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NATIONAL INCOME TAX WORKBOOK 2021

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2021 National Income Tax Workbook

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IN MEMORIUM

Robert P. Achenbach, Jr., JD, served as the chief administrative officer of the Land Grant University Tax Education Foundation, Inc. (LGUTEF) for nearly 11 years ending with his sudden and unexpected death in November 2020. Robert served the LGUTEF membership and all attendees of member tax schools faithfully and with good cheer.

Robert wrote the "Rulings and Cases" chapter each year and coauthored the "Agricultural and Natural Resource Issues" chapters and several other chapters of the *National Income Tax Workbook*. He provided support to the editorial team as needed.

Additionally, Robert was the owner of the Agricultural Law Press, for which he served as the publisher, writer, and editor of the biweekly *Agricultural Law Digest* newsletter, the *Agricultural Law Manual*, and *Harl, Farm Estate and Business Planning* text. Robert was the lead author for the 14-volume treatise *Harl and Achenbach, Agricultural Law* (Matthew Bender). Robert was also the author of the *Achenbach, Farm Income Tax Manual* (Matthew Bender).

Robert shared his knowledge generously with his colleagues to discuss complicated fact patterns and resolve difficult income tax problems. He sought to arrive at the best possible resolution for whatever situation was at hand.

Robert's kind and gentle presence will be missed at LGUTEF meetings. Further, Robert's wealth of knowledge of agricultural income taxation and his research and writing skills will be greatly missed by his readers and those who were blessed to be his friend.

George F. Patrick was a founding director and served as the first president of LGUTEF. George provided steady leadership with a quiet demeanor as LGUTEF was formed and grew to provide the *National Income Tax Workbook* as foundational income tax education materials for the LGUTEF membership. George passed away in March 2020.

Additionally, George was a founding director and past president of the American Agricultural Economics Association. George represented Purdue University on the National Farm Income Tax Extension Committee, an advisory committee to the IRS, for many years.

George also directed Purdue University's Income Tax School since 1976 and became a national leader in the development of educational materials, especially with respect to effects of the tax law on farmers. George served as the Purdue University LGUTEF representative.

George's career focused on many aspects of farm management and economics, frequently at the intersection of taxation and farm business management. He will be missed by friends and colleagues alike.

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IN RECOGNITION

William (Bill) R. Klump earned his bachelor's of science in commerce in 1974 and became a CPA in Kentucky in 1978. Bill was an instructor for the University of Kentucky's tax school program from 1997 until his retirement in 2020. Bill represented UKY with the University of Illinois tax workbook program.

Bill was part of the exploratory committee that led to the creation of LGUTEF. Bill served as a founding director, ongoing director, and chair of the audit committee. Bill's unique perspective as a practicing CPA brought a balance to the board and he was instrumental in helping to form and create the foundation that exists today.

Over the years, Bill's contributions have helped LGUTEF mature and grow and to allocate adequate resources to produce two outstanding texts for use in income tax education: the *National Income Tax Workbook* and *Agricultural Tax Issues*. His oversight and service on the audit committee is greatly appreciated.

Bill provided leadership input in 2015 through 2020 as LGUTEF underwent editorial leadership changes. He brought "real world" expertise to bear and helped with the process. His professional presence and ability to bridge issues of importance in a respectful manner, yet help those in organizational leadership see potential outcomes, is greatly appreciated. Bill will be missed at future LGUTEF meetings, and the board and members wish him well.

Virginia (Ginger) Uzendoski was the University of Nebraska at Lincoln LGUTEF representative for the past decade. Ginger was responsible for UNL's Tax Institute from 2001 until her retirement in January 2021. She brought energy and ideas to both the Tax Institute and the LGUTEF board, where she served two terms.

Ginger also chaired the LGUTEF long-range planning committee, which helped the foundation look at the future and explore alternate avenues to deliver income tax education. Her leadership and vision of broadening as well as enhancing traditional education delivery methods has helped LGUTEF meet the ever- changing environment of tax education. In part, distance learning ideas Ginger brought to the LGUTEF membership helped with the transition to online education during the COVID pandemic.

Ginger focused on the needs of the attendees at UNL's Tax Institute to ensure the best possible experiences in continuing tax education. She brought the same client-based attitude during her service as a director on the LGUTEF board, which was very much appreciated.

The board and members thank Ginger for her dedicated service to LGUTEF, and we wish her a long and happy retirement.

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Workbooks Online

Starting with the *2020 National Income Tax Workbook*, the archive of the past 10 annual workbooks will no longer be provided in CD-ROM format and is not included with the printed book.

All participants in the Land Grant University Tax Education Foundation (LGUTEF) member school seminars, whether attending in-person or by online webinar, will receive online access to the current workbook and the past 10 years of workbooks. The sponsoring school will create a subscription for each participant to access the online archive and the participant will receive an email with access information, including a user ID and password.

As with the CD-ROM version, the online archive PDF files are identical to the printed *2021 National Income Tax Workbook*. The archived files of past books are also identical to those past printed books and are not updated for changes in the tax laws.

We recommend that you download the 2021 files prior to attending the in-person seminars to avoid connectivity, battery power, or other technical issues.

Access to the files will be available online until September 15, 2022. Before that date, participants may download any files that they want to access after that date. Access will be renewed for attendees of the 2022 seminars.

The files are password protected to limit copying, printing, and editing. However, participants can download the files and add and save comments to the files on a digital device.

CORRECTIONS for all chapters and the *2021 National Income Tax Workbook Update* (January 2022) are posted as they become available at www.taxworkbook.com (user name: class2021; password: class2021).

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INTRODUCTION

Welcome to the *2021 National Income Tax Workbook*. Here at the Land Grant University Tax Education Foundation, we have adapted to changes in our book production process. Our summer editing meeting was online for the second time. While we missed the in-person meeting, we had 45 instructors and contributors participate in the workbook development process.

The American Rescue Plan Act (ARPA) substantially changed how tax practitioners process payroll and will prepare 2021 returns. This book explains the new laws, as interpreted and clarified by guidance that was issued throughout 2021.

This book reviews common ethical issues for the tax practitioner, and it contains 10 case studies to illustrate those issues. It explains emerging real estate tax issues for developers, brokers, and homeowners.

In addition, this book discusses new guidance for claiming the employee retention credit and family and sick leave credits, and it provides comprehensive tax information for S corporations, partnerships, and nonprofit organizations.

Finally, this book explains important tax laws, practice and procedure, and planning ideas for business and individual taxpayers, trusts and estates, retirement and investments, and taxpayers with agricultural income.

As this book goes to publication, the Treasury and the IRS continue to issue regulations and procedures for the new tax laws, and additional legislation is pending in Congress. The IRS Coronavirus Tax Relief page provides links to news releases, fact sheets, and statements about the new tax laws. It provides tax tips, frequently asked questions, videos, and links to social media and legal guidance about the new tax laws [www.irs.gov/newsroom/tax-reform].

We will publish updates and corrections to the *2021 National Income Tax Workbook* on our website [www.taxworkbook.com]. We will also issue a *2021 National Income Tax Workbook Update* to provide information on regulations, procedures, laws, and cases that are issued after publication of this book.

This publication is produced by the Land Grant University Tax Education Foundation. The Land Grant University Tax Education Foundation is pleased to provide the *National Income Tax Workbook* to approximately 29,000 tax practitioners in tax schools taught in 30 states. Please visit our website at taxworkbook.com for more information about online courses and tax workshops near you.

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Lori Miller, JD, LLM in taxation, is an attorney in Whitefish, Montana. She is also licensed to practice in California and Washington. Her legal practice emphasizes tax law, estate planning, and business law. She is the lead editor of the *2021 National Income Tax Workbook*. She wrote the "Ethics," "Trusts and Estates," "Tax Rates and Useful Tables," and "New and Expiring Legislation" chapters, and contributed to several other chapters in the book.

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Nina S. Collum, PhD, CPA, is an assistant professor in the School of Accountancy at Louisiana Tech University. She has previously written chapters on automobiles, construction contractors, natural resources, AMT, recapture, real estate issues, divorce, estate and gift taxes, trade or business, and related party issues, and she has assisted in the workbook editing process since 2005. She is an assistant editor and coauthored the "Retirement, Investing, and Savings" chapter in the *2021 National Income Tax Workbook*.

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Patricia Ugorowski retired in 2012 after a 38½-year career with the IRS. She was a revenue agent for 35 years, with 5 years as an LB&I partnership technical adviser, providing agents guidance on passive activity and at-risk issues in addition to partnership issues. Throughout her career Trish was involved in classroom, continuing professional education, and online courses as an instructor and as a course developer. She was also an instructor or IRS coordinator for the MSU Income Tax Schools for 16 years and taught income tax courses for Lansing Community College for 13 years. Trish is currently an enrolled agent. Trish authored the "IRS Issues" chapter in the *2021 National Income Tax Workbook*.

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COMMONLY USED ACRONYMS

ABA	American Bar Association
ABLE	Achieving a Better Life Experience
ACA	Affordable Care Act
ACRS	Accelerated cost recovery system
ACTC	Additional child tax credit
ADS	Alternative depreciation system
AE&P	Accumulated earnings and profits
AFR	Applicable federal rate
AFS	Applicable financial statement
AFSP	Annual Filing Season Program
AFTR	Annual federal tax refresher
AGI	Adjusted gross income
AICPA	American Institute of Certified Public Accountants
AIME	Average indexed monthly earnings
ALE	Applicable large employer
ALV	Annual lease value
AMT	Alternative minimum tax
APTC	Advance premium tax credit
ATB	Adjusted tax basis
ATI	Adjusted taxable income
AOTC	American opportunity tax credit
ATG	Audit technique guide
ATIN	Adoption taxpayer identification number
BEA	Basic exclusion amount
BIG	Built-in gains
CAF	Centralized Authorization File
CAP	Collection Appeals Program
CCM	Completed contract method
CD	Certificate of deposit
CDP	Collection due process
CE	Continuing education
COD	Cancellation of debt
COGS	Cost of goods sold
CPA	Certified public accountant
CRT	Charitable remainder trust
CRAT	Charitable remainder annuity trust
CRUT	Charitable remainder unitrust
CTC	Child tax credit
DAF	Donor advised fund
DB	Declining balance
DNI	Distributable net income
DOL	Department of Labor
DPAD	Domestic production activities deduction
DPGR	Domestic production gross receipts
DSUE	Deceased spousal unused exclusion
EA	Enrolled agent
EFIN	Electronic filing identification number
EFTPS	Electronic federal tax payment system
EIDL	Economic injury disaster loan
EIN	Employer identification number
EIP	Economic impact payment
EITC (EIC)	Earned income tax credit
E&P	Earnings and profits
ERISA	Employee Retirement Income Security Act of 1974
ESBT	Electing small business trust
ESRP	Employer shared responsibility provisions
ESPP	Employee stock purchase plan
FAQ	Frequently asked question
FATCA	Foreign Account Tax Compliance Act
FBAR	Report of Foreign Bank and Financial Accounts
FICA	Federal Insurance Contributions Act
FIFO	First-in, first-out
FLP	Family limited partnership
FMLA	Family and Medical Leave Act
FMV	Fair market value
FRA	Full retirement age
FSA	Farm Service Agency
FSA	Health flexible spending arrangement
FTC	Federal Trade Commission
FTD	Failure to deposit
FTE	Full-time employee
FTF	Failure to file
FTP	Failure to pay
FUTA	Federal Unemployment Tax Act
GAAP	Generally accepted accounting principles
GDS	General depreciation system
GRAT	Grantor retained annuity trust
GSTT	Generation skipping transfer tax
GVW	Gross vehicle weight (or GVWR gross vehicle weight rating)
HCTC	Health coverage tax credit
HDHP	High-deductible health plan
HHS	Department of Health and Human Services
HOH	Head of household
HRA	Health reimbursement arrangement
HSA	Health savings account
HY	Half-year
ICHRA	Individual coverage HRA
ILIT	Irrevocable life insurance trust
IP PIN	Identity protection PIN
IRA	Individual retirement account
IRB	Internal Revenue Bulletin
IRC	Internal Revenue Code

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IRD	Income in respect of a decedent
IRS	Internal Revenue Service
ISO	Incentive stock option
ITIN	Individual taxpayer identification number
JCT	Joint Committee on Taxation
LB&I	Large Business and International
LCSP	Lowest-cost silver plan
LITC	Low Income Taxpayer Clinics
LLC	Limited liability company
LLP	Limited liability partnership
LTA	Local taxpayer advocate
MACRS	Modified accelerated cost recovery system
MAGI	Modified adjusted gross income
MEC	Minimum essential coverage
MFJ	Married filing jointly
MFS	Married filing separately
MPGE	Manufactured, produced, grown, or extracted
MSA	Medical savings account
MV	Minimum value
NEC	Nonemployee compensation
NIIT	Net investment income tax
NOL	Net operating loss
NTA	National Taxpayer Advocate
NTEE	National Taxonomy of Exempt Entities
OAR	Operations assistance request
OASDI	Old-Age, Survivors, and Disability Insurance Program
ODC	Credit for other dependents
OIC	Offer in compromise
OID	Original issue discount
PAL	Passive activity loss
PCM	Percentage completion method
PIA	Primary insurance amount
PLLC	Professional limited liability company
PPP	Paycheck Protection Program
PTC	Premium tax credit
PTIN	Preparer tax identification number
PTP	Publicly traded partnership
QBI	Qualified business income
QCC	Qualified conservation contribution
QCD	Qualified charitable distribution
QDOT	Qualified domestic trust
QI	Qualified intermediary
QPAI	Qualified production activities income
QRPBI	Qualified real property business indebtedness
QSEHRA	Qualified small employer health reimbursement arrangement
QSST	Qualified subchapter S trust
QSUB	Qualified subchapter S subsidiary
QTIP	Qualified terminable interest property
REIT	Real estate investment trust
RIC	Regulated investment company
RMD	Required minimum distribution
RPE	Relevant pass-through entity
RPO	Return preparer office
RSU	Restricted stock unit
RV	Recreational vehicle
SALT	State and local taxes
SARSEP	Salary reduction SEP IRA
SBA	Small Business Administration
SB/SE	Small Business/Self Employed
SE	Self-employment
SEC	Securities and Exchange Commission
SECA	Self-employment Contributions Act
SEE	Special enrollment exam
SEP	Simplified employee pension plan
SIMPLE	Savings incentive match plan for employees
SL	Straight-line
SLCSP	Second lowest-cost silver plan
SMLLC	Single-member LLC
SMR	Standard mileage rate
SSA	Social Security Administration
SSN	Social security number
SSTB	Specified service trade or business
SUV	Sport utility vehicle
TAO	Taxpayer assistance order
TAS	Taxpayer Advocate Service
TCJA	Tax Cuts and Jobs Act of 2017
TE/GE	Tax Exempt/Government Entities
TIN	Taxpayer identification number
TFRP	Trust fund recovery penalty
TIGTA	Treasury Inspector General for Tax Administration
UBIA	Unadjusted basis immediately after acquisition
UBTI	Unrelated business taxable income
UDFI	Unrelated debt-financed income
UNICAP	Uniform capitalization
VITA	Volunteer Income Tax Assistance

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1
ETHICS

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LEARNING OBJECTIVES

After completing this session, participants will be able to perform the following job-related actions:

- ✔ Understand the ethical challenges in remote work settings
- ✔ Understand what services constitute the unauthorized practice of law
- ✔ Comply with ethical duties when volunteering for a nonprofit
- ✔ Know how to recognize and report an abusive tax evasion scheme
- ✔ Understand the role of judicial doctrines in tax research and due diligence

INTRODUCTION

This chapter discusses important state and federal ethics obligations for the tax practitioner. It also gives tax practitioners the information necessary to remain compliant with Circular 230, *Regulations Governing Practice before the Internal Revenue Service*, and other ethical obligations. It includes a discussion of ethical challenges when working from home, including the duties of confidentiality, competency, and due diligence. This chapter reviews what services constitute the unauthorized practice of law. This chapter also details the steps that tax practitioners must take to comply with their ethical duties when they volunteer for a nonprofit.

This chapter explains how to recognize and report abusive tax schemes, and the role of judicial doctrines in complying with a tax practitioner's due diligence obligations. Finally, this chapter uses 10 case studies to explore ethical dilemmas. The case studies illustrate how to handle real-life ethical issues by focusing on common challenges that tax practitioners confront when working with clients, the public, and other professionals.

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WORKING REMOTELY This section reviews ethical challenges for tax practitioners who work remotely.

Many tax professionals have expanded remote work options to keep themselves, their staff, and their clients safe. Working remotely can also be convenient and cost effective. A tax practitioner who is working from home or another remote location has the same ethical obligations as a tax practitioner who works in a traditional physical office, but it may be more difficult for the practitioner to comply with those obligations. This section discusses how to comply with the ethical duties of confidentiality, competency, and due diligence when working from a remote location.

Confidentiality

Confidentiality and nondisclosure rules impose a duty to protect client information from disclosure to third parties, and tax practitioners must ensure that they are fully protecting electronic files, physical files, telephone communication, emails, and other client communication in a home office or a remote location. This section reviews the laws and standards that impose a duty of confidentiality. It then explains how to maintain the confidentiality of client files and other client information when working remotely.

Ethical Duty of Confidentiality

Ethical obligations of confidentiality and nondisclosure come from federal tax law, state law, and professional organization standards. This section reviews the laws and standards that require a tax practitioner to protect confidential client information.

I.R.C. § 7216 Nondisclosure

I.R.C. § 7216 prohibits tax return preparers from disclosing or using a client's information, without the client's specific consent, for any purpose other than tax preparation. For purposes of section 7216, *tax return preparers* include, but are not limited to, the following:

- Return preparers who are engaged in the business of preparing returns, and preparers who assist in preparing returns or hold themselves out as return preparers
- Casual preparers who are compensated
- Electronic return originators
- Electronic return transmitters
- Intermediate service providers
- Software developers
- Reporting agents

Tax return information is all information tax return preparers obtain from taxpayers or other sources in any form or manner that is used to prepare tax returns, or that is obtained in connection with the preparation of returns. It also includes all computations, worksheets, and printouts preparers create; correspondence from the IRS during the preparation, filing, and correction of returns; statistical compilations of tax return information; and tax return preparation software registration information.

Certain disclosures and uses are permissible without client consent (see Treas. Reg. § 301.7216-2). All other disclosures of tax return information require client consent.

State Confidentiality Laws

Most states have enacted statutes or administrative codes that make documents prepared by a licensed accountant for his or her clients confidential communications. These rules and regulations allow disclosure of communications in certain situations, such as court proceedings or by subpoena.

Professional Organization Standards

Local, state, national, and international accounting boards and organizations promulgate confidentiality requirements for their members. For example, members of the American Institute of Certified Public Accountants (AICPA) are bound by its Code of Professional Conduct. Under the AICPA Code of Professional Conduct, a member cannot disclose confidential client information without the specific consent of the client.

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Confidential client information is any information obtained from the client that is not available to the public.

Disclosure may be allowed to do the following:

- Comply with professional obligations
- Comply with a validly issued and enforceable subpoena or summons
- Comply with applicable laws and government regulations
- Review a member's professional practice
- Initiate a complaint with, or respond to, an ethics or disciplinary inquiry or proceedings

[AICPA Code of Professional Conduct § 1.700.001]

OBSERVATION

Professional Organization Standards

Professional organization standards are usually binding only on members of the professional organization. For example, the AICPA's Statements on Standards for Tax Services (SSTS) are enforceable tax practice standards for members of the AICPA. Regardless, professional organization standards help define professional duties and are instructive for tax practitioners who are not members of the organization.

Protecting Files

Tax practitioners who work from home may have to bring paper files and other client documents to their homes or other remote work location. They must make reasonable efforts to ensure that household members and visitors do not have access to confidential documents. They should maintain the documents in a secure location that unauthorized persons are prohibited from accessing.

The tax practitioner may also access and store electronic files on a computer or other devices in a home office or other remote location. He or she may be remotely accessing an office computer or storing and retrieving documents in the cloud (an internet-based platform). Electronic files can be ethically accessed and stored if the tax practitioner takes reasonable care to assure that

1. all such materials remain confidential;
2. and reasonable safeguards are employed to ensure that the data is protected from breaches, data loss, and other risks.

CROSS-REFERENCE

Data Protection

IRS Commissioner Rettig notes that "we all have a role in protecting taxpayer data, and the tax professional community is a critical part of that effort." And: "It's more important than ever to take appropriate security precautions, protect remote work sites, use two-factor authentication and plan ahead for all possibilities." See the "IRS Issues" chapter in this book for a discussion of cybersecurity and data protection.

Protecting Other Client Information

When working remotely, tax practitioners have a duty to take reasonable precautions to ensure that client communications, including telephone calls, text messages, email, and video conferencing are conducted in a way that keeps those communications confidential. The tax practitioner should dedicate a private area where he or she can have client-related conversations or video conferences and take reasonable precautions to ensure that those communications cannot be overheard by other persons in the household.

PRACTITIONER NOTE

Smart Devices

Smart devices such as Amazon Echo and Google Nest may record and store conversations. Employees and contractors of the device manufacturer may listen to those recordings in their efforts to improve their products. Tax practitioners should remove those devices from the home office or remote work locations or carefully review privacy settings and know how to turn off microphones and cameras.

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Video Conferencing

Video conferencing may be a useful way to communicate with staff, colleagues, and clients when working from home or another remote location. To comply with the duty to protect confidential client information, tax practitioners must ensure that third parties cannot overhear or join the conference.

There have been many reported instances of hackers hijacking videoconferences. On March 30, 2020, the FBI issued the following guidance to mitigate teleconference hijacking threats:

- Do not make meetings public
- Require a meeting password or use other features that control the admittance of guests
- Do not share a link to a teleconference on an unrestricted publicly available social media post
- Provide the meeting link directly to specific people
- Manage screensharing options. For example, many of these services allow the host to change screensharing to "Host Only"
- Ensure users are using the updated version of remote access/meeting applications
- Ensure that your organization's telework policy or guide addresses requirements for physical and information security

The video conferencing platform Zoom contains the recommendation shown in **Figure 1.1**.

FIGURE 1.1
Zoom Privacy Recommendation

> It's always smart to lock your front door, even when you're inside the house. When you lock a Zoom Meeting that's already started, no new participants can join, even if they have the meeting ID and password (if you have required one). In the meeting, click Participants at the bottom of your Zoom window. In the Participants pop-up, click the button that says Lock Meeting.

Competency and Due Diligence

Tax practitioners have ethical duties to diligently provide competent services to their clients. For practitioners who are working from home or a remote location, fulfilling those duties may require a certain level of technical competency. This section reviews the ethical duties of competency and due diligence and explains how those duties apply to a tax practitioner who is communicating with clients and accessing data and records from a home office or other remote work location.

Ethical Duties of Competency and Due Diligence

Under Circular 230 § 10.35, a practitioner must possess the necessary competence to engage in practice before the IRS. Competent practice requires the appropriate level of knowledge, skill, thoroughness, and preparation necessary for the matter for which the practitioner is engaged. While competency requires fundamental skills and often specialized tax knowledge and expertise, it may also require an understanding of technology to comply with due diligence and other ethical duties.

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PRACTITIONER NOTE

Technological Competence

While the tax and accounting profession has not adopted formal ethical standards for technological competence, other professions have extended the ethical duty of competence to require that members of the profession be technologically competent. The American Bar Association (ABA) Model Rules of Professional Conduct state that to maintain the requisite knowledge and skill to be competent, a lawyer should keep abreast of changes in the law and its practice, including the benefits and risks associated with relevant technology. The National Association of Social Workers (NASW) Code of Ethics provides that social workers who use technology in the provision of social work services should ensure that they have the necessary knowledge and skills to provide such services in a competent manner, which includes an understanding of the special communication challenges when using technology and the ability to implement strategies to address these challenges.

Circular 230 § 10.22 requires a practitioner to exercise due diligence when preparing or assisting in the preparation of, approving, and filing tax returns, documents, affidavits, and other papers relating to IRS matters. Best practices dictate that the tax practitioner clearly communicate with the client and advise the client about how the law (including applicable judicial doctrines) applies to the relevant facts [Circular 230 § 10.33]. The tax practitioner must also promptly dispose of pending tax matters [Circular 230 § 10.23]. Thus, a tax practitioner who works remotely must have the technological knowledge, skill, and preparation to clearly communicate with clients, and promptly address pending matters.

Diligent Communication

In a typical tax practitioner-client relationship, the client can retain the tax practitioner and communicate relevant information. The tax practitioner advises the client, and the client makes decisions about important matters. Providing tax and accounting services to a client through electronic means may enhance access to services that are unavailable in person because of geographical distance, clients' disabilities, or illnesses. However, because a tax practitioner who works from a home or remote office may not meet with clients in person, the practitioner must ensure that the use of technology to communicate with a client does not interfere with the client's ability to understand, deliberate, and make decisions.

CROSS-REFERENCE

Client with Diminished Capacity

If a client may have diminished capacity or be subject to undue influence, the tax practitioner may have additional ethical responsibilities to ensure that the client (or his or her agent) is able to initiate representation and make informed decisions. See pages 84–96 in the *2019 National Income Tax Workbook* for a discussion of representing a client with diminished capacity.

Tax practitioners who use electronic communication to obtain information from and provide information to clients should consider adopting the following practice standards:

- Adopt security and data protection protocols for electronic communication
- Become proficient in a variety of technological platforms
- Keep apprised of new technology
- Understand each client's available technology and proficiency using that technology
- Learn each client's preferences for using electronic communication tools
- Explain to clients, in writing, how technology will be used to gather and store information
- Gather information in a manner that reasonably ensures the identity of the provider, and the reliability and accuracy of the information
- Prioritize phone and video calls to maintain interpersonal relationships and gather nonverbal information that is not easily conveyed by email and text message

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- Periodically assess whether clients benefit from receiving services through electronic means and, when appropriate, offer alternative methods of service delivery
- Plan for potential technology failure and interruption of services

Prompt Disposition

To comply with the duty to promptly address and resolve pending matters, tax practitioners who work remotely must have reliable access to office calendars, software, and file systems to track deadlines and act promptly. A practitioner should, if necessary, retain an information technology expert to ensure that the following safeguards are in place:

1. Incoming documents (e.g., mail received at the office) are being stored securely and those records are transmitted to offsite practitioners.
2. Calendaring programs that track events and deadlines are cloud-based so they are shared and updated in real time.
3. Programs, files, and records that are needed for the continuation of essential work functions are accessible at the remote location.
4. Data is backed up, and there is a plan to quickly restore data that has been lost, corrupted, or accidentally deleted.

CROSS-REFERENCE

Duty to Preserve Documents

Tax practitioners who work remotely must comply with their obligation to retain records. See pages 59–62 in the *2020 National Income Tax Workbook* for a discussion of how traditional record retention rules apply to electronically stored records.

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UNAUTHORIZED PRACTICE OF LAW This section reviews what constitutes the unauthorized practice of law.

Under Circular 230 § 10.32, tax practitioners who are not attorneys cannot give legal advice. State statutes also limit the practice of law to licensed attorneys. This section discusses how to distinguish between giving tax advice and the unauthorized practice of law. In particular, it explains when giving business entity advice and drafting business documents is the unauthorized practice of law. This section also reviews when tax practitioners are allowed to engage in the practice of law.

The Practice of Law

Determining whether an activity constitutes the unauthorized practice of law requires a two-step analysis. First, the tax practitioner must determine if the activity constitutes the practice of law. Second, the tax practitioner must determine if the activity is authorized even though it constitutes the practice of law. While the definition of the *practice of law* differs slightly from state to state, the following are examples of some activities that may constitute the unauthorized practice of law:

1. Drafting corporate documents such as articles, bylaws, and minutes (discussed later)
2. Drafting legal documents such as noncompete agreements, confidentiality agreements, asset or stock purchase agreements, employment agreements, independent contractor agreements, nondisclosure agreements, limited liability company operating agreements, and real estate purchase agreements
3. Interpreting laws and giving advice regarding a client's rights and obligations under those laws
4. Advising clients regarding immigration matters
5. Advising clients regarding bankruptcy matters, such as the availability of a discharge of tax debt in a bankruptcy proceeding
6. Representation in certain venues (such as courts and certain administrative agencies)
7. Sending correspondence to creditors that disputes a client's debt
8. Representing debtors in the resolution of their debts with creditors
9. Engaging in any arbitration, mediation, or alternative dispute resolution for profit

Difficult Question of Law Test

Some courts have adopted a *difficult question of law* test. In an illustrative case from Minnesota, James L. Conway was preparing an income tax return. Preliminary to and as part of that service, he advised the taxpayer as to whether the taxpayer had attained partnership status, whether the taxpayer had a valid marriage for exemption purposes, and whether the taxpayer should file a joint return with a woman to whom he had never been ceremonially married.

The court stated that the line between what is and what is not the practice of law cannot be drawn with precision, but the practice of law involves the resolution of legal questions that are difficult or doubtful and that reasonably demand the application of a trained legal mind. Determination of a difficult or complex question of law is the practice of law. Although the preparation of the tax return was not of itself the practice of law, the court concluded that Mr. Conway, incidental to such preparation, resolved certain difficult legal questions about partnership status and marital status, which, taken as a whole, constituted the practice of law [*Gardner v. Conway*, 234 Minn. 468 (1951)].

Commonly Understood Test

Other courts have adopted a commonly understood test. Under this test, the practice of law includes those activities that are commonly understood to be the practice of law. In *State Bar v. Arizona Land Title & Trust Co.*, the title company engaged in the unauthorized practice of law when it drafted deeds or conveyances; drafted notes, mortgages, or contracts for the sale of real estate; prepared lease termination agreements

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or assignments; gave advice concerning the legal effect of transactions involving or affecting interests in or title to real property or creating or releasing burdens or encumbrances upon land; gave advice concerning the legal effects of clauses in wills or other legal instruments; and gave advice about the implications of tax legislation. The court found that those acts that lawyers have customarily carried on throughout the centuries constitute the practice of law [*State Bar v. Arizona Land Title & Trust Co.*, 366 P.2d 1 (1961)].

Choosing a Business Entity

Tax practitioners may be asked to advise clients regarding the structure of a business. While a tax professional may offer advice about the tax treatment of different entities, he or she cannot advise about legal matters. **Figure 1.2** shows a comparison of what is likely construed as tax advice and what may be construed as legal advice.

FIGURE 1.2
Tax or Legal Advice

TAX ADVICE	LEGAL ADVICE
I expect to have large losses in the first few years of business operations. Which type of entity will allow me to use those losses to offset other income?	I am starting a high-risk business. Which type of entity will give me the greatest liability protection?
Will I pay more taxes with a C corporation or an S corporation?	What should my corporate bylaws include?
How can I lower self-employment taxes?	What provisions should my LLC operating agreement include to address services provided by members?
What are the tax consequences of a member-managed LLC versus a manager-managed LLC?	What legal authority should be granted to a manager of a manager-managed LLC, and what authority should the members retain?
What states have the lowest tax rates?	What states have the most protective business laws?

In *Columbus Bar Association v. Verne*, an Ohio CPA advised two business partners about how to structure a business and drafted Articles of Organization using forms from the Secretary of State. He did not prepare an operating agreement. The business partners had a dispute, and the court found that the CPA performed a valuable function in advising on financial matters in the formation of a company, such as how best to structure a business entity for tax benefits, but there were still many remaining issues that require legal analysis in choosing a business structure. In addition to liability protection, an operating agreement could have minimized disputes between the members [*Columbus Bar Assn. v. Verne*, 99 Ohio St.3d 50, 2003-Ohio-2463 (May 16, 2003)].

CROSS-REFERENCE

Choice of Entity

Tax professionals may advise a client about the tax implications when choosing a business entity. See the "Choice of Entity" chapter in this book for a discussion of the tax considerations in choosing a type of entity.

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Completing Business Forms

Tax advisers may be asked to assist with preparing and filing business formation documents, such as articles of incorporation or other clerical forms. Tax professionals may be able to place or fill-in factual information on a standard form for a client if filling the form is merely clerical. However, if the information on the form requires legal knowledge, completing the form may constitute the unauthorized practice of law.

Articles of Incorporation

The Illinois State Bar Association has considered whether nonlawyers can take information from a client and use it to complete preprinted business registration documents. The association has issued the following opinion:

> Individuals may complete and file corporate documents; however, if the individual receives any assistance or advice from nonlawyers in completing the forms, such as forms for filing articles of incorporation, even those provided by the Secretary of State, the person providing the assistance is unlawfully engaged in the unauthorized practice of law. This determination includes assistance provided by accountants [Illinois State Bar Association Advisory Opinion on Professional Conduct Opinion No. 95-7, October 1995 Topic: Unauthorized Practice of Law].

Similarly, the Kentucky Bar Association has concluded that a nonlawyer may not prepare articles of incorporation. The association has issued the following opinion:

> Drafting articles of incorporation is unquestionably the practice of law. See KBA U-7. Where the drafter has no beneficial interest in the new entity, the drafter must be an attorney licensed in Kentucky or he/she cannot prepare the articles without engaging in the unauthorized practice of law [Kentucky Bar Association Unauthorized Practice of Law Opinion KBA U-60 Issued: September 1999].

Figure 1.3 shows screenshots from a Montana Secretary of State electronic form to incorporate a domestic for-profit corporation. The preparation of articles of incorporation may raise several legal issues, such as the following:

- Close corporation. When should the shareholders select this option and when should the corporation have directors?
- Professional corporation. When must the shareholders select this option, and how does it affect who can be a shareholder and the shareholders' personal liability?
- Business purpose. What are the corporation's lawful business objectives?
- Authorized shares. How many classes of shares are there, and what rights do those classes have?

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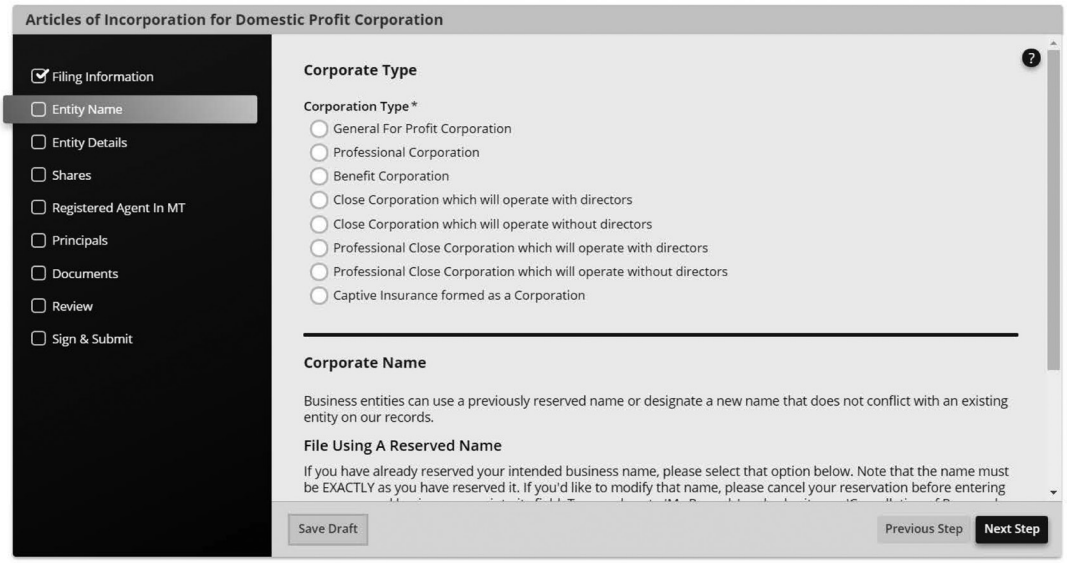
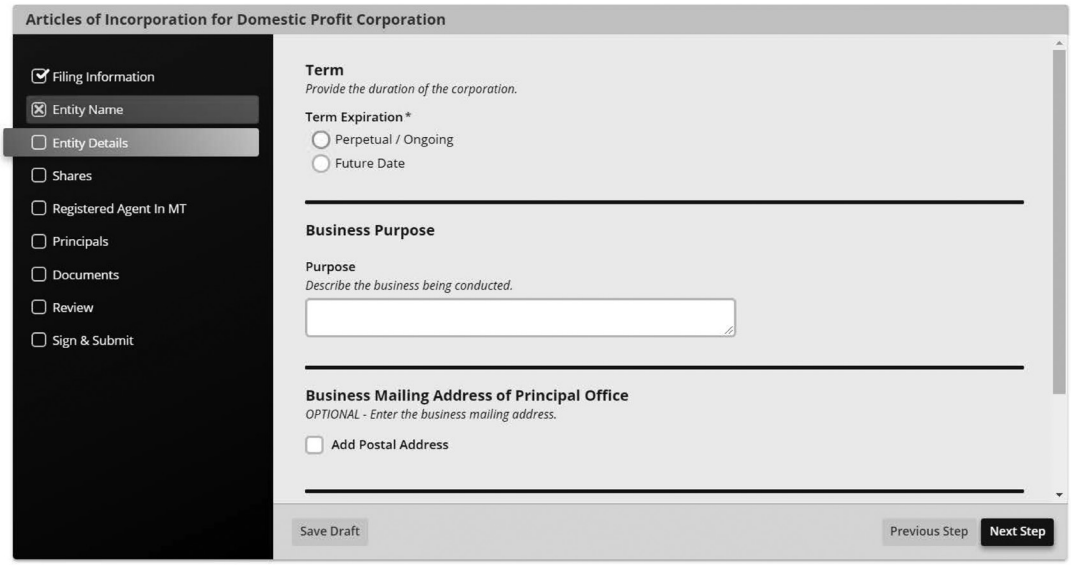
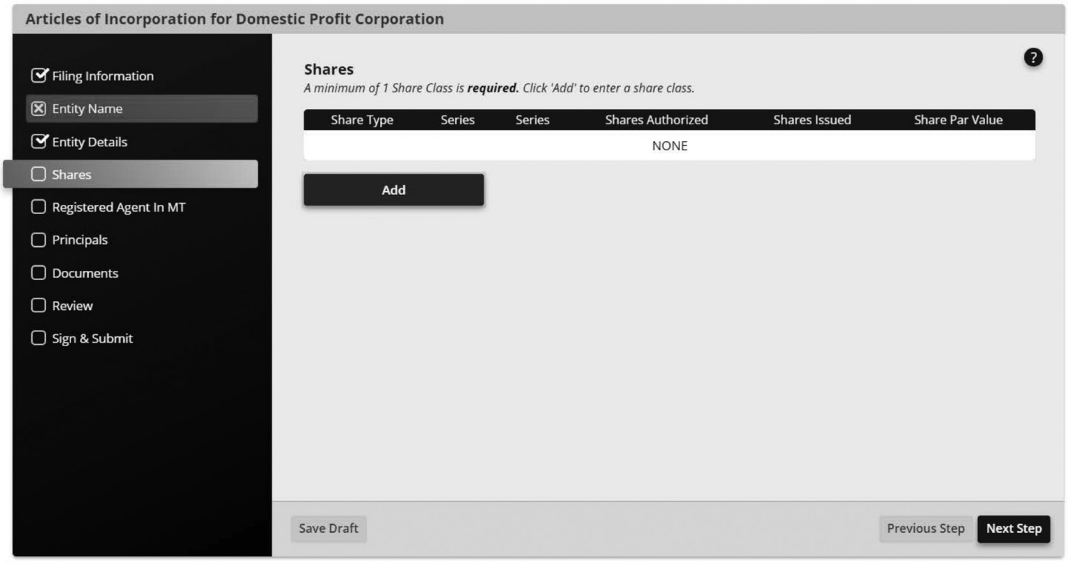
FIGURE 1.3
Articles of Incorporation for Domestic Profit Corporation







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Clerical Forms

Tax practitioners may be asked to prepare Secretary of State annual reports for business clients or other nontax filings. To the extent that the forms require entry of information that the client has provided, and do not require legal advice, such form preparation is likely not the unauthorized conduct of law. However, if the preparation involves helping the client understand what needs to be filled in, advising the client about the consequences of completing the form in a certain manner, or otherwise providing legal advice concerning the completion of the form, completing the form may constitute the unauthorized practice of law.

Activities That Are Authorized

Even if an activity constitutes the practice of law, there may be authorization for a nonlawyer to conduct that activity. If an activity is the practice of law but the activity is authorized, the activity is not the unauthorized practice of law.

Representation before the IRS

Circular 230 § 10.3 authorizes certain certified public accountants and enrolled agents to provide representation before the IRS. Representation is defined by Circular 230 § 10.2 as all matters connected with a presentation to the IRS or any of its officers or employees relating to a taxpayer's rights, privileges, or liabilities under laws or regulations administered by the IRS. Such presentations include, but are not limited to, the following actions:

1. Preparing documents
2. Filing documents
3. Corresponding and communicating with the IRS
4. Rendering written advice with respect to any entity, transaction, plan, or arrangement, or other plan or arrangement having a potential for tax avoidance or evasion

Annual Filing Season Program (AFSP) participants have limited practice rights. They can represent clients whose returns they prepared and signed, but only before revenue agents, customer service representatives, and similar IRS employees, including the Taxpayer Advocate Service. Attorneys, CPAs, and enrolled agents are the only tax professionals with unlimited representation rights, meaning they can represent their clients on any matters including audits, payment and collection issues, and appeals. PTIN holders without an AFSP Record of Completion or other professional credential can only prepare tax returns. They cannot represent clients before the IRS.

CROSS-REFERENCE

Credentials for Representation

For a further discussion of the credentials required to provide representation before the IRS, see the "IRS Issues" chapter in this book.

Representation in Tax Court

Tax Court Rule 200 allows nonlawyers to practice before the Tax Court. Nonlawyers must pass a written examination to demonstrate that they are competent to provide representation before the Tax Court. In 2018, the most recent test year, only 15.38% of applicants passed the exam. The 2020 test was postponed to 2021 due to COVID-19.

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Tax Advice and Submissions to the IRS

Circular 230 §§ 10.33 and 10.37 contemplate that tax advisers will give advice and prepare submissions to the IRS. In the course of providing these services, tax practitioners must establish the facts, determine which facts are relevant, evaluate the reasonableness of any assumptions or representations, relate the applicable law (including potentially applicable judicial doctrines) to the relevant facts, and arrive at a conclusion supported by the law and the facts [Circular 230 § 10.33(a)(2)]. Circular 230 also contemplates that tax practitioners will advise the client regarding the importance of the conclusions reached, including, for example, whether a taxpayer may avoid accuracy-related penalties under the Internal Revenue Code if a taxpayer acts in reliance on the tax practitioner's advice [Circular 230 § 10.33(a)(3)].

Circular 230 § 10.37 also authorizes a tax practitioner to give written advice on federal tax matters. *Federal tax matters* are any matters concerning the application or interpretation of

1. a revenue provision, as defined in I.R.C. § 6110(i)(1)(B);
2. any provision of law impacting a person's obligations under the Internal Revenue Code and accompanying regulations, including but not limited to the person's liability to pay tax or obligation to file returns; or
3. any other law or regulation administered by the IRS.

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VOLUNTEERING FOR A NONPROFIT This section discusses ethical considerations for tax practitioners who serve on the board of a nonprofit organization.

A tax practitioner can bring valuable knowledge and experience to the governance of a nonprofit organization. Serving on the board of a nonprofit organization may also establish relationships with potential new clients and increase a tax practitioner's recognition in the community. All services that a tax practitioner provides are subject to the relevant ethical rules and standards, regardless of whether the practitioner receives compensation for those services. Thus, when a tax practitioner volunteers to serve on the board of a nonprofit organization, he or she must comply with those rules and standards, including the duties to avoid conflicts of interest, act with integrity and objectivity, and protect confidential client information.

Conflicts of Interest

Generally, tax practitioners may not represent a client if the representation involves a conflict of interest. A *conflict of interest* exists if the representation of one client will be directly adverse to another client; or there is a significant risk that the representation of one or more clients will be materially limited by the practitioner's responsibilities to another client, a former client, or a third person, or by a personal interest of the practitioner [Circular 230 § 10.29(a)]. However, the practitioner may represent a client if

1. the practitioner reasonably believes that the practitioner will be able to provide competent and diligent representation to each affected client;
2. the representation is not prohibited by law; and
3. each affected client waives the conflict of interest and gives informed consent, confirmed in writing by each affected client, at the time the existence of the conflict of interest is known by the practitioner.

[Circular 230 § 10.29(b)]

The AICPA Code of Professional Conduct Rule 1.110.010 states that in determining whether a professional service, relationship, or matter would result in a conflict of interest, a member should use professional judgment, considering whether a reasonable and informed third party who is aware of the relevant information would conclude that a conflict of interest exists. When volunteering for a nonprofit, tax practitioners must typically identify any conflict of interest, evaluate the conflict of interest, and if necessary, disclose the conflict and obtain consent. The practitioner must also comply with any conflict-of-interest policy (discussed later) that the organization has adopted.

Identification of a Conflict of Interest

Before agreeing to act as a director of a nonprofit organization, a tax practitioner should take reasonable steps to identify circumstances that might create a conflict of interest including identification of the relevant relationships between the parties involved and the type and scope of the services to be provided. AICPA Code of Professional Conduct Rule 1.110.020 states that when a member serves as a director of an entity, an adverse interest threat to the member's objectivity may exist if the member's clients are customers of the entity or likely to engage in significant transactions with the entity. Specifically, the rule states the following:

> A member's general knowledge and experience may be very helpful to an entity in formulating policies and making business decisions. Nevertheless, if the member's clients are likely to engage in significant transactions with the entity, it would be more appropriate for the member to serve as a consultant to the board. Under such an arrangement, the member could limit activities to those that do not threaten the member's compliance with these rules. If,

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however, the member serves as a board member, the member should evaluate the significance of any threats and apply safeguards, when necessary, to eliminate or reduce the threats to an acceptable level.

Example 1.1
Potential Conflict with Client

Ginger Hayes is a CPA. Ginger serves on the board of directors of the local community foundation. The board has a grants program under which it solicits grant proposals from nonprofit organizations that benefit the community and surrounding areas, raises funds from private donors, and then makes grants to the worthy applicants. The community foundation has a grants committee that screens and ranks the initial grant applications, but ultimately the board must approve the grant recipients.

Ginger's CPA firm prepares the annual Form 990, Return of Organization Exempt From Income Tax, for Trails West, Inc., a nonprofit organization that is dedicated to increasing public access to hiking and biking trails. Trails West has applied for a grant from the community foundation. Ginger may have a conflict of interest if she participates in the board decision to approve or deny the grant to Trails West. Ginger could disclose her relationship with Trails West and recuse herself from participating in the vote on the grant application.

Evaluation of a Conflict of Interest

When a conflict of interest has been identified, the practitioner must evaluate the conflict of interest to determine if the practitioner will be able to provide competent and diligent representation to each affected party. In some cases, the tax practitioner may be able to implement safeguards to reduce the threat of a conflict to an acceptable level. Safeguards could include the following:

1. Restructuring or segregating certain responsibilities and duties
2. Obtaining appropriate oversight
3. Withdrawing from the decision-making process related to the matter giving rise to the conflict of interest
4. Consulting with third parties, such as a professional body, legal counsel, or another professional accountant

[AICPA Code of Professional Conduct Rule 1.110.010.10]

In cases where an identified conflict could be significant and the practitioner cannot reduce the threat caused by the conflict of interest, the tax practitioner should decline to volunteer for the organization.

Disclosure of a Conflict of Interest and Consent

If a conflict of interest exists and the tax practitioner reasonably believes that he or she can still provide competent and diligent representation, the tax practitioner must disclose the nature of the conflict of interest to the clients and other parties affected by the conflict and obtain their informed written consent to perform the services. Rule 1.4(b) of the ABA Model Rules of Professional Conduct states that a lawyer must "explain a matter to the extent reasonably necessary to permit the client to make informed decisions regarding the representation." At a minimum, informed consent necessitates an understanding of

1. what is involved in the transaction, and
2. the scope of the risk in having the tax practitioner provide services when there is a potential or actual conflict of interest.

Each affected client who waives a conflict of interest must give informed consent, confirmed in writing. The client must give the written confirmation within a reasonable time after the informed consent, but not later than 30 days. The practitioner must retain copies of the written consents for at least 36 months from the date of the conclusion of the representation of the affected clients, and the practitioner must provide the written consents to any officer or employee of the IRS on request [Circular 230 § 10.29].

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Confidential Information

As discussed earlier, a tax practitioner generally has a duty to keep information confidential. That duty extends to confidential information obtained from clients and from volunteer activities. When a tax practitioner serves on the board of a nonprofit organization, the tax practitioner may simultaneously have a fiduciary duty to the organization and a duty to protect the confidentiality of information obtained from the organization or from other clients. The practitioner must evaluate whether those two duties conflict.

Example 1.2
Confidential Client Information

Ginger from Example 1.1 is still serving on the board of the local community foundation. The community foundation has received a grant request from Homes for Humanity, a nonprofit that builds low-income housing. Ginger has a client who works for Homes for Humanity, and the client has confidentially revealed that she suspects that the executive director is mismanaging funds. As a director of the community foundation, Ginger has a fiduciary duty to ensure that the community foundation's grants are spent in furtherance of its exempt purpose. However, Ginger cannot disclose confidential client information. At a minimum, Ginger should consult with her attorney, and not participate in the grant-making process.

Integrity and Objectivity

Under the AICPA Code of Professional Conduct Rule 1.100.001, in the performance of any professional service, a member must maintain objectivity and integrity. The duty extends to services provided on a volunteer basis. A tax practitioner who is asked to become a member of a nonprofit board of directors should determine whether he or she will be asked to advise the corporation in matters involving financial statements, tax, or accounting and consider whether the dual role of board member and service provider will impede the practitioner's objectivity and integrity.

Differences of Opinion

AICPA Code of Professional Conduct Rule 2.130.020 notes that threats to compliance with the duties of integrity and objectivity may exist when there is a difference of opinion relating to the application of accounting principles; auditing standards; or other relevant professional standards, including standards applicable to tax and consulting services or applicable laws or regulations. The rule states that the threat is not at an acceptable level if the position taken results in a material misrepresentation of fact or a violation of applicable laws or regulations.

If the tax practitioner cannot reduce the threat to an acceptable level, the AICPA Code of Professional Conduct directs the practitioner to discuss the concerns with the supervisor and, if necessary, with the appropriate higher level of management within the organization. If the discussion does not resolve the conflict, the AICPA rules direct a practitioner to take the following steps to comply with the integrity and objectivity rule:

1. Determine whether the organization's internal policies and procedures have any additional requirements for reporting differences of opinion
2. Determine whether the tax practitioner is responsible for communicating his or her concerns to third parties, such as regulatory authorities or the organization's external accountant and whether any such communication would violate the duty of confidentiality
3. Consult with legal counsel regarding his or her responsibilities
4. Document his or her understanding of the facts, the accounting principles, auditing standards, or other relevant professional standards involved or applicable laws or regulations and the conversations and parties with whom these matters were discussed

If the practitioner concludes that no safeguards can eliminate or reduce the threats to an acceptable level or if the practitioner concludes that the organization has not taken appropriate

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action, then he or she should consider terminating the relationship with the organization and take appropriate steps to eliminate his or her exposure to subordination of judgment [AICPA Code of Professional Conduct Rule 2.130.020, §§ .08 and .09].

Gifts and Entertainment

Threats to a tax practitioner's integrity and objectivity may exist when the practitioner accepts gifts or entertainment that are not considered reasonable under the circumstances [AICPA Code of Professional Conduct Rule 2.120.010]. Whether gifts or entertainment are reasonable may depend on the following:

1. The nature of the gift or entertainment
2. The occasion giving rise to the gift or entertainment
3. The cost or value of the gift or entertainment
4. The nature, frequency, and value of other gifts and entertainment offered or accepted
5. Whether the entertainment was associated with the active conduct of business directly before, during, or after the entertainment
6. Whether other customers or vendors also participated in the entertainment
7. Whether the gifts or entertainment are from a customer or vendor of an employer

[AICPA Code of Professional Conduct Rule 2.120.010, § .04]

Example 1.3
Gift of Appreciation

Jacob Sanchez is an attorney and a CPA. He served on the board of a nonprofit organization for 5 years. When Jacob reached his 5-year anniversary on the board, the organization held a banquet to thank Jacob for his years of service. The nonprofit organization gave Jacob a crystal bowl with the nonprofit logo and Jacob's name etched on the side. Given the nature of the gift, the occasion, and the one-time frequency, it is likely reasonable for Jacob to accept the gift.

Due Diligence

While state law may grant some immunity from liability for nonprofit volunteers, before agreeing to serve as a nonprofit director, a tax practitioner should conduct due diligence to protect himself or herself from potential claims.

Review Bylaws

The tax practitioner should have his or her attorney review the bylaws and other governing documents of the nonprofit organization to confirm that they contain an indemnification provision. **Figure 1.4** shows a sample indemnification provision in a nonprofit organization's bylaws.

Review Insurance

The tax practitioner should verify that the nonprofit organization maintains both a general liability insurance policy and a directors and officers policy. Due diligence could also include review of the policies by an insurance agent to confirm adequate amounts and types of coverage.

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FIGURE 1.4
Sample Indemnification Provision

ARTICLE VI.
Indemnification, Insurance, and Director Liability

6.1 For the purposes of this Article VI, "agent" means any person who is or was a director, officer, employee, or other agent of the Corporation; and "proceeding" means any threatened, pending, or completed action or proceeding, whether civil, criminal, administrative, or investigative.

6.2 To the extent provided in M.C.A. § 35-2-447, the Corporation shall have power to indemnify any person who was or is a party or is threatened to be made a party to any proceeding by reason of the fact that such person is or was an agent of the Corporation, against expenses, judgments, fines, settlements, and other amounts actually and reasonably incurred in connection with such proceeding if such person acted in good faith and in a manner such person reasonably believed to be in the best interests of the Corporation and, in the case of a criminal proceeding, had no reasonable cause to believe the conduct of such person was unlawful. The termination of any proceeding by judgment, order, settlement, conviction, or upon a plea of nolo contendere or its equivalent shall not, of itself, create a presumption that the person did not act in good faith and in a manner that the person reasonably believed to be in the best interests of the Corporation or that the person had reasonable cause to believe that the person's conduct was unlawful.

6.3 To the fullest extent permitted under Montana law, as now in effect or as may hereafter be amended, there shall be no personal liability to a third party for monetary damages on the part of a volunteer director or volunteer executive officer of a nonprofit corporation, caused by the director's negligent act or omission in the performance of that person's duties as a director or officer, provided that the person's act or omission was within the scope of the director's or executive officer's duties; performed in good faith and not reckless, wanton, intentional or grossly negligent; and either the damages are covered by liability insurance or the director or executive officer and the Board of Directors had made all reasonable efforts in good faith to obtain available liability insurance.

6.4 The Corporation has the power to purchase and maintain insurance on behalf of any director, officer, employee, or agent of the Corporation against any liability asserted against or incurred by the agent in such capacity or arising out of the agent's status as such.

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Review Conflict-of-Interest Policy

As part of the application for tax exempt status, Form 1023, Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code, requires an organization seeking exemption to disclose whether it has adopted a conflict-of-interest policy and submit a copy of the policy. Appendix A to Form 1023 contains a sample conflict-of-interest policy. A tax practitioner who serves as a director of an exempt organization should request a copy of the conflict-of-interest policy adopted by the organization and comply with the procedures set forth in the policy. **Figure 1.5** shows the IRS sample policy.

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FIGURE 1.5
Sample Conflict-of-Interest Policy

Article I.
Purpose.

The purpose of the conflict of interest policy is to protect the interests this tax-exempt organization (Organization) interest when it is contemplating entering into a transaction or arrangement that might benefit the private interest of an officer or director of the Organization or might result in a possible excess benefit transaction). This policy is intended to supplement but not replace any applicable state and federal laws governing conflict of interest applicable to nonprofit and charitable organizations.

Article II.
Definitions.

1. **Interested Person.** Any director, principal officer, or member of a committee with governing board delegated powers, who has a direct or indirect financial interest, as defined below, is an interested person.
2. Financial Interest. A person has a financial interest if the person has, directly or indirectly, through business, investment, or family:
   a. An ownership or investment interest in any entity with which the Organization has a transaction or arrangement,
   b. A compensation arrangement with the Organization or with any entity or individual with which the Organization has a transaction or arrangement, or
   c. A potential ownership or investment interest in, or compensation arrangement with, any entity or individual with which the Organization is negotiating a transaction or arrangement.
   d. Compensation includes direct and indirect remuneration as well as gifts or favors that are not insubstantial. A financial interest is not necessarily a conflict of interest. Under Article III, Section 2, a person who has a financial interest may have a conflict of interest only if the appropriate governing board or committee decides that a conflict of interest exists.

Article III.
Procedures.

1. **Duty to Disclose.** In connection with any actual or possible conflict of interest, an interested person must disclose the existence of the financial interest and be given the opportunity to disclose all material facts to the directors and members of committees with governing board delegated powers considering the proposed transaction or arrangement.
2. **Determining Whether a Conflict of Interest Exists.** After disclosure of the financial interest and all material facts, and after any discussion with the interested person, he/she shall leave the governing board or committee meeting while the determination of a conflict of interest is discussed and voted upon. The remaining board or committee members shall decide if a conflict of interest exists.
3. **Procedures for Addressing the Conflict of Interest.**
   a. An interested person may make a presentation at the governing board or committee meeting, but after the presentation, he/she shall leave the meeting during the discussion of, and the vote on, the transaction or arrangement involving the possible conflict of interest.
   b. The chairperson of the governing board or committee shall, if appropriate, appoint a disinterested person or committee to investigate alternatives to the proposed transaction or arrangement.
   c. After exercising due diligence, the governing board or committee shall determine whether the Organization can obtain, with reasonable efforts, a more advantageous transaction or arrangement from a person or entity that would not give rise to a conflict of interest.
   d. If a more advantageous transaction or arrangement is not reasonably possible under circumstances not producing a conflict of interest, the governing board or committee shall determine by a majority vote of the disinterested directors whether the transaction or arrangement is in the Organization's best interest, for its own benefit, and whether it is fair and reasonable. In conformity with the above determination, it shall make its decision as to whether to enter into the transaction or arrangement.
4. **Violations of the Conflicts of Interest Policy.**
   a. If the governing board or committee has reasonable cause to believe an officer or director has failed to disclose actual or possible conflicts of interest, it shall inform the member of the basis for such belief and afford the member an opportunity to explain the alleged failure to disclose.
   b. If, after hearing the member's response and after making further investigation as warranted by the circumstances, the governing board or committee determines the member has failed to disclose an actual or possible conflict of interest, it shall take appropriate disciplinary and corrective action.

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Article IV.
Records of Proceedings.

The minutes of the governing board and all committees with board delegated powers shall contain:

a. The names of the persons who disclosed or otherwise were found to have a financial interest in connection with an actual or possible conflict of interest, the nature of the financial interest, any action taken to determine whether a conflict of interest was present, and the governing board or committee's decision as to whether a conflict of interest in fact existed.

b. The names of the persons who were present for discussions and votes relating to the transaction or arrangement, the content of the discussion, including any alternatives to the proposed transaction or arrangement, and a record of any votes taken in connection with the proceedings.

Article V.
Compensation.

a. A voting member of the governing board who receives compensation, directly or indirectly, from the Organization for services is precluded from voting on matters pertaining to that member's compensation.

b. A voting member of any committee whose jurisdiction includes compensation matters and who receives compensation, directly or indirectly, from the Organization for services is precluded from voting on matters pertaining to that member's compensation.

c. No voting member of the governing board or any committee whose jurisdiction includes compensation matters and who receives compensation, directly or indirectly, from the Organization, either individually or collectively, is prohibited from providing information to any committee regarding compensation.

Article VI.
Annual Statements.

Each director, principal officer, and member of a committee with governing board delegated powers shall annually sign a statement which affirms such person:

a. Has received a copy of the conflict of interest policy,

b. Has read and understands the policy,

c. Has agreed to comply with the policy, and

d. Understands the Organization is charitable and to maintain its federal tax exemption it must engage primarily in activities that accomplish one or more of its tax-exempt purposes.

Article VII.
Periodic Reviews.

To ensure the Organization operates in a manner consistent with charitable purposes and does not engage in activities that could jeopardize its tax-exempt status, periodic reviews shall be conducted. The periodic reviews shall, at a minimum, include the following subjects:

a. Whether compensation arrangements and benefits are reasonable, based on competent survey information, and the result of arm's length bargaining.

b. Whether partnerships, joint ventures, and arrangements with management organizations conform to the Organization's written policies, are properly recorded, reflect reasonable investment or payments for goods and services, further charitable purposes, and do not result in inurement, impermissible private benefit or in an excess benefit transaction.

Article VIII.
Use of Outside Experts.

When conducting the periodic reviews as provided for in Article VII, the Organization may, but need not, use outside advisors. If outside experts are used, their use shall not relieve the governing board of its responsibility for ensuring periodic reviews are conducted.

a. The names of the persons who disclosed or otherwise were found to have a financial interest in connection with an actual or possible conflict of interest, the nature of the financial interest, any action taken to determine whether a conflict of interest was present, and the governing board or committee's decision as to whether a conflict of interest in fact existed.

b. The names of the persons who were present for discussions and votes relating to the transaction or arrangement, the content of the discussion, including any alternatives to the proposed transaction or arrangement, and a record of any votes taken in connection with the proceedings.

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ABUSIVE TAX EVASION SCHEMES This section discusses how to recognize and report abusive tax schemes.

A main goal of most tax return preparers is to reduce the tax liability of their clients. Allowable tax avoidance includes actions that minimize taxes through deductions, credits, and other methods authorized under the tax laws and regulations. On the contrary, tax evasion is a failure to pay or a deliberate underpayment of taxes.

There are a large number of illegal tax evasion schemes and tax professionals must recognize these schemes to avoid civil and criminal penalties. Tax professionals must also be careful to protect their clients from tax scams. Those who take part in scams could be subject to substantial penalties and interest. This section first discusses how to recognize tax evasion schemes, and then reviews a tax practitioner's ethical duties, how to report an abusive tax scheme, and potential penalties for participation in an abusive tax evasion scheme.

Recognizing Tax Evasion Schemes

If a tax transaction sounds too good to be true, it may be an illegal tax avoidance scheme. Promoters often advertise these schemes at investment or tax seminars or on the internet. They promise to reduce or eliminate taxes. Abusive tax schemes may recommend that a taxpayer do the following:

1. Underreport income
2. Intentionally omit income
3. Overstate deductions
4. Keep two sets of books
5. Make false entries in books and records
6. Claim personal expenses as business expenses
7. Claim false deductions
8. Hide or transfer assets or income

Abusive tax schemes often involve multiple flow-through entities that are used to evade taxes. These schemes are characterized by the use of trusts, limited liability companies, limited liability partnerships, international business companies, foreign financial accounts, offshore credit/debit cards, and other similar instruments. The schemes are usually complex, involving multilayer transactions for the purpose of concealing the true nature and ownership of the taxable income and/or assets. **Figure 1.6** shows some of the claims that promoters make.

FIGURE 1.6
Abusive Tax Scheme Promoter Claims

"Never Pay Taxes Again"
"Deduct the Cost of your Personal Residence"
"Deduct the Cost of your Child's Education"
"The IRS Doesn't Want You to Know About This"
"So New, Your Tax Professional Doesn't Even Know About It"
"I Can Get You a Big Refund"
"Share/Borrow EITC Dependents"
"Put Your Money in a Trust and Never Pay Taxes Again"

Example 1.4
Foreign Trust Tax Scheme

Ashley James attended a tax seminar. The presenter advised attendees to form four trusts for a business. One domestic trust is in charge of the daily operations. The other domestic trust is an equipment trust formed to hold the business equipment that is leased back to the business trust at inflated rates to offset any income reported on the business trust tax return. Then, the income from the equipment trust is distributed to a foreign trust, which offsets any tax due on the equipment trust tax return. The foreign trust then distributes all or most of its income to a second foreign trust. Because the second foreign trust has only foreign income, there is no US filing requirement.

While the trust documentation and business records make it appear that the taxpayer is no longer in control of the business or its assets, the taxpayer still exercises full control. The promoted scheme is an abusive foreign trust scheme, and Ashley's tax practitioner should advise her to not participate.

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PRACTITIONER NOTE

Listed Transactions

A listed transaction is a transaction that is the same as or substantially similar to one of the types of transactions that the IRS has determined to be a tax avoidance transaction. These transactions are identified by notice, regulation, or other form of published guidance as a listed transaction. See www.irs.gov/businesses/corporations/listed-transactions for recognized abusive and listed transactions. Taxpayers who participate in a reportable transaction and are required to file a federal tax return or information return must file Form 8886, Reportable Transaction Disclosure Statement. A listed transaction is not necessarily an illegal tax avoidance scheme, and tax benefits from the transaction may be allowed.

Ethical Duties

Under Circular 230 § 10.34, tax practitioners have an ethical duty to not willfully, recklessly, or through gross incompetence sign a tax return or claim for refund, advise a client to take a position on a tax return or claim for refund, or prepare a portion of a tax return or claim for refund that the practitioner knows or reasonably should know

1. contains a position that lacks a reasonable basis;
2. is an unreasonable position as described in I.R.C. § 6694(a)(2) (a tax shelter with no reasonable basis to believe that the position will, more likely than not, be sustained on its merits); or
3. is a willful attempt by the practitioner to understate the liability for tax or is a reckless or intentional disregard of rules or regulations.

A pattern of conduct is a factor that is considered in determining whether a practitioner acted willfully, recklessly, or through gross incompetence. Allowing a taxpayer to take a return position that perpetuates an illegal tax scheme could result in disciplinary action and penalties (discussed later).

Reporting

The IRS requests assistance from the tax professional community to identify promoters of "too good to be true" abusive tax scams and unscrupulous tax preparers using illegal scams to avoid paying taxes. The IRS Lead Development Center (LDC) investigates abusive promoters and tax return preparers. If appropriate, the LDC will refer cases to the IRS Criminal Investigation (CI), which investigates and brings criminal charges against promoters of abusive tax schemes and tax professionals who assist or further them.

Tax practitioners can report an illegal tax avoidance scheme by completing Form 14242, Report Suspected Abusive Tax Promotions or Preparers. Form 14242, shown partially in **Figure 1.7**, can be faxed to 877.477.9135, or mailed to the following address:

Internal Revenue Service Lead
Development Center
Stop MS5040
24000 Avila Road
Laguna Niguel, CA 92677-3405

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FIGURE 1.7
Form 14242, Page 1

Report Suspected Abusive Tax Promotions or Preparers

Use Form 14242 to report a suspected abusive tax avoidance scheme and/or tax return preparers who promote such schemes. More information about tax avoidance schemes and promoters is available at www.irs.gov/LDC.

Answer the following questions as accurately as possible. Fields on this form have been designed to expand as additional information in entered.

Mail the completed form to:

Internal Revenue Service
Lead Development Center
Stop MS5040
24000 Avila Road
Laguna Niguel, CA 92677

You may also **FAX** your form to (949) 389-5083.

1. a. Describe the suspected tax scheme being promoted

b. Was the tax scheme promoted as a "new" legal tax strategy ☐ Yes ☐ No

2. How did you become aware of the promotion or promoter *(Internet, email, TV, flyer, newspaper, magazine, friend, relative, etc.).*

3. When did you first learn about the tax promotion *(mm/dd/yyyy)*

4. Promoter Information *(If more than one promoter is involved, provide information on all promoters)*

Name of promoter(s)

Social Security Number (SSN) of promoter(s)

Mailing address of promoter(s)

Email address of promoter(s)

Telephone number of promoter(s)

Headquarter location of promoter(s)

5. Describe the function/role of each person involved in the promotion

6. Do you have copies of any promotional material supplied by the promoter

☐ Yes ☐ No If **YES**, attach copies of the promotional material to your completed form

7. a. What was the cost for the promotional material

b. Did the cost include

A monthly service fee ☐ Yes ☐ No ☐ Unknown

An audit protection fee ☐ Yes ☐ No ☐ Unknown

8. How did you obtain the promotional information *(Internet, mail, email, telephone solicitation, professional acquaintance, etc.).*

9. a. Did the promoter hold any seminars or meetings to promote the tax scheme ☐ Yes ☐ No ☐ Unknown

b. If you answered **YES** in 9a, what was the cost associated with attending the seminar or meeting

c. Where was the seminar or meeting held

d. When was the seminar or meeting held *(mm/dd/yyyy)*

e. Did you personally attend any seminar or meeting associated with the promotion or promoter ☐ Yes ☐ No

Form **14242** (9-2011) Catalog Number 57652G www.irs.gov Department of the Treasury - Internal Revenue Service

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The IRS also maintains an abusive tax shelter hotline that tax practitioners can use to provide information (anonymously, if preferred) about abusive tax shelter transactions. The Office of Tax Shelter Analysis is primarily interested in potentially abusive transactions that may be employed by many taxpayers and could pose a significant compliance risk to the IRS. **Figure 1.8** shows how to contact the abusive tax shelter hotline.

FIGURE 1.8
Contact the Abusive Tax Shelter Hotline

Fax:	844.201.5535
E-mail address:	irs.tax.shelter.hotline@irs.gov
Mailing address:	Internal Revenue Service 1973 North Rulon White Blvd LB&I: OTSA - M/S 4916 Ogden, UT 84201

Penalties

Promoting, furthering, or participating in abusive tax schemes may result in penalties for the preparer and for the taxpayer. This section discusses some of the applicable penalties.

Understatement of Liability

I.R.C. § 6694 imposes a return preparer penalty for understatement of a taxpayer's liability. The penalty for a section 6694(a) understatement due to unreasonable positions is the greater of $1,000 or 50% of the income derived by the tax return preparer from the return or claim for refund. A position is unreasonable unless there is or was substantial authority, or unless there is reasonable basis for the position, and the position is disclosed.

A position on a tax shelter is unreasonable unless it is reasonable to believe that it would more likely than not (greater-than-50% possibility) be sustained on its merits. For purposes of this penalty, a tax shelter is defined as a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement if a significant purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of federal income tax.

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The penalty for a section 6694(b) understatement due to willful or reckless conduct is the greater of $5,000 or 75% of the income derived by the tax return preparer from the return or claim for refund. Willful or reckless conduct is a willful attempt in any manner to understate the liability for tax on the return or claim, or a reckless or intentional disregard of rules or regulations.

Promoting Abusive Tax Shelters

I.R.C. § 6700 imposes a penalty on 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 and the taxpayer knows or has reason to know that the statements are false, the penalty is equal to 50% 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% of the income derived from the activity).

Aiding and Abetting an Understatement

The I.R.C. § 6701 penalty for aiding and abetting an understatement of tax liability is $1,000 ($10,000 if the conduct relates to a corporation's tax return). Any person subject to the penalty can be penalized only once for documents relating to the same taxpayer for a single tax period or event. The penalty applies to anyone who aids or assists in, procures, or advises about the preparation or presentation of any portion of a return, affidavit, claim, or other document, if the person knows (or has reason to believe) that such portion will be used in connection with any material matter arising under the internal revenue laws, and that such portion would result in an understatement of a tax liability.

Fraud and False Statements

The I.R.C. § 7206 penalties for fraud and false statements are a fine of not more than $100,000 ($500,000 for a corporation), imprisonment of up to 3 years, or both (together with the costs of prosecution). The penalties apply to someone who willfully signs a return, statement, or other document under the penalty of perjury, if the signor does not believe that every material matter is true and correct. The penalties also apply to someone who willfully aids or assists in, or procures, counsels, or advises the preparation or presentation of a tax return, affidavit, claim, or other document in which any material matter is fraudulent or false.

Fraudulent Returns, Statements, or Other Documents

The I.R.C. § 7207 penalties for fraudulent returns, statements, or other documents are a fine of not more than $10,000 ($50,000 for a corporation), imprisonment of up to 1 year, or both. The penalties apply to any person who willfully delivers or discloses to the IRS a list, return, account, statement, or other document, that contains a material matter that the person knows is fraudulent or false.

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JUDICIAL TAX DOCTRINES This section discusses a tax practitioner's duty to consider judicial tax doctrines.

Tax practitioners have a duty to know how to apply the tax rules contained in the Internal Revenue Code and Treasury regulations, and they also have an ethical duty to consider the purpose and justification of those rules and regulations. Circular 230 § 10.33 requires the tax practitioner to evaluate the reasonableness of any assumptions or representations, relate the applicable law (including potentially applicable judicial doctrines) to the relevant facts, and arrive at a conclusion supported by the law and the facts.

Judicial tax doctrines are principles of tax practice that often have arisen from judicial decisions interpreting the Internal Revenue Code. While uncodified judicial tax doctrines may be broader or less precisely defined than standards that come from the Internal Revenue Code and Treasury regulations, tax practitioners have a duty to consider judicial tax doctrines when providing tax advice and preparing tax returns. This section reviews the step transaction doctrine, and the doctrines that consider substance over form and the business purpose of a transaction.

Step Transaction Doctrine

Taxpayers may construct a series of transactions (steps) to move or allocate tax benefits such as deductions, depreciation, or income from one party to another for a more favorable tax outcome. The step transaction doctrine considers whether the series of transactions should be collapsed into a single transaction–the end result–to determine its correct tax treatment. Application of the step transaction doctrine often negates the intended tax benefits of the multiple steps to the intermediate parties.

The step transaction doctrine treats a series of formally separate steps as a single transaction if the steps are in substance integrated, interdependent, and focused toward a particular result [*Penrod v. Commissioner*, 88 T.C. 1415 (1987)]. Thus, when a taxpayer has embarked on a series of transactions that are in substance a single, unitary, or indivisible transaction, the courts have disregarded the intermediary steps and have given credence only to the completed transaction [*Palmer v. Commissioner*, 62 T.C. 684 (1974)].

Courts have established three tests for evaluating the likelihood that a proposed series of transactions will be collapsed under the step transaction doctrine. To diligently give tax advice and prepare tax returns, tax practitioners must look at the transactions' end result, interdependence, and whether there was a binding commitment to complete one or more of the subsequent transactions.

End Result Test

The end result test evaluates the transactions' connection to a specific end result. If the taxpayer's intent is to undertake the transactions in a particular order (supposedly as separate transactions) to achieve a targeted result, the transactions fail this test. The series of steps will be collapsed into one transaction. Under the end result test, tax practitioners must ask whether a series of formally separate steps are really prearranged parts of a single transaction intended from the beginning to reach the ultimate result.

Interdependence Test

The interdependence test is sometimes also referred to as the mutual interdependence test. Two or more transactions are evaluated to determine if they can stand alone individually. If, for example, legal relationships are created by the initial transaction, and those relationships are meaningless without the completion of the second transaction, the steps fail this test. The set of transactions is treated as one transaction. Under the interdependence test, tax practitioners must ask whether, based on a reasonable interpretation of objective facts, the steps were so interdependent that the taxpayer would not have completed one transaction without the other transactions.

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Binding Commitment Test

The binding commitment test collapses a series of transactions into one if, at the time the first step is entered into, there was a binding commitment to undertake the later step. If at the inception of the first transaction, a binding commitment exists to complete a second transaction, the transactions fail this test. The steps are collapsed into one transaction, with (generally) one tax outcome.

Substance Over Form and Business Purpose

Satisfying the literal language of a statute or regulation does not ensure tax-free treatment if the transaction lacked a business purpose. Tax practitioners must consider whether a tax reduction strategy has economic substance or is solely to avoid taxes. The doctrine of substance over form states that a transaction's economic substance controls its tax treatment if its economic substance varies from its legal form. The business purpose doctrine disregards a transaction if it has no substantial business purpose other than to avoid or reduce federal tax. If tax avoidance is the only objective of a transaction, the tax benefits of the overall transaction may be disallowed.

Example 1.5
Substance over Form Test

Jenny Owens enjoyed a successful career and wanted to begin transferring ownership of her company as part of her estate planning. At age 76, Jenny realized that she may not have enough time to accomplish a totally tax-free transfer using annual gift tax exclusions. She enlisted 20 of her friends to help. Jenny transferred stock valued at $15,000 to each of her four children and each of her 20 friends. Immediately upon receipt of the stock, the 20 friends gifted the stock to Jenny's four children. The form of this transaction allows the annual gift tax exclusion to be used for each of the transfers. However, the substance is that all the stock transfers were for the benefit of Jenny's four children [see *Heyen v. United States*, 945 F.2d 359 (10th Cir. 1991)].

The economic substance doctrine and business purpose doctrine are codified at I.R.C. § 7701(o), which defines the term *economic substance doctrine* to mean the common law doctrine under which the tax benefits of a transaction are not allowable if the transaction does not have economic substance or lacks a business purpose. A transaction has economic substance only if

1. the transaction changes (apart from federal income tax effects) the taxpayer's economic position in a meaningful way, and
2. the taxpayer has a substantial purpose (apart from federal income tax effects) for entering into such transaction.

I.R.C. § 6662 generally imposes a 20% penalty on the amount of the understatement on a tax return that understates the tax due resulting from disallowance of claimed tax benefits because a transaction lacks economic substance [within the meaning of section 7701(o)].

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CASE STUDIES The following 10 case studies illustrate common ethical challenges for the tax practitioner.

NOTE: The following case studies are intended to promote a discussion of how ethical guidelines are applied in a tax practice. They are not intended to show malice, discrimination, or favoritism toward any person, race, religion, or culture. The case studies are based on fictitious persons and hypothetical situations. They are solely for educational purposes.

Case Study 1: Negative Online Reviews

Ronald Frank is a tax return preparer. Ronald prepared a return for Naomi Carter. In preparing the return, Ronald determined that although Naomi worked from home in 2020, she was not eligible for the home office deduction. Naomi told Ronald that she had a spin bike, kettlebell weights, and a yoga mat in her home office, and she also uses the office as a gym. Without the deduction, Naomi owed an additional $3,000 federal income tax.

Naomi was unhappy with Ronald's work, and hired another return preparer to prepare her return. She posted negative reviews about Ronald on Yelp and Google. The reviews generally criticized Ronald and alleged that he made errors on her return. The reviews were as follows:

> Client review of Ronald Frank
> Ft. Meyers, Florida
> Rating 1 out of 5
>
> Do not trust this person with your taxes
> Posted by Naomi53@aol.com

> Client Review of Ronald Frank
> Ft. Myers, Florida
> Rating 1 out of 5
>
> Ronald Frank is an incompetent tax return preparer and he made lots of mistakes on my return. He missed the home office deduction, and it would have cost me $3,000. Fortunately, my new return preparer caught the mistake and claimed the deduction. Do not use Ronald Frank to prepare your taxes.
> Posted by Naomi C.

Ronald contacted the sites, but they would not remove the reviews. The sites told Ronald that the reviews were personal opinion.

1. Can Ronald post rebuttals?
2. What information can he not post?
3. What information should he post?

See the Case Study 1 Response on page 34.

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Case Study 2: Working Remotely

Eddie Chen is a CPA. He lives in the New Jersey suburbs and works in New York City. Even after the COVID-19 stay-at-home order was lifted, Eddie's employer allowed him to continue to work from home. Without his 40-mile commute, he has time to get his work done, clean the house, bake banana bread, and have dinner ready when his wife gets home from work.

Eddie has a home office, but he shares the printer and internet with his wife and children. On Monday morning, Eddie received the mail that was forwarded from the office. There was a 30-day collection notice from the IRS. The client is his children's orthodontist, Elisha Price. Eddie fed the notice into the scanner and went to the kitchen to get a cup of coffee.

While Eddie was away from the desk, Eddie's daughter came into the office to print her homework. When he returned, he found her standing next to the desk. The scanned document was sitting in the scanner tray on his desk, in plain sight. The document contained Elisha's name, address, and social security number.

Later that morning, Eddie emailed the notice to Elisha. However, he could not connect to the office server, and he did not enter the notice deadline in his calendaring program. Eddie received a phone call from Elisha 45 days later. She was angry and in a raised voice demanded to know why the IRS had taken funds out of her bank account. Eddie's wife was in the next room and overheard the conversation.

1. What are Eddie's duties to safeguard client information?
2. Has Eddie violated those duties?
3. Has Eddie violated any other ethical duties?
4. What should Eddie have done differently?

See the Case Study 2 Response on pages 34 and 35.

Case Study 3: Unauthorized Practice of Law

John and Jeff McDonald wanted to start a business renting all-terrain vehicles (ATVs) in the summer and snowmobiles in the winter. They own a cabin in Wyoming that is adjacent to 3,000 acres of public land and started purchasing used vehicles. John and Jeff met with their tax return preparer, Luke Gray, to discuss tax planning for the business. Luke recommended that John and Jeff form an S corporation to "save some money on taxes." In 2020, Luke prepared the articles of incorporation, filed the articles with the state, and applied for an EIN.

During peak summer tourist season, John and Jeff rented an average of 20 ATVs per day, and the business was very profitable. The snowmobile rental business was highly contingent on weather, and the 2020–2021 winter had less than average snowfall.

Two customers from Florida rented a snowmobile. They were injured while trying to ride up a very steep slope. The customers are now suing the corporation. They are also alleging that John and Jeff are personally liable because they did not comply with all the "corporate formalities."

1. Did Luke engage in the unauthorized practice of law when he recommended an S corporation and prepared the articles of incorporation?
2. What advice should Luke have given John and Jeff?

See the Case Study 3 Response on page 35.

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Case Study 4: Judicial Tax Doctrines

George Jones lives in Alaska. He grew up in eastern Washington, and his elderly father, Richard, lived on the 80-acre family farm. In 2019, Richard's attorney told Richard to transfer the farm to George, Richard's only child, to protect it in case Richard needed to go to an assisted living facility. Richard died in 2021. His will devised all his assets to George.

George wants to sell the farm. However, Richard purchased the farm in 1961 for $30,000. A developer is interested in buying the farm to build a new subdivision and has offered George $1,175,000. George consulted with his accountant in Alaska, Tiffany Black. Tiffany advised George that there was no step-up in basis, and he would pay approximately $230,000 in federal income tax on the sale.

George contacted his father's estate attorney to find out if he could "undo" the 2019 transfer. The attorney told George that he could file a judicial action to set aside the transfer. Then George would inherit the farm. George asks Tiffany if the attorney's proposed action would reduce his tax liability.

1. How should Tiffany respond?
2. Does Tiffany have an ethical duty to consider any judicial doctrines?

See the Case Study 4 Response on page 36.

Case Study 5: Volunteering for a Nonprofit

Alex Graham recently graduated from the University of the Northwest with a degree in accounting and finance. Alex opened an office in downtown Polson doing general accounting and tax return preparation. The Polson Food Pantry, a nonprofit organization, asked Alex to serve on its board of directors. Alex thought that serving on a nonprofit board would enhance his reputation in the business community, generate some new business, and also benefit his community. He agreed to serve a 2-year term as director.

The Food Pantry has a paid part-time chief executive officer (CEO) and 5 volunteer directors. Alex is the only director with tax and accounting experience. The CEO and other volunteer directors rely on him for assistance with payroll, preparing financial statements, and completing the annual Form 990 tax return.

In 2020, his first year as a director, Alex did the following for the Food Pantry:

1. Reviewed the organization's electronic payroll and deposit schedule
2. Prepared the quarterly financials for the board meetings
3. Prepared the 2019 tax return based on information that he received from the CEO

In 2022, the IRS sent a notice to the Food Pantry assessing $7,000 in unpaid payroll taxes. Also, an audit of the Food Pantry's records discovered that the 2019 tax return had underreported expenses and overreported contributions.

1. Do Alex's dual responsibilities as a CPA and director violate any ethical duties?
2. What is Alex's liability for the unpaid taxes and incorrect returns?
3. What could Alex have done differently?

See the Case Study 5 Response on pages 36 and 37.

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Case Study 6: Abusive Tax Schemes

Sunny Tanaka is a CPA. Her client, Sasha Burman, owns a chain of profitable yoga studios. Sasha showed Sunny a brochure for an investment that Sasha thinks could save her a lot of money on taxes. The brochure contains the following excerpt:

> Green Tree, LLC has acquired 75 acres of forest in eastern Washington and is granting a conservation easement to the Washington Forest Conservancy so that the land cannot be developed. THE IRS DOES NOT WANT YOU TO KNOW ABOUT THIS, but for every dollar that you invest in our company, you will be entitled to a $3 charitable contribution deduction. That is 300% more than your initial investment, and the deduction will be fully substantiated by a qualified IRS appraisal. Contact us to discuss how you can reduce your taxes and help protect the environment.

1. How should Sunny investigate whether the scheme is legitimate?
2. How should Sunny advise Sasha?
3. Does Sunny have a duty to report the scheme?

See the Case Study 6 Response on pages 37 and 38.

Case Study 7: Client with Diminished Capacity

Lilah Stewart is a CPA. She recently moved to the suburbs and works primarily from home. Lilah has prepared tax returns for Brian Johnson for 20 years. Brian lives approximately 40 miles from Lilah. Brian's wife died in 2019, and the last time that she saw Brian, Lilah had noticed that Brian's health seemed to be declining. In preparation for the 2021 tax filing season, Lilah emailed Brian an organizer to gather information about his income and expenses. Lilah did not receive the completed organizer.

Two weeks later, Lilah left Brian a voicemail asking him to complete the organizer and return it to her. In response, Lilah received the following email:

> Hi Lilah. Thanks for taking care of this. I don't own the house anymore and my only income was $21,000 from social security. I paid $100,000 to my home health care worker, Linda James. I should be entitled to a big deduction. Linda pays all my bills so please direct deposit the refund in Linda's account #123456 at First Mountain Bank.

1. Can Lilah prepare a return based on the information that Brian has provided?
2. Does Lilah have any duty to confirm the information provided, or the identity of the sender?

See the Case Study 7 Response on page 38.

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Case Study 8: Tax Advice

Samantha Timmons worked for the local ski resort as a chairlift engineer. On December 29, 2020, she was maintaining one of the lifts. A cable snapped and injured Samantha's wrist. An ambulance transported Samantha to the hospital, and she later filed an injury report with her employer.

Earlier that week Samantha had posted pictures on Facebook showing her drinking a beer while she was snowboarding. Samantha's employer claimed that she had falsified the injury report and she was really injured in a snowboarding accident. The employer fired Samantha, and Samantha sued her employer for wrongful termination. The suit settled out of court, and the employer agreed to pay Samantha $250,000. The employer withheld $15,000 in federal income taxes.

On April 14, 2021, Samantha sent the following text message to her tax advisor at J&T Tax Preparation Services:

> Hi Jake. I have a quick question for you. I am doing my taxes online today. I got hurt at work and my employer fired me. My lawyer sued them and got me a big settlement. Do I have to include that in my income? Let me know ASAP because I have to get this filed by tomorrow. Thanks.

1. Should Jake respond to Samantha's text?
2. If he chooses to respond, how much information should Jake include?
3. What other due diligence obligations does Jake have?

See the Case Study 8 Response on page 39.

Case Study 9: Conflict of Interest

Jeff Alvarado has been preparing joint individual income tax returns and providing tax advice for his clients Donna and Henry Watson for over 10 years. Jeff also prepares the annual tax return for Donna and Henry's jointly owned veterinary and dog grooming business, which is an LLC taxed as a partnership. Donna recently called Jeff's office to let him know that she and Henry have separated, and they have filed for a divorce.

Donna told Jeff's office manager that she and Henry each have an attorney. They have entered into preliminary divorce settlement negotiations and have agreed that they will continue to own and operate the business jointly. Donna is a veterinarian, and she will continue to provide vet services. Henry will provide the grooming services. The business has a small retail line of CBD pet supplements that are sold to both veterinary and grooming customers. They have agreed to split profits 50/50 but have asked Jeff to advise them about how they should structure the compensation for their services.

1. Can Jeff continue to provide advice and services for Donna, Henry, and the business?
2. What, if anything, should he do before providing such services?

See the Case Study 9 Response on page 40.

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Case Study 10: Data Protection and Confidentiality/Working Remotely

The 2021 tax preparation season was the busiest tax season ever for Denman and Associates. Raymond Denman, the owner of the firm, got to the office at 5:00 a.m. seven days a week and did not leave until 9:00 p.m. Several of the associates were still working from home, and Raymond did not have time to provide a lot of oversight. At 1:00 a.m., as Raymond was home responding to emails from upset clients who still had not received their refunds, Raymond received the following email:

> FROM: IRS Tax E-Filing
>
> SUBJECT: Verifying your EFIN before e-filing
>
> In order to help protect both you and your clients from unauthorized/fraudulent activities, the IRS requires that you verify all authorized e-file originators prior to transmitting returns through our system. That means we need your EFIN (e-file identification number) verification and Driver's license before you e-file.
>
> Please have a current PDF copy or image of your EFIN acceptance letter (5880C Letter dated within the last 12 months) or a copy of your IRS EFIN Application Summary, found at your e-Services account at IRS.gov, and Front and Back of Driver's License emailed in order to complete the verification process. Email: (fake email address)
>
> If your EFIN is not verified by our system, your ability to e-file will be disabled until you provide documentation showing your credentials are in good standing to e-file with the IRS.
>
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> 2800 E. Commerce Center Place, Tucson, AZ 85706

Raymond suspects that the email may have been sent to everyone in the firm. Raymond immediately called the firm's information technology professional and left her a message asking her to come to the office to investigate whether there has been a security breach.

1. What should Raymond do to ensure that his employees safeguard their personal information?
2. What best practices should Raymond implement for his employees working from home?

See the Case Study 10 Response on page 41.

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Case Study 1 Response

Naomi has posted negative reviews about her tax return preparer, Ronald, because Ronald advised her that she cannot claim a home office deduction for her dual-purpose home gym and office. Ronald could try to contact Naomi and ask her to remove or edit her posts.

1. If Naomi refuses to remove or edit her negative posts, Ronald may want to make a curative post.
2. Ronald must be careful to not violate his duties of confidentiality and nondisclosure. He should not post any details that are not disclosed in the original post. Naomi did not use her full name in the reviews, and Ronald should not use her full name in the rebuttals. See the Oregon State Bar Disciplinary Decision No. 18-104, in which a lawyer disclosed confidential client information in response to negative online reviews. His intent was to discredit the client and undermine the credibility of the critical review. The lawyer claimed a self-defense exception to the duty of confidentiality. The disciplinary panel found that the exception did not apply and suspended the lawyer for 30 days. The lawyer has appealed, and the case is pending [Oregon Supreme Court Case No. SC S067502].
3. Ronald should keep his response general and factual. He could post the following:

   Dear Naomi, thank you for your feedback. I value my clients' satisfaction, and I would like to respond to your post to resolve several inaccuracies. However, as a tax professional with over 10 years of experience preparing tax returns, I take privacy very seriously. Please contact me at the office at 406.444.0006 so that we can discuss your eligibility for deductions and credits.

Case Study 2 Response

While working from home, Eddie disclosed a client document, missed a deadline, and failed to keep a client conversation confidential.

1. As a return preparer, Eddie has a duty to safeguard Elisha's information, even when he is working from home. I.R.C. § 7216 prohibits him from disclosing or using a client's information, without the client's specific consent. As a CPA licensed in New York, Eddie must also comply with state law requirements to keep client communications confidential. Specifically, Article VI of the New York Code of Professional Conduct says that to preserve client trust and provide the best possible service to clients Eddie must closely guard client information and treat it as confidential. Eddie must also comply with the rules of any professional organization of which he is a member. For example, if Eddie is a member of the AICPA, he cannot disclose confidential client information (defined as any information obtained from the client that is not available to the public) without the client's specific consent.
2. Eddie has violated his duties of confidentiality and nondisclosure by leaving a confidential client document in plain sight, emailing unencrypted sensitive client information (a document that contained the client's name and social security number), and failing to protect the confidentiality of his verbal communication with Elisha.
3. Eddie may have also violated his duties to represent Elisha diligently and competently. He emailed a time-sensitive document and did not get any acknowledgment that Elisha received the document. He neglected to calendar the deadline and did not follow up with Elisha to discuss action that could have been taken to prevent a levy. While encrypted email is an effective way to securely communicate confidential information, it may not be appropriate for important and time-sensitive communication. Considering the importance of the transaction and the time frame involved, Eddie should have attempted to communicate with Elisha by phone or mail to discuss how to avoid a levy.

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4. If Eddie cannot have a secure home office, he must take steps to safeguard confidential client information. The FTC Standards for Safeguarding Customer Information Rule requires Eddie to adopt an information security program. The security program should include prohibitions on emailing unencrypted sensitive personal information and a provision to ensure that taxpayer information, including data on hardware and media, is not left unsecured on desks or the printer.

   Eddie should also adopt an electronic document management policy to help mitigate or eliminate the risks associated with transmitting and storing documents electronically. That policy may establish guidelines for the use of email or other electronic communication, and limit use of email as the sole source of communication for important and time-sensitive information.

   Eddie must implement measures to ensure that confidential client communication is not inadvertently overheard. If he cannot have a phone or video conference in a location where the conversation cannot be overheard, he should try to limit those conversations to times when his wife is at work and the kids are at school.

   Eddie must adopt procedures to ensure that important client deadlines are not missed. If necessary, he should retain an information technology specialist to ensure that he has access to the office calendaring program. If a client agrees to receive communication by encrypted email, Eddie should have a policy to ensure receipt of the email and timely follow up.

   Finally, there has been a security breach and an unauthorized disclosure of personal client information (the client's name, address, and social security number). If Eddie reasonably believes that the disclosures may cause a material risk of harm, loss, or injury to Elisha, he may have an obligation under the state security breach reporting law to report the breach.

Case Study 3 Response

John and Jeff have asked Luke for advice regarding the structure of their ATV and snowmobile rental business. Luke may offer advice about the tax treatment of different entities, but he cannot advise his clients about legal matters.

1. Advising John and Jeff about the self-employment tax savings of an S corporation versus a limited liability company is within the scope of authorized tax advice. Advising them about what is necessary to ensure liability protection is likely legal advice. John and Jeff have asked Luke to assist them with filing business formation documents. Such assistance may constitute the unauthorized practice of law if the information on the forms requires legal knowledge. Such assistance may also be prohibited under state law.
2. Bylaws, shareholder's agreements, operating agreements, and other entity governance documents can prevent disputes between the owners and protect against personal liability for claims against the corporation or company. Luke should advise John and Jeff to consult with their attorney and insurance agent to discuss how best to protect the limited liability status of the business.

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Case Study 4 Response

George has asked his accountant, Tiffany, about the tax implications of a series of transactions.

1. Under the Circular 230 Best Practices for Tax Advisors, Tiffany's response must relate the facts to the applicable law and arrive at conclusions that are supported by the law and the facts. Best practices also include advising George regarding the importance and potential consequences of the conclusions reached, including potential penalties. Applying the applicable law, Tiffany may conclude that George will receive a step-up in basis of the real estate if he is "acquiring the property from a decedent" [I.R.C. § 1014]. Thus, if the lifetime transfer is voided, given a strict construction of the statute, George may be entitled to a basis in the property equal to the FMV on his father's date of death.
2. Best practices also require Tiffany to consider any applicable judicial doctrines [Circular 230 § 10.34(a)(2)]. Under the step transaction doctrine, a series of formally separate steps will be treated as a single transaction if the steps are integrated, interdependent, and focused toward a particular result [*Penrod v. Commissioner*, 88 T.C. 1415 (1987)]. To diligently give tax advice and prepare a tax return for George, Tiffany must consider whether the lawsuit is a prearranged part of a single transaction intended from the beginning to reach the ultimate result (a step-up in basis) and whether George would file the lawsuit if it did not result in a tax savings. Tiffany should also consider whether the lawsuit has any purpose other than the avoidance of federal income tax. If not, the transactions may lack economic substance.

Case Study 5 Response

As a director of the Polson Food Pantry, Alex reviewed the organization's electronic payroll and deposit schedule, prepared the quarterly financials for the board meetings, and prepared the 2019 tax return based on information that he received from the CEO. Now, the IRS has assessed unpaid payroll taxes, and an audit of the organization's tax return shows underreported expenses and overreported contributions.

1. Alex's responsibilities as a provider of tax and accounting services, and his fiduciary responsibilities as a director of the nonprofit organization could create a conflict of interest if there is a significant risk that the services that he provides in either role will be materially limited by his responsibilities in the other role [Circular 230 § 10.29(a)]. He may also have a difficult time maintaining his duty of confidentiality if, for example, the CEO does not share the IRS notice and audit findings with the board of directors. Finally, as a tax practitioner, Alex has a duty to act with objectivity and integrity. The duty extends to volunteer services. If the CEO does not agree to remedy the unpaid payroll taxes and amend the tax return, Alex may have to resign from the board.
2. Alex could be held liable for the unpaid payroll taxes if he is a responsible party [as defined under I.R.C. § 6672(a)]. Typically, an unpaid, voluntary board member of a tax-exempt organization will not be considered a responsible person if the board member is solely serving in an honorary capacity, does not participate in the day-to-day or financial operations of the business, and does not have actual knowledge of the failure on which the penalty is based [I.R.C. § 6672(e)]. This exception, however, does not apply if it results in no person being liable. Also, a voluntary board member of a tax-exempt organization who is extensively involved in the financial decisions of the company may be a responsible person. See *Jefferson v. United States*, 459 F.Supp.2d 685 (N.D. Ill. 2006), in which a 20-year volunteer board president of a nonprofit organization was responsible for payroll taxes because he had check signing

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authority and control of financial affairs, and he was aware that trust fund taxes had not been paid.

Alex could also be responsible for the errors on the income tax return. The CEO failed to provide him with accurate information, but as a director, Alex likely had full access to that information. Whether his reliance on information that the CEO provided was reasonable, without any verification or further inquiry, depends on several factors, including the CEO's reputation, expertise, and objectivity.

3. To avoid this outcome, before he served on the board, Alex could have evaluated the potential for a conflict of interest and possible threats to his ethical duties. If he knew from the outset that the board wanted him to provide tax and accounting services, and he could not reduce the threat of a conflict of interest to an acceptable level, Alex could have volunteered to provide those services for free without being a member of the board.

Case Study 6 Response

Sunny's client, Sasha, has asked for her advice about whether a tax scheme could legitimately save her money.

1. If it sounds too good to be true, it probably is. Before she advises Sasha about the tax benefits of the scheme, Sunny must investigate whether it is legitimate. Sunny could start by reviewing the list of abusive and listed transactions at www.irs.gov/businesses/corporations/listed-transactions. She would find Notice 2017-10, which describes the following abusive scheme:

   > The promoters (i) identify a pass-through entity that owns real property, or (ii) form a pass-through entity to acquire real property. Additional tiers of pass-through entities may be formed. The promoters then syndicate ownership interests in the pass-through entity that owns the real property, or in one or more of the tiers of pass-through entities, using promotional materials suggesting to prospective investors that an investor may be entitled to a share of a charitable contribution deduction that equals or exceeds an amount that is two and one-half times the amount of the investor's investment. The promoters obtain an appraisal that purports to be a qualified appraisal as defined in I.R.C. § 170(f)(11)(E)(i) but that greatly inflates the value of the conservation easement based on unreasonable conclusions about the development potential of the real property. After an investor invests in the pass-through entity, either directly or through one or more tiers of pass-through entities, the pass-through entity donates a conservation easement encumbering the property to a tax-exempt entity. Investors who held their direct or indirect interests in the pass-through entity for one year or less may rely on the pass-through entity's holding period in the underlying real property to treat the donated conservation easement as long-term capital gain property under I.R.C. § 170(e)(1). The promoter receives a fee

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or other consideration with respect to the promotion, which may be in the form of an interest in the pass-through entity.

The notice states that the IRS intends to challenge the purported tax benefits from this transaction based on the overvaluation of the conservation easement. The IRS may also challenge the purported tax benefits from this transaction based on the partnership antiabuse rule, economic substance, or other rules or doctrines.

2. Under Circular 230 § 10.34, tax practitioners have an ethical duty to not willfully, recklessly, or through gross incompetence sign a tax return or claim for refund, advise a client to take a position on a tax return or claim for refund, or prepare a portion of a tax return or claim for refund that the practitioner knows or reasonably should know contains a position that lacks a reasonable basis, is an unreasonable position, or is a tax shelter with no reasonable basis to believe that the position will, more likely than not, be sustained on its merits. If Sunny concludes that there is no reasonable basis to claim the inflated deduction promised by the scheme, she should advise Sasha to not participate. Sunny also has a duty under Circular 230 § 10.34(c) to inform Sasha about potential penalties that may apply if Sasha submits a return that underreports income and should inform Sasha about the listed transaction reporting requirements.
3. Sunny likely does not have a legal duty to report the scheme. However, the IRS encourages tax practitioners to help identify illegal tax avoidance schemes. Sunny could report the scheme by completing Form 14242, Report Suspected Abusive Tax Promotions or Preparers. If she prefers, she can file the form anonymously.

Case Study 7 Response

Lilah has had no face-to-face contact with her client Brian, and Lilah may suspect that Brian has diminished capacity based on her prior meeting with him and the current circumstances.

1. Lilah has provided Brian with an organizer to complete, and instead she has received an email that exacerbates Lilah's concerns that Brian may be unduly influenced by his caregiver. Brian owned a home that he no longer owns, and $100,000 seems excessive to pay a caregiver. Also, Brian has purportedly given control of his finances to the caregiver. If Lilah determines that the information that Brian has provided is inconsistent or incomplete, she cannot rely on that information to prepare his income tax return and must request additional substantiation.
2. Lilah has received only an email from Brian. She has not talked to him or met with him. Given her suspicions about Brian's diminished capacity, and the caregiver who appears to have moved into his home and may be exerting undue influence, Lilah should make additional efforts to communicate with Brian by phone, video conference, or in person to confirm that he is the sender of the email. If Lilah determines that there is a risk of substantial harm to Brian, and Lilah reasonably believes that Brian is unable because of diminished capacity, either temporary or permanent, to handle his financial affairs, Lilah may consult with individuals or entities that can assist Brian. However, Lilah must consider Brian's wishes, and the impact on her duty to maintain Brian's confidential information. In this case, Lilah could contact Brian's daughter to determine if she has a power of attorney authorizing her to act for him.

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Case Study 8 Response

In a text message, Samantha has asked her tax adviser, Jake, a "quick question" about including settlement proceeds in her income.

1. Providing substantive tax advice in a text message or email is not necessarily a best practice, but often clients ask their tax advisers to provide a prompt response to an urgent matter. Text messages tend to be shorter and less formal, and Jake must consider whether he can provide an adequate response and document that response for his records. A simple "yes" or "no" answer in this case may not be sufficient to fulfill Jake's ethical obligations.
2. When providing advice, Jake must comply with the Circular 230 standards for written advice, which apply to electronically communicated advice such as emails and text messages. Circular 230 § 10.37 requires Jake to use reasonable efforts to identify and ascertain relevant facts, reasonably consider all relevant facts and circumstances, and relate applicable law and authorities to the facts. While there is no standard format for communicating advice, Jake must use his professional judgment and should consider, among other factors, the importance of the transaction and amounts involved, the short time to give advice, and the technical complexity of the issues.
3. Typically, Jake can rely on information furnished by the client, without verification. However, he cannot ignore the implications of information furnished and must make reasonable inquiries if the information furnished appears to be incorrect, inconsistent, or incomplete [Circular 230 § 10.34]. Here, Samantha has given him no information about the underlying claim in the lawsuit or the basis for the settlement. Jake has a duty to request additional information. Given the complexity and importance of the transaction and the time frame involved he may conclude that it is better to email or call Samantha.

In this case, Samantha has a specific question about inclusion of income. Jake's sample text and follow-up email responses could include the following:

TO: SAMANTHA TIMMONS (406) 862-5555

Hi Samantha. This is a complicated issue and I need more information before I can respond. I will send you an email, and then let's plan to discuss this further. FYI, the 2020 tax filing deadline is extended to May 17, so we have time to figure this out.

TO: SAMANTHA.T53@HMAIL.COM

Samantha, you asked whether you have to include a settlement from your employer in your income. In some cases, a settlement that is received on account of physical injury is not included in income. However, we must consider what claims you raised in court and for what reason the settlement was paid. For example, if your lawsuit only alleged that you were wrongfully fired, and the lawsuit was paid to compensate you for that wrongful firing, you likely have to include the settlement proceeds in income. Please send me a copy of the court documents and also a copy of the settlement agreement. I will do some research, and then schedule a time for us to meet and discuss the specific requirements for excluding a settlement from income.

Disclaimer. Any tax advice in this email reflects our professional judgment based on our understanding of the facts provided to us and on current tax law. Tax law is subject to change. Subsequent changes in the facts provided to us, in the law, or its interpretation may affect this advice. We are not responsible for updating our advice for subsequent changes in the law or its interpretation.

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Case Study 9 Response

Donna and Henry have asked their personal and business accountant, Jeff Alvarado, to continue to provide tax advice and return preparation services following Donna and Henry's divorce. The company is an LLC, and after the divorce, all income and expenses will be reported on Donna and Henry's individual income tax returns.

1. Jeff may have a conflict of interest if there is a significant risk that representation of one client will either be directly adverse to the other client or will be materially limited by Jeff's responsibilities to the other client. For example, the company may have more than one trade or business for purposes of the I.R.C. § 199A qualified business income (QBI) deduction. The veterinary business is a specified service trade or business (SSTB). However, the grooming and supplement businesses may be separate trades or businesses that are not SSTBs [Treas. Reg. § 1.199A-5(c)(1)(iii)(B), Example 2]. If Jeff's duties to provide competent and diligent representation to both the company and its owners affects his ability to objectively determine the compensation structure and allocations of income and expenses (including W-2 wages) among the trades or businesses, the representation involves a conflict of interest.
2. If there is a conflict of interest, Jeff may represent both the company and its members only if Jeff reasonably believes that he will be able to provide competent and diligent representation to each affected client; the law does not prohibit the representation; and each affected client waives the conflict of interest and gives informed consent, confirmed in writing by each affected client, at the time the existence of the conflict of interest is known by the practitioner [Circular 230 § 10.29].

   The clients must give the written confirmation within a reasonable period of time after the informed consent, but not later than 30 days. Jeff must retain copies of the written consents for at least 36 months from the date of the conclusion of the representation of the affected clients, and he must provide the written consents to any officer or employee of the IRS on request.

   Although there may be a potential conflict of interest, if Jeff reasonably believe that he will be able to provide competent and diligent representation to Donna, Henry, and the business he should have all the parties waive the conflict of interest and give informed consent, confirmed in writing, prior to the representation. The waiver should

   - make all parties aware that Jeff represents both the LLC and its members,
   - clearly describe the potential for a conflict of interest (how the allocations of income and expenses and the compensation structure will affect the QBI items that will be used to calculate the QBI deduction on their individual income tax returns), and
   - state that if an actual conflict arises, Jeff may have to withdraw his representation.

   Jeff should ask both Donna and Henry to sign the waiver individually and on behalf of the company. He should also recommend, in writing, that they have their individual attorneys review the waiver prior to signing.

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Case Study 10 Response

Raymond's firm has received a phishing email that solicits the recipient's name and EFIN, which can then be used by cyberthieves to impersonate the tax professional and file fraudulent returns.

1. Raymond should save the email as a file and then send it as an attachment to phishing@irs.gov. He should notify the Treasury Inspector General for Tax Administration at www.tigta.gov to report the IRS impersonation scam and immediately warn his employees about the scam. He should have the IT professional update the firm's security software and scan for viruses. If any of Raymond's employees fell for the scam, he will need to take additional action.
2. As the person with principal authority and responsibility for overseeing the firm's practice, Raymond has a duty to take reasonable steps to ensure that the firm has adequate procedures to ensure that all members, associates, and employees comply with Circular 230 [Circular 230 § 10.36]. To safeguard client information, and personal information that can be used to perpetuate fraud, Raymond should adopt an information security program. The security program should include ways to protect sensitive personal information and employees should be well trained on their duties under the program. The program should include a requirement that employees working from home have security software that automatically updates, and training on how to recognize and avoid phishing scams.

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TRUSTS AND ESTATES

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LEARNING OBJECTIVES

After completing this session, participants will be able to do the following:

- ✔ Calculate the gross estate
- ✔ Understand when an estate should consider electing portability of the deceased spousal unused exclusion (DSUE)
- ✔ Determine the amount of the DSUE
- ✔ Know who has authority to obtain information and file returns for a deceased taxpayer
- ✔ Recognize income in respect of a decedent and know how it is taxed
- ✔ Identify a grantor trust
- ✔ Know what deductions are available to an estate or trust
- ✔ Recognize deductions for a beneficiary of a terminated estate or trust
- ✔ Know when an estate must file an estate tax return

INTRODUCTION

The basic estate exclusion amount in 2021 is $11,700,000, and any unused exclusion amount is portable between spouses. This chapter first discusses how to calculate the gross estate. It then reviews how the value of the gross estate is used to determine whether to make the portability election, and how the election is made.

This chapter explains who is authorized to file returns and obtain information for a deceased taxpayer. It also discusses income in respect of a decedent, and how that income is taxed.

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This chapter reviews language that makes a trust a grantor trust and deductions that are available to a trust (including final regulations that provide guidance on determining the character, amount, and allocation of deductions in excess of gross income succeeded to by a beneficiary on the termination of an estate or nongrantor trust).

Finally, this chapter explains when an estate must file an estate tax return.

THE GROSS ESTATE This section explains what is included in the gross estate.

Tax practitioners may need to calculate the value of the gross estate to determine whether the taxpayer should engage in planning to reduce or eliminate estate tax, to evaluate whether an estate should elect portability, and to determine when an estate must file a tax return. This section provides an overview of how the estate tax is calculated and describes what is included in the gross estate.

PRACTITIONER NOTE

Applicable Credit

The applicable credit amount (formerly called the unified credit amount) is the allowable credit against estate and gift taxes. The credit is first applied against the gift tax, as taxable gifts are made. To the extent that any credit remains at death, it is applied against the estate tax.

Estate Tax Overview

I.R.C. § 2001(a) imposes a tax on the estates of all decedents who were citizens or residents of the United States at the date of death. The tax is generally calculated by applying the I.R.C. § 2001(c) rate schedule in effect at the time of the decedent's death to the decedent's cumulative taxable gifts and taxable estate. The estate tax is reported on Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return (discussed later).

The decedent's taxable estate is the gross estate less certain deductions. The estate tax due is determined after applying a credit based on an applicable exclusion amount, which is generally the sum of the basic exclusion amount and any deceased spousal unused exclusion (DSUE) (discussed later).

The 2021 basic exclusion amount is $11,700,000 per individual ($23,400,000 for a married couple). In 2026, the basic exclusion amount is scheduled to revert to $5,000,000 ($10,000,000 for a married couple) as adjusted for inflation. **Figure 2.1** shows the basic exclusion amounts since 2011.

FIGURE 2.1
Basic Exclusion Amounts

Year of Death	Exclusion Amount
2011	$5,000,000
2012	$5,120,000
2013	$5,250,000
2014	$5,340,000
2015	$5,430,000
2016	$5,450,000
2017	$5,490,000
2018	$11,180,000
2019	$11,400,000
2020	$11,580,000
2021	$11,700,000

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Example 2.1
Taxpayer Subject to Estate Tax

Evan Lee was unmarried. Evan died in 2021 and left his entire estate to his niece, Amy. His estate was valued at $17,000,000. He had not made any taxable gifts during his lifetime. Evan's estate will owe approximately $2,120,000 [($17,000,000 − $11,700,000 exclusion amount) × 40%] in estate tax.

Calculation of the Gross Estate

The gross estate includes the value at the time of death of all property, real or personal, tangible or intangible, wherever situated [I.R.C. § 2035]. Treas. Reg. § 20.2031-1 defines the gross estate of a decedent who was a citizen or resident of the United States at the time of his or her death as the total value of the interests described in I.R.C. §§ 2033 through 2044.

CROSS-REFERENCE

Estate Planning

A taxpayer whose gross estate exceeds (or is likely to exceed) the 2026 reduced exclusion amount should consider planning to take advantage of the 2020–2025 increased exclusion amount. See pages 411–415 in the *2020 National Income Tax Workbook* for a discussion of planning for use of the increased basic exclusion amount.

Property in Which the Decedent Had an Interest

I.R.C. § 2033 includes in the gross estate all property in which the decedent had an interest at the time of his or her death. Treas. Reg. § 20.2033-1(b) provides the following miscellaneous examples of property that is included in the gross estate:

- A cemetery lot owned by the decedent, but its value is limited to the value of that part of the lot that can be sold and that is not designed for the interment of the decedent and the members of his or her family
- Property subject to homestead or other exemptions under local law
- Notes or other claims held by the decedent, even though they are cancelled by the decedent's will
- Interest and rents accrued at the date of the decedent's death
- Uncollected dividends that are payable to the decedent or his or her estate because on or before the date of the decedent's death he or she was a stockholder of record

CROSS-REFERENCE

Special Use Valuation

Pursuant to I.R.C. § 2032A, an executor of an estate may be able to elect to value certain farm and closely held business real property at its farm or business use value rather than its FMV. There is a limitation on the amount of the election. See pages 249–251 in the *2020 National Income Tax Workbook* for a discussion of special use valuation.

Dower or Curtesy Interests

I.R.C. § 2034 includes in the gross estate the surviving spouse's dower or curtesy interests. These interests are a surviving spouse's right to receive a share of the deceased spouse's estate under state law. They are commonly referred to as an elective share. The following is an example of a portion of a state's elective share law:

> The surviving spouse of a decedent who dies domiciled in this state has a right of election, under the limitations and conditions stated in this part, to take an elective-share amount equal to 50% of the value of the marital-property portion of the augmented estate. [M.C.A. § 72-2-232(a)]

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Gifts Made within 3 Years of Death

Under I.R.C. § 2035, property is included in the gross estate if

1. the decedent made a transfer (by trust or otherwise) of an interest in any property, or relinquished a power with respect to any property, during the 3-year period ending on the date of the decedent's death; and
2. the value of such property (or an interest in the property) would have been included in the decedent's gross estate under I.R.C. § 2036, 2037, 2038, or 2042 if the decedent had retained such transferred interest or relinquished power on the date of his or her death.

Property is not included if it is sold in a bona fide sale for adequate and full consideration in money or money's worth. The amount of the gross estate is increased by the amount of any gift tax paid by the decedent or his or her estate on any gift made by the decedent or his or her spouse during the 3-year period ending on the date of the decedent's death [I.R.C. § 2035(b)]. For purposes of sections 2035 and 2038, any transfer from a revocable trust is treated as a transfer made directly by the decedent.

Transfers with Retained Life Estate

I.R.C. § 2036 includes transfers with a retained life estate unless the transfer is a bona fide sale for adequate and full consideration in money or money's worth. The retained interest must be retained for life, for any period not ascertainable without reference to the transferor's death, or for any period that does not end before the transferor's death. It includes a retained right to the possession or enjoyment of, or the right to the income from, the property, or the right, either alone or with any person, to designate the persons who possess or enjoy the property or the income from the property.

The retention of the right to vote (directly or indirectly) shares of stock of a controlled corporation is the retention of the enjoyment of transferred property. A *controlled corporation* is a corporation in which the decedent owned or had the right to vote stock with at least 20% of the total combined voting power of all classes of stock. I.R.C. § 318 constructive ownership rules apply.

Example 2.2
Life Estate

John Kenyon created an irrevocable trust and transferred three rental properties to the trust. The trust states that it must distribute all income to John during his lifetime. Upon John's death, the remaining trust assets must be distributed to John's three children. John has retained the right to income from the property for his lifetime, and the rental properties are included in his gross estate under section 2036.

Example 2.3
Period Not Ascertainable without Reference to Death

Juanita Gomez transferred investment assets to an irrevocable trust for the benefit of her niece. Juanita reserved the right to receive the income from transferred property in quarterly payments. The trust provides that no part of the income between the last quarterly payment and the date of Juanita's death may be distributed to Juanita or her estate. The retained right to income is not ascertainable without reference to Juanita's death, and the investment assets are included in her gross estate under section 2036 [Treas. Reg. § 20.2036-1(b)(1)(i)].

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PRACTITIONER NOTE

Discharge of Legal Obligation

A decedent is deemed to have retained or reserved the use, possession, right to the income, or other enjoyment of the transferred property to the extent that the use, possession, right to the income, or other enjoyment is to be applied toward the discharge of a legal obligation of the decedent. The term *legal obligation* includes a legal obligation to support a dependent during the decedent's lifetime.

Example 2.4
Retained Right Did Not End before Death

Dmitri Ivanov transferred his personal residence to his daughter Anna. Dmitri retained the right to use the residence for 10 years. Dmitri died 7 years after the transfer. The FMV of the personal residence is included in Dmitri's gross estate under section 2036(a)(1) because he retained the right to use the residence for a period that did not end before his death [Treas. Reg. § 20.2036-1(c)(1)(ii), Example 2].

Transfers Taking Effect at Death

I.R.C. § 2037 states that the gross estate includes the value of all the decedent's property that he or she transferred (except for a bona fide sale for adequate and full consideration in money or money's worth), if

1. possession or enjoyment of the property can, through ownership of such interest, be obtained only by surviving the decedent;
2. the decedent retained a reversionary interest in the property; and
3. the value of the reversionary interest immediately before the decedent's death is more than 5% of the value of the property.

The term *reversionary interest* includes a possibility that property transferred by the decedent may return to the decedent or his or her estate, or may be subject to a power of disposition by the decedent. It does not include a possibility that the income alone from such property may return to the decedent or become subject to a power of disposition by him or her (but see the earlier discussion of retained rights under section 2036). A reversionary interest does not include the possibility that the decedent during his or her lifetime might have received back an interest in transferred property by inheritance through the estate of another person, or a statutory right of a spouse to receive a portion of the decedent's estate [Treas. Reg. § 20.2037-1(c)(2)].

Example 2.5
No Reversionary Interest

Margaret O'Leary transferred property in trust with the income payable to her husband, Connor, for life and, at Connor's death, the remainder is to be distributed to Margaret's surviving children. If Margaret does not have surviving children at the time of Connor's death, the remainder of the trust is to be distributed to Margaret or her estate. Because Connor and Margaret's children can possess or enjoy the property without surviving Margaret, no part of the property is includable in Margaret's gross estate under section 2037. However, the value of the reversionary interest may be included in her gross estate under section 2033 [Treas. Reg. § 20.2037-1(e), Example 1].

Example 2.6
Reversionary Interest

Jack Hollings transferred property in trust with the income payable to his wife, Alicia, for life and with the remainder payable to Jack or, if he is not living at Alicia's death, to his daughter, Melissa, or her estate. Melissa cannot obtain possession or enjoyment of the property without surviving Jack. Therefore, if Jack's reversionary interest immediately before his death exceeded 5% of the value of the property, the value of the property less the value of Alicia's life estate is includable in Jack's gross estate [Treas. Reg. § 20.2037-1(e), Example 3].

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Revocable Transfers

The gross estate includes the value of all property transferred after June 22, 1936, if the transferor retains the power to change the enjoyment of the property by altering, amending, revoking, or terminating the transfer. It also includes property over which such power is relinquished during the 3-year-period ending on the date of the decedent's death [I.R.C. § 2038].

Under Treas. Reg. § 20.2038-1, section 2038 does not apply

1. to the extent that the transfer was for adequate and full consideration in money or money's worth;
2. if the decedent's power could be exercised only with the consent of all parties having an interest (vested or contingent) in the transferred property, and if the power adds nothing to the rights of the parties under local law; or
3. to a power held solely by a person other than the decedent.

If the decedent had the unrestricted power to remove or discharge a trustee at any time and appoint himself or herself as trustee, the decedent is considered as having the powers of the trustee. The following language retains the right to amend or revoke a trust:

> Grantor, during grantor's lifetime, reserves the right to amend or revoke the trust. Upon the death of grantor, the trust shall be irrevocable.

Annuities

Under I.R.C. § 2039, the gross estate includes the remaining value of an annuity or similar payment that was payable to the decedent for life, for any period that is determined with reference to the decedent's death, or for any period that does not end before the decedent's death. The amount included in the gross estate is the proportionate part of the purchase price contributed by the decedent and certain amounts contributed by the decedent's employer or former employer.

Joint Interests

Pursuant to I.R.C. § 2040, the gross estate includes the value of property that is held as joint tenants with right of survivorship by the decedent and any other person, or as tenants by the entirety by the decedent and spouse. It also includes jointly owned bank accounts. Generally, the included value is the full value of the property or account unless the joint owner furnished consideration. However, if the interest was acquired by gift, devise, bequest, or inheritance, only the decedent's fractional interest is included.

Only 50% of a qualified joint interest is included. A *qualified joint interest* is an interest in property held solely by the decedent and the decedent's spouse as tenants by the entirety or joint tenants with right of survivorship. Section 2040 does not apply to property held as tenants in common.

Example 2.7
Joint Owners

Frank and Freida Willis are brother and sister. In 2020, they purchased a rental property in Montana. The deed to the property contains the language in **Figure 2.2**.

FIGURE 2.2
Frank and Freida's Deed

QUITCLAIM DEED	
GRANTOR(s):	JUDY A. HOLBRIGHT
Address:	P.O. Box 3333, Coram, MT, 59912
GRANTEE(s):	FRANK WILLIS and FREIDA WILLIS, as joint tenants with right of survivorship
Address:	P.O. Box 2222, Hungry Horse, MT 59919
LEGAL DESCRIPTION:	Lot 22 of Meadow Lake Country Club Estates Phase II, according to the map or plat thereof on file and of record in the office of the Clerk and Recorder of Flathead County, Montana

Frank died in 2021, and his interest passed to Freida by operation of law. Absent evidence that Freida had contributed any part of the purchase price of the property, the value of the entire property is included in Frank's gross estate. If Freida can demonstrate that she paid one-half of the

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purchase price, then only one-half of the value of the property is included in Frank's gross estate.

Powers of Appointment

The gross estate includes any property over which the decedent has, at the time of his or her death, a general power of appointment created after October 21, 1942. It also includes certain exercises or releases of a power of appointment [I.R.C. § 2041]. The power to consume or appropriate is a power of appointment. Similarly, a power given to a decedent to affect the beneficial enjoyment of trust property or its income by altering, amending, or revoking the trust instrument or terminating the trust is a power of appointment.

A general power of appointment is a power of appointment that is exercisable in favor of the decedent, his or her estate, his or her creditors, or the creditors of his or her estate. The following is an example of a general power of appointment:

> If my wife survives me, my wife shall have a power of appointment, exercisable by her Last Will and Testament, to direct distribution of the remaining trust assets to her estate. If my wife fails to exercise this power of appointment, the trustee shall distribute the remaining trust assets in equal shares to my children.

A power to consume, invade, or appropriate property for the benefit of the decedent that is limited by an ascertainable standard relating to the health, education, support, or maintenance of the decedent is not a general power of appointment.

PRACTITIONER NOTE

Ascertainable Standard

A power to use property for the comfort, welfare, or happiness of the holder of the power is not limited by an ascertainable standard. Examples of powers that are limited by an ascertainable standard are powers exercisable for the holder's support; support in reasonable comfort; maintenance in health and reasonable comfort; support in his accustomed manner of living; education, including college and professional education; health; and medical, dental, hospital and nursing expenses and expenses of invalidism [Treas. Reg. § 20.2041-1].

If a power of appointment was created after October 21, 1942, and is exercisable only by the decedent with the consent of the person who created the power or certain adverse parties, then the power is not a general power of appointment.

Practitioner Note

Lapse of Power of Appointment

The lapse of a power of appointment created after October 21, 1942, during the life of the individual possessing the power, is considered a release of the power to the extent that the value is the greater of $5,000 or 5% percent of the aggregate value at the time of the lapse. A Crummey withdrawal right is a general power of appointment and nonexercise of that withdrawal right is a lapse of that general power of appointment. To the extent that it exceeds the greater of $5,000 or 5% of the value of the trust, the lapsed power could be included in the beneficiary's gross estate. Treas. Reg. § 20.2041-3(d) specifies when releases and lapses of a power of appointment are included in the gross estate.

Life Insurance Proceeds

Life insurance proceeds paid to the estate (or for the benefit of the estate) or beneficiaries under policies on the life of the decedent are included in the gross estate if the decedent had any incidents of ownership [I.R.C. § 2042]. *Incidents of ownership* are not limited to ownership of the policy and generally include the right of the insured or his or her estate to the economic benefits of the policy. Thus, incidents of ownership include the powers to do the following:

- Change the beneficiary
- Surrender or cancel the policy
- Assign the policy
- Revoke an assignment
- Pledge the policy for a loan
- Obtain from the insurer a loan against the surrender value of the policy

[Treas. Reg. § 20.2042-1(c)(2)]

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The term *incidents of ownership* also includes a reversionary interest in the policy or its proceeds if the value of the reversionary interest immediately before the death of the decedent exceeded 5% of the value of the policy. The term *reversionary interest* includes a possibility that the policy or its proceeds may return to the decedent or his or her estate and also a possibility that the policy or its proceeds may become subject to a power of disposition by the decedent.

Transfers for Insufficient Consideration

In general, the transfers, trusts, interests, rights, or powers described in sections 2035 to 2038 and section 2041 are not subject to federal estate tax if they are made, created, exercised, or relinquished in a bona fide sale for adequate and full consideration in money or money's worth. The transfer must have been made in good faith, and the price must have been an adequate and full equivalent reducible to a money value. If the price was less than full consideration, only the excess of the FMV of the property over the price received by the decedent is included in the gross estate [I.R.C. § 2043]. A release of marital rights in the decedent's property or marital rights in the estate is not consideration.

Marital Deduction Property

Under I.R.C. § 2044, the gross estate includes certain property in which the decedent had a qualifying income interest for life and for which the transferor received a deduction under I.R.C. § 2056(b)(7) (estate tax marital deduction for qualified terminable interest property) or I.R.C. § 2523(f) (gift tax marital deduction for qualified terminable interest property).

PRACTITIONER NOTE

Basis

For purposes of determining the basis of property acquired from a decedent under I.R.C. § 1014, property included in a decedent's gross estate under section 2044 is considered to have been acquired from or to have passed from the decedent to the person receiving the property upon the decedent's death.

Example 2.8
Inclusion of Trust Subject to Election

Under Madison Becker's will, assets valued at $800,000 passed to a trust for her husband, Sam. The trust directs payment of all income to Sam each year, and upon Sam's death, the trust principal is to be distributed to Madison's children. Madison's executor elected under section 2056(b)(7) to treat the entire trust property as qualified terminable interest property and claimed an $800,000 marital deduction. At Sam's death, the FMV of the trust property is $740,000, and this amount is included in Sam's gross estate [Treas. Reg. § 20.2044-1(e), Example 1].

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ELECTING PORTABILITY An estate can elect portability of the deceased spousal unused exclusion.

A surviving spouse can add the unused exclusion amount of the deceased spouse to the basic exclusion amount of the surviving spouse. This section explains when to elect portability of the deceased spousal unused exclusion (DSUE), and how to make that election or opt out.

Whether to Make the Portability Election

Generally, if the combined gross estates of a married couple are below the basic exclusion amount, the portability election may not be necessary. If the couple's combined gross estates are more than the basic exclusion amount but less than twice the basic exclusion amount, the portability election may be advantageous. If the combined gross estates exceed twice the basic exclusion amount, then typically planning with A-B or A-B-C trusts is preferable to electing portability.

Combined Estate below Basic Exclusion Amount

If the combined assets of a married couple are well below the basic exclusion amount, it may not be necessary to elect portability. Regardless, the value of the clients' gross estate and/or the amount of the basic exclusion amount may change in the future. Thus, it is advisable for the tax practitioner to discuss making the election, even if it does not currently seem necessary, and to document the decision to not make the election.

Example 2.9
No Portability Election

Sara and Sebastian Rivers had a combined gross estate valued at $3,000,000. They made no taxable gifts. Sebastian died in 2021. He devised his 50% interest in their estate to Sara. The unlimited marital deduction applied, and no estate tax was owed. Sebastian's estate, acting on the advice of its accountant, Jerome Jensen, did not elect portability. Sara dies in 2026 when the basic exclusion amount is $6,000,000 (estimated). The value of her gross estate is $3,500,000, and no estate tax is owed.

Example 2.10
Tax Practitioner Advice

Jerome, from Example 2.9, advised Sebastian's estate to not make the portability election. His advice was correct given the value of Sara and Sebastian's estate at that time. However, the value of Sara's gross estate could increase in the future, and changes in legislation could reduce the basic exclusion amount. Thus, it is advisable for Jerome to discuss making the election, even if it does not currently seem necessary, and to document the decision to not make the election. **Figure 2.3** is a sample letter from Jerome confirming that he discussed the portability election.

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FIGURE 2.3
Sample Letter to Executor

Dear Mrs. Rivers,

Please allow me to express my sympathy for your recent loss. It is always difficult to lose a loved one and settling an estate can be time-consuming and stressful. Recently we discussed the election for portability of the deceased spousal unused exclusion (DSUE) amount. I am writing this letter to summarize that discussion, and the basis for your decision to not elect portability of your husband's DSUE.

Each US person has a basic exclusion from estate and gift tax. For taxpayers dying in 2021, that exclusion is $11,700,000. Absent any changes in the law, that amount will be reduced to approximately $6,000,000 for taxpayers dying in 2026. The DSUE election makes the exclusion portable between spouses, which means that the unused exclusion of the first deceased spouse is added to the exclusion of the surviving spouse.

Unless the estate opts out, the portability election is made automatically by timely filing a complete and properly prepared estate tax return (Form 706). The filing can be made only by an authorized person. In this case, you are the person authorized to file Form 706 because you have been appointed as executor of the estate. If the estate is filing Form 706 solely to elect portability, the deadline for filing can be up to 2 years after the date of death.

For spouses whose assets may exceed the basic exclusion amount, electing DSUE portability can be advantageous. Take, for example, spouses with a combined estate of $8,000,000. The husband died in 2021 and devised the entire estate outright to his wife. The husband's estate did not elect portability. The wife dies in 2026. Her estate has an estimated $6,000,000 exclusion and must pay estate tax on $2,000,000 ($8,000,000 − $6,000,000). If instead the husband's estate had elected portability, the husband's $11,700,000 DSUE (based on the 2021 exclusion amount) would have been carried over to the wife's estate, and the wife's $17,700,000 ($11,700,000 + $6,000,000) exclusion would have more than offset the $8,000,000 estate. The wife's estate would have owed no estate tax.

For a surviving spouse whose assets do not currently exceed the basic exclusion amount, electing portability may still be advantageous because the size of your estate may increase in the future. Also, while the basic exclusion amount is permanently indexed for inflation, subsequent tax legislation could reduce the amount of the exclusion. However, you must weigh the possible benefits of electing portability against the time and expense to make the election. A complete and properly prepared estate tax return must include an accurate calculation of the DSUE amount, which may necessitate obtaining costly appraisals of estate assets.

As we discussed, the likelihood that your estate could exceed the basic exclusion amount is small, and the cost to elect portability is high. Accordingly, you have decided to not make the election. Please let me know immediately if you have any additional questions about the portability election or if any information in this letter does not accurately reflect our discussion. Thank you.

Sincerely,
Jerome Jensen, CPA

Note: This sample letter is provided for general educational purposes. The terms of such a letter are very fact-specific, and laws in taxing jurisdictions vary. For these reasons, the sample letter is not applicable in all circumstances.

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Combined Estate below Two Times the Basic Exclusion Amount

If the value of the combined estates of a married couple are anticipated to be between the basic exclusion amount ($11,700,000 for 2021) and twice the basic exclusion amount ($23,400,000 for 2021), it may be advantageous to elect portability. Portability allows the predeceased spouse to make an outright bequest to the surviving spouse. The surviving spouse receives the assets of the predeceased spouse and has the DSUE to ensure that those assets are not taxed in the estate of the surviving spouse. When the surviving spouse dies, appreciated assets receive a step-up in basis.

Example 2.11
Electing Portability Eliminates Estate Tax

Amy and Evan Lee are married taxpayers with two adult children, Cole and Alex. Their combined gross estate is $7,000,000. They made no taxable gifts. Evan died in 2016 and left his entire estate to Amy. Evan's estate elected portability of his $5,450,000 DSUE. If Amy dies in 2026, when the basic exclusion amount is $6,000,000 (estimated) and her gross estate is $8,000,000, Amy's estate will have an $11,450,000 ($6,000,000 + $5,450,000 DSUE) applicable exclusion amount and will owe no estate tax. If Evan's estate had not made the election, Amy's estate would have a $6,000,000 (estimated) basic exclusion amount, and would owe estate tax on approximately $2,000,000 ($8,000,000 − $6,000,000).

Combined Estate above Two Times the Basic Exclusion Amount

Portability allows the surviving spouse to use the DSUE of the deceased spouse and allows the heirs of the surviving spouse to receive a step-up in the basis of appreciated estate assets. However, with portability, the appreciation on the deceased spouse's assets is included in the estate of the surviving spouse. Thus, for estates that do or could exceed the combined basic exclusion amount, it may still be advisable to distribute the predeceased spouse's assets to a credit shelter trust instead of electing portability. Any appreciation on the assets in the credit shelter trust are not included in the estate of the surviving spouse.

CROSS-REFERENCE

Credit Shelter Trust Planning

See the "Death of the Taxpayer" chapter in the *2016 National Income Tax Workbook* for a discussion of estate planning with a credit shelter trust, and examples comparing an estate that elected portability with an estate that funded a credit shelter trust.

Example 2.12
Estate Planning with an A-B Trust and No Portability

Shawn and Shannon Jackson had a combined estate of $12,000,000 divided equally between them. In 2017, Shawn died, leaving $5,490,000 (the basic exclusion amount) to a credit shelter trust for his wife, Shannon. Shannon dies in 2026, leaving her $6,000,000 estate to the couple's children. The value of the credit shelter trust has increased to $6,300,000 but is not included in Shannon's estate. Thus, Shawn's $5,490,000 exclusion shelters $6,300,000, which does not receive a step-up in basis. If instead Shawn's estate had elected portability, Shannon's estate would have a $5,490,000 DSUE, but her estate would include the full value of the appreciated assets.

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PRACTITIONER NOTE

Nontax Use of Trusts

There may be nontax reasons to distribute assets to a trust for the surviving spouse, rather than electing portability and making an outright distribution. Those reasons could include protection for an ill or vulnerable spouse, ensuring that assets of the predeceased spouse are ultimately distributed to designated heirs, or protection from creditors' claims.

How to Make the Portability Election

To make a portability election, the executor must file a complete and properly prepared Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return [I.R.C. § 2010(c)(5)(A)]. Filing a complete and properly prepared return automatically elects portability, unless the executor chooses to opt out.

Who Can File the Election

Only the executor of the estate can make an election for the surviving spouse to take the DSUE amount [I.R.C. § 2010(c)(5)(A)]. However, I.R.C. § 2203 defines an *executor* as the executor or administrator of the decedent, or, if there is no executor or administrator appointed, qualified, and acting within the United States, then any person in actual or constructive possession of any property of the decedent.

PRACTITIONER NOTE

Non-US Spouse

In general, under I.R.C. § 2056(d)(1), there is no marital deduction for a surviving spouse who is not a US citizen. There is an exception for property held in a qualified domestic trust (QDOT) [I.R.C. § 2056(d)(2)]. There is also an exception for a surviving spouse who becomes a US citizen if the surviving spouse becomes a citizen before the day on which the tax is imposed, and the surviving spouse was a resident of the United States at all times after the death of the deceased spouse and until becoming a citizen [I.R.C. § 2056(d)(4)]. Pursuant to Treas. Reg. § 20.2010-3(c)(2), when a surviving spouse becomes a citizen after the death of the surviving spouse's last deceased spouse, the DSUE amount becomes available to him or her on the date that the surviving spouse becomes a citizen. Special rules apply if the property is held in a QDOT. The estate of a nonresident surviving spouse who is not a citizen of the United States at the time of the surviving spouse's death cannot use the DSUE amount of any deceased spouse of such surviving spouse, except to the extent allowed under an applicable tax treaty [Treas. Reg. § 20.2010-3(e)].

Timely Filed Election

Under Treas. Reg. § 20.2010-2(a)(1), the due date of an estate tax return to elect portability is 9 months after the decedent's date of death or the last day of the period covered by an extension (if the estate has obtained a 6-month extension of time for filing). The IRS will not grant an additional extension of time to elect portability under Treas. Reg. § 301.9100-3 (discussed next) to any estate that is required to file an estate tax return because the value of the gross estate exceeds the threshold amount described in I.R.C. § 6018.

Simplified Procedure

Rev. Proc. 2017-34, 2017-26 I.R.B. 1282, provides a simplified method to obtain an extension under section 301.9100-3. The simplified method is available to the executor (either an appointed executor or a nonappointed executor of a decedent's estate) if the following apply:

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1. The decedent was survived by a spouse, died after December 31, 2010, and was a citizen or resident of the United States on the date of death.
2. The executor is not required to file an estate tax return under section 6018(a), as determined based on the value of the gross estate and adjusted taxable gifts and without regard to the need to file for portability purposes.
3. The executor did not file an estate tax return within the time required by Treas. Reg. § 20.2010-2(a)(1) for filing an estate tax return.
4. The executor satisfies all other requirements of Rev. Proc. 2017-34.

The executor must file a complete and properly prepared Form 706 on or before the second anniversary of the decedent's death. An executor wishing to elect portability under this extension must state at the top of the Form 706 that the return is "Filed Pursuant to Rev. Proc. 2017-34 to Elect Portability under § 2010(c)(5)(A)."

Letter Ruling

If the estate is filing an estate tax return only to elect portability and did not file timely or within the extension provided in Rev. Proc. 2017-34, the estate can request an extension by requesting a letter ruling under Treas. Reg. § 301.9100-3 (regulatory extensions) [Treas. Reg. § 20.2010-2(a)(1)]. For the IRS to use its discretion to grant an extension under Treas. Reg. § 301.9100-3, the taxpayer must have acted reasonably and in good faith in failing to timely make the election. A taxpayer is deemed to have acted reasonably and in good faith if the taxpayer

1. requested relief before the IRS discovered the failure to make the regulatory election;
2. failed to make the election because of intervening events beyond the taxpayer's control;
3. failed to make the election because, after exercising reasonable diligence (considering the taxpayer's experience and the complexity of the return or issue), the taxpayer was unaware of the necessity for the election;
4. reasonably relied on the written advice of the IRS; or
5. reasonably relied on a qualified tax professional, including a tax professional employed by the taxpayer, and the tax professional failed to make, or advise the taxpayer to make, the election.

[Treas. Reg. § 301.9100-3(b)(1)]

A taxpayer is deemed to have not acted reasonably and in good faith if

1. the taxpayer sought to alter a return position for which an accuracy-related penalty has been or could be imposed under I.R.C. § 6662 at the time the taxpayer requested relief [considering any qualified amended return filed within the meaning of Treas. Reg. § 1.6664-2(c)(3)], and the new position requires or permits a regulatory election for which relief is requested;
2. the taxpayer was informed in all material respects of the required election and related tax consequences, but chose not to file the election; or
3. specific facts have changed since the due date for making the election that make the election advantageous to a taxpayer, and the taxpayer's decision to seek relief involves hindsight.

[Treas. Reg. § 301.9100-3(b)(3)]

Complete and Properly Prepared Estate Tax Return

To make the portability election, the estate tax return must be complete and properly prepared [Treas. Reg. § 20.2010-2(a)(7)(i)]. A complete and properly prepared return is a return that is prepared in accordance with the instructions for Form 706. The requirements of Treas. Reg. §§ 20.6018-2, 20.6018-3, and 20.6018-4 must be satisfied. Thus, a qualified person must file the return (discussed earlier). The return must contain certain information about the assets of the gross estate and claimed deductions, must include a certified copy of the will and certain other documents, and must calculate the DSUE amount.

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Reporting of Value Not Required

If filing a return is not required under I.R.C. § 6018(a), then the estate tax return does not have to report the specific value of the following:

- Marital deduction property under either I.R.C. § 2056 or 2056A (qualified domestic trust)
- Charitable deduction property under I.R.C. § 2055(a)

[Treas. Reg. § 20.2010-2(a)(7)(ii)]

The return must still report the description, ownership, and/or beneficiary of such property, and all other information necessary to establish the right of the estate to the deduction. The exception to reporting value does not apply in certain circumstances, and it applies only if the executor exercises due diligence in estimating the total value of the gross estate, including the marital deduction and charitable deduction property.

If the exception applies, the estate tax return does not have to report the individual valuations for marital and charitable deduction property. However, the executor must give his or her best estimate of the value of these properties and must report on the estate tax return, under penalties of perjury, the range within which the value of the total gross estate falls.

PLANNING POINTER

Statute of Limitations for Valuation

Under I.R.C. § 6501(a), the IRS has 3 years after the date of filing to assess and bring an action to collect additional taxes. There are exceptions for false returns, willful evasion, failure to file, and extension by agreement [I.R.C.§ 6501(c)]. Estate and gift tax returns that omit items that exceed 25% of the value of the gross estate are subject to a 6-year statute of limitations. The executor filing Form 706 solely to elect portability does not have to report valuations for I.R.C.§§ 2056, 2056A, and 2055(a) property. However, reporting valuations on Form 706 starts the statute of limitations on valuation. This may be important for certain real and personal property, such as standing timber and works of art, which are inherently difficult to value.

Reporting the DSUE Amount

The executor of a decedent's estate must include a computation of the DSUE amount on the estate tax return. The DSUE amount is the lesser of

1. the basic exclusion amount, or
2. the applicable exclusion amount of the last deceased spouse reduced by the amount with respect to which the tentative tax on the estate of the deceased spouse is determined under I.R.C. § 2001(b)(1).

[I.R.C § 2010(c)(4)]

The DSUE amount is calculated in Part 6 Section C of Form 706. **Figure 2.4** shows Part 6 Section C.

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FIGURE 2.4
Form 706 Calculation of the DSUE Amount

Section C. DSUE Amount Portable to the Surviving Spouse (To be completed by the estate of a decedent making a portability election.)
Complete the following calculation to determine the DSUE amount that can be transferred to the surviving spouse.

1	Enter the amount from line 9d, Part 2—Tax Computation	**1**	
2	Reserved	**2**	
3	Enter the value of the cumulative lifetime gifts on which tax was paid or payable. See instructions	**3**	
4	Add lines 1 and 3	**4**	
5	Enter amount from line 10, Part 2—Tax Computation	**5**	
6	Divide amount on line 5 by 40% (0.40) (do not enter less than zero)	**6**	
7	Subtract line 6 from line 4	**7**	
8	Enter the amount from line 5, Part 2—Tax Computation	**8**	
9	Subtract line 8 from line 7 (do not enter less than zero)	**9**	
10	DSUE amount portable to surviving spouse (Enter lesser of line 9 or line 9a, Part 2—Tax Computation)	**10**	

Section D. DSUE Amount Received From Predeceased Spouse(s) (To be completed by the estate of a deceased surviving spouse with DSUE amount from predeceased spouse(s))
Provide the following information to determine the DSUE amount received from deceased spouses.

A Name of Deceased Spouse (dates of death after December 31, 2010, only)	**B** Date of Death (enter as mm/dd/yy)	**C** Portability Election Made? Yes	**C** No	**D** If "Yes," DSUE Amount Received From Spouse	**E** DSUE Amount Applied by Decedent to Lifetime Gifts	**F** Year of Form 709 Reporting Use of DSUE Amount Listed in col. E	**G** Remaining DSUE Amount, if any (subtract col. E from col. D)
Part 1 — DSUE RECEIVED FROM LAST DECEASED SPOUSE							
Part 2 — DSUE RECEIVED FROM OTHER PREDECEASED SPOUSE(S) AND USED BY DECEDENT							
Total (for all DSUE amounts from predeceased spouse(s) applied)							

Add the amount from Part 1, column D, and the total from Part 2, column E. Enter the result on line 9b, Part 2—Tax Computation ▶

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Last Deceased Spouse

The last deceased spouse is the most recently deceased individual who, at that individual's death after December 31, 2010, was married to the surviving spouse [Treas. Reg. § 20.2010-1(d)(5)]. A decedent is the last deceased spouse of a surviving spouse even if, on the date of the death of the surviving spouse, the surviving spouse is married to another (then-living) individual. If a surviving spouse marries again and that marriage ends in divorce or an annulment, the subsequent death of the divorced spouse does not end the status of the prior deceased spouse as the last deceased spouse of the surviving spouse. The divorced spouse, not being married to the surviving spouse at death, is not the last deceased spouse as that term is defined in Treas. Reg. § 20.2010-1(e)(5) [Treas. Reg. § 20.2010-3(a)(3)].

Ordering Rules

The DSUE amount must be applied before a decedent's own exclusion amount is applied. Similarly, when a taxable gift is made, the DSUE amount received from the last deceased spouse is applied before the surviving spouse's basic exclusion amount.

Example 2.13
Ordering of DSUE

Bart Edwards was married to Heather Edwards. Heather died in 2012. Bart served as her executor and elected to take the $3,000,000 DSUE amount. In 2014, Bart married Cindy Cole. Bart died in 2016 with a $5,000,000 taxable estate. Bart's estate first applied the $3,000,000 DSUE (from Heather), then Bart's $5,450,000 exclusion. Bart's estate elected portability for the $3,450,000 [($3,000,000 + $5,450,000) − $5,000,000] remaining DSUE to Cindy.

The DSUE amount from a prior deceased spouse is no longer available to the surviving spouse at the death of the most recent spouse. If the last deceased spouse of the surviving spouse had no DSUE amount, or if the executor of the decedent's estate did not make a portability election, the surviving spouse's estate has no DSUE amount (except as applied to lifetime taxable gifts) to include in determining the applicable exclusion amount [Treas. Reg. § 20.2010-3(a)(2)]. Treas. Reg. § 20.2010-3(b)(1)(ii) provides an exception to this rule where the surviving spouse applied the DSUE amount from a prior deceased spouse to offset lifetime taxable gifts.

Example 2.14
DSUE Used for Taxable Gifts

Hunter Hadley died in 2011, survived by his wife, Whitney. Neither made any taxable gifts during Hunter's lifetime. Hunter's executor elected portability of Hunter's $5,000,000 DSUE amount. In 2021, Whitney made $2,000,000 in taxable gifts to her children and reported the gifts on a timely filed gift tax return. Whitney applied $2,000,000 of Hunter's DSUE amount to the taxable gifts, and Whitney owed no gift tax. Whitney had $3,000,000 ($5,000,000 − $2,000,000) of Hunter's DSUE amount remaining.

Whitney marries Michael Hernandez in 2022. Michael dies in 2026, and his executor elects portability of Michael's $6,000,000 (estimated) DSUE amount. Whitney dies in 2027. The DSUE amount available to Whitney's estate is $8,000,000 (Michael's $6,000,000 DSUE amount + Hunter's $2,000,000 DSUE amount that was applied to Whitney's 2021 taxable gifts). The $8,000,000 DSUE amount is added to Whitney's $6,300,000 basic exclusion amount (estimated for 2027), and Whitney's applicable exclusion amount is $14,300,000 [Treas. Reg. § 20.2010-3(b)(2), Example].

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PRACTITIONER NOTE

Examining Deceased Spouse's Return

Treas. Reg. § 20.2010-3(d) gives the IRS the authority to examine returns of each of the surviving spouse's deceased spouses whose DSUE amount is included in the surviving spouse's applicable exclusion amount, regardless of whether the I.R.C. § 6501 period of limitations on assessment has expired for the return. However, if the period for assessment has expired, the audit is limited to a determination of the correct DSUE amount held by the decedent at death.

Opting Out

If the estate must file Form 706 because the value of the gross estate exceeds the basic exclusion amount, filing Form 706 will elect portability unless the executor checks the box in Part 6, Section A, to opt out. If no return is required, not filing Form 706 opts out of the portability election. **Figure 2.5** shows the opt-out election on Form 706.

FIGURE 2.5
Opting Out of Portability on Form 706

Form 706 (Rev. 8-2019)

Estate of:	Decedent's social security number

Part 6—Portability of Deceased Spousal Unused Exclusion (DSUE)

Portability Election

A decedent with a surviving spouse elects portability of the DSUE amount, if any, by completing and timely filing this return. No further action is required to elect portability of the DSUE amount to allow the surviving spouse to use the decedent's DSUE amount.

Section A. Opting Out of Portability

The estate of a decedent with a surviving spouse may opt out of electing portability of the DSUE amount. Check here and do not complete Sections B and C of Part 6 only if the estate opts **NOT** to elect portability of the DSUE amount. ☐

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DEATH OF A TAXPAYER This section explains who has authority to file returns and obtain information about a deceased taxpayer.

During his or her lifetime, a taxpayer can use a state law power of attorney, a third-party designation, or IRS Form 2848, Power of Attorney and Declaration of Representative, to grant another person certain legal authority to act on behalf of the taxpayer. However, powers of attorney and other grants of authority to act terminate when the taxpayer dies.

A court-appointed administrator, personal representative, or executor of the estate of the deceased taxpayer (the decedent) has authority to act on behalf of the decedent, but many times the decedent's assets pass automatically to his or her heirs (e.g., assets held in joint tenancy with right of survivorship, or accounts with payable on death or transfer on death beneficiary designations), and there is no court-appointed administrator or executor. This section reviews different grants of legal authority and who has legal authority to act on behalf of a decedent.

PRACTITIONER NOTE

Court-Appointed Representative

The title of a person who is appointed by a court to represent a decedent's estate varies from state to state and may also vary depending on the timing and other circumstances of the appointment. The court-appointed representative is often called an administrator, an executor, or a personal representative. For purposes of this discussion, the term *executor* is used for a court-appointed administrator, executor, or personal representative.

Powers of Attorney

A taxpayer can execute a power of attorney to appoint an attorney-in-fact or an agent to act for the taxpayer in financial, tax, and other matters. A general power of attorney is a power of attorney that terminates upon a physical or mental disability that renders the person that executed the power unable to manage his or her own affairs. A durable power of attorney remains valid even after the person who executed the power is unable to manage his or her own affairs. Powers of attorney, even those that are durable, terminate upon the death of the person who executed the power of attorney.

Form 2848, Power of Attorney and Declaration of Representative, is a power of attorney that allows another person to represent the taxpayer before the IRS. The representative appointed by Form 2848 has limited authority over matters specified in the Form 2848. That authority terminates upon the death of the taxpayer. However, the executor of a decedent's estate may appoint a different representative. The executor must file Form 2848 and attach Form 56, Notice Concerning Fiduciary Relationship, and a copy of the letters of administration, letters testamentary, or court order appointing the executor.

Third-Party Designee

A taxpayer can authorize the IRS to discuss a return with a friend, family member, or any other person if the taxpayer checks the "Yes" box in the third-party designee area of the tax return and provides the required information. The authorization allows the designee to

- give the IRS information missing from the taxpayer's return;
- call the IRS for information about the processing of the taxpayer's return, or the status of a refund or payment(s);

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- receive copies of notices or transcripts related to the return, upon request; and
- respond to certain IRS notices about math errors, offsets, and return preparation.

The designee cannot receive refund checks, bind the taxpayer to any agreements, or represent the taxpayer before the IRS. The authorization automatically terminates no later than the due date (without regard to extensions) for filing the subsequent tax year's return. The authorization also terminates upon the death of the taxpayer.

Executor

When the taxpayer dies, the executor of the decedent's estate has authority to act on behalf of the taxpayer.

PRACTITIONER NOTE

Probate

A deceased taxpayer's last will and testament may name an executor. The executor must file a court action for appointment (a probate) to have authority over the decedent's estate.

Upon appointment by the court, the executor automatically has both the right and the responsibility to undertake all actions the taxpayer is required to perform. For example, the executor must file returns and pay any taxes due on behalf of the taxpayer. The executor must sign the return. If it is a joint return, the surviving spouse must also sign the return. An executor of a taxpayer is deemed to be the taxpayer and is not required to file a power of attorney with the IRS. However, an executor must file Form 56, Notice Concerning Fiduciary Relationship, to notify the IRS of the fiduciary relationship.

PRACTITIONER NOTE

Digital Assets

Almost all states have adopted the Revised Uniform Fiduciary Access to Digital Assets Act, which gives fiduciaries (such as an executor, trustee, or agent under a power of attorney) the legal authority to manage digital assets (electronic records such as online bank accounts or social media accounts).

Request for Prompt Assessment

The IRS usually has 3 years from the later of the date an income tax return is filed or its due date to charge any additional income tax due. However, a personal representative can file a request to reduce the time for assessment to 18 months from the date the written request for prompt assessment was received. This request is made on Form 4810, Request for Prompt Assessment Under Internal Revenue Code Section 6501(d).

Request for Discharge from Personal Liability

An executor can make a request for discharge from personal liability for a decedent's income, gift, and estate taxes. The request must be made after those returns are filed, using Form 5495, Request for Discharge From Personal Liability Under Internal Revenue Code Section 2204 or 6905. Following discharge, the IRS may still assess tax deficiencies against the executor to the extent that he or she is in possession of the decedent's property.

No Fiduciary Appointed

If all the decedent's assets pass by operation of law, there may not be a need for a court-appointed executor. This section details who has authority to act on behalf of a decedent if there is no court-appointed executor.

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Signing a Return

If no executor has been appointed, the surviving spouse (on a joint return) must sign the return and write in the signature area "filing as surviving spouse." If no executor has been appointed and if there is no surviving spouse, the person in charge of the decedent's property must file and sign the return as "personal representative." If the return claims a refund, and it is not a joint return filed by a surviving spouse or an original return filed by the executor, the filer must also submit Form 1310, Statement of Person Claiming Refund Due a Deceased Taxpayer.

Requesting Information

The executor of an estate may receive the returns and return information of the deceased individual. Often, an estate is already settled at the time of the request for returns and return information, and the executor of the estate no longer has authority to act; or one was never appointed. Any heir at law, next of kin, beneficiary under the will, or donee (recipient) of property may request the returns and return information of a deceased individual. Such person must have a material interest that will be affected by the requested information. A material interest is an important interest and is generally, but not always, financial in nature.

The requester must furnish satisfactory evidence that he/she is an executor, trustee, heir at law, next of kin, beneficiary under the decedent's will, or a donee of property. Acceptable documentation includes, but is not limited, to birth and/or death certificates, letters testamentary, a will, or another court document.

If the requester is an heir at law, next of kin, beneficiary, or donee, he or she must show a material interest that will be affected by the requested information. In some states, however, simply establishing a material interest may not be adequate.

The request for information must include the following, at a minimum:

1. The decedent's complete name, address, and social security number
2. A copy of the decedent's death certificate
3. Either a copy of letters testamentary approved by the court, or IRS Form 56, if there is no court proceeding

Power to Act

Under Treas. Reg. § 601.503, if no executor or trustee is acting or responsible for disposition of the matter and the estate has been distributed to the residuary beneficiary, the residuary beneficiary is considered the fiduciary of the taxpayer (with power to act on behalf of the taxpayer) and must file Form 56 to notify the IRS of the fiduciary relationship. Similarly, if the decedent died intestate (without a will) or the executor has been discharged and is not responsible for disposition of the matter (or none was ever appointed), the distributee must file Form 56.

The IRS may require evidence of the discharge of the executor (if one had been appointed) and evidence that the executor is not responsible for disposition of the matter. It also may require a statement signed under penalty of law to show the relationship of the individual who signs Form 56 to the decedent and the right of the signer to a share of the assets claimed under the law of the domicile of the decedent.

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INCOME IN RESPECT OF A DECEDENT

This section explains the taxation of income in respect of a decedent.

This section defines income in respect of a decedent (IRD). It discusses how IRD is taxed, and then reviews the tax and reporting treatment of common items of IRD such as compensation income, farm income, and US savings bond interest.

Definition of IRD

Income in respect of a decedent (IRD) is certain income that a decedent was entitled to as gross income but is not properly includable in computing the decedent's taxable income for the tax year in which he or she died, or any prior tax year. IRD includes the following:

1. All accrued income of a decedent who reported his or her income by use of the cash receipts and disbursements method
2. Income accrued solely by reason of the decedent's death in case of a decedent who reports his or her income by use of an accrual method of accounting
3. Income to which the decedent had a contingent claim at the time of his or her death

[Treas. Reg. § 1.691(a)-1]

Example 2.15
No IRD on Postdeath Sale of Stock

Before his death, Adam Rosenbloom acquired 10,000 shares of XYZ Corporation capital stock for $100 per share. During his lifetime, Adam entered into an agreement with XYZ Corporation whereby the corporation agreed to purchase, and Adam agreed that his executor would sell the 10,000 shares at the book value of the shares at the date of Adam's death. After Adam's death, his executor sold the shares for $500 per share pursuant to the agreement. Because the sale of stock took place after Adam's death, the appreciation in value of the shares before his death is not IRD. If instead Adam sold the shares during his lifetime, but did not receive payment before his death, any gain on the sale would constitute IRD when the proceeds are received [Treas. Reg. § 1.691(a)-2(b), Example 4].

