a Form 990-N. An organization may also request retroactive reinstatement, but it must demonstrate the failure to file was due to reasonable cause.

Erroneous revocation. The IRS has procedures in place to assist organizations that believe they have been erroneously listed as auto-revoked. This includes situations where an organization has documentation that it met its filing requirement for one or more years during the three-consecutive-year period. An organization can fax us the relevant information (e.g., an IRS receipt for a filed return) to 855-247-6123 to resolve the issue.

Additional resources
- FAQs on auto revocation
- Automatic revocation of exemption
- Pub 4991 Automatic Revocation of Tax-Exempt Status

IRS Issues Substantial Guidance (Notice 2024-5)

The IRS covered many areas for tax exempt organizations in Notice 2024-5. Included in the new notices is guidance on:

- Procedures for acquiring determination letters on issues on tax-exempt status under §§ 501 or 521 including private foundation status, and other determinations related to tax-exempt organizations. For guidance on retirement plans, see Rev. Proc. 2024-4).
- Procedures for revocation or modification of determination letters.
- Guidance on applicable user fees for requesting determination letters.

IRS Guidance on Elective Payments and Transfer of Certain Credits (§6417; NPRM REG-101607-23; IR-2023-116)

The Inflation Reduction Act of 2022 (IRA) added §6417 to the IRC. This allows "applicable entities" (including tax-exempt organizations) to make an election to treat an applicable credit (for tax exempt entities this includes the commercial clean vehicle credit) as making a payment against the tax imposed by subtitle A of the Code (i.e., income tax).

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Tax exempt entities may convert credit refundable. Beginning in 2023, the regulations allow qualified taxpayers to elect to be treated as an "applicable entity[1]" for limited purposes. In turn, applicable entities may elect to treat any "applicable credit" as an income tax payment on the entity's tax return rather than treat it as a nonrefundable credit. Once the credit is used to cover any taxes owed by the entity, the remaining amount is available to be refunded, essentially converting the credit from a nonrefundable to a refundable credit.

Example. The Bears QB Club decides to purchase electric vehicles for its workers and qualifies for a clean commercial vehicle credit of $15,000. The QB Club is a tax-exempt entity and pays no income tax so it cannot benefit from the tax credit. However, the Bears QB Club elects to be treated as an "applicable entity", files its Form 990 and claims the credit as tax paid for the 2024 tax year. There is no tax due with Form 990 and the credit shown is treated as a tax over payment. The Club receives a $15,000 refund from the IRS.

Credit may also be sold. Additionally, if an entity is unable to make the applicable entity election, it can still make an election to transfer (i.e., sell) all or a portion of an eligible credit to unrelated taxpayers for cash payments (i.e., buy). The buyer and the seller negotiate and agree to the terms and pricing. The unrelated taxpayers are then able to claim the transferred credits on their tax return. The cash payments are not included in gross income of the eligible taxpayer and are not deductible by the unrelated taxpayers.

Pre-registration essential for tax-exempts. IRS is strongly encouraging tax-exempt organizations planning to use energy credit elective pay or transfer election to complete pre-filing registration process as soon as possible. Organizations should submit the pre-filing registration ***at least 120 days prior*** to when the organization plans to file its tax return on which it will make its election. A timely filed return (including extensions) is required to make an elective payment election. Electronic return filing, if not required, is strongly encouraged. The pre-filing registration request cannot be filed before the beginning of the tax year in which the taxpayer will earn the credit related to an elective payment election or transfer election (e.g., January 1, 2025, for a credit earned in 2025 calendar year).

Note – we discuss the pre-registration process in detail in the business credit chapter.

[1] Applicable entities include tax-exempt organizations, State and local governments, Indian tribal governments, Alaska Native Corporations, the Tennessee Valley Authority, rural electric cooperatives, and, in the case of three of these credits, certain taxpayers eligible to elect the elective payment of credit amounts in a taxable year.

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NIL Collectives Usually Have No Exempt Purpose AM 2023-004

In 2021, the NCAA adopted an interim name, image, and likeness (NIL) policy permitting student-athletes to be compensated for use of their NIL without impacting their NCAA eligibility. Since this policy was adopted, many organizations, generally referred to as NIL collectives, have been established by boosters and fans of one or more of a university's athletic programs to develop and fund NIL deals for student-athletes.

Reg. §1.501(c)(3)-1(d)(1)(ii) states that an organization is not organized and operated exclusively for exempt purposes unless it serves a public rather than a private interest (i.e., designated individuals). Additionally, §501(c)(3) requires that, when evaluating an organization's qualification for tax exemption, determining whether the organization's activity furthers an exempt or nonexempt purpose, or both. If both, whether the nonexempt purpose is incidental to the exempt purpose.