Example 2.16
IRD on Predeath Sale of Apples and Transfer to Cooperative

Maria Romano owned and operated an apple orchard. She was a cash method taxpayer. During her lifetime, Maria sold and delivered 1,000 bushels of apples to the Honeycrisp Canning Factory, but did not receive payment before her death. Maria also delivered 3,000 bushels of apples to the Gala Cooperative Association, but she did not receive any distributions before her death.

After Maria's death, her executor received payment from the Honeycrisp Canning Factory. He also received a distribution from the Gala Cooperative that was Maria's share of the cooperative's apple sales. The gain from the sale of apples to Honeycrisp constitutes IRD when received. The distribution from the cooperative is also IRD [Treas. Reg. § 1.691(a)-2(b), Example 5].

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Taxation of IRD

Generally, IRD must be included in gross income of the recipient. The character of the income for the recipient is usually the same as the character that the income would have had for the decedent. The recipient may be able to claim an income tax deduction that would otherwise have been allowable to the decedent.

Inclusion in Gross Income

IRD must be included in gross income for the tax year it is received by

- the decedent's estate if the estate receives it;
- the beneficiary, if the right to income is passed directly to the beneficiary and the beneficiary receives it; or
- any person to whom the estate properly distributes the right to receive it.

[I.R.C. § 691]

Example 2.17 Estate and Beneficiary Receive IRD

Juan Garcia was a cash method taxpayer. Juan was entitled at the date of his death to a large salary payment to be made in equal annual installments over 5 years. Juan's estate collected two installment payments and distributed the right to the remaining installment payments to Juan's daughter, Juanita, who was the residuary beneficiary of the estate. The estate must include the two installment payments in its gross income. Juanita must include the remaining three installment payments in her gross income [Treas. Reg. § 1.691(a)-2(b), Example 1].

Character of Income

The income that a taxpayer receives in respect of a decedent has the same character that it would have had if the decedent received the income. The provisions of section 1014(a), relating to the basis of property acquired from a decedent, do not apply [Treas. Reg. § 1.691(a)-3].

Example 2.18 Retained Character of IRD

In 2003, Tonya Jackson purchased a sculpture as an investment for $10,000. On February 1, 2021, Tonya, a cash method taxpayer, sold the sculpture for $30,000. The sale contract required the buyer to pay her on or before March 1, 2021. Tonya died on February 10, before she received the payment. Tonya's son, Damian, was her sole heir and executor. He received the payment on February 28. The income would have been long-term capital gain to Tonya if she had received it. Thus, Damian does not get a step-up in basis and he must include the $20,000 ($30,000 − $10,000) long-term capital gain in his 2021 income.

Transfer of Right to IRD

If the estate or other person entitled to IRD transfers the IRD, the transferor must include in income the greater of the consideration received for the transfer of IRD or the FMV of the transferred right [Treas. Reg. § 1.691(a)-4]. A transfer includes a sale, gift, exchange, a transfer by inheritance, or other disposition. However, if the transferee must include the IRD in gross income, then the transferor does not have to include the IRD in his or her gross income.

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Example 2.19
Transfer of IRD

Janice White's estate received a payment for wages that Janice earned before her death. Pursuant to Janice's last will and testament, the estate transferred the payment to Janice's wife, Jennifer. Jennifer must include the payment in her gross income when received, and the estate does not have to include the payment in its income.

Deductions

Deductions for business expenses, income-producing expenses, interest, and taxes, for which the decedent was liable but are not properly allowable as deductions on the decedent's final income tax return, are allowed as deductions. The estate or other person who acquires an interest in the decedent's property (subject to such obligations) because of the decedent's death can claim the deduction.

Income that the decedent had a right to receive is included in the decedent's gross estate and is subject to estate tax. This IRD is also taxed when received by the recipient (the estate or the beneficiary). However, in the year in which IRD is included in income, the recipient can claim an income tax deduction for the estate tax paid on the income. An individual recipient reports the deduction as an itemized deduction on Schedule A (Form 1040), line 16, Other itemized deductions.

Under Treas. Reg. § 1.691(c)-1, the deduction is calculated as follows:

1. Determine the net value of the IRD items included in the gross estate.
2. Determine how much of the estate tax is attributable to inclusion of those items.

Example 2.20
Calculating the Deduction for Estate Tax Paid

John Washington was an attorney who kept his books using the cash method. When John died, he was entitled to a $1,500 fee for services he provided in a case that was ongoing at the time of his death.

The $1,500 was included in his gross estate. The estate tax return deducted $200 for business expenses for which the estate was liable. The $1,300 ($1,500 − $200) net IRD increased the estate tax liability by $520 ($1,300 × 40%). In the year after the estate closed, John's son, Jackson, collected the fee owed, and Jackson included that amount in his gross income. Jackson may deduct the $520 estate tax amount as an itemized deduction.

Types of Income in Respect of a Decedent

This section reviews some common types of IRD, including wages, farm income, and US savings bond interest.

Wages

Wages or other employee compensation earned by the decedent but unpaid at the time of death are IRD. If the employer makes the payment after the employee's death but in the same year the employee died, the employer will withhold social security and Medicare taxes on the payment and report the payment on the employee's Form W-2 only as social security wages (box 3) and Medicare wages (box 5). The employer will report the payment in box 3 of Form 1099-MISC, Miscellaneous Information. If the employer makes the payment after the year of death, the employer will not report it on Form W-2 and will not withhold social security and Medicare taxes.

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Example 2.21
Wages Paid after Death

Zane Kenyon died on March 1, 2021. Prior to his death, his employer, First American Credit Union, paid him $10,000, and withheld $1,500 for federal income tax. When Zane died, his employer owed him $3,000 in wages. First American paid the estate $3,000 (less the social security and Medicare taxes withheld) on July 20, 2021. Because First American made the payment during the year of death, it withheld social security and Medicare taxes on the $3,000 payment and completed Form W-2 and Form 1099-MISC, as shown in **Figure 2.6** and **Figure 2.7**.

FIGURE 2.6
Zane Kenyon's Form W-2

22222	a Employee's social security number XXX-XX-XXXX	OMB No. 1545-0008	
b Employer identification number (EIN) XX-XXXXXXX		1 Wages, tips, other compensation $10,000	2 Federal income tax withheld $1,500
c Employer's name, address, and ZIP code First American Credit Union 100 Central Ave. Columbia Falls, MT 59912		3 Social security wages $13,000	4 Social security tax withheld $806
		5 Medicare wages and tips $13,000	6 Medicare tax withheld $188.50
		7 Social security tips	8 Allocated tips
d Control number		9	10 Dependent care benefits
e Employee's first name and initial / Last name / Suff. Zane Kenyon 345 Railway Street Whitefish, MT 59937		11 Nonqualified plans	12a Code
		13 Statutory employee / Retirement plan / Third-party sick pay	12b Code
		14 Other	12c Code
			12d Code
f Employee's address and ZIP code			

15 State Employer's state ID number	16 State wages, tips, etc.	17 State income tax	18 Local wages, tips, etc.	19 Local income tax	20 Locality name
MT XXXXXXXX	$10,000	$500			

Form **W-2** Wage and Tax Statement **2021** Department of the Treasury—Internal Revenue Service

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FIGURE 2.7
The Estate of Zane Kenyon's Form 1099-MISC

☐ VOID ☐ CORRECTED

PAYER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no.	1 Rents $	OMB No. 1545-0115	Miscellaneous Information
First American Credit Union 100 Central Ave. Columbia Falls, MT 59912	2 Royalties $	2021 Form 1099-MISC	
	3 Other income $ 3,000	4 Federal income tax withheld $	Copy 1 For State Tax Department
PAYER'S TIN: XX-XXXXXXX / RECIPIENT'S TIN: XX-XXXXXXX	5 Fishing boat proceeds $	6 Medical and health care payments $	
RECIPIENT'S name: Estate of Zane Kenyon	7 Payer made direct sales totaling $5,000 or more of consumer products to recipient for resale ☐	8 Substitute payments in lieu of dividends or interest $	
Street address (including apt. no.): 21 Tamarack Lane	9 Crop insurance proceeds $	10 Gross proceeds paid to an attorney $	
City or town, state or province, country, and ZIP or foreign postal code: Kalispell, MT 59901	11 Fish purchased for resale $	12 Section 409A deferrals $	
Account number (see instructions) / FATCA filing requirement ☐	13 Excess golden parachute payments $	14 Nonqualified deferred compensation $	
	15 State tax withheld $ / $	16 State/Payer's state no.	17 State income $ / $

Form **1099-MISC** www.irs.gov/Form1099MISC Department of the Treasury - Internal Revenue Service

The employer reports the $3,000 gross amount paid to the estate, even though amounts were withheld for social security and Medicare tax. The estate has $3,000 IRD.

Farm Income

A farmer's growing crops and livestock at the date of death usually are not IRD because they have not yet been harvested and sold. However, when a cash method farmer receives (or had the right to receive) rent in the form of a crop share prior to his or her death, the rent is reported in the year in which the crop share is sold or otherwise disposed of. The portion of the proceeds attributable to the rental period prior to the decedent's death is IRD. However, if the decedent sold the crops prior to his or her death, the full proceeds are included on the decedent's final income tax return, even if the rental period did not end until after the decedent's death.

Example 2.22
Crop Share Earned before Death

Allen Richards was a cash method taxpayer. He leased part of his farm for a 1-year period beginning March 1, 2021. The rent was one-third of the crop, payable in cash when Allen directed the sale of the crop share. Allen died on April 19, and he was alive for 50 days of the rental period. In September, the personal representative of Allen's estate ordered the crop to be sold, and the tenant paid the estate $1,500. The estate had $205 [(50 ÷ 365 days) × $1,500] IRD and $1,295 ($1,500 − $205) income.

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US Savings Bonds

If the decedent owned series EE or series I US savings bonds and was a cash method taxpayer who reported the interest each year, the interest earned in the year of death (up to the date of death) must be reported on the decedent's final return. The transferee (estate or beneficiary) typically reports on its return only the interest earned after the date of death.

If the taxpayer did not report the interest each year and had purchased the bonds with personal funds, interest earned before death must be reported in one of the following ways:

1. The executor or other person who is required to file the decedent's final income tax return can elect to include all the interest earned on the bonds before the decedent's death on the return. The transferee (estate or beneficiary) then includes only the interest earned after the date of death on its return.
2. If the executor or other person who is required to file the decedent's final income tax return does not make the election described in (1), the interest earned up to the date of death is IRD. All the interest earned before and after the decedent's death is income to the transferee (estate or beneficiary). A transferee who uses the cash method of accounting can defer reporting any of it as income until the bonds are either cashed or reach the maturity date, whichever is earlier. When the transferee reports the interest, the transferee can claim a deduction for any federal estate tax paid because of interest (if any) included in the decedent's estate.

If a beneficiary receives series EE or series I bonds from an estate in satisfaction of a specific dollar bequest and the decedent was a cash method taxpayer who did not elect to report interest each year, only the interest earned after receipt of the bonds is income to the beneficiary. The interest earned up to the date of death and any interest earned prior to the date of distribution is income to (and reportable by) the estate.

Example 2.23
Inherited Bond—No Election to Include Interest

Sharon Hunter's uncle, Frank Hunter, died and left Sharon a $1,000 series EE bond. Sharon and Frank are both cash method taxpayers. Frank purchased the bond for $500 and had not elected to report the interest each year. At the date of death, $200 interest had accrued on the bond. The personal representative of Frank's estate chose not to include the $200 accrued interest on Frank's final income tax return. The $200 is IRD. Sharon does not choose to report the interest each year as it is earned. If she cashes the bond when it reaches its $1,000 maturity value, Sharon must report $500 [$1,000 maturity value − $500 purchase price] of interest income.

PRACTITIONER NOTE

IRAs

If a beneficiary receives a lump-sum distribution from an inherited traditional IRA, the distribution is taxable as IRD up to the amount of the decedent's taxable balance.

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GRANTOR TRUSTS This section explains how to recognize a grantor trust.

A trust is a separate legal entity created by a grantor (also called a trustor or settlor) under state law for the benefit of beneficiaries. The grantor is the creator of the trust relationship and is generally the owner of the assets initially contributed to the trust. A trustee has legal title to trust assets and manages the assets of the trust for the benefit of the trust beneficiaries. The beneficiaries are those persons who are entitled to receive benefits from the trust.

A grantor trust is a trust over which the grantor or other owner retains the power to control or direct the trust's income or assets. A trust is treated as a grantor trust if the trust meets any of the grantor trust definitions in I.R.C. § 673, 674, 675, 676, or 677. If a trust is a grantor trust, then typically the grantor is treated as the owner, and the grantor must take into account all income, deductions, credits, and other tax attributes of the trust. In some cases, someone other than the grantor is treated as the owner of a grantor trust under I.R.C. § 678. This section reviews the grantor trust rules, with a focus on language that a tax practitioner should look for to determine whether a trust is a grantor trust.

PRACTITIONER NOTE

Gross Estate Inclusion

The grantor trust rules pertain to income tax and do not automatically result in inclusion of the trust property in the gross estate for purposes of the estate tax. See the earlier discussion of when trust property may be included in the gross estate.

Reversionary Interests

Under I.R.C. § 673, with limited exceptions, the grantor is treated as the owner of any part of a trust in which he or she (or his or her spouse) has a reversionary interest in either income or principal if the initial value of the reversionary interest exceeds 5% of the value of the trust. The reversionary interest is a return to the grantor of possession or enjoyment of trust income or principal that takes effect within 10 years from the date of transfer to the trust. However, a grantor is not treated as the owner of a trust under section 673 if his or her reversionary interest takes effect only upon the death of the sole beneficiary who is the lineal descendent of the grantor and under age 21.

The following clauses could indicate a grantor trust if the value of the reversionary interest is more than 5% of the initial value of the trust:

> Trustee shall pay all income to grantor's daughter, Riley Jones, in annual or more frequent installments, at the trustee's discretion. On the date that is 3 years from the date of the trust the trust shall terminate, and the trustee shall distribute all remaining income and principal to the grantor or her estate.

> Trustee shall pay all income to grantor's daughter, Riley Jones, in annual or more frequent installments, at the trustee's discretion. Riley's mother, Amanda Wright, has the authority to terminate the trust. Upon termination of the trust, the trustee shall distribute all remaining income and principal to the grantor or her estate.

Power to Control Beneficial Enjoyment

I.R.C. § 674(a) states the general rule that the grantor will be treated as the owner of any part of a trust over which the grantor (or grantor's spouse) or a nonadverse party can direct the disposition of the beneficial enjoyment of the trust income or principal. A *nonadverse party* is generally a person who does not have any substantial beneficial interest in the trust that would be adversely affected by the exercise (or nonexercise) of a power that

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the person has over the trust. The power over beneficial enjoyment includes the power to add or remove beneficiaries, shift the beneficiaries' interests in income or principal, or the power to determine when to make distributions.

Under I.R.C. § 674(b) the following powers will not cause grantor trust status:

1. A power to apply income to support a dependent, to the extent that the power is not exercised
2. A power to control beneficial enjoyment only after occurrence of an event after which the grantor would not be treated as owner under section 673
3. A power exercisable only by will (other than a power to appoint accumulated income)
4. A power to allocate income or principal among charitable beneficiaries
5. A power to distribute principal to a beneficiary if that power is limited by a reasonably definite standard (e.g., health, education, maintenance, and support)
6. A power to temporarily withhold income
7. A power to withhold income while the beneficiary is disabled or under age 21
8. A power to allocate receipts and disbursements between income and principal

Under I.R.C. § 674(c), if the trustee is not the grantor and the majority of trustees are not related or subordinate to the grantor, the trustee can have the power to determine distributions of income and principal to a beneficiary or a class of beneficiaries without causing grantor trust status. However, the trust will be a grantor trust if the independent trustee has the power to add a beneficiary (except for children born or adopted after establishment of the trust).

The following language may indicate a grantor trust if the grantor or grantor's spouse is trustee:

> Trustee may make distributions of income and principal in such amounts and to such of the trust beneficiaries as the trustee determines, in the trustee's sole discretion.

Administrative Powers

I.R.C. § 675 contains four powers that result in grantor trust status: the power to deal with trust assets for less than full and adequate consideration, the power to borrow without adequate interest or security, the actual borrowing of trust funds, and certain administrative powers exercisable in a nonfiduciary capacity.

Power to Deal with Trust Assets

Under section 675(1), a grantor is treated as the owner of trust assets if the grantor or a nonadverse party has the power to purchase, exchange, or otherwise deal with or dispose of trust income or principal for less than adequate consideration.

Power to Borrow without Adequate Interest or Security

Pursuant to section 675(2), a power of the grantor or a nonadverse party to borrow from the trust without adequate security or interest will cause grantor trust status unless the trustee is authorized under the trust instrument to make loans to anyone without regard to adequate interest or security. The mere existence of the power to borrow without adequate security or interest will cause the trust to be a grantor trust even though no loan is made [Ltr. Rul. 1999-42-017 (July 22, 1999); and Ltr. Rul. 96-45-013 (August 9, 1996)]. The following language gives the grantor the right to borrow from the trust and could cause grantor trust status:

> The trustee shall have the authority to loan to the grantor, and the grantor shall have the authority to borrow from the trust, all or any part of income or principal of the trust, without adequate interest or security. Grantor may exercise this power unconditionally, without the approval of the trustee, or any other party.

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Borrowing Funds from the Trust

The actual borrowing, either directly or indirectly, from the trust by the grantor or the grantor's spouse results in grantor trust status under section 675(3) to the extent that it is not completely repaid, including interest, before the beginning of the next tax year. The rule does not apply to loans with adequate interest and adequate security if the trustee is not the grantor or a related or subordinate party.

Administrative Powers

Section 675(4) treats the grantor as owner of any part of the trust over which any person has a nonfiduciary power to do the following:

1. Vote or direct the voting of a significant interest in stock or securities
2. Control the investment of trust funds
3. Reacquire trust principal by substituting other property of an equivalent value

The following language gives the grantor a power of substitution and will cause grantor trust status:

> Grantor shall have the right and power at any time, acting in a nonfiduciary capacity and without consent of the trustee, to withdraw any asset of the trust if the grantor simultaneously substitutes therefor other property of an equivalent value.

Power to Use Income for the Benefit of Grantor

I.R.C. § 677 treats the grantor as the owner of the income of a trust if, without the approval or consent of an adverse party or in the discretion of the grantor or a nonadverse party, the income may be distributed to the grantor or the grantor's spouse, held or accumulated for future distribution to the grantor or the grantor's spouse, or applied to the payment of life insurance premiums for an insurance policy on the life of the grantor or the grantor's spouse.

Person Other Than Grantor Treated as Owner

Under I.R.C. § 678(a), a person other than the grantor of the trust is treated as the owner of a trust if he or she has the power, exercisable solely by that person, to vest the income or principal of the trust in himself or herself. That person may also be treated as the owner of the trust if he or she partially released or modified that power in a way that would cause that person to be treated as the grantor under sections 671 to 677. Section 678(a) does not apply to a power over income if the grantor is treated as the owner.

CROSS-REFERENCE

Grantor Trust Reporting

See pages 419–421 in the *2020 National Income Tax Workbook* for a discussion of grantor trust reporting.

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TRUST AND ESTATE DEDUCTIONS

This section discusses final regulations that clarify the deductions that are available to a trust or estate.

Final regulations clarify that certain deductions allowed to an estate or nongrantor trust are not miscellaneous itemized deductions [T.D. 9918]. Therefore, these deductions are not affected by the suspension of the deductibility of miscellaneous itemized deductions for tax years beginning after December 31, 2017, and before January 1, 2026. The final regulations also provide guidance on determining the character, amount, and allocation of deductions in excess of gross income succeeded to by a beneficiary on the termination of an estate or nongrantor trust. The final regulations apply to tax years beginning after October 19, 2020. Taxpayers may choose to apply the amendments to Treas. Reg. §§ 1.67-4, 1.642(h)-2m, and 1.642(h)-5 to tax years beginning after December 31, 2017, and on or before October 19, 2020.

Fiduciary Deductions

The Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97, §11045(a), added I.R.C. § 67(g). Section 67(g) prohibits individual taxpayers from claiming miscellaneous itemized deductions for any tax year beginning after December 31, 2017, and before January 1, 2026. Prior to the TCJA, miscellaneous itemized deductions were allowable to the extent that they exceeded 2% of AGI. Section 67(b) defines *miscellaneous itemized deductions* as itemized deductions other than those listed in section 67(b)(1) through (12).

I.R.C. § 67(e) provides that, for purposes of section 67, an estate or trust computes its adjusted gross income in the same manner as that of an individual, except that the following additional deductions are allowable:

1. Costs paid or incurred in connection with the administration of an estate or nongrantor trust that would not have been incurred if the property were not held in the estate or trust [I.R.C. § 67(e)(1)]
2. The personal exemption of an estate or nongrantor trust [I.R.C. § 642(b)]
3. The distribution deduction for trusts distributing current income [I.R.C. § 651]
4. The distribution deduction for estates and trusts accumulating income [I.R.C. § 661]

Accordingly, section 67(e) removes these deductions from the definition of itemized deductions under section 63(d), and thus from the definition of miscellaneous itemized deductions under section 67(b) and treats them as deductions allowable in arriving at AGI [Treas. Reg. § 1.67-4(a)(1)(ii)]. However, the final regulations clarify that a cost is not a section 67(e) deduction and thus is subject to both the 2%-of-AGI floor in sections 67(a) and 67(g) to the extent that it is included in the definition of miscellaneous itemized deductions under section 67(b), is incurred by an estate or nongrantor trust (including the S portion of an electing small business trust), and commonly or customarily would be incurred by a hypothetical individual holding the same property [Treas. Reg. § 1.67-4(a)(2)].

Costs Subject to the 2%-of-AGI Floor

Costs that are still subject to the 2%-of-AGI floor may include the following:

- Defense of a claim against the estate, the decedent, or the nongrantor trust that are unrelated to the existence, validity, or administration of the estate or trust
- Ownership costs, such as condominium fees, insurance premiums, maintenance and lawn services, and auto insurance and registration
- Tax return preparation fees for returns for tax returns (for example, gift tax returns) that are commonly and customarily filed by individuals
- Investment advice fees (including any related services that would be provided to any individual investor as part of an investment advisory fee)
- Cost of appraisals for purposes unrelated to the trust or estate (for example, insurance)

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Costs Not Subject to the 2%-of-AGI Floor

The following costs may not be subject to the 2%-of-AGI floor:

- Defense of a claim against the estate, the decedent, or the nongrantor trust that is related to the existence, validity, or administration of the estate or trust
- Tax preparation fees for estate and generation-skipping transfer tax returns, fiduciary income tax returns, and the decedent's final individual income tax return
- Certain incremental costs of investment advice beyond the amount that is normally charged to an individual investor, such as a special, additional charge that is added solely because the investment advice is given to a trust or estate rather than to an individual or attributable to an unusual investment objective or the need for a specialized balancing of the interests of various parties (beyond the usual balancing of the varying interests of current beneficiaries and remaindermen)
- Appraisal fees incurred by an estate or a nongrantor trust to determine the FMV of assets as of the decedent's date of death (or the alternate valuation date), to determine value for purposes of making distributions, or if required to properly prepare the estate's or trust's tax returns, or a generation-skipping transfer tax return
- Other fiduciary expenses that are not commonly or customarily incurred by individuals, such as probate court fees and costs; fiduciary bond premiums; legal publication costs of notices to creditors or heirs; the cost of certified copies of the decedent's death certificate; and costs related to fiduciary accounts

Beneficiary Deductions

I.R.C. § 642(h) provides that if, on the termination of an estate or trust, the estate or trust has a net operating loss (NOL) carryover under I.R.C. § 172; a capital loss carryover under I.R.C. § 1212; or certain excess deductions (defined later), then the beneficiaries succeeding to the property of the estate or trust can carry over the deduction or excess. This section discusses the deductions that may be allowable to a beneficiary, and how those deductions are reported.

NOL and Capital Loss Carryovers

Under Treas. Reg. § 1.642(h)-1, if on the final termination of an estate or trust, there is a section 172 NOL carryover or a section 1212 capital loss carryover that would be allowable to the estate or trust in a tax year after the tax year of termination but for the termination, the carryovers are allowed to the beneficiaries succeeding to the property of the estate or trust. The NOL carryover and the capital loss carryover are the same in the hands of a beneficiary as in the estate or trust, except that the capital loss carryover in the hands of a beneficiary that is a corporation is a short-term loss even if it would have been a long-term loss in the hands of the estate or trust.

The NOL carryover and the capital loss carryover are first taken into account in the tax year of the beneficiary in which or with which the estate or trust terminates. Under Treas. Reg. § 1.642(h)-1, a beneficiary that succeeds to a NOL carryover of a terminated estate or trust may only carry forward the NOL and cannot carry it back.

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Example 2.24
Estate Has an NOL Carryover

On January 31, 2020, Alan Adams died leaving a will that provides for the distribution of all of Adam's estate to his friend Brian Bester. The period of administration of the estate terminated on December 31, 2020, and the estate distributed all the property to Brian. Brian reports his income on a calendar-year basis. **Figure 2.8** shows the estate's income and deductions during the administration period.

FIGURE 2.8
Alan Adams Estate Income and Deductions

Income		
Taxable interest	$2,500	
Business income	3,000	
Total income		$5,500
Expenses		
Business expenses (including administrative expenses allocable to business income)	$5,000	
Administrative expenses not allocable to business income that would not have been incurred if the property were not in a trust [section 67(e) deductions]	9,800	
Total expenses		$14,800

Under I.R.C. § 172(d)(4), the allowable nonbusiness expenses ($9,800) are limited to nonbusiness income ($2,500). The NOL carryover of the estate is $2,000 [$5,500 total income − ($5,000 + $2,500) adjusted deductions].

Brian is allocated the $2,000 unused NOL carryover of the terminated estate in 2020, and the allowance of any NOL carryover for Brian is determined under section 172. Brian cannot carry back any of the NOL.

The $7,300 ($9,800 − $2,500) of nonbusiness deductions that are not taken into account in determining the NOL of the estate are excess deductions on termination of the estate, which are allocated to Brian and retain their character as section 67(e) deductions. **Figure 2.9** shows Brian's Schedule K-1, box 11.

FIGURE 2.9
Brian Bester's Schedule K-1, Box 11

11	Final year Deductions
A	7,300
E	2,000

[Treas. Reg. § 1.642(h)-5(a) Example 1]

Excess Deductions

On the termination of an estate or trust, if the estate or trust has, for the last tax year of the estate or trust, deductions [other than the deductions allowed under section 642(b) for the personal exemption or section 642(c) for charitable contributions)] in excess of gross income for such year, then the beneficiaries succeeding to the property of the estate or trust can carry over the excess deductions. Thus, excess deductions on termination occur only during the last tax year of the trust or decedent's estate when the total deductions (excluding the charitable deduction and exemption) are greater than the gross income during that tax year.

Excess deductions are allowable only in the tax year of the beneficiary in which or with which the estate or trust terminates. That is, excess deductions of a terminated estate or trust may not carry over to a subsequent year of the beneficiary. A beneficiary who does not have enough income in that year to absorb the entire deduction cannot carry the balance over to any succeeding year. The final regulations clarify that beneficiaries may claim all or part of the excess deductions under section 642(h)(2) before, after, or together with the same character of deductions separately allowable to the beneficiary under the Internal Revenue Code.

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Example 2.25
Estate Has Excess Deductions

ABC Trust distributed all its assets to Brett Brown and terminated on December 31, 2021. As of that date, it had excess deductions of $18,000, all characterized as allowable in arriving at AGI under section 67(e). Brett, who reports on the calendar-year basis, could claim the $18,000 as a deduction allowable in arriving at his 2021 AGI. However, if the deduction (when added to other allowable deductions that he claims for the year) exceeds Brett's gross income, he may not carry over the excess to any subsequent year [Treas. Reg. § 1.642(h)-2(a)].

Character of Excess Deduction

The character of each deduction (i.e., a nonmiscellaneous itemized deduction or a miscellaneous itemized deduction) while in the estate or trust does not change when the beneficiary succeeds to the deduction on termination of the estate or trust [Treas. Reg. § 1.642(h)-2(a)]. In addition, these deductions are subject to any applicable limitations when calculating the beneficiary's tax liability.

Amount of Excess Deduction

The amount of the excess deductions in the final year is determined as follows:

1. Each deduction directly attributable to a class of income is allocated in accordance with the provisions in Treas. Reg. § 1.652(b)-3(a).
2. To the extent of any remaining income after application of step 1, deductions are allocated in accordance with the provisions in Treas. Reg. § 1.652(b)-3(b) and (d).
3. Deductions remaining after the application of steps 1 and 2 comprise the excess deductions on termination of the estate or trust. These deductions are allocated proportionately to the beneficiaries succeeding to the property of the estate or trust in accordance with Treas. Reg. § 1.642(h)-4.

Example 2.26
Calculation of Excess Deductions

Daria Mendez died in 2019, leaving an estate of which the residuary legatees are her niece and nephew Elena Mendez (75%) and Francisco Mendez (25%). The estate's income and deductions in its final year are shown in **Figure 2.10**.

FIGURE 2.10
Daria Mendez's Estate's Income and Deductions

Income		
Dividends	$3,000	
Taxable interest	500	
Rent	2,000	
Capital gain	1,000	
Total income		$ 6,500
Expenses		
Rental real estate expenses [section 62(a)(4) deduction]	$2,000	
Probate fees [section 67(e) deduction]	1,500	
Estate tax preparation fees [section 67(e) deduction]	8,000	
Legal fees [section 67(e) deduction]	2,500	
Personal property taxes (nonmiscellaneous itemized deduction)	3,500	
Total expenses		$17,500

The character and amount of the excess deductions is determined by allocating the deductions among the estate's items of income. The $2,000 of rental real estate expenses is allocated to the $2,000 of rental income. In the exercise of the executor's discretion, the executor allocated $3,500 of personal property taxes and $1,000 of section 67(e) deductions to the remaining income. As a result, the excess deductions on termination of the estate were $11,000 ($17,500 − $6,500), which were all section 67(e) deductions.

The excess deductions are allocated in accordance with the beneficiaries' interests in the estate. The executor allocates $8,250 ($11,000 × 75%) to Elena and $2,750 ($11,000 × 25%) to Francisco.

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If the executor instead allocated $4,500 of section 67(e) deductions to the remaining income of the estate, the excess deductions on termination of the estate would be $11,000, consisting of $7,500 of section 67(e) deductions and $3,500 of personal property taxes. The nonmiscellaneous itemized deduction for personal property taxes may be subject to limitation on Elena's and Francisco's returns [Treas. Reg. § 1.642(h)-5(b), Example 2].

Reporting

Excess deductions and loss carryovers are reported on Schedule K-1 (Form 1041), Beneficiary's Share of Income, Deductions, Credits, etc. **Figure 2.11** shows the box 11 codes and **Figure 2.12** shows the instructions for the codes.

FIGURE 2.11
Schedule K-1 (Form 1041) Box 11 Codes – Final Year Deductions

Box 11 Code	Description
A	Excess deductions – Section 67(e) expenses
B	Excess deductions – Non-miscellaneous itemized deductions
C	Short-term capital loss carryover
D	Long-term capital loss carryover
E	Net operating loss carryover – regular tax
F	Net operating loss carryover – minimum tax

FIGURE 2.12
Schedule K-1 (Form 1041) Box 11 Code Instructions

Box 11, Code A–Excess Deductions on Termination – Section 67(e) Expenses
If this is the final return of the estate or trust, and there are excess deductions on termination that are section 67(e) expenses reported to you as a beneficiary, you may deduct the excess deductions shown in box 11, code A, as an adjustment to income. Report this amount as a write-in on Schedule 1 (Form 1040), Part II, line 22. On the dotted line next to line 22, enter the amount of the expense using the code "ED67(e)." Include the expense in the total amount reported on line 22.

Box 11, Code B–Excess Deductions on Termination – Non-Miscellaneous Itemized Deductions
If this is the final return of the estate or trust, and there are excess deductions on termination that are non-miscellaneous itemized deductions reported to you as a beneficiary, you may deduct the excess deductions shown in box 11, code B, on the applicable line on Schedule A (Form 1040). The fiduciary will provide you with a statement of allowable deductions.

Box 11, Codes C and D–Unused Capital Loss Carryover
Upon termination of the trust or decedent's estate, the beneficiary succeeding to the property is allowed to deduct any unused capital loss carryover under section 1212. A short-term capital loss carryover, reported as code C, is reported on Schedule D (Form 1040), line 5. A long-term capital loss carryover, reported as code D, is reported, as appropriate, on Schedule D (Form 1040), line 12; line 5 of the 28% Rate Gain Worksheet for Schedule D, line 18; and line 16 of the Unrecaptured Section 1250 Gain Worksheet for Schedule D, line 19.

Box 11, Codes E and F–NOL Carryover
Upon termination of a trust or decedent's estate, a beneficiary succeeding to its property is allowed to deduct any unused net operating loss (NOL) if the carryover would be allowable to the trust or estate in a later tax year but for the termination. The deduction for regular tax purposes, reported as code E, is reported on Schedule 1 (Form 1040), line 8. A deduction for an Alternative Tax NOL (ATNOL) carryover for Alternative Minimum Tax (AMT) purposes, reported as code F, is reported on Form 6251, line 2f.

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REPORTING A TAXABLE ESTATE

This section explains when an estate must file an estate tax return.

Under I.R.C. § 6018(a), if a gross estate exceeds the basic exclusion amount in effect at the date of death, less certain lifetime taxable gifts, the estate must file Form 706. The basic exclusion amount excludes any DSUE amount that the decedent had at death. The filing requirements for nonresident aliens are different than those for citizens and resident aliens [I.R.C. § 6018(a)(2)]. Estates of nonresident aliens must file Form 706-NA if the date of death value of the decedent's US-situated assets, together with the gift tax specific exemption and the amount of adjusted taxable gifts, exceeds the $60,000 filing threshold. **Figure 2.13** shows the summary of the reporting of the gross estate on Form 706.

FIGURE 2.13
Form 706 Gross Estate Reporting

Part 5—Recapitulation. **Note:** If estimating the value of one or more assets pursuant to the special rule of Reg. section 20.2010-2(a)(7)(ii), enter on both lines 10 and 23 the amount noted in the instructions for the corresponding range of values. See instructions for details.

Item no.	Gross estate		Alternate value	Value at date of death
1	Schedule A—Real Estate	1		
2	Schedule B—Stocks and Bonds	2		
3	Schedule C—Mortgages, Notes, and Cash	3		
4	Schedule D—Insurance on the Decedent's Life (attach Form(s) 712)	4		
5	Schedule E—Jointly Owned Property (attach Form(s) 712 for life insurance)	5		
6	Schedule F—Other Miscellaneous Property (attach Form(s) 712 for life insurance)	6		
7	Schedule G—Transfers During Decedent's Life (att. Form(s) 712 for life insurance)	7		
8	Schedule H—Powers of Appointment	8		
9	Schedule I—Annuities	9		
10	Estimated value of assets subject to the special rule of Reg. section 20.2010-2(a)(7)(ii)	10		
11	Total gross estate (add items 1 through 10)	11		
12	Schedule U—Qualified Conservation Easement Exclusion	12		
13	Total gross estate less exclusion (subtract item 12 from item 11). Enter here and on line 1 of Part 2—Tax Computation	13		

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The estate must file Form 706 within 9 months after the date of the decedent's death. The estate may receive an automatic 6-month extension of the time to file by submitting Form 4768, Application for Extension of Time To File a Return and/or Pay U.S. Estate (and Generation-Skipping Transfer) Taxes.

The estate tax is due within 9 months of the date of the decedent's death, but the estate can request an extension of time for payment by filing Form 4768. Under I.R.C. § 6166, the estate can elect to pay the tax in installments. Under I.R.C. § 6163, the estate can elect to postpone the part of the tax attributable to a reversionary or remainder interest. These elections are made by checking "Yes" on lines 3 and 4 (respectively) of Form 706, Part 3–Elections by the Executor, and attaching the required statements. **Figure 2.14** shows the Part 3 elections.

FIGURE 2.14
Form 706 Elections to Delay Payment

3	Do you elect to pay the taxes in installments as described in section 6166? . . . . . If "Yes," you must attach the additional information described in the instructions. **Note: By electing section 6166 installment payments, you may be required to provide security for estate tax deferred under section 6166 and interest in the form of a surety bond or a section 6324A lien.**	**3**		
4	Do you elect to postpone the part of the taxes due to a reversionary or remainder interest as described in section 6163? .	**4**		

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BUSINESS TAX ISSUES

3

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LEARNING OBJECTIVES

After completing this session, participants will be able to perform the following job-related actions:

- ✔ Understand how marijuana-related businesses are taxed under federal law
- ✔ Assist a day care provider to calculate and report a business-use-of-home deduction
- ✔ Calculate cost of goods sold on Schedule C (Form 1040)
- ✔ Know how to maximize the qualified business income (QBI) deduction by dividing or aggregating trades or businesses
- ✔ Understand the partnership capital account reporting requirements
- ✔ Know what real property and incidental personal property is eligible for a like-kind exchange
- ✔ Understand when gain from an involuntary conversion may be eligible for nonrecognition treatment

INTRODUCTION

Several more states legalized recreational marijuana in 2021, and the IRS is increasingly focusing on tax compliance issues for marijuana businesses. This chapter reviews current tax laws for marijuana businesses and new IRS guidance. In 2021, shutdowns increased the demand for day care, yet those businesses faced challenges in operating with heightened health and safety

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requirements. This chapter discusses the general rules for the business-use-of the home deduction, and the rules that apply to day care providers.

This chapter also explains how to calculate cost of goods sold on Schedule C (Form 1040), Profit or Loss From Business (Sole Proprietorship), and how an owner of multiple trades or businesses can maximize the qualified business income deduction by dividing or aggregating those businesses. This chapter also discusses the newly implemented requirement for partnerships to report tax basis capital accounts. Finally, this chapter explains what real property is eligible for like-kind exchange treatment under the final regulations, and when gain from an involuntary conversion may be deferred.

ISSUE 1: MARIJUANA-RELATED BUSINESSES This section discusses federal taxation of marijuana-related businesses.

In the 2020 elections, Arizona, New Jersey, Montana, and South Dakota (pending litigation) legalized some form of recreational marijuana. New York legalized recreational marijuana in April 2021. As more states legalize recreational and medical marijuana, tax revenue from the sales of marijuana and marijuana-related products is growing quickly, and the IRS is focusing on tax compliance issues for the marijuana industry. This section discusses the current laws and new IRS guidance on how a marijuana-related business (MRB) is taxed under federal law.

State Law

Although sale and/or possession of marijuana is illegal under federal law, the majority of states have enacted laws allowing medical marijuana and as of this writing, 16 states and the District of Columbia allow recreational marijuana. A summary of the marijuana laws by state is shown in **Figure 3.1**.

FIGURE 3.1
State Marijuana Laws

State	Recreational	Medical	Illegal or Some Medical Conditions Allowed
Alabama			X
Alaska	X	X	
Arizona	X	X	
Arkansas		X	
California	X	X	
Colorado	X	X	
Connecticut		X	
Delaware		X	
District of Columbia	X	X	
Florida		X	
Georgia			X
Hawaii		X	
Idaho			X
Illinois	X	X	
Indiana			X

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FIGURE 3.1 (continued)
State Marijuana Laws

State	Recreational	Medical	Illegal or Some Medical Conditions Allowed
Iowa			X
Kansas			X
Kentucky			X
Louisiana		X	
Maine	X	X	
Maryland		X	
Massachusetts	X	X	
Michigan	X	X	
Minnesota		X	
Mississippi		X*	
Missouri		X	
Montana	X	X	
Nebraska			X
Nevada	X	X	
New Hampshire		X	
New Jersey	X	X	
New Mexico		X	
New York	X	X	
North Carolina			X
North Dakota		X	
Ohio		X	
Oklahoma		X	
Oregon	X	X	
Pennsylvania		X	
Rhode Island		X	
South Carolina			X
South Dakota	X*	X	
Tennessee			X
Texas			X
Utah		X	
Vermont	X	X	
Virginia			X
Washington	X	X	
West Virginia		X	
Wisconsin			X
Wyoming			X

* Pending litigation.

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PRACTITIONER NOTE

CBD

Cannabidiol (CBD) is derived from hemp. The 2018 Farm Bill, Pub. L. No. 115-334, removed hemp (.3% or less THC) from the Controlled Substances Act, but it did not necessarily legalize products made with CBD. Many states have adopted laws allowing CBD, but CBD products that are marketed to treat diseases or have other therapeutic benefits are illegal under federal law unless the product is FDA-approved.

Federal Law

Federal law prohibits the unlawful manufacture, importation, possession, use, and distribution of certain dangerous drugs (controlled substances). Marijuana is a Schedule I controlled substance, and federal law prohibits the sale of marijuana. Although some form of sale is legal in most states, under the US Constitution Article VI supremacy clause, federal laws take precedence over conflicting state law.

Federal Income Taxation of MRBs

In general, I.R.C. § 61 makes income from an MRB taxable income. I.R.C. § 280E denies any deductions or credits for a business that sells controlled substances. Thus, illegal MRBs cannot deduct expenses of operating the business. However, a taxpayer trafficking in a Schedule I or Schedule II controlled substance is entitled to determine inventoriable costs using the applicable inventory-costing regulations under section I.R.C. § 471 [C.C.A. 2015-04-011 (December 10, 2014)].

CROSS-REFERENCE

Due Diligence for Tax Professionals

In 2014, the Internal Revenue Service Advisory Council, Office of Professional Responsibility subgroup, asked for published guidance to clarify that a tax professional will not be considered unethical, will not be targeted for audit, and will not be in violation of Circular 230 solely for representing or preparing a return for a business that is illegal under federal law but legal under state law. No such guidance has been issued yet. Because of the lack of clear guidance, tax practitioners must exercise due diligence to mitigate the risks and uncertainties associated with assisting MRBs. See pages 92–95 in the *2018 National Income Tax Workbook* for a discussion of due diligence when providing services to an MRB.

Included in Gross Income

MRBs are illegal under federal law, but these businesses must pay federal income tax on their taxable income under I.R.C. § 61(a) [*James v. United States*, 366 U.S. 213, 218 (1961)]. I.R.C. § 61(a) defines gross income broadly, using 15 examples of items that are includable in gross income. Section 61(a)(3) provides that gross income includes net gains derived from dealings in property, which includes controlled substances produced or acquired for resale. Thus, even income from illegal sources is taxable, and state compliant marijuana dispensaries have taxable income [IRS Marijuana Industry Frequently Asked Questions (FAQs), www.irs.gov/businesses/small-businesses-self-employed/marijuana-industry-frequently-asked-questions, citing *Olive v. Commissioner*, 792 F.3d 1146 (9th Cir. 2015); *Feinberg v. Commissioner*, 916 F.3d 1330 (10th Cir. 2019); and *Beck v. Commissioner*, T.C. Memo. 2015-149].

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No Deductions

I.R.C. § 280E states the following:

> No deduction or credit shall be allowed for any amount paid or incurred during the taxable year in carrying on any trade or business if such trade or business (or the activities which comprise such trade or business) consists of trafficking in controlled substances (within the meaning of schedule I and II of the Controlled Substances Act) which is prohibited by federal law or the law of any state in which such trade or business is conducted.

No Deduction for Ordinary and Necessary Business Expenses

I.R.C. § 162 allows a deduction for ordinary and necessary expenses incurred in carrying on a trade or business. The amount of the expense is deducted in the current tax year, unless another provision of the code or regulations requires the taxpayer to defer deduction to a subsequent tax year, capitalize an asset, or disallows the deduction entirely [e.g., I.R.C. § 267(a)(2), 471(a), 263A(a), or 280E]. Section 280E eliminates the deduction for ordinary and necessary expenses under section 162 because of the illegality of the business itself. Because marijuana is a Schedule I drug, an MRB cannot deduct ordinary and necessary business expenses under section 162.

No Other Deductions

Section 280E disallows other deductions that are incurred in carrying on an MRB, such as I.R.C. § 164 (deduction for taxes), I.R.C. § 165 (loss deduction), I.R.C. § 167 (depreciation deduction), and I.R.C. § 170 (charitable deduction). In *San Jose Wellness v. Commissioner*, 156 T.C. No. 4 (2021), the taxpayer operated a medical marijuana dispensary under California law. The taxpayer incurred certain expenses in connection with its operations and deducted those expenses on its federal income tax returns. The taxpayer also claimed deductions for depreciation and charitable contributions. The IRS denied the deductions.

The court held that section 280E disallows deductions under any code section for businesses that traffic in a controlled substance. The court upheld the denial of the deductions, including the depreciation and charitable contribution deductions.

No Credits

Section 280E also denies all credits for any amount paid or incurred in carrying on an MRB [see also IRS FAQs, citing *Northern California Small Business Assistants Inc. v. Commissioner*, 153 T.C. 65 (2019)].

Cost of Goods Sold

Treas. Reg. § 1.61-3 defines *gross income* from a manufacturing, merchandising, or mining activity as the excess of receipts over cost of goods sold. *Cost of goods sold* (COGS) is the term given to the adjusted basis of merchandise sold during the tax year. The COGS concept embraces expenditures necessary to acquire, construct, or extract a physical product that is to be sold; the seller can have no gain until he or she recovers the economic investment that he or she has made directly in the actual item sold [*Reading v. Commissioner*, 70 T.C. 730 (1978)].

A taxpayer calculates COGS using the following formula: beginning inventories plus current-year production costs (in the case of a producer) or current-year purchases (in the case of a reseller) less ending inventories. In general, the taxpayer determines gross income by subtracting COGS from gross receipts, and then determines taxable income by subtracting all ordinary and necessary business expenses from gross income.

Unlike a deduction, which may be currently deductible, when accounting for COGS the taxpayer must capitalize an item's cost in the year of acquisition or production and either amortize it or wait until the year the item is sold to make the corresponding adjustment to gross income.

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PRACTITIONER NOTE

Uniform Capitalization Rules

The I.R.C. § 263A uniform capitalization rules require resellers and producers of merchandise to treat as inventoriable costs the direct costs of property purchased or produced, respectively, and a proper share of those indirect costs that are allocable (in whole or in part) to that property. Section 263A increased the types of costs that are inventoriable compared to the rules under I.R.C. § 471. C.C.A. 2015-04-011 concludes that section 263A is barred by section 280E.

The IRS takes the position that section 280E-affected taxpayers must calculate their COGS pursuant to section 471 and the associated treasury regulations as they existed when section 280E was enacted. Accordingly, an MRB may not deduct, for example, advertising or selling expenses. It may, however, reduce its gross receipts by its cost of goods sold, as calculated pursuant to section 471.

Direct Costs

Under Treas. Reg. § 1.471-3(b), the cost of the inventory for a marijuana reseller using an inventory method includes the following:

- Invoice price of the marijuana purchased, less trade or other discounts
- Transportation or other necessary charges incurred in acquiring possession of the marijuana

Similarly, under Treas. Reg. § 1.471-3(c), the cost of the inventory for a marijuana producer using an inventory method includes the following:

- Direct material costs (marijuana seeds or plants)
- Direct labor costs (e.g., planting, cultivating, harvesting, sorting)
- Certain indirect costs (discussed next)

Indirect Costs

In addition to the direct costs, a marijuana producer's cost of inventory may include certain indirect costs [Treas. Reg. § 1.471-11(c)(2)(i) and (iii)]. The regulations list the following category 1 indirect production costs, which the taxpayer must include in the computation of the amount of inventoriable costs:

1. Repair expenses
2. Maintenance
3. Utilities, such as heat, power, and light
4. Rent
5. Indirect labor and production supervisory wages, including basic compensation, overtime pay, vacation and holiday pay, sick leave pay [other than payments pursuant to a wage continuation plan under section 105(d)], shift differential, payroll taxes, and contributions to a supplemental unemployment benefit plan
6. Indirect materials and supplies
7. Tools and equipment not capitalized
8. Costs of quality control and inspection to the extent such costs are incident to and necessary for production or manufacturing operations or processes

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If an MRB produces financial statements in accordance with generally accepted accounting principles (GAAP), the cost of inventory can also include the following costs to the extent that they are properly allocated to inventory for GAAP purposes:

1. Taxes deductible under section 164, other than state, local, and foreign income taxes
2. Depreciation and depletion
3. Deductible employee benefits, including pension and certain profit-sharing contributions; workers' compensation expenses; stock bonus plans; premiums on life and health insurance; and miscellaneous employee benefits such as safety, medical treatment, cafeteria plans, recreational facilities, and membership dues
4. Costs pertaining to strikes, rework labor, scrap, and spoilage
5. Administrative expenses related to production
6. Officers' salaries related to production
7. Insurance costs related to production

PRACTITIONER NOTE

State Excise Tax

In C.C.A. 2015-31-016 (June 9, 2015), the IRS concluded that a taxpayer who pays the state of Washington marijuana excise tax should treat the expenditure as a reduction in the amount realized on the sale of the property. Though section 280E prohibits deductions and credits for MRBs, the memorandum concludes that the excise tax is not a deduction from gross income or a tax credit. Consequently, section 280E does not preclude a taxpayer from accounting for this excise tax as a reduction in the amount realized on the sale of the property.

Federal Employment Taxes and Estimated Tax Payments

MRBs have no exemption from their employment tax obligations, and MRB owners may be subject to penalties for failure to make estimated tax payments [IRS FAQs]. However, due to federal law, it may be difficult for an MRB to obtain a bank account. Some IRS Taxpayer Assistance Centers accept cash. **Figure 3.2** shows IRS Publication 5435.

Businesses may be assessed a penalty if they do not make federal tax deposits using the Electronic Federal Tax Payment System. However, penalty relief is potentially available on a case-by-case basis for taxpayers without access to a bank account based on reasonable cause. It is the taxpayer's responsibility to request a penalty reduction or an abatement [www.irs.gov/payments/cash-payments-to-the-irs-over-10000-frequently-asked-questions].

PRACTITIONER NOTE

Cash Payments over $10,000

Under I.R.C. § 6050I, an MRB must report cash receipts greater than $10,000, in a single transaction and/or related transactions. See IRS Publication 1544, *Reporting Cash Payments of Over $10,000*.

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FIGURE 3.2
IRS Publication 5435

Need to pay your taxes in cash? There are ways to pay.

By law, all individuals and businesses are required to pay federal taxes. The easiest and most secure way to pay is always online or through the IRS2Go mobile app. But some industries, such as cannabis, can have trouble obtaining a bank account and need to pay their federal taxes with cash using U.S. currency.

If that's you, there are **ways to pay**. Our goal is to make the process of paying your taxes as convenient, safe and secure as we possibly can for every type of taxpayer.

Here are the **ways to pay**:

1. For a fee, you can either obtain a prepaid credit card to pay online or through the IRS2Go mobile app, or you can purchase a money order or cashier's check at a post office, grocery store, retailer or bank, and pay by mail. (**Note**: most institutions have limits on how much you can put on a prepaid credit card or money order.) Never mail cash to an IRS office.
2. If you need to pay less than $1,000, you can pay in person at one of our retail partners.
3. If you need to pay with cash in person at a secure IRS location, you'll need to make an appointment.
    - First, call 844-545-5640. An IRS representative will ask you for contact information and the approximate amount of your payment, the number and denomination of bills, and the tax period(s) and type(s) of taxes you want to pay (e.g., income taxes for 2019). They will help you schedule an appointment at an IRS Taxpayer Assistance Center (TAC) that can process your cash payment.
    - You should call 30 to 60 days before you want to pay to secure a convenient time. We usually can't accommodate last-minute appointments. (**Note**: IRS TAC operations may be limited due to the COVID-19 crisis or other administrative issues. When you call, we can provide you with the most up-to-date details.)
    - When you schedule an appointment to make a large cash payment of $10,000 or more, you'll receive a confirmation call from an IRS representative at the IRS TAC to confirm the details of your payment and help you prepare for your visit.
    - IRS TACs that accept cash have controlled access to ensure your safety. Our specially trained staff will help make the process as convenient and efficient as possible for you.

Click here for more information on what to expect or visit our FAQ to learn more about this process.

Publication 5435 (EN-SP) (8-2020) Catalog Number 74736V Department of the Treasury **Internal Revenue Service** www.irs.gov

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ISSUE 2: BUSINESS-USE-OF-HOME DEDUCTION FOR DAY CARE PROVIDERS Day care providers can deduct expenses for business use of the home.

In 2020 and 2021, family day care providers faced unique challenges brought about by the pandemic. These businesses may have had increased operating costs to implement health and safety measures, and decreased revenue because of capacity limits.

Family day care providers provide care for children, persons over age 65, or persons who cannot care for themselves. They typically provide the care in the provider's own home. Many family day care businesses operate as a sole proprietorship.

The IRS has determined that day care providers often overstate the deduction for business use of the home, and that recordkeeping is often inadequate [IRS Child Care Provider Audit Technique Guide (www.irs.gov/pub/irs-utl/child_care_provider.pdf)]. This section discusses the business-use-of-home deduction and recordkeeping for a day care provider who conducts his or her business as a sole proprietorship.

Business Use of the Home

A day care provider who regularly uses a portion of his or her home exclusively for a trade or business may qualify to deduct home expenses such as mortgage interest, real estate taxes, and insurance. This section reviews the general requirements to claim the deduction, and the specific rules that are applicable to day care providers. It also explains how a day care provider calculates and reports the deduction.

General Eligibility Rules

Under the general rules, to qualify for the business-use-of-the-home deduction, the taxpayer must meet one of the following three function tests:

1. A portion of the dwelling unit is the principal place of the taxpayer's trade or business.
2. The taxpayer uses a portion of the dwelling unit to meet or deal with patients, clients, or customers in the normal course of a trade or business.
3. The taxpayer uses a separate structure (not attached to the dwelling unit) in connection with the taxpayer's trade or business.

A home office may qualify as the principal place of business if the taxpayer uses the office to conduct substantial business administration or management activities and there is no other fixed location where those activities are conducted. Certain administrative and management activities at a location other than the home will not preclude claiming the deduction.

The taxpayer's use must be regular and exclusive. Regular usage is a facts and circumstances determination. It requires more than incidental or occasional use. To qualify under the exclusive use test, the taxpayer must use a specific area of his or her home only for a trade or business. The area used for business can be a room or other separately identifiable space. The space does not need to be marked off by a permanent partition.

The taxpayer does not meet the exclusive use requirement if the home office is used solely for business during office hours and for personal use at other times. However, areas in the home that are used to store a business's inventory or product samples are exempt from the exclusive use requirement if the home is the only fixed location of the retail or wholesale business, the space is separately identifiable, and it is used for storage on a regular basis [I.R.C. § 280A(c)(2)].

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PRACTITIONER NOTE

Employees

For an employee to claim the deduction, the exclusive use must be for the convenience of the employer. A common law employee's home office deduction is a miscellaneous itemized deduction, subject to the 2%-of-AGI floor. Effective for tax years beginning after December 31, 2017, and before January 1, 2026, these itemized deductions are suspended.

Eligibility Rules for Day Care Providers

The exclusive use rule does not apply to areas of the home used on a regular basis in the taxpayer's trade or business of providing day care for children, for persons age 65 or older, or for persons who are physically or mentally unable to care for themselves [I.R.C. § 280A(c)(4)]. Licensing requirements may also apply.

Regular Use of the Home

Rev. Rul. 92-3, 1992-1 C.B. 141, states that the occasional nonuse of a room for a business day will not disqualify the room from being considered regularly used. If a room is available for day care use throughout each business day and is regularly used as part of the provider's routine provision of day care (including a bathroom, an eating area for meals, or a bedroom used for naps), the square footage of that room will be considered as used for day care throughout each business day.

A day care provider is not required to keep records of the specific hours of usage of rooms during business hours. However, the occasional use of a room that is ordinarily not available as part of the routine provision of day care (e.g., a bedroom ordinarily restricted from day care use but used occasionally for naps) will not be considered as used for day care throughout each business day.

Example 3.1
Regularly used for Business Purposes

Natalie Gordon has three children in her care, and she uses three bedrooms for naps because the children sleep better when they are separated. Natalie regularly uses the three bedrooms in her day care business. Natalie's house has a formal dining room, but the children primarily eat their meals in the kitchen. If Natalie does not use the dining room on a continuous, ongoing, or recurring basis, it is not used regularly in her day care business.

Day Care Services

Day care services are services that are primarily custodial in nature and that are provided for only certain hours during the day. Day care services may include educational, developmental, or enrichment activities that are incidental to the primary custodial services. If the services performed in the home are primarily educational or instructional, they do not qualify as day care services. The determination of whether activities are incidental to the primary custodial services generally depends on all the facts and circumstances of the case.

Educational instruction to children of nursery school age is deemed to be incidental to the custodial services. Educational instruction to children of kindergarten age is usually deemed incidental to the custodial services if the instruction is not instead of public instruction under a state compulsory education requirement. Enrichment instruction in arts and crafts to children, disabled individuals, or the elderly is usually deemed incidental to the custodial services rendered [Prop. Treas. Reg. § 1.280A-2].

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Licensing

To qualify for the business-use-of-home deduction, the provider must have applied for, been granted, or be exempt from having a current license, certification, registration, or approval as a day care center or as a family or group day care home under applicable state law. The provider does not meet this requirement if his or her application was rejected, or the license or other authorization was revoked.

Calculating the Deduction

If the dwelling unit is regularly used for day care and is not exclusively used for business, the taxpayer must allocate expenses by square footage and by time spent on the activity.

CROSS-REFERENCE

Actual Expense Method

If the taxpayer uses the portion of the dwelling unit exclusively for business, expenses are usually allocated on a square footage basis. The taxpayer calculates the home office deduction using the actual expense method or a safe harbor method. See pages 214–215 in the *2019 National Income Tax Workbook* for a discussion of the actual expense method.

Under Rev. Rul. 92-3, a day care provider calculates the deduction for business use of a home by multiplying the total costs incurred during the year that are allocable to the use of the home by the following two fractions:

1. The total square footage in the home that is available for day care use throughout each business day and that is regularly used in that business, divided by the total square footage of the home
2. The total hours in the year that the day care business is operated (including substantiated preparation and cleanup time), divided by the total number of hours in a year

The deduction is limited to the excess of the gross income derived from the day care business over the otherwise allowable deductions allocable to the day care business (e.g., interest and taxes) and the deductions allocable to that business that are not allocable to the use of the dwelling (e.g., food and supplies). In addition, pursuant to I.R.C. § 262(b), no deduction is allowed for the cost of basic local telephone service for the first telephone line provided to the home.

Example 3.2
Calculating the Deduction

Andy Adams, a calendar year taxpayer, operates a full-time day care facility in Andy's home in Michigan. Andy is a licensed day care provider under Michigan law. During business hours, Andy provides day care for several young children other than his own children. Andy regularly operates his day care business 4,380 hours per year, which includes the time he spends before and after regular business hours preparing for and cleaning up after the children.

Some children arrive at Andy's home for day care at 7 a.m., and some do not leave his home until 6 p.m. At any time during Andy's business day, he has at least one child (other than his own children) in his home for day care. Andy has adequate records that substantiate the number of hours and days that his business was operated and the number of children who attended his day care.

Andy's home is 1,600 square feet. Although no rooms in the home are used exclusively for the day care business, several rooms in the home are available for day care use throughout the business day and are regularly used in the day care business. These rooms are 1,200 square feet.

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Figure 3.3 shows Andy's substantiated home costs in 2021.

FIGURE 3.3
Andy's 2021 Home Costs

Expense	Amount
Interest and taxes	$5,000
Electricity, gas, water, trash, maintenance, insurance	4,000
Depreciation	1,000
Total expenses	$10,000

In addition, Andy's home has one telephone line, and Andy pays $20 per month for basic local telephone service. Michigan law requires Andy to have a telephone to be a licensed day care provider. Andy uses the telephone for both business and personal calls.

To calculate the deduction for the business use of his home, Andy must multiply the $10,000 total costs incurred during the year home by two fractions. The first fraction is ¾ [1,200 square feet regularly used in the day care business ÷ 1,600 total square feet in the home] or 75%. The second fraction is ½ [4,380 total hours in the year that the day care business is operated ÷ 8,760 total hours in a year] or 50%.

Thus, except as limited by section 280A(c)(5), Andy can deduct $3,750 [0.75 × 0.50 × $10,000], which represents the portion of the $10,000 in expenses attributable to his use of 1,200 square feet of his home for day care for 4,380 hours. Andy may be able to claim the nonbusiness portion of the otherwise deductible interest and taxes as an itemized deduction. Under I.R.C. § 262(b), the $20 monthly expense for basic local telephone service is a nondeductible personal expense, even though the state requires Andy to have a telephone [adapted from Rev. Rul. 92-3]. **Figure 3.4** shows Part I of Andy's Form 8829, Expenses for Business Use of Your Home. Figure 3.4 shows the 2020 form because the 2021 form was not available at the time of the publication. Note that on line 5, in a leap year, there are 8,784 hours in a year. This figure uses the number of hours in 2021, which is not a leap year.

FIGURE 3.4
Andy's Form 8829, Part I

Form **8829**
Department of the Treasury
Internal Revenue Service (99)

Expenses for Business Use of Your Home
► 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.

OMB No. 1545-0074
2020
Attachment Sequence No. 176

Name(s) of proprietor(s): Andy Adams
Your social security number: XXX-XX-XXXX

Part I Part of Your Home Used for Business

1	Area used regularly and exclusively for business, regularly for daycare, or for storage of inventory or product samples (see instructions)			1	1,200
2	Total area of home			2	1,600
3	Divide line 1 by line 2. Enter the result as a percentage			3	75 %
	For daycare facilities not used exclusively for business, go to line 4. All others, go to line 7.				
4	Multiply days used for daycare during year by hours used per day	4	4380 hr.		
5	If you started or stopped using your home for daycare during the year, see instructions; otherwise, enter 8,784	5	8760 hr.		
6	Divide line 4 by line 5. Enter the result as a decimal amount	6	.5		
7	Business percentage. For daycare facilities not used exclusively for business, multiply line 6 by line 3 (enter the result as a percentage). All others, enter the amount from line 3 ►			7	37.5 %

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CROSS-REFERENCE

Safe Harbor Method

Rev. Proc. 2013-13, 2013-06 I.R.B. 478, provides an optional safe harbor method that taxpayers may use to calculate the home office deduction. This simplified computation multiplies $5 by the qualified business square footage, limited to 300 square feet. Therefore, the maximum deduction that can be claimed under the safe harbor is $1,500 ($5 × 300). Qualified business use for the safe harbor includes providing day care services. See pages 215–218 in the *2019 National Income Tax Workbook* for a discussion of this method.

Total Square Footage of the Home

Square footage of the home can be determined from house plans, blueprints, escrow papers, or any other documents that substantiate the square footage. Pursuant to the IRS Child Care Provider Audit Technique Guide, a common error taxpayers make is to include only one floor in the total square footage. Another common error occurs where the taxpayer is using the garage in the business. The square footage of the garage must be added to the denominator (total home space) and the numerator (business usage space).

Example 3.3
Determining Total Square Footage

Angela Walker operates a day care facility on the main floor of her 1,800 square foot home. Her home has a full basement that she does not use for the day care. The basement is 1,200 square feet. Angela's total square footage is 3,000 (1,800 + 1,200).

Time Percentage

The day care provider must calculate the total number of hours the home was used for the day care business during the year. Hours spent cooking, cleaning, and preparing activities for the business could be included in the calculation. However, the IRS Child Care Provider Audit Technique Guide cautions examiners that Rev. Rul. 92-3 is not an absolute rule. The time outside of the regular hours to be added can be more or less depending on the facts and circumstances in each case, which need to be evaluated under I.R.C. § 162 (ordinary and necessary expenses).

Some providers, because of the type of service provided and/or ages of the children, might spend more time preparing activities for the children than others. In addition, some preparation work might be done on the weekends. Recordkeeping time can also be included.

Recordkeeping

Pursuant to I.R.C. § 6001 and Treas. Reg. § 1.6001-1(a), taxpayers must keep records to substantiate the amount of any deduction.

PRACTITIONER NOTE

Substantiation of Food Costs

Rev. Proc. 2003-22, 2003-10 I.R.B. 577, simplifies recordkeeping requirements by providing an optional standard meal and snack rates that family day care providers may use in computing the deductible cost of food provided to eligible children in the day care. Providers do not have to keep records of actual food costs but must still record the name of each eligible child, dates and hours of attendance in the family day care, and the type and quantity of meals and snacks served.

A day care provider should keep a detailed log of his or her activities to substantiate the number of hours spent in the day care business. If necessary, a tax practitioner can help a provider reconstruct time records based on sign-in and sign-out sheets, contracts, attendance records, and receipts.

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ISSUE 3: CALCULATING COST OF GOODS SOLD ON SCHEDULE C (FORM 1040)

This section reviews how to calculate cost of goods sold on Schedule C (Form 1040).

Cost of goods sold (COGS) represents the cost to produce or acquire inventory that has been sold to customers, and manufacturers and merchants calculate COGS to offset receipts from the sale of those goods.

Under Treas. Reg. § 1.61-3, gross income from a manufacturing, merchandising, or mining activity is the excess of total sales and investment income over COGS. This section discusses how a sole proprietorship calculates and reports COGS on Schedule C (Form 1040), Profit or Loss From Business (Sole Proprietorship).

Calculating COGS

COGS is calculated as the beginning inventory, plus production and acquisition costs incurred during the year (expenses included in the cost of inventory under I.R.C. §§ 471 and 263A), minus the closing inventory.

PRACTITIONER NOTE

Small Business Taxpayers

Small business taxpayers [average annual gross receipts of $26,000,000 (for 2020 and 2021) or less for the 3 prior tax years] do not have to keep inventories. Instead, they can treat inventory as nonincidental material or supplies and deduct the amounts paid to acquire or produce the inventoriable items in the year in which they are first used or consumed in the business. In the alternative, small business taxpayers can account for inventory in a way that conforms to the taxpayer's financial accounting treatment of inventories.

Calculate Beginning Inventory

For a merchant, beginning inventory is the cost of merchandise on hand at the beginning of the year. For a manufacturer or producer, beginning inventory is the cost of raw materials and supplies, work in process, and finished goods on hand at the beginning of the year.

Add Purchases

Merchants add the cost of all merchandise they bought for sale during the year. Manufacturers or producers add the cost of all raw materials or parts purchased for manufacture into a finished product. In calculating the cost of purchases, merchants and manufacturers must use the actual price paid and deduct returns. They also have to exclude merchandise that is withdrawn for personal or family use. If merchants or manufacturers receive a trade discount on their purchases, the discounted price should be included in COGS. Cash discounts, such as a reduction in the purchase price for early payment of an invoice, can be deducted from total purchases, or they can be credited to a separate account.

Add Labor Costs

For manufacturers, labor costs included in COGS are both the direct and indirect labor used in fabricating raw materials into a finished product. Direct labor costs are amounts paid to full- and part-time employees and independent contractors who work on the manufactured product. Indirect labor costs are amounts paid to employees who perform a general factory function that does not have any direct connection with making the final product but that is a necessary part of the manufacturing process. Direct and indirect labor costs can include wages, overtime pay, vacation pay, holiday pay, and payroll taxes.

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Add Materials and Supplies Costs

Materials and supplies that are directly and indirectly used in manufacturing goods are included in COGS. Direct material costs include the cost of materials that become an integral part of specific property produced, as well as materials that are consumed in the ordinary course of production and that can be identified or associated with particular units or groups of units of property produced [Treas. Reg. § 1.471-11]. Indirect material costs include the cost of materials that are not an integral part of specific property produced and the cost of materials that are consumed in the ordinary course of performing production or resale activities that cannot be identified or associated with particular units of property.

Add Other Costs

Other costs incurred in a resale, manufacturing, or mining process may be included if they are incident to and necessary expenses of the resale, manufacturing, or mining operation. Such other costs that may be included in COGS are as follows:

- Shipping and handling
- Overhead expenses such as repairs, utilities, rent, insurance, depreciation, and taxes
- Maintenance, quality control, and inspections

Other costs that are not included in COGS are marketing expenses, advertising expenses, and selling expenses.

Subtract Inventory at End of Year

To calculate COGS, the taxpayer must then subtract the value of inventory on hand at the end of the year (including the portion of the cost of raw materials and supplies, labor, and overhead expenses that were allocated to ending inventory).

Reporting COGS on Schedule C (Form 1040)

Sole proprietorships (and single-member LLCs taxed as disregarded entities) calculate and report COGS in Part III of Schedule III of Schedule C (Form 1040). **Figure 3.5** shows Part III, Cost of Goods Sold.

FIGURE 3.5
Part III of Schedule C (Form 1040), Cost of Goods Sold

Part III **Cost of Goods Sold** (see instructions)

33	Method(s) used to value closing inventory: a ☐ Cost b ☐ Lower of cost or market c ☐ Other (attach explanation)		
34	Was there any change in determining quantities, costs, or valuations between opening and closing inventory? If "Yes," attach explanation . . . . . ☐ Yes ☐ No		
35	Inventory at beginning of year. If different from last year's closing inventory, attach explanation . . .	35	
36	Purchases less cost of items withdrawn for personal use	36	
37	Cost of labor. Do not include any amounts paid to yourself	37	
38	Materials and supplies	38	
39	Other costs	39	
40	Add lines 35 through 39	40	
41	Inventory at end of year	41	
42	**Cost of goods sold.** Subtract line 41 from line 40. Enter the result here and on line 4	42	

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ISSUE 4: MAXIMIZING THE QUALIFIED BUSINESS INCOME (QBI) DEDUCTION

This section explains when dividing or aggregating trades or businesses will increase the QBI deduction.

This section reviews how to calculate the I.R.C. § 199A qualified business income (QBI) deduction. It shows the calculations for a taxpayer with income at or below, within, or above the phasein range and how the W-2 wage and capital limitation and the specified service trade or business (SSTB) limitation apply. This section then explains when it may be beneficial for a taxpayer with multiple trades or businesses to divide those businesses and account for each trade or business separately, and when it may be beneficial to aggregate those businesses.

Calculating the QBI Deduction

In general, the QBI deduction is the lesser of 20% of QBI or 20% of the taxpayer's taxable income before the QBI deduction (the taxable income limit). The deduction may be further limited by the W-2 wage and unadjusted basis immediately after acquisition (UBIA) of qualified property limitations (collectively called the W-2 wage and capital limit). This section first discusses what constitutes QBI and the specified service trade or business (SSTB) limit. It then explains the taxable income limit and how the W-2 wage and capital limit and SSTB limit may reduce the deduction.

Example 3.4 Calculating the QBI Deduction

Miguel Hernandez is an architect. He conducts his business as a sole proprietorship. The business maintains a complete and separate set of books and records. In 2021, the business had $100,000 of QBI. Miguel's taxable income was $150,000. Miguel's section 199A deduction is $20,000 [$100,000 × 20%].

Definition of QBI

QBI is the net amount of qualified items of income, gain, deduction, and loss with respect to any qualified trade or business of the taxpayer. A *trade or business* is defined with reference to I.R.C. § 162, including certain self-rentals [Treas. Reg. § 1.199A-1(b)(14)]. QBI items must be effectively connected with a US trade or business and must be included or allowed in determining taxable income for the tax year. QBI excludes the following:

- Dividends, including qualified dividends
- Interest, unless it is allocable to a trade or business
- Capital gains and losses (short-term or long-term)
- Gains and losses from transactions of foreign personal holding companies
- Income from annuities, unless received in connection with a trade or business

QBI also does not include wages, salaries, and guaranteed payments for services [I.R.C. § 199A(c)(4)]. The deductible portion of the tax on self-employment (SE) income under I.R.C. § 164(f), the self-employed health insurance deduction under I.R.C. § 162(l), and the deduction for contributions to qualified retirement plans under I.R.C. § 404 may reduce QBI.

Limitations on the QBI Deduction

The following three limitations may reduce the QBI deduction:

1. Taxable income limit [I.R.C. § 199A(a)(2)]
2. W-2 wage and capital limit [I.R.C. § 199A(b)(2)(B)]
3. SSTB limit [I.R.C. § 199A(d)(2)]

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Taxable Income Limit

The QBI deduction is limited to the lesser of 20% of QBI or 20% of the taxpayer's taxable income before the QBI deduction. Taxable income excludes any net capital gain. Net capital gain is any long-term capital gain, unrecaptured I.R.C. § 1250 gain, collectibles gain, I.R.C. § 1202 small business stock gain, and qualified dividends [Treas. Reg. § 1.199A(b)(3)].

W-2 Wage and Capital Limit

The QBI deduction is limited to the greater of

1. 50% of the W-2 wages with respect to the qualified trade or business; or
2. 25% of the W-2 wages with respect to the qualified trade or business, plus 2.5% of the UBIA of all qualified property.

[I.R.C. § 199A(b)(2)]

This W-2 wage and capital limit fully applies to taxpayers with taxable income above the phasein range. It does not apply to taxpayers whose taxable income is below the phasein range, and it partially applies to taxpayers within the phasein range [I.R.C. § 199A(b)(3)]. **Figure 3.6** shows the phasein ranges for 2020, and **Figure 3.7** shows the phasein ranges for 2021.

The taxpayer's taxable income determines whether the taxpayer exceeds the threshold. Taxable income includes income and deductions of the taxpayer and his or her spouse (if filing a joint return). In some cases, business income may exceed the threshold, but the taxpayer's other deductions can reduce taxable income below the threshold.

CROSS-REFERENCE

W-2 Wages and UBIA of Qualified Property

See pages 17–23 in the *2019 National Income Tax Workbook* for a discussion of the definition of W-2 wages, the allocation of wages, the definition of UBIA of qualified property, and allocating UBIA of qualified property.

FIGURE 3.6
QBI Phasein Ranges for 2020

	Single, HoH	MFJ	MFS
Threshold	$163,300	$326,600	$163,300
Phasein range	$163,301–$213,300	$326,601–$426,600	$163,301–$213,300
Fully phased in	> $213,300	> $426,600	> $213,300

FIGURE 3.7
QBI Phasein Ranges for 2021

	Single, HoH	MFJ	MFS
Threshold	$164,900	$329,800	$164,925
Phasein range	$164,901–$214,900	$329,801–$429,800	$164,926–$214,925
Fully phased in	> $214,900	> $429,800	> $214,925

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Example 3.5
Taxable Income above the Phasein Range

Brian Jefferson is a single taxpayer. In 2021, he had $200,000 wages and $75,000 QBI from an S corporation. Brian's share of the corporation's UBIA in qualified property was $10,000 and his share of the total wages paid by the corporation was $15,000. Brian's $262,450 [$200,000 wages + $75,000 QBI −$12,550 standard deduction] taxable income is above the phasein range, and the W-2 wage and capital limit applies in full. Brian's QBI deduction is limited to $7,500, which is the greater of $7,500 [$15,000 W-2 wages × 50%] or $4,000 [($15,000 W-2 wages × 25%) + ($10,000 UBIA of qualified property × 2.5%)].

CROSS-REFERENCE

Income within the Phasein Range

When taxable income exceeds the threshold but is still within the phasein range, the W-2 wage and capital limit and the SSTB limitation apply proportionately. See pages 78–80 and 82–85 in the *2020 National Income Tax Workbook* for comprehensive examples of calculating the QBI deduction for a taxpayer whose taxable income is within the phasein range.

SSTB Limitation

If a trade or business is an SSTB, no QBI, W-2 wages, or UBIA of qualified property from the SSTB may be included by any individual whose taxable income exceeds the phasein ranges shown in Figures 3.6 and 3.7 [Treas. Reg. § 1.199A-1(d)].

A phasein rule, provided in Treas. Reg. § 1.199A-1(d)(2), applies to individuals with taxable income within the phasein range. These individuals can include an applicable percentage that limits the QBI, W-2 wages, and UBIA of qualified property from an SSTB that are used to calculate the individual's section 199A deduction. The SSTB limit does not apply to individuals with taxable income at or below the threshold amount (i.e., all SSTB income is QBI).

Treas. Reg. § 1.199A-1(b)(14) defines a trade or business with reference to I.R.C. § 162. Thus, a trade or business means a section 162 trade or business other than the trade or business of performing services as an employee. I.R.C. § 199A(d)(2) defines an SSTB as any trade or business involving the performance of services in the following fields:

- Health
- Law
- Accounting
- Actuarial science
- Performing arts
- Consulting
- Athletics
- Financial services
- Brokerage services
- Any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners

I.R.C. § 199A(d)(2)(B) adds investing and investment management, trading, and dealing in securities, partnership interests, or commodities to the list of SSTBs. However, section 199A(d)(2)(A) specifically excludes engineering and architecture from the definition of SSTBs.

CROSS-REFERENCE

SSTBs

Treas. Reg. § 1.199A-5(b) repeats this list of SSTBs, provides general guidance on the definition of an SSTB, and provides definitional guidance on the meaning of a trade or business involving the performance of services in each of the fields listed in section 199A(d)(2). See pages 48–63 in the *2019 National Income Tax Workbook* for a comprehensive discussion of and examples of SSTBs.

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PRACTITIONER NOTE

De Minimis Rule

Treas. Reg. § 1.199A-5(c)(1) sets forth a de minimis rule under which a trade or business will not be an SSTB merely because it provides a small amount of services in a specified service activity. A trade or business with gross receipts of $25,000,000 or less for the tax year is not an SSTB if less than 10% of the gross receipts of the trade or business are attributable to the performance of services in an SSTB. For purposes of determining whether this 10% test is satisfied, the performance of any activity incident to the actual performance of services in the field is considered the performance of services in that field. A trade or business with gross receipts of greater than $25,000,000 for the tax year is not an SSTB if less than 5% of the gross receipts of the trade or business are attributable to the performance of services in an SSTB.

Multiple Trades or Businesses—Dividing Businesses

An individual or a relevant pass-through entity (RPE) can have more than one trade or business for purposes of section 162 and thus for section 199A. Each trade or business must be separately tested to determine whether that trade or business is an SSTB. If one trade or business is an SSTB and another is not, and the taxpayer has taxable income above the threshold, it may be advantageous to calculate the QBI for each business separately.

Example 3.6
Separate Trades or Businesses

Animal Care, LLC provides veterinarian services performed by licensed staff. It also develops and sells its own line of organic dog food at its veterinarian clinic and online. The veterinarian services are considered to be the performance of services in the field of health. Animal Care, LLC separately invoices for its veterinarian services and the sale of its organic dog food. It maintains separate books and records for its veterinarian clinic and its development and sale of its dog food. The company also has separate employees who are unaffiliated with the veterinary clinic and who work only on the formulation, marketing, sales, and distribution of the organic dog food products.

Animal Care, LLC treats its veterinary practice and the dog food development and sales as separate trades or businesses for purposes of sections 162 and 199A. Animal Care, LLC has gross receipts of $3,000,000. Of that total, $1,000,000 is attributable to the veterinary services, which is an SSTB. Although the gross receipts from the services in the field of health exceed 10% of the company's total gross receipts, the dog food development and sales business is not considered an SSTB because the veterinary practice and the dog food development and sales are separate trades or businesses under section 162 [Treas. Reg. § 1.199A-5(c)(1)(iii)(B), Example 2].

Antiabuse Rule

Treas. Reg. § 1.199A-5(c)(2) provides an antiabuse rule. The rule is meant to prevent an SSTB from splitting its trade or business into two businesses, with one providing services or leasing property to the other. The final section 199A regulations provide that if a trade or business provides property or services to an SSTB and there is 50%-or-more common ownership of the trades or businesses, that portion of the trade or business that provides property or services to the 50%-or-more-commonly-owned SSTB will be treated as a separate SSTB with respect to the related parties. For purposes of this rule, 50%-or-more common ownership includes direct or indirect ownership by related parties within the meaning of I.R.C. § 267(b) or 707(b).

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Allocation of QBI Items

Under Treas. Reg. § 1.199A-3(b)(5), if an individual or an RPE directly conducts multiple trades or businesses and has items of QBI that are properly attributable to more than one trade or business, the individual or RPE must allocate those items among the several trades or businesses using a reasonable method based on all the facts and circumstances. The individual or RPE may use a different reasonable method with respect to different items of income, gain, deduction, and loss. The chosen reasonable method for each item must be consistently applied from one tax year to another and must clearly reflect the income and expenses of each trade or business. The overall combination of methods must also be reasonable based on all facts and circumstances. The books and records maintained for a trade or business must be consistent with these allocations.

The preamble to the final section 199A regulations notes that whether direct tracing or allocations based on gross income are reasonable methods depends on the facts and circumstances of each trade or business. Different reasonable methods may be appropriate for different items. However, once a method is chosen for an item, it must be applied consistently with respect to that item. The Treasury Department and the IRS will continue to study this issue and request additional comments, including comments with respect to potential safe harbor allocation methods.

PRACTITIONER NOTE

Books and Records

Whether there are multiple trades or businesses is a factual determination, but the Treasury Department and the IRS believe that multiple trades or businesses generally will not exist within an entity unless different methods of accounting could be used for each trade or business under Treas. Reg. § 1.446-1(d)(1). Treas. Reg. § 1.446-1(d)(2) provides that no trade or business will be considered separate and distinct unless a complete, separate set of books and records is kept for such trade or business.

When Dividing is Beneficial

If an individual or an RPE has more than one trade or business for purposes of section 162 and thus for section 199A, one of the businesses is an SSTB, and the taxpayer (or RPE owner) has taxable income that is over the threshold, separating the businesses may result in a higher deduction.

Example 3.7
Dividing Lines of a Business

Glacier, Inc. is an S corporation that provides accounting services in an office downtown. Its sole shareholder, Brenda Polar, is a CPA. The S corporation has no qualified property. Brenda also provides freelance editing services for a national tax publication. She performs those services in her home office. The editing income is paid to the S corporation, which reduces Brenda's self-employment tax liability. Brenda files taxes as single. Her 2021 taxable income was $225,000, and the W-2 wage and capital limit and SSTB limit apply in full.

As the accounting firm is an SSTB, none of its W-2 wages can be included to calculate the QBI deduction, and Brenda's QBI deduction is $0. If instead Brenda keeps two sets of books and records and treats the editing business (not an SSTB) and the accounting business as two separate trades or businesses, she may claim a $15,000 QBI deduction.

In 2021, Glacier, Inc. had $150,000 QBI and paid Brenda $100,000 wages. The editing income was 50% of Glacier's gross income, so Brenda allocates $75,000 of the QBI income to each business and $50,000 W-2 wages to each business. **Figure 3.8** shows Brenda's Form 8995-A, Qualified Business Income Deduction. Figure 3.8 shows the 2020 form because the 2021 was not available at the time of this publication.

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FIGURE 3.8
Brenda Polar's Form 8995-A

Form **8995-A**
Department of the Treasury
Internal Revenue Service

Qualified Business Income Deduction

► Attach to your tax return.
► Go to *www.irs.gov/Form8995A* for instructions and the latest information.

OMB No. 1545-2294
2020
Attachment Sequence No. **55A**

Name(s) shown on return: **Brenda Polar**

Your taxpayer identification number: **XXX-XX-XXXX**

Note: *You can claim the qualified business income deduction* ***only*** *if you have qualified business income from a qualified trade or business, real estate investment trust dividends, publicly traded partnership income, or a domestic production activities deduction passed through from an agricultural or horticultural cooperative. See instructions. Use this form if your taxable income, before your qualified business income deduction, is above $163,300 ($326,600 if married filing jointly), or you're a patron of an agricultural or horticultural cooperative.*

Part I Trade, Business, or Aggregation Information

Complete Schedules A, B, and/or C (Form 8995-A), as applicable, before starting Part I. Attach additional worksheets when needed. See instructions.

1	(a) Trade, business, or aggregation name	(b) Check if specified service	(c) Check if aggregation	(d) Taxpayer identification number	(e) Check if patron
A	GLACIER, INC. - EDITING	☐	☐	XX-XXXXXXX	☐
B		☐	☐		☐
C		☐	☐		☐

Part II Determine Your Adjusted Qualified Business Income

			A	B	C
2	Qualified business income from the trade, business, or aggregation. See instructions	2	75,000		
3	Multiply line 2 by 20% (0.20). If your taxable income is $163,300 or less ($326,600 if married filing jointly), skip lines 4 through 12 and enter the amount from line 3 on line 13	3	15,000		
4	Allocable share of W-2 wages from the trade, business, or aggregation	4	50,000		
5	Multiply line 4 by 50% (0.50)	5	25,000		
6	Multiply line 4 by 25% (0.25)	6	12,500		
7	Allocable share of the unadjusted basis immediately after acquisition (UBIA) of all qualified property	7	0		
8	Multiply line 7 by 2.5% (0.025)	8	0		
9	Add lines 6 and 8	9	12,500		
10	Enter the greater of line 5 or line 9	10	25,000		
11	W-2 wage and UBIA of qualified property limitation. Enter the smaller of line 3 or line 10	11	15,000		
12	Phased-in reduction. Enter the amount from line 26, if any. See instructions	12	0		
13	Qualified business income deduction before patron reduction. Enter the greater of line 11 or line 12	13	15,000		
14	Patron reduction. Enter the amount from Schedule D (Form 8995-A), line 6, if any. See instructions	14	0		
15	Qualified business income component. Subtract line 14 from line 13	15	15,000		
16	Total qualified business income component. Add all amounts reported on line 15 ►	16	15,000		

For Privacy Act and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 71661B Form **8995-A** (2020)

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FIGURE 3.8 (continued)
Brenda Polar's Form 8995-A

Part IV	Determine Your Qualified Business Income Deduction				
27	Total qualified business income component from all qualified trades, businesses, or aggregations. Enter the amount from line 16	27	15,000		
28	Qualified REIT dividends and publicly traded partnership (PTP) income or (loss). See instructions	28	0		
29	Qualified REIT dividends and PTP (loss) carryforward from prior years	29	(0)		
30	Total qualified REIT dividends and PTP income. Combine lines 28 and 29. If less than zero, enter -0-	30	0		
31	REIT and PTP component. Multiply line 30 by 20% (0.20)	31	0		
32	Qualified business income deduction before the income limitation. Add lines 27 and 31 ►			32	15,000
33	Taxable income before qualified business income deduction	33	225,000		
34	Net capital gain. See instructions	34	0		
35	Subtract line 34 from line 33. If zero or less, enter -0-			35	225,000
36	Income limitation. Multiply line 35 by 20% (0.20)			36	56,250
37	Qualified business income deduction before the domestic production activities deduction (DPAD) under section 199A(g). Enter the smaller of line 32 or line 36 ►			37	15,000
38	DPAD under section 199A(g) allocated from an agricultural or horticultural cooperative. Don't enter more than line 33 minus line 37			38	0
39	Total qualified business income deduction. Add lines 37 and 38 ►			39	15,000
40	Total qualified REIT dividends and PTP (loss) carryforward. Combine lines 28 and 29. If zero or greater, enter -0-			40	(0)

Form **8995-A** (2020)

Aggregation of Activities

Usually, a taxpayer with interests in more than one trade or business must separately calculate the QBI deduction for each business [I.R.C. § 199A(b)(1)(A)]. When applying the W-2 wage and capital limit, the W-2 wages and qualified property for one trade or business may not be combined with the wages and qualified property from another trade or business. However, the taxpayer can combine separate activities into a single trade or business (aggregation).

Aggregation may increase the QBI deduction if, for example, one business has W-2 wages and the other does not. The grouping must meet the requirements for aggregation under Treas. Reg. § 1.199A-4. This section explains when a taxpayer can aggregate trades or businesses for the QBI deduction, and when aggregation is beneficial.

Requirements for Aggregation

To qualify for aggregation, the trades or businesses must meet the following three requirements:

1. Each business is not an SSTB.
2. There is a business relationship.
3. There is common ownership.

Figure 3.9 shows the requirements for aggregation.

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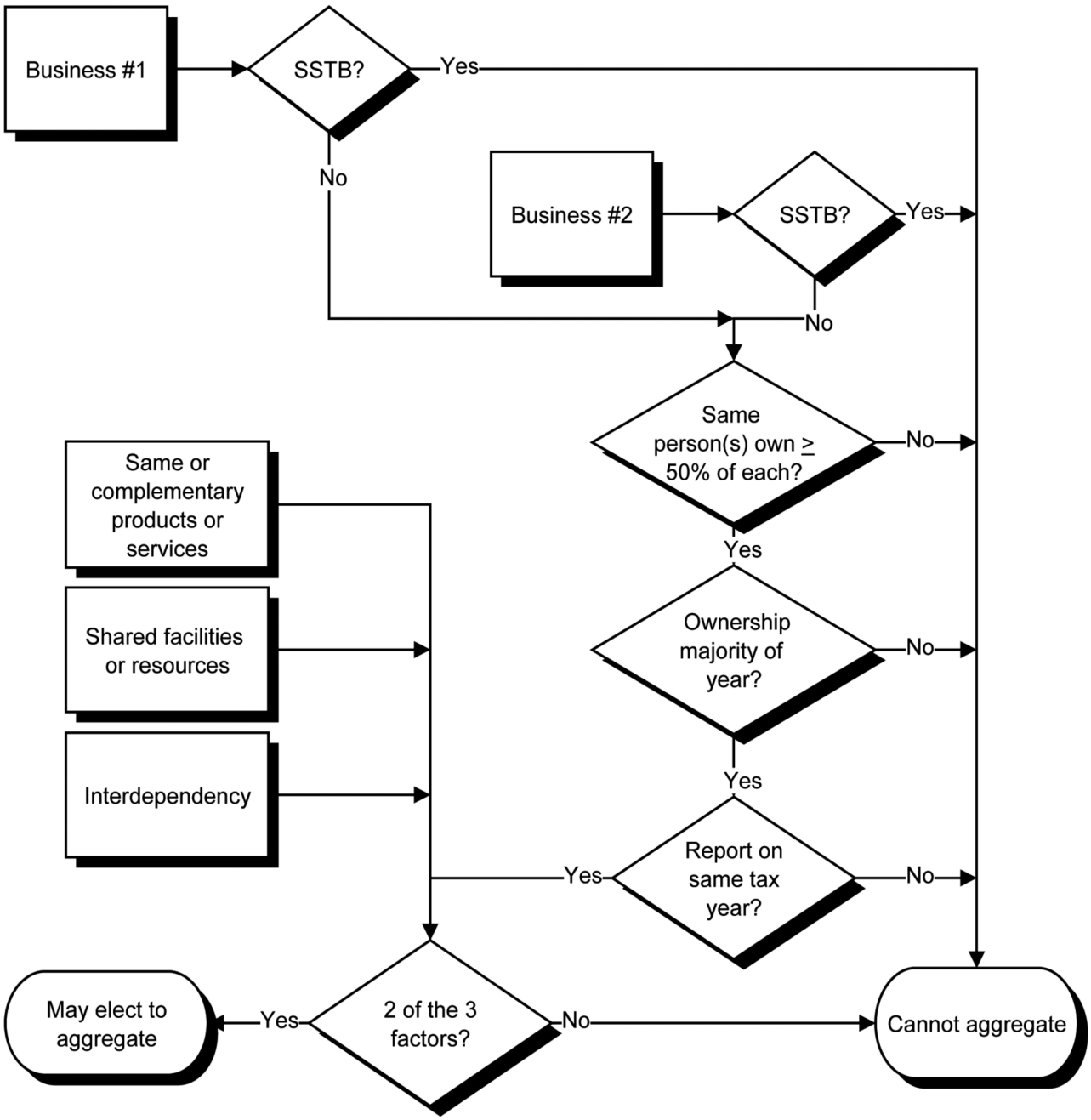
FIGURE 3.9
Requirements for Aggregation



Business Relationship

There must be a connection between each of the businesses that are aggregated. Each business must share at least two of the following attributes with the others:

1. The businesses must provide products, property, or services that are the same or customarily offered together.
2. The businesses must share the same facilities or business functions, such as personnel, accounting, legal, manufacturing, purchasing, human resources, or information technology resources.
3. There must be coordination or interdependence between (or among) the businesses.

[Treas. Reg. § 1.199A-4(b)(1)(v)]

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Common Ownership

To aggregate more than one trade or business, a person, or group of persons must own at least 50% of each trade or business [Treas. Reg. § 1.199A-4(b)(1)(i)]. Incidents of ownership include outright ownership, stock in an S corporation, and a capital or profits interest in a partnership. Satisfaction of the ownership test extends to all owners of an entity, and not only to persons who have a 50%-or-greater ownership in the entity. To meet the ownership test, there must be common ownership for more than one-half of the tax year [Treas. Reg. § 1.199A-4(b)(1)(ii)]. The common ownership must exist on the last day of the tax year.

CROSS-REFERENCE

Attribution Rules

For purposes of the ownership test, the I.R.C. §§ 267(b) and 707(b) attribution rules apply. See page 27 in the *2019 National Income Tax Workbook* for a discussion of the attribution rules.

PRACTITIONER NOTE

Section 469 Grouping

I.R.C. § 469 was enacted to limit the deduction of certain passive losses and therefore serves a very different purpose than the allowance of a section 199A deduction. Under section 469, one or more trade or business activities or rental activities may be treated as a single activity if the activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of section 469. Unlike the QBI aggregation rules, the section 469 grouping is based on the facts and circumstances. The factors that are given the greatest weight in determining whether activities constitute an appropriate economic unit are similarities and differences in types of trades or businesses, the extent of common control, the extent of common ownership, geographical location, and interdependencies between or among the activities. An election to aggregate businesses for the QBI deduction does not affect any election(s) to group under section 469.

Example 3.8
Similar Products, Shared Business Functions

Alice Anderson wholly owns and operates a catering business and a restaurant through separate disregarded entities. The catering business and the restaurant share centralized purchasing to obtain volume discounts and a centralized accounting office that performs all the bookkeeping, tracks and issues statements on all the receivables, and prepares the payroll for each business. Alice maintains a website and print advertising materials that reference both the catering business and the restaurant. Alice uses the restaurant kitchen to prepare food for the catering business. The catering business employs its own staff and owns equipment and trucks that are not used or associated with the restaurant.

Because the restaurant and catering business are held in disregarded entities, Alice is treated as operating each of these businesses directly and satisfies the ownership test. The businesses provide the same services in that both businesses offer prepared food to customers. The two businesses share the same kitchen facilities and share centralized purchasing, marketing, and accounting. Alice can elect to aggregate the catering business and the restaurant [Treas. Reg. § 1.199A-4(d), Example 1].

Example 3.9
Dissimilar Products, Shared Business Functions

A clothing manufacturer and a pet food business are under common ownership. The products are not similar, but the two activities share common management. Because the shared management is the only business function test that the two businesses satisfy, the owners cannot elect to aggregate these businesses [Treas. Reg. § 1.199A-4(d), Example 3].

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Example 3.10
Residential and Commercial Property Are Dissimilar

Stonefly Corporation owns 100% of the interests in a residential condominium building and 100% of the interests in a commercial rental office building. Both building operations share centralized accounting, legal, and human resource functions.

Stonefly owns more than 50% of each trade or business and satisfies the ownership test. Although both businesses share significant centralized business elements, the two building operations are not the same type of property. Stonefly Corporation must treat the residential condominium building and the commercial rental office building as separate trades or businesses [Treas. Reg. § 1.199A-4(d), Example 17].

Deciding When to Aggregate

Aggregation is beneficial if one of the businesses has more W-2 wages or UBIA than it needs to meet the W-2 wage and capital limitation, and the QBI deduction of the other business is reduced by that limitation. Without excess wages or UBIA, aggregation may reduce the QBI deduction.

Example 3.11
Aggregation Increases QBI Deduction

Morgan and Jessica Hart are married and file a joint return for 2021. Their taxable income is above the phasein range, so they are subject to the W-2 wage and capital limit on all their income. They are not subject to the taxable income limit. Morgan and Jessica are the 100% owners of Wild River Whitewater Rafting Company and Tranquil River Fly Fishing Company, both of which are S corporations.

The raft company and the fishing company operate from the same facility, which is owned by the raft company. They share boats that are also owned by the raft company. They share accounting and other administrative services. The rafting customers typically also book a fly fishing trip. **Figure 3.10** shows the QBI items for each business.

FIGURE 3.10
QBI Items

	Wild River Whitewater Rafting	Tranquil River Fly Fishing
Net income (all QBI)	$1,000,000	$1,000,000
W-2 wages	$600,000	$150,000
UBIA of qualified property	$3,000,000	$0

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Figure 3.11 compares the QBI deductions for the raft company and the fly fishing company as separate trades or businesses, and the deduction if they are aggregated.

FIGURE 3.11
Separate and Aggregated Deductions

Separate Businesses	Wild River Whitewater Rafting	Tranquil River Fly Fishing
Tentative QBI deduction (20% QBI)	$200,000	$200,000
50% W-2 wages	$300,000	$75,000
25% W-2 wages + 2.5% UBIA	$225,000	$37,500
W-2 wage and capital limit	$300,000	$75,000
QBI deduction	$200,000	$75,000

Aggregated Businesses	Wild River Whitewater Rafting and Tranquil River Fly Fishing
Tentative QBI deduction (20% QBI)	$400,000
50% W-2 wages	$375,000
25% W-2 wages + 2.5% UBIA	$262,500
W-2 wage and capital limit	$375,000
QBI deduction	$375,000

The raft company has more W-2 wages than it needs to support a deduction for 20% of its income. The QBI deduction for the fly fishing company is reduced by the W-2 wage and capital limitation. Aggregation allows the fly fishing company to use the excess W-2 wages and increases the overall QBI deduction by $100,000 [$375,000 – ($200,000 + $75,000)].

Consistency and Reporting

Once an individual chooses to aggregate two or more trades or businesses, the individual must consistently report the aggregated trades or businesses in all subsequent tax years. However, an individual can add a newly created or newly acquired trade or business to an existing aggregated trade or business if it meets the requirements for aggregation.

In a subsequent year, if there is a significant change in facts and circumstances and an individual's prior aggregation of trades or businesses no longer qualifies for aggregation, then the trades or businesses will no longer be aggregated. The individual must determine a new permissible aggregation (if any).

For each tax year, individuals must attach a statement to their returns identifying each aggregated trade or business. The statement must contain the following:

1. A description of each trade or business
2. The name and EIN of each entity in which a trade or business is operated
3. Information identifying any trade or business that was formed, ceased operations, was acquired, or was disposed of during the tax year
4. Information identifying any aggregated trade or business of an RPE in which the individual holds an ownership interest
5. Such other information as the IRS may require in forms, instructions, or other published guidance

If an individual fails to attach the required aggregation statement to his or her return, the IRS can disaggregate the individual's trades or businesses. The individual cannot aggregate trades or businesses that the IRS has disaggregated for the subsequent 3 tax years [Treas. Reg. § 1.199A-4(c)(2)(ii)].

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ISSUE 5: PARTNERSHIP CAPITAL ACCOUNT REPORTING REQUIREMENTS

This section discusses updated capital account reporting requirements for partnerships.

Over the past decade and a half, partnership tax filings have increased. For fiscal year 2019, 3,946,342 partnership returns were filed [IRS Publication 55-B (Rev. 6-2020), *Internal Revenue Service Data Book, 2019* (www.irs.gov/pub/irs-pdf/p55b.pdf)]. This increase in filings reinforced the IRS's need to improve the partnership data that is available for its compliance selection processes. In tax years that start on or after January 1, 2020, a partnership that is required to report capital accounts on its tax return must report those capital accounts using the transactional approach for the tax basis method.

This section discusses partnership capital accounts and provides guidance regarding calculating capital accounts using the transactional approach. It also reviews two other methods that the IRS has proposed to calculate tax basis capital account, when capital account reporting is required, and applicable penalties.

Capital Accounts

Prior to the 2020 tax year, partnerships could report their partners' capital accounts for the tax year on Schedules K-1 (Form 1065), Partner's Share of Income, Deductions, Credits, etc., using a variety of methods that are based on different principles [for example, tax basis, generally accepted accounting principles (GAAP), section 704(b) book, or any other method]. Although reporting is now required using the tax basis, partnerships may still maintain capital accounts on a book value or FMV basis. This section reviews book value and FMV capital accounts and explains how to calculate tax basis capital accounts that comply with the new reporting requirements.

Book Capital Accounts

I.R.C. § 704(b) requires a partnership to maintain book value capital accounts for special allocations to meet the safe harbor test for substantial economic effect [Treas. Reg. § 1.704-1(b)(2)(ii)(b)(1) and (iv)]. A book value capital account is increased by the following:

1. The amount of money contributed by the partner to the partnership
2. The FMV of property contributed by the partner to the partnership (net of liabilities that the partnership is considered to assume or take subject to)
3. Allocations to the partner of partnership income and gain (or items thereof)

A book value capital account is decreased by the following:

1. The amount of money that the partnership distributes to the partner
2. The FMV of property that the partnership distributes to the partner (net of liabilities that such partner is considered to assume or take subject to)
3. Allocations to the partner of nondeductible partnership expenditures as described in I.R.C. § 705(a)(2)(B)
4. Allocations to the partner of partnership loss and deduction (or item thereof)

FMV Capital Account

FMV capital accounts are like book value capital accounts but also include adjustments due to a change in the FMV of the partnership assets. FMV capital accounts represent each partner's share of the FMV of the partnership's assets.

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Tax Basis Capital Account

A partner's tax basis capital account (sometimes referred to as tax capital) represents the partner's equity as calculated using tax principles, not based on GAAP, section 704(b), or other principles. Under the transactional approach, a tax basis capital account is generally increased by the following:

1. The amount of money contributed to the partnership
2. The adjusted basis of property contributed to the partnership decreased by any liabilities that the partnership assumes (or to which the property is subject) in connection with the contribution (which the Form 1065 instructions note may result in a negative number)
3. The partner's distributive share of partnership income or gain (including tax-exempt income)
4. The partner's share of the excess of the deductions for depletion (other than oil and gas depletion) over the basis of the property subject to depletion
5. The amount of liabilities of the partnership assumed by the partner, excluding liabilities in connection with a distribution of property
6. The partner's distributive share of any increase to the tax basis of partnership property under I.R.C. § 734(b)

A tax basis capital account is generally decreased by the following:

1. The amount of money distributed by the partnership to the partner
2. The adjusted basis of property distributed by the partnership to the partner less the liabilities that the partner assumes (or to which the property is subject) in connection with the distribution (which may result in a negative number)
3. The partner's distributive share of losses and deductions, including noncapital, nondeductible expenses
4. The partner's distributive share of the deduction for depletion for any partnership oil and gas property to the extent such deduction does not exceed the proportionate share of the adjusted basis of such property allocated to the partner
5. The partner's distributive share of the adjusted tax basis of charitable property contributions and foreign taxes paid or accrued
6. The amount of the partner's individual liabilities that are assumed by the partnership, excluding liabilities assumed in connection with a contribution of property
7. The partner's distributive share of any decrease to the tax basis of partnership property under section 734(b)

PRACTITIONER NOTE

I.R.C. § 743(b) Basis Adjustments

While section 734 adjustments are adjustments to a partner's tax basis capital accounts under the transactional approach, adjustments under I.R.C. § 743 do not affect a partner's tax basis capital account. Section 743 adjustments affect only the partner acquiring an interest in the partnership. The 2020 Form 1065 instructions state that if section 743 adjustments were included in a partner's beginning tax basis capital account balance, those adjustments must be removed from the partner's capital account in the 2020 tax year and reported as a 2020 tax year other increase (decrease) item.

Example 3.12
Initial Capital Accounts Comparing Tax Basis, Book, and FMV Methods

Robert, Phil, and Linda Wilson formed RPL, LLC, which is taxed as a partnership. Robert contributed land with a $200,000 FMV, a $175,000 cost basis, and a $150,000 adjusted tax basis. The land was subject to a $50,000 liability that the company assumed. **Figure 3.12** shows Robert's initial capital account balance calculated on a tax basis method, book value method, and FMV.

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FIGURE 3.12
Robert's Initial Capital Account in RPL, LLC

	Tax Basis	Book	FMV
Land	$150,000	$200,000	$200,000
Debt	(50,000)	(50,000)	(50,000)
Capital account	$100,000	$150,000	$150,000

Example 3.13
Robert's Tax Basis Capital Account Adjustments

The facts are the same as in Example 3.12. In 2021, RPL, LLC had $450,000 income that was allocated $150,000 ($450,000 ÷ 3) to each member. RPL made a $100,000 distribution to each member. The calculation of Robert's tax basis capital account is shown in **Figure 3.13**.

FIGURE 3.13
Robert's Adjusted Tax Basis Capital Account in RPL, LLC

	Tax Basis
Beginning capital account	$100,000
Income	150,000
Distribution	(100,000)
Ending capital account	$150,000

Negative Tax Basis Capital Account

A partner's tax basis capital account can be negative if a partnership allocates tax losses or deductions or make distributions to the partner in excess of the partner's tax basis equity in the partnership, or when a partner contributes property subject to debt in excess of its adjusted tax basis to a partnership.

PRACTITIONER NOTE

Basis of the Partnership Interest vs. Tax Basis Capital Account

Tax basis capital accounts are not the same as a partner's basis in his or her partnership interest. A partner's basis in a partnership interest is increased by the partner's share of partnership liabilities under I.R.C. § 752, and the partner's tax basis capital account is not. A partner cannot have a negative basis in his or her partnership interest but may have a negative capital account.

Example 3.14
Negative Tax Basis Capital Account

The facts are the same as in Examples 3.12 and 3.13, except that RPL, LLC had a $450,000 loss in 2021. RPL, LLC has $600,000 recourse liabilities (the $450,000 loss and $150,000 liabilities assumed by the company on contributed property). The calculation of Robert's negative tax basis capital account is shown in **Figure 3.14**.

FIGURE 3.14
Robert's Negative Tax Basis Capital Account in RPL, LLC

	Tax Basis
Beginning capital account	$100,000
Income (loss)	(150,000)
Distribution	(100,000)
Ending capital account	($150,000)

Robert's tax basis capital account is negative. However, his basis in his partnership interest cannot be negative. Under I.R.C. § 752, the partnership allocates $200,000 ($600,000 ÷ 3) of the partnership's recourse liabilities to Robert. Robert has a $50,000 [($150,000) + 200,000 recourse liabilities] remaining basis in his partnership interest (after the allocation of the loss and the distribution). Therefore, Robert can deduct the allocated loss and take the $100,000 distribution tax-free. Robert's Schedule K-1 (Form 1065), Partner's Share of Income, Deductions, Credits, etc., is shown in **Figure 3.15**. Figure 3.15 shows the 2020 form because the 2021 form was not available at the time of this writing.

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FIGURE 3.15
Robert's Schedule K-1 (Form 1065)

651119

☐ Final K-1 ☐ Amended K-1 OMB No. 1545-0123

Schedule K-1 (Form 1065)
Department of the Treasury
Internal Revenue Service

2020

For calendar year 2020, or tax year beginning / / 2020 ending / /

Partner's Share of Income, Deductions, Credits, etc. ▶ See separate instructions.

Part I Information About the Partnership

A Partnership's employer identification number
XX-XXXXXXX

B Partnership's name, address, city, state, and ZIP code
RPL, LLC
100 Tax Workbook Lane
Austin, TX 73301

C IRS Center where partnership filed return ▶

D ☐ Check if this is a publicly traded partnership (PTP)

Part II Information About the Partner

E Partner's SSN or TIN (Do not use TIN of a disregarded entity. See instructions.)
XXX-XX-XXXX

F Name, address, city, state, and ZIP code for partner entered in E. See instructions.
Robert Wilson
55 College Ave.
Austin, TX 73301

G ☐ General partner or LLC member-manager ☒ Limited partner or other LLC member

H1 ☒ Domestic partner ☐ Foreign partner

H2 ☐ If the partner is a disregarded entity (DE), enter the partner's:
TIN _____ Name _____

I1 What type of entity is this partner? Individual

I2 If this partner is a retirement plan (IRA/SEP/Keogh/etc.), check here ☐

J Partner's share of profit, loss, and capital (see instructions):

	Beginning	Ending
Profit	33.3 %	33.3 %
Loss	33.3 %	33.3 %
Capital	33.3 %	33.3 %

Check if decrease is due to sale or exchange of partnership interest . . ☐

K Partner's share of liabilities:

	Beginning	Ending
Nonrecourse	$	$
Qualified nonrecourse financing	$	$
Recourse	$	$ 200,000

☐ Check this box if Item K includes liability amounts from lower tier partnerships.

L **Partner's Capital Account Analysis**

Beginning capital account	$ 100,000
Capital contributed during the year	$
Current year net income (loss)	$ (150,000)
Other increase (decrease) (attach explanation)	$
Withdrawals & distributions	$ (100,000)
Ending capital account	$ (150,000)

M Did the partner contribute property with a built-in gain or loss?
☒ **Yes** ☐ **No** If "Yes," attach statement. See instructions.

N **Partner's Share of Net Unrecognized Section 704(c) Gain or (Loss)**
Beginning $ 50,000
Ending $ 50,000

Part III Partner's Share of Current Year Income, Deductions, Credits, and Other Items

1	Ordinary business income (loss) (150,000)	15	Credits
2	Net rental real estate income (loss)		
3	Other net rental income (loss)	16	Foreign transactions
4a	Guaranteed payments for services		
4b	Guaranteed payments for capital		
4c	Total guaranteed payments		
5	Interest income		
6a	Ordinary dividends		
6b	Qualified dividends		
6c	Dividend equivalents	17	Alternative minimum tax (AMT) items
7	Royalties		
8	Net short-term capital gain (loss)		
9a	Net long-term capital gain (loss)	18	Tax-exempt income and nondeductible expenses
9b	Collectibles (28%) gain (loss)		
9c	Unrecaptured section 1250 gain		
10	Net section 1231 gain (loss)	19	Distributions 100,000
11	Other income (loss)		
		20	Other information
12	Section 179 deduction		
13	Other deductions		
14	Self-employment earnings (loss)		

21 ☐ More than one activity for at-risk purposes*
22 ☐ More than one activity for passive activity purposes*
*See attached statement for additional information.

For IRS Use Only

For Paperwork Reduction Act Notice, see Instructions for Form 1065. www.irs.gov/Form1065 Cat. No. 11394R **Schedule K-1 (Form 1065) 2020**

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Notice 2020-43

Notice 2020-43, 2020-27 I.R.B. 1, recognizes that due to the array of transactions that might affect partner tax capital under the transactional approach (discussed earlier), it is possible that partnerships that have been using the transactional approach may not have adjusted partner tax capital accounts in the same way under similar fact patterns. Several commenters explained that providing detailed guidance that would make the transactional approach consistent in all potential transactions would be a major project that would consume significant IRS resources.

To provide a consistent framework for all partnerships and other persons to comply with the tax capital reporting requirement, Notice 2020-43 proposes a requirement for partnerships to use only one of two alternative methods to satisfy the tax capital reporting requirement for partnership tax years that end on or after December 31, 2020. The two methods are a modified outside basis method in which a partnership may report the partner's basis in its partnership interest, reduced by the partner's allocable share of partnership liabilities, and a modified previously taxed capital method in which a partnership reports the partner's share of previously taxed capital, as calculated under a modified version of Treas. Reg. § 1.743-1(d).

PRACTITIONER NOTE

2020 Beginning Capital Account Balance

Partnerships that did not report partners' capital accounts on the tax basis method for 2019 or otherwise maintain tax basis capital accounts in their books and records (for example, for purposes of reporting negative capital accounts) could determine each partner's beginning capital account balance for 2020 using the tax basis method, the modified outside basis method, the modified previously taxed capital method, or the section 704(b) method. There were special rules for publicly traded partnerships.

Modified Outside Basis Method

The amount to report as a partner's beginning capital account under the modified outside basis method is the partner's adjusted tax basis in its partnership interest as determined under the principles and provisions of subchapter K (including I.R.C. §§ 705, 722, 733, and 742). Next, the partnership subtracts from that basis

1. the partner's share of partnership liabilities under section 752, and
2. the partner's net section 743(b) adjustments, if any.

For purposes of establishing a partner's beginning capital account, the partnership may rely on the adjusted tax basis information that the partner provides, unless the partnership has knowledge of facts indicating that the provided information is clearly erroneous.

Example 3.15
Modified Outside Basis Method

On January 15, 2020, Dilbert Gherkin purchased a 25% interest in Pickle Factory, LLC for $250,000. The LLC is taxed as a partnership. Under I.R.C. § 752, Dilbert is allocated $425,000 of company liabilities. His basis in his LLC interest is $675,000 ($250,000 + $425,000). At the time of purchase, Dilbert's share of basis in the LLC's assets was $525,000. The LLC made an election under I.R.C. § 754, and as a result, Dilbert had a $150,000 ($675,000 − $525,000) section 743 basis adjustment. Dilbert's tax basis capital account under the modified outside basis method is $100,000 ($675,000 − $425,000 − $150,000).

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Modified Previously Taxed Capital Method

The amount to report as a partner's beginning capital account under the modified previously taxed capital method is equal to

1. the amount of cash the partner would receive if the partnership liquidated after selling all its assets in a fully taxable transaction for cash equal to the FMV of the assets;
2. increased by the amount of tax loss determined without including any section 743(b) basis adjustments that would be allocated to the partner following such a liquidation; and
3. decreased by the amount of tax gain determined without including any section 743(b) basis adjustments that would be allocated to the partner following such a liquidation.

Example 3.16
Modified Previously Taxed Capital Method

The facts are the same as in Example 3.15 except that that the value of Pickle Factory, LLC has increased to $1,700,000. Its basis in the company assets is $600,000. Under a deemed sale, the LLC would recognize $1,100,000 ($1,700,000 −$600,000) gain. The company would allocate $275,000 ($1,100,000 × 25%) gain to Dilbert. Dilbert's share of the sale proceeds is $425,000 ($1,700,000 × 25%). His tax basis capital account under the modified previously taxed capital method is $150,000 ($425,000 −$275,000).

PLANNING POINTER

Alternatives to FMV

Instead of using the FMV of the assets for the modified previously taxed capital method, the partnership may determine its net liquidity value, and gain or loss, by using the basis of the assets under section 704(b), as determined for financial accounting purposes, or on the basis set forth in the partnership agreement for purposes of determining what each partner would receive if the partnership were to liquidate, as determined by partnership management.

Capital Account Reporting Requirements

A partnership reports partner tax capital accounts in item L (Part II) of Schedule K-1 (Form 1065). The partnership does not have to complete item L on Schedule K-1 if all the following conditions apply:

- The partnership's total receipts for the tax year were less than $250,000.
- The partnership's total assets at the end of the tax year were less than $1,000,000.
- The partnership files Schedules K-1 with its return and furnishes the schedules to the partners on or before the due date (including extensions) for the partnership return.
- The partnership is not filing and is not required to file Schedule M-3 (Form 1065), Net Income (Loss) Reconciliation for Certain Partnerships.

[Schedule B (Form 1065), Other Information, Question 4]

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PRACTITIONER NOTE

Other Reporting

Partnerships must also report partners' information about separate I.R.C. § 465 at-risk activities and a partner's share of net unrecognized section 704(c) gain or loss (for nonpublicly traded partnerships). I.R.C. § 704(c) defines built-in gains and losses as the difference between the FMV and adjusted tax basis of assets contributed to a partnership.

Penalties

I.R.C. § 6722 imposes a penalty on a partnership's failure to furnish a complete and correct Schedule K-1 (Form 1065) to a partner. A complete and correct Schedule K-1 includes the required capital account, built-in gain, and at-risk information. I.R.C. § 6698 imposes a penalty on a partnership's failure to file a partnership return that shows the required information (including each Schedule K-1). Reasonable cause exceptions may apply.

Notice 2021-13, 2021-6 I.R.B. 832, provides penalty relief for the 2020 tax year. The notice states that solely for tax year 2020 (for partnership returns for the 2020 tax year), the IRS will not assess a partnership a penalty for any errors in reporting its partners' beginning capital account balances on Schedules K-1 if the partnership takes ordinary and prudent business care to follow the Form 1065 instructions and calculate and report the beginning capital account balances. Similarly, penalties will not be assessed if a partnership incorrectly reports a partner's ending capital account balance to the extent the incorrect information is attributable solely to the incorrect information reported as the beginning capital account balance on the 2020 Schedule K-1 for which relief under Notice 2021-13 is available.

Partnerships are also eligible for a waiver of accuracy-related penalties under I.R.C. § 6662 for any imputed underpayment attributable to an adjustment to a partner's beginning capital account balance reported by the partnership for the 2020 tax year to the extent the adjustment arises from the inclusion of incorrect information for which the partnership qualifies for relief under Notice 2021-13. This penalty relief will be in addition to the reasonable cause exception to penalties under I.R.C. § 6724 for any incorrect reporting of a beginning capital account balance.

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ISSUE 6: LIKE-KIND EXCHANGES Final regulations explain what real property is eligible for a like-kind exchange.

I.R.C. § 1031 provides for the nonrecognition of gain or loss on the exchange of qualifying like-kind property that is used in a trade or business or held for investment. Under section 1031, any realized gain or loss is typically not recognized until the taxpayer disposes of the property acquired in the exchange. The Tax Cuts and Jobs Act of 2017 (TCJA), Pub. L. No. 115-97 § 13303, eliminated like-kind exchanges of personal property. Like-kind exchange treatment is still available for real property exchanges. Final regulations issued December 2, 2020, clarify what property qualifies as real property and is still eligible for like-kind exchange treatment.

This section discusses the requirements for a like-kind exchange and explains what is real property that qualifies for an exchange. This section also discusses the taxation of like-kind exchanges and the recapture rules that can cause income recognition at the time of the exchange.

Definitions

The following terms are used when discussing like-kind exchanges:

- *Boot* is cash paid or received by a taxpayer in addition to property transferred in a like-kind exchange. Boot also refers to unlike property given or received in an otherwise like-kind exchange.
- *Deferred gain* is gain that is realized in a like-kind exchange but not recognized at the time of the exchange. Deferral is accomplished by carrying over the basis from the relinquished property to the replacement property.
- *I.R.C. § 1245 property* is depreciable personal property and certain depreciable real property. Upon a disposition of section 1245 property, gain is taxed as ordinary income (but not self-employment income) to the extent of allowed or allowable depreciation.
- *I.R.C. § 1250 property* is depreciable real property (other than section 1245 property). Upon a disposition of section 1250 property, gain is taxed as ordinary income to the extent the allowed or allowable depreciation exceeds straight-line depreciation. Gain resulting from straight-line depreciation is subject to a maximum 25% tax rate.
- *Realized gain* is the difference between the adjusted basis of an asset and its FMV at the time it is transferred to another taxpayer. The realized gain may not be recognized at the time of the transfer because the transaction is tax deferred.
- *Recognized gain* is gain realized on the disposition of property that must be included in the gross income of the taxpayer who disposed of the property. All recognized gain is realized gain but not all realized gain is recognized gain.
- *Relinquished property* is property transferred to another party in a like-kind exchange.
- *Replacement property* is property received from another party in a like-kind exchange.

Requirements for Like-Kind Exchanges

The following conditions must be met for an exchange to be a like-kind exchange:

1. The relinquished property and the replacement property must be real property (discussed later).
2. The taxpayer completing the exchange must hold the relinquished property and the replacement property for investment or for productive use in a trade or business, not for personal use.
3. The real property cannot be held primarily for sale (i.e., inventory).

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4. The relinquished property and the replacement property must be like-kind. In general, all types of real estate are considered to be like-kind. However, real property outside of the United States and real property in the United States are not like-kind property.

CROSS-REFERENCE

Like-Kind Property

Under existing regulations, relinquished and replacement real property must be of the same nature and character, but it does not have to be of the same grade or quality. It does not matter whether the property is improved or unimproved. Under Treas. Reg. § 1.1031(a)-1(c), a taxpayer may continue to trade city real estate for a farm or ranch or for a leasehold interest of 30 years or more. The regulations do not change these rules. See pages 40–41 in the *2017 National Income Tax Workbook* for a further discussion of what constitutes like-kind property.

Real Property

Final regulations define *real property* for purposes of a like-kind exchange on or after December 2, 2020 [T.D. 9935]. The final regulations provide that real property is the following:

- Land and improvements to land
- Unsevered natural products of land, including growing crops, plants, and timber
- Water and air space superjacent to land
- Fee ownership, co-ownership, a leasehold, or an option to acquire real property; an easement; stock in a cooperative housing corporation; and certain shares in a mutual ditch, reservoir, or irrigation company

[Treas. Reg. § 1.1031(a)-3(a)]

Property is also classified as real property for section 1031 purposes if, on the date it is transferred in an exchange, the property is real property under the law of the state or local jurisdiction in which that property is located. However, a determination that property is personal property under state law does not preclude a determination that property is real property based on all the facts and circumstances under the various factors provided in the final regulations or if the property is specifically listed in the final regulations.

Real property that was eligible for like-kind exchange treatment under the law in effect prior to enactment of the TCJA is still eligible for like-kind exchange treatment and property that was ineligible for like-kind exchange treatment prior to enactment of the TCJA remains ineligible.

Improvements to Land

The regulations define *improvements to land* as inherently permanent structures and structural components of inherently permanent structures.

Inherently Permanent Structures

The following are some of the inherently permanent structures listed in the regulations:

- Buildings (structures that are permanently affixed, enclosed with walls, and covered by a roof)
- In-ground swimming pools
- Roads
- Bridges
- Tunnels
- Paved parking areas
- Parking facilities
- Other pavements
- Special foundations
- Stationary wharves and docks
- Fences
- Cell towers
- Oil and gas pipelines
- Grain storage bins and silos

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An inherently permanent structure may be permanently affixed by weight alone. If property is not listed in the regulations, a determination of whether it is an inherently permanent structure is based on the following factors:

1. The manner in which it is affixed to real property
2. Whether the distinct asset is designed to be removed or to remain in place
3. The damage that removal of the distinct asset would cause to the item itself or to the property to which it is affixed
4. Any circumstances that suggest the expected period of affixation in not indefinite
5. The time and expense required to remove the distinct asset

[Treas. Reg. § 1.1031(a)-3]

PRACTITIONER NOTE

Machinery and Equipment

Under the final regulations, machinery or equipment may be an inherently permanent structure if it is permanently affixed to real property and will ordinarily remain affixed for an indefinite period of time. The final regulations remove the provision in the proposed regulations that stated that machinery and equipment is considered real property only if it does not produce or contribute to the production of income.

Structural Components

Structural components are real property if they are integrated into an inherently permanent structure. If interconnected assets work together to serve an inherently permanent structure (for example, systems that provide a building with electricity, heat, or water), the assets are analyzed together as one distinct asset that may be a structural component. A structural component may qualify as real property only if the taxpayer holds its interest in the structural component together with a real property interest in the space in the inherently permanent structure served by the structural component.

Structural components include the following if they are integrated into an inherently permanent structure:

- Walls, partitions, and doors
- Wiring and plumbing systems
- Central air conditioning and heating systems
- Pipes and ducts
- Elevators and escalators
- Floors, ceilings, and permanent coverings of walls, floors, and ceilings
- Insulation
- Chimneys
- Fire suppression systems, including sprinkler systems and fire alarms, fire escapes, security systems, humidity control systems, and other similar property

If a distinct asset is not listed in the final regulations as a structural component, a determination of whether it is a structural component is based on the following factors:

1. The time, manner, and expense of installing and removing the component
2. Whether the component is designed to be moved
3. The damage that removal would cause to the component or to the structure
4. Whether the component is installed during construction of the inherently permanent structure to which it is attached

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Example 3.17
Sculpture Is Real Property

Cal Brown owns an office building whose atrium contains a large metal sculpture. The sculpture is 30 feet tall and 18 feet wide, and weighs 5 tons. The building was specifically designed to support the sculpture, which is permanently affixed to the building by supports embedded in the building's foundation. Removal would be costly and time-consuming, and would destroy the sculpture and damage the building's foundation. The sculpture was constructed within the building. The sculpture is reasonably expected to remain in the building indefinitely.

The sculpture is not listed in the regulations as an inherently permanent structure, and Cal must use the factors in the regulations to determine whether the sculpture is an inherently permanent structure. The sculpture is permanently affixed. It is not designed to be moved, and any removal would be costly, would be time-consuming, and would cause significant damage to the sculpture and the building. The sculpture was installed during the construction of the building. The sculpture meets the four factors that support the conclusion that the sculpture is a structural component of the building. Therefore, the sculpture is real property [Treas. Reg. § 1.1031(a)-3(b), Example 3].

Example 3.18
3D Printer and Generator Are Real Property

Ed Capitol, LLC owns a building that it uses in its trade or business of manufacturing airplane parts. On the ground floor of the building, there is an industrial 3D printer that can print airplane wings and an electrical generator that serves the building and the 3D printer in a backup capacity. The 3D printer weighs 12 tons and is designed to remain in place indefinitely. The printer was installed during the construction of the building because it does not fit through any doorway. Removal of the printer would be time-consuming and costly and would cause significant damage to the building.

The generator was also installed during construction of the building and is designed to remain in place indefinitely. While removal of the generator would be costly and time-consuming, it would not result in substantial damage to the generator or the building.

The 3D printer and generator are not listed as examples of structural components in the regulations. The printer meets all four factors (discussed earlier) in the regulations and is likely a structural component. The generator was installed during construction and is intended to remain indefinitely. It is difficult and costly to remove. It is consequently a structural component of the building and is real property [Treas. Reg. § 1.1031(a)-3(b), Example 5].

Intangible Assets

Intangible assets that are real property for purposes of section 1031 include a fee ownership; a co-ownership; a leasehold; an option to acquire real property; an easement; stock in a cooperative housing corporation; and certain shares in a mutual ditch, reservoir, or irrigation company. Similar interests are real property if the intangible asset

1. derives its value from real property, and
2. is inseparable from the real property.

The following intangible assets are not real property for purposes of section 1031 regardless of the classification of such property under state or local law:

- Stock (other than in a cooperative housing corporation), bonds, or notes
- Other securities or evidence of indebtedness or interest
- Interests in a partnership other than an interest in a partnership that has in effect a valid election under section 761(a) to be excluded from the application of all of subchapter K
- Certificates of trust or beneficial interests
- Choses in action

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PRACTITIONER NOTE

Licenses and Permits

A license, permit, or other similar right that is solely for the use, enjoyment, or occupation of land or an inherently permanent structure that is in the nature of a leasehold or easement generally is an interest in real property under section 1031. Conversely, a license or permit to engage in or operate a business on real property is not real property or an interest in real property regardless of its classification under state or local law.

Incidental Property Rule

Under Treas. Reg. § 1.1031(k)-1(g)(7), personal property that is incidental to replacement real property (incidental personal property) is disregarded in determining whether a taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or non-like-kind property held by the qualified intermediary are expressly limited. Personal property is incidental to real property acquired in an exchange if, in standard commercial transactions, the personal property is typically transferred together with the real property, and the aggregate FMV of the incidental personal property transferred with the real property does not exceed 15% of the FMV of the replacement real property.

Example 3.19
Incidental Personal Property Received

Sam Revere is exchanging an apartment building with a $1,100,000 FMV and a $400,000 adjusted basis. The replacement property is an office building that includes office furniture that is typically transferred with an office building. The FMV of the building is $1,000,000, and the FMV of the furniture is $100,000.

In a standard commercial transaction, the buyer of an office building typically also acquires some or all of the office furniture in the building. The FMV of the personal property Sam will acquire does not exceed 15% of the FMV of the office. Accordingly, the personal property is incidental to the real property in the exchange and is disregarded in determining whether Sam's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or non-like-kind property are expressly limited.

Upon the receipt of the personal property, Sam recognizes $100,000 gain under section 1031(b), which is the lesser of the $700,000 ($1,100,000 FMV − $400,000 adjusted basis) realized gain on the disposition of the relinquished property and the $100,000 FMV value of the non-like-kind property Sam acquired in the exchange [Treas. Reg. § 1.1031(k)-1(g)(8), Example 6].

Taxation of Like-Kind Exchanges

If the exchange is solely in-kind (that is, if qualifying property is exchanged for other qualifying property), the basis of the property received is the same as the basis of the property surrendered. No gain or loss is reported on the exchange.

CROSS-REFERENCE

Exchanges between Related Parties

A gain from a like-kind exchange between related persons must be recognized if either the property transferred or the property received is sold within 2 years after the exchange. The gain is recognized as of the date of the subsequent sale. See pages 42–44 in the *2016 National Income Tax Workbook* for a discussion of the definition of a related party, and certain exceptions to the requirement that a related party recognize the deferred gain.

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Receipt of Boot

If cash or unlike property (boot) is received in addition to the like-kind property, the result is a partially or fully taxable exchange. The seller is taxed on the gain realized, but only to the extent of the lesser of (1) the cash received plus the FMV of any unlike property received or (2) the realized gain. Any recognized gain, plus cash or unlike property paid or received, will cause an adjustment to the basis of the property received.

PRACTITIONER NOTE

Deferred Exchange

If the seller actually receives cash and other property and then obtains the replacement property at a later time, it is classified as a sale and not a like-kind exchange. It is possible to structure the transaction such that the taxpayer may sell the relinquished property, and transfer the sales contract to a qualified intermediary (QI) who collects and holds the cash. The QI then completes the exchange within prescribed timeframes. For additional information on deferred like-kind exchanges, see pages 52–54 in the *2017 National Income Tax Workbook*.

Example 3.20
Farmland Exchange—Receipt of Boot

Rob Russell owns 50 acres of northern Minnesota land with a $10,000 basis and a $50,000 FMV. Claire Martin owns 10 acres of Alabama farmland with a $45,000 FMV. Rob agrees to trade his land for Claire's land. Claire will give Rob $5,000 cash to make the exchange equal. **Figure 3.16** calculates Rob's $40,000 realized gain.

FIGURE 3.16
Calculation of Rob Russell's Realized Gain

FMV of property received	$45,000
Other unlike property received (cash)	5,000
Total amount received (sale price)	$50,000
Basis of property transferred	(10,000)
Other unlike property given (cash)	0
Gain realized	$40,000

Rob has realized an economic gain. However, gain is recognized (i.e., reported as taxable income) only on the amount of unlike property or cash received. Rob received $5,000 unlike property (cash), and he will recognize $5,000 of his gain. **Figure 3.17** shows the calculation of Rob's basis in the replacement property.

FIGURE 3.17
Rob Russell's Basis in the Replacement Property

Basis of land exchanged	$10,000
Plus: unlike property given (cash)	0
Plus: gain recognized	5,000
Less: unlike property received (cash)	(5,000)
Basis of new land	$10,000

Payment of Boot

If the taxpayer pays cash in addition to the relinquished property, there is no gain or loss if the transaction otherwise qualifies as a like-kind exchange. The amount of cash paid increases the basis of the replacement property.

Assumption of Liabilities

If one party exchanges property with a mortgage that the other party assumes, it is treated as though he or she receives cash from the other party to pay off that mortgage and adds to the boot received. If both parties exchange property with liabilities, the net assumption of debt is boot paid or received.

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Like-Kind Exchanges and Recapture

If property subject to recapture rules under I.R.C. § 1245, 1250, 1252, 1254, or 1255 is exchanged for property subject to the same recapture rules (for example, section 1245 property is exchanged for other section property), the recognized recapture is limited to the amount of any gain that is recognized (generally because of boot received). Any amount that is not recaptured in the year of the exchange carries over to the new property and is recaptured upon any taxable disposition of the new property.

However, if the replacement property is not subject to the same recapture rules as the relinquished property, the recapture rules require taxpayers to recognize the recapture income at the time of the exchange, even though no boot is received, and no gain would have been recognized under the general provisions of section 1031. For example, exchanging section 1245 real property for section 1250 real property requires the taxpayer to recapture depreciation on the relinquished property [I.R.C. § 1245(b)(4)].

OBSERVATION

Different Recapture Rules

In some cases, section 1245 real property and property that is not section 1245 property are like-kind. In those cases, the section 1245 recapture rules can cause gain to be recognized as ordinary income at the time of the like-kind exchange even though the gain would not have to be recognized under the section 1031 like-kind exchange rules. Similar rules apply when replacement property is acquired under I.R.C. § 1033 (involuntary conversion) for property that was destroyed in a casualty, stolen, condemned, or disposed of under the threat of condemnation.

Property Subject to Same Recapture Rules

Taxpayers who exchange property subject to recapture rules for like-kind property subject to the same recapture rules must carry the recapture amount over to the replacement property. The carried-over amount is subject to recapture upon a taxable disposition of the replacement property.

Example 3.21 Exchange of Section 1245 Property

In 2021, George Waddle, who operates an organic farm, traded a parcel of land with a commercial greenhouse (greenhouse 1) for another parcel of land with a greenhouse closer to his farm stand (greenhouse 2). The greenhouses meet the definition of real property and are section 1245 property. The FMV of each parcel of land was the same. However, the FMV of greenhouse 1 was $90,000 and the FMV of greenhouse 2 was $85,000, so George received $5,000 cash in addition to greenhouse 2.

George's adjusted basis in greenhouse 1 was $62,645, and his recomputed basis was $100,000 ($62,645 adjusted basis + $37,355 accumulated depreciation). George's *realized* gain was $27,355 ($85,000 + $5,000 −$62,645). His *recognized* gain under section 1031 is limited to the $5,000 boot received.

George's realized depreciation recapture is the lesser of his $27,355 realized gain and his $37,355 accumulated depreciation, or $27,355. His recognized depreciation recapture is limited to the $5,000 gain he realized on the like-kind exchange. George carries over the remaining $22,355 ($27,355 – $5,000) of depreciation recapture to greenhouse 2.

Figure 3.18 shows the calculation of George's realized and recognized gains, and **Figure 3.19** shows George's completed Form 8824, Like-Kind Exchanges. George reports the recognized gain (boot) on Form 4797, as shown in **Figure 3.20**. Figures 3.19 and 3.20 use the 2020 forms because the 2021 forms were not available at the time of this publication.

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FIGURE 3.18
George Waddle's Realized and Recognized Gain

FMV of greenhouse 2	$85,000
Cash received	5,000
Amount realized	$90,000
Adjusted basis of greenhouse 1	(62,645)
Realized section 1245 gain	$27,355
Recognized section 1245 recapture	(5,000)
Deferred section 1245 recapture	$22,355

FIGURE 3.19
George Waddle's Form 8824, Parts I and III

Form **8824**
Department of the Treasury
Internal Revenue Service

Like-Kind Exchanges
(and section 1043 conflict-of-interest sales)
► Attach to your tax return.
► Go to *www.irs.gov/Form8824* for instructions and the latest information.

OMB No. 1545-1190
2020
Attachment Sequence No. 109

Name(s) shown on tax return: George Waddle
Identifying number: XXX-XX-XXXX

Part I Information on the Like-Kind Exchange

Note: Generally, only real property should be described on lines 1 and 2. However, you may describe personal property transferred prior to January 1, 2018, as part of an exchange subject to the like-kind exchange transition rule described in the instructions, and/or real property on lines 1 and 2, if you are filing this form to report the disposition of property exchanged in a previously reported related party like-kind exchange. If the property described on line 1 or line 2 is real or personal property located outside the United States, indicate the country.

1 Description of like-kind property given up:
Commercial greenhouse 1

2 Description of like-kind property received:
Commercial greenhouse 2

3	Date like-kind property given up was originally acquired (month, day, year)	3	02/02/2019
4	Date you actually transferred your property to the other party (month, day, year)	4	07/02/2021
5	Date like-kind property you received was identified by written notice to another party (month, day, year). See instructions for 45-day written identification requirement	5	07/02/2021
6	Date you actually received the like-kind property from other party (month, day, year). See instructions	6	07/02/2021

7 Was the exchange of the property given up or received made with a related party, either directly or indirectly (such as through an intermediary)? See instructions. If "Yes," complete Part II. If "No," go to Part III . . . ☐ Yes ☑ No

Note: Do not file this form if a related party sold property into the exchange, directly or indirectly (such as through an intermediary); that property became your replacement property; and none of the exceptions in line 11 applies to the exchange. Instead, report the disposition of the property as if the exchange had been a sale. If one of the exceptions on line 11 applies to the exchange, complete Part II.

(continued on next page)

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FIGURE 3.19 (continued)
George Waddle's Form 8824, Parts I and III

Part III Realized Gain or (Loss), Recognized Gain, and Basis of Like-Kind Property Received

Caution: If you transferred **and** received **(a)** more than one group of like-kind properties or **(b)** cash or other (not like-kind) property, see ***Reporting of multi-asset exchanges*** in the instructions.

Note: Complete lines 12 through 14 **only** if you gave up property that was not like-kind. Otherwise, go to line 15.

12	Fair market value (FMV) of other property given up	12		
13	Adjusted basis of other property given up	13		
14	Gain or (loss) recognized on other property given up. Subtract line 13 from line 12. Report the gain or (loss) in the same manner as if the exchange had been a sale		14	
	Caution: If the property given up was used previously or partly as a home, see ***Property used as home*** in the instructions.			
15	Cash received, FMV of other property received, plus net liabilities assumed by other party, reduced (but not below zero) by any exchange expenses you incurred. See instructions		15	5,000
16	FMV of like-kind property you received		16	85,000
17	Add lines 15 and 16		17	90,000
18	Adjusted basis of like-kind property you gave up, net amounts paid to other party, plus any exchange expenses **not** used on line 15. See instructions		18	62,645
19	**Realized gain or (loss).** Subtract line 18 from line 17		19	27,355
20	Enter the smaller of line 15 or line 19, but not less than zero		20	5,000
21	Ordinary income under recapture rules. Enter here and on Form 4797, line 16. See instructions		21	5,000
22	Subtract line 21 from line 20. If zero or less, enter -0-. If more than zero, enter here and on Schedule D or Form 4797, unless the installment method applies. See instructions		22	0
23	**Recognized gain.** Add lines 21 and 22		23	5,000
24	Deferred gain or (loss). Subtract line 23 from line 19. If a related party exchange, see instructions		24	22,355
25	**Basis of like-kind property received.** Subtract line 15 from the sum of lines 18 and 23		25	62,645

FIGURE 3.20
George Waddle's Form 4797, Part II

Form **4797**

Department of the Treasury
Internal Revenue Service

Sales of Business Property
(Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2))

▶ **Attach to your tax return.**
▶ **Go to *www.irs.gov/Form4797* for instructions and the latest information.**

OMB No. 1545-0184

2020

Attachment Sequence No. **27**

Name(s) shown on return	Identifying number
George Waddle	XXX-XX-XXXX

Part II Ordinary Gains and Losses (see instructions)

10 Ordinary gains and losses not included on lines 11 through 16 (include property held 1 year or less):

11	Loss, if any, from line 7	11	( )
12	Gain, if any, from line 7 or amount from line 8, if applicable	12	
13	Gain, if any, from line 31	13	
14	Net gain or (loss) from Form 4684, lines 31 and 38a	14	
15	Ordinary gain from installment sales from Form 6252, line 25 or 36	15	
16	Ordinary gain or (loss) from like-kind exchanges from Form 8824	16	5,000
17	Combine lines 10 through 16	17	5,000
18	For all except individual returns, enter the amount from line 17 on the appropriate line of your return and skip lines a and b below. For individual returns, complete lines a and b below.		
a	If the loss on line 11 includes a loss from Form 4684, line 35, column (b)(ii), enter that part of the loss here. Enter the loss from income-producing property on Schedule A (Form 1040), line 16. (Do not include any loss on property used as an employee.) Identify as from "Form 4797, line 18a." See instructions	18a	
b	Redetermine the gain or (loss) on line 17 excluding the loss, if any, on line 18a. Enter here and on Schedule 1 (Form 1040), Part I, line 4	18b	5,000

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Example 3.22
Sale of Replacement Property

The facts are the same as in Example 3.21. In 2022, George sells greenhouse 2 for $90,000. He has $25,890 accumulated depreciation, and his adjusted basis is $36,755 ($62,645 basis − $25,890 accumulated depreciation). He will have a $53,245 ($90,000 selling price – $36,755 adjusted basis) gain. The $22,355 deferred recapture from greenhouse 1 reduces George's section 1231 gain to $5,000 ($53,245 – $25,890 – $22,355).

Property Subject to Different Recapture Rules

If a taxpayer exchanges property subject to recapture rules for like-kind property that is not subject to the same recapture rules, he or she must recognize the recaptured income at the time of the like-kind exchange because the replacement property will not be subject to those recapture rules upon a subsequent disposition.

PRACTITIONER NOTE

Recapture Income

Because buildings placed in service after 1986 are section 1250 property depreciated under the straight-line method, most taxpayers have no realized recapture income from a like-kind exchange of real property. However, taxpayers could occasionally have realized recapture income from real property relinquished in a like-kind exchange if, for example, a taxpayer exchanges real property that is a single purpose agricultural structure, or other section 1245 property treated as real property.

Example 3.23
Exchange of Different Property

Penny Plum is an organic farmer. In 1990, she paid $120,000 for a parcel of land with a large commercial greenhouse. She depreciated the property using straight-line depreciation. In 2021, when the property had a $20,000 basis and a $500,000 FMV, Penny gave up her business and decided to try tax return preparation. She exchanged the commercial greenhouse for an office building. The FMV of the office building was $500,000.

Because the office building and greenhouse are like-kind properties, section 1031 would allow Penny to defer her $480,000 ($500,000 – $20,000) gain on the greenhouse. However, section 1245 requires Penny to recognize $100,000 of recapture income on the section 1245 greenhouse that was exchanged for the section 1250 office building.

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ISSUE 7: INVOLUNTARY CONVERSIONS

This section reviews the nonrecognition treatment of gains on property that was involuntarily converted.

Under I.R.C. § 1033(a)(1), no gain is recognized if property that was destroyed, stolen, seized, or condemned is compulsorily or involuntarily converted into similar property. This nonrecognition treatment is mandatory. If instead such property is converted into money or unlike property, and the taxpayer purchases similar or related property to replace the converted property, at the election of the taxpayer, gain is recognized only to the extent that the amount realized on the conversion exceeds the cost of the replacement property. The involuntary conversion rules apply to any property (personal use property as well as business and investment property) that is involuntarily converted.

CROSS-REFERENCE

Casualty Losses and Theft Losses

This section discusses the rules for nonrecognition of gain upon an involuntary conversion. Section 1033 applies only to gains and does not affect the recognition or nonrecognition of losses from involuntary conversions. See pages 302–315 in the *2020 National Income Tax Workbook* for a discussion of the casualty loss deduction.

Loss of Property

Nonrecognition treatment may be available for property that was disposed of due to destruction, theft, seizure or requisition, a taking by condemnation, or the sale or exchange of such property under threat or imminence of requisition or condemnation [Treas. Reg. § 1.1033(a)-2]. This section explains involuntary conversions due to destruction, theft, or condemnation.

Destruction

An involuntary conversion may apply to partial or total destruction of property. First, a taxpayer's property must be involuntarily damaged, and second, the property must no longer be available for the taxpayer's intended use for the property. The taxpayer must generally have no choice as to whether to dispose of the damaged property and must be compelled to replace the damaged property.

Definition of Destruction

The term *destruction* in section 1033 has the same meaning as the term *casualty* in I.R.C. § 165(c)(3) except that the destruction does not have to be sudden [Rev. Rul. 59-102, 1959-1 C.B. 200]. Under section 165, a casualty is a sudden, unexpected, and unusual event that causes damage or destruction of property. Thus, a section 1033 destruction must be unexpected (not ordinarily unanticipated) and unusual (not a day-to-day occurrence).

Example 3.24
Loss Due to Disease

Jennifer Lee has a tree farm in Texas. In 2020, Southern Pine Beetles infested the trees. Between 8 and 9 months later, the trees died and became worthless. The loss was unusual and unexpected, and gain on the subsequent sale of the trees may qualify as gain from an involuntary conversion if Jennifer replants the trees. However, the loss will not qualify for a casualty loss deduction because it does not meet the suddenness requirement [based on Ltr. Rul. 85-44-001 (July 12, 1985)].

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Partial Destruction

The possibility that partial damage might be small or result in a nominal amount of reduction in gain is not a reason to deny relief [*Willamette Industries v. Commissioner*, 118 T.C. 126 (2002)]. However, the sale of damaged property does not qualify if the damage can be repaired. In *C.G. Willis v. Commissioner*, 41 T.C. 468 (1964), *aff'd* 342 F.2d 996 (3d Cir. 1965), the taxpayer sold a partially damaged ship even though the ship was repairable and reusable. The sale proceeds were used to purchase a barge that better served the taxpayer's business. The court denied deferral for the sale proceeds, concluding that the ship was not sold because of the conversion. Rather, it was sold as the "result of a business decision by the owner that the money equivalent of the unrepaired ship would serve its business interests better."

Example 3.25
Sale after Partial Damage

Malls, Inc. owned a shopping center that contained several stores and offices that were occupied by tenants. A fire in the mall caused damage to some of the units, but the tenants in the undamaged units continued their tenancy after the fire. Malls, Inc. decided that the future of shopping was online, sold the entire shopping center, and invested the insurance and sale proceeds in an online shopping platform.

Even if the online shopping platform is similar to the brick-and-mortar shopping center, Malls, Inc. cannot defer the gain on the sale because it could have repaired the damaged property and continued to rent to the tenants in the undamaged property. If the replacement property is similar to the damaged property, Malls, Inc. may be able to defer any gain on the receipt of the insurance proceeds for the fire-damaged portion of the property [based on Rev. Rul. 78-377, 1978 C.B. 208].

Theft

A theft is the unlawful taking or removing of property with the intent to deprive the owner of it. It includes, but is not limited to, larceny, robbery, and embezzlement. It may also include property taken as a result of extortion, blackmail, threats, or kidnapping. Mislaid or lost property is not a theft. Under section 1033, no gain is recognized if property that was stolen is compulsorily or involuntarily converted into similar property.

Condemnation

Under the law of eminent domain, governments have the right to acquire private property if the property is needed for public use. The taking is called a condemnation. Governments use eminent domain to acquire property for roads, telephone lines, electric lines, railroad tracks, or other public services.

Condemnation Award

The government must compensate the owner of the condemned property (a condemnation award) for the property taken. Amounts the government pays on a mortgage or lien against the property are part of the award, even if the debt is nonrecourse (the owner is not personally liable). Interest paid for a delay in paying a condemnation award is not part of the condemnation award and must be reported separately as ordinary income.

If property was condemned or disposed of under the threat of condemnation, the taxpayer calculates his or her gain or loss by comparing the adjusted basis of the condemned property with the net condemnation award (total award less costs to obtain the award). If the net condemnation award is more than the adjusted basis of the condemned property, the taxpayer has a gain.

The taxpayer can postpone reporting a gain from a condemnation if he or she buys replacement property. If only part of the property is condemned, the taxpayer can treat the cost of restoring the remaining part to its former usefulness as the cost of replacement property. Special rules apply to the condemnation of a main home (discussed later).

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Example 3.26
Condemnation

The city of West Grove needed to widen Route 2, which is the main access route through the city. Marvin Woods has 40 acres along Route 2. He has a pasture adjacent to the highway, and his house is on the rear portion of the property. West Grove took an acre of Marvin's property by condemnation. The city paid Marvin $25,000. His adjusted basis in the property was $10,000. Marvin has a $15,000 ($25,000 − $10,000) gain. If Marvin reinvests the $25,000 condemnation award in similar property, he does not have to recognize the gain.

PLANNING POINTER

Sale of Related Property

A voluntary sale of property may be treated as a forced sale that qualifies as an involuntary conversion if the property has a substantial economic relationship to property that was condemned, and the condemned property cannot be reasonably or adequately replaced. A substantial economic relationship exists if together the properties are one economic unit.

Severance Damages

Severance damages are amounts that the government pays to compensate an owner of condemned property for any decrease in value of the remaining property because of the condemnation, or to restore the remaining property to its same usefulness after the condemnation. Severance damages are not part of the condemnation award and are treated as the amount realized from an involuntary conversion of the retained property. Severance damages reduce the basis of the remaining property.

If the severance damages exceed the basis of the retained property, the taxpayer has a gain. However, the taxpayer can defer reporting the gain by purchasing property that is similar or related in use. Costs to restore the remaining property to its former usefulness are treated as the cost of replacement property.

Similar Replacement Property

A taxpayer can postpone reporting the gain on an involuntary conversion if he or she buys property that is similar or related in service or use to the involuntarily converted property within the replacement period (discussed later). Gain is also postponed if the taxpayer buys a controlling interest (at least 80%) in a corporation owning property that is similar or related in service or use to the replaced property.

PRACTITIONER NOTE

Purchase of Replacement Property

Property or stock purchased before the disposition of the converted property is considered to have been purchased for the purpose of replacing the converted property only if such property or stock is held by the taxpayer on the date of the disposition of the converted property. Property acquired by gift or inheritance that does not have a cost basis will not qualify as a replacement for the converted property.

Business or Investment Real Property

A special rule under section 1033(g) states that if real property (not including stock in trade or other property held primarily for sale) held for productive use in a trade or business or for investment is (as the result of its seizure, requisition, or condemnation, or threat or imminence thereof) compulsorily or involuntarily converted, property of a like kind to be held either for productive use in trade or business or for investment is treated as property that is similar or related in service or use to the property so converted.

Tangible Business or Investment Property

If a taxpayer's property held for productive use in a trade or business or for investment is located in a disaster area and is compulsorily or involuntarily converted as a result of a federally declared disaster, tangible property of a type held for productive use in a trade or business is treated as property that is similar or related in service or use to the converted property [section 1033(h)].

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Other Property

If the taxpayer is the owner and user of the converted property, *similar or related in service or use* means that replacement property must function in the same way as the property it replaces.

Example 3.27
Dissimilar Ownership and Use

Wilbur Harper's house was condemned by the state. Wilbur used the condemnation award to buy a grocery store, and he moved into a rental house. The replacement property is not similar or related in service or use to the condemned property and Wilbur cannot defer any realized gain.

If the taxpayer owns the condemned property but does not use it for himself or herself (i.e., an investment), *similar or related in service or use* means that any replacement property must have the same relationship of services or uses as the property it replaces. Factors to consider include the following:

1. Whether the properties are of similar service to the taxpayer
2. The nature of the business risks connected with the properties
3. What management and other services the taxpayer must provide to the tenants

Basis of Replacement Property

If the taxpayer receives property that is similar or related in service or use to the converted property, his or her basis for the new property is the same as the basis for the converted property. If the taxpayer receives money and purchases similar or related property, the basis of the new property is the cost of the property decreased by the amount of the gain not recognized. If the property purchased consists of more than one parcel of property, the basis must be allocated to the purchased properties in proportion to their respective costs.

Example 3.28
Trade or Business Property Gain

Charlie O'Neil has a commercial painting company that he operates as a sole proprietorship. He has a 5-acre parcel of land with a paint shop that he uses exclusively in his business. In 2021, the state condemned a 0.5-acre parcel along the south boundary of Charlie's land for use as a public park. The state paid Charlie $32,000 for the land, and it had a $12,000 basis. Charlie purchased an additional acre on the north boundary of his land for $70,000.

Charlie has a $20,000 ($32,000 proceeds − $12,000 basis) realized gain on the condemnation, which he defers by his purchase of the replacement property. Charlie's basis in the replacement property is $50,000 ($70,000 purchase price − $20,000 deferred gain).

Replacement Period

The replacement period begins on the date of the disposition of the converted property, or on the earliest date that there is a threat or imminence of condemnation. The replacement period generally is 2 years after the end of the first tax year in which any gain on the conversion is realized. It is extended to 4 years for a loss of the taxpayer's main home or its contents located in a federally declared disaster area [I.R.C. § 1033(h)].

A taxpayer can apply to the IRS for an extension of the replacement period. The taxpayer must submit the request before the end of the replacement period. Ordinarily, requests for extensions are granted near the end of the replacement period or the extended replacement period. Extensions are usually limited to a period of 1 year or less. The high market value or scarcity of replacement property is not a sufficient reason for granting an extension. The taxpayer may be eligible for an extension if the replacement property is being built and the taxpayer clearly shows that the replacement or restoration cannot be made within the replacement period.

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To get an extension, the taxpayer must show the following:

1. The taxpayer had reasonable cause for not having filed the application within the required period of time.
2. The filing of such application was made within a reasonable time after the expiration of the required period of time.

CROSS-REFERENCE

Sales of Livestock

Generally, if the sale or exchange of livestock is due to drought, flood, or other weather-related conditions in an area eligible for federal assistance, the replacement period ends 4 years after the close of the first tax year in which the taxpayer realizes any part of the gain from the sale or exchange. If the weather-related conditions continue for longer than 3 years, the replacement period may be extended further. See the "Agricultural and Natural Resource Tax Issues" chapter for a discussion of sales of livestock due to weather-related conditions.

Involuntary Conversion of Principal Residence

Under I.R.C. § 121(d)(5), the destruction, theft, seizure, requisition, or condemnation of a principal residence is treated as a sale of the residence. The taxpayer may be able to exclude up to $250,000 ($500,000 MFJ) of the gain. If the taxpayer's gain is more than the exclusion amount, and the taxpayer buys similar or related replacement property, he or she may be able to postpone reporting the rest of the gain. The replacement property must cost at least as much as the amount realized from the condemnation less the excluded gain.

The taxpayer must reduce the basis of the replacement property by the deferred gain. The taxpayer is treated as having owned and used the replacement property as the taxpayer's main home for the period he or she owned and used the converted property as a main home.

Example 3.29
Ownership and Use Test

In 2021, the state condemned a home that Cathy and Troy Schmid had used as a personal residence for 5 years before the condemnation. The city paid Cathy and Troy a $700,000 condemnation award. Their adjusted basis in the property was $150,000. Cathy and Troy realize a $550,000 ($700,000 − $150,000) gain. Cathy and Troy file jointly, and they can exclude $500,000 of the realized gain from gross income. The amount realized is $200,000 ($700,000 − $500,000), and the gain realized is $50,000 ($200,000 amount realized − $150,000 adjusted basis). If Cathy and Troy buy a new home for $800,000, they can elect to postpone the $50,000 realized gain. Their basis in the new home is $750,000 ($800,000 purchase price − $50,000 deferred gain). Their election is shown in Figure 3.21 (in the next section).

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Election and Reporting

If the taxpayer receives property that is similar or related in service or use to the involuntarily converted property, nonrecognition treatment is mandatory. No reporting is required. If the taxpayer receives money or property that is not similar or related in service or use to the involuntarily converted property, and then buys qualifying replacement property within the replacement period, the taxpayer can elect to postpone reporting the gain on the property purchased. If the cost of the replacement property is less than the amount realized, the taxpayer must also report the gain up to the unspent part of the amount realized.

A taxpayer reports the election to postpone reporting gain on a statement attached to the taxpayer's return for the tax year in which he or she realizes the gain. If the taxpayer buys the replacement property after he or she files the return reporting the election to postpone reporting the gain, the taxpayer must attach a statement to the return for the year of the purchase. The statement must contain detailed information about the replacement property. **Figure 3.21** shows the election to defer gain for Troy and Cathy Schmid (from Example 3.29).

FIGURE 3.21
Election to Defer Gain

Election to Defer Gain under I.R.C. § 1033

On February 8, 2021, the taxpayers realized a gain from the condemnation of their principal residence. The taxpayers elect to postpone this casualty gain and have purchased replacement property that is similar or related in use.

Condemnation award received	$700,000
Adjusted tax basis	(150,000)
Gain realized	$550,000
Gain excluded under I.R.C. § 121	(500,000)
Gain deferred	(50,000)
Gain recognized	$ 0
Cost of replacement property (principal residence)	$800,000
Gain deferred	(50,000)
Basis of replacement property	$750,000

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AGRICULTURAL AND NATURAL RESOURCE TAX ISSUES

4

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LEARNING OBJECTIVES

After completing this session, participants will be able to perform the following job-related actions:

- ✔ Understand how to assist farmers and ranchers to reduce taxes in higher-income years
- ✔ Calculate the tax on a sale of farm assets
- ✔ Know how livestock sales are taxed, and when income may be deferred
- ✔ Understand when a taxpayer can defer reporting crop insurance and disaster payments
- ✔ Understand how to calculate, carry over, and report net operating losses
- ✔ Know how a cooperative and its patrons calculate and report the qualified business income deduction
- ✔ Know how to close out a farming business

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INTRODUCTION

In 2021, adverse weather, changes in consumer demand, and supply chain disruptions created new challenges for farmers and ranchers. Some may have had unusually high income, and others may have decided to get out of the business of farming or ranching. This chapter explains tax planning strategies for a taxpayer in a high-income year, and the tax consequences of a sale of farm assets.