The Office of Professional Responsibility noted that when applying these principles to NIL collectives, the benefit to private interests will, in most cases, be more than incidental. Student-athletes generally benefit from a NIL collective through the compensation paid by the collective for the use of their NIL. Therefore, such created NIL collectives are not tax exempt under §501(c)(3).

PGA Tax Exempt Status in Question WSJ PGA Investigation, Press Release

On June 6, 2023, the PGA announced that it will "merge" with the Saudi Arabian Public Investment Fund (PIF), the entity behind LIV Golf organization that has caused so much controversy. The PGA Tour's announcement stated that the combined tour will form a "collectively owned, for profit entity to ensure that all stakeholders benefit from a model that delivers maximum excitement and competition among the game's best players."

Congress is not happy with professional sports tax-exempt status. The PGA Tour is currently exempt from tax under §501(c)(6) which applies to business leagues, chambers of commerce, real estate and trade boards and professional football leagues. Several Congressional lawmakers have raised concerns about the validity of the PGA's tax-exempt status, especially considering this new merger. Congressman Garamendi introduced the "No Corporate Tax Exemption for Professional Sports Act" to try and end the loophole that the PGA and many other sports leagues exploit to avoid paying any Federal corporate income tax. In 2015, the NFL voluntarily stopped claiming tax-exempt status.

Critics have accused the Saudi government of using this relationship to improve its reputation thought "sportswashing." Furthermore, the U.S. Justice Department will review the PGA Tour and PIF "merger" plans to determine if it violates antitrust law. The PGA Tour said the agreement is not a merger but rather an investment.

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IRS Reminds Charities of the Ban on Political Intervention

Political campaign activity can jeopardize an organization's §501(c)(3) tax-exempt status. To assist organizations to know what they can and can't do, the IRS introduced a video series called Political Campaigns and Charities. The series provides examples of prohibited activities and explains steps an organization should take to avoid an inadvertent violation. Organizations are encouraged to review this and other on-line training for tax-exempt organizations at stayexempt.irs.gov.

Eight Recent Technical Guides Published

Exempt Organizations and Government Entities has published three new Technical Guides (TG). These guides are comprehensive, issue-specific documents that combine and update the Audit Technique Guides with other technical content. The newest TGs are:

- TG 3-31, 32, 33 Foundation Classification, Supporting Organizations, Publication 6015, 6016, and 6017
- TG 23 Religious and Apostolic Associations IRC 501(d), Publication 5627, Exempt Organizations Technical Guide
- TG 58 Excise Taxes on Self-Dealing under IRC 4941, Publication 5616, Exempt Organizations Technical Guide
- TG 6 IRC 501(c)(6) Business Leagues
- TG 45 Suspension of Exempt Status
- TG 61 Excise Taxes on Investments which Jeopardize Charitable Purposes

Top 10 Reasons Application for Exemption is Rejected (IRS Website)

The IRS has compiled a list of the Top 10 reasons tax exempt applications are rejected:

1. Omitting the user fee or paying an incorrect amount.
2. Omitting some or all the required information on the principal officers and/or board of directors. For each officer and board member the applicant must include:
   a. Names and mailing address.
   b. Title and position; and
   c. Annual compensation if any.
3. Not having a director, trustee, principal officer, or other authorized individual sign the application. The person signing the application must show his or her title or other authority to sign. ***A taxpayer's representative may not sign Form 1023 but may sign Form 1024.*** Form 1023 and Form 1023-EZ must be electronically signed on www.pay.gov.

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4. Not supplying the IRS with a copy of ***adopted*** by-laws, code of regulations or any other document that sets out the organization's rules of operation.
5. Excluding required financial data.
6. Not including the month the organization's annual accounting period ends. The accounting period ending date on the application should match the date stated in the by-laws, on financial statements, and on any prior returns filed.
7. Omitting one or more required schedules. Some lines on Form 1023 require supporting schedules – make sure they are provided.
8. Failure to complete all required pages.
9. Failure to supply detailed information about the organization's activities. Supplied information should be sufficient to show IRS how the organization will achieve its exempt purpose. For this, the applicant needs to supply specific activities that will achieve that purpose (the "who, what, when, where why and how" approach). Be sure to explain past, present, and planned activities. If nothing has started yet, explain plans that supply a clear understanding of how the organization will operate.
10. Failure to attach a complete copy of organizing documents and all amendments (e.g., articles of incorporation or, if not incorporated, similar organizing document such as a constitution, articles of association, or by-laws, etc.). At a minimum, documentation needs to show legal name, the purposes, and the date of adoption. At least two members of the organization should sign the document. For Section 501(c)(3) applicants, the organizing document must comply with the organizational test for exemption.

Tax Exempt Organizations Annual Reporting Requirements Clarified (T.D. 9898)

IRS final regulations under §6033 were recently promulgated to align the regulations with recent statutory changes. The new regulations address certain instances where the IRS has exercised discretion under the statute and regulations to relieve organizations from some filing requirements as appropriate. Specifically, the regulations:

- Clarified that political organizations (§527) with gross receipts greater than $25,000 are generally required to file Form 990 as if they were exempt from taxes under §501(a) (§1.6033-2(a)(5)); and

- Specified that only charitable (§501(c)) and political (§527) organizations are required to provide names and addresses of contributors on Forms 990, Forms 990-EZ, and Forms 990-PF (§1.6033-2(a)(2).

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Unrelated Business Income Tax (§511; §512)

UBI Overview. Even though most non-profit entities are exempt from income tax, such organizations (including retirement plans) that engage in unrelated business-like activities are taxed on any net profit from such activities. This taxable income is called unrelated business income (UBI), which is defined as any trade or business activity substantially unrelated (other than as a fundraising activity) to the entity's charitable, educational, or other exempt activity of the organization. UBI generating activities do not include any trade or business (§513(a)):

- If substantially all the work in carrying on the trade or business is performed for the organization without compensation;
- Which is continued (for charitable organizations and colleges and universities) by the organization primarily for the convenience of its members, students, patients, officers, or employees;
- Which is a local association of employees (§501(c)(4)) organized before May 27, 1969, which is selling items of work-related clothes and equipment and items normally sold through vending machines, through food dispensing facilities, or by snack bars, for the convenience of its members at their usual places of employment; or
- Which is the selling of merchandise, substantially all of which has been received by the organization as gifts or contributions.

Further guidance on specific UBI activities and exclusions can be found in §513 but is too voluminous for our purposes here.

UBI is reported on Form 990-T, the Return of Organization Exempt from Income Tax, which is filed separately from Form 990. Tax is assessed at the C corporation tax rate (currently 21%).

IRS Develops Webpage for Tax Exempt Organizations (Charities and Nonprofits)

The IRS has developed a webpage on its website that supplies multiple resources available to charitable and nonprofit organizations. The webpage includes information about:

- Exempt organization types by IRC section (e.g., charitable and religious organizations, private foundations, political organizations, etc.).
- Applying for tax exempt status
- Annual file requirements and the related forms.
- Education sessions.
- Charitable contributions – which tax exempts qualify for deductible contributions.
- Tax-exempt organization database search.

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Electronic Filing Required for Tax Exemption Applications (§501 and §521; Rev. Proc. 2022-05).

Overview. Entities organized and used exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition, or for the prevention of cruelty to children or animals may apply for tax exempt status with the IRS. Most organizations apply for exempt status by filing Form 1023, Application for Recognition of Exemption, or Form 1023-EZ, Streamlined Application for Recognition of Exemption. Organizations who are approved receive a determination letter confirming its approval. The determination letter also says whether the organization must file annual information returns and specifies whether contributions to the organization are tax deductible. The Form 1023 filing fee is $600 (in 2023), $275 for Form 1023-EZ.

Certain organizations are automatically granted tax exempt status and do not have to file Form 1023 (or Form 1023-EZ). These entities include:

- Churches, synagogues, temples, and mosques.
- Integrated auxiliaries of churches and conventions or associations of churches.
- Any organization that normally has gross income of $5,000 or less.

Preparer note. Regardless of the filing fee, some organizations may want to apply for tax exempt status even if not needed to do so to obtain a determination letter for their records. Tax exempt organizations are often asked to supply the determination letter to individuals or other organizations (e.g., when applying for grants or services from another organization).

Cannot find the determination letter – now what? Organizations who received a determination letter in 2014 or later can download a copy from the Tax Exempt Organization Search section on the IRS website. For those who received determination letters issued prior to 2014, Form 4506-A may be submitted by fax or mail to request a copy of the exemption letter.

Filing Form 1023 or Form 1023-EZ. Entities have historically filed Form 1023 on paper and mailed it to the IRS for processing. All Forms 1023 (Form 1023, Form 1023-EZ) ***must be filed electronically***. The only way to file Form 1023 and Form 1023-EZ is electronically at Pay.gov. Entities may use the Form 1023-EZ Eligibility Worksheet included in the instructions for Form 1023-EZ to determine if they qualify to use Form 1023-EZ. Otherwise, the only other option is Form 1023.

IRS Updates Exempt Status Application Procedures (Rev. Proc. 2022-5)

The IRS updated its procedures for most organizations applying for tax exempt status. The new procedures also apply to revocation or modification of an existing determination letter and updates applicable user fees when a determination letter is necessary. Some the notable changes include:

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- More information and procedures for electronic submission of tax exemption requests.
- Requests for group exemption letters will not be accepted until publication of the final revenue procedure or other relevant guidance.
- Clarification of relief provided under §9100 for late tax-exempt status elections.