This chapter discusses how sales of livestock are taxed, and when a taxpayer can defer recognizing income on a weather-related sale of livestock or defer reporting payments for damaged or destroyed crops. This chapter also explains how a taxpayer calculates a net operating loss and applies the loss carryovers, and how agricultural and horticultural cooperatives and their patrons calculate the qualified business income deduction. Finally, for the taxpayer who has sold farm assets and ceased farming, this chapter reviews the steps that are necessary to close out the business.

ISSUE 1: TAX PLANNING FOR HIGHER-INCOME YEARS

This section discusses planning strategies for farmers and ranchers to reduce tax in higher-income years.

Due to weather and rapidly changing market conditions from year to year, farmers, ranchers, and other agricultural producers may have significant changes in their income. Market prices for some commodities increased in 2021, and farmers have an opportunity to engage in planning to minimize their tax liability.

This section discusses marginal and effective tax rates, and the following planning strategies:

1. Deferring taxes
2. Retirement plan contributions
3. Accelerating depreciation
4. Bunching itemized deductions
5. Self-employment tax planning
6. Maximizing permanent tax benefits

Marginal and Effective Tax Rates

A taxpayer's marginal tax rate is the rate of tax on the last dollar of taxable income. Individual income tax rates have a progressive marginal tax rate structure. This means that the percentage of tax increases at higher income levels. Marginal tax rates are important for planning because they help determine the rate of tax on the next dollar of taxable income, or the reduction in tax by reducing taxable income.

A taxpayer's effective tax rate is the average tax rate paid on all taxable income. The effective tax rate is typically lower than the marginal rate because the highest marginal rate applies only to part of taxable income, deductions and credits reduce taxable income, and some income may be taxed at preferential tax rates (e.g., capital gains rates). A primary goal of tax planning is to reduce the taxpayer's marginal rate, which will reduce the taxpayer's effective tax rate.

PRACTITIONER NOTE

Tax Rate Schedules

The IRS provides tax tables (in the Form 1040 instructions) for taxable income up to $100,000. The tax amounts in the tax tables are based on midpoint ranges of taxable income. However, the examples in this section use the tax rate schedules to calculate the tax to facilitate the discussion of marginal tax rates.

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Example 4.1
Calculating the Marginal Rate

David Samuels is a single taxpayer. His 2020 farm profits were $32,000. When combined with income from a rental house and his other deductions, his taxable income was $40,600. Based on the 2020 tax rate schedule shown in **Figure 4.1**, David was in the 22% marginal tax rate bracket, which starts at $40,125. He paid $4,617.50 tax on $40,125 of his income (at rates ranging from 10% to 12%) and was taxed at a 22% rate on the remaining $475 ($40,600 − $40,125). David's total income tax was $4,722 [$4,617.50 + (22% × $475)]. Any additional profits would have been taxed at the 22% marginal tax rate (until David's taxable income exceeded $85,525). David's effective tax rate was approximately 11.6% ($4,722 ÷ $40,600).

FIGURE 4.1 2020
Tax Rate Schedule—Unmarried Individual
(Other Than Surviving Spouses and Heads of Household)

If Taxable Income Is:	The Tax Is:
Not over $9,875	10% of the taxable income
Over $9,875 but not over $40,125	$987.50 plus 12% of the excess over $9,875
Over $40,125 but not over $85,525	$4,617.50 plus 22% of the excess over $40,125
Over $85,525 but not over $163,300	$14,605.50 plus 24% of the excess over $85,525
Over $163,300 but not over $207,350	$33,271.50 plus 32% of the excess over $163,300
Over $207,350 but not over $518,400	$47,367.50 plus 35% of the excess over $207,350
Over $518,400	$156,235 plus 37% of the excess over $518,400

PRACTITIONER NOTE

Effective Tax Rate

The effective tax rate typically considers only federal income tax. It does not include FICA taxes, self-employment tax, or state and local taxes.

Example 4.2
Increased Marginal Rate

David, from Example 4.1, has a profitable corn and soybean crop in 2021, and his taxable income is $95,662. Based on the 2021 tax rate schedule shown in **Figure 4.2**, David is in the 24% marginal tax rate, which starts at $86,375. David's total income tax is $16,980 [$14,751 + {($95,662 − $86,375) × 24%}]. His effective tax rate increased to approximately 17.8% ($16,980 ÷ $95,662).

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FIGURE 4.2
2021 Tax Rate Schedule—Unmarried Individual (Other Than Surviving Spouses and Heads of Household)

If Taxable Income Is:	The Tax Is:
Not over $9,950	10% of the taxable income
Over $9,950 but not over $40,525	$995 plus 12% of the excess over $9,950
Over $40,525 but not over $86,375	$4,664 plus 22% of the excess over $40,525
Over $86,375 but not over $164,925	$14,751 plus 24% of the excess over $86,375
Over $164,925 but not over $209,425	$33,603 plus 32% of the excess over $164,925
Over $209,425 but not over $523,600	$47,843 plus 35% of the excess over $209,425
Over $523,600	$157,804.25 plus 37% of the excess over $523,600

PRACTITIONER NOTE

Capital Gains Tax Rates

The tax rates for long-term capital gains are also progressive, but the rate brackets are generally 0%, 15%, and 20%. In 2021, a single taxpayer is in the 0% bracket for long-term capital gains up to $40,400; the 15% bracket for long-term capital gains up to $445,850; and the 20% bracket for amounts in excess of $445,850.

Deferring Taxes

High-income taxpayers can take advantage of several tax provisions that allow them to defer income. Cash basis taxpayers can postpone the receipt of income or prepay certain expenses. Deferral of income on a weather-related livestock sale or payments received for damaged or destroyed crops are discussed later.

PRACTITIONER NOTE

Risks of Deferral

Deferral or nonrecognition can decrease or postpone a tax liability. In low-income years, taxpayers may prefer to forgo deferral. Similarly, it may not be advantageous to defer income if, for example, tax rates are higher when the income is recognized, or the taxpayer is in a higher income tax bracket. Deferral can also affect eligibility for certain deductions and credits and retirement contributions (discussed later), taxation of social security income, and eligibility for federal student aid or other resource-based benefits.

Deferring Receipt of Income

Cash method taxpayers include income when it is actually or constructively received [Treas. Reg. § 1.451-1]. Thus, cash basis taxpayers can defer income by deferring the sale of a commodity. They can also defer payment on the sale. However, under the constructive receipt doctrine of I.R.C. § 451, income may be included before it is actually received if it is credited to the taxpayer's account, set apart for the taxpayer, or otherwise made available to the taxpayer. Income is not constructively received if there is a substantial limitation or restriction on the taxpayer's receipt of the income [Treas. Reg. § 1.451-2(a)].

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Example 4.3
Deferring Receipt

Jennifer Wilson is a grain producer in North Dakota. Jennifer harvested her grain in November 2020. If Jennifer sells the grain in January 2021 (a deferral of less than 2 months), she will defer payment of tax on the sale by a full year.

CROSS-REFERENCE

Nonrecognition Treatment

Like-kind exchanges and reinvestment of proceeds from involuntary conversions can also defer income recognition. The deferred gain carries over to the replacement property. See the "Business Tax Issues" chapter in this workbook for a discussion of like-kind exchanges and involuntary conversions.

Example 4.4
Constructive Receipt

Sally Comstock is a corn producer in Iowa. Sally sold $50,000 of grain to a local dairy farm on December 30, 2021. When Sally delivered the corn to the farm, the neighbor offered to give her a check. Sally declined the check and told the buyer to put it in the mail the following week. Sally has constructive receipt of the $50,000 and must include the payment in her 2021 income.

CROSS-REFERENCE

Farm Income Averaging

I.R.C. § 1301 farm income averaging allows farmers to spread out income tax liability over a 4-year period. Income averaging may result in less tax if the current year's income is high relative to the taxable income (which includes income from farming) from prior years. Income averaging may be particularly useful in a year when a farmer is selling assets or getting out of the business of farming. See pages 605–608 in the *2019 National Income Tax Workbook* for a discussion of farm income averaging.

PRACTITIONER NOTE

Installment Sale

I.R.C. § 453(b) defines an installment sale as a disposition of property in which at least one payment is to be received in a tax year after the year of the disposition. Farmers who use the cash method of accounting are not required to include the commodities they produce in inventory at the end of the year. Therefore, they can use the installment method to report gain from the sale of those commodities. The installment method defers income recognition until payments are received. Although the tax savings of an installment sale can be significant, the seller acts as a lender and incurs the risk that the buyer will default. Also, the installment method does not defer the recognition of I.R.C.§ 1245 gain. All recapture income must be recognized in the first year of the sale, regardless of the amount of the first payment.

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Prepaying Expenses

Cash method taxpayers typically claim deductions when they pay expenses [Treas. Reg. § 1.461-1]. Thus, a strategy for cash basis farm and ranch owners to reduce their taxable business income is to pay as many expenses as possible. However, cash method taxpayers may not be able to claim a current deduction if an expenditure results in the creation of an asset having a useful life that extends substantially beyond the close of the tax year. The 12-month rule allows certain prepaid expenses, and the taxpayer may deduct certain prepaid farm supplies.

12-Month Rule

Under the 12-month rule, a taxpayer is not required to capitalize amounts paid to create certain rights or benefits that do not extend beyond the earlier of

- 12 months after the right or benefit begins, or
- the end of the tax year after the tax year in which payment is made.

For example, the taxpayer can deduct prepaid rent and insurance if the benefits do not extend beyond 12 months or the end of the next tax year.

Example 4.5
Prepaid Insurance

On November 1, 2021, Fred Franklin signed a contract for insurance on his farm equipment. He paid $3,800 for a 1-year policy. The policy term starts December 15, 2021.The 12-month rule applies to the payment because the policy does not extend beyond December 15, 2022 (12 months after the first date that Fred benefits from the policy) and it does not extend beyond December 31, 2022 (the end of the tax year following the tax year in which Fred made the payment). Fred can deduct the $3,800 payment in 2021.

PRACTITIONER NOTE

Prepaid Interest

Cash basis taxpayers cannot deduct prepaid interest, even if the prepayment meets the 12-month rule [I.R.C. § 461(g)]. They must deduct the interest in the year that it is due.

Prepaid Farm Supplies

Farmers may be able to deduct prepaid farm supplies, subject to some limitations [I.R.C. § 464]. Prepaid farm supplies include the following items if paid for during the year:

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

A cash method taxpayer's deduction for prepaid farm supplies may be limited to 50% of the taxpayer's other deductible farm expenses for the year [all Schedule F (Form 1040), Profit or Loss From Farming, deductions except prepaid farm supplies]. This deduction limit for prepaid farm supplies expense does not apply if the taxpayer is a farm-related taxpayer and farm supply expenses exceed 50% of other deductible farm expenses because of a change in business operations caused by unusual circumstances. The deduction limit also does not apply if a farm-related taxpayer's total prepaid farm supplies expense for the preceding 3 tax years is less than 50% of the taxpayer's total other deductible farm expenses for those 3 tax years.

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A taxpayer is *a farm-related taxpayer* if any of the following tests apply:

1. The taxpayer's main home is on a farm.
2. The taxpayer's principal business is farming.
3. A member of the taxpayer's family meets (1) or (2). For this purpose, *family* includes brothers and sisters, half-brothers and half-sisters, spouses, parents, grandparents, children, grandchildren, and aunts and uncles and their children.

If the deduction limit applies, the taxpayer can deduct the excess cost of farm supplies other than poultry in the year used or consumed. The excess cost of poultry bought for use (or for both use and resale) is deductible in the year following the year it is paid for. The excess cost of poultry bought for resale is deductible in the year sold.

Example 4.6
Prepaid Farm Supplies

In 2021, Sonja Granger, a cash method taxpayer, bought fertilizer ($40,000), feed ($10,000), and seed ($5,000) for use in 2022. Her total 2021 prepaid farm supplies expense was $55,000 ($40,000 + $10,000 + $5,000). Sonja's 2021 other deductible farm expenses were $100,000. Under the general rule, Sonja's 2021 deduction for the prepaid farm supplies is limited to $50,000 ($100,000 × 50%). Sonja can deduct the excess $5,000 ($55,000 − $50,000) prepaid farm supplies expense in a later tax year when the supplies are used. If Sonja is a farm-related taxpayer, and her total prepaid farm supplies expense for the preceding 3 tax years was less than 50% of her total other deductible farm expenses for those 3 tax years, her 2021 deduction will not be limited.

In addition to the 50% limitation, the cost of supplies purchased in the current year for use in the following year is deductible by a cash basis taxpayer in the current year only if the taxpayer meets the following three tests:

1. The expenditure is a payment and not merely a deposit.
2. The prepayment is made for a legitimate business purpose such as securing a lower price.
3. The deduction does not cause a material distortion of income.

[Rev. Rul. 79-229, 1979-2 C.B. 210]

OBSERVATION

Rev. Rul. 79-229

Although Rev. Rul. 79-229 specifically discusses prepaid livestock feed expenses, the IRS applied these requirements to prepayments for all farm supply expenses in the *Farmer's Audit Technique Guide*, chapter 4, "Expenses," 2006. That audit technique guide has been removed and is being revised.

Payment or Deposit

Whether a payment is a purchase or a deposit depends on the facts and circumstances in each case. The following factors indicate that a payment is a purchase:

- The purchase was made under a binding commitment to accept delivery of a specific quantity at a fixed price.
- The taxpayer is not entitled, by contract or business custom, to a refund or repurchase.

The following factors indicate that a payment is a deposit:

- There are no specific quantity terms.
- There is a right to a refund of any unapplied payment credit at the end of the contract.
- The seller treats the payment as a deposit.
- There is a right to substitute other goods or products for those specified in the contract.

A provision permitting substitution of ingredients to vary the particular feed mix to meet the current diet requirements of the taxpayer's livestock would not suggest a deposit. Further, a price adjustment to reflect market value at the date of delivery is not, by itself, proof of a deposit [Rev. Rul. 79-229, supra].

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Valid Business Purpose

The prepayment has a business purpose only if there is a reasonable expectation of receiving some business benefit from prepaying. The following are some examples of valid business benefits:

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

Other factors considered in determining the existence of a business purpose are whether the prepayment was a condition imposed by the seller and whether that condition was meaningful.

Material Distortion of Income

The following factors should be considered in determining whether there is a material distortion of income:

- Customary business practice in conducting the farm operations
- The amount of the expense in relation to past purchases
- The time of year the purchase was made
- The amount of the expense in relation to the taxpayer's income for the year

Practitioner Note

Other Expenses

Prepaying expenses can defer income. In addition, paying off accounts payable and accelerating repair and maintenance projects can reduce taxable income.

Retirement Plan Contributions

Regular IRA, SEP, SIMPLE, 401(k), and other retirement contributions provide another opportunity to defer reporting income. The taxpayer claims a deduction for the contribution when made and is not taxed until amounts are distributed.

Planning Pointer

Establishing an Account

IRAs must be established before the due date (excluding extensions) for the business income tax return for the year the plan is established. SEPs must be set up before the due date (including extensions) for the income tax return. An employer that has been in existence before October 1 but has not previously set up a SIMPLE plan must establish the plan no later than October 1.

Example 4.7
SEP Contributions

George Griffin is 40 years old. He operates his farm as a single-member LLC taxed as a disregarded entity. The company generated a $200,000 Schedule F (Form 1040) profit in 2021. The company had no employees and established a SEP in August 2021. The company contributed $13,500 to the SEP on January 30, 2022. The contribution does not exceed the 2021 contribution limit, which is the lesser of 25% of earned income or $58,000. George can deduct the contribution in 2021.

Accelerating Depreciation

Investments in dairy and breeding livestock, equipment, and single-purpose livestock and horticultural facilities are recovered through depreciation. Depreciation begins when the asset is placed in service even if the taxpayer purchases the asset on a deferred payment plan. This section reviews when the mid-quarter convention can be used to maximize depreciation.

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CROSS-REFERENCE

Tangible Property

The tangible property regulations may allow the taxpayer to currently deduct amounts paid to acquire, produce, or improve a unit of tangible property [T.D. 9636, 2013-43 I.R.B. 331]. See pages 268–277 in the *2016 National Income Tax Workbook* for a discussion of the regulations.

Mid-Quarter Convention

The mid-quarter convention is used if more than 40% of the bases of qualifying property is placed in service in the final quarter of the tax year [Treas. Reg. § 1.168(d)(1)]. Qualifying property is all depreciable MACRS property except nonresidential (39-year) real property, residential rental (27.5-year) property, and railroad grading or tunnel bore property, reduced by any section 179 expense deduction taken on the property. Under the mid-quarter convention, property is deemed to be placed in service as of the middle of the quarter. For a calendar-year taxpayer, a purchase in March will generate 10.5 months of depreciation, and a purchase in October will generate only 1.5 months of depreciation. Thus, triggering the mid-quarter convention will increase or decrease depreciation, depending on the when property is placed in service.

Example 4.8
Less Depreciation with Late-Year Purchase

Ivan Logan, a calendar-year taxpayer, purchased $80,000 of equipment in September 2021. The equipment is 5-year MACRS property, and Ivan is eligible to use the MACRS 200% DB method. Ivan has $16,000 [$80,000 × 20%] of depreciation.

To offset some of his 2021 income, Ivan purchases $54,000 of additional equipment in December 2021. Ivan must now use the mid-quarter convention because 40.3% [$54,000 ÷ ($80,000 + $54,000)] of his total qualifying purchases for the year were made in the last quarter. Ivan's total depreciation on the $134,000 ($80,000 + 54,000) of equipment will be only $14,700 [($80,000 × 0.15) + ($54,000 × 0.05)], which is 4.5 months of depreciation on the September purchases and 1.5 months of depreciation on the December purchases.

If instead Ivan takes a $667 section 179 deduction on his December purchases, his total year's qualifying purchases would be $133,333 ($134,000 − $667). His December purchases (net of the section 179 deduction) would be $53,333 ($54,000 − $667), which is 40% ($53,333 ÷ $133,333) of the total year's purchases. As the bases of qualifying property placed in service in the last quarter of 2021 does not exceed 40%, Ivan does not have to use the mid-quarter convention.

Example 4.9
More Depreciation with Late-Year Purchase

The facts are the same as in Example 4.8 except that Ivan purchased the $80,000 of equipment in March 2021 instead of September 2021. Ivan must still use the mid-quarter convention because of the December purchase and his depreciation is $30,700 [($80,000 × 0.35) + ($54,000 × 0.05)], which is 10.5 months of depreciation on the January purchases and 1.5 months of depreciation on the December purchases. If his December purchases had not triggered the mid-quarter convention, his depreciation under the half-year convention would have been only $26,800 ($134,000 × 0.20).

CROSS-REFERENCE

Bonus Depreciation

The additional first-year depreciation deduction under I.R.C. § 168(k) (bonus depreciation) is currently 100%. Bonus depreciation is the default for qualifying property, but taxpayers can elect out of bonus depreciation. See pages 362–368 in the *2020 National Income Tax Workbook* for a discussion of new and used property that qualifies for bonus depreciation.

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CROSS-REFERENCE

Section 179 Expense Deduction

Under I.R.C. § 179, the taxpayer can elect to recover all or part of the cost of certain qualifying property, in the year it is placed in service, instead of recovering the cost by taking depreciation deductions, by deducting it in the year the property is placed in service. See page 230 in the *2020 National Income Tax Workbook* for a comparison of bonus depreciation to the section 179 deduction.

Bunching Itemized Deductions

With the increase in the standard deduction ($25,100 for MFJ in 2021), the allowance for a charitable contribution deduction without itemizing ($600 for MFJ taxpayers in 2021), the limit on the deduction for state and local taxes, and elimination of certain miscellaneous itemized deductions, most taxpayers find that is it more advantageous to claim the standard deduction. However, bunching itemized deductions and claiming the itemized deduction in a higher-income year may be useful for the taxpayer whose itemized deductions do not exceed the standard deduction in any given year.

In the standard deduction year, the taxpayer can do the following:

- Delay charitable contributions
- Defer nonessential medical expenses such as glasses and hearing aids if medical expenses could exceed the 7.5%-of-AGI threshold in the itemized deduction year

In the itemized deduction year, the taxpayer can do the following:

- Catch up on deferred charitable contributions and medical expenses
- Pay estimated state income taxes and property taxes that have been billed [up to the $10,000 (MFJ) limit on the deduction for state and local taxes]

Example 4.10
Alternating Standard and Itemized Deductions

Mary Flowers files a joint tax return with her husband, Rob. In 2019, they had $22,000 of itemized deduction and claimed the $24,400 standard deduction. In 2020, they had $24,000 of itemized deductions and claimed the $24,800 standard deduction. Mary and Rob typically contribute $5,000 per year to the local food bank. They made no contributions for 2019 and 2020 and contributed $15,000 in 2021. In 2021, they made a state estimated tax payment and had $44,000 total itemized deductions. The standard deduction was only $25,100. Mary and Rob increased their deductions by $18,900 ($44,000 − $25,100). If they are in the 22% marginal tax bracket, they reduce their income taxes by $4,158 ($18,900 × 22%) by using this bunching strategy.

PLANNING POINTER

Donor Advised Funds

Similar to the bunching contributions strategy, a taxpayer can make a large deductible contribution to a donor advised fund (DAF). The taxpayer receives the deduction in the year the contribution is made and retains the right to direct future distributions from the DAF to qualified charities.

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Self-Employment Tax Planning

Farmers, like other individuals, are generally subject to self-employment (SE) tax on their SE income under I.R.C. § 1401. This 15.3% tax is comprised of a 12.4% old-age, survivors, and disability insurance (OASDI) tax (also called social security) and a 2.9% hospital insurance (also called Medicare) tax. SE tax is imposed on net earnings from self-employment, which I.R.C. § 1402(a) defines as gross income derived from a trade or business carried on by an individual or a partnership in which the individual is a member, less allowable deductions that are attributable to that trade or business.

Self-employed taxpayers pay SE tax on 92.35% of SE income, which equalizes the self-employed taxpayer with an employee for whom the employer pays a 7.65% share of FICA (Federal Insurance Contributions Act) tax that is not included in the employee's income. The OASDI tax is imposed on only the first $142,800 (for 2021) of wages, tips, and net SE earnings. There is no limit on the amount of wages, tips, and net earnings that are subject to the 2.9% Medicare tax. A 0.9% additional Medicare tax applies to wages, tips, and net earnings that exceed a certain threshold ($250,000 for MFJ and $200,000 for single or HoH) for a calendar year.

By separating a business into an entity that holds and leases the real property, and an entity that conducts the farming operations, a farmer may be able to reduce SE tax. Qualification as a limited partner may also reduce SE tax.

Renting to a Commonly Controlled Entity

If a taxpayer leases real property to a commonly controlled entity, the rental income from the leasing entity will not be subject to SE tax if the rent is not more than the fair rental value and there is no actual nexus between the lease and the arrangement in which the lessor materially participates [See *Martin v. Commissioner*, 149 T.C. 293 (2017)]. The lease should be in writing and should specifically state that no material participation by the property owner is required. The taxpayer should obtain and retain documentation that the rental rate is equal to or less than the rate for comparable properties.

Example 4.11
Reducing SE Tax

Polly Woolworth, a single taxpayer, operates a sheep operation as a sole proprietorship. Her average annual profit is usually $135,000 and she typically pays approximately $19,075 ($135,000 × 0.9235 × 15.3%) SE tax each year. In 2021, her profit increased to $280,000, and the amount subject to SE tax is $258,580 ($280,000 × 0.9235). Her SE tax is $25,206 [($142,800 × 12.4%) + ($258,580 × 2.9%)]. She is also subject to an additional Medicare tax of $527 [($258,580 − $200,000) × 0.9%].

If instead Polly had transferred the farm real estate to Woolworth Realty, LLC and transferred the inventory, livestock, and equipment to Woolworth Farms, LLC, Woolworth Realty could lease the farmland to Woolworth Farms. The lease must specify that Woolworth Realty and its owner (Polly) are not required to participate in the activities of Woolworth Farms. If the fair rental value of her farm real estate was $65,000 per year, Woolworth Farms would have a $215,000 ($280,000 – $65,000) profit. The amount subject to SE tax is $192,553 ($215,000 × 0.9235). Her SE tax would be $23,465 [($142,800 × 12.4%) + ($192,553 × 2.9%)]. She would no longer be subject to an additional Medicare tax because her SE earnings do not exceed $200,000. Her total savings would be $2,268 ($25,206 + $527 − $23,465).

Limited Partners

An LLC member's distributive share of company income is generally SE income that is subject to SE tax. Similarly, guaranteed payments from an LLC that conducts a trade or business are not wages but are treated as SE income. This SE income treatment also applies to guaranteed payments for the use of the member's capital and payments for services. Limited partners are not subject to SE tax on their distributive share of partnership income [I.R.C. § 1402(a)(13)] (but guaranteed payments to limited partners for services are SE income). Proposed regulations would allow LLC members (or partners in a partnership) to be treated the same as limited partners.

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PRACTITIONER NOTE

Substantial Authority for Tax Position

The proposed regulations were never finalized, and Congress subsequently prohibited any final or new regulations on this issue. However, the taxpayer may cite the proposed regulations to support the position that there is substantial authority for the limited partner to exclude his or her distributive share of earnings from SE earnings.

To be treated as a limited partner under the proposed regulations, the member must not

1. have unlimited personal liability for the company's debts, by virtue of being a member,
2. have authority under the law to contract on behalf of the organization (This authority may be conferred by state law or by the operating agreement adopted by the members.), or
3. participate in the trade or business activities of the company for more than 500 hours in the tax year question.

[Prop. Treas. Reg. § 1.1402(a)-2(h)(2)]

PRACTITIONER NOTE

Service Partners

An individual who is a service partner in a service partnership cannot be a limited partner. A service partnership is a partnership substantially all the activities of which involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting.

The proposed regulations would allow an individual who is not a limited partner for SE tax purposes to exclude from SE net earnings a portion of that individual's distributive share if the individual holds more than one class of interest. An individual holding more than one class of interest in the partnership who is not treated as a limited partner under the general rule is treated as a limited partner with respect to a specific class of partnership interest held by such individual if, immediately after the individual acquires that class of interest,

1. the limited partners under the general rule own a substantial, continuing interest in that specific class of partnership interest, and
2. the individual's rights and obligations with respect to that specific class of interest are identical to the rights and obligations of those limited partners.

Similarly, the proposed regulations would permit an individual who participates in the trade or business of the partnership to bifurcate his or her distributive share by disregarding guaranteed payments for services. In each case, however, bifurcation of interests would be allowed only to the extent the individual's distributive share is identical to the distributive share of partners who qualify as limited partners under the proposed regulations, without regard to the bifurcation rules, and who own a substantial interest in the partnership. Together, these rules would exclude from an individual's net earnings from SE amounts that are demonstrably returns on capital invested in the partnership.

CROSS-REFERENCE

S Corporations

S corporation shareholders do not have to pay SE tax on the S corporation income that exceeds reasonable compensation. See the "Choice of Entity" chapter in this workbook for a discussion of the taxation of S corporations and how they can minimize SE tax.

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Maximizing Permanent Tax Benefits

Permanent tax benefits are benefits that are available each year but cannot be carried over to future years. These permanent tax benefits include the standard deduction and the self-employed health insurance deduction. For tax years after 2025, they also include personal and dependent exemptions. Other tax benefits are phased out at higher levels of AGI and can be increased by strategies that reduce AGI, such as deferring income, accelerating depreciation, and bunching itemized deductions (discussed earlier).

CROSS-REFERENCE

Phaseout Ranges

The "Tax Rates and Useful Tables" chapter in this workbook lists most deduction and credit phaseout ranges for 2019, 2020, and 2021.

A farmer can maximize permanent tax benefits and reduce taxable income in a high-income year by hiring his or her children.

Income Tax

If a child is a bona fide employee, then the business can deduct reasonable wages and other related necessary expenses, including medical benefits, on Schedule F (Form 1040), Profit or Loss From Farming; or on Schedule C (Form 1040), Profit or Loss From Business (Sole Proprietorship). Employee-related expenses are generally deductible as I.R.C. § 162 ordinary and necessary business expenses.

Each taxpayer can claim a standard deduction. For dependents, the standard deduction is the greater of $1,100 or $350 plus earned income, limited to the regular standard deduction amount for the child's filing status. For 2021, the standard deduction for a single taxpayer is $12,550. Thus, the child's standard deduction can offset the wages paid.

Employment Tax

Payment for the services of a child is subject to income tax and income tax withholding, regardless of the child's age. However, if the child works for a sole proprietorship or a partnership in which the only partners are parents of the child, special rules regarding employment tax apply depending on the child's age. Payment for the services of a child under age 18 employed by his or her parents is not subject to social security, Medicare, or FUTA taxes [I.R.C. § 3121(b)(3)(A)].

Example 4.12
Farmer Hiring His Children

Don Humphry is in the 24% marginal tax bracket and pays SE tax at an effective rate of 14.13% (15.3% × 0.9235). He has 3 children, ages 14, 15, and 17, who have no other income. If Don establishes a bona fide employment relationship with his children and pays them each $12,000 per year to work on the family farm, he could reduce his SE tax liability by $5,087 ($12,000 × 3 children × 14.13%). Don would reduce his taxable income by $33,456 [$36,000 wages paid – $2,544 ($5,087 × 50%) reduced SE tax deduction]. Don's income tax savings is $8,029 ($33,456 × 24%), and his total tax savings is $13,116 ($8,029 + $5,087). Because each child's wages are less than the standard deduction amount, and they are under age 18, there is no federal income tax or employment tax liability on the wages paid.

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ISSUE 2: SALE OF FARM ASSETS

This section reviews the tax consequences of selling farm assets.

The pandemic put an enormous strain on production and supply chain networks and changed consumer demands. It may have exacerbated challenges for farmers. Farmers have many reasons for getting out of the business of farming, including financial distress, retirement, or simply wanting to do something different. Regardless of the reason, liquidation generally triggers significant tax liability.

This section reviews the tax consequences of selling farm assets. It explains how to calculate the basis in farm assets, the taxation on a sale of those assets, and recapture provisions. It also discusses several planning tools to lessen the tax impact of liquidating a farming business.

Initial Basis

Generally, the initial basis of an asset depends on whether the asset was acquired by gift, inheritance, exchange, or purchase.

Basis of Gifted Property

For purposes of calculating a gain, the donee's basis is the same as the donor's basis. For purposes of calculating a loss, if basis is greater than FMV on the date of the gift, the basis of the gifted property is its FMV [I.R.C. § 1015(a)]. Basis is increased (but not above the FMV of the property at the time of the gift) by the amount of gift tax paid with respect to the gift.

Example 4.13
Gift of Appreciated Land

Gerald McCoy gifted five acres of farmland to his granddaughter Matilda Hatcher. At the time of the gift, the land was worth $150,000. Gerald originally purchased the land for $80,000 and made no improvements. Matilda's basis for purposes of calculating a gain or a loss on a sale of the land is $80,000.

Example 4.14
Gift of Land with Basis Greater Than FMV

The facts are the same as in Example 4.13 except that at the time of the gift, the boundary of the 100-year flood zone of a nearby river had been expanded to include the land, and the land's FMV at the time of the gift was $75,000. Matilda's basis for purposes of calculating a gain is the land's $80,000 FMV and her basis for purposes of calculating a loss is the land's $75,000 FMV at the date of the gift.

Basis in Inherited Property

The basis of inherited property is generally equal to its FMV as of the decedent's date of death [I.R.C. § 1014]. This is referred to as a step-up in basis if the FMV of the asset at the date of the decedent's death is more than the decedent's adjusted tax basis in the property, but it can also be a step-down in basis if the value of the FMV of the asset on the decedent's date of death is less than the adjusted tax basis in the property.

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The general date-of-death FMV rule does not apply to the following:

1. *Alternate valuation date.* The executor elects to value the decedent's property as of 6 months after the date of death, or when the property is sold, if earlier (the I.R.C. § 2032 alternate valuation date). If the executor makes this election, the basis is the FMV on the alternate valuation date.
2. *Special use valuation.* The executor elects special use valuation under I.R.C. § 2032A for certain farm real estate or closely held business real property. If the executor makes this election, the basis is the special use valuation.
3. *Income in respect of a decede*nt. Income in respect of a decedent (IRD) does not receive a date of death valuation. The recipient receives the asset with a carryover basis and is taxed on the sale of the asset (or receipt of the income) in the same manner as the decedent would have been taxed.
4. *Conservation easement property.* To the extent of the applicability of the exclusion described in I.R.C. § 2031(c) (exclusion for land subject to a qualified conservation easement), the basis is a carryover basis from the decedent.
5. *Property of decedents dying in 2010.* For estates of decedents who died in 2010, the executor could elect to opt out of the estate tax. If the executor made the election, modified carryover basis rules applied.

Example 4.15
Basis in Inherited Farm Property

John Daniels died in November 2021. He left his farm assets to his son, Brian Daniels. **Figure 4.3** shows the FMV of the assets on the date of death.

FIGURE 4.3
John Daniels' Estate Assets

Receivable for crops sold in October 2021	$37,000
Farm machinery	$175,000
Farm real property	$12,450,000

The executor of John's estate elected special use valuation for the farm real property, which valued it at $11,260,000 ($12,450,000 − $1,190,000). Brian's basis in the receivable is income in respect of decedent and receives no basis adjustment. Brian will be taxed on the $37,000 (receivable for crops sold in October 2021) as ordinary income when it is received. Brian's basis in the machinery is its $175,000 FMV and his basis in the real property is its $11,260,000 special use valuation.

Gifts within 1 Year of Death

To prevent the use of the stepped-up basis for certain predeath gifts, I.R.C. § 1014(e) states that if the decedent acquired appreciated property by gift during the 1-year period ending on the date of the decedent's death, and such property is acquired from the decedent by (or passes from the decedent to) the donor of such property (or the spouse of such donor), the donor's basis in the property is the decedent's adjusted basis of the property immediately before the decedent's death. The term *appreciated property* means any property if the FMV of such property on the day it was transferred to the decedent by gift exceeds its adjusted basis.

Jointly Held Property

Determining the basis of property passing to a surviving joint tenant depends on the relationship between the surviving joint tenant and the decedent. For married individuals, the basis depends on whether they live in a community property state or a common law state.

I.R.C. § 2040 generally provides that the value of the gross estate includes the value of co-owned property except to the extent the surviving co-owner can show that the property originally belonged to the survivor and was not received from the decedent for less than adequate and full consideration in money or money's worth. There are three exceptions:

1. If the property was acquired by gift, bequest, devise, or inheritance, as a tenancy by the entirety by the decedent and spouse, then one-half of the value is treated as the decedent's interest.

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2. If the property was acquired by gift, bequest, devise, or inheritance by the decedent and any other person as joint tenants with right of survivorship and their interests are not otherwise specified or fixed by law, then the decedent's interest includes a fractional part that is determined by dividing the value by the number of joint tenants with right of survivorship.
3. If there is a qualified joint interest, the value included in the gross estate is one-half of the value of the qualified joint interest. A *qualified joint interest* is any interest in property held by the decedent and the decedent's spouse as tenants by the entirety or joint tenants with right of survivorship, but only if the decedent and spouse are the only joint tenants.

Spouses in community property states (Washington, California, Arizona, Idaho, Louisiana, Nevada, New Mexico, Texas, Wisconsin, and Alaska) are generally treated as owning one-half of the community property. Pursuant to I.R.C. § 1014(b)(6), if at least one-half of a decedent spouse's interest in community property is included in his or her gross estate, the basis of the entire property is stepped up (or stepped down) to the property's date-of-death FMV.

Example 4.16
Jointly Held Property

Sam and John Adams are brothers. They purchased their farmland together as tenants in common. Sam died in 2020, when the FMV of the land was $960,000. Sam had originally contributed $600,000 of the $800,000 purchase price. Therefore, only 75% ($600,000 ÷ 800,000) of the farmland is included in Sam's estate. That portion of the farmland receives a basis adjustment to $720,000 ($960,000 × 75%) FMV as of Sam's date of death. John's basis in the remaining 25% of the farmland is his $200,000 original contribution to the purchase price. John's new basis in the farmland is $920,000 ($720,000 + $200,000).

Example 4.17
Qualified Joint Interest

Shawna Fields purchased farmland in Wyoming for $560,000. In 2015, she titled the property to herself and her husband, Mac, as joint tenants with right of survivorship. Mac died in 2021, when the FMV of the land was $950,000. The farmland is a qualified joint interest and one-half of the land is included in Mac's estate. Shawna takes a $475,000 ($950,000 × 50%) basis in 50% of the land, and her basis in the remaining 50% is her $280,000 ($560,000 × 50%) original contribution to the purchase price.

Basis of Exchanged Property

When an exchange of real property qualifies as like-kind, the exchange is tax-deferred unless the taxpayer receives cash or other unlike property. The basis in the relinquished property carries over to the replacement property received. Any additional cash paid increases the basis of the replacement property.

CROSS-REFERENCE

Nonrecognition Transactions

Similarly, gain is deferred on an involuntary conversion of property. If the taxpayer receives property that is similar or related in service or use to the converted property, his or her basis for the new property is the same as the basis for the converted property. See the "Business Tax Issues" chapter in this workbook for a discussion of like-kind exchanges and involuntary conversions.

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Basis of Purchased Property

The initial cost basis of property the taxpayer purchases is the amount the taxpayer pays in cash, debt obligations, other property, or services [I.R.C. § 1012]. Cost includes the purchase price and also expenses connected with the purchase, such as sales tax or shipping.

When property is converted from personal to business use, the basis for depreciation is the lesser of the property's adjusted tax basis or FMV as of the date of conversion. For converted property sold at a gain, the basis is the original cost or other basis increased by amounts paid for capital improvements and decreased by depreciation taken. However, for converted property sold at a loss, the starting point to calculate basis is the lesser of the adjusted tax basis or FMV at the time of the conversion to business use.

Example 4.18
Conversion of Personal Residence

On January 1, 2020, Sharon Sarandon moved out of her home on her dairy farm and began using the house to provide housing for her herdsperson. The housing is a condition of employment. Sharon's basis in the house was $75,000 at the time of conversion, and its FMV was $70,000. Sharon's basis for calculating depreciation and her starting basis if she later sells the house at a loss is the lesser $70,000 FMV. If Sharon later sells the house at a gain, her basis is $75,000 less allowable depreciation.

Taxation of Gains and Losses

When the taxpayer sells property used in a farm business, the taxable gain or loss is usually treated as ordinary income or capital gain under the rules for I.R.C. § 1231 transactions. Section 1231 transactions are sales and exchanges of real or depreciable property held longer than 1 year and used in a trade or business. However, even if section 1231 treats a gain as a capital gain, the taxpayer may have to treat all or part of the gain on disposition of depreciable property as ordinary income. This section discusses section 1231 treatment and depreciation recapture.

I.R.C. § 1231 Gains and Losses

The section 1231 general rule provides that if section 1231 gains exceed section 1231 losses for a tax year, the net gains are treated as long-term capital gains. If gains do not exceed losses, then the net loss is treated as an ordinary loss. Section 1231 property includes both depreciable and nondepreciable assets used in a business if the taxpayer has owned them for a required holding period. The capital gain treatment for net section 1231 gains applies only to the extent that these gains exceed net section 1231 losses that were deducted for the past 5 years and that were not previously recaptured.

Section 1231 Transactions

Section 1231 gains and losses are the taxable gains and losses from section 1231 transactions. Section 1231 transactions include the following property when held for the required holding period (discussed later):

1. Sales or exchanges of real property or depreciable personal property used in a trade or business
2. Sales or exchanges of cattle and horses held for draft, breeding, dairy, or sporting purposes
3. Sales or exchanges of other livestock (excluding poultry) held for draft, breeding, dairy, or sporting purposes
4. Sales, exchanges, or involuntary conversion of unharvested crops disposed of with the land, if the land was held longer than the required holding period and the same person buys the crops and the land
5. Cutting of timber or disposal of timber, coal, or iron ore that is treated as a sale
6. Involuntary conversions from a casualty, theft, seizure, or condemnation of business property or capital assets held for more than 1 year and held in connection with a trade or business

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Excluded Property

Section 1231(b)(1) specifically excludes the following property from the definition of *property used in a trade or business*:

- Property that is includable in the taxpayer's inventory at the close of the tax year
- Property that is held primarily for sale to customers in the ordinary course of the trade or business
- A patent, invention, model, or design (whether or not patented); a secret formula or process; a copyright; a literary, musical, or artistic composition; or a letter, memorandum, or similar property held by a taxpayer who created or acquired the property as set forth in I.R.C. § 1221(a)(3)
- Certain publications of the US government

Additionally, the tangible property regulations exclude any asset that the taxpayer expenses under the de minimis safe harbor [Treas. Reg. § 1.263(a)-1(f)(3)(iii)].

PRACTITIONER NOTE

De Minimis Election

The taxpayer must report the sale of tangible business property that the taxpayer elected to expense under the tangible property de minimis safe harbor on Form 4797, Sales of Business Property, Part II, regardless of how long the taxpayer held the asset. The full amount of the gain is taxed as ordinary income and is not subject to SE tax.

Excluded Gain

Gain that is treated as ordinary income under I.R.C. § 1239 is not included in the netting of section 1231 gains and losses. Section 1239 requires a taxpayer to treat gain realized on the sale of an asset to a related party as ordinary income if the property is depreciable by the buyer. The section 1239(b) definition of *related persons* includes only the following three relationships:

- A person and all entities that are controlled entities with respect to such person
- A taxpayer and any trust in which such taxpayer (or his or her spouse) is a beneficiary, unless the beneficiary's interest in the trust is a remote contingent interest within the meaning of I.R.C. § 318(a)(3)(B)(i)
- An executor of an estate and a beneficiary of the estate, except in the case of a sale or exchange in satisfaction of a pecuniary bequest

Holding Period

For an asset to qualify as a section 1231 transaction, it must be held for the required holding period. For most property, this means that it must be held more than 12 months. However, for cattle and horses held for draft, breeding, dairy, or sporting purposes, the livestock must be held 24 months or more. For other livestock, the required holding period is 12 months or more.

Example 4.19
Section 1231 Gain

In 2021, Whitney Hubble had a $145,000 gain from the sale of cattle that she held for breeding. She also had a $7,000 loss from the sale of a farm tractor. Her holding period in both the cattle and the tractor was greater than 24 months. Whitney had no net section 1231 losses for the past 5 years. Whitney's $138,000 ($145,000 − $7,000) recognized net gain on section 1231 property is taxed as a capital gain.

Example 4.20
Section 1231 Loss

The facts are the same as in Example 4.19 except that Whitney sold only the tractor in 2021. She has a $7,000 recognized net loss on section 1231 property, which is taxed as an ordinary loss.

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Nonrecaptured Section 1231 Losses

Section 1231 losses and gains recognized in the same year are netted. If there is a net section 1231 gain in any of the 5 years following a year with a net section 1231 loss, that gain is treated as ordinary income to the extent of the prior nonrecaptured net section 1231 loss (net section 1231 losses that were not applied against a net section 1231 gain). Nonrecaptured losses do not affect the recognized gain amount, but they change the character of that gain to ordinary income. The losses are recaptured in the order in which they occurred, and subsequent-year section 1231 net gains in excess of the net prior-year losses still receive long-term capital gain treatment.

Depreciation Recapture

Taxpayers may have to recapture depreciation as ordinary income if they sell I.R.C. § 1245 or 1250 property at a gain. A taxable disposition of section 1245 property requires the taxpayer to recognize all of the realized gain as ordinary income up to the total of the allowed or allowable depreciation deductions for the property. A taxable disposition of section 1250 property requires the taxpayer to recognize ordinary income only if the property was depreciated using an accelerated method of depreciation and the total depreciation deductions at the time of disposition exceed the allowable amount using a straight-line method.

I.R.C. § 1245 Depreciation Recapture

Section 1245 requires the taxpayer to recognize ordinary income on the sale of section 1245 property in the amount that is the lesser of

1. the recomputed basis of the property, or
2. the excess of the amount realized over the adjusted basis of the property.

The term *recomputed basis* generally means the adjusted basis recomputed by adding all adjustments reflected in the adjusted basis for allowed or allowable depreciation or amortization deductions. Any recognized gain that is more than the part that is ordinary income is a section 1231 gain.

The following are examples of farm assets that are section 1245 property:

- Depreciable personal property
- Other depreciable tangible property (except buildings or their structural components) used as an integral part of manufacturing, production, or extraction and for which certain basis adjustments were made for depreciation deductions
- A single-purpose agricultural or horticultural structure defined in I.R.C. § 168(i)(13)

Example 4.21
Recapture of I.R.C. §§ 168 and 179 Depreciation

In 2019, Sam Elliot purchased a new loader for use on his farm. He elected out of bonus depreciation but chose to expense $10,000 of the $120,000 purchase price under section 179. Sam depreciated the loader as MACRS 5-year property using the half-year convention. He sold the loader in 2021 for $65,000. The calculation of his $42,240 adjusted basis is shown in **Figure 4.4**.

FIGURE 4.4
Sam Elliot's Adjusted Basis

Initial cost		$120,000
Section 179 election		(10,000)
Basis for depreciation		$110,000
Depreciation:		
2019: $110,000 × 0.20	$22,000	
2020: $110,000 × 0.32	35,200	
2021: $110,000 × 0.192 × 0.5	10,560	
Accumulated depreciation		(67,760)
Adjusted basis		$42,240

When Sam sells the loader in 2021, he has a $22,760 ($65,000 − $42,240) gain. The loader's recomputed basis equals its original $120,000 cost ($42,240 adjusted basis + $10,000 section 179 deduction + $67,760 accumulated depreciation). The entire $22,760 realized gain is taxed as ordinary income under section 1245 because it is less than Sam's $77,760 ($10,000 + $67,760) total cost recovery deductions.

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I.R.C. § 1250 Depreciation Recapture

Section 1250 property is defined as depreciable real property that is not and has never been section 1245 property. For example, although some single-purpose agricultural or horticultural structures are real property, they are not section 1250 property because I.R.C. § 1245(a)(3)(D) defines them as section 1245 property.

Gain realized on the sale of section 1250 property is recaptured as ordinary income to the extent that the post-1969 allowed or allowable depreciation exceeds the otherwise allowable straight-line (SL) depreciation. The portion of gain equivalent to the allowable SL depreciation is called *unrecaptured section 1250 gain*, and it is taxed at a maximum rate of 25%. Any excess gain over the purchase price is taxed as section 1231 capital gain at a maximum rate of 20% for 2021.

OBSERVATION

Ordinary Income Recapture

Most section 1250 property is depreciated using the SL method and is therefore not subject to ordinary income recapture. However, the unrecaptured section 1250 gain rule (the 25% tax rate) still applies to allowable SL depreciation to the extent of the realized gain.

Example 4.22
Sale of a MACRS Farm Building

Reed Pepper, a sole proprietor, purchased a farm building on July 1, 2011, for $100,000. He depreciated the building as MACRS 20-year property using the 150% declining balance (DB) method and the half-year (HY) convention.

On July 2, 2021, Reed sold the building for $110,000. Reed's adjusted basis in the building at the time of the sale was $44,615 ($100,000 cost – $55,385 accumulated depreciation), resulting in a $65,385 ($110,000 – $44,615) realized gain. Under the SL method of depreciation, Reed's accumulated depreciation would have been only $50,000. Reed's ordinary income from the section 1250 recapture is $5,385 ($55,385 – $50,000), which is the excess depreciation claimed over SL depreciation.

The other $50,000 of gain attributable to Reed's prior depreciation deductions is unrecaptured section 1250 gain, which is taxed at a maximum rate of 25%. Because Reed sold the building for more than his original cost, he also has a $10,000 ($110,000 − $100,000) section 1231 gain on the building. The sale of the land is a section 1231 transaction (discussed earlier).

Figure 4.5 shows the calculation of Reed's realized gain on the sale of the building. His $65,385 realized gain consists of $5,385 ordinary income recapture, $50,000 unrecaptured section 1250 gain, and $10,000 section 1231 gain.

FIGURE 4.5
Reed Pepper's Realized Gain

Sale price	$110,000
Adjusted basis ($100,000 – $55,385)	(44,615)
Realized gain	$ 65,385
Section 1250 ordinary income recapture	$ 5,385
Unrecaptured section 1250 gain	50,000
Section 1231 gain	10,000
Realized gain	$65,385

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Tax Planning Strategies

A taxpayer who sells substantially all the farm assets should engage in tax planning to try to reduce the tax liability on the sale. The strategies discussed earlier for high-income years may be beneficial. In addition, the taxpayer should consider allocating the sale price in a manner that minimizes tax or using an installment sale of the assets.

Allocation of Sale Price

When the taxpayer sells a farm in an asset sale, the taxpayer (seller) and buyer must allocate the total sale price among the purchased assets. To minimize taxes, the seller can allocate more of the purchase price to assets that are taxed at a preferential rate. **Figure 4.6** shows assets that may be included in the sale of a farm, and their tax treatment, upon a sale. Figure 4.6 assumes that all required holding periods and use requirements have been met.

FIGURE 4.6
Tax Treatment on a Sale of Farm Assets

Asset	Tax Treatment When Sold
Personal residence	Gain excluded up to $250,000 ($500,000 for MFJ) under section 121
Land	Capital gain treatment under section 1231
Accounts receivable	Ordinary income subject to SE tax
Inventory (crops, feed, supplies, fuels)	Ordinary income subject to SE tax
Livestock raised for sale	Ordinary income subject to SE tax
Dairy, breeding, sport, draft livestock	Capital gain treatment under section 1231
Equipment	Generally ordinary income under section 1245
Grain bins, silos, fence, tile, barnyard	Generally ordinary income under section 1245
Single purpose agricultural or horticultural buildings	Generally ordinary income under section 1245
General purpose buildings	Several possible tax rates under section 1250

Ultimately, the overall allocation of the sale price will be negotiated between the buyer and seller, with the seller placing high priority on allocation to assets that minimize tax on the sale, and the buyer typically trying to place high priority on allocation to assets that maximize immediate deductions. **Figure 4.7** shows typical allocation priorities for a seller and buyer of farm assets.

FIGURE 4.7
Allocation Priorities for Seller and Buyer

Asset	Seller	Buyer
Personal residence	High	Low
Land	High	Low
Accounts receivable	No preference	No preference
Inventory (crops, feed, supplies, fuels)	Low	High
Livestock raised for sale	Low	High
Dairy, breeding, sport, draft livestock	Medium	Medium
Equipment	High (up to tax basis)	Medium
Grain bins, silos, fence, tile, barnyard	High (up to tax basis)	Medium
Single purpose agricultural and horticultural buildings	High (up to tax basis)	Medium
General purpose buildings	Medium–low	Medium–low

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PRACTITIONER NOTE

Form 8594

The seller and buyer of a group of farm assets must use Form 8594, Asset Acquisition Statement Under Section 1060, to report the sale if goodwill or going concern value attaches, or could attach, to the assets and if the purchaser's basis in the assets is determined only by the amount paid for the assets.

Installment Sale

A taxpayer who wants to sell all his or her assets in one year can reduce the tax liability by reporting the sale proceeds as an installment sale under I.R.C. § 453. An installment sale is a sale of property where the seller receives at least one payment after the tax year of the sale. This can benefit a farmer wanting to get out of business, particularly when the farmer expects future income to be low. It can also benefit a buyer who can pay for the acquired assets over time.

PLANNING POINTER

Installment Sale vs. Farm Income Averaging

Farm income averaging may achieve a similar result as an installment sale, without the uncertainty and risk of spreading the sale over time.

Installment method treatment is automatic if the following requirements are met:

- There is a gain on the sale (losses cannot be reported on the installment method).
- At least one payment is received in a tax year after the year of the sale.
- The gain is not from depreciation recapture arising from the sale of depreciable property, such as purchased breeding livestock, equipment, and single-purpose agricultural buildings.

Sellers report interest and gain in income in the year the payment is received. The seller calculates annual gain from the installment sale by multiplying the payments received by a gross profit percentage, which is a ratio of the gross profit to the total contract price.

CROSS-REFERENCE

Installment Sales

See pages 227–229 the *2019 National Income Tax Workbook* for additional information about installment sales and an example of calculating the gross profit percentage.

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ISSUE 3: LIVESTOCK SALES This section explains the tax treatment of the sale of livestock.

The taxpayer's purpose for holding livestock determines how the sale of that livestock will be treated for income and SE tax purposes. If the taxpayer raised the livestock or purchased the livestock, with the primary intent to sell it in the ordinary course of business, then the income is ordinary and is subject to SE tax. If the taxpayer held the livestock for dairy, breeding, sport, or draft purposes, the sale is treated as the sale of a business asset and is not subject to SE tax. The ultimate use by the buyer does not affect the seller's tax treatment. Special rules apply to weather-related sales of livestock.

Livestock Held for Sale

The sale of livestock held for sale generates ordinary income. For raised livestock, the basis of the animal sold is typically zero because the costs of raising it were deducted during the years the animal was being raised. Gain on the sale is generally the gross sale price less any expenses of the sale. Gain on the sale of purchased livestock held for sale is typically the gross sale price less the basis (initial purchase price) and any expenses of the sale.

Example 4.23
Sale of Livestock Held for Sale

Jack Springer raises pigs for sale as market hogs. Some of the pigs are born on Jack's farm, and others he purchases from a neighbor as feeder pigs and feeds them out to market hog weight. In 2021, Jack sold $245,000 of hogs that he had raised and $138,000 of hogs that he had purchased as feeder pigs for $18,000. Jack reports the sale of raised hogs on line 2 of Schedule F (Form 1040), Profit or Loss From Farming. He reports the sale of the pigs he purchased for resale on line 1a and the cost of those pigs on line 1b (even if the cost was incurred in a prior year). He reports raised hogs on line 2 and his $365,000 [$245,000 + ($138,000 − $18,000)] gross profit on line 9. Jack's net income on Schedule F is subject to SE tax. **Figure 4.8** shows Jack's Schedule F (Form 1040), Part I. Figure 4.8 shows the 2020 form because the 2021 form was not available at the time of this publication.

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FIGURE 4.8
Jack Springer's Schedule F (Form 1040) Part I

SCHEDULE F (Form 1040)
Department of the Treasury
Internal Revenue Service (99)

Profit or Loss From Farming

► Attach to Form 1040, Form 1040-SR, Form 1040-NR, Form 1041, or Form 1065.
► Go to *www.irs.gov/ScheduleF* for instructions and the latest information.

OMB No. 1545-0074
2020
Attachment Sequence No. 14

Name of proprietor	Social security number (SSN)
Jack Springer	XXX-XX-XXXX

A Principal crop or activity	B Enter code from Part IV	C Accounting method:	D Employer ID number (EIN) (see instr.)
Hog and pig farming	► 1 1 2 2 1 0	☑ Cash ☐ Accrual	

E Did you "materially participate" in the operation of this business during 2020? If "No," see instructions for limit on passive losses ☑ Yes ☐ No
F Did you make any payments in 2020 that would require you to file Form(s) 1099? See instructions ☑ Yes ☐ No
G If "Yes," did you or will you file required Form(s) 1099? ☑ Yes ☐ No

Part I Farm Income—Cash Method. Complete Parts I and II. (Accrual method. Complete Parts II and III, and Part I, line 9.)

1a	Sales of livestock and other resale items (see instructions)				1a	138,000		
b	Cost or other basis of livestock or other items reported on line 1a				1b	18,000		
c	Subtract line 1b from line 1a						1c	120,000
2	Sales of livestock, produce, grains, and other products you raised						2	245,000
3a	Cooperative distributions (Form(s) 1099-PATR)	3a		3b	Taxable amount		3b	
4a	Agricultural program payments (see instructions)	4a		4b	Taxable amount		4b	
5a	Commodity Credit Corporation (CCC) loans reported under election						5a	
b	CCC loans forfeited	5b		5c	Taxable amount		5c	
6	Crop insurance proceeds and federal crop disaster payments (see instructions):							
a	Amount received in 2020	6a		6b	Taxable amount		6b	
c	If election to defer to 2021 is attached, check here ► ☐			6d	Amount deferred from 2019		6d	
7	Custom hire (machine work) income						7	
8	Other income, including federal and state gasoline or fuel tax credit or refund (see instructions)						8	
9	**Gross income.** Add amounts in the right column (lines 1c, 2, 3b, 4b, 5a, 5c, 6b, 6d, 7, and 8). If you use the accrual method, enter the amount from Part III, line 50. See instructions ►						9	365,000

Livestock Held for Dairy, Breeding, Sport, or Draft

If a taxpayer holds livestock for dairy, breeding, sport, or draft purposes, the sale of that livestock is treated as the sale of a business asset. The livestock could be either raised or purchased. As business assets, the sale of such livestock is reported on Form 4797, Sales of Business Property. In general, the sale of business assets generates ordinary gains or losses that are not subject to SE tax. However, section 1231 often applies to provide preferential tax treatment to such sales. Section 1245 takes away some or all of that preferential treatment on the sale of purchased livestock. This section also reviews when livestock producers who are forced to sell animals because of weather-related conditions may be eligible to postpone recognition of income.

I.R.C. § 1231

As discussed earlier, section 1231 provides, in part, that if business assets are held the required holding period and the taxpayer has a net gain on all section 1231 transactions during the year, that gain will be taxed as a capital gain (subject to the nonrecaptured section 1231 5-year lookback discussed in Issue 2 of this chapter). If the taxpayer has a net loss on all section 1231 transactions during the year, that loss will be an ordinary loss (not a capital loss). The required holding period for cattle (dairy and beef) and horses is 24 months or more. For all other livestock, the required holding period is 12 months or more.

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Section 1231 transactions are reported on Form 4797, Sales of Business Property, Part I. Section 1231 transactions that are not subject to any recapture or special reporting requirements are reported on line 2. Other section 1231 transactions (installment sales, like-kind exchanges, casualties, and from Part III) are reported on lines 3–6. The net gain or loss is reported on line 7 and any nonrecaptured net section 1231 losses are reported on line 8. The remainder of Part I applies capital gain treatment for any net gain and ordinary income treatment for any net loss.

Example 4.24 Capital Gain Treatment on Raised Cow Sale

In 2021, Marc Farmer, a Wisconsin dairyman, sold raised cows from his dairy herd for $12,000. He had held the cows for more than 24 months, so they qualify as section 1231 property. Marc does not have any nonrecaptured section 1231 losses from prior years. Marc reports the sale in Part I of Form 4797. **Figure 4.9** shows Marc's Form 4797, Part I. (Figure 4.9 shows the 2020 form because the 2021 form was not available at the time of this publication.) If this is Marc's only section 1231 transaction for the year, the $12,000 is a long-term capital gain and is transferred to Schedule D (Form 1040), Capital Gains and Losses.

FIGURE 4.9
Marc Farmer's Form 4797, Part I: Raised Cow Sale

Form **4797**
Department of the Treasury
Internal Revenue Service

Sales of Business Property
(Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2))
► Attach to your tax return.
► Go to *www.irs.gov/Form4797* for instructions and the latest information.

OMB No. 1545-0184
2020
Attachment Sequence No. 27

Name(s) shown on return: Marc Farmer
Identifying number: XXX-XX-XXXX

1 Enter the gross proceeds from sales or exchanges reported to you for 2020 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20. See instructions 1

Part I **Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty or Theft—Most Property Held More Than 1 Year** (see instructions)

2 (a) Description of property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis, plus improvements and expense of sale	(g) Gain or (loss) Subtract (f) from the sum of (d) and (e)
RAISED DAIRY COWS	VARIOUS	VARIOUS	12,000			12,000

3	Gain, if any, from Form 4684, line 39	3	
4	Section 1231 gain from installment sales from Form 6252, line 26 or 37	4	
5	Section 1231 gain or (loss) from like-kind exchanges from Form 8824	5	
6	Gain, if any, from line 32, from other than casualty or theft	6	
7	Combine lines 2 through 6. Enter the gain or (loss) here and on the appropriate line as follows	7	12,000
	Partnerships and S corporations. Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 10, or Form 1120-S, Schedule K, line 9. Skip lines 8, 9, 11, and 12 below.		
	Individuals, partners, S corporation shareholders, and all others. If line 7 is zero or a loss, enter the amount from line 7 on line 11 below and skip lines 8 and 9. If line 7 is a gain and you didn't have any prior year section 1231 losses, or they were recaptured in an earlier year, enter the gain from line 7 as a long-term capital gain on the Schedule D filed with your return and skip lines 8, 9, 11, and 12 below.		
8	Nonrecaptured net section 1231 losses from prior years. See instructions	8	
9	Subtract line 8 from line 7. If zero or less, enter -0-. If line 9 is zero, enter the gain from line 7 on line 12 below. If line 9 is more than zero, enter the amount from line 8 on line 12 below and enter the gain from line 9 as a long-term capital gain on the Schedule D filed with your return. See instructions	9	12,000

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Example 4.25
Partial Capital Gain Treatment on Raised Cow and Purchased Cow Sale

The facts are the same as in Example 4.24 except that Marc also sold purchased cattle for $70,000. He had held the cows for more than 24 months. His initial purchase price for the cows was $100,000, and he took $27,750 depreciation. Thus, his adjusted tax basis was $72,250 ($100,000 − $27,750). Marc had a $2,250 ($72,250 − $70,000) loss on the sale of the purchased cows. He reports the sale in Part I of Form 4797, and it offsets some of the gain from the raised cow sale. Marc receives long-term capital gain treatment on only $9,750 ($12,000 − $2,250), as shown in **Figure 4.10**. Figure 4.10 shows the 2020 form because the 2021 form was not available at the time of this publication.

FIGURE 4.10 Marc Farmer's Form 4797, Part I: Raised and Purchased Cow Sales

Form **4797**

Department of the Treasury
Internal Revenue Service

Sales of Business Property
(Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2))

► Attach to your tax return.
► Go to *www.irs.gov/Form4797* for instructions and the latest information.

OMB No. 1545-0184
2020
Attachment Sequence No. 27

Name(s) shown on return: Marc Farmer
Identifying number: XXX-XX-XXXX

1 Enter the gross proceeds from sales or exchanges reported to you for 2020 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20. See instructions 1

Part I **Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty or Theft—Most Property Held More Than 1 Year** (see instructions)

2 (a) Description of property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis, plus improvements and expense of sale	(g) Gain or (loss) Subtract (f) from the sum of (d) and (e)
RAISED DAIRY COWS	VARIOUS	VARIOUS	12,000			12,000
PURCHASED DAIRY COWS	VARIOUS	VARIOUS	70,000	27,750	100,000	(2,250)

3	Gain, if any, from Form 4684, line 39	3	
4	Section 1231 gain from installment sales from Form 6252, line 26 or 37	4	
5	Section 1231 gain or (loss) from like-kind exchanges from Form 8824	5	
6	Gain, if any, from line 32, from other than casualty or theft	6	
7	Combine lines 2 through 6. Enter the gain or (loss) here and on the appropriate line as follows	7	9,750
	Partnerships and S corporations. Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 10, or Form 1120-S, Schedule K, line 9. Skip lines 8, 9, 11, and 12 below.		
	Individuals, partners, S corporation shareholders, and all others. If line 7 is zero or a loss, enter the amount from line 7 on line 11 below and skip lines 8 and 9. If line 7 is a gain and you didn't have any prior year section 1231 losses, or they were recaptured in an earlier year, enter the gain from line 7 as a long-term capital gain on the Schedule D filed with your return and skip lines 8, 9, 11, and 12 below.		
8	Nonrecaptured net section 1231 losses from prior years. See instructions	8	
9	Subtract line 8 from line 7. If zero or less, enter -0-. If line 9 is zero, enter the gain from line 7 on line 12 below. If line 9 is more than zero, enter the amount from line 8 on line 12 below and enter the gain from line 9 as a long-term capital gain on the Schedule D filed with your return. See instructions	9	9,750

Example 4.26
Section 1231 Ordinary Losses on Raised Cow Sale

The facts are the same as in Example 4.25 except that Marc sold only the purchased cows in 2021. Marc transfers the net loss from Form 4797 Part I to Part II, as shown in **Figure 4.11**. (Figure 4.11 shows the 2020 form because the 2021 form was not available at the time of this publication.) Marc reports the loss as an ordinary loss on Form 1040, Schedule 1, Additional Income and Adjustments to Income.

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FIGURE 4.11
Marc Farmer's Form 4797, Part I: Ordinary Loss on Purchased Cow Sale

Form **4797**

Department of the Treasury
Internal Revenue Service

Sales of Business Property

(Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2))

▶ **Attach to your tax return.**
▶ **Go to *www.irs.gov/Form4797* for instructions and the latest information.**

OMB No. 1545-0184
2020
Attachment Sequence No. **27**

Name(s) shown on return: **Marc Farmer**

Identifying number: XXX-XX-XXXX

1	Enter the gross proceeds from sales or exchanges reported to you for 2020 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20. See instructions	1	

Part I **Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty or Theft—Most Property Held More Than 1 Year** (see instructions)

2 (a) Description of property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis, plus improvements and expense of sale	(g) Gain or (loss) Subtract (f) from the sum of (d) and (e)
PURCHASED DAIRY COWS	VARIOUS	VARIOUS	70,000	27,750	100,000	(2,250)

3	Gain, if any, from Form 4684, line 39	3	
4	Section 1231 gain from installment sales from Form 6252, line 26 or 37	4	
5	Section 1231 gain or (loss) from like-kind exchanges from Form 8824	5	
6	Gain, if any, from line 32, from other than casualty or theft	6	
7	Combine lines 2 through 6. Enter the gain or (loss) here and on the appropriate line as follows	7	(2,250)
	Partnerships and S corporations. Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 10, or Form 1120-S, Schedule K, line 9. Skip lines 8, 9, 11, and 12 below. **Individuals, partners, S corporation shareholders, and all others.** If line 7 is zero or a loss, enter the amount from line 7 on line 11 below and skip lines 8 and 9. If line 7 is a gain and you didn't have any prior year section 1231 losses, or they were recaptured in an earlier year, enter the gain from line 7 as a long-term capital gain on the Schedule D filed with your return and skip lines 8, 9, 11, and 12 below.		
8	Nonrecaptured net section 1231 losses from prior years. See instructions	8	
9	Subtract line 8 from line 7. If zero or less, enter -0-. If line 9 is zero, enter the gain from line 7 on line 12 below. If line 9 is more than zero, enter the amount from line 8 on line 12 below and enter the gain from line 9 as a long-term capital gain on the Schedule D filed with your return. See instructions	9	(2,250)

Part II **Ordinary Gains and Losses** (see instructions)

10 Ordinary gains and losses not included on lines 11 through 16 (include property held 1 year or less):

11	Loss, if any, from line 7	11	(2,250)
12	Gain, if any, from line 7 or amount from line 8, if applicable	12	
13	Gain, if any, from line 31	13	
14	Net gain or (loss) from Form 4684, lines 31 and 38a	14	
15	Ordinary gain from installment sales from Form 6252, line 25 or 36	15	
16	Ordinary gain or (loss) from like-kind exchanges from Form 8824	16	
17	Combine lines 10 through 16	17	(2,250)
18	For all except individual returns, enter the amount from line 17 on the appropriate line of your return and skip lines a and b below. For individual returns, complete lines a and b below.		
a	If the loss on line 11 includes a loss from Form 4684, line 35, column (b)(ii), enter that part of the loss here. Enter the loss from income-producing property on Schedule A (Form 1040), line 16. (Do not include any loss on property used as an employee.) Identify as from "Form 4797, line 18a." See instructions	18a	
b	Redetermine the gain or (loss) on line 17 excluding the loss, if any, on line 18a. Enter here and on Schedule 1 (Form 1040), Part I, line 4	18b	(2,250)

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Nonrecaptured Section 1231 Losses

Losses and gains recognized on livestock sales in the same year are netted on Form 4797. As discussed in Issue 2 of this chapter, if there is a net section 1231 gain in any of the 5 years following a year with a net section 1231 loss, that gain is treated as ordinary income to the extent of the prior nonrecaptured net section 1231 loss.

CROSS-REFERENCE

Nonrecaptured Section 1231 Losses

For further information on nonrecaptured section 1231 losses, see pages 38–40 in the *2014 National Income Tax Workbook*.

Livestock Not Held the Required Holding Period

If the livestock was not held for the required holding period, any gain or loss is ordinary and is reported on Form 4797, Part II (Ordinary Gains and Losses).

Example 4.27
Ordinary Income on Sale of Dairy Heifers

Heidi Morton raised heifers to become part of her dairy herd. Due to excellent herd health, she had more heifers ready to enter the milking herd than she could handle in her facilities. Therefore, she sold $8,500 of her heifers. Heidi had not held the heifers for 24 months, and the sale did not qualify for section 1231 tax treatment. Heidi reports the gain as ordinary income in Part II of Form 4797, as shown in **Figure 4.12**. (Figure 4.12 shows the 2020 form because the 2021 form was not available at the time of this publication.) The gain is not subject to SE tax.

If instead Heidi had held the dairy calves for sale or raised them with the intent of selling them, she would report the sale on Schedule F (Form 1040), Profit or Loss From Farming, and the income would be subject to SE tax.

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FIGURE 4.12

Heidi Morton's Form 4797, Part II: Ordinary Gain on Raised Heifer Sale

Form **4797**

Department of the Treasury
Internal Revenue Service

Sales of Business Property

(Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2))

▶ **Attach to your tax return.**
▶ **Go to *www.irs.gov/Form4797* for instructions and the latest information.**

OMB No. 1545-0184

2020

Attachment Sequence No. **27**

Name(s) shown on return	Identifying number
Heidi Morton	**XXX-XX-XXXX**

1	Enter the gross proceeds from sales or exchanges reported to you for 2020 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20. See instructions	1	

Part I **Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty or Theft—Most Property Held More Than 1 Year** (see instructions)

2 (a) Description of property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis, plus improvements and expense of sale	(g) Gain or (loss) Subtract (f) from the sum of (d) and (e)

3	Gain, if any, from Form 4684, line 39	3	
4	Section 1231 gain from installment sales from Form 6252, line 26 or 37	4	
5	Section 1231 gain or (loss) from like-kind exchanges from Form 8824	5	
6	Gain, if any, from line 32, from other than casualty or theft	6	
7	Combine lines 2 through 6. Enter the gain or (loss) here and on the appropriate line as follows	7	
	Partnerships and S corporations. Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 10, or Form 1120-S, Schedule K, line 9. Skip lines 8, 9, 11, and 12 below.		
	Individuals, partners, S corporation shareholders, and all others. If line 7 is zero or a loss, enter the amount from line 7 on line 11 below and skip lines 8 and 9. If line 7 is a gain and you didn't have any prior year section 1231 losses, or they were recaptured in an earlier year, enter the gain from line 7 as a long-term capital gain on the Schedule D filed with your return and skip lines 8, 9, 11, and 12 below.		
8	Nonrecaptured net section 1231 losses from prior years. See instructions	8	
9	Subtract line 8 from line 7. If zero or less, enter -0-. If line 9 is zero, enter the gain from line 7 on line 12 below. If line 9 is more than zero, enter the amount from line 8 on line 12 below and enter the gain from line 9 as a long-term capital gain on the Schedule D filed with your return. See instructions	9	

Part II **Ordinary Gains and Losses** (see instructions)

10 Ordinary gains and losses not included on lines 11 through 16 (include property held 1 year or less):

DAIRY HEIFERS	**VARIOUS**	**VARIOUS**	**8,500**			**8,500**

11	Loss, if any, from line 7	11	( )
12	Gain, if any, from line 7 or amount from line 8, if applicable	12	
13	Gain, if any, from line 31	13	
14	Net gain or (loss) from Form 4684, lines 31 and 38a	14	
15	Ordinary gain from installment sales from Form 6252, line 25 or 36	15	
16	Ordinary gain or (loss) from like-kind exchanges from Form 8824	16	
17	Combine lines 10 through 16	17	**8,500**
18	For all except individual returns, enter the amount from line 17 on the appropriate line of your return and skip lines a and b below. For individual returns, complete lines a and b below.		
a	If the loss on line 11 includes a loss from Form 4684, line 35, column (b)(ii), enter that part of the loss here. Enter the loss from income-producing property on Schedule A (Form 1040), line 16. (Do not include any loss on property used as an employee.) Identify as from "Form 4797, line 18a." See instructions	18a	
b	Redetermine the gain or (loss) on line 17 excluding the loss, if any, on line 18a. Enter here and on Schedule 1 (Form 1040), Part I, line 4	18b	**8,500**

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I.R.C. § 1245

Purchased livestock that is held the required holding period; is held for dairy, breeding, sport, or draft purposes; and is sold at a gain is subject to the section 1245 depreciation recapture provisions. Only the economic gain from the sale of the livestock for more than the original cost is a section 1231 transaction. Any gain generated as a result of accumulated depreciation is recaptured as ordinary income. The taxpayer reports the sale on Form 4797, Part III, which allocates the gain due to depreciation recapture as ordinary income, and then allocates the remaining gain that is eligible for section 1231 treatment.

Example 4.28
Sale of Purchased Cows with Depreciation Recapture

In 2021, Sam Russell sold cows for $7,800. He had purchased them in 2018 for $15,000 and held them for breeding, and they are fully depreciated. Sam reports the sale on Form 4797, Part III, as shown in **Figure 4.13**; and then transfers it to Form 4797, Part II, as shown in **Figure 4.14**. (Figures 4.13 and 4.14 show the 2020 form because the 2021 form was not available at the time of this publication.) All the gain is ordinary because it is less than the amount of accumulated depreciation. Sam reports the $7,800 on Form 1040, Schedule 1.

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FIGURE 4.13
Sam Russell's Form 4797, Part III: Gain from Depreciation Recapture

Form 4797 (2020) Page **2**

Part III **Gain From Disposition of Property Under Sections 1245, 1250, 1252, 1254, and 1255** (see instructions)

19 (a) Description of section 1245, 1250, 1252, 1254, or 1255 property:	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)
A PURCHASED COWS	07/18/18	08/12/21
B		
C		
D		

These columns relate to the properties on lines 19A through 19D. ▶		Property A	Property B	Property C	Property D
20 Gross sales price (**Note:** *See line 1 before completing.*)	20	7,800			
21 Cost or other basis plus expense of sale	21	15,000			
22 Depreciation (or depletion) allowed or allowable	22	15,000			
23 Adjusted basis. Subtract line 22 from line 21	23	0			
24 Total gain. Subtract line 23 from line 20	24	7,800			
25 If section 1245 property:					
a Depreciation allowed or allowable from line 22	25a	15,000			
b Enter the **smaller** of line 24 or 25a.	25b	7,800			
26 If section 1250 property: If straight line depreciation was used, enter -0- on line 26g, except for a corporation subject to section 291.					
a Additional depreciation after 1975. See instructions	26a				
b Applicable percentage multiplied by the **smaller** of line 24 or line 26a. See instructions.	26b				
c Subtract line 26a from line 24. If residential rental property **or** line 24 isn't more than line 26a, skip lines 26d and 26e	26c				
d Additional depreciation after 1969 and before 1976.	26d				
e Enter the **smaller** of line 26c or 26d	26e				
f Section 291 amount (corporations only)	26f				
g Add lines 26b, 26e, and 26f	26g				
27 If section 1252 property: Skip this section if you didn't dispose of farmland or if this form is being completed for a partnership.					
a Soil, water, and land clearing expenses	27a				
b Line 27a multiplied by applicable percentage. See instructions	27b				
c Enter the **smaller** of line 24 or 27b	27c				
28 If section 1254 property:					
a Intangible drilling and development costs, expenditures for development of mines and other natural deposits, mining exploration costs, and depletion. See instructions	28a				
b Enter the **smaller** of line 24 or 28a.	28b				
29 If section 1255 property:					
a Applicable percentage of payments excluded from income under section 126. See instructions	29a				
b Enter the **smaller** of line 24 or 29a. See instructions	29b				

Summary of Part III Gains. Complete property columns A through D through line 29b before going to line 30.

30	Total gains for all properties. Add property columns A through D, line 24	30	7,800
31	Add property columns A through D, lines 25b, 26g, 27c, 28b, and 29b. Enter here and on line 13	31	7,800
32	Subtract line 31 from line 30. Enter the portion from casualty or theft on Form 4684, line 33. Enter the portion from other than casualty or theft on Form 4797, line 6	32	0

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FIGURE 4.14
Sam Russell's Form 4797, Part II: Ordinary Gains

Part II **Ordinary Gains and Losses** (see instructions)

10	Ordinary gains and losses not included on lines 11 through 16 (include property held 1 year or less):		
11	Loss, if any, from line 7	11	( )
12	Gain, if any, from line 7 or amount from line 8, if applicable	12	
13	Gain, if any, from line 31	13	7,800
14	Net gain or (loss) from Form 4684, lines 31 and 38a	14	
15	Ordinary gain from installment sales from Form 6252, line 25 or 36	15	
16	Ordinary gain or (loss) from like-kind exchanges from Form 8824	16	
17	Combine lines 10 through 16	17	7,800
18	For all except individual returns, enter the amount from line 17 on the appropriate line of your return and skip lines a and b below. For individual returns, complete lines a and b below.		
a	If the loss on line 11 includes a loss from Form 4684, line 35, column (b)(ii), enter that part of the loss here. Enter the loss from income-producing property on Schedule A (Form 1040), line 16. (Do not include any loss on property used as an employee.) Identify as from "Form 4797, line 18a." See instructions	18a	
b	Redetermine the gain or (loss) on line 17 excluding the loss, if any, on line 18a. Enter here and on Schedule 1 (Form 1040), Part I, line 4	18b	7,800

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Casualty Gain or Loss

Gain or loss from dairy, breeding, sport, or draft livestock due to casualty or theft is treated the same as a casualty gain or loss on any other property held for use in a trade or business. A loss is the decrease in the FMV of the livestock, but not more than the remaining tax basis. In the event of a total loss, the loss is the remaining tax basis. This loss is then reduced by any insurance proceeds or government disaster payments that the taxpayer receives or expects to receive. If insurance proceeds or government disaster payments exceed the remaining basis, the taxpayer has a casualty gain.

CROSS-REFERENCE

Casualty Gains and Losses

See pages 302–315 in the *2020 National Income Tax Workbook* for a discussion of casualty gains and losses and the deferral of that gain by purchasing replacement property.

Weather-Related Livestock Sales

Livestock producers who are forced to sell animals because of weather-related conditions, such as flood, drought, or other conditions that cause a shortage of water or feed, may be eligible to postpone recognition of income. I.R.C. § 1033 generally provides for nonrecognition of gain when property is involuntarily converted and replaced with property that is similar or related in service or use. Gain on weather-related sales of livestock may also be deferred under I.R.C. § 451(g).

Involuntary Conversion

Section 1033(e) allows taxpayers to postpone gain on livestock (other than poultry) held for any length of time for draft, breeding, or dairy purposes if (1) the livestock is sold because of drought, flood, or other weather-related conditions, and (2) the sale would not have occurred under the taxpayer's usual business practices.

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PRACTITIONER NOTE

Sport Livestock Ineligible

The involuntary conversion of livestock held for sport does not qualify for nonrecognition treatment [by non-inclusion in the list of eligible livestock at I.R.C. § 1033(e)(1)].

PRACTITIONER NOTE

Death of Taxpayer before Replacement

If the taxpayer dies before replacing the involuntarily converted property, the replacement period expires—it does not carry over to a beneficiary of the estate. The personal representative may need to amend the tax return for the year of the involuntary conversion to report the gain that was realized.

Replacement Period

To postpone the gain, the taxpayer must generally purchase replacement livestock within 2 years of the end of the tax year of the sale. If the taxpayer's area has been declared eligible for federal assistance, however, the replacement period is extended to 4 years [I.R.C. § 1033(e)(2)(A)]. In addition, the IRS can extend the replacement period if the weather-related events, generally drought, continue for more than 3 years.

Each September, the IRS publishes the list of counties that experienced exceptional, extreme, or severe drought conditions during the prior 12-month period. If an area is on that list, an extended replacement period applies. Generally, the replacement period is extended until the end of the taxpayer's first tax year ending after the first drought-free year.

Replacement Property

The replacement livestock must generally be of the same kind as the original livestock (i.e., breeding heifers must be purchased in exchange for breeding heifers, not dairy). However, if because of drought, flood, or other weather-related conditions, it is not feasible for the taxpayer to reinvest the proceeds from compulsorily or involuntarily converted livestock in property similar or related in use to the livestock, other property used for farming purposes (including real property in the case of soil or environmental contamination) is treated as property that is similar or related in service or use [I.R.C. § 1033(f)]. The taxpayer's basis in the replacement livestock equals the basis in the livestock sold, plus any amount invested in the replacement livestock that exceeds the proceeds from the sale.

Only the additional animals sold in excess of normal sales can be replaced without recognition of gain. For example, if the taxpayer usually sells one-fifth of the herd each year, only the sales in excess of one-fifth will qualify for deferral.

Making the Election

The election to defer the payment of tax on the gain by purchasing replacement livestock is made by not reporting the deferred gain on the tax return and by attaching a statement showing the details of the involuntary conversion. The statement must include the following:

1. Evidence of the weather-related conditions that forced the sale or exchange of the livestock
2. A computation of the amount of gain realized on the sale or exchange
3. The number and kind of livestock sold or exchanged
4. The number of livestock of each kind that would have been sold or exchanged under usual business practices if the weather-related conditions had not occurred

[Treas. Reg. § 1.1033(e)-1(e)]

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I.R.C. § 451(g) Deferral

I.R.C. § 451(g) generally allows cash method farmers to elect to defer reporting income from certain livestock sold because of drought, flood, or other weather-related conditions. The taxpayer may elect to include such income in the tax year following the tax year in which such sale or exchange occurs.

To qualify for the election, the taxpayer must meet the following conditions:

1. The taxpayer's principal trade or business is farming [within the meaning of I.R.C. § 6420(c)(3)].
2. The taxpayer uses the cash receipts and disbursements method of accounting.
3. The taxpayer establishes that, under his or her usual business practices the sale or exchange would not have occurred in the tax year in which it occurred if not for the drought, flood, or other weather-related disaster.
4. The weather-related conditions that caused an area to be declared eligible for federal assistance caused the sale of livestock.

The livestock do not have to be raised or sold in the declared disaster area; they just have to be sold because of the weather-related condition that caused an area to be declared eligible for federal assistance. Also, the sale can take place before or after an area is declared eligible for federal assistance if the same weather-related condition caused the sale.

Usual Business Practice

The determination of the number of animals that a farmer would have sold if he or she had followed usual business practice is made considering all the facts and circumstances [Treas. Reg. § 1.451-7(b)]. For example, if the taxpayer usually holds all calves until the year after they are born before selling them, but was forced because of weather-related conditions to sell them in the year they were born, the proceeds from the sale of all the calves may be reported in the year following the year of the sale. For taxpayers who have not established a usual business practice, the determination will consider the usual business practices of similarly situated taxpayers in the same general region as the taxpayer.

Making the Election

The election to defer income from sales precipitated by drought, flood, or other weather-related conditions is made separately for each broad generic classification of animals (e.g., hogs, sheep, and cattle). Separate elections cannot be made solely because of the animals' age, sex, or breed [Treas. Reg. § 1.451-7(d)].

The election must be made by the due date of the return (including extensions) for the tax year of the sale [Treas. Reg. § 1.451-7(g)]. If the livestock are for draft, breeding, or dairy purposes and the period for buying replacement property for the livestock under the involuntary conversion rules of I.R.C. § 1033(e)(2) is extended to 4 years, the election of a 1-year deferral is valid if made during the replacement period [I.R.C. § 451(g)(3)]. The election must be made separately for each tax year to which it is to apply. Once made, an election to defer income can only be revoked with IRS consent.

The taxpayer makes the election by attaching a statement to the return or an amended return. The statement making the election must include the name and address of the taxpayer and the following information for each classification of livestock for which the election is made:

1. A declaration that the taxpayer is making an election under section 451(g) [this provision was renumbered from 451(e) by the Tax Cuts and Jobs Act of 2017 (TCJA), Pub. L. No. 115-97 § 13221]
2. Evidence of the existence of the weather-related disaster conditions that forced the early sale or exchange of the livestock and the date, if known, that the federal government designated the area as eligible for assistance
3. A statement explaining the relationship of the disaster area to the taxpayer's early sale or exchange of the livestock
4. The total number of animals sold in each of the 3 preceding years

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5. The number of animals that would have been sold in the tax year if the taxpayer followed his or her normal business practice in the absence of the weather-related disaster
6. The total number of animals sold, and the number sold because of the weather-related disaster during the tax year
7. A computation of the amount of income to be deferred for each classification of animal

Livestock Deaths Due to Disease

Death of livestock because of disease is not a casualty because it is not sudden and unexpected. The death may be treated as an involuntary conversion, and the taxpayer can defer reporting gain by purchasing replacement livestock.

If draft, breeding, dairy, or sporting livestock qualifies as section 1231 property, the gain or loss from the death is netted with other section 1231 transactions for the year and reported on Form 4797, Part I (unless there is depreciation recapture, which is reported in Part III). If draft, breeding, dairy, or sporting livestock has been held for less than 12 months (24 months for cattle and horses) when the animal dies, the gain or loss is not a section 1231 gain or loss and is reported on Form 4797, Part II.

Income or loss resulting from the death of livestock that was purchased and held for sale in the ordinary course of business is reported on Schedule F (Form 1040). If the taxpayer uses the cash method of accounting, the taxpayer reports the purchase cost on line 1b of Schedule F (Form 1040) and reports any insurance proceeds on line 1a of Schedule F (Form 1040). Livestock raised for sale generally have a zero basis for the cash basis taxpayer, and any insurance proceeds received are reported on line 2 of Schedule F (Form 1040).

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ISSUE 4: CROP INSURANCE AND DISASTER PAYMENTS

This section discusses the tax reporting requirements and tax planning opportunities for farm producers who receive crop insurance and disaster payments.

Farmers often experience crop damage from natural or manmade disasters. The farmer may receive crop insurance proceeds or a disaster relief payment. Under Treas. Reg. § 1.61-4(c), the insurance proceeds are included in gross income to the extent of the amount received in cash or its equivalent for the crop injured or destroyed. These proceeds are also subject to SE tax.

Generally, cash basis farmers must include proceeds from crop insurance and federal disaster programs in gross income for the tax year in which they receive the payments. This can create unusually high income if a farmer typically sells a portion or all of his or her crop the year after it is harvested, and the farmer receives an insurance or disaster payment in the year the crop would have been harvested. That farmer will receive the sale proceeds from the previous year's crop and the compensation for the current year's crop loss in the same tax year. In some cases, the farmer can make an election to postpone reporting the insurance or disaster payments to the year following receipt.

Deferral of Income

Under I.R.C. § 451(f), cash basis farmers can elect to include crop insurance proceeds in gross income for the tax year following the tax year of the destruction or damage. This deferral protects farmers from recognizing excessive income in one year, when their regular practice would have been to sell the crop in the following tax year. The election is optional, and farmers should consider the impact of the deferral on income in the subsequent year. For alternatives to making the election, see the earlier discussion of income tax planning for high-income years.

PRACTITIONER NOTE

Payments in a Year Subsequent to Year of Loss

The 1-year deferral election applies only to proceeds received during the tax year of the destruction or damage. Proceeds received the following tax year must be included in gross income for the tax year of receipt.

If the taxpayer receives crop insurance and disaster payments in the same year, the taxpayer must treat the payments in a consistent manner, either including the amounts in income in the year of receipt or electing to include the amounts in income in the year following the year of destruction or damage [Notice 89-55, 1989-1 C.B. 696].

Types of Deferred Payments

The section 451(f) deferral election applies to insurance proceeds and disaster payments. It does not apply to revenue protection insurance proceeds.

Insurance Proceeds and Disaster Payments

The section 451(f) deferral election applies to insurance proceeds and disaster payments received as a result of destruction or damage to crops. It also applies to disaster payments received from the federal government under the Agricultural Act of 1949 and the Disaster Assistance Act of 1988 as a result of (1) destruction or damage to crops caused by drought, flood, or any other natural disaster, or (2) the inability to plant crops because of such a natural disaster.

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Treas. Reg. § 1.451-6(a) extends this election to all federal payments received as a result of destruction or damage to crops caused by drought, flood, or any other natural disaster, or the inability to plant crops because of such a natural disaster (prevented planting payments). The federal payments are treated as insurance proceeds received as a result of destruction or damage to crops.

PRACTITIONER NOTE

Market Facilitation Program and Coronavirus Food Assistance Program

Exporters of US agricultural goods may receive payments under the Market Facilitation Program. These are not payments for damage or destruction. They are compensation for price damage caused by trade disruptions. Similarly, Coronavirus Food Assistance Program payments are generally related to price and not crop damage. Cash basis farmers must therefore include these payments in income in the year received.

Revenue Protection Insurance

To qualify for the section 451(f) election, the payment must have been made for destruction or damage to crops. This means that the taxpayer must suffer an actual loss due to this destruction or damage [Notice 89-55, supra]. Payments made under insurance policies that provide coverage for reduced revenue or losses unrelated to destruction or damage do not qualify for deferral.

Most farmers, however, are covered under revenue protection policies that provide combined coverage for revenue losses and disaster losses. In this case, farmers must determine which portion of any indemnity payment is attributable to lost revenue and which portion is due to crop loss caused by destruction or damage. There is no guidance on the allocation, and taxpayers must make an allocation using a reasonable method.

OBSERVATION

IRS Publication 225

The 2020 IRS Publication 225, *Farmer's Tax Guide*, states that deferral is not permitted for proceeds received from revenue insurance policies. This statement could be construed to disallow deferral of all payments from a revenue insurance policy, including those attributable to damage or destruction. However, it appears to be an overgeneralized statement of the principle that payments for loss of revenue are not deferrable. The Publication 225 Committee of RuralTax.org has been working with the IRS to clarify that the portion of proceeds for damage or destruction may be deferred.

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Example 4.29
Allocating Revenue Protection Payments

Daphne Indigo is a farmer who uses the cash method of accounting. She usually sells her corn in the year following the harvest. In 2021, her 300-acre farm flooded, and most of her corn crop was destroyed. In 2021, her revenue protection policy calculated her claim and paid the amount shown in **Figure 4.15**.

The difference between Daphne's approved yield and her actual yield was 130 (180 – 50) bushels. Her yield loss from destruction or damage was $276,900 (130 bushels × $7.10 harvest price × 300 acres). There was no price loss because the $7.10 harvest price exceeds the $7.00 base price. The $139,200 paid by the insurance company is all eligible for deferral because it is fully related to the damage loss.

FIGURE 4.15
Revenue Protection Policy Proceeds: Harvest Price Higher Than Base

Approved yield	180 bushels per acre	
Coverage level	65%	
Base price	$7.00	
Harvest price	$7.10	
Actual yield	50 bushels per acre	
Guaranteed amount	180 bushels × $7.00 base price × 65% coverage level	
	× 300 acres	$245,700
Calculated revenue	50 bushels × $7.10 harvest price × 300 acres	(106,500)
insurance payment		$139,200

Example 4.30
Revenue Protection Policy Proceeds: Harvest Price Lower Than Base

The facts are the same as in Example 4.29 except that the harvest price is $6.50, instead of $7.10. **Figure 4.16** shows the calculation of Daphne's revenue protection policy claim and the amount paid.

The difference between Daphne's approved yield and her actual yield was 130 (180 – 50) bushels. Her yield loss from destruction or damage was $253,500 (130 bushels × $6.50 × 300 acres), and her price loss from market decline was $7,500 [($7.00 – $6.50) × 50 bushels × 300 acres]. Daphne's total revenue loss is $261,000 ($253,500 + $7,500). Her loss from the destruction of her crop is 97.13% ($253,500 ÷ $261,000) of the total revenue loss. Daphne can defer $143,947 ($148,200 insurance payment × 97.13%).

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FIGURE 4.16
Revenue Protection Policy: Harvest Price Lower Than Base

Approved yield	180 bushels per acre	
Coverage level	65%	
Base price	$7.00	
Harvest price	$6.50	
Actual yield	50 bushels per acre	
Guaranteed amount	180 bushels × $7.00 base price × 65% coverage level	
	× 300 acres	$245,700
Calculated revenue	50 bushels × $6.50 harvest price × 300 acres	(97,500)
insurance payment		$148,200

OBSERVATION

Group Risk and Other Risk Management Policies

Some farmers received payments under group risk protection (GRP) and group risk income protection (GRIP) insurance. These policies pay an insured producer if the county average yield or average revenue falls below the specified level of coverage. The producer can purchase coverage from 70% to 95% of expected county yield or revenue. Information on average county yields and the average revenues necessary to compute insurance payments for corn, soybeans, cotton, and rice are generally not available until the year following the year of loss, and there is no direct relationship between an individual producer's yield and insurance payments under GRP and GRIP. Thus, insurance payments from those policies are not eligible for deferral under section 451(f).

Requirements for the Election

To qualify for the deferral election, a farmer must

- report income on the cash receipts and disbursements method of accounting;
- receive the crop insurance proceeds in the same year the crops are damaged; and
- establish that under normal business practice, income from the crops would have been included in gross income for any tax year following the tax year of the destruction or damage. (This normal business practice test is discussed in the next section.)

[Treas. Reg. § 1.451-6(a)(1)]

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Normal Business Practice

A taxpayer establishes its normal business practice to include income from the crops in a subsequent year by a declaration the taxpayer makes on the election statement (discussed later). The taxpayer, however, should preserve records showing that his or her normal business practice has been to report the sale of the crops in the year following the year in which they are harvested.

To establish a normal business practice, Rev. Rul. 74-145, 1974-1 C.B. 113, requires a taxpayer to show that he or she would have reported a substantial portion (more than 50%) of the income from the damaged or destroyed crops in the year following the damage or destruction. The Eighth Circuit applied this substantial portion test to disallow a deferral election where a taxpayer would have reported 65% of his income from the sale of his sugar beet crop in the year of harvest and 35% in the following year [*Nelson v. Commissioner*, 568 F.3d 662 (8th Cir. 2008)].

For farmers receiving insurance payments for multiple crops, the substantial portion test is based solely on the crops for which they are receiving insurance payments. It does not apply to crops for which they are not receiving an insurance or disaster payment. In *Nelson*, the court held that a farmer seeking to take advantage of deferral when two or more crops are damaged must first establish qualification for such deferral. In other words, a farmer seeking to defer insurance proceeds from damage to two or more crops must show the customary practice was to defer more than 50% of the income from each crop.

This interpretation by the Eighth Circuit suggests that deferral is available only if regular practice is to report more than 50% in the year following harvest. Outside of the Eighth Circuit, a reasonable interpretation may be that farmers can aggregate historical sale proceeds from the crops for which they receive disaster payments when determining whether the substantial potion test is met for the trade or business. Farmers may not, however, include sale proceeds from crops for which no insurance payments were received.

Example 4.31
Normal Business Practice for Multiple Crops

Elaine Nelson is a farmer. In 2021, she received insurance proceeds because a hailstorm damaged her oat and sorghum crops. Elaine has historically received substantially similar income from her oat crop and her sorghum crop, and she usually sells 65% of her oat crop in the year of harvest and 65% of her sorghum crop in the year after harvest. Under the *Nelson* holding, Elaine cannot defer reporting the crop insurance and disaster payments because the substantial portion test must be met for each crop for which an insurance payment was being made.

Outside of the Eighth Circuit (which includes Arkansas, Iowa, Minnesota, Missouri, Nebraska, North Dakota, and South Dakota), Elaine may be able to defer reporting. Her normal business practice is to sell, in the aggregate, more than 50% of her crop in the year following harvest. If Elaine elects to defer reporting the insurance proceeds, she must defer reporting all the insurance proceeds even though her normal practice would have been to sell and report oat income at harvest.

Entire Trade or Business

The election to defer recognition of income until the following tax year must be made for an entire trade or business [Treas. Reg. § 1.451-6(a)(2)]. In other words, taxpayers who have a history of selling 40% of their grain in the year of harvest and 60% of their grain in the following year cannot allocate income recognition between 2 years to simulate their normal business practice. Instead, they must either elect to defer all proceeds or none of them. The same choice would apply to both disaster payments and crop insurance proceeds received in that year. If a farmer has more than one farming business, he or she must make a separate election for each farming business. *Separate businesses* are defined for this provision as those for which the taxpayer keeps separate books and is allowed to use different methods of accounting. In general, that standard requires the businesses to be separate and distinct.

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Example 4.32
Crop Insurance and Disaster Payments: Single Trade or Business

Bart Maines is a farmer. He received $12,000 in 2021 for prevented planting crop insurance coverage for his soybean crop. He also received $8,000 in disaster assistance payments for damage to his corn crop. He operates his farm as a single trade or business. Bart normally sells his corn and soybeans in the year following harvest. Bart cannot report the $12,000 crop insurance payment in 2021 and elect to report the $8,000 in disaster payments in 2022. Because Bart operates the farm as a single trade or business, he must make a single election for all proceeds.

Example 4.33
Crop Insurance and Disaster Payments: Multiple Trades or Businesses

The facts are the same as in Example 4.32 except that Bart planted soybeans through his sole proprietorship and planted corn through a partnership in which he is a 50% partner. Bart can report the disaster payment for the soybean crop in 2021, and the partnership can elect to defer reporting the crop insurance proceeds to 2022.

Making the Election

The election to postpone reporting the income from insurance and disaster payments can be made on an original return or an amended return for the tax year of the destruction or damage [Treas. Reg. § 1.451-6(b)(1)]. The taxpayer reports the amount of the crop insurance proceeds on line 6a of Schedule F (Form 1040), Profit or Loss From Farming, but does not include the amount as taxable income on line 6b. The taxpayer then checks the box on line 6c and attaches a statement that includes the following information:

1. Name and address of the taxpayer (or a duly authorized representative)
2. A statement that the farmer is making an election under section 451(f) [the regulation references section 451(d), which was changed by the TCJA] and Treas. Reg. § 1.451-6
3. Identification of the specific crop or crops physically destroyed or damaged
4. A statement that under normal business practice the farmer would have included income from the destroyed or damaged crops in gross income for a tax year following the year the crops were destroyed or damaged
5. The cause of the destruction or damage of the crops and the date or dates it occurred
6. The total payments received from insurance carriers, itemized for each specific crop, and the date each payment was received
7. The name of each insurance carrier from whom payments were received

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Once an election is made, it cannot be revoked for that tax year without consent from the IRS district director. Requests for consent to revocation can be made by sending a letter to the district director for the district in which the taxpayer files his or her return. The letter must include the taxpayer's name, address, identification number; the year for which the revocation is requested; and the reason for the request. **Figure 4.17** is a sample statement to attach to the return.

FIGURE 4.17
Election to Postpone Recognition of Income

Election under I.R.C. § 451(f) to
Postpone Recognition of Disaster Payments and Crop Insurance Proceeds
Jennifer Garcia, SSN XXX-XX-XXXX
Route 2, Box 2
Bitterweed, MS 38000

Jennifer Garcia elects to postpone recognition of the following disaster payments and crop insurance proceeds under I.R.C. § 451(f) and Treas. Reg. § 1.451-6. The crops for which these proceeds were received would have been sold in 2022 under her normal business practice.

Crop Destroyed or Damaged	Cause	Date of Destruction or Damage	Payment Received	Date of Payment	Insurance Carrier or Other Payer
Soybeans	Rain	05/10/2021	$15,000	10/15/2021	Crops Ins., Inc.
Corn	Drought	07/10/2021	$21,000	10/15/2021	Crops Ins., Inc.

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ISSUE 5: NET OPERATING LOSSES This section explains how a taxpayer calculates a net operating loss and then uses that loss as a deduction in another tax year.

A taxpayer who has business expenses in excess of business income (an operating loss) can offset nonbusiness income (subject to certain limitations) and treat any remaining excess business expenses as a net operating loss (NOL) that can then be carried to other tax years. This section discusses NOL issues for farmers. It explains how to calculate an NOL, the taxable income limitation, carryovers periods, and how to calculate an NOL carryover and claim the NOL deduction.

Calculating an NOL

The calculation of an I.R.C. § 172 NOL starts with the taxpayer's taxable loss and then adds back certain excluded items. In general, the following items are not allowed when figuring an NOL:

1. Any deduction for personal exemptions (suspended for tax years 2018 through 2025)
2. Capital losses that exceed capital gains (for noncorporate taxpayers)
3. The I.R.C. § 1202 exclusion of the gain from the sale or exchange of qualified small business stock (for noncorporate taxpayers)
4. Nonbusiness deductions that exceed nonbusiness income (for noncorporate taxpayers)
5. The NOL deduction
6. The qualified business income (QBI) deduction

Business Income and Deductions

For a taxpayer other than a corporation, nonbusiness deductions are allowed only to the extent of nonbusiness income. *Business income* is income earned in a trade or business, including farming. It includes the following:

1. Salaries, wages, and commissions
2. Self-employment income
3. Rental income
4. Ordinary gain from the sale of depreciable business assets, including livestock used in the trade or business, and business real estate
5. Unemployment compensation included in income
6. Allocated business income from a partnership or S corporation

Business deductions include the following:

1. Deductions allowed in conducting the trade or business
2. State and local income taxes on business income
3. Ordinary loss on the sale of I.R.C. § 1244 (small business) stock
4. Allocated business loss from a partnership or S corporation
5. Casualty and theft losses from a federally declared disaster (including business and nonbusiness)
6. Ordinary losses from the sale of depreciable business assets and business real estate
7. Deduction for 50% of self-employment tax
8. Deduction for self-employed health insurance
9. Educator expense deduction

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Nonbusiness Income and Deductions

Nonbusiness income includes the following:

1. Interest on investments
2. Taxable IRA distributions
3. Dividends
4. Pensions, annuities, and some royalties
5. Nonbusiness income from a partnership or S corporation
6. Taxable portion of social security benefits

Nonbusiness deductions include the following:

1. Personal exemption (when allowed in calculating taxable income)
2. Standard deduction
3. Contributions to an IRA or other retirement plans taken as an adjustment to gross income
4. Medical expense deduction
5. Health savings account (HSA) contributions
6. Charitable contributions deduction
7. Student loan interest deduction
8. State and local taxes deduction on nonbusiness income
9. Home mortgage interest deduction

CROSS-REFERENCE

Additional Loss Limitations

Before determining whether an NOL exists, a taxpayer's business losses are subject to other limitations. The business must be a business and not a hobby. The taxpayer must have sufficient basis and at-risk amounts in the activity. Passive activity losses may be limited to passive activity income. See the "Loss Limitations" chapter in the *2017 National Income Tax Workbook* for a discussion of these other limits on losses.

Example 4.34
Calculating an Individual's NOL

Maxine Creek is unmarried with no dependents. She itemizes deductions. **Figure 4.18** shows Maxine's 2020 income, deductions, gains, and losses.

FIGURE 4.18 Maxine Creek's 2020 Income, Deductions, Gains, and Losses

Net Schedule F (Form 1040) loss	($125,000)
Interest income (nonbusiness)	7,000
Interest expense on home mortgage	(10,000)
State and local property taxes (nonbusiness)	(4,000)
Taxable income	($132,000)

Maxine calculates her $125,000 NOL on Schedule A (Form 1045), Application for Tentative Refund, as shown in **Figure 4.19**.

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FIGURE 4.19
Maxine Creek's Schedule A (Form 1045)

Schedule A—NOL (see instructions)

1	For individuals, subtract your standard deduction or itemized deductions from your adjusted gross income and enter it here. For estates and trusts, enter taxable income increased by the total of the charitable deduction, income distribution deduction, and exemption amount (see instructions)				1	(132,000)
2	Nonbusiness capital losses before limitation. Enter as a positive number (see instructions)			2		
3	Nonbusiness capital gains (without regard to any section 1202 exclusion)			3		
4	If line 2 is more than line 3, enter the difference. Otherwise, enter -0-			4		
5	If line 3 is more than line 2, enter the difference. Otherwise, enter -0-	5				
6	Nonbusiness deductions (see instructions)			6	14,000	
7	Nonbusiness income other than capital gains (see instructions)	7	7,000			
8	Add lines 5 and 7			8	7,000	
9	If line 6 is more than line 8, enter the difference. Otherwise, enter -0-				9	7,000
10	If line 8 is more than line 6, enter the difference. Otherwise, enter -0-. **But don't enter more than line 5**	10				
11	Business capital losses before limitation. Enter as a positive number			11		
12	Business capital gains (without regard to any section 1202 exclusion)	12				
13	Add lines 10 and 12			13		
14	Subtract line 13 from line 11. If zero or less, enter -0-			14		
15	Add lines 4 and 14			15		
16	Enter the loss, if any, from line 16 of your 2020 Schedule D (Form 1040). (For estates and trusts, enter the loss, if any, from line 19, column (3), of Schedule D (Form 1041).) Enter as a positive number. If you don't have a loss on that line (and don't have a section 1202 exclusion), skip lines 16 through 21 and enter on line 22 the amount from line 15			16		
17	Section 1202 exclusion. Enter as a positive number (see instructions)				17	
18	Subtract line 17 from line 16. If zero or less, enter -0-			18		
19	Enter the loss, if any, from line 21 of your 2020 Schedule D (Form 1040). (For estates and trusts, enter the loss, if any, from line 20 of Schedule D (Form 1041).) Enter as a positive number			19		
20	If line 18 is more than line 19, enter the difference. Otherwise, enter -0-			20		
21	If line 19 is more than line 18, enter the difference. Otherwise, enter -0-				21	
22	Subtract line 20 from line 15. If zero or less, enter -0-				22	
23	NOL deduction for losses from other years. Enter as a positive number				23	
24	**NOL.** Combine lines 1, 9, 17, and 21 through 23. If the result is less than zero, enter it here and on page 1, line 1a. If the result is zero or more, you **don't** have an NOL				24	(125,000)

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Taxable Income Limitation

For losses arising in tax years beginning after December 31, 2017, the Tax Cuts and Jobs Act of 2017 (TCJA), Pub. L. No. 115-97, limits the NOL deduction to 80% of taxable income. The 80% taxable income limitation is calculated without regard to the deductions allowable under I.R.C. §§ 172 (NOL deduction), 199A (QBI deduction), and 250 (deduction for foreign-derived intangible income and global intangible low-taxed income). Excess losses generally may be carried forward indefinitely, and carryovers of such NOLs to other tax years are adjusted to take account of the 80% taxable income limitation.

The Coronavirus Aid, Relief, and Economic Security Act of 2021 (CARES Act), Pub. L. No. 116-136, suspended the application of the 80% taxable income limitation for tax years beginning after December 31, 2017, and before January 1, 2021. The 80% taxable income limitation continues to apply to any tax year beginning after December 31, 2020, and to NOLs arising in tax years beginning after December 31, 2017 and carried to a tax year beginning after December 31, 2020.

The Consolidated Appropriations Act, 2021 (CAA), Pub. L. No. 116-260, contains Division N Subtitle B, which is the COVID-Related Tax Relief Act of 2020 (COVIDTRA). Under COVIDTRA, a taxpayer with a farming NOL for a tax year beginning in 2018, 2019, or 2020 could elect to disregard the amendments made by the CARES Act. If the taxpayer makes the election, the 80% limitation (based on modified taxable income) under the TCJA will apply to determine the NOL deduction for each tax year beginning in 2018, 2019, or 2020 to the extent the deduction is attributable to NOLs arising in tax years beginning after December 31, 2017. Also, the NOL carryback will be determined under the TCJA (discussed in the next section).

Carryover Periods

The carryover rules depend on when an NOL was incurred and the type of business in which the loss was incurred.

Pre-2018 NOLs

NOLs arising in tax years beginning before January 1, 2018, could be carried back 2 years and carried forward 20 years. The taxpayer could elect to forgo the 2-year carryback period. NOLs arising from certain casualty losses were eligible for a 3-year carryback period. Farming losses were subject to a 5-year carryback period. However, the taxpayer could elect to treat the farming losses as nonfarm NOLs (subject to a 2-year carryback period) or elect to waive the carryback period completely and carry the loss forward.

A *farming loss* is the lesser of

1. the amount that would be the NOL for the tax year if only income and deductions attributable to farming businesses [as defined in section 263A(e)(4)] are taken into account, or
2. the amount of the NOL for the tax year.

A farming loss for any tax year is treated as a separate NOL and is taken into account after the remaining portion of the NOL for the tax year.

2018, 2019, and 2020 NOLs

The TCJA eliminated the 20-year limitation on carryovers (except for certain insurance companies that are still limited to a 20-year carryover period). The TCJA also repealed the 2-year NOL carryback. However, farming losses (defined earlier) and certain insurance company losses could still be carried back 2 years. A taxpayer who was entitled to the 2-year carryback could elect to waive the 2-year carryback.

The CARES Act provides that any NOL (including farming losses) arising in a tax year beginning after December 31, 2017, and before January 1, 2021, must be carried back to the 5 tax years preceding the tax year of the loss (the 5-year carryback period). Special rules apply to real estate investment trusts and life insurance companies. The taxpayer could elect to waive the carryback period.

Under COVIDTRA § 281, taxpayers with a farming loss for any tax year beginning in 2018, 2019, or 2020 could elect to retain the 2-year NOL carryback (elected prior to the CARES Act) instead of the 5-year carryback in the CARES Act. Farmers could also revoke an election to waive the NOL carryback and carry back the NOL for 5 years pursuant to the CARES Act.

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Rev. Proc. 2021-14, 2021-30 I.R.B. 158, provides guidance regarding the elections to disregard the CARES Act amendments. This revenue procedure prescribes when and how to make an election with regard to all NOLs of the taxpayer, regardless of whether the NOL is a farming loss NOL. This revenue procedure also provides that a taxpayer is treated as having made a deemed election under § 2303(e)(1) of the CARES Act if the taxpayer, before December 27, 2020, filed one or more original or amended federal income tax returns, or applications for tentative refund, that disregard the CARES Act amendments with regard to a farming loss NOL. This revenue procedure further prescribes when and how to revoke an election made under I.R.C. § 172(b)(1)(B)(iv) or § 172(b)(3) to waive the 2-year carryback period for the farming loss portion of a farming loss NOL incurred in a tax year beginning in 2018 or 2019.

2021 NOLs

NOLs for tax years beginning in 2021 can be carried forward indefinitely (except for insurance companies). Nonfarming NOLs cannot be carried back (except for insurance companies). By default, farming losses must be carried back 2 years. However, the taxpayer can elect to not apply the 2-year carryback. The election must be made by the due date (including extensions) for filing the taxpayer's return for the tax year of the NOL. Once made, the election is irrevocable for that tax year [I.R.C. § 172(b)(1)(B)(iv)]. If the taxpayer filed his or her original return on time but did not make the election, the taxpayer can make the election on an amended return filed within 6 months of the due date of the return (excluding extensions) [Treas. Reg. § 301.9100-2].

Example 4.35
Electing to Waive Carryback

In 2021, Jim Mustang had a $38,000 farming NOL. He filed his 2021 income tax return in February 2022. He did not file an election to waive the NOL carryback. If Jim wants to carry the loss forward, he must file the election on an amended tax return by October 15, 2022. If he does not make a timely election to waive the carryback, he must first carry the loss back to 2019, and then to 2020.

PLANNING POINTER

Carrybacks and Carryforwards

Usually, a carryback is preferable to a carryforward because it results in a certain and quick tax refund. However, the taxpayer should determine the years in which the individual tax rate was, or is expected to be, the highest and use as much of the NOL deduction as possible in those years. If the carryback years were taxed at very low rates, and the year following the NOL is likely to produce high income and a high tax rate, the taxpayer may want to opt for the carryforward only. The taxpayer should also avoid carrying an NOL to a year in which modified taxable income is much greater than taxable income, because the NOL is absorbed to the extent of modified taxable income, but its tax benefit is limited to taxable income (or 80% of taxable income in years that the 80% limitation applies).

Ordering of Carryover Years

A taxpayer must carry the loss to the earliest carryover year and then must carry any remaining loss to the next earliest carryover year [I.R.C. § 172(b)(2)]. As a result, taxpayers may be required to carry an NOL to a year that results in no refund. A farmer can elect to forgo the entire carryback period but cannot elect to forgo only part of the carryback period.

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NOL Carryover Amount

In a carryover or carryback year, the taxpayer claims a deduction for the full NOL carried to that year. However, the NOL deduction cannot reduce taxable income below zero, so the amount of NOL that is absorbed in a carryover year is limited to the *modified taxable income* for that year. The amount of the NOL may be subject to the 80% of taxable income limitation.

Modified taxable income for this purpose is generally taxable income with the following adjustments:

1. Determine the amount of the NOL deduction without regard to the NOL for the loss year or for any tax year thereafter
2. Exclude capital losses that exceed capital gains [I.R.C. § 172(d)(2)]
3. Exclude the gain from the sale or exchange of I.R.C. § 1202 small business stock [I.R.C. § 172(d)(2)(B)]
4. Exclude any personal and dependency exemption deductions for tax years prior to 2018 or after 2025 [I.R.C. § 172(d)(3)]
5. Exclude the QBI deduction [I.R.C. § 172(d)(8)]
6. Adjust other income and deductions that are based on adjusted gross income (AGI) to reflect the changes to AGI caused by items 1, 2, 3, and 5. These include the following:
   a. The special $25,000 allowance for passive activity losses from rental real estate activities
   b. Taxable social security benefits
   c. IRA deductions
   d. Excludable savings bond interest
   e. The exclusion of amounts received under an employer's adoption assistance program
   f. The student loan interest deduction
   g. Tuition and fees deduction
   h. Itemized deductions such as medical expenses and casualty and theft losses

The remaining NOL carryover is calculated by subtracting modified taxable income from the NOL carried into that year and applying the 80% taxable income limitation (for losses arising in 2021).

Example 4.36
Carryback of NOL

The facts are the same as in Example 4.35. Maxine did not forgo the 2-year carryback period for her farming NOL. The 2020 NOL is carried back to 2018. Any carryback amount remaining after applying the 2020 NOL to 2018 will first offset income from 2019, and then carry forward to 2021 until it is completely absorbed. **Figure 4.20** shows Maxine's 2018 income, deductions, gains, and losses.

FIGURE 4.20
Maxine Creek's 2018 Income, Deductions, Gains, and Losses

Net Schedule F (Form 1040) income	$106,000
Interest income (nonbusiness)	27,000
Net capital loss	(3,000)
Deduction for one-half SE tax	(7,489)
QBI deduction	(19,702)
Interest expense on home mortgage	(14,000)
State and local property taxes	(5,400)
Taxable income	$ 83,409

Maxine recalculates her 2018 taxable income on either Form 1045 or Form 1040X, Amended U.S. Individual Income Tax Return, by subtracting the full amount of her 2020 NOL. As a result, she has zero taxable income and will claim a refund of all income tax paid. The SE tax she paid on the 2018 Schedule F (Form 1040) profits will not be affected by the NOL carryback. Because the $125,000 NOL is more than the adjusted taxable income for the earliest year to which it was carried, Maxine must file Schedule B (Form 1045), NOL Carryover, to calculate the amount of the NOL to be carried to 2019.

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Example 4.37
Absorption of NOL in Carryback Year

The facts are the same as in Example 4.36. Maxine's $125,000 NOL deduction exceeded her taxable income for 2018, as originally reported. However, her originally reported $83,409 taxable income for 2018 is not the amount of deduction absorbed. She must adjust her taxable income for 2018 by excluding the $3,000 net capital loss deduction and the $19,702 QBI deduction.

Maxine's adjusted taxable income is $106,111 ($83,409 + $3,000 + $19,702). Maxine carries $18,889 ($125,000 − $106,111) of her 2020 NOL to 2019. Any amount not used in 2019 carries over to 2021 (where it is subject to the 80% of taxable income limitation). Maxine could not use the $3,000 capital loss in 2018, so it carries over to 2019. **Figure 4.21** shows Maxine's NOL carryover calculations on Schedule B (Form 1045).

FIGURE 4.21
Maxine Creek's Schedule B (Form 1045)

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Schedule B—NOL Carryover (see instructions)

Complete one column before going to the next column. Start with the earliest carryback year.		2 preceding tax year ended ▶ 12/31/2018		____ preceding tax year ended ▶		____ preceding tax year ended ▶	
1	**NOL deduction.** Enter as a positive number		125,000				
2	Taxable income before 2020 NOL carryback (see instructions). For estates and trusts, increase this amount by the sum of the charitable deduction and income distribution deduction (see instructions)	83,409					
3	Net capital loss deduction (see instructions)	3,000					
4	Section 1202 exclusion. Enter as a positive number (see instructions)						
5	Domestic production activities deduction (see instructions)	19,702					
6	Adjustment to adjusted gross income (see instructions)						
7	Adjustment to itemized deductions (see instructions)						
8	For individuals, enter deduction for exemptions. For estates and trusts, enter exemption amount						
9	Modified taxable income. Combine lines 2 through 8. If zero or less, enter -0- (see instructions)		106,111				
10	**NOL carryover** (see instructions)		18,889				

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Carryovers with Change of Marital Status

If an NOL arises in a year when a joint return was filed and is carried to separate returns, section 172 requires allocation of the NOL carryover to the spouse whose loss or deduction items created the NOL. Similarly, capital loss carryforwards are allocated based on the separate capital gains and losses of each spouse.

Example 4.38
NOL Carryforward after Divorce

Bill and Melanie Harris were divorced in July 2021. In 2018, they had a $68,000 loss from Bill's tomato operation. They had elected to not carry the loss back, and the NOL carryforward to 2021 is $45,000. Because the loss originated with Bill's sole proprietorship, only Bill can use the remaining carryforward.

PLANNING POINTER

Decedent's NOL

I.R.C.§ 6013(a)(3) allows the surviving spouse to file jointly with the deceased spouse. A surviving spouse filing jointly with the decedent can use any of the deceased spouse's unused NOLs to offset the surviving spouse's income on the decedent's final return. For example, he or she could sell separately owned property at a gain, or take a taxable distribution from an IRA to generate taxable income in the year of the spouse's death and use the remaining NOL.

Claiming the NOL Deduction

This section explains how to report an NOL carryback or carryforward.

Reporting a Carryback

There are two methods by which the taxpayer can claim the NOL deduction in a carryback year.

1. The taxpayer can file Form 1045 within 1 year following the close of the NOL tax year.
2. The taxpayer can file Form 1040X within 3 years after the due date (including extensions) for the return of the NOL tax year.

To recalculate total tax liability for a carryback year using Form 1045, the taxpayer must first recalculate AGI for that year on Form 1045, lines 10 and 11, and the "After carryback" column for the applicable carryback year. As the NOL deduction reduces AGI, the taxpayer may need to recalculate the following income or deduction items that are based on or limited to a percentage of AGI:

- The special allowance for passive activity losses from rental real estate activities
- Taxable social security benefits
- IRA deductions
- Excludable savings bond interest
- The exclusion of amounts received under an employer's adoption assistance program
- The student loan interest deduction
- The tuition and fees deduction

Next, the taxpayer must recalculate taxable income on Form 1045, lines 12 through 15, and the "After carryback" column. The taxpayer uses the recalculated AGI from Form 1045, line 11, using the "After carryback" column to refigure certain deductions and other items that are based on or limited to a percentage of AGI, such as the following:

- Itemized deduction for medical expenses
- Itemized deduction for mortgage insurance premiums
- Itemized deduction for personal casualty and theft losses

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- Miscellaneous deductions subject to the 2%-of-AGI limit (suspended in tax years 2018 through 2025)
- Qualified business income (QBI) deduction if limited by taxable income
- Personal and dependent exemptions if previously limited by AGI (suspended in tax years 2018 through 2025)

PRACTITIONER NOTE

Charitable Contribution Deduction

The charitable contribution deduction is not recalculated even though the reduced AGI may have otherwise limited the amount of the deduction. However, I.R.C. § 170(d)(1)(B) requires a reduction in a taxpayer's charitable contribution carryover to the extent an excess charitable contribution reduces modified taxable income [as computed under section 172(b)(2)] and increases an NOL carryover.

Finally, the taxpayer uses the recalculated taxable income from Form 1045, line 15, using the "After carryback" column to refigure total tax liability on Form 1045, lines 16 through 30, and the "After carryback" column using the rates and tables in effect for that year. The taxpayer must recalculate income tax; alternative minimum tax; and any credits that are based on or limited by AGI, MAGI, or tax liability. The NOL deduction does not reduce SE tax for carryback or carryforward years [I.R.C. § 1402(a)(4)].

Reporting a Carryover

To deduct the NOL in a carryover year the taxpayer makes the negative entry on the "Other income" line of Schedule 1 (Form 1040). The taxpayer must file a statement with the return for the year (either carryback or carryover) in which the NOL deduction is taken explaining the loss and providing detailed computations of the NOL deduction [Treas. Reg. § 1.172-1(c)].

CROSS-REFERENCE

NOLs and QBI

Generally, an NOL carryforward is not directly included in calculating QBI. However, it reduces the taxpayer's taxable income. Thus, the NOL deduction may increase the QBI deduction if the taxpayer's taxable income exceeds the phasein range. The NOL deduction may also reduce the QBI deduction by lowering the taxable income limit. See the "Qualified Business Income Deduction Issues" chapter in the *2020 National Income Tax Workbook* for a discussion of the QBI deduction and QBI losses.

NOLs and Farm Income Averaging

Taxpayers who are engaged in a farming business may be able to average all or some of the farm income by using income tax rates from the 3 prior years (base years) to calculate the tax on that income. Income averaging may lower the income tax liability in a year where farm income and taxable income are higher compared to one or more of the 3 prior years.

An NOL that is carried to a base year under the I.R.C. § 1301 income averaging rules is allowed in full when computing the taxable income for the base year–even if the deductions exceed gross income and the result is negative taxable income. However, any NOL that may provide a tax benefit in another tax year must be added back to calculate base-year taxable income for any subsequent years' income averaging calculations [Treas. Reg. § 1.1301-1(d)(2)]. This prevents taxpayers from receiving a double benefit from an NOL.

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The instructions for Schedule J (Form 1040), Income Averaging for Farmers and Fishermen, include a worksheet that adds back deductions that may provide a benefit in another tax year. Amounts that may provide a benefit in another year include the following:

- The NOL for the base year
- The NOL for any other year to the extent carried forward from the base year
- The capital loss deduction allowed for the base year to the extent such deduction does not reduce the capital loss carryover from the base year because it exceeds adjusted taxable income

Example 4.39
Calculating Base-Year Income

In 2021, Frank and Olive Farmer elected to average $24,000 of income attributable to a farming business. One-third of the elected farm income ($24,000 ÷ 3 = $8,000) is added to the 2019 base-year income. In 2019, Frank and Olive reported $12,650 AGI and claimed a $24,400 standard deduction. There was no deduction for personal exemptions in 2019. Therefore, their 2019 base-year taxable income was negative $11,750 [$12,650 −$24,400]. Despite negative taxable income, the Farmers did not have an NOL for 2019.

After adding the elected farm income to the negative taxable income, their 2019 base year taxable income is negative $3,750 [$8,000 + ($11,750)]. If Frank and Olive elect to income-average in 2022, having made the base-year adjustments to account for the 2021 election, their 2019 base-year taxable income for the 2022 election is negative $3,750, allowing this amount of 2022 elected farm income to be tax-free.

Example 4.40
Calculating Base-Year Income with Base-Year NOL

The facts are the same as in Example 4.39 except that Frank and Olive had a $12,000 farm loss in 2019. They claimed the standard deduction and had no other income or deductions. Their taxable income was negative $36,400 [($12,000) – ($24,400)]. The farm loss generated a $12,000 NOL. Therefore, their base-year taxable income for 2019 is reduced by the NOL carryover amount. The 2019 taxable income for income averaging purposes is negative $24,400 [($36,400) + $12,000].

CROSS-REFERENCE

NOLs and Net Investment Income Tax

I.R.C. § 1411 imposes a 3.8% surtax on the net investment income of certain individuals, trusts, and estates. A section 1411 NOL is allowed as a deduction in calculating net investment income. See pages 116–118 in the *2017 National Income Tax Workbook* for a discussion of NOLs and the net investment income tax.

CROSS-REFERENCE

NOLs and Alternative Minimum Tax

Alternative minimum tax (AMT) loss rules allow a taxpayer to use an AMT loss from one year to offset AMT in another year. See pages 118–123 in the *2017 National Income Tax Workbook* for a discussion of the alternative tax net operating loss deduction.

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ISSUE 6: QBI FOR COOPERATIVES AND THEIR PATRONS

This section explains the final QBI regulations for cooperatives and their patrons.

I.R.C. § 199A was enacted as part of the Tax Cuts and Jobs Act of 2017 (TCJA), Pub. L. No. 115-97. Section 199A(a) establishes the qualified business income (QBI) deduction for individuals, estates, and trusts. Eligible taxpayers can deduct up to 20% of their QBI from sole proprietorships and pass-through entities and can deduct up to 20% of qualified real estate investment trust (REIT) dividends and publicly traded partnership (PTP) income for tax years 2018 through 2025.

Most cooperatives are classified as C corporations, and C corporations do not qualify for the section 199A(a) QBI deduction. Although cooperatives are C corporations for federal income tax purposes, I.R.C. § 1382(b) and (c) allow cooperatives to determine taxable income after deducting distributions of patronage dividends or similar payments to patrons. The effect of these deductions is to remove the distributions from income taxed at the cooperative level and subject the distributions to income tax only at the patron level.

Agricultural or horticultural cooperatives may be entitled to a domestic production activities deduction under I.R.C. § 199A(g). The section 199A(g) deduction is based on the former I.R.C. § 199 domestic production activities deduction (DPAD). A cooperative can pass through any portion of this deduction by making qualified payments to its patrons.

This section discusses how patrons of cooperatives calculate their section 199A deduction and how cooperatives calculate and pass through their deduction to their patrons. It focuses on final treasury regulations that clarify the section 199A deduction for cooperatives and their patrons [T.D. 9947]. The final regulations generally apply to tax years beginning after January 19, 2021. However, taxpayers may choose to apply them to tax years beginning on or before that date if taxpayers follow the rules in their entirety and in a consistent manner. Alternatively, taxpayers may rely on Prop. Treas. Reg. §§ 1.199A-7 through 1.199A-12 and Prop. Treas. Reg. § 1.1388-1(f) issued on June 19, 2019, for tax years beginning on or before January 19, 2021, if taxpayers follow the proposed regulations in their entirety and in a consistent manner.

CROSS-REFERENCE

Other Trade or Business Income

To the extent a patron operating a trade or business has income directly from that business (as opposed to receiving a patronage dividend from a cooperative), the patron must follow the rules of Treas. Reg. §§ 1.199A-1 through 1.199A-6 to calculate the section 199A deduction. To the extent a patron receives patronage dividends or similar payments from a cooperative, the patron must follow the additional special rules and clarification in Treas. Reg. § 1.199A-7 to calculate the section 199A deduction. See the "Business Tax Issues" chapter in this Workbook for a discussion of the QBI deduction for other trades or businesses.

Definitions

Whereas section 199A(a) is generally available to patrons of all cooperatives, sections 199A(b)(7) and 199A(g) apply only to specified cooperatives and their patrons.

Specified Cooperatives

Section 199A(g)(4) and Treas. Reg. § 1.199A-8(a)(2) define a *specified cooperative* as a cooperative to which subtitle A, chapter 1, subchapter T, part 1, of the Internal Revenue Code applies (a corporation operating on a cooperative basis, except mutual savings banks, insurance companies, most tax-exempt organizations, and certain utilities) and which

1. manufactures, produces, grows, or extracts (MPGE) in whole or significant part within the United States any agricultural or horticultural product; or
2. is engaged in the marketing of agricultural or horticultural products that have been MPGE in whole or significant part within the United States by the cooperative patrons.

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Specified cooperatives may be nonexempt or exempt. Exempt and nonexempt cooperatives can deduct patronage distributions if they satisfy the requirements described in section 1382(b). However, exempt cooperatives can also deduct nonpatronage distributions if they meet the requirements under section 1382(c). Thus, section 199A(g) provides different rules for exempt and nonexempt cooperatives.

Exempt Cooperatives

Under Treas. Reg. § 1.199A-8(a)(2)(ii), a specified cooperative that is qualified as a farmer's cooperative organization under I.R.C. § 521 is an exempt specified cooperative. In contrast, a specified cooperative that is not so qualified is a nonexempt specified cooperative. I.R.C. § 521(b)(1)(a) and (b) define an exempt cooperative as farmers, fruit growers, or like associations organized and operated on a cooperative basis

1. for the purpose of marketing the products of members or other producers, and turning back to them the proceeds of sales, less the necessary marketing expenses, based on either the quantity or the value of the products furnished by them; or
2. for the purpose of purchasing supplies and equipment for the use of members or other persons and turning over such supplies and equipment to them at actual cost, plus necessary expenses.

If a cooperative does not meet this definition and follow other strict requirements, then it is nonexempt for section 199A purposes.

Patrons

Treas. Reg. § 1.199A-8(a)(3) states that the definition of a *patron* is found in Treas. Reg. § 1.1388-1(e). Under this regulation, a patron includes any person with whom or for whom the cooperative association does business on a cooperative basis, whether a member or a nonmember of the cooperative association; and whether an individual, a trust, estate, partnership, company, corporation, or cooperative association.

Patronage Dividend

I.R.C. § 1388(a) defines a *patronage dividend* as an amount a cooperative pays to its patrons

1. based on quantity or value of business done with or for such patron;
2. under an obligation of the cooperative to pay this amount, and the obligation existed before the cooperative received the amount paid; and
3. that is determined by reference to the cooperative's net earnings from business done with or for its patrons.

A patronage dividend does not include an amount paid to a patron to the extent that the amount is out of earnings of the business that is not done with or for patrons, or the amount is out of earnings from business done with or for other patrons to whom no amounts are paid, or to whom smaller amounts are paid for substantially identical transactions. A patronage dividend may include the following:

- Money
- The stated dollar value of qualified written notices of allocation
- The FMV of other property

Patronage and Nonpatronage

Treas. Reg. § 1.1388-1(f) states that whether an item of income or deduction is patronage or nonpatronage sourced is determined by applying the directly related use test. The *directly related use test* provides that if the income or deduction is produced by a transaction that actually facilitates the accomplishment of the cooperative's marketing, purchasing, or service activities, then the income or deduction is from patronage sources.

However, if the transaction producing the income or deduction does not actually facilitate the accomplishment of these activities but merely enhances the overall profitability of the cooperative, and is just incidental to the association's cooperative operation, then the income or deduction is from nonpatronage sources.

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The final regulations remove the last sentence in the definition that prohibited the netting of patronage and nonpatronage items. The final regulations also revise the definition of *income from sources other than patronage* by cross-referencing the definition of patronage and nonpatronage in section 1.1388-1(f).

Agricultural or Horticultural Products

Under I.R.C. § 1.199A-8(a)(4), agricultural and horticultural products include agricultural, horticultural, viticultural, dairy products, livestock, the products of livestock, poultry, the products of poultry, bee raising, edible forestry products, and all products raised or produced on farms. They also include certain processed or manufactured products including aquatic products that are farmed by a specified cooperative, fertilizer, diesel fuel, and other supplies used in agricultural or horticultural production that are manufactured, produced, grown, or extracted by a specified cooperative.

The definition in the final regulations provides the following examples (without limitation) of products that are considered agricultural or horticultural products, including specific agricultural or horticultural products, livestock products, edible forestry products, and farmed aquatic products:

- Fruits
- Grains
- Oilseeds
- Rice
- Vegetables
- Legumes
- Grasses (including hay)
- Plants of all kinds
- Flowers (including hops)
- Seeds
- Tobacco
- Cotton
- Sugar cane
- Sugar beets
- Wool
- Fur
- Hides
- Eggs
- Down
- Honey
- Silk
- Nuts
- Mushrooms
- Fish
- Crustaceans
- Shellfish
- Seaweed

The final regulations maintain the approach in the proposed regulations that the definition of agricultural or horticultural products does not include intangible property, but also provide language further clarifying the exclusion. The clarifying language provides that intangible rights include the rights to manufacture, produce, grow, extract, and sell an agricultural or horticultural product with certain characteristics protected by a patent and the trademark of a brand.

This exclusion of intangible property does not apply to intangible characteristics of any particular agricultural or horticultural product. For example, gross receipts from the sale of different varieties of oranges would be considered from the disposition of agricultural or horticultural products. However, gross receipts from the license of the right to produce and sell a certain variety of an orange would be considered separate from the orange and not from an agricultural or horticultural product [Preamble to T.D. 9947].

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QBI Deduction for Cooperatives and Their Patrons

The final regulations generally adopt the proposed regulations, and to the extent a patron receives patronage dividends or similar payments from a cooperative, Treas. Reg. § 1.199A-7 provides rules to calculate the QBI deduction. Patronage dividends or similar payments from cooperatives may be included in a patron's QBI to the extent that these payments

1. are related to the patron's trade or business;
2. are qualified items of income, gain, deduction, and loss at the cooperative's trade or business level (reported in box 8 of Form 1099-PATR);
3. are not income from a specified service trade or business (SSTB) at the cooperative's trade or business level (unless the patron has taxable income below the threshold amount) (reported in box 9 of Form 1099-PATR); and
4. are properly reported to the patron by the cooperative.

Limitations

The cooperative must provide information to the patron (discussed later) regarding whether the payments are qualified items of SSTB or non-SSTB income. The patron must make the determination of W-2 wages and unadjusted basis immediately after acquisition (UBIA) of qualified property for each trade or business. Cooperatives do not allocate their W-2 wages and UBIA of qualified property to patrons. The patron must apply the W-2 wage and capital limitations and the SSTB limitations. Specified cooperatives must also report whether payments are qualified payments, which are subject to special limitation rules (discussed next).

CROSS-REFERENCE

QBI Deduction

See the "Qualified Business Income Deduction: Specified Service Trades or Businesses" chapter in the *2019 National Income Tax Workbook* for a complete discussion of SSTBs. See also the "Qualified Business Income Deduction: Non–Specified Service Trades or Businesses" chapter in the 2019 book for a detailed explanation of the definition of QBI and the other limitations that may reduce the amount of the deduction.

Reduction for Payments from Specified Cooperatives

Because patrons of specified cooperatives may be eligible to take both a section 199A(a) and section 199A(g) deduction, Treas. Reg. § 1.199A-7(f) provides that a patron of a specified cooperative that receives a qualified payment (reported in box 7 of Form 1099-PATR, as show in Figure 4.25) must reduce its section 199A(a) deduction as provided in Treas. Reg. § 1.199A-1(e)(7). Under that section, the patron's section 199A deduction must be reduced by the lesser of

- 9% of the QBI for the trade or business that is properly allocable to qualified payments received from the cooperative, or
- 50% of the W-2 wages for the trade or business that are allocable to qualified payments received from the cooperative.

This reduction is required regardless of whether the specified cooperative passes through the section 199A(g) deduction to the patrons in that tax year. *Qualified payments* are any amount of a patronage dividend or per-unit retain allocation received by a patron from a specified cooperative that is attributable to the portion of the specified cooperatives qualified production activities income (QPAI), for which the cooperative is allowed a section 199A(g) deduction. For this purpose, patronage dividends include any advances on patronage and per-unit retain allocations include per-unit retains paid in money during the tax year. The final regulations remove the sentence that states a specified cooperative calculates its qualified payments using the same method of accounting it uses to calculate its taxable income.

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Additional Expenses

Treas. Reg. § 1.199A-3(b)(1)(vi) provides that, in general, deductions attributable to a trade or business are included for purposes of computing QBI to the extent that the individual's gross income from the trade or business is taken into account in calculating the allowable deduction. These deductions include the following:

- The deduction for self-employment (SE) tax under I.R.C. § 164(f)
- The deduction for self-employed health insurance under I.R.C. § 162(l)
- The deduction for contributions to qualified retirement plans under I.R.C. § 404

The taxpayer must include these deductions in the QBI calculation before the taxpayer applies the reduction for qualified payments from specified cooperatives.

Example 4.41
Calculating the QBI Deduction—with Wages and Additional Expenses

Sal Armino owns and operates a row crop operation in Indiana. He has no livestock. In calendar year 2021, Sal sold 100% of his corn and soybeans to the local farmers' cooperative, which is a specified nonexempt cooperative. Sal received a timely Form 1099-PATR from the cooperative showing an $80,000 patronage dividend, $450,000 per-unit paid in money (PURPIM), and a $2,500 section 199A(g) pass-through deduction.

Sal's 2021 farm expenses were $480,000, including $50,000 of W-2 wages. Sal's filing status is married filing jointly and his taxable income was $60,000. Sal claimed the following:

- $3,532 [($50,000 farming income × 0.9235 × 0.153) × 50%] deduction for one-half of SE tax
- $7,500 deduction for self-employed health insurance
- $4,000 deduction for contribution to a qualified retirement plan

Sal's QBI is $34,968 ($50,000 − $3,532 − $7,500 − $4,000). His preliminary QBI deduction is $6,994 ($34,968 × 20%). Because 100% of Sal's sales were to the cooperative, Sal must reduce his $6,994 preliminary QBI calculation by $3,147, which is the lesser of

1. $3,147 ($34,968 QBI × 9%), or
2. $25,000 ($50,000 W-2 wages × 50%).

Sal's QBI deduction is $3,847 ($6,994 − $3,147). His QBI is not reduced by the $12,000 ($60,000 × 20%) taxable income limit. Sal adds the $2,500 pass-through section 199A(g) deduction (which is not limited by his taxable income), and his total QBI deduction for the farming operation is $6,347 ($3,847 + $2,500). **Figure 4.22** shows the calculations of Sal's QBI deduction.

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FIGURE 4.22
Sal Armino's QBI Calculation

	Qualified Payments
Schedule F (Form 1040) gross income ($450,000 + $80,000)	$530,000
Schedule F (Form 1040) expenses	(480,000)
Schedule F (Form 1040) net profit	$50,000
One-half of SE tax	(3,532)
Contribution to qualified retirement plan	(4,000)
Self-employed health insurance	(7,500)
QBI	$34,968
Preliminary QBI deduction (20% × $34,968)	$6,994
Lesser of $3,147 (9% of QBI) or $25,000 (50% of wages)	(3,147)
QBI deduction before pass-through deduction	$ 3,847
Pass-through section 199A(g) deduction	2,500
QBI deduction	$ 6,347

Example 4.42
Calculating the QBI Deduction—without Wages

The facts are the same as in Example 4.41 except that Sal's $480,000 of business expenses include no W-2 wages. Sal reduces his $6,994 QBI deduction by $0, which is the lesser of $3,147 ($34,968 QBI × 9%) or $0 ($0 W-2 wages × 50%). Sal can claim the full $6,994 QBI deduction plus the $2,500 pass-through section 199A(g) deduction. His total QBI deduction is $9,494 ($6,994 + $2,500).

Allocation Methods

Because qualified payments from a specified cooperative will reduce the QBI deduction of patrons who pay W-2 wages, such patrons with both qualified payments and income that is not a qualified payment must allocate those items and related deductions. The rules in Treas. Reg. § 1.199A-7(f)(2) provide an allocation method for a patron who receives qualified payments and income that is not a qualified payment in a trade or business. The regulations also provide a safe harbor allocation method.

Reasonable Method

If in any tax year a patron receives both qualified payments and income that is not a qualified payment in a trade or business, the patron must allocate those items and related deductions using a reasonable method based on all the facts and circumstances. Different reasonable methods may be used for different items of income, gain, deduction, and loss. The chosen reasonable method for each item must be consistently applied from one tax year to another and must clearly reflect the

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income and expenses of each trade or business. The overall combination of methods must also be reasonably based on all the facts and circumstances. The books and records maintained for a trade or business must be consistent with any allocations.

Safe Harbor Method

The safe harbor allocation method is intended to provide a straightforward method for patrons to allocate items related to qualified payments from a specified cooperative. A patron with taxable income under the threshold amount can use the safe harbor to apportion its deductions, losses, and W-2 wages for any tax year in which the patron receives qualified payments and income from other than qualified payments in its trade or business.

Under the safe harbor, the patron may apportion its deductions, losses, and W-2 wages ratably between income from qualified payments and income from other than qualified payments for purposes of calculating the reduction in QBI. Accordingly, the deductions and losses amount apportioned to determine QBI allocable to qualified payments is equal to the proportion of the total deductions and losses that the amount of income or gain related to qualified payments bears to total income or gain used to determine QBI. The same proportion applies to determine the W-2 wages amount allocable to the portion of the trade or business that received qualified payments.

PRACTITIONER NOTE

2021 Threshold Amounts

The QBI taxable income threshold amounts for 2021 are $329,800 for married filing jointly, $164,925 for married filing separately, and $164,900 for single and head of household.

Example 4.43
Safe Harbor Allocation of Qualified and Nonqualified Payments

Archie Holland received a 1099-PATR from his local cooperative, showing both qualified and nonqualified payments from a specified cooperative. All his farm income comes from sales to the cooperative. The 1099-PATR shows $270,000 of qualified payments (per-unit retains and patronage dividends) and $10,000 of nonqualified payments. The cooperative passed through a $1,000 section 199A(g) deduction.

Archie's taxable income was $50,000. His expenses for the year were $200,000, which included $10,000 of W-2 wages. His SE income was $80,000 [$270,000 + $10,000 − $200,000), and he deducted one-half of his SE tax, which was $5,652 [($80,000 × 0.9235 × 0.153) × 50%]. His self-employed health insurance premium was $12,000, and he made no retirement contributions.

Archie can include the $10,000 of nonqualified payments and the $270,000 qualified payments in his QBI. The nonqualified payments are 3.57% ($10,000 ÷ $280,000) of his total income for the year. Archie reduces his expenses allocable to qualified payments by 3.57%. Archie must also reduce the deduction for the qualified payments by the lesser of $5,611 [9% × ($80,000 − $5,652 – $12,000) QBI] or 50% of wages allocable to qualified payments of $4,822 [$10,000 × (100.00 % − 3.57%) × 50%].

Archie's preliminary QBI deduction is $7,648 ($446 from nonqualified payments + $7,202 from qualified payments). After adding the $1,000 section 199A(g) deduction passed through from the cooperative, his final QBI deduction is $8,648 ($7,648 + $1,000). **Figure 4.23** shows the calculation of Archie's QBI deduction. The taxable income limit does not limit his deduction.

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FIGURE 4.23
Archie Holland's QBI Deduction with Safe Harbor Allocation

	Total Business Income	Nonqualified Payments	Qualified Payments
Percentage of total income		3.57%	96.43%
Schedule F (Form 1040) gross income	$280,000	$10,000	$270,000
Schedule F (Form 1040) expenses	(200,000)	(7,140)	(192,860)
One-half of SE tax	(5,652)	(202)	(5,450)
Self-employed health insurance	(12,000)	(428)	(11,572)
Net QBI	$62,348	$2,230	$60,118
Preliminary QBI deduction (20% × QBI)		$446	$12,024
Reduction is lesser of			
9% of qualified business income ($5,611)		N/A	
50% of wages ($4,822)		N/A	(4,822)
QBI deduction		$ 446	$ 7,202

Example 4.44
Safe Harbor Allocation between a Cooperative and a Noncooperative

In 2021, Mary Donaldson sold her sugar beets and grain to both a local cooperative elevator and a noncooperative grain merchandiser. Mary's income and expenses are shown in **Figure 4.24**.

FIGURE 4.24
Mary Donaldson's 2021 Income and Expenses

Patronage dividends and per unit retains paid in money (PURPIM)	$491,400
Sales to a noncooperative grain merchandiser	264,600
Total sales	$756,000
Total expenses (including W-2 wages)	$696,000

Under the safe harbor allocation, Mary allocates her expenses 65% ($491,400 patronage dividends and PURPIM ÷ $756,000 total sales) to the cooperative and 35% to the noncooperative.

Cooperative Reporting Requirements

Under Treas. Reg. § 1.199A-7(c)(3) and (d)(3), cooperatives must separately determine the amounts of qualified items from non-SSTBs and qualified items from SSTBs in distributions made to cooperative patrons. Cooperatives must also report the 199A(g) deduction passed through to patrons (discussed later).

The final regulations maintain a reporting requirement for cooperatives, but the rules in proposed § 1.199A-7(c)(3) and (d)(3) are revised to simplify the cooperative's reporting obligation with respect to qualified items from non-SSTBs and qualified items from SSTBs. The proposed regulations required that the cooperative report the amounts of qualified items with respect to each non-SSTB of the cooperative, with a similar requirement for SSTBs. However, to reduce burden and clarify that cooperatives

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do not make trade or business and corresponding aggregation determinations, the final regulations require the cooperative to report the total net amount of qualified items from non-SSTBs in distributions to patrons without delineating these amounts business by business. A similar change was made to the reporting requirements for qualified items in distributions from SSTBs. The Form 1099-PATR, shown in **Figure 4.25**, has been updated to include boxes for qualified items and SSTB items.

Patrons then determine the extent that those payments are included in the QBI of the patrons' trade or business. For example, a patron will determine whether those payments are related to the patron's trade or business and whether any items in the SSTB distributions reported by the cooperative are includable as qualified items of income, gain, deduction, and loss at the patron's level after consideration of the threshold and phasein amounts as applied to the patron's taxable income.

FIGURE 4.25
2021 Form 1099-PATR

☐ CORRECTED (if checked)

PAYER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no.		1 Patronage dividends $	OMB No. 1545-0118	**Taxable Distributions Received From Cooperatives**
		2 Nonpatronage distributions $	2021	
		3 Per-unit retain allocations $	Form 1099-PATR	
PAYER'S TIN	RECIPIENT'S TIN	4 Federal income tax withheld $	5 Redeemed nonqualified notices $	**Copy B For Recipient**
RECIPIENT'S name		6 Section 199A(g) deduction $	7 Qualified payments (Section 199A(b)(7)) $	This is important tax information and is being furnished to the IRS. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported.
Street address (including apt. no.)		8 Section 199A(a) qual. items $	9 Section 199A(a) SSTB items $	
City or town, state or province, country, and ZIP or foreign postal code		10 Investment credit $	11 Work opportunity credit $	
Account number (see instructions)		12 Other credits and deductions $	13 Specified Coop ☐	

Form **1099-PATR** (keep for your records) www.irs.gov/Form1099PATR Department of the Treasury - Internal Revenue Service

Allocating Expenses

One commenter to the proposed regulations suggested that the SSTB reporting requirements be revised to address when a cooperative provides services from SSTBs to patrons. For example, if a cooperative provides a service to patrons as part of an SSTB of the cooperative, the patron's use of that service may be a deductible expense in his or her qualified trade or business. The patron pays the cooperative $1,000 for the service, and the cooperative later pays the patron a patronage dividend of $50 related to the service. Under the proposed regulations if the patron's income is over the threshold amount, the patron would not be able to include the $50 in its QBI calculation because it is SSTB income. However, the patron would have a $1,000 expense that would reduce QBI. In substance, however, the patron would have only paid $950 for the service. Under the final regulations, a patron can allocate expenses between its qualified trade or business income and the SSTB income up to the amount of the patronage dividend.

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Zero-Presumption Rule

Under the proposed regulations, if the cooperative does not report on or before the due date of the Form 1099-PATR the amount of such qualified SSTB and non-SSTB items of income, gain, deduction, and loss in the distributions to the patron, the distributions from the cooperative that may be included in the patron's QBI are presumed to be zero. The final regulations do not provide relief from the zero-presumption rule, because it is a presumption that the patron may rebut with appropriate evidence or documentation. The preamble notes that an example of appropriate evidence or documentation would be a corrected Form 1099-PATR issued from the cooperative to the patron.

Deduction for Specified Cooperatives

I.R.C. § 199A(g) provides a deduction for specified agricultural and horticultural cooperatives. The section 199A(g) deduction allowed is equal to 9% of the lesser of

1. the qualified production activities income (QPAI), or
2. the taxable income (as adjusted) of the specified cooperative for the tax year.

The deduction is further limited to 50% of the W-2 wages of the specified cooperative that are properly allocable to domestic production gross receipts (DPGR).

Only a specified cooperative can claim the section 199A(g) deduction. A specified cooperative may pass all, some, or none of the section 199A(g) deduction to all patrons, but only eligible patrons can take the deduction. An eligible taxpayer is generally a patron other than a C corporation or a specified cooperative. A specified cooperative must identify in a written notice the amount of the section 199A(g) deduction being passed through to the patron. The cooperative must mail the notice to the taxpayer no later than the fifteenth day of the ninth month following the end of the cooperative's tax year. The specified cooperative must report the amount of section 199A(g) deduction passed through to the taxpayer on Form 1099-PATR, box 6. The cooperative reduces its deduction under I.R.C. § 1382 by the amount of the passed-through section 199A(g) deduction.

PRACTITIONER NOTE

New DPAD

An individual farmer who is a patron of a specified cooperative may be entitled to two deductions under section 199A. A farmer can have a qualified trade or business that generates a section 199A(a) QBI deduction, and the farmer may also receive a section 199A(g) deduction from a specified cooperative. The section 199A(g) deduction is based on the former DPAD.

Deduction for a Nonexempt Specified Cooperative

The final regulations retain the four-step process for nonexempt specified cooperatives to calculate the section 199A(g) deduction [Treas. Reg. § 1.199A-8(b)].

Step 1: Identify Gross Receipts and Related Deductions

To determine the section 199A(g) deduction, a nonexempt specified cooperative first identifies its patronage and nonpatronage gross receipts and related cost of goods sold (COGS), deductible expenses, W-2 wages, and other deductions, and allocates them between the gross receipts from patronage and nonpatronage (see the earlier discussion of the definition of patronage and nonpatronage) activity. A nonexempt specified cooperative can use only patronage gross receipts and related deductions to calculate qualified production activities income (QPAI), oil-related QPAI, or the W-2 wage limitation. A nonexempt specified cooperative cannot use its nonpatronage gross receipts and related deductions to calculate its section 199A(g) deduction (other than as allowed under the de minimis rules).

Gross receipts are the specified cooperative's receipts for the tax year that are recognized under the specified cooperative's methods of accounting used for federal income tax purposes for the tax year. Gross receipts include total sales (net of

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returns and allowances) and all amounts received for services. In addition, gross receipts include any income from investments and from incidental or outside sources. For example, gross receipts include interest [except interest under I.R.C. § 103 but including original issue discount], dividends, rents, royalties, and annuities, regardless of whether the amounts are derived in the ordinary course of the specified cooperative's trade or business.

Gross receipts are not reduced by COGS or by the cost of property sold described in I.R.C. § 1221(a)(1), (2), (3), (4), or (5). Finally, gross receipts do not include amounts received by the specified cooperative with respect to sales tax or other similar state or local taxes if, under the applicable state or local law, the tax is legally imposed on the purchaser of the good or service and the specified cooperative merely collects and remits the tax to the taxing authority.

The final regulations revise the proposed regulations to benefit and reduce complexity for specified cooperatives with de minimis gross receipts from nonpatronage activities. The final regulations also revise the rule for applicable gross receipts in Treas. Reg. § 1.199A-8(b)(2)(ii) to allow a specified cooperative to include all nonpatronage gross receipts in non-DPGR for purposes of the de minimis rules in Treas. Reg. § 1.199A-9(c)(3) and increase the percentage in the de minimis rules from 5% percent to 10% percent. Thus, a specified cooperative when calculating its patronage section 199A(g) deduction can treat all of its gross receipts as DPGR if it derives less than 10% percent of its total gross receipts from non-DPGR (with non-DPGR now possibly including all gross receipts from nonpatronage as well as other patronage non-DPGR).

Step 2: Determine Gross Receipts That Are Domestic Production Gross Receipts

A nonexempt specified cooperative determines patronage gross receipts that qualify as domestic production gross receipts (DPGR). It does not use nonpatronage gross receipts to determine DPGR.

DPGR are the gross receipts of the specified cooperative that are derived from any lease, rental, license, sale, exchange, or other disposition of an agricultural or horticultural product that is manufactured, produced, grown, or extracted (MPGE) by the specified cooperative or its patrons in whole or significant part within the United States. DPGR does not include gross receipts derived from services or the lease, rental, license, sale, exchange, or other disposition of land unless a de minimis or other exception applies. Treas. Reg. § 1.199A-9 provides additional rules for determining if gross receipts are DPGR.

Step 3: Determine Qualified Production Activity Income

A nonexempt specified cooperative determines its QPAI from patronage DPGR and patronage deductions identified in step 1 and step 2. A nonexempt specified cooperative does not use nonpatronage gross receipts or deductions to determine QPAI.

QPAI for the tax year means an amount equal to the excess (if any) of

1. DPGR for the tax year, over
2. the sum of COGS that are allocable to DPGR and other expenses, losses, or deductions [other than the section 199A(g) deduction] that are properly allocable to DPGR.

QPAI is computed without including the section 199A(g) deduction or any deduction allowed under section 1382(b). Treas. Reg. § 1.199A-10 provides additional rules for calculating QPAI.

Step 4: Calculate the Deduction

In general, a specified cooperative is allowed a deduction equal to 9% of the lesser of

1. QPAI of the specified cooperative for the tax year, or
2. taxable income of the specified cooperative for the tax year.

The deduction for any tax year cannot exceed 50% of the patronage W-2 wages attributable to DPGR for the tax year. Treas. Reg. § 1.199A-11 provides additional rules for calculating the patronage W-2 wage limitation.

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PRACTITIONER NOTE

W-2 Wages

Rev. Proc. 2021-11, 2021-6 I.R.B. 833, provides methods for calculating W-2 wages for purposes of the limitation based on W-2 wages and amends the method for determining W-2 wages for taxpayers with short tax years.

Under the final regulations, taxable income is defined in I.R.C. § 63 and adjusted under I.R.C. § 1382 and Treas. Reg. §§ 1.1382-1 and 1.1382-2. For purposes of determining the amount of the deduction, taxable income is limited to taxable income and related deductions from patronage sources other than allowed under the de minimis rules. Patronage net operating losses (NOLs) reduce certain taxable income. Taxable income is computed without the section 199A(g) deduction or any deduction allowable under section 1382(b).

Exempt Specified Cooperatives

An exempt specified cooperative must calculate two separate section 199A(g) deductions, one patronage sourced and the other nonpatronage sourced, unless it treats all of its nonpatronage gross receipts and related deductions as patronage under the de minimis rules. Patronage and nonpatronage gross receipts; related COGS that are allocable to DPGR; and other expenses, losses, or deductions [other than the section199A(g) deduction] that are properly allocable to DPGR (deductions), DPGR, QPAI, NOLs, and W-2 wages are not netted to calculate these two separate section 199A(g) deductions.

Exempt Specified Cooperative Patronage Deduction

The specified cooperative calculates its patronage section 199A(g) deduction following steps 1 through 4 (discussed earlier) as if it were a nonexempt specified cooperative.

Exempt Specified Cooperative Nonpatronage Deduction

A specified cooperative calculates its nonpatronage section 199A(g) deduction following steps 2 through 4 (discussed earlier) using only nonpatronage gross receipts and related nonpatronage deductions unless the de minimis rules apply. For purposes of determining the amount of the nonpatronage section 199A(g) deduction, taxable income is limited to taxable income and related deductions from nonpatronage sources. Nonpatronage NOLs reduce taxable income. Taxable income is computed without taking into account the section 199A(g) deduction or any deduction allowable under section 1382(c).

Taxable Income Limit

An eligible taxpayer may deduct the lesser of the section 199A(g) deduction identified on the notice from the cooperative or the eligible taxpayer's taxable income in the tax year in which the eligible taxpayer receives the timely written notice from the cooperative. For this purpose, the eligible taxpayer's taxable income is determined without taking into account the section 199A(g) deduction being passed through to the eligible taxpayer and after taking into account any section 199A(a) deduction allowed to the eligible taxpayer.

Any section 199A(g) deduction the eligible taxpayer does not use in the tax year in which the eligible taxpayer receives the notice from the cooperative is lost and cannot be carried forward or carried back to other tax years. The taxable income limitation for the section 199A(a) deduction does not limit the deductibility of the section 199A(g) deduction passed through to the eligible taxpayer.

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PRACTITIONER NOTE

W-2 Wage Limit

The W-2 wage limitation described in Treas. Reg. § 1.199A-8(b)(5)(ii)(B) is applied at the cooperative level whether or not the specified cooperative chooses to pass through some or all of the section 199A(g) deduction. Any section 199A(g) deduction that has been passed through by a specified cooperative to an eligible taxpayer is not subject to the W-2 wage limitation a second time at the eligible taxpayer's level.

Example 4.45
Calculating the Section 199A(g) Deduction: Cooperative

Charleston Cooperative is a grain marketing nonexempt specified cooperative, with $5,250,000 in gross receipts in 2021 from the sale of grain grown by its patrons. The cooperative paid $4,000,000 to its patrons at the time the grain was delivered in the form of per-unit retain allocations pursuant to an agreement and another $1,000,000 in patronage dividends after the close of the 2021 tax year. The cooperative had $250,000 of other expenses in 2021, including $100,000 of W-2 wages.

The cooperative has DPGR of $5,250,000, and its QPAI is $5,000,000 ($5,250,000 − $250,000). Its section 199A(g) deduction is $50,000, which is the least of $450,000 ($5,000,000 QPAI × 9%), $450,000 ($5,000,000 taxable income × 9%), or $50,000 ($100,000 W-2 wages × 50%). The cooperative passes through the entire section 199A(g) deduction to its patrons and reduces its $5,000,000 ($1,000,000 patronage dividends + $4,000,000 per-unit retain allocations) deduction allowable under section 1382(b) by $50,000 [Treas. Reg. § 1.199A-8(e)(1), Example 1].

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ISSUE 7: CLOSING OUT A FARMING BUSINESS This section discusses the steps to take to close a farming business.

After a taxpayer has sold all its farm assets and ceased farming operations, the taxpayer must close out the business. The steps to take to close out the business vary depending on the type of entity. However, most businesses will have to file a final income tax return, make final tax payments and file final reports, cancel the employer identification number (EIN), and store records.

Final Return

The taxpayer must file a final return for the year the business is closed. The type of return to file depends on whether the business is a sole proprietorship, partnership, or corporation.

Sole Proprietorship

A sole proprietorship (or single-member LLC taxed as a disregarded entity) files a final Schedule F (Form 1040), Profit or Loss From Farming. The proprietorship must also file Schedule SE (Form 1040), Self-Employment Tax, if net earnings from the business are $400 or more.

Partnership

A partnership (or multimember LLC taxed as a partnership) files Form 1065, U.S. Return of Partnership Income. The partnership must check the "Final return" box (line G) and the "Final K-1" box on Schedule K-1 (Form 1065), Partner's Share of Income, Deductions, Credits, Etc. **Figure 4.26** shows the boxes on Form 1065 and Schedule K-1. Figure 4.26 shows the 2020 forms because the 2021 forms were not available at the time of this publication.

FIGURE 4.26
Final Return Box and Final K-1 Box

Form **1065**
Department of the Treasury
Internal Revenue Service

U.S. Return of Partnership Income

For calendar year 2020, or tax year beginning _____, 2020, ending _____, 20____.

► Go to *www.irs.gov/Form1065* for instructions and the latest information.

OMB No. 1545-0123

2020

A Principal business activity	**Type or Print**	Name of partnership	**D** Employer identification number
B Principal product or service		Number, street, and room or suite no. If a P.O. box, see instructions.	**E** Date business started
C Business code number		City or town, state or province, country, and ZIP or foreign postal code	**F** Total assets (see instructions) $

G Check applicable boxes: **(1)** ☐ Initial return **(2)** ☐ Final return **(3)** ☐ Name change **(4)** ☐ Address change **(5)** ☐ Amended return

H Check accounting method: **(1)** ☐ Cash **(2)** ☐ Accrual **(3)** ☐ Other (specify) ► _____

I Number of Schedules K-1. Attach one for each person who was a partner at any time during the tax year ► _____

J Check if Schedules C and M-3 are attached . . . . . ► ☐

K Check if partnership: **(1)** ☐ Aggregated activities for section 465 at-risk purposes **(2)** ☐ Grouped activities for section 469 passive activity purposes

651119

Schedule K-1 (Form 1065)
Department of the Treasury
Internal Revenue Service

2020

For calendar year 2020, or tax year beginning / / 2020 ending / /

Partner's Share of Income, Deductions, Credits, etc. ► See separate instructions.

☐ Final K-1 ☐ Amended K-1

OMB No. 1545-0123

Part III Partner's Share of Current Year Income, Deductions, Credits, and Other Items

1	Ordinary business income (loss)	15	Credits
2	Net rental real estate income (loss)		
3	Other net rental income (loss)	16	Foreign transactions

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Corporation

A C corporation must file Form 1120, U.S. Corporate Income Tax Return, for the year it closes the business, and check the "Final return" box. An S corporation must file Form 1120-S, U.S. Income Tax Return for an S Corporation, for the year it closes the business. It must check the "Final return" box on Form 1120-S and the "Final K-1" box on Schedule K-1 (Form 1120-S), Shareholder's Share of Income, Deductions, Credits, Etc.

A corporation (or farmer's cooperative) must file Form 966, Corporate Dissolution or Liquidation, if it adopts a resolution or plan to dissolve the corporation or liquidate any of its stock. It must file Form 966 within 30 days after the resolution or plan is adopted. **Figure 4.27** shows Form 966.

FIGURE 4.27
Form 966, Corporate Dissolution or Liquidation

Form **966**
(Rev. October 2016)
Department of the Treasury
Internal Revenue Service

Corporate Dissolution or Liquidation

(Required under section 6043(a) of the Internal Revenue Code)
▶ **Information about Form 966 and its instructions is at *www.irs.gov/form966.***

OMB No. 1545-0123

Please type or print

Name of corporation — **Employer identification number**

Number, street, and room or suite no. (If a P.O. box number, see instructions.) — Check type of return

City or town, state, and ZIP code

☐ 1120 ☐ 1120-L ☐ 1120-IC-DISC ☐ 1120S ☐ Other ▶

1 Date incorporated	**2** Place incorporated	**3** Type of liquidation ☐ Complete ☐ Partial	**4** Date resolution or plan of complete or partial liquidation was adopted
5 Service Center where corporation filed its immediately preceding tax return	**6** Last month, day, and year of immediately preceding tax year	**7a** Last month, day, and year of final tax year	**7b** Was corporation's final tax return filed as part of a consolidated income tax return? If "Yes," complete 7c, 7d, and 7e. ☐ Yes ☐ No
7c Name of common parent		**7d** Employer identification number of common parent	**7e** Service Center where consolidated return was filed

	Common	Preferred
8 Total number of shares outstanding at time of adoption of plan of liquidation		
9 Date(s) of any amendments to plan of dissolution		
10 Section of the Code under which the corporation is to be dissolved or liquidated		
11 If this form concerns an amendment or supplement to a resolution or plan, enter the date the previous Form 966 was filed		

Attach a certified copy of the resolution or plan and all amendments or supplements not previously filed.

Under penalties of perjury, I declare that I have examined this form, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete.

Signature of officer | Title | Date

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PRACTITIONER NOTE

Sale of Business or Assets

The taxpayer may have to file Form 4797, Sales of Business Property, for each year that it sells or exchanges property used in the business, or if closing the business reduces the business use of eligible section 179 property to 50% or less. With limited exceptions, the taxpayer must file Form 8594, Asset Acquisition Statement, if there is a transfer of a group of assets that make up a trade or business and the purchaser's basis in such assets is determined wholly by the amount paid for the assets [I.R.C. § 1060].

Final Payments and Reporting

A farming business that has closed may need to make final payments and deposits and file final reports as follows:

1. Pay employees final wages and compensation
2. Make final federal tax deposits
3. File Form 941, Employer's Quarterly Federal Tax Return (or Form 944, Employer's Annual Federal Tax Return or 943, Employer's Annual Federal Tax Return for Agricultural Employees), for the calendar quarter in which the final wage payments are made
   a. Check the box to tell the IRS the business has closed and enter the date final wages were paid on line 17 of Form 941 or line 14 of Form 944
   b. Attach a statement to the return showing the name of the person keeping the payroll records and the address where those records will be kept
4. File Form 940, Employer's Annual Federal Unemployment (FUTA) Tax Return, for the calendar year in which final wages are paid and check box "d" in the "Type of Return" section to show that the form is final
5. Furnish Forms W-2, Wage and Tax Statement, to the employees for the calendar year in which the final wage payments are made
6. File Form W-3, Transmittal of Income and Tax Statements, to transmit Copy A to the Social Security Administration
7. Furnish any necessary Forms 1099-NEC, Nonemployee Compensation, and file Form 1096, Annual Summary and Transmittal of U.S. Information Returns, to transmit paper copies of Forms 1099 to the IRS

Cancel the EIN

A farming business that has closed must cancel its EIN and close its IRS business account. When the business has filed all necessary returns and paid all taxes owed, the taxpayer must send the IRS a letter that includes the following:

- The complete legal name of the business
- The business EIN
- The business address
- The reason for closing the account
- A copy of the EIN assignment notice (if the taxpayer has a copy)

The taxpayer must send the notice to Internal Revenue Service, Cincinnati, Ohio 45999.

Recordkeeping

After a farming business has closed, the taxpayer must retain business records. The duration of the record keeping depends on the type of document.

Property Records

Generally, the taxpayer should keep records relating to property until the period of limitations expires for the year in which the business disposes of the property. If property was acquired in an involuntary conversion or like-kind exchange, the taxpayer must also retain records on the relinquished or converted property until the period of limitations expires on the year in which the business disposes of the replacement property.

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Employment Tax Records

The business should keep all records of employment taxes for at least 4 years.

Income Tax Records

The business should keep records that support items of income, deductions, or credits shown on a tax return until the period of limitations for that tax return runs out. The following limitation periods may apply to a farming business's income tax returns:

- 3 years from the date of filing an original return or 2 years from the date the tax was paid, whichever is later
- 7 years for a claim for a loss from worthless securities or bad debt deduction
- 6 years for unreported income that is more than 25% of the gross income shown on the return

If a return was filed early, the return is treated as having been filed on the due date. The limitation period never begins to run if no return was filed, or a fraudulent return was filed.

PRACTITIONER NOTE

Other Substantiation Purposes

Even if the statute of limitations has expired, the taxpayer may need to keep the records for other purposes, such as insurance or liability claims, or to substantiate nondeductible IRA contributions.

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CHOICE OF ENTITY

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LEARNING OBJECTIVES

After completing this session, participants will be able to perform the following job-related actions:

- ✔ Understand the default and elective classifications for a business entity
- ✔ Know the key characteristics of different business entity types
- ✔ Understand how the choice of entity may affect the use of losses
- ✔ Know which entity type will maximize the qualified business income deduction
- ✔ Identify the fringe benefits that are excluded from income of a partner or S corporation shareholder
- ✔ Know the income tax filing obligations for a disregarded entity, a partnership, a C corporation, and an S corporation
- ✔ Understand when multiple entities can or must be aggregated

INTRODUCTION

The Tax Cuts and Jobs Act of 2017 (TCJA), Pub. L. No. 115-97, reduced the tax rate for C corporations from a graduated scale between 15% and 35% to a flat 21% rate [I.R.C. § 11(b)]. However, C corporation owners are taxed on distributed earnings and do not qualify for the qualified business income (QBI) deduction. S corporations, LLCs, and partnerships typically do not pay tax at the entity level (although certain taxes may apply to an S corporation with C corporation history). In addition, S corporation shareholders do not pay self-employment (SE) tax on their share of net income (but the shareholders' compensation is subject to employment taxes).

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This chapter first reviews the entity classification rules. It then gives an overview of the tax factors to consider in selecting a business entity. This chapter discusses how the choice of entity affects loss limitations, SE tax, the QBI deduction, and allowable fringe benefits. Finally, this chapter explains reporting obligations and when multiple entities can or must be aggregated.

ENTITY CLASSIFICATION This section reviews the default and elective entity classifications.

The Internal Revenue Code recognizes only two business entities, the partnership [I.R.C. 7701(a)(2)] and the corporation [I.R.C. § 7701(a)(3)]. There is no statutory classification for an organization that does not fit into one of these two categories. Under Treas. Reg. § 301.7701-3, an unincorporated domestic entity with more than one owner is, by default, a partnership. Thus, a multimember LLC is classified as a partnership. However, it can elect to be treated as a corporation for federal income tax purposes. A single-member LLC (SMLLC) is, by default, a disregarded entity. It too can elect to be taxed as a corporation for federal tax purposes [Treas. Reg. § 301.7701-3(b)(1)].

Changing the Default Classification

An unincorporated entity can typically change its tax status without changing its nontax business form. For incorporated entities, the rules are less flexible. The entity must be a C corporation unless it has a valid S corporation election in effect [I.R.C. § 1361(a)]. **Figure 5.1** shows the default classification and the optional federal tax elections for the most common domestic business entities.

FIGURE 5.1
Classification of Domestic Business Entities

State Law	Federal Tax Default	Federal Tax Elections*
Sole proprietorship	Income reported by owner	None
Commercial corporation	C corporation	S corporation
Professional corporation	C corporation	S corporation
General partnership	Partnership	C corporation or S corporation
Limited partnership	Partnership	C corporation or S corporation
Limited liability partnership	Partnership	C corporation or S corporation
Limited liability limited partnership	Partnership	C corporation or S corporation
SMLLC	Disregarded entity	C corporation or S corporation
LLC—multimember	Partnership	C corporation or S corporation

*Treas. Reg. § 301.7701-3

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LLC Classification Changes

An LLC (or partnership) that elects to be taxed as a C corporation "checks the box" on Form 8832, Entity Classification Election. An LLC (or partnership) that elects to be taxed as an S corporation files Form 2553, Election by a Small Business Corporation.

LLC to Corporation

An election to change classification from an LLC to a corporation (C corporation or S corporation) will be treated as if the LLC's owner(s) contributed all of the assets and liabilities to the corporation in exchange for stock. Under I.R.C. § 351, no gain or loss is recognized when property is transferred to the corporation solely in exchange for stock in the corporation and immediately after the exchange the LLC member or members are in control of the corporation. However, the shareholder recognizes gain if assumed liabilities exceed the adjusted basis of the contributed assets.

PRACTITIONER NOTE

Limit on Elections

Once an eligible entity makes an election to change its classification, the entity generally cannot elect to change its classification again during the 60-month period after the effective date of the election. However, the IRS may (by private letter ruling) permit the entity to change its classification by election within the 60-month period if more than 50% of the ownership interests in the entity, as of the effective date of the election, are owned by persons that did not own any interests in the entity on the effective date or the filing date of the entity's prior election. The 60-month limitation does not apply if the previous election was made by a newly formed eligible entity and was effective on the date of formation.

LLC Ownership Changes

Ownership changes may cause an entity to change from an SMLLC treated as a disregarded entity to a multimember LLC taxed as a partnership. Similarly, an entity may change from a multimember LLC taxed as a partnership to an SMLLC treated as a disregarded entity.

CROSS-REFERENCE

Spousal LLCs

If an LLC is wholly owned by spouses as community property, the spouses may choose to treat the LLC as an SMLLC, which is taxed as a disregarded entity. The spouses may also choose to treat the LLC as a partnership. See pages 136–137 in the *2019 National Income Tax Workbook* for a discussion of LLCs owned by spouses.

An SMLLC may become a multimember LLC because of the following:

1. Sale of an interest
2. Gift of an interest
3. Death of a member and distribution of the member's interest to multiple heirs
4. Divorce of spouses reporting as a disregarded entity under Rev. Proc. 2002-69, 2002-2 C.B. 831
5. Relocation of spouses reporting as a disregarded entity under Rev. Proc. 2002-69
6. Distribution of an interest from an entity to multiple shareholders, partners, members, or beneficiaries

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A multimember LLC may become an SMLLC because of the following:

1. Sale of all LLC interests to a single member
2. Gift of all LLC interests to a single member
3. Redemption of LLC interests
4. Death of a member
5. Relocation of spouses to a community property state
6. Divorce award of an interest to one spouse in a non–community property state
7. Merger of members of an LLC
8. Purchase of the interests of all but one owner under the I.R.C. § 736 retirement of a partner provisions

CROSS-REFERENCE

Tax Consequences of Ownership Changes

See pages 173–176 in the *2019 National Income Tax Workbook* for a discussion of the tax consequences of a change in classification (e.g., from a partnership to a disregarded entity or from a disregarded entity to a partnership).

Corporation Classification Changes

A corporation can change from a C corporation to an S corporation by filing Form 2553, and a corporation can change from an S corporation to a C corporation by revoking the section 1362 election. However, a corporation cannot otherwise change its tax status without changing its business form. Commencing on the effective date of the election, a business that elects to be taxed as a corporation is subject to all the federal income tax rules that apply to corporations.

CROSS-REFERENCE

S Corporation Eligibility

An entity that elects to be taxed as an S corporation must meet the eligibility requirements of I.R.C. § 1361 and file the I.R.C. § 1362 election. Some states require a separate election and/or eligibility. The entity must be a domestic corporation, have only allowable shareholders, have no more than 100 shareholders, have only one class of stock, and not be an ineligible corporation (i.e., certain financial institutions, insurance companies, and domestic international sales corporations). See pages 103–110 in the *2020 National Income Tax Workbook* for a further discussion of the eligibility requirements, and how to make and revoke the election.

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ENTITY TYPES This section discusses some of the key tax considerations of a disregarded entity, a partnership, a C corporation, and an S corporation.

This section gives an overview of the tax factors to consider in selecting a business entity.

PRACTITIONER NOTE

Other Factors to Consider

This section gives an overview of tax considerations in choosing a business entity. There are numerous other tax and nontax factors to consider in choosing an entity, including liability protection, step-up in basis of appreciated property after the death of an owner or sale of an owner's interest, allowable type and number of owners, and whether an entity will be subject to the partnership audit regime.

SMLLC

An LLC is an entity created by state statute. By default, a single-member LLC (SMLLC) is classified as a disregarded entity. For tax purposes, the entity's assets, liabilities, income, and deductions are treated as belonging directly to the owner. If the sole owner is an individual, he or she reports ordinary income or loss on Schedule C (Form 1040), Profit or Loss From Business (Sole Proprietorship); Schedule E (form 1040), Supplemental Income or Loss; or Schedule F (Form 1040), Profit or Loss From Farming. An SMLLC's income is generally self-employment (SE) income, and the owner pays income tax and SE tax on the LLC income.

An SMLLC owner with taxable income below the I.R.C. § 199A threshold may be able to claim a greater qualified business income (QBI) deduction than a partnership that makes guaranteed payments to its partners or an S corporation that pays wages to its shareholders, because guaranteed payments and wages are not QBI. However, if the SMLLC owner has taxable income in or above the phasein range, the W-2 wage and capital limit applies, and may decrease or even eliminate the deduction because of the lack of W-2 wages. The QBI deduction is discussed in greater detail later.

CROSS-REFERENCE

Practice of Law

An LLC (SMLLC or multimember LLC) is typically formed by filing articles of organization with the state. The LLC operating agreement can prevent disputes between the owners and protect against personal liability for claims against the company. A nonlawyer who drafts corporate documents such as articles, bylaws, and operating agreements may be engaging in the unauthorized practice of law. See pages 7–12 in this workbook for a discussion of the unauthorized practice of law.

PRACTITIONER NOTE

EIN

An SMLLC that is a disregarded entity and does not have employees or excise tax liability does not need an employer identification number (EIN). It can use the name and taxpayer identification number of the single-member owner. However, for purposes of employment tax and certain excise taxes, an LLC with only one member is still considered a separate entity and it must obtain an EIN.

Partnership

Taxpayers may jointly own property, invest in assets, or operate a business. If their economic relationship is characterized as a partnership, they are subject to the reporting and filing requirements under subchapter K. I.R.C. § 761(a) defines a partnership broadly to include a syndicate, group, pool, joint venture, or other organization that carries on any business, financial operation, or venture, and that is not otherwise classified as a corporation, trust, or estate.

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The term *partner* includes a member in such a syndicate, group, pool, joint venture, or organization. Thus, for federal tax purposes, the term *partnership* is not limited to the common-law meaning of partnership but is broader in scope and includes groups not commonly called partnerships. Most states have a formal process to organize and register a partnership. However, a partnership may be created for purposes of federal tax law even if there is no partnership organized under state law.

CROSS-REFERENCE

Electing out of Subchapter K

Under Treas. Reg. § 1.761-2, certain unincorporated organizations may be excluded from some or all the partnership rules. A qualified joint venture, whose only members are a married couple filing a joint return, can elect not to be treated as a partnership for federal tax purposes. See pages 238–244 in the *2017 National Income Tax Workbook* for a discussion of electing out of subchapter K.

A partnership (including a multimember LLC taxed as a partnership) passes through its items of income, gain, losses, deductions, and credits to its partners. The partners are taxed on their distributive share of partnership income. A partner (other than a limited partner) must also pay SE tax on his or her distributive share of partnership income.

Partnerships have more flexibility in allocating items of income and loss to their owners than S corporations. S corporations generally must allocate all items, including income and expense, credits, and other deductions, to shareholders on a per-share, per-day basis. Partnership allocations may differ from a partner's interest in the partnership if they meet the requirements of I.R.C. § 704(b) (the partnership agreement provides an allocation and the allocation has substantial economic effect). However, I.R.C. § 704(c) requires the partnership to allocate built-in gains and losses on contributed property to the contributing partner.

Partners do not receive wages from the partnership [Rev. Rul. 69-184, 1969-1 C.B. 256]. In contrast, if S corporation shareholders provide labor or management services, the S corporation must pay them reasonable compensation that is subject to employment taxes. A partnership (that is not taxed as a C or S corporation) can compensate its owners for their contributions of capital, labor, and/or management by allocation of profits or guaranteed payments. Guaranteed payments are not QBI and may reduce a partner's QBI deduction.

C Corporation

C corporations pay a flat 21% tax rate on corporate taxable income. The distribution of earnings and profits is taxed as income to the shareholder. Under current law, qualified dividends, which include most distributions from domestic corporations, are taxed at the reduced tax rate of 0%, 15%, or 20%, depending on the taxpayer's income tax bracket. C corporation income is not eligible for the QBI deduction. For a higher-income taxpayer [greater than $200,000 ($250,000 for MFJ) taxable income], dividends received from a C corporation will also be subject to the 3.8% net investment income tax (NIIT).

CROSS-REFERENCE

C Corporations vs. Pass-Through Entities

Because of the lower tax rate on corporate income, C corporations that retain earnings may pay less taxes than a partner in a partnership or an S corporation shareholder. However, if the C corporation makes distributions, the combined corporate level tax and tax on shareholder distributions is usually higher than the tax on a partnership or S corporation owner. See pages 458–480 in the *2018 National Income Tax Workbook* for a comparison of C corporation taxation with the taxation of a disregarded entity, partnership, and S corporation.

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S Corporation

Like a partnership, an S corporation (with no C corporation history) is not subject to federal income tax on its earnings [I.R.C. § 1363(a)]. Instead, items of income, loss, deduction, and credits pass through to the shareholders, who report their pro rata share of these items on their individual income tax returns [I.R.C. § 1366(a)].

The S corporation must pay its shareholders reasonable compensation for services provided to the corporation, and that compensation is subject to employment taxes and included in W-2 wages for the QBI deduction. However, other distributions are not subject to SE tax and may qualify as QBI. Also, the distributive share of income of materially participating S corporation shareholders is not subject to the NIIT.

An S corporation with C corporation history may be subject to tax at the entity level. Thus, an S corporation that was formerly a C corporation may be taxed on its built-in gains (BIG) under I.R.C. § 1374. It may also be taxed on its excess net passive income under I.R.C. § 1375.

CROSS-REFERENCE

Entity Level Tax

See pages 141–148 in the *2020 National Income Tax Workbook* for a discussion of the built-in gains tax and the tax on excess net passive income.

Entity Comparison

Figure 5.2 compares the attributes of partnerships, S corporations, C corporations, and proprietorships. Figure 5.2 is adapted from the Joint Committee on Taxation, *Choice of Business Entity: Present Law and Data Relating to C Corporations, Partnerships, and S Corporations*, Table 1 (April 10, 2015) (JCX-71-15).

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FIGURE 5.2
Comparison of Business Entities

Item	Partnerships	S Corporations	C Corporations	Disregarded Entity
Entity classification	Default status for multimember LLC	Elective status for multimember LLC or SMLLC if qualified for S corporation status and filing Form 2553	Elective status for multimember LLC or SMLLC filing Form 8832	Default status for SMLLC
Maximum number of equity interests	No maximum number	Maximum 100 shareholders (family members may be treated as one shareholder for this purpose)	No limitation	One
Classes of equity interests	No limitation	One class of stock (voting rights are disregarded in making this determination)	No limitation	N/A
Ineligible entities	Generally, partnerships with equity interests that are publicly traded; banks and certain insurance companies must use the corporate form	Foreign corporations; financial institutions using reserve method of accounting; insurance companies; domestic international sales corporations (DISCs) and former DISCs	None	N/A
Eligible owners	All persons and entities eligible to be partners	Individuals, estates, certain trusts, charities, and qualified retirement plans	All persons eligible	Individual
Foreign taxpayers	Eligible to be a partner; certain income subject to withholding tax	Ineligible to be a shareholder	Eligible to be a shareholder; dividends subject to withholding tax with possible reduced treaty rate	Eligible
Tax-exempt taxpayers	Eligible to be a partner; income subject to generally applicable unrelated business income tax	Tax-exempt taxpayers (other than charities and qualified retirement plans) ineligible to be a shareholder; all items of income and loss of charities and qualified retirement plans (other than ESOPs) included in unrelated business taxable income; items of income and loss of ESOPs not included in unrelated business taxable income	Eligible to be a shareholder; dividend generally not subject to unrelated business income tax	Eligible to be an owner; income subject to generally applicable unrelated business income tax
Trusts	Eligible to be a partner; usual trust taxation rules apply	Only grantor trusts, testamentary trusts, qualified subchapter S trusts, and electing small business trusts eligible as shareholders; special taxation rules apply	Eligible to be a shareholder; usual trust taxation rules apply	Eligible

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FIGURE 5.2 (continued)
Comparison of Business Entities

Item	Partnerships	S Corporations	C Corporations	Disregarded Entity
Allocation of income and losses	Allocation in accordance with partnership agreement if allocation is in accordance with each partner's interest in the partnership, or the allocation has substantial economic effect	Pro rata among shares on a daily basis	Not applicable (income and losses do not pass through)	All to owner
Limitation on losses	Losses limited to basis in partnership interest, which includes partner's share of partnership debt; subject to amount at risk, passive activity loss, and excess business loss limits	Losses limited to basis in stock and indebtedness of corporation to shareholder; no inclusion of corporate debt in shareholder basis; subject to amount at risk, passive activity loss, and excess business loss limits	Losses deductible against corporate income; NOLs generally can be carried forward; capital losses generally can be carried back 3 years and forward 5 years	Subject to amount at risk, passive activity loss, and excess business loss limits
Contributions of unencumbered property to entity	Tax-free; built-in gain or loss allocated to contributing partner	Tax-free if contributors are in control of the corporation after the exchange; no special rules allocating built-in gain or loss to contributor	Tax-free if contributors are in control of the corporation after the exchange	N/A
Distributions of property (liquidating or otherwise)	Generally tax-free; carryover or substituted basis to partner; partnership may elect to make basis adjustment in partnership property to reflect adjustments to distributee partner	Any gain in distributed property is recognized by the corporation and allocated to the shareholders; FMV basis to the shareholder	Any gain in distributed property taxable to the corporation; shareholder taxed if amount of distribution exceeds stock basis	All business property treated as property of owner
Transfer of equity interests	Gain treated as ordinary income to extent of ordinary income on assets held by partnership; partnership may elect to adjust basis of its assets with respect to transferee partner to reflect purchase price	Gain treated as capital; no adjustments to basis of corporate property	Gain treated as capital	Fully taxable as asset sale, unless contributed to partnership or controlled corporation
Termination of entity	Termination if not more than one owner, or ceases to carry on any business or investment	No provision	No provision	Generally, nontaxable

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FIGURE 5.2 (continued)
Comparison of Business Entities

Item	Partnerships	S Corporations	C Corporations	Disregarded Entity
Treatment of C corporation converting to partnership or S corporation	Corporation must liquidate and gain or loss is recognized to corporation and shareholders	Generally, no taxation upon election; corporate tax is imposed on built-in gain if assets sold during 5-year period after election effective; distribution of subchapter C earnings and profits taxable as a dividend; special rules applicable to a corporation with accumulated earnings and excess net passive investment income	N/A	N/A
Treatment of disregarded entity or partnership converting to C corporation or S corporation	Tax-free if transferors are in control of the corporation after the exchange; possible exception where contributed property is subject to debt	N/A	N/A	Tax-free if transferor is in control of the corporation after the exchange; possible exception where contributed property is subject to debt
Mergers and other reorganizations with corporations	Not eligible to engage in tax-free reorganization with corporation	Eligible party to a tax-free corporate reorganization	Eligible party to a tax-free corporate reorganization	Not eligible to engage in tax-free reorganization with corporation
Corporate tax rules of subchapter C	Rules inapplicable	Rules generally applicable, with certain exceptions	Rules applicable	Rules inapplicable
Wholly owned corporate subsidiary	Corporation treated as separate entity	Parent corporation may elect to treat wholly owned subsidiary as disregarded entity	Not subject to tax on dividends or liquidating distributions paid between wholly owned subsidiaries; may be eligible to file consolidated returns	Corporation treated as separate entity
Federal income tax rates	All income is allocated to owners and taxed at their rates	All income that exceeds reasonable compensation to owner employees is allocated to owners and taxed at their rates	All income that exceeds reasonable compensation to owner employees is taxed at a flat 21% rate	All income is taxed to the individual owner
Application of employment and SE taxes	Except in certain cases involving a limited partner, each partner's share of net business income is net earnings from SE	Amounts paid as reasonable compensation to a shareholder-employee are wages subject to employment tax; no amount of shareholder's share of S corporation income is net earnings from SE	Amounts paid as compensation are wages subject to employment tax; no amounts are net earnings from SE	Net business income is net earnings from SE

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FIGURE 5.2 (continued)
Comparison of Business Entities

Item	Partnerships	S Corporations	C Corporations	Disregarded Entity
Treatment of earnings as investment income for purposes of the net investment income tax (NIIT)	Business income of limited partners who are not active in the business and that is not net earnings from SE is treated as investment income for the NIIT	Business income of shareholders not active in the business is treated as investment income for the NIIT	Dividends paid to individuals are treated as investment income for the NIIT	Subject to NIIT unless section 1231 gain or income subject to SE tax
Qualified business income (QBI)	QBI, W-2 wages, and qualified property passed through to eligible partners	QBI, W-2 wages, and qualified property passed through to shareholders	Not eligible for QBI deduction	QBI, W-2 wages, and qualified property used to calculate the owner's QBI deduction

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LOSSES LIMITED BY BASIS Partnership or S corporation losses may be limited to the extent that they exceed the owner's basis.

Pass-through losses incurred by a partnership or S corporation are deductible to the extent of the owner's basis in the entity and basis in certain indebtedness. The risk of economic loss is enough to give a partner debt basis, whereas only an actual economic outlay gives an S corporation shareholder debt basis.

Partnership Losses

For a partnership (including a multimember LLC that is taxed as a partnership), outside basis is the LLC member's basis in his or her LLC interest. Each member is also deemed to own a share of the LLC's assets. The basis of the LLC's assets is referred to as inside basis. Outside basis may limit the amount of partnership losses that the partner can use to offset nonpartnership income.

I.R.C. § 704(d) states that a partner's distributive share of a partnership loss (including a capital loss) is allowed only to the extent of the adjusted basis of the partner's interest in the partnership at the end of the partnership year in which the loss occurred. Any excess loss over the partner's basis is carried over for use in the next tax year in which the partner has basis available.

Basis in a partnership interest is generally calculated as the basis at the time of acquisition,

1. increased by
   a. additional contributions,
   b. the partner's share of partnership liabilities, and
   c. the partner's distributive share of taxable and nontaxable partnership income; and
2. decreased (not below zero) by
   a. the money (including a decreased share of partnership liabilities or an assumption of the partner's individual liabilities by the partnership) and adjusted basis of property distributed to the partner by the partnership;
   b. the partner's distributive share of the partnership losses (including capital losses); and
   c. the partner's distributive share of nondeductible partnership expenses that are not capital expenditures.

[I.R.C. § 705]

Thus, any alteration in a partner's interest in a partnership may cause a reallocation of partnership liabilities. When a partner's share of partnership liabilities increases, the partner is treated as if he or she made a cash contribution in the amount of the increase and adjusts basis in his or her interest upward by the same amount [I.R.C. §§ 752(a) and 721(a)].

PRACTITIONER NOTE

COVID Relief Loans and Grants

Taxpayers whose Paycheck Protection Program (PPP) loans are forgiven do not have to include the forgiven amount in income. The taxpayer can deduct otherwise deductible expenses paid with the PPP loan proceeds, and the forgiveness will not preclude a basis increase or reduce other tax attributes. Similar exclusion rules apply to targeted economic injury disaster loans (EIDL) and EIDL advances.

S Corporation Losses

Losses and deductions taken by an S corporation shareholder cannot exceed the basis in the shareholder's stock, plus the basis in indebtedness from the S corporation to the shareholder [I.R.C. § 1366(d)(1)]. Basis in S corporation stock is calculated as the basis at the time of acquisition, increased by the shareholder's share of the corporation's income, and decreased by the shareholder's share of deductions and losses. Distributions (other than dividends from accumulated earnings and profits from an S corporation with a C corporation history) also reduce basis.

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Adjustments to basis are made annually on the last day of the S corporation year (or immediately before the disposition of S corporation stock). Under the general rules, for tax years beginning on or after August 18, 1988, adjustments are made in the following order:

1. Income items, including tax-exempt income and separately stated income, and excess depletion increase basis.
2. Distributions (other than dividends from the corporation's accumulated earnings and profits) decrease basis, but not below zero.
3. Nondeductible, noncapital expenses and depletion decrease basis, but not below zero.
4. Items of loss and deduction decrease basis, but not below zero.

CROSS-REFERENCE

Elective Ordering Rule

Under Treas. Reg. § 1.1367-1(g), a shareholder can elect to decrease basis by items of loss or deduction before the shareholder decreases basis by noncapital nondeductible expenses. See pages 120–121 in the *2020 National Income Tax Workbook* for a discussion of the elective ordering rules.

Example 5.1
Losses Greater Than Basis

Smithfield, Inc., an S corporation, has one shareholder, Pam Smithfield. At the beginning of 2021, Pam's stock basis was $30,000. In 2021, Smithfield reported a $40,000 ordinary loss. Pam's loss deduction is limited to her $30,000 basis, and the remaining $10,000 loss carries forward.

A shareholder can obtain debt basis by loaning the S corporation money or property in which the shareholder has basis. There must be bona fide indebtedness from the corporation to the shareholder [Treas. Reg. § 1.1366-2]. A shareholder does not obtain basis of indebtedness in the S corporation merely by guaranteeing a loan or acting as a surety, accommodation party, or in a similar capacity relating to a loan. When a shareholder makes a payment on the S corporation's bona fide indebtedness for which the shareholder has acted as guarantor or in a similar capacity, the shareholder may increase the shareholder's basis of indebtedness to the extent of that payment [Treas. Reg. § 1.1366-2(a)(2)(ii)].

Example 5.2
Shareholder Guarantee

Claire Conrad is the sole shareholder of Glacier, Inc., an S corporation. In 2020, Claire guaranteed a $100,000 bank loan made to Glacier. In 2021, Glacier was unable to make the loan payments, and Claire used her personal funds to pay $20,000 of loan principal on Glacier's behalf. The loan guarantee does not affect Claire's basis in 2020, but her principal payment increases her basis by $20,000 in 2021 [Treas. Reg. § 1.1366-2(a)(2)(iii), Example 4].

PRACTITIONER NOTE

Draft Form

In July 2021, the IRS issued a notice and request for comments on draft Form 7203, S Corporation Shareholder Stock and Basis Limitations, which is used to calculate stock and debt basis.

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SELF-EMPLOYMENT TAX Conducting business as an S corporation may reduce the shareholder's self-employment tax.

Both S and C corporations deduct expenses for wages paid, even if those payments are made to shareholder-employees. Because wages are deductible, but dividends paid are not, there is an incentive for a C corporation to disguise distributions to owners as wages to claim a deduction. On the contrary, S corporation wages are subject to employment taxes, which creates an incentive to characterize payments as a share of earnings instead of wages.

To prevent the treatment of wages as earnings that are not subject to employment taxes, an S corporation must pay its shareholders reasonable compensation for services that they provide to the corporation. If the salary paid to an S corporation shareholder is not reasonable, the IRS can recharacterize a shareholder distribution as wages that are subject to employment taxes.

CROSS-REFERENCE

Reasonable Compensation

See pages 135–137 in the *2020 National Income Tax Workbook* for an explanation of how to determine reasonable compensation for an S corporation shareholder.

If a disregarded entity or partner in a partnership pays self-employment (SE) tax on all the business income, the unincorporated business is subject to more SE tax than the S corporation. For instance, a taxpayer with $10,000 of SE income and whose wages plus net SE earnings do not exceed the maximum wage limit for social security tax ($142,800 for 2021) is subject to $1,413 ($10,000 × 0.9235 × 0.153) SE tax on this income. The one-half of SE tax deduction reduces the taxpayer's taxable income by $707 ($1,413 × 0.50). A taxpayer with a 22% marginal tax rate pays approximately 34.6% [{$1,413 SE tax – ($707 × 0.22 marginal tax rate) + ($10,000 × 0.22 marginal tax rate} ÷ $10,000] total tax on this income.

If instead the income was profit from an S corporation, the overall rate is 22%, the taxpayer's marginal tax rate. If the business is, for example, a real estate rental activity that is not subject to SE tax, a disregarded entity or partnership may be preferable to either a C or an S corporation because it may generate a higher qualified business income deduction (discussed next).

CROSS-REFERENCE

Limited Partners

A limited partner is generally not subject to SE tax on his or her distributive share of partnership income. See pages 141–142 in this workbook for a discussion of the proposed regulations that describe when an LLC member may be treated as a limited partner.

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QUALIFIED BUSINESS INCOME DEDUCTION The choice of a business entity may impact the qualified business income deduction.

The taxpayer's choice of business entity may increase or decrease the qualified business income (QBI) deduction. The QBI deduction effectively reduces the individual income tax rates [but not the self-employment (SE) tax rate] by 20%. C corporations do not qualify for the QBI deduction. Thus, this section compares the QBI deduction for an LLC with the QBI deduction for an S corporation.

CROSS-REFERENCE

QBI Deduction

See pages 96–113 in this workbook for a discussion of the QBI deduction, the wage and capital limit, and strategies to maximize the deduction.

An S corporation and an LLC (unless it has elected to be a C corporation) are both pass-through entities for income tax purposes. Generally, they do not pay income tax at the entity level (although certain taxes may apply to S corporations with C corporation history). The owner of an LLC pays income tax and SE tax on the LLC income. The wage or salary paid by an S corporation to its shareholder-employees is subject to income tax and FICA tax. However, the FICA tax is paid on only the compensation, and the net income is not subject to SE tax.

QBI Defined

QBI does not include wages, salaries, and guaranteed payments for services [I.R.C. § 199A(c)(4)]. An S corporation decreases SE tax for the owner but can also decrease the QBI deduction because the S corporation must pay reasonable compensation to its shareholder-employees. This income is not QBI for the shareholder and reduces the corporation's QBI if it is attributable to a qualified trade or business. However, for a taxpayer with taxable income that exceeds the threshold, the wages paid prevent application of the W-2 wage and capital limitation. For 2021, the thresholds are $164,900 for single and head of household returns, $329,800 for joint filers, and $164,925 for married filing separately.

If the owner's taxable income is below the phasein range, the LLC will generate a higher QBI deduction than the S corporation because all its income may qualify as QBI, while the S corporation salary does not qualify as QBI. Once the owner's taxable income is above the phasein range, an LLC with no employees and insubstantial qualified property will generate a zero QBI deduction because the LLC is fully subject to the wage and capital limitation.

Shareholder Salary

As discussed in the "Self-Employment Tax" section, S corporations must pay shareholders who perform services reasonable compensation. They cannot characterize all payments as dividends that are not subject to FICA, FUTA, and withholding taxes [Rev. Rul. 74-44, 1974-1 C.B. 287]. If the salary paid to an S corporation shareholder is not reasonable, the IRS can recharacterize a shareholder distribution as wages that are subject to employment tax. As a shareholder's salary may reduce QBI (and increase employment taxes), there may be an incentive to reduce compensation. However, for purposes of the QBI deduction, reasonable compensation of an S corporation shareholder includes any amounts (including distributions) paid by the S corporation to the shareholder, up to the amount that would constitute reasonable compensation.

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Guaranteed Payments

Guaranteed payments to partners reduce the QBI allocated to each partner, resulting in a lower QBI deduction. If instead a partnership made no guaranteed payments, and treated payments to its partners as a distribution of partnership income, the partnership will have more QBI that it can allocate to its partners.

Example 5.3 Guaranteed Payments

Jen and Jerry Christianson are equal partners in J&J Construction, a partnership that conducts a qualified trade or business. In 2021, J&J had $550,000 of QBI before deducting $250,000 in guaranteed payments made to Jen and Jerry for their services ($125,000 each). J&J had $300,000 ($550,000 − $250,000) of QBI after deducting the guaranteed payments. The partnership allocates $150,000 ($300,000 × 50%) of QBI to each partner. The guaranteed payments to Jen and Jerry are not QBI. Jen and Jerry each calculate the QBI deduction on their $150,000 share of QBI (subject to the W-2 wage and capital limit and the taxable income limit).

Example 5.4 Profit Allocation

The facts are the same as in Example 5.3 except that J&J made no guaranteed payments to Jen and Jerry. The partnership allocates $275,000 ($550,000 × 50%) of QBI to each partner. Jen and Jerry each calculate the QBI deduction on their $275,000 share of QBI (subject to the W-2 wage and capital limit and the taxable income limit). Their share of QBI without a guaranteed payment is $125,000 ($275,000 − $150,00) higher than their share of QBI with a guaranteed payment.

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FRINGE BENEFITS Certain employee exclusions for fringe benefits are not available to a partner or a more-than-2% S corporation shareholder.

A fringe benefit is a form of pay for the performance of services. Generally, fringe benefits are included in wages under I.R.C. § 3401(a) and Treas. Reg. § 31.3401(a)-1. However, some employer-provided fringe benefits are specifically excluded from the employee's income.

Under I.R.C. § 1372, for purposes of certain employee fringe benefits, a person who directly or indirectly owns more than 2% of the stock in the S corporation (at any time during the year), or stock with more than 2% of the voting power (a 2% shareholder), is treated as a partner in a partnership. Thus, a 2% shareholder is treated as self-employed, and not as an employee of the S corporation, for purposes of employee fringe benefits. As a consequence, many fringe benefits that are not available to partners are also not available to 2% shareholder-employees on a tax-favored basis.

This section examines the tax treatment of the following fringe benefits:

1. Health and accident insurance
2. Contributions to a health savings account (HSA)
3. Group term life insurance
4. Meals and lodging furnished for the convenience of the employer
5. Cafeteria plans
6. Educational assistance
7. Dependent care assistance

PRACTITIONER NOTE

2% Shareholder

The commonly used term *2% shareholder* actually refers to a shareholder who owns more than 2% of the stock of the S corporation on any day of the corporation's tax year [I.R.C.§ 1372(b)]. The shareholder can own the stock directly, or indirectly through attribution. Under I.R.C. § 318, a person is the owner of stock held by a spouse, children, parents, and grandchildren; and a person is the owner of a portion of stock held by an estate or trust. The ownership share is proportionate to that person's percentage interest in the estate or actuarial interest in the trust. This rule does not apply to employee trusts such as ESOPs.

Health and Accident Insurance

Typically, employers can pay health and accident insurance premiums and deduct the cost of the premium. Employees can exclude the employer-paid cost of the coverage from gross income [I.R.C. § 106(a)]. Moreover, the employee has no gross income when the insurance company pays benefits to the extent the payments are used for medical care [I.R.C. § 105(b)].

S Corporation Payments

For health insurance premiums the S corporation pays for a 2% shareholder-employee, the S corporation can deduct the cost of the premium, but the shareholder must include the payment in his or her gross income [Rev. Rul. 91-26, 1991-1 C.B. 184]. Unlike a partnership, an S corporation may not account for accident and health insurance premiums paid on behalf of a shareholder-employee as a reduction in distributions to the shareholder-employee.

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Partnership Payments

Similarly, premiums that a partnership pays on behalf of a partner are treated as a guaranteed payment to the extent the premiums are determined without regard to partnership income. The guaranteed payment is deductible by the partnership and included in the partner's income. Alternatively, if a partnership accounts for accident and health insurance premiums paid on behalf of a partner as a reduction in distributions to the partner, the partnership cannot deduct the premiums.

Self-Employed Health Insurance Deduction

A partner or a 2% shareholder-employee can claim the deduction for self-employed health insurance costs. However, the deduction is limited to the earned income from the business providing the coverage [I.R.C. § 162(l)(2)(A)]. For an S corporation shareholder-employee, earned income is equal to the wages from the S corporation. The taxpayer cannot claim the deduction for any calendar month in which the taxpayer or his or her spouse is eligible to participate in another employer's subsidized health care plan [I.R.C. § 162(l)(2)(B)]. The taxpayer claims the deduction in the same year that the entity includes the premiums in the taxpayer's income.

Health Savings Account

A health savings account (HSA) is a tax-exempt account that is set up to pay certain medical expenses. The contributions to the account are tax deductible. The contributions are excluded from the employee's gross income [I.R.C. § 106(d)], and the contributions are not subject to social security or Medicare tax. Distributions from the plan are not taxable if they are used to pay the plan owner's medical expenses during his or her lifetime or up to 1 year after death.

Eligibility

Only a person who is covered by a *high-deductible health plan* (HDHP) can establish an HSA. For 2021, the HDHP deductible amount must be at least $1,400 for self-only coverage and $2,800 for family coverage. The 2021 maximum out-of-pocket expenses cannot exceed $7,000 for self-only coverage and $14,000 for a family plan.

Contribution Limits

An employer may make deductible contributions to an HSA on behalf of one or more employees. The maximum contribution is the same as the maximum contribution for individuals. In 2021, that limit is $3,600 for self-only coverage and $7,200 for family coverage. Eligible persons age 55 and older can contribute an additional $1,000 per year [I.R.C. § 223(b)(3)]. The employer's contributions reduce the amount that the employee can contribute to his or her HSA.

S Corporation Contributions

An S corporation can generally deduct HSA contributions for a 2% shareholder-employee. The 2% shareholder-employee cannot exclude the contribution from gross income [Notice 2005-8, 2005-1 C.B. 368], but the contribution is not subject to FICA and FUTA if the employer's plan complies with I.R.C. § 3121(a) (2)(B) (medical expenses for sickness or accident disability). A 2% shareholder can complete Form 8889, Health Savings Accounts (HSAs), and claim a deduction for the contribution.

Partnership Contributions

Contributions by a partnership to a bona fide partner's HSA are not contributions by an employer to an employee's HSA. If the partnership treats the contributions as distributions to the partner under I.R.C. § 731, the partnership cannot deduct the contributions, and the contributions do not affect the distributive shares of partnership income and deductions. The contributions are reported as distributions of money on Schedule K-1 (Form 1065), Partner's Share of Income,

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Deductions, Credits, etc. These distributions are not included in the partner's net earnings from self-employment under section 1402(a). The partner, if otherwise eligible, can deduct the contributions.

If instead the HSA contributions are treated as a guaranteed payment to the partner for services provided to the partnership in the partnership's trade or business, the partnership can deduct the contributions and they are included in the partner's gross income and net earnings from self-employment. The partner, if otherwise eligible can deduct the contributions.

Group Term Life Insurance

I.R.C. § 79 provides an exclusion for premiums paid on group term life insurance for coverage of no more than $50,000 per employee. The employer does not have to withhold federal income tax or pay FUTA tax on any group term life insurance provided to an employee. The employer must report as compensation the amount of the premium for insurance in excess of $50,000, calculated using rates based on the employee's age [Treas. Reg. § 1.79-3(d)].

In general, there must be at least 10 employees participating in the plan. There are certain exceptions for employers with fewer than 10 employees or fewer than 10 insurable employees [Treas. Reg. § 1.79-1(c)(2)]. There are also special rules for employees covered by multiemployer or union plans.

A self-employed person is not an employee for purposes of the group term life insurance rules. Therefore, a 2% shareholder or a partner cannot claim any exclusion for group term life insurance. Group term life insurance provided to a 2% shareholder is included in wages and in the calculation of social security and Medicare taxes, but the employer does not have to withhold federal income tax or pay FUTA tax on the cost of the group term life insurance coverage provided to the 2% shareholder.

Meals and Lodging

I.R.C. § 119 provides an exclusion from gross income for the value of certain meals and lodging that an employer provides to an employee for the employer's benefit. Meals must be served on the employer's premises [I.R.C. § 119(a)(1)]. For lodging to be excludable, it must be on the employer's premises and must be a condition of employment [I.R.C. § 119(a)(2)].

I.R.C. § 119 does not treat a self-employed person as an employee for purposes of the exclusion, and the value of employer-provided meals and lodging is included in the gross income of a 2% S corporation shareholder or a partner.

Cafeteria Plans

A *cafeteria plan* is an arrangement that an employer adopts to allow employees to choose certain tax-advantaged fringe benefits or cash compensation. A participant who chooses nontaxable benefits is not deemed to be in constructive receipt of the forgone cash [I.R.C. § 125(a)]. Section 125 does not treat self-employed taxpayers as employees. Thus, 2% shareholders and partners may not participate in those plans.

PLANNING POINTER

2% Shareholder Participation in Cafeteria Plan

All participants in a cafeteria plan must be current or former employees [I.R.C.§ 125(d)(1)(A)]. Because a 2% S corporation shareholder is not treated as an employee for fringe benefit purposes, participation by a 2% shareholder can disqualify the plan and thus adversely affect all of the employees. A C corporation converting to S corporation status should review its cafeteria plan and make sure that 2% shareholders and family members of 2% shareholders are not plan participants as of the date the S election takes effect.

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Educational Assistance

An employer may establish a qualified educational assistance program for its employees. The employer's contributions are fully deductible, and the distributions may be tax free to the employee who receives the benefit if the program does not discriminate in favor of highly compensated employees within the meaning of I.R.C. § 414(q). For 2021, a 5% owner or a person whose compensation exceeds $130,000 (and is in the top 20% of most highly paid employees) is a highly compensated employee. The antidiscrimination rule limits the amounts payable for highly compensated individuals (as a group) to 5% of the total benefits paid for the year. Attribution rules extend the shareholder ownership rules to a spouse and minor children. A self-employed person is treated as an employee for this purpose, and distributions are excluded from his or her income [Treas. Reg. § 1.127-2(h)(1)(iii)].

PRACTITIONER NOTE

Student Loan Payments

Section 2206 of the Coronavirus Aid, Relief, and Economic Security Act (CARES Act), Pub. L. No. 116-136, expands the definition of educational assistance to include certain employer payments of student loans paid after March 27, 2020, and before January 1, 2026. The exclusion applies to the payment by an employer of principal or interest on any qualified education loan incurred by the employee for the employee's education.

Dependent Care Assistance

I.R.C. § 129 allows employees to exclude employer paid amounts to provide dependent care assistance. The maximum exclusion is $10,500 per year ($5,250 for married persons filing separate returns), limited to the employee or spouse's earned income. Self-employed persons can exclude dependent care assistance from their gross income [I.R.C. § 129(e)(3)]. However, the benefits provided for principal owners (those who own more than 5%) or their spouses or dependents cannot exceed 25% of the total paid by the employer to all employees for the year [I.R.C. § 129(d)(4)].

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INCOME TAX FILING OBLIGATIONS This section reviews the income tax filing obligations for a disregarded entity, a partnership, a C corporation, and an S corporation.

This section reviews income tax filing obligations for a disregarded entity, a partnership, an S corporation, and a C corporation.

Disregarded Entity

If a single-member LLC (SMLLC) does not elect to be treated as a corporation, the SMLLC is a disregarded entity, and the SMLLC's income and expenses are reported on its owner's federal tax return. If the owner is an individual, the disregarded entity reports business income and expenses on Schedule C Form 1040), Profit or Loss From Business (Sole Proprietorship); Schedule E (Form 1040), Supplemental Income or Loss; or Schedule F (Form 1040), Profit or Loss From Farming. If the SMLLC is owned by a corporation or partnership, the SMLLC income and expenses are reported on the owner's federal tax return as a division of the corporation or partnership.

The filing deadline for calendar-year taxpayers is April 15 (postponed to May 17, 2021, for the 2020 tax year). If the deadline is on a Saturday, Sunday, or legal holiday, the due date is delayed until the next business day. Taxpayers can obtain an automatic 6-month extension of the time to file (but not the time to pay) by filing Form 4868, Application for Automatic Extension of Time To File U.S. Individual Income Tax Return.

Partnership

Partnerships (and multimember LLCs taxed as partnerships) file Form 1065, U.S. Return of Partnership Income. Schedule K-1 (Form 1065), Partner's Share of Income, Deductions, Credits, etc., allocates partnership income, gains, losses, deductions, credits, and other partnership information to the partners who then report those items on their own tax returns. Every domestic partnership must file Form 1065, unless it receives income and does not incur any expenditures treated as deductions or credits for federal income tax purposes.

Generally, a domestic partnership must file Form 1065 by the fifteenth day of the third month following the date its tax year ended. For calendar-year partnerships, the due date is March 15. If the due date is on a Saturday, Sunday, or legal holiday, a return filed by the next business day is treated as timely. Taxpayers can file Form 7004, Application for Automatic Extension of Time To File Certain Business Income Tax, Information, and Other Returns, to obtain an automatic 6-month extension of the time to file.

C Corporation

C corporations (other than tax-exempt corporations) and entities electing to be taxed as a corporation generally must file Form 1120, U.S. Corporation Income Tax Return. The return is due on the fifteenth day of the fourth month following the end of the corporation's tax year. A corporation that has dissolved must generally file by the fifteenth day of the fourth month after the date it dissolved. Special rules apply to corporations with fiscal years ending in June.

If the due date is on a Saturday, Sunday, or legal holiday, the corporation can file on the next business day. The corporation can obtain an automatic extension of the time to file by filing Form 7004.

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S Corporation

A corporation or other entity must file Form 1120-S, U.S. Income Tax Return for an S Corporation, if

1. it elected to be an S corporation by filing Form 2553,
2. the IRS accepted the election, and
3. the election remains in effect.

Schedule K-1 (Form 1120-S), Shareholder's Share of Income, Deductions, Credits, etc., allocates S corporation income, gains, losses, deductions, credits, and other information to the shareholders who then report those items on their own tax returns.

Generally, an S corporation must file Form 1120-S by the fifteenth day of the third month after the end of its tax year. For calendar-year corporations, the due date is March 15. A corporation that has dissolved must generally file by the fifteenth day of the third month after the date it dissolved. If the S corporation election was terminated during the tax year and the corporation reverts to a C corporation, the corporation must file Form 1120-S for the S corporation's short year by the due date (including extensions) of the C corporation's short year return.

If the due date is on a Saturday, Sunday, or legal holiday, the corporation can file on the next business day. The corporation can file Form 7004 to request an automatic extension of the time to file.

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MULTIPLE ENTITY ISSUES This section discusses the aggregation rules for multiple business entities.

A taxpayer may conduct a trade or business through multiple entities. If the trades or businesses constitute a controlled group, they may be treated as a single business. This section reviews when trades or businesses must be aggregated under the controlled group rules. This section also discusses when businesses must be aggregated for determining whether an employer is subject to the employer shared responsibility provisions and employer reporting requirements of the Patient Protection and Affordable Care Act (Affordable Care Act), Pub. L. No. 111-148.

Controlled Groups

Under the I.R.C. § 1563 controlled group rules, two or more corporate employers with common ownership may be treated as a single employer. Similar controlled group rules apply to proprietorships and partnerships under common control [I.R.C. § 414(c)]. All employees of companies in the controlled group must be considered to determine if a retirement plan maintained by a controlled group member meets the requirements of I.R.C. §§ 401, 408(k), 408(p), 410, 411, 415, and 416.

PRACTITIONER NOTE

Other Aggregations

The controlled group rules apply in several other contexts, such as I.R.C. § 52 (computing the work opportunity credit), I.R.C. § 448 (gross receipts test), I.R.C. § 125 (cafeteria plans), and I.R.C. § 179 (election to expense depreciable assets).

I.R.C. § 1563 provides rules for determining a parent-subsidiary controlled group and a brother-sister controlled group (and combinations of the two). Similar controlled group rules apply to proprietorships and partnerships under common control.

Parent-Subsidiary

In a parent-subsidiary controlled group, one or more chains of corporations is connected through stock ownership with a common parent corporation, and the following two tests are met:

1. Stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote or at least 80% of the total value of shares of all classes of stock of each of the corporations, except the common parent corporation, is owned by one or more of the other corporations.
2. The common parent corporation owns stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote or at least 80% of the total value of shares of all classes of stock of at least one of the other corporations, excluding, in computing such voting power or value, stock owned directly by such other corporations.

In a parent-subsidiary controlled group, stock owned by a corporation includes the stock it directly owns and stock it owns under the constructive ownership rules relating to stock options, partnerships, estates, and trusts in I.R.C. § 1563(e).

Brother-Sister

In a brother-sister controlled group, five or fewer persons who are individuals, estates, or trusts own stock in two or more corporations and possess more than 50% of the total combined voting power of all classes of stock entitled to vote or more than 50% of the total value of shares of all classes of stock of each corporation, including the stock ownership of each such person only to the extent such stock ownership is identical with respect to each such corporation. Stock owned by an individual, trust, or estate includes directly owned stock and stock owned under all of the constructive ownership rules of I.R.C. § 1563(e).

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Constructive Ownership

I.R.C. § 1563(e) provides the following constructive ownership rules for determining a controlled group of businesses:

1. Stock options owned by a person are treated as stock owned by such person.
2. Stock owned directly or indirectly by a partnership is deemed owned by any partner having a 5% or more capital or profits interest in the partnership. The constructive ownership is proportionate to the greater of the capital or profits interest.
3. Stock owned directly or indirectly by an estate or trust [other than an I.R.C. § 401(a) employees' trust] is deemed owned by any beneficiary who has a 5% or more actuarial interest, to the extent of the actuarial interest.
4. Stock owned directly or indirectly by a trust (other than an employee's trust) in which a person is considered the owner (grantors and others treated as substantial owners) is deemed owned by such owner.
5. Stock owned directly or indirectly by a corporation is deemed proportionately owned by any shareholder who owns 5% or more in value of its stock.
6. Stock owned directly or indirectly by a spouse (other than a spouse who is legally separated from the individual under a decree of divorce or decree of separate maintenance) is deemed owned by the individual, unless all of the following criteria are met:
   a. The individual does not directly own any stock in the corporation during the year.
   b. The individual is not a director or employee and does not participate in the management of the corporation during the year.
   c. Not more than 50% of the corporation's gross income for the tax year is derived from royalties, rents, dividends, interest, and annuities.
   d. The stock is not subject to conditions that limit the spouse's right to dispose of the stock and run in favor of the individual or the individual's children who have not attained age 21.
7. Stock owned directly or indirectly by an individual's children under the age of 21 is deemed owned by the individual.
8. Stock owned directly or indirectly by an individual is deemed owned by the individual's children under the age of 21.
9. An individual who owns more than 50% of the total combined voting power or total value of a corporation's stock is deemed to own the stock held directly or indirectly by his or her parents, grandparents, grandchildren, and children who have attained age of 21.

PRACTITIONER NOTE

Affiliated Service Group

Section 414(m) was enacted to prevent circumvention by expanding the idea of control to separate, but affiliated, entities. All employees of the members of an affiliated service group are treated as if they were employed by a single employer.

CROSS-REFERENCE

QBI Aggregation

A taxpayer may choose to aggregate multiple trades or businesses into a single trade or business for purposes of the I.R.C. § 199A qualified business income (QBI) deduction. There must be common control, no specified service trades or businesses, and a business relationship. See pages 96–106 in this workbook for a discussion of the QBI deduction and the aggregation rules.

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Applicable Large Employers

Under the Affordable Care Act, an applicable large employer (ALE) must comply with the employer shared responsibility provisions, and the employer information reporting provisions for offers of minimum essential coverage.

Employer Mandate

ALEs must either offer minimum essential coverage (MEC) that is affordable and that provides *minimum value* (MV) to their full-time employees (and MEC to their dependents), or potentially make an employer shared responsibility payment (ESRP) to the IRS. Large employers (regardless of whether health care coverage was offered), health care issuers, and some small employers (those providing self-insured health care coverage) must report that coverage to the IRS.

An ALE may be liable for an ESRP under I.R.C. § 4980H if a full-time employee received a premium tax credit (PTC) through the HealthCare.gov Marketplace and the employer either

1. did not offer MEC to at least 95% of full-time employees [I.R.C. § 4980H(a)], or
2. offered coverage that was not affordable or that did not provide MV or did not offer such coverage to the full-time employee receiving the PTC [I.R.C. § 4980H(b)].

Aggregating Employees

Certain businesses with a common owner or that are otherwise related are generally combined and treated as a single employer for determining ALE status. If the combined number of full-time employees and full-time equivalent employees (FTEs) for the group is on average 50 or more for the preceding year, then each employer in the group is an ALE.

If two or more companies have a common owner or are otherwise related under I.R.C. § 414(b), (c), (m), or (o), they are treated as a single employer for determining whether they collectively have at least 50 FTEs in the prior year. This treatment as a single employer is determined under the same rules that apply for other tax and employee benefit purposes. If the combined total FTEs meets the threshold, the companies combined are an aggregated ALE group, and each separate company is an ALE that is subject to the employer shared responsibility provisions for its employees, including the companies that individually do not have enough employees to meet the threshold (although a member of the group that has no employees is not an ALE). Whether a particular company owes an ESRP and any ESRP amount are determined separately for each of the related companies.

I.R.C. § 414(b) refers to a controlled group of corporations, while I.R.C. § 414(c) refers to trades or businesses, whether or not incorporated, under common control. A controlled group exists when any two or more entities are connected through common ownership in a parent-subsidiary controlled group, a brother-sister controlled group, or a combination of the two. Any type of business entity can be a member of a controlled group for this purpose–a corporation, partnership, sole proprietorship, trust, estate, or limited liability company. I.R.C. § 414(m) defines an affiliated service group. Employers must apply the family and entity attribution rules to determine ownership.

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CROSS-REFERENCE

Common Control

See pages 126–130 in the *2016 National Income Tax Workbook* for a further discussion of the controlled groups and examples of how the rules are applied to aggregate employers for purposes of the Affordable Care Act.

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INDIVIDUAL TAX ISSUES: PART 1

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Issue 3: Exclusion of Gain on the
Sale of a Principal Residence 259

LEARNING OBJECTIVES

After completing this session, participants will be able to do the following:

- ✔ Know what contributions qualify for a charitable contribution deduction
- ✔ Apply the limits on a charitable contribution deduction
- ✔ Understand what remodel costs increase basis
- ✔ Claim energy credits for improvements to a residence
- ✔ Know when gain is excluded on the sale of a principal residence
- ✔ Understand the tax treatment on the sale of a residence converted from a rental to a principal residence

INTRODUCTION

In 2021, taxpayers who claim the standard deduction can claim an above-the-line charitable contribution deduction for cash contributions to qualified charities. Taxpayers who itemize deductions can claim a deduction of up to 100% of AGI for qualified cash contributions. This chapter reviews the new and existing rules for claiming the charitable contribution deduction.

With lower interest rates and higher prices for new homes in 2021, many taxpayers opted to remodel their existing homes. This chapter reviews the remodel costs that are added to basis, and the energy credits that may be available for energy efficient home improvements. Finally, this chapter reviews the exclusion for gain on the sale of a principal residence, and how that exclusion applies when a home has been used for business purposes or when a rental property has been converted to a principal residence.

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ISSUE 1: CHARITABLE CONTRIBUTIONS—Taxpayers can claim a deduction for contributions to qualified charitable organizations.

In 2021, taxpayers who claim the standard deduction can claim a $300 ($600 MFJ) above-the-line charitable contribution deduction for cash contributions to qualified charities (not a supporting organization or a donor advised fund). Taxpayers who itemize deductions can deduct charitable contributions of money or property to qualified organizations (defined later). The increased charitable contribution limits under the Coronavirus Aid, Relief, and Economic Security Act of 2020 (CARES Act), Pub. L. No. 116-136, are extended through 2021.

This section reviews the new and existing rules for claiming the charitable contribution deduction. It explains the new limits on charitable contribution deductions, and how to calculate and apply deduction carryovers. This section reviews how to value and substantiate a charitable contribution. It explains the types of split-interest gifts. Finally, this section discusses reporting requirements for charitable contributions, and tax planning to maximize the deduction for charitable giving.

Qualified Charitable Organization

I.R.C. § 170(c) defines a charitable contribution as a contribution or gift to or for the use of qualifying governmental entities or other qualifying nonprofit organizations if the contribution or gift is made for exclusively public purposes. To qualify for a deduction, a taxpayer must make a charitable contribution to or for the use of one of the following qualified organizations:

1. The US government, a state of the United States including the District of Columbia, a possession of the United States, or a political subdivision of any of these (The contribution must be made exclusively for public purposes.)
2. A corporation, trust, or community chest, fund, or foundation
   a. that is created or organized in or under the laws of any of the governments listed in item 1;
   b. that is organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster national or international sports competition and its activities do not involve the provision of athletics facilities or equipment, or for the prevention of cruelty to children or animals;
   c. in which no part of the net earnings inure to any private shareholder or individual; and
   d. that is not disqualified for tax exemption under section 501(c)(3) because of attempting to influence legislation, and that does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office
3. A post or organization of war veterans, including auxiliary units of, societies of, or trusts or foundations for the post or organization, organized in the United States or one of its possessions, and in which no part of the net earnings inure to the benefit of any private shareholder or individual
4. A domestic fraternal society, order, or association, operating under the lodge system, but only if such contribution or gift is to be used exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals
5. A cemetery company owned and operated exclusively for the benefit of its members, including not-for-profit cemetery corporations chartered solely for burial purposes and not permitted to engage in any unrelated business

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OBSERVATION

Above-the-Line Deduction

While contributions to a donor advised fund or a supporting organization do not qualify for the above-the-line charitable deduction, those contributions could qualify for an itemized deduction.

Ineligible Organizations

Contributions to political candidates, political parties, and lobbying organizations are not tax deductible. Generally, bar associations, chambers of commerce, civic leagues, country clubs, social clubs, homeowner's associations, and labor unions are not qualified organizations. Also, contributions to foreign organizations are generally not deductible with certain exceptions for organizations in Canada, Mexico, and Israel.

PRACTITIONER NOTE

Verifying Qualified Organizations

A taxpayer can verify the nonprofit status of organizations at www.irs.gov/charities-nonprofits/search-for-tax-exempt-organizations. It is best to search for an organization using the employer identification number rather than the name because spelling and punctuation vary.

Contributions to Individuals

Contributions to individuals are not deductible, and qualifying donations may not be earmarked for the benefit of a specific person or family. However, a taxpayer can deduct a contribution to a qualified organization that helps needy or worthy individuals if the taxpayer does not indicate that the contribution is for a specific person.

Example 6.1
Contributions for Disaster Relief

Flooding destroyed the Dawson family's home in Georgia. Friends of the family set up a GoFundMe page to raise money for the family to replace their home and personal belongings. The American Red Cross provided disaster relief services in the Dawsons' hometown. They set up a shelter and provided the Dawsons and other disaster victims with clean water and hot meals. A contribution to the American Red Cross is tax deductible, but contributors cannot deduct contributions to the GoFundMe campaign.

Qualifying Donations

A taxpayer can make a deductible charitable contribution of cash or property. A taxpayer typically cannot claim a deduction for free services provided to a qualified organization or for allowing a qualified organization to use property without paying rent. However, the taxpayer can deduct actual expenses incurred in providing services or the use of property.

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Donations with a Benefit to the Donor

If the payment a donor makes to a charity is partly a contribution and partly for goods or services, it is a quid pro quo contribution. The donor cannot deduct the part of the contribution that represents the value of a benefit that the donor receives from the contribution. With some exceptions (discussed later), the qualified organization must give the donor a written disclosure statement if the quid pro quo contribution is more than $75. The required written disclosure statement must

1. inform the donor that the amount of the contribution that is deductible for federal income tax purposes is limited to the excess of any money (and the value of any property other than money) contributed by the donor over the FMV of goods or services provided by the charity, and
2. provide the donor with a good-faith estimate of the FMV of the goods or services that the donor received.

Example 6.2
Charity Ball

Anna Wang purchased a $50 ticket to the Rainbow Fashion Show. The show was held to benefit the local Rainbow Pride Organization, a qualified nonprofit organization. Everyone who attended the show had to purchase a $50 ticket. Therefore, the FMV of the ticket is $50. Anna cannot deduct the cost of the ticket, even if she does not attend the show. However, if Anna makes a $50 contribution to the nonprofit organization and refuses the ticket, she can deduct the full contribution [Rev. Rul. 67-246, 1967-2 C.B. 104].

Example 6.3
Charity Symphony Concert

Mary Mahoney purchased a $75 ticket to a symphony concert to benefit the local symphony, a qualified nonprofit organization. The regular price of a symphony concert ticket is $50. Mary can deduct $25 ($75 − $50) as a charitable contribution.

Insubstantial Benefit

A benefit that the donor receives in exchange for a contribution may be disregarded if the payment occurs in the context of a fundraising campaign in which the charity informs patrons how much of their payment is a deductible contribution, and either

1. the FMV of all benefits received in connection with the payment is not more than 2% of the payment, or $113 (for 2021), whichever is less; or
2. the payment is $56.50 (for 2021) or more and the only benefits the donor receives in connection with the payment are low-cost articles (bookmarks, calendars, key chains, mugs, posters, T-shirts, etc.) bearing the organization's name or logo [Rev. Proc. 90-12, 1990-1 C.B. 471]. For tax years beginning in 2021, *low-cost articles* are items costing $11.30 or less.

Example 6.4
Insubstantial Items

Frank Fernandez donated $100 to his local public radio station and received a T-shirt with the radio station's logo. The T-shirt is considered an insubstantial item, and Frank can deduct the full $100 as a charitable contribution.

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Membership Benefits

Certain membership benefits are disregarded when determining the deductibility of membership fees or dues paid to a qualified organization. The taxpayer and the organization can disregard the following membership benefits if the organization provides them in exchange for an annual payment of $75 or less:

- Free or discounted admission, other than admission to athletic events (see the later discussion of athletic tickets) to the organization's facilities or events
- Free or discounted parking
- Preferred access to goods or services
- Discounts on the purchase of goods or services
- Admission to member-only events when the cost per person to the organization is not more than $11.30 (for 2021)

Example 6.5
Discounted Admission

Martha Winfield pays $40 annually to be a member of Sonnenberg Gardens, a qualified charitable organization. In exchange, she receives free admission to the gardens and discounts at other public gardens in the United States and Canada. Martha can deduct the full $40 as a charitable contribution.

Donations for Right to Purchase Athletic Tickets

Effective for contributions made in tax years after December 31, 2017, the Tax Cuts and Jobs Act of 2017 (TCJA), Pub. L. No. 115-97, amends I.R.C. § 170(l) to provide that no charitable deduction is allowed for a payment to an institution of higher education in exchange for which the payer receives the right to purchase tickets or seating at an athletic event.

Example 6.6
Right to Purchase and Receipt of Athletic Tickets

Mitch Chamberlin donated $500 to the University of North Dakota for the right to purchase football tickets. He paid $200 for football tickets with a $200 FMV. Mitch cannot deduct any portion of the $500 donation as a charitable contribution.

PRACTITIONER NOTE

State Tax Credits

An individual taxpayer making payments to a qualified charitable organization must reduce the federal charitable contribution deduction by the amount of any state or local tax credit that the taxpayer receives or expects to receive in return. No reduction is required if the state or local credit received or expected to be received is not more than 15% of the charitable contribution. An individual who itemizes deductions may treat any disallowed portion of the charitable contribution of cash as a payment of state and local taxes.

Contributions of Property

In general, a contribution to a qualified charitable organization of the entire interest in property is deductible. Donations of partial interests in property are not deductible except for a remainder interest in a personal residence or farm, a contribution of an undivided portion of the taxpayer's entire interest in property, a qualified conservation contribution, and donations to certain trusts (certain partial interests are discussed later).

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Clothing and Household Items

Donated clothing or household items must be in good used condition or better [I.R.C. § 170(f)(16)(A)]. There is an exception for a contribution of a single item of clothing or a household item if the taxpayer deducts more than $500 for the item and obtains an appraisal. Household items include furniture and furnishings, electronics, appliances, linens, and other similar items. Household items do not include food; paintings, antiques, and other objects of art; jewelry and gems; and collections.

Car, Boat, or Airplane

When donating a used car, boat, or airplane with a claimed FMV of more than $500, the taxpayer can generally deduct the lesser of

1. the gross proceeds from the sale of the vehicle by the donee, or
2. the FMV on the date of the contribution (if it is more than cost or other basis).

If the qualified charitable organization makes a significant intervening use of or material improvement to the vehicle before transferring it, the taxpayer generally can deduct the vehicle's FMV at the time of the contribution. Also, if the qualified organization gives the vehicle, or sells it (other than at an auction) for a price well below FMV, to a needy individual to further the organization's charitable purpose, the taxpayer generally can deduct the vehicle's FMV at the time of the contribution. If the qualified organization sells the vehicle for $500 or less and neither of the two exceptions apply, the taxpayer can deduct the lesser of $500 or the FMV of the vehicle on the date of the contribution [See Notice 2005-44, 2005-25 I.R.B. 1287].

Example 6.7
Donation of a Vehicle—Sale

Mario Ricci donated a used car to a qualified charitable organization. Mario bought the car 5 years ago for $15,000, and the car's FMV at the time of the donation was $3,000. The organization sold the car for $2,800 and gave Mario a Form 1098-C, Contributions of Motor Vehicles, Boats, and Airplanes, that showed the $2,800 gross proceeds. Mario's charitable contribution deduction is limited to the $2,800 selling price.

Inventory

In general, the deduction for charitable contributions of inventory property under I.R.C. § 170 is limited to the lesser of the inventory's FMV or the taxpayer's basis in the contributed inventory.

Under I.R.C. § 170(e)(3)(C), a taxpayer who makes certain qualified contributions of food inventory from a trade or business can take a larger deduction if the FMV of the contributed food inventory exceeds its basis. A qualified contribution must be made to a qualified organization, which is defined as a nonprofit group that is religious, charitable, educational, scientific, or literary in purpose. An organization that works to prevent cruelty to children (or animals) is also a qualified organization. A qualified contribution must meet the following conditions:

1. The food must be "apparently wholesome food."
2. The food must be intended for human consumption.
3. The food must meet all the quality and labeling standards imposed by federal, state, and local laws, but the food does not have to be readily marketable due to appearance, age, freshness, grade, size, surplus, and other conditions.
4. The receiving organization must use the food only for the care of the ill, the needy, or infants.
5. The use of the food must be related to the receiving organization's exempt purpose or function.

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6. The organization must agree not to transfer the donated food for money, other property, or services.
7. The receiving organization must provide a written statement agreeing to comply with the requirements for the use of the food.
8. The receiving organization cannot be a private nonoperating foundation.
9. The donated food must satisfy any applicable requirements of the Federal Food, Drug, and Cosmetic Act and regulations on the date of the transfer and for the previous 180 days.

CROSS-REFERENCE

Contribution of Food Inventory

See pages 190–192 of the *2016 National Income Tax Workbook* for a detailed discussion of determining the FMV of the contribution and calculating the deduction for charitable contributions of food inventory, and the limitation on the deduction.

Contribution of Services

Taxpayers cannot deduct a contribution of services. However, taxpayers can deduct unreimbursed expenses incurred while performing services for a qualified charitable organization. For example, the taxpayer can deduct the cost of purchasing and cleaning a uniform (without general utility) that the taxpayer is required to wear while performing donated services. Similarly, out-of-pocket meal, lodging, and travel expenses necessarily incurred in performing donated services are deductible.

Meals and Lodging

Reasonable expenditures for meals and lodging necessarily incurred while away from home in the course of performing donated services are deductible [Treas. Reg. § 1.170A-1(g)]. To qualify, these expenses must be

- directly connected with the services provided to the organization;
- incurred only because of the services provided; and
- not personal, living, or family expenses.

For purposes of the deduction for costs for meals and lodging incurred while performing donated services, the definition of *away from home* is the same as in I.R.C. § 162.

Automobile Expenses

A taxpayer can deduct as a charitable contribution any unreimbursed out-of-pocket expenses, such as the cost of gas and oil, directly related to the use of a car in providing services to a charitable organization. He or she cannot deduct general repair and maintenance expenses, depreciation, registration fees, or the costs of tires or insurance. In lieu of actual automobile expenses, a taxpayer can use the standard mileage rate to calculate the deduction for use of a car in relation to donation of services. For 2021, the mileage rate is 14¢ per mile driven in service of charitable organizations. The taxpayer can also deduct parking fees and tolls whether he or she uses actual expenses or the standard mileage rate.

Travel Expenses

Generally, the taxpayer can claim a charitable contribution deduction for travel expenses necessarily incurred while away from home performing services for a charitable organization only if there is no significant element of personal pleasure, recreation, or vacation in the travel. Deductible travel expenses may include air, rail, and bus transportation; and car fares or other costs of transportation between the airport or station and a hotel.

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Example 6.8
Charitable Travel Expenses

Jasmine Williams volunteered for a qualified charitable organization that was building a house for a low-income family. She drove her personal automobile 100 miles to the jobsite. She worked on the construction of the house for 3 days, slept at a volunteer's house within walking distance of the construction site, and ate her meals in a local diner. At the end of the 3 days, Jasmine traveled 100 miles back to her home. Jasmine can deduct the cost of her meals because she was away from home overnight. Additionally, she may deduct $28 (200 miles × 14¢) for travel.

Example 6.9
Charitable Travel with Personal Benefit

Sofia Torres volunteered for a qualified charitable organization that was building a house for a low-income family. She drove her personal automobile 75 miles to the jobsite. She worked on the construction of the house for 2 hours per day for 3 days, slept at her sister's house, and visited with family in the evenings. She and her sister ate most of their meals at a local restaurant. At the end of 3 days, Sofia traveled 75 miles back to her home. The cost of Sofia's meals and travel is not deductible as the trip was partially for personal pleasure.

Determining Fair Market Value

To claim a deduction for a contribution of property, the taxpayer must determine the FMV of the donated property. FMV is the price at which property would change hands between a willing buyer and a willing seller, neither having to buy or sell, and both having reasonable knowledge of all the relevant facts.

PRACTITIONER NOTE

Valuation Overstatement Penalty

I.R.C. § 6662 imposes penalties for an underpayment of income tax that is attributable to a substantial understatement of income tax. The Consolidated Appropriations Act of 2021, Pub. L. No. 116-260, modifies I.R.C. § 6662(b) to impose a 50% (previously 20%) penalty if the taxpayer substantially overstates the above-the-line charitable contribution deduction for a cash contribution.

Used Clothing and Household Items

There is no fixed formula or method for finding the value of items of clothing. Similarly, the FMV of used household items, such as furniture, appliances, and linens cannot be established by a formula (such as using a percentage of the cost to buy a new replacement item). The FMV is the price that buyers of used items pay in stores that sell used clothing or household items, such as consignment or thrift shops.

Cars and Boats

If the taxpayer contributes a car to a charitable organization, he or she must determine its FMV. Certain commercial firms and trade organizations publish used car pricing guides, commonly called "blue books," that contain complete dealer sale prices or dealer average prices for recent model years. The taxpayer must use the price listed in the guide for a private party sale, not the dealer retail value. However, the FMV of a donated car is the same as the price listed in a used car guide for a private party sale only if the guide lists a sales price for a car that is the same make, model, and year, sold in the same area, in the same condition, with the same or similar options or accessories, and with the same or similar warranties as the donated car.

Except for small, inexpensive boats, the valuation of boats should be based on an appraisal by a marine surveyor or appraiser.

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PRACTITIONER NOTE

Appraisal Costs

The taxpayer may need to obtain an appraisal to value donated assets. The taxpayer cannot claim a charitable contribution deduction for the cost of appraising property to determine its FMV. For tax years before 2018 and after 2025, the taxpayer may deduct that cost as a miscellaneous itemized deduction on Schedule A (Form 1040), Itemized Deductions, subject to the 2%-of-AGI floor.

Substantiation

The substantiation requirements for a deductible charitable contribution depend on the type and amount of the contribution.

Cash Contributions

The taxpayer must maintain records of cash contributions. Acceptable forms of substantiation include a canceled check; a credit card statement; a receipt or letter from the donee charitable organization showing the name of the donee, the date of the contribution, and the amount of the contribution; or payroll deduction records.

Cash Contributions $250 or More

For single cash donations of $250 or more, the taxpayer must obtain a contemporaneous written acknowledgment from the donee organization. To be contemporaneous, the donor must generally obtain written acknowledgment no later than the date the donor files the return for the tax year the contribution is made (or the due date of the return, including extensions, if earlier). The written acknowledgment must provide the following:

1. The amount of any cash paid by the taxpayer and a description, but not necessarily the value, of any property other than cash the taxpayer transferred to the donee organization
2. A statement of whether the donee organization provided any goods or services in consideration, in whole or in part, for any of the contributed cash or other property
3. A description and good-faith estimate of the value of any goods or services other than intangible religious benefits that the donee organization provided to the donor
4. A statement of any intangible religious benefits that the donee organization provided to the donor

[Treas. Reg. § 1.170A-13(f)(2)]

Quid Pro Quo Contributions

If the taxpayer makes a cash donation that is more than $75 and receives goods or services in exchange (a quid pro quo contribution), the donee organization must provide the taxpayer with written substantiation of the value of goods or services that the taxpayer received. See the earlier discussion of donations with a benefit to the donor. An organization does not have to give the donor this statement if one of the following applies:

1. The organization is a governmental organization, or an organization formed only for religious purposes, and the only benefit the taxpayer receives is an intangible religious benefit (such as admission to a religious ceremony) that generally is not sold in commercial transactions outside the donative context.
2. The taxpayer receives only items whose value is not substantial (as described earlier).
3. The taxpayer receives only membership benefits that can be disregarded.

Example 6.10
Intangible Religious Benefit

Willow Forest donated $10,000 to her church. She received only a religious benefit from attending church services. The church should provide Willow with a written acknowledgment of the gift and a statement that the benefit received was an intangible religious benefit only. Willow may deduct the full $10,000.

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Noncash Contributions

For a noncash contribution, the records the taxpayer must keep depend on whether the deduction for the contribution is less than $250, at least $250 but not more than $500, over $500 but not more than $5,000, or over $5,000.

Less Than $250

A taxpayer who contributes noncash property to a qualified organization must maintain a receipt from the donee for each contribution and showing the following information:

- The name and address of the donee organization
- The date and location of the contribution
- A reasonably detailed description of the property
- For a donation of securities, the name of the issuer, the type of security, and whether it is regularly traded on a stock exchange or in an over-the-counter market

If the taxpayer is unable to obtain a receipt–for example, by depositing property at an unattended collection box–then a receipt from the organization is not required, but the taxpayer must keep reliable written records.

In addition to the information contained on the receipt, the taxpayer must keep reliable written records of contributions of property. Among other information, the records must include the following:

1. The FMV of the property at the time of the contribution and how the taxpayer determined the FMV
2. If an appraiser determined the FMV, a copy of the signed appraisal
3. The terms of any conditions attached to the contribution of property, such as earmarks for a particular use or restrictions on use or disposition

[Treas. Reg. § 1.170A-13(b)(2)]

At Least $250 but Not More Than $500

If the taxpayer claims a deduction for a noncash contribution that is at least $250 but not more than $500, the taxpayer must have a contemporaneous written acknowledgment from the donee organization. The taxpayer must maintain the reliable written records described earlier.

In addition, the contemporaneous written acknowledgment from the donee organization must include the following:

- The name of the donee organization
- The date and location of the contribution
- A reasonably detailed description of the donated property
- Whether the taxpayer received any goods or services as a result of the donation, and if so, a good-faith estimate of the FMV of the goods or services received
- If the donee organization provides any intangible religious benefits, a statement to that effect

[Treas. Reg. § 1.170A-13(f)]

More Than $500 but Not More Than $5,000

If the taxpayer claims a deduction for a noncash contribution that is more than $500 but not more than $5,000, the taxpayer must have the written acknowledgment from the donee organization and must maintain the reliable records discussed earlier. Additionally, the taxpayer must have written records that include the following:

- How and when the taxpayer acquired the property
- The cost or adjusted basis of property that the taxpayer held less than 12 months, and when available, the cost or other adjusted basis of property (other than publicly traded securities) held 12 months or more

[Treas. Reg. § 1.170A-13(b)(3)]

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PRACTITIONER NOTE

Form 8283

If the taxpayer claims a charitable contribution deduction for noncash gifts that are more than $500, the taxpayer must complete Form 8283, Noncash Charitable Contributions.

More Than $5,000

If the taxpayer claims a deduction for a noncash contribution that is more than $5,000, the taxpayer must have the written acknowledgment from the donee organization and must maintain the reliable records discussed earlier. In addition, the taxpayer usually must obtain a qualified appraisal (with some exceptions listed later) [Treas. Reg. § 1.170A-13(c)(2)].

The $5,000 limit applies to the combined value of all similar items donated within a single tax year. If the value of the donation exceeds $500,000, the taxpayer must attach the full appraisal to the tax return.

Qualified Appraisal

A *qualified appraisal* must meet the following requirements:

1. The appraisal must be made not more than 60 days prior to the date of contribution and not later than the due date of the return, including extensions, or the date the taxpayer first files an amended return claiming the deduction.
2. A qualified appraiser must prepare, sign, and date the appraisal.
3. The appraisal fee cannot be based on a percentage of the value of the appraised property.
4. The appraisal must contain
   a. a detailed description of the property;
   b. a statement of the physical condition of any tangible property;
   c. the date or expected date of the contribution;
   d. the terms of any agreement or understanding related to the donee's use of the property;
   e. the name, address, and identifying number of the appraiser;
   f. the appraiser's qualifications;
   g. a statement that the appraisal was prepared for income tax purposes;
   h. the date of the appraisal;
   i. the appraised FMV on the date of the contribution;
   j. the valuation method used to determine FMV; and
   k. the specific basis used for the valuation, such as statistical sampling or comparable sales.

[Treas. Reg. § 1.170A-13(c)(3)]

No Appraisal Required

A qualified appraisal is not required if the property is

- nonpublicly traded stock and the claimed deduction is greater than $5,000 but not more than $10,000;
- a vehicle, including a car, boat, or airplane, for which the deduction is limited to the gross proceeds from its sale;
- qualified intellectual property, such as a patent;
- certain publicly traded securities;
- inventory and other property donated by certain C corporations that are qualified contributions for the care of the ill, the needy, or infants, within the meaning of I.R.C. § 170(e)(3)(A); or
- stock in trade, inventory, or property held primarily for sale to customers in the ordinary course of a trade or business.

Although a qualified appraisal is not required for these types of property, the taxpayer still must provide information about the contribution.

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Out-of-Pocket Expenses

If the taxpayer provides services to a qualified charitable organization and has related unreimbursed out-of-pocket expenses, considered separately, of $250 or more (for example, the taxpayer pays $250 for an airline ticket to attend a convention of a qualified organization as a chosen representative), the taxpayer must have adequate records to prove the amount of the expenses. In addition, the taxpayer must get a contemporaneous acknowledgment from the qualified organization that contains

1. a description of the services provided;
2. a statement of whether the organization provided the taxpayer with any goods or services to reimburse him or her for the expenses incurred;
3. a description and a good-faith estimate of the value of any goods or services (other than intangible religious benefits) provided to reimburse the taxpayer; and
4. a statement that the only benefit the taxpayer received was an intangible religious benefit, if that was the case.

If the taxpayer claims expenses directly related to use of a car in providing services to a qualified organization, the taxpayer must keep reliable written records of his or her expenses. Whether the records are considered reliable depends on all the facts and circumstances. The records should be kept regularly and at or near the time the expenses are incurred. They should show the name of the organization and the dates the taxpayer used his or her car for a charitable purpose. If the taxpayer uses the standard mileage rate, the records must show the miles driven for the charitable purpose. If the taxpayer deducts actual expenses, the records must show the costs of operating the car that are directly related to a charitable purpose.

Contribution Limits

The CARES Act allows individual taxpayers to deduct cash contributions up to 100% of AGI for 2020 (25% of taxable income for corporate taxpayers). The Consolidated Appropriations Act of 2021, Pub. L. No. 116-260, extended that 100% limit through the 2021 tax year. The expanded limit does not apply to contributions to supporting organizations or donor advised funds (DAFs). Special rules may apply to disaster relief contributions and qualified conservation contributions (discussed later). For all other tax years beginning after December 31, 2017, and before January 1, 2026, the taxpayer can deduct cash contributions that do not exceed 60% (up from 50%) of the taxpayer's AGI.

PRACTITIONER NOTE

Contribution Base

For purposes of section 170, the contribution limits are a percentage of the taxpayer's contribution base. The term *contribution base* means AGI under I.R.C. § 62, computed without regard to any net operating loss carryback to the tax year under I.R.C. § 172. In this section, the contribution base is referred to as AGI.

Cash contributions that exceed the AGI limitation can be carried forward up to 5 years. Noncash contributions continue to be limited to 50% of AGI. The amount a taxpayer can deduct may be further limited to 30% or 20% of AGI, depending on the type of property contributed and the type of donee organization. The limits are first applied based on the type of donee organization.

PRACTITIONER NOTE

Disaster Relief

Corporate cash charitable contributions for disaster relief may qualify for a new 100% limit. See I.R. 2021-27 (January 29, 2021) at www.irs.gov/newsroom/new-law-increases-deduction-limit-for-corporate-cash-contributions-for-disaster-relief-irs-provides-recordkeeping-relief.

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50%-Limit Organizations

Organizations to which a taxpayer can contribute up to 50% of AGI for noncash contributions, and 100% of AGI for cash contributions (except to supporting organizations and DAFs) include the following:

- Churches
- Educational organizations
- Hospitals and medical research organizations
- The federal government or state government or its political subdivision
- Publicly supported charities and other public charities
- Private operating foundations
- Certain private nonoperating foundations that make qualifying distributions

30%-Limit Organizations

The 30%-of-AGI limit applies to organizations that are not 50% limit organizations, such as the following:

- Veterans' groups
- Fraternal societies
- Certain private nonoperating foundations

30% Limit for Capital Gain Property

A separate 30% limit applies to capital gain property donated to 50%-limit organizations. However, if the taxpayer elects to reduce the FMV of the property by the appreciation in value that would have been long-term capital gain if the property was sold, the 50% limit applies. *Capital gain property* is property that would have resulted in a long-term capital gain if the taxpayer sold the property at FMV on the date of the contribution.

If the taxpayer makes the capital gain property election, the election applies to all capital gain property contributed to 50%-limit organizations during a tax year. It also applies to carryovers of this category of contribution from an earlier tax year. The taxpayer must make the election on an original return or on an amended return filed by the due date for filing the original return.

PRACTITIONER NOTE

The 20% Limit

Generally, a 20% limit applies to contributions of capital gain property to any organization other than a 50%-limit organization or for the use of a qualified organization. The contribution is limited to 20% of AGI unless certain amounts are smaller. See Treas. Reg. § 1.170A-8(c).

Ordinary Income Property

Ordinary income property is property that would have resulted in ordinary income or short-term capital gain income if the taxpayer sold the property at FMV on the date that the taxpayer contributed the property. The deduction for contributions of ordinary income property is the property's FMV less the amount that would be ordinary income or short-term capital gain if the taxpayer sold the property for FMV. Thus, the deduction for a contribution of ordinary income property is often limited to the taxpayer's basis in the property. The charitable contribution is not reduced if the taxpayer includes the ordinary or capital gain income in his or her gross income in the same year as the contribution.

Example 6.11
Calculating the Limits—No Election

In March 2021, Josef Amir gave the local humane society [a section 501(c)(3) organization] $2,000 cash and land with a $28,000 FMV and a $22,000 basis. Josef held the land for investment purposes for more than 1 year. He did not make the capital gain property election to reduce the land's FMV by the appreciation in value. Therefore, the amount of Josef's charitable contribution for the land is its $28,000 FMV. Josef also gave $5,000 cash to a private nonoperating foundation to which the 30% limit applies. Josef's 2021 AGI was $50,000.

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The $2,000 cash donated to the humane society is considered first and is fully deductible as a 2021 qualified cash contribution. The $5,000 cash contribution to the private nonoperating foundation is considered next. Because the $28,000 noncash contribution to the humane society is more than $25,000 (50% × Josef's $50,000 AGI), Josef cannot deduct the contribution to the private nonoperating foundation in 2021, but he can carry over the deduction to 2022. The contribution of land is considered next. Josef's contribution deduction for the land is limited to $15,000 ($50,000 AGI × 30%). He can carry over the $13,000 ($28,000 − $15,000) unused part of the contribution. For 2021, Josef's charitable contribution deduction is limited to $17,000 ($2,000 + $15,000). His carryover to 2022 is $18,000 ($5,000 + $13,000). **Figure 6.1** shows Josef's completed Worksheet 2 from IRS Publication 526, *Charitable Contributions*. Figure 6.1 shows the 2020 worksheet because the 2021 worksheet was not available at the time of this publication.

FIGURE 6.1
Worksheet 2 for Josef Amir

Worksheet 2. Applying the Deduction Limits

Caution: Don't use this worksheet to figure the contributions you can deduct this year if you have a carryover of a charitable contribution from an earlier year.

Step 1. Enter any qualified conservation contributions (QCCs) made during the year.				
1.	If you are a qualified farmer or rancher, enter any QCCs subject to the limit based on 100% of adjusted gross income (AGI)	1		
2.	Enter any QCCs not entered on line 1	2		
Step 2. Enter your other charitable contributions made during the year.				
3.	Enter cash contributions that you elect to treat as qualified contributions plus cash contributions payable for relief efforts in qualified disaster areas that you elected to treat as qualified contributions. Don't include this amount on line 4 below	3		2,000
4.	Enter your contributions of capital gain property "for the use of" any qualified organization	4		
5.	Enter your other contributions "for the use of" any qualified organization. Don't include any contributions you entered on a previous line	5		
6.	Enter your contributions of capital gain property to qualified organizations that aren't 50% limit organizations. Don't include any contributions you entered on a previous line	6		
7.	Enter your other contributions to qualified organizations that aren't 50% limit organizations. Don't include any contributions you entered on a previous line	7		5,000
8.	Enter your contributions of capital gain property to 50% limit organizations deducted at fair market value. Don't include any contributions you entered on a previous line	8		28,000
9.	Enter your noncash contributions to 50% limit organizations other than capital gain property you deducted at fair market value. Be sure to include contributions of capital gain property to 50% limit organizations if you reduced the property's fair market value. Don't include any contributions you entered on a previous line	9		
10.	Enter your cash contributions to 50% limit organizations that you elected not to treat as qualified contributions. Don't include any contributions you entered on a previous line	10		
Step 3. Figure your deduction for the year (if any result is zero or less, enter -0-)				
11.	Enter your adjusted gross income (AGI)	11		50,000
	Cash contributions subject to the limit based on 60% of AGI (If line 10 is zero, enter -0- on lines 12 through 14.)			
12.	Multiply line 11 by 0.6	12		
13.	**Deductible amount.** Enter the smaller of line 10 or line 12	13		
14.	Carryover. Subtract line 13 from line 10	14		0
	Noncash contributions subject to the limit based on 50% of AGI (If line 9 is zero, enter -0- on lines 15 through 18.)			
15.	Multiply line 11 by 0.5	15		
16.	Subtract line 13 from line 15	16		
17.	**Deductible amount.** Enter the smaller of line 9 or line 16	17		
18.	Carryover. Subtract line 17 from line 9	18		0
	Contributions (other than capital gain property) subject to limit based on 30% of AGI (If lines 5 and 7 are both zero, enter -0- on lines 19 through 25.)			
19.	Multiply line 11 by 0.5	19	25,000	
20.	Add lines 8, 9, and 10	20	28,000	
21.	Subtract line 20 from line 19	21	0	
22.	Multiply line 11 by 0.3	22	15,000	
23.	Add lines 5 and 7	23	5,000	
24.	**Deductible amount.** Enter the smallest of line 21, 22, or 23	24	0	
25.	Carryover. Subtract line 24 from line 23	25		5,000
	Contributions of capital gain property subject to limit based on 30% of AGI (If line 8 is zero, enter -0- on lines 26 through 31.)			
26.	Multiply line 11 by 0.5	26	25,000	
27.	Add lines 9 and 10	27	0	
28.	Subtract line 27 from line 26	28	25,000	
29.	Multiply line 11 by 0.3	29	15,000	
30.	**Deductible amount.** Enter the smallest of line 8, 28, or 29	30	15,000	
31.	Carryover. Subtract line 30 from line 8	31		13,000

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FIGURE 6.1 (continued)
Worksheet 2 for Josef Amir

	Contributions subject to the limit based on 20% of AGI (If lines 4 and 6 are both zero, enter -0- on lines 32 through 41.)			
32.	Multiply line 11 by 0.5	32		
33.	Add lines 13, 17, 24, and 30	33		
34.	Subtract line 33 from line 32	34		
35.	Multiply line 11 by 0.3	35		
36.	Subtract line 24 from line 35	36		
37.	Subtract line 30 from line 35	37		
38.	Multiply line 11 by 0.2	38		
39.	Add lines 4 and 6	39		
40.	**Deductible amount.** Enter the smallest of line 34, 36, 37, 38, or 39	40		
41.	Carryover. Subtract line 40 from line 39	41		0
	QCCs subject to limit based on 50% of AGI (If line 2 is zero, enter -0- on lines 42 through 46.)			
42.	Multiply line 11 by 0.5	42		
43.	Add lines 13, 17, 24, 30, and 40	43		
44.	Subtract line 43 from line 42	44		
45.	**Deductible amount.** Enter the smaller of line 2 or line 44	45		
46.	Carryover. Subtract line 45 from line 2	46		0

Note: Worksheet 2 continues on the next page.

Worksheet 2—continued

	QCCs subject to limit based on 100% of AGI (If line 1 is zero, enter -0- on lines 47 through 51.)			
47.	Enter the amount from line 11	47		
48.	Add lines 13, 17, 24, 30, 40, and 45	48		
49.	Subtract line 48 from line 47	49		
50.	**Deductible amount.** Enter the smaller of line 1 or line 49	50		
51.	Carryover. Subtract line 50 from line 1	51		0
	Qualified cash contributions for 2020 and qualified contributions for certain disaster relief efforts (If line 3 is zero, enter -0- on lines 52 through 56.)			
52.	Enter the amount from line 11	52	50,000	
53.	Add lines 13, 17, 24, 30, 40, 45, and 50	53	15,000	
54.	Subtract line 53 from line 52	54	35,000	
55.	**Deductible amount.** Enter the smaller of line 3 or line 54	55	2,000	
56.	Carryover. Subtract line 55 from line 3	56		0
	Deduction for the year			
57.	Add lines 13, 17, 24, 30, 40, 45, 50, and 55. Enter the total here and include the deductible amounts on Schedule A (Form 1040), line 11 or line 12, whichever is appropriate. Also, enter the amount from line 55 on the dotted line next to the line 11 entry space	57	17,000	

Note. Any amounts in the carryover column are not deductible this year but can be carried over to next year. See *Carryovers*, later, for more information about how you will use them next year.

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Carryovers

The taxpayer can carry over any contributions he or she cannot deduct in the current year because they exceed the limits based on the taxpayer's AGI. Generally, disallowed deductions carry forward 5 years. However, a disallowed qualified conservation contribution can be carried forward for 15 years. Contributions that are carried over are subject to the same percentage limits in the year to which they are carried. For example, contributions subject to the 30% limit in the year in which they are made are 30%-limit contributions in the year to which they are carried.

For each category of contributions, the taxpayer deducts carryover contributions only after deducting all allowable contributions in that category for the current year. If the taxpayer has carryovers from 2 or more prior years, he or she must use the carryover from the earlier year first. A carryover of a contribution to a 50%-limit organization must be used before current-year contributions to organizations other than 50%-limit organizations.

Example 6.12
Carryover of 50%-Limit Contributions

In 2020, Jacques Martin made an $18,000 cash contribution to his DAF, which is held by a public charity. Because of the 60%-of-AGI limit, he deducted only $10,000 in 2020 and carried over the remaining $8,000 ($18,000 – $10,000). In 2021, his AGI was $20,000, and he made an $8,000 cash contribution to the DAF. Jacques deducts the 2021 cash contribution in full because it is less than $12,000 ($20,000 × 60%-of-AGI limit). His 2020 carryover is also subject to the 60%-of-AGI limit, and he can deduct $4,000 ($12,000 60%-of-AGI limit – $8,000 current-year contribution). Jacques carries over the remaining $4,000 ($8,000 – $4,000) 2020 contribution to 2022.

PRACTITIONER NOTE

Special Carryover Rules

Special carryover rules apply to taxpayers who (1) are married in some years, but not married in others due to marriage, divorce, or death of a spouse; (2) change from a separate return to a joint return or vice versa; (3) have a net operating loss carryover; or (4) claim the standard deduction in a carryover year. See Treas. Reg. § 1.170A-10 for more information.

Partial Interest Gifts

Generally, no tax deduction is allowed for the contribution of a partial interest in property. However, there are exceptions for a remainder interest in a personal residence or farm, a contribution of an undivided portion of the taxpayer's entire interest in property, donations to certain trusts, and a qualified conservation contribution (QCC). This section discusses QCCs, life estates, and charitable remainder trusts.

Qualified Conservation Contribution

Under I.R.C. § 170(h)(1), a qualified conservation contribution (QCC) is a contribution of a qualified real property interest to a qualified organization exclusively for conservation purposes. The conservation purpose must be protected in perpetuity.

Qualified Real Property Interest

A qualified real property interest is any of the following interests in real property:

- The donor's entire interest other than a mineral interest
- A remainder interest
- A restriction (granted in perpetuity) on the use that may be made of the property (referred to in this section as a conservation easement)

[I.R.C. § 170(h)(2)]

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Qualified Organization

To be an eligible donee, an organization must be a qualified organization, have a commitment to protect the conservation purposes of the donation, and have the resources to enforce the restrictions. Generally, the following are qualified organizations:

- A community chest, corporation, trust, fund, or foundation organized or created in or under the laws of the United States, any state, the District of Columbia, or any possession of the United States (including Puerto Rico); organized and operated only for charitable, religious, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals
- Certain organizations that foster national or international amateur sports competition
- War veterans' organizations, including posts, auxiliaries, trusts, or foundations, organized in the United States or any of its possessions (including Puerto Rico)
- Domestic fraternal societies, orders, and associations operating under the lodge system
- Certain nonprofit cemetery companies or corporations
- The United States or any state, the District of Columbia, a US possession (including Puerto Rico), a political subdivision of a state or US possession, or an Indian tribal government or any of its subdivisions that perform substantial government functions

PRACTITIONER NOTE

Transfer by the Donee

The instrument of conveyance must prohibit the donee from subsequently transferring the qualified real property interest, unless the transfer requires the donee organization, as a condition of the transfer, to carry out the original conservation purpose. Also, subsequent transfers must be restricted to organizations that qualify, at the time of the subsequent transfer, as an eligible donee. If there is a later unexpected change that makes it impossible or impractical to continue to use the property for conservation purposes, the donee can sell or exchange the property and must use any proceeds in a manner that is consistent with the conservation purposes of the original contribution [Treas. Reg. § 1.170A-14(c)(2)].

Conservation Purposes

Conservation purposes are defined as

1. preserving land areas for outdoor recreation by, or the education of, the general public;
2. protecting a relatively natural habitat of fish, wildlife, or plants, or a similar ecosystem;
3. preserving open space, including farmland and forest land, if it yields a significant public benefit; or
4. preserving a historically important land area or a certified historic structure.

[I.R.C. § 170(h)(4)(A)]

Recreation or Education

The donation of a qualified real property interest to reserve land areas for the outdoor recreation of the general public or for the education of the general public is a conservation purpose. Thus, conservation purposes include, for example, the preservation of a water area for the use of the public for boating or fishing, or a nature or hiking trail for public use. The use by the general public must be substantial and regular.

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Protection of Environmental System

The donation of a qualified real property interest to protect a significant relatively natural habitat in which a fish, wildlife, or plant community, or similar ecosystem normally lives is a conservation purpose. The habitat or environment may have been altered to some extent by human activity, but the fish, wildlife, or plants must continue to exist there in a relatively natural state. For example, the preservation of a lake formed by a manmade dam or a salt pond formed by a manmade dike meets the conservation purposes test if the lake or pond is a nature feeding area for a wildlife community that includes rare, endangered, or threatened native species.

Preservation of Open Space

The donation of a qualified real property interest to preserve open space (including farmland and forest land) will meet the conservation purposes test if such preservation is

- pursuant to a clearly delineated federal, state, or local governmental conservation policy and will yield a significant public benefit; or
- for the scenic enjoyment of the general public and will yield a significant public benefit.

The following factors may be considered in determining whether a contribution made for the preservation of open space has a significant public benefit:

1. The uniqueness of the property to the area
2. The intensity of land development in the vicinity of the property
3. The consistency of the proposed open space use with public conservation programs
4. The consistency of the proposed open space use with existing private conservation programs in close proximity to the property
5. The likelihood that development of the property would lead to or contribute to degradation of the scenic, natural, or historic character of the area
6. The opportunity for the general public to use the property or to appreciate its scenic values
7. The importance of the property in preserving a local or regional landscape or resource that attracts tourism or commerce to the area
8. The likelihood that the donee will acquire equally desirable and valuable substitute property or property rights
9. The cost to the donee of enforcing the terms of the conservation restriction
10. The population density in the area of the property
11. The consistency of the proposed open space use with a legislatively mandated program identifying particular parcels of land for future protection

Significant public benefit could include the preservation of farmland pursuant to a state program for flood prevention and control or the preservation of a unique natural land formation for the enjoyment of the general public.

Historic Preservation

The donation of a qualified real property interest to preserve a historically important land area or a certified historic structure will meet the conservation purposes test. When restrictions to preserve a building or land area within a registered historic district permit future development on the site, a deduction is allowed only if the terms of the restrictions require that such development conform with appropriate local, state, or federal standards for construction or rehabilitation within the district.

Some visual public access to the donated property is required. In a historically important land area, the entire property does not have to be visible to the public for a donation to qualify. However, the public benefit from the donation may be insufficient to qualify for a deduction if only a small portion of the property is visible. Where the historic land area or certified historic structure is not visible from a public way, the terms of the easement must give the general public the opportunity to view the characteristics and features of the property on a regular basis.

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Example 6.13
Public Access to Historic Property

Anabelle Adams and her family live in a house in a certified historic district in South Carolina. The entire house, including its interior, has architectural features representing classic Victorian period architecture. Anabelle donates an exterior and interior easement on the property to a qualified organization but continues to live in the house with her family. The house is surrounded by a high stone wall that obscures the public's view of it from the street.

Pursuant to the terms of the easement, the house may be opened to the public from 10:00 a.m. to 4:00 p.m. on one Sunday in May and one Sunday in November each year for house and garden tours. These tours are to be under the supervision of the donee and open to members of the general public upon payment of a small fee. In addition, under the terms of the easement, the donee organization has the right to photograph the interior and exterior of the house and distribute such photographs to magazines, newsletters, or other publicly available publications.

The terms of the easement also permit persons affiliated with educational organizations, professional architectural associations, and historical societies to make an appointment through the donee organization to study the property. The donor is not aware of any facts indicating that the public access to be provided by the donee organization will be significantly less than that permitted by the terms of the easement.

The two opportunities for public visits per year, when combined with the ability of the general public to view the architectural characteristics and features that are the subject of the easement through photographs, the opportunity for scholarly study of the property, and the fact that the house is used as an occupied residence, satisfy the requirement for public access [Treas. Reg. § 1.170A-14(d)(5)(v), Example 1].

Exclusivity

The QCC must be used exclusively for conservation purposes. Incidental benefit to the donor does not preclude a deduction. However, a deduction is generally not allowed if the contribution would accomplish one of the conservation purposes (discussed earlier) but would permit destruction of other significant conservation interests. For example, the preservation of farmland pursuant to a state program for flood prevention and control does not qualify for a deduction if under the terms of the contribution a significant naturally occurring ecosystem could be injured or destroyed by the use of pesticides in the operation of the farm. Uses of the property, such as selective timber harvesting or selective farming, are allowed if those uses do not impair significant conservation interests.

Example 6.14
Impermissible Use

Amy Singh owns a 900-acre parcel of woodland, rolling pasture, and orchards on the crest of a mountain in West Glacier, Montana. All of the property is clearly visible from the nearby national park. Because of the strict enforcement of an applicable zoning plan, the highest and best use of the property is as a subdivision of 40-acre tracts. Amy wants to donate a scenic easement on the property to a qualifying conservation organization, but she would like to reserve the right to subdivide the property into 90-acre parcels with no more than one single-family home allowable on each parcel. Random building on the property, even as little as one home for each 90 acres, would destroy the scenic character of the view. Accordingly, no deduction is allowed for the donation of the easement [Treas. Reg. § 1.170A-14(f), Example 3].

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Enforceable in Perpetuity

Under Treas. Reg. § 1.170A-14(g), any interest in the property that the donor (and the donor's successors in interest) retains must be subject to legally enforceable restrictions (such as recording) that will prevent uses that are inconsistent with the conservation purposes of the donation. If there is a mortgage on the property, the lender must subordinate its rights in the property to the right of the qualified organization to enforce the conservation purposes of the gift in perpetuity. A negligible possibility that a remote future event could defeat the conservation interest is allowed.

Amount of the Deduction

Treas. Reg. § 1.170A-14(h) states that the value of a contribution of a perpetual conservation restriction is the FMV of the perpetual conservation restriction at the time of the contribution. If there is a substantial record of sales of easements comparable to the donated easement (such as purchases pursuant to a governmental program), the FMV of the donated easement is based on the sales prices of such comparable easements. If no substantial record of marketplace sales is available to use as a meaningful or valid comparison, as a general rule (but not necessarily in all cases) the FMV of a perpetual conservation restriction is equal to the difference between the FMV of the property it encumbers before granting the restriction and the FMV of the encumbered property after granting the restriction.

Example 6.15
Valuing a Conservation Easement

In 2021, Delma Davis donated a conservation easement on 20 acres of undeveloped land that is valued at $200,000 at its highest and best use. The FMV of the land after the donation is reduced to $110,000. Accordingly, the value of the easement, and thus the amount eligible for a deduction under section 170(f), is $90,000 ($200,000 − $110,000).

If the grant of the easement increases the value of any other property that the donor or a related person owns, the amount of the deduction for the conservation contribution must be reduced by the amount of the increase in the value of the other property. If the grant does not decrease the value of the property, the taxpayer may not be entitled to a deduction.

In *Wendell Falls Development, LLC v. Commissioner*, T.C. Memo. 2018-193, the taxpayer purchased 1,280 acres for development of a planned community. The taxpayer granted the county a conservation easement that required use of 125 acres as a park, and the taxpayer claimed a QCC deduction for the easement. The court found that the taxpayer received a substantial benefit from the easement because the park enhanced the value of the residential and commercial properties on the remaining acres. The court also found that the highest and best use of the 125 acres was for a park, so the grant did not reduce its value. The taxpayer was not entitled to a charitable contribution deduction.

Limitations on the Deduction

An individual may generally deduct a QCC up to 50% of AGI (100% for 2020 and 2021) minus the deduction for other charitable contributions. For corporations, in general, the maximum amount allowable as a charitable contribution deduction for any tax year is 10% of the corporation's taxable income for that year (25% for 2020 and 2021), computed with certain adjustments described in I.R.C. § 170(b)(2)(D).

CROSS-REFERENCE

Qualified Farmer or Rancher

An individual who is a qualified farmer or rancher may deduct up to 100% of the individual's AGI (after reduction by other contributions) for the donation of a QCC. If the donated property is used in agriculture or livestock production, the terms of the contribution must require that the property remain available for such use.

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If a taxpayer's total QCCs exceed the applicable limits, any excess amounts carry over for up to 15 years. The carryover amounts are subject to the same AGI limits in the carryover years [I.R.C. § 170(b)(1)(E)].

Substantiation

If a taxpayer makes a QCC and claims a deduction, the taxpayer must maintain the same records as with all noncash contributions but also documentation of the conservation purpose furthered by the donation. The taxpayer must report the contribution on Form 8283, Noncash Charitable Contributions. If the contribution is over $5,000, the taxpayer must complete Section B of Form 8283. Section B requires signatures of the donor, the donee organization, and the qualified appraiser, if applicable.

In *Belair Woods, LLC v. Commissioner*, T.C. Memo. 2018-159, an LLC granted a conservation easement on 141 acres of land. The LLC used an appraiser to value the easement and claimed a $4,780,000 charitable contribution deduction. The appraiser and donee qualified organization executed the Form 8283 but did not include any cost or adjusted basis of the property. The court held that the LLC did not meet the substantiation requirements and was not entitled to a charitable deduction for the transfer of the conservation easement. A similar holding was reached in *RERI Holdings I, LLC v. Commissioner*, 149 T.C. 1 (2017).

For noncash contributions in excess of $5,000, the donor must also obtain a qualified appraisal, prepared by a qualified appraiser [Treas. Reg. § 1.170A-16(d)]. For noncash contributions in excess of $500,000, the taxpayer must attach the appraisal to his or her tax return [Treas. Reg. § 1.170A-16(e)]. For a QCC of a facade of a building registered in historic districts, I.R.C. § 170(h)(4)(B)(iii)(I) requires the taxpayer to attach the appraisal to his or her tax return regardless of the amount of the deduction. The taxpayer must also attach photographs of the entire exterior of the building, and a description of all restrictions on the development of the building. If the taxpayer fails to attach a required appraisal, the taxpayer cannot claim a charitable contribution deduction.

Life Estate

With limited exceptions (including a QCC, discussed earlier and a charitable remainder trust, discussed next), the taxpayer cannot deduct a charitable contribution of less than his or her entire interest in property. Thus, a contribution of the right to use property is a contribution of less than an entire interest in that property and is generally not deductible.

However, a taxpayer can make a charitable contribution of a partial interest (not in trust) if it qualifies as an undivided portion of the donor's entire interest, a partial interest that would qualify for a deduction if it had been transferred in trust, or a remainder interest in a personal residence or farm [Treas. Reg. § 1.170A-7(b)].

Undivided Portion of Entire Interest

A deduction is allowed under section 170 for the value of a charitable contribution (not in trust) of an undivided portion of a donor's entire interest in property. An undivided portion of a donor's entire interest in property must consist of a fraction or percentage of every substantial interest or right the donor owns in such property and must extend over the entire term of the donor's interest in such property and in other property into which such property is converted.

Partial Interests Deductible in Trust

A deduction is allowed under section 170 for the value of a charitable contribution (not in trust) of a partial interest in property that is less than the donor's entire interest in the property if it would be deductible under section 170(f)(2) and Treas. Reg. § 1.170A-6 (pooled income funds and charitable remainder trusts, which are discussed later) if such interest had been transferred in trust.

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Remainder Interest in Personal Residence or Farm

A taxpayer can contribute a remainder interest in his or her personal residence or farm and retain a life estate or a term interest that allows the taxpayer to continue to use or derive income from the property. The taxpayer can deduct the value of the remainder interest that passes to the qualified beneficiary when the life estate or term interest terminates.

PRACTITIONER NOTE

Personal Residence

The term *personal residence* means any property used by the taxpayer as his or her personal residence even though it is not used as a principal residence. For example, the taxpayer's vacation home may be a personal residence. Stock owned by a taxpayer as a tenant-stockholder in a cooperative housing corporation may also qualify.

The FMV of a remainder interest in real property that is not transferred in trust must be determined in accordance with section 170(f)(4) and Treas. Reg. § 1.170A-12. Section 170(f)(4) provides that in determining the value of a remainder interest in real property for purposes of section 170, depreciation and depletion of such property shall be taken into account.

If the remainder interest follows only one life, the value is generally determined under Treas. Reg. § 20.2031-7 using the I.R.C. § 7520 interest rate and Table S life contingencies prescribed for the date of the gift. If the remainder interest follows a term for years, the value of the remainder interest is generally determined under Treas. Reg. § 25.2512-5 using Table B in Treas. Reg. § 20.2031-7(d)(6). The actuarial tables are at www.irs.gov/retirement-plans/actuarial-tables. If the remainder interest is dependent on the continuation or the termination of more than one life or upon a term that is concurrent with one or more lives, the value is generally determined with a special factor [See Treas. Reg. § 1.170A-12(e)].

Example 6.16
Contribution of a Remainder Interest

On March 3, 2021, Andy Narwhal, age 67, gave a remainder interest in his personal residence to a local charitable organization and retained a life estate that allows him to live in the residence for the remainder of his life. The section 7520 interest rate in March 2021 was 0.8%. The house had a $1,000,000 FMV at the time of the gift. **Figure 6.2** shows a portion of Table S.

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FIGURE 6.2
Table S Interest at 0.8%

Age	Annuity	Estate	Remainder	Age	Annuity	Estate	Remainder
0	56.5967	0.45277	0.54723	55	22.6843	0.18147	0.81853
1	56.4452	0.45156	0.54844	56	22.0149	0.17612	0.82388
2	55.9252	0.44740	0.55260	57	21.3502	0.17080	0.82920
3	55.3912	0.44313	0.55687	58	20.6911	0.16553	0.83447
4	54.8482	0.43879	0.56121	59	20.0370	0.16030	0.83970
5	54.2986	0.43439	0.56561	60	19.3876	0.15510	0.84490
6	53.7429	0.42994	0.57006	61	18.7435	0.14995	0.85005
7	53.1826	0.42546	0.57454	62	18.1059	0.14485	0.85515
8	52.6166	0.42093	0.57907	63	17.4754	0.13980	0.86020
9	52.0449	0.41636	0.58364	64	16.8521	0.13482	0.86518
10	51.4681	0.41174	0.58826	65	16.2357	0.12989	0.87011
11	50.8861	0.40709	0.59291	66	15.6221	0.12498	0.87502
12	50.2993	0.40239	0.59761	67	15.0128	0.12010	0.87990
13	49.7098	0.39768	0.60232	68	14.4096	0.11528	0.88472
14	49.1195	0.39296	0.60704	69	13.8139	0.11051	0.88949

At age 67, the remainder interest factor from Table S is 0.87990. The value of the gifted remainder interest is therefore $879,900 ($1,000,000 × 0.87990).

Charitable Remainder Trust

Charitable remainder trusts (CRT) are irrevocable split-interest trusts. A noncharitable beneficiary receives a stream of income for the duration of the trust (life or a term that does not exceed 20 years), and a designated charity receives the remaining trust assets upon termination. Charitable remainder trusts can be either annuity trusts or unitrusts, depending on the method used to calculate the payment amounts.

A charitable remainder annuity trust (CRAT) is a charitable remainder trust in which the income payments to the noncharitable beneficiary are fixed. The trustee(s) calculate the payment amount by multiplying the designated percentage by the fair market value of the assets initially placed in the trust. A charitable remainder unitrust (CRUT) is a charitable remainder trust in which the income payments to the noncharitable beneficiary fluctuate with the FMV of the assets in the trust. The trustee(s) calculate the payment amount by multiplying the designated percentage by the FMV of the assets as they are valued each year.

The grantor receives an immediate income tax deduction for the present actuarial value of the remainder interest that will pass to the charity. Income paid to the CRUT noncharitable beneficiaries is generally taxable [I.R.C. § 664(b)]. Income generated by the trust is generally not taxable to the trust [I.R.C. § 664(c)(1)], except that the trust may be liable for an excise tax on unrelated business taxable income (UBTI) [I.R.C. §§ 664(c)(2) and 512]. If the grantor is the income beneficiary, and the grantor dies before the end of the trust term, a portion of the value of the trust is included in the grantor's estate because of the retained income interest [I.R.C. § 2036]. The estate has an offsetting charitable deduction for the balance of trust assets passing to charity [I.R.C. § 2055].

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Reporting Charitable Deductions

Qualifying donations are subject to different reporting requirements based on the type and amount of donation. Individual taxpayers report charitable contributions on Schedule A (Form 1040), Itemized Deductions. For 2021, taxpayers who do not itemize deductions can claim a $300 ($600 MFJ) above-the-line charitable contribution deduction (for a cash contribution) on Form 1040, U.S. individual Income Tax Return, line 10b, or on Form 1040-SR, U.S. Tax Return for Seniors, line 10b.

Form 8283

Taxpayers must also report noncash charitable contributions that exceed $500 on Form 8283, Noncash Charitable Contributions. If the deduction is over $5,000, the taxpayer must complete Section B of Form 8283. Section B requires signatures of the donor, the donee organization, and the qualified appraiser, if applicable. If the deduction is more than $500,000, the taxpayer must typically attach a qualified appraisal to the tax return (see the earlier discussion of when a qualified appraisal is not required). The IRS may disallow the deduction for a noncash charitable contribution if it is more than $500 and the taxpayer does not submit Form 8283 with his or her return.

Form 8282

A donee organization must file Form 8282, Donee Information Return, if, within 3 years of receiving property for which it was required to sign a Form 8283, it sells, exchanges, consumes, or otherwise disposes of the property. The organization must also send the donor taxpayer a copy of Form 8282. The donee organization does not have to file Form 8282 to report the sale of an item if the donee taxpayer signed a statement on Section B of Form 8283 stating that the appraised value of the item, or a specific item within a group of similar items, was $500 or less. For this purpose, all shares of nonpublicly traded stock or securities, or items that form a set (such as a collection of books written by the same author) are treated as one item. The organization does not have to file Form 8282 if it consumed or distributed the donated property, without consideration, in fulfilling the organization's purpose or function as a tax-exempt organization [Treas. Reg. § 1.170A-13(a)].

Form 5227

A section 664 CRT does not file Form 1041, U.S. Income Tax Return for Estates and Trusts. Instead, a CRT files Form 5227, Split-Interest Trust Information Return. If the CRT has any unrelated business taxable income, it also must file Form 4720, Return of Certain Excise Taxes Under Chapters 41 and 42 of the Internal Revenue Code.

Tax Planning with Charitable Contributions

The Tax Cuts and Jobs Act of 2017 (TCJA), Pub. L. No. 115-97, significantly increased the standard deduction and made some changes that limit a taxpayer's itemized deductions. As a result, many taxpayers who formerly itemized deductions may find it more advantageous to claim the standard deduction, which for 2021 is $25,100 for MFJ and surviving spouses, $18,800 for head of household, and $12,550 for single and MFS taxpayer (indexed for inflation in later years). Certain taxpayers who do not typically itemize deductions can benefit from making a charitable contribution if the contribution is structured as a contribution to a donor advised fund or a qualified charitable distribution.

Contribution to a Donor Advised Fund

I.R.C. § 4966(d)(2) defines a *donor advised fund* as

1. a fund or account owned and controlled by a sponsoring organization,
2. that is separately identified by reference to contributions of the donor or donors, and
3. where the donor (or a person appointed or designated by the donor) has or reasonably expects to have advisory privileges over the distribution or investments of the assets.

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Generally, a donor advised fund (DAF) is a separately identified fund or account that is maintained and operated by an I.R.C. § 501(c)(3) organization, which is called a sponsoring organization. Each account is composed of contributions made by individual donors. The donor makes the contribution to the DAF, and the sponsoring organization has legal control over the donation. However, the donor, or the donor's representative, retains advisory privileges with respect to the distribution of the funds. Thus, a taxpayer can make a large deductible contribution to a DAF, receive the deduction in the year the contribution is made, and retain the right to direct future distributions from the DAF to qualified charities.

Example 6.17
Deduction for Contribution to DAF

Sam and Winona Watson file a joint return. The Watsons typically pay $5,000 in state and local taxes and make a $15,000 charitable contribution each year. **Figure 6.3** shows their 2019, 2020, and 2021 deductions claiming the standard deduction, and **Figure 6.4** shows their deductions with a $45,000 contribution to a DAF in 2019, and no contributions in 2020 and 2021. The DAF can then make their annual charitable contribution.

FIGURE 6.3
Sam and Winona Watson's Deductions—Standard Deduction

	2019	2020	2021	3-Year Total
Standard deduction	$24,400	$24,800	$25,100	$74,300
Above-the-line charitable contribution deduction	0	300	600	900
Total deductions	$24,400	$25,100	$25,700	$75,200

FIGURE 6.4
Sam and Winona Watson's Deductions—DAF Contribution

	2019	2020	2021	3-Year Total
Itemized deductions*	$50,000	$0	$0	$50,000
Standard deduction	0	24,800	25,100	49,900
Total deductions	$50,000	$24,800	$25,100	$99,900

*$5,000 state and local taxes plus $45,000 DAF contribution

Their $99,100 ($50,000 + $24,800 + $25,100) total deductions with the DAF contribution exceed their $75,200 ($24,400 + $25,100 + $25,700) deductions without the contribution by $23,900 ($99,100 – $75,200).

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Qualified Charitable Distributions

A qualified charitable distribution (QCD) is a distribution that goes directly from an IRA to a qualified charity. It is sometimes referred to as an IRA rollover. The distribution satisfies the requirement to take a required minimum distribution (RMD) for a taxpayer who is age 72 or over.

A QCD allows an IRA owner who is at least age 70½ to distribute up to $100,000 from the IRA directly to a charity without having to claim the distribution in taxable income. Although the owner does not receive a charitable contribution deduction, the owner does not have a taxable distribution. The exclusion is available only to the extent the owner would have otherwise had to include the distribution in taxable income.

A taxpayer who does not have sufficient itemized deductions to claim a charitable contribution deduction can use a QCD to make a charitable contribution and reduce AGI below the threshold for certain deductions, credits, exclusions, and other tax and nontax benefits. Some of the benefits of a QCD include the following:

1. The contribution reduces overall AGI (because the taxpayer would otherwise have a taxable distribution), which decreases federal income taxes.
2. Decreasing AGI could make the taxpayer eligible for higher deductions and credits.
3. Decreasing AGI could decrease Medicare premiums.
4. Decreasing AGI could decrease the taxable portion of social security benefits.
5. The taxpayer can benefit from a charitable contribution, even if he or she does not itemize deductions or the taxpayer's deductions exceed the contribution base.

PLANNING POINTER

Charitable Beneficiaries

If an IRA owner has specified bequests to charitable beneficiaries in his or her estate plan, it may be preferable to fund those bequests from an IRA. The owner can designate the charity as a full or partial beneficiary of the IRA. Unlike an individual beneficiary, who must pay tax on distributions, distributions to the charity are generally not taxable.

PRACTITIONER NOTE

IRA Contributions

The SECURE Act repeals the maximum age for contributions to an IRA and provides that the excludable amount of a QCD for a tax year is reduced by the aggregate amount of IRA contributions deducted for the tax year and any earlier tax years in which the individual was age 70½ or older by the last day of the year (post-age 70½ contributions). The excludable amount of QCDs for a tax year is not reduced by the amount of post-age 70½ contributions that caused a reduction in the excludable amount of QCDs for earlier tax years.

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ISSUE 2: REMODELING A RESIDENCE Taxpayers may claim an energy credit for qualifying home improvements.

In 2021, home prices broke records, and there was increased demand for home remodels. The I.R.C. § 121 exclusion (see Issue 3 of this chapter) is not adjusted for inflation. This section discusses which home improvements increase basis. It also reviews energy tax credits for certain home improvements.

Additions to Basis

Under the I.R.C. § 1016 general rule, the cost or other basis of a residence is increased by improvements and betterments. On the contrary, repair expenditures that do not add much to the value, utility, or the life of the property and instead keep the property in good condition are not added to basis. In *Plainfield-Union Water Co. v. Commissioner*, 39 T.C. 333 (1962), the court stated that an expenditure that returns property to the state it was in before the situation prompting the expenditure arose, and that does not make the property more valuable, more useful, or longer-lived, is usually deemed a repair. **Figure 6.5** compares improvements with repairs and other expenditures that do not increase basis.

The taxpayer can add repair-type work to basis if it is done as part of an extensive remodeling or restoration job. For example, repainting the bathroom is a repair, but painting as part of an extensive bathroom remodel is an improvement.

FIGURE 6.5
Improvements vs. Repairs

Improvement	Repairs
Adding another room (such as a bathroom or bedroom)	Redecorating a room
Adding a deck	Restaining the deck
Landscaping	Lawn mowing and weed removal
Putting on a new roof	Replacing damaged shingles
Installing a new heating or cooling system	Maintaining or repairing an existing heating or cooling system
Paving the driveway	Filling in cracks in the pavement
Putting in new windows	Replacing a broken windowpane
Painting done while remodeling the kitchen	Repainting the kitchen
Installing a built-in oven	Buying a countertop microwave
Installing a security system	Security system monitoring
New siding	Replacing worn siding pieces
Installing a fireplace	Chimney cleaning
Putting in new doors	Replacing broken door hardware

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CROSS-REFERENCE

Casualty Losses

If a home is damaged from a casualty, repairs that restore the property to its precasualty condition typically increase basis. See pages 302–315 in the *2020 National Income Tax Workbook* for a discussion of casualty losses.

Residential Energy Credits

This section explains three credits for residential energy improvements. It reviews the nonbusiness energy property credit, the residential energy efficient property credit, and the new energy efficient home credit.

I.R.C. § 25C Nonbusiness Energy Property

An individual is allowed an income tax credit that is equal to the sum of

1. 10% of the amount paid or incurred by the taxpayer for qualified energy efficiency improvements installed during the tax year, and
2. the amount of the residential energy property expenditures paid or incurred by the taxpayer during the tax year.

The Taxpayer Certainty and Disaster Tax Relief Act of 2020 (TCDTRA), Pub. L. No. 116-260, § 141 extends the section 25C nonbusiness energy property credit through 2021. The credit is nonrefundable and cannot be carried forward.

Limitations

There is a lifetime limitation on the credit, and the credit is limited to $500 for all tax years ending after December 31, 2005. For exterior windows (including skylights), the limitation amount is $200. There is also a limitation on the credit for residential energy property expenditures. The amount of the credit cannot exceed

- $50 for any advanced main air circulating fan;
- $150 for any qualified natural gas, propane, or oil furnace or hot water boiler; and
- $300 for any item of energy-efficient building property.

Qualified Energy Efficiency Improvements

The term *qualified energy efficiency improvements* means any energy efficient building envelope component, if such component is installed in or on a dwelling unit (which includes a house, houseboat, mobile home, cooperative apartment, condominium, and certain manufactured homes) located in the United States and owned and used by the taxpayer as the taxpayer's principal residence (within the meaning of I.R.C. § 121). The original use of the component must commence with the taxpayer, and the component must reasonably be expected to remain in use for at least 5 years.

The term *energy efficient building envelope component* means a building envelope component that meets the following:

- Roof or roof products must meet applicable Energy Star program requirements.
- An exterior window, door, or skylight must meet version 6.0 Energy Star program requirements.
- Other components must meet the prescriptive criteria for such component established by the 2009 International Energy Conservation Code, as such code (including supplements) is in effect on the date of the enactment of the American Recovery and Reinvestment Tax Act of 2009, Pub. L. No. 111-5.

The term *building envelope component* means

- any insulation material or system that is specifically and primarily designed to reduce the heat loss or gain of a dwelling unit when installed in or on the dwelling unit;
- exterior windows (including skylights);
- exterior doors; and
- any metal roof or asphalt roof installed on a dwelling unit, but only if such roof has appropriate pigmented coatings or cooling granules that are specifically and primarily designed to reduce the heat gain of the dwelling unit.

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Residential Energy Property Expenditures

Residential energy property expenditures are expenditures made by the taxpayer for qualified energy property that is installed on or in connection with a dwelling unit located in the United States and owned and used by the taxpayer as the taxpayer's principal residence (within the meaning of section 121), and originally placed in service by the taxpayer. They include labor costs that are properly allocable to the onsite preparation, assembly, or original installation of the property.

Qualified energy property is any energy-efficient building property; a qualified natural gas, propane, or oil furnace or hot water boiler; or an advanced main air circulating fan that must meet certain performance and quality standards. *Energy-efficient building property* means the following:

1. An electric heat pump water heater that yields a Uniform Energy Factor of at least 2.2 in the standard Department of Energy test procedure
2. An electric heat pump that achieves the highest efficiency tier established by the Consortium for Energy Efficiency, as in effect on January 1, 2009
3. A central air conditioner that achieves the highest efficiency tier established by the Consortium for Energy Efficiency, as in effect on January 1, 2009
4. A natural gas, propane, or oil water heater that has either a Uniform Energy Factor of at least 0.82 or a thermal efficiency of at least 90%
5. A stove that uses the burning of biomass fuel (plant derived fuel that is renewable or recurring, such as crops and trees) to heat a dwelling unit located in the United States and used as a residence by the taxpayer, or to heat water for use in such a dwelling unit, and that has a thermal efficiency rating of at least 75% (eliminated for tax years beginning after December 31, 2020, and replaced by a credit for biomass fuel property in section 25D)

PRACTITIONER NOTE

Timing of Expenditure

For purposes of the nonbusiness energy credit and the residential energy efficient property credit (discussed later), generally, an expenditure is made when the original installation of the item is completed. However, for an expenditure in connection with the construction or reconstruction of a structure, the expenditure is treated as made when the taxpayer begins the original use of the constructed or reconstructed structure [I.R.C. § 25D(e)(8)].

Basis Adjustments

If the taxpayer claims a nonbusiness energy property credit, the amount of the credit reduces the increase in the basis of the property that would result from the expenditure for which the credit is claimed.

PRACTITIONER NOTE

Energy Subsidies

For purposes of determining the expenditures made under section 25C, the taxpayer cannot include expenditures that are made from subsidized energy financing [as defined in I.R.C. § 48(a)(4)(C)].

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I.R.C. § 25D Residential Energy Efficient Property Credit

An individual is allowed an income tax credit for a percentage of the following expenditures:

1. Qualified solar electric property expenditures
2. Qualified solar water heating property expenditures
3. Qualified fuel cell property expenditures (subject to a special $500 limitation)
4. Qualified small wind energy property expenditures
5. Qualified geothermal heat pump property expenditures
6. Qualified biomass fuel property expenditures

LAW CHANGE

Biomass Fuel Property

The Taxpayer Certainty and Disaster Tax Relief Act of 2020 (TCDTRA) § 148 added qualified biomass fuel property expenditures to the list of expenditures that qualify for the credit. That term means property that uses the burning of biomass fuel to heat a dwelling unit located in the United States and used as a residence by the taxpayer, or to heat water for use in such a dwelling unit, and that has a thermal efficiency rating of at least 75% (measured by the higher heating value of the fuel). Biomass fuel means any plant-derived fuel available on a renewable or recurring basis. The provision is effective for tax years beginning after December 31, 2020.

Amount of the Credit

A taxpayer can claim the following percentages of eligible expenditures:

- 30% for property placed in service after December 31, 2016, and before January 1, 2020
- 26% for property placed in service after December 31, 2019, and before January 1, 2023
- 22% for property placed in service after December 31, 2022, and before January 1, 2024

There is currently no credit for property placed in service after December 31, 2023. The credit is nonrefundable, but unused amounts can be carried forward. As with the nonbusiness energy credit, there is no basis increase to property for which a credit is claimed.

Form 5695

Taxpayers use Form 5695, Residential Energy Credits, to claim the residential energy efficient property credit (Part I) and the nonbusiness energy property credit (Part II).

Example 6.18
Claiming the Residential Energy Efficient Property Credit

Mary and Gary Jefferson remodeled their home in 2021. They purchased and installed an energy efficient wood burning stove. The stove cost $4,500, and they paid $1,000 for installation. **Figure 6.6** shows the technical data for the stove.

FIGURE 6.6
The Jeffersons' Stove Specifications

TECHNICAL DATA:		
HEAT		
BTu output	27	kBTU
Heat range (min-max)	12–27	kBTU
Heating capacity (25-68 degrees F)	1000+	sq.ft.
Emissions	1.1	g/hr
Efficiency	78	%

The stove has a thermal efficiency rating of 78%. Mary and Gary can claim a residential energy efficient property credit equal to 26% of the $5,500 ($4,500 + $1,000) cost of the stove and installation. **Figure 6.7** shows a portion of their Form 5695. Figure 6.7 shows the 2020 form because the 2021 form was not available at the time of this publication. The 2020 form does not show the addition of biomass fuel property as eligible property.

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FIGURE 6.7
The Jeffersons' Form 5695

Form **5695**
Department of the Treasury
Internal Revenue Service

Residential Energy Credits

► Go to *www.irs.gov/Form5695* for instructions and the latest information.
► Attach to Form 1040, 1040-SR, or 1040-NR.

OMB No. 1545-0074
2020
Attachment Sequence No. **158**

Name(s) shown on return: Mary and Gary Jefferson

Your social security number: X X X X X X X X X

Part I **Residential Energy Efficient Property Credit** (See instructions before completing this part.)

Note: Skip lines 1 through 11 if you only have a **credit carryforward from 2019.**

1	Qualified solar electric property costs	1	5,500
2	Qualified solar water heating property costs	2	
3	Qualified small wind energy property costs	3	
4	Qualified geothermal heat pump property costs	4	
5	Add lines 1 through 4	5	5,500
6	Multiply line 5 by 26% (0.26)	6	1,430

6

LAW CHANGE

Commercial Building Improvements

The TCDTRA makes permanent the deduction for energy efficiency improvements to a building envelope, lighting, heating, cooling, ventilation, and hot water systems of commercial buildings. It updates the ASHRAE Reference Standard 90.1 from the 2007 standard to the most recent standard as of 2 years before the start of construction, and it also indexes the $1.80-per-square-foot limitation for inflation.

Figure 6.8 compares the section 25C and 25D credits. See Notice 2013-70, 2013-47 I.R.B. 528, for additional guidance on these credits.

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FIGURE 6.8
Comparison of Section 25C and Section 25D Credits

	Section 25C	Section 25D
Amount of the credit	10% of qualified energy efficiency improvements Residential energy property expenditures	26% of eligible expenditures for 2021
Refundable credit	No	No
Excess carries forward	No	Yes
Lifetime limit	$500 ($200 for windows)	No
Dollar limits	$50 for any advanced main air circulating fan $150 for any qualified natural gas, propane, or oil furnace or hot water boiler $300 for any item of energy-efficient building property	No
Claim for new construction	No (addition or renovation to existing allowed)	Yes
Claim for second home	No	Yes, except fuel cell
Labor included	Includes costs for onsite preparation, assembly, original installation. Not building envelope component	Includes costs for onsite preparation, assembly, or original installation, piping and wiring to connect to dwelling unit
IRS form to claim credit	Form 5695	Form 5695

I.R.C. § 45L Energy-Efficient Home Credit

The new energy-efficient home credit is a credit for a qualified new energy-efficient home that is constructed by an eligible contractor that the taxpayer acquired from the eligible contractor for use as a residence. The credit amount is $2,000 for certain dwelling units (including manufactured homes), and $1,000 for manufactured homes that meet less stringent energy efficiency standards. The credit amount reduces basis. TCDTRA § 146 extends the section 45L(g) credit to homes acquired in 2021.

An *eligible contractor* is the person who constructed the qualified new energy efficient home or, for a manufactured home, the manufactured home producer. *Qualified new energy-efficient home* means a newly constructed dwelling unit located in the United States. The dwelling unit must meet certain energy saving requirements and standards.

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ISSUE 3: EXCLUSION OF GAIN ON THE SALE OF A PRINCIPAL RESIDENCE

This section reviews the rules for exclusion of gain on the sale of a taxpayer's principal residence.

A taxpayer's principal residence is a personal capital asset. If it is sold at a loss, it is a nondeductible personal loss. If it is sold at a gain, it is a capital gain subject to tax at the preferential capital gains rates. However, I.R.C. § 121 provides an exclusion of gain on the sale of a principal residence. The maximum exclusion amount is $250,000 ($500,000 MFJ).

Ownership and Use Tests

To exclude gain under section 121, the taxpayer must meet the following three requirements:

1. The taxpayer must have owned the home for 2 or more of the previous 5 years. If the taxpayers file a joint return, only one spouse must satisfy this ownership test.
2. The taxpayer must have used the home as his or her principal residence for 2 or more of the previous 5 years. If the taxpayers file a joint return, both spouses must meet the use test.
3. At least 2 years must have elapsed since the last sale for which the taxpayer used the exclusion. If the taxpayers file a joint return, neither spouse may have used the exclusion for a sale within the last 2 years.

PRACTITIONER NOTE

Individual Ownership

Homes owned by partnerships, multimember LLCs, and corporations do not meet the ownership requirements for the individual taxpayer even if the only two owners of the entity are husband and wife. However, ownership in a cooperative housing corporation and ownership by a single-member LLC treated as a disregarded entity or a grantor trust may qualify.

If spouses do not meet all three of the exclusion criteria, they must calculate an exclusion of up to $250,000 separately for each spouse. Both spouses are treated as owning the home during the time that either spouse owned it.

The ownership and use tests are applied, in aggregate, to the 5 years ending on the date of the sale, and may be satisfied during nonconcurrent periods. Short, temporary absences are included in the use test.

PRACTITIONER NOTE

Suspension of 5-Year Test

Taxpayers may choose to suspend the 5-year test period during any time that either the taxpayer or his or her spouse serves on qualified official extended duty as a member of the uniformed services or Foreign Service of the United States, as an employee of the intelligence community, or serves outside the United States as an employee of the Peace Corps. It may also be suspended while the taxpayer or his or her spouse serves outside the United States as a Peace Corps volunteer. The 5-year period cannot be extended for more than 10 years.

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Use as a Principal Residence

A taxpayer's residence may include a houseboat, a house trailer, or the house or apartment that the taxpayer is entitled to occupy as a tenant-stockholder in a cooperative housing corporation [Treas. Reg. § 1.121-1(b)(1)].

If a taxpayer uses more than one property as a residence, whether a property is used by the taxpayer as the taxpayer's principal residence depends on all the facts and circumstances. The property that the taxpayer uses a majority of the time during the year ordinarily will be considered the taxpayer's principal residence. Relevant factors in determining a taxpayer's principal residence include, but are not limited to, the following:

1. The taxpayer's place of employment
2. The principal place of abode of the taxpayer's family members
3. The address listed on the taxpayer's federal and state tax returns, driver's license, automobile registration, and voter registration card
4. The taxpayer's mailing address for bills and correspondence
5. The location of the taxpayer's banks
6. The location of religious organizations and recreational clubs with which the taxpayer is affiliated

[Treas. Reg. § 1.121-1(b)(2)]

OBSERVATION

Divorced Taxpayers

An individual who owns a residence is considered to use it as a personal residence if the spouse or former spouse is using the residence as a result of a separation or divorce instrument.

Sale of Vacant Land Adjacent to Principal Residence

Vacant land that the taxpayer has owned and used as part of the principal residence qualifies for the exclusion if the sale of the principal residence occurs within 2 years before or after the sale of the land. The vacant land must be adjacent to the residence, and the sale of the vacant land must also meet the other section 121 requirements.

Example 6.19
Sale of Adjacent Land

In 2015, Penelope Peabody purchased a home for $150,000, and an adjacent parcel of land for $50,000. She has owned and used the home as her principal residence since the purchase. She uses the land for her garden, yard, and storage shed. On February 15, 2021, Penelope sold the home to one buyer for $250,000. On October 10, 2021, she sold the land to a different buyer for $100,000. Penelope may exclude the entire $150,000 [($250,000 + $100,000) – ($150,000 + $50,000)] gain under section 121.

Exceptions to 2-Year Tests

A reduced maximum exclusion is allowed if the taxpayer fails to meet one of the 2-year tests because of a change in employment, health, or unforeseen circumstances [Treas. Reg. § 1.121-3]. The reduced exclusion is available if these changes apply to the taxpayer, the taxpayer's spouse, a co-owner of the home, anyone else for whom the home was his or her residence, and certain relatives of these persons (all referred to as the *taxpayer* in this discussion).

Certain safe harbors (discussed next) are deemed to be because of a change in employment, health, or unforeseen circumstances. If a safe harbor does not apply, then the reason for not meeting the test depends on all the facts and circumstances, including, but not limited to the following:

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1. Whether the sale or exchange and the circumstances giving rise to the sale or exchange are proximate in time
2. Whether the suitability of the property as the taxpayer's principal residence materially changed
3. Whether the taxpayer's financial ability to maintain the property is materially impaired
4. Whether the taxpayer uses the property as the taxpayer's residence during the period of the taxpayer's ownership of the property
5. Whether the circumstances giving rise to the sale or exchange were not reasonably foreseeable when the taxpayer began using the property as the taxpayer's principal residence
6. Whether the circumstances giving rise to the sale or exchange occur during the period of the taxpayer's ownership and use of the property as the taxpayer's principal residence

Work-Related Move

A sale or exchange is because of a change in the place of employment if the following two criteria are met:

- The change in the place of work occurs during the time that the taxpayer owned and used the residence as his or her principal residence.
- The taxpayer took a new job in a work location that is at least 50 miles farther from the home than the former work location or, if there was no former work location, the taxpayer began a new job that is at least 50 miles from the home.

Health-Related Move

A sale or exchange is deemed to be made for health if a physician recommends a change of residence for health reasons.

Example 6.20
Move for Health Reasons

Babs Obi has chronic asthma. She purchased a house in Minnesota in 2020 that she uses as her principal residence. Her doctor told Babs that moving to a warm, dry climate would mitigate her asthma symptoms. In 2021, Babs sold her house and moved to Arizona to relieve her asthma symptoms. The sale is within the safe harbor for a health-related move, and Babs can claim a reduced maximum exclusion amount under section 121(c)(2) [Treas. Reg. § 1.121-3(d)(3), Example 4].

Unforeseeable Events

A sale or exchange is deemed to be by reason of unforeseen circumstances if any of the following events occur during the period that the taxpayer owns and uses the residence as the taxpayer's principal residence:

- An involuntary conversion of the home
- A natural or manmade disaster or an act of terrorism resulted in a casualty to the residence
- The taxpayer, spouse, a co-owner of the home, anyone else for whom the home was his or her residence, or certain relatives
  - died;
  - ceased employment and became eligible for unemployment compensation;
  - became unable, because of a change in employment or self-employment status, to pay housing costs and reasonable basic living expenses for the household (including expenses for food, clothing, medical expenses, taxes, transportation, court-ordered payments, and expenses reasonably necessary for making an income);
  - became divorced or legally separated; or
  - gave birth to two or more children from the same pregnancy.

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Calculating the Reduced Exclusion Amount

The reduced exclusion is equal to the $250,000 ($500,000 MFJ) maximum exclusion multiplied by a fraction. The denominator is 730 days or 24 months. The numerator is the least of

1. the time that the taxpayer owned the property during the 5-year period ending on the date of sale,
2. the time that the taxpayer used the property as his or her principal residence during the 5-year period ending on the date of the sale, or
3. the time between the date of the most recent prior sale to which the exclusion applied and the date of the current sale.

Example 6.21
Reduced Exclusion Amount

Gerald and Emily Haven bought their North Carolina principal residence on October 1, 2020, for $200,000. On August 1, 2021, they sold the residence for $350,000 and moved to Kansas for Gerald's new job. They realized a $150,000 ($350,000 — $200,000) gain on the sale. They can exclude up to $208,333 [$500,000 × (10 months ÷ 24 months)] gain and do not have any taxable income on the sale.

Sale of Home by Surviving Spouse

If the taxpayer's spouse died before the sale or exchange, the surviving spouse can still exclude up to $500,000 of gain if

- the sale or exchange is no later than 2 years after the spouse's death;
- at the time of the spouse's death, both spouses met the use requirement, at least one spouse met the ownership requirement, and neither spouse had used the section 121 exclusion within the last 2 years; and
- the surviving spouse did not remarry before the sale or exchange.

[I.R.C. § 121(b)(4)]

Sale of Residence by Unmarried Co-Owners

Unmarried co-owners of a house must maintain records of the expenses they incurred to purchase the property, and expenses for improvements that increased basis. The owners must separately calculate their gain and apply their section 121 exclusions.

Example 6.22
Co-Owner Sale of Residence

Brenda Toth and Chip Taylor are not married, but they reside together. In 2013, they purchased a home for $150,000 at a foreclosure sale, each paying $75,000 ($150,000 ÷ 2) of the purchase price. Brenda paid $120,000 to remodel the home, and Chip provided most of the labor. The home was their principal residence for the entire time. In 2021, they sold the house for $660,000. Brenda has a $135,000 [($660,000 ÷ 2) – ($75,000 + $120,000)] gain, and Chip has a $255,000 [($660,000 ÷ 2) – $75,000] gain.

Brenda's $135,000 gain is fully excluded under section 121. She does not have to report the sale because she did not receive a Form 1099-S, Proceeds From Real Estate Transactions. Chip can exclude $250,000 of the gain under section 121 and must pay tax on the remaining $5,000 ($255,000 – $250,000) gain.

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Brenda and Chip separately report the sale. **Figure 6.9** shows a portion of Chip's Form 8949, Sales and Other Dispositions of Capital Assets, Part II (Long-Term). He reports the exclusion with code "H" in column (f). He also reports the $5,000 gain on line 10 of Schedule D (Form 1040), Capital Gains and Losses. Figure 6.9 shows the 2020 form because the 2021 form was not available at the time of this publication.

FIGURE 6.9
Chip Taylor's Form 8949

Form **8949**
Department of the Treasury
Internal Revenue Service

Sales and Other Dispositions of Capital Assets

► Go to *www.irs.gov/Form8949* for instructions and the latest information.
► File with your Schedule D to list your transactions for lines 1b, 2, 3, 8b, 9, and 10 of Schedule D.

OMB No. 1545-0074
2020
Attachment Sequence No. **12A**

Name(s) shown on return	Social security number or taxpayer identification number
Chip Taylor	XXX-XX-XXXX

Before you check Box A, B, or C below, see whether you received any Form(s) 1099-B or substitute statement(s) from your broker. A substitute statement will have the same information as Form 1099-B. Either will show whether your basis (usually your cost) was reported to the IRS by your broker and may even tell you which box to check.

Form 8949 (2020) Attachment Sequence No. **12A** Page **2**

Name(s) shown on return. Name and SSN or taxpayer identification no. not required if shown on other side	Social security number or taxpayer identification number

Before you check Box D, E, or F below, see whether you received any Form(s) 1099-B or substitute statement(s) from your broker. A substitute statement will have the same information as Form 1099-B. Either will show whether your basis (usually your cost) was reported to the IRS by your broker and may even tell you which box to check.

Part II **Long-Term.** Transactions involving capital assets you held more than 1 year are generally long-term (see instructions). For short-term transactions, see page 1.

Note: You may aggregate all long-term transactions reported on Form(s) 1099-B showing basis was reported to the IRS and for which no adjustments or codes are required. Enter the totals directly on Schedule D, line 8a; you aren't required to report these transactions on Form 8949 (see instructions).

You *must* check Box D, E, *or* F below. Check only one box. If more than one box applies for your long-term transactions, complete a separate Form 8949, page 2, for each applicable box. If you have more long-term transactions than will fit on this page for one or more of the boxes, complete as many forms with the same box checked as you need.

- ☐ **(D)** Long-term transactions reported on Form(s) 1099-B showing basis was reported to the IRS (see **Note** above)
- ☐ **(E)** Long-term transactions reported on Form(s) 1099-B showing basis **wasn't** reported to the IRS
- ☑ **(F)** Long-term transactions not reported to you on Form 1099-B

1 (a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold or disposed of (Mo., day, yr.)	(d) Proceeds (sales price) (see instructions)	(e) Cost or other basis. See the **Note** below and see *Column (e)* in the separate instructions	Adjustment, if any, to gain or loss. If you enter an amount in column (g), enter a code in column (f). See the separate instructions. (f) Code(s) from instructions	(g) Amount of adjustment	(h) Gain or (loss). Subtract column (e) from column (d) and combine the result with column (g)
One-half undivided interest in personal residence	07/1/2013	07/01/2021	330,000	75,000	H	(250,000)	5,000
2 Totals. Add the amounts in columns (d), (e), (g), and (h) (subtract negative amounts). Enter each total here and include on your Schedule D, **line 8b** (if **Box D** above is checked), **line 9** (if **Box E** above is checked), or **line 10** (if **Box F** above is checked) ►			330,000	75,000		(250,000)	5,000

Note: If you checked Box D above but the basis reported to the IRS was incorrect, enter in column (e) the basis as reported to the IRS, and enter an adjustment in column (g) to correct the basis. See *Column (g)* in the separate instructions for how to figure the amount of the adjustment.

Form **8949** (2020)

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Sale of Residence with Business Use

Business use of a portion of the residence may affect the calculation of gain or loss on the sale of the residence. The tax treatment depends on whether the space used for business purposes was within the living area or was a separate building.

Business Use within the Living Area

If the part of the taxpayer's property used for business is within the living area of the home, such as a home office, the taxpayer does not have to allocate gain on the sale of the property between the business part of the property and the residential part of the property. However, the taxpayer cannot apply the section 121 exclusion to the part of any gain equal to allowed or allowable depreciation. That gain is considered unrecaptured section 1250 gain, which will be taxed at the taxpayer's ordinary income tax rate but limited to a maximum of 25% and may be subject to the 3.8% net investment income tax.

Example 6.23
Sale of Home with Office

On July 20, 2021, Paul Martinez sold his home for $250,000. He originally purchased the home for $120,000 and allocated $100,000 to the house and $20,000 to the land. Paul meets all the tests for the section 121 exclusion. Paul used 10% of the living space of the residence as business property. He took $2,051 depreciation.

Figure 6.10 shows Paul's gain on the sale. His $2,051 recognized gain is taxed at a maximum rate of 25%.

FIGURE 6.10
Paul Martinez's Sale of Home with Office

Home purchase price	$120,000
Depreciation allowed or allowable	(2,051)
Adjusted basis of home	$117,949
Selling price	$250,000
Adjusted basis of home	(117,949)
Realized gain	$ 132,051
Recognized gain (limited to allowable depreciation)	$2,051
Excluded gain (limited to $250,000)	$130,000

PRACTITIONER NOTE

Safe Harbor

If the taxpayer calculates the business-use-of-the-home deduction using the Rev. Proc. 2013-13, 2013-06 I.R.B. 478, safe harbor ($5 per square foot for a maximum of 300 square feet), there is no accumulated depreciation that must be recaptured when the residence is sold.

Business Use Not within the Living Area

If the part of the taxpayer's property used solely for business is not within the living area of the home, the sale is treated as two separate sales. The taxpayer reports the business property sale on Form 4797, Sales of Business Property. The taxpayer must allocate the amount realized and the basis between the part of the property used for business and the part of the property used as a home.

If the taxpayer took depreciation deductions on the home, the business percentage is the same percentage used to calculation the depreciation deductions. If the taxpayer did not take depreciation deductions, he or she must compare the size of the business space to the size of the whole property and express this as a percentage.

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All gain attributable to the business portion is taxable. The depreciation portion of the gain on the nonbusiness portion is unrecaptured section 1250 gain, and any remaining gain is long-term capital gain that may be excluded under section 121.

Example 6.24
Business Use in Separate Structure

Marcia Stoltz operates a fitness studio in the unattached garage at her principal residence. She purchased the property in 2015 for $120,000 and allocated $88,000 to the house, $12,000 to the garage, $1,500 to the land under the garage, and $18,500 to the remaining land. During the 5-year period of business use, Marcia claimed $1,846 depreciation. She sold the property in 2021 for $250,000. The appraisal at the time of sale allocated $20,000 to the garage and land under it.

Marcia must calculate gain from the business portion of the sale. Her adjusted basis is $11,654 ($12,000 garage + $1,500 land – $1,846 depreciation) and she has a $8,346 ($20,000 sale price – $11,654 adjusted basis) realized gain. The $1,846 portion of the gain resulting from depreciation is taxed at a maximum 25% rate, and the remaining $6,500 ($8,346 – $1,846) is taxed as long-term capital gain.