What about other non-profit organizations (Form 1024)? Non-charitable organizations may also qualify for tax exempt status. Such organizations typically include labor and agricultural organizations, business leagues, social clubs, fraternal beneficiary societies, VEBAs, cemeteries, mutual insurance companies, etc. These organizations file for tax exempt status by filing Form 1024 or Form 1024-A. A good rule of thumb is organizations qualifying under §501(c)(3) use Form 1023 and almost everyone else uses Form 1024 or Form 1024-A. The 2023 user fee for Form 1024 or Form 1024-A is $600.

E-filing now required for organizations using Form 1024 and Form 1024-A. Entities qualifying for tax exempt status under §501(a) file for exemption using Form 1024. Entities filing for exemption under §501(c)(4) (civic leagues, social welfare or local employee associations) file Form 1024-A. Forms 1024 and 1024-A must also be filed electronically.

Due date. Generally, if Form 1023 is filed within 27 months after the end of the month in which the entity was legally formed, and the application is approved, the tax-exempt status will be effective retroactively back to the date of legal formation. If Form 1023 is not filed within 27 months, the exempt status effective date will be the date it is filed. See the form instructions for exceptions and special rules.

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Glossary

Agricultural Chemicals Security Credit

30% credit available for eligible agricultural businesses for the costs of protecting certain agricultural chemicals

Alcohol Fuel Credit

Comprised of the straight alcohol credit, the alcohol fuel mixture credit, the small ethanol producer credit, and the cellulosic biofuel producer credit; qualifying alcohol includes methanol and ethanol

Alternative Fuel Motor Vehicle Credit

A nonrefundable credit covering five distinct areas of motor vehicles – qualified hybrid vehicles, qualified fuel cell vehicles, qualified alternative fuel motor vehicles and heavy hybrids, advanced lean-burn technology vehicles, and the plug in conversion credit

Biodiesel and Renewable Diesel Credit

Comprised of the straight biodiesel credit, the biodiesel mixture credit, and the small agri-biodiesel producer credit

Business Energy Credit

Available for businesses with costs incurred for alternative energy sources; 30% of costs for solar, fuel cells, and small wind turbines, and 10% of costs for geothermal systems, microturbines, and combined heat and power

Disabled Access Credit

A nonrefundable credit available for small businesses that incur costs to provide access to disabled persons under the 1990 ADA Act

Employer Provided Child Care

A 25% credit for qualified childcare facility expenditures plus 10% of resource and referral expenditures up to a maximum of $150,000 per tax year

Federal Renewable Electricity Production Credit

A per-kilowatt-hour tax credit available for those generating electricity through qualified energy resources and sold by the taxpayer to an unrelated person during the tax year

Fuel Tax Credit

Tax is paid on fuel to provide funds for repairing and replacing highways damaged by the vehicles using the fuel; this credit is typically for those using fuel for off-road purposes (i.e. farming) whose vehicle use does not damage roadways

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Full Time Equivalents

The number of full time employees an employer would have if based upon the hours worked by every employees (up to a maximum of 2,080 per employee) during the year; the hours worked, excluding owners family members, and seasonal employees, is divided by 2,080 to determine the full time equivalents for purposes of the small business health care credit

Indian Employment Credit

Designed to encourage businesses to hire certain individuals who live on or near an Indian reservation

New Hire Credit

Available for businesses that hire unemployed workers that meet certain qualifications; designed to speed of the hiring of the unemployed

New Markets Tax Credit

Available for businesses that made Qualified Equity Investments to acquire stock/capital interest in designated Community Development Entities whose proceeds are invested in qualified low-income community developments

Qualified Plug-In Vehicle Credit

Available for vehicles with GVW under 14,000 lbs, is designed for highway use, and which is propelled significantly by an electric motor drawing power from a battery with a capacity of at least 4 kilowatt hours; you must be able to recharge the battery from an external source

Rehabilitation Credit

A credit available for the rehabilitation or reconstruction of certain buildings; 10% of costs for building place in service before 1936 and 20% of costs for certified historic structures

Research Activities Credit

A complex credit available to businesses that increase their research activities during the year

Small Business Health Care Credit

Credit designed to assist employers with less than 25 employees with providing their employees health insurance; the credit begins to phase out at 11 employees and is completely gone at 25 employees; wage restrictions also apply

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Small Employer Pension Plan Startup

Designed for small businesses to offset the costs of setting up and administering a new qualified employer plan

Tip Credit

Available to food and beverage establishments where tipping is customary; equal to the employer's portion of social security and Medicare taxes paid on tips received by employees

Work Opportunity Credit

Credit to reduce the federal tax of private-for-profit employers; many states also offer similar credits for state taxes

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