Marcia reports the garage sale in Part III of Form 4797. **Figure 6.11** shows a portion of Marcia's Form 4797. Figure 6.11 shows the 2020 form because the 2021 form was not available at the time of this publication. Note that Form 4797 does not separately report Marcia's unrecaptured section 1250 gain. It will be separated from other capital gains on the Capital Gains Worksheet [included in the Schedule D (Form 1040) instructions] and taxed at a maximum 25% rate. Marcia can exclude the $91,500 [($250,000 – $20,000) – ($120,000 + $18,500)] realized gain from the portion of the sale allocated to her principal residence under section 121.

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FIGURE 6.11
Marcia Stoltz's Form 4797

Part III **Gain From Disposition of Property Under Sections 1245, 1250, 1252, 1254, and 1255** (see instructions)

19 (a) Description of section 1245, 1250, 1252, 1254, or 1255 property:	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)
A Business use garage sold with personal residence	07/01/2015	07/01/2021
B		
C		
D		

These columns relate to the properties on lines 19A through 19D. ▶		Property A	Property B	Property C	Property D
20 Gross sales price (**Note:** *See line 1 before completing.*)	20	20,000			
21 Cost or other basis plus expense of sale	21	13,500			
22 Depreciation (or depletion) allowed or allowable	22	1,846			
23 Adjusted basis. Subtract line 22 from line 21	23	11,654			
24 Total gain. Subtract line 23 from line 20	24	8,346			
25 If section 1245 property:					
a Depreciation allowed or allowable from line 22	25a				
b Enter the **smaller** of line 24 or 25a	25b				
26 If section 1250 property: If straight line depreciation was used, enter -0- on line 26g, except for a corporation subject to section 291.					
a Additional depreciation after 1975. See instructions	26a				
b Applicable percentage multiplied by the **smaller** of line 24 or line 26a. See instructions	26b				
c Subtract line 26a from line 24. If residential rental property **or** line 24 isn't more than line 26a, skip lines 26d and 26e	26c				
d Additional depreciation after 1969 and before 1976	26d				
e Enter the **smaller** of line 26c or 26d	26e				
f Section 291 amount (corporations only)	26f				
g Add lines 26b, 26e, and 26f	26g	0			
27 If section 1252 property: Skip this section if you didn't dispose of farmland or if this form is being completed for a partnership.					
a Soil, water, and land clearing expenses	27a				
b Line 27a multiplied by applicable percentage. See instructions	27b				
c Enter the **smaller** of line 24 or 27b	27c				
28 If section 1254 property:					
a Intangible drilling and development costs, expenditures for development of mines and other natural deposits, mining exploration costs, and depletion. See instructions	28a				
b Enter the **smaller** of line 24 or 28a	28b				
29 If section 1255 property:					
a Applicable percentage of payments excluded from income under section 126. See instructions	29a				
b Enter the **smaller** of line 24 or 29a. See instructions	29b				

Summary of Part III Gains. Complete property columns A through D through line 29b before going to line 30.

30 Total gains for all properties. Add property columns A through D, line 24	30	8,346
31 Add property columns A through D, lines 25b, 26g, 27c, 28b, and 29b. Enter here and on line 13	31	
32 Subtract line 31 from line 30. Enter the portion from casualty or theft on Form 4684, line 33. Enter the portion from other than casualty or theft on Form 4797, line 6	32	8,836

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CROSS-REFERENCE

Sale of Vacation Home

The exclusion of gain under section 121 applies only to the taxpayer's principal residence. The sale of a vacation home is not eligible for the exclusion. See pages 190–195 in the *2019 National Income Tax Workbook* for a discussion of the tax rules that apply to vacation rentals.

Converting Rental Property to a Principal Residence

A taxpayer may want to take the section 121 exclusion by moving into rental property 2 years before the sale. However, for the sale of rental property converted to a principal residence, the taxpayer cannot exclude the part of the gain equal to any depreciation deduction allowed or allowable for periods after May 6, 1997. Also, under I.R.C. § 121(b)(5) there is no exclusion for gain allocated to periods of nonqualified use. Gain must be allocated to periods of nonqualified use based on the ratio of the aggregate periods of nonqualified use to the period the taxpayer owned the property.

Nonqualified use is any use after January 1, 2009, that was not use as the principal residence for the taxpayer, his or her spouse, or former spouse. However, a period of nonqualified use does not include the following:

1. Any portion of the 5-year period immediately preceding the sale that is after the last date that such property is used as the taxpayer's (or spouse's) principal residence (qualified use preceding nonqualified use)
2. Any period (not to exceed an aggregate period of 10 years) during which the taxpayer or the taxpayer's spouse is serving on qualified official extended duty
3. Any other period of temporary absence (not to exceed an aggregate period of 2 years) due to change of employment, health conditions, or such other unforeseen circumstances

Example 6.25
Sale of Vacation Home Used as Principal Residence

On May 1, 2010, Jack Bourbon purchased a vacation home for $250,000. He rented the property periodically and claimed $18,000 depreciation. He moved into the home and used it as his personal residence on May 1, 2015. On May 1, 2021, he sold the home for $375,000. Jack meets the requirements for the section 121 gain exclusion. However, the amount of gain attributable to depreciation is not excluded, and only the gain for his period of qualified use as his personal residence is excluded.

Jack owned the property for 11 years, of which only 6 were qualified use. **Figure 6.12** shows the calculation of his $68,182 excludable gain, and his $74,818 reportable gain, of which $18,000 is unrecaptured section 1250 gain.

FIGURE 6.12
Jack Bourbon's Gain on Sale of Former Vacation Rental Home

Sale price	$375,000
Cost basis before depreciation	(250,000)
Total gain for proration	$125,000
Eligible for exclusion [(6 ÷ 11) × $125,000]	(68,182)
Gain allocable to nonqualified use	$ 56,818
Accumulated depreciation	18,000
Total reportable gain	$ 74,818

Jack reports the gain on the taxable portion of the sale in Part III of Form 4797 as shown in **Figure 6.13**. Figure 6.13 shows the 2020 form because the 2021 form was not available at the time of this publication. The portion of the sale price allocable to the nonqualified use is $170,454 [(5 ÷ 11) × $375,000], and the portion of the basis allocated to the nonqualified use is $113,636 [(5 ÷ 11) × $250,000].

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FIGURE 6.13
Jack Bourbon's Form 4797

Form 4797 (2020) Page **2**

Part III **Gain From Disposition of Property Under Sections 1245, 1250, 1252, 1254, and 1255** (see instructions)

19 (a) Description of section 1245, 1250, 1252, 1254, or 1255 property:	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)
A Vacation home portion of personal residence	7/01/2010	7/01/2021
B		
C		
D		

These columns relate to the properties on lines 19A through 19D. ▶		Property A	Property B	Property C	Property D
20 Gross sales price (**Note:** *See line 1 before completing.*)	20	170,454			
21 Cost or other basis plus expense of sale	21	113,636			
22 Depreciation (or depletion) allowed or allowable	22	18,000			
23 Adjusted basis. Subtract line 22 from line 21	23	95,636			
24 Total gain. Subtract line 23 from line 20	24	74,818			
25 If section 1245 property:					
a Depreciation allowed or allowable from line 22	25a				
b Enter the **smaller** of line 24 or 25a	25b				
26 If section 1250 property: If straight line depreciation was used, enter -0- on line 26g, except for a corporation subject to section 291.					
a Additional depreciation after 1975. See instructions	26a				
b Applicable percentage multiplied by the **smaller** of line 24 or line 26a. See instructions	26b				
c Subtract line 26a from line 24. If residential rental property **or** line 24 isn't more than line 26a, skip lines 26d and 26e	26c				
d Additional depreciation after 1969 and before 1976	26d				
e Enter the **smaller** of line 26c or 26d	26e				
f Section 291 amount (corporations only)	26f				
g Add lines 26b, 26e, and 26f	26g	0			
27 If section 1252 property: Skip this section if you didn't dispose of farmland or if this form is being completed for a partnership.					
a Soil, water, and land clearing expenses	27a				
b Line 27a multiplied by applicable percentage. See instructions	27b				
c Enter the **smaller** of line 24 or 27b	27c				
28 If section 1254 property:					
a Intangible drilling and development costs, expenditures for development of mines and other natural deposits, mining exploration costs, and depletion. See instructions	28a				
b Enter the **smaller** of line 24 or 28a	28b				
29 If section 1255 property:					
a Applicable percentage of payments excluded from income under section 126. See instructions	29a				
b Enter the **smaller** of line 24 or 29a. See instructions	29b				

Summary of Part III Gains. Complete property columns A through D through line 29b before going to line 30.

30	Total gains for all properties. Add property columns A through D, line 24	30	74,818
31	Add property columns A through D, lines 25b, 26g, 27c, 28b, and 29b. Enter here and on line 13	31	0
32	Subtract line 31 from line 30. Enter the portion from casualty or theft on Form 4684, line 33. Enter the portion from other than casualty or theft on Form 4797, line 6	32	74,818

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CROSS-REFERENCE

Deferral of Gain

A section 1031 exchange allows the taxpayer to defer gain recognition on the sale of the relinquished property. Real property may be eligible for like-kind exchange treatment if the relinquished property and the replacement property were held for business or investment purposes. While a principal residence will not qualify for a section 1031 exchange, a vacation home may qualify if the taxpayer meets the safe harbor requirements in Rev. Proc. 2008-16, 2008-10 I.R.B. 547. See the "Business Tax Issues" chapter in this workbook for a discussion of like-kind exchanges.

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IRS ISSUES

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LEARNING OBJECTIVES

After completing this session, participants will be able to perform the following job-related actions:

- ✔ Identify the services provided by the IRS Return Preparer Office
- ✔ Know who must have a preparer tax identification number (PTIN)
- ✔ Apply for or renew a PTIN
- ✔ Apply to be an enrolled agent
- ✔ Participate in the Annual Filing Season Program
- ✔ Identify when to refer a case to the Taxpayer Advocate Service
- ✔ Know the services that the Taxpayer Advocate Service provides
- ✔ Identify current cyberscams and know how to avoid them
- ✔ Know how to use IRS online tools
- ✔ Understand new and existing payment arrangement options

INTRODUCTION

This chapter provides an overview of the IRS Return Preparer Office (RPO) programs. It reviews the requirements for Taxpayer Advocate Service assistance. It also discusses current scams used to steal private information from individuals or businesses. This chapter discusses new online tools and filing obligations for taxpayers and preparers. Finally, this chapter explains new and existing payment arrangements that can help taxpayers who have been financially impacted by COVID-19.

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ISSUE 1: IRS RETURN PREPARER OFFICE The IRS Return Preparer Office provides oversight and support for tax professionals.

The IRS Return Preparer Office (RPO) oversees preparer tax identification numbers (PTINs), enrollment programs, IRS approved education providers, and the Annual Filing Season Program (AFSP) for tax return preparers. This section discusses PTINs, the Enrolled Agent program, and the AFSP.

Preparer Tax Identification Numbers

A PTIN is a number issued by the IRS to paid tax return preparers. It is used as the tax return preparer's identification number. PTINs were created as a substitute for a tax return preparer's social security number. Vendors and others can obtain the PTIN holder listing. PTIN holders cannot opt out of the disclosure of their contact information because the Freedom of Information Act (FOIA) makes the information public.

PRACTITIONER NOTE

Electronic Filing Identification Number

A PTIN, when applicable, must be placed in the Paid Preparer section of a tax return that the tax return preparer prepared for compensation. An Electronic Filing Identification Number (EFIN) is a number issued by the IRS to individuals or firms that have been approved as authorized IRS e-file providers. It is included with all electronic return data transmitted to the IRS. There is no fee for an EFIN. PTINs are issued to individuals. EFINs are issued to individuals or firms. Most preparers need both.

Who Must Have a PTIN

All enrolled agents must have a PTIN. Tax return preparers (defined later) who are paid for preparing or assisting in the preparation of all or substantially all of any US federal tax return, claim for refund, or other tax form submitted to the IRS must have a PTIN, unless the form is specifically excepted. Attorneys and CPAs are only required to obtain a PTIN if they prepare or assist in the preparation of all or substantially all of any tax return or claim for refund.

Enrolled retirement plan agents (ERPAs) are only required to obtain a PTIN if they prepare or assist in the preparation of all or substantially all of any tax return or claim for refund that is not on the list of forms exempt from the PTIN requirement. ERPAs who prepare only Form 5300 or 5500 series returns are not required to obtain a PTIN.

The IRS has identified 28 forms or series of forms that do not require a paid preparer to have a PTIN. These forms include

1. audit-related forms such as
   a. Form 870, Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment;
   b. Form 872, Consent to Extend the Time to Assess Tax; and
   c. Form 906, Closing Agreement On Final Determination Covering Specific Matters;
2. information documents such as
   a. the Form W-2 series or returns,
   b. the Form 1098 series, and
   c. the Form 1099 series; and
3. Form 2848, Power of Attorney and Declaration of Representative.

For a complete list of the excepted forms, see www.irs.gov/tax-professionals/frequently-asked-questions-do-i-need-a-ptin.

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Tax Return Preparer

Under Treas. Reg. § 301.7701-15, a *tax return preparer* is any person who prepares for compensation, or who employs one or more persons to prepare for compensation, all or a substantial portion of any return of tax or any claim for refund of tax under the Internal Revenue Code. A person may be considered a tax return preparer regardless of educational qualifications or professional status requirements.

A person outside the US who prepares a return or claim for refund is a tax return preparer regardless of nationality, residence, or location of the person's place of business if the person otherwise satisfies the definition of *tax return preparer.* An individual who furnishes to a taxpayer or other tax return preparer enough information and advice so that completion of the return or claim for refund is largely a mechanical or clerical matter is considered a tax return preparer even though that person does not place or review placement of the information on the tax return or claim for refund.

Signing Tax Return Preparers

Signing and nonsigning preparers must have a PTIN. A *signing tax return preparer* is the individual tax return preparer who has the primary responsibility for the overall substantive accuracy of the return or claim for refund.

Nonsigning Tax Return Preparer

A *nonsigning tax return preparer* is any tax return preparer who is not a signing tax return preparer but who prepares all or a substantial portion of a return or claim for refund with respect to events that have already occurred at the time the advice is given. If an individual gives a taxpayer advice only before a transaction occurs, the individual is not a tax return preparer.

An individual who provides advice (written or oral) to a taxpayer (or another tax return preparer) when the advice leads to a position or entry that constitutes a substantial portion of the tax return is an example of a nonsigning tax return preparer. Time spent on providing tax advice after events have occurred is disregarded if the time is less than 5% of the aggregate time incurred by the individual with respect to a position(s) giving rise to an understatement.

Example 7.1
Nonsigning Tax Return Preparer

George Jackson is an attorney in a law firm. George provided legal advice to a large corporate taxpayer regarding a completed transaction. The advice that George provided was directly relevant to the determination of an entry on the taxpayer's return, and this advice led to a position(s) or entry that constituted a substantial portion of the return. However, George did not prepare any other portion of the return and was not the signing tax return preparer. George is considered a nonsigning tax return preparer [Treas. Reg. § 301.7701-15(b)(2)(ii), Example 1].

Example 7.2
Not a Tax Return Preparer

George, from Example 7.1, provided legal advice to another taxpayer regarding the consequences of a proposed transaction. Based on this advice, the taxpayer entered into the transaction. If George gives no further advice after the transaction occurs, he is not considered a tax return preparer.

If George gives supplemental advice to the taxpayer after the transaction is completed and the time in giving this advice is less than 5% of the total time he spent giving tax advice before and after the transaction, George is not a tax return preparer [Treas. Reg. § 301.7701-15(b)(2)(ii), Examples 2 and 3].

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Substantial Portion

An individual who provides tax advice on a position that is directly relevant to the determination of the existence, characterization, or amount of an entry on a return or claim for refund is regarded as having prepared that entry. Whether that schedule, entry, or other portion of a return or claim for refund is substantial is determined considering whether the person knows or reasonably should know that the tax attributable to that schedule, entry, or other portion is a substantial portion of the tax required to be shown.

Factors to consider include, but are not limited to the following:

- The size and complexity of the item relative to the taxpayer's gross income
- The size of the understatement attributable to the item compared to the taxpayer's reported tax liability

For a nonsigning tax return preparer, the schedule or other portion of a return or claim for refund is not considered to be substantial if the schedule, entry, or other portion of the return or claim for refund involves amounts of gross income, deductions, or amounts used to determine credits that are

1. less than $10,000, or
2. less than $400,000 and less than 20% of the gross income (AGI for individuals) shown on the return or claim for refund.

If there is more than one schedule, entry, or other portion involved, they are aggregated in applying this de minimis rule. The de minimis rule does not apply to signing tax return preparers. A tax return preparer of one return is not considered to be a tax return preparer of another tax return merely because an entry on the first return may affect an entry reported on the other return unless the entry or entries on the first return are directly reflected on the other return and constitute a substantial portion of the other return.

Example 7.3
Preparation of Partnership Return

Olivia Rossi prepared the 2021 XYZ Partnership return. She will be considered a tax return preparer of the individual partners' returns if the entries on the partnership return that are reportable on a partner's return constitute a substantial portion of the partner's return.

Example 7.4
Reporting Form Is Not a Substantial Portion of Return

Cornelius Wagner prepared a Form 8886, Reportable Transaction Disclosure Statement, for a taxpayer. He did not prepare the tax return or advise the taxpayer about the tax return position for the transaction reported on Form 8886. Preparation of Form 8886 is not directly relevant to the determination of the existence, characterization, or amount of any entry on a tax return or claim for refund. Cornelius has not prepared a substantial portion of the tax return and is not considered a tax return preparer [Treas. Reg. § 301.7701-15(b)(3)(iv), Example 1].

Example 7.5
De Minimis Rule

Cornelius, from Example 7.4, prepares a schedule for an individual taxpayer's Form 1040, U.S. Individual Income Tax Return. The return reported $4,000 in dividend income, and Cornelius gave the taxpayer advice about Schedule A (Form 1040) that resulted in a $5,000 medical expense deduction. He did not sign the return. Cornelius is not a nonsigning tax return preparer because the total aggregate amount of deductions was less than $10,000 [Treas. Reg. § 301.7701-15(b)(3)(iv), Example 2].

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Exclusions from Tax Return Preparer

Treas. Reg. § 301.7701-15(f) provides that the following persons are not tax return preparers:

1. An official or employee of the IRS performing official duties
2. An individual providing tax assistance under a Volunteer Income Tax Assistance (VITA) program established by the IRS, but only with respect to those returns prepared as part of the VITA program
3. Any organization sponsoring or administering a VITA program established by the IRS, but only with respect to that sponsorship or administration
4. Any individual providing tax counseling for the elderly under a program established pursuant to section 163 of the Revenue Act of 1978 but only with respect to returns prepared as part of that program
5. Any organization sponsoring or administering a program to provide tax counseling for the elderly established pursuant to section 163 of the Revenue Act of 1978, but only with respect to that sponsorship or administration
6. Any individual who provides tax assistance as part of a qualified low-income taxpayer clinic (LITC) defined by I.R.C. § 7526, but only with respect to those returns and claims for refund prepared as part of the LITC program
7. Any organization that is a qualified LITC as defined in section 7526
8. An individual providing only typing, reproduction, or other mechanical assistance in the preparation of a tax return or claim for refund
9. An individual preparing a return or claim for refund of a taxpayer, officer, general partner, member, shareholder, or employee of a taxpayer, by whom the individual is regularly and continuously employed or compensated or in which the individual is a general partner
10. An individual preparing a return or claim for refund for a trust, estate, or other entity of which the individual is a fiduciary or is an officer, general partner, or employee of the fiduciary
11. An individual preparing a claim for refund for a taxpayer in response to a notice of deficiency issued to the taxpayer or a waiver of restriction on assessment after the start of an audit of the taxpayer or another taxpayer if the other taxpayer's audit determination directly or indirectly affects the taxpayer's tax liability
12. A person who prepares a return or claim for refund for a taxpayer with no explicit or implicit agreement for compensation, even if the person receives an insubstantial gift, return service, or favor

The following special rules apply to these exceptions:

- The exception for individuals providing tax assistance through a LITC and for a qualified LITC (items 6 and 7) applies only if the assistance is directly related to a controversy with the IRS for which the qualified LITC is assisting or is an ancillary part of an LITC program to inform individuals for whom English is a second language about their rights and responsibilities under the Internal Revenue Code. The exception does not apply if the LITC charges a separate fee, varies a fee based on whether the LITC assists with a return or claim for refund, or charges more than a nominal fee for its services.
- For purposes of the exception for an individual preparing a return or claim for refund for an employer or a partnership (item 9), if one corporation owns more than 50% of the voting power of another corporation, the employees of each corporation are considered employees of the other corporation.
- For purposes of the exception for an individual preparing a return or claim for refund for a trust or estate (item 10), an estate, guardianship, conservatorship, committee, or any similar arrangement for a taxpayer who is under a legal disability (e.g., minor, an incompetent, or an infirm individual) is considered to be a trust or estate.

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Example 7.6
Mechanical Assistance Exception

Miguel Morales is a reporting agent. He received employment tax information from a client's business records. Miguel did not give the client any tax advice or exercise any discretion or independent judgment on the client's underlying tax positions. Miguel processed the client's information, signed the return as authorized by the client pursuant to Form 8655, Reporting Agent Authorization, and filed the return using information that the client supplied. Miguel is not a tax return preparer. If Miguel also gave the client tax advice about whether workers are employees or independent contractors for federal tax purposes, Miguel is a tax return preparer [Treas. Reg. § 301.7701-15(f)(6), Examples 1 and 2].

Example 7.7
Clerical Services Exception Applies

Barclay Goodwin works for Astoria Summers, a tax return preparer. Barclay answers telephone calls, makes copies, enters client tax information gathered by Astoria into the data fields of the tax software, and electronically files the returns that Astoria prepared. Barclay may be exercising judgment regarding which data fields in the software to use, but he is not exercising any discretion or independent judgment as to the clients' underlying tax positions. He merely provides clerical assistance or incidental services and is not a tax return preparer.

Example 7.8
Clerical Assistance Exception Does Not Apply

The facts are the same as in Example 7.7, except that Barclay also interviews some clients, obtains necessary information from them, determines whether the information provided is sufficient to prepare the returns, and determines the amount and character of entries on the returns. If these determinations constitute all or substantially all of a tax return, Barclay is considered a tax return preparer.

Obtaining a PTIN

An individual can apply for a PTIN online at https://rpr.irs.gov/datamart/mainMenuUSIRS, or submit a paper application on Form W-12, IRS Paid Preparer Tax Identification Number (PTIN) Application. An online application takes about 15 minutes, and the PTIN number is generally provided immediately. It may take 4 to 6 weeks to process a paper application. The fee is $35.95 for 2021, which is comprised of $21.00 for IRS costs and $14.95 for third-party processing. The PTIN fee is nonrefundable.

PTINs are issued for a specific calendar year. A current-year PTIN refers to a PTIN for the current calendar year, while next year refers to a PTIN for the upcoming calendar year. PTIN applications for the upcoming year can be submitted beginning in mid-October each year.

Online PTIN Account

The preparer must create an online PTIN account before applying for a PTIN online. If the preparer submits a paper application, he or she should still create an online account. The online account allows a preparer to do the following:

1. Inactivate a PTIN of a preparer (other than an enrolled agent) who does not expect to prepare federal tax returns for compensation for a full calendar year

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2. Opt out of the preparer directory
3. Submit a name change request
4. Update PTIN account information
5. Reactivate a PTIN that was inactivated within 3 years

PRACTITIONER NOTE

Online PTIN System

The online PTIN system allows an individual to sign-up for and renew a PTIN, keep account information current, view continuing education credits, and receive communications from the IRS Return Preparer Office.

Name and Address

The name and address on the application should be the preparer's name and address as shown on the most recently filed income tax return, except that punctuation in the address should be omitted. If the preparer's name changes after he or she submits the PTIN application or renewal, the preparer may submit a name change request through the online PTIN account or in writing along with a copy of documentation supporting the change

Tax Compliance

In the PTIN application, a preparer must attest to compliance with all personal and business tax obligations or provide an explanation if they are not. For purposes of obtaining a PTIN, an individual is in tax compliance if

1. all individual and business returns that are due have been filed (or an extension requested), and
2. all taxes that are due have been paid (or acceptable payment arrangements have been made).

Bankruptcy generally will not affect a PTIN application. A balance due account with the IRS that is in bankruptcy status will not result in a preparer failing the tax compliance test. But, for an account to be in bankruptcy status, the taxpayer must have included the IRS debt in the bankruptcy filing.

Social Security Number

An applicant who does not have an SSN can apply for a PTIN using the online or paper Form W-12 but must also file an additional form with documentation specified in Rev. Proc 2010-41, 2010-48 I.R.B. 781. US residents who do not have an SSN for religious reasons file Form 8945, PTIN Supplemental Application for U.S. Citizens Without a Social Security Number Due to Conscientious Religious Objection along with documentation to establish identity and status. Such documentation includes a passport or passport card, voter registration card, civil birth certificate, US driver's license, US military ID card, naturalization papers, US state ID card, or foreign military ID card.

Foreign preparers who do not have or are not eligible for an SSN and are not US citizens or US resident aliens also file Form 8946, PTIN Supplemental Application for Foreign Persons Without a Social Security Number, along with documentation to establish identity and status. Such documentation includes a passport, foreign voter's registration card, civil birth certificate, foreign driver's license, US visa, foreign military ID card, or national ID card. An individual taxpayer identification number (ITIN) cannot be used in a PTIN application.

No US Income Tax Return

If a preparer applying for a PTIN has never filed a US income tax return, has not filed a US income tax return in the past 4 years, or does not have a US income tax filing requirement, he or she can complete and submit the PTIN application online. However, he or she must also submit an original or notarized or certified copy of his or her social security card and an original or notarized or certified copy of a government issued document with a current photo ID. Examples include the following:

- Passport or passport card
- Driver's license
- US state ID card
- Military ID card
- National ID card

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PRACTITIONER NOTE

Document Format

Original documents are accepted but it is recommended that the preparer send only notarized or certified copies. Certified copies must be certified by the issuing agency or official custodian of the original record. Certifications must stay attached to the copies of the documents when they are submitted. Notarized copies must be notarized by a US notary public. The notary must see the valid, unaltered, original documents and verify that the copies conform to the original. The preparer must submit the copy that bears the mark of the notary. Photocopies or faxes of notarized or certified documents are not acceptable.

PTIN Contact Information

PTIN assistance is available Monday through Friday from 8 a.m. to 5 p.m. CST. **Figure 7.1** shows the PTIN contact information.

FIGURE 7.1
PTIN Contact Information

PTIN Account Information Line (toll-free): 877.613.PTIN (7846)
Toll Number for International Callers: +1.915.342.5655
Hearing Impaired Callers TTY: 877.613.3686
Live chat is available for general PTIN questions (not specific to an individual's PTIN account) at www.irs.gov/tax-professionals/contact-the-return-preparer-program.

Renewing a PTIN

PTINs expire on December 31 of the year for which they were issued. Renewal each year generally begins mid-October for a number that is valid for the next calendar year. PTINs may be renewed online or by using a paper Form W-12 and checking the "Renewal" box. The cost to renew a PTIN is $35.95 for 2021.

If a PTIN has been expired for more than 1 full calendar year, the preparer must renew each previous year during which the preparer prepared returns or was an enrolled agent. If the preparer was inactive, he or she can put the PTIN into voluntary inactive status retroactively for the years involved. If a PTIN was inactive or expired for more than 3 consecutive years, the preparer must submit a new registration application. A preparer who does not plan to prepare any returns for compensation in the future does not need to notify the IRS. The preparer can just let the PTIN expire.

PRACTITIONER NOTE

PTIN Misuse

Data is available for all PTIN holders that have a minimum of 50 returns processed under their PTIN in the calendar year. From the Main Menu of the PTIN account, under "Additional Activities," select "View My Summary of Returns Filed." A chart will display the number of Form 1040 series returns processed through the date specified. If the number is substantially higher than the number of tax returns prepared and the preparer suspects possible misuse of his or her PTIN, he or she should complete Form 14157, Return Preparer Complaint.

Enrolled Agent Program

An enrolled agent (EA) is an individual who has earned the privilege of representing taxpayers before the IRS. EAs have unlimited practice rights. They are unrestricted as to which taxpayers they can represent, what types of tax matter they can handle, and in which IRS offices they may represent taxpayers. **Figure 7.2** shows the contact information for the Office of Enrollment. The hours of operation are 6:30 a.m. to 5:00 p.m. CST.

FIGURE 7.2
Office of Enrollment Contact Information

Telephone: 855.472.5540
E-mail: EPP@irs.gov
Fax Number (for name/address change request or proof of CE credits): 855.889.7959
Mailing Address: IRS, Enrolled Agent Policy & Management, P.O. Box 33968, Detroit, MI 48232

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General Requirements

To become an EA a tax professional must do the following:

1. Obtain a PTIN
2. Apply to take the Special Enrollment Examination (SEE)
3. Achieve passing scores on all 3 parts of the SEE within 3 years (former IRS employees may be exempt from taking the exam, discussed later)
4. Apply for enrollment using Pay.gov Form 23 or by mailing Form 23, Application for Enrollment to Practice Before the Internal Revenue Service
5. Pay the $67.00 (nonrefundable) enrollment fee
6. Pass a suitability check, which includes tax compliance and criminal background checks [see Circular 230 §§ 10.5(d)(1) and 10.51 for an explanation of the suitability requirements.]

Former IRS employees can become an EA without taking the SEE if they were regularly engaged in applying and interpreting the provisions of the Internal Revenue code relating to income, estate, gift, employment, or excise taxes. In general, the experience must include at least 5 years in one of the following taxpayer-facing fields:

- Appeals officer
- Special agent
- Revenue officer
- Revenue agent
- Tax specialist
- Tax law specialist
- Settlement officer

At least 3 of the 5 qualifying years must have occurred within the last 5 years before separation from the IRS. If the former employee's IRS experience does not provide the same overall background as a public sector candidate who passes all three parts of the SEE, enrollment will be restricted to a specific area of representation.

Special Enrollment Exam

The SEE consists of three parts: (1) individuals; (2) businesses; and (3) representation, practices, and procedures. The examination parts may be taken in any order. Each part has 100 questions and is 3.5 hours long. The actual seat time is 4 hours to allow for a tutorial, survey, and one scheduled 15-minute break. Parts do not have to be taken on the same day or on consecutive days. Each part may be taken four times during the test window which runs from May 1 to the end of February the next year.

Scores from previously passed parts may be carried over up to 2 years from the date each part was passed. To provide flexibility due to the pandemic, the 2-year period was extended to 3 years for examination parts that had not expired as of February 29, 2020, and any examination parts passed on June 1, 2020, and later.

Example 7.9
Examination Part Not Expired as of February 29, 2020

Dinesh Patel is an EA applicant. He passed Part 1 of the SEE on November 15, 2019 and passed Part 2 on February 15, 2020. He has until November 15, 2022, to pass Part 3. Otherwise, he loses credit for Part 1. He has until February 15, 2023, to pass all other parts of the examination or he will lose credit for Part 2.

Example 7.10
Examination Parts Passed on or after June 1, 2020

The facts are the same as in Example 7.9, except that Dinesh passed Part 1 on June 1, 2020, and passed Part 2 on September 1, 2020. He has until June 1, 2023, to pass the remaining part or he will lose credit for Part 1. He has until September 1, 2023, to pass all other parts of the examination or he will lose credit for Part 2.

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Scheduling the Exam

Exam parts are scheduled online at Prometric.com; by calling Prometric at 800.306.3926 (toll-free) or 443.751.4193 (toll) (Monday through Friday between 8 a.m. and 9 p.m. ET); or by submitting Form 2587, Application for Special Enrollment Examination. The fee for each part is $185 and is paid when the appointment is scheduled.

There is no refund for cancellation. However, if the appointment is rescheduled at least 30 calendar days prior to the original appointment date, there is no additional rescheduling fee. If the applicant reschedules 5 to 29 calendar days before the original appointment, the fee is $35. The applicant must pay a full examination fee if he or she reschedules less than 5 calendar days before the appointment.

Preparing for the Exam

Preparing for the SEE should include study of the Internal Revenue Code; Treasury Department Circular 230; and IRS publications, forms, and instructions. There are commercially available materials and preparation courses to prepare for the SEE.

Prometric's website provides a computer-based test tutorial and a free "test drive" of the examination [www.prometric.com/test-takers/search/irs]. The IRS provides sample questions with official IRS answers [www.irs.gov/tax-professionals/enrolled-agents/sample-special-enrollment-examination-questions-and-official-answers].

Maintaining EA Status

An EA maintains EA status by timely EA renewal, timely PTIN renewal (discussed previously), and meeting continuing education requirements.

EA Renewal

EA renewal occurs every 3 years based on the last digit of the EA's SSN. Renewal may be done online using Pay.gov Form 8554 or by mailing Form 8554, Application for Renewal of Enrollment to Practice Before the Internal Revenue Service. There is a $67 fee for renewal. **Figure 7.3** shows the EA renewal periods.

FIGURE 7.3
EA Renewal Periods

SSN Ending	Renewal Cycle	Renewal Application Period	Renewal Cycle Expiration
7, 8, 9 or No SSN	2018-2021	November 1, 2020 through January 31, 2021	March 31, 2021
0, 1, 2, 3	2019-2022	November 1, 2021 through January 31, 2022	March 31, 2022
4, 5, 6,	2020-2023	November 1, 2022 through January 31, 2023	March 31, 2023

An EA who does not timely renew is placed into inactive status. An EA in inactive status can still submit a late renewal for approval, however, the EA must provide proof of all continuing education (CE) credits earned during the renewal period (even if the CE shows in the EA's PTIN account). If an EA has not renewed for two renewal cycles, the EA will be placed in terminated status. Anyone in terminated status must retake the SEE to apply for reenrollment.

Continuing Education

EAs must earn 72 hours of CE from an IRS approved CE provider every 3 years, based on the EA's renewal cycle. EAs must earn a minimum of 16 hours of CE every calendar year, of which 2 must be ethics. For the first renewal cycle, which could involve less than 3 full years, the requirement is prorated (but not the ethics requirement). **Figure 7.4** shows the CE requirements for the EA's first renewal cycle.

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FIGURE 7.4
CE Requirements for EA's First Renewal Cycle

CE Requirements for an Enrollee's First Renewal Cycle														
SSN Ending	Year of Enrollment	Calendar Month Enrollment Granted												Renewal Cycle
		Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	
7, 8, 9 & No SSN	2018	72	70	68	66	64	62	60	58	56	54	52	50	2018-2021
	2019	48	46	44	42	40	38	36	34	32	30	28	26	
	2020	24	22	20	18	16	14	12	10	8	6	4	2	
0, 1, 2, 3	2019	72	70	68	66	64	62	60	58	56	54	52	50	2019-2022
	2020	48	46	44	42	40	38	36	34	32	30	28	26	
	2021	24	22	20	18	16	14	12	10	8	6	4	2	
4, 5, 6	2020	72	70	68	66	64	62	60	58	56	54	52	50	2020-2023
	2021	48	46	44	42	40	38	36	34	32	30	28	26	
	2022	24	22	20	18	16	14	12	10	8	6	4	2	

EAs can earn up to 6 instructor hours each year. Only excess federal tax law update hours may be counted toward the federal tax law requirement. Excess hours in ethics and federal tax law cannot be counted toward other categories. Identity theft and data security programs focusing on enhancing tax professional awareness and protecting client data, including review of Publications 4556 and 4524 safeguards, can qualify for CE credit in the federal tax law category. The Annual Federal Tax Refresher (AFTR) course does not count towards EA CE credits.

EAs must retain the following CE records for 4 years:

- Name of the CE provider organization
- Location of the program and dates attended
- Title of the program, approval number received for the program, and copy of program content
- Written course outlines, course syllabi, textbook, and/or electronic materials provided or required by the program
- Credit hours claimed
- Name(s) of the instructors(s), discussion leader(s), or speakers(s), if appropriate
- Certificate of completion and/or signed statement of the attendance hours from the CE provider

PRACTITIONER NOTE

IRS Approved CE Providers

A list of IRS-approved CE providers is located at www.ceprovider.us/public/default/listing. This list may not be complete as some providers have opted out of being listed.

Annual Filing Season Program

The Annual Filing Season Program (AFSP) is a voluntary program intended to recognize and encourage unenrolled tax return preparers who voluntarily increase their knowledge and improve their filing season competency through continuing education (CE). Preparers who complete the AFSP are issued a Record of Completion and included in the Directory of Federal Tax Return Preparers with Credentials and Select Qualifications. The directory is a searchable, sortable listing that taxpayers can use to find a return preparer who carries their preferred credentials or qualification(s) [https://irs.treasury.gov/rpo/rpo.jsf].

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PTIN holders without an AFSP Record of Completion (discussed later) or other credentials can only prepare tax returns. For returns prepared and signed after December 31, 2015, they cannot represent clients before the IRS. A preparer who has competed the AFSP has limited representation rights for any return they prepared and signed. *Limited representation rights* mean representation before revenue agents, customer service representatives, and similar IRS employees, including the Taxpayer Advocate Service.

PRACTITIONER NOTE

Credentialed Preparers

The AFSP is not intended for credentialed preparers (attorneys, CPAs, or EAs), but they are not prohibited from participating. Attorneys, CPAs, and EAs are the only tax professionals with unlimited representation rights, meaning they can represent their clients on any matters including audits, payment/collection issues, and appeals. If a credentialed preparer seeks to participate in the AFSP, he or she must meet the same requirements as those preparers in the exempt category (discussed later).

Record of Completion

Tax return preparers must generally meet the following three requirements to obtain an AFSP Record of Completion:

1. Complete 18 hours of CE from an IRS-approved CE provider that includes a 6-hour Annual Federal Tax Refresher (AFTR) course (unless an exemption applies), 10 hours of other federal tax law topics, and 2 hours of ethics
2. Have an active PTIN
3. Consent to adhere to specific practice obligations outlined in Circular 230 Subpart B and § 10.51.

Unenrolled preparers who have passed recognized state or national tests qualify for an exemption from the AFTR course but still must obtain 15 hours of continuing education. Following the completion of all CE requirements and renewal of the PTIN for the upcoming year, eligible return preparers will receive an email from the IRS. The email will provide instructions for logging into the PTIN account and completing the process to obtain a Record of Completion.

AFTR Course and Test

The AFTR courses are provided by CE providers following content guidelines that the IRS publishes annually. The course covers filing season issues and tax law updates. AFTR courses are offered from June 1 through December 31. An outline of the course is at www.irs.gov/pub/irs-utl/approved_rpo_aftr_course_outline.pdf and test parameters are at www.irs.gov/pub/irs-utl/aftr_test_parameters.pdf.

The CE provider administers a knowledge-based comprehension test at the end of the course. The test includes all tax law topics covered in the AFTR course. Participants are given a maximum of 3 hours to complete 100 multiple choice questions and must answer at least 70% of the questions correctly. CE providers provide course completion information to the IRS after the participant successfully completes the test.

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AFTR Course Exemptions

Some unenrolled preparers are exempt from the AFTR course requirements because they have completed other recognized state or national competency tests. These preparers still must meet other program requirements including 15 CE credits (10 federal tax law, 3 federal tax law updates, and 2 ethics). Preparers who can obtain the AFTR – Record of Completion without taking the AFTR course are the following:

- Anyone who passed the Registered Tax Return Preparer test administered by the IRS between November 2011 and January 2013 (exempt if AFSP is still in place)
- Established state-based return preparer program participants currently with testing requirements (These preparers include active registrants of the Oregon Board of Tax Practitioners, California Tax Education Council, or Maryland State Board of Individual Tax Preparers.)
- Tax practitioners who have passed the SEE Part I within 2 years as of the first day of the upcoming filing season
- VITA volunteer quality reviewers and instructors with active PTINs
- Others accredited by the Accreditation Council for Accountancy and Taxation's Accredited Business Accountant/Advisor (ABA) and Accredited Tax Preparer (ATP) programs

PRACTITIONER NOTE

Eligibility

Under Rev. Proc. 2014-42, 2014-29 I.R.B. 192, certain people are ineligible to participate in the AFSP, such as preparers who have been disbarred or suspended from practice before the IRS, or who have been convicted of certain felonies; and preparers who are not in compliance with their personal federal tax obligations. If the IRS determines a preparer is not eligible for the program or proposes to revoke the preparer's participation, the IRS provides a written explanation along with instructions on how to appeal the decision.

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ISSUE 2: TAXPAYER ADVOCATE SERVICE The Taxpayer Advocate Service is an independent organization within the IRS that helps taxpayers and protects taxpayer rights.

The Taxpayer Advocate Service (TAS) works with taxpayers and their representatives to resolve tax issues. The TAS recommends systemic changes at the IRS or in the tax laws. The TAS does the following:

1. Provides tax law updates and guidance
2. Sponsors Problem Solving Day events throughout the country to assist taxpayers with unresolved tax issues [see www.taxpayeradvocate.irs.gov/contact-us/upcoming-events/tas-assistance-offered-at-local-problem-solving-days/]
3. Holds focus groups at the Nationwide Tax Forum (NTF) to hear tax practitioners' thoughts, experiences, and ideas about tax administration
4. Conducts educational seminars at the NTF
5. Meets one-on-one with tax practitioners at the NTF to resolve the practitioners' most difficult IRS cases
6. Issues Taxpayer Assistance Orders for hardship cases in which the TAS does not have authority to act
7. Provides taxpayer assistance on matters within the authority of the TAS
8. Administers the Low-Income Taxpayer Clinic Program
9. Works to identify and find solutions to systemic tax issues
10. Administers the Taxpayer Advocacy Panel, which is a group of volunteers that help the IRS identify ways to improve customer service
11. Submits two reports to Congress every year
12. Publishes the Taxpayer Bill of Rights

The TAS has offices in each state, the District of Columbia, and Puerto Rico [www.irs.gov/advocate/local-taxpayer-advocate]. There is a national office, and there are area offices that provide program guidance and direction to the local taxpayer advocates (LTAs). This section discusses what the TAS can do. It also explains how a tax practitioner or a taxpayer can obtain TAS assistance.

TAS Authority

The TAS has two types of authority: statutory and delegated. Statutory authority comes from I.R.C. §§ 7803(c) and 7811. Delegated authority comes from delegation orders. If the TAS does not have authority to take an action on a case, TAS routinely advocates using Operations Assistance Requests (OARs), Taxpayer Assistance Orders (TAOs), and Taxpayer Advocate Directives (TADs).

Statutory Authority

Pursuant to I.R.C. § 7803(c), the TAS

1. assists taxpayers in resolving problems with the IRS;
2. identifies areas in which taxpayers have problems in dealings with the IRS;
3. to the extent possible, proposes changes in the administrative practices of the IRS to mitigate problems; and
4. identifies potential legislative changes that may be appropriate to mitigate such problems.

I.R.C. § 7811 authorizes the TAS to issue TAOs if the taxpayer is suffering or is about to suffer significant hardship because of how the IRS administers the internal revenue laws. A significant hardship includes the following:

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- An immediate threat of adverse action
- A delay of more than 30 days in resolving taxpayer account problems
- The taxpayer incurring significant costs (including fees for professional representation) if relief is not granted
- Irreparable injury to, or a long-term adverse impact on, the taxpayer if relief is not granted

Delegated Authority

Delegated authority allows the TAS to resolve routine and nonsubstantive cases the same way that other functions within the IRS exercise the same authority. *Routine* is defined as cases generally resolved through the application of standard procedures and guidelines to a given set of facts and circumstances. Such cases are usually customer service problems with clear compliance issues. Delegated authority includes the power to do the following:

- Make credits or refunds within the applicable period of limitations (including manual refunds) after the IRS has first determined that a refund (or credit) is appropriate, and the amount of such refund (or credit)
- Issue, modify, or rescind TAOs for cases under TAS jurisdiction
- Approve replacement checks for lost or stolen refunds without a credit balance on an account where hardship or unreasonable delay exists
- Gather documentation to substantiate credits to taxpayer accounts where a taxpayer furnishes proof of payment, but the IRS cannot locate the payment within a reasonable time
- Release liens in cases not currently open in another IRS function if the account is fully paid and there is substantiation that there are no other balances owed
- Release levies in systemically generated cases
- Make trust fund recovery penalty adjustments in certain cases
- Accept certain installment agreements
- Correct certain errors such as decimal point errors and transposition errors and math errors

All rules and procedures that apply to the IRS exercising the same authority apply to the TAS (including the I.R.M. and any dollar tolerances or thresholds). However, TAS employees cannot act on cases that are open in another IRS function or overrule determinations made by employees of other IRS functions who have been delegated comparable authority. They cannot take any action that results in appeal rights.

Example 7.11
Correcting an Administrative Error

Danielle Kim properly filed her 2017 tax return. Shortly after, she began receiving notices of a balance due. The notices showed that the IRS changed her AGI, taxable income, and taxes. Danielle tried repeatedly to resolve this problem with the IRS to no avail. She contacted the TAS for assistance. The case met TAS criteria and was accepted into the program. The TAS employee identified an obvious input error (decimal in the wrong place). This was an IRS administrative error and the TAS has authority to adjust and restore the return as Danielle originally filed it [I.R.M. § 13.1.4.2.3.3].

TAS Case Acceptance Criteria

The TAS has established case criteria that qualify taxpayers for TAS assistance [I.R.M. § 13.1.7.2], which includes an independent review by a case advocate of actions that have been taken or need to be taken to resolve the problems taxpayers are experiencing. The criteria under which TAS accepts a case do not govern whether a taxpayer is entitled to relief. Similarly, the criteria under which TAS accepts a case do not govern whether TAS can issue a TAO. The criteria for TAS case acceptance fall into four main categories: economic burden, systemic burden, best interest of the taxpayer, and public policy.

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Economic Burden

Economic burden cases involve financial difficulty for the taxpayer. An IRS action or inaction has caused or will cause negative financial consequences or have a long-term adverse effect on the taxpayer. There are the following economic burden criteria:

Criteria 1: The taxpayer is experiencing economic harm or is about to suffer economic harm.

Economic harm may be the result of actions by the IRS, or it may be created because of personal circumstances in the taxpayer's life. Economic harm is not the same as economic hardship.

Example 7.12
Economic Harm from Refund Delay

Georgia Baxter's return has been selected for examination based on her claim for the earned income tax credit. She is expecting a $3,000 refund. She cannot wait for the completion of the examination because she has a serious medical condition and no health insurance. She needs the money to pay for nonelective surgery and prescription drugs. This case should be accepted into the TAS program as a Criteria 1 case [I.R.M. § 13.1.7.2.1(1)].

Criteria 2: The taxpayer is facing an immediate threat of adverse action.

Adverse action may be the filing of a notice of federal tax lien, serving a notice of levy, or seizing property. Threat of adverse action can also include utility cutoffs or evictions that may result in negative financial consequences or economic burden. A *threat* is a warning of impending action that will have a negative impact on the taxpayer, and *immediate* means in the very near future.

Example 7.13
Immediate Threat of Adverse Action—Personal Circumstances

On June 15, Ahmed Joseph came to the TAS with an eviction notice stating that he will be evicted on July 1 if his rent is not paid. Ahmed is waiting for a $2,000 refund from his 2020 income tax return. This refund will pay in full his arrearage and prevent the eviction. This case would be accepted into the TAS program as a Criteria 2 case because the threat of adverse action exists (the eviction notice), and the threat is immediate (15 days) [I.R.M. § 13.1.7.2.1(2)].

Criteria 3: The taxpayer will incur significant costs if relief is not granted.

Situations where the IRS is unable to immediately make adjustments, process returns, or release a lien could result in the taxpayer having to incur significant costs. Significant costs could include professional fees for representation. The LTA determines what constitutes significant costs based on the facts and circumstances of each case.

Example 7.14
Significant Cost without Relief

The IRS sent Acme Corporation a notice requesting payment of outstanding employment taxes and penalties. The notice indicates Acme owed $10,000 for 12 employment tax quarters. Acme sent the IRS documentation that Acme believes shows that if all its payments were applied to each quarter correctly, there would be no balance due. The IRS requested additional records and documentation. Because there are 12 quarters involved, Acme asserts that it will need to hire an accountant who estimates he will charge at least $5,000 to organize all the records and provide a detailed analysis of how to apply the deposits and payments. Acme is facing significant costs [I.R.M. § 13.1.7.2.1(3)].

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Criteria 4: The taxpayer will suffer irreparable injury or long-term adverse impact if relief is not granted.

The taxpayer may lose assets, income, or potential income if no relief is granted. There may be a loss of the ability to be licensed or bonded as part of the taxpayer's occupation, or loss of borrowing power or clients because of the filing of a notice of federal tax lien. Damage to a taxpayer's credit rating that results in denial of a loan may be an irreparable injury.

Example 7.15
Irreparable Injury from Lien

Dagwood Jones has a lien on his property due to an outstanding tax liability. He is trying to refinance his mortgage, which would result in a lower monthly payment and would allow him to pay his outstanding tax liability. He has filed an amended return that would eliminate the tax liability. The amended return has been selected for examination, but no action has been taken. This case should be accepted into the TAS program as a Criteria 4 case [I.R.M. § 13.1.7.2.1(4)].

Systemic Burden

Systemic burden cases involve an IRS process, system, or procedure that has failed to operate as intended, and as a result the IRS has failed to timely respond to resolve a taxpayer issue. There are the following systemic burden criteria:

Criteria 5: The taxpayer has experienced a delay of more than 30 days to resolve a tax account problem.

Criteria 5 is met if the taxpayer's problem or inquiry is delayed more than 30 days beyond the usual response time. If there is no established time frame for a specific action based on an I.R.M. provision, IRS form, or other official document, Criteria 5 is met when the problem or inquiry is delayed more than 30 days after the initial date the taxpayer made a request for IRS assistance. Criteria 5 is also met when the IRS sends multiple interim responses but takes no other action. Delays due to the taxpayer's unresponsiveness do not meet Criteria 5.

Example 7.16
Delay of More than 30 Days

Gigi Greco filed her 2020 individual income tax return with a Schedule C (Form 1040) claiming business expenses. She received a notice 10 months ago that the return was selected for examination, and she provided the requested documentation. Gigi has received no further contact from the IRS, which is a delay of more than 30 days beyond the normal response time [I.R.M. § 13.1.7.2.2(1)].

PRACTITIONER NOTE

COVID-19 Delays

Normal or required response dates may have been postponed because of COVID-19 delays at the IRS.

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Criteria 6: The taxpayer has not received a response or resolution to the problem or inquiry by the date promised.

The taxpayer was promised a response by a certain date and has not received that response.

Example 7.17
No IRS Response by Date Promised

Julie Steinberg has been in contact with the Correspondence Examination unit at an IRS campus because of alleged unreported income. The tax examiner requested substantiation of Julie's basis in stock that she sold. Julie sent the information 5 weeks ago. She received IRS correspondence acknowledging receipt of the information. The IRS correspondence also indicated that a determination would be made, and the IRS would contact Julie by March 5. On March 7, Julie contacts the NTA toll-free number for assistance. The inquiry should be accepted into TAS as a Criteria 6 case because the IRS did not contact Julie by the promised date of March 5 [I.R.M. § 13.1.7.2.2(2)].

Criteria 7: A system or procedure has either failed to operate as intended or failed to resolve the taxpayer's problem or dispute within the IRS.

Examples include the IRS's failure to reverse a refund freeze or to properly apply a credit elect to another period.

Example 7.18
The IRS Failed to Resolve a Taxpayer's Problem

Horace Weber wrote to the IRS for an abatement of his federal tax deposit penalty and requested a credit elect to the next quarter. The IRS abated the penalty, but the overpayment was not credited to the next quarter. Horace's circumstances meet Criteria 7 because the IRS's procedures for crediting overpayments failed to operate as intended [I.R.M. § 13.1.7.2.2(3)].

Best Interest of the Taxpayer

The NTA accepts "best interest of the taxpayer" cases to ensure that taxpayers receive fair and equitable treatment and that their rights are protected.

Criteria 8: The way that the tax laws are being administered raises considerations of equity or has impaired or will impair the taxpayer's rights.

Case Criteria 8 is used if the case does not fit into any other TAS case criteria. Criteria 8 applies to the impairment of a taxpayer's rights, such as the right to be informed, the right to quality service, and the right to pay no more than the correct amount of tax. If no rights have been impaired, the TAS considers the equities. If the action the IRS is taking is not equitable, a case can also be classified as Criteria 8.

Example 7.19
Economic Harm from Levy

Phillipa Mendez seeks TAS assistance because a levy was issued before she received her collection due process (CDP) rights, and she wants TAS assistance in getting the levy released because she cannot pay for her basic living expenses with the levy in place. Although the taxpayer's rights have been impaired because of the IRS's failure to provide CDP rights, it would not be appropriate to classify the case as Criteria 8 because Phillipa is also experiencing economic harm, and the case would meet Case Criteria 1 [I.R.M. § 13.1.7.2.3(1)].

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Public Policy

The National Taxpayer Advocate (NTA) determines case acceptance under this category. Criteria 9 may apply only when the taxpayer's case does not fit within any other criteria.

Criteria 9: The NTA determines that compelling public policy warrants assistance to an individual or group of taxpayers.

The NTA designates the issues that qualify for acceptance under this criterion by a memo that the NTA issues at least annually. The NTA issued an Interim Guidance Memo (IGM) on November 20, 2020 (effective until November 19, 2022), that designates Criteria 9 cases to include private debt collection; passport denial, revocation, or limitation; automatic exempt organization revocations due to failure to file an annual return or notice for 3 consecutive years; and congressional referred tax account-related inquiries (excluding stand-alone economic impact payment issues after November 23, 2020) that do not fit into any other category.

TAS Operations Assistance Requests

If the TAS does not have delegated authority to take actions necessary to resolve a taxpayer's issues, the TAS uses the Form 14212 Operations Assistance Request (OAR) process to request action by an IRS operating division or functional unit. I.R.M. § 13.1.19 describes the TAS OAR process.

The case advocate conducts research and identifies issues. It requests internal and external documents. The case advocate requests that the IRS take specific action (or refrain from taking specific action), and where appropriate, explains the account changes that need to be made to implement the request.

If the IRS employee assigned to the OAR cannot reach an agreement with the case advocate about the appropriate action or the agreed upon action is not completed by the agreed upon date, the case advocate elevates the case to his or her manager for review. If the manager does not reach an agreement (or agreed upon actions are not timely completed), and the taxpayer faces a significant hardship, the case may be elevated to the LTA who may take steps to issue a TAO (discussed next).

TAS Taxpayer Assistance Orders

I.R.C. § 7811 authorizes the NTA to issue a Taxpayer Assistance Order (TAO) when a taxpayer is suffering or is about to suffer a significant hardship as a result of the manner in which the internal revenue laws are being administered. The decision to issue a TAO is unrelated to the case criteria code assigned to the case. The section 7811 determination regarding significant hardship must be made prior to consideration of a TAO.

A finding that a taxpayer is suffering or about to suffer a significant hardship as a result of the manner in which the internal revenue laws are being administered by the IRS will not automatically result in the issuance of a TAO. After making a determination of significant hardship, the NTA must determine whether the facts and the law support relief for the taxpayer.

PRACTITIONER NOTE

Taxpayer or Tax Practitioner Application

The taxpayer or the taxpayer's authorized representative can file an application for a TAO. A request for a TAO is made on Form 911, Request for Taxpayer Advocate Service Assistance (And Application for Taxpayer Assistance Order) (or other specified form) or in a written statement that provides sufficient information for the TAS to determine the nature of the harm or the need for assistance.

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A TAO will be considered when all the following factors are present:

1. The taxpayer is suffering or about to suffer a significant hardship if relief is not granted.
2. The significant hardship results from how the IRS is administering the law.
3. The TAS does not have the authority to take the actions needed to grant relief to the taxpayer or to resolve a case issue.
4. The IRS operating division or function does not agree with the TAS on the proper resolution of specific case issues, or the IRS fails to perform the actions recommended by the TAS.

A *significant hardship* includes the following:

- An immediate threat of adverse action
- A delay of more than 30 days in resolving taxpayer account problems
- The taxpayer incurring significant costs (including fees for professional representation) if relief is not granted
- Irreparable injury to, or a long-term adverse impact on, the taxpayer if relief is not granted
- A serious privation (more than just economic or personal convenience) caused or about to be caused to the taxpayer as a result of how the IRS is administering the revenue laws

PRACTITIONER NOTE

Form 9102

Although it is not necessary to issue a Form 12412, Operation Assistance Request (OAR), before issuing a Form 9102, Taxpayer Assistance Order (TAO), in most cases the CA will issue an OAR prior to a TAO, if time permits. The only requirement before issuing a TAO is that a conversation takes place between TAS and the responsible official in the IRS operating division or function about the requested action. See I.R.M. § 13.1.20.4.1 for the Form 9102 writing guidelines.

A TAO may be issued for either of two purposes:

1. To direct the operating division or function take a specific action, cease a specific action, or refrain from taking a specific action
2. To direct the IRS to review at a higher level, expedite consideration of, or reconsider a taxpayer's case

A TAO requires only actions that are otherwise permitted by law, regulations, or other guidance. It may not be issued to determine the merits of a taxpayer's liability or to overturn or circumvent an established process for administrative or judicial review of a taxpayer's case.

Example 7.20
TAO for Reconsideration of an Offer in Compromise

The IRS rejected Katrina Thompson's offer in compromise (OIC). Katrina filed Form 911, Request for Taxpayer Advocate Service Assistance (and Application for Taxpayer Assistance Order). The NTA discovered facts that supported acceptance of the OIC. The NTA may issue a TAO ordering the IRS to reconsider its rejection of the offer or to review the rejection of the offer at a higher level. The TAO may include the NTA's analysis of and recommendation for resolving the case [Treas. Reg. § 301.7811-1(c)(4), Example 2].

Example 7.21
TAO for Certain Appeals Action

Loretta Russo filed a protest requesting Appeals consideration of the IRS's proposed denial of her request for innocent spouse relief. Appeals advised Loretta that it is going to issue a final determination denying the request. Loretta filed Form 911. The NTA reviewed the administrative record and concluded that the facts support granting innocent spouse relief. The NTA may issue a TAO ordering Appeals to refrain from issuing a final determination and reconsider or review at a higher level its decision to deny the relief. The TAO may include the NTA's analysis of and recommendation for resolving the case [Treas. Reg. § 301.7811-1(c)(4), Example 3].

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Requesting TAS Assistance

A taxpayer makes a request for TAS assistance by phone, in person, or by completing Form 911, Request for Taxpayer Advocate Service Assistance (and Application for Taxpayer Assistance Order). If the TAS accepts the request, it assigns a case advocate. The case advocate independently reviews the issue, updates the taxpayer and his or her representative on resolution progress, and provides an anticipated timeline for action. The case advocate also advises the taxpayer on how to avoid future federal tax problems.

Contact by Phone or in Person

The taxpayer can call 1.877.777.4778. The taxpayer can also call or visit the local TAS office to discuss the taxpayer's problem. The addresses and phone numbers for the local TAS offices are available at www.irs.gov/advocate/local-taxpayer-advocate or in IRS Publication 1546, *Taxpayer Advocate Service: We Are Here to Help You.*

Form 911

The taxpayer can complete Form 911 and mail or fax it to the local TAS office. The taxpayer must complete Section I, Taxpayer Information, and Section II, Representative Information (if appropriate). The taxpayer describes the problem in section 12a of Section I and describes the requested relief in section 12b of Section I.

The taxpayer should include the details of the tax issue, the difficulties it is creating for the taxpayer, and what the IRS did or did not do to resolve the issue. If there has been an IRS delay of more than 30 days, the taxpayer should include the date that he or she contacted the IRS for assistance. If a deadline has been postponed because of the COVID-19 pandemic, the application should clearly show that the taxpayer is eligible for relief under both the normal response date and any revised timeline. The problem must meet the TAS acceptance criteria (discussed earlier). The taxpayer can submit supporting documentation with Form 911.

The taxpayer should set forth as many relief actions as may be appropriate. Being as specific as possible will help the TAS understand what types of relief will help the taxpayer.

A tax practitioner may submit Form 911 for the taxpayer. He or she should also submit Form 2848, Power of Attorney and Declaration of Representative. By filing Form 911, the taxpayer authorizes the TAS to contact third parties as necessary to respond to the request for assistance. If the taxpayer or his or her representative does not receive a response within one week of the submission of Form 911, the taxpayer or the representative should call the TAS office where the form was filed.

PRACTITIONER NOTE

IRS Resolution

Prior to contacting the TAS, the taxpayer or his or her representative should first try to resolve the case with the appropriate IRS supervisor.

CROSS-REFERENCE

Statute of Limitations

An application for a TAO suspends the statute of limitations for any action that is the subject of the TAO [Treas. Reg. § 301.7811-1(e)]. The statute of limitations is not suspended in cases where the Ombudsman issues an order in the absence of a written application for relief by the taxpayer or the taxpayer's duly authorized representative. See pages 517–518 in the *2017 National Income Tax Workbook* for a discussion of the suspension of the statute of limitations.

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ISSUE 3: CYBERSECURITY Cybercriminals use text, email, and phone scams to steal information and perpetuate fraud.

In 2021, cybercriminals used coronavirus lures to steal personal data, financial information, and economic impact payments. Tax practitioners must be aware of common tax scams to protect themselves and their clients. This section reviews the most common recent tax-related scams. It explains how tax practitioners can protect themselves and their businesses from these scams and how taxpayers can obtain and use an identity protection personal identification number (IP PIN).

CROSS-REFERENCE

Cybersecurity

For additional information on recognizing and reporting phishing schemes and other scams, and a tax practitioner's duties to safeguard information, see pages 176–185 in the *2020 National Income Tax Workbook*.

Pandemic-Related Fraud

The Federal Trade Commission (FTC) reports that fraud linked to COVID-19 cost Americans $382,000,000 as of March 2021. More than 217,000 people filed a coronavirus-related fraud report with the FTC since January 2020. Criminals succeeded in stealing money through several scams related to economic impact payments (EIPs), false unemployment benefit claims, fake contract tracers, funeral assistance scams, and fraudulent disaster relief and charitable contribution solicitations.

Economic Impact Payment Scams

Criminals use stimulus-themed emails and text messages to trick individuals into providing personally identifiable information and bank account details. They also sought to steal economic impact payments (EIPs) by trying to get recipients to sign their checks over.

One scam involves a text message saying the sender has received a direct deposit of the payment from COVID-19 TREAS FUND but further action is required to accept the payment. The taxpayer is then directed to accept the payment by using a link that leads to a phishing web address. The fake link appears to come from a state agency or relief organization. The fake website looks like the IRS.gov GetMyPayment website and requests the input of personal and financial account information.

Another scam consists of a call impersonating an IRS employee offering to assist in processing the taxpayer's EIP. The impersonator says that to send the EIP he or she needs the taxpayer's personal information and the taxpayer's banking username and password.

Scammers may also try to convince victims to deposit fraudulent or stolen US treasury checks into the victim's bank account. After the deposit is made, the scammers request that the victim send the funds to another account or use the funds to purchase prepaid cards.

The IRS advises the following:

- The IRS will deposit the EIP into the direct deposit account the taxpayer previously provided on his or her tax return (or, in the alternative, send a paper check).
- The IRS will not call and ask you to verify payment details.
- Do not give out bank account, debit account, or PayPal account information, even if someone claims it is necessary to get the check.
- Delete any texts or emails claiming that you can get your money faster by sending personal information or clicking on links. Do not click on any links in those emails.

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- If you receive a "check" in the mail it may be a fraud. A "check" for an odd amount (especially one with cents), or a check that requires the payee to verify the check online or by calling a number is a fraudulent check.
- Anyone with information about fraud in this area or any other tax related fraud is asked to please contact Internal Revenue Service, Criminal Investigation at: PhiladelphiaFieldOffice@ci.irs.gov

OBSERVATION

Child Tax Credit

The first monthly payment of the expanded and newly advanceable child tax credit (CTC) was made on July 15. Approximately 39,000,000 households were scheduled to begin receiving monthly payments without any further action required. The IRS is establishing two online portals to facilitate updating taxpayer payment preferences and taxpayer information. The first portal is for taxpayers to opt-out of advanced monthly payments of the CTC if the taxpayers prefer a single payment in 2022. The second portal allows taxpayers who do not normally file and families with changes in circumstances to determine eligibility for the CTC. Tax practitioners should be cautious of text, phone, and email "assistance" offered by cybercriminals posing as IRS employees and scams related to issuance of the advanceable CTC.

False Unemployment Benefit Claims

States have experienced a surge in fraudulent unemployment claims filed by organized crime rings using stolen identities. Criminals are using these stolen identities to fraudulently collect benefits across multiple states.

Scammers use websites that mimic government unemployment insurance benefit websites to trick individuals into thinking they are applying for unemployment benefits when they are really giving away personal information. Scammers file fraudulent claims for unemployment compensation using the stolen personally identifiable information. The payments are made to the identity thieves, and the unrelated individuals whose names and personal information were stolen do not receive any of the payments.

The IRS advises taxpayers who receive an incorrect Form 1099-G, Certain Government Payments, to contact the state issuing agency to request a revised form. The state agency should issue the identity theft victim a corrected Form 1099-G reporting $0 and file the form with the IRS as soon as possible after the error is discovered. If the taxpayer is unable to get a timely, corrected form from the state, he or she should still file an accurate tax return reporting only the income received and save the documentation of the attempts to obtain a corrected form from the state agency.

The following could also indicate that the taxpayer is the victim of unemployment identity theft:

- He or she receives mail from a government agency about an unemployment claim or payment. This includes unexpected payments or debit cards.
- A taxpayer's employer receives a request for information about an unemployment claim in the taxpayer's name.

Taxpayers should report unemployment identity theft to the state where it occurred. There is a state directory at www.dol.gov/agencies/eta/UIIDtheft. The Department of Labor also recommends that taxpayers report unemployment identity theft that occurred during the COVID-19 pandemic to the U.S. Department of Justice National Center for Disaster Fraud [www.justice.gov/disaster-fraud/webform/ncdf-disaster-complaint-form].

Tracing and Testing Scams

Scammers pretending to be contact tracers have been sending text messages with a link that will download malware to the user's device. A scammer may also call posing as a state contact tracer but will request personal information such as a social security number, bank account, or credit card number.

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The FBI warns the public to be aware of the following other potential indicators of fraudulent activity:

- Claims of FDA approval for antibody testing that cannot be verified
- Advertisements for antibody testing through social media platforms, email, telephone calls, online, or from unsolicited/unknown sources
- Marketers offering "free" COVID-19 antibody tests or providing incentives for undergoing testing
- Individuals contacting you in person, phone, or email to tell you the government or government officials require you to take a COVID-19 antibody test
- Practitioners offering to perform antibody tests for cash

Funeral Assistance Scams

Under the Coronavirus Response and Relief Supplemental Appropriations Act of 2021 and the American Rescue Plan Act of 2021, the Federal Emergency Management Agency (FEMA) is authorized to pay up to $9,000 for COVID-19 related funeral expenses incurred after January 20, 2020. Survivors apply for benefits by contacting FEMA at 844.684.6333.

Even before the program became available in April 2021, scammers were contacting individuals to offer to "register" them for assistance. Contact may be made by phone, text, email, or through social media. The scammer may require payment and may ask for personal or financial information of the individual or of the deceased person.

FEMA scams should be reported to the FEMA Helpline at 800.621.3362 or the National Center for Fraud Hotline at 866.720.5721. Complaints can also be made to local law enforcement agencies or to the FTC at ReportFraud.ftc.gov.

Tax-Related Phishing

Phishing is a scam typically carried out through unsolicited email and/or websites that pose as legitimate sites and lure unsuspecting victims to provide personal and financial information.

An ongoing IRS impersonation scam targets primarily staff and students of educational institutions who have an ".edu" email address. The phishing emails display the IRS logo and use various subject lines such as "Tax Refund Payment" or "Recalculation of your tax refund payment." It asks that the recipient click a link and submit a form to claim a refund. The website requests the taxpayer's name, social security number, date of birth, prior-year's AGI, driver's license number, current address, and electronic filing PIN.

Recipients should not click on the link in the email. Instead, they should save the email using "save as" and send it as an attachment to phishing@irs.gov.

PRACTITIONER NOTE

Identity Protection PIN

If the taxpayer believes that he or she inadvertently gave an identity thief personally identifiable information, the taxpayer should consider immediately applying for an identity protection PIN (IP PIN). This is a voluntary opt-in program. An IP PIN is a six-digit number that helps prevent identity thieves from filing fraudulent tax returns in the victim's name. The taxpayer should also check his or her credit reports for suspicious activity or new unauthorized lines of credit and consider a credit freeze, which can protect against new unauthorized accounts.

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Phone Scams

Phone calls (and phone messages) attempt to trick or intimidate taxpayers into providing money or personally identifiable information. In some phone scams, callers claim to be IRS employees, and use false names and IRS identification badge numbers. They may know a lot about their targets, and they usually alter the caller ID to make it look like the IRS is calling.

Victims are told they owe money to the IRS, and it must be paid promptly through a gift card or wire transfer. Victims may be threatened with arrest, deportation, or suspension of a business or driver's license. In many cases, the caller becomes hostile and insulting. Victims may be told they have a refund due to try to trick them into sharing private information.

Some of the scams include the following:

- "We're calling to tell you your identity was stolen; you need to buy some gift cards to fix it."
- "We'll cancel your Social Security number" or "Your Social Security Number has been suspended."
- "This is the Bureau of Tax Enforcement, and we're putting a lien or levy on your assets."
- We're from the Taxpayer Advocate Service, and we need some information."

PRACTITIONER NOTE

Reporting IRS Scams

Taxpayers and tax practitioners can report IRS-related scams to the Treasury Inspector General for Tax Administration (TIGTA) using the online complaint form [www.treasury.gov/tigta/contact_report_scam.shtml] or call 1.800.366.4484. If Treasury-related, report the scam to the Office of the Treasury Inspector General (TIG) at OIGCounsel@oig.treas.gov. IRS or Treasury-related fraudulent calls should also be reported to phishing@irs.gov (Subject: IRS Phone Scam).

Tax Practitioner Protection

Tax practitioners remain high-value targets of cybercriminals seeking to steal sensitive tax information, so they can file fraudulent returns. Thus, all tax professionals should implement security measures to protect client data and their businesses.

Taxes-Security-Together-Checklist

The IRS, state tax agencies, and the tax industry partners who make up the Security Summit created a Taxes-Security-Together Checklist. The checklist is a guide to help tax professionals with cybersecurity. The checklist includes the following:

1. Deploy the Security Six measures
   a. Activate antivirus software
   b. Use a firewall
   c. Opt for two-factor authentication on online accounts
   d. Use backup software/services
   e. Use drive encryption
   f. Create and secure a Virtual Private Network (VPN)
2. Create a data security plan. Federal law requires all professional tax preparers, regardless of size, to create and maintain an information security plan for client data. The data plan should focus on key areas such as employee management and training; information systems; and detecting and managing system failures.
3. Educate yourself on phishing scams
   a. Learn about spear phishing emails
   b. Beware of ransomware
4. Recognize the signs of client data theft
   a. Clients receive IRS letters about suspicious tax returns in their name
   b. More returns filed with your Electronic Filing Identification Number than you submitted
   c. Clients receive tax transcripts they did not request

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5. Create a data theft recovery plan
   a. Contact the local IRS stakeholder liaison immediately
   b. Assist the IRS in protecting clients
   c. Contract with a cybersecurity expert to stop thefts

Additional Resources

To stay up to date on the latest threats and scams, tax practitioners can bookmark and follow the IRS "Protect your Clients; Protect Yourself" campaign at www.irs.gov/tax-professionals/protect-your-clients-protect-yourself page. They can also register for e-News for Tax Professionals, and e-Services users can register for Quick Alerts to stay informed about the latest news and threats. The IRS also posts cybersecurity information on its social media at Twitter.com/IRStaxpros, Twitter.com/IRSNews, and Facebook.com/IRStaxpros.

Identity Protection Personal Identification Number

The Identity Protection Personal Identification Number (IP PIN) is a six-digit code known only to the taxpayer and the IRS. Its purpose is to prevent identity thieves from filing fraudulent tax returns using a taxpayer's personally identifiable information. The IP PIN acts as an authentication number to validate the correct owner of the social security number or individual taxpayer identification number shown on the return.

The IP-PIN program began in 2011 to protect confirmed identity theft victims from ongoing tax-related fraud. In recent years, the IRS allowed taxpayers in specific states to voluntarily opt into the IP PIN program. Beginning in January 2021, the program was expanded to all taxpayers who can verify their identities. The IP PIN program is voluntary for taxpayers other than those who have been victims of identity theft or those who have filed an identity theft affidavit because of suspected stolen identity refund fraud.

PRACTITIONER NOTE

Opting Out

Once the taxpayer is in the program, the IRS will send a new IP PIN each year. The CP01A notices, IP PIN notices, are sent to taxpayers from mid-December through early January. However, the IRS is developing an opt-out option for taxpayers who no longer want to use an IP PIN. Opting-out will not be available to taxpayers who were victims of identity theft.

Getting an IP PIN

If the taxpayer is a confirmed identity theft victim, the IRS will mail the taxpayer an IP PIN on a CP01A Notice if the case is resolved prior to the start of the next filing season. Other taxpayers who have a social security number or an individual taxpayer identification number and can verify their identities are eligible to enroll in the IP PIN program. Dependents are eligible for an IP PIN if they can pass the identity verification process.

If a taxpayer has already established secure access to an IRS online services account, he or she can sign in and follow the prompts to get an IP PIN. Taxpayers can register for an IRS online services account at www.irs.gov/payments/view-your-tax-account, and then must pass the secure access identity authentication or verify identity by an alternative method.

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Secure Access Identity Authentication

The taxpayer needs the following information to register for an online services account and verify his or her identity:

- Email address
- Social security number or individual tax identification number
- Tax filing status and mailing address
- One financial account number linked to the taxpayer's name
- Credit card: last 8 digits (no American Express, debit or corporate cards, Barclays cards, and some cards issued by US banks in US territories)
- Student loan (cannot verify Nelnet loans)
- Mortgage or home equity loan
- Home equity line of credit (HELOC)
- Auto loan
- Mobile phone number

The mailing address used to register must match the address on the last return filed, even if it is not the most recent address. This address is used only for identification purposes. If secure access can verify a mobile phone number associated with the taxpayer's name, the system will send a one-time activation code to the mobile phone number. The applicant must use the code within 10 minutes of receipt.

If secure access cannot verify the mobile phone number (or if the applicant does not have a US-based mobile phone number associated with his or her name and the applicant requests a code by mail), the activation code is sent by mail within 10 business days. The code is a one-time only code that is valid for 30 days.

Every time a user logs in to the online account, the IRS Password Service sends a security code by text message or phone call. Text messages originate from 77958 and phone calls originate from 202.318.5542. This code is valid for only 10 minutes. A user can request a new code from the login screen, but after a few attempts the account will be locked for 24 hours.

The user can retrieve a forgotten username or password on the login page. He or she can change a username, password, or mobile number by logging into the account and selecting "Profile." The IRS call center cannot find usernames, unlock accounts, or reset passwords.

If a user suspects suspicious login activity, he or she can log in and change the password. If the account holder no longer needs access to IRS online services, he or she can lock access to the account.

Alternative Methods to Verify Identity

Taxpayers who are unable to verify their identities online have the following two options:

1. Taxpayers with AGI that is $72,000 or less may complete Form 15227, Application for an Identity Protection Personal Identification Number (IP PIN), and mail or fax it to the IRS. An IRS customer service representative will contact the taxpayer and verify his or her identity by phone. The taxpayer can call 1.800.908.4490 to verify the caller is an IRS employee. Taxpayers using this method will receive their IP PIN in the mail the following tax year.
2. Taxpayers who cannot verify their identities online and who are ineligible to file Form 15227 must contact the IRS and make an appointment at a Taxpayer Assistance Center to verify their identity in person. Two forms of identification are required, including one government-issued picture identification. Taxpayers who verify their identity in person will receive an IP PIN in the mail within 3 weeks.

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Using the IP PIN

Once an IP PIN has been assigned to a taxpayer it must be entered on electronic and paper tax returns to avoid rejection or delays. The IP PIN is used on only Forms 1040, 1040-NR, 1040-SR, 1040-PR, and 1040-SS. Assigned IP PINs are required on any return filed during the calendar year for which the IP PIN is valid including any late-filed prior-year tax returns (originals, not amendments).

Where to Enter the IP PIN

The signer of the return enters the assigned IP PIN next to the signature. If a dependent has an IP PIN, it must be entered on an e-filed Form 1040 series return, Form 2441, Child and Dependent Care Expenses, and the earned income tax credit schedule. A dependent's IP PIN is not entered on a paper return.

Retrieving an IP PIN

If the taxpayer loses an IP PIN or does not receive a CP01A notice with the new IP PIN for the year, he or she can retrieve the number through the Get an IP PIN online tool. Even if a taxpayer already established an online account, he or she may be required to verify identity again.

If the taxpayer cannot retrieve the IP PIN online, he or she can call 800.908.4490 for specialized assistance. This assistance is available Monday through Friday, 7 a.m. to 7 p.m. of the taxpayer's local time (Alaska and Hawaii follow Pacific Time). An assistor will verify the taxpayer's identity and mail the IP PIN to the address of record within 21 days.

Retrieving the number by phone is not an option if the taxpayer has moved since January 1 of the current year or it is after October 14 and the taxpayer has not filed current- or prior-year returns.

The taxpayer should file a paper return without the IP PIN and expect a delay in processing the return and issuing any refund due.

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ISSUE 4: IRS ONLINE TOOLS. The IRS continues to develop online tools to assist taxpayers and tax practitioners.

The IRS has implemented and expanded several online tools. This section discusses a new process to submit Forms 2848 and 8821 online, forms that can be filed with e-signatures, and forms that now can or must be filed electronically.

Submitting Forms 2848 and 8821 Online

To address situations that have arisen during the ongoing pandemic, the IRS established an online option that allows tax professionals to obtain consent remotely on Form 2848, Power of Attorney and Declaration of Representative, and Form 8821, Tax Information Authorization and submit those form electronically [I.R. 2021-20 (January 25, 2021)]. IRS Commissioner Chuck Rettig has said, "This is a first step in our ongoing efforts to expand digital options for tax professionals using electronic signatures and online uploads." Tax professionals can find the new "Submit Forms 2848 and 8821 Online" at IRS.gov/taxpros. It also has "friendly" web addresses that can be bookmarked: IRS.gov/submit2848 and IRS.gov/submit8821.

Tax professionals must have a secure access account, including a current username and password, or create an account before submitting an online authorization form. The taxpayer and the tax professional must sign Form 2848. If the tax professional uses the new online option, the signatures on the forms can be handwritten or electronic. Form 8821 needs only the taxpayer's signature. If the tax professional uses the electronic signature option for a new client, the tax professional must first authenticate the client's identity.

Tax professionals may also use the online platform to revoke or withdraw previous authorizations. However, the new online option cannot be used to ask questions or address other issues. The process to mail or fax authorization forms to the IRS is still available. Signatures on mailed or faxed forms must be handwritten. Electronic signatures are not allowed.

PRACTITIONER NOTE

Logging Out

Users must log out of IRS's e-Services website before using the power of attorney website.

Using the Online Tool

Submitting Forms 2848 or 8821 requires the following steps:

1. The taxpayer electronically or physically signs Form 2848 or Form 8821 and submits it to the tax professional by mail, fax, or secure email.
2. If required, the tax professional authenticates the taxpayer's identity.
3. The tax professional signs the form either electronically or physically (only Form 2848).
4. The tax professional signs into secure access with his or her username and password and selects "Submit Forms 2848 and 8821 Online." The professional must agree to the terms and conditions of using the Taxpayer Digital Communications (TDC). This is a one-time only request.
5. The tax professional uploads the electronic version of Form 2848 or Form 8821 via the upload tool. Once a form is uploaded, it is routed to the Centralized Authorization File (CAF) unit for processing.
6. The CAF unit verifies the information on the form and, if processable, enters it into the CAF database.

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The tool will ask a series of questions that a user must answer to correctly route the forms to the proper CAF unit. The questions include the following:

1. Form type: 2848, 8821, or withdrawing or revoking prior authorizations
2. Whether, if required, the tax professional authenticated the taxpayer's identity
3. Whether the taxpayer is a domestic or international client
4. Whether the third-party is working for a low-income taxpayer clinic

The client's taxpayer identification number must be entered before the tax professional selects the authorization file for upload (discussed next). Once the uploaded file is visible, the tax professional selects "submit" to send the file to the CAF. The word "success" will appear if the submission goes through. The tool then gives tax professionals the option to upload another file without the need to go through secure access again.

Electronic Signatures

Electronic signatures can be any of the following:

1. A typed name that is typed on a signature block
2. A scanned or digital image of a handwritten signature attached to an electronic record
3. A handwritten signature inputted onto an electronic signature pad
4. A handwritten signature, mark, or command inputted on a display screen with a stylus device

[IRS FAQs: online submission of power of attorney and tax information authorization forms (FAQs) Q&A 1]

OBSERVATION

Digital Signatures

An electronic signature is an electronic symbol attached to an electronic record that a person will sign. A digital signature, such as DocuSign or Adobe Sign is a type of electronic signature.

Identity Authentication

The tax practitioner must authenticate a taxpayer's identity if the taxpayer electronically signs the form in a remote transaction (e.g., not in the practitioner's presence) and the tax practitioner does not have a personal or business relationship with the taxpayer.

Individual Taxpayer

To authenticate an individual taxpayer's identity for remote transactions, the tax practitioner must take the following steps:

1. Inspect a valid government photo identification (ID) of the taxpayer and compare the photo to the taxpayer. Examples of a government photo ID include a driver's license, employer ID, school ID, state ID, military ID, national ID, voter ID, visa, or passport
2. Use a self-taken picture of the taxpayer or video conferencing to compare to the ID
3. Record the name, social security number or taxpayer identification number (TIN), address, and date of birth of the taxpayer
4. Verify the taxpayer's name, address, and social security number or TIN using secondary documentation, such as a federal or state tax return, IRS notice or letter, social security card, credit card, or utility statement
5. Retain the record created in Step 3 for 7 years

[FAQs Q&A 3–5]

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Business Entity Taxpayer

To authenticate a business entity (including a tax-exempt entity) taxpayer's identity, the practitioner must take the following steps:

1. Verify by documentation that the signing individual has authority to sign on behalf of the business entity taxpayer. Authorized signers for business entities are as follows:
   a. Corporation. An officer having authority under applicable state law to bind the corporation, any person designated by the board of directors or other governing body, any officer or employee on a written request signed by any principal officer and attested to by the secretary or other officer, or any bona fide shareholder of record owning 1% or more of the outstanding stock of the corporation
   b. S Corporation. Any person who was a shareholder during any part of the period covered by the return during which an election under I.R.C. § 1362(a) was in effect, any person authorized by applicable state law to act for a dissolved corporation, or any person who has a material interest that will be affected by the information in the return
   c. Partnership. Any person who was a member of the partnership during any part of the period covered by the return
   d. Bipartisan Budget Act (BBA) Centralized Regime Partnership. Any person or entity that was a partner in the partnership during any part of the period covered by the return, and if an individual is signing, any person who is the partnership representative (PR) of the partnership for the period covered by the return. If an entity is the PR signing for the partnership, any person who is the designated individual of the entity that was the PR for the partnership for the period covered by the return and any person under applicable state law with the current authority to bind the entity PR
2. Inspect a valid government-issued photo identification of the individual authorized to represent the business entity taxpayer and compare it to a self-taken picture or video conferencing image of the authorized individual
3. Record the name, EIN, and the address of the business entity taxpayer
4. Verify the business entity taxpayer's name, EIN, and address through secondary documentation, such as a tax information reporting form (e.g., W-2, 1099), an IRS notice or letter, or a utility statement
5. Retain the record created in Step 3 for 7 years

Uploading the Forms

The tax practitioner must first save the forms in a .pdf, .jpeg, .jpg, or .gif file format. He or she can upload only one form at a time, and there is a 15MB file size limit. The IRS does not offer telephone support for the online platform but will send an email confirmation when the form is successfully submitted and will mail a letter to the tax practitioner and the taxpayer if the form is rejected [FAQs Q&A 12-14]. An IRS webinar showing how to upload the forms is available at www.irsvideos.gov/Webinars/UploadingForms2848And8821WithElectronicSignatures.

PRACTITIONER NOTE

Barcode Technology

The IRS is adding barcode technology to the CP14 and CP14 IA notices that inform taxpayers that they owe money on unpaid taxes and their payment options. Taxpayers can use their smartphones to scan a QR code in the CP14 or CP14 IA to go directly to IRS.gov and securely access their account, set up a payment plan, or contact the Taxpayer Advocate Service.

CAF Review

The confirmation email and "success" message that the tax practitioner receives when submitting the form is only to notify the user that the form has been successfully submitted. The online submission process does not eliminate the CAF unit review and processing. If after review, the CAF unit rejects a form, the IRS sends a notice of rejection to the representative and the taxpayer by mail.

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There is no expedited processing for online submissions. The CAF Unit processes online submissions in the same manner as forms that are faxed or mailed, which means they are reviewed on a first-come first-served basis.

PRACTITIONER NOTE

Tax Pro Account

Tax professionals with a Tax Pro Account have the ability to electronically initiate and sign an online third-party authorization form. If the client has an IRS online account, the form will electronically transfer into the client's account. The client can then electronically sign the form through the client's online account. The form is then routed to the CAF unit automatically, and processing will be almost immediate.

e-Signatures on Mailed Forms

To protect employees, taxpayers, and their representatives by minimizing the need for in-person contact, the IRS has temporarily allowed electronic signatures on certain forms that currently require a handwritten signature. The forms must be postmarked from August 28, 2020, through December 31, 2021. There is no specific technology required for the electronic signatures. **Figure 7.5** shows a list of the forms.

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FIGURE 7.5
Electronic Signatures Allowed

Form Number	Form Title or Purpose
11-C	Occupational Tax and Registration Return for Wagering
637	Application for Registration (For Certain Excise Tax Activities)
706	U.S. Estate (and Generation-Skipping Transfer) Tax Return
706, Schedule R-1	Payment voucher for the Generation-Skipping Transfer (GST) Tax
706-A	U.S. Additional Estate Tax Return
706-GS(D)	Generation-Skipping Transfer Tax Return For Distributions
706-GS(D-1)	Notification of Distribution From a Generation-Skipping Trust
706-GS(T)	Generation-Skipping Transfer Tax Return For Terminations
706-NA	U.S. Estate (and Generation-Skipping Transfer) Tax Return
706-QDT	U.S. Estate Tax Return for Qualified Domestic Trusts
709	U.S. Gift (and Generation-Skipping Transfer) Tax Return
730	Monthly Tax Return for Wagers
1066	U.S. Income Tax Return for Real Estate Mortgage Investment Conduit
1120-C	U.S. Income Tax Return for Cooperative Associations
1120-FSC	U.S. Income Tax Return of a Foreign Sales Corporation
1120-H	U.S. Income Tax Return for Homeowners Associations
1120-IC-DISC	Interest Charge Domestic International Sales Corporation Return
1120-L	U.S. Life Insurance Company Income Tax Return
1120-ND	Return for Nuclear Decommissioning Funds and Certain Related Persons
1120-PC	U.S. Property and Casualty Insurance Company Income Tax Return
1120-REIT	U.S. Income Tax Return for Real Estate Investment Trust
1120-RIC	U.S. Income Tax Return for Regulated Investment Companies
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1128	Application To Adopt, Change, or Retain a Tax Year
2678	Employer/Payer Appointment of Agent
3155	Application for Change in Accounting Method
3520	Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts
3520-A	Annual Information Return of Foreign Trust with a U.S. Owner
4421	Declaration – Executor's Commissions and Attorney's Fees
4768	Application for Extension of Time to File a Return and/or Pay U.S. Estate (and Generation-Skipping Transfer) Taxes
8038, 8038-G, 8038-GC	Pertaining to tax-exempt bonds
8283	Noncash Charitable Contributions
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8802	Application for U.S. Residency Certification
8832	Entity Classification Election
8971	Information Regarding Beneficiaries Acquiring Property From a Decedent
8973	Certified Professional Employer Organization/Customer Reporting
§ 83(b) elections	Election to include restricted property in income in the year of transfer

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Electronic Filing

The IRS has added a new electronic submission process for Form 1024-A, Application for Recognition of Exemption Under Section 501(c)(4) of the Internal Revenue Code, and Form 1040-X, Amended U.S. Individual Tax Return.

Form 1024-A

As part of ongoing efforts to improve service for the tax-exempt community, the IRS issued a revised Form 1024-A that can be filed electronically. "Electronic filing will make the Form 1024-A application easier to complete while reducing errors," said Edward Killen, Acting Commissioner of the IRS Tax Exempt and Government Entities division. "Electronic filing also shortens IRS processing time so applicants won't wait as long for a response."

The form must be submitted at pay.gov. After April 5, 2021, the Form 1024-A must be submitted electronically. The required user fee is $600 for 2021. Applicants must pay the fee through pay.gov when submitting the form. Payment can be made directly from a bank account or by credit or debit card. Rev. Proc. 2021-08, 2021-4 I.R.B. 502, modifies Rev. Proc. 2021-5, 2021-1 I.R.B. 250, by mandating the electronic submission of Form 1024-A.

PRACTITIONER NOTE

Notice of Intent to Operate

Section 501(c)(4) organizations may choose to seek a determination letter recognizing tax-exempt status under section 501(c)(4) by filing Form 1024-A but are not required to do so except in certain cases [for example, I.R.C. § 6033(j)(2) regarding failures to file annual information returns or annual electronic notifications required under section 6033(a) or (i)]. Submission of Form 1024-A does not relieve an organization of the requirement to submit Form 8976, Notice of Intent to Operate Under Section 501(c)(4). An organization must notify the IRS that it is operating as a section 501(c)(4) organization no later than 60 days after the date the organization was organized by electronically filing Form 8976 and paying a $50 user fee through pay.gov. In an IRS memorandum, the IRS provides guidance to examiners in determining whether an organization has timely filed Form 8976 and assessing the applicable penalties for failure to do so [TE/GE-04-0321-0006 (March 1, 2021)].

Form 1040-X

The revised Form 1040-X and instructions allow either electronic filing using tax software products or mailing the form. The instructions state that e-filing is available for amending 2019 and 2020 returns that were originally e-filed. E-filing amended returns will result in much faster processing and refunds. Tax practitioners should contact their tax software provider to verify the provider's participation in amended return e-filing, for specific instructions needed to submit an amended return, and for answers to any questions.

Filers will be allowed to electronically file up to three accepted amended returns. After the third accepted amended return, all subsequent attempts will reject. Currently, the normal processing time of up to 16 weeks also applies to electronically filed amended returns. Some returns may take longer to process. Direct deposit is not allowed.

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An amended return for tax year 2019 or 2020 can also be filed on paper. As of February 2021, the most recent paper Form 1040-X is the January 2020 revision. If the tax practitioner is amending a 2020 calendar year return, he or she should manually enter "2020" in the entry box next to "calendar year" on the line below the calendar year checkboxes. The practitioner should then complete the form as usual, using the most recent revision of Form 1040-X and the Instructions for Form 1040 for the tax year being amended.

The tax practitioner must file a paper form in the following circumstances:

1. Only tax year 2019 and 2020 1040 and 1040-SR returns can be amended electronically at this time. Amended returns for any other tax years or tax types must be filed by paper.
2. There must be a record of an original electronically filed return for tax year 2019 or tax year 2020. If the original tax year 2019 or tax year 2020 return was filed by paper, it must be amended by paper.
3. If the primary social security number is different from the one provided on the original return, then the amended return must be filed by paper.
4. If the spouse's social security number (if applicable) is different from the one provided on the original return, then the amended return must be filed by paper.
5. If the filing status differs from the filing status on the original return, then the amended return must be filed by paper.

The Taxpayer First Act of 2019, Pub. L. No. 116-25, amended section 6033 to require mandatory electronic filing of annual returns for tax-exempt organizations, and the return for reporting unrelated business income. The electronic filing mandate applies for tax years beginning after the date of enactment (July 1, 2019). However, the IRS provided some transitional relief. For tax years ending July 31, 2021, and later, Forms 990-EZ must be filed electronically.

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ISSUE 5: TAX PAYMENT ARRANGEMENTS Collection changes help taxpayers impacted by COVID-19.

The IRS has reviewed its collection activities to see how it could provide relief for taxpayers who owe taxes but are struggling financially because of the pandemic. IRS Commissioner Chuck Rettig has said, "The IRS understands that many taxpayers face challenges, and we're working hard to help people facing issues paying their tax bills." The IRS is expanding taxpayer options for making payments and other ways to resolve tax debt. This section discusses installment agreements, and how the IRS Taxpayer Relief Initiative expands payment options.

Installment Agreements

A taxpayer who cannot pay a tax liability in full may be able to pay, settle, or reduce the liability in several ways. This section discusses installment agreements. A taxpayer may request an installment agreement to pay taxes due in monthly payments. To qualify for an installment agreement, a taxpayer must be current in all filings.

Certain applications for an installment agreement can be made online (see the later discussion of the online application). Otherwise, the taxpayer must submit Form 9465, Installment Agreement Request, and Form 433-F, Collection Information Statement. Taxpayers may also apply by phone at 800.829.1040 (individual) or 800.829.4933 (business). Under the Taxpayer Relief Initiative, certain qualified individual taxpayers who owe less than $250,000 may set up installment agreements without providing a financial statement or substantiation if their monthly payment proposal is sufficient.

CROSS-REFERENCE

Offer in Compromise

The taxpayer may be eligible to request an offer in compromise (OIC), which is a request to settle the tax debt for less than the full amount owed. An OIC may be requested based on doubt as to collectability, doubt as to liability, or effective tax administration. See pages 531–550 in the *2017 National Income Tax Workbook* for an in-depth discussion of the three types of offers, how to submit an offer, how to complete Form 433-A (OIC), and the calculation of the offer amount.

User Fees

If an installment agreement is approved, the IRS charges a one-time user fee. Individuals with lower incomes are eligible for a reduced fee of $43. This reduced user fee is for individuals whose adjusted income is equal to or below 250% of the criteria established by poverty guidelines updated annually by the US Department of Health and Human Services. The reduced fee does not apply to corporations or partnerships. **Figure 7.6** shows the AGI levels to qualify for the reduced fee.

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FIGURE 7.6
Low-Income Taxpayer AGI Threshold for Reduced User Fees

Low-Income Taxpayer Adjusted Gross Income Guidance			
Size of Family Unit	**48 Contiguous States and D.C., and U.S. Territories**	**Alaska**	**Hawaii**
1	$32,200	$40,225	$37,050
2	$43,550	$54,425	$50,100
3	$54,900	$68,625	$63,150
4	$66,250	$82,825	$76,200
5	$77,600	$97,025	$89,250
6	$88,950	$111,225	$102,300
7	$100,300	$125,425	$115,350
8	$111,650	$139,625	$128,400
For each additional person, add	$11,350	$14,200	$13,050

Taxpayers use Form 13844, Application for Reduced User Fee for Installment Agreements, to apply for the reduced fee. The application must be made within 30 days from the date of the taxpayer's installment agreement acceptance letter. If income has recently decreased, the taxpayer should submit a new Form 433-F with the form. If the taxpayer already paid a user fee of more than $43, the IRS applies the excess to the taxpayer's tax liability.

The IRS will waive the user fees for a low-income taxpayer who agrees to make electronic payments through a debit instrument by entering into a direct debit installment agreement. If a low-income taxpayer cannot make electronic payments, then the IRS will reimburse the user fees upon completion of the installment agreement.

Figure 7.7 shows the user fees for a short-term (180 days or less) installment plan, and a long-term installment plan (more than 180 days).

FIGURE 7.7
Installment Plan Fees

Payment Method	Fees
Short-term payment plan ■ Paid directly from a checking or savings account (Direct Pay) (individuals only) ■ Paid online or by phone using EFTPS ■ Paid by check, money order, or debit/credit card (card fees may apply)	■ Apply online, $0 setup fee (individuals only, currently limited to 120 days) ■ Apply by phone, mail, or in-person, $0 setup fee (up to 180 days) ■ Penalties and interest accrue until the balance is paid in full
Long-term payment plan (installment agreement) paid through Direct Debit	■ Apply online, $31 setup fee ■ Apply by phone, mail, or in-person, $107 setup fee ■ Low-income, apply online, by phone, or in-person, setup fee is waived ■ Penalties and interest accrue until the balance is paid in full
Long-term payment plan ■ Paid directly from a checking or savings account (Direct Pay) (individuals only) ■ Paid online or by phone using EFTPS ■ Paid by check, money order, or debit/credit card (card fees may apply)	■ Apply online, $149 setup fee ■ Apply by phone, mail, or in-person, $225 setup fee ■ Low-income, apply online, by phone, or in-person, $43 setup fee, which may be reimbursed if certain conditions are met ■ Penalties and interest accrue until the balance is paid in full

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Interest and Penalties

Interest and penalties continue to accrue on the unpaid balance while an installment plan is in effect. However, the IRS generally will not take enforced collection actions

1. when a payment plan is being considered,
2. while a plan is in effect,
3. for 30 days after a request is rejected or terminated, or
4. while the IRS evaluates an appeal of a rejected or terminated agreement.

The I.R.C. § 6651 failure-to-pay penalty is applied each month. The standard rate for the penalty is 0.5% per month. An individual taxpayer's failure-to-pay penalty is reduced to 0.25% for any month in which an approved installment agreement is in effect if the return relating to the liability being paid in installments was timely filed (including extensions). The reduced rate does not apply if prior to the installment agreement, the tax was subject to the 1%-per-month rate under I.R.C. § 6651(d). The 1% rate begins either 10 days after notice of intent to levy or on the day on which notice and demand for immediate payment was made. The failure-to-pay penalty cannot exceed 25% in the aggregate.

PRACTITIONER NOTE

Other Payment Options

Payment by credit card or taking out a loan may be preferable to an IRS installment agreement. The interest rate and the processing fee charged for use of a credit card or the interest on a loan may be lower than the combination of interest and penalties imposed by the IRS over the length of the installment agreement.

Guaranteed Installment Agreement

Under I.R.C. § 6159(c), an individual is guaranteed an installment agreement if the following requirements are met:

1. The aggregate amount of the liability, excluding interest, penalties, additions to tax, and additional amounts, does not exceed $10,000.
2. The taxpayer (and spouse if a joint return) has not during the preceding 5 tax years
   a. failed to file any return,
   b. failed to pay any tax required to be shown on a return, or
   c. entered into an installment agreement for payment of any tax.
3. The IRS determines that the taxpayer is financially unable to pay the liability in full when due.
4. The agreement requires full payment within 3 years.
5. The taxpayer agrees to file all returns and pay all tax while the agreement is in effect.

As a matter of policy, the IRS grants guaranteed agreements even if taxpayers can pay the balance in full [I.R.M. § 5.14.5.3(2)]. The IRS is not required to but may file a notice of federal tax lien. Under the Taxpayer Relief Initiative, some individual taxpayers who only owe for the 2019 tax year and who owe $250,000 or less may qualify to set up an installment agreement without a notice of federal tax lien filed by the IRS.

Online Application

A taxpayer can apply online for a long-term payment plan if tax, penalties, and interest are $50,000 or less and the taxpayer has filed all required returns. A taxpayer can apply online for a short-term payment plan (180 days or less under the Taxpayer Relief Initiative) if the taxpayer owes less than $100,000 in tax, interest, and penalties.

A sole proprietor or an independent contractor applies as an individual. A business taxpayer may apply online for a long-term payment plan if tax, penalties, and interest are $25,000 or less and the taxpayer has filed all required returns.

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PRACTITIONER NOTE

Online Payment Agreement Tool

The IRS Online Payment Agreement tool allows a taxpayer to view details of a current payment plan (type of agreement, due dates, and amounts to pay). It also allows taxpayers to change the monthly payment amount or monthly payment due date, convert an existing agreement to a Direct Debit agreement, change the bank routing and account number on a Direct Debit agreement, and reinstate after default. Additionally, qualified taxpayers with existing Direct Debit agreements may now be able to use the Online Payment Agreement tool to propose lower monthly payment amounts. [See www.irs.gov/payments/online-payment-agreement-application#Apply/Revise%20as%20Individual%20Button.]

Termination (Default) of an Installment Agreement

The IRS may terminate an installment agreement if a taxpayer does any of the following:

1. Fails to pay an installment payment when due under the terms of the agreement
2. Fails to pay another tax liability at the time the liability is due
3. Fails to provide an updated financial statement upon request
4. Provided information prior to the date of the agreement that was inaccurate or incomplete
5. Fails to pay a modified payment amount based on updated financial information

[I.R.M. § 5.14.11.3]

Before terminating the agreement, the IRS will typically notify the taxpayer in writing and give him or her 30 days to comply with the terms of the agreement. The taxpayer can request reinstatement of a defaulted or terminated plan. If the agreement is in default (not yet terminated), the IRS must reinstate the agreement if the taxpayer remedies the default (unless there is another reason for default). There may be a fee to reinstate a defaulted plan. In most other situations, the IRS must conduct a financial statement analysis to reevaluate the taxpayer's ability to pay.

PRACTITIONER NOTE

New Tax Balances

Under the Taxpayer Relief Initiative, the IRS has said that instead of defaulting an agreement, it will automatically add certain new tax balances to existing installment agreements for individuals and out of business taxpayers.

Other Expanded Payment Options

Taxpayers who owe taxes always had options to get help through payment plans and other tools from the IRS. The new IRS Taxpayer Relief Initiative is expanding on those tools. This section explains revised COVID-related collection procedures under the Taxpayer Relief Initiative.

Temporarily Delaying Collection

Taxpayers can contact the IRS to request a temporary delay of the collection process. If the IRS determines a taxpayer is unable to pay, it may delay collection until the taxpayer's financial condition improves. Prior to approving the collection delay the IRS may request a completed Form 433-F, Collection Information Statement; Form 433-A, Collection Information Statement for Wage Earners and Self-Employed Individuals; or Form 433-B, Collection Information Statement for Businesses, and proof of the taxpayer's financial status.

If collection is delayed, the amount owed will continue to accrue penalties and interest. The IRS may also file a notice of federal tax lien to protect the government's interest in the taxpayer's assets. Tax practitioners can call the IRS at 1.800.829.1040 or the number on the taxpayer's tax bill or notice to request a temporary delay of the collection process or to discuss other payment options.

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Relief from Penalties

The IRS is highlighting reasonable cause assistance available for taxpayers with failure to file, pay, and deposit penalties. First-time penalty abatement relief is also available for the first time a taxpayer is subject to one or more of these tax penalties. Requests for this relief can be made by contacting the number on the taxpayer's notice or responding in writing. However, to request relief, the IRS reminds taxpayers that they must be responsive when they receive a balance due notice.

Offer in Compromise

The relief initiative provides additional flexibility for some taxpayers who are temporarily unable to meet the payment terms of an accepted offer in compromise (OIC). Without this added flexibility, the OIC would default if the taxpayer missed payments. If the taxpayer cannot make the OIC payments, the tax practitioner should contact the IRS to discuss payment options.

OBSERVATION

OIC Application

The process to apply for an OIC and the criteria to obtain an OIC has not changed. Tax practitioners should use the most recent revision of Forms 433-A, 433-B, and 656, Offer in Compromise, which is April 2021.

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INDIVIDUAL TAX ISSUES: PART 2

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LEARNING OBJECTIVES

After completing this session, participants will be able to do the following:

- ✔ Understand the rules a taxpayer must satisfy to claim the earned income tax credit (EIC) with or without qualifying children
- ✔ Understand the phasein and phaseout properties of the EIC
- ✔ Know the new rules that expand EIC eligibility
- ✔ Understand how a minister's income and housing are taxed
- ✔ Recognize when a US taxpayer can claim a foreign tax credit or foreign housing exclusion
- ✔ Understand the tax issues for a non-US person with US real estate rental income
- ✔ Apply the tax laws that characterize the gain on currency exchanges
- ✔ Understand how tax treaties and international social security agreements overrule or modify the Internal Revenue Code

INTRODUCTION

The American Rescue Plan Act of 2021 (ARPA), Pub. L. No 117-2, expanded eligibility for the earned income tax credit (EIC). This chapter reviews the existing rules to be eligible for the EIC and the expanded eligibility requirements. It also explains how it may be advantageous to calculate the 2021 EIC using 2019 income.

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This chapter discusses the taxation of a minister's income. It explains when and how a minister can claim an exclusion from self-employment tax. It also reviews how licensed ministers can exclude from income tax a housing allowance paid to the minister or the FMV of a parsonage that is provided to him or her in exchange for ministerial services.

Finally, this chapter reviews tax issues for US persons with foreign income and non-US persons with US income. It explains when a taxpayer can claim the foreign earned income exclusion and foreign tax credits. It reviews foreign currency exchange rate issues and the taxation of foreign owners with US real estate rentals. Finally, this section explains tax treaties and social security agreements that are designed to prevent double taxation and may reduce a taxpayer's tax obligation.

ISSUE 1: EARNED INCOME TAX CREDIT This section discusses who is eligible for the earned income tax credit and how to calculate and report the credit.

The earned income tax credit (EIC) is a refundable tax credit intended to benefit working taxpayers with low to moderate income. A taxpayer may be able to claim the EIC for himself or herself, and for a qualifying child. In 2018, 26,500,000 taxpayers received a total of $64,900,000,000 from the EIC [Congressional Research Service, The "Childless" EITC: Temporary Expansion for 2021 Under the American Rescue Plan Act of 2021 (ARPA; P.L. 117-2), US Congress, May 3, 2021, https://crsreports.congress.gov/product/pdf/IN/IN11610]. This section explains who can claim the EIC and new laws that expand the availability of the EIC. It also discusses how to calculate and report the credit.

Rules for All Taxpayers Claiming the EIC

To claim the credit, all taxpayers must meet seven rules and certain additional rules (discussed later). All taxpayers claiming the EIC must

1. have AGI below the phaseout limit for 2021;
2. have a valid SSN;
3. with a limited exception (discussed later) not be filing as MFS;
4. be a US citizen or resident alien for the entire tax year;
5. not file Form 2555, Foreign Earned Income; or 2555-EZ, Foreign Earned Income Exclusion;
6. have investment income of $10,000 (for 2021) or less; and
7. have earned income.

[I.R.C. § 32(c)(1)]

Adjusted Gross Income Limitations

To claim the EIC for 2021, the taxpayer's AGI reported on line 11 of Form 1040, U.S. Individual Income Tax Return, or Form 1040-SR, U.S. Tax Return for Seniors, must be less than

- $51,464 ($57,414 for MFJ) if the taxpayer has three or more qualifying children,
- $47,915 ($53,865 for MFJ) if the taxpayer has two qualifying children,
- $42,158 ($48,108 for MFJ) if the taxpayer has one qualifying child, or
- $21,430 ($37,380 for MFJ) if the taxpayer does not have a qualifying child.

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LAW CHANGE

Increased Limits

For a taxpayer with no qualifying child, the American Rescue Plan Act of 2021 (ARPA), Pub. L. No 117-2, changes the minimum ages for the taxpayer (discussed later), eliminates the maximum age, and increases the earned income and phaseout amounts. It also raises the investment income limit for 2021. The changes in the investment income limit apply to tax years beginning after December 31, 2020.

Valid Social Security Number

The taxpayer (and spouse, if MFJ) must have a valid social security number (SSN) issued by the Social Security Administration (SSA) by the due date of the return, including extensions. To claim the EIC for a qualifying child, the child must also have a valid SSN [I.R.C. § 32(c)(1)(E) and (F)].

An SSN is not valid for purposes of the EIC if the social security card includes the legend "Not valid for employment" and was issued so the taxpayer or spouse could get a federally funded benefit. For tax years beginning after December 31, 2020, APRA § 9622 states that taxpayers with qualifying children who fail to meet the identification requirements for the children can claim the EIC for taxpayers without children.

PRACTITIONER NOTE

Individual Taxpayer Identification Number

A taxpayer with an individual taxpayer identification number (ITIN) is not eligible for the EIC.

Married Filing Separately

Under former law, a married taxpayer could not claim the EIC unless he or she filed a joint return. Under ARPA, a separated spouse who is married but does not file a joint return for the year is considered unmarried if the spouse resides with his or her qualifying child for more than one-half of the year and, during the last 6 months of the tax year, does not have the same principal place of abode as the individual's spouse, or has a decree, instrument, or agreement (other than a decree of divorce) described in I.R.C. § 121(d)(3)(C) with respect to the individual's spouse and is not a member of the same household with the individual's spouse by the end of the year.

US Citizen or Resident Alien

If the taxpayer (or spouse if MFJ) was a nonresident alien for any part of the year, he or she cannot claim the EIC unless the taxpayer files MFJ, one spouse is a US citizen or resident alien, and the nonresident spouse chooses to be treated as a US resident.

PRACTITIONER NOTE

US Possessions

ARPA § 9625 adds I.R.C. § 7530, which addresses reimbursement payments to US possessions that have or enact an EIC.

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Filing Form 2555

A taxpayer cannot claim the EIC if he or she is filing Form 2555, Foreign Earned Income, or Form 2555-EZ, Foreign Earned Income Exclusion.

Investment Income

ARPA § 9624 raises the investment income limit from $2,200 (adjusted for inflation) to $10,000 (adjusted for inflation for tax years after 2021). IRS Publication 596, *Earned Income Credit (EIC)*, Worksheet 1, shown in **Figure 8.1**, shows how to calculate a taxpayer's investment income.

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FIGURE 8.1
IRS Publication 596, Worksheet 1

Worksheet 1. **Investment Income** *Keep for Your Records*

Use this worksheet to figure investment income for the earned income credit when you file Form 1040 or 1040-SR.

Interest and Dividends

1.	Enter any amount from Form 1040 or 1040-SR, line 2b	**1.**	
2.	Enter any amount from Form 1040 or 1040-SR, line 2a, plus any amount on Form 8814, line 1b	**2.**	
3.	Enter any amount from Form 1040 or 1040-SR, line 3b	**3.**	
4.	Enter the amount from Schedule 1 (Form 1040), line 8, that is from Form 8814 if you are filing that form to report your child's interest and dividend income on your return. (If your child received an Alaska Permanent Fund dividend, use Worksheet 2 in this chapter to figure the amount to enter on this line.)	**4.**	

Capital Gain Net Income

5.	Enter the amount from Form 1040 or 1040-SR, line 7. If the amount on that line is a loss, enter -0-	**5.**	
6.	Enter any gain from Form 4797, Sales of Business Property, line 7. If the amount on that line is a loss, enter -0-. (But, if you completed lines 8 and 9 of Form 4797, enter the amount from line 9 instead.)	**6.**	
7.	Subtract line 6 of this worksheet from line 5 of this worksheet. (If the result is less than zero, enter -0-.)	**7.**	

Royalties and Rental Income From Personal Property

8.	Enter any royalty income from Schedule E, line 23b, plus any income from the rental of personal property shown on Schedule 1 (Form 1040), line 8	**8.**	
9.	Enter any expenses from Schedule E, line 20, related to royalty income, plus any expenses from the rental of personal property deducted on Schedule 1 (Form 1040), line 22	**9.**	
10.	Subtract the amount on line 9 of this worksheet from the amount on line 8. (If the result is less than zero, enter -0-.)	**10.**	

Passive Activities

11.	Enter the total of any net income from passive activities (such as income included on Schedule E, line 26, 29a (col. (h)), 34a (col. (d)), or 40; or an ordinary gain identified as "FPA" on Form 4797, line 10). (See instructions below for lines 11 and 12.)	**11.**	
12.	Enter the total of any losses from passive activities (such as losses included on Schedule E, line 26, 29b (col. (g)), 34b (col. (c)), or 40; or an ordinary loss identified as "PAL" on Form 4797, line 10). (See instructions below for lines 11 and 12.)	**12.**	
13.	Combine the amounts on lines 11 and 12 of this worksheet. (If the result is less than zero, enter -0-.)	**13.**	
14.	Add the amounts on lines 1, 2, 3, 4, 7, 10, and 13. Enter the total. **This is your investment income**	**14.**	
15.	Is the amount on line 14 more than **$3,650**? ☐ **Yes.** You can't take the credit. ☐ **No.** Go to *Step 3* of the Form 1040 and 1040-SR instructions for line 27 to find out if you can take the credit (unless you are using this publication to find out if you can take the credit; in that case, go to *Rule 7*, next).		

Instructions for lines 11 and 12. In figuring the amount to enter on lines 11 and 12, don't take into account any royalty income (or loss) included on line 26 of Schedule E or any income (or loss) included in your earned income or on line 1, 2, 3, 4, 7, or 10 of this worksheet. To find out if the income on line 26 or line 40 of Schedule E is from a passive activity, see the Schedule E instructions. If any of the rental real estate income (or loss) included on Schedule E, line 26, isn't from a passive activity, print "NPA" and the amount of that income (or loss) on the dotted line next to line 26.

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Earned Income

To claim the EIC, the taxpayer must have earned income. Earned income includes the following:

- Wages, salaries, tips, and other taxable employee pay
- Net earnings from self-employment
- Gross income received as a statutory employee

PRACTITIONER NOTE

Minister's Housing

The rental value of a home or a housing allowance provided to a minister generally is not subject to income tax but is included in net earnings from self-employment. It is included in earned income for the EIC.

Earned income does not include interest and dividends, pensions and annuities, social security and railroad retirement benefits, alimony and child support, welfare benefits, workers' compensation benefits, unemployment compensation (insurance), and veterans' benefits.

Claiming the EIC with No Qualifying Child

Taxpayers claiming the credit with no qualifying children must meet four rules in addition to the seven rules discussed previously. The taxpayer must meet a minimum age requirement, and generally cannot be the dependent or qualifying child of another taxpayer.

Age

For tax year 2021, if a taxpayer is claiming the EIC with no qualifying children, ARPA reduces the required minimum age to 19 (formerly age 25) and eliminates the maximum age (formerly age 65). Different age limits apply to a specified student, qualified former foster youth, or a qualified homeless youth.

Specified Student

The minimum age for a specified student (other than a qualified former foster youth or a qualified homeless youth) is reduced to age 24. A specified student is an eligible student who meets the requirements of section 484(a)(1) of the Higher Education Act of 1965 and is carrying at least one-half the normal full-time workload for the course of study the student is pursuing during at least 5 calendar months of the year.

Qualified Former Foster Youth

The minimum age for a qualified former foster youth is age 18. A qualified former foster youth is an individual who attained age 14, was in foster care provided under the supervision or administration of an entity administering (or eligible to administer) a plan under part B or part E of title IV of the Social Security Act (without regard to whether federal assistance was provided with respect to such child under such part E), and gives the administering entity consent to disclose information to the IRS about the status of the individual as a qualified former foster youth.

Qualified Homeless Youth

The minimum age for a qualified homeless youth is age 18. A qualified homeless youth is an individual who certifies, in a manner specified by the IRS, that he or she is either an unaccompanied youth who is a homeless child or youth; or is unaccompanied, at risk of homelessness, and self-supporting.

Not a Dependent

To claim the EIC, the taxpayer (or spouse if MFJ) cannot be a dependent of another person. Even if another individual can claim the taxpayer as a dependent but does not, the taxpayer cannot claim the EIC.

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Not a Qualifying Child

A taxpayer (or spouse if MFJ) cannot claim the EIC if he or she is a qualifying child of another taxpayer. A taxpayer is not the qualifying child of another taxpayer if the person for whom the taxpayer meets the relationship, age, residency, and joint return tests is not required to file an income tax return and either does not file an income tax return, or files a return only to get a refund of income tax withheld or estimated tax paid.

Residence

The taxpayer's home (and spouse's, if MFJ) must have been in the United States for more than one-half of the year. Special rules apply to military personnel. For purpose of the EIC, the United States means the 50 states and the District of Columbia.

Claiming the EIC with a Qualifying Child

If the taxpayer has a qualifying child, he or she must the first seven rules and must meet additional requirements. The qualifying child must meet the relationship, age, residency, and joint return tests. The child cannot be claimed as a qualifying child by more than one person.

Relationship

The qualifying child must be the taxpayer's son, daughter, stepchild, foster child, or a descendant of any of them (for example, a grandchild); or brother, sister, half-brother, half-sister, stepbrother, stepsister, or a descendant of any of them (for example, a niece or nephew). Adopted children are treated as the taxpayer's children for purposes of the EIC.

Age

The qualifying child must be

- under age 19 at the end of 2021 and younger than the taxpayer (or the taxpayer's spouse if MFJ);
- under age 24 at the end of 2021, a student, and younger than the taxpayer (or the taxpayer's spouse if MFJ); or
- permanently and totally disabled at any time in 2021, regardless of age.

For purposes of the EIC, a qualifying child is a student if they attend school full-time for at least some part of 5 calendar months during the year. The months do not have to be consecutive.

Residency

To qualify for the EIC, the qualifying child must have lived with the taxpayer in the US for more than one-half of the year.

Joint Return

A qualifying child cannot file a joint return for the tax year in which the taxpayer claims the EIC. However, the child may file a joint return solely to claim a refund of income tax withheld or estimated tax payments made.

Child Cannot Be Claimed by More Than One Person

Sometimes a child may meet the tests to be a qualifying child of more than one taxpayer. However, only one person can claim the child as a qualifying child.

CROSS-REFERENCE

Allocating Credits

If the child could be a qualifying child of more than one taxpayer, the tiebreaker rules determine who can claim the child for the EIC and other tax benefits. See pages 326–328 in the *2020 National Income Tax Workbook* for a discussion of the tiebreaker rules and allocating credits.

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Not a Qualifying Child of Another Taxpayer

A taxpayer cannot claim the EIC if the taxpayer is a qualifying child of another taxpayer, as discussed previously.

Claiming the EIC

Tax practitioners typically calculate the EIC based on the taxpayer's current-year earned income. However, the Taxpayer Certainty and Disaster Tax Relief Act of 2020 allowed taxpayers to elect to use their 2019 earned income to figure their 2020 EIC if the 2019 earned income was more than the 2020 earned income.

CROSS-REFERENCE

Due Diligence

Effective for tax years beginning after December 31, 2017, I.R.C. § 6695(g) is amended to extend the tax return preparer due diligence requirements to a determination of eligibility to file as head of household. See pages 94–102 in the *2018 National Income Tax Workbook* for an explanation of the diligence requirements for preparers who file returns claiming the head of household filing status, the EIC, child tax credit, additional child tax credit, and American opportunity tax credit.

Under ARPA, If the taxpayer's earned income for the first tax year beginning in 2021 is less than the earned income for the first tax year beginning in 2019, the taxpayer can use 2019 earned income to calculate the EIC. If the taxpayer files jointly, earned income is the 2019 income of both spouses.

Example 8.1
Election to Use 2019 Income for 2021 EIC

Lucy Chan is a single mother with two children, Ethan and Luna. Lucy files as head of household. Ethan and Luna are Lucy's qualifying children for purposes of the EIC. No other person is eligible to claim Ethan or Luna. In 2021, Lucy earned $10,000 in wages. She had no other income.

In 2019, Lucy earned $16,000 wages. Lucy's EIC using the EIC tables shown in **Figure 8.2** is $4,010. If instead Lucy elects to use her 2019 earned income to calculate her 2021 EIC, her EIC using the EIC tables is $5,920. Lucy reports the $5,920 credit on Form 1040, line 27. Lucy must complete Schedule EIC, shown in **Figure 8.3**, and attach it to her return. Figures 8.2 and 8.3 show the 2020 tables and form because the 2021 tables and form were not available at the time of this publication.

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FIGURE 8.2
EIC Tables

If the amount you are looking up from the worksheet is–		And your filing status is–							
		Single, head of household, or qualifying widow(er) and you have–				Married filing jointly and you have–			
		0	1	2	3	0	1	2	3
At least	But less than	Your credit is–				Your credit is–			
9,200	9,250	505	3,137	3,690	4,151	538	3,137	3,690	4,151
9,250	9,300	501	3,154	3,710	4,174	538	3,154	3,710	4,174
9,300	9,350	497	3,171	3,730	4,196	538	3,171	3,730	4,196
9,350	9,400	493	3,188	3,750	4,219	538	3,188	3,750	4,219
9,400	9,450	489	3,205	3,770	4,241	538	3,205	3,770	4,241
9,450	9,500	485	3,222	3,790	4,264	538	3,222	3,790	4,264
9,500	9,550	482	3,239	3,810	4,286	538	3,239	3,810	4,286
9,550	9,600	478	3,256	3,830	4,309	538	3,256	3,830	4,309
9,600	9,650	474	3,273	3,850	4,331	538	3,273	3,850	4,331
9,650	9,700	470	3,290	3,870	4,354	538	3,290	3,870	4,354
9,700	9,750	466	3,307	3,890	4,376	538	3,307	3,890	4,376
9,750	9,800	462	3,324	3,910	4,399	538	3,324	3,910	4,399
9,800	9,850	459	3,341	3,930	4,421	538	3,341	3,930	4,421
9,850	9,900	455	3,358	3,950	4,444	538	3,358	3,950	4,444
9,900	9,950	451	3,375	3,970	4,466	538	3,375	3,970	4,466
9,950	10,000	447	3,392	3,990	4,489	538	3,392	3,990	4,489
10,000	10,050	443	3,409	4,010	4,511	538	3,409	4,010	4,511
10,050	10,100	439	3,426	4,030	4,534	538	3,426	4,030	4,534
10,100	10,150	436	3,443	4,050	4,556	538	3,443	4,050	4,556
10,150	10,200	432	3,460	4,070	4,579	538	3,460	4,070	4,579
16,000	16,050	0	3,584	5,920	6,660	435	3,584	5,920	6,660
16,050	16,100	0	3,584	5,920	6,660	431	3,584	5,920	6,660
16,100	16,150	0	3,584	5,920	6,660	427	3,584	5,920	6,660
16,150	16,200	0	3,584	5,920	6,660	423	3,584	5,920	6,660

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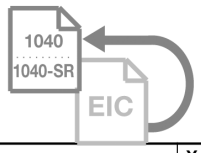
FIGURE 8.3
Lucy Chan's Schedule EIC

SCHEDULE EIC
(Form 1040)

Department of the Treasury
Internal Revenue Service (99)

Earned Income Credit

Qualifying Child Information



► **Complete and attach to Form 1040 or 1040-SR only if you have a qualifying child.**
► **Go to *www.irs.gov/ScheduleEIC* for the latest information.**

OMB No. 1545-0074

2020

Attachment Sequence No. **43**

Name(s) shown on return: **Lucy Chan**

Your social security number: **XXX-XX-XXXX**

Before you begin:

- See the instructions for Form 1040 or 1040-SR, line 27, to make sure that **(a)** you can take the EIC, and **(b)** you have a qualifying child.
- Be sure the child's name on line 1 and social security number (SSN) on line 2 agree with the child's social security card. Otherwise, at the time we process your return, we may reduce or disallow your EIC. If the name or SSN on the child's social security card is not correct, call the Social Security Administration at 1-800-772-1213.

CAUTION

- *You can't claim the EIC for a child who didn't live with you for more than half of the year.*
- *If you take the EIC even though you are not eligible, you may not be allowed to take the credit for up to 10 years. See the instructions for details.*
- *It will take us longer to process your return and issue your refund if you do not fill in all lines that apply for each qualifying child.*

Qualifying Child Information	Child 1	Child 2	Child 3
1 Child's name If you have more than three qualifying children, you have to list only three to get the maximum credit.	First name: Ethan Last name: Chan	First name: Luna Last name: Chan	First name Last name
2 Child's SSN The child must have an SSN as defined in the instructions for Form 1040 or 1040-SR, line 27, unless the child was born and died in 2020. If your child was born and died in 2020 and did not have an SSN, enter "Died" on this line and attach a copy of the child's birth certificate, death certificate, or hospital medical records showing a live birth.	XXX-XX-XXXX	XXX-XX-XXXX	
3 Child's year of birth	Year 2010 *If born after 2001 **and** the child is younger than you (or your spouse, if filing jointly), skip lines 4a and 4b; go to line 5.*	Year 2013 *If born after 2001 **and** the child is younger than you (or your spouse, if filing jointly), skip lines 4a and 4b; go to line 5.*	Year ____ *If born after 2001 **and** the child is younger than you (or your spouse, if filing jointly), skip lines 4a and 4b; go to line 5.*
4 a Was the child under age 24 at the end of 2020, a student, and younger than you (or your spouse, if filing jointly)?	☐ Yes. *Go to line 5.* ☐ No. *Go to line 4b.*	☐ Yes. *Go to line 5.* ☐ No. *Go to line 4b.*	☐ Yes. *Go to line 5.* ☐ No. *Go to line 4b.*
b Was the child permanently and totally disabled during any part of 2020?	☐ Yes. *Go to line 5.* ☐ No. The child is not a qualifying child.	☐ Yes. *Go to line 5.* ☐ No. The child is not a qualifying child.	☐ Yes. *Go to line 5.* ☐ No. The child is not a qualifying child.
5 Child's relationship to you (for example, son, daughter, grandchild, niece, nephew, eligible foster child, etc.)	Son	Daughter	
6 Number of months child lived with you in the United States during 2020 • If the child lived with you for more than half of 2020 but less than 7 months, enter "7." • If the child was born or died in 2020 and your home was the child's home for more than half the time he or she was alive during 2020, enter "12."	12 months *Do not enter more than 12 months.*	12 months *Do not enter more than 12 months.*	____ months *Do not enter more than 12 months.*

For Paperwork Reduction Act Notice, see your tax Cat. No. 13339M **Schedule EIC (Form 1040) 2020**

8

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ISSUE 2: TAX ISSUES FOR MINISTERS

This issue addresses special tax rules that apply to the income and deductions of ministers and members of religious orders.

A minister is a duly ordained, commissioned, or licensed minister of a church; or a member of a religious order who is engaged in the trade or business of performing ministerial services. Such ministerial services include the performance of sacerdotal functions; the conduct of religious worship; and the control, conduct, and maintenance of religious organizations. Whether services performed by a minister constitute the conduct of religious worship or the ministration of sacerdotal functions depends on the tenets and practices of the particular religious body constituting the church or church denomination [Treas. Reg. § 1.1402(c)-5]. A minister could be a priest; a rabbi; or any other ordained, commissioned, or licensed member of a religious order who provides ministerial services. The term *minister* and the term *church* are not specific to any particular religion. The courts and the IRS use these terms broadly to describe the leader of worship (music, education, youth) and the place of worship in any religion.

Income Tax

A minister is subject to income tax on all earnings. Earnings include wages; offerings; and fees for performing marriages, baptisms, funerals, and other services. A minister is not subject to income tax on a housing allowance, which is discussed later. The minister's earnings are subject to income tax regardless of whether the minister is an employee or is self-employed. However, the treatment of expenses related to the earnings differs. If the minister is self-employed, the minister must deduct expenses related to the self-employment (SE) income on Schedule C (Form 1040). If the minister is an employee, there is no deduction for any unreimbursed expenses in tax years 2018 through 2025. After 2025, unreimbursed employee expenses are deductible on Schedule A (Form 1040) as miscellaneous itemized deductions subject to the 2%-of-AGI floor.

PRACTITIONER NOTE

Accountable Plan

The church can adopt an accountable plan to reimburse ministerial expenses incurred by its employees [Treas. Reg. § 1.62-2]. Amounts treated as paid under an accountable plan are excluded from the employee's gross income, are not reported as wages or other compensation on the employee's Form W-2, and are exempt from withholding and employment taxes.

Example 8.2
Payment to Minister

Reverend Linda Gomez is a traveling minister. She goes from church to church and conducts religious services. Often the church members make a "love offering" to Reverend Gomez as a visiting minister. The payment is not a gift. It is compensation for her services, and Reverend Gomez must include the payment in her taxable income.

Example 8.3
Gift to Minister

Reverend Julie Greenburg, an ordained minister, served as the spiritual leader of the Rocky Mountain Church for 20 years. When Reverend Greenburg was retiring, the church asked its members to contribute a special offering to recognize her years of service. The congregation made the contribution directly to Reverend Greenburg to express their gratitude for her. The contribution is a gift to her from the grateful congregation.

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Tax Withholding

A minister's salary is not subject to federal income tax withholding if

- the minister is a duly ordained, commissioned, or licensed minister; a member of a religious order (who has not taken a vow of poverty); or a Christian Science practitioner or reader; and
- the salary is for ministerial services.

If the salary is not subject to withholding, the minister may need to make estimated payments of federal income tax and SE tax. Alternatively, the minister can enter into a voluntary withholding agreement with the church to withhold income and SE tax.

Example 8.4
Employee Minister

Pastor John Mason is employed as a senior pastor at Cornerstone Church in Hopewell, New York. In 2021, Cornerstone Church paid Pastor Mason a $48,500 salary. He chose to make estimated tax payments. Cornerstone Church must issue a Form W-2 to Pastor Mason showing $48,500 in box 1. Box 2 is blank because he did not request federal withholding, and boxes 3–6 are blank because he is considered to be self-employed for purposes of social security and Medicare withholding. Cornerstone Church must complete the state portion of the Form W-2 and include state and local withholding, if applicable.

Self-Employment Tax

For social security and Medicare tax purposes, regardless of a minister's status as an employee or independent contractor, the services performed in the exercise of the ministry are considered SE earnings and are generally subject to SE tax (unless the minister is a member of a religious order and has taken a vow of poverty or the minister has received an exemption from the IRS).

PRACTITIONER NOTE

Employment Status for Other Tax Purposes

Even though all income from performing ministerial services is subject to SE tax for social security tax purposes, if the minister is an employee, income earned is treated as wages for income tax and retirement plan purposes.

Ministers are covered by social security and Medicare provisions under the Self-Employment Contributions Act (SECA), not the Federal Insurance Contributions Act (FICA). If the minister is an employee, there are no FICA deductions on FormW-2, and the minister must file Schedule SE (Form 1040), Self-Employment Tax, and pay SE tax.

Social Security Equivalent

To offset the higher social security tax paid by ministers, a church may pay a minister a social security equivalent that is typically equal to 7.65% of compensation (salary and housing). This is the employer's portion of social security tax that the church would have paid. The social security equivalent amount must be included in the minister's taxable wages reported in box 1 of Form W-2, This amount is subject to federal income tax, state income tax, and SECA tax.

Exemption from SE Tax

If a minister is opposed to the payment of social security and Medicare tax because of religious beliefs, the minister can request an exemption from SE tax. The exemption applies only to earnings from ministerial services. To apply for the exemption, the minister must file Form 4361, Application for Exemption From Self-Employment Tax for Use by Ministers, Members of Religious Orders and Christian Science Practitioners, by the due date of Form 1040, including extensions, for the second tax year in which the minister received at least $400 in net SE earnings from ministerial services. The 2 years do not have to be consecutive.

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If the IRS approves the exemption, the IRS will add a code to the minister's IRS account, which will appear on transcripts issued from that account. The minister must still make the IRS aware of the exemption by writing "Exempt–Form 4361" on Schedule 2 (Form 1040), line 4. Unless the IRS specifically offers an opportunity to reenter the social security system, the exemption is permanent. The minister still must pay SE tax on other SE earnings. The minister should check box A on Schedule SE (Form 1040) to indicate that a Form 4361 has been filed to exempt the ministerial earnings from SE tax.

Example 8.5
SE Tax Exemption

Reverend Barbara Baxter had $2,800 in ministerial earnings in 2017, her first year in the ministry. She returned to school full-time in 2018, and had no ministerial income in 2018, 2019, or 2020. In 2021, she earned $12,500 from her ministry duties. She must file her request for the exemption from SE tax by the due date, including extensions, for her 2021 return. If she does not receive IRS approval for the exemption by the due date of the return, she must pay her 2021 SE tax by that date.

Housing Exclusion

Under I.R.C. § 107, ordained, commissioned, or licensed ministers may be able to exclude from income tax a housing allowance paid to the minister or the FMV of a parsonage that is provided to him or her in exchange for ministerial services. Ministers can exclude the housing allowance (sometimes referred to as the rental or parsonage allowance) from income for income tax purposes, but they must include the allowance in income for SE tax purposes.

OBSERVATION

Court Challenge to Housing Allowance

In 2017, the federal district court for the Western District of Wisconsin held that the section 107 housing exclusion was unconstitutional on the grounds that it discriminates against secular employees and violates both the establishment clause of the First Amendment and the equal protection clause of the Fifth Amendment. Subsequently, the Seventh Circuit Court of Appeals overturned the district court ruling and found that the exclusion is constitutional [*Gaylor v. Mnuchin*, Case Nos. 18-1277 & 18-1280 (7th Cir. 2018)].

Housing Allowance

If the church or other employer organization pays the minister a housing allowance, the church or other organization must officially designate the payment amount as a housing allowance before it makes the payment.

PLANNING POINTER

Housing Allowance Best Practices

Although the IRS has allowed housing allowances based on an oral designation, it is recommended that the allowance be designated in writing by a resolution of the governing body, an employment contract, or a formally approved church budget.

The minister can exclude the housing allowance from income if he or she uses the allowance to provide or rent a home, and the allowance is not more than reasonable pay for the minister's services. The amount that the minister can exclude cannot exceed the lowest of

1. the amount actually used to provide the home (mortgage payments, utilities, repairs, property taxes, furnishings, property insurance);
2. the amount officially designated as a housing allowance; or
3. the fair rental value of the home, including furnishings and utilities.

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PRACTITIONER NOTE

Fair Rental Value

There is no guidance on how ministers determine the fair rental value of the home. A realtor or appraiser may be able to document rent paid for comparable homes. Alternatively, ministers could estimate the annual cost of owning and maintaining a comparable home.

Housing Provided

If the church or other employer organization provides the minister with a home, the minister can exclude from gross income the fair rental value of the home, including furnishings and utilities. The exclusion cannot be more than the reasonable pay for the minister's services. If the minister pays for the utilities, the minister can exclude any allowance designated for utility costs, up to the actual cost.

Reporting the Housing Allowance

The church can either report the amount of the housing allowance in box 14 of Form W-2 or provide written documentation to the minister. The minister can exclude the allowance from gross income but must report the allowance on Schedule SE (Form 1040). Most, but not all, states follow the federal treatment and exclude the allowance from gross income.

Excess housing allowance is an allowance in excess of reasonable salary, the fair rental value of the home (including utilities), or the amount actually used to provide a home. The minister must include excess housing allowance in gross income, and report that income as wages on Form 1040, line 1 (Wages, salaries, tips, etc.) with the notation "Excess housing allowance."

Example 8.6
Housing Allowance in Excess of Rental Value

Temple Beth Sholom pays Rabbi Joshua Bitran a $2,000-per-month housing allowance, for a total of $24,000 per year. Rabbi Bitran is buying his house. The monthly mortgage payments and the utilities total $26,400 per year. Real estate taxes and insurance are included in his mortgage payments. The fair rental value of his home is $22,000 per year, including the furnishings and utilities.

Rabbi Bitran can exclude $22,000 from his gross income, which is the lowest of the $24,000 allowance, the $26,400 actual costs, and the $22,000 fair rental value. Rabbi Bitran must include the $2,000 ($24,000 – $22,000) excess housing allowance in his gross income. The full $24,000 allowance is included in Rabbi Bitran's income for SE tax purposes.

PRACTITIONER NOTE

Itemized Deductions

Even though a minister is allowed to exclude some or all of the housing allowance from income, the minister can still claim the full deductions for mortgage interest and real estate taxes (subject to the limitation on the deduction for state and local taxes) as itemized deductions on Schedule A (Form 1040).

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Example 8.7
Use of Parsonage and Excess Compensation

Temple Beth Sholom gave Rabbi Abby Allen the use of a home owned by the temple. Rabbi Allen does not have to include in gross income the fair rental value of the home and the utilities paid by the temple. However, if her compensation, including the fair rental value of the parsonage, is in excess of reasonable compensation, she must include the value of the housing in excess of reasonable compensation in her gross income. As with all housing provided to ministers, Rabbi Allen must include the entire fair rental value of the parsonage in her income for purposes of calculating her SE tax.

Housing Allowance for Retired Ministers

A retired minister can exclude from gross income the rental value of the home furnished, or the housing allowance paid, to him or her in retirement. Generally, pension payments paid to retired ministers from an established plan are taxable as pension income. However, distributions from a denominationally sponsored retirement plan may also be designated as a housing allowance and therefore eligible for the exclusion (subject to the same requirements as a housing allowance before retirement). The Form 1099-R would designate the housing allowance amount and the gross amount of the distribution. The recipient should attach a supplemental schedule to his or her tax return to explain the difference between Form 1040, lines 5a and 5b. Withdrawals from plans that are not sponsored by the denomination are not eligible for the housing exclusion.

PRACTITIONER NOTE

Expenses and Tax-Exempt Income

Because of the housing exclusion, I.R.C. § 265 requires a minister to allocate business expenses between taxable and nontaxable income. However, for tax years after 2017 and before 2026, there is no deduction for employee business expenses, and no allocation is required.

CROSS-REFERENCE

Qualified Business Income Deduction

Ministers may qualify for the I.R.C. § 199A qualified business income (QBI) deduction based on their self-employment income from speaking engagements, and wedding and funeral fees. See the "Business Tax Issues" chapter in this workbook for a discussion of the QBI deduction.

Form W-2 and Schedule SE

This section illustrates how to complete Form W-2 and Schedule SE (Form 1040) for a minister.

Example 8.8
Reporting Requirements

In 2021, Pastor Joe Allen received a $22,000 salary from Cornerstone Community Church. The church offers a section 403(b) plan. Pastor Allen contributed $3,000 as a salary deferral, and the church matched his contribution. The church designated and paid a $24,000 housing allowance. To make Pastor Allen's compensation comparable to that of the nonministerial staff, the church paid him $1,683 ($22,000 × 7.65%) as a social security equivalent payment. Pastor Allen performs weddings on weekends. In 2021, he netted $2,200 in wedding fees, which is self-employment income.

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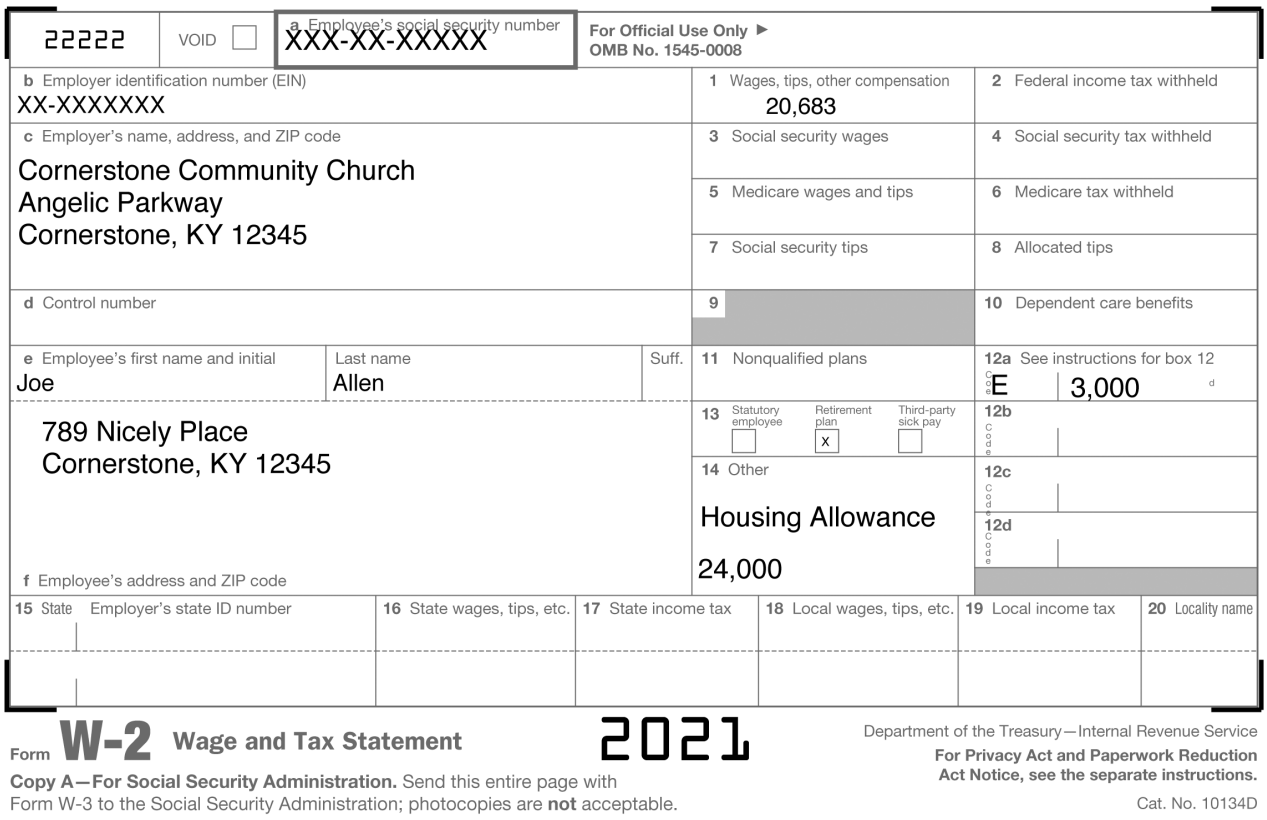
Figure 8.4 shows a portion of Pastor Allen's Form W-2. Box 1, $20,683 taxable wages, includes the salary and the social security equivalent payment less the salary deferral ($22,000 + $1,683 – $3,000). Box 12a shows the $3,000 elective deferral. Box 14 shows the $24,000 housing allowance.

FIGURE 8.4
Pastor Allen's Form W-2



22222 VOID ☐ a Employee's social security number XXX-XX-XXXX For Official Use Only ► OMB No. 1545-0008

b Employer identification number (EIN): XX-XXXXXXX

c Employer's name, address, and ZIP code:
Cornerstone Community Church
Angelic Parkway
Cornerstone, KY 12345

d Control number

e Employee's first name and initial: Joe | Last name: Allen | Suff.

789 Nicely Place
Cornerstone, KY 12345

f Employee's address and ZIP code

1 Wages, tips, other compensation: 20,683
2 Federal income tax withheld
3 Social security wages
4 Social security tax withheld
5 Medicare wages and tips
6 Medicare tax withheld
7 Social security tips
8 Allocated tips
9
10 Dependent care benefits
11 Nonqualified plans
12a See instructions for box 12 Code E 3,000
13 Statutory employee ☐ Retirement plan X Third-party sick pay ☐
12b Code
14 Other: Housing Allowance 24,000
12c Code
12d Code

15 State	Employer's state ID number	16 State wages, tips, etc.	17 State income tax	18 Local wages, tips, etc.	19 Local income tax	20 Locality name

Form W-2 Wage and Tax Statement 2021

Department of the Treasury—Internal Revenue Service

Copy A—For Social Security Administration. Send this entire page with Form W-3 to the Social Security Administration; photocopies are **not** acceptable.

For Privacy Act and Paperwork Reduction Act Notice, see the separate instructions.

Cat. No. 10134D

Figure 8.5 shows a portion of Pastor Allen's Schedule SE (Form 1040). Line 2 reports the $46,883 subject to SE tax ($22,000 wages + $1,683 social security equivalent – $3,000 elective deferral + $24,000 housing allowance + $2,200 SE income). There is no entry on line 5a, which is used by nonministerial employees of churches that elect exemption from employer social security and Medicare taxes. Figure 8.5 shows the 2020 form because the 2021 form was not available at the time of this publication.

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FIGURE 8.5
Pastor Allen's Schedule SE

SCHEDULE SE (Form 1040)
Department of the Treasury
Internal Revenue Service (99)

Self-Employment Tax

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

OMB No. 1545-0074
2020
Attachment Sequence No. 17

Name of person with self-employment income (as shown on Form 1040, 1040-SR, or 1040-NR): Joe Allen

Social security number of person with **self-employment** income ► XXX-XX-XXXX

Part I Self-Employment Tax

Note: If your only income subject to self-employment tax is **church employee income,** see instructions for how to report your income and the definition of church employee income.

A If you are a minister, member of a religious order, or Christian Science practitioner **and** you filed Form 4361, but you had $400 or more of **other** net earnings from self-employment, check here and continue with Part I . . . . . ► ☐

Skip lines 1a and 1b if you use the farm optional method in Part II. See instructions.

1a	Net farm profit or (loss) from Schedule F, line 34, and farm partnerships, Schedule K-1 (Form 1065), box 14, code A	1a	
b	If you received social security retirement or disability benefits, enter the amount of Conservation Reserve Program payments included on Schedule F, line 4b, or listed on Schedule K-1 (Form 1065), box 20, code AH	1b	( )

Skip line 2 if you use the nonfarm optional method in Part II. See instructions.

2	Net profit or (loss) from Schedule C, line 31; and Schedule K-1 (Form 1065), box 14, code A (other than farming). See instructions for other income to report or if you are a minister or member of a religious order	2	46,883
3	Combine lines 1a, 1b, and 2	3	46,883
4a	If line 3 is more than zero, multiply line 3 by 92.35% (0.9235). Otherwise, enter amount from line 3	4a	43,296
	Note: If line 4a is less than $400 due to Conservation Reserve Program payments on line 1b, see instructions.		
b	If you elect one or both of the optional methods, enter the total of lines 15 and 17 here	4b	
c	Combine lines 4a and 4b. If less than $400, **stop;** you don't owe self-employment tax. **Exception:** If less than $400 and you had **church employee income,** enter -0- and continue ►	4c	43,296
5a	Enter your **church employee income** from Form W-2. See instructions for definition of church employee income — 5a		
b	Multiply line 5a by 92.35% (0.9235). If less than $100, enter -0-	5b	
6	Add lines 4c and 5b	6	43,296
7	Maximum amount of combined wages and self-employment earnings subject to social security tax or the 6.2% portion of the 7.65% railroad retirement (tier 1) tax for 2020	7	137,700
8a	Total social security wages and tips (total of boxes 3 and 7 on Form(s) W-2) and railroad retirement (tier 1) compensation. If $137,700 or more, skip lines 8b through 10, and go to line 11 — 8a		
b	Unreported tips subject to social security tax from Form 4137, line 10 — 8b		
c	Wages subject to social security tax from Form 8919, line 10 — 8c		
d	Add lines 8a, 8b, and 8c	8d	0
9	Subtract line 8d from line 7. If zero or less, enter -0- here and on line 10 and go to line 11 ►	9	137,700
10	Multiply the **smaller** of line 6 or line 9 by 12.4% (0.124)	10	5,369
11	Multiply line 6 by 2.9% (0.029)	11	1,256
12	**Self-employment tax.** Add lines 10 and 11. Enter here and on **Schedule 2 (Form 1040), line 4**	12	6,625
13	**Deduction for one-half of self-employment tax.** Multiply line 12 by 50% (0.50). Enter here and on **Schedule 1 (Form 1040), line 14** — 13	3,313	

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ISSUE 3: INTERNATIONAL TAX ISSUES This section reviews credits and exclusions for US persons working abroad and also tax issues for non-US persons with US income.

US persons whose tax home is in a foreign country may qualify to claim the foreign earned income exclusion. If US persons are subject to US income tax on foreign-sourced income, they may be entitled to a credit for taxes paid in the foreign jurisdiction. This section explains who is eligible for the earned income exclusion and the tax credit, and how to claim the exclusion or the credit.

If the taxpayer has income that is denominated in a foreign currency, the tax practitioner must know how to convert that currency to US dollars. This section explains exchange rates, and how to report foreign currency exchanges. It also explains the taxation of non-US owners who own US rental properties, and how tax treaties and social security agreements may reduce or eliminate US taxes to avoid double taxation.

Foreign Earned Income Exclusion

US citizens or resident aliens who live abroad are taxed on their worldwide income. However, under I.R.C. § 911, they may qualify to exclude from income the amount of their foreign earnings, subject to a maximum that is adjusted annually for inflation ($108,700 for 2021). In addition, they can exclude or deduct certain foreign housing costs. This section discusses the foreign earned income exclusion.

Requirements for the Exclusion

To claim the foreign earned income exclusion, the foreign housing exclusion, or the foreign housing deduction

1. the taxpayer must have foreign earned income;
2. his or her tax home must be in a foreign country; and
3. he or she must meet the bona fide residence test or the physical presence test.

Foreign Earned Income

Foreign earned income is income the taxpayer receives for performing services while the taxpayer's tax home was in a foreign country and the taxpayer met either the bona fide residence test or the physical presence test (discussed later). Earned income is pay for personal services performed, such as wages, salaries, or professional fees. It can also include noncash income, such as the value of an employer-provided vehicle, and certain allowances and reimbursements.

Foreign earned income does not include the following amounts:

1. Amounts paid by a corporation that represent a distribution of earnings and profits
2. The excluded value of meals and lodging furnished for the convenience of the employer
3. Pension or annuity payments, including social security benefits
4. Pay received as an employee of the US government or any of its agencies or instrumentalities
5. Amounts included in income under I.R.C. §§ 402(b) and 403(c) (beneficiaries of a nonexempt trust or certain annuities)
6. Disallowed international moving costs that are included in income
7. Payments received after the end of the tax year following the year in which the services that earned the income were performed

[Treas. Reg. § 1.911-3]

Tax Home in Foreign Country

To qualify for the foreign earned income exclusion, the taxpayer's tax home must be in a foreign country throughout his or her period of bona fide residence or physical presence abroad.

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PRACTITIONER NOTE

Foreign Country

A foreign country is any territory (including the air space and territorial waters) under the sovereignty of a government other than that of the United States. A foreign country does not include US possessions such as Puerto Rico, Guam, the Commonwealth of the Northern Mariana Islands, the US Virgin Islands, or American Samoa.

A *tax home* is the taxpayer's home for purposes of I.R.C. § 162(a)(2) (to determine traveling expenses while away from home [I.R.C. § 911(d)(3)]. It is the location of a taxpayer's regular or principal place of business, employment, or post of duty. A tax home is the place where the taxpayer is permanently or indefinitely engaged to work as an employee or self-employed individual.

If the taxpayer does not have a regular or main place of business because of the nature of his or her business, the tax home is his or her regular place of abode in a real and substantial sense [Treas. Reg. § 1.911-2(b)]. *Abode* is where the taxpayer regularly lives.

Example 8.9
Taxpayer's Abode Is Not Foreign Country

Robert Carter is employed on an offshore oil rig in the territorial waters of a foreign country. He works a 28-day-on/28-day-off schedule. He returns to his family residence in the United States during his off periods. Robert is considered to have an abode in the United States and does not satisfy the tax home test in the foreign country. He cannot claim the foreign earned income exclusion.

Temporary presence of the individual in the United States does not necessarily mean that the individual's abode is in the United States during that time. Maintenance of a dwelling in the US, even if that dwelling is used by the individual's spouse and dependents, does not necessarily mean that the individual's abode is in the US.

Bona Fide Residence Test

To meet the bona fide residence test, a taxpayer must establish that he or she was a bona fide resident of a foreign country or countries for an uninterrupted period that includes an entire tax year. The bona fide residence test can be used to qualify for the foreign earned income and foreign housing exclusions and the foreign housing deduction only if the taxpayer is either

- a US citizen, or
- a US resident alien who is a citizen or national of a country with which the United States has an income tax treaty in effect.

Whether a location is a bona fide residence depends on several factors, such as the taxpayer's intention or the purpose of the trip, and the nature and length of the stay abroad. The IRS decides whether a taxpayer qualifies as a bona fide resident of a foreign country largely based on facts reported on Form 2555, Foreign Earned Income Exclusion. **Figure 8.6** shows Form 2555, Part II.

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FIGURE 8.6
Form 2555, Part II, Bona Fide Residence Test

Part II **Taxpayers Qualifying Under Bona Fide Residence Test**

Note: Only U.S. citizens and resident aliens who are citizens or nationals of U.S. treaty countries can use this test. See instructions.

10 Date bona fide residence began ▶ _____, and ended ▶ _____

11 Kind of living quarters in foreign country ▶ **a** ☐ Purchased house **b** ☐ Rented house or apartment **c** ☐ Rented room **d** ☐ Quarters furnished by employer

12a Did any of your family live with you abroad during any part of the tax year? . . . . . ☐ **Yes** ☐ **No**

b If "Yes," who and for what period? ▶ _____

13a Have you submitted a statement to the authorities of the foreign country where you claim bona fide residence that you aren't a resident of that country? See instructions . . . . . ☐ **Yes** ☐ **No**

b Are you required to pay income tax to the country where you claim bona fide residence? See instructions . ☐ **Yes** ☐ **No**

If you answered "Yes" to 13a and "No" to 13b, you don't qualify as a bona fide resident. Don't complete the rest of this part.

14 If you were present in the United States or its possessions during the tax year, complete columns **(a)–(d)** below. **Don't** include the income from column **(d)** in Part IV, but report it on Form 1040 or 1040-SR.

(a) Date arrived in U.S.	**(b)** Date left U.S.	**(c)** Number of days in U.S. on business	**(d)** Income earned in U.S. on business (attach computation)	**(a)** Date arrived in U.S.	**(b)** Date left U.S.	**(c)** Number of days in U.S. on business	**(d)** Income earned in U.S. on business (attach computation)

15a List any contractual terms or other conditions relating to the length of your employment abroad. ▶ _____

b Enter the type of visa under which you entered the foreign country. ▶ _____

c Did your visa limit the length of your stay or employment in a foreign country? If "Yes," attach explanation . ☐ **Yes** ☐ **No**

d Did you maintain a home in the United States while living abroad? . . . . . ☐ **Yes** ☐ **No**

e If "Yes," enter address of your home, whether it was rented, the names of the occupants, and their relationship to you. ▶ _____

For Paperwork Reduction Act Notice, see the Instructions for Forms 1040 and 1040-SR. Cat. No. 11900P Form **2555** (2020)

Physical Presence Test

A taxpayer meets the physical presence test if he or she is physically present in a foreign country or countries for 330 full days during a period of 12 consecutive months. The 330 qualifying days do not have to be consecutive. The physical presence test applies to both US citizens and resident aliens.

PRACTITIONER NOTE

Exception to the Bona Fide Residence and the Physical Presence Tests

The minimum time requirements of the bona fide residence test and the physical presence test can be waived if the taxpayer must leave a foreign country because of war, civil unrest, or similar adverse conditions in the foreign country. The taxpayer must be able to show that he or she reasonably could have expected to meet the minimum time requirements if not for the adverse conditions. To qualify for the waiver, the taxpayer must have had his or her tax home in the foreign country and must have been a bona fide resident of, or have been physically present in, the foreign country on or before the beginning date of the waiver. The IRS annually publishes a list of the foreign countries in which the minimum time requirements are waived. For tax year 2020, the list is in Rev. Proc. 2021-21, 2021-17 I.R.B. 1118.

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The physical presence test is based only on how long a taxpayer stays in a foreign country or countries. This test does not depend on the type of residence the taxpayer establishes, intentions about returning to the United States, or the nature and purpose of the stay abroad. However, the taxpayer's intentions regarding the nature and purpose of the stay abroad are relevant in determining whether he or she meets the tax home test, as explained earlier in this section.

A full day is a period of 24 consecutive hours, beginning at midnight and ending at the following midnight [Treas. Reg. § 1.911-2(d)(2)]. A taxpayer must spend each of the 330 full days in a foreign country. Partial days do not count. The physical presence test is reported on Form 2555, Part III, as shown in **Figure 8.7**.

FIGURE 8.7
Form 2555, Part III, Physical Presence Test

Form 2555 (2020) Page **2**

Part III **Taxpayers Qualifying Under Physical Presence Test**

Note: U.S. citizens and all resident aliens can use this test. See instructions.

16 The physical presence test is based on the 12-month period from ▶ _____ through ▶ _____

17 Enter your principal country of employment during your tax year. ▶ _____

18 If you traveled abroad during the 12-month period entered on line 16, complete columns **(a)–(f)** below. Exclude travel between foreign countries that didn't involve travel on or over international waters, or in or over the United States, for 24 hours or more. If you have no travel to report during the period, enter "Physically present in a foreign country or countries for the entire 12-month period." **Don't** include the income from column **(f)** below in Part IV, but report it on Form 1040 or 1040-SR.

(a) Name of country (including U.S.)	**(b)** Date arrived	**(c)** Date left	**(d)** Full days present in country	**(e)** Number of days in U.S. on business	**(f)** Income earned in U.S. on business (attach computation)

PRACTITIONER NOTE

Filing Extension

A taxpayer relying on the physical presence test to claim the foreign earned income exclusion cannot file the return until he or she has met the full 330-day period. If the taxpayer needs additional time to meet the bona fide residence test or the physical presence test, her or she can file Form 2350, Application for Extension of Time to File U.S. Income Tax Return. The form must be filed by the due date for filing the taxpayer's return. Generally, if both the taxpayer's tax home and his or her abode are outside the United States and Puerto Rico on the regular due date of the return, the due date for filing the return is June 15. Form 2350 does not extend the time to pay taxes. Alternatively, the taxpayer can file a return without the exclusion, and then file an amended return.

Calculating the Exclusion

The amount of the foreign earned income exclusion is the lesser of

1. the limit on the excludable amount, or
2. foreign earned income for the tax year minus the foreign housing exclusion.

The foreign earned income exclusion amount is adjusted annually for inflation. For tax year 2021, the foreign earned income exclusion is up to $108,700 per qualifying person. The amount of qualified housing expenses eligible for the housing exclusion and housing deduction is also limited. The limitation on housing expenses is generally 30% of the maximum foreign earned income exclusion. For the 2021 tax year, the housing amount limitation is $32,610. However, the limit varies depending on the location of the qualifying individual's foreign tax home and the number of qualifying days in the tax year.

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PRACTITIONER NOTE

Part-Year Exclusion

If a taxpayer qualifies under either the bona fide residence test or the physical presence test for only part of the year, he or she must adjust the maximum exclusion amount based on the number of qualifying days in the year.

Claiming the Foreign Earned Income Exclusion

The foreign earned income exclusion is voluntary. A taxpayer can claim the foreign earned income exclusion by completing the appropriate parts of Form 2555, Foreign Earned Income; or Form 2555-EZ, Foreign Earned Income Exclusion. Generally, the taxpayer must claim the exclusion with the following:

- a timely filed US individual income tax return (including any extensions),
- a return amending a timely filed return, or
- a late-filed return filed within 1 year from the original due date of the return (determined without regard to any extensions).

CROSS-REFERENCE

Revoking the Exclusion

Once a taxpayer chooses to claim the exclusion, that choice remains in effect for that year and all future years unless the taxpayer revokes the election. See page 452 in the *2017 National Income Tax Workbook* for a discussion of revoking the election.

Exemption from Withholding

If a US taxpayer is working abroad for a US employer, and some or all of the wages paid by the US employer could qualify for a foreign earned income exclusion, then that taxpayer may request a reduction or exemption from withholding of US income tax on those earnings. The employee makes the request by giving Form 673, Statement for Claiming Exemption From Withholding on Foreign Earned Income Eligible for the Exclusion(s) Provided by Section 911, to his or her US employer. An employer who receives a completed and signed Form 673 from the employee can exclude the qualified non-US wages from income tax withholding.

Foreign Tax Credit

The foreign tax credit is intended to prevent double taxation for US citizens, resident aliens, and nonresident aliens who paid foreign income tax and are subject to US tax on foreign source income. Generally, if the foreign tax rate is higher than the US rate, there will be no US tax on the foreign income. If the foreign tax rate is lower than the US rate, US tax on the foreign income will be limited to the difference between the rates. The foreign tax credit reduces US taxes on foreign source income. It cannot reduce taxes on US source income.

PLANNING POINTER

Deduction

The taxpayer can choose to take the amount of any qualified foreign taxes paid or accrued during the year as a foreign tax credit or as an itemized deduction. Taken as a deduction, foreign income taxes reduce taxable income. Taken as a credit, foreign income taxes reduce tax liability. Generally, it is more advantageous to take the credit.

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Eligible Taxes

The following taxes are eligible for the foreign tax credit if they are paid to a foreign country or one of its political subdivisions, or to a US possession:

- Income tax
- War profits tax
- Excess profits tax

[Treas. Reg. § 1.901-2]

Foreign taxes on income can qualify even though they are not imposed under an income tax law if the tax is in lieu of an income, war profits, or excess profits tax. A foreign levy is an income tax only if it meets both of the following requirements:

- It is a tax that the taxpayer must pay, and the taxpayer receives no specific economic benefit from paying it.
- The predominant character of the tax is that of an income tax in the US sense.

A foreign tax imposed on an individual to pay for retirement, old-age, death, survivor, unemployment, illness, or disability benefits, or for substantially similar purposes, is not a specific economic benefit (and may qualify for the credit) if the amount of the tax does not depend on the age, life expectancy, or similar characteristics of that individual. However, there is no credit for social security taxes paid to a country with which the United States has a Social Security Totalization Agreement (discussed later).

PRACTITIONER NOTE

Tax Treaties

Some tax treaties specifically define which taxes qualify for foreign tax credit treatment. US citizens living in certain treaty countries may be able to take an additional foreign tax credit for foreign tax imposed on certain items of US income. Thus, the tax practitioner should review the applicable tax treaty.

Taxes that are not eligible for the credit include the following:

1. Taxes paid to a foreign country that the taxpayer does not legally owe
2. Taxes paid or accrued on excluded income (e.g., taxes excluded by the foreign earned income exclusion)
3. Taxes based on assets, such as real estate taxes
4. Foreign taxes based on gross receipts or the number of units produced, rather than on realized net income (unless the taxes are imposed in lieu of an income tax)
5. Turnover tax, luxury tax, wealth tax, or occupancy tax
6. Taxes of US persons controlling foreign corporations and partnerships who fail to file the required information returns

Claiming the Credit

Taxpayers calculate and claim the credit on Form 1116, Foreign Tax Credit (Individual, Estate, or Trust). Individual taxpayers attach Form 1116 to their individual income tax returns. The credit is the lesser of the foreign tax paid or accrued or the limit on the credit. The foreign tax credit is limited to the part of total US tax that is in proportion to taxable income from sources outside the United States compared to total taxable income. The allowable foreign tax credit cannot be more than the taxpayer's actual foreign tax liability.

PRACTITIONER NOTE

Foreign Source Qualified Dividends and Gains

If the taxpayer received foreign sourced qualified dividends and/or capital gains (including long-term capital gains, unrecaptured section 1250 gain, and/or section 1231 gains) that are taxed in the US at a reduced tax rate, the taxpayer must make an adjustment on Form 1116. See the Form 1116 instructions for additional details.

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A taxpayer may be exempt from the foreign tax credit limit and can claim the foreign tax credit without filing Form 1116 if the taxpayer meets the following conditions:

1. All foreign source gross income for the tax year is passive category income (which includes most interest, dividends, rents, and royalties).
2. All the income and any foreign taxes paid on it are reported to the taxpayer on a payee statement such as Form 1099-DIV or Form 1099-INT.
3. The taxpayer's qualified foreign taxes are not more than $300 ($600 if MFJ).

CROSS-REFERENCE

Net Investment Income Tax

Taxpayers cannot offset the net investment income tax (NIIT) with a credit for foreign taxes paid [Treas. Reg. § 1.1411-1(e)]. See the "Current Real Estate Tax Issues" chapter in this workbook for a discussion of the NIIT.

Foreign Currency and Exchanges

Foreign sourced income and foreign assets are usually denominated in the currency of the source country. All entries on US tax returns must be expressed in US dollars. If the taxpayer's functional currency is the US dollar, the tax practitioner must translate into dollars all items of income, expenses (including taxes), and other items that the taxpayer receives, pays, or accrues in a foreign currency and that will affect computation of income tax.

Exchange Rate

An exchange rate (also called *rate of exchange*, *foreign exchange rate*, or *currency exchange rate*) is the rate at which one currency may be converted into another. The tax practitioner generally must use the prevailing exchange rate when the taxpayer received, paid, or accrued the item.

The IRS has no official exchange rate. Generally, it accepts any posted exchange rate that is used consistently. The following government and external resources provide currency exchange rates:

- Treasury Department's Currency Exchange Rate (www.fiscal.treasury.gov/reports-statements/treasury-reporting-rates-exchange/)
- Federal Reserve Bank (www.federalreserve.gov/data.htm)
- US Department of Agriculture (www.ers.usda.gov/data-products/agricultural-exchange-rate-data-set/)
- Oanda.com (www1.oanda.com/currency/converter/)
- xe.com (www.xe.com/)
- x-rates.com (www.x-rates.com/)

Instead of the spot rate (the actual rate on a specific day), tax practitioners may have to use the yearly average rate, or the calendar year-end rate. For example, the yearly average rate is used to report a composite of multiple transactions in a year, and the year-end rate is used to determine the highest value of a foreign account for purposes of the requirement to file the Report of Foreign Bank and Financial Accounts (FBAR).

Example 8.10 Reporting Gain

Glenda and Scott Christiansen are Canadian citizens. They have a vacation home in Vancouver, Washington. In 2020 and 2021, Glenda and Scott could not drive to their vacation home because of the border closing. They decided to sell the home to their Canadian friend, Nora Altman. Nora paid the purchase price in Canadian dollars. When reporting the gain on the sale, Glenda and Scott must translate the sale price into US dollars as of the date of the sale.

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Reporting Foreign Currency Transactions

The functional currency of US taxpayers is generally the US dollar. If a US taxpayer engages in a transaction denominated in nonfunctional currency, it will most likely result in a foreign currency exchange gain or loss, separate from the underlying transaction. A foreign currency exchange gain or loss is the gain or loss realized due to the change in exchange rates between the booking date and the payment date of a transaction involving an asset or liability denominated in a nonfunctional currency.

I.R.C. § 988 provides guidelines for the treatment of certain transactions denominated in a foreign currency. These transactions include the following:

1. Acquisition of a debt instrument
2. Becoming the obligor of a debt instrument
3. Accruing (or otherwise taking into account) any item of expense or income that will be paid or received after the accrual
4. Entering into or acquiring any forward contract, futures contract, option, or similar financial instrument
5. Disposition of foreign currency (but not if an individual disposes of foreign currency in a personal transaction)

Under the general rules, any foreign currency gain or loss attributable to a section 988 transaction must be calculated separately and treated as ordinary income or loss.

I.R.C. § 1256 Election

Gain or loss on a section 1256 contract is treated as 60% long-term gain or loss and 40% short-term gain or loss. This results in a maximum tax rate of approximately 23% compared to 37% under the ordinary income tax rates. With limited exceptions, a section 1256 contract is one of the following:

- Regulated futures contract
- Foreign currency contract
- Nonequity option
- Dealer equity option
- Dealer securities futures contract

Taxpayers use Form 6781, Gains and Losses From Section 1256 Contracts and Straddles, to report gains and losses on qualifying section 1256 transactions. The taxpayer can make an election to treat certain foreign currency gains or losses as capital gains or losses. He or she must attach a list of the foreign currency contracts covered by the election(s). On the attachment, the taxpayer must show the net gain or loss reported from those contracts and identify where the gain or loss is reported on the return. The taxpayer must also identify the transaction before the close of the day on which the transaction is entered into [I.R.C. § 988(a)(1)(B)].

Business Currency Exchanges

Companies that conduct business abroad may have a foreign currency gain or loss because of changes in the foreign currency exchange rate.

Example 8.11
Accrued Receivable

L.A. Holdings is a US vendor that sells custom furniture. A customer in Europe ordered a sofa and L.A. Holdings sent the customer a $1,000 invoice. The customer paid that invoice after 45 days. Using the exchange rate at the time that LA Holdings accrued the income, the invoice was $1,100. At the time the invoice was paid, it was worth $1,200. The resulting $100 gain is ordinary income. The gain is calculated separately from the gain on the sale of the sofa.

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Foreign Owners of US Rental Properties

A non-US person (a nonresident alien or foreign entity) who owns US rental real estate is subject to US income tax on the rental income. US source fixed or determinable annual or periodical (FDAP) income (that is not effectively connected with a US trade or business) is subject to US tax at a 30% rate. Effectively connected income (ECI) is taxed at graduated rates on a net basis. Thus, the taxation of rental income depends on whether it is characterized as FDAP (passive investment income) or ECI (business income).

FDAP Income

If rental income is FDAP, the payer must withhold tax under Internal Revenue Code Chapter 3, unless the foreign payee elects to treat the income as effectively connected with a US trade or business. If the foreign payee chooses to treat this income as effectively connected, the payee must give the payer Form W-8ECI (discussed next). The withholding is 30% on the gross amount of each rental payment. The payee must send the withheld funds to the IRS, and failure to do so could result in imposition of the withholding tax on the payee.

CROSS-REFERENCE

TIN

A non-US business entity must obtain an employer identification number for tax reporting. A non-US individual must obtain an individual taxpayer identification number (ITIN). See pages 458–561 in the *2016 National Income Tax Workbook* for a discussion of ITINs.

ECI

Rental income is ECI if either the taxpayer is engaged in a US trade or business or makes an I.R.C. § 871(d) election to treat rental income as ECI. The non-US owner completes Form W-8ECI, Certificate of Foreign Person's Claim That Income Is Effectively Connected With the Conduct of a Trade or Business in the United States, and gives it to the payer or withholding agent. The owner must certify, under penalties of perjury, that the rental income is includable in his or her gross income. **Figure 8.8** shows the Form W-8ECI certification.

FIGURE 8.8
Form W-8ECI Certification

Part II Certification

Under penalties of perjury, I declare that I have examined the information on this form and to the best of my knowledge and belief it is true, correct, and complete. I further certify under penalties of perjury that:

- I am the beneficial owner (or I am authorized to sign for the beneficial owner) of all the payments to which this form relates,
- The amounts for which this certification is provided are effectively connected with the conduct of a trade or business in the United States,
- The income for which this form was provided is includible in my gross income (or the beneficial owner's gross income) for the taxable year, **and**
- The beneficial owner is not a U.S. person.

Sign Here

Furthermore, I authorize this form to be provided to any withholding agent that has control, receipt, or custody of the payments of which I am the beneficial owner or any withholding agent that can disburse or make payments of the amounts of which I am the beneficial owner.

I agree that I will submit a new form within 30 days if any certification made on this form becomes incorrect.

Signature of beneficial owner (or individual authorized to sign for the beneficial owner) | Print name | Date (MM-DD-YYYY)

☐ **I certify that I have the capacity to sign for the person identified on line 1 of this form.**

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 25045D Form **W-8ECI** (Rev. 7-2017)

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The payer of the income can rely on a properly completed Form W-8ECI to treat the payment associated with the Form W-8ECI as a payment to a foreign person who beneficially owns the amounts paid and is entitled to an exemption from withholding. The owner has a duty to notify the payer if a change in circumstances makes any information on the form incorrect.

The election to treat real property income as ECI is made by attaching a statement [as described in Treas. Reg. § 1.871-10(d)] to the non-US person's tax return. If the election is made, the non-US person's rental, net of deductions properly allocated and apportioned to such income, is taxed at graduated rates. Once made, the election can only be revoked with the consent of the IRS.

Return Filing Requirements

If a non-US property owner is not engaged in a US trade or business during the year and all tax is fully withheld at the source, no US tax return is required. However, the owner must file a US tax return if the tax liability is not fully satisfied by withholding. A non-US owner whose rental income is deemed ECI must annually submit a US nonresident tax return (or foreign corporation tax return, if appropriate), and pay tax on the net income.

PRACTITIONER NOTE

Recordkeeping

While the W-8ECI is given to the tenant or property manager, a tax practitioner who provides services to the non-US owner should request a copy of the W-8ECI for his or her file.

CROSS-REFERENCE

Selling Real Property

The Foreign Investment in Real Property Tax Act requires withholding on the sale of US real property by a non-US person. See pages 536–541 in the *2019 National Income Tax Workbook* for a discussion of the withholding requirements.

Tax Treaties and Social Security Agreements

The United States has tax treaties (conventions) with several foreign countries. Bilateral social security agreements coordinate the US social security program with comparable programs in other countries.

Tax Treaties

Under tax treaties, residents of foreign countries may be taxed at a reduced rate or exempt from US income taxes on certain items of income, profit, or gain they receive from US sources. These reduced rates and exemptions vary among countries and specific items of income. The treaty provisions are generally reciprocal.

PRACTITIONER NOTE

Double Taxation

Treaties are intended to avoid double taxation. The foreign earned income exclusion and foreign tax credit (discussed earlier) also help avoid double taxation.

In addition to investment income, most tax treaties also address income from other sources such as employment, self-employment, government service, artists and athletes, students and teachers, and capital gains. The IRS publishes tax treaty tables that summarize the types of income that may be exempt or subject to a reduced rate of tax [www.irs.gov/individuals/international-taxpayers/tax-treaty-tables]. The US Department of the Treasury publishes the text of treaties and technical explanations [www.treasury.gov/resource-center/tax-policy/treaties/Pages/treaties.aspx].

Treaty provisions may be applicable if a nonresident alien of a treaty country does any of the following in the United States:

- Earns income from a foreign employer
- Has self-employment income
- Teaches at a US university or other accredited educational institution

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- Is a student who receives a scholarship or fellowship grant
- Sells or exchanges personal property

Treaty Models

Most tax treaties follow either the Organization for Economic Co-operation and Development (OECD) Model Tax Convention on Income and on Capital or the United Nations (UN) Model Convention.

The OECD is an international organization that analyzes and recommends policies to promote effective international cooperation. The UN model tends to preserve greater taxing rights for the country where profits arise and require the residence country to give a credit for taxes paid or an exemption from taxes on those profits.

PRACTITIONER NOTE

State Taxation

Most states follow the applicable tax treaty. However, if a nonresident alien works in one of the following states, they may owe state income tax even though their income is exempt from federal income tax under a tax treaty: Alabama, Arkansas, California, Connecticut, Hawaii, Kansas, Kentucky, Maryland, Mississippi, Montana, New Jersey, New York, North Dakota, and Pennsylvania.

Savings Clauses

US Income tax treaties typically include a saving clause that preserves or saves the right of the United States to tax its citizens and residents as if the tax treaty had not come into effect. However, many tax treaties have exceptions to the saving clause that may allow a resident alien to continue to claim treaty benefits. For example, a nonresident alien student may be exempt from tax on a research grant. When the student becomes a resident alien, he or she can generally no longer claim a tax treaty exemption for this income. However, the treaty exemption will continue to apply if the student meets the requirements for the tax treaty's savings clause.

International Social Security Agreements

International social security agreements, often called totalization agreements, have two main purposes. First, they eliminate double social security taxation on a worker from one country who works in another country and would otherwise have to pay social security tax to both countries on the same earnings. Second, the agreements help fill gaps in benefit protection for workers who have divided their careers between the United States and another country. A list of the Social Security Agreements currently in place with the US can be found at www.ssa.gov/international/agreements_overview.html.

Dual Coverage Problems

Without some means of coordinating social security coverage, people who work outside their country of origin may be covered under the social security systems of two countries simultaneously for the same work. Both countries may require the employer and employee or self-employed person to pay social security taxes.

US Social Security extends to American citizens and US resident aliens employed abroad by American employers. This extraterritorial US coverage frequently results in dual tax liability for the employer and employee because most countries impose social security contributions on anyone working in their territory.

Dual tax liability can affect US citizens and residents working for foreign affiliates of American companies and US citizens and residents who are self-employed outside the United.

Paying dual social security contributions is especially costly for companies that offer tax equalization arrangements for their expatriate employees. A firm that sends an employee to work in another country often guarantees that the assignment will not result in a reduction of the employee's after-tax income. Employers agree to pay both the employer and employee share of host country social security taxes because the employer's payment of an employee's share of the contribution is taxable compensation to the employee. The employer will also pay this additional income tax, which then increases the employee's taxable income and tax liability even further.

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Eliminating Dual Coverage

The goal of all US totalization agreements is to eliminate dual social security coverage and taxation while maintaining the coverage of as many workers as possible under the system of the country where they are likely to have the greatest attachment, both while working and after retirement. The agreements exempt workers from coverage under the system of one country or the other when their work would otherwise be covered under both systems. Under the basic territoriality rule, an employee who would otherwise be covered by both the US and a foreign system remains subject exclusively to the coverage laws of the country in which he or she is working.

Detached Worker Rule

Each agreement (except the one with Italy) includes an exception to the territoriality rule designed to minimize disruptions in the coverage careers of workers whose employers send them abroad on a temporary (5 years or less) assignment. Under this detached worker exception, a person who is temporarily transferred to work for the same employer in another country remains covered only by the country from which he or she has been sent. The American employer must have entered into an I.R.C. § 3121(l) agreement with the US Treasury Department with respect to the foreign affiliate.

Self-Employment Rules

US social security coverage extends to self-employed US citizens and residents whether their work is performed in the United States or another country. As a result, when they work outside the United States, self-employed citizens and residents are almost always dually covered by the US and the host country. Most US agreements eliminate dual coverage by assigning coverage to the worker's country of residence. For example, under the US/Canada agreement, a dually covered self-employed US citizen living in Canada is covered only by the Canadian system and is excluded from US coverage.

Certificates of Coverage

Workers who are exempt from US or foreign social security taxes under an agreement must document their exemption by obtaining a certificate of coverage from the country that will continue to cover them. When the other country issues a certificate certifying that the employee is covered by the foreign system, the employer can immediately stop withholding and paying US social security taxes on the employee's earnings. A self-employed US citizen or resident must attach a photocopy of the foreign certificate to his or her US tax return each year as proof of the US exemption from self-employment taxes.

PRACTITIONER NOTE

Types of Coverage

The provisions for eliminating dual coverage apply to social security and Medicare coverage. Some agreements may also apply to coverage and contributions under other programs in the foreign country, such as insurance for short-term sickness, work accident, and unemployment. As a result, workers exempted from foreign coverage by one of these agreements pay no taxes for these additional programs and generally may not receive benefits from them.

Totalization Benefits

Workers who have divided their careers between the United States and a foreign country sometimes fail to qualify for social security benefits from one or both countries because they have not worked long enough or recently enough to meet minimum eligibility requirements. Under a totalization agreement, such workers may qualify for partial US or foreign benefits based on combined, or totalized, coverage credits from both countries. A person who wishes to file a claim for benefits under a totalization agreement may do so at any social security office in the United States or the foreign country.

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Treaty-Based Return Position Disclosures

Taxpayers file Form 8833, Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b), to explain why social security and Medicare taxes are not being paid on self-employment income. Taxpayers also use Form 8833 to disclose any other treaty-based position required to be disclosed under I.R.C. § 6115 or Treas. Reg. § 301.7701(b)-7. There are penalties for failure to disclose.

A *treaty-based position* is a position that a treaty of the United States overrules or modifies a provision of the Internal Revenue Code and thereby causes, or potentially causes, a reduction of tax on the taxpayer's tax return. For these purposes, a treaty includes, but is not limited to, an income tax treaty; estate and gift tax treaty; or a friendship, commerce, or navigation treaty. **Figure 8.9** shows the 2020 Form 8833.

FIGURE 8.9
Form 8833

Form **8833**
(Rev. November 2020)
Department of the Treasury
Internal Revenue Service

Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b)
► **Attach to your tax return.**
► **Go to *www.irs.gov/Form8833* for the latest information.**

OMB No. 1545-1354

Attach a separate Form 8833 for each treaty-based return position taken. Failure to disclose a treaty-based return position may result in a penalty of $1,000 ($10,000 in the case of a C corporation) (see section 6712).

Name	U.S. taxpayer identifying number	Reference ID number, if any (see instructions)

Address in country of residence	Address in the United States

Check one or both of the following boxes as applicable.
- The taxpayer is disclosing a treaty-based return position as required by section 6114 . . . . . ► ☐
- The taxpayer is a dual-resident taxpayer and is disclosing a treaty-based return position as required by Regulations section 301.7701(b)-7 . . . . . ► ☐

Note: If the taxpayer is a dual-resident taxpayer and a long-term resident, by electing to be treated as a resident of a foreign country for purposes of claiming benefits under an applicable income tax treaty, the taxpayer will be deemed to have expatriated pursuant to section 877A. For more information, see the instructions.

Check this box if the taxpayer is a U.S. citizen or resident or is incorporated in the United States . . . . . ► ☐

1 Enter the specific treaty position relied on:
a Treaty country _____
b Article(s)

2 List the Internal Revenue Code provision(s) overruled or modified by the treaty-based return position

3 Name, identifying number (if available to the taxpayer), and address in the United States of the payor of the income (if fixed or determinable annual or periodical). See instructions.

4 List the provision(s) of the limitation on benefits article (if any) in the treaty that the taxpayer relies on to prevent application of that article ►

5 Is the taxpayer disclosing a treaty-based return position for which reporting is specifically required pursuant to Regulations section 301.6114-1(b)? . . . . . ☐ Yes ☐ No
If "Yes," enter the specific subsection(s) of Regulations section 301.6114-1(b) requiring reporting . . . . ► _____
Also include the information requested in line 6.

6 Explain the treaty-based return position taken. Include a brief summary of the facts on which it is based. Also, list the nature and amount (or a reasonable estimate) of gross receipts, each separate gross payment, each separate gross income item, or other item (as applicable) for which the treaty benefit is claimed _____

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CURRENT REAL ESTATE TAX ISSUES

9

Issue 1: Real Estate Rental Losses 342
Issue 2: Qualified Business Income Deduction and Losses 351
Issue 3: Tax Issues for Real Estate Developers 359
Issue 4: Net Investment Income Tax 367

LEARNING OBJECTIVES

After completing this session, participants will be able to do the following:

- ✔ Explain the passive activity loss limitations and how they apply to a real estate professional
- ✔ Apply the special $25,000 allowance for passive activity rental losses
- ✔ Allocate basis to subdivided lots
- ✔ Explain the factors that determine whether a real estate developer will be characterized as a dealer or an investor
- ✔ Know when a taxpayer is subject to the net investment income tax, and calculate that tax

INTRODUCTION

In 2020 and 2021, eviction moratoriums prohibited landlords from evicting certain tenants for failure to pay rent. Those landlords may have lost income because of the inability to evict nonpaying tenants. This chapter discusses the passive activity loss rules, the rules that apply if a taxpayer qualifies as a real estate professional, and the $25,000 special allowance for passive activity rental losses. This chapter also explains when the taxpayer can claim the I.R.C. § 199A qualified business income (QBI) deduction for rental real estate activities, and how that deduction is calculated if the taxpayer has QBI losses.

With a strong housing market in 2021, there was significant new development activity. This chapter reviews the allocation of basis

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to subdivided lots, and whether the developer will be characterized as a dealer who pays tax at ordinary income rates, or an investor who can use the preferential capital gains tax rates. Finally, this chapter reviews the general net investment income tax rules, and how those rules apply to a taxpayer with real estate rentals or a real estate developer.

ISSUE 1: REAL ESTATE RENTAL LOSSES Passive activity loss limitations may limit the deduction for a real estate rental loss.

I.R.C. § 469 may limit the deduction for losses incurred in a real estate rental activity. However, if the taxpayer is a real estate professional who materially participates in the activity, losses in those activities are not limited. A special $25,000 loss allowance applies to certain taxpayers who actively participate in a real estate rental activity. This section discusses how the general passive activity loss (PAL) rules apply to limit the deduction of passive activity losses and how those rules apply to a real estate professional. This section also reviews when a taxpayer is eligible for the $25,000 special allowance.

General Passive Activity Loss Rules

Under the general PAL rules, a taxpayer's current-year deductible passive activity losses are limited to passive activity income. Unused losses are suspended and carried over. The taxpayer can deduct those suspended losses when he or she disposes of his or her entire interest in the activity in a fully taxable disposition to an unrelated person or entity [I.R.C. § 469(g)]. The PAL rules apply to the following:

1. Any rental activity (defined later), regardless of whether the taxpayer materially participates, unless the taxpayer is a real estate professional who materially participates, or the $25,000 special allowance applies (discussed later) [I.R.C. § 469(c)(2) and (c)(4)]
2. A trade or business in which the taxpayer does not materially participate [I.R.C. § 469(c)(1)]

CROSS-REFERENCE

Other Loss Limitations

Although a loss may not be limited by the PAL rules, it may be limited by other loss limitations, such as the at-risk rules, the tax-basis rules, or the limitation on capital losses. See the "Loss Limitations" chapter in the *2017 National Income Tax Workbook* for a discussion of these other loss limits.

Taxpayers Subject to the PAL Rules

The PAL rules apply to the following taxpayers:

1. Individuals
2. Estates
3. Trusts (other than grantor trusts)
4. Personal service corporations
5. Closely held C corporations

The PAL rules do not apply to grantor trusts, S corporations, or partnerships at the entity level. However, they do apply to the deemed owner of a grantor trust, an S corporation shareholder, or to a partner in a partnership who is in one of the five categories previously listed. When a partnership or S corporation conducts an activity, each item of gross income and deduction allocated to a taxpayer from the pass-through entity is determined (in any case in which participation is relevant) by

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reference to the taxpayer's participation in the activity that generated the item. The taxpayer's participation is determined for the entity's tax year, not the taxpayer's tax year [Temp. Treas. Reg. § 1.469-2T(e)(1)].

PRACTITIONER NOTE

Closely Held C Corporation

Closely held C corporations that are not personal service corporations can deduct passive losses (and use credits) to the extent of net active income. Net active income includes income and deductions from all activities except portfolio investments. A closely held C corporation is described in I.R.C. § 465(a)(1)(B) as a C corporation that meets the I.R.C. § 542(a) stock ownership requirement that five or fewer individuals, directly or indirectly, own more than 50% in value of the corporation's outstanding stock at any time during the last half of the tax year.

Rental Activities

An activity is a rental activity if tangible property held in connection with the activity is used by customers or held for use by customers and the gross income is paid principally for that use of that tangible property. The regulations provide the following three general tests for characterization of payments for use of property based on average length of customer use:

1. If the average period of customer use is 7 days or less, the income is not characterized as rent [Temp. Treas. Reg. § 1.469-IT(e)(3)(ii)(A)].
2. If the average period of customer use is more than 7 days, but not more than 30 days, the income is rent unless the owner provides significant personal services [Temp. Treas. Reg. § 1.469-1T(e)(3)(iv)(B)].
3. With a few exceptions, if the average period of customer use exceeds 30 days, the activity will be rental unless the owner provides extraordinary personal services [Temp. Treas. Reg. § 1.469-1T(e)(3)(ii)(C) and (e)(3)(v)].

The following are not rental activities:

- Incidental rental of property used in a nonrental trade or business activity
- Making the property available during business hours for nonexclusive use by various customers
- Providing property for use in an activity conducted by a partnership, S corporation, or joint venture in which the taxpayer owns an interest

Disposition of an Interest in a Passive Activity

Disposition of the taxpayer's entire interest in a passive activity allows the taxpayer to recognize any loss associated with the activity. For the year of the disposition, any current-year losses and all the suspended losses are released in full and are treated as losses that are not from a passive activity. Any loss recognized on disposition is also treated as not from a passive activity. However, any gain recognized on the disposition will reduce the disposition year loss deduction. The disposition must be of the entire activity in a completely taxable transaction and may not be made to a related party.

Real Estate Professionals

Persons who qualify as real estate professionals treat real estate rental activities as nonpassive activities if they materially participate in those activities [I.R.C. § 469(c)(7)]. To qualify as a real estate professional, a taxpayer must meet both of the following two tests:

1. The taxpayer must perform more than one-half of the personal services in all trades or businesses during the tax year in real property trades or businesses in which the taxpayer materially participates.
2. The taxpayer must perform more than 750 hours of services during the tax year in real property trades or businesses in which he or she materially participates.

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A taxpayer may qualify as a real estate professional through a combination of real estate services. The total hours must satisfy the requirements of section 469(c)(7)(B) (more than one-half of the personal services performed in trades or businesses are performed in real property trades or businesses, and the taxpayer performs more than 750 hours of services in real property trades or businesses).

PRACTITIONER NOTE

Material Participation

The real estate professional provision does not automatically treat real estate rentals as active. Any real property rental activity of a real estate professional must meet the material participation standards, discussed later, or the activity will remain passive.

Real Property Trade or Business

A real property trade or business is any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business [I.R.C. § 469(c)(7)(C)]. Real property operation is the day-to-day operations of a trade or business relating to the maintenance and occupancy of the real property. The principal purpose of such business operations must be the provision of the use of the real property, or physical space accorded by or within the real property, to one or more customers, and not the provision of other significant or extraordinary personal services to customers in conjunction with the customers' incidental use of the real property or physical space. Cleaning and maintenance of common areas, routine repairs, trash collection, elevator service, and security are not significant personal services.

A real estate agent who brings together buyers and sellers of real property is engaged in a real property brokerage trade or business under section 469(c)(7)(C). However, a mortgage broker who is a broker of financial instruments is not in a real property brokerage trade or business within the meaning of § 469(c)(7)(C) [C.C.A. 2015-04-010 (January 23, 2015)].

Meeting the Tests

If the real estate professional is married, at least one spouse must separately meet both tests. However, the activities of both spouses are included for purposes of measuring material participation in the rental activities. Personal services rendered as an employee count toward the real estate professional tests only if the employee owns at least 5% of the employer's stock or other equity [Treas. Reg. § 1.469-9(c)(5)]. The I.R.C. § 318 attribution rules apply to determine constructive ownership.

PRACTITIONER NOTE

Participation Recordkeeping

The taxpayer must have records of the time spent on all personal service activities, especially when the taxpayer has another occupation. Post-event estimates of time spent participating in a rental activity and activity logs created in response to an IRS audit generally fail to meet the taxpayer's burden to establish time spent in a real estate business unless the logs were created from substantiated information such as appointment books or calendars.

Material Participation

If the taxpayer qualifies as a real estate professional, then profit or loss from a real estate rental activity is not passive if the taxpayer materially participates in the real estate rental activity [I.R.C. § 469(c)(7)]. If the taxpayer does not materially participate in the real estate rental activity, the profit or loss is passive. For other nonrental business activities, if the taxpayer materially participates in the trade or business, the profit or loss is not passive. Material participation is defined as involvement in the operation of the activity on a regular, continuous, and substantial basis (qualitative standard) [I.R.C. § 469(h)(1)].

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Material Participation Tests

Temp. Treas. Reg. § 1.469-5T(a) adopts seven tests to determine material participation, and a taxpayer who meets any one of the tests materially participates in an activity.

1. Participation Exceeds 500 Hours

An individual materially participates in an activity if the individual participates in the activity for more than 500 hours in the tax year.

2. Substantially All Participation in the Activity

An individual materially participates in an activity if the individual's participation in the activity constitutes substantially all the participation in the activity for the tax year. For this test, the participation by individuals who are not owners are considered in determining whether the individual's participation was substantially all the participation.

3. More Than 100 Hours and Not Less Than Anyone Else

An individual materially participates in an activity if the individual participates in the activity for more than 100 hours and at least as much as any other individual. Participation by non-owners counts in applying this test.

Example 9.1
No Material Participation

Sandy Baxter purchased a condo in Florida. Sandy and her relatives do not use the condo for personal use. The condo is available for monthly rental and Sandy uses a management company to manage the property. The management company takes reservations, collects rent, and makes any necessary repairs. In 2021, 10 customers rented the condo for a total of 350 days (35 days average per customer). Because Sandy does not materially participate in the activity, the condo rental activity is a passive activity that is subject to the PAL limitations.

4. Significant Participation Activities

An individual materially participates in an activity if the activity is a significant participation activity for the tax year, and the individual's aggregate participation in all significant participation activities during the year exceeds 500 hours. An activity is a significant participation activity if it is a trade or business activity in which the individual significantly participates (more than 100 hours) for the tax year, and the activity does not meet any of the other six tests for material participation. This test applies only to trades or businesses, and not to rentals.

5. Material Participation for 5 of Last 10 Years

An individual who met one of the other material participation tests for 5 of the 10 tax years preceding the current tax year (whether or not consecutive) is a material participant for the current year.

6. Material Participation in Personal Service Activity for 3 Years

An individual who materially participates in a personal service activity for at least 3 tax years (whether or not consecutive) preceding the current tax year is treated as a material participant for the rest of the individual's ownership in the activity. An activity is a personal service activity if it involves the performance of personal services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, or in any other trade or business in which capital is not a material income-producing factor [Temp. Treas. Reg. § 1.469T-5(d)].

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7. Facts and Circumstances

An individual may materially participate in an activity if, based on all the facts and circumstances, he or she participates on a regular, continuous, and substantial basis. The following rules apply to the facts and circumstances test:

1. A taxpayer who participates for 100 or fewer hours does not materially participate.
2. Management activities of the taxpayer do not count unless
   a. no person except the taxpayer is compensated for management services, and
   b. no person provides more hours of management services than the taxpayer.

[Temp. Treas. Reg. § 1.469-5T(b)]

Definition of Participation

Generally, any work performed by an individual in connection with an activity in which the individual owns an interest at the time the work is performed, regardless of the capacity in which the individual performs the work, is treated as participation in the activity [Treas. Reg. § 1.469-5(f)(1)]. However, work not customarily performed by owners does not count toward material participation if one of the principal purposes of the work is to avoid the application of the PAL rules [Temp. Treas. Reg. § 1.469-5T(f)(2)(i)].

Work done by an individual in the individual's capacity as an investor is not participation unless the individual is directly involved in the day-to-day management or operations of the activity [Temp. Treas. Reg. § 1.469-5T(f)(2)(ii)]. Married taxpayers generally may combine their participation in determining whether they meet a material participation test, even if they do not file a joint tax return [I.R.C. § 469(h)(5)]. Special participation rules apply to activities of a limited partnership (discussed later).

Aggregating Rental Real Estate Activities

A taxpayer that qualifies as a real estate professional may elect to treat all rental real estate activities as one single activity [Treas. Reg. § 1.469-9(g)(1)]. The election aggregates all rentals, whether owned individually or through a pass-through entity such as a partnership, S corporation, or trust. With a valid aggregation election, material participation is measured considering the entire rental portfolio and not for each individual property. The aggregation automatically includes newly acquired properties.

Generally, real estate professionals may not group rental real estate activities with other activities, including activities related to other real property trades or businesses [Treas. Reg. § 1.469-9(e)(3)(i)]. Thus, only the participation of the taxpayer in the rental real estate activity may be used to determine if the taxpayer materially participates in the rental real estate activity. A special rule applies to certain management activities [see Treas. Reg. § 1.469-9(e)(3)(ii)].

Making the Election

The election to group real estate rental activities is made by filing a statement with the taxpayer's original income tax return for the tax year [Treas. Reg. § 1.469-9(g)(3)]. See Rev. Proc. 2011-34, 2011-24 I.R.B. 875, for information about making a late election. The statement must contain a declaration that the taxpayer is a qualifying taxpayer (a real estate professional) for the tax year and is making the election pursuant to I.R.C. § 469(c)(7)(A).

This election is binding for the tax year in which it is made and for all future tax years in which the taxpayer qualifies as a real estate professional even if there are intervening years in which the taxpayer is not a real estate professional. The failure to make an election in a previous year does not preclude making an election in the current year.

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Effect of the Election

A taxpayer who makes the grouping election must treat all his or her interests in rental real estate as a single rental real estate activity. Taxpayers cannot elect grouping for some rental properties and not others. Grouping activities into a larger activity allows the taxpayer to measure material participation in the activities as a whole, rather than in each activity separately.

Example 9.2
Measuring Material Participation for a Group

Bobby Bailey owns interests in four residential rental properties and one commercial rental property. All the properties are in the same neighborhood. Bobby hired a property management company to manage the four residential properties. Bobby spends 1,200 hours per year in the management of the commercial property, and that management qualifies him as a real estate professional. The property management is his only job.

Without a grouping election, Bobby does not meet the material participation tests for the residential real estate. However, if he elects to aggregate the residential rentals with the commercial rental and treat them as a single activity, his participation in the commercial rental activity is sufficient for him to be treated as materially participating in the aggregate real estate activity, including the residential rental activities.

Limited Partnership Interests

If a taxpayer elects to group activities and holds at least one real estate interest through a limited partnership, the taxpayer's combined rental real estate activity may be treated as a limited partnership interest for purposes of determining material participation [Treas. Reg. § 1.469-9(f)(1)]. Under the material participation rules, a limited partner is generally not treated as materially participating in the activities of the limited partnership. However, the limited partner can materially participate in a limited partnership real estate rental activity if he or she meets the more than 500 hours test, or the material participation for 5 of the preceding 10 tax years test.

PRACTITIONER NOTE

Personal Service Limited Partnership

A limited partner in a limited partnership that conducts a personal service activity may materially participate if he or she meets the personal service activity for 3 years test.

A combined activity that includes a limited partnership interest is treated as a limited partnership interest only if 10% or more of the taxpayer's gross rental income from all rental real estate interests comes from limited partnership interests. If the taxpayer's share of gross rental income from limited partnership interests is less than 10% of the taxpayer's total gross rental income for the tax year, the taxpayer can use any of the seven material participation tests.

Former Passive Activities

Generally, section 469(f) provides that suspended PALs or passive activity credits continue to be treated as arising from a passive activity. However, a real estate professional who elects to aggregate rental activities may use suspended PALs from a formerly passive rental activity to offset the net income from the grouped activities.

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Example 9.3
Grouping Former Passive Activities

Carlos Perez is a real estate broker who conducts his business as a sole proprietorship. Carlos owns rental properties on Dakota, Iowa, and Colorado Avenues. He qualifies as a real estate professional in 2021 due to his brokerage activity. In 2020, Carlos had a property management company manage the properties. In 2020 the Dakota property had a $6,000 PAL, the Iowa property had a $10,000 PAL, and the Colorado property had $12,000 passive activity income. Carlos had a $4,000 [$12,000 – ($6,000 + $10,000)] total suspended PAL, which he carried forward to 2021.

In 2021, Carlos purchased a commercial building, and he spent over 500 hours managing the building. The commercial property had $50,000 net income. The Dakota property had a $4,000 PAL, the Iowa property had a $5,000 PAL, and the Colorado property had $8,000 net income. If Carlos elects to group the rental activities, the four properties are treated as nonpassive.

Carlos has $49,000 ($50,000 − $4,000 − $5,000 + $8,000) excess gain in the current year, and he can use the $4,000 suspended PAL to offset the nonpassive net income from the grouped rental activities. His 2021 rental income is $45,000 ($49,000 − $4,000).

Without the aggregation (grouping) election, the commercial property is active, and the residential properties remain passive. Carlos has a $1,000 ($8,000 − $4,000 − $5,000) net loss, which he adds to the $4,000 PAL from 2020. Carlos carries the $5,000 ($1,000 + $4,000) loss to 2022. His 2021 rental income is $50,000.

Dispositions of Grouped Activities

Generally, upon disposition of a taxpayer's entire interest in a passive activity, any current-year losses and suspended losses are not subject to the PAL rules and are treated as losses that are not from a passive activity. However, if the taxpayer makes the election to group rental real estate activities, the section 469(g) disposition rules apply to the single combined rental real estate activity. Suspended losses are not freed up until the taxpayer completely disposes all of the properties.

Revocation of Election

A taxpayer can revoke the grouping election only in a tax year in which there is a material change in the taxpayer's facts and circumstances, or in a subsequent year in which the facts and circumstances are still materially changed. The fact that an election is less advantageous to the taxpayer in a particular tax year is not, of itself, a material change in the taxpayer's facts and circumstances. Similarly, a break in the taxpayer's status as a qualifying taxpayer is not, of itself, a material change in the taxpayer's facts and circumstances.

To revoke the election, a taxpayer files a statement with his or her original tax return for the year of revocation. The statement must include a declaration that the taxpayer is revoking the election under I.R.C. § 469(c)(7)(A) and an explanation of the nature of the material change [Treas. Reg. § 1.469-9(g)(3)].

$25,000 Special Allowance

The PAL limitations do not apply to up to $25,000 of passive losses (or the deduction equivalent of the passive activity credit) from rental real estate activities if the taxpayer is a natural person, and the taxpayer actively participates in the rental real estate activity. The allowance begins to phase out if the taxpayer's modified AGI is over $100,000 for MFJ, single, and HoH. A reduced allowance and beginning phaseout apply to married filing separately taxpayers (discussed later).

Estates can qualify for the $25,000 loss allowance in tax years ending less than 2 years after the date of the decedent's death if the decedent would have qualified in the year of death [I.R.C.§ 469(i)(4)]. Revocable trusts that elect to be treated as part of the estate can qualify under the same conditions. The amount of the exemption is reduced by the exemption allowable to a surviving spouse for the tax year ending with or within the tax year of the estate.

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Active Participation

Active participation does not require regular, continuous, and substantial involvement in operations, but the taxpayer must participate in making management decisions or arranging for others to provide services (such as repairs) in a significant and bona fide sense. Management decisions may include approving new tenants, deciding on rental terms, approving capital or repair expenditures, and other similar decisions.

PRACTITIONER NOTE

Ownership Requirements

A taxpayer cannot meet the active participation test if his or her interest (including a spouse's interest) in the real estate rental activity is less than 10% (by value) of all interests in the activity [I.R.C. § 469(i)(6)(A)]. A limited partner in a limited partnership does not actively participate in partnership activities.

Example 9.4
Active Participation Test

Cole Cunningham owns a vacation home that he formerly used as his primary residence. Cole does monthly rentals and does not provide any significant services. He hires a property management company but reserves the right to approve tenants. He hires a contractor to make routine repairs. Cole meets the active participation test because he is involved in management decisions and arranges for repair services.

Phaseout of Allowance

The $25,000 maximum allowance is reduced by 50¢ for each $1 of MAGI above $100,000. The allowance is fully phased out at $150,000 MAGI. The following two rules apply to married taxpayers filing separate returns:

1. If they live together at any time during the year, they cannot claim an allowance.
2. If they do not live together at any time during the year, each spouse's maximum allowance is $12,500, which is phased out by 50¢ for each $1 of MAGI that exceeds $50,000. The allowance is fully phased out at $75,000 MAGI.

For purposes of the phaseout, MAGI is AGI determined without reference to the following:

1. The taxable social security and tier 1 railroad retirement benefits included in income under I.R.C. § 86
2. The exclusion from income of interest from US savings bonds used to pay higher education expenses
3. The exclusion of amounts received under an employer's adoption assistance program
4. The deduction for qualified retirement saving contributions
5. The student loan interest deduction
6. The tuition and fees deduction (if extended)
7. The deduction for foreign-derived intangible income and global intangible low-taxed income
8. The passive activity losses or other losses allowed because of the real estate professional rules
9. The overall loss from a publicly-traded partnership
10. The deduction for one-half of self-employment tax

[I.R.C. § 469(i)(3)(E) and IRS Publication 925, *Passive Activity and At-Risk Rules*].

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Ordering Rules

Before deducting the allowance, the taxpayer must combine the net income and net losses from all the taxpayer's active participation real estate rental activities and apply the prior year's unused losses. If the taxpayer has net income from those activities, that income is offset first by rental real estate activities that produce losses before the $25,000 allowance is used. If there is an overall net loss from these rental real estate activities, all income from rental real estate activities is allocated entirely to the rental real estate loss activities. Losses from other passive activities can be absorbed by income from rental real estate activities only if there is overall net income from the rental real estate activities [Treas. Reg. § 1.469-9(j)(1)].

OBSERVATION

Effect of Ordering Rule

The allocation formula minimizes the allocation of carryforward losses to rental real estate activities, thereby reducing the probability of claiming the $25,000 rental real estate deduction in future years.

Example 9.5
Application of $25,000 Allowance

Alex Andrews owns a retail rental building on Oak Street and a commercial rental building on Chestnut Street. Alex qualifies as a real estate professional. He does not elect to treat the two rentals as one activity. In 2021, Alex materially participated in the Oak Street rental, which has $100,000 of passive losses disallowed from prior years and produced a $20,000 nonpassive loss in 2021.

Alex did not materially participate in the Chestnut Street rental, which had $40,000 of passive income in 2021. Alex also had $50,000 of income from other nonpassive sources. He otherwise meets the requirements for the $25,000 special allowance.

Because the Oak Street rental is not a passive activity in 2021, the $20,000 nonpassive loss can offset part of Alex's $50,000 of nonpassive income so Alex has $30,000 ($50,000 − $20,000) of nonpassive income. Alex uses the Oak Street rental's $100,000 prior-year disallowed passive losses to offset the Chestnut Street rental's $40,000 passive income and has $60,000 ($100,000 − $40,000) of passive losses remaining from the Oak Street rental. He can use the special allowance to offset up to $25,000 of nonpassive income with the Oak Street passive losses. As a result, Alex has $5,000 ($30,000 − $25,000) of nonpassive income remaining and $35,000 ($60,000 − $25,000) of disallowed passive losses that he will carry over [Treas. Reg. § 1.469-9(j)(2), Example].

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ISSUE 2: QUALIFIED BUSINESS INCOME DEDUCTION AND LOSSES

This section discusses the qualified business income deduction for a real estate rental business.

Taxpayers may claim the I.R.C. § 199A qualified business income (QBI) deduction for a real estate rental trade or business. This section explains when a real estate rental is a trade or business that may have QBI. Many taxpayers with rental properties may have a loss for 2021 due to the moratorium that prevented eviction of nonpaying tenants. This section also discusses the treatment of QBI losses.

CROSS-REFERENCE

QBI Deduction

For a detailed discussion of how to calculate the deduction, and the limitations that apply, see the "Qualified Business Income Deduction: Non–Specified Service Trades or Businesses" and the "Qualified Business Income Deduction: Specified Service Trades or Businesses" chapters in the *2019 National Income Tax Workbook*.

QBI Deduction for Real Estate Rentals

QBI includes the net income or loss from qualified real estate activities if those activities give rise to a trade or business under I.R.C. § 162. Rev. Proc. 2019-38, 2019-42 I.R.B. 942, provides a safe harbor for the determination of when a rental real estate activity is a trade or business. QBI also includes a rental to a commonly controlled activity (a self-rental).

Trade or Business

Under Treas. Reg. § 1.199A-1, the determination of whether a rental activity is a trade or business is based on an analysis of the facts and circumstances. The taxpayer does not have to materially participate in the rental activity. In determining whether a rental real estate activity is a section 162 trade or business, relevant factors might include, but are not limited to the following:

1. The type of rented property (commercial real property versus residential property)
2. The number of properties rented
3. The owner's or the owner's agent's day-to-day involvement
4. The types and significance of any ancillary services provided under the lease
5. The terms of the lease (for example, a triple net lease versus a traditional lease and a short-term lease versus a long-term lease)

[Preamble to the final section 199A regulations]

The US Supreme Court has stated that for an activity to constitute a trade or business, the taxpayer must be involved in the activity with continuity and regularity and the taxpayer's primary purpose for engaging in the activity must be for income or profit. A sporadic activity, a hobby, or an amusement or diversion does not qualify [*Commissioner v. Groetzinger*, 480 U.S. 23 (1987)].

Rev. Proc. 2019-38 Safe Harbor

Rev. Proc. 2019-38 establishes a safe harbor under which a rental real estate enterprise may be treated as a trade or business solely for purposes of section 199A. A rental activity that fails the safe harbor requirements may still be treated as a trade or business based on the facts and circumstances.

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Rental Real Estate Enterprise

The safe harbor applies to a *rental real estate enterprise*, which is defined as an interest in real property held for the production of rents. A rental real estate enterprise may consist of an interest in multiple properties. The individual or relevant pass-through entity (RPE) relying on this revenue procedure must hold the interest directly or through a disregarded entity.

Vacation home rentals subject to I.R.C. § 280A limitations and triple net lease properties are not eligible for the safe harbor and cannot be included in the taxpayer's rental real estate enterprise for purposes of satisfying the safe harbor. For purposes of this revenue procedure, a triple net lease includes a lease agreement that requires the tenant or lessee to pay taxes, fees, and insurance, and to be responsible for maintenance activities for a property in addition to rent and utilities. Self-rentals and rentals treated as specified service trades or businesses (SSTBs) (because they rent property to a commonly owned SSTB) are also not eligible.

PRACTITIONER NOTE

Triple Net Leases

While triple net lease rentals are excluded from the safe harbor, they may qualify as a trade or business. If real estate that is rented pursuant to a triple net lease is otherwise treated as a trade or business under section 199A, then the business may have QBI.

Taxpayers must either treat each property held for the production of rents as a separate enterprise or treat all similar properties held for the production of rents as a single enterprise. Commercial and residential real estate may not be part of the same enterprise. Thus, commercial real estate held for the production of rents may only be part of the same enterprise with other commercial real estate, and residential properties may only be part of the same enterprise with other residential properties.

PRACTITIONER NOTE

Mixed Use Property

Special rules apply to property that is both commercial and residential (mixed use property). While IRS FAQs that have not been reported in the Internal Revenue Bulletin are not authoritative, the IRS Tax Cuts and Jobs Act, Provision 11011, Section 199A, Qualified Business Income Deduction FAQ 59, provides a detailed explanation of the application of the safe harbor to mixed use property [www.irs.gov/newsroom/tax-cuts-and-jobs-act-provision-11011-section-199a-qualified-business-income-deduction-faqs#rental].

Once a taxpayer or RPE treats interests in similar commercial properties or similar residential properties as a single rental real estate enterprise under the safe harbor, the taxpayer or RPE must continue to treat interests in all similar properties, including newly acquired properties, as a single rental real estate enterprise when the taxpayer or RPE continues to rely on the safe harbor.

Taxpayers may not vary this aggregation choice from year to year unless there has been a significant change in facts and circumstances. However, a taxpayer or RPE that chooses to treat its interest in each residential or commercial property as a separate rental real estate enterprise may choose to treat its interests in all similar properties as a single rental real estate enterprise in a future year.

PRACTITIONER NOTE

Aggregating Rental Real Estate

Rental real estate that is a trade or business can be aggregated with other trades or businesses, including other rental real estate trades or businesses, if the rules of Treas. Reg. § 1.199A-4 are met. This includes rental real estate that rises to the level of a section 162 trade or business, rental real estate enterprises that meet the safe harbor requirements, and self-rentals.

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Safe Harbor Test

Under the safe harbor, a rental real estate enterprise that has been in existence less than 4 years may be treated as a trade or business if the taxpayer performs at least 250 hours of services each tax year with respect to the enterprise. For rental real estate enterprises that have been in existence for at least 4 years, the taxpayer must perform 250 or more hours of rental services per year with respect to the rental real estate enterprise in any 3 of the 5 consecutive tax years that end with the reporting tax year (or in each year for an enterprise held for less than 5 years).

Services with respect to a real estate enterprise include the following services performed by owners, employees, and independent contractors:

- Advertising to rent or lease the real estate
- Negotiating and executing leases
- Verifying information contained in prospective tenant applications
- Collection of rent
- Daily operation, maintenance, and repair of the property, including purchasing materials and supplies
- Management of the real estate
- Supervision of employees and independent contractors

Hours spent by any person with respect to the owner's capacity as an investor, such as arranging financing; procuring property; reviewing financial statements or reports on operations; planning, managing, or constructing long-term capital improvements; and traveling to and from the real estate (in the capacity as an investor) are not counted as hours of service with respect to the enterprise. The safe harbor also requires that the owner keep separate books and records and separate bank accounts for the rental real estate enterprise (discussed later).

A rental real estate enterprise that satisfies the safe harbor and is treated as a trade or business for purposes of section 199A is not necessarily a section 162 trade or business. Failure to meet the safe harbor does not necessarily preclude rental real estate activities from being a section 162 trade or business based on the facts and circumstances.

Recordkeeping Requirements

To rely on the safe harbor, the taxpayer must maintain separate books and records to reflect income and expenses for each real estate enterprise. The taxpayer must also maintain contemporaneous records, including time reports, logs, or similar documents that include

1. hours of all services performed,
2. a description of all services performed,
3. dates on which such services were performed, and
4. who performed the services.

If an employee or independent contractor performs the services with respect to the rental real estate enterprise, the taxpayer may provide a description of the rental services performed by such employee or independent contractor; the amount of time such employee or independent contractor generally spends performing such services for the enterprise; and time, wage, or payment records for such employee or independent contractor. The taxpayer must make the records available for inspection at the IRS's request.

Reporting Requirements

A taxpayer or RPE must include a statement–attached to the timely filed original return on which it claims the section 199A deduction or passes through section 199A information–indicating that the requirements of the revenue procedure have been satisfied. The statement must include the following information separately for each rental real estate enterprise:

1. A description (including the address and rental category) of all rental real estate properties that are included in each rental real estate enterprise
2. A description (including the address and rental category) of rental real estate properties acquired and disposed of during the tax year
3. A representation that the requirements of the revenue procedure have been satisfied

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PRACTITIONER NOTE

Facts and Circumstances Test

Given the stringent requirements to meet the safe harbor, and the additional recordkeeping and reporting requirements, taxpayers may choose to instead rely on the facts and circumstances test to demonstrate that the rental real estate enterprise is a trade or business. The safe harbor is not available to taxpayers that fail to meet the contemporaneous records requirement. If the taxpayer does not rely on the safe harbor, and the rental real estate otherwise rises to the level of a section 162 trade or business or meets the self-rental rule, the recordkeeping and reporting requirements do not apply. However, the taxpayer still bears the burden to show the right to a claimed deduction.

Self-Rentals

Solely for purposes of section 199A, the rental or licensing of tangible or intangible property to a related trade or business that is an individual or RPE is treated as a trade or business if the rental or licensing and the other trade or business are commonly controlled under Treas. Reg. § 1.199A-1(b)(14). This rule allows taxpayers to aggregate their trades or businesses with the associated rental property regardless of whether the rental activity and the trade or business are otherwise eligible to be aggregated under Treas. Reg. § 1.199A-4(b). Thus, if there is common control, a rental activity associated with a trade or business is deemed to also be a trade or business.

Common control under the final section 199A regulations means that the same person or group of persons, directly or by attribution under I.R.C. § 267(b) or 707(b), owns 50% or more of each trade or business. For a trade or business owned by an S corporation, ownership must be 50% or more of the issued and outstanding shares of the corporation. For a trade or business owned by a partnership, ownership must be 50% or more of the capital or profits in the partnership.

PRACTITIONER NOTE

Rental to an SSTB

If real estate is rented to a commonly owned SSTB, the portion of real estate rented to the commonly owned SSTB is a separate SSTB with respect to the related parties. Any portions not rented to the commonly owned SSTB, as well as any interests held by an unrelated party, would not be a SSTB.

QBI Losses

A cash method taxpayer may have a loss from a rental business in 2021. Under Treas. Reg. § 1.199A-1(d)(2)(iii)(A), if an individual's QBI from at least one trade or business is less than zero, the individual must offset the QBI attributable to each trade or business that produced net positive QBI with the QBI from each trade or business that produced net negative QBI in proportion to the relative amounts of net QBI in the trades or businesses with positive QBI. The adjusted QBI is then used to apply the W-2 wage and capital limit. The W-2 wages and unadjusted basis immediately after acquisition (UBIA) of qualified property from the trades or businesses that produced net negative QBI are not taken into account and are not carried over to the subsequent year.

If the individual's total QBI is less than zero, the portion of the individual's section 199A deduction related to QBI is zero for the tax year. The negative total QBI is treated as negative QBI from a separate trade or business in the succeeding tax years.

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PRACTITIONER NOTE

Accrual Method Taxpayers

An accrual method taxpayer who is in the real estate rentals trade or business includes rent due in QBI even if rent was not paid during the eviction moratorium. If the tenant fails to pay amounts owed, the taxpayer can claim a bad-debt deduction in the year the debt becomes partially or totally worthless, which may generate a negative QBI.

Current-Year Qualified Business Loss

A loss from a qualified business offsets income from other qualified businesses.

- If the overall QBI is positive, it reduces the QBI from each other business proportionately [Treas. Reg. § 199A-1(d)(2)(iii)(A)].
- If the overall QBI is negative, the QBI component is zero, and the negative amount is a carryforward, which offsets QBI in future years [Treas. Reg. § 1.199A-1(d)(2)(iii)(B)].

Example 9.6
Loss from Qualified Business

Susan Graham (age 50) is a single taxpayer with salary income and interests in three businesses that are not SSTBs. She operates an organic farm and a log furniture business, and she owns an apartment building. Susan qualifies as a real estate professional, and she materially participates in a rental real estate business. The businesses are all unrelated and cannot be aggregated. All three businesses use the cash method of accounting.

In 2021, Susan had $150,200 of salary income. Her QBI from the farm was $150,000, and her share of the W-2 wages was $40,000. Her QBI from the furniture business was $150,000, and her share of the W-2 wages was $30,000. She had a negative $50,000 QBI from the rental real estate business, and her share of the W-2 wages was $10,000. The farm and the furniture businesses leased their property and equipment and had no qualified property. Susan's taxable income is shown in **Figure 9.1**. This example is intended to illustrate the netting of QBI losses and does not include the deduction for one-half of SE tax.

FIGURE 9.1
Susan's Taxable Income (QBI Loss)

Salary income	$150,200
QBI ($150,000 + $150,000 - $50,000)	250,000
AGI	$400,200
Standard deduction	(12,550)
Taxable income before the QBI deduction	$387,650

Susan must reduce her QBI from the farm and the furniture businesses by the QBI loss from the rental real estate business. As her QBI from the farm and furniture businesses was the same, Susan allocates the $50,000 QBI loss to the businesses in equal shares. Thus, her QBI from each business is $125,000 [$150,000 – ($50,000 × 50%)]. Susan's tentative QBI deduction for each business is $25,000 ($125,000 × 20%).

Susan's taxable income is above the phasein range ($214,900 for 2021) for single taxpayers, and the W-2 wage and capital limit applies in full. Her QBI deduction for the farm is limited to the lesser of $25,000 or $20,000 ($40,000 W-2 wages × 50%). Her QBI deduction for the furniture business is limited to the lesser of $25,000 or $15,000 ($30,000 W-2 wages × 50%). Susan's total QBI deduction is $35,000 ($20,000 + $15,000). She cannot use the W-2 wages of the rental business to increase her QBI deduction. The combined QBI deduction is less than $77,530 ($387,650 taxable income × 20%), and she can claim the full $35,000 QBI deduction.

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CROSS-REFERENCE

Aggregating a Loss Business

Aggregation or disaggregation may have no effect on the overall QBI deduction when one or more of the businesses has income and one or more has losses. Losses must offset gains, regardless of whether the taxpayer elects to aggregate the activities. However, an aggregation election can allow inclusion of the W-2 wages and UBIA of qualified property of the loss business for purposes of calculating the W-2 wage and capital limit. See the "Business Tax Issues" chapter in this workbook for a discuss of when it is advantageous to aggregate businesses.

When the overall QBI is negative, the negative amount carries forward and offsets future QBI [I.R.C. §199A(c)(2)].

Example 9.7
QBI Loss Carryover

The facts are the same as in Example 9.6, except that Susan's loss from the rental real estate business is $400,000. This loss exceeds the combined $300,000 ($150,000 + $150,000) income from the other two qualified businesses. Because there is no QBI, there is no QBI deduction for 2021. The negative combined QBI of $100,000 ($150,000 + $150,000 − $400,000) carries forward and is treated as negative QBI from a separate trade or business for purposes of computing the section 199A deduction in the next tax year. However, for income tax purposes, the $100,000 loss may offset Susan's $150,200 of salary income. Because Susan is a real estate professional who materially participated in the rental business, her loss is not limited by the passive activity loss (PAL) rules.

Losses that are limited by basis, at-risk, or PAL rules are not included in taxable income and are not qualified items of income, gain, deduction, or loss. Thus, they are not current-year QBI.

Example 9.8
PAL Not Included in QBI

Tiara Jackson owns rental property that rises to the level of a section 162 trade or business. The rental property generated a $20,000 net loss in 2021. Tiara is not a real estate professional, and the loss is disallowed under the section 469 PAL limitations. The $20,000 loss is not included in the calculation of Tiara's 2021 taxable income, so it is not included in her QBI for that year. However, if the loss is allowed in 2022, the loss will be treated as a qualified business net loss carryforward from a separate trade or business and will be used to calculate Tiara's 2022 QBI deduction.

Previously Disallowed Losses

Any losses disallowed, suspended, or limited under the provisions of sections 461(l) (tax shelters), 465 (at-risk rules), 469 (PAL rules), 704(d) (partnership basis limitation), and 1366(d) (S corporation basis limitation), or any other similar provisions, must be used, for purposes of section 199A and the 199A regulations, in order from the oldest to the most recent on a first-in, first-out (FIFO) basis [Treas. Reg. § 1.199A-3(b)(1)(iv)]. However, losses or deductions that were disallowed, suspended, limited, or carried over from tax years ending before January 1, 2018, are not taken into account in a later tax year for purposes of computing QBI. If the loss was generated in 2018 or later, it is included in QBI if it is a qualified item of deduction or loss that would otherwise be included in QBI, but not until the year it is included or allowed in taxable income.

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Attributes of Loss or Deduction

A taxpayer's section 469 groupings may differ from the taxpayer's section 199A aggregations. Thus, a previously disallowed section 469 loss carryforward is allocated to those groupings when it is later used. Also, a previously disallowed loss may relate to a trade or business that is no longer in existence. To address these issues, final regulations provide that previously disallowed losses are treated as a loss from a separate trade or business. To the extent that losses relate to a publicly traded partnership (PTP), they must be treated as losses from a separate PTP.

Treas. Reg. § 1.199A-3(b)(1)(iv)(C) provides that whether the disallowed loss or deduction is attributable to a trade or business and otherwise meets the requirements of section 199A is determined in the year the loss is incurred. Also, whether a disallowed loss or deduction is attributable to an SSTB (including whether an individual has taxable income under the threshold amount, within the phasein range, or in excess of the phasein range) is determined in the year the loss is incurred.

If the business is an SSTB and the individual's taxable income is at or below the threshold amount in the year the loss or deduction is incurred, the entire disallowed loss or deduction is taken into account when applying the suspended loss in a subsequent year. If the individual's taxable income is within the phasein range, then only the applicable percentage of the disallowed loss or deduction is taken into account when applying the suspended loss. If the individual's taxable income exceeds the phasein range, none of the disallowed loss or deduction is taken into account in a subsequent year.

Example 9.9
Suspended SSTB Loss

Maria Armani is a single taxpayer. She owns 100% of a commercial building that she leases to Armani Medical Group, LLC. Maria is a 50% owner of the LLC, which is an SSTB. The lease of the building is a self-rental and is treated as a separate SSTB. In 2021, the rental business had a $20,000 loss, which was suspended under section 465. Because the entire loss is suspended, none of the negative QBI is used to determine Maria's section 199A deduction for 2021. The negative QBI is from an SSTB. Maria's taxable income before the section 199A deduction is above the phasein range. If Maria takes the loss into account in determining her 2022 income, and her taxable income is within the phasein range, none of the negative QBI will be taken into account in determining her 2022 QBI.

Partially Allowed Losses

To the extent a loss is partially disallowed, QBI in the year of disallowance is reduced proportionately. Thus, if a loss or deduction attributable to a trade or business is only partially allowed during the tax year in which it is incurred, only the portion of the allowed loss or deduction that is attributable to QBI is considered in determining QBI from the trade or business in the year the loss or deduction is incurred. The portion of the allowed loss or deduction attributable to QBI is determined by multiplying the total amount of the allowed loss by a fraction. The numerator is the portion of the total loss incurred during the tax year that is attributable to QBI, and the denominator is the amount of the total loss incurred during the tax year [Treas. Reg. § 1.199A-3(b)(1)(iv)(B)].

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Example 9.10
Calculating a Partially Allowed Loss

Andre Bauer is single. He is a 50% owner of Atlas Property Management, LLC, which is classified as a partnership for federal income tax purposes. In 2021, Andre's allocable share of loss from the company was $100,000 and $80,000 was negative QBI. Under the section 465 at-risk rules, $60,000 of the allocable loss is allowed in determining Andre's taxable income. Andre had no other previously disallowed losses under section 465 or any other code provision. Because 80% ($80,000 ÷ $100,000) of Andre's allocable loss is attributable to QBI, he reduces the amount he takes into account in determining QBI proportionately. Andre will include $48,000 ($60,000 × 80%) of the allowed loss in negative QBI in determining his 2021 section 199A deduction. The remaining $32,000 ($60,000 − $48,000) of negative QBI is treated as negative QBI from a separate trade or business for purposes of computing the section 199A deduction in the year the loss is taken into account in determining Andre's taxable income [Treas. Reg. § 1.199A-3(b)(1)(iv)(D), Example 1].

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ISSUE 3: TAX ISSUES FOR REAL ESTATE DEVELOPERS This issue reviews important tax issues for real estate developers.

While some housing markets faced declines in 2021, The US Census Bureau and the US Department of Housing and Urban Development announced that in May 2021, there were 1,681,000 building permits issued for residential construction, and 1,572,000 housing starts. Building permits were up approximately 34.9% from May 2020, and housing starts were up approximately 50.3% [www.census.gov/construction/nrc/pdf/newresconst.pdf].

This section discusses tax issues for real estate developers. It explains how to allocate costs among subdivided lots. It reviews when a developer is an investor who is entitled to capital gains tax rates on the sale of the improved lots, and when the developer is a dealer and the gain is ordinary income. This section also discusses the I.R.C. § 1237 rule that allows certain taxpayers to subdivide and sell lots and retain investor status. Finally, this section explains installment sales for a real estate investor.

Allocating Costs

The basis of purchased land is typically its cost. When a taxpayer buys land for development, the taxpayer must allocate the purchase cost among the subdivided lots and also the improvements.

Subdivided Land

When a part of a larger property is sold, the cost or other basis of the entire property must be equitably apportioned among the several parts, and the gain realized or loss sustained on the part of the entire property sold is the difference between the selling price and the cost or other basis allocated to such part. The sale of each part is treated as a separate transaction, and gain or loss is computed separately on each part [Treas. Reg. § 1.61-6(a)]. Thus, if the taxpayer buys a tract of land and subdivides it, the taxpayer must determine the basis of each lot.

PRACTITIONER NOTE

Acquisition Costs

The costs to facilitate the land acquisition, such as legal fees, title policies, surveys, and realtors' commissions, are capital expenditures and must be added to basis. An amount paid by the taxpayer in the process of investigating or otherwise pursuing the acquisition of real property does not facilitate the acquisition if it relates to activities performed in the process of determining whether to acquire real property and which real property to acquire [Treas. Reg. § 1.263(a)-2(f)]. Capitalized acquisition costs must also be allocated among the subdivided lots.

If all the lots are identical and have the same value, the taxpayer can divide the total purchase price by the number of lots. However, some lots may be larger or may have natural characteristics that make them more valuable, and the taxpayer must equitably apportion the basis among the lots.

Section 61 does not define *equitable apportionment*, and case law indicates what may be an acceptable method to equitably apportion basis. A commonly used method is the fair market value (FMV) method.

The FMV method considers the value of the separate parcels. The value may be based on several factors, such as size, topography, location, desirable features, access, natural landscape, zoning, and existing easements. Use of the FMV method must be substantiated by evidence, such as a real estate appraisal.

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In the *Estate of Samuel B. Walton*, T.C. Memo 1962-63, the taxpayer inherited 150 acres of Kentucky farmland. The property was subdivided, improved, and sold. The court found that in determining basis, considerable weight must be given to the opinions of real estate dealers who are familiar with market values of property in the area involved. The accuracy of a valuation, however, may be tested by what actually happened. At the time of the litigation, one-third of the property was still undeveloped because of soil conditions giving rise to sewage problems. The court considered it reasonable to assign a lesser value per acre to the one-third of the property that was in relatively poor condition.

Improvements

The developer must also allocate the cost of improvements, such as roads and utilities, to the subdivided lots. Improvements to common areas may be allocated to basis. Rev. Rul. 68-478, 1968-2 C.B. 330, generally states that if the developer makes improvements for the basic purposes of inducing people to buy the lots, the cost of such construction is properly a part of the cost basis of the lots, even though the subdivider retains tenuous rights, without practical value, to the constructed improvements. However, if the subdivider retains ownership and control of the improvements and does not part with the property then the cost of the improvements is not properly a part of the cost basis of the lots.

In *Homes by Ayres v. Commissioner*, 795 F.2d 832 (9th Cir. 1986), the taxpayers engaged in the construction and sale of large-scale tract housing developments. The taxpayers accounted for their construction costs by accumulating costs for each phase of a subdivision. These costs included direct costs, such as labor, materials, and permits, and indirect costs, such as overhead, payroll taxes, and vehicle operation costs. The taxpayers would accumulate all direct and indirect costs for the year and then allocate them according to one of three methods to determine the cost of houses sold in each phase.

The relative sales value method determines cost of houses sold by multiplying total capitalized costs (costs already incurred plus estimated costs of completion) by the ratio of the selling prices of the houses sold to the estimated selling prices of all houses in the phase. The average cost method multiplies total capitalized costs by the ratio of the total number of houses sold to the aggregate number of houses to be sold in a phase. The square footage method allocates costs by multiplying total capitalized costs by the ratio of the aggregate square footage of houses sold to the aggregate square footage of all houses to be sold in a phase. The court found that all three of these methods comport with generally accepted accounting principles, and the IRS admitted that they accurately reflect income.

PRACTITIONER NOTE

Future Improvement Costs

If a developer sells subdivided lots before the development work is completed, he or she can (with IRS consent) include in the basis of the properties sold an allocation of the estimated future cost for common improvements. See Rev. Proc. 92-29, 1992-1 C.B. 748.

Uniform Capitalization Rules

The I.R.C. § 263A uniform capitalization (UNICAP) rules require capitalization of the direct costs and a portion of indirect costs to produce certain real property. *Capitalization* means that the cost is added to basis. The UNICAP rules apply to real property built by a developer for sale to its customers. A taxpayer does not have to comply with the UNICAP rules if the average annual gross receipts for the 3-tax-year period ending with the tax year that precedes the current tax year does not exceed $26,000,000 (for 2021).

A large developer who is not exempt from the UNICAP rules must capitalize direct costs and also indirect costs. Direct costs include the cost of materials that are consumed in the process of constructing the building and those that become a part of the real property itself [Treas. Reg. § 1.263A-1(e)(2)(i)(A)]. Direct labor costs include all labor costs related to the construction, including holiday, vacation, and sick pay [Treas. Reg. § 1.263A-1(e)(2)(i)(B)]. Indirect costs are those that directly benefit construction or are incurred because of construction [Treas. Reg. § 1.263A-1(e)(3)(i)]. These costs include insurance, utilities, repairs, and maintenance.

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Real Estate Dealer or Investor

Generally, a real estate investor is taxed on the sale of real estate at preferential capital gains tax rates, whereas a real estate dealer's net sale proceeds are ordinary income. Investors in real estate can benefit from I.R.C. § 1031 exchanges and I.R.C. § 453 installment sale reporting (discussed later), which are benefits that are not available to dealers of real property. However, investors may be subject to the passive activity loss (PAL) limitations if they do not materially participate. They may also have capital loss limitations, whereas for a dealer, a loss could offset ordinary income. This section discusses when a real estate developer will be characterized as a dealer, and when he or she will be characterized as an investor.

Judicial Factors

I.R.C. § 1221 excludes from the definition of a capital asset any property that is held by the taxpayer primarily for sale to customers in the ordinary course of business. Courts have considered the following factors to determine whether property is held primarily for sale in the ordinary course of a trade or business:

1. The purpose for the purchase and duration of the ownership
2. The continuity, extent, volume, and frequency of sales
3. The sales activity of the owner
4. Subdivision or development activities
5. Other sources of income
6. The taxpayer's status as a dealer
7. The taxpayer's purchase of other property at the time of the sale

Purpose for the Purchase

The purpose for holding real property is a question of intent and motive, and each case is decided on its own facts and circumstances. Property purchased as long-term investment indicates investor status and property purchased primarily for sale indicates dealer status. Selling lots because the property is no longer suited for its intended purpose may not necessarily indicate dealer status if there is evidence to show a change in the purpose.

Example 9.11
Purchased to Resell

Floyd Miller buys houses to renovate and resell. He has had 15 sales over 3 years, and most of those sales occur within 4 months of purchases. Floyd buys property for the purpose of reselling it, which indicates dealer status.

Example 9.12
Change in Purpose

Jen and Joel Christianson purchased land that they then subdivided into three duplex lots. They put in a road and utilities. Their original intent was to build multifamily housing and keep it as a rental. Shortly after their purchase, Jen lost her job. Due to financial pressure, they sold the lots. Their original intent was to hold the property as a rental, which indicates investor status.

Continuity, Extent, Volume, and Frequency of Sales

A one-time sale or liquidation indicates investor status, whereas frequent, regular, and substantial sales indicate dealer status.

Sales Activity

If the owner or his or her agent engages in extensive sales activities, has a sales office, and advertises the property, the owner is more likely to be characterized as a dealer. On the contrary, an owner who does not solicit buyers or hire a real estate broker may be an investor. An investor typically holds property until it has appreciated in value.

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Subdivision and Development Activity

An investor typically does not personally engage in any development activity. On the contrary, a dealer usually undertakes substantial development of the property. Rezoning the property for eventual subdivision may indicate dealer intent.

Other Sources of Income

Taxpayers who can demonstrate that the time spent in investment activities is insignificant compared to the time spent in their everyday occupation may be able to achieve investor status. Substantial income exclusive of real estate investment activities could suggest investor status.

Other Property Purchases

A taxpayer who continues to purchase more properties as part of a basic plan of buying and selling real estate may be a dealer.

I.R.C. § 1237

I.R.C. § 1237 allows a taxpayer, other than through a C corporation, to subdivide and sell property and maintain investor status. Qualifying taxpayers can sell real estate from a single tract held for investment without the income being treated as ordinary income merely because of subdividing the tract or of active efforts to sell it. The rule is not applicable to real estate dealers.

Requirements

To qualify under section 1237, the taxpayer must meet the following requirements:

1. The taxpayer did not previously hold the tract, or any lot or parcel of the tract, primarily for sale to customers in the ordinary course of a trade or business (unless the prior holding qualified under section 1237) and, in the same tax year in which the sale occurs, the taxpayer does not hold any other real property primarily for sale to customers in the ordinary course of business.
2. The taxpayer did not make any improvement that substantially enhances the value of the lot or parcel sold, and no such improvement is made pursuant to a contract of sale between the taxpayer and the buyer. An improvement is deemed to be made by the taxpayer if such improvement is made by
   a. the taxpayer or members of his or her family [as defined in I.R.C. § 267(c)(4)], a corporation controlled by the taxpayer, an S corporation in which the taxpayer is a shareholder, or by a partnership in which the taxpayer is a partner;
   b. a lessee, but only if the improvement constitutes income to the taxpayer; or
   c. the federal, state, or local government, or a political subdivision thereof, but only if the improvement constitutes an addition to basis for the taxpayer.
3. The taxpayer holds the lot or parcel, except for real property acquired by inheritance or devise, for at least 5 years.

Tax Consequences

If section 1237 applies, and the taxpayer has sold fewer than six lots or parcels from the same tract as of the end of the tax year, the entire gain will be capital gain. Two or more contiguous lots sold to a single buyer in a single sale are counted as only one parcel. Gain (but not more than 5% of the sale price of each lot) is treated as ordinary income in and after the year in which the sixth lot or parcel is sold.

Example 9.13
Gain Allocation

Jayden Ali met the conditions of section 1237 and subdivided a parcel of land. In 2020, he sold four single-tract lots to four different buyers. A fifth buyer purchased three adjacent lots, which are deemed to be one lot. Because Jayden has sold only five lots or parcels from the tract, any gain he realizes on the sales will be capital gain.

In 2021, Jayden sold the sixth lot for $100,000. He had a $50,000 basis, and the expenses of the sale were $3,000. Jayden's realized gain is $47,000 ($100,000 − $50,000 − $3,000), of which the amount of ordinary income attributable to the sale is $2,000, as calculated in **Figure 9.2**. The remaining $45,000 is treated as capital gain.

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FIGURE 9.2 Jayden Ali's Gain Allocation

Sale price		$100,000
Basis		(50,000)
Excess over basis		$ 50,000
5% of selling price ($100,000 × 5%)	$5,000	
Excess of expenses over 5% of selling price ($3,000 – $5,000)	(0)	(5,000)
Amount of gain realized treated as capital gain		$ 45,000
5% of selling price ($100,000 × 5%)	$5,000	
Expenses of sale	(3,000)	
Amount of gain realized treated as ordinary income		$ 2,000

[Treas. Reg. § 1.1237-1(e)(2)(ii)], Example 2]

PRACTITIONER NOTE

10-Year Rule

Under the 10-year rule, a taxpayer can make certain improvements that are necessary to make the property marketable and still claim the benefits of section 1237. The taxpayer must hold the property for 10 years and make an election to not add the cost of the improvement to the basis of the property, or of any other property, and not deduct the cost as an expense.

Installment Sales

An installment sale may reduce a seller's tax obligation by reporting the sale over more than one tax year. I.R.C. § 453(b) defines an installment sale as a disposition of property in which at least one payment is to be received in a tax year after the year of the disposition. The proceeds can be received in a lump sum payment if it is made in a year after the tax year in which the taxpayer disposes of the property. The taxpayer cannot report a loss on the installment method, and certain gains and recapture income are excluded from installment method reporting.

Dealer Dispositions

An installment sale does not include dealer dispositions. A *dealer disposition* is a disposition of personal property by a person who regularly sells property of the same type. It is also a disposition of real property held by the taxpayer for sale to customers in the ordinary course of the taxpayer's trade or business [I.R.C. § 453(l)(1)]. A dealer disposition does not include the disposition of property used or produced in the business of farming and the disposition of certain timeshares and unimproved residential lots [I.R.C. § 453(l)(2)].

Recognition of Gain

The installment method defers income recognition until payments are received. The taxpayer calculates a gross profit percentage using a ratio of the gross profit to the total contract price, and each payment is partially a return of capital and partially a taxable gain.

PRACTITIONER NOTE

Default Method

Use of the installment sale method is required for eligible sales unless the taxpayer elects out. The election out is made by reporting the full amount of the gain on a timely filed (including extensions) return for the year of the sale.

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Example 9.14
Installment Sale

On July 15, 2021, Zara Singh sold a 20-acre tract of land for $550,000. She had purchased the land on July 1, 2019. Zara had initially planned to subdivide the land and build and sell single family homes. However, with the high cost of building materials and the scarcity of labor, her intent changed. At the time of the sale, she held the land as investment property. Her basis in the land was $396,000.

Zara received a $250,000 down payment, and the buyer signed a promissory note for $300,000. The note requires 5% interest on the unpaid balance. The note requires the buyer to make a $60,000 payment (plus interest) on July 14 of each year for the following 5 years. Zara paid $5,000 to her attorney and her CPA for services related to the sale. Zara has a $149,000 ($550,000 – $396,000 adjusted basis – $5,000 selling expense) gain. She did not elect out of installment reporting.

Zara reports the sale on Form 6252, Installment Sale Income, shown as **Figure 9.3**. Figure 9.3 shows the 2020 Form 6252 because the 2021 form was not available at the time of this publication. Zara has a 0.2709 ($149,000 ÷ $550,000) gross profit percentage, and she reports a $67,725 ($250,000 × 0.2709) installment sale gain. If the payments are received as scheduled, Zara will report a $16,254 ($60,000 × 0.2709) gain each year. She will report interest received on Schedule B (Form 1040), Interest and Ordinary Dividends.

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FIGURE 9.3
Zara Singh's 2021 Form 6252

Form **6252**
Department of the Treasury
Internal Revenue Service

Installment Sale Income

▶ Attach to your tax return.
▶ Use a separate form for each sale or other disposition of property on the installment method.
▶ Go to *www.irs.gov/Form6252* for the latest information.

OMB No. 1545-0228
2020
Attachment Sequence No. **67**

Name(s) shown on return: Zara Singh
Identifying number: XXX-XX-XXXX

1	Description of property ▶ 20 acres located at 130 Haskill Creek Rd., Spokane, WA				
2a	Date acquired (mm/dd/yyyy) ▶ 7/1/2019 **b** Date sold (mm/dd/yyyy) ▶ 7/15/2021				
3	Was the property sold to a related party (see instructions) after May 14, 1980? If "No," skip line 4				☐ Yes ☑ No
4	Was the property you sold to a related party a marketable security? If "Yes," complete Part III. If "No," complete Part III for the year of sale and the 2 years after the year of sale				☐ Yes ☐ No

Part I **Gross Profit and Contract Price.** Complete this part for all years of the installment agreement.

5	Selling price including mortgages and other debts. **Don't** include interest, whether stated or unstated			5	550,000
6	Mortgages, debts, and other liabilities the buyer assumed or took the property subject to (see instructions)	6			
7	Subtract line 6 from line 5	7	550,000		
8	Cost or other basis of property sold	8	396,000		
9	Depreciation allowed or allowable	9			
10	Adjusted basis. Subtract line 9 from line 8	10	396,000		
11	Commissions and other expenses of sale	11	5,000		
12	Income recapture from Form 4797, Part III (see instructions)	12			
13	Add lines 10, 11, and 12			13	401,000
14	Subtract line 13 from line 5. If zero or less, **don't** complete the rest of this form. See instructions			14	149,000
15	If the property described on line 1 above was your main home, enter the amount of your excluded gain. See instructions. Otherwise, enter -0-			15	
16	**Gross profit.** Subtract line 15 from line 14			16	149,000
17	Subtract line 13 from line 6. If zero or less, enter -0-			17	
18	**Contract price.** Add line 7 and line 17			18	550,000

Part II **Installment Sale Income.** Complete this part for all years of the installment agreement.

19	Gross profit percentage (expressed as a decimal amount). Divide line 16 by line 18. (For years after the year of sale, see instructions.)			19	.2709
20	If this is the year of sale, enter the amount from line 17. Otherwise, enter -0-			20	
21	Payments received during year (see instructions). **Don't** include interest, whether stated or unstated			21	250,000
22	Add lines 20 and 21			22	250,000
23	Payments received in prior years (see instructions). **Don't** include interest, whether stated or unstated	23			
24	**Installment sale income.** Multiply line 22 by line 19			24	67,725
25	Enter the part of line 24 that is ordinary income under the recapture rules. See instructions			25	
26	Subtract line 25 from line 24. Enter here and on Schedule D or Form 4797. See instructions			26	67,725

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Related Party Sales

Related persons may use the installment sale method, but the seller must recognize part or all of the gain if a second disposition occurs before the end of the earlier of the following time periods:

1. Before all payments are made for the first sale
2. Within two years after the date of the related party sale

A disposition by the related party purchaser within the applicable period requires the original seller to recognize all or part of the deferred gain in the year the related party makes the second disposition. The original seller is treated as receiving the amount realized on the second disposition, regardless of whether the related person makes a payment to the original seller. The amount treated as received by the person making the first disposition is limited to the lesser of the total amount realized on the second disposition, or the total contract price for the first disposition less payments received.

An involuntary conversion (when the threat occurred after the first disposition) or a disposition after the earlier of the death of the person making the first disposition, or the death of the person acquiring the property in the first disposition, is not treated as a second disposition [I.R.C. § 453(e)(6)]. The acceleration of gain also does not apply if the taxpayer can demonstrate to the IRS that tax avoidance was not the primary reason for either the first or the second disposition [I.R.C. § 453(e)(7)].

Generally, the IRS will accept a non-tax-avoidance explanation if the second disposition was forced (for example, a creditor of the related party purchaser foreclosed on the property or the related party purchaser declared bankruptcy), or if the second disposition was also an installment sale, with terms of payment substantially equal to or longer than those for the first sale. However, the resale terms must not permit significant deferral of recognition of gain from the first sale (for example, if amounts from the resale are being collected sooner than the amounts from the original sale).

PRACTITIONER NOTE

Unstated Interest

The unstated interest rules recharacterize a portion of each annual payment as interest if the installment contract does not require adequate interest [I.R.C. § 7872]. Adequate interest is generally based on the applicable federal rates (AFRs), which the IRS issues monthly. AFRs vary by the length of the contract and the frequency of payments.

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ISSUE 4: NET INVESTMENT INCOME TAX This section reviews when a real estate developer or a taxpayer with real estate rentals must pay the net investment income tax.

If a real estate developer achieves status as an investor (instead of a dealer), he or she may be subject to the I.R.C. § 1411 net investment income tax (NIIT). A taxpayer with real estate rental income or disposition gains may also be subject to the NIIT. The NIIT subjects higher-income taxpayers to a 3.8% tax on unearned income equal to the 2.9% and 0.9% additional Medicare tax they pay on earned income. Generally, the 3.8% NIIT for individuals applies to the lesser of (1) net investment income or (2) modified adjusted gross income (MAGI) over the following threshold amounts:

- $250,000 for MFJ or a surviving spouse [as defined in I.R.C. § 2(a)]
- $125,000 for MFS
- $200,000 for all other taxpayers
- [I.R.C. § 1411(b)]

These threshold amounts are not indexed for inflation.

For purposes of calculating the NIIT, MAGI is adjusted gross income (AGI) from line 11 of Form 1040, U.S. Individual Income Tax Return, increased by the difference between any amount excluded as foreign earned income and the amount of any deductions (taken into account in computing AGI) or exclusions disallowed because they were allocable to excluded foreign income [I.R.C. § 1411(d)].

PLANNING POINTER

Nonresident Aliens

Generally, only US citizens and residents are liable for NIIT. The tax does not apply to nonresident aliens [I.R.C. § 1411(e)(1)]. Citizens and residents married to nonresident aliens typically use married filing separately status to determine NIIT liability.

Net Investment Income

Net investment income is certain income or gain subject to the NIIT, less allowable deductions allocable to that income or gain. Income from interest, dividends, annuities, royalties, and rents is subject to the NIIT unless it is derived in the ordinary course of a trade or business that is not a passive activity. Net investment income also includes

1. net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in an active trade or business, and
2. income from businesses that generate passive income under I.R.C. § 469.

[I.R.C. § 1411(c)(1)-(2)]

Real Estate Rental Income

Net investment income includes gross income from rents other than rent that is derived in the ordinary course of a nonpassive trade or business. The preamble to the final NIIT regulations state that once an individual establishes real estate professional status, that status alone does not demonstrate that all rental real estate activities rise to the level of an active trade or business.

Treatment of Certain Nonpassive Rental Activities

To the extent that gross rental income is treated as not passive under the self-rental rules or because the taxpayer groups the rental activity with an active trade or business activity, the rental income is deemed to be derived in the ordinary course of a nonpassive trade or business. Similarly, if gain or loss resulting on the disposition of property is treated as nonpassive gain or loss because of the self-rental rules or a grouping, then the gain or loss is deemed to be derived from property used in the ordinary course of a nonpassive trade or business.

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Safe Harbor for Real Estate Professionals

Treas. Reg. § 1.1411-4(g)(7)(i) provides a safe harbor for real estate professionals. This safe harbor incorporates two of the seven material participation tests from Temp. Treas. Reg. § 1.469-5T. Real estate professionals can exclude rental income from the NIIT if they

1. participate in a rental real estate activity for more than 500 hours during the tax year, or
2. participate in rental real estate activities for more than 500 hours in any 5 tax years during the 10 tax years immediately preceding the current tax year.

The definition of *participation* is the same as in the material participation test (discussed in Issue 1 of this chapter). Real estate professionals who do not meet either safe harbor requirement may still exclude their rental activities from the NIIT if they can otherwise show that their rental activity is in the ordinary course of a nonpassive trade or business.

Passive Trade or Business Income

Income subject to the NIIT includes income from a trade or business for which the taxpayer's activities are passive under I.R.C. § 469. Special rules apply to working capital. The NIIT regulations borrow from section 469 and its implementing regulations to define passive income subject to the NIIT. As discussed in Issue 1, a passive activity as an activity that involves the conduct of any trade or business in which the taxpayer does not materially participate.

To determine whether gross income is derived in a trade or business, the following rules apply:

1. For an individual, estate, or trust that owns or engages in a trade or business directly (or indirectly through ownership of an interest in a disregarded entity), the determination is made at the individual, estate, or trust level.
2. For an individual, estate, or trust that owns an interest in a passthrough entity (for example, a partnership or S corporation) that engaged in a trade or business, the determination of material participation is made at the owner level (except for certain trading businesses, for which the determination is made at the entity level).

[Treas. Reg. § 1.1411-4(b)]

Calculating the Net Investment Income Tax

Taxpayers calculate and report the NIIT on Form 8960, Net Investment Income Tax–Individuals, Estates, and Trusts. Individual taxpayers report their investment income on lines 1 through 8 of Form 8960, and they report investment expenses allocable to investment income and modifications on lines 9a through 11. Taxpayers report net investment income (total investment income minus total investment expenses and modifications) on line 12 of Form 8960, and calculate the tax in Part III of Form 8960.

Example 9.15
Calculating the NIIT

Daria and Dakota Black Elk are married and file jointly. They own several residential rental properties in which they do not materially participate. In 2021, they had $545,000 MAGI, which included the following income and expenses:

- $480,000 wages
- $85,000 real estate rental income
- $20,000 in expenses allocable to the rental income

Daria and Dakota must use the lesser of the following two amounts to determine their NIIT liability:

- $65,000 ($85,000 real estate rental income – $20,000 expenses allocable to the rental income) net investment income
- $295,000 ($545,000 MAGI – $250,000 applicable threshold) excess of MAGI over applicable threshold

Because $65,000 is less than $295,000, Daria and Dakota use net investment income to determine their NIIT liability. Daria and Dakota report the $65,000 on line 16 of Form 8960. Their NIIT reported on line 17 is $2,470 ($65,000 × 3.8%). Daria and Dakota include the $2,470 on line 8 of Schedule 2 (Form 1040), Additional Taxes. **Figure 9.4** shows their Form 8960, and **Figure 9.5** shows their Schedule 2

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(Form 1040). Figures 9.4 and 9.5 show the 2020 forms because the 2021 forms were not available at the time of this publication.

FIGURE 9.4
Daria and Dakota Black Elk's Form 8960

Form **8960**
Department of the Treasury
Internal Revenue Service (99)

Net Investment Income Tax—Individuals, Estates, and Trusts
▶ Attach to your tax return.
▶ Go to *www.irs.gov/Form8960* for instructions and the latest information.

OMB No. 1545-2227
2020
Attachment Sequence No. 72

Name(s) shown on your tax return: Daria and Dakota Black Elk
Your social security number or EIN: XXX-XX-XXXX

Part I Investment Income
☐ Section 6013(g) election (see instructions)
☐ Section 6013(h) election (see instructions)
☐ Regulations section 1.1411-10(g) election (see instructions)

1	Taxable interest (see instructions)			1	
2	Ordinary dividends (see instructions)			2	
3	Annuities (see instructions)			3	
4a	Rental real estate, royalties, partnerships, S corporations, trusts, etc. (see instructions)	4a	85,000		
b	Adjustment for net income or loss derived in the ordinary course of a non-section 1411 trade or business (see instructions)	4b			
c	Combine lines 4a and 4b			4c	85,000
5a	Net gain or loss from disposition of property (see instructions)	5a			
b	Net gain or loss from disposition of property that is not subject to net investment income tax (see instructions)	5b			
c	Adjustment from disposition of partnership interest or S corporation stock (see instructions)	5c			
d	Combine lines 5a through 5c			5d	
6	Adjustments to investment income for certain CFCs and PFICs (see instructions)			6	
7	Other modifications to investment income (see instructions)			7	
8	Total investment income. Combine lines 1, 2, 3, 4c, 5d, 6, and 7			8	85,000

Part II Investment Expenses Allocable to Investment Income and Modifications

9a	Investment interest expenses (see instructions)	9a	20,000		
b	State, local, and foreign income tax (see instructions)	9b			
c	Miscellaneous investment expenses (see instructions)	9c			
d	Add lines 9a, 9b, and 9c			9d	20,000
10	Additional modifications (see instructions)			10	
11	Total deductions and modifications. Add lines 9d and 10			11	20,000

Part III Tax Computation

12	Net investment income. Subtract Part II, line 11, from Part I, line 8. Individuals, complete lines 13–17. Estates and trusts, complete lines 18a–21. If zero or less, enter -0-			12	65,000
	Individuals:				
13	Modified adjusted gross income (see instructions)	13	545,000		
14	Threshold based on filing status (see instructions)	14	250,000		
15	Subtract line 14 from line 13. If zero or less, enter -0-	15	295,000		
16	Enter the smaller of line 12 or line 15			16	65,000
17	Net investment income tax for individuals. Multiply line 16 by 3.8% (0.038). **Enter here and include on your tax return** (see instructions)			17	2,470
	Estates and Trusts:				
18a	Net investment income (line 12 above)	18a			
b	Deductions for distributions of net investment income and deductions under section 642(c) (see instructions)	18b			
c	Undistributed net investment income. Subtract line 18b from 18a (see instructions). If zero or less, enter -0-	18c			
19a	Adjusted gross income (see instructions)	19a			
b	Highest tax bracket for estates and trusts for the year (see instructions)	19b			
c	Subtract line 19b from line 19a. If zero or less, enter -0-	19c			
20	Enter the smaller of line 18c or line 19c			20	
21	Net investment income tax for estates and trusts. Multiply line 20 by 3.8% (0.038). **Enter here and include on your tax return** (see instructions)			21	

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 59474M Form **8960** (2020)

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FIGURE 9.5
Daria and Dakota Black Elk's Form 1040, Schedule 2

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
2020
Attachment Sequence No. 02

Name(s) shown on Form 1040, 1040-SR, or 1040-NR: Daria and Dakota Black Elk

Your social security number: XXX-XX-XXXX

Part I Tax

1	Alternative minimum tax. Attach Form 6251	1	
2	Excess advance premium tax credit repayment. Attach Form 8962	2	
3	Add lines 1 and 2. Enter here and on Form 1040, 1040-SR, or 1040-NR, line 17	3	

Part II Other Taxes

4	Self-employment tax. Attach Schedule SE	4	
5	Unreported social security and Medicare tax from Form: a ☐ 4137 b ☐ 8919	5	
6	Additional tax on IRAs, other qualified retirement plans, and other tax-favored accounts. Attach Form 5329 if required	6	
7a	Household employment taxes. Attach Schedule H	7a	
b	Repayment of first-time homebuyer credit from Form 5405. Attach Form 5405 if required	7b	
8	Taxes from: a ☐ Form 8959 b ☑ Form 8960 c ☐ Instructions; enter code(s)	8	2,470
9	Section 965 net tax liability installment from Form 965-A	9	
10	Add lines 4 through 8. These are your **total other taxes.** Enter here and on Form 1040 or 1040-SR, line 23, or Form 1040-NR, line 23b	10	2,470

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 71478U Schedule 2 (Form 1040) 2020

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RETIREMENT, INVESTING, AND SAVINGS

10

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LEARNING OBJECTIVES

After completing this session, participants will be able to do the following:

- ✔ Understand who can participate in an I.R.C. § 403(b) plan and how contributions are made to the plan
- ✔ Know how to plan to maximize social security benefits
- ✔ Know how to plan to minimize tax on social security benefits
- ✔ Explain the tax consequences of the conversion of a traditional IRA to a Roth IRA
- ✔ Recognize prohibited transactions for a self-directed IRA
- ✔ Understand and report the deduction for contributions to a health savings account
- ✔ Know the requirements for an individual coverage health reimbursement arrangement
- ✔ Understand how stock options are taxed

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INTRODUCTION

This chapter explains important retirement, investing, and savings tax issues. It reviews participation in section 403(b) plans, the types of contributions to those plans, and the limits on contributions. This chapter also discusses how a taxpayer can convert a traditional IRA to a Roth IRA, and the tax consequences of that conversion. It reviews the prohibited transaction rules that apply to self-directed IRAs, and how those rules apply to a self-directed IRA that owns rental property.

This chapter discusses which taxpayers are eligible for a health savings account, and it provides an example of how the taxpayer calculates and reports the contribution deduction. The IRS and Treasury recently issued final regulations for individual coverage health reimbursement arrangements (ICHRAs). This chapter summarizes those regulations and reviews the general requirements for an employer to offer an ICHRA.

Finally, this chapter discusses types of stock options that an employee or contractor may receive. It provides an overview of how those stock options are taxed, and the tax elections that the recipient may consider making.

ISSUE 1: I.R.C. § 403(B) RETIREMENT PLANS Tax-exempt organizations can adopt a section 403(b) plan.

A tax-exempt I.R.C. § 501(c)(3) organization, a public school, or a church can establish a section 403(b) retirement plan, which is also called a tax-sheltered annuity plan (TSA). Employees save for retirement by contributing to individual accounts. Employers can also contribute to the employees' accounts. The deferred salary is generally not subject to federal or state income tax until it is distributed. However, a 403(b) plan may also offer designated Roth accounts. Salary contributed to a Roth account is taxed currently and is tax-free (including earnings) when it is distributed.

Plan Participation

The following employees are eligible to participate in a 403(b) plan:

- Employees of tax-exempt organizations established under section 501(c)(3)
- Employees of public school systems who are involved in the day-to-day operations of a school
- Employees of cooperative hospital service organizations
- Civilian faculty and staff of the Uniformed Services University of the Health Sciences
- Employees of public school systems organized by Indian tribal governments
- Certain ministers, including self-employed ministers

If an employer allows one employee to defer salary into a 403(b) plan, the employer must allow all employees to make elective deferrals to the plan. However, the employer can exclude the following employees from the plan:

- Employees who will contribute $200 or less annually
- Employees who participate in a section 401(k) or 457(b) plan or in another section 403(b) plan of the employer
- Nonresident aliens
- Employees who normally work less than 20 hours per week
- Students performing services described in I.R.C. § 3121(b)(10) (generally, employees of a school, college, or university who are students that are enrolled and regularly attend classes at the institution)

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Types of Contributions

Contributions to a section 403(b) plan may consist of the following:

1. Elective deferrals (including Roth contributions)
2. Nonelective contributions (employer contributions such as matching contributions, mandatory contributions, and discretionary contributions)
3. After-tax employee contributions
4. Any combination of 1, 2, and 3

Generally, the employee does not report contributions to a 403(b) account (except Roth contributions) on his or her tax return. The employer reports the contributions on Form W-2, Wage and Tax Statement.

PRACTITIONER NOTE

Ministers

Self-employed ministers deduct their contributions on line 15 of Form 1040, Schedule 1. See IRS Publication 571, *Tax-Sheltered Annuity Plans (403(b) Plans)*, for special rules that apply to calculate the maximum contribution for a minister or church employee.

Contribution Limits

Generally, the contributions to an employee's 403(b) account are subject to two limits

1. the limit on annual additions, or
2. the limit on elective deferrals.

If the employee will be age 50 or older by the end of the year, he or she may also be able to make additional catch-up contributions.

Limit on Annual Additions

The limit on annual additions applies to the total contributions (employee elective salary deferrals and all employer contributions) made annually to the section 403(b) account. This limit is generally the lesser of $58,000 (for 2021) or 100% of includable compensation for the employee's most recent year of service.

Includable Compensation

Includable compensation is the taxable wages and benefits (calculated without the foreign earned income and housing exclusions) the employee received from an eligible employer in the employee's most recent full year of service. Includable compensation also includes an elective deferral or other amounts contributed or deferred by an eligible employer at the election of the employee that would be includable in the gross income of the employee but for the rules of the following:

1. I.R.C. § 125 cafeteria plan contributions
2. I.R.C. § 132(f)(4) qualified transportation fringe benefits
3. I.R.C. § 402(e)(2) certain distributions by the United States to nonresident aliens
4. I.R.C. § 402(h)(1)(B) certain simplified employee pension (SEP) contributions
5. I.R.C. § 402(k) contributions to SIMPLE retirement accounts
6. I.R.C. § 457(b) deferred compensation plan contributions

[Treas. Reg. § 1.403(b)-2(b)(11)]

Includable compensation does not include compensation received at any time that the employer was not an eligible employer, employer's contributions to the section 403(b) account, employer contributions to a qualified plan that are on the employee's behalf and excludable from income, and the cost of incidental life insurance. The amount of includable compensation is determined without regard to any community property laws.

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Most Recent Year of Service

A year of service is a full year during which an individual is a full-time employee of an eligible employer, plus fractional credit for each part of a year during which the individual is either a full-time employee of an eligible employer for a part of the year or a part-time employee of an eligible employer [Treas. Reg. § 1.403(b)-2(b)(21)]. A year of service is based on the employer's annual work period, not the employee's tax year. Treas. Reg. § 1.403(b)-4(e) provides the rules for determining years of service.

The *most recent year of service* is the employee's last full year of service, ending on the last day of the employee's tax year that the employee worked for the employer that maintained a 403(b) account on his or her behalf. If the employee's tax year is not the same as the employer's annual work period, the most recent year of service is made up of parts of at least two of the employer's annual work periods.

Example 10.1
Academic Year Annual Work Period

Jackson Hadley is a calendar-year taxpayer. He is a full-time professor at ABC University. The university's annual work period is the academic year (October through May). To calculate Jackson's includable compensation for 2021, his most recent year of service is his service from January through May 2021, and from October through December 2021.

Example 10.2
Calculating Includable Compensation for Most Recent Year of Service

Felicia Diez has been periodically working full-time for a local hospital since September 2018. She must calculate the limit on annual additions for 2021. The hospital's annual work period is January to December, and it has always been eligible to provide a section 403(b) plan to its employees.

Figure 10.1 shows the years of service that Felicia provided to the hospital, her taxable wages, and her elective deferrals. The hospital provided no other plans or benefits to Felicia.

Figure 10.1
Felicia Diez's Service and Compensation

Year	Years of Service	Taxable Wages	Elective Deferrals
2021	6/12 of a year	$42,000	$2,000
2020	4/12 of a year	$16,000	$1,650
2019	4/12 of a year	$16,000	$1,650

Because Felicia did not work the entire 2021 year, her most recent year of service will include the time she worked in 2021 and the time she worked in the preceding years that bring the total time worked for the hospital to 1 year. She calculates her most recent year of service as follows:

- 6/12 of a year in 2021
- 4/12 of a year in 2020
- 2/12 of a year in 2019

Her wages for this year of service are $66,000 [$42,000 + $16,000 + ($16,000 ÷ 2)]. Her elective deferrals for this year of service are $4,475 [$2,000 + $1,650 + ($1,650 ÷ 2)]. Her includable compensation is $70,475 ($66,000 + $4,475). Her limit on annual additions for 2021 is $58,000, which is the lesser of her $70,475 includable compensation and the $58,000 maximum amount.

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Limit on Elective Deferrals

The second component of the maximum annual contribution is the limit on elective deferrals. The agreement between the employer and employee allows for a portion of the employee's compensation to be directly invested in a section 403(b) account for the employee. Generally, the annual limit on these elective deferrals is $19,500 (for 2021). The limit is reduced by elective employee deferrals made to the following:

- Section 401(k) plans (to the extent excluded from income)
- Roth contribution plans
- SIMPLE plans
- Salary reduction simplified employee pension (SARSEP) plans that were set up prior to 1997
- All section 403(b) plans
- Section 501(c)(18) plans (pension trusts created before June 25, 1959, forming part of a plan for the payment of benefits under a pension plan funded only by contributions of employees such as employee unions) to the extent excluded from income

Example 10.3
Calculating the Contribution Limit

The facts are the same as in Example 10.2, and Felicia's 2021 limit on annual additions is $58,000. The limit on elective deferrals is $19,500. Felicia is under age 50, and the maximum amount that she can contribute to her section 403(b) account is $19,500. Her employer can contribute the remaining $38,500 ($58,000–$19,500).

15-Year Rule

If an employee has worked for a qualified organization for 15 years or more, and it is allowed by the terms of the section 403(b) plan, the limit on elective deferrals to the employee's section 403(b) account is increased by the least of the following:

1. $3,000
2. $15,000, reduced by the sum of the additional pretax elective deferrals made in prior years because of this rule and the aggregate amount of designated Roth contributions allowed in prior years because of this rule
3. $5,000 times the number of the employee's years of service for the organization, minus the total elective deferrals made by the employer on behalf of the employee for earlier years

Employees qualifying under this 15-year rule may have elective deferrals for as much as $22,500 for 2021. Amounts in excess of the standard limit are applied first to the 15-year rule, then to the age 50 catch-up.

Calculating Years of Service

The employee must calculate years of service to determine if he or she is eligible for the 15-year rule that increases the limit on elective deferrals. For purposes of the 15-year rule, years of service are calculated through the year for which the calculation is being made. *Years of service* are the total number of years as a full-time employee for the employer maintaining the 403(b) account as of the end of the year.

Example 10.4
Figuring Years of Service

The annual work period for full-time teachers employed by Abbey Public School is September through December, and February through May. Terry Thomas began working for the school on September 1, 2017. She has always worked full-time for each annual work period. At the end of 2021, Terry had 4.5 years of service, as shown in **Figure 10.2**.

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FIGURE 10.2
Terry Thomas's Years of Service

Year	Period Worked	Years of Service
2017	9/1 through 12/31	0.5
2018	2/1 through 5/31 and 9/1 through 12/31	1
2019	2/1 through 5/31 and 9/1 through 12/31	1
2020	2/1 through 5/31 and 9/1 through 12/31	1
2021	2/1 through 5/31 and 9/1 through 12/31	1

Catch-Up Contributions

An employee may be able to make catch-up contributions that exceed the maximum contribution limit. An employee is eligible to make catch-up contributions if

- he or she is age 50 by the end of the year,
- the plan document allows for catch-up contributions, and
- the maximum elective deferrals that can be made to the 403(b) account have been made for the plan year.

The maximum annual catch-up contribution is the lesser of $6,500 (for 2021) or the excess of compensation for the year, over the elective deferrals that are not catch-up contributions. Catch-up contributions are beyond the basic limit on elective deferrals.

Distributions

Generally, a distribution can only be made from a 403(b) account if the employee does any of the following:

1. Reaches age 59½
2. Has a severance from employment
3. Dies
4. Becomes disabled
5. For elective deferrals, encounters financial hardship
6. Has a qualified reservist distribution
7. Has a qualified birth or adoption distribution
8. Has certain distributions of lifetime income investments

In general, distributions from the plan are taxable as ordinary income. Distributions from a Roth contribution plan are generally tax-free.

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ISSUE 2: SOCIAL SECURITY PLANNING This section reviews social security retirement planning.

This section explains how social security benefits are calculated and taxed. It also illustrates common planning techniques that can maximize the amount of social security benefits and reduce taxable income.

Definitions

This section provides definitions for terms that are commonly used to calculate social security benefits, and to engage in social security benefit planning.

Average Indexed Monthly Earnings

When the Social Security Administration (SSA) calculates an insured worker's benefit, its first (indexes) his or her earnings to reflect the change in general wage levels that occurred during the worker's years of employment. Up to 35 years of earnings are needed to compute average indexed monthly earnings. After the SSA determines the number of years, it selects those years with the highest indexed earnings, sums such indexed earnings, and divides the total amount by the total number of months in those years. The SSA then rounds the resulting average amount down to the next lower dollar amount. The result is the average indexed monthly earnings (AIME).

Bend Points

The *bend points* are dollar amounts at which the percentage of AIME used in the calculation of the primary insurance amount changes. The applicable bend points depend on the year in which a worker (1) attains age 62, (2) becomes disabled before age 62, or (3) dies before attaining age 62. For 2021, the bend points are the first $996 of AIME, the amount above $996 and through $6,002, and the amount over $6,002. A table listing bend points for prior years is at www.ssa.gov/OACT/COLA/bendpoints.html.

Full Retirement Age

Under current law, an individual can draw full retirement benefits at full retirement age (FRA). FRA is the following:

- Those born in 1937 and earlier reach FRA at age 65.
- The FRA increases 2 months per year of birth to age 66 for individuals born from 1943 to 1955.
- The FRA further increases 2 months per year of birth to age 67 for those born in 1960 or later.

Indexed Earnings

An individual's earnings are always indexed to the average wage level 2 years prior to the year of first eligibility. If an individual reaches age 62 in 2021, then 2021 is the year of eligibility, and earnings for years before 2019 are adjusted based on the 2019 national average wage index (NAWI).

Primary Insurance Amount

The *primary insurance amount* (PIA) is the benefit (before rounding down to the next lower whole dollar) an individual receives if he or she elects to receive retirement benefits at FRA. At this age, the benefit is not reduced for early retirement or increased for delayed retirement. The PIA is the sum of three separate percentages of portions of AIMEs.

Retirement Age

An individual is eligible to draw retirement benefits at a permanently reduced rate at the age of 62. This is the current retirement age.

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Calculating Social Security Benefits

Social security benefits are equal to an individual's primary insurance amount (PIA) if the individual retires at full retirement age (FRA). To compute PIA, earnings for years before the individual reaches age 60 are indexed for inflation. The 35 years with the highest earnings (including the years after age 59 that are not indexed) are then used to compute the individual's average indexed monthly earnings (AIME).

The PIA is based on the AIME by applying the bend points for that year. The 2021 PIA is calculated as

- 90% of the first $996 of AIME, plus
- 32% of AIME over $996 and through $6,002, plus
- 15% of AIME over $6,002.

The PIA is rounded to the next lower multiple of $0.10 if it is not already a multiple of $0.10. The effect of the PIA brackets is that earnings in a lower bracket increase benefits by a greater amount than earnings in a higher bracket. For the 2021 PIA, if AIME is less than $996, then an additional $1 of AIME increases social security retirement benefits by 90¢ per month. If AIME exceeds $996 but is less than or equal to $6,002, an additional $1 above $996 increases monthly social security benefits by 32¢. When AIME exceeds $6,002, the return on an additional $1 of AIME above $6,002 is only 15¢ per month.

PRACTITIONER NOTE

Contribution Rate Does Not Change

Although benefits as a percentage of earnings decrease as earned income increases, the social security contribution rate does not decrease with higher earnings. The 2021 contribution base for social security taxes is $142,800, and the tax rate (not including Medicare) is 12.4% for all earnings through the base amount. If the worker is an employee, the employee and employer each pay 6.2%. A self-employed person pays the full 12.4%.

Example 10.5
Calculation of Retirement Benefit

Donna Fanning reached age 66 in 2021 and retired on July 1 after earning $45,000. Her AIME is $6,000 based on her top 35 years of indexed annual earnings. Based on this information, Donna's PIA is calculated using the 2017 bend points (the year Donna attained age 62), as shown in **Figure 10.3**.

Donna's initial monthly benefit is $2,320.40. Because the $45,000 she earned in the months prior to attaining FRA was less than the $50,520 limit (discussed later), her social security benefits for 2021 are not reduced. Additional earnings resulting in a higher AIME would have a limited effect on Donna's retirement benefit because her AIME is already above the 15% bend point. If Donna's AIME was $1,000 higher (e.g., $7,000), her PIA (i.e., her social security benefit) would be $150 ($1,000 × 15%) higher.

FIGURE 10.3
Donna Fanning's PIA Calculation

2017 Bend Points	AIME Amount in Bracket	PIA Percentage	PIA
$0 through $885	$ 885	90%	$ 796.50
Over $885 through $5,336	$4,451	32%	$1,242.30
Over $5,336	$ 664	15%	$ 99.60
Total	$5,000	N/A	$2,320.40

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Spousal Benefits

The combined monthly social security benefits for a married couple who have both reached FRA is the greater of the following two amounts:

1. The sum of each individual's own benefits, or
2. 150% of the retirement benefits of the spouse with the higher benefit

Example 10.6
Spousal Retirement Benefits

Bill and Mary Jones both retired in 2021 after reaching FRA. Mary, a former librarian, qualifies for $1,400 of monthly retirement benefits. Bill, a former teacher, qualifies for $600 of monthly benefits. However, Bill's spousal benefit is $700 (50% × $1,400). Thus, Bill and Mary qualify for $2,100 ($1,400 + $700) of benefits per month.

PLANNING POINTER

Spousal Benefit after Death of Taxpayer

At the death of the taxpayer, the surviving spouse who is FRA or older will generally receive social security benefits equal to the greater of the benefit based on his or her earnings history or the deceased spouse's benefit. However, if the deceased worker started receiving reduced retirement benefits before FRA, the retirement insurance benefit limit may apply to the surviving spouse. The retirement insurance benefit limit is generally the higher of

- the reduced monthly retirement benefit to which the deceased spouse would have been entitled if he or she had lived, or
- 82.5% of the unreduced deceased spouse's monthly benefit if he or she had started receiving benefits at FRA.

Early or Late Retirement

Individuals who elect to receive social security retirement benefits prior to attaining their FRA accept a permanent reduction in their monthly benefit. If an individual chooses to begin receiving benefits at age 62, the reduction may be as much as 30%. **Figure 10.4** shows the reduction in benefits at age 62 depending on when the taxpayer reaches FRA. Conversely, if an individual delays drawing benefits until a later year (i.e., a year after the FRA year), benefits increase up to 8% with each year's delay to age 70.

FIGURE 10.4
Reduction in PIA at Age 62

Year of Birth	FRA	Benefit Reduction
1943–1954	66	25.00%
1955	66 and 2 months	25.83%
1956	66 and 4 months	26.67%
1957	66 and 6 months	27.50%
1958	66 and 8 months	28.33%
1959	66 and 10 months	29.17%
1960 and later	67	30.00%

The SSA has several benefits calculators available at www.ssa.gov/benefits/calculators/. The calculators will compute the effect on the benefit amount if the taxpayer files for early or delayed retirement benefits. An online retirement estimator at www.ssa.gov/benefits/retirement/estimator.html estimates benefits based on an individual's actual social security record.

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Taxpayers should consider the following when trying to determine when to start receiving their social security benefits:

- If a person starts receiving benefits before FRA, he or she will receive a reduction in benefits as much as 30%.
- The longer a person waits to start drawing social security (up to age 70), the higher the monthly benefit received.
- Life expectancy for the individual will determine the total amount of benefits actually received. Benefits stop at the death of the taxpayer unless there is a qualifying spouse or dependent. Statistical life expectancy may be a useful planning tool, but the planner may wish to modify that expectancy based on the health and family history of the taxpayer.
- Receiving benefits while working may result in a reduced benefit.

OBSERVATION

Maximum Benefit

Each year the SSA announces a maximum benefit. For 2021, it is $3,113 per month for a worker who retires at his or her FRA. The maximum for a worker who retires at age 62 is $2,324 per month and $3,895 for a worker who retires at age 70.

Example 10.7
Claiming Benefits at Age 62, FRA, or Age 70

Based on his earnings history, Sanford (Sandy) Clemens is eligible for the maximum benefit amount. **Figure 10.5** shows Sandy's life expectancy based on IRS Table 1, Single Life Table at ages 62, 66 (FRA), and 70, and his payments if he achieves that life expectancy and claims benefits at each of those ages.

If Sandy waits until age 70, his overall payments will be $170,357 ($878,712 − $708,355) higher than if he claimed benefits at age 62. However, the increase in total payments between age 62 and 66 is $113,477 ($821,832 − $708,355), and there is only an additional $56,880 ($878,712 − $821,832) if Sandy postpones his benefits from FRA to age 70. Note that if Sandy considers the net present value of the benefits, the difference between payments at age 62 and payments at age 70 will be significantly less.

FIGURE 10.5
Comparison of Benefits at Age 62, FRA, and Age 70

Age	Expected Remaining Life	Maximum Monthly Payment	Total Payments
62	25.40	$2,324	$708,355
66	22.00	$3,113	$821,832
70	18.80	$3,895	$878,712

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Working before FRA

A taxpayer collecting social security retirement benefits before FRA is subject to an annual earnings limitation. If annual earnings exceed the limit, the taxpayer must repay a portion, or all, benefits received during that year. The current annual earnings limitation, or ceiling on earned income to avoid a reduction in benefits, is as follows:

- For individuals under FRA at the end of the year, benefits are reduced $1 for every $2 earned over $18,960 (for 2021).
- For individuals who reach FRA during the year, benefits are reduced $1 for every $3 earned over $50,520 (for 2021) until the month the worker turns FRA.
- For individuals who attained FRA before 2021, there is no annual earnings limitation.

Special Payments after Retirement

Self-employed business owners frequently earn money that is not distributed until after they retire and start collecting social security benefits. Any net income that the taxpayer receives after the first year of retirement is a special payment if the taxpayer performed the services before he or she became entitled to social security benefits. Some special payments to self-employed people include farm agricultural program payments, income from carryover crops, or income of an owner of a business who does not perform significant services in that business.

Wage earners may also receive special payments for amounts earned before retirement but not paid until after retirement. For an employee, special payments may include accumulated sick or vacation pay, severance pay, bonuses, and commissions.

Taxpayers who are collecting social security benefits before FRA and have earned income above the allowable earnings limits can exclude the special payments from total earnings. The taxpayer must notify the SSA of any special payments.

Taxation of Social Security Benefits

If a taxpayer receives social security benefits, a portion of those benefits may be included in gross income. Recipients of social security benefits receive Form SSA-1099, Social Security Benefit Statement, reporting benefits received during the year. **Figure 10.6** shows Form SSA-1099. Figure 10.6 shows the 2020 form because the 2021 form was not available at the time of this publication.

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FIGURE 10.6
Form SSA-1099

FORM SSA-1099 – SOCIAL SECURITY BENEFIT STATEMENT

2020 • PART OF YOUR SOCIAL SECURITY BENEFITS SHOWN IN BOX 5 MAY BE TAXABLE INCOME.
• SEE THE REVERSE FOR MORE INFORMATION.

Box 1. Name		Box 2. Beneficiary's Social Security Number
Box 3. Benefits Paid in 2020	Box 4. Benefits Repaid to SSA in 2020	Box 5. Net Benefits for 2020 *(Box 3 minus Box 4)*

DESCRIPTION OF AMOUNT IN BOX 3	DESCRIPTION OF AMOUNT IN BOX 4
	Box 6. Voluntary Federal Income Tax Withheld
	Box 7. Address
	Box 8. Claim Number *(Use this number if you need to contact SSA.)*

Form **SSA-1099-SM** (1-2021) **DO NOT RETURN THIS FORM TO SSA OR IRS**

SAMPLE

The amount includable in income is determined by calculating the taxpayer's provisional income based on modified adjusted gross income and comparing it to two threshold amounts, the base amount and the adjusted base amount.

If provisional income is below the base amount, none of the taxpayer's social security benefits will be taxable. If it is between the base amount and the adjusted base amount, up to 50% of the benefits will be taxable. If provisional income exceeds the adjusted base amount, up to 85% of the benefits will be taxable. **Figure 10.7** shows how to determine modified adjusted gross income, provisional income, the base amount, and the adjusted base amount.

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FIGURE 10.7
Social Security Tax Calculation Terms

Modified adjusted gross income	■ Taxpayer's adjusted gross income (AGI) without social security ■ Plus tax-exempt interest ■ Plus excluded employer-reimbursed adoption expenses ■ Plus excluded unemployment benefits ■ Plus the deduction for student loan interest ■ Plus the tuition and fees deduction
Provisional income	■ Modified adjusted gross income ■ Plus one-half social security benefits
Base amount	■ $32,000 MFJ ■ $0 MFS and taxpayer lived with spouse any time during the year ■ $25,000 for any other filing status
Adjusted base amount	■ Over $44,000 MFJ ■ $0 MFS and taxpayer lived with spouse any time during the year ■ Over $34,000 for any other filing status

Example 10.8
Provisional Income Exceeds Adjusted Base Amount

Mary and Jeff Houston file a joint tax return. They received $20,000 in social security benefits in 2021. Mary had a $35,000 capital gain from a stock sale. They also had $9,000 interest income ($4,000 from tax-exempt bonds). Their modified adjusted gross income, provisional income, base amount, and adjusted base amount are shown in **Figure 10.8**.

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FIGURE 10.8
Mary and Jeff Houston's Calculation of Taxable Social Security Benefits

Modified adjusted gross income	■ $40,000 AGI without social security ■ Plus $4,000 tax-exempt interest ■ $44,000 modified adjusted gross income
Provisional income	■ $44,000 modified adjusted gross income ■ Plus $10,000 one-half social security benefits ■ $54,000 provisional income
Base amount	■ $32,000 MFJ
Adjusted base amount	■ Over $44,000 MFJ

Their includable benefits are $14,500, which is the lesser of

1. $17,000 ($20,000 × 85%); or
2. $14,500 {[$6,000, which is the lesser of $6,000 or $10,000 ($20,000 × 50%)] + $8,500 [($54,000 −$44,000) × 85%]}.

Figure 10.9 shows Mary and Jeff's taxable social security income worksheet.

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FIGURE 10.9

Mary and Jeff Houston's Worksheet 1 from IRS Publication 915, *Social Security and Equivalent Railroad Retirement Benefits*

Social Security Benefits Worksheet—Lines 6a and 6b *Keep for Your Records*

Before you begin:
- ✓ If you are excluding unemployment compensation from your income, complete the Unemployment Compensation Exclusion Worksheet—Schedule 1, line 8, before completing this worksheet.
- ✓ Figure any write-in adjustments to be entered on the dotted line next to Schedule 1, line 22 (see the instructions for Schedule 1, line 22).
- ✓ If you are married filing separately and you lived apart from your spouse for all of 2020, enter "D" to the right of the word "benefits" on line 6a. If you don't, you may get a math error notice from the IRS.
- ✓ Be sure you have read the ***Exception*** in the line 6a and 6b instructions to see if you can use this worksheet instead of a publication to find out if any of your benefits are taxable.

1.	Enter the total amount from **box 5** of **all** your **Forms SSA-1099** and **RRB-1099.** Also enter this amount on Form 1040 or 1040-SR, line 6a	**1.** 20,000	
2.	Multiply line 1 by 50% (0.50)	**2.**	10,000
3.	• If you are not excluding unemployment compensation from income, combine the amounts from Form 1040 or 1040-SR, lines 1, 2b, 3b, 4b, 5b, 7, and 8. • If you are excluding unemployment compensation from income, combine the amounts from Form 1040 or 1040-SR , lines 1, 2b, 3b, 4b, 5b, 7, Schedule 1, lines 1 through 7, and line 3 of the Unemployment Compensation Exclusion Worksheet	**3.**	40,000
4.	Enter the amount, if any, from Form 1040 or 1040-SR, line 2a	**4.**	4,000
5.	Combine lines 2, 3, and 4	**5.**	54,000
6.	Enter the total of the amounts from Form 1040 or 1040-SR, line 10b, Schedule 1, lines 10 through 19, plus any write-in adjustments you entered on the dotted line next to Schedule 1, line 22	**6.**	0
7.	Is the amount on line 6 less than the amount on line 5? ☐ **No.** STOP None of your social security benefits are taxable. Enter -0- on Form 1040 or 1040-SR, line 6b. ☐ **Yes.** Subtract line 6 from line 5	**7.**	54.000
8.	If you are: • Married filing jointly, enter $32,000 • Single, head of household, qualifying widow(er), or married filing separately and you **lived apart** from your spouse for all of 2020, enter $25,000 • Married filing separately and you lived with your spouse at any time in 2020, skip lines 8 through 15; multiply line 7 by 85% (0.85) and enter the result on line 16. Then, go to line 17	**8.**	32,000
9.	Is the amount on line 8 less than the amount on line 7? ☐ **No.** STOP None of your social security benefits are taxable. Enter -0- on Form 1040 or 1040-SR, line 6b. If you are married filing separately and you **lived apart** from your spouse for all of 2020, be sure you entered "D" to the right of the word "benefits" on line 6a. ☐ **Yes.** Subtract line 8 from line 7	**9.**	22,000
10.	Enter: $12,000 if married filing jointly; $9,000 if single, head of household, qualifying widow(er), or married filing separately and you **lived apart** from your spouse for all of 2020	**10.**	12,000
11.	Subtract line 10 from line 9. If zero or less, enter -0-	**11.**	10,000
12.	Enter the **smaller** of line 9 or line 10	**12.**	12,000
13.	Enter one-half of line 12	**13.**	6,000
14.	Enter the **smaller** of line 2 or line 13	**14.**	6,000
15.	Multiply line 11 by 85% (0.85). If line 11 is zero, enter -0-	**15.**	8,500
16.	Add lines 14 and 15	**16.**	14,500
17.	Multiply line 1 by 85% (0.85)	**17.**	17,000
18.	**Taxable social security benefits.** Enter the **smaller** of line 16 or line 17. Also enter this amount on Form 1040 or 1040-SR, line 6b	**18.**	14,500

TIP *If any of your benefits are taxable for 2020* ***and*** *they include a lump-sum benefit payment that was for an earlier year, you may be able to reduce the taxable amount. See* Lump-Sum Election *in Pub. 915 for details.*

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Social Security Benefits Planning

As discussed earlier, a portion of social security benefits must be included in gross income if provisional income is equal to or exceeds the base amount. Up to 85% of benefits may be taxable if provisional income exceeds the adjusted base amount. Thus, reducing provisional income can reduce the taxable portion of social security benefits. A qualified charitable distribution can reduce provisional income for a taxpayer who is required to take a required minimum distribution (RMD).

For married taxpayers, shifting earnings from one spouse to another could reduce their overall social security tax. Shifting earnings could also increase the amount of the PIA.

CROSS-REFERENCE

Planning for Higher-Income Years

See the "Agricultural and Natural Resource Tax Issues" chapter in this workbook for a discussion of planning strategies to reduce taxes in higher-income years.

Qualified Charitable Distributions

A qualified charitable distribution allows a taxpayer who has attained age 70½ to make a distribution of up to $100,000 directly from an IRA to a qualified charity [I.R.C. § 408(d)(8)]. The distribution is not included in gross income and can reduce the taxable amount of social security benefits that the taxpayer receives. The payment must be made directly by the IRA trustee to the qualified charity. The distribution satisfies the requirement to take an RMD for a taxpayer who is age 72 or over.

Example 10.9
Qualified Charitable Distribution

Jeanne Dubois is age 72. In 2021, she received $20,000 social security benefits and a $20,000 RMD from her IRA. She had no tax-exempt interest. Jeanne gave $10,000 to a qualified charity but did not have sufficient deductions to itemize.

Jeanne's provisional income is $30,000 [$20,000 + ($20,000 × 50%)]. Her provisional income exceeds the $25,000 base amount for a single taxpayer (but not the $34,000 adjusted base amount), and up to 50% of her social security could be taxable. The includable amount is limited to 50% of the excess of her provisional income over the base amount. Therefore, $2,500 [($30,000 − $25,000) × 50%)] of her social security would be included in her gross income. Her total AGI, including her IRA distribution, would be $22,500 ($2,500 + $20,000).

If instead Jeanne made a $10,000 QCD to the qualified charity, she would have a $10,000 RMD. Her provisional income is $20,000 [$10,000 + ($20,000 × 50%)], which is below the base amount. None of her social security benefits would be included in her gross income. Her total AGI would be $10,000. **Figure 10.10** compares Jeanne's taxable social security benefits without a QCD and with a QCD.

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FIGURE 10.10
Jeanne Dubois's Taxable Social Security Benefits Comparison

	Without a QCD	With a QCD
Modified adjusted gross income	$20,000	$10,000
One-half of social security benefits	10,000	10,000
Provisional income	$30,000	$20,000
Base amount	$25,000	$25,000
Excess over base amount	$5,000	$0
Includable social security	$2,500	$0

PLANNING POINTER

Installment Sales

Taxpayers with an installment sale of assets should consider electing out of installment sale reporting to avoid the taxation of social security benefits in multiple years. The tax practitioner must determine whether a higher tax rate in the year of sale (with electing out of installment reporting) would be offset by lower AGI in subsequent years and less includable social security benefits.

Planning for Spouses

Spouses may be able to change how they report business earnings to lower SE tax and maximize future social security benefits by doing the following:

1. A self-employed spouse can pay wages to a non-owner spouse if the non-owner spouse earned the wages.
2. A spouse can report his or her share of a self-employed spouse's business income as SE income if he or she is legitimately a partner in the business.
3. A self-employed spouse may be able to pay rent to a non-self-employed spouse for real estate and equipment owned by the non-self-employed spouse.

Lowering SE Tax

Shifting earnings between spouses will have no impact on SE tax if both spouses are below or if both spouses are above the social security tax wage base ($142,200 for 2021) before and after they shift their earnings. The shift does not affect their total social security tax liability. However, if one spouse is above and the other spouse is below the wage base, shifting earnings may increase or decrease their total social security tax liability.

Example 10.10
Both Spouses below the Wage Base

Pete Pond is self-employed. In 2021, his wife Tina earned $40,000 as an employee. Pete's net SE income was $30,000. If they form a partnership to recognize Tina's contribution to the business and agree to split profits equally, the reduction in Pete's SE tax is equal to the increase in Tina's SE tax because both incomes are below the social security wage base.

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Example 10.11
One Spouse above and One Spouse below the Wage Base

The facts are the same as in Example 10.10 except that Tina earned $144,500 ($2,300 above the $142,200 social security wage base). The shift of $15,000 from Pete to Tina by forming a partnership reduces their total social security tax by $1,718 ($15,000 × .9235 × 12.4%) because the $15,000 reduction in Pete's SE income that is subject to the 12.4% social security tax does not increase Tina's social security tax because her salary is above the wage base.

Maximizing Social Security Benefits

Whether shifting income between spouses will increase social security benefits depends on the AIME of each spouse relative to the bend points in the PIA calculation. If both spouses' AIME is between the same bend points, shifting AIME from one spouse to the other does not change their total social security benefits. If each spouse's AIME is between different bend points, shifting AIME from one spouse to the other changes their total PIA.

Example 10.12
Same Bend Points

Bob and Carol Howard are married taxpayers. Bob's AIME is $4,000, and Carol's AIME is $1,000, which are both in the 32% range for computing the PIA. The current year is one of the highest 35 years of earnings for both Bob and Carol. If Bob shifts $15,000 of his business profits to Carol, his AIME decreases by $35.71 ($15,000 ÷ 420 months) and Carol's AIME increases by the same amount. Because they are between the same bend points, the profit shift decreases Bob's PIA by $11.40 ($35.71 × 32%) and increases Carol's PIA by the same amount.

Example 10.13
Different Bend Points

The facts are the same as in Example 10.12 except that Bob's AIME is $7,000 and Carol's AIME is $600. The current year is one of the highest 35 years of earnings for both Bob and Carol. The $15,000 profit shift still decreases Bob's AIME by $35.71 and increases Carol's AIME by the same amount. However, the shift of the AIME decreases Bob's PIA by $5.30 ($35.71 × 15%) and increases Carol's PIA by $32.10 ($35.71 × 90%).

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ISSUE 3: IRA CONVERSIONS This section discusses conversions from a traditional IRA to a Roth IRA.

Although there are no current tax deductions for contributions to a Roth IRA, a Roth IRA offers two major advantages: distributions that are a return of the regular contributions and qualified distributions are tax free (discussed next) and there are no required minimum distributions during the owner's lifetime.

In 2021, individuals with modified adjusted gross income (MAGI) equal to or above $140,000 ($208,000 MFJ and $10,000 MFS who lived with a spouse at any time during the tax year) cannot contribute to a Roth IRA. There is no income limit on the conversion of a traditional IRA to a Roth IRA. Thus, a taxpayer who earns too much to contribute directly to a Roth IRA can contribute to a nondeductible traditional IRA and then convert the traditional IRA to a Roth IRA to bypass the income limit.

PRACTITIONER NOTE

MAGI

MAGI for Roth IRA purposes is AGI with some adjustments. The taxpayer first subtracts income from converting a traditional IRA to a Roth IRA and income from any rollovers from qualified employer plans to a Roth IRA. The taxpayer then adds back the traditional IRA deduction, student loan interest deduction, tuition and fees deduction, foreign earned income exclusion, foreign housing exclusion or deduction, excludable qualified savings bond interest, and excluded employer-provided adoption benefits.

Roth IRA Distributions

A qualified distribution from a Roth IRA is not included in gross income. In general, the term *qualified distribution* means any payment or distribution

1. made on or after the date on which the individual attains age 59½,
2. made to a beneficiary (or to the estate of the individual) on or after the death of the individual,
3. attributable to the individual's being disabled, or
4. that is a qualified special purpose distribution.

[I.R.C. § 408A(d)(2)(A)]

A payment or distribution from a Roth IRA is not a qualified distribution if the payment or distribution is made within the 5-tax year period beginning with the first tax year for which the individual made a contribution to a Roth IRA (or such individual's spouse made a contribution to a Roth IRA) established for such individual [I.R.C. § 408A(d)(2)(B)].

Traditional IRA Contribution Limits

A taxpayer's 2021 traditional IRA contribution is generally limited to the lesser of $6,000 ($7,000 if age 50 or older) or the taxpayer's compensation. If the taxpayer has more than one IRA, the limit applies to the total contributions made to all the traditional IRAs for the year.

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General Conversion Rules

For many taxpayers, converting an established traditional IRA to a Roth IRA offers the opportunity to pay the tax now and take distributions later without having to pay tax on the future earnings. The taxpayer can withdraw assets from a traditional IRA and reinvest those same assets (within 60 days) in a Roth IRA. The amount that is withdrawn and timely contributed (converted) to the Roth IRA is called a conversion contribution. A conversion can also be done as a trustee-to-trustee transfer or a same trustee transfer.

The 10% additional tax on early distributions does not apply [I.R.C. § 408A(d)(3)(A)(ii)] unless the contributed amount is subsequently withdrawn from the Roth IRA within 5 years of a conversion. However, if the traditional IRA was a deductible IRA, a part or all of the distribution from the traditional IRA may be included in gross income and subjected to ordinary income tax. Also, a taxpayer cannot convert any amount that must be distributed from the traditional IRA as a required minimum distribution, which must be included in the taxpayer's income.

Example 10.14
Conversion from a Traditional Deductible IRA

Abigail Anderson has a traditional IRA that currently has a $24,000 value. She has a zero basis in the account because her contributions were tax deductible. To avoid tax on future appreciation in the IRA, she converts the entire account to a newly created Roth IRA. Abigail must pay income tax on the conversion. She will report the $24,000 in Part II of Form 8606, Nondeductible IRAs, as shown in **Figure 10.11**, and on her Form 1040, U.S. Individual Income Tax Return, line 4a (IRA distributions) and line 4b (Taxable amount). Figure 10.11 shows the 2020 Form because the 2021 form was not available at the time of publication.

FIGURE 10.11
Form 8606, Part II, for Abigail Anderson

Form 8606 (2020) Page **2**

Part II **2020 Conversions From Traditional, SEP, or SIMPLE IRAs to Roth IRAs**

Complete this part if you converted part or all of your traditional, SEP, and SIMPLE IRAs to a Roth IRA in 2020.

16	If you completed Part I, enter the amount from line 8. Otherwise, enter the net amount you converted from traditional, SEP, and SIMPLE IRAs to Roth IRAs in 2020	**16**	24,000
17	If you completed Part I, enter the amount from line 11. Otherwise, enter your basis in the amount on line 16 (see instructions)	**17**	0
18	**Taxable amount.** Subtract line 17 from line 16. If more than zero, also include this amount on 2020 Form 1040, 1040-SR, or 1040-NR, line 4b	**18**	24,000

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Creating a Backdoor Roth IRA

To create a backdoor Roth IRA, the taxpayer first contributes to a traditional nondeductible IRA. The taxpayer then converts the traditional IRA to a Roth IRA. Only the earnings on the account are taxable because the taxpayer has basis in the contributions.

PRACTITIONER NOTE

Backdoor Strategy

The IRS could assert that the step transaction doctrine applies to the backdoor Roth strategy. However, the conference report (footnotes 268, 269, 276, and 277) for the Tax Cuts and Jobs Act of 2017 (TCJA), Pub. L. No. 115-97, states, "Although an individual with AGI exceeding certain limits is not permitted to make a contribution directly to a Roth IRA, the individual can make a contribution to a traditional IRA and convert the traditional IRA to a Roth IRA."

Example 10.15 Backdoor Roth IRA

Jason Johnson, age 50 and single, earns $165,000 per year. He cannot contribute to a Roth IRA because his MAGI exceeds the I.R.C. § 408A(c)(3)(A) phaseout range for a single taxpayer ($140,000 for 2021). Jason wants to take advantage of tax-free income when he retires. He has no other type of retirement savings.

In 2021, Jason made the $7,000 ($6,000 + $1,000 for age 50 and older) maximum contribution to a nondeductible IRA. He will report the contribution on Form 8606, Nondeductible IRAs, Part I. Jason then converted his nondeductible IRA to a Roth IRA by taking a distribution from the traditional IRA and reinvesting it in a Roth IRA within 60 days.

At the time of the conversion, the nondeductible IRA had $100 of earnings. Jason reports this amount in Part II of Form 8606 and includes it on line 4b of Form 1040. Jason can contribute to the nondeductible traditional IRA annually. He can make a conversion to a Roth IRA annually or less frequently.

Basis Allocation with Multiple IRAs

The exclusion ratio used to determine the amount of any distribution from the traditional IRA, including the backdoor Roth IRA contribution, must be based on all of the taxpayer's traditional IRAs. Thus, if the taxpayer has a traditional IRA with deductible contributions, the basis in the newly established IRA will be allocated among the new and any existing IRA, increasing the amount of tax that the taxpayer must pay when the taxpayer converts the account.

Example 10.16 Multiple IRAs

Felipe Garcia is age 45. He is single. Felipe participates in his employer's SEP plan where he works. All the SEP contributions were excluded from Felipe's income. At the beginning of 2021, his SEP plan was valued at $205,000. Felipe's marginal tax rate was 24%, and his MAGI was too high to contribute to a Roth IRA.

In 2021, Felipe established a nondeductible IRA with a $6,000 contribution. He converted the account to a Roth IRA when there was $100 in earnings. The tax-free portion of the conversion amount is 2.8% [$6,100 ÷ ($205,000 + $6,100)], or $171 ($6,100 × 2.8%). The tax on the $6,100 conversion is $1,423 [($6,100 – $171 apportioned basis) × 24%)]. This contrasts with the $24 ($100 × 24%) of tax that would have been due if all of the $6,000 basis was allocated to the new account. Felipe's completed Form 8606 is shown in **Figure 10.12**. The 2020 form is shown because the 2021 form was not available at the time of publication.

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FIGURE 10.12
Form 8606 for Felipe Garcia

Form **8606**
Department of the Treasury
Internal Revenue Service (99)

Nondeductible IRAs

▶ Go to *www.irs.gov/Form8606* for instructions and the latest information.
▶ For coronavirus-related distributions, see the instructions.
▶ Attach to 2020 Form 1040, 1040-SR, or 1040-NR.

OMB No. 1545-0074
2020
Attachment Sequence No. 48

Name. If married, file a separate form for each spouse required to file 2020 Form 8606. See instructions. — Felipe Garcia
Your social security number — XXX-XX-XXXX

Fill in Your Address Only if You Are Filing This Form by Itself and Not With Your Tax Return

Home address (number and street, or P.O. box if mail is not delivered to your home): 1234 Abbey Road
Apt. no.:
City, town or post office, state, and ZIP code. If you have a foreign address, also complete the spaces below (see instructions): Fargo, ND 58102
Foreign country name:
Foreign province/state/county:
Foreign postal code:

Part I **Nondeductible Contributions to Traditional IRAs and Distributions From Traditional, SEP, and SIMPLE IRAs**
Complete this part only if one or more of the following apply.

- You made nondeductible contributions to a traditional IRA for 2020.
- You took distributions from a traditional, SEP, or SIMPLE IRA in 2020 **and** you made nondeductible contributions to a traditional IRA in 2020 or an earlier year. For this purpose, a distribution does not include a rollover (other than a repayment of a qualified disaster distribution (see 2020 Forms 8915-C, 8915-D, and 8915-E)), qualified charitable distribution, one-time distribution to fund an HSA, conversion, recharacterization, or return of certain contributions.
- You converted part, but not all, of your traditional, SEP, and SIMPLE IRAs to Roth IRAs in 2020 **and** you made nondeductible contributions to a traditional IRA in 2020 or an earlier year.

1	Enter your nondeductible contributions to traditional IRAs for 2020, including those made for 2020 from January 1, 2021, through April 15, 2021. See instructions			1	6,000
2	Enter your total basis in traditional IRAs. See instructions			2	0
3	Add lines 1 and 2			3	6,000
	In 2020, did you take a distribution from traditional, SEP, or SIMPLE IRAs, or make a Roth IRA conversion? — **No** ▶ Enter the amount from line 3 on line 14. Do not complete the rest of Part I. — **Yes** ▶ Go to line 4.				
4	Enter those contributions included on line 1 that were made from January 1, 2021, through April 15, 2021			4	0
5	Subtract line 4 from line 3			5	6,000
6	Enter the value of **all** your traditional, SEP, and SIMPLE IRAs as of December 31, 2020, plus any outstanding rollovers. Subtract any repayments of qualified disaster distributions (see 2020 Forms 8915-C, 8915-D, and 8915-E)	6	205,000		
7	Enter your distributions from traditional, SEP, and SIMPLE IRAs in 2020. **Do not** include rollovers (other than repayments of qualified disaster distributions (see 2020 Forms 8915-C, 8915-D, and 8915-E)), qualified charitable distributions, a one-time distribution to fund an HSA, conversions to a Roth IRA, certain returned contributions, or recharacterizations of traditional IRA contributions (see instructions)	7	0		
8	Enter the net amount you converted from traditional, SEP, and SIMPLE IRAs to Roth IRAs in 2020. Also enter this amount on line 16	8	6,100		
9	Add lines 6, 7, and 8	9	211,100		
10	Divide line 5 by line 9. Enter the result as a decimal rounded to at least 3 places. If the result is 1.000 or more, enter "1.000"	10	× .028		
11	Multiply line 8 by line 10. This is the nontaxable portion of the amount you converted to Roth IRAs. Also enter this amount on line 17	11	171		
12	Multiply line 7 by line 10. This is the nontaxable portion of your distributions that you did not convert to a Roth IRA	12	0		
13	Add lines 11 and 12. This is the nontaxable portion of all your distributions			13	171
14	Subtract line 13 from line 3. This is **your total basis in traditional IRAs for 2020 and earlier years**			14	5,829
15a	Subtract line 12 from line 7			15a	0
b	Enter the amount on line 15a attributable to qualified disaster distributions from 2020 Forms 8915-C, 8915-D, and 8915-E (see instructions). Also, enter this amount on 2020 Form 8915-C, line 23; 2020 Form 8915-D, line 22; **or** 2020 Form 8915-E, line 13, as applicable			15b	0
c	**Taxable amount.** Subtract line 15b from line 15a. If more than zero, also include this amount on 2020 Form 1040, 1040-SR, **or** 1040-NR, line 4b			15c	0
	Note: You may be subject to an additional 10% tax on the amount on line 15c if you were under age 59½ at the time of the distribution. See instructions.				

For Privacy Act and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 63966F Form **8606** (2020)

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FIGURE 10.12 (continued)
Form 8606 for Felipe Garcia

Part II 2020 Conversions From Traditional, SEP, or SIMPLE IRAs to Roth IRAs

Complete this part if you converted part or all of your traditional, SEP, and SIMPLE IRAs to a Roth IRA in 2020.

16	If you completed Part I, enter the amount from line 8. Otherwise, enter the net amount you converted from traditional, SEP, and SIMPLE IRAs to Roth IRAs in 2020	16	6,100
17	If you completed Part I, enter the amount from line 11. Otherwise, enter your basis in the amount on line 16 (see instructions)	17	171
18	**Taxable amount.** Subtract line 17 from line 16. If more than zero, also include this amount on 2020 Form 1040, 1040-SR, or 1040-NR, line 4b	18	5,929

OBSERVATION

IRA Basis and Value

Because basis is divided among all of the taxpayer's IRAs, it is very important for the tax practitioner to obtain information about all of the taxpayer's IRAs.

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ISSUE 4: SELF-DIRECTED IRAS

Taxpayers can use a self-directed IRA to invest in real estate, virtual currency, and other assets.

IRAs typically provide investment options that include stocks, bonds, CDs, and mutual funds. A self-directed IRA allows broader investment choices that may include real estate, virtual currency, promissory notes, and closely held businesses. However, holding these types of investments creates the risk that the IRA will violate the prohibited transaction rules. Such a violation could result in a loss of the IRA's tax-deferred status and recognition of tax on a deemed distribution of the IRA assets, imposition of a 10% early withdrawal penalty, and excise taxes on the prohibited transaction.

This section discusses allowable IRA investments and prohibited investments. It explains what constitutes a prohibited transaction and how a self-directed IRA is used to invest in real estate. If the IRA engages in unrelated business activities, or borrows money to finance a real estate purchase, the IRA may have unrelated business taxable income (UBTI) or unrelated debt-financed income (UDFI). This section reviews how UDFI is taxed. Finally, this section explains some of the risks in investing in self-directed IRAs, and how to avoid those risks.

Self-Directed IRA Investments

Self-directed IRAs have the same tax advantages and similar contribution and distribution requirements as other IRAs, but the account holder is responsible for the investment choices. The law does not prohibit IRAs from investing in real estate and other assets (except as discussed next). However, IRA custodians are not required to offer these investments, and for administrative convenience, most IRA custodians allow investments only in stocks, bonds, mutual funds, and CDs. A self-directed IRA can invest in a closely held business, real estate, virtual currency, and any other types of investments that are not prohibited by law.

Prohibited Investments

IRAs are subject to investment restrictions described in I.R.C. § 408 and cannot be invested in collectibles or life insurance contracts. If the IRA invests in prohibited assets, the amount invested is considered distributed in the year invested, and the taxpayer may have to pay a 10% early withdrawal penalty. Collectibles under I.R.C. § 408(m) include all of the following:

1. Works of art
2. Rugs or antiques
3. Metals or gems (although certain bullion is exempt)
4. Stamps or coins (although certain coins are exempt)
5. Alcoholic beverages
6. Certain other tangible property

Investments That Are Not Collectibles

For purposes of allowable IRA investments, the term *collectible* does not include the following:

- Certain gold, silver, and platinum coins, and coins issues under state law
- Certain gold, silver, platinum, or palladium bullion that is in the physical possession of a bank or an IRS-approved nonbank trustee

Prohibited Transactions

Prohibited transactions are certain transactions between a retirement plan and a disqualified person (defined next). A disqualified person who takes part in a prohibited transaction must pay an excise tax. A prohibited transaction between the IRA and the IRA owner will also result in loss of the IRA's tax-deferred status, and a deemed distribution of the IRA assets.

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I.R.C. § 4975(c)(1) defines prohibited transactions as any direct or indirect

1. sale or exchange, or leasing, of any property between a plan and a disqualified person;
2. lending of money or other extension of credit between a plan and a disqualified person;
3. furnishing of goods, services, or facilities between a plan and a disqualified person;
4. transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a plan;
5. act by a disqualified person who is a fiduciary by which he or she deals with the plan's income or assets in his or her own interests; or
6. receipt of any consideration for the personal account of a disqualified person who is a fiduciary from any party dealing with the plan in connection with a transaction involving the income or assets of the plan.

Disqualified Persons

A *disqualified person* is defined in I.R.C. § 4975(e)(2) as the following:

1. Fiduciaries, which are defined as anyone with discretionary authority or control in managing the IRA or its assets, anyone who renders investment advice for a fee or other compensation, or anyone who has any discretionary authority or responsibility in administering the plan
2. A person providing services to the plan
3. An employer who has employees covered under the plan
4. An employee organization whose members are covered under the plan
5. An owner, directly or indirectly, of more than 50% of an entity that is an employer or employee organization described in 3 or 4
6. Family members, which include the spouse of the owner, ancestors, lineal descendants, and any spouse of a lineal descendant (siblings, aunts, uncles, and cousins are not considered family members for this rule) of any individual described in 1, 2, 3, or 5
7. A corporation, partnership, trust, or estate that is more than 50% owned, directly or indirectly, by persons described in 1, 2, 3, 4, or 5
8. An officer, director (or an individual having powers or responsibilities similar to those of officers or directors), a 10% or more shareholder, or a highly compensated employee (earning 10% or more of the yearly wages of an employer) of a person described in subparagraph 3, 4, 5, or 7
9. A 10% or more (in capital or profits) partner or joint venturer of a person described in 3, 4, 5, or 7

Example 10.17
Disqualified Persons

Ray Robbins, age 55, formed a self-directed IRA to invest in real estate. He already owns three rental properties. Ray can contribute the maximum contribution amount ($7,000 for 2021 because he is age 50 or older). Ray, as owner of the self-directed IRA, has discretion to make investment decisions. Thus, he is a disqualified person. Ray cannot sell one of his rental properties to the IRA or engage in any other prohibited transaction with the IRA.

Prohibited Transaction Examples

Examples of possible prohibited transactions between the plan and a disqualified person include the following:

- Borrowing money from the IRA
- Selling property to the IRA
- Using the IRA as security for a loan
- Buying property for personal use (present or future) with IRA funds

Guaranteeing debts of the IRA is also a prohibited transaction. In *Thiessen v. Commissioner*, 146 T.C. 7 (2016), the Tax Court held that the taxpayers engaged in a prohibited transaction when they used a corporation owned by their self-directed IRAs to acquire the assets of a metal design and fabrication business. The corporation signed a promissory note for a portion of the purchase price, and the taxpayers personally guaranteed the note.

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The IRS argued that when the taxpayers guaranteed the note, it was a prohibited transaction that caused a deemed distribution of all of the IRA assets. The Tax Court agreed that the guarantees were indirect extensions of credit from the taxpayers to their IRAs, and that the prohibited transactions caused the IRAs to lose their status as IRAs.

Not Prohibited Transactions

I.R.C. § 4975(d) provides exemptions from the prohibited transaction rules. A loan made by the plan to a disqualified person who is a participant or beneficiary of the plan is not a prohibited transaction if the loan

1. is available to all such participants or beneficiaries on a reasonably equivalent basis,
2. is not made available to highly compensated employees in an amount greater than the amount made available to other employees,
3. is made in accordance with specific provisions regarding such loans set forth in the plan,
4. bears a reasonable rate of interest, and
5. is adequately secured.

Additional exemptions include a contract with a disqualified person for office space or certain services necessary to establish or operate the plan if the compensation is reasonable, and receipt of a plan benefit by a disqualified person who is a plan participant or beneficiary if it is on the same terms as all other participants or beneficiaries.

PRACTITIONER NOTE

Prohibited Transaction Exemptions

The Department of Labor issues prohibited transaction exemptions (PTEs). For example, PTE 80-26, as amended by PTE 2002-13, provides an exception to the prohibition on loans if the IRA does not have sufficient funds to pay its operating expenses. The IRA owner can provide an interest-free, unsecured loan even though he or she would not be allowed to directly pay the expenses for the IRA. If the loan term is 60 days or longer, there must be a written agreement that contains all the material terms of the loan.

Real Property in a Self-Directed IRA

A self-directed IRA can purchase real property, but to avoid violation of the prohibition transaction rules, the IRA must comply with the following:

1. The IRA cannot purchase property owned by the owner or a disqualified person.
2. The IRA must title the real estate in the name of the IRA (e.g., Trust Company Custodian for the benefit of Karla Jones IRA).
3. The IRA must purchase the property using IRA funds (discussed next).
4. If the IRA obtains a loan to purchase the property, the loan must be nonrecourse financing, and the IRA owner or a disqualified person cannot be held liable either as a borrower or a guarantor.

Financing Real Property

Funds to purchase real estate must come from the IRA. If the IRA does not have enough cash to purchase property, it can borrow the funds. The loan must be a nonrecourse loan because the IRA owner cannot be personally liable for the repayment. A disqualified person cannot secure the loan. In the event of a default, the property securing the loan must be the only source of repayment, and it must be property of the IRA.

Example 10.18
Financing a Real Estate Purchase

Ray Robbins from Example 10.17 caused his self-directed IRA to enter into a contract to purchase a rental home for $125,000. Ray's IRA has only $100,000 in available funds to buy the property. Ray must find a lender willing to provide the IRA with a nonrecourse loan. The IRA will have to pay any minimum down payment imposed by the lender or the IRA custodian. Ray and his wife cannot personally guarantee the loan because they are disqualified persons.

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Managing Rental Property

Typically, a self-directed IRA investing in real estate invests in income-generating rental property. The IRA can form an LLC to buy and manage rental properties. The IRA invests in the LLC, and the IRA is a 100% owner of the LLC, which then purchases the property. The LLC collects the rent and pays the expenses. The IRA account holder is typically the manager of the LLC.

Taxation of Rental Income

Income accrues in an IRA tax-free, so an IRA typically does not have to file a tax return. However, a self-directed IRA may have I.R.C. § 512 unrelated business taxable income (UBTI). Under section 512, a tax-exempt entity must pay tax on income that is unrelated to the entity's exempt purpose. If the IRA has gross income of more than $1,000 from activities that are an unrelated trade or business, it must file Form 990-T, Exempt Organization Business Income Tax Return, and pay tax on this income.

Real property rental income is typically exempt from UBTI, but under I.R.C. § 514, income earned by an exempt organization from property used for a nonexempt purpose that has been acquired by incurring debt is unrelated debt-financed income (UDFI). A portion of the rental income from property that is debt-financed is UDFI, and a portion of the income from the sale of debt-financed property is UDFI. If the IRA has gross UDFI income of more than $1,000, it must file Form 990-T and pay tax on the UDFI (the portion of the profit attributable to the debt financing). The tax is calculated using the estates and trusts tax rates.

Example 10.19
Unrelated Debt-Financed Income

Rebecca Rogers has a $100,000 IRA balance. She directed her IRA to purchase a rental home for $125,000. The IRA made a $90,000 down payment and financed the remaining $35,000 ($125,000 − $90,000). The loan was interest only for the first year. The IRA collected $11,400 in gross rents in 2021 and had $3,000 of expenses that were directly connected to the debt-financed property. The average adjusted basis of the property for the year was $120,000. The UDFI was $2,850 [$11,400 × ($30,000 ÷ $120,000)], and the total allocable deductions were $750 [$3,000 × ($30,000 ÷ $120,000)]. The $1,000 specific deduction is allowed, and the IRA has a $110 [($2,850 − $750 − $1,000) × 10% estates and trusts tax rate] tax liability. **Figure 10.13** shows the IRA's completed Form 990-T. Figure 10.13 shows the 2020 Form 990-T because the 2021 form was not available at the time of publication.

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FIGURE 10.13
Form 990-T for the Rebecca Rogers IRA

Form **990-T**

Department of the Treasury
Internal Revenue Service

Exempt Organization Business Income Tax Return
(and proxy tax under section 6033(e))

For calendar year 2020 or other tax year beginning _____, 2020, and ending _____, 20 ____

▶ Go to *www.irs.gov/Form990T* for instructions and the latest information.
▶ Do not enter SSN numbers on this form as it may be made public if your organization is a 501(c)(3).

OMB No. 1545-0047

2020

Open to Public Inspection for 501(c)(3) Organizations Only

A ☐ Check box if address changed.

B Exempt under section
☐ 501( )( )
☑ 408(e) ☐ 220(e)
☐ 408A ☐ 530(a)
☐ 529(a) ☐ 529A

Print or Type

Name of organization (☐ Check box if name changed and see instructions.)
Rebecca Rogers IRA

Number, street, and room or suite no. If a P.O. box, see instructions.
1234 Main Street

City or town, state or province, country, and ZIP or foreign postal code
Starkville, MS 39759

C Book value of all assets at end of year ▶

D Employer identification number
XX-XXXXXX

E Group exemption number (see instructions)

F ☐ Check box if an amended return.

G Check organization type ▶ ☐ 501(c) corporation ☐ 501(c) trust ☐ 401(a) trust ☑ Other trust ☐ Applicable reinsurance entity

H Check if filing only to ▶ ☐ Claim credit from Form 8941 ☐ Claim a refund shown on Form 2439

I Check if a 501(c)(3) organization filing a consolidated return with a 501(c)(2) titleholding corporation ▶ ☐

J Enter the number of attached Schedules A (Form 990-T) ▶ 1

K During the tax year, was the corporation a subsidiary in an affiliated group or a parent-subsidiary controlled group? ▶ ☐ Yes ☐ No
If "Yes," enter the name and identifying number of the parent corporation ▶

L The books are in care of ▶ IRA Custodian Telephone number ▶ xxx-xxx-xxxx

Part I Total Unrelated Business Taxable Income

1	Total of unrelated business taxable income computed from all unrelated trades or businesses (see instructions)	1	2,100
2	Reserved	2	
3	Add lines 1 and 2	3	2,100
4	Charitable contributions (see instructions for limitation rules)	4	
5	Total unrelated business taxable income before net operating losses. Subtract line 4 from line 3	5	2,100
6	Deduction for net operating loss. See instructions	6	
7	Total of unrelated business taxable income before specific deduction and section 199A deduction. Subtract line 6 from line 5	7	2,100
8	Specific deduction (generally $1,000, but see instructions for exceptions)	8	1,000
9	**Trusts.** Section 199A deduction. See instructions	9	
10	**Total deductions.** Add lines 8 and 9	10	1,000
11	**Unrelated business taxable income.** Subtract line 10 from line 7. If line 10 is greater than line 7, enter zero	11	1,100

Part II Tax Computation

1	**Organizations taxable as corporations.** Multiply Part I, line 11 by 21% (0.21) ▶	1	
2	**Trusts taxable at trust rates.** See instructions for tax computation. Income tax on the amount on Part I, line 11 from: ☑ Tax rate schedule or ☐ Schedule D (Form 1041) ▶	2	110
3	**Proxy tax.** See instructions ▶	3	
4	Other tax amounts. See instructions	4	
5	Alternative minimum tax (trusts only)	5	
6	**Tax on noncompliant facility income.** See instructions	6	
7	**Total.** Add lines 3 through 6 to line 1 or 2, whichever applies	7	110

For Paperwork Reduction Act Notice, see instructions. Cat. No. 11291J Form **990-T** (2020)

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Risk of Fraud

An IRA account holder forms a self-directed IRA with a custodian (e.g., a bank or trust company). In its "Investor Alert: Self-Directed IRAs and the Risk of Fraud (August 8, 2018)," the Securities and Exchange Commission (SEC) warns investors of the risks associated with self-directed IRAs. It explains ways that fraudsters may use to perpetrate fraud, how investors can avoid fraud with self-directed IRAs, and recourse for fraud victims [www.investor.gov/introduction-investing/general-resources/news-alerts/alerts-bulletins/investor-alerts/investor-14]. This section summarizes the contents of this investor alert.

Custodial Responsibilities and Information

Fraudsters may misrepresent the duties of self-directed IRA custodians to deceive investors into believing that their investments are legitimate or protected against losses. Self-directed IRA custodians are responsible only for holding and administering the assets in a self-directed IRA. They generally do not evaluate the quality or legitimacy of any investment in the self-directed IRA. Most custodial agreements between a self-directed IRA custodian and an investor explicitly state that the self-directed IRA custodian has no responsibility for investment performance.

Self-directed IRAs allow investors to hold alternative investments that, unlike publicly traded securities, may have limited financial and other information available. Even when financial information for these alternative investments is available, self-directed IRA custodians usually do not investigate the accuracy of any financial information that is provided.

Avoiding Fraud

Investors can take several steps to reduce the risk of fraud.

Verify Self-Directed IRA Account Statement Information

Alternative investments may be illiquid and difficult to value. As a result, self-directed IRA custodians often list the value of the investment as the original purchase price, the original purchase price plus returns reported by the promoter, or a price provided by the promoter. If possible, the investor should try to independently verify this information provided in account statements.

Avoid Unsolicited Investment Offers

An investor should exercise extreme caution before investing in an unsolicited investment offer that promotes the use of a self-directed IRA.

Ask Questions

An investor should always ask if the person offering the investment is registered or licensed, and if the investment itself is registered. Then the investor should verify the answers with an unbiased source, such as the SEC or state securities regulator.

Be Wary of Guaranteed Returns

Every investment carries some degree of risk, and the level of risk typically correlates with the return an investor can expect to receive. Lower risks generally correspond to lower returns, and higher returns typically involve higher risk. Fraudsters often spend a lot of time trying to convince investors that extremely high returns are low risk by calling them "guaranteed" or "can't miss" opportunities. High returns typically represent potential rewards for investors who are willing and financially able to take big risks.

Consult a Professional

For alternative asset investment opportunities in self-directed IRAs, investors should consider getting a second opinion from a licensed, unbiased investment professional or an attorney. This second opinion is especially important if the investor is opening a new account outside a traditional financial institution or well-recognized broker-dealer.

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Recourse for Fraud Victims

An investor who has lost money in a fraudulent investment or scheme involving a self-directed IRA or a third-party custodian can do the following:

- Submit a complaint to the SEC's Office of Investor Education and Advocacy [www.investor.gov/introduction-investing/investing-basics/glossary/complaints]
- Review the SEC's resources for victims of securities law violations [www.investor.gov/protect-your-investments/fraud/resources-victims-securities-law-violations]
- Contact the investor's state securities administrator [www.nasaa.org/contact-your-regulator/]

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ISSUE 5: HEALTH SAVINGS ACCOUNTS Eligible taxpayers can claim an above-the-line deduction for a contribution to a health savings account.

A health savings account (HSA) is a tax-advantaged medical savings account that allows taxpayers to use pretax money to pay medical expenses. To be eligible, a taxpayer must have a high-deductible health plan (HDHP). The participant cannot be enrolled in Medicare or be claimed as a dependent on another person's tax return.

PLANNING POINTER

Medicare Recipient

Taxpayers enrolled in Medicare cannot contribute to an HSA, but they can use HSA contributions made prior to age 65 to pay the premiums for Medicare Part B, Part D, and Medicare Advantage plans.

Setting up an HSA

No permission or authorization from the IRS is required to establish an HSA. The taxpayer sets up an HSA with a trustee, which can be a bank, an insurance company, or anyone already approved by the IRS to be a trustee of IRAs or Archer MSAs. The HSA can be established through a trustee that is different from the taxpayer's health plan provider.

Qualifying for an HSA

To claim the full contribution deduction, qualifying taxpayer must be covered under an HDHP on the first day of the last month of the tax year (December 1 for most taxpayers). For 2021, an HDHP must have a $1,400 minimum annual deductible and $7,000 maximum out-of-pocket expenses for self-only coverage. For family coverage, an HDHP must have a $2,800 minimum annual deductible and $14,000 maximum out-of-pocket expenses.

To be eligible, the taxpayer can have no other health coverage (except certain limited types of coverage). The taxpayer cannot be enrolled in Medicare and cannot be claimed as a dependent on someone else's tax return.

Contributions

The taxpayer, the taxpayer's family, an employer, or anyone else can make contributions to HSAs. Contributions up to an annual limit (inflation-adjusted after 2006) are deductible as an above-the-line deduction by the taxpayer who owns the HSA. Employer contributions up to the annual limit are not included in an employee's income and are not deductible by the employee. For 2021, the contribution limit is $3,600 for self-only coverage and $7,200 for family coverage, which includes all other coverage. HSA-eligible individuals over 55 years old may contribute an extra $1,000 annually.

Distributions

Distributions from an HSA, including earnings on contributions, used exclusively to pay qualified medical expenses of the account beneficiary, spouse, or dependents, are excluded from gross income. A taxpayer can receive distributions from an HSA even if he or she is not currently eligible to make contributions to the HSA. However, any part of a distribution not used to pay qualified medical expenses is included in gross income and is subject to an additional 20% tax, unless an exception applies (e.g., disability, death, or Medicare eligibility).

Generally, qualified medical expenses for HSA purposes are unreimbursed medical expenses that could otherwise be deducted on Schedule A (Form 1040), before the AGI limitation. The taxpayer claims a current-year deduction for contributions to the HSA but does not have to currently use the funds in the account.

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Reporting Contributions

Contributions made by an employer are excluded from the employee's income. Contributions by a partnership to a partner's HSA for services rendered that are treated as guaranteed payments are deductible by the partnership and includable in the partner's gross income and self-employment income. The partner can deduct the contribution made to the partner's HSA. Contributions by an S corporation to a 2% shareholder-employee's HSA for services rendered are deductible by the S corporation, included in the shareholder-employee's gross income, and may not be subject to FICA and FUTA. The shareholder-employee can deduct the contribution made to the shareholder-employee's HSA.

The taxpayer should receive Form 5498-SA, HSA, Archer MSA, or Medicare Advantage MSA Information, from the trustee showing the amount contributed to the HSA during the year. An employer's contributions will also be reported on Form W-2, box 12, code W. The taxpayer reports all contributions to the HSA on Form 8889, Health Savings Accounts (HSAs), and files the form with his or her individual income tax return.

Example 10.20
Deduction for HSA Contribution

Jamal Wilson is a self-employed, single taxpayer who is age 35. In 2021, he was covered under an HDHP and he was eligible to make an HSA contribution. He made the maximum $3,600 contribution and took no distributions. **Figure 10.14** shows the Form 5498-SA that Jamal received. **Figure 10.15** shows his Form 8889, Part I. Figure 10.15 shows the 2020 form because the 2021 form was not available at the time of this publication; however, it uses the 2021 contribution limit. Jamal reports the $3,600 contribution as a deduction on his 2021 Form 1040, Schedule 1, line 12. He files Form 8889 with the return.

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FIGURE 10.14
Jamal Wilson's Form 5498-SA

2727 ☐ VOID ☐ CORRECTED

TRUSTEE'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone number		1 Employee or self-employed person's Archer MSA contributions made in 2021 and 2022 for 2021	OMB No. 1545-1518	HSA, Archer MSA, or Medicare Advantage MSA Information
First Bank of Oregon 100 River Street Bend, Oregon 97701		$	2021	
		2 Total contributions made in 2021 $ 3,600	Form 5498-SA	
TRUSTEE'S TIN XX-XXXXXXX	PARTICIPANT'S TIN XXX-XX-XXXX	3 Total HSA or Archer MSA contributions made in 2022 for 2021 $		Copy A For Internal Revenue Service Center
PARTICIPANT'S name Jamal Wilson		4 Rollover contributions $	5 Fair market value of HSA, Archer MSA, or MA MSA $ 9,200	File with Form 1096. For Privacy Act and Paperwork Reduction Act Notice, see the 2021 General Instructions for Certain Information Returns.
Street address (including apt. no.) 32 Penny Lane		6 HSA ☑ Archer MSA ☐ MA MSA ☐		
City or town, state or province, country, and ZIP or foreign postal code Bend, Oregon 97701				
Account number (see instructions) XXX-XX				

Form 5498-SA Cat. No. 38467V www.irs.gov/Form5498SA Department of the Treasury - Internal Revenue Service

FIGURE 10.15
Jamal Wilson's Form 8889, Part I

Form **8889**
Department of the Treasury
Internal Revenue Service

Health Savings Accounts (HSAs)

► **Attach to Form 1040, 1040-SR, or 1040-NR.**
► **Go to *www.irs.gov/Form8889* for instructions and the latest information.**

OMB No. 1545-0074
2020
Attachment Sequence No. **52**

Name(s) shown on Form 1040, 1040-SR, or 1040-NR	Social security number of HSA beneficiary. If both spouses have HSAs, see instructions ►
Jamal Wilson	XXX-XX-XXXX

Before you begin: Complete Form 8853, Archer MSAs and Long-Term Care Insurance Contracts, if required.

Part I **HSA Contributions and Deduction.** See the instructions before completing this part. If you are filing jointly and both you and your spouse each have separate HSAs, complete a separate Part I for each spouse.

1	Check the box to indicate your coverage under a high-deductible health plan (HDHP) during 2020. See instructions ►			☑ Self-only ☐ Family
2	HSA contributions you made for 2020 (or those made on your behalf), including those made from January 1, 2021, through April 15, 2021, that were for 2020. **Do not** include employer contributions, contributions through a cafeteria plan, or rollovers. See instructions		2	3,600
3	If you were under age 55 at the end of 2020 and, on the first day of **every** month during 2020, you were, or were considered, an eligible individual with the **same** coverage, enter $3,550 ($7,100 for family coverage). **All others,** see the instructions for the amount to enter		3	3,600
4	Enter the amount you and your employer contributed to your Archer MSAs for 2020 from Form 8853, lines 1 and 2. If you or your spouse had family coverage under an HDHP at any time during 2020, also include any amount contributed to your spouse's Archer MSAs		4	0
5	Subtract line 4 from line 3. If zero or less, enter -0-		5	3,600
6	Enter the amount from line 5. But if you and your spouse each have separate HSAs and had family coverage under an HDHP at any time during 2020, see the instructions for the amount to enter		6	3,600
7	If you were age 55 or older at the end of 2020, married, and you or your spouse had family coverage under an HDHP at any time during 2020, enter your additional contribution amount. See instructions		7	
8	Add lines 6 and 7		8	3,600
9	Employer contributions made to your HSAs for 2020	9 0		
10	Qualified HSA funding distributions	10 0		
11	Add lines 9 and 10		11	0
12	Subtract line 11 from line 8. If zero or less, enter -0-		12	3,600
13	**HSA deduction.** Enter the **smaller** of line 2 or line 12 here and on Schedule 1 (Form 1040), Part II, line 12 **Caution:** If line 2 is more than line 13, you may have to pay an additional tax. See instructions.		13	3,600

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ISSUE 6: INDIVIDUAL COVERAGE HEALTH REIMBURSEMENT ARRANGEMENTS

This issue covers final regulations on individual HRAs.

I.R.C. § 105 allows for the reimbursement of medical expenses under an employer-sponsored health plan. Under a health reimbursement arrangement (HRA), the employer contributes to the employee's plan. The contributions are excluded from the employee's income and wages. Distributions must be paid to reimburse the employee for qualified medical expenses of the employee and his or her spouse and dependents. Unused amounts can usually be carried over to the next year.

This section discusses the recently issued final regulations on individual coverage HRAs (ICHRAs) [T.D. 9949] that clarify the application of the employer shared responsibility provisions and certain nondiscrimination rules to ICHRAs and provide certain safe harbors for the application of those provisions to ICHRAs.

PRACTITIONER NOTE

Final Regulations

The IRS issued an advance copy of the final regulations, but due to a federal regulatory freeze, they are not effective until they are published in the Federal Register. As of the time of this writing, the final regulations have not yet been published in the Federal Register.

Background

Before the implementation of the Patient Protection and Affordable Care Act (ACA), Pub. L. No. 111-148, many small businesses had HRAs that reimbursed their employees for the cost of medical expenses or health care coverage they purchased on their own. The ACA market reforms imposed minimum coverage requirements on all group health plans. Failure of an employer-provided group health plan to meet market reforms can result in the imposition of the excise tax under I.R.C. § 4980D.

Stand-alone HRAs are exempt from the market reform requirements if they were established to reimburse employees for excepted benefits such as limited dental and vision benefits and some long-term care coverage. Also, plans with fewer than two participants who are current employees were exempt from the market reforms. Thus, stand-alone plans with only one current employee or plans that covered only retirees are exempt. However, due to the penalties for failure to comply, employers ended most nonexempt stand-alone HRAs, and employees lost significant tax savings.

CROSS-REFERENCE

Excepted Benefits

See pages 413–414 of the *2015 National Income Tax Workbook* for a discussion of what qualifies as an excepted benefit.

Regulations issued June 20, 2019 (effective for plan years beginning on or after January 1, 2020) allow employers to establish ICHRAs to help their employees purchase health care insurance or pay medical expenses on a tax-advantaged basis for plan years beginning in 2020. ICHRAs are funded solely by the employer. Regulations issued as an advance notice on January 13, 2021, clarify the application of the 2019 regulations.

Required Insurance

Employees and any covered dependents must be enrolled in individual health insurance coverage, or Medicare Parts A and B (hospital insurance and medical insurance), or Part C (Medicare Advantage), in order to receive reimbursements for medical care expenses from the ICHRA. ICHRA reimbursements may include premiums and cost sharing for individual health insurance coverage and for Medicare.

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The new regulations allow integration of an HRA with individual health insurance coverage, including the following types of plans:

- Individual insurance coverage purchased through the Marketplace
- ACA-compliant individual insurance coverage purchased outside of the Marketplace
- Certain non-ACA-compliant individual insurance plans for which the requirements are waived
- Medicare

Health care sharing ministries are not currently eligible coverage. ICHRAs may not integrate with short-term, limited-duration insurance or coverage that consists solely of dental, vision, or other excepted benefits.

Tax Savings

ICHRAs reimburse employees for medical care expenses (as defined in I.R.C. § 213) up to any maximum dollar amount that the employer makes available each year. In addition, an ICHRA may also reimburse expenses incurred by the employee's spouse; dependents; and children who, as of the end of the tax year, have not attained age 27. The employer can allow unused amounts in any year to roll over from year to year. ICHRAs provide a tax savings because the reimbursements provided to employees through the ICHRA are excluded from the employees' income and wages for federal income tax and employment tax purposes.

Example 10.21
ICHRA Tax Savings

Lionel and Lane Meisner are married with no children. Their annual taxable income is $200,000. Lionel has always received his insurance from his employer, but Lane purchases her own individual insurance coverage. Lane pays $1,200 per month for her current plan.

In 2020, Lane's employer began offering an ICHRA for its employees. The plan provides reimbursement of up to $12,000 per year. Her employer does not offer a family plan. Lane can exclude the $12,000 per year from her income and wages, which results in a $2,880 ($12,000 × 24%) per year tax savings. The $12,000 will also be exempt from FICA taxes and any applicable state income tax.

Substantiation

Employers providing ICHRAs to their employees must implement and comply with reasonable procedures to ensure that two substantiation requirements are met. First, to enroll in an ICHRA, the employee (and any dependents covered by the plan) must prove actual enrollment in eligible coverage, including individual health insurance coverage, Medicare Parts A and B, or Medicare Part C, for each month covered by the ICHRA.

Second, the employer must not allow the ICHRA to reimburse a medical care expense unless, prior to the reimbursement, the participant substantiates that the individual on whose behalf the reimbursement is requested is (or was) enrolled in eligible coverage for the month during which the medical care expense was incurred.

The IRS has provided sample attestation forms for substantiating annual coverage and for substantiating ongoing coverage. The forms and instructions can be found at www.irs.gov/pub/irs-utl/health_reimbursement_arrangements_faqs.pdf.

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Nondiscrimination

To prevent employers from using an ICHRA to encourage high-risk employees to purchase insurance on the individual market rather than enroll in a current group health plan, employers that offer an ICHRA must offer it on the same terms to all individuals within a class of employees. Thus, an employer can offer a group health plan to one class of employees, and an ICHRA to another class of employees.

Employers may make distinctions, using classes based on the following status:

1. Full-time employees
2. Part-time employees
3. Employees working in the same geographic location (generally, the same insurance rating area, state, or multistate region)
4. Seasonal employees
5. Employees in a unit of employees covered by a particular collective bargaining agreement
6. Employees who have not satisfied a waiting period
7. Nonresident aliens with no US-based income
8. Salaried workers
9. Nonsalaried workers (such as hourly workers)
10. Temporary employees of staffing firms
11. Any group of employees formed by combining two or more of these classes

Minimum class size rules apply if the employer offers a traditional group health plan to some employees and an ICHRA to other employees based on full-time or part-time status, salaried or nonsalaried status, or geographic location if the location is smaller than a state. For an employer with fewer than 100 employees, the minimum class size is 10 employees.

Employers can offer new employees an ICHRA, while grandfathering current employees in a traditional group health plan. Employers can offer increased amounts for older workers and for workers with more dependents.

The 2021 regulations provide that an ICHRA that satisfies the age variation exception under Treas. Reg. § 54.9802-4(c)(3)(iii)(B) (the same terms requirement) will not be treated as failing to satisfy the requirements to provide nondiscriminatory benefits solely due to the variation based on age. However, the Treasury Department and the IRS note that satisfying the terms of the safe harbors under the final regulations does not automatically satisfy the prohibition on nondiscriminatory operation. Thus, among other situations, if a disproportionate number of highly compensated employees qualify for and use the maximum HRA amount allowed based on age compared to the number of non–highly qualified employees who qualify for and use lower HRA amounts based on age, the individual coverage HRA may be found to be discriminatory, and excess reimbursements of the highly compensated employees will be included in their income.

Impact on the Premium Tax Credit

ICHRAs will provide substantial tax-advantaged savings for many employees purchasing health care insurance or services. For other employees, however, the ICHRA could substantially increase the cost of their coverage. This is because employees (and their spouses and dependents) who are offered an affordable ICHRA are ineligible for the premium tax credit (PTC). A PTC is not allowed for an individual's Marketplace coverage if the individual chooses to be covered by an ICHRA, regardless of whether it is affordable.

CROSS-REFERENCE

Premium Tax Credit

The PTC (usually paid in advance) is available to offset the cost of plans purchased on the Marketplace for taxpayers with family income that is at or below 400% of the federal poverty limit (higher limits apply in 2021 and 2022). If the ICHRA is unaffordable, the employee can opt out of the ICHRA and still be eligible for the PTC. See page 395 in the *2020 National Income Tax Workbook* for an example of calculating affordability.

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Notice to Employees

Employers must provide written notice to employees to ensure that they are aware of the impact of the ICHRA on their PTC eligibility and to give the employee key information about the ICHRA. Generally, the employer must send the notice at least 90 days prior to the offer of the ICHRA.

Safe Harbors for Applicable Large Employers

Employers with an average of 50 or more full-time employees (including full-time equivalent employees) in the preceding calendar year are applicable large employers (ALEs) and are still subject to the ACA employer shared responsibility provision (ESRP). An ALE generally must offer minimum essential coverage that is affordable and provides minimum value, or make an employer shared responsibility payment if a full-time employee obtains a PTC for purchasing coverage through the Marketplace. The 2021 final regulations under I.R.C. § 4980H provide several safe harbors for ALEs to determine whether an offer of an ICHRA is an offer of affordable coverage for purposes of the ESRP.

Location Safe Harbor

Under the 2021 regulations, for purposes of section 4980H(b), an employer may use the lowest-cost silver plan for the employee for self-only coverage offered through the Exchange where the employee's primary site of employment is located (instead of where the employee resides) for determining whether an offer of an ICHRA to a full-time employee is affordable. The final regulations provide that the location safe harbor may be used in combination with the other safe harbors provided in the final regulations. If the employer uses the cost for the plan where the employee resides, the regulations state that an employer may rely on the residence information reported by an employee, unless the employer has knowledge that the residence information reported by an employee is incorrect.

Look-Back Month Safe Harbor

A safe harbor allows employers to use prior-year (or, in some cases, beginning of the year) premium information to determine affordability for purposes of section 4980H (the look-back month safe harbor). Specifically, for calendar-year ICHRAs, the look-back month safe harbor allows the employer to determine an employee's required contribution for any calendar month by using the monthly premium for the lowest-cost silver plan for January of the prior calendar year. For a non-calendar-year ICHRA, the look-back month safe harbor allows the employer to determine an employee's required contribution for any calendar month by using the monthly premium for the lowest-cost silver plan for January of the current calendar year.

The final regulations provide that an ALE may use the look-back month safe harbor in addition to the other safe harbors included in the final regulations, and that an ALE may apply the look-back month safe harbor even if the ALE decides not to use the location safe harbor.

Household Income Safe Harbor

Employers that offer ICHRAs will not know employees' household incomes. Therefore, the 2021 regulations retain the rules that allow an employer offering an ICHRA to a class of employees to use the following safe harbors to determine whether the offer of the HRA is affordable for purposes of section 4980H(b):

- Use the employee's W-2 wages (Form W-2 safe harbor)
- Use the lower of the employee's hourly rate of pay as of the first day of the coverage period (generally the first day of the plan year) or the employee's lowest hourly rate of pay during the calendar month multiplied by 130 hours (rate-of-pay safe harbor)
- Use the federal poverty line

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Example 10.21
Application of the Safe Harbors

Mountain Valley Outfitters, Inc. (MVO) offers all its full-time employees and their dependents an ICHRA with a calendar-year plan year. In 2021, MVO made $6,000 available in the HRA for each full-time employee, without regard to family size. Thus, the monthly HRA amount for each full-time employee was $500 ($6,000 ÷ 12).

All of the MVO employees have a primary site of employment in the city of Mountain Valley. MVO chose to use the location safe harbor and the look-back month safe harbor. MVO also chose to use the rate-of-pay safe harbor for its full-time employees.

Maria Mendez, an MVO employee, was 40 years old on January 1, 2021, the first day of the plan year. The monthly premium for the applicable lowest-cost silver plan for a 40-year-old offered through the Exchange in Mountain Valley (regardless of where Maria lives) for January 2020 (the look-back month) is $600. Maria's required HRA contribution for each month of 2021 is $100 (the $600 cost of the applicable lowest-cost silver plan determined under the location safe harbor and the look-back month safe harbor —the $500 monthly HRA amount). The monthly amount determined under the rate-of-pay safe harbor for Maria is $2,000 for each month in 2021.

MVO has made an offer of affordable, minimum value coverage to Maria for purposes of section 4980H(b) for each month of 2021 because Maria's $100 required HRA contribution does not exceed $197 (9.83% required contribution percentage for 2021 × $2,000 monthly amount determined under the rate-of-pay safe harbor). MVO will not be liable for an assessable payment under section 4980H(b) for Maria for any month in 2021 [Treas. Reg § 54.4980H-4(f)(8), Example 1].

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ISSUE 7: STOCK OPTIONS This section discusses the taxation of statutory and nonstatutory stock options.

An employer may grant an employee or an independent contractor the option to buy the employer's stock as payment for the employee or contractor's services. The recipient may have income when he or she receives the option, exercises the option, or disposes of the stock received from the exercise of the option.

This section discusses the two types of stock options. Options granted under an incentive stock option (ISO) plan or an employee stock purchase plan (ESPP) are statutory stock options. Stock options that are not granted under an ISO plan or an ESPP are nonstatutory stock options.

Statutory Stock Options

An employer can grant an employee a statutory (qualified) stock option. Under Treas. Reg. § 1.421-1, an *option* means the right or privilege of an individual to purchase stock from a corporation at a certain price. The option must be in writing (paper or electronic) and express, among other things, an offer to sell at the option price, the maximum number of shares that can be purchased under the option, and the time during which the offer remains open.

Statutory stock options are incentive stock options (ISOs) under I.R.C. § 422 and options granted under an employee stock purchase plan (ESPP) described in I.R.C. § 423. An option qualifies as a statutory option only if the option is not transferable (other than by will or by the laws of descent and distribution) by the individual to whom the option was granted, and is exercisable, during the lifetime of such individual, only by such individual. However, the employee can designate who can exercise the option after the employee's death.

A pledge of the stock that can be purchased under an option as security for a loan that is used to pay the option price does not violate the nontransferability requirements. Also, the transfer of an option to a grantor trust does not disqualify the option as a statutory option if, under I.R.C. § 671 and applicable state law, the employee is the deemed sole owner. A transfer of an option incident to divorce or pursuant to a domestic relations order will disqualify it as a statutory option.

Exercise of the Option

Generally, the employee does not include any amount in gross income when he or she receives or exercises the option (but the exercise may be subject to AMT). The employer does not have a deduction when the employee exercises the option, and no amount other than the price paid under the option is considered as received by the employer corporation. The employee has taxable income or deductible loss when he or she sells the stock bought by exercising the option (discussed later).

Until the IRS issues further guidance, the IRS will not assess employment taxes or federal income tax withholding obligations on the exercise of a statutory option, or the disposition of the stock acquired by an employee by exercise of the option [Notice 2002-47, 2002-2 C.B. 97].

Disposition of the Stock

Generally, if the employee holds the stock for at least 2 years from the date of grant and 1 year from the date of exercise (a *qualifying disposition*), then the employee recognizes capital gain (or loss) on disposition of the stock (but there is still no deduction for the employer). Special rules apply to a qualifying disposition of stock acquired under an ESPP if the option's exercise price was less than the share's FMV when the option was granted [See I.R.C. § 423(c)].

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If the employee fails to meet the required holding period (a *disqualifying disposition*), the employee has compensation (ordinary income) on the date of the disqualifying disposition equal to the difference between the exercise price and FMV of the underlying stock on the date of exercise. If the stock at issue was restricted (i.e., subject to a substantial risk of forfeiture), the income is the difference between the exercise price and the FMV on the date the restriction lapsed. The employer can take a corresponding wage deduction for the amount treated as ordinary income to the employee.

PRACTITIONER NOTE

Annual Limitations

There is a $100,000 annual limitation on the value of an employee's ISO that may become exercisable for the first time during any calendar year. [See Treas. Reg. § 1.422-4.] This limit is determined based on the FMV of the stock at the time the option is granted and not at the time the option vests. The excess amount over $100,000 is treated as a nonstatutory option. For options granted under an ESPP, no employee can purchase stock of the employer that exceeds $25,000 of the FMV of the stock (determined when the option is granted) for each calendar year in which the option is outstanding. [See Treas. Reg. § 1.423-2(i).]

Example 10.22
Taxation of Incentive Stock Options

On April 1, 2020, Connection Corp. granted its employee, Susan Lee, the option to purchase 4,000 shares in the company at $50 per share, which was the current FMV of the shares. The shares were granted under Connection's incentive stock option (ISO) plan. On April 1, 2021, Susan exercised her option to purchase the shares. Susan does not have any income upon the grant or the exercise of the option.

On April 3, 2002, Susan sells the shares for $100 per share. Susan has a $200,000 (4,000 × $50) gain.

Because Susan sold the shares more than 2 years from grant date and more than 1 year from the exercise date, the sale is a qualifying disposition and pays tax at the capital gains tax rates.

Reporting

Following the exercise of a statutory option, I.R.C. § 6039 requires corporations to furnish a written statement to each employee to report

1. the corporation's transfer of stock pursuant to the employee's exercise of an ISO; and
2. the corporation's (or its agent's) recording the first transfer of the legal title of a share of stock acquired by the employee pursuant to the exercise of an ESPP option described in I.R.C. § 423(c) (relating to a special rule where the option price is between 85% and 100% of value of stock).

The transfer of stock to the employee pursuant to the exercise of an ISO must be reported on Form 3921, Exercise of an Incentive Stock Option Under Section 422(b). The transfer or sale of stock acquired pursuant to the exercise of an option under an ESPP is reported on Form 3922, Transfer of Stock Acquired Through an Employee Stock Purchase Plan Under Section 423(c).

The income from a disqualifying disposition is considered wages and must be reported on the employee's Form W-2. However, the income from disqualifying dispositions is not subject to employment taxes [Notice 2002-47, supra].

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Nonstatutory Stock Options

A nonstatutory stock option allows an employee or independent contractor to purchase the employer's stock. Generally, there are no tax consequences for the employer or the employee on the grant of a nonstatutory stock option in connection with the performance of services if the option does not have a readily ascertainable FMV. If an option has a readily ascertainable FMV at the time of the grant, the employee will recognize compensation at that time. An option has a readily ascertainable FMV if the stock is actively traded on an established market or its FMV can otherwise be measured with reasonable accuracy. It does not have a readily ascertainable FMV if it is not actively traded and cannot be currently exercised or transferred [Treas. Reg. § 1.83-7(b)].

Exercise of the Option

The employee will have ordinary income (and owe employment taxes) on the exercise (purchase) of a nonstatutory stock option [Rev. Rul. 78-185, 1978-1 C.B. 304]. The corporation is generally entitled to a corresponding deduction.

Risk of Forfeiture

If the stock received on exercise is subject to a substantial risk of forfeiture, the compensation is not included in the employee's income until the termination of that risk of forfeiture, unless the employee makes an I.R.C. § 83(b) election (discussed later). Under the general rule of I.R.C. § 83(a), an employee or independent contractor who performs services in exchange for property is subject to tax in the year that the property becomes substantially vested or is transferable (whichever is earlier).

Section 83(a) does not apply if the service provider disposes of the property in an arm's-length transaction before it becomes transferable or the risk of forfeiture is removed. The amount of includable income is the excess of the FMV of the property (determined without vesting restrictions) at the time that it becomes transferable or not subject to substantial risk of forfeiture, over the amount paid for the property.

Rights in property are generally subject to a substantial risk of forfeiture if the rights to full enjoyment of the property are conditioned, directly or indirectly, on

1. the future performance, or the refraining from the performance, of substantial services by any individual; or
2. the occurrence of a condition related to the purpose of the transfer, if the possibility of forfeiture is substantial.

Property is not transferred subject to a substantial risk of forfeiture if at the time of transfer the facts and circumstances demonstrate that the forfeiture condition is unlikely to be enforced. Further, property is not transferred subject to a substantial risk of forfeiture to the extent that the employer must pay the FMV of the stock to the employee upon the forfeiture. The risk that the value of the stock will decline during a certain time does not constitute a substantial risk of forfeiture [Treas. Reg. § 1.83-3(c)].

Section 83(b) Election

A recipient of substantially nonvested stock in connection with the performance of services can elect to include the FMV of the stock in income in the year that the property is transferred. The recipient's compensation income is the FMV of the stock received over amounts the recipient paid. If the recipient makes the election, any subsequent appreciation in value of the stock is generally treated as capital gain income. The recipient's basis in the stock equals the amount the recipient paid for the property, plus the amount included in gross income under section 83(b) [Treas. Reg. § 1.83-2(a)].

Reporting

An employer must report the excess of the FMV of stock received upon exercise of a nonstatutory stock option over the amount paid for the stock option. The employer reports that amount on Form W-2 in boxes 1, 3 (up to the social security wage base), and 5; and in box 12 using the code "V."

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Section 83(i) Deferral

The Tax Cuts and Jobs Act, Pub. L. No. 115-97, amended section 83 to allow qualified employees of privately held corporations to defer paying income tax, for up to 5 years, on the exercise of qualified stock options and restricted stock units (RSUs). Notice 2018-97, 2018-52 I.R.B. 1062, provides additional information on the application of section 83(i). In general, executives, highly compensated officers, and those owning 1% or more of the corporation's stock cannot make the deferral election. Federal Insurance Contributions Act (FICA) tax and Federal Unemployment Tax Act (FUTA) tax payable on the value of qualified stock may not be deferred.

If a qualified employee makes a section 83(i) election, income is included in the tax year of the employee that includes the earliest of

1. the first date such qualified stock becomes transferable (including, the date it becomes transferable to the employer);
2. the date the employee first becomes an excluded employee;
3. the first date that any stock of the issuing corporation becomes readily tradable on an established securities market;
4. the date that is 5 years after the first date the rights of the employee in such stock are transferable or not subject to a substantial risk of forfeiture, whichever occurs earlier; or
5. the date that the employee revokes the election.

Qualified Employee

Section 83(i)(3)(A) defines a *qualified employee* as any individual who is not an excluded employee and who agrees to meet such requirements as the IRS determines are necessary to ensure that the corporation's income tax withholding requirements with respect to the qualified stock are met. An *excluded employee* is defined under section 83(i)(3)(B) as, with respect to any corporation, any individual

1. who is a 1% owner at any time during the calendar year or who was a 1% owner at any time during the 10 preceding calendar years;
2. who is or has been at any prior time
   a. the chief executive officer (or an individual acting in such capacity), or
   b. the chief financial officer (or an individual acting in such capacity);
3. who bears a family member relationship described in I.R.C. § 318(a)(1) to any individual described in 2(a) or 2(b); or
4. who is one of the four highest-compensated officers of the corporation for the tax year, or was one of the four highest-compensated officers of such corporation for any of the 10 preceding tax years, determined on the basis of the shareholder disclosure rules for compensation under the Securities Exchange Act of 1934 (as if such rules applied to such corporation).

Qualified Stock

Section 83(i)(2)(A) defines *qualified stock* as any stock in a corporation that is the employer of a qualified employee, if

- such stock is received in connection with the exercise of a stock option or in settlement of an RSU, and
- such stock option or RSU was granted in connection with the performance of services as an employee and during a calendar year that the employer corporation was an eligible corporation.

All persons treated as a single employer under I.R.C. § 414(b) are treated as one corporation. Qualified stock does not include any stock if the employee may sell the stock to, or otherwise receive cash in lieu of stock from, the corporation at the time that the employee's rights to the stock first become transferable or not subject to a substantial risk of forfeiture.

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Eligible Corporation

An *eligible corporation* is any corporation that, with respect to any calendar year,

- has none of its (or any predecessor's) stock readily tradable on an established securities market during any preceding calendar year, and
- has a written plan under which, in such calendar year, not less than 80% of all employees who provide services to the corporation in the United States (or any possession of the United States) are granted stock options, or are granted RSUs, with the same rights and privileges to receive qualified stock.

Excluded employees and certain part-time employees are excluded from the 80% calculation.

Making the Election

The section 83(i) deferral election must be made no later than 30 days after the first date the rights of the employee in the stock are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier. The election is made in a manner similar to the section 83(b) election. No election may be made under section 83(i) if the qualified employee made an election under section 83(b) with respect to such qualified stock, or if any stock of the corporation that issued the qualified stock is readily tradable on an established securities market at any time before the election is made.

In addition, the qualified employee cannot make this election if the corporation that issued the stock purchased any of its outstanding stock in the calendar year preceding the calendar year that includes the first date the rights of the employee are transferable or are not subject to a substantial risk of forfeiture, unless

1. not less than 25% of the total dollar amount of the stock so purchased is deferral stock, and
2. the determination of which individuals from whom deferral stock is purchased is made on a reasonable basis.

Notice Requirements

Section 83(i)(6) requires the corporation to notify the employee at the time an amount attributable to the stock would first be includable in the employee's gross income (or a reasonable time before), certify to the employee that such stock is qualified stock, and notify the employee that the employee may be eligible to defer income on such stock. The corporation must also notify the employee that if the employee makes the election, the amount of income recognized at the end of the deferral period will be based on the value of the stock at the time the rights of the employee first become transferable or not subject to a risk of forfeiture, even if the value of the stock has declined during the deferral period; and that the amount of such income recognized at the end of the deferral period will be subject to withholding.

CROSS-REFERENCE

Notice 2018-97

See Notice 2018-97, supra, for additional guidance on the application of the 80% requirement for an eligible corporation, the application of federal income tax withholding to the deferred income related to the qualified stock, and the employer's ability to not allow employees to elect the deferred treatment.

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Example 10.23
Grant of Restricted Nonstatutory Stock Options—No 83(b) Election

AB Tech is a private tech start-up. On January 1, 2020, AB Tech granted its CEO, Emilio Ricci, the option to purchase 1,000 shares of restricted stock that vest after 4 years of service to the company. The exercise price is $100 per share. At the time of the grant, the shares had no readily ascertainable value, and the grant of the option is not compensation to Emilio.

Emilio exercised the option on January 1, 2021, when the share value was $150 per share. Emilio has $50,000 (1,000 × $50) compensation income. However, because there is a substantial risk of forfeiture, the compensation is not included in his income until the risk of forfeiture terminates (the shares vest). If at the time of vesting, the shares are valued at $200 per share, Emilio has $100,000 (1,000 × $100) income.

Example 10.24
Grant of Restricted Nonstatutory Stock Options—83(b) Election

The facts are the same as in Example 10.23, except that when Emilio exercised the stock option, he made a section 83(b) election to include the FMV of the shares in his 2021 income. Emilio includes the $50,000 in his 2021 income. He has no additional income when the shares vest.

PLANNING POINTER

Restricted Stock Units

RSUs are a grant of company shares that are subject to a vesting schedule. The recipient typically does not receive the stock until it vests. Because the recipient does not receive the stock until it is vested, a section 83(b) election is not allowed. Absent a section 83(i) election, the taxpayer has income equal to the FMV of the shares at the time of vesting. When the taxpayer sells the shares, the value included in compensation is his or her basis in the shares, and is reported on Form 8949, Sales and Other Dispositions of Capital Assets, with adjustment code "B" in column (f).

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CONSTRUCTION INDUSTRY TAX ISSUES

11

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LEARNING OBJECTIVES

After completing this session, participants will be able to do the following:

- ✔ Explain how to account for long-term construction contracts
- ✔ Understand the deductions for business transportation
- ✔ Determine the deduction for an employer who provides a vehicle for employees and the portion of the value that is included in the employee's income
- ✔ Know when to deduct meal and entertainment expenses
- ✔ Classify a construction worker as an employee or an independent contractor

INTRODUCTION

The construction industry has more than 680,000 employers with over 7,000,000 employees, and creates nearly $1.3 trillion worth of structures each year [Associated General Contractors Association Construction Data, www.agc.org/learn/construction-data]. The construction sector includes taxpayers who construct buildings or engineer projects (e.g., highways and utility systems). Construction work may also include additions, alterations, or maintenance and repairs [North American Industry Classification System (NAICS)].

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CROSS-REFERENCE

Real Estate Developers

Businesses that are primarily engaged in the preparation of sites for new construction and that subdivide land for sale as building sites also are included in the NAICS construction sector. See the "Current Real Estate Tax Issues" chapter in this workbook for a discussion of tax issues that apply to real estate developers.

Project terms and specifications are usually formalized in a contract with the owners of construction projects (prime contracts) or contracts with other construction contractors (subcontracts). Construction activities generally are managed at a fixed business location, but the employees or independent contractors must travel to perform the construction activities at multiple project sites.

This chapter reviews accounting methods for long-term contracts. It explains the deductions for motor vehicle expenses and meal and entertainment expenses. Finally, this chapter discusses when a construction worker will be classified as an employee and when the worker is classified as an independent contractor.

ISSUE 1: ACCOUNTING FOR LONG-TERM CONSTRUCTION CONTRACTS

This section reviews the percentage-of-completion method of accounting and when a construction contractor is exempt from using that method.

The Tax Cuts and Jobs Act of 2017 (TCJA), Pub. L. No. 115-97, expanded the types of taxpayers that may use the cash method of accounting under I.R.C. § 448(c). Taxpayers, other than tax shelters, with annual average gross receipts that do not exceed $26,000,000 (for 2021) for the 3 prior tax years can use the cash method of accounting.

The TCJA also exempts certain taxpayers from the requirement to keep inventories, expands the exception from the uniform capitalization (UNICAP) rules, and expands the exception for small construction contracts from the requirement to use the percentage-of-completion method (PCM). This section provides an overview of the PCM and then explains the exceptions for home construction contracts and for small construction contractors.

Percentage-of-Completion Method

If the home construction contract or small construction contractor exceptions (discussed later) do not apply, I.R.C. § 460 generally requires the use of the PCM for a long-term contract. The PCM requires revenue recognition throughout the contract term.

Long-Term Construction Contracts

Long-term contracts are defined in I.R.C. §460(f)(1) as any contract for the manufacture, building, installation, or construction of property, if the contract is not completed within the tax year in which the contract is entered into. Special rules apply to manufacturing contracts. The contract term does not have to exceed 1 year. A long-term contract is one that starts in one tax year and ends in another. Exempt construction contracts are discussed later.

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PRACTITIONER NOTE

Services vs. Construction

An architect who only draws plans and supervises construction is not engaged in the manufacture, building, installation, or construction of property. Similarly, a contract to provide engineering services does not qualify as a long-term contract because it does not require the taxpayer to actually construct or build anything.

Construction Contract

A construction contract that is not completed in the contracting year is a long-term construction contract if it involves the building, construction, reconstruction, or rehabilitation of real property; the installation of an integral component to real property; or the improvement of real property (collectively referred to as construction). *Real property* means land; buildings; and inherently permanent structures, such as roadways, dams, and bridges. Real property does not include vessels, offshore drilling platforms, or unsevered natural products of land.

An integral component to real property includes property not produced at the site of the real property but intended to be permanently affixed to the real property, such as elevators and central heating and cooling systems. Thus, for example, a contract to install a heating system in a building is a construction contract because a building is real property, but a contract to install a heating system in a recreational vehicle (RV) is not a construction contract because an RV is not real property [Treas. Reg. § 1.460-3(a)].

Contract Dates

A construction contractor enters into a contract on the date that the contract binds the contractor and the customer, even if the contract is subject to unsatisfied conditions that are not within the contractor's control (such as obtaining financing). If a contractor delays entering into a contract for a principal purpose of avoiding section 460, the contractor is treated as having entered into a contract not later than the contract commencement date [Treas. Reg. § 1.460-1(c)(2)].

The contract is completed upon the earlier of the following two events:

1. The customer can use the constructed property for its intended purpose (other than for testing) and has incurred at least 95% of the total allocable contract costs.
2. The construction contractor completes the construction, and the customer accepts the completed building.

[Treas. Reg. § 1.460-1(c)(3)]

Example 11.1
Contract Completion

In 2019, Casey Behr, a calendar-year taxpayer, entered into a contract to construct an office building for Barbara Bennett. Casey's average annual gross receipts for the prior 3 years are $30,000,000. In November 2020, Casey completed the building, and Barbara's tenants began to move in. In early December 2020, Barbara notified Casey of some minor construction defects that he needed to correct.

Casey agreed to correct the defects in January 2021. He reasonably estimated that the cost of correcting the defects will be less than 5% of the total allocable contract costs. The contract is complete in 2020 because in that year, Barbara's tenants used the building and Barbara had incurred at least 95% of the total construction contract costs [Treas. Reg. § 1.460-1(j), Example 3].

PCM Calculation

Section 460 generally requires a taxpayer to determine the income from a long-term construction contract using the PCM described in Treas. Reg. § 1.460-4(b). The PCM requires the contractor to report the portion of the total contract price that corresponds to the percentage of the entire contract that the contractor completed during the tax year. Thus, the contractor includes a portion of the total contract price in gross income as the contractor incurs allocable contract costs.

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The amount of gross revenue reported each year is determined by the following three steps:

1. Determine the completion factor, which is the ratio of the cumulative allocable contract costs that the contractor has incurred through the end of the tax year to the estimated total allocable contract costs that the contractor reasonably expects to incur under the contract.
2. Calculate cumulative gross receipts by multiplying the completion factor from step 1 by the total contract price.
3. Calculate current-year gross receipts, which is the difference between the amount of cumulative gross receipts for the current tax year from step 2 and the amount of cumulative gross receipts for the immediately preceding tax year (the difference can be a positive or negative number).

[Treas. Reg. § 1.460-4(b)(2)]

Figure 11.1 shows the calculation of current-year gross receipts using the PCM as provided in the IRS Construction Audit Technique Guide (page 131) [www.irs.gov/pub/irs-pdf/p5522.pdf].

FIGURE 11.1
PCM Calculation of Current-Year Gross Receipts

Cumulative allocable contract costs divided by total estimated allocable contract costs	×	Total contract price	=	Cumulative gross receipts	Less gross receipts reported in prior year	=	Current-year gross receipts to be reported for the taxable year

Example 11.2
PCM Long-Term Contract Year 1

On January 1, 2020, Blue Construction Co., a calendar-year taxpayer, entered into a long-term contract. The contract price is $100,000,000 and the estimated contract costs are $62,500,000. In 2020, Blue Construction incurred $7,000,000 of contract costs. Its 2020 gross receipts are $11,200,000 [($7,000,000 total contract costs incurred ÷ $62,500,000 total estimated costs) × $100,000,000 total contract price]. Blue Construction's net contract income for 2020 is $4,200,000 ($11,200,000 gross receipts − $7,000,000 current-year costs).

Example 11.3
PCM Long-Term Contract Year 2

In 2021, Blue Construction (from Example 11.2) incurred an additional $35,000,000 of contract costs. Its estimated total costs did not change. Blue Construction's cumulative contract costs incurred are $42,000,000 ($7,000,000 in 2020 + $35,000,000 in 2021). Its 2021 gross receipts are $56,000,000 [{($42,000,000 cumulative contract costs incurred ÷ $62,500,000 total estimated costs} × $100,000,000 total contract price) − $11,200,000 cumulative gross receipts for the preceding year)]. Blue Construction's net contract income for 2021 is $21,000,000 ($56,000,000 current-year gross receipts − $35,000,000 current-year costs).

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Allocable Contract Costs

The allocable contract costs that are used in the PCM calculation are generally those direct and indirect costs that must be capitalized under Treas. Reg. § 1.263A-1(e) through (h) [Treas. Reg. § 1.460-5(b)]. A taxpayer may elect to use the simplified cost-to-cost method to allocate costs to a long-term contract subject to the PCM. Under the simplified cost-to-cost method, a taxpayer determines a contract's completion factor based on only direct material costs; direct labor costs; and depreciation, amortization, and cost recovery allowances on equipment and facilities directly used to manufacture or construct the subject matter of the contract [Treas. Reg. § 1.460-5(b)].

PRACTITIONER NOTE

Look-Back Method

Contractors using the PCM must generally apply the look-back method upon completion of each contract. In the tax year of completion, the contractor determines whether the taxes paid in each year of the contract were more or less than the amount that would have been paid if the actual cost and contract price, rather than estimated contract price and cost, had been used to compute gross income. This look-back computation does not result in an adjustment to tax, but instead results in interest due to or from the taxpayer [I.R.C. § 460(b)(2)].

Total Contract Price

The *total contract price* is the amount that a contractor reasonably expects to receive under a long-term contract, including holdbacks, retainages, and cost reimbursements. Contingent payments such as bonuses and incentive fees must be included in total contract price when the contractor can reasonably predict that the amount will be earned [Treas. Reg. § 1.460-4(b)(4)(i)].

Postcompletion Income and Expenses

If a contract is complete, but not all contract costs have been incurred by the end of the tax year of completion, the contractor does not include the total contract price in the tax year of completion. Instead, the contractor includes the remaining contract price in income for the tax year following the completion year [Treas. Reg. § 1.460-4(b)(3)]. If a taxpayer incurs an allocable contract cost after the completion year, the taxpayer must account for that cost using a permissible method of accounting.

PRACTITIONER NOTE

10% Method

Instead of determining the income from a long-term contract beginning with the contracting year, a taxpayer may elect to use the 10% method under section 460(b)(5). Under the 10% method, a taxpayer does not include in gross income any amount related to allocable contract costs until the tax year in which the taxpayer has incurred at least 10% of the estimated total allocable contract costs [Treas. Reg. § 1.460-4(b)(6)].

Home Construction Contract Exemption

The general requirement to use the PCM and the cost allocation rules does not apply to any long-term construction contract that is a home construction contract. The taxpayer may (but is not required to) use the PCM and can use any other permissible method for exempt contracts (discussed later).

Under Treas. Reg. § 1.460-3(b)(2), a long-term contract is a home construction contract if a taxpayer (including a subcontractor working for a general contractor) reasonably expects to attribute 80% or more of the estimated total allocable contract costs (including the cost of land, materials, and services), determined as of the close of the contracting year, to the construction of either of the following:

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1. Dwelling units, as defined in I.R.C. § 168(e)(2)(A)(ii)(I) (a house or apartment used to provide living accommodations in a building or structure, but does not include a unit in a hotel, motel, or other establishment more than one-half of the units in which are used on a transient basis), contained in buildings containing 4 or fewer dwelling units (including buildings with 4 or fewer dwelling units that also have commercial units)
2. Improvements to real property directly related to, and located at the site of, the dwelling units

Each townhouse or rowhouse is a separate building. The taxpayer can include an allocable share of common area costs (e.g., sewers, roads, clubhouses) in the calculation of the total contract costs if the cost is reasonably incurred and will benefit the dwelling units, and if the taxpayer is contractually obligated, or required by law, to construct the common area improvements within the tract or tracts of land that contain the dwelling units.

Mixed Use Costs

If a contract involves the construction of both commercial units and dwelling units within the same building, a taxpayer must allocate the costs among the commercial units and dwelling units using a reasonable method or combination of reasonable methods. A reasonable method includes specific identification, or allocation by square footage or fair market value (FMV).

Residential Construction Contracts

A taxpayer may determine the income from a long-term construction contract that is a residential construction contract using either the PCM or the percentage-of-completion/capitalized-cost method (PCCM) of accounting described in Treas. Reg. § 1.460-4(e). A residential construction contract is a home construction contract, as defined earlier, except that the building or buildings being constructed contain more than 4 dwelling units.

Small Contractor Exemption

The requirement to use the PCM and the cost allocation rules does not apply to a construction contract that meets the small contractor exemption described in Treas. Reg. § 1.460-3(b)(1)(ii), and those taxpayers can use the PCM or any method that is permissible for an exempt contract.

The small contractor exemption applies to a construction contract

- entered into after December 31, 2017,
- in a tax year ending after December 31, 2017,
- by a taxpayer other than a tax shelter prohibited from using the cash receipts and disbursements method of accounting under section 448(a)(3), and
- who estimates at the time the contract is entered into that the contract will be completed within the 2-year period beginning on the contract commencement date.

The contractor must meet the gross receipts test for the tax year in which the contractor enters into the contract.

Gross Receipts Test

Treas. Reg. 1.460-3(b)(3) defines the gross receipts test with reference to the gross receipts test of I.R.C. § 448(c) and Treas. Reg. § 1.448-2(c)(2). This gross receipts test applies even if the taxpayer is not otherwise subject to section 448(a) (a C corporation, a partnership with a C corporation partner, or a tax shelter). The section 448 gross receipts test applies to taxpayers with annual average gross receipts that do not exceed $26,000,000 (for 2021) for the 3-prior-tax-year period. If the taxpayer is not a corporation or a partnership, generally the test is applied as if each trade or business is a corporation or a partnership. Special rules apply to individuals, and to partners and S corporation shareholders.

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Example 11.4
Contractor Meeting the Gross Receipts Test

Atlas Builders, a C corporation, is a plumbing contractor that installs plumbing fixtures in customers' homes or businesses. Atlas's gross receipts for the 2018, 2019, and 2020 tax years are $20,000,000, $16,000,000, and $30,000,000, respectively. Atlas's average annual gross receipts for the 3 tax-year period preceding the 2021 tax year is $22,000,000 [($20,000,000 + $16,000,000 + $30,000,000) ÷ 3]. Atlas may use the cash method for the 2021 tax year because its average annual gross receipts for the preceding 3 tax years is not more than the gross receipts test amount, which is $26,000,000 for 2021 [Treas. Reg. § 1.448-2(c)(2)(v)(B), Example].

Gross Receipts of Individuals

Except when the aggregation rules of section 448(c)(2) apply, the gross receipts of a taxpayer other than a corporation or partnership are the amount derived from all the taxpayer's trades or businesses. Amounts not related to a trade or business are excluded from the gross receipts. For example, an individual taxpayer's gross receipts do not include inherently personal amounts, such as personal injury awards or settlements paid because of an injury to the individual taxpayer, disability benefits, social security benefits that the taxpayer received during the tax year, and wages the taxpayer received as an employee that are reported on Form W-2, Wage and Tax Statement.

Example 11.5
Individual with Two Trades or Businesses

Art Adams is an individual who operates two separate and distinct trades or businesses that are reported on Schedule C (Form 1040), Profit or Loss From Business (Sole Proprietorship), of Art's federal income tax return. For 2021, one trade or business has annual average gross receipts for the prior 3 years of $5,000,000, and the other trade or business has average annual gross receipts for the prior 3 years of $35,000,000. For 2021, neither of Art's trades or businesses meets the gross receipts test ($5,000,000 + $35,000,000 = $40,000,000, which is greater than the inflation-adjusted gross receipts test amount for 2020, which is $26,000,000) [Treas. Reg. § 1.460-3(b)(3)(ii)(D), Example 1].

Partners and S Corporation Shareholders

Except when the aggregation rules of section 448(c)(2) apply, each partner in a partnership includes a share of partnership gross receipts in proportion to such partner's distributive share (as determined under section 704) of items of gross income that were taken into account by the partnership under section 703. Similarly, a shareholder includes the pro rata share of S corporation gross receipts taken into account by the S corporation under section 1363(b).

Exempt Contract Methods

The general requirement to use the PCM and the cost allocation rules described in Treas. Reg. § 1.460-5(b) or (c) do not apply to an exempt contract, which is a long-term construction contract that is a home construction contract or a contract that meets the small contractors exemption. Thus, a taxpayer may determine the income from an exempt construction contract using the PCM, the exempt contract PCM in Treas. Reg. § 1.460-4(c), the completed contract method (CCM) in Treas. Reg. § 1.460-4(d), or any other permissible method of accounting under I.R.C. § 446. This section discusses the exempt contract PCM and the CCM.

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CROSS-REFERENCE

Cash and Accrual Methods

See the "Tax Accounting Issues" chapter in the *2015 National Income Tax Workbook* for a discussion of the cash and accrual method and the requirement to keep inventories.

Exempt Contract PCM

A contractor who is exempt from the requirement to use the PCM can use the exempt contract PCM detailed in Treas. Reg. § 1.460-4(c)(2). Similar to the PCM, a taxpayer using the exempt contract PCM generally must include in income the portion of the total contract price that corresponds to the percentage of the entire contract that the taxpayer has completed during the tax year.

Under the exempt contract PCM, the contractor can determine the percentage of completion at of the end of the tax year by using any method of cost comparison (e.g., comparing direct labor costs incurred to date to estimated total direct labor costs) or by comparing the work performed on the contract with the estimated total work to be performed, provided such method is used consistently and clearly reflects income.

Completed Contract Method

Taxpayers may use the CCM to account for their long-term exempt contracts. Treas. Reg. § 1.460-4(d) provides that, in general, a taxpayer using the CCM must include in the contract's completion year (as defined earlier) the gross contract price, and all allocable contract costs incurred by the completion year.

Example 11.6
Using the CCM

Brentwood Builders, Inc. is a calendar-year taxpayer that uses the CCM to account for long-term exempt construction contracts. In 2020, Brentwood entered into a contract to build a single-family residence for Natasha Brown. The contract price is $500,000. Brentwood finished the home in 2021 and had incurred $350,000 in costs. Brentwood reports no income or expenses in 2020 because the contract is not complete. Instead, Brentwood reports the full $150,000 ($500,000 − $350,000) of income in 2021.

Changing Accounting Methods

Final section 460 regulations issued in December 2020 state that a taxpayer may adopt any permissible method of accounting for each classification of contract. Such adoption is not a change in method of accounting under section 446 and the accompanying regulations. For example, a taxpayer that has had only contracts classified as nonexempt long-term contracts and has used the PCM for these contracts may adopt an exempt contract method in the tax year it first enters into an exempt long-term contract.

A change in the method of accounting used for exempt construction contracts is a change in method of accounting under section 446 and the accompanying regulations. A taxpayer changing its method of accounting must obtain IRS consent. Rev. Proc. 2019-43, 2019-48 I.R.B. 1107, allows the following automatic changes for small business contractors:

- Changing its method of accounting for an exempt long-term contract from the PCM to the exempt contract PCM
- Choosing to stop capitalizing costs under I.R.C. § 263A (UNICAP rules) for a home construction contract

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ISSUE 2: TRANSPORTATION EXPENSES A construction contractor may deduct certain transportation expenses.

A construction contractor and its employees may have an office or other fixed place of business, and travel from the office to project sites. This section discusses when a contractor can deduct business transportation expenses, and the two available methods to calculate that deduction. This section also discusses an employer's deduction for providing employees with the use of employer-owned vehicles, and how to calculate the personal-use value of the employer-owned vehicle that must be included in the employee's income.

Allowable Transportation Expenses

I.R.C. § 162(a) allows a deduction for ordinary and necessary expenses paid or incurred during the tax year in carrying on any trade or business. I.R.C. § 262, however, provides that no deduction is allowed for personal, living, or family expenses. A construction contractor may deduct transportation expenses that are ordinarily and necessarily incurred, for example, to get from one workplace to another in the course of business, to procure supplies or equipment, or to attend meetings with customers.

The costs of commuting between the contractor's residence and place of business generally are nondeductible personal expenses under Treas. Reg. §§ 1.162-2(e) and 1.262-1(b)(5). However, there are exceptions to this general rule, which are discussed in the next section.

Example 11.7
Nondeductible Commuting Expenses

Jennifer Sullivan is a construction contractor. She has an office where she regularly meets with customers and manages all her project activities. Jennifer drives from her residence to her office and back each day. While driving, she often makes calls to schedule subcontractors and order materials. Although Jennifer is working while she is in the car, the expenses of commuting between her home and her office are nondeductible personal expenses.

Deductible Commuting Expenses

The costs of going between one business location and another business location generally are deductible under section 162(a). Also, the contractor can deduct daily transportation expenses incurred going between a residence and a temporary workplace outside the metropolitan area where the taxpayer lives and normally works. The contractor can deduct daily transportation expenses incurred going between a residence and a temporary workplace, regardless of distance, if the taxpayer has at least one regular place of business located away from the taxpayer's residence.

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Temporary Workplace

If employment at a work location is realistically expected to last (and does in fact last) for 1 year or less, the employment is temporary in the absence of facts and circumstances indicating otherwise. If employment at a work location is realistically expected to last for more than 1 year or there is no realistic expectation that the employment will last for 1 year or less, the employment is not temporary, regardless of whether it actually exceeds 1 year. If employment at a work location initially is realistically expected to last for 1 year or less, but at some later date the employment is realistically expected to exceed 1 year, that employment will be treated as temporary (in the absence of facts and circumstances indicating otherwise) until the date that the taxpayer's realistic expectation changes and will be treated as not temporary after that date [Rev. Rul. 99-7, 1991-1 C.B. 361].

Residence Is Principal Place of Business

If the contractor's residence is his or her principal place of business, the contractor may deduct expenses to go between the residence and another work location in the same trade or business, regardless of whether the other work location is regular or temporary and regardless of the distance. The residence is considered a principal place of business if it meets the requirements of I.R.C. § 280A(c)(1)(A). The term *principal place of business* includes a place of business that the taxpayer uses for the administrative or management activities of any trade or business if there is no other fixed location where the taxpayer conducts substantial administrative or management activities of that trade or business.

Example 11.8
Deductible Commuting Expenses

Tyler Stanton is an architect. He has a home office that is his principal place of business. Two or three times a week, Tyler drives out to project sites to inspect the work and consult with the contractor or owner. Tyler can deduct the expenses of his transportation between the work sites and also the transportation from the work sites to and from his home.

Deducting Transportation Expenses

Contractors that own cars, trucks, vans, or sport utility vehicles (SUVs) and use them for business purposes deduct business transportation expenses using either the business standard mileage rate (SMR) or actual costs. A taxpayer using the SMR deducts the current-year rate (56¢ per mile in 2021) times the number of business miles traveled. A taxpayer who uses the actual costs can deduct the actual costs that are allocable to business transportation, which may include operating costs, such as gasoline, oil, maintenance, and repairs; and fixed costs, such as depreciation, licensing and registration fees, personal property taxes, and insurance.

CROSS-REFERENCE

Transportation Fringe Benefits

While the Tax Cuts and Jobs Act of 2017 (TCJA), Pub. L. No. 115-97, eliminated the employer deduction for most qualified transportation fringe benefits, an employer can still deduct certain amounts paid for qualified parking. See pages 438–441 in the *2019 National Income Tax Workbook* for a discussion of transportation fringe benefits.

Standard Mileage Rate

A taxpayer who wants to use the SMR must elect it for the first year the vehicle is used for business. A taxpayer who elects to use the SMR in the first year may deduct either the SMR or actual expenses in subsequent years. However, a taxpayer who uses the SMR for a leased car must use it for the entire lease period. The business SMRs for 2019–2021 are shown in **Figure 11.2**.

FIGURE 11.2
Business Standard Mileage Rates

Year	Rate	Notice
2019	58.0¢	2019-2, 2019-02 I.R.B. 281
2020	57.5¢	2020-5, 2020-04 I.R.B. 380
2021	56.0¢	2021-2, 2021-03 I.R.B. 478

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SMR Eligibility

A taxpayer may use the business SMR to substantiate the deduction amount for an automobile that a taxpayer either owns or leases. A taxpayer cannot use the SMR in any of the following situations:

- The taxpayer owns or leases and uses five or more automobiles in the business at the same time, as in a fleet.
- The automobile is leased, and the taxpayer did not use the SMR or a fixed and variable rate allowance for the entire lease period.
- The taxpayer claimed a depreciation deduction for the automobile using any method other than straight-line (SL), including an I.R.C. § 179 deduction or bonus depreciation.
- The taxpayer has unreimbursed employee travel expenses subject to the 2%-of-AGI-floor and paid or incurred during the time that those miscellaneous itemized deductions are suspended.
- The taxpayer is a rural mail carrier employed by the US Postal Service and received a qualified reimbursement.

[Rev. Proc. 2019-46, 2019-49 I.R.B. 1301]

Additional Expenses

A taxpayer who claims the SMR may also deduct the business portion of other automobile-related expenses, including the following:

- Parking fees and tolls
- Interest paid on a loan to purchase the automobile
- State and local property taxes (other than amounts paid to acquire or dispose of the automobile, which are treated as part of the acquisition cost, or the amount realized on disposition)

[Rev. Proc. 2019-46, supra]

If the automobile is operated less than 100% for business purposes, a taxpayer must allocate the business and nonbusiness portion of the allowable deductions for interest and taxes.

Example 11.9
Prorated Interest Deduction

Eduardo Torres is a self-employed electrician. In 2021, he used his pickup truck 8,000 miles for business transportation and 2,000 miles for nondeductible commuting. He paid $1,800 in interest expense on the loan to purchase the truck and $350 for taxes and registration. Eduardo can deduct $6,200 [(8,000 business miles × 56.0¢ SMR) + ($1,800 interest × 80%) + ($350 taxes and registration × 80%)] on his Schedule C (Form 1040), Profit or Loss From Business (Sole Proprietorship).

SMR Depreciation Component

If a taxpayer uses the business SMR to compute the expense of operating an automobile for any year, a per-mile depreciation component (published by the IRS in an annual notice) is treated as the depreciation claimed by the taxpayer, and the depreciation allowable for those years in which the taxpayer used the business SMR. The depreciation component reduces the automobile's basis (but not below zero). The depreciation components for 2011–2021 are shown in **Figure 11.3**.

FIGURE 11.3
SMR Depreciation Component

Years	Rate per Mile
2011	22.0¢
2012	23.0¢
2013	23.0¢
2014	22.0¢
2015	24.0¢
2016	24.0¢
2017	25.0¢
2018	25.0¢
2019	26.0¢
2020	27.0¢
2021	26.0¢

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Example 11.10
Mileage-Based Depreciation

In 2017, Amy Liu paid $34,000 for an SUV that she used exclusively in her construction business. From 2017 through 2021, she used the SMR to calculate her automobile expense deduction on Schedule C (Form 1040). Amy sold the vehicle for $15,000 at the end of 2021, after having driven it 87,700 total miles.

I.R.C. § 1245 requires previously claimed depreciation deductions to be recaptured as ordinary income to the extent of the realized gain on disposition of the asset. Because the depreciation component of the SMR may vary each year, Amy must use her actual business mileage for each year to calculate her basis reduction, as shown in **Figure 11.4**.

FIGURE 11.4
Gain on Sale of Vehicle after Claiming SMR

	Year	Miles × Depreciation Rate	Depreciation	Adjusted Basis Calculation	Gain Calculation
Selling price					$ 15,000
Purchase price				$ 34,000	
Depreciation	2017	14,000 × 25¢	$ 3,500		
	2018	18,400 × 25¢	4,600		
	2019	19,700 × 26¢	5,122		
	2020	17,500 × 27¢	4,725		
	2021	18,100 × 26¢	4,706		
Total depreciation		87,700 miles		(22,653)	
Adjusted basis					(11,347)
Gain recognized					$ 3,653

If, after using the business SMR, the taxpayer uses actual costs, the taxpayer must use straight-line depreciation for the automobile's remaining estimated useful life, subject to the applicable depreciation deduction limitations under section 280F.

Actual Costs

To use the actual expense method, a taxpayer must determine the costs to operate the automobile for the portion of the automobile's overall use that is business use. Deductible expenses include the following:

- Gas and oil
- Maintenance and repairs
- Tires
- Registration fees and taxes
- Licenses
- Vehicle loan interest
- Insurance
- Rental or lease payments
- Depreciation (discussed next)
- Interest on the purchase
- State and local property taxes (other than on an acquisition or disposition)

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PRACTITIONER NOTE

Tolls and Parking Fees

A taxpayer who uses the SMR or the actual expense method can deduct parking fees and tolls attributable to the business use of the automobile.

Depreciation Deductions

Taxpayers who use the actual expense method can claim a depreciation deduction. Automobiles, pickup trucks, vans, and SUVs are 5-year MACRS property, and may be eligible for bonus depreciation, as well as the section 179 deduction if vehicles are used more than 50% in the active conduct of a trade or business. I.R.C. § 280F(a) limits the annual depreciation deduction (which includes the section 179 deduction) for vehicles classified as passenger automobiles, and the section 179 deduction is limited for certain SUVs. This section also discusses depreciation for heavier trucks and vans that are not subject to those limitations.

Passenger Automobiles

A passenger automobile is defined in I.R.C. § 280F(d)(5) as a four-wheeled vehicle that is manufactured primarily for use on public streets, roads, and highways, and is rated at

1. 6,000 or fewer pounds unloaded gross vehicle weight (GVW) if the vehicle is a car, or
2. 6,000 or fewer pounds GVW for vans and trucks.

The GVW can usually be found on the label attached to the inside edge of the driver's side door. It is often marked as GVWR (gross vehicle weight rating).

CROSS-REFERENCE

Personal Use of Autos

This section assumes that the taxpayer's business use of the automobile is 100%. If business use is less than 100%, the taxpayer must substantiate business use and can claim a proportionate share of the depreciation deduction. If business use falls to 50% or less, the taxpayer must recapture a portion of the claimed depreciation. See pages 197–200 in the *2015 National Income Tax Workbook* for a discussion of these rules.

Depreciation Limits

The maximum depreciation deduction depends on the date the passenger automobile was acquired and the year it was placed in service. The TCJA increased the section 280F deduction limits for most passenger automobiles (including trucks and vans) placed in service after December 31, 2017. **Figure 11.5** shows the depreciation deduction limits for passenger automobiles (including trucks and vans) placed in service in 2019, 2020, and 2021 (without bonus depreciation). The limits with bonus depreciation are discussed later.

FIGURE 11.5
Depreciation Deduction Limitations—Without Bonus Depreciation

Placed in Service	First Year	Second Year	Third Year	Later Years
2019[1]	$10,100	$16,100	$9,700	$5,760
2020[2]	$10,100	$16,100	$9,700	$5,760
2021[3]	$10,200	$16,400	$9,800	$5,860

[1] Rev. Proc. 2019-26, 2019-24 I.R.B. 1323
[2] Rev. Proc. 2020-37, 2020-33 I.R.B. 381
[3] Rev. Proc. 2021-31, 2021-34 I.R.B. 324

CROSS-REFERENCE

Earlier Depreciation Deduction Limits

See the "Tax Rates and Useful Tables" chapter in this workbook for the depreciation deduction limits for vehicles placed in service in 2018 and earlier years.

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Example 11.11
Depreciation Deduction Limit

On June 1, 2020, Francisco De Luca purchased an SUV with a 5,800-pound GVW for $60,000. He used it solely in his construction business and wants to deduct actual expenses rather than using the SMR. He did not elect the section 179 deduction and elected out of bonus depreciation.

The SUV is MACRS 5-year property, and Francisco uses the half-year (HY) convention. His MACRS 2020 depreciation deduction is $12,000 ($60,000 × 20%). However, Francisco's depreciation is limited by section 280F to $10,100.

Under I.R.C. § 168(k)(2)(F)(i), the section 280F bonus depreciation amount is increased by $8,000 per year. **Figure 11.6** shows the depreciation deduction limits for vehicles placed in service in 2019, 2020, and 2021 with bonus depreciation.

FIGURE 11.6
Depreciation Deduction Limits—With Bonus Depreciation

Placed in Service	First Year	Second Year	Third Year	Later Years
2019	$18,100	$16,100	$9,700	$5,760
2020	$18,100	$16,100	$9,700	$5,760
2021	$18,200	$16,400	$9,800	$5,860

These depreciation deduction limits apply to any accelerated cost recovery, including bonus depreciation and the section 179 deduction. The section 179 deduction is discussed later.

PRACTITIONER NOTE

Leased Automobiles

Business taxpayers may lease rather than own vehicles. The depreciation deduction limit on a leased passenger automobile for a taxpayer who uses the actual expense method is imposed indirectly through a lease inclusion amount [I.R.C. § 280F(c)]. A taxpayer leasing a passenger automobile for 30 days or longer may have to reduce each year's lease payment deduction by a specified inclusion amount. For vehicles leased and put into service in 2021, the taxpayer has a lease inclusion amount if the FMV of the vehicle was more than $51,000. Taxpayers claiming the business SMR cannot deduct a lease payment and have no inclusion amount.

CROSS-REFERENCE

Bonus Depreciation and the Section 280 Limit

Under I.R.C § 280F(a)(1)(B) any depreciation disallowed under I.R.C. § 280F(a)(1) during the regular recovery period is treated as an expense in the first year following the end of the recovery period. Because 100% bonus depreciation allows full depreciation in the first year, the disallowed depreciation in the first year is equal to the difference between the depreciation limitation and the total basis of the automobile. The full amount of depreciation limited by section 280F in year 1 cannot begin recovery until year 7 (the first year following the recovery period). This situation is ameliorated through a safe harbor in Rev. Proc. 2019-13, 2019-9 I.R.B. 744. See pages 453–455 in the *2019 National Income Tax Workbook* for a discussion of the safe harbor and an example illustrating the safe harbor.

Passenger Automobile Bonus Depreciation

Passenger automobiles typically qualify for bonus depreciation, and bonus depreciation automatically applies to eligible property. However, taxpayers may elect out of using bonus depreciation [I.R.C. § 168(k)(7)]. Electing out of bonus depreciation affects asset classes, not individual assets. Thus, if the taxpayer elects out of bonus depreciation for a passenger automobile, the election includes all MACRS 5-year assets.

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Section 179 Deduction for Passenger Automobiles

I.R.C. § 179 allows a taxpayer to elect to deduct up to $1,050,000 (for 2021) of the cost of qualifying property placed in service during the year. The section 179 deduction is phased out dollar-for-dollar if the taxpayer places more than $2,620,000 (for 2021) of qualifying property in service during the acquisition tax year. The current-year allowable deduction is limited to the taxpayer's aggregate taxable income from the active conduct of trades or businesses and any unused section 179 deduction carries forward.

The section 179 deduction is calculated first, and it reduces depreciable basis. Then, the taxpayer calculates bonus depreciation on the reduced depreciable basis. Finally, the taxpayer calculates regular depreciation after reducing basis by the section 179 deduction and bonus depreciation.

While a passenger automobile is qualifying property for purposes of the section 179 deduction, I.R.C. § 280F(d)(1) provides that any section 179 deduction for passenger automobiles is subject to the same limitations as if the section 179 deduction were allowable under I.R.C. § 168. Thus, the section 179 deduction for a passenger automobile is limited to no more than the first-year depreciation limitation plus bonus depreciation ($18,200 for 2021). The basis of the property for purposes of computing future depreciation deductions is reduced by the full amount of the section 179 deduction.

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Remaining Deduction

If a contractor makes a section 179 election for a business passenger vehicle, the contractor can deduct up to $18,200 (for 2021) and begins to deduct the remaining basis in year 7 (the first year following the recovery period subject to the $5,860 annual limit). Thus, there are no deductions in years 2–6 [See Rev. Proc. 2019-13 § 4.04, Example 2].

SUVs over 6,000 Lbs. GVW

SUVs with a GVW of more than 6,000 lbs. are exempt from the section 280F(a) limitations. Consequently, heavy SUVs used for business are depreciated using regular depreciation rules. The taxpayer may make a section 179 election for a qualifying SUV, which is as a four-wheeled vehicle primarily designed or which can be used to carry passengers over public streets, roads, or highways (but not operated exclusively on rails) that is not subject to section 280F and is rated at not more than 14,000 pounds GVW [I.R.C. § 179(b)(5)(B)].

The definition of a qualifying SUV specifically excludes vehicles that are buses, pickup trucks, and cargo vans, which are defined as follows:

- A bus is a vehicle designed to have a seating capacity of more than nine persons behind the driver's seat.
- A pickup truck is a vehicle equipped with a cargo area at least 6 feet in interior length that is an open area or is designed for use as an open area but is enclosed by a cap and not readily accessible directly from the passenger compartment.
- A cargo van is a vehicle that has an integral enclosure fully enclosing the driver compartment and load-carrying device. It does not have seating rearward of the driver's seat and has no body section protruding more than 30 inches ahead of the leading edge of the windshield.

The section 179 deduction for an SUV placed in service in 2021 is limited to $26,200. However, because an SUV that qualifies for the section 179 deduction is not subject to the section 280F limits, the taxpayer may claim 100% bonus depreciation.

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Section 179 vs. Bonus Depreciation

The limit on the section 179 deduction may be irrelevant for many taxpayers because 100% bonus depreciation is allowed on both new and used vehicles. However, the bonus depreciation decision applies to all assets within any given recovery class placed in service that year by the taxpayer. The section 179 decision is made on an asset-by-asset basis rather than a class-by-class basis.

Pickup Trucks and Cargo Vans

Most pickup trucks that are one-half ton or larger and full-size cargo vans have a GVW of more than 6,000 lbs. and are exempt from the section 280F(a) limitations. Most pickup trucks (that have at least a 6-foot bed) and cargo vans are also excluded from the section 179 limit on the deduction for SUVs. Thus, regular depreciation rules apply.

A contractor can elect to claim the section 179 deduction for a qualifying heavy business truck or cargo van (subject to the 2021 $1,050,000 limit, the business income limit, and the 2021 $2,620,000 phaseout discussed earlier). Qualifying property is tangible property acquired by purchase from an unrelated party for use in an active trade or business in the United States. The property may be new or used.

Bonus depreciation (100% in 2021) is an additional deduction after any section 179 deduction and before the taxpayer calculates regular MACRS depreciation for the year the property is placed in service. There is 100% bonus depreciation for heavier trucks and cargo vans (new or used). If the taxpayer does not want to take bonus depreciation, the taxpayer must elect out of bonus depreciation for that class of property. Electing out of bonus depreciation is performed on each separate class life of assets.

After the taxpayer deducts the bonus depreciation for qualified property, the taxpayer uses the remaining basis to calculate the regular MACRS depreciation deduction. A light general-purpose truck is a truck for use over the road and has an actual unloaded weight less than 13,000 pounds. It is 5-year property under the general depreciation system (GDS) and alternative depreciation system (ADS). A heavy general-purpose truck includes heavy general-purpose trucks, concrete ready mix-truckers, and ore trucks, for use over the road and that have an actual unloaded weight of 13,000 pounds or more. It is 5-year property under the GDS and 6-year property under the ADS.

Substantiation of Vehicle Expenses

A taxpayer who claims the business SMR must keep an account book, diary, log, statement of expense, trip sheets, or similar record to substantiate the date, destination, mileage, and business purpose of the trip. A taxpayer claiming the SMR and additional expenses, such as tolls or parking, and a taxpayer who claims actual expenses must keep similar written records, and also documentary evidence, such as receipts, canceled checks, or bills to support the purchase price of the vehicle and the expenses incurred. The written records should be created at or near the time of the business use or the time the expense is incurred. **Figure 11.7** shows a sample daily business mileage and expense log from IRS Publication 463, *Travel, Gift, and Car Expenses.*

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FIGURE 11.7
Sample Daily Business Mileage and Expense Log

Table 5-2. **Daily Business Mileage and Expense Log** **Name:**

Date	Destination (City, Town, or Area)	Business Purpose	Odometer Readings			Expenses	
			Start	Stop	Miles this trip	Type (Gas, oil, tolls, etc.)	Amount
	Weekly Total						
Total Year-to-Date							

Employee Use of Employer Vehicle

If a construction contractor provides an employee with a company vehicle that is available for the employee's personal use, the value of the personal use usually must be included in the employee's wages as a fringe benefit and is subject to both income and employment taxes. Employers must withhold federal employment taxes (and pay their share of employment taxes).

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Federal Income Tax Withholding

Employers can choose to withhold federal income taxes or can elect no withholding, but only if they timely notify employees of that election and properly include the value in boxes 1, 3, 5, and 14 of a timely provided Form W-2, Wage and Tax Statement.

The two most common methods used to determine the value of personal use are the cents-per-mile method and the annual lease value (ALV) method. There is also a commuting value method. If these valuation rules do not apply, the vehicle value to the employee may be determined under general valuation principles [i.e., the fair market value (FMV) that an individual would pay to lease such vehicle in an arm's-length transaction in the same geographic area under similar or comparable conditions] [Treas. Reg. § 1.61-21(b)(4)].

Cents-per-Mile Method

Employers may use the cents-per-mile method to value the personal use of an employer's vehicle if the employer reasonably expects that the employee will regularly use the vehicle in the employer's trade or business throughout the year (or a shorter period that the employer owns or leases the vehicle), or the vehicle is driven at least 10,000 miles primarily by employees [Treas. Reg. § 1.61-21(e)(1)]. The term *vehicle* means any motorized wheeled vehicle manufactured primarily for use on public streets, roads, and highways.

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Under the safe harbors, a vehicle is regularly used if 50% or more of the total annual mileage is business use or the vehicle is generally used each workday to transport at least three employees of the employer to and from work in an employer-sponsored commuting vehicle pool. Infrequent business use of the vehicle, such as for occasional trips to the airport or between the employer's multiple business premises, does not constitute regular use of the vehicle in the employer's trade or business.

An employer must adopt the cents-per-mile rule as of the first day that an employee uses the vehicle for personal use or the first day that the commuting valuation rule (discussed later) is not used. Once adopted, the employer must use the cents-per-mile rule for all subsequent years that it qualifies, unless the vehicle qualifies for the commuting valuation rule.

Limitations on Use of the Method

For 2021, the cents-per-mile method may be used only if the FMV of the vehicle is $51,100 or less on the day it is first made available to an employee [Notice 2021-2, 2021-03 I.R.B. 478]. The personal use of vehicles with a FMV in excess of this amount must be valued under the general valuation principles or the ALV method.

Included Expenses

The cents-per-mile rate includes the FMV of maintenance and insurance for the vehicle. With respect to miles driven in the United States, Canada, or Mexico, the cents-per-mile rate includes the FMV of fuel that the employer provides. The FMV of other services is not included.

Calculation of the Employee's Income Amount

If the requirements for the cents-per-mile method are satisfied, then an employee's taxable amount for personal use of an employer-provided automobile is calculated by multiplying the business SMR by the total miles the employee drives the vehicle for personal purposes (as substantiated in a contemporaneous written record). For 2021, the business SMR for the use of cars, vans, pickups, or panel trucks is 56¢ per mile.

Annual Lease Value Method

If the employer provides an automobile that is available to an employee for an entire calendar year, the value included in the employee's income may be calculated as the automobile's ALV less the amount that is excluded from the employee's wages as a working condition benefit. For an automobile that is available to an employee for less than an entire calendar year, the value of the benefit provided is based on either a prorated ALV or the daily lease value [Treas. Reg. § 1.61-21(d)(1)]. For purposes of the ALV, the term *automobile* means any four-wheeled vehicle manufactured primarily for use on public streets, roads, and highways.

Employers may adopt the ALV method on the first day on which the automobile is made available to an employee for personal use (or the first day on which the commuting valuation rule, discussed later, is not used). An employer must use the ALV rule for all subsequent years unless the automobile qualifies for the commuting valuation rule.

LAW CHANGE

COVID-19 Relief

A special pandemic relief rule in 2020 allowed certain employers using the ALV method to change to the cents-per-mile method beginning March 13, 2020. Those employers could continue using that method or change back to the ALV method for 2021 [Notice 2021-7, 2021-03 I.R.B. 482].

Calculation of ALV

The ALV of an automobile is calculated by first determining the vehicle's FMV as of the first day that the vehicle is made available to the employee and then using the table in the regulations to find the ALV that corresponds to the vehicle's FMV [Treas. Reg. § 1.61-21(d)(2)(i)]. **Figure 11.8** shows the ALV table included as Table 3-1 in IRS Publication 15-B (2021), *Employer's Tax Guide to Fringe Benefits*. Generally, the vehicle's FMV is the arm's-length amount to purchase the vehicle in that jurisdiction, including all amounts attributable to the purchase, such as sales tax and title fees [Treas. Reg. § 1.61-21(d)(5)(i)]. A safe harbor determines FMV of an employer-owned vehicles as the arm's-length purchase price.

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FIGURE 11.8
Annual Lease Value Table

Automobile FMV	Annual Lease Value
$0 to $999	$600
1,000 to 1,999	$850
2,000 to 2,999	$1,100
3,000 to 3,999	$1,350
4,000 to 4,999	$1,600
5,000 to 5,999	$1,850
6,000 to 6,999	$2,100
7,000 to 7,999	$2,350
8,000 to 8,999	$2,600
9,000 to 9,999	$2,850
10,000 to 10,999	$3,100
11,000 to 11,999	$3,350
12,000 to 12,999	$3,600
13,000 to 13,999	$3,850
14,000 to 14,999	$4,100
15,000 to 15,999	$4,350
16,000 to 16,999	$4,600
17,000 to 17,999	$4,850
18,000 to 18,999	$5,100
19,000 to 19,999	$5,350
20,000 to 20,999	$5,600
21,000 to 21,999	$5,850
22,000 to 22,999	$6,100
23,000 to 23,999	$6,350
24,000 to 24,999	$6,600
25,000 to 25,999	$6,850
26,000 to 27,999	$7,250
28,000 to 29,999	$7,750
30,000 to 31,999	$8,250
32,000 to 33,999	$8,750
34,000 to 35,999	$9,250
36,000 to 37,999	$9,750
38,000 to 39,999	$10,250
40,000 to 41,999	$10,750
42,000 to 43,999	$11,250
44,000 to 45,999	$11,750
46,000 to 47,999	$12,250
48,000 to 49,999	$12,750
50,000 to 51,999	$13,250
52,000 to 53,999	$13,750
54,000 to 55,999	$14,250
56,000 to 57,999	$14,750
58,000 to 59,999	$15,250
More than 59,999	(25% × FMV) + $500

Recalculation of the ALV

Under Treas. Reg. § 1.61-21(d)(2)(iv), the ALVs are based on 4-year lease terms. Therefore, the ALV remains in effect for the period that begins with the first date the employer applies the ALV to the automobile and ends on December 31 of the fourth full calendar year following that date.

The ALV for each subsequent 4-year period is calculated by determining the FMV of the automobile as of the first January 1 following the preceding 4-year period and selecting the corresponding amount in the annual lease value table. Under the safe harbor, the recalculated FMV may be determined by using the vehicle's retail value as reported in a nationally recognized pricing source that regularly reports new or used automobile retail values [Treas. Reg. § 1.61-21(d)(5)(iii)].

Included Expenses

The ALV includes the FMV of maintenance and insurance for the automobile. The FMV of fuel provided by the employer must be valued separately. The FMV of other services that the employer provides must also be added.

Calculation of the Employee's Income Amount

I.R.C. § 132(a)(3) provides that gross income does not include any fringe benefit that qualifies as a working condition fringe. A working condition fringe means any benefit provided to an employee of the employer to the extent that, if the employee paid for the benefit, the payment would be allowable as a deduction under I.R.C. § 162 or 167. Employers that provide vehicles for their employees' use can exclude as a working condition fringe the amount that would be allowable as a deductible business expense if the employee paid for its use.

If the employee uses the vehicle for both business and personal use, the value of the working condition fringe is the part determined to be for business use of the vehicle. Thus, the employer generally reduces the lease value by the amount that is business use of the automobile. The employee must account to the employer for the business use by keeping a contemporaneous log or other written record to substantiate the usage (mileage, for example), the time and place of the travel, and the business purpose of the travel.

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Commuting Valuation Rule

An employer can use the commuting valuation rule if all the following requirements are met:

1. The employer owns or leases the vehicle and provides it to one or more employee for use in the employer's trade or business and it is used in that trade or business.
2. For bona fide noncompensatory business reasons, the employer requires the employee to commute in the vehicle.
3. The employer established a written policy that prohibits the employee, and any individual whose use would be taxable to the employee, from using the vehicle for personal purposes other than for commuting or de minimis personal use (such as a stop for a personal errand on the way between a business delivery and the employee's home).
4. The employee does not use the vehicle for personal purposes other than commuting and de minimis personal use.
5. The employee is not a control employee (defined later).

[Treas. Reg. § 1.61-21(f)]

Under the commuting valuation rule, the employer determines the value of a vehicle provided to an employee for commuting use by multiplying each one-way commute (from home to work or from work to home) by $1.50. If more than one employee commutes in the vehicle, this value applies to each employee. This amount must be included in the employee's wages or reimbursed by the employee and includes any employer-provided goods or services such as fuel.

The following are control employees of a nongovernment employer in 2021:

- Board or shareholder-appointed, confirmed, or elected officers of the employer whose compensation is $115,000 or more
- Directors of the employer
- Employees whose compensation is $235,000 or more
- Employees who own a 1% or greater equity, capital, or profits interest in the employer (attribution rules apply)

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ISSUE 3: MEAL AND ENTERTAINMENT EXPENSES Construction contractors may deduct certain business meal and entertainment expenses.

A construction contractor may incur business meal and entertainment expenses. The contractor may, for example, provide meals to employees at a remote work site, dine with prospective customers or project managers or subcontractors, or have a holiday party for employees. This section discusses the deduction for food or beverage expenses and an exception to the disallowance of the deduction for entertainment expenses.

General Rules

In general, I.R.C. § 274 limits or disallows deductions for certain meal and entertainment expenditures that otherwise would be allowable under chapter 1 of the Internal Revenue Code, primarily under section 162(a), which allows a deduction for ordinary and necessary expenses paid or incurred during the tax year in carrying on any trade or business.

Limit on Lavish Meals

I.R.C. § 274(k) provides that, with limited exceptions, a deduction for any business meals is allowed only if (1) the expense is not lavish or extravagant under the circumstances and (2) the taxpayer (or employee of the taxpayer) is present at the furnishing of the food or beverages. Under the final regulations (T.D. 9925), no deduction is allowed for the expense of any food or beverages provided by the taxpayer (or an employee of the taxpayer) unless

1. the expense is not lavish or extravagant under the circumstances;
2. the taxpayer, or an employee of the taxpayer, is present at the furnishing of such food or beverages; and
3. the food or beverages are provided to the taxpayer or a business associate.

50% Limit on Meals

I.R.C. § 274(n)(1), again with limited exceptions, limits the deduction for any expense for food or beverages to no more than 50% of the expense that otherwise would be allowed. The final regulations define *food or beverages* as all food and beverage items, regardless of whether they are characterized as meals, snacks, or other types of food and beverages, and regardless of whether the food and beverages are treated as de minimis fringes under I.R.C. § 132(e). The regulations define *food or beverage expenses* to mean the cost of food or beverages, including any delivery fees, tips, and sales tax.

CROSS-REFERENCE

100% Limit for 2021 and 2022

The Taxpayer Certainty and Disaster Tax Relief Act of 2021, Pub. L. 116-260, § 210, added I.R.C. § 274(n)(2)(D), allowing a 100% deduction for food and beverages provided by a restaurant after December 31, 2020, and before January 1, 2023. See the "New and Expiring Legislation" chapter in this workbook for a discussion of the temporary deduction.

CROSS-REFERENCE

Exceptions to the Limitations

The limitations on the deduction of food or beverage expenses in sections 274(k)(1) (no deduction for lavish business meals or if the taxpayer or an employee is not present) and (n)(1) (the 50% limit) do not apply if the expense is described in paragraph (2), (3), (4), (7), (8), or (9) of section 274(e). The exceptions to the limitations that may be applicable to a construction contractor are discussed in this section. See pages 238–240 in the *2020 National Income Tax Workbook* for a discussion of all the exceptions to the two limitations on meal expense deductions.

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Section 274(a) Limit on Entertainment

I.R.C. § 274(a) disallows a deduction for an activity or facility that qualifies as entertainment, amusement, or recreation. The disallowance does not apply to food and beverages furnished on the business premises of the taxpayer primarily for employees, certain recreational expenses for employees, expenses treated as compensation, reimbursed expenses (discussed later), and certain other expenses described in section 274(e).

Work Site Meals

A construction contractor may provide meals for its employees on a job site. The fair market value (FMV) of meals an employer provides to an employee may be excluded from the employee's gross income as a de minimis fringe benefit [I.R.C. § 132(a)(4)] or under the I.R.C. § 119(a) exclusion for meals furnished at the convenience of the employer. The Tax Cuts and Jobs Act of 2017 (TCJA), Pub. L. No. 115-97, repealed the exception to section 274(n) for de minimis fringe meals, and with limited exceptions, an employer's deduction for the cost of providing meals, regardless of whether they are de minimis, is limited to 50% of the cost.

Under section 119, meals furnished on the employer's premises (that is, the employee's place of work) and for the convenience of the employer are excluded from income. The employee cannot be given an option to receive additional pay instead of meals.

In tax years after 2025, I.R.C. § 274(o) eliminates the deduction for section 119(a) meals that are furnished on the business premises, for the convenience of the employer. Thus, in 2020 through 2025, the employer can deduct 50% of the cost of these meals, and the employee can exclude these amounts from income. If the expenses meet the requirements for exclusion under section 119(a), after 2025 no deduction will be allowed.

PRACTITIONER NOTE

Meal Expenses Included in Income

If the employer furnishes meals to employees on the business premises, and the meals are included in the employee's income, the employer may be able to deduct 100% of the cost of the meals. See the later discussion of meals that are included in compensation.

Meals must be furnished to an employee, which excludes certain partners in partnerships and S corporation owner/shareholders (discussed later), for a substantial noncompensatory business reason. A construction contractor furnishes meals for the employer's convenience if the nature of the business restricts an employee to a short meal (30 to 45 minutes) and employees cannot be expected to eat elsewhere during the short period or if the employees could not otherwise eat proper meals within a reasonable period because there are insufficient eating facilities near the job site.

Example 11.12
Meals Furnished at Remote Location

Big Bend Construction is building a house for a customer on 160 acres outside of Jackson Hole, Wyoming. The construction site is accessed by a 20-mile dirt road, and it is 25 miles from the nearest eating establishment. Big Bend purchases ready-to-eat boxed lunches from a grocery store and delivers them to its employees working at the site. Due to the location of the site, the employees could not eat proper meals within a reasonable period. The employees can exclude the value of the meals from their income, and Big Bend Construction can deduct 50% of the cost of the meals. If instead Big Bend purchased meals from a restaurant, it could deduct 100% of the cost of the meals.

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Business Meals and Entertainment

A construction contractor may provide meals to a business associate. *Business associate* means a person with whom 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. Provided that the other requirements of section 162 (ordinary and necessary expense) and section 274 are met (not lavish and the taxpayer or an employee is present), the contractor can deduct 50% of the cost of the meal (100% for restaurant meals in 2021 and 2022).

Entertainment

The term *entertainment* means any activity that is generally considered to constitute entertainment, amusement, or recreation (such as entertaining at bars, theaters, country clubs, golf and athletic clubs, sporting events), and on hunting, fishing, vacation, and similar trips, including such activity relating solely to the taxpayer or the taxpayer's family. These activities are treated as entertainment regardless of whether they are related to or associated with the active conduct of the taxpayer's trade or business. Thus, the contractor cannot deduct the costs of entertainment provided to a business associate, even if the purpose of the entertainment activity is to conduct business.

Meals during an Entertainment Activity

The final regulations provide that for purposes of section 274(a), the term *entertainment* does not include food or beverages unless the food or beverages are provided at or during an entertainment activity and the costs of the food or beverages are not separately stated from the entertainment costs. Food or beverages provided at or during an entertainment activity generally are treated as part of the entertainment activity.

However, the food or beverages are not considered entertainment if the food or beverages are purchased separately from the entertainment, or the cost of the food or beverages is stated separately from the cost of the entertainment on one or more bills, invoices, or receipts. The amount charged for food or beverages on a bill, invoice, or receipt must reflect the venue's usual selling cost for those items if they were to be purchased separately from the entertainment or must approximate the reasonable value of those items.

If the food or beverages are not purchased separately from the entertainment, or the cost of the food or beverages is not stated separately from the cost of the entertainment on one or more bills, invoices, or receipts, no allocation between entertainment and food or beverage expenses may be made and, with some exceptions, the entire amount is a nondeductible entertainment expenditure.

Recreational Expenses for Employees

A construction contractor may hold a holiday party, picnic, summer outing, or other event in which the contractor provides food and beverages. Pursuant to section 274(e)(4), the final regulations provide that any food or beverage expense paid or incurred by a taxpayer for a recreational, social, or similar activity, primarily for the benefit of the taxpayer's employees, is not subject to the deduction limitations in section 274(k)(1) and (n)(1). Similarly, these events are not subject to the disallowance for entertainment expenses. Thus, the contractor can deduct 100% of the cost of the food and beverages if it is an ordinary and necessary business expense.

Activities that discriminate in favor of highly compensated employees, officers, shareholders, or others who own a 10% or greater interest in the business are not considered paid or incurred primarily for the benefit of employees. For purposes of this exception, an employee owning less than a 10% interest in the taxpayer's trade or business is not considered a shareholder or other owner. An employee is treated as owning any interest owned by a member of the employee's family [within the meaning of section I.R.C. § 267(c)(4)].

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PRACTITIONER NOTE

Excluded Meals

The deduction exception for recreational or social activities does not apply to expenses for meals if the value of the meal is excluded from employees' income under section 119. Meals that are provided for the convenience of the employer are not primarily for the benefit of the taxpayer's employees.

The following examples illustrate the deduction exception for employee recreational expenses. They assume that the amounts incurred are ordinary and necessary business expenses under section 162.

Example 11.13 Recreational Expenses (No Discrimination)

Ambient Electric hosts a holiday party for its employees in a hotel ballroom. There is a buffet dinner and an open bar. The cost of the party, including food and beverage expenses, is not subject to the deduction limitations because the holiday party is a recreational, social, or similar activity primarily for the benefit of non–highly compensated employees. Thus, Ambient may deduct 100% of the cost of the party [Treas. Reg. § 1.274-12(c)(2)(iii)(B), Example 1].

Example 11.14 Recreational Expenses (Discrimination)

The facts are the same as in Example 11.13, except that Ambient invites only highly compensated employees to the holiday party, and the invoice that the hotel provides lists the costs for food and beverages separately from the cost of the rental of the ballroom. The costs reflect the venue's usual selling price for food or beverages. The recreational expense exception does not apply to the rental of the ballroom or the food and beverage expenses because Ambient invited only highly compensated employees to the holiday party.

However, the food and beverage expenses are not treated as entertainment expenses. Therefore, Ambient is not subject to the full disallowance for its separately stated food and beverage expenses. Unless another exception applies, Ambient can deduct 50% of the food and beverage expenses (100% if the food and beverages are provided by the hotel restaurant), the section 274(k)(1) limits apply, and it cannot deduct the ballroom rental fees [Treas. Reg. § 1.274-12(c)(2)(iii)(B), Example 2].

Example 11.15 Client Dinner

Olivia Jensen is a landscape architect. She invited an employee and a client to dinner at a restaurant. Because it was the employee's birthday, Olivia ordered a special dessert in celebration. Because the meal is a business meal and is not primarily for the benefit of the employee, the employee recreational expenses exception does not apply, even though an employee social activity (the birthday celebration) occurred during the meal. Unless another exception applies, Olivia may deduct only 50% of the meal expense (100% in 2021 and 2022), and the section 274(k)(1) limits apply [Treas. Reg. § 1.274-12(c)(2)(iii)(B), Example 5].

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Meal Expenses Treated as Compensation

I.R.C. §§ 274(e)(2) and (e)(9) provide exceptions from the limitations on meal deductions for meal expenses that are treated as compensation of an employee or other service provider. For an employee, the employer must treat the expense as employee compensation on the employee's tax return, and as wages to an employee for purposes of withholding. For an independent contractor, the expense is excepted if it is properly included in the worker's income as compensation or a prize or award or the payer must include the amount on an information return (or it is less than $600).

If only a portion of an expense is excluded from income, or partially included in compensation and wages, the exception applies only to the extent that the amount is treated as compensation and wages to the employee (plus any amount that the recipient reimburses the payer).

Example 11.16
Full Amount Treated as Compensation

Gator, Builders, Inc. provides food and beverages to its individual employees without charge at the construction job site. The food and beverages do not meet the definition of a de minimis fringe or meals provided at the convenience of the employer, so the costs are not excluded from an employee's income.

Gator treats the full FMV of the food and beverage expenses as compensation and wages, and properly determines this amount under Treas. Reg. § 1.61-21. Under section 274(e)(2) and Treas. Reg. § 1.274-12(c)(2)(i)(A), the expenses associated with the food and beverages provided to the employees are not subject to the 50% deduction limitation. Thus, Gator Builders may deduct 100% of the food and beverage expenses [Treas. Reg. § 1.274-12(c)(2)(i)(E), Example 1].

Example 11.17
Employee Partially Pays

The facts are the same as in Example 11.16, except that each employee pays $8 per day for the food and beverages. The FMV of the food and beverages is $10 per day, per employee.

Gator incurs $9 per day, per employee for the food and beverages. Gator treats the food and beverage expenses as compensation and wages, and properly determines the amount of the inclusion under Treas. Reg. § 1.61-21 to be $2 ($10 FMV − $8 reimbursed by the employee) per day, per employee. Therefore, Gator Builders can deduct 100% of the food and beverage expenses, or $9 per day, per employee [Treas. Reg. § 1.274-12(c)(2)(i)(E), Example 2].

Example 11.18
Meals Excluded from Employee Income under I.R.C. § 119

Holly Stewart is a plumbing contractor. She provides meals to her employees without charge when the employees are working at remote job sites with no available eating facilities. The meals are properly excluded from the employees' income under section 119 as meals provided for the convenience of the employer.

Because the entire value of the employees' meals is excluded from the employees' income, there is nothing to be included in the employees' income under Treas. Reg. § 1.61-21. Thus, the exception for meals included in compensation does not apply and, assuming no other exceptions apply, Holly can deduct only 50% of the expenses for the food and beverages that she provides to her employees [Treas. Reg. § 1.274-12(c)(2)(i)(E), Example 3].

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Reimbursed Meal Expenses

I.R.C. § 274(e)(3) provides an exception for food or beverage expenses incurred by one person for the performance of services for another person under a reimbursement or other expense allowance arrangement. This exception does not eliminate limitations on the deduction but instead changes the taxpayer who is subject to the limitation.

If an employee pays or incurs food or beverage expenses while performing services as an employee, and the employer reimburses those expenses under a reimbursement or other expense allowance arrangement, the limits apply

- to the employee to the extent that the employer treats the reimbursement as compensation and wages to the employee, or
- to the employer to the extent that the employer does not treat the reimbursement as compensation and wages to the employee.

Similarly, for food or beverage expenses paid or incurred while performing services as an independent contractor, the limitations apply to the party that is identified in an agreement between the parties as subject to the limitations. If an agreement does not identify which party is subject to the limitations, then the deduction limitations apply

- to the independent contractor to the extent that he or she does not account to the client or customer, or
- to the client or customer if the independent contractor accounts for the expenses with substantiation that satisfies section 274(d) (generally the amount, date, and business purpose of the expense).

[Treas. Reg. § 1.274-12(c)(2)(ii)]

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ISSUE 4: EMPLOYEE OR INDEPENDENT CONTRACTOR CLASSIFICATION

This section reviews how a construction contractor determines if a worker is an employee or an independent contractor.

A construction contractor typically has both employees and independent contractors (usually called subcontractors). If a worker is an employee, the employer is responsible for withholding income tax and the employee share of FICA taxes, and the employer must pay a matching share of FICA taxes. The employer must also pay federal and state unemployment taxes and workers' compensation and may have to provide health coverage under the Affordable Care Act (ACA), Pub. L. No. 111-148.

Businesses that hire independent contractors must report compensation paid to those contractors on Form 1099-NEC, Nonemployee Compensation. An independent contractor must pay his or her own income and self-employment (SE) tax.

Common-Law Factors

Generally, a worker is an independent contractor if the person for whom the worker performs services has the right to control and direct the worker, not only as to the result to be accomplished by the work, but also as to the details and means by which the result is accomplished [Treas. Reg. §§ 31.3401(c)-1(b) and 31.3121(d)-1(c)(2)].

Rev. Rul. 87-41, 1987-1 C.B. 296, outlines 20 common-law factors, drawn from prior rulings and case law, that help determine whether a worker is an employee. To clarify their application, the IRS sorts these factors into the following three categories:

1. Behavioral control
2. Financial control
3. Relationship of the parties

The importance of individual factors in the three categories depends on the occupation and the factual context in which the services are performed. No single factor is decisive. Taxpayers must consider each factor and document their reasoning for the conclusions that they reach. The following discussion reviews some of the more common factors in each of the three categories.

Behavioral Control

Behavioral control considers whether the business has the right to direct and control how and when the work is done. More control by the business makes it more likely that the worker is an employee. Two key elements of behavioral control are instructions and training. The more detailed the instructions are, the more control the business exercises over the worker. Factors to consider include the following:

- Does the business tell the worker only what should be done, rather than how it should be done?
- Can a worker choose where to purchase supplies and equipment, or what assistants to hire to complete the job?
- Can the worker choose what tools to use, or how, where, and when to do the work?
- What is the basis for evaluating the worker and the work product? (Is the end result all that counts?)
- Does the business provide or require training? When a business trains the worker to do a job in a particular manner, it often indicates an employer-employee relationship. If the training includes company procedures and methods, the evidence of an employer-employee relationship is even stronger.

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Financial Control

A business has financial control if it controls the financial aspects of the worker's job. Factors to consider include the following:

- Who purchases the tools and equipment? A significant investment by the worker is certainly a factor, but it is not necessarily a defining one. Some mechanics and construction workers who are employees spend large amounts of money on tools and equipment. Some independent contractors have little invested in equipment because of the nature of their work.
- Who pays the expenses? Employers do not always reimburse employees for expenses, but the worker who incurs a large amount of unreimbursed business expenses is more likely to be an independent contractor.
- Does the worker have an opportunity for profit or loss? Employees are frequently paid by the unit (such as an hour, a week, or an amount produced). Independent contractors often charge a flat fee for an entire project, and they generate a profit or a loss based on expenses they incur in relation to the flat fee.

Relationship of the Parties

On its own, a written contract stating that the worker is not an employee is not sufficient evidence for the IRS to accept a worker's status, but an agreement between the worker and the business can be significant if it is difficult to determine the worker's status after examining the other facts. Factors to consider include the following:

- Does the business provide employee-type fringe benefits (e.g., vacation pay, insurance, and retirement plan contributions) to the worker?
- How long has the work relationship continued, and is it exclusive?
- Are the services provided by the worker a key aspect of the payer's normal business activity?
- Are the services provided by the worker available to others?
- Does the worker advertise and maintain a business location?

PRACTITIONER NOTE

Request for Determination

If a business cannot determine whether a worker qualifies as an independent contractor after weighing the facts and circumstances, either the business or the worker can file Form SS-8, Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding, to request a ruling. Most states also have a procedure to request a determination that a worker is an independent contractor and no workers' compensation insurance is required.

Construction Industry Case Law

Independent contractor classification requires examination and documentation of the facts and circumstances of each case. The following are examples from cases and rulings that are specific to the construction industry. These cases are summarized to illustrate how to classify a construction worker. Some of these cases have had subsequent proceedings on other procedural and factual issues.

Independent Contractor Classification

In the following cases, the courts held that a worker was an independent contractor.

Kurio v. United States

Kurio, a construction contractor, subcontracted drywall work or construction from house and apartment builders. He furnished materials for the construction work but arranged with others to haul or truck the materials to the jobs. The workers (known as hangers, tapers, floaters, and sanders) actually fabricated the materials into walls, and others cleaned up and hauled or trucked trash from the jobs after completion of the drywall construction on the jobs. They furnished their own tools and vehicles.

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Kurio did not determine or have the right to determine the particular worker who would perform the hanging, taping, floating, and sanding work contracted to be done. He did not control or have the right to control the hours the workers worked, when they did the work, how many days a week they worked, how many hours a day they worked, how they went about doing the work, or anything regarding the actual manner and means of accomplishing their work. The workers planned and attended to all of the details regarding the manner and means of accomplishing their work. The opportunity for profit or risk of loss from the operations of the drywall workers and haulers was in their hands alone.

Further, each drywall construction job was of comparatively short duration and the workers were free to accept other jobs with other contractors on completion of the job. There was no permanent relationship. Kurio filed and issued Forms 1099 for all the workers. The court found that the relationship was one of contractor-subcontractor and that Kurio was entitled to a refund of erroneously assessed FICA, FUTA, and withholding taxes [*Kurio v. United States*, 281 F. Supp. 252 (S.D. Tex. 1968)].

Tristate Developers v. United States

Tristate, a home improvement contractor, primarily installed siding and roofing on homes. Tristate used salespersons to obtain the contracts, and applicators (installers) to perform the labor. Occasionally, the work orders would specify start and completion dates, but generally the timing of work performance was left to the applicators.

Tristate had the right to control only the result to be accomplished by the applicators; it did not have the right to control the manner and method in which the work was to be performed. The applicators were free to accept work orders of a similar kind from competitors. The applicators had their own tools, equipment, and transportation. They employed their own workers. They were paid upon job completion.

Tristate briefly posted advertising signs at the jobsite and had one applicator and his helper wear uniforms with Tristate's name on them. It quickly abandoned its advertising efforts. Tristate had job expediters on site, but their basic functions were to remedy problems of uncollected bills and complaints over poor workmanship, to assess problems (such as undetected rot) that arose during a job, to arrange bank financing for customers, to verify the quantity of materials needed, and generally to keep the jobs moving to an expeditious conclusion.

Accordingly, the court found that the applicators were independent contractors, and Tristate was not required to withhold taxes on wages paid [*Tristate Developers. v United States*, 549 F.2d 190 (Ct. Cl. 1977)].

Beyer v. United States

The plaintiffs did business as Penn Aluminum Construction Company, which was engaged in the structural renovation, repair, and improvement of residences in Pennsylvania and the surrounding states. For each job, Pen Aluminum prepared a work order that contained information on the name, address, and telephone number of the homeowner, a general description of the work to be done, and a description of the kind, size, color, and location of material to be applied. It then assigned the work order to applicators, who would perform the work.

Penn Aluminum had a regular force of applicators who were full-time employees and whose status was not at issue. However, when the regular force could not handle all the work orders, the company engaged four additional applicators for the excess work.

The applicators had to furnish their own trucks, tools, and equipment. The contract recited that the applicator performed the work as an independent contractor and had to carry liability insurance. There were no time limits on commencement or completion of the job, and working hours were not specified. Penn Aluminum expected the work to be done within a reasonable time.

Penn Aluminum furnished the materials and displayed a sign at the jobsite with its name. However, all work was performed away from Penn Aluminum's premises, and the company did not employ any supervisors or other personnel at the jobsites to direct the manner or method by which the jobs progressed. The company did not give the applicators any instructions other than the work order for the job.

The court found that the applicators were independent contractors [*Beyer v. United States*, 41 A.F.T.R.2d (RIA) 78-930 (Ct. Cl. Tr. Div. 1978)].

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Jones v. Commissioner

Uriah Jones, a marble and tile installer, was hired to do tiling work for a condominium renovation. The contractor paid him a set price. The contractor provided the tile, but Uriah provided all his own tools and supplies such as grout and glue. The contractor did not reimburse him for the supplies.

Initially, Uriah set his own hours of work on the condominium renovation. However, following a dispute with the contractor regarding the hours worked, Uriah agreed to maintain a fixed work schedule of 10:30 a.m. to 4:30 p.m. Despite this, Uriah was free to complete the contract work by the means and methods of his choice.

That same year, Uriah did work for three other companies that all treated him as an employee. The contractor issued him Form 1099-MISC after he had filed his tax return. He did not amend the return to include the income from the condo project.

The court found that, considering all the evidence, Uriah was an independent contractor, and he was responsible for self-employment tax [*Jones v. Commissioner*, T.C. Memo. 2007-249].

Employee Classification

In the following cases, the courts held that a worker was an employee.

Chase Mfg. v. United States

Chase Manufacturing Company operated a home improvement business that engaged primarily in the sale and installation of aluminum siding. Chase engaged applicators to install the siding. Chase found the applicators by advertising in the "help wanted" section of the newspaper, word of mouth, and referrals from its suppliers.

Chase did not train applicators or give them instructions as to the manner of installation. When an applicator was hired for the first time, the Chase owner, or a salesperson, stopped by to check the progress of the job. Once the owner was familiar with the applicator's work, the visits were less frequent. Chase did not inspect or approve the jobs prior to completion.

Applicators supplied their own tools, equipment, and trucks to haul tools, equipment, and materials to a job site. However, if the applicator needed assistance, Chase provided it. Applicators were paid by the job, based on the quantity of materials used. Occasionally, applicators would draw against a job that was not yet completed. The company paid holiday bonuses to several applicators, and occasionally paid bonuses for a special job.

Applicators determined their own hours, and when they would start and finish a job. They were expected, however, to start a job soon after accepting it. Applicators did not refuse jobs; if such refusals were numerous, however, Chase probably would not offer them regular work. Of the two applicators whose depositions were introduced in court, neither advertised their services to the general public. One worked exclusively for Chase. The other did occasional small jobs on his own, usually on weekends, but the majority of his income was from work for Chase. The applicators determined their own vacation schedule.

Chase carried worker's compensation insurance for all its applicators. Chase also carried liability insurance.

The court concluded that, considering all the factors, the applicators were employees because they worked almost exclusively for company, profits were not dependent on their own managerial skills but on the number of jobs performed for company, and Chase did not establish that it retained the right to discharge the applicators [*Chase Mfg. v. United States*, 446 F. Supp. 698 (E.D. Mo. 1978)].

Ramirez v. Commissioner

Juan Ramirez operated a waterproofing business. Ramirez controlled each job site, delegated responsibilities, and directed each of his three worker's actions to varying degrees based on the individual worker's respective experience. He also provided all materials for each job and reimbursed his workers for expenses on the job. Further, there was a lack of an opportunity for profit or loss on the part of the workers. The workers were employees of the taxpayer's waterproofing business, not independent contractors [*Ramirez v. Commissioner*, T.C. Memo. 2007-346].

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Klingler v. U.S.

Arthur Klingler was a carpentry contractor in Iowa. He hired workers using newspaper ads and paid them an hourly rate, although he occasionally paid them by the job. Arthur provided the major tools and equipment, and the workers supplied their own hand tools.

Arthur could suggest methods for doing particular jobs. He trained inexperienced workers and supervised the general appearance of the work site. He could move workers from one job to another and had the power to hire and fire the workers. Generally, the workers worked full-time for him and did not attempt to find other work. When one job ended, workers expected to be and were taken to the next job. He provided liability insurance for all the workers.

The court found that one worker who owned his own carpentry business and worked on his own time was an independent contractor. The court found that the other workers were employees as they worked under Arthur's supervision and control in the course of his business [*Klingler v. United States*, 42 A.F.T.R. 2d (RIA)78-5997 (D.C. Iowa 1978].

McCombs v. United States

William C. McCombs, Inc. conducted a home improvement business, and a substantial part of its business was applying new siding or roofing to the homes of its customers. To perform the actual labor, McCombs used siding installers, called applicators, who were compensated on a piecework basis (e.g., a certain rate per square of siding applied). They were paid every Friday, regardless of whether the work was completed.

All contracts with the applicators were oral and there was no guarantee of a definite number of jobs, although they would sometimes be told that there was work throughout the year and that they would get work when it was available. There was no agreement preventing applicators from working for other contractors between jobs for McCombs, and some did. McCombs delivered all materials to the jobsite. The applicators generally owned their own trucks and tools, but McCombs would lend tools to any applicator who did not have them.

Business signs were displayed at the jobsites indicating that McCombs Company was the contractor engaged by the homeowner. The applicators wore uniforms, supplied by McCombs, that said "Wm. C. McCombs Co. Inc. Roofing and Siding." McCombs also arranged with several of the applicators to display its advertising on their own trucks.

McCombs employed salaried supervisors who would frequently visit the job sites, to ensure competent performance and, if necessary, to instruct an applicator in certain techniques and procedures. McCombs occasionally fired an applicator before completion of the job because of personal conduct or poor performance.

McCombs paid part of the premiums for those applicators who participated in the company's group health and group life insurance programs. In certain instances, some applicators received a lump sum bonus that was usually referred to as vacation pay.

The court found that given all the factors, in particular the degree of control, the applicators were employees [*McCombs v. United States*, 436 F.2d 979 (Ct. Cl. 1971)].

Independent Contractor Reporting

Prior to 2020, an independent contractor's compensation was reported on a Form 1099-MISC, Miscellaneous Income. In 2020, the IRS introduced the new Form 1099-NEC, Nonemployee Compensation, specifically for reporting independent contractor income. Form 1099-NEC is shown in **Figure 11.9**.

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FIGURE 11.9
Form 1099-NEC (Nonemployee Compensation)

7171 ☐ VOID ☐ CORRECTED

PAYER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no.		OMB No. 1545-0116 2021 Form 1099-NEC	Nonemployee Compensation
PAYER'S TIN	RECIPIENT'S TIN	1 Nonemployee compensation $	Copy A For Internal Revenue Service Center File with Form 1096.
RECIPIENT'S name		2 Payer made direct sales totaling $5,000 or more of consumer products to recipient for resale ☐	For Privacy Act and Paperwork Reduction Act Notice, see the 2021 General Instructions for Certain Information Returns.
Street address (including apt. no.)		3	
City or town, state or province, country, and ZIP or foreign postal code		4 Federal income tax withheld $	
Account number (see instructions)	2nd TIN not. ☐	5 State tax withheld $ $	6 State/Payer's state no.
			7 State income $ $

Form 1099-NEC Cat. No. 72590N www.irs.gov/Form1099NEC Department of the Treasury - Internal Revenue Service

Do Not Cut or Separate Forms on This Page — Do Not Cut or Separate Forms on This Page

With limited exceptions, taxpayers must file Form 1099-NEC (and furnish a copy to the recipient) if, in the course of a trade or business, they make at least a $600 payment for

1. services performed by a nonemployee, including parts and materials;
2. fish (or other aquatic life) purchased from anyone engaged in the trade or business of catching fish; or
3. services of an attorney or law firm.

Thus, construction contractors must file Form 1099-NEC and furnish a copy to each independent contractor to whom they paid at least $600, including parts and materials. The construction contractor must file and furnish the form by January 31 for the previous calendar year.

CROSS-REFERENCE

Backup Withholding

The taxpayer must also file Form 1099-NEC for each person from whom he or she has withheld any federal income tax (reported in box 4) under the backup withholding rules, regardless of the amount of the payment. See pages 221–222 in the *2018 National Income Tax Workbook* for a discussion of backup withholding.

Section 530 of the Revenue Act of 1978, Pub. L. No. 95-600, as extended by section 269(c) of the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, may grant relief from the classification of an employee as an independent contractor if the employer had a reasonable basis for not treating the worker as an employee. To qualify for relief under section 530, employers must file Form 1099-NEC. Additional requirements for relief are discussed in Rev. Proc. 85-18, 1985-1 C.B. 518.

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PAYROLL AND TAX CREDIT ISSUES

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LEARNING OBJECTIVES

After completing this session, participants will be able to perform the following job-related actions:

- ✔ Understand an employer's tax withholding and deposit obligations
- ✔ Know how an employee, employer, or self-employed taxpayer repays deferred payroll or self-employment taxes
- ✔ Understand when an employer should amend a 2020 tax return to claim the employee retention credit
- ✔ Know how Paycheck Protection Program loan forgiveness impacts the employee retention credit
- ✔ Calculate the employee retention credit for the first two quarters and the last two quarters in 2021
- ✔ Know which employers are eligible for the paid sick leave and family leave credits
- ✔ Recognize the recent changes to the eligibility for and amounts of the paid sick leave and family leave credits
- ✔ Understand when an employer can claim a COBRA premium assistance credit

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INTRODUCTION

In response to the COVID-19 pandemic, Congress passed legislation to assist employers as they continued to keep employees on the payroll. The legislation created several new refundable payroll tax credits, including the employee retention credits, credits for qualified sick and family leave wages, and COBRA premium assistance credits. Pandemic relief legislation also postponed the deadlines for withholding and depositing payroll taxes.

This chapter provides a review of the general tax withholding and reporting requirements and then explains key relief provisions and their impact on 2021 returns. It discusses repayment of deferred payroll and self-employment taxes. It reviews changes to the employee retention credit and the paid sick leave and family leave credits. Finally, this chapter discusses the COBRA premium assistance credit.

ISSUE 1: PAYROLL TAX OVERVIEW This section reviews general payroll tax withholding requirements.

Wages and self-employment earnings are subject to employment taxes under the Federal Insurance Contributions Act (FICA) and the Self-Employment Contributions Act (SECA), respectively. FICA and SECA provide for old-age, survivors, and disability insurance (OASDI) benefits and hospital insurance. The OASDI is funded through a 12.4% social security tax on wages or self-employment earnings (capped at $142,800 in 2021), and the hospital insurance is funded through a 2.9% Medicare tax on all wages or earnings. There is an additional 0.9% employee Medicare tax on wages and self-employment earnings above $200,000 for single and head of household filers and $250,000 for joint filers [I.R.C. §§ 3101(b)(2), 1401(b)(2)].

This section explains the general rules for payroll withholding, deposits, and reporting. The special COVID-relief payroll deferral rules are discussed in Issue 2.

Employer Obligations

Employers that pay wages must withhold and deposit federal and state income tax, social security tax, and Medicare tax from an employee's wages. They must also pay the employer's share of social security tax and Medicare tax, state unemployment tax, and federal unemployment tax on an employee's wages.

Income Tax Withholding

Employers use Form W-4, Employee's Withholding Certificate, to determine the amount of federal income tax to withhold from an employee's wages. If a new employee does not provide a completed Form W-4, the employer must withhold income tax as if the employee is single and as if there are no entries on Form W-4, steps 2, 3, and 4. Employers can use the Income Tax Withholding Assistant for Employers at www.IRS.gov/ITWA to help calculate federal income tax withholding or the methods specified in IRS Publication 15-T, *Federal Income Tax Withholding Methods*.

Social Security and Medicare

Employers must withhold and remit 6.2% of social security tax and 1.45% of Medicare tax from the employee's earnings [I.R.C. § 3101(a) and (b)]. The employer must also pay a matching 6.2% social security tax and 1.45% Medicare tax [I.R.C. § 3111(a) and (b)(1)]. For 2021, the maximum amount of wages subject to the social security tax is $142,800. There is no wage base limit for the Medicare tax.

If an employee's wages exceed a certain threshold ($250,000 MFJ and $200,000 single), there is a .9% additional Medicare tax on amounts that exceed the threshold. Employers must withhold and remit the additional Medicare tax from wages for a calendar year in which the employer

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pays wages to an employee that exceed $200,000 and continuing until the end of the calendar year. The additional Medicare tax is imposed only on the employee. There is no employer share of additional Medicare tax.

Payroll Tax Deposits

Generally, employers must deposit the income tax withheld and the employer and employee portions of the social security and Medicare taxes. Tax deposits are made monthly or semiweekly. Before the beginning of each calendar year, the employer determines which of the two deposit schedules it must use. The deposit schedule is based on the employer's total taxes after adjustments and nonrefundable credits reported on Form 941, Employer's Quarterly Federal Tax Return, line 12; or on Form 944, Employer's Annual Federal Tax Return, line 9, during a lookback period.

Deposit Schedule

For a Form 941 filer, the deposit schedule for a calendar year is determined from the total taxes reported on Forms 941, line 12, in a 4-quarter lookback period. The lookback period begins July 1 of the second preceding year and ends June 30 of the preceding year. An employer that reported $50,000 or less of taxes for the lookback period is a monthly schedule depositor. An employer that reported more than $50,000 is a semiweekly schedule depositor.

Under the monthly deposit schedule, the employer must deposit employment taxes on payments made during a month by the fifteenth day of the following month. Under the semiweekly deposit schedule, the employer must deposit employment taxes for payments made on Wednesday, Thursday, and/or Friday by the following Wednesday, and deposit taxes for payments made on Saturday, Sunday, Monday, and/or Tuesday by the following Friday.

A deposit that is required to be made on a day that is a weekend or a federal holiday is considered timely if it is made by the close of the next business day. If the employer on a monthly or semiweekly deposit schedule accumulates $100,000 or more in taxes on any day, it must deposit the tax by the next business day.

CROSS-REFERENCE

Payroll Tax Penalties

Penalties apply to a failure to timely make deposits or to deposits that are less than the required amount. For more information on payroll tax penalties, including the penalties for failing to file correct information returns, failing to furnish correct payee statements, failing to make required deposits, and liabilities under the trust fund recovery penalty, see pages 214–215 in the *2018 National Income Tax Workbook*. For 2020 and 2021, Notice 2020-22 and Notice 2021-24 (discussed later) offer limited penalty relief related to several refundable coronavirus-related payroll tax credits.

Deposit with a Return

If the Form 941 total tax liability (Form 941, line 12) for either the current quarter or the prior quarter is less than $2,500, and the employer did not incur a $100,000 next-day deposit obligation during the current quarter, the employer can make the payment with a timely filed Form 941 instead of making deposits. An employer can make a payment with a timely filed Form 944 if the Form 944 net tax liability for the year (Form 944, line 9) is less than $2,500.

Payroll Tax Reporting

Employers must file payroll tax returns to report wages subject to income tax withholding or social security and Medicare tax. Employers must also annually file a Form W-2, Wage and Tax Statement, for each employee.

Forms 941 and 944

Most employers file the quarterly Form 941. Agricultural employers file the annual Form 943, Employer's Annual Federal Tax Return for Agricultural Employees. An employer that believes that its employment taxes for the calendar year will be $1,000 or less can call the IRS and ask to file Form 944 instead of Form 941. After the employer contacts the IRS, the IRS will send a written notice that the filing requirement has been changed to Form 944. The employer must receive written notice from the IRS to file Form 944 instead of Form 941 before it files Form 944.

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Form W-2

Employers must annually complete Form W-2, Wage and Tax Statement, for each employee. Form W-2 reports the total amount of wages paid, FICA taxes withheld, and federal and state income taxes withheld. Employers must also complete Form W-3, Transmittal of Wage and Tax Statements. Employers file Forms W-2 and W-3 with the Social Security Administration (SSA) by January 31 of the year following the calendar year in which wages were paid. The employer can file the form by mail or electronically, but if an employer has more than 250 Forms W-2, all forms must be filed electronically. Employers must send the employee a copy of Form W-2 by January 31.

The amount of withheld income tax reported on Form W-3 should match the amounts reported on the quarterly or annual payroll tax returns. With the exception of the additional Medicare tax, the social security and Medicare tax shown on the payroll tax returns should generally equal twice the amounts shown on Form W-3. If the IRS finds a discrepancy between the amounts reported on the payroll tax returns and the amounts reported to the SSA, the IRS will request additional information.

Self-Employed Taxpayer Obligations

Self-employed taxpayers pay a 15.3% self-employment (SE) tax, which is comprised of a 12.4% social security tax and a 2.9% Medicare tax. SE tax is imposed on net earnings from self-employment, which I.R.C. § 1402(a) defines as gross income derived from a trade or business carried on by an individual or a partnership in which the individual is a member, less allowable deductions that are attributable to that trade or business. Self-employed taxpayers pay SE tax on 92.35% of SE income, which equalizes the self-employed taxpayer with an employee for whom the employer pays a 7.65% share of FICA tax that is not included in the employee's income.

The social security tax is imposed on only the first $142,800 (for 2021) of wages, tips, and net SE earnings. There is no limit on the amount of wages, tips, and net earnings that are subject to the 2.9% Medicare tax. The 0.9% additional Medicare tax may apply. SE tax is calculated and reported on Schedule SE (Form 1040), Self-Employment Tax. If net SE earnings are less than $400, no SE tax is owed.

CROSS-REFERENCE

Estimated Tax Payments

Self-employed individuals who are not farmers generally must make estimated tax payments if they expect to owe at least $1,000 in tax for the current year, and tax withholding and refundable credits will be less than the smaller of 90% of the tax on the current-year tax return or 100% (110% for taxpayers with AGI of $150,000 or more) of tax on the prior-year return. See pages 223–234 in the *2018 National Income Tax Workbook* for a further discussion of estimated tax requirements, reporting, and penalties.

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ISSUE 2: PAYROLL TAX DEFERRAL This section reviews the procedures for repaying payroll taxes deferred in 2020.

Section 2302 of the Coronavirus Aid, Relief, and Economic Security Act (CARES Act), Pub. L. No. 116-136, allowed employers to temporarily defer the deposit and payment of the employer's portion of social security and Railroad Retirement Tax Act (RRTA) payroll taxes (6.2%). Self-employed individuals could defer payment of the equivalent of the employer's social security portion of Self-Employed Contributions Act (SECA) taxes.

On August 8, 2020, a Memorandum on Deferring Payroll Tax Obligations directed the secretary of the Treasury to defer the withholding, deposit, and payment of the employee's share of social security tax (6.2%) on wages or compensation paid from September 1, 2020, through December 31, 2020. This deferral applied to employees whose biweekly wages were less than $4,000 ($104,000 per year), calculated on a pretax basis.

Payment Deferral of Employer Payroll Tax

The payment deferral of the employer's portion of social security tax was available from March 27, 2020, through December 31, 2020. The deferral also applied to deposits of the employer's share of social security tax that would otherwise be due after December 31, 2020, as long as the deposits relate to the tax imposed on wages paid (1) during the quarter ending on December 31, 2020, for employers filing quarterly employment tax returns, or (2) during the payroll tax deferral period for all other employers.

Repayment Deadlines

Taxpayers must deposit 50% of the deferred payroll tax by December 31, 2021, and the remaining 50% is due by December 31, 2022.

OBSERVATION

Deferred Payment Due Date

Because both December 31, 2021, and December 31, 2022, are nonbusiness days, payments made on the next business day will be considered timely.

Any payments or deposits made before December 31, 2021, are first applied against the payment due on December 31, 2021, and then applied against the payment due on December 31, 2022.

Example 12.1
Repayment of Deferred Taxes

Dogwood Landscaping Company's social security tax obligation for the third quarter of 2020 was $30,000. Dogwood deposited $10,000 of the $30,000 in the third quarter of 2020, but deferred depositing the remaining $20,000 ($30,000 − $10,000). Dogwood reported the deferred taxes on Form 941, line 13b. Dogwood must pay $5,000 [($30,000 maximum deferral amount × 50%) − $10,000 payment] by December 31, 2021, and $15,000 ($30,000 − $10,000 − $5,000) by December 31, 2022.

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Example 12.2
Partial Repayment of Deferred Taxes

Daisy Gardening Company's share of social security tax for the third quarter of 2020 was $20,000 and Daisy deposited $15,000 of the $20,000 during the third quarter of 2020. It deferred depositing the remaining $5,000 ($20,000 − $15,000) and reported the deferred taxes on Form 941, line 13b. Daisy does not have to pay any deferred amount until December 31, 2022, because 50% of the $20,000 amount that could have been deferred has already been paid. Daisy must repay the $5,000 deferral by December 31, 2022.

If the taxpayer deposits applicable employment taxes otherwise due during the payroll tax deferral period by the deferred payment deadlines, the deposits are treated as timely. For SECA tax purposes, 50% of the tax liability incurred under section 1401(a) during the payroll tax deferral period is not treated as taxes requiring estimated tax payments until the applicable dates.

Paying the Deferred Amount

Deferred amounts owed may be paid

1. electronically using the Electronic Federal Tax Payment System (EFTPS),
2. by credit or debit card, or
3. by check or money order.

If paying by EFTPS, an employer that files Form 941 must select Form 941, the calendar quarter in 2020 to which the payment relates, and select payment due on an IRS notice. If the payment relates to more than one quarter, the employer must make separate payments for each quarter.

Example 12.3
Paying by EFTPS

Nelson's Manufacturing Co. files Form 941, Employer's Quarterly Federal Tax Return. It wants to pay $300 of its deferred employer's share of social security tax, $100 which is attributable to the second calendar quarter of 2020, and the other $200 which is attributable to the third calendar quarter of 2020. Nelson's must make two payments through EFTPS. Each payment should be made for the calendar quarter to which the deferral is attributable, and the entry in EFTPS must reflect it as a payment due on an IRS notice. Thus, Nelson's must pay $100 for the second calendar quarter of 2020, and then pay $200 for the third calendar quarter of 2020.

If paying by check or money order, the employer must include a 2020 Form 941-V, Payment Voucher. The employer should fill in the circle for the quarter in which the payment had been deferred. On the check, the employer should write its EIN, "Form 941," and the calendar quarter in which the payment was originally deferred.

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Deferral for Self-Employed Taxpayer

The CARES Act allowed self-employed individuals to also defer payments of 50% of social security tax imposed on their net self-employment earnings, beginning March 27, 2020, and ending December 31, 2020. Self-employed individuals who deferred these payments were not subject to a penalty for failure to make estimated tax payments.

Like employers, self-employed individuals are required to repay the deferred tax in two installments: 50% by December 31, 2021, and the rest by December 31, 2022. COVID Tax Tip 2021-96 (July 6, 2021) explains that individuals can pay the deferred amount any time on or before the due date by making payments through the EFTPS or by credit or debit card, money order, or with a check. These should be separate payments from other tax payments to ensure they are applied to the deferred tax balance on the tax year 2020, Form 1040, U.S. Individual Income Tax Return. The IRS will not recognize the payment for deferred tax if it is with other tax payments or paid with the current Form 1040. Taxpayers should designate the payment as "deferred Social Security tax."

Deferral of Employee Payroll Tax

Notice 2020-65, 2020-38 I.R.B. 567, issued guidance on the employee's portion of the employment tax deferral. The notice directed repayment of the deferred amounts, ratably on a monthly basis, between January 1, 2021, and April 30, 2021. The Consolidated Appropriations Act, 2021 (CAA), Pub. L. No. 116-260, Division N, Subtitle B, COVID-Related Tax Relief Act of 2020 (COVIDTRA), § 274, extended the time to pay the employee's deferred employment taxes through December 31, 2021.

Notice 2021-11, 2021-06 I.R.B. 827, states that employers must withhold and pay the total deferred employee share of social security tax ratably from wages paid to the employee between January 1, 2021, and December 31, 2021. Interest, penalties, and additions to tax will begin to accrue on January 1, 2022. If necessary, the employer can arrange to otherwise collect the total deferred taxes from the employee.

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ISSUE 3: EMPLOYEE RETENTION CREDIT This section explains the 2020 and 2021 employee retention credit.

To encourage employers to keep employees on the payroll during the COVID-19 crisis, the Coronavirus Aid, Relief, and Economic Security (CARES) Act, Pub. L. No. 116-136, added the employee retention credit (ERC). The ERC is a refundable payroll tax credit. Employers claim the credit against the employer's share of social security tax and tier 1 tax under the Railroad Retirement Tax Act (RRTA) in 2020 and the first 2 quarters of 2021, and claim the credit against the employer's share of Medicare tax in the last two quarters of 2021.

In anticipation of receiving the ERC, eligible employers can reduce their deposits of federal employment taxes, including withheld taxes, that would otherwise be required, up to the amount of the anticipated credit. Eligible employers can also request an advance of the anticipated credit amount that exceeds the reduced federal employment tax deposits by filing Form 7200, Advance Payments of Employer Credits Due to COVID-19.

The ERC was implemented by three separate laws, and the rules for the 2020 credit are modified and expanded for the 2021 ERC. Small differences apply between the first two quarters and the last two quarters of 2021. This section reviews the rules for the 2020 ERC, how the credit interacts with Paycheck Protection Program loan forgiveness in 2020 and 2021, and the procedures to file amended returns to claim the credit for 2020. This section then explains the expanded rules for the 2021 ERC, and how those rules change from the first two quarters to the last two quarters of 2021.

Legislative History

Under the CARES Act, the ERC applied only to wages paid after March 12, 2020, and before January 1, 2021. Employers were not eligible for the ERC if they received a Paycheck Protection Program (PPP) loan. Because of the greater benefit of the PPP in 2020, most eligible businesses elected to participate in the PPP instead of claiming the ERC.

On December 27, 2020, the Taxpayer Certainty and Disaster Tax Relief Act of 2020 (TCDTRA), § 206, enacted as part of the Consolidated Appropriations Act, 2021 (CAA), Pub. L. No. 116-260, amended the CARES Act retroactively to allow employers who received PPP loans to qualify for the ERC if the payroll expenses paid with forgiven PPP proceeds were not used as qualified wages to claim the ERC. Section 207 of the TCDTRA extended the credit through June 30, 2021, and modified the ERC for the first two quarters of 2021. It increased the credit rate, credit limit, and eligibility for the credit.

On March 11, 2021, the American Rescue Plan Act of 2021 (ARPA), Pub. L. No. 117-2, codified the ERC as I.R.C. § 3134. ARPA extended and modified the ERC for the third and fourth quarters of 2021.

2020 Employee Retention Credit

For 2020, the ERC was available to eligible employers, including tax-exempt organizations, that paid qualified wages, including certain health plan expenses, to some or all employees after March 12, 2020, and before January 1, 2021. Notice 2021-20, 2021-11 I.R.B. 922, provides guidance on the ERC, as it applies to qualified wages paid after March 12, 2020, and before January 1, 2021. Notice 2021-49, 2021-34 I.R.B. 316, provides guidance on the 2020 and 2021 ERC.

After enactment of the TCDTRA, many employers who were previously ineligible for the ERC in 2020 became eligible for the credit. Employers can file amended payroll tax returns (and related income tax returns) to retroactively claim the ERC.

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PRACTITIONER NOTE

Self-Employed Taxpayers

Self-employed individuals are not eligible to claim the ERC for their own earnings. However, they may be able to claim the credit for wages paid to their employees.

Eligible Employers

An *eligible employer* is any employer carrying on a trade or business during calendar year 2020 for which, during any calendar quarter, either of the following applied:

1. The operation of the trade or business carried on during calendar year 2020 was fully or partially suspended due to orders from an appropriate governmental authority limiting commerce, travel, or group meetings (for commercial, social, religious, or other purposes) due to COVID-19 (the suspended business test).
2. Such calendar quarter is within the period in which the employer had a significant decline in gross receipts (the decline in gross receipts test).

PRACTITIONER NOTE

Eligible Employer vs. Qualified Wages

An employer with business operations that are fully or partially suspended due to a governmental order during a portion of a calendar quarter is an eligible employer for the entire calendar quarter. However, qualified wages include only those otherwise eligible wages paid during the full or partial shutdown period.

For purposes of the ERC, *trade or business* has the same meaning as in I.R.C. § 162, other than the trade or business of performing services as an employee. Under section 162, an activity does not qualify as a trade or business unless its primary purpose is to make a profit and it is carried on with regularity and continuity. Household employers, for example, are not operating a trade or business and are not eligible for the ERC. Tax-exempt organizations described in I.R.C. § 501(c) and exempt from tax under I.R.C. § 501(a) are deemed to be engaged in a trade or business with respect to all the organization's operations.

Suspended Business Test

For purposes of the suspended business test, eligible employers must have been carrying on a trade or business during the calendar quarter for which the credit is determined. A governmental order (defined next) must have suspended that business in whole or in part.

PRACTITIONER NOTE

Entity Type

Employers of any size, including tax exempt organizations, are eligible to claim the ERC. In 2020, federal, state, and local government entities, and agencies or instrumentalities of those governments, were not eligible employers under the CARES Act. The CAA extended eligibility to certain government entities (discussed later). Tribal governments or tribal entities may be eligible if they meet the other requirements.

Governmental Orders

Orders from an appropriate governmental authority include orders, proclamations, or decrees from the federal government or any state or local government that limit commerce, travel, or group meetings (for commercial, social, religious, or other purposes) due to COVID-19 and relate to the suspension of an employer's operation of its trade or business. Orders that are not from the federal government must be from a governmental authority that has jurisdiction over the employer's operations.

Governmental orders do not include comments made during press conferences or in interviews with the media; the declaration of a state of emergency by a governmental authority that does not limit commerce, travel, or group meetings; or declarations that do not suspend an employer's business operation. Whether orders, proclamations, or decrees are governmental orders is determined without regard to the level of enforcement of the governmental order.

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Fully or Partially Suspended Business

If a governmental order has fully suspended an employer's operations, the employer will generally qualify for the ERC. Employers may also qualify if their operations are partially suspended by governmental order.

Generally, the operation of a trade or business is partially suspended if a governmental authority imposes restrictions on the employer's operations by limiting commerce, travel, or group meetings due to COVID-19, and the employer can still continue some, but not all of its typical operations. Under Notice 2021-20, recommendations to close (as opposed to orders) or decreased customer activity as a result of COVID-19 are not a full or partial suspension (but the employer may qualify under the decline in gross receipts test). Additionally, if the work can continue in a comparable manner through telework, there is no partial suspension.

Essential businesses that were not suspended during COVID-19 lockdowns do not qualify for the ERC. However, if under the facts and circumstances, more than a nominal portion of the business operation was suspended by a governmental order, the business may have had a partial suspension. The business may also qualify if a governmental order required the business to close for a period of time during normal working hours.

PRACTITIONER NOTE

Nominal Portion of the Business

For purposes of the ERC, a portion of the employer's business operation is deemed to constitute more than a nominal portion of its business operation if either the gross receipts from that portion of the business operation are not less than 10% of the total gross receipts or the hours of service performed by the employees in that portion of the business are not less than 10% of the total number of hours of service performed by all employees in the employer's business.

Notice 2021-20 provides criteria for determining whether a business was partially suspended and includes detailed examples. **Figure 12.1** summarizes that guidance.

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FIGURE 12.1
Guidance on Partial Suspensions

No Partial Suspension	May Have Partial Suspension
Pursuant to governmental orders, customers stay home, and a business experiences a reduction in demand for its products or services.	Suppliers are unable to make deliveries of critical goods or materials.
A business voluntarily suspends operations or voluntarily reduces hours.	Closure suspends business operations for certain purposes, but not others if, under the facts and circumstances, the operations that are closed are more than a nominal portion of the business operation.
The workplace is closed by a governmental order, but continued business operations are comparable to preclosure operations (e.g., through telework).	If all, or all but a nominal portion, of an employer's business operations may continue, but the operations are subject to modification due to a governmental order (e.g., to satisfy distancing requirements), such modification is a partial suspension of business operations due to a governmental order if the modification required by the governmental order has more than a nominal effect.
Required modifications to customer behavior (e.g., mask requirements or making store aisles one way to enforce social distancing) or that require employees to wear masks and gloves while performing their duties will not result in more than a nominal effect on the business operations.	If an employer incurs a significant delay (e.g., beyond 2 weeks) in moving operations to comparable telework (e.g., implementing telework policies or providing employees with equipment to telework), business may be deemed subject to a partial suspension during the transition period.

Example 12.4
Temporary Closure

Processed Foods, Inc. operates a food production facility that usually operates 24 hours each day. The local health department ordered all food production businesses to deep clean their workplaces once every 24 hours to reduce the risk of COVID-19 exposure to workers. During three quarters of 2020, Processed Foods reduced its daily operating hours by 5 hours per day to comply with this order. Processed Foods qualifies for the ERC under the suspended business test for the three quarters, even if it does not meet the decline in gross receipts test for those quarters.

Example 12.5
Partial Closure

Stuff for All, Corp. (SFA) is a large retailer. A governmental order required SFA to close its storefront for two quarters in 2020. During this time, it could deliver phone-ordered items to customers through a curbside pickup service. The storefront operation comprises more than a nominal part of SFAs business, and its business operations were partially suspended during these two quarters.

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Example 12.6
Open with Restrictions

The facts are the same as in Example 12.5. In the fourth quarter of 2020, the governmental order was revised to allow storefront traffic. However, SFA was required to enforce strict occupancy limits. As a result, customers sometimes had to wait in short lines before being able to enter the store. Because customers were required to wait only a short time outside the store and only during busy times, the governmental order during the fourth quarter of 2020 did not have more than a nominal effect on SFA's business operations. SFA would not be eligible for the ERC in the fourth quarter unless it qualifies under the reduction in gross receipts test.

PLANNING POINTER

Suspension vs. Decline in Gross Receipts

If the employer can establish a significant decline in gross receipts, no suspension is required. The employer does not have to establish that the decline was COVID-19-related. Qualifying under the decline in gross receipts test (discussed next) may result in a larger credit because the employer can consider all wages paid during the quarter, not just the wages paid during the shutdown period.

Decline in Gross Receipts Test

For the 2020 ERC, an employer is an eligible employer under the decline in gross receipts test in the first calendar quarter for which gross receipts were less than 50% of gross receipts for the same calendar quarter in 2019. The eligibility period ends with the earlier of January 1, 2021, or the calendar quarter following the first calendar quarter in which gross receipts were greater than 80% of gross receipts for the same calendar quarter in 2019.

Example 12.7
Applying the Decline in Gross Receipts Test

Comfort Shoes is a shoe store in a retail shopping mall. In the early part of 2020, it had fewer customers. It made improvements to its retail website, and by the third quarter of 2020, its revenue had increased. **Figure 12.2** compares its gross receipts for the first three quarters of 2019 and 2020.

FIGURE 12.2
Comfort Shoes Gross Receipts

	First Quarter	Second Quarter	Third Quarter
2019 Gross Receipts	$210,000	$230,000	$250,000
2020 Gross Receipts	$100,000	$190,000	$230,000
Percent (2020 ÷ 2019)	48%	83%	92%

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Comfort Shoes experienced a significant decline in gross receipts beginning on the first day of the first calendar quarter of 2020 (less than 50%) and ending on the first day of the third calendar quarter of 2020 (quarter following first quarter greater than 80%). Comfort Shoes is eligible for the ERC in the first and second quarters of 2020.

PRACTITIONER NOTE

New Businesses

Special rules apply to calculating the decline in gross receipts for a business that started in 2019 or an employer that acquired a business in 2020. See Notice 2021-20, Q&A 27 and 28. Businesses that began after February 15, 2020, may be eligible to claim an ERC in 2021 under new provisions for recovery startup businesses (discussed later).

For employers, other than tax-exempt organizations, gross receipts for the ERC has the same meaning as in I.R.C. § 448(c). For tax-exempt organizations, gross receipts for the ERC has the same meaning as in I.R.C. § 6033. The CAA clarified that the gross receipts test for tax-exempt businesses applies to all gross receipts, not just the gross receipts from unrelated trade or business income.

PRACTITIONER NOTE

Gross Receipts

Rev. Proc. 2021-33 provides a safe harbor that allows a taxpayer to exclude certain items from gross receipts. PPP loan forgiveness, Economic Aid Act grants, and restaurant revitalization grants are excluded [Rev. Proc. 2021-33, 2021-34 I.R.B. 327].

Calculating the 2020 ERC

For 2020, the maximum ERC is 50% of qualified wages (including allocable qualified health plan expenses) that an eligible employer paid in a calendar quarter. The maximum qualified wages that can be included for the 2020 ERC is $10,000 per employee for all quarters. Thus, the maximum 2020 ERC is $5,000 ($10,000 × 50%) per employee.

Qualified Wages

Qualified wages are generally limited to wages, as defined in I.R.C. § 3121(a), and compensation, as defined in I.R.C. § 3231(e), both determined without regard to the social security wage base, paid by an eligible employer to some or all of its employees (who are not related to the employer) after March 12, 2020, and before January 1, 2021. Qualified wages also include the amounts paid by the employer to maintain a group health plan for the employee, to the extent the health benefit is excluded from the employee's gross income under I.R.C. § 106.

For a large eligible employer (more than 100 employees), qualified wages are the wages paid to an employee for time that the employee is not providing services due to a full or partial suspension of the employer's business operations due to a governmental order, or because the business is experiencing a significant decline in gross receipts. For a small eligible employer (100 or fewer employees), qualified wages are the wages paid with respect to an employee during any period in the calendar quarter in which the business operations are fully or partially suspended due to a governmental order or during any calendar quarter in which the business is experiencing a significant decline in gross receipts.

Notice 2021-49 states that employers are not required to include full-time equivalent employees in determining the number of employees. An employee's status as a full-time employee is irrelevant and wages paid to an employee who is not full-time may be treated as qualified wages if all other requirements to treat the amounts as qualified wages are satisfied. Any cash tips treated as wages within the definition of section 3121(a) or compensation within the definition of section 3231(e)(3) are treated as qualified wages if all other requirements to treat the amounts as qualified wages are satisfied.

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Example 12.8
ERC Calculation

Stray Cat Consulting (SCC) employed four employees throughout 2020. The business experienced a significant decline in gross receipts for the second, third, and fourth quarters. **Figure 12.3** shows its payroll and the calculation of the ERC.

FIGURE 12.3
SCC's Payroll and ERC Calculation for 2020

	Q2 Payroll	Q2 ERC	Q3 Payroll	Q3 ERC	Q4 Payroll	Q4 ERC
Employee 1	$2,500 wages, $500 health care benefits	$1,500 ERC ($3,000 qualified wages × 50%)	$2,500 wages, $500 health care benefits	$1,500 ERC ($3,000 qualified wages × 50%)	$2,500 wages, $500 health care benefits	$1,500 ERC ($3,000 qualified wages × 50%)
Employee 2	$8,000 wages, $500 health care benefits	$4,250 ERC ($8,500 qualified wages × 50%)	$8,000 wages, $500 health care benefits	$750 ERC ($1,500 qualified wages × 50%)	$8,000 wages, $500 health care benefits	$0 ERC ($0 qualified wages)
Employee 3	$10,000 wages, $500 health care benefits	$5,000 ERC ($10,000 qualified wages × 50%)	$10,000 wages, $500 health care benefits	$0 ERC ($0 qualified wages)	$10,000 wages, $500 health care benefits	$0 ERC ($0 qualified wages)
Employee 4	No wages, $500 health care benefits	$250 ERC ($500 qualified wages × 50%)	No wages, $500 health care benefits	$250 ERC ($500 qualified wages × 50%)	No wages, $500 health care benefits	$250 ERC ($500 qualified wages × 50%)
Total	$22,500	$11,000	$22,500	$2,500	$22,500	$1,750

The eligible wages included in the ERC calculations for employees 2 and 3 are limited by the $10,000 maximum qualified wages per employee for all quarters. For 2020, SCC was eligible for a $15,250 ($11,000 + $2,500 + $1,750) ERC.

PRACTITIONER NOTE

No Wage Duplication

Qualified wages exclude any wages used to determine the Families First Coronavirus Response Act credit for that employee and that period. Similarly, any wages taken into account in determining the ERC are not taken into account for purposes of I.R.C. § 45S (paid family and medical leave credit). As explained later, employers cannot claim the ERC on any qualified wages that are counted as payroll costs to obtain PPP loan forgiveness.

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Aggregating Employers

All employers that are members of a controlled group of corporations or trades or businesses under common control under I.R.C. § 52(a) or (b), members of an affiliated service group under I.R.C. § 414(m), or otherwise aggregated under I.R.C. § 414(o) are treated as a single employer for purposes of the ERC. As a result of aggregation, these entities are treated as a single employer for purposes of the following ERC rules:

- Determining whether the employer has a trade or business operation that was fully or partially suspended due to orders related to COVID-19 from an appropriate governmental authority
- Determining whether the employer experiences a significant decline in gross receipts
- Determining whether the employer averaged more than 100 full-time employees
- Determining the maximum credit amount per employee

Related Individuals Exclusion

Section 2301(e) of the CARES Act provides that rules similar to the rules of I.R.C. § 51(i)(1) apply in calculating the ERC. This provision prevents employers from counting wages paid to certain relatives as qualified wages for purposes of calculating the work opportunity credit. Thus, wages paid to related individuals are not qualified wages for the ERC. A *related individual* is an employee who has of any of the following relationships to an individual employer:

1. Child or a descendant of a child
2. Brother, sister, stepbrother, or stepsister
3. Father or mother, or an ancestor of either
4. Stepfather or stepmother
5. Niece or nephew
6. Aunt or uncle
7. Son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law

If the eligible employer is a corporation, then a related individual is any person that bears any of the seven relationships to a person who directly or indirectly owns more than 50% in value of the outstanding stock of the corporation. If the eligible employer is an entity other than a corporation, then a related individual is any person that bears any of the seven relationships to a person who directly or indirectly owns more than 50% of the capital and profits interests in the entity.

Indirect ownership of stock or an interest in another entity is determined by I.R.C. § 267(c), which provides, in part, that an individual is deemed to own the stock that is owned, directly or indirectly, by or for his or her family. Family includes only brothers and sisters (whole or half-blood), spouse, ancestors, and lineal descendants.

If the eligible employer is an estate or trust, then a related individual includes a grantor, beneficiary, or fiduciary of the estate or trust, or any person that bears any of the seven relationships to a person who is a grantor, beneficiary, or fiduciary of the estate or trust.

Section 51(i)(1) does not directly prohibit claiming the ERC for wages paid to an owner of a corporation or the spouse of an owner. However, the section 267(c) family attribution rules could disallow the wages of greater-than-50% owners and their spouses.

Notice 2021-49 provides that a majority owner of a corporation is a related individual for purposes of the ERC if the majority owner has a brother or sister (whether by whole or half-blood), ancestor, or lineal descendant. That is, applying the constructive ownership rules of section 267(c), the direct majority owner's ownership of the corporation is attributed to each of the owner's family members with a relationship described in section 267(c)(4). Because each of those family members is considered to own more than 50% of the stock of the corporation after applying section 267(c), the direct majority owner of the corporation would have one of the seven relationships to the family member who is a constructive majority owner and is therefore a related individual.

PRACTITIONER NOTE

Self-Employed

The section 267(c) attribution rules apply to ownership of stock or an interest in a partnership or another entity. They do not apply to a sole proprietorship. Thus, the spouse of a sole proprietor who is an employee of the proprietorship is seemingly not a related individual for purposes of the ERC.

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The spouse of a majority owner is a related individual for purposes of the ERC if the majority owner has a family member who is a brother or sister (whether by whole or half-blood), ancestor, or lineal descendant and the spouse bears one of the seven relationships to the family member. For example, a direct majority owner's brother would be a constructive majority owner under section 267(c)(2) and (4) and the spouse of the direct majority owner would be considered a related individual to the constructive majority owner by virtue of the in-law relationship described in section 152(d)(2)(G). If the majority owner of a corporation has no brother or sister (whether by whole or half-blood), ancestor, or lineal descendant, then the majority owner and the spouse are not related individual within the meaning of section 51(i)(1) and the wages paid to the majority owner and/or the spouse may be qualified wages for purposes of the ERC.

OBSERVATION

Dependents

Section 2301(e) of the CARES Act and I.R.C. § 3134(e) provide, in relevant part, that rules similar to the rules of section 51(i)(1) apply. Under section 51(i)(1)(c) a related party is also a dependent of the taxpayer (and certain other individuals). To be a related party to the taxpayer, the dependent must have the same principal place of abode of the taxpayer and also be a member of the taxpayer's household.

Example 12.9
Related Corporate Owners

Acme Corporation is owned 80% by Eric Johnson and 20% by Frank Johnson. Frank is Eric's son. Acme was an eligible employer for the first calendar quarter of 2021. Both Eric and Frank are employees of Acme. Pursuant to the section 267(c) attribution rules, Eric and Frank are treated as 100% owners of Acme. Thus, Acme cannot treat wages paid to either Eric or Frank as qualified wages because they are both related individuals for purposes of the ERC [Notice 2021-49, Example 1].

Example 12.10
Sole Corporate Owner with Nonemployee Child

Geri Smith owns 100% of Broadmoor, Inc. Henry is Geri's son. Broadmoor was an eligible employer for the first calendar quarter of 2021. Geri is an employee of Broadmoor, but Henry is not. Pursuant to the section 267(c) attribution rules, Henry is attributed 100% ownership of Broadmoor, and both Geri and Henry are treated as 100% owners. Accordingly, Broadmoor cannot not treat wages paid to Geri as qualified wages because Geri is a related individual for purposes of the ERC [Notice 2021-49, Example 2].

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Example 12.11
Spouse Owner and Spouse Employee

Jennifer Lee owns 100% of Capital Corporation. Capital Corporation was an eligible employer for the first calendar quarter of 2021. Jennifer is married to Kenneth, and they have no other family members as defined in section 267(c)(4). Jennifer and Kenneth are both employees of the corporation. Pursuant to the attribution rules of section 267(c), Kenneth is attributed 100% ownership of Capital Corporation, and both Jennifer and Kenneth are treated as 100% owners. However, Jennifer and Kenneth do not have any of the relationships to each other described in section 152(d)(2)(A)-(H). Accordingly, wages paid by Capital Corporation to Jennifer and Kenneth in the first calendar quarter of 2021 may be treated as qualified wages if the amounts satisfy the other requirements to be treated as qualified wages [Notice 2021-49, Example 3].

Interaction of the ERC and the Paycheck Protection Program in 2020 and 2021

Section 206(c) of the TCDTRA retroactively changed the CARES Act to allow employers who received PPP loans in 2020 to qualify for the ERC. Consequently, for 2020, employers can generally claim the ERC on any qualified wages that are not counted as payroll costs in obtaining PPP loan forgiveness. Any wages that could count toward eligibility for the ERC or PPP loan forgiveness can generally be applied to either of these two programs, but not both.

PPP Loan Forgiveness

The PPP expanded the Small Business Administration (SBA) loan program to provide federally guaranteed loans to small employers and eligible self-employed individuals impacted by COVID-19. These loans were designed to be forgiven if the borrower met program requirements. Forgiven loan proceeds are excluded from gross income, and the borrower can deduct expenses paid with PPP loan proceeds. For additional details, see www.sba.gov/funding-programs/loans/covid-19-relief-options/paycheck-protection-program.

To receive PPP loan forgiveness, the borrower must use at least 60% of the loan proceeds for payroll costs and the remainder for nonpayroll costs. Authorized payroll costs include compensation for employees whose principal place of residence is the United States. Payroll costs exclude qualified wages (defined earlier) that are included in the calculation of the ERC. **Figure 12.4** shows payroll and nonpayroll costs for PPP loan forgiveness. Including the maximum amount of nonpayroll costs allowed on a PPP forgiveness application is an important strategy for maximizing ERC eligibility in 2020 and 2021.

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FIGURE 12.4
PPP Loan Forgiveness Payroll and Nonpayroll Costs

Payroll Costs	Nonpayroll Costs
Compensation to employees (whose principal place of residence is the United States) in the form of salary, wages, commissions, or similar compensation, (with limits on cash compensation)	Business mortgage interest payments
Cash tips or equivalent	Business rent or lease payments
Payment for vacation, parental, family, medical, or sick leave	Business utility payments
Allowance for dismissal or separation	Covered operations expenditures
Payment for the provision of employee benefits consisting of group health care or group life, disability, vision, or dental insurance, including insurance premiums, and payment of retirement benefits	Covered property damage costs
Payment of state or local tax assessed on employee compensation	Covered supplier costs
Owner compensation replacement for the self-employed and net earnings from self-employment for partners	Covered worker protection expenditures

Deemed Election

Section 2301(g)(1) of the CARES Act, as amended by the TCDTRA, allows an eligible employer to elect to exclude certain qualified wages for purposes of the ERC. An eligible employer generally makes the election by not claiming the ERC for those qualified wages on its federal employment tax return. However, an eligible employer that received a PPP loan is deemed to have made the election for those qualified wages included in the amount reported as payroll costs on a PPP Loan Forgiveness Application.

The amount for which the eligible employer is deemed to have made the election is the qualified wages amount included in the payroll costs reported on the forgiveness application, up to (but not over) the amount that is necessary to support the amount of the PPP loan that is forgiven. The ERC does not apply to the qualified wages for which the election or deemed election is made. An eligible employer is not deemed to have made an election for any qualified wages paid by the eligible employer that are not included in the payroll costs reported on the forgiveness application.

Example 12.12
Including Only Wages for PPP Forgiveness

Good Eats Restaurant, LLC received a $100,000 PPP loan. Good Eats is an eligible employer and paid $100,000 in qualified wages that would qualify for the ERC during the second and third quarters of 2020. To receive forgiveness of its loan, Good Eats reported a total of $100,000 of payroll costs, all attributable to employee wages. Good Eats submitted an application for PPP forgiveness and reported the $100,000 of qualified wages as payroll costs in support of forgiveness. The loan was forgiven in early 2021. Good Eats also paid $40,000 in nonpayroll costs during this period but did not report those costs on the forgiveness application.

Good Eats is deemed to have made an election to exclude $100,000 of qualified wages for purposes of the ERC, which was the qualified wages included in the payroll costs reported on the PPP forgiveness application sufficient to support forgiveness. Good Eats is not eligible for the ERC for this period.

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Example 12.13
Including Wages and Nonpayroll Costs for PPP Forgiveness

The facts are the same as in Example 12.12, except that to receive forgiveness of its loan, Good Eats reported $60,000 of payroll costs, all attributable to employee wages, and $40,000 in nonpayroll costs. The loan was forgiven in early 2021. Good Eats is deemed to have made an election to exclude $60,000 of qualified wages for purposes of the ERC, which was the qualified wages included in the payroll costs reported on the PPP forgiveness application sufficient to support forgiveness. Good Eats can claim the ERC based on the $40,000 in qualified wages paid during this period.

If an eligible employer reported wages on a PPP forgiveness application, but the loan was not forgiven, those wages may be included for the ERC. Similarly, if an eligible employer obtains forgiveness of only a portion of the PPP loan amount, the employer is deemed to have made an election for the minimum amount of qualified wages included in the payroll costs reported on the forgiveness application necessary to receive forgiveness.

PLANNING POINTER

Maximizing the ERC

To maximize the ERC, employers should first allocate toward forgiveness any payroll expenses that are payroll costs for PPP forgiveness but are not qualified wages for purposes of the ERC. These expenses include employer contributions for employee retirement benefits and compensation of partners.

Tax Treatment of the ERC

An ERC is not income to the employer. However, the employer must reduce expenses that the employer could otherwise deduct on its federal income tax return. Specifically, section 2301(e) of the CARES Act provides that an employer's deduction for qualified wages, including qualified health plan expenses, is reduced by the amount of the ERC. Employers do not reduce the deduction for the employer's share of social security and Medicare taxes by any portion of the credit.

PRACTITIONER NOTE

Amended Income Tax Returns

Employers who retroactively claim the 2020 ERC by filing an amended employment tax return, as discussed next, must also amend their federal income tax return to reduce the deduction claimed for the qualified wages. This amended return may result in additional tax and late payment penalties. As of the date of this writing, penalty relief has been requested, but not granted. The cost to amend the returns, and the additional tax and penalties may exceed the value of the credit.

Claiming the 2020 ERC on Amended Returns

Employers that filed an employment tax return in 2020 but did not claim the ERC—most likely because they received a PPP loan in 2020 and the ERC was disallowed—may amend their 2020 employment tax returns to claim the credit. Employers must file a separate Form 941-X, Adjusted Employer's Quarterly Federal Tax Return and Claim for Refund, and complete Worksheet 1, Adjusted Credit for Qualified Sick and Family Leave Wages, and the Employee Retention Credit, for each quarter they wish to claim the credit. Agricultural employers that filed an annual Form 943, Employer's Annual Federal Tax Return for Agricultural Employees, may claim their 2020 ERC by filing a Form 943-X, Adjusted Employer's Annual Federal Tax Return for Agricultural Employees or Claim for Refund.

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Procedure to File Amended Returns

In claiming the ERC, the employer must generally take the following steps:

1. Determine quarter(s) of eligibility
2. Determine qualified wages (including allocable health care expenses paid)
3. Eliminate wages used on a successful PPP forgiveness application, those for which certain other credits were taken, or (if the basis of qualification was a shutdown) those wages attributable to periods during which employees were working
4. Eliminate wages paid to unqualified employees (related parties, those for whom a work opportunity credit was paid in a 2020 quarter)
5. Calculate the ERC by quarter
6. Complete and file the Form 941-X, 943-X, or 944-X (and accompanying worksheets), as appropriate
7. Amend the 2020 income tax return as necessary to reduce a prior deduction for qualified wages in the amount of the ERC

Period of Limitations

Generally, an employer may correct overreported taxes on a previously filed Form 941 by filing the Form 941-X within 3 years of the date the Form 941 was filed or 2 years from the date the employer paid the tax reported on Form 941, Employer's Quarterly Federal Tax Return, whichever is later. For purposes of the period of limitations, Forms 941 for a calendar year are considered filed on April 15 of the succeeding year if filed before that date.

Employers must use the April 2021 instructions and the October 2020 version of Form 941-X when amending payroll tax returns to claim the 2020 ERC. Employers should mail these amended returns to the appropriate address listed in the instructions.

Example 12.14
Amending Returns to Claim the 2020 ERC

Rolly Anderson owns and operates Rolly's Roadhouse. In the third quarter of 2020, the business had a 60% decline in gross receipts, as compared to the same quarter in 2019. The business had three employees who were not related individuals. Rolly received a $60,000 PPP loan at the beginning of the third quarter, and he erroneously thought that he could not claim the ERC for 2020.

The PPP loan was forgiven in 2021. On his forgiveness application, Rolly listed his expenses, as shown in **Figure 12.5**.

FIGURE 12.5
Rolly's Roadhouse Costs on the PPP Forgiveness Application

Nonpayroll Costs:	
Rent	$15,000
Mortgage interest	5,000
Utilities	4,000
Total nonpayroll costs	$24,000
Payroll Costs:	
Owner compensation replacement	$20,833
Other employee compensation, including health care benefits	15,167
Total payroll costs	$36,000

In determining Rolly's ERC, Rolly is deemed to have made an election not to take into account those qualified wages that are required to support his forgiveness application. Rolly could spend up to $24,000 ($60,000 × 40%) of his PPP proceeds on nonpayroll costs. Rolly had to spend the remaining $36,000 ($60,000 × 60%) on payroll costs. Of the $36,000 in required payroll costs, $20,833 was owner compensation replacement, which is not qualified wages for purposes of the ERC. Consequently, Rolly needs only $15,167 ($36,000 − $20,833) in additional wages and health care costs to support his forgiveness application.

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Rolly is deemed to have made an election to take into account $15,167 qualified wages to support his forgiveness application. Thus, he had $44,833 ($60,000 − $15,167) of qualified wages for purposes of the ERC. Each of Rolly's three employees had over $10,000 in qualified wages in the third quarter, and Rolly can claim the full $15,000 ERC ($10,000 limit per employee × 50% × 3 employees). Rolly claims his $15,000 ERC on an amended Form 941-X for quarter three of 2020. He must also amend his Schedule C (Form 1040), Profit or Loss From Business (Sole Proprietorship), to reduce his wage deduction by the credit amount.

Figure 12.6 shows Rolly's Form 941-X for the third quarter in 2020, and **Figure 12.7** shows his Worksheet 1.

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FIGURE 12.6
Rolly's Roadhouse's Form 941-X

Form **941-X:** **Adjusted Employer's QUARTERLY Federal Tax Return or Claim for Refund**
(Rev. October 2020) Department of the Treasury — Internal Revenue Service OMB No. 1545-0029

Employer identification number (EIN) X X – X X X X X X X

Name *(not your trade name)* Rolly Anderson

Trade name *(if any)* Rolly's Roadhouse

Address 123 Mulberry St.
Number Street Suite or room number

White Bear Lake | MN | 55038
City State ZIP code

Foreign country name | Foreign province/county | Foreign postal code

Return You're Correcting...

Check the type of return you're correcting.

- [x] **941**
- [ ] **941-SS**

Check the ONE quarter you're correcting.

- [ ] **1:** January, February, March
- [ ] **2:** April, May, June
- [x] **3:** July, August, September
- [ ] **4:** October, November, December

Enter the calendar year of the quarter you're correcting.
2020 (YYYY)

Enter the date you discovered errors.
/ / (MM / DD / YYYY)

Read the separate instructions before completing this form. Use this form to correct errors you made on Form 941 or 941-SS. Use a separate Form 941-X for each quarter that needs correction. Type or print within the boxes. You MUST complete all four pages. Don't attach this form to Form 941 or 941-SS unless you're reclassifying workers; see the instructions for line 36.

Part 1: Select ONLY one process. See page 5 for additional guidance.

- [ ] **1. Adjusted employment tax return.** Check this box if you underreported amounts. Also check this box if you overreported amounts and you would like to use the adjustment process to correct the errors. You must check this box if you're correcting both underreported and overreported amounts on this form. The amount shown on line 27, if less than zero, may only be applied as a credit to your Form 941, Form 941-SS, or Form 944 for the tax period in which you're filing this form.
- [x] **2. Claim.** Check this box if you overreported amounts only and you would like to use the claim process to ask for a refund or abatement of the amount shown on line 27. Don't check this box if you're correcting ANY underreported amounts on this form.

Part 2: Complete the certifications.

- [x] **3. I certify that I've filed or will file Forms W-2, Wage and Tax Statement, or Forms W-2c, Corrected Wage and Tax Statement, as required.**

Note: If you're correcting underreported amounts only, go to Part 3 on page 2 and skip lines 4 and 5. If you're correcting overreported amounts, for purposes of the certifications on lines 4 and 5, Medicare tax doesn't include Additional Medicare Tax. Form 941-X can't be used to correct overreported amounts of Additional Medicare Tax unless the amounts weren't withheld from employee wages or an adjustment is being made for the current year.

4. If you checked line 1 because you're adjusting overreported federal income tax, social security tax, Medicare tax, or Additional Medicare Tax, check all that apply. You must check at least one box.
I certify that:

- [ ] **a.** I repaid or reimbursed each affected employee for the overcollected federal income tax or Additional Medicare Tax for the current year and the overcollected social security tax and Medicare tax for current and prior years. For adjustments of employee social security tax and Medicare tax overcollected in prior years, I have a written statement from each affected employee stating that he or she hasn't claimed (or the claim was rejected) and won't claim a refund or credit for the overcollection.
- [ ] **b.** The adjustments of social security tax and Medicare tax are for the employer's share only. I couldn't find the affected employees or each affected employee didn't give me a written statement that he or she hasn't claimed (or the claim was rejected) and won't claim a refund or credit for the overcollection.
- [ ] **c.** The adjustment is for federal income tax, social security tax, Medicare tax, or Additional Medicare Tax that I didn't withhold from employee wages.

5. If you checked line 2 because you're claiming a refund or abatement of overreported federal income tax, social security tax, Medicare tax, or Additional Medicare Tax, check all that apply. You must check at least one box.
I certify that:

- [ ] **a.** I repaid or reimbursed each affected employee for the overcollected social security tax and Medicare tax. For claims of employee social security tax and Medicare tax overcollected in prior years, I have a written statement from each affected employee stating that he or she hasn't claimed (or the claim was rejected) and won't claim a refund or credit for the overcollection.
- [ ] **b.** I have a written consent from each affected employee stating that I may file this claim for the employee's share of social security tax and Medicare tax. For refunds of employee social security tax and Medicare tax overcollected in prior years, I also have a written statement from each affected employee stating that he or she hasn't claimed (or the claim was rejected) and won't claim a refund or credit for the overcollection.
- [ ] **c.** The claim for social security tax and Medicare tax is for the employer's share only. I couldn't find the affected employees, or each affected employee didn't give me a written consent to file a claim for the employee's share of social security tax and Medicare tax, or each affected employee didn't give me a written statement that he or she hasn't claimed (or the claim was rejected) and won't claim a refund or credit for the overcollection.
- [x] **d.** The claim is for federal income tax, social security tax, Medicare tax, or Additional Medicare Tax that I didn't withhold from employee wages.

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For Paperwork Reduction Act Notice, see the separate instructions. *www.irs.gov/Form941X* Cat. No. 17025J Form **941-X** (Rev. 10-2020)

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FIGURE 12.6 (continued)
Rolly's Roadhouse's Form 941-X

Name *(not your trade name)*	Employer identification number (EIN)	Correcting quarter 3 (1, 2, 3, 4)
		Correcting calendar year (YYYY)
Rolly Anderson	XXX-XX-XXX	2020

Part 3: Enter the corrections for this quarter. If any line doesn't apply, leave it blank.

		Column 1 *Total corrected amount (for ALL employees)*		Column 2 *Amount originally reported or as previously corrected (for ALL employees)*	=	Column 3 *Difference (If this amount is a negative number, use a minus sign.)*		Column 4 *Tax correction*
6.	**Wages, tips, and other compensation** (Form 941, line 2)	60,000 .	–	60,000 .	=	0 .	Use the amount in Column 1 when you prepare your Forms W-2 or Forms W-2c.	
7.	**Federal income tax withheld from wages, tips, and other compensation** (Form 941, line 3)	9,000 .	–	9,000 .	=	0 .	Copy Column 3 here ▶	0 .
8.	**Taxable social security wages** (Form 941 or 941-SS, line 5a, Column 1)	60,000 .	–	60,000 .	=	0 .	× 0.124* =	0 .
	* If you're correcting your employer share only, use 0.062. See instructions.							
9.	**Qualified sick leave wages** (Form 941 or 941-SS, line 5a(i), Column 1)	.	–	.	=	.	× 0.062 =	.
10.	**Qualified family leave wages** (Form 941 or 941-SS, line 5a(ii), Column 1)	.	–	.	=	.	× 0.062 =	.
11.	**Taxable social security tips** (Form 941 or 941-SS, line 5b, Column 1)	.	–	.	=	.	× 0.124* =	.
	* If you're correcting your employer share only, use 0.062. See instructions.							
12.	**Taxable Medicare wages & tips** (Form 941 or 941-SS, line 5c, Column 1)	60,000 .	–	60,000 .	=	0 .	× 0.029* =	0 .
	* If you're correcting your employer share only, use 0.0145. See instructions.							
13.	**Taxable wages & tips subject to Additional Medicare Tax withholding** (Form 941 or 941-SS, line 5d)	.	–	.	=	.	× 0.009* =	.
	* Certain wages and tips reported in Column 3 shouldn't be multiplied by 0.009. See instructions.							
14.	**Section 3121(q) Notice and Demand—Tax due on unreported tips** (Form 941 or 941-SS, line 5f)	.	–	.	=	.	Copy Column 3 here ▶	.
15.	**Tax adjustments** (Form 941 or 941-SS, lines 7 through 9)	.	–	.	=	.	Copy Column 3 here ▶	.
16.	**Qualified small business payroll tax credit for increasing research activities** (Form 941 or 941-SS, line 11a; you must attach Form 8974)	.	–	.	=	.	See instructions	.
17.	**Nonrefundable portion of credit for qualified sick and family leave wages** (Form 941 or 941-SS, line 11b)	.	–	.	=	.	See instructions	.
18.	**Nonrefundable portion of employee retention credit** (Form 941 or 941-SS, line 11c)	.	–	.	=	.	See instructions	.
19.	**Special addition to wages for federal income tax**	.	–	.	=	.	See instructions	.
20.	**Special addition to wages for social security taxes**	.	–	.	=	.	See instructions	.
21.	**Special addition to wages for Medicare taxes**	.	–	.	=	.	See instructions	.
22.	**Special addition to wages for Additional Medicare Tax**	.	–	.	=	.	See instructions	.
23.	Combine the amounts on lines 7 through 22 of Column 4							0 .
24.	**Deferred amount of social security tax*** (Form 941 or 941-SS, line 13b)	.	–	.	=	.	See instructions	.
	* Use this line to correct the employer deferral for the second quarter of 2020 and the employer and employee deferral for the third and fourth quarters of 2020.							
25.	**Refundable portion of credit for qualified sick and family leave wages** (Form 941 or 941-SS, line 13c)	.	–	.	=	.	See instructions	.

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FIGURE 12.6 (continued)
Rolly's Roadhouse's Form 941-X

Name *(not your trade name)*	Employer identification number (EIN)	Correcting quarter 3 (1, 2, 3, 4)
		Correcting calendar year (YYYY)
Rolly Anderson	XXX-XX-XXX	2020

Part 3: Enter the corrections for this quarter. If any line doesn't apply, leave it blank. *(continued)*

		Column 1 *Total corrected amount (for ALL employees)*		Column 2 *Amount originally reported or as previously corrected (for ALL employees)*	=	Column 3 *Difference (If this amount is a negative number, use a minus sign.)*		Column 4 *Tax correction*
26.	**Refundable portion of employee retention credit** (Form 941 or 941-SS, line 13d)	15,000 .	–	0 .	=	15,000 .	See instructions	-15,000 .
27.	**Total.** Combine the amounts on lines 23 through 26 of Column 4							-15,000 .

If line 27 is less than zero:

- If you checked line 1, this is the amount you want applied as a credit to your Form 941 or 941-SS for the tax period in which you're filing this form. (If you're currently filing a Form 944, Employer's ANNUAL Federal Tax Return, see the instructions.)
- If you checked line 2, this is the amount you want refunded or abated.

If line 27 is more than zero, this is the amount you owe. Pay this amount by the time you file this return. For information on how to pay, see *Amount you owe* in the instructions.

28.	**Qualified health plan expenses allocable to qualified sick leave wages** (Form 941 or 941-SS, line 19)	.	–	.	=	.		
29.	**Qualified health plan expenses allocable to qualified family leave wages** (Form 941 or 941-SS, line 20)	.	–	.	=	.		
30.	**Qualified wages for the employee retention credit** (Form 941 or 941-SS, line 21)	30,000 .	–	0 .	=	30,000 .		
31.	**Qualified health plan expenses allocable to wages reported on Form 941 or 941-SS, line 21** (Form 941 or 941-SS, line 22)	.	–	.	=	.		
32.	**Credit from Form 5884-C, line 11, for this quarter** (Form 941 or 941-SS, line 23)	.	–	.	=	.		
33a.	**Qualified wages paid March 13 through March 31, 2020, for the employee retention credit (use this line to correct only the second quarter of 2020)** (Form 941 or 941-SS, line 24)	.	–	.	=	.		
33b.	**Deferred amount of the employee share of social security tax included on Form 941 or 941-SS, line 13b (use this line to correct only the third and fourth quarters of 2020)** (Form 941 or 941-SS, line 24)	.	–	.	=	.		
34.	**Qualified health plan expenses allocable to wages reported on Form 941 or 941-SS, line 24 (use this line to correct only the second quarter of 2020)** (Form 941 or 941-SS, line 25)	.	–	.	=	.		

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FIGURE 12.6 (continued)
Rolly's Roadhouse's Form 941-X

Name *(not your trade name)*	Employer identification number (EIN)	Correcting quarter 3 (1, 2, 3, 4)
		Correcting calendar year (YYYY)
Rolly Anderson	XXX-XX-XXX	2020

Part 4: Explain your corrections for this quarter.

☐ **35. Check here if any corrections you entered on a line include both underreported and overreported amounts.** Explain both your underreported and overreported amounts on line 37.

☐ **36. Check here if any corrections involve reclassified workers.** Explain on line 37.

37. You must give us a detailed explanation of how you determined your corrections. See the instructions.

Calculated and claimed the employee retention credit, which was not claimed in 2020. This amendment is made in response to the change in law that allows a 2020 employee retention credit, even if the employer received Paycheck Protection Program loan forgiveness.

Part 5: Sign here. You must complete all four pages of this form and sign it.

Under penalties of perjury, I declare that I have filed an original Form 941 or Form 941-SS and that I have examined this adjusted return or 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.

X **Sign your name here**

Print your name here: **Rollly Anderson**

Print your title here: **Owner**

Date / /

Best daytime phone

Paid Preparer Use Only

Check if you're self-employed . . . ☐

Preparer's name

PTIN

Preparer's signature

Date / /

Firm's name (or yours if self-employed)

EIN

Address

Phone

City

State

ZIP code

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FIGURE 12.7
Rolly's Roadhouse's Form 941-X, Worksheet 1

Worksheet 1. Adjusted Credit for Qualified Sick and Family Leave Wages and the Employee Retention Credit—*(continued)*

Step 3.		**Figure the employee retention credit**				
	3a	Qualified wages (excluding qualified health plan expenses) for the employee retention credit (Form 941, Part 3, line 21, or, if corrected, Form 941-X, line 30, column 1)	3a	30,000		
	3b	Qualified health plan expenses allocable to qualified wages for the employee retention credit (Form 941, Part 3, line 22, or, if corrected, Form 941-X, line 31, column 1)	3b			
	3c	Qualified wages (excluding qualified health plan expenses) paid March 13, 2020, through March 31, 2020, for the employee retention credit (Form 941, Part 3, line 24, or, if corrected, Form 941-X, line 33a, column 1). Enter an amount here only for the second quarter Form 941-X	3c			***Caution**: Only complete lines 3c and 3d for your second quarter 2020 Form 941-X.*
	3d	Qualified health plan expenses allocable to qualified wages paid March 13, 2020, through March 31, 2020, for the employee retention credit (Form 941, Part 3, line 25, or, if corrected, Form 941-X, line 34, column 1). Enter an amount here only for the second quarter Form 941-X	3d			
	3e	Add lines 3a, 3b, 3c, and 3d	3e	30,000		
	3f	**Retention credit.** If you're correcting the second, third, or fourth quarter of 2020, multiply line 3e by 50% (0.50). If you're correcting a 2021 quarter, multiply line 3e by 70% (0.70)			3f	15,000
	3g	Enter the amount of the employer share of social security tax from Step 1, line 1l	3g	3,720		
	3h	Enter the amount of the nonrefundable portion of the credit for qualified sick and family leave wages from Step 2, line 2j	3h			
	3i	Subtract line 3h from line 3g	3i	3,720		
	3j	**Nonrefundable portion of employee retention credit.** Enter the smaller of line 3f or line 3i. Enter this amount on Form 941-X, line 18, column 1			3j	
	3k	**Refundable portion of employee retention credit.** Subtract line 3j from line 3f and enter this amount on Form 941-X, line 26, column 1			3k	15,000

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2021 Employee Retention Credit

Section 207 of the TCDTRA amended section 2301 of the CARES Act to extend the application of the ERC to qualified wages paid after December 31, 2020, and before July 1, 2021. The amendment also expanded the scope and amount of the ERC. IRS Notice 2021-23, 2021-16 I.R.B. 1113, provides detailed guidance for the ERC claimed during the first two quarters of 2021. It states that Notice 2021-20 continues to apply, except where provisions were modified by the TCDTRA. Consequently, except where specifically noted, the 2021 ERC follows the same general rules (discussed earlier) for the 2020 ERC.

On March 11, 2021, the American Rescue Plan Act (ARPA) added new I.R.C. § 3134 to provide an ERC (similar to that provided by the CARES Act, as extended by the TCDTRA) for qualified wages paid from July 1, 2021, through December 31, 2021. Generally, the rules for the ERC for the third and fourth quarters of 2021 are substantially similar to those for the first two quarters of 2021. This section discusses the new provisions added by ARPA for the third and fourth quarters of 2021.

PRACTITIONER NOTE

Credit Significantly Enhanced

As a result of the TCDTRA changes, many employers who did not qualify for the ERC in 2020 may now qualify for the newly expanded 2021 ERC. Additionally, the credit will generally be significantly larger. Tax practitioners should ensure that eligible employers are aware of this credit, even if the practitioner does not process payroll tax returns.

PRACTITIONER NOTE

Pending Legislation

The Infrastructure Investment and Jobs Act passed the Senate on August 10, 2021. If enacted, it will end the ERC on September 30, 2021 for employers other than recovery startup businesses (as defined under that act).

Eligible Employers

While most governmental entities remain ineligible for the credit, the TCDTRA made the following entities eligible for the ERC beginning January 1, 2021:

- An organization that is described in I.R.C. § 501(c)(1) and is exempt from tax under I.R.C. § 501(a)
- A college or university
- A governmental entity whose principal purpose or function is providing medical or hospital care

These entities are automatically treated as satisfying the trade or business requirement for the ERC.

Decline in Gross Receipts Test

In 2020, the decline in gross receipts test applied to an employer whose gross receipts were less than 50% of its gross receipts for the same calendar quarter in 2019. For 2021, the TCDTRA defines an eligible employer under the decline in gross receipts test as an employer whose gross receipts for a calendar quarter in 2021 are less than 80% of the gross receipts (a 20% or more decline) for the same calendar quarter in 2019. If the employer was not in existence at the beginning of the same calendar quarter in 2019, it can use its 2020 gross receipts for that quarter as the comparison.

In 2021, an employer may elect to use an alternative quarter to calculate gross receipts. Under this election, an employer may generally determine if the decline in gross receipts test is met for a calendar quarter in 2021 by comparing its gross receipts for the immediately preceding calendar quarter with those for the corresponding calendar quarter in 2019 (substituting 2020 for 2019 if the employer did not exist as of the beginning of that quarter in 2019).

This means that for the first quarter of 2021, an employer may elect to use its gross receipts for the fourth calendar quarter of 2020 compared to those for the fourth calendar quarter of 2019 to determine if the gross receipts test is met. If an employer was not in existence as of the beginning of the fourth calendar quarter of 2019, then the alternative quarter election is not available for the first calendar quarter of 2021.

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PRACTITIONER NOTE

Making the Alternative Calculation Election

An election to use an alternative quarter to calculate gross receipts is made by claiming the ERC for the quarter using the alternative quarter to calculate gross receipts.

PRACTITIONER NOTE

Documenting Gross Receipts

Eligible employers must maintain documentation to support the determination of the decline in gross receipts, including which calendar quarter an eligible employer elects to use in measuring the decline.

Credit Calculation

From January 1, 2021, through December 31, 2021, the ERC percentage increases from 50% percent of qualified wages to 70% (including allocable qualified health plan expenses). Additionally, in 2021, employers can include qualified wages (and allocable qualified health plan expenses) in an amount up to $10,000 per employee per quarter (instead of for all quarters). This means that an eligible employer can claim up to a $28,000 ($10,000 × 70% × 4 quarters) credit per employee in 2021.

Qualified Wages

For 2020, for an eligible employer with an average number of full-time employees greater than 100 in 2019, qualified wages are the wages paid to an employee for time that the employee is not providing services due to either a full or partial suspension of an employer's business operations due to a governmental order, or the business experiencing a significant decline in gross receipts. If the eligible employer had 100 or fewer full-time employees in 2019, qualified wages are the wages paid with respect to any employee during any period in the calendar quarter in which the business met either test.

In 2021, employers with more than 500 employees in 2019 (increased from 100) may claim the credit based on wages of employees who were not providing services. In 2021, employers with 500 or fewer employees in 2019 may claim the credit based on wages of all employees, regardless of whether they worked. The aggregation rules apply.

Severely Financially Distressed Employers

For quarters three and four of 2021, ARPA created a new category of employer. Severely financially distressed employers are employers whose revenue for any quarter in 2021 is less than 10% of its revenue for the comparable quarter in 2019. Severely financially distressed employers with more than 500 employees may claim the credit based on the wages of all employees, regardless of whether their employees were working.

Recovery Startup Businesses

Under ARPA, recovery startup businesses can claim the ERC, limited to $50,000 per quarter (after application of the wage limit). A recovery startup business is an employer that

- began carrying on a trade or business after February 15, 2020;
- had average annual gross receipts of $1,000,000 or less for the 3 tax years ending with the tax year before the calendar quarter in which the employer claims the ERC; and
- is not otherwise eligible for the third or the fourth quarter, as applicable, for the ERC because business operations were not fully or partially suspended due to a governmental order or because gross receipts were not less than 80% of the gross receipts for the same calendar quarter in calendar year 2019.

The determination is made separately for each calendar quarter. The aggregation rules apply to the determination of whether an employer is a recovery startup business, and also to the application of the $50,000 limit.

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OBSERVATION

New Businesses

If a business started after February 15, 2020, can show a reduction of gross receipts in quarters three or four of 2020, or can show that it was subject to a government shutdown, it will an eligible business and is not subject to the $50,000 limit. Before July 1, 2021, the ERC was not available to businesses started after February 15, 2020. That restriction has been removed.

PRACTITIONER NOTE

Work Opportunity Credit

Notice 2021-20 stated that under section 2301(h)(1) of the CARES Act, an employee could not be included for purposes of computing the ERC for any period that an employer is allowed a work opportunity credit under section 51 with respect to that employee. Section 207(f) of the TCDTRA removed this restriction for 2021. The same wages, however, cannot be applied to both credits.

Not Qualified Wages

Qualified ERC wages under new section 3134 exclude wages taken into account for the following credits:

- I.R.C. § 41 (research credit)
- I.R.C. § 45A (Indian employment credit)
- I.R.C. § 45P (wage credit for active military)
- I.R.C. § 45S (employer credit for paid family and medical leave)
- I.R.C. § 51 (work opportunity credit)
- I.R.C. § 1396 (empowerment zone employment credit)
- I.R.C. § 3131 (qualified sick leave wages for leave taken after March 31, 2021)
- I.R.C. § 3132 (qualified family leave wages for leave taken after March 31, 2021)

Qualified wages also exclude wages that were used as payroll costs in connection with a Shuttered Venue Operator Grant under section 324 of the Economic Aid to Hard-Hit Small Businesses, Nonprofits, and Venues Act of the CAA; or a restaurant revitalization grant under section 5003 of ARPA. Employers can receive both a PPP loan and the ERC; however, employers cannot receive both loan forgiveness and a credit for the same wages (as explained earlier).

Example 12.15
Calculating the 2021 Credit

Stray Cat Consulting (SCC) from Example 12.8 employed the same four employees throughout 2021 and provided the same pay and benefits to those employees as it did in 2020. The business experienced a significant decline in gross receipts for quarters one through three of 2021, as compared to 2019. Its payroll and credit calculation are shown in **Figure 12.8**.

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FIGURE 12.8
SCC's 2021 Payroll and ERC Calculation

	Q1 Payroll	Q1 ERC	Q2 Payroll	Q2 ERC	Q3 Payroll	Q3 ERC
Employee 1	$2,500 wages, $500 health care benefits	$2,100 ERC ($3,000 qualified wages × 70%)	$2,500 wages, $500 health care benefits	$2,100 ERC ($3,000 qualified wages × 70%)	$2,500 wages, $500 health care benefits	$2,100 ERC ($3,000 qualified wages × 70%)
Employee 2	$8,000 wages, $500 health care benefits	$5,950 ERC ($8,500 qualified wages × 70%)	$8,000 wages, $500 health care benefits	$5,950 ERC ($8,500 qualified wages × 70%)	$8,000 wages, $500 health care benefits	$5,950 ERC ($8,500 qualified wages × 70%)
Employee 3	$10,000 wages, $500 health care benefits	$7,000 ERC ($10,000 qualified wages × 70%)	$10,000 wages, $500 health care benefits	$7,000 ERC ($10,000 qualified wages × 70%)	$10,000 wages, $500 health care benefits	$7,000 ERC ($10,000 qualified wages × 70%)
Employee 4	No wages, $500 health care benefits	$350 ERC ($500 qualified wages × 70%)	No wages, $500 health care benefits	$350 ERC ($500 qualified wages × 70%)	No wages, $500 health care benefits	$350 ERC ($500 qualified wages × 70%)
Totals	$22,500	$15,400 ERC	$22,500	$15,400 ERC	$22,500	$15,400 ERC

In 2021, employers can include qualified wages (and allocable qualified health plan expenses) in an amount up to $10,000 per employee per quarter (instead of for all quarters). Therefore, for 2021, Stray Cat Consulting is eligible for a $46,200 ERC ($15,400 × 3 quarters) compared to its $15,250 for 2020.

Claiming the Credit in 2021

In 2021, eligible employers may continue to reduce employment tax deposits in anticipation of the ERC, in accordance with the requirements of Notice 2020-22, 2020-17 I.R.B. 664, as amplified by Notice 2021-24, 2021-18 I.R.B. 1122 (which extends deposit penalty relief to apply to deposits of employment taxes that are reduced in anticipation of the ERC). Employers claim the credit on payroll tax returns, including the applicable quarterly Form 941 or the yearly Form 943 or Form 944.

Advance Credit

In 2021, before filing an employment tax return, small employers can request an advance of the credit by filing Form 7200, Advance Payment of Employer Credits Due to COVID-19. The advance payment of the ERC cannot exceed 70% of the average quarterly wages paid in calendar year 2019. If the employer receives an advance payment, it must reconcile the advance with the credit calculated on the payroll tax return. Small employers are defined as those employers with an average of 500 or fewer FTEs in 2019. Employers that were not in business in 2019 look to 2020 to determine whether they had an average of 500 or fewer FTEs and to calculate the limit on the advance payment.

Nonrefundable Portion

The ERC is a refundable credit against certain payroll taxes. For wages paid between January 1, 2021, and July 1, 2021, the nonrefundable portion of the ERC is against the employer's share of social security tax (6.2%). For wages paid after June 30, 2021, the nonrefundable portion of the ERC is against the employer's share of Medicare tax (1.45%). The excess is treated as a refundable overpayment.

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Extended Period to Assess Tax

Under ARPA, there is a 5-year statute of limitations for the IRS to audit and assess a deficiency for claiming the ERC in quarters three and four of 2021. Prior quarters are subject to the standard 3-year limitation.

Avoiding Common Errors on Form 941

COVID Tax Tip 2021-64 (May 10, 2021) suggests the following to avoid common errors when filing payroll tax returns:

- Ensure that the number of employees is accurate.
- Report advanced credits received, not the requested payment of credits. If an employer has not received the advance payment of a credit that it requested, the employer should not report it on Form 941.
- Use Form 7200 to request the advance payment of a credit, not for reporting the credit or claiming the credit. An employer must claim the credit on the applicable employment tax return, typically Form 941.
- If an employer has received the advance payment requested, it must reconcile it on Form 941 by reporting the advance payments received and claiming the credits for which it is eligible.
- If an employer receives an advance payment of a credit but does not claim a corresponding credit on its employment tax return, the employer may receive a balance due notice.
- If an employer filed an employment tax return and did not report a credit that it was otherwise entitled to, the employer will need to file an amended return using Form 941-X to claim those eligible credits.

Comparison of the ERC Provisions

Figure 12.9 compares the ERC in 2020 with the ERC for the first two quarters in 2021, and the ERC for the last two quarters in 2021.

FIGURE 12.9
Comparison of ERC Provisions

	2020	2021 Q1 and Q2	2021 Q3 and Q4
Time Period for Wages	March 13, 2020–December 31, 2020	January 1, 2021–June 30, 2021	July 1, 2021–December 31, 2021
Amount of Credit	50% of qualified wages (including allocable health plan expenses) Limited to $10,000 in qualified wages per employee for all quarters, so maximum ERC is $5,000 ($10,000 × 50%) per employee for the year	70% of qualified wages (including allocable health plan expenses) Limited to $10,000 in qualified wages per employee per quarter, so maximum ERC is $28,000 ($10,000 × 4 quarters × 70%) per employee for the year	
Decline in Gross Receipts Test	Employers whose operations were fully or partially suspended or had a reduction in gross receipts of more than 50% for quarter as compared to 2019 (employer will lose eligibility the quarter after first quarter where gross receipts exceed 80% of 2019 gross receipts)	Employers whose operations were fully or partially suspended or had a reduction in gross receipts of more than 20% for quarter as compared to 2019 May use prior quarter and compare to equivalent 2019 quarter to establish eligibility	

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FIGURE 12.9 (continued)
Comparison of ERC Provisions

	2020	2021 Q1 and Q2	2021 Q3 and Q4
Employees Not Providing Service	Employers with 100 or fewer full-time employees in 2019 can claim ERC for all qualified wages Employers with more than 100 full-time employees may claim ERC only for employees that are not performing services	Employers with 500 or fewer full-time employees in 2019 can claim ERC for all qualified wages Employers with more than 500 full-time employees may claim ERC only for employees that are not performing services	Same as quarters one and two, 2020, but large severely financially distressed employers (gross receipts less than 10% percent of gross receipts for same quarter in 2019) can claim ERC for employees, regardless of whether they are performing services
Recovery Startup Business	N/A	N/A	After February 15, 2020, may claim up to $50,000 credit per quarter, even if it was not subject to shutdown or did not have a significant decline in gross receipts
Interaction with Other Provisions	An employee will not be included for the ERC for any period that an employer is allowed a work opportunity credit under I.R.C. § 51 for that employee Qualified wages exclude wages taken into account for FFCRA credits, and other FMLA credit under I.R.C. § 45S Employers can receive both a PPP loan and the ERC, however, employers cannot receive both loan forgiveness and a credit for the same wages.	Qualified wages exclude wages taken into account for credits under I.R.C. §§ 41, 45A, 45P, 45S, 51, 1396, and FFCRA Qualified wages exclude amounts used as payroll costs necessary for PPP loan forgiveness	Qualified wages exclude wages taken into account for credits under I.R.C. §§ 41, 45A, 45P, 45S, 51, 1396, 3131, and 3132 Qualified wages exclude amounts used as payroll costs necessary for PPP loan forgiveness Qualified wages exclude wages used for payroll costs for shuttered operator grants and restaurant revitalization grants
Nonrefundable Portion	For wages paid before July 1, 2021, the nonrefundable portion of the employee retention credit is against the employer's share of social security tax		For wages paid after June 30, 2021, the nonrefundable portion of the employee retention credit is against the employer's share of Medicare tax
Advance Credit	Form 7200 advance credit available to all eligible employers	Form 7200 advance credit in an amount up to 70% of 2019 average quarterly wages, available only to employers with 500 or fewer full-time employees	
Government Employers	No government employers	Public colleges, universities, and organizations whose primary purpose is to provide medical or hospital care	
Statutory Enforcement Period	3 years	3 years	5 years

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ISSUE 4: SICK LEAVE AND FAMILY LEAVE CREDITS

This section reviews the rules for claiming payroll tax credits for sick leave and family leave provided to employees or for sick leave or family leave taken by a self-employed person in 2020 or 2021.

From April 1, 2020, through December 31, 2020, the Families First Coronavirus Response Act (FFCRA), Pub. L. No.116-127 (March 18, 2020), provided for paid coronavirus-related leave through the Emergency Paid Sick Leave Act (EPSLA) and the Emergency Family and Medical Leave Expansion Act (Expanded FMLA). The COVID-Related Tax Relief Act of 2020 (COVIDTRA), Pub. L. No. 116-260, extended the FFCRA leave credits through March 31, 2021. However, it did not amend the EPSLA and Expanded FMLA, and the requirement that employers provide leave expired on December 31, 2020. The American Rescue Plan of 2021 (ARPA), Pub. L. No. 117-2, further extended the tax credits for sick and family leave, through September 30, 2021, and expanded the availability of the credits for leave taken from April 1, 2021, through September 30, 2021.

2020 and Q1 2021 Sick and Family Leave Credits

From April 1, 2020, through December 31, 2020, the EPSLA required up to 80 hours of paid sick leave if workers were unable to work for certain reasons related to COVID-19, and the Expanded FMLA required certain paid family and medical leave. The 2020 EPSLA and Expanded FMLA were extended through March 31, 2021 (but no longer mandatory for employers in 2021), and then modified for the remainder of 2021 (discussed later). Eligible employers providing leave under the EPSLA and the Expanded FMLA are entitled to refundable tax credits to cover the cost of the leave paid for the time during which employees were unable to work. Certain self-employed persons in similar circumstances are entitled to similar credits.

Eligible Employers

Eligible employers under the EPSLA and the Expanded FMLA are businesses and tax-exempt organizations with fewer than 500 employees. The federal government, the governments of any state or political subdivision, and any agencies or instrumentalities of those governments are not eligible employers entitled to receive tax credits for providing paid leave wages under the EPSLA or Expanded FMLA. The FFCRA provides self-employed persons with similar credits.

OBSERVATION

No Trade or Business Requirement

Unlike the ERC, the FFCRA imposes no trade or business requirement for an employer to be eligible. This means, for example, that household employers are generally eligible to claim the credits. To be eligible, a self-employed taxpayer must regularly carry on a trade or business.

Wages

Wages are defined in I.R.C. § 3121(a), determined without regard to I.R.C. § 3121(b)(1)-(22). They also include compensation, as defined in I.R.C. § 3231(e), determined without regard to the exclusions under I.R.C. § 3231(e)(1).

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PRACTITIONER NOTE

Qualified Sick and Family Leave Wages

Under FFCRA § 7001, qualified sick leave wages are those wages that must be paid under the EPSLA. Similarly, FFCRA § 7003 defines qualified family leave wages as those wages that must be paid under the Expanded FMLA. I.R.C. § 3131(c)(1) defines qualified sick leave wages as wages paid by an employer that would have been required had the EPSLA applied after March 31, 2021. Under I.R.C. § 3132(c)(1), qualified family leave wages are wages paid by an employer that would be required to be paid by reason of the Expanded FMLA (including the amendments made by ARPA) as if it applied after March 31, 2021. This means that, for purposes of the credit, qualified family leave wages and qualified sick leave wages paid to care for someone else are limited to two-thirds of regular pay, up to a maximum of $200 per day.

There is no double benefit allowed, and qualified leave wages taken into account for the tax credits may not be taken into account for purposes of determining a credit under I.R.C. § 45S. Qualified leave wages for which an employer is allowed tax credits are not eligible as payroll costs for purposes of receiving PPP loan forgiveness.

OBSERVATION

Interaction of Credits

Under the FFCRA, the family leave credit (10 weeks) can be combined with the sick leave credit (2 weeks) for credits for up to 12 weeks of leave per employee. However, the same wages cannot be taken into account for both credits.

Sick Leave Credits

Under the FFCRA, employers can receive sick leave credits equal to 100% of the qualified sick leave wages. The employer can take into account up to 80 hours or 2 weeks of qualified sick leave wages per employee and the sick leave credits are capped at $511 per day ($5,110 in the aggregate), if an employee is unable to work or telework for the following reasons:

1. The employee is subject to a federal, state, or local quarantine or isolation order related to COVID-19.
2. A health care provider advises the employee to self-quarantine due to concerns related to COVID-19.
3. The employee is experiencing symptoms of COVID-19 and seeking a medical diagnosis.

The employer can take into account up to 80 hours or 2 weeks of qualified sick leave wages per employee at a rate of two-thirds of the employee's regular rate of pay, capped at $200 per day ($2,000 in the aggregate) if an employee is unable to work or telework for the following reasons:

1. The employee is caring for an individual who is subject to a federal, state, or local quarantine or isolation order related to COVID-19 or is advised by a health care provider to self-quarantine due to concerns related to COVID-19.
2. The employee is caring for his or her child and the child's school or place of care is closed, or the child's care provider is unavailable due to COVID-19.
3. The employee is experiencing any other substantially similar condition specified by the secretary of Health and Human Services in consultation with the secretary of the Treasury and the secretary of Labor.

Family Leave Credits

Under the FFCRA, eligible employers can receive family leave credits equal to 100% of the qualified family leave wages. Qualified family leave wages are paid at a rate of two-thirds of the employee's regular rate of pay, capped at $200 per day ($10,000 in the aggregate).

The credits are available if an employee is unable to work or telework for the following reasons:

- The employee must care for his or her child because the child's school or place of care has been closed (including the closure of a summer camp, summer enrichment program, or other summer program).
- The child's care provider is unavailable, for reasons related to COVID-19.

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PRACTITIONER NOTE

First 10 Days of Leave

In 2020, the employer was not required to pay family leave for the first 10 days for which an employee took leave. However, during that 10-day period, an employee could receive qualified sick leave wages as provided under the EPSLA or may receive other forms of paid leave, such as accrued sick leave, annual leave, or other paid time off under the eligible employer's policy.

Example 12.16
Two Limitations

Eddie Jones works for Twin Bridges Construction. In May 2020, Eddie took 1 day off work to care for his son, Jeff, who was exposed to COVID-19 at school. Jeff's doctor advised the quarantine. Twin Bridges paid Eddie his regular rate of pay, which was $270 per day. Twin Bridges can take a $180 ($270 × 2/3) paid sick leave credit. If instead Eddie's regular rate of pay was $330 per day, Twin Bridge's credit is limited to the $200 ($330 × 2/3 = $220) cap.

Additions to the Credits

The sick leave and family leave credits also include the employer's share of Medicare tax imposed on those wages and the allocable cost of maintaining health insurance coverage for the employee (qualified health plan expenses). Additionally, employers are not subject to the employer's share of social security tax imposed on qualified leave wages.

Tax Treatment of the Credits

In 2020 and the first quarter of 2021, eligible employers must include the full amount of the credit for qualified leave wages (and the credit for allocable health plan expenses and the eligible employer's share of the Medicare tax) in gross income. Qualified leave wages and health care expenses for which the employer claims the credit generally remain deductible as an ordinary and necessary business expense.

Qualified leave wages are wages subject to withholding of federal income tax and the employee's share of social security and Medicare taxes. Qualified leave wages are also considered wages for purposes of other benefits that the eligible employer provides, such as contributions to 401(k) plans. If the employer is otherwise eligible to deduct its portion of the social security tax on all wages, the employer can deduct the amount of federal employment taxes before reduction by the tax credits.

Self-Employed Taxpayers

Self-employed taxpayers can claim similar tax credits under the FFCRA. An eligible self-employed individual is defined as an individual who

- regularly carries on any trade or business within the meaning of I.R.C. § 1402 and
- would be eligible to receive qualified sick leave wages or qualified family leave wages under the EPSLA or Expanded FMLA if the individual was an employee of an eligible employer (other than himself or herself) that is subject to the requirements of the EPSLA or Expanded FMLA.

Eligible self-employed individuals are allowed an income tax credit to offset their federal self-employment tax equal to their qualified sick leave equivalent amount or qualified family leave equivalent amount. The credit amount is capped in the same way as the credit provided to employers.

PRACTITIONER NOTE

Q1 of 2021 Sick and Family Leave Credits

COVIDTRA extended the FFCRA leave credits through March 31, 2021, for both employers and the self-employed. It did not, however, extend the requirement that employers provide this leave. Otherwise, it did not change the rules or reset credit limits for the FFCRA credits. Thus, any credits claimed in 2020 reduced the credits available in the first quarter of 2021.

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Q2 and Q3 of 2021 Sick and Family Leave Credits

ARPA resets and expands the payroll tax credits for sick and family leave and extends those credits through September 30, 2021. ARPA codifies the credits as I.R.C. § 3131 (credit for paid sick leave), I.R.C. § 3132 (payroll credit for paid family leave), and I.R.C. § 3133 (special rule related to tax on employers). Except as noted below, the same general rules as the 2020 FFCRA credits (as modified by COVIDTRA to remove the mandatory requirement to provide leave) apply.

Additional Eligible Employers

Eligible employers must have fewer than 500 employees. Certain governmental employers are eligible regardless of the number of employees. Generally, governmental employers (including any agency or instrumentality of the government) are eligible to receive tax credits for qualified leave wages paid with respect to leave taken by employees beginning on April 1, 2021, through September 30, 2021, without regard to the number of employees. However, the federal government, and any agency or instrumentality of the federal government that is not an organization described in section 501(c)(1), is not an eligible employer.

Sick Leave Credits Expanded

I.R.C. § 3131 allows 10 days of qualified paid sick leave per employee for leave occurring from April 1 through September 30, 2021, and adds immunization-related absences to the reasons for leave. Eligible employers may receive sick leave credits for qualified sick leave wages paid to employees who are unable to work or telework for the following reasons:

1. The employee is under a federal, state, or local quarantine or isolation order related to COVID-19.
2. A health care provider advises the employee to self-quarantine due to concerns related to COVID-19.
3. The employee is:
   a. experiencing symptoms of COVID-19 and seeking a medical diagnosis;
   b. seeking or awaiting the results of a diagnostic test for, or a medical diagnosis of, COVID-19 and the employee has been exposed to COVID-19 or the employee's employer has requested the test or diagnosis; or
   c. obtaining immunization related to COVID-19 or recovering from any injury, disability, illness, or condition related to the immunization.
4. The employee is caring for an individual who was subject to a federal, state, or local quarantine or isolation order related to COVID-19 or is advised by a health care provider to self-quarantine due to concerns related to COVID-19.
5. The employee is caring for his or her child because the child's school or place of care of the child is closed, or the childcare provider is unavailable, due to COVID-19 precautions.
6. The employee is experiencing any other substantially similar condition specified by the secretary of Health and Human Services (HHS) in consultation with the secretary of the Treasury and the secretary of Labor.

The secretary of HHS has specified, in consultation with the secretaries of Treasury and Labor, that an employee who takes leave to accompany an individual to obtain immunization related to COVID-19, or to care for an individual who is recovering from any injury, disability, illness, or condition related to the immunization, is experiencing a *substantially similar condition* for which the eligible employer may pay qualified sick leave wages.

Sick Leave Credit Amount

The maximum sick leave credit amount is up to 100% of qualified sick leave wages. The maximum amount of qualified sick leave wages (including certain collectively bargained contributions) included for purposes of the credit is limited to 2 weeks, with a maximum rate of $511 per day ($5,110 in the aggregate) for reasons related to the employee's own health needs (reasons 1, 2, and 3). The maximum credit is two-thirds of regular pay, up to $200 per day ($2,000 in the aggregate) for reasons related to the employee's need to care for others (reasons 4, 5, and 6).

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Additional Sick Leave Credit Amounts

The employer is subject to the employer's share of social security and Medicare taxes imposed on qualified sick leave wages, but the tax credit is increased by the employer's share of social security and Medicare taxes imposed on the qualified sick leave wages, and also by allocable qualified health plan expenses. These expenses include amounts paid by the employer to maintain a group health plan, to the extent the benefit is excluded from income by I.R.C. § 106(a). These increases are not subject to the maximum daily or aggregate limits.

Family Leave Credits Expanded

For April 1, 2021, through September 30, 2021, an eligible employer may claim a refundable tax credit for qualified family leave wages (including certain collectively bargained contributions) it pays. For the second and third quarters of 2021, eligibility for the paid family leave credit is expanded to include all the reasons allowed for paid sick leave in the second and third quarters of 2021 (but the wages cannot be for the same hours for purposes of claiming the credits). Thus, qualified leave includes employees who are unable to work or telework because they are obtaining immunization related to COVID-19 or recovering from any injury, disability, illness, or condition related to the immunization; accompanying an individual to obtain immunization related to COVID-19; or caring for an individual who is recovering from any injury, disability, illness, or condition related to the immunization.

Family Leave Credit Amounts

The family leave credit is equal to 100% of qualified family leave wages paid by the employer. The maximum amount of qualified leave that may be taken into account is limited to 12 weeks at a maximum rate of two-thirds of the employee's regular rate of pay, capped at $200 per day ($12,000 in the aggregate). The wage limit is determined without regard to any qualified family leave wages that the employer paid prior to April 1, 2021. That is, ARPA resets the maximum amount of paid family leave for which an employer may claim tax credits for wages paid with respect to leave taken by employees beginning on April 1, 2021, through September 30, 2021.

Additional Family Leave Credit Amounts

Under I.R.C. §§ 3132 and 3133, qualified family leave wages are subject to the employer's share of social security tax and Medicare tax, but the family leave credit is increased by the employer's share of social security and Medicare taxes imposed on the qualified family leave wages. The credit is also increased by allocable qualified health plan expenses. The health plan expenses and the tax increases to the credit are not subject to the maximum daily or aggregate limits.

OBSERVATION

Payroll Taxes

Qualified sick and family leave wages paid prior to April 1, 2021, are subject only to the employer's share of Medicare tax (and not the employer's share of social security tax). Therefore, the employer is entitled to receive credits to offset only the Medicare tax for those periods.

Claiming the Credits

In anticipation of claiming the sick and family leave credits, employers can reduce federal employment taxes, including withheld taxes that would otherwise be required to be deposited with the IRS. Notice 2021-24, 2021-18 I.R.B. 1122, provides deposit penalty relief. If the amount of the credit exceeds the federal employment taxes, the employer may request an advance payment of the credit by filing Form 7200, Advance Payment of Employer Credits Due to COVID-19. Employers must report their total qualified leave wages for each calendar quarter on their federal employment tax returns, usually Form 941 Employer's Quarterly Federal Tax Return, and reconcile any advance payments received.

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PRACTITIONER NOTE

Antidiscrimination

The credits for qualified sick and family leave wages are disallowed in a quarter in which the employer provides the leave in a manner that discriminates in favor of highly compensated employees, full-time employees, or employees on the basis of employment tenure.

Tax Treatment of the Credits

In the third and fourth quarters of 2021, eligible employers must include the full amount of the credits received for qualified leave wages (plus the credits for allocable qualified health plan expenses, certain collectively bargained contributions, and the employer's share of social security and Medicare taxes imposed on the qualified leave wages). Qualified leave wages and health care expenses generally remain deductible. If the eligible employer is otherwise eligible to deduct its portion of the Medicare tax and social security tax on all wages, the proper amount deductible is the amount of these taxes before any reduction by the tax credits.

Interaction with other Credits

For the second quarter of 2021, to the extent an employer receives the ERC on the same wages that are qualified leave wages, the employer must reduce the tax credit for qualified sick or leave wages by the portion of the credit allowed under section 2301 of the CARES Act that is attributable to the same wages. For the third quarter of 2021, any qualified leave wages employers take into account for purposes of the paid sick or leave credits may not be taken into account for purposes of the employee retention credit.

An employer cannot claim a sick or family leave credit for the same wages used to claim the following credits:

- I.R.C. § 45A (Indian employment credit)
- I.R.C. § 45P (wage credit for active military)
- I.R.C. § 45S (employer credit for paid family and medical leave)
- I.R.C. § 51 (work opportunity credit)

The tax credit for qualified family and sick leave wages is reduced by the amount of any wages taken into account for determining the tax credit allowed under I.R.C. § 41 (research credit). An eligible employer may not receive tax credits for wages that are taken into account as payroll costs in connection with obtaining forgiveness of a PPP loan.

Qualified wages also exclude wages that were used as payroll costs in connection with a Shuttered Venue Operator Grant under section 324 of the Economic Aid to Hard-Hit Small Businesses, Nonprofits, and Venues Act; or a restaurant revitalization grant under section 5003 of ARPA.

PRACTITIONER NOTE

Empowerment Zone Employment Credit

I.R.C. §§ 3131 and 3132 do not include the section 1396 empowerment zone employment credit in the list of credits for which an employer cannot use the same wages to claim the sick or family leave credits. However, the Form 941 instructions include section 1396.

Extended Limitation Period

The statute of limitations for assessment of tax attributable to the disallowance of a sick or family leave credit claimed from April 1, 2021, through September 30, 2021, will not expire until 5 years from the later of

1. the date of filing of the original return that includes the calendar quarter in which the credit was claimed, or
2. the date the return is treated as filed under I.R.C. § 6501(b)(2).

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Documenting Eligibility for the Credits

Eligible employers should keep all records related to paid sick and family leave credits for at least 6 years after the date the tax becomes due or is paid, whichever comes later. An eligible employer will substantiate eligibility for the paid sick leave or paid family leave credits if the employer receives a written request for the leave from the employee in which the employee provides the following:

- The employee's name
- The date(s) for which leave is requested
- A statement of the COVID-19 related reason the employee is requesting leave and written support for that reason
- A statement that the employee is unable to work, including by means of telework, for that reason

In addition to the statement from the employee, the employer should create and maintains records that include the following information:

1. Documentation to show how the eligible employer determined the amount of qualified sick and family leave wages paid to employees that are eligible for the credit, including records of work, telework, and qualified sick leave and qualified family leave
2. Documentation to show how the eligible employer determined the amount of qualified health plan expenses that the employer allocated to wages
3. Documentation to show how the eligible employer determined the amount of collectively bargained benefits that the employer allocated to wages
4. Copies of any completed Forms 7200 that the eligible employer submitted to the IRS
5. Copies of the completed Forms 941 that were submitted to the IRS

Self-Employed Taxpayers

ARPA provides comparable sick leave and family leave income tax credits for self-employed individuals carrying on any trade or business within the meaning of I.R.C. § 1402. To be eligible for the refundable credit, the self-employed individual must meet the requirements to receive paid sick leave or family leave as though they had been an employee under the EPSLA or Expanded FMLA.

ARPA allows self-employed taxpayers a family leave credit for a maximum of 60 days, and a potential sick leave credit of 10 days for 2021. In calculating the credit, the self-employed taxpayer can elect to use the prior year's net earnings if it would result in a higher tax credit. The credit amounts are subject to the same limitations as the credits for employers. A self-employed individual must reduce sick or family leave equivalent amounts by any qualified sick or family leave wages paid to them by an employer.

Self-employed individuals determine their family and sick leave equivalent tax credits on Form 7202, Credits for Sick Leave and Family Leave for Certain Self-Employed Individuals. They may reduce estimated payments by the expected credits. However, self-employed individuals cannot use Form 7200 to request an advance of the credit. They must maintain documentation establishing their eligibility for the credits.

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Comparison of Sick and Family Leave Credit Provisions

Figure 12.10 compares the sick and family leave credit provisions in 2020, the first quarter of 2021, and the second and third quarters of 2021.

FIGURE 12.10
Comparison of Sick and Family Leave Credit Provisions

	2020 Q2, Q3, and Q4	2021 Q1	2021 Q2 and Q3
Time Period for Wages	April 1–December 31, 2020	January 1–March 31, 2021	April 1, 2021–September, 2021
Eligible Employers	Businesses and tax-exempt organizations with fewer than 500 employees No eligibility for federal, state, or local governments (Tribal governments are eligible.)		Businesses and tax-exempt organizations with fewer than 500 employees State and local governments are eligible, regardless of size
Leave Mandate	Employers are required to provide paid sick and family leave to eligible employees	Leave is optional, but credits are available to compensate eligible employers that provide it	
Sick Leave Reasons	(1) Employee subject to quarantine or isolation, (2) advised by health care professional to quarantine, (3) experiencing COVID-19 symptoms and seeking a diagnosis, (4) caring for an individual subject to quarantine or isolation order or advised to quarantine, or (5) caring for a child whose school or daycare was closed		All sick leave reasons for 2020 and 2021 Q1 and adds (1) seeking or awaiting the results of a diagnostic test for, or a medical diagnosis of, COVID-19; (2) obtaining immunization related to COVID-19 or recovering from any injury, disability, illness, or condition related to the immunization; or (3) accompanying someone who is obtaining immunization related to COVID-19 or caring for someone who is recovering from any injury, disability, illness, or condition related to the immunization
Family Leave Reasons	Care for a child of the employee if the child's school or place of care has been closed or the childcare provider is unavailable for reasons related to COVID-19		All sick leave reasons for 2021 Q2 and Q3
Sick Leave Credit Limits	100% percent of qualified wages, which include 2 weeks or 80 hours, capped at $511/day ($5,110 in aggregate) for reasons related to employee's own health needs; two-thirds regular pay up to $200 per day ($2,000 in aggregate) to care for others		Resets available sick leave limits and provides up to 10 days per employee

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FIGURE 12.10 (continued)
Comparison of Sick and Family Leave Credit Provisions

	2020 Q2, Q3, and Q4	2021 Q1	2021 Q2 and Q3
Family Leave Credit Limits	100% of qualified wages, which include 10 weeks, two-thirds regular pay up to $10,000 ($200 per day)		Resets available family leave limits and provide up to 12 weeks per employee ($12,000 limit)
Additions to the Credits	Employer's share of Medicare tax imposed on wages and cost of health insurance coverage allocable to qualified wages (employers not subject to employer's share of social security tax on qualified wages)		Allocable health insurance coverage, collective bargaining contributions (subject to wage limit), employer's share of social security and Medicare (employer subject to Medicare and social security tax on qualified wages)
Interaction with Other Provisions	May not take into account same wages for FMLA credit under I.R.C. § 45S Employers can receive both a PPP loan and family and sick leave credits; wages are not eligible as payroll costs for PPP loan forgiveness		Qualified wages don't include wages taken into account for credits under I.R.C. §§ 45A, 45P, 45S, 51, 1396 Tax credit is reduced by amount of research credit under I.R.C. § 41 Cannot use wages used for payroll costs for PPP, shuttered operator grants, and restaurant revitalization grants For Q2, if receives ERC on same wages, employer must reduce credit by credit allowed under ERC. For Q3, qualified leave wages may not be taken into account for ERC
Taxation of Credit	Credits included in employer's gross income; expenses deductible		
Advance Credit	Form 7200 advance credit available to all eligible employers		
Statutory Enforcement Period	3 years	3 years	5 years
Self-Employed	May claim up to 10 days of sick leave and 50 days of family leave, applying average daily self-employment income	May claim a family leave credit for a maximum of 60 days, and a sick leave credit of 10 days in 2021 May only claim credit for vaccine and vaccine-related conditions during the second and third quarters	

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ISSUE 5: COBRA PREMIUM ASSISTANCE CREDITS This section reviews the temporary COBRA premium assistance and its corresponding premium assistance payroll tax credit.

The American Rescue Plan Act of 2021 (ARPA), Pub. L. No. 117-2, established the Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA) premium assistance and a corresponding payroll tax credit to assist workers who might otherwise lose health care. Specifically, section 9501 of ARPA provides for a temporary 100% reduction in the premium individuals and their families would otherwise have to pay to elect COBRA continuation coverage due to a loss of coverage as the result of

- a reduction in hours, or
- an involuntary termination of employment.

The temporary premium assistance is also available to individuals enrolled in state programs that provide coverage comparable to COBRA, often called mini-COBRA.

From April 1 through September 30, 2021, an assistance-eligible individual is treated as having paid 100% of any premiums required for the COBRA coverage. An *assistance-eligible individual* is generally an individual who is eligible for COBRA continuation coverage (except for those who voluntarily terminated their employment or those whose employment was terminated for gross misconduct) and who elected COBRA coverage. Premium assistance is not available if an individual is eligible for coverage under any other group health plan or for Medicare.

ARPA section 9501(a)(4) provides an extended election period for certain individuals who did not have an election of COBRA continuation coverage in effect on April 1, 2021. This extended election period is available for an individual who would be an assistance-eligible individual if the individual had a COBRA continuation coverage election in effect on April 1, 2021, or an individual who previously elected COBRA continuation coverage and discontinued that coverage before April 1, 2021. The extended election period continues for 60 days after these individuals are provided notice of the extended election period.

This premium assistance is fully excluded from the individual's gross income under new I.R.C. § 139I. Any premiums the individual had already paid for the coverage must be reimbursed no later than 60 days after the date the individual elects the continuation coverage.

PRACTITIONER NOTE

IRS Guidance

IRS Notice 2021-31, 2021-23 I.R.B. 1173, provides detailed guidance on the new COBRA premium assistance and its corresponding payroll tax credit. Notice 2021-46, 2021-33 I.R.B. 303, supplements Notice 2021-31 and addresses additional issues.

Premium Assistance Credit

To fund this health care coverage, the person to whom premiums are payable (employer, plan, or insurer) is allowed a refundable payroll tax credit that covers the cost of the premiums. This COBRA premium assistance credit allowed under newly added I.R.C. § 6432 is equal to the amount of the premium that would have been charged in the absence of the premium assistance and does not include any amount of subsidy that the employer would have otherwise provided. The refundable credit is allowed against the premium payee's share of Medicare taxes. If the credit exceeds the tax, the excess is treated as a refundable overpayment. The premium payee is eligible for the credit when it receives the potential assistance-eligible individual's election of COBRA continuation coverage and must include the credit in income.

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Example 12.17
Eligibility for the Premium Assistance Credit

Spruce Tech Services has a calendar-month COBRA period of coverage, and its COBRA premium payments are due on the tenth day of each calendar month. Spruce pays its employees semimonthly, with payroll periods ending on the fifteenth of the month and the last day of the month. On June 17, 2021, Spruce received a COBRA election from a former employee who elected COBRA continuation coverage as of April 1, 2021. Spruce is entitled to a credit as of June 17, 2021, for the premiums not paid by the former employee for the periods of coverage April 1, 2021, through April 30, 2021; May 1, 2021, through May 31, 2021; and June 1, 2021, through June 30, 2021.

Claiming the Credit

The employer, plan, or insurer claims the credit by reporting the credit (the refundable and the nonrefundable portions) and the number of individuals receiving COBRA premium assistance on its federal employment tax returns, usually Form 941, Employer's Quarterly Federal Tax Return. In anticipation of receiving the credit, the employer, plan, or insurer may (1) reduce the deposits of federal employment taxes, including withheld taxes, that it would otherwise be required to deposit, up to the amount of the anticipated credit; and (2) request an advance of the amount of the anticipated credit that exceeds the federal employment tax deposits available for reduction by filing Form 7200, Advance Payments of Employer Credits Due to COVID-19. Notice 2021-24, 2021-18 I.R.B. 1122, provides penalty relief for the reduction in deposits in anticipation of the credit.

PRACTITIONER NOTE

No Employment Tax Liability

If the premium payee entitled to claim the credit does not have an employment tax liability, the premium payee should claim the credit on the Form 941 for the quarter in which the premium payee becomes entitled to the credit. The premium payee should also report any advance payments received in anticipation of the credit on the same Form 941. The premium payee should enter zero on all remaining nonapplicable lines so that the overpayment amount on the Form 941 is the amount of the credit reduced by any advance payment received.

COBRA premium assistance is only available for periods of coverage beginning on or after April 1, 2021, through periods of coverage beginning on or before September 30, 2021. However, the COBRA premium assistance credit may be claimed on employment tax returns for the second, third, or fourth quarter of 2021, depending on when the employer (or other entity) becomes entitled to the credit.

Tax Treatment of Credit

Under I.R.C. § 6432(e), the premium assistance credit is included in the gross income of the recipient. No credit is allowed with respect to any amount taken into account as qualified wages for the ERC or for family or sick leave credits.

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TAX RATES This section includes the 2019, 2020, and 2021 tax rates.

2019 TAX RATE SCHEDULES

Section 1(j)(2)(A)—Married Individuals Filing Joint Returns and Surviving Spouses

If Taxable Income Is:	The Tax Is:
Not over $19,400	10% of the taxable income
Over $19,400 but not over $78,950	$1,940 plus 12% of the excess over $19,400
Over $78,950 but not over $168,400	$9,086 plus 22% of the excess over $78,950
Over $168,400 but not over $321,450	$28,765 plus 24% of the excess over $168,400
Over $321,450 but not over $408,200	$65,497 plus 32% of the excess over $321,450
Over $408,200 but not over $612,350	$93,257 plus 35% of the excess over $408,200
Over $612,350	$164,709.50 plus 37% of the excess over $612,350

Section 1(j)(2)(B)—Heads of Households

If Taxable Income Is:	The Tax Is:
Not over $13,850	10% of the taxable income
Over $13,850 but not over $52,850	$1,385 plus 12% of the excess over $13,850
Over $52,850 but not over $84,200	$6,065 plus 22% of the excess over $52,850
Over $84,200 but not over $160,700	$12,962 plus 24% of the excess over $84,200
Over $160,700 but not over $204,100	$31,322 plus 32% of the excess over $160,700
Over $204,100 but not over $510,300	$45,210 plus 35% of the excess over $204,100
Over $510,300	$152,380 plus 37% of the excess over $510,300

Section 1(j)(2)(C)—Unmarried Individuals (Other Than Surviving Spouses and Heads of Households)

If Taxable Income Is:	The Tax Is:
Not over $9,700	10% of the taxable income
Over $9,700 but not over $39,475	$970 plus 12% of the excess over $9,700
Over $39,475 but not over $84,200	$4,543 plus 22% of the excess over $39,475
Over $84,200 but not over $160,725	$14,382.50 plus 24% of the excess over $84,200
Over $160,725 but not over $204,100	$32,748.50 plus 32% of the excess over $160,725
Over $204,100 but not over $510,300	$46,628.50 plus 35% of the excess over $204,100
Over $510,300	$153,798.50 plus 37% of the excess over $510,300

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Section 1(j)(2)(D)—Married Individuals Filing Separate Returns

If Taxable Income Is:	The Tax Is:
Not over $9,700	10% of the taxable income
Over $9,700 but not over $39,475	$970 plus 12% of the excess over $9,700
Over $39,475 but not over $84,200	$4,543 plus 22% of the excess over $39,475
Over $84,200 but not over $160,725	$14,382.50 plus 24% of the excess over $84,200
Over $160,725 but not over $204,100	$32,748.50 plus 32% of the excess over $160,725
Over $204,100 but not over $306,175	$46,628.50 plus 35% of the excess over $204,100
Over $306,175	$82,354.75 plus 37% of the excess over $306,175

Section 1(j)(2)(E)—Estates and Trusts

If Taxable Income Is:	The Tax Is:
Not over $2,600	10% of the taxable income
Over $2,600 but not over $9,300	$260 plus 24% of the excess over $2,600
Over $9,300 but not over $12,750	$1,868 plus 35% of the excess over $9,300
Over $12,750	$3,075.50 plus 37% of the excess over $12,750

Section 1(j)(5)—Capital Gains Rates (Noncorporate Taxpayers)

Category of Gain	Tax Rate
Gain on collectibles	28%
I.R.C. § 1202 gain	28%
Unrecaptured I.R.C. § 1250 gain	25%
Net long-term capital gain*	
Taxable income does not exceed $78,750 (MFJ), $39,375 (MFS), $52,750 (HoH), $39,375 single, $2,650 (estate or trust)	0%
Taxable income does not exceed $488,850 (MFJ), $244,425 (MFS), $461,700 (HoH), $434,550 (single), $12,950 (estate or trust)	15%
Taxable income exceeds the maximum 15% rate amount	20%

* Qualified dividends are taxed at the net long-term capital gain rate.

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2020 TAX RATE SCHEDULES

Section 1(j)(2)(A)—Married Individuals Filing Joint Returns and Surviving Spouses

If Taxable Income Is:	The Tax Is:
Not over $19,750	10% of the taxable income
Over $19,750 but not over $80,250	$1,975 plus 12% of the excess over $19,750
Over $80,250 but not over $171,050	$9,235 plus 22% of the excess over $80,250
Over $171,050 but not over $326,600	$29,211 plus 24% of the excess over $171,050
Over $326,600 but not over $414,700	$66,543 plus 32% of the excess over $326,600
Over $414,700 but not over $622,050	$94,735 plus 35% of the excess over $414,700
Over $622,050	$167,307.50 plus 37% of the excess over $622,050

Section 1(j)(2)(B)—Heads of Households

If Taxable Income Is:	The Tax Is:
Not over $14,100	10% of the taxable income
Over $14,100 but not over $53,700	$1,410 plus 12% of the excess over $14,100
Over $53,700 but not over $85,500	$6,162 plus 22% of the excess over $53,700
Over $85,500 but not over $163,300	$13,158 plus 24% of the excess over $85,500
Over $163,300 but not over $207,350	$31,830 plus 32% of the excess over $163,300
Over $207,350 but not over $518,400	$45,926 plus 35% of the excess over $207,350
Over $518,400	$154,793.50 plus 37% of the excess over $518,400

Section 1(j)(2)(C)—Unmarried Individuals (Other Than Surviving Spouses and Heads of Households)

If Taxable Income Is:	The Tax Is:
Not over $9,875	10% of the taxable income
Over $9,875 but not over $40,125	$987.50 plus 12% of the excess over $9,875
Over $40,125 but not over $85,525	$4,617.50 plus 22% of the excess over $40,125
Over $85,525 but not over $163,300	$14,605.50 plus 24% of the excess over $85,525
Over $163,300 but not over $207,350	$33,271.50 plus 32% of the excess over $163,300
Over $207,350 but not over $518,400	$47,367.50 plus 35% of the excess over $207,350
Over $518,400	$156,235 plus 37% of the excess over $518,400

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Section 1(j)(2)(D)—Married Individuals Filing Separate Returns

If Taxable Income Is:	The Tax Is:
Not over $9,875	10% of the taxable income
Over $9,875 but not over $40,125	$987.50 plus 12% of the excess over $9,875
Over $40,125 but not over $85,525	$4,617.50 plus 22% of the excess over $40,125
Over $85,525 but not over $163,300	$14,605.50 plus 24% of the excess over $85,525
Over $163,300 but not over $207,350	$33,271.50 plus 32% of the excess over $163,300
Over $207,350 but not over $311,025	$47,367.50 plus 35% of the excess over $207,350
Over $311,025	$83,653.75 plus 37% of the excess over $311,025

Section 1(j)(2)(E)—Estates and Trusts

If Taxable Income Is:	The Tax Is:
Not over $2,600	10% of the taxable income
Over $2,600 but not over $9,450	$260 plus 24% of the excess over $2,600
Over $9,450 but not over $12,950	$1,904 plus 35% of the excess over $9,450
Over $12,950	$3,129 plus 37% of the excess over $12,950

Section 1(j)(5)—Capital Gains Rates (Noncorporate Taxpayers)

Category of Gain	Tax Rate
Gain on collectibles	28%
I.R.C. § 1202 gain	28%
Unrecaptured I.R.C. § 1250 gain	25%
Net long-term capital gain*	
Taxable income does not exceed $80,000 (MFJ), $40,000 (MFS), $53,600 (HoH), $40,000 (single), $2,650 (estate or trust)	0%
Taxable income does not exceed $496,600 (MFJ), $248,300 (MFS), $469,050 (HoH), $441,450 (single), $13,150 (estate or trust)	15%
Taxable income exceeds the maximum 15% rate amount	20%

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2021 TAX RATE SCHEDULES

Section 1(j)(2)(A)—Married Individuals Filing Joint Returns and Surviving Spouses

If Taxable Income Is:	The Tax Is:
Not over $19,900	10% of the taxable income
Over $19,900 but not over $81,050	$1,990 plus 12% of the excess over $19,900
Over $81,050 but not over $172,750	$9,328 plus 22% of the excess over $81,050
Over $172,750 but not over $329,850	$29,502 plus 24% of the excess over $172,750
Over $329,850 but not over $418,850	$67,206 plus 32% of the excess over $329,850
Over $418,850 but not over $628,300	$95,686 plus 35% of the excess over $418,850
Over $628,300	$168,993.50 plus 37% of the excess over $628,300

Section 1(j)(2)(B)—Heads of Households

If Taxable Income Is:	The Tax Is:
Not over $14,200	10% of the taxable income
Over $14,200 but not over $54,200	$1,420 plus 12% of the excess over $14,200
Over $54,200 but not over $86,350	$6,220 plus 22% of the excess over $54,200
Over $86,350 but not over $164,900	$13,293 plus 24% of the excess over $86,350
Over $164,900 but not over $209,400	$32,145 plus 32% of the excess over $164,900
Over $209,400 but not over $523,600	$46,385 plus 35% of the excess over $209,400
Over $523,600	$156,355 plus 37% of the excess over $523,600

Section 1(j)(2)(C)—Unmarried Individuals (Other Than Surviving Spouses and Heads of Households)

If Taxable Income Is:	The Tax Is:
Not over $9,950	10% of the taxable income
Over $9,950 but not over $40,525	$995 plus 12% of the excess over $9,950
Over $40,525 but not over $86,375	$4,664 plus 22% of the excess over $40,525
Over $86,375 but not over $164,925	$14,751 plus 24% of the excess over $86,375
Over $164,925 but not over $209,425	$33,603 plus 32% of the excess over $164,925
Over $209,425 but not over $523,600	$47,843 plus 35% of the excess over $209,425
Over $523,600	$157,804.25 plus 37% of the excess over $523,600

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Section 1(j)(2)(D)—Married Individuals Filing Separate Returns

If Taxable Income Is:	The Tax Is:
Not over $9,950	10% of the taxable income
Over $9,950 but not over $40,525	$995 plus 12% of the excess over $9,950
Over $40,525 but not over $86,375	$4,664 plus 22% of the excess over $40,525
Over $86,375 but not over $164,925	$14,751 plus 24% of the excess over $86,375
Over $164,925 but not over $209,425	$33,603 plus 32% of the excess over $164,925
Over $209,425 but not over $314,150	$47,843 plus 35% of the excess over $209,425
Over $314,150	$84,496.75 plus 37% of the excess over $314,150

Section 1(j)(2)(E)—Estates and Trusts

If Taxable Income Is:	The Tax Is:
Not over $2,650	10% of the taxable income
Over $2,650 but not over $9,550	$265 plus 24% of the excess over $2,650
Over $9,550 but not over $13,050	$1,921 plus 35% of the excess over $9,550
Over $13,050	$3,146 plus 37% of the excess over $13,050

Section 1(j)(5)—Capital Gains Rates (Noncorporate Taxpayers)

Category of Gain	Tax Rate
Gain on collectibles	28%
I.R.C. § 1202 gain	28%
Unrecaptured I.R.C. § 1250 gain	25%
Net long-term capital gain*	
Taxable income does not exceed $80,800 (MFJ), $40,400 (MFS), $54,100 (HoH), $40,400 (single), $2,700 (estate or trust)	0%
Taxable income does not exceed $501,600 (MFJ), $250,800 (MFS), $473,750 (HoH), $445,850 (single), $13,250 (estate or trust)	15%
Taxable income exceeds the maximum 15% rate amount	20%

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AUTOMOBILES, TRUCKS, AND VANS This section includes standard mileage rates, the depreciation amount included in the business standard mileage rate, the I.R.C. § 280 passenger automobile depreciation limits, and the inclusion amounts for leased vehicles.

Standard Mileage Rates

Cents per Mile	2019	2020	2021
Business	58.0	57.5	56.0
Charity work	14.0	14.0	14.0
Medical/moving*	20.0	17.0	16.0

* The TCJA suspends the moving expense deduction for individual taxpayers in 2018 through 2025, except for armed forces members who move pursuant to a military order.

Depreciation Included in Standard Mileage Rate

Years	Cents per Mile*
2011	22.0
2012	23.0
2013	23.0
2014	22.0
2015	24.0
2016	24.0
2017	25.0
2018	25.0
2019	26.0
2020	27.0
2021	26.0

* The business standard mileage rate cannot be used to claim an itemized deduction for most unreimbursed employee travel expenses while the deduction for miscellaneous itemized expenses is suspended (2018 through 2025).

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Depreciation Limits under I.R.C. § 280F

Year Placed in Service	First Year	Second Year	Third Year	Later Year
2011 basic for cars	$3,060	$4,900	$2,950	$1,775
2011 basic for pickups and vans	$3,260	$5,200	$3,150	$1,875
2011 additional first year	$8,000	–	–	–
2012 basic for cars	$3,160	$5,100	$3,050	$1,875
2012 basic for pickups and vans	$3,360	$5,300	$3,150	$1,875
2012 additional first year	$8,000	–	–	–
2013 basic for cars	$3,160	$5,100	$3,050	$1,875
2013 basic for pickups and vans	$3,360	$5,400	$3,250	$1,975
2013 additional first year	$8,000	–	–	–
2014 basic for cars	$3,160	$5,100	$3,050	$1,875
2014 basic for pickups and vans	$3,460	$5,500	$3,350	$1,975
2014 additional first year	$8,000	–	–	–
2015 basic for cars	$3,160	$5,100	$3,050	$1,875
2015 basic for pickups and vans	$3,460	$5,600	$3,350	$1,975
2015 additional first year	$8,000	–	–	–
2016 basic for cars	$3,160	$5,100	$3,050	$1,875
2016 basic for pickups and vans	$3,560	$5,700	$3,350	$2,075
2016 additional first year	$8,000	–	–	–
2017 basic for cars	$3,160	$5,100	$3,050	$1,875
2017 basic for pickups and vans	$3,560	$5,700	$3,450	$2,075
2017 additional first year	$8,000	–	–	–
2018 basic for cars*	$10,000	$16,000	$9,600	$5,760
2018 basic for pickups and vans	$10,000	$16,000	$9,600	$5,760
2018 additional first year	$8,000	–	–	–
2019 basic for cars, pickups, and vans	$10,100	$16,100	$9,700	$5,760
2019 additional first year	$8,000	–	–	–
2020 basic for cars, pickups, and vans	$10,100	$16,100	$9,700	$5,760
2020 additional first year	$8,000	–	–	–
2021 basic for cars, pickups, and vans	$10,200	$16,400	$9,800	$5,860
2021 additional first year	$8,000	–	–	–

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SUV Limit under I.R.C. § 179

2019	2020	2021
$25,500	$25,900	$26,200

Lease Inclusion Amounts for Passenger Automobiles Including Trucks and Vans with a Lease Term Beginning in Calendar Year 2021

Fair Market Value of Passenger Automobile (Including Trucks and Vans)		Tax Year during Lease				
Over	Not Over	1st	2nd	3rd	4th	5th & Later
$51,000	$52,000	$0	$0	$1	$0	$1
$52,000	$53,000	1	1	1	2	2
$53,000	$54,000	1	2	2	3	4
$54,000	$55,000	1	3	3	5	5
$55,000	$56,000	2	3	5	6	6
$56,000	$57,000	2	4	6	7	8
$57,000	$58,000	2	5	7	8	10
$58,000	$59,000	3	5	8	10	11
$59,000	$60,000	3	6	9	11	13
$60,000	$62,000	3	7	11	13	15
$62,000	$64,000	4	9	13	15	18
$64,000	$66,000	5	10	15	18	21
$66,000	$68,000	5	12	17	21	24
$68,000	$70,000	6	13	20	23	27
$70,000	$72,000	7	14	22	26	30
$72,000	$74,000	7	16	24	29	33
$74,000	$76,000	8	18	26	31	36
$76,000	$78,000	9	19	28	34	39
$78,000	$80,000	9	21	30	37	42
$80,000	$85,000	11	23	34	41	48
$85,000	$90,000	12	27	40	47	55
$90,000	(see Rev. Proc. 2021-31, 2021-34 I.R.B. 324, Table 3 for FMV in excess of $90,000)					

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BUSINESS EXPENSE LIMITS This section includes limits on business expense deductions and depreciation tables.

I.R.C. § 179 Election to Expense Depreciable Assets

	2019	2020	2021
Maximum deduction	$1,020,000	$1,040,000	$1,050,000
Phaseout begins at new investment of	$2,550,000	$2,590,000	$2,620,000

I.R.C. § 274 Meal and Entertainment Expense Deduction

	2019	2020	2021
Limit for most workers (with some exceptions)	50%	50%	50%*
Limit for transportation workers subject to DOT hours of service limits	80%	80%	80%

The TCJA eliminates the deduction for most entertainment expenses.
*There is a 100% deduction for business meal food and beverage expenses, including any carry-out or delivery meals, provided by a restaurant that are paid or incurred in 2021 and 2022.

I.R.C. § 469 Rental Real Estate Special Allowance Limits

Years 2019 to 2021	Maximum	MAGI
MFJ	$25,000	$100,000–$150,000
S or HoH	$25,000	$100,000–$150,000
MFS (living apart)	$12,500	$50,000–$75,000
MFS (living together)	0	N/A

I.R.C. § 199A Qualified Business Income Deduction Threshold Amount

	2020	2021
MFJ	$326,600	$329,800
MFS	$163,300	$164,925
S or HoH	$163,300	$164,900

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ADS and GDS Recovery Periods

GDS Property Class	Recovery Period
3-year property	3 years
5-year property	5 years
7-year property	7 years
10-year property	10 years
15-year property	15 years
20-year property	20 years
25-year property	25 years
Residential rental property	27.5 years
Nonresidential real property	39 years

ADS Property Class	Recovery Period
Rent-to-own property	4 years
Automobiles and light-duty trucks	5 years
Computers and peripheral equipment	5 years
High-technology telephone station equipment	5 years
High-technology medical equipment	5 years
Personal property with no class life	12 years
Natural gas gathering lines	14 years
Single-purpose agricultural and horticultural structures	15 years
Any tree or vine bearing fruit or nuts	20 years
Initial clearing and grading land improvements for gas utility property	20 years
Initial clearing and grading land improvements for electric utility transmission and distribution plants	25 years
Certain electric transmission property	30 years
Natural gas distribution lines	35 years
Qualified improvement property	20 years
Nonresidential real property	30 years*
Residential rental property	40 years
Certain section 1245 real property	40 years
Railroad grading and tunnel bore	50 years

*40 for property placed in service before January 1, 2018.

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CHILD AND DEPENDENT CREDITS

This section includes dollar ceilings and AGI phaseouts for individual income tax credits available to qualifying families.

Adoption Credit

Any Filing Status	2019	2020	2021
Maximum Credit up to	$14,080	$14,300	$14,400
AGI or MAGI Phaseout	$211,160–$251,160	$214,520–254,520	$216,660–256,660

Child Tax Credit

Filing Status	2019	2020	2021
MFJ Credit	up to $2,000	up to $2,000	up to $3,000 for qualifying children who have attained age 6 but not age 18 by the end of the 2021 tax year and up to $3,600 for qualifying children who have not attained age 6 by the end of the 2021 tax year
MFJ AGI or MAGI phaseout	$400,000	$400,000	$400,000*
S, HoH, or QW Credit	up to $2,000	up to $2,000	up to $3,000 for qualifying children who have attained age 6 but not age 18 by the end of the 2021 tax year and up to $3,600 for qualifying children who have not attained age 6 by the end of the 2021 tax year
S, HoH, or QW	$200,000	$200,000	$200,000*
MFS Credit	up to $2,000	up to $2,000	up to $3,000 for qualifying children who have attained age 6 but not age 18 by the end of the 2021 tax year and up to $3,600 for qualifying children who have not attained age 6 by the end of the 2021 tax year
MFS AGI or MAGI phaseout	$200,000	$200,000	$200,000*

*The phaseout amounts for the increased portion ($1,000 or $1,600) are reduced for over $150,000 for MFJ and QW, over $112,500 for HoH, and over $75,000 for all other taxpayers.

Credit for Dependent

Any Filing Status	2019	2020	2021
Credit amount	$500	$500	$500

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Refundable Portion of Child Tax Credit

Any Filing Status	2019	2020	2021
Earned income threshold	$2,500	$2,500	$2,500
Refundable amount limit	$1,400	$1,400	$1,400*

*A taxpayer is eligible for the increased refundable amount ($1,000 or $1,600) if the taxpayer, or the spouse of a taxpayer filing a joint return, had a main home in the United States for more than one-half of the tax year beginning in 2021 or was a bona fide resident of Puerto Rico for the tax year beginning in 2021. For all other taxpayers, the refundable portion of the credit is limited to $1,400.

Child and Dependent Care Credit

	2019	2020	2021*
AGI limits	■ AGI up to $15,000 35% credit ■ AGI $15,001 to $43,000 34% to 21% credit ■ AGI over $43,000 20% credit	■ AGI up to $15,000 35% credit ■ AGI $15,001 to $43,000 34% to 21% credit ■ AGI over $43,000 20% credit	■ AGI up to $125,000 50% credit ■ AGI $125,000 to $185,000 50% to 20% credit ■ AGI over $400,000 20% to 0% credit ■ AGI over $440,000 0% credit
Includable qualifying expenses (cannot exceed earned income)	■ $3,000 one dependent ■ $6,000 two or more dependents	■ $3,000 one dependent ■ $6,000 two or more dependents	■ $8,000 one dependent ■ $16,000 two or more dependents

*The credit is refundable for some taxpayers in 2021.

Earned Income Tax Credit

2019 Earned Income Tax Credit Rate and Earned Income or AGI Range

Taxpayers Not Filing as Married Filing Jointly or Married Filing Separately

Qualifying Children	Credit Rate (%)	Income for Maximum Credit	Phaseout	Phaseout Rate (%)	Maximum Credit
None	7.65	$6,920–$8,650	$8,650–$15,570	7.65	$529
One	34.00	$10,370–$19,030	$19,030–$41,094	15.98	$3,526
Two or more	40.00	$14,570–$19,030	$19,030–$46,703	21.06	$5,828
Three or more	45.00	$14,570–$19,030	$19,030–$50,162	21.06	$6,557

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Taxpayers Filing as Married Filing Jointly

Qualifying Children	Credit Rate (%)	Income for Maximum Credit	Phaseout	Phaseout Rate (%)	Maximum Credit
None	7.65	$6,920–$14,450	$14,450–$21,370	7.65	$529
One	34.00	$10,370–$24,820	$24,820–$46,884	15.98	$3,526
Two or more	40.00	$14,570–$24,820	$24,820–$52,493	21.06	$5,828
Three or more	45.00	$14,570–$24,820	$24,820–$55,952	21.06	$6,557
Excessive investment income for 2019: $3,600					

2020 Earned Income Tax Credit Rate and Earned Income or AGI Range

Taxpayers Not Filing as Married Filing Jointly or Married Filing Separately

Qualifying Children	Credit Rate (%)	Income for Maximum Credit	Phaseout	Phaseout Rate (%)	Maximum Credit
None	7.65	$7,030–$8,790	$8,790–$15,820	7.65	$538
One	34.00	$10,540–$19,330	$19,330–$41,756	15.98	$3,584
Two or more	40.00	$14,800–$19,330	$19,330–$47,440	21.06	$5,920
Three or more	45.00	$14,800–$19,330	$19,330–$50,954	21.06	$6,660

Taxpayers Filing as Married Filing Jointly

Qualifying Children	Credit Rate (%)	Income for Maximum Credit	Phaseout	Phaseout Rate (%)	Maximum Credit
None	7.65	$7,030–$14,680	$14,680-$21,710	7.65	$538
One	34.00	$10,540–$25,220	$25,220-$47,646	15.98	$3,584
Two or more	40.00	$14,800–$25,200	$25,220-$53,330	21.06	$5,920
Three or more	45.00	$14,800–$25,220	$25,220-$56,844	21.06	$6,660
Excessive investment income for 2020: $3,650					

2021 Earned Income Tax Credit Rate and Earned Income or AGI Range

Taxpayers Not Filing as Married Filing Jointly or Married Filing Separately

Qualifying Children	Credit Rate (%)	Income for Maximum Credit	Phaseout	Phaseout Rate (%)	Maximum Credit
None	15.3	$9,820–$11610	$11,610–$21,430	15.3	$1,502
One	34.00	$10,640–$19,520	$19,520–$42,158	15.98	$3,618
Two or more	40.00	$14,950–$19,520	$19,520–$47,915	21.06	$5,980
Three or more	45.00	$14,950–$19,520	$19,520–$51,464	21.06	$6,728

Taxpayers Filing as Married Filing Jointly

Qualifying Children	Credit Rate (%)	Income for Maximum Credit	Phaseout	Phaseout Rate (%)	Maximum Credit
None	15.3	$9,820–$17,560	$17,560–$27,380	15.3	$1,502
One	34.00	$10,640–$25,470	$25,470–$48,108	15.98	$3,618
Two or more	40.00	$14,950–$25,470	$25,470–$53,865	21.06	$5,980
Three or more	45.00	$14,950–$25,470	$25,470–$57,414	21.06	$6,728
Excessive investment income for 2021: $10,000					

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EDUCATION-RELATED TAX BENEFITS

This section includes dollar ceilings and AGI phaseout ranges for education tax benefits.

Coverdell Education Savings Accounts

Filing Status	2019	2020	2021
MFJ Contribution limit	$2,000	$2,000	$2,000
MFJ MAGI phaseout	$190,000–$220,000	$190,000–$220,000	$190,000–$220,000
S, HoH, QW, or MFS Contribution limit	$2,000	$2,000	$2,000
S, HoH, QW, or MFS MAGI phaseout	$95,000–$110,000	$95,000–$110,000	$95,000–$110,000

American Opportunity Tax Credit

Filing Status	2019	2020	2021
MFJ Maximum credit	$2,500	$2,500	$2,500
MFJ MAGI phaseout	$160,000–$180,000	$160,000–$180,000	$160,000–$180,000
S, HoH, or QW Maximum credit	$2,500	$2,500	$2,500
S, HoH, or QW MAGI phaseout	$80,000–$90,000	$80,000–$90,000	$80,000–$90,000
MFS Maximum credit	$0	$0	$0
MFS MAGI phaseout	N/A	N/A	N/A

Lifetime Learning Credit

Filing Status	2019	2020	2021
MFJ Maximum credit	$2,000	$2,000	$2,000
MFJ MAGI phaseout	$116,000–$136,000	$118,000-$138,000	$119,000-$139,000
S, HoH, or QW Maximum credit	$2,000	$2,000	$2,000
S, HoH, or QW MAGI phaseout	$58,000–$68,000	$59,000–$69,000	$59,000–$69,000
MFS Maximum credit	$0	$0	$0
MFS MAGI phaseout	N/A	N/A	N/A

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Student Loan Interest Deduction

Filing Status	2019	2020	2021
MFJ Maximum deduction	$2,500	$2,500	$2,500
MFJ MAGI phaseout	$140,000–$170,000	$140,000–$170,000	$140,000–$170,000
S, HoH, or QW Maximum deduction	$2,500	$2,500	$2,500
S, HoH, or QW MAGI phaseout	$70,000–$85,000	$70,000–$85,000	$70,000–$85,000
MFS Maximum deduction	$0	$0	$0
MFS MAGI phaseout	N/A	N/A	N/A

US Savings Bond Interest Exclusion

Filing Status	2019	2020	2021
MFJ or QW Maximum exclusion	Qualifying expenses	Qualifying expenses	Qualifying expenses
MFJ or QW MAGI phaseout	$121,600–$151,600	$123,550–$153,550	$124,800-$154,800
S or HoH Maximum exclusion	Qualifying expenses	Qualifying expenses	Qualifying expenses
S or HoH MAGI phaseout	$81,100–$96,100	$82,350–$97,350	$83,200-$98,200
MFS Maximum exclusion	$0	$0	$0
MFS MAGI phaseout	N/A	N/A	N/A

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ESTATE, GIFT, AND TRUST This section includes amounts and limitations related to Forms 706, 709, and 1041.

Estate and Generation-Skipping Transfer Taxes

	2019	2020	2021
Estate tax applicable exclusion amount	$11,400,000*	$11,580,000*	$11,700,000*
Estate tax applicable credit amount	$4,505,800	$4,577,800	$4,625,800
Special use valuation reduction limit	$1,160,000	$1,180,000	$1,190,000
Generation-skipping transfer exemption (GST)	$11,400,000	$11,580,000	$11,700,000
Estate value qualifying for 2% interest for installment payments	$1,550,000	$1,570,000	$1,590,000

* If elected, the amount of the exclusion that is unused by the estate of the first spouse to die can be used by the estate of the surviving spouse.

Gift Tax

	2019	2020	2021
Gift tax applicable exclusion amount	$11,400,000*	$11,580,000*	$11,700,000*
Gift tax applicable credit amount	$4,505,800	$4,577,800	$4,625,800
Annual exclusion for gifts	$15,000	$15,000	$15,000
Annual exclusion for gifts to non-US spouse	$155,000	$157,000	$159,000

* If elected, the amount of the exclusion that is unused by the estate of the first spouse to die can be used by the surviving spouse.

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Estate and Gift Tax Unified Tax Rates

The following tax rates apply to the taxable estate or taxable gift without reduction for the applicable exclusion amount. The resulting tax is reduced by the applicable credit amount.

Rates after 2012

Column A Taxable Amount Over	Column B Taxable Amount Not Over	Column C Tax on Amount in Column A	Column D Tax Rate 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%

Estate and Trust Exemption Deductions

	2019	2020	2021
Estate Regular Tax Exemption Deduction	$600	$600	$600
Simple Trust Regular Tax Exemption Deduction	$300	$300	$300
Complex Trust Regular Tax Exemption Deduction	$100	$100	$100
AMT Exemption Deduction	$25,000	$25,400	$25,700
AMT Exemption Deduction Phaseout	$83,500	$84,800	$85,650–$188,450

Estimated Income Tax Requirement for Estates and Trusts

Tax Payments Must Equal or Exceed Lesser of	2019	2020	2021
% of current year tax liability or	90%	90%	90%
% of prior-year liability			
if AGI ≤ $150,000	100%	100%	100%
if AGI > $150,000	110%	110%	110%

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FRINGE BENEFITS This section includes annual limitations on the tax-free amount of fringe benefits that are adjusted based on the consumer price index.

Adoption Assistance

	2019	2020	2021
Maximum exclusion per child	$14,080	$14,300	$14,440
MAGI Phaseout	$211,160–$251,160	$214,520–$254,520	$216,660–$256,660

Transportation Assistance Exclusion Per Month

	2019	2020	2021
Qualified parking expenses	$270	$265	$270
Transit pass or transportation in commuter highway vehicle	$270	$265	$270
Bicycle commuting	N/A*	N/A*	N/A*

* The TCJA suspends the exclusion for tax years 2018 through 2025.

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HEALTH CARE This section includes information related to Archer medical savings accounts, health savings accounts, long-term care insurance, Medicare premiums, and the self-employed health insurance deduction.

Archer Medical Savings Accounts (MSAs)*

	2019	2020	2021
Self-Only Coverage			
Minimum annual deductible	$2,350	$2,350	$2,400
Maximum annual deductible	$3,500	$3,550	$3,600
Maximum annual out-of-pocket expenses (other than premiums)	$4,650	$4,750	$4,800
Family Coverage			
Minimum annual deductible	$4,650	$4,750	$4,800
Maximum annual deductible	$7,000	$7,100	$7,150
Maximum annual out-of-pocket expenses (other than premiums)	$8,550	$8,650	$8,750

* Individuals with existing Archer MSAs may continue to fund them if they remain eligible.

Health Savings Accounts (HSAs)

	2019	2020	2021
Increase in annual contribution limitation for age 55 or older	$1,000	$1,000	$1,000
Self-Only Coverage			
Minimum annual deductible	$1,350	$1,400	$1,400
Maximum annual out-of-pocket expenses	$6,750	$6,900	$7,000
Maximum monthly contributions is 1/12 of annual deductible	$3,500	$3,550	$3,600
Family Coverage			
Minimum annual deductible	$2,700	$2,800	$2,800
Maximum annual out-of-pocket expenses	$13,500	$13,800	$14,000
Maximum monthly contributions is 1/12 of annual deductible	$7,000	$7,100	$7,200

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Maximum Deductible Long-Term Care Premiums (Age at End of Year)

	2019	2020	2021
40 or less	$420	$430	$450
More than 40, less than 51	$790	$810	$850
More than 50, less than 61	$1,580	$1,630	$1,690
More than 60, less than 71	$4,220	$4,350	$4,520
More than 70	$5,270	$5,430	$5,640
Maximum excludable long-term care per diem	$370	$380	$400

Medicare

Medicare Deductibles

	2019	2020	2021
Part A deductible	$1,364	$1,408	$1,484
Part B deductible	$185	$198	$203
Part D deductible	varies	varies	varies

Medicare Part A Premium if Not Fully Insured

Monthly Premium Part A Coverage	2019	2020	2021
Less than 30 quarters of coverage	$437	$458	$471
30 to 39 quarters of coverage	$240	$252	$259

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Medicare Part B Premiums and Deductibles

The Social Security Administration generally uses information from the beneficiary's tax return filed during the preceding year, so that 2021 premiums are based on income for 2019 that was reported on returns filed in 2020.

2019 Medicare Part B Premiums

2017 MAGI

Single, HoH, and QW	MFJ	MFS	Beneficiary's Premium*
$85,000 or less	$170,000 or less	$85,000 or less	$135.50
$85,001–$107,000	$170,001–$214,000	N/A	$189.60
$107,001–$133,500	$214,001–$267,000	N/A	$270.90
$133,501–$160,000	$267,001–$320,000	N/A	$352.20
$160,001–$500,000	$320,001–$750,000	$85,001– $415,000	$433.40
$500,000 and above	$750,000 and above	$415,000 and above	$460.50

* The standard premium will be $135.50 (or higher) however, some who get SS benefits may pay less than this amount.

2020 Medicare Part B Premiums

2018 MAGI

Single, HoH, and QW	MFJ	MFS	Beneficiary's Premium*
$87,000 or less	$174,000 or less	$87,000 or less	$144.60
$87,001-$109,000	$174,001–$218,000	N/A	$202.40
$109,000-$136,000	$218,001–$272,000	N/A	$289.20
$136,001-$163,000	$272,001–$326,000	N/A	$376.00
$163,001-$500,000	$326,001–$750,000	$87,001–$413,000	$462.70
$500,000 and above	$750,000 and above	$413,000 or above	$491.60

* The standard premium will be $144.60 (or higher) however, some who get SS benefits may pay less than this amount.

2021 Medicare Part B Premiums

2019 MAGI

Single, HoH, and QW	MFJ	MFS	Beneficiary's Premium*
$88,000 or less	$176,000 or less	$88,000 or less	$148.50
$88,001-$111,000	$176,001–$222,000	N/A	$207.90
$109,000-$136,000	$218,001–$272,000	N/A	$297.00
$136,001-$163,000	$272,001–$326,000	N/A	$386.10
$163,001-$500,000	$326,001–$750,000	$87,001–$413,000	$475.20
$500,000 and above	$750,000 and above	$413,000 or above	$504.90

* The standard premium will be $148.50 (or higher) however, some who get SS benefits may pay less than this amount.

Self-Employed Health Insurance Deduction

	2019	2020	2021
Percentage of premium deductible	100%	100%	100%

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INDIVIDUALS This section lists the 2019, 2020, and 2021 amounts for selected items that are adjusted annually.

AMT Exemption Amount

Filing Status	2019	2020	2021
MFJ or QW	$111,700	$113,400	$114,600
Single or HoH	$71,700	$72,900	$73,600
MFS	$55,850	$56,700	$57,300
Estates and trusts	$25,000	$25,400	$25,700

AMTI Phaseout Ranges for the AMT Exemption Amount

Filing Status	2019	2020	2021
MFJ or QW	$1,020,600	$1,036,800	$1,047,200–$1,505,600
Single or HoH	$510,300	$518,400	$523,600–$818,000
MFS	$510,300	$518,400	$523,600–$752,800
Estates and trusts	$83,500	$84,800	$85,650–$188,450

28% AMT Tax Rate on Excess Taxable Income Over

Filing Status	2019	2020	2021
MFJ, single, HoH, estates, trusts	$194,800	$197,900	$199,900
MFS	$97,400	$98,950	$99,950

AMT Exemption for a Child subject to "Kiddie Tax"

	2019	2020	2021
Lesser of	$71,700 or the child's earned income for the tax year plus $7,750	$72,900 or the child's earned income for the tax year plus $7,900	$73,600 or the child's earned income for the tax year plus $7,950

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Net Investment Income Tax Thresholds

Filing Status	2019	2020	2021
MFJ or QW	$250,000	$250,000	$250,000
Single or HoH	$200,000	$200,000	$200,000
MFS	$125,000	$125,000	$125,000
Estates and trusts (beginning of highest tax bracket)	$12,750	$12,950	$13,050

Itemized Deductions: Beginning of AGI Phaseout

Filing Status	2019	2020	2021
MFJ	N/A	N/A	N/A
HoH	N/A	N/A	N/A
Single	N/A	N/A	N/A
MFS	N/A	N/A	N/A

I.R.C. § 152(d)(1)(B) Gross Income Limitation for a Qualifying Relative

2020	2021
$4,300	$4,300

Personal and Dependent Exemptions Deduction

	2019	2020	2021
Deduction for each personal and dependent exemption	$0	$0	$0

Personal and Dependent Exemptions Deduction: AGI Phaseout Ranges

Filing Status	2019	2020	2021
MFJ or QW	N/A	N/A	N/A
Single	N/A	N/A	N/A
HoH	N/A	N/A	N/A
MFS	N/A	N/A	N/A

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Standard Deduction

	2019	2020	2021
MFJ or QW	$24,400	$24,800	$25,100
Single	$12,200	$12,400	$12,550
HoH	$18,350	$18,650	$18,800
MFS	$12,200	$12,400	$12,550
Additional for elderly/blind – married	$1,300	$1,300	$1,350
Additional for elderly/blind – unmarried and not a surviving spouse	$1,650	$1,650	$1700
Taxpayer claimed as dependent (greater of table amount or earned income plus $350 but not exceeding nondependent standard deduction)	$1,100	$1,100	$1,100

Estimated Tax Requirements for Individuals

Tax Payments Must Equal or Exceed Lesser of	2019	2020	2021
% of current-year tax liability	90%	90%	90%
% of prior-year liability If AGI = or less than $150,000 ($75,000 MFS)	100%	100%	100%
% of prior-year liability If AGI greater than $150,000 ($75,000 MFS)	110%	110%	110%

Foreign Earned Income (EI) and Foreign Housing Costs Exclusions

	2019	2020	2021
Foreign earned income exclusion	$105,900	$107,600	$108,700
Threshold for housing expenses in excess of 16% of foreign EI	$16,944	$17,216	$17,392
Housing exclusion maximum*	$31,770	$32,280	$32,610

* Housing exclusion is equal to the housing expenses in excess of 16% of foreign earned income exclusion. This amount cannot exceed 30% of foreign earned income exclusion unless the location/country has a higher amount. If the limitation on housing expenses is higher for tax year 2021 than the 2020 adjusted limitations, qualified taxpayers may apply the adjusted limitations for tax year 2021 to their 2020 tax year. See Notice 2021-18

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INTEREST RATES This section includes applicable federal rates for September 2020 through August 2021, including AFRs for the present value of an annuity, the Farm Credit System Bank rates, and the IRS interest rates for tax overpayments and underpayments.

Applicable Federal Rates

A short-term loan or installment sale is 3 years or less. A mid-term loan or installment sale is more than 3 years but not more than 9 years. A long-term loan or installment sale is more than 9 years. Future monthly applicable federal rates (AFR) can be found at apps.irs.gov/app/picklist/list/federalRates.html.

September 2020

	Annual	Semiannual	Quarterly	Monthly
Short-term AFR	.14%	.14%	.14%	.14%
Mid-term AFR	.35%	.35%	.35%	.35%
Long-term AFR	1.00%	1.00%	1.00%	1.00%

October 2020

	Annual	Semiannual	Quarterly	Monthly
Short-term AFR	.14%	.14%	.14%	.14%
Mid-term AFR	.38%	.38%	.38%	.38%
Long-term AFR	1.12%	1.12%	1.12%	1.12%

November 2020

	Annual	Semiannual	Quarterly	Monthly
Short-term AFR	.13%	.13%	.13%	.13%
Mid-term AFR	.39%	.39%	.39%	.39%
Long-term AFR	1.17%	1.17%	1.17%	1.17%

December 2020

	Annual	Semiannual	Quarterly	Monthly
Short-term AFR	.15%	.15%	.15%	.15%
Mid-term AFR	.48%	.48%	.48%	.48%
Long-term AFR	1.31%	1.31%	1.31%	1.31%

January 2021

	Annual	Semiannual	Quarterly	Monthly
Short-term AFR	.14%	.14%	.14%	.14%
Mid-term AFR	.52%	.52%	.52%	.52%
Long-term AFR	1.35%	1.35%	1.35%	1.35%

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February 2021

	Annual	Semiannual	Quarterly	Monthly
Short-term AFR	.12%	.12%	.12%	.12%
Mid-term AFR	.56%	.56%	.56%	.56%
Long-term AFR	1.46%	1.45%	1.45%	1.45%

March 2021

	Annual	Semiannual	Quarterly	Monthly
Short-term AFR	.11%	.11%	.11%	.11%
Mid-term AFR	.62%	.62%	.62%	.62%
Long-term AFR	1.62%	1.61%	1.61%	1.60%

April 2021

	Annual	Semiannual	Quarterly	Monthly
Short-term AFR	.12%	.12%	.12%	.12%
Mid-term AFR	.89%	.89%	.89%	.89%
Long-term AFR	1.98%	1.97%	1.97%	1.96%

May 2021

	Annual	Semiannual	Quarterly	Monthly
Short-term AFR	.13%	.13%	.13%	.13%
Mid-term AFR	1.07%	1.07%	1.07%	1.07%
Long-term AFR	2.16%	2.15%	2.14%	2.14%

June 2021

	Annual	Semiannual	Quarterly	Monthly
Short-term AFR	.13%	.13%	.13%	.13%
Mid-term AFR	1.02%	1.02%	1.02%	1.02%
Long-term AFR	2.08%	2.07%	2.06%	2.06%

July 2021

	Annual	Semiannual	Quarterly	Monthly
Short-term AFR	.12%	.12%	.12%	.12%
Mid-term AFR	1.00%	1.00%	1.00%	1.00%
Long-term AFR	2.07%	2.06%	2.05%	2.05%

August 2021

	Annual	Semiannual	Quarterly	Monthly
Short-term AFR	.19%	.19%	.19%	.19%
Mid-term AFR	1.00%	1.00%	1.00%	1.00%
Long-term AFR	1.89%	1.88%	1.88%	1.87%

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Blended Annual Rate

2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
0.22%	0.22%	0.28%	0.45%	0.73%	1.09%	2.03%	2.42%	.89%	.13%

AFR for Determining the Present Value of an Annuity or Interest in a Property (I.R.C. § 7520)

September 2020	.4%
October 2020	.4%
November 2020	.4%
December 2020	.6%
January 2021	.6%
February 2021	.6
March 2021	.8%
April 2021	1.0%
May 2021	1.2%
June 2021	1.2%
July 2021	1.2%
August 2021	1.2%

Farm Credit System Bank Interest Rates

For Computing I.R.C. § 2032A Special Use Values in 2019

Farm Credit System Bank	Location of Property	Interest Rate
AgFirst, FCB	Delaware, District of Columbia, Florida, Georgia, Maryland, North Carolina, Pennsylvania, South Carolina, Virginia, West Virginia	5.27%
AgriBank, FCB	Arkansas, Illinois, Indiana, Iowa, Kentucky, Michigan, Minnesota, Missouri, Nebraska, North Dakota, Ohio, South Dakota, Tennessee, Wisconsin, Wyoming	4.68%
CoBank, ACB	Alaska, Arizona, California, Colorado, Connecticut, Hawaii, Idaho, Kansas, Maine, Massachusetts, Montana, New Hampshire, New Jersey, New Mexico, New York, Nevada, Oklahoma, Oregon, Rhode Island, Utah, Vermont, Washington	4.37%
Texas, FCB	Alabama, Louisiana, Mississippi, Texas	5.00%

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For Computing I.R.C. § 2032A Special Use Values in 2020

Farm Credit System Bank	Location of Property	Interest Rate
AgFirst, FCB	Delaware, District of Columbia, Florida, Georgia, Maryland, North Carolina, Pennsylvania, South Carolina, Virginia, West Virginia	5.37%
AgriBank, FCB	Arkansas, Illinois, Indiana, Iowa, Kentucky, Michigan, Minnesota, Missouri, Nebraska, North Dakota, Ohio, South Dakota, Tennessee, Wisconsin, Wyoming	4.74%
CoBank, ACB	Alaska, Arizona, California, Colorado, Connecticut, Hawaii, Idaho, Kansas, Maine, Massachusetts, Montana, New Hampshire, New Jersey, New Mexico, New York, Nevada, Oklahoma, Oregon, Rhode Island, Utah, Vermont, Washington	4.53%
Texas, FCB	Alabama, Louisiana, Mississippi, Texas	5.12%

For Computing I.R.C. § 2032A Special Use Values in 2021

Farm Credit System Bank	Location of Property	Interest Rate
AgFirst, FCB	Delaware, District of Columbia, Florida, Georgia, Maryland, North Carolina, Pennsylvania, South Carolina, Virginia, West Virginia	_____
AgriBank, FCB	Arkansas, Illinois, Indiana, Iowa, Kentucky, Michigan, Minnesota, Missouri, Nebraska, North Dakota, Ohio, South Dakota, Tennessee, Wisconsin, Wyoming	_____
CoBank, ACB	Alaska, Arizona, California, Colorado, Connecticut, Hawaii, Idaho, Kansas, Maine, Massachusetts, Montana, New Hampshire, New Jersey, New Mexico, New York, Nevada, Oklahoma, Oregon, Rhode Island, Utah, Vermont, Washington	_____
Texas, FCB	Alabama, Louisiana, Mississippi, Texas	_____

Interest Rates for Overpayments and Underpayments of Tax

Quarter	Noncorporate Overpayment and Underpayment	Corporate Over-Payment	Corporate Underpayment	Corporate Overpayment That Exceeds $10,000	Large Corporate Underpayment (Generally over $100,000)
Jul. 1, 2020-Sep. 30, 2020	3%	2%	3%	.5%	5%
Oct. 1, 2020-Dec. 31, 2020	3%	2%	3%	.5%	5%
Jan. 1, 2021-Mar. 31, 2021	3%	2%	3%	.5%	5%
Apr. 1, 2021-June 30, 2021	3%	2%	3%	.5%	5%
Jul. 1, 2021-Sep. 30, 2021	3%	2%	3%	.5%	5%

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RETIREMENT PLANS This section includes dollar ceilings for contributions to qualified plans and individual retirement accounts (IRAs) and AGI limits for deducting contributions to traditional IRAs.

2019 IRA Limits

	Filing	Maximum	Modified AGI
Traditional IRA deduction if taxpayer is covered by an employer plan	MFJ or QW	$6,000	$103,000–$123,000
	S or HoH	$6,000	$64,000–$74,000
	MFS	$6,000	$0–$10,000
Traditional IRA deduction if taxpayer (lived with and MFJ) is NOT covered by an employer plan but spouse is covered	MFJ or QW	$6,000	$193,000–$203,000
	S or HoH	$6,000	N/A
	MFS	$6,000	$0–$10,000
Roth IRA Contribution	MFJ or QW	$6,000	$193,000–$203,000
	S or HoH	$6,000	$122,000–$137,000
	MFS	$6,000	$0–$10,000

2020 IRA Limits

	Filing	Maximum	Modified AGI
Traditional IRA deduction if taxpayer is covered by an employer plan	MFJ or QW	$6,000	$104,000–$124,000
	S or HoH	$6,000	$65,000-$75,000
	MFS	$6,000	$0–$10,000
Traditional IRA deduction if taxpayer (lived with and MFJ) is NOT covered by an employer plan but spouse is covered	MFJ or QW	$6,000	$196,000–$206,000
	S or HoH	$6,000	N/A
	MFS	$6,000	$0–$10,000
Roth IRA Contribution	MFJ or QW	$6,000	$196,000–$206,000
	S or HoH	$6,000	$124,000–$139,000
	MFS	$6,000	$0–$10,000

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2021 IRA Limits

	Filing	Maximum	Modified AGI
Traditional IRA deduction if taxpayer is covered by an employer plan	MFJ or QW	$6,000	$105,000–$125,000
	S or HoH	$6,000	$66,000–$76,000
	MFS	$6,000	$0–$10,000
Traditional IRA deduction if taxpayer (lived with and MFJ) is NOT covered by an employer plan but spouse is covered	MFJ or QW	$6,000	$198,000–$208,000
	S or HoH	$6,000	N/A
	MFS	$6,000	$0–$10,000
Roth IRA Contribution	MFJ or QW	$6,000	$198,000–$208,000
	S or HoH	$6,000	$125,000–$140,000
	MFS	$6,000	$0–$10,000

Retirement Plan Contribution Limits

Year	IRAs	SIMPLE1	457	401(k); 403(b); & SARSEP[1]	Defined Contribution Plan & SEP	Defined Benefit Plan	Compensation Limit	Stock Bonus and Profit- Sharing
2011	5,000	11,500	16,500	16,500	49,000	195,000	245,000	25%
2012	5,000	11,500	17,000	17,000	50,000	200,000	250,000	25%
2013	5,500	12,000	17,500	17,500	51,000	205,000	255,000	25%
2014	5,500	12,000	17,500	17,500	52,000	210,000	260,000	25%
2015	5,500	12,500	18,000	18,000	53,000	210,000	265,000	25%
2016	5,500	12,500	18,000	18,000	53,000	210,000	265,000	25%
2017	5,500	12,500	18,000	18,000	54,000	215,000	270,000	25%
2018	5,500	12,500	18,500	18,500	55,000	220,000	275,000	25%
2019	6,000	13,000	19,000	19,000	56,000	225,000	280,000	25%
2020	6,000	13,500	19,500	19,500	57,000	230,000	285,000	25%
2021	6,000	13,500	19,500	19,600	58,000	230,000	290,000	25%

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Age 50 Catch-Up Contribution Limit

Tax Year	IRAs	SIMPLE Plans	All Other Plans
2011	1,000	2,500	5,500
2012	1,000	2,500	5,500
2013	1,000	2,500	5,500
2014	1,000	2,500	5,500
2015	1,000	3,000	6,000
2016	1,000	3,000	6,000
2017	1,000	3,000	6,000
2018	1,000	3,000	6,000
2019	1,000	3,000	6,000
2020	1,000	3,000	6,500
2021	1,000	3,000	6,500

Saver's Credit—Qualified Retirement Savings Contributions

2019 Saver's Credit

Filing Status	Credit Amount	AGI Range
MFJ	50% of up to $4,000	up to $38,500
HoH	50% of up to $2,000	up to $28,875
MFS, S, or QW	50% of up to $2,000	up to $19,250
MFJ	20% of up to $4,000	$38,501–$41,500
HoH	20% of up to $2,000	$28,876–$31,125
MFS, S, or QW	20% of up to $2,000	$19,251–$20,750
MFJ	10% of up to $4,000	$41,501–$64,000
HoH	10% of up to $2,000	$31,126–$48,000
MFS, S, or QW	10% of up to $2,000	$20,751–$32,000

2020 Saver's Credit

Filing Status	Credit Amount	AGI Range
MFJ	50% of up to $4,000	up to $39,000
HoH	50% of up to $2,000	up to $29,250
MFS, S, or QW	50% of up to $2,000	up to $19,500
MFJ	20% of up to $4,000	$39,001–$42,500
HoH	20% of up to $2,000	$29,251–$31,875
MFS, S, or QW	20% of up to $2,000	$19,501–$21,250
MFJ	10% of up to $4,000	$42,501–$65,000
HoH	10% of up to $2,000	$31,876–$48,750
MFS, S, or QW	10% of up to $2,000	$21,251–$32,500

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2021 Saver's Credit

Filing Status	Credit Amount	AGI Range
MFJ	50% of up to $4,000	up to $39,500
HoH	50% of up to $2,000	up to $29,625
MFS, S, or QW	50% of up to $2,000	up to $19,750
MFJ	20% of up to $4,000	$39,501–$43,000
HoH	20% of up to $2,000	$29,626–$32,250
MFS, S, or QW	20% of up to $2,000	$19,751–$21,500
MFJ	10% of up to $4,000	$43,001–$66,000
HoH	10% of up to $2,000	$32,251–$49,500
MFS, S, or QW	10% of up to $2,000	$21,501–$33,000

Social Security and Medicare Information

	2019	2020	2021
OASDI tax maximum earnings	$132,900	$137,700	$142,800
OASDI portion of FICA tax rate (employee and employer)	6.20%	6.20%	6.20%
HI portion of FICA tax rate (employee and employer)	1.45%	1.45%	1.45%
OASDI portion of SE tax rate	12.40%	12.40%	12.40%
HI portion of SE tax rate	2.90%	2.90%	2.90%
Earned income threshold for 0.9% Medicare tax	$250,000 MFJ $200,000 S, QW, Hoh $125,000 MFS	$250,000 MFJ $200,000 S, QW, HoH $125,000 MFS	$250,000 MFJ $200,000 S, QW, HoH $125,000 MFS
Domestic employee wage threshold	$2,100	$2,200	$2,300
Earnings required to earn one quarter of social security coverage	$1,360	$1,410	$1,470
Monthly earnings ceiling for social security			
Below full retirement age (FRA)	$3,910	$4,050	$4,210
Above FRA	Unlimited	Unlimited	Unlimited

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OTHER INFORMATION This section includes miscellaneous amounts helpful to tax practitioners.

Credit for the Elderly or Disabled

Filing Status	I.R.C. § 22 Amount	AGI Phaseout Range
S, HoH, QW	$5,000	$7,500–$17,500
MFJ (both spouses qualify)	$7,500	$10,000–$25,000
MFJ (one spouse qualifies)	$5,000	$10,000–$20,000
MFS (did not live with spouse)	$3,750	$5,000–$12,500

Miscellaneous Information

	2019	2020	2021
Kiddie tax applies to unearned income over	$2,200	$2,200	$2,200
Backup withholding rate	24%	24%	24%
Supplemental wage withholding rates	22%	22%	22%
More than $1 million in supplemental pay, withhold	37%	37%	37%

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IRS Hotlines and Other Toll-Free Numbers

Service	Telephone Number	Hours of Operation
ACS (collection) self-employed	800.829.3903	M-F, 8:00 a.m.–8:00 p.m., local time
ACS (collection) wage earners	800.829.7650	M-F, 8:00 a.m.–8:00 p.m., local time
Business and Specialty Tax Line	800.829.4933	M–F, 7:00 a.m.– 7:00 p.m., local time
Criminal investigation/fraud	800.829.0433	M-F, 7:00 a.m.–7:00 p.m., local time
Disaster or Combat Zone Special Hotline	866.562.5227	M–F, 7:00 a.m.–7:00 p.m., local time
e-help (Practitioners Only)	866.255.0654	M–F, 6:30 a.m.– 6:00 p.m., central time
EFTPS payment by phone	800.555.3453	24/7
Electronic Federal Tax Payment System (EFTPS) Information	800.555.4477	24/7
Employer Identification Number (EIN)	800.829.4933	M–F, 7:00 a.m.–7:00 p.m., local time
Excise Tax and Form 2290 Help Line	866.699.4096	hours not reported
FBAR and Title 31 Help Line	866.270.0733	M–F, 7:00 a.m.– 3:30 p.m., central time
(not toll free)	313.234.6146	
First Time Homebuyer Credit	800.919.0352	recorded options
Forms 706 and 709 Help Line	866.699.4083	M–F, 7:00 a.m.– 3:00 p.m., central time
Forms and Publications	800.829.3676	M–F, 7:00 a.m.– 7:00 p.m., local time
Identity Protection Specialized Unit	800.908.4490	M–F, 7:00 a.m.– 7:00 p.m., local time
Individual Taxpayer Identification Number (ITIN)	800.908.9982	M-F, 7:00 a.m.–7:00 p.m., local time
Information Return Reporting	866.455.7438	M–F, 7:30 a.m.– 4:30 p.m., central time
Innocent Spouse	855.851.2009	M-F, 6:30 a.m.–2:30 p.m., central time
IRS Tax Help Line for Individuals	800.829.1040	M–F, 7:00 a.m.– 7:00 p.m., local time
Practitioner Priority Service	866.860.4259	M–F, 7:00 a.m.– 7:00 p.m., local time
Refund Hotline	800.829.1954	M–F, 7:00 a.m.– 7:00 p.m., local time
Refund Status	800.829.4477	24/7
Social Security (employers)	800.772.6270	M–F, 7:00 a.m.– 7:00 p.m., eastern time
SSA benefits questions (general)	800.772.1213	M-F, 7:00 a.m.–7:00 p.m.
Tax Exempt and Government Entities (TEGE) Help Line	877.829.5500	M–F, 8:00 a.m.– 5:00 p.m., local time
Taxpayer Advocacy Panel	888.912.1227	hours not reported
Taxpayer Advocate Service (TAS) Help Line	877.777.4778	M–F, 7:00 a.m.– 7:00 p.m., local time
Tax shelter hotline (abusive schemes)	866.775.7474	24/7
Telephone Device for the Deaf (TDD): Forms, Tax Help, TAS	800.829.4059	M–F, 7:00 a.m.– 7:00 p.m., local time

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INTRODUCTION

The myriad rules and procedures of the federal tax system are created and modified through a profusion of laws, administrative and judicial proceedings, congressional and administrative pronouncements, and other legal documents. These rules and procedures are in constant flux, and the tax practitioner must keep up to date on the current authoritative interpretation of the tax laws to provide accurate tax advice and prepare tax returns. The latter portion of this chapter summarizes relevant 2020–2021 rulings and cases that affirm, interpret, modify, and create tax laws.

Occasional errors, ambiguities, or contradictions in the rules further complicate the practitioner's task, and the tax practitioner must decide when to attempt to take advantage of the resulting uncertainty to a taxpayer's advantage. The beginning of this chapter explains the I.R.C. § 6662 penalty, and it discusses how to determine if there is substantial authority for a position, and the types of authorities that constitute substantial authority.

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SUBSTANTIAL AUTHORITY Statutes, cases, and other types of authority help to establish substantial authority for a position taken on a tax return.

I.R.C. § 6662 imposes penalties for understatements of tax if the taxpayer does not have substantial authority for the tax position taken.

Substantial Understatement Penalty

I.R.C. § 6662 generally imposes a penalty on the amount of the understatement on a tax return that understates the tax due resulting from the following:

1. Negligence or disregard of rules or regulations
2. Substantial understatement of income tax
3. Substantial valuation misstatement under chapter 1 of the Internal Revenue Code
4. Substantial overstatement of pension liabilities
5. Substantial estate or gift tax valuation understatement
6. Disallowance of claimed tax benefits because a transaction lacks economic substance [within the meaning of I.R.C. § 7701(o)] or fails to meet the requirements of any similar rule of law
7. Undisclosed foreign financial asset understatement
8. Inconsistent estate basis
9. Any overstatement of the 2021 above-the-line deduction for charitable cash contributions

For purposes of item 1, *negligence* includes any failure to make a reasonable attempt to comply with the provisions of the Internal Revenue Code, and the term *disregard* includes any careless, reckless, or intentional disregard. There is a *substantial understatement* of income tax for any tax year if the amount of the understatement of tax for the tax year exceeds the greater of 10% (5% for the QBI deduction) of the tax required to be shown on the return for the tax year or $5,000.

PRACTITIONER NOTE

Rule for Corporations

In the case of a corporation other than an S corporation or a personal holding company (as defined in I.R.C. § 542), there is a substantial understatement of income tax for any tax year if the amount of the understatement for the tax year exceeds the lesser of 10% of the tax required to be shown on the return for the tax year (or, if greater, $10,000), or $10,000,000.

The penalty does not apply to any portion of the understatement if there is substantial authority to support the position taken on the tax return, or if the taxpayer adequately discloses the relevant facts affecting the tax treatment of the item and there is a reasonable basis for the position taken on the tax return.

PRACTITIONER NOTE

Reasonable Basis

The reasonable basis standard is not as stringent as the substantial authority standard. There is a reasonable basis for a position on a tax return if there is some authority for the position even if the weight of contrary authority is greater. However, the reasonable basis standard is not satisfied by a return position that is merely arguable or is merely a colorable claim. It must be reasonably based on authorities that can be used to find substantial authority for a position, considering the relevance and persuasiveness of the authorities and subsequent developments [Treas. Reg. § 1.6662-3(b)(3)]. See the "Penalties and Defenses" chapter in the *2016 National Income Tax Workbook* for a further discussion of the penalty and defenses to the penalty.

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Definition of Substantial Authority

There is *substantial authority* for a position taken on a tax return only if the weight of authorities supporting the position is substantial in relationship to the weight of authorities supporting contrary positions. The taxpayer does not have to meet the more-likely-than-not standard, which is a greater-than-50% likelihood of the position being upheld. However, there is no bright-line test for substantial authority, and the regulations define substantial authority as an objective standard determined by analyzing the law and applying the law to all relevant facts [Treas. Reg. § 1.6662-4(d)(2)].

The possibility that a return will not be audited or, if audited, that an item will not be raised on audit is not relevant in determining whether the substantial authority standard (or the reasonable basis standard) is satisfied.

The authority of an item may be diminished by other types of authority that may distinguish or even overrule prior interpretations of tax law. For example, a court can determine that a statute is unconstitutional or that a regulation is void because it was improperly promulgated, or it overreaches statutory authority.

Any item of authority must also be sufficiently similar in its facts to the taxpayer's facts to be substantial authority. Rulings and cases are insufficient authority if their facts and circumstances are distinguishable from the taxpayer's facts and circumstances.

PRACTITIONER NOTE

Taxpayer Intent

Two courts have held that for tax positions involving issues of taxpayer intent, substantial authority is determined by the facts rather than the law. The courts reasoned that all tax positions have authority, and the deciding factor is whether the taxpayer's tax position is supported by the facts [*Osteen v. Commissioner*, 62 F.3d 356 (11th Cir. 1995); and *Estate of Kluener v. Commissioner*, 154 F.3d 630 (6th Cir. 1998)].

Authorities

In determining whether there is substantial authority for a position taken on a tax return, the taxpayer can rely on statutes, regulations, revenue rulings and procedures, and other sources of authority. Taxpayers typically cannot rely on private letter rulings, general counsel memoranda, other IRS information releases and reports, and tax opinions.

In conducting the substantial authority analysis, the weight given to the authorities must reflect their "relevance and persuasiveness" and the "type of document providing the authority" [Treas. Reg. § 1.6662-4(d)(3)(ii)].

PRACTITIONER NOTE

IRS FAQs

Frequently asked questions and other items posted on IRS.gov that have not been published in the Internal Revenue Bulletin are not legal authority. The FAQs and other items should not be used to sustain a position unless the items (e.g., FAQs) explicitly indicate otherwise or the IRS indicates otherwise by press release or by notice or announcement published in the Internal Revenue Bulletin [I.R.M. § 4.10.7.2.4]. The National Taxpayer Advocate has recommended that the IRS never assess a penalty against a taxpayer for taking a position consistent with an FAQ posted on the IRS website at the end of a taxpayer's tax year or at the time of return filing unless the IRS has convincing evidence the taxpayer knew the FAQ had been changed [https://taxpayeradvocate.irs.gov/news/nta-blog-protecting-taxpayer-rights-FAQ].

Internal Revenue Code

Although subject to occasional ambiguities, the US Code, including chapter 26, is clear authority for tax return positions unless a federal court has determined that the code provision is unconstitutional. If two or more courts disagree on the constitutionality or interpretation of a portion of the Internal Revenue Code, the authority of a court's decision remains limited to the jurisdiction of each court until an appellate court of wider jurisdiction resolves the conflict.

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Where code provisions are complex and do not have IRS explanations in regulations or other authoritative pronouncements, a taxpayer's well-reasoned construction of the applicable statutory provision may be substantial authority even though the court accepts the IRS's interpretation in the case [Treas. Reg. § 1.6662-4(d)(3)(ii); *Van Wyk v. Commissioner*, 113 T.C. 441 (1999)].

Proposed, Temporary, and Final Regulations

IRS regulations, cited as Prop. Treas. Reg. § ___, Temp. Treas. Reg. § ___, or Treas. Reg. § ___, are the IRS's interpretation and implementation of federal tax law. Taxpayers can rely on these regulations as authority for a position taken on a tax return. However, a proposed regulation may have limited weight as an authority for a tax position.

Temporary and proposed regulations are essentially first drafts issued to provide an opportunity for taxpayers, practitioners, and other interested parties to submit comments to the IRS on the regulations and their intended effect. The IRS considers the comments and issues final regulations.

The IRS recognizes that new regulations can affect taxpayers' and practitioners' knowledge of tax law, and temporary and proposed regulations often include the option for taxpayers to use the new temporary and proposed regulations as authority or continue to use prior law or regulations until the final regulations are issued. Thus, prior-existing final regulations or other IRS pronouncements may remain substantial authority until the final regulations are published in the *Federal Register*.

The regulations are subject to revision when the experience of taxpayers and the IRS reveals inconsistencies, ambiguities, and limitations. Also, the regulations are subject to review by US courts for proper promulgation under the rules of the Administrative Procedures Act, reasonableness, and statutory authority. Thus, tax practitioners must keep up to date on any changes in the regulations and any court decisions that impact their authority.

The preamble to the regulations, published in the *Federal Register*, is not as authoritative as the regulations themselves, but the preamble often gives background authority for the IRS's position in the regulations, and it can be useful in interpreting the regulations.

Revenue Rulings and Revenue Procedures

The IRS issues revenue rulings and revenue procedures in the Internal Revenue Bulletin (I.R.B.) available at https://apps.irs.gov/app/picklist/list/internalRevenueBulletins.html. Prior to 2009, the I.R.B.s were collected in single-volume Cumulative Bulletins, covering 6 months of I.R.B.s. Revenue rulings focus on the IRS's interpretation of tax law, regulations, and rulings by federal courts. Revenue rulings often relate to a given set of facts and provide a ruling that applies the tax law to those facts. Revenue rulings and revenue procedures can constitute authority for a position taken on a tax return if the taxpayer's facts and circumstances are the same as those in the ruling.

Revenue procedures focus more on tax practice aspects of tax law, and provide procedures for implementing tax laws, IRS regulations, and federal court rulings. Revenue procedures are also used to report changes in monetary limits and factors, such as the annual mileage rate for vehicle deductions. Revenue procedures can constitute authority for a position on a tax return.

Tax Treaties

Tax treaties and the regulations thereunder, and Treasury Department and other official explanations of such treaties, can support a position on a tax return that involves tax issues with other countries.

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Federal Court Cases

Federal courts have a hierarchy of authority and geographic jurisdiction, and they have a strong preference to follow the precedent of the same or higher courts within their jurisdiction.

The US Supreme Court's rulings provide the ultimate national authority for interpreting issues of tax law, followed by the regional authority of the 13 circuit courts of appeals and the trial courts, including the district courts, the US Tax Court, and federal specialty courts, such as bankruptcy courts. The federal courts have geographical limits on their jurisdiction over taxpayers and other federal courts (see **Figure 14.1**). The US Tax Court has national jurisdiction over all states and territories of the United States.

FIGURE 14.1 Jurisdiction of the Courts

Jurisdiction of Circuit Courts of Appeals

- DC Circuit—District of Columbia
- First Circuit—Maine, New Hampshire, Massachusetts, Rhode Island, Puerto Rico
- Second Circuit—Vermont, New York, Connecticut
- Third Circuit—Pennsylvania, New Jersey, Delaware, US Virgin Islands
- Fourth Circuit—Maryland, Virginia, West Virginia, North Carolina, South Carolina
- Fifth Circuit—Texas, Louisiana, Mississippi
- Sixth Circuit—Michigan, Ohio, Kentucky, Tennessee
- Seventh Circuit—Wisconsin, Illinois, Indiana
- Eighth Circuit—Minnesota, Iowa, Missouri, Arkansas, Nebraska, North Dakota, South Dakota
- Ninth Circuit—Montana, Idaho, Washington, Oregon, California, Nevada, Arizona, Alaska, Hawaii, Guam, Northern Mariana Islands
- Tenth Circuit—Wyoming, Utah, Colorado, New Mexico, Kansas, Oklahoma
- Eleventh Circuit—Alabama, Georgia, Florida
- Federal Circuit—Nationwide jurisdiction

Except for the Federal Circuit, the jurisdiction of each federal circuit court of appeal is limited geographically, as shown in Figure 14.1. These courts can hear appeals of the federal district court decisions and US Tax Court decisions by taxpayers in their jurisdictions. Similarly, the rulings of each circuit court of appeals have authority only in that court's jurisdiction, although another circuit court may give weight to another circuit's ruling on a case with similar facts.

The Federal Circuit Court of Appeals has jurisdiction over a variety of subjects, including international trade, government contracts, patents, trademarks, certain money claims against the US government, federal personnel, veterans' benefits, and public safety officers' benefits claims. Appeals to the court come from all federal district courts, the United States Court of Federal Claims, the United States Court of International Trade, and the United States Court of Appeals for Veterans Claims. The court also hears appeals from certain administrative agencies.

The Tax Court's jurisdiction is the entire United States and its possessions. Therefore, a Tax Court opinion involving a taxpayer in California is precedential for a taxpayer in New York. However, Tax Court cases are appealed to the US Circuit Court of Appeals for the circuit in which the taxpayer lives. If a circuit court of appeals overrules a Tax Court case, the case is overruled only with respect to taxpayers who live in that circuit [Treas. Reg. § 1.6662-4(d)(3)(iii)]. Taxpayers outside the jurisdiction of the circuit court of appeals that overruled the Tax Court are not bound by that appellate decision.

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The Tax Court issues the following types of written decisions:

- Regular decisions (T.C.), which are published and precedential
- Memorandum decisions (T.C. Memo.), which are not published by the Tax Court and are not precedential but can be cited as legal authority
- Summary decisions (T.C. Summary Opinion), which are not published by the Tax Court and are not precedential but may also be cited

While the Treasury regulations that define substantial authority do not distinguish between published and unpublished cases, this is a relevant factor to consider.

In a Tax Court bench opinion, the Tax Court judge orally states the opinion in court during the trial session. The Tax Court sends the parties a copy of the transcript reflecting the judge's opinion within a few weeks after the trial. In addition, all bench opinions delivered after March 1, 2008, are posted on the Tax Court's docket inquiry system. A taxpayer cannot rely on a bench opinion as precedent.

An authority ceases to be an authority only to the extent that it is overruled or modified, explicitly or implicitly, by a body with the power to overrule or modify the earlier authority. For example, a district court opinion is not authority if overruled, explicitly or implicitly, by the United States Court of Appeals for that district. However, an opinion of the United States Tax Court is not considered overruled or modified by a United States Court of Appeals to which the taxpayer does not have a right of appeal, unless the Tax Court adopts the holding of that Court of Appeals [Treas. Reg. § 1.6662-4(d)(3)(iii)]. See Figure 15.1 for the jurisdictions of the 13 United States Circuit Court of Appeals.

A taxpayer can rely on a case as substantial authority even if a court has ruled in the IRS's favor on a particular tax issue if the case contained complex fact situations and complex or unsettled law. Thus, even though a court disagrees with the cases cited by the taxpayer and rules against the taxpayer, the case can be substantial authority for the taxpayer's position to avoid the I.R.C. § 6662 penalty [see *Unger v. Commissioner*, T.C. Memo. 1990-15].

Similarly, even where the facts of several past cases are similar to the current taxpayer's facts, courts in different jurisdictions can reach inconsistent results. The current court's choice to follow only some courts' ruling does not negate the value of the rejected court rulings as substantial authority [see *Crawford v. Commissioner*, T.C. Memo. 1993-192].

Congressional Committee Reports

Courts look to congressional committee reports on bills for interpretation of laws only if the court holds that a law, or section of a law, is ambiguous in meaning. Thus, if the meaning of a law is reasonably clear, a contrary interpretation in a congressional committee report will have little weight as an authority for the contrary meaning.

The Joint Committee on Taxation is a nonpartisan congressional committee formed of members from the House Committee on Ways and Means and the Senate Finance Committee. The committee's annual "Bluebooks" provide explanations of enacted legislation. Use of a Joint Committee analysis is not substantial authority over other forms of legislative history or IRS regulations, but can be a useful guide for understanding legislation subject to various interpretations.

Private Letter Ruling and Technical Advice Memorandum

A private letter ruling (Ltr. Rul.) is an IRS National Office ruling requested by a taxpayer, and it is limited in authority to the facts of that one taxpayer. A technical advice memorandum (T.A.M.) is an intra-IRS ruling from the National Office to district or area IRS directors responding to questions involving specific taxpayers. Like a Ltr. Rul., a T.A.M. carries no precedential authority except for the taxpayer involved in the ruling.

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A Ltr. Rul. or T.A.M. issued after October 31, 1976, can be substantial authority for the tax treatment of an item by a taxpayer if the treatment is supported by the conclusion of a ruling or a determination letter issued to the taxpayer, by the conclusion of a technical advice memorandum in which the taxpayer is named, or by an affirmative statement in a revenue agent's report with respect to a prior tax year of the taxpayer. The preceding sentence does not apply, however, if

1. there was a misstatement or omission of a material fact or the facts that subsequently develop are materially different from the facts on which the written determination was based; or
2. the written determination was modified or revoked after the date of issuance by
   a. a notice to the taxpayer to whom the written determination was issued;
   b. the enactment of legislation or ratification of a tax treaty;
   c. a decision of the US Supreme Court;
   d. the issuance of temporary or final regulations; or
   e. the issuance of a revenue ruling, revenue procedure, or other statement published in the I.R.B.

Action on Decision and General Counsel Memorandum

An Action on Decision (A.O.D.) is a formal memorandum prepared by the IRS Office of Chief Counsel that announces the litigation position the IRS will take with regard to the court decision addressed in the A.O.D. A.O.D.s are characterized as an acquiescence, a nonacquiescence, or an acquiescence in result only, and indicate whether the IRS will follow a significant adverse opinion of the Tax Court, a district court, the Court of Federal Claims, a bankruptcy court, or an appellate court.

General Counsel Memoranda (G.C.M.) are written by the Office of the Chief Counsel for internal use. They "contain the reasons behind the adoption of revenue rulings, private letter rulings, and technical advice memoranda" and have "important precedential value in determining future tax questions" [*Taxation with Representation Fund v. IRS*, 485 F. Supp. 263, at 266 (D. D.C. 1980)]. A taxpayer usually cannot cite a G.C.M. as precedent.

IRS Information Releases, Notices, and Announcements

Notices, announcements, and press releases provide short-term explanations that the IRS may later incorporate into a revenue ruling, revenue procedure, or regulation. Such statements often include a time limit for reliance by taxpayers and are designed to give advance notice of the IRS's position on specific areas of tax law. Under Rev. Rul. 1990-91, 1990-2 C.B. 262, IRS notices and announcements are accorded the same weight as revenue rulings and revenue procedures. An IRS Notice can provide insight into the IRS's interpretation of law but cannot override provisions of the Internal Revenue Code [*Feigh v. Commissioner*, 152 T.C. No. 15 (2019)].

Tax Opinions

Although Treas. Reg. § 1.6662-4(d)(3)(iii) specifically states that a written tax opinion by a tax expert is not substantial authority, some cases have held that the reliance on a written tax opinion of a lawyer is substantial authority. [See, e.g., *Klamath Strategic Investment Fund, LLC v. United States*, 472 F. Supp.2d 885 (E.D. Tex. 2007).] However, most courts have followed the regulations, and found that a tax opinion is not substantial authority.

PRACTITIONER NOTE

More Than One Position

There may be substantial authority for more than one position with respect to the same item or set of facts [Treas. Reg. § 1.6662-4(d)(3)(i)]. That means it is possible for two different taxpayers who take two different positions on the same issue to each have substantial authority for the chosen position.

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RULINGS AND CASES This section contains a selection of IRS rulings and court cases issued since the publication of the *2020 National Income Tax Workbook.*

These rulings and cases have been edited and appear in a condensed form. The tax practitioner must read the entire text of the rulings and cases before relying on them.

Business Entity Issues

Nonprofits

Tikar v. Commissioner
I.R.C. § 501

A nonprofit corporation was not operated exclusively for an exempt purpose.

Facts

Dr. Seghers was a cardiologist who, after a short stay in Cameroon, developed an interest in Tikar culture. He began importing Tikar artifacts such as handicrafts and statues. Sometime in 1996, Dr. Seghers's father, Conrad Seghers, created a foundation for the purpose of promoting African art from Cameroon by establishing museums and organizing exhibits. In 1999, Dr. Seghers formed a Texas nonprofit corporation that was organized to promote African art.

The corporation filed Form 1023, Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code. The application stated that its activities included presenting expositions of objects belonging to the corporation and negotiating contracts with museums and other organizations to organize expositions. In the balance sheet section of the application, it listed $15,000,000 in African art.

The IRS requested additional information about acquisition and ownership of the art. The taxpayer responded that the art was owned by the nonprofit corporation, and that it would be exhibited. The IRS approved the application for recognition of exemption based on that information. While the corporation was originally classified as a public charity, it did not have any public support, and the IRS later classified it as a private foundation.

On its 2012 Form 990-PF, the corporation reported $25,040,000 as the book value for inventories for sale or use and reported $25,000,00 in mortgages and other notes payable. The IRS audited the return and requested additional information. In 2016, the IRS advised the corporation that its tax-exempt status was being revoked because its expenses for activities to authenticate the artifacts did not further its exempt purpose, the corporation did not actually own the artifacts, and the corporation had only held one exhibit in its 20 years of operations.

Analysis

I.R.C. § 501(a) exempts organizations described in section 501(c) from federal income taxation. Section 501(c)(3) includes corporations organized and operated 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. No part of the net earnings of can inure to the benefit of any private shareholder or individual.

To be exempt under section 501(c)(3), an organization must be both organized exclusively for one or more of the exempt purposes specified in that section (the organizational test) and operated exclusively for such purposes (the operational test). Under the operational test, an organization will be regarded as operated exclusively for one or more exempt purposes only if it engages primarily in activities that accomplish one or more of the exempt purposes specified in section 501(c)(3). An organization will not meet the test if more than an insubstantial part of its activities is not in furtherance of an exempt purpose [Treas. Reg. § 1.501(c)(3)-1(c)(1)].

An entity is deemed not to operate exclusively for exempt purposes if net earnings are distributed or otherwise inure to the benefit of private individuals. Factors that indicate prohibited inurement and private benefit include control by the founder over the entity's funds, assets,

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and disbursements; use of entity money for personal expenses; payment of salary or rent to the founder without any accompanying evidence or analysis of the reasonableness of the amounts; and purported loans to the founder showing a ready private source of credit.

The court found that the corporation did not prove that it owned the artifacts, and that the activities of the corporation primarily benefited Dr. Seghers's private interests. Thus, the corporation did not prove that it served a public interest and did not show that it was operated for an exempt purpose.

Holding

The court held that the corporation did not operate exclusively for one or more exempt purposes under section 501(c)(3), and the court upheld the revocation of the corporation's tax-exempt status.

[*Tikar v. Commissioner*, T.C. Memo. 2021-53]

Business Tax Issues

Credits

Leon Max v. Commissioner
I.R.C. §§ 41, 174

The fashion design process is not eligible for a research tax credit.

Facts

Leon Max, Inc. is a clothing designer that specializes in apparel for women. It has a structured process for conceptualizing, designing, and developing garments (the preproduction process). A design team creates a concept for each collection then a designer sketches the clothing and chooses the fabric. Patternmakers create patterns for each component of the garment, which are then used to cut out each piece of fabric.

A sample maker sews the components together to make a sample, and then tries the sample on a model to determine how it fits. Leon Max then creates a sale sample to present to customers. When a customer orders the clothing, the taxpayer creates a production prototype, which it sends to third-party manufacturers in China.

In 2013, the taxpayer hired a tax consulting firm to conduct a study on the research and development tax credits. The consultant reviewed design sketches, prototype photographs, spec sheets, markers, and email correspondence, and analyzed financial documents. It concluded that some of the projects qualified for the research and experimentation tax credit. Based on the consultant's study, Leon Max filed an amended 2011 tax return, claiming $426,255 of research credits. On its 2012 return, it claimed $496,462 of research credits.

The IRS issued a notice of deficiency disallowing the research credits. The IRS argued that the taxpayer's process did not qualify for the research credit because the process was nontechnical, typical of the industry, and was concerned more with style, taste, and seasonality.

Analysis

I.R.C. § 41 allows taxpayers to take a credit for increasing research activities. Qualified research expenses are in-house research expenses, including wages for employees working on qualified research and costs paid or incurred for supplies for qualified research, and contract research expenses. To be qualified research, the research must relate to a new or improved function, performance, reliability, or quality of the product or process. Certain activities cannot be qualified research. Qualified research does not include research after commercial production; adaptation or duplication of an existing business component; market research, testing, or development; or routine or ordinary testing or inspection for quality control.

To be qualified research under section 41, the project or activities must satisfy the following four tests:

1. I.R.C. § 174 test
2. The technological information test
3. The business component test
4. The process of experimentation test

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The section 174 test requires research expenditures to be eligible for treatment as expenses under section 174. The taxpayer must show that it does not already have information that can address a capability or method for improving the product or design of the product and its activities were meant to eliminate those uncertainties. The court found that determining how to cut and drape fabric was not investigative and was finding a common solution to a common problem.

An activity is qualified research if it is undertaken for the purpose of discovering information that is technological in nature. Information is technological in nature if the process of experimentation used to discover such information fundamentally relies on principles of the physical or biological sciences, engineering, or computer science. Leon Max argued that its fit testing relied on engineering and its fabric draping and alignment relied on material sciences. The court found that fit testing was not complex and was not engineering, and draping fabric was not materials science.

Under the process of experimentation test, substantially all the research activities must constitute elements of a process of experimentation for a qualified purpose. A purpose is not qualified if it relates to style, taste, cosmetic, or seasonal design factors. The court found that Leon Max's design and creation activities were largely for cosmetic purposes.

The business component test requires that research undertaken to discover information must be intended to be used to develop a new or improved business component of the taxpayer. A business component is any product, process, computer software, technique, formula, or invention that is held for sale, lease, or license, or used by the taxpayer in its trade or business. The court did not address the business component test because Leon Max failed to satisfy any of the other tests.

The court concluded that the in-house testing the taxpayer did was quality control, which does not qualify as a research or experimental expenditure.

Holding

The court held that a clothing designer's activities did not constitute qualified research and expenses of those activities were not eligible for the section 41 credit for increasing research activities.

[*Leon Max v. Commissioner*, T.C. Memo. 2021-37]

Deductions

Aspro v. Commissioner
I.R.C. § 162

Management fees were disguised dividends and not deductible compensation.

Facts

Aspro, Inc., a C corporation, operated an asphalt paving business in Iowa. Aspro had 66 to 75 employees and operated two stationary asphalt plants. The corporation had three shareholders whose ownership interests were divided: 40%, 40%, and 20%. Aspro did not declare or distribute dividends to any of its shareholders during the years in issue or any prior years.

Aspro did not enter into any written management or consulting services agreement with any of its three shareholders. No management fee rate or billing structure was negotiated or agreed to between the shareholders and the corporation, and none of the shareholders invoiced or billed Aspro for any of the services provided. Aspro's board of directors approved the management fees to be paid to the shareholders at a meeting later in the tax year, when the board had a better idea how the company was going to perform and how much earnings the company should retain. The board minutes did not indicate how the determinations were made.

The board approved a lump sum management fee for each shareholder. The board did not consider the services provided, or the value of those services. Aspro paid $500,000 to each of the 40% shareholders in 2012 and $800,000 to each entity in 2013 and 2014. It claimed deductions for all management fees paid, and the IRS disallowed those deductions.

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Analysis

A corporation may deduct all of the ordinary and necessary expenses paid or incurred during the tax year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered [I.R.C. § 162(a)(1)]. An expense is ordinary if it is customary or usual within a particular trade, business, or industry or relates to a transaction of common or frequent occurrence in the type of business involved. An expense is necessary if it is appropriate and helpful for the development of the business. Whether an expense is ordinary and necessary is generally a question of fact.

In testing whether compensation is deductible, courts consider whether the payments were purely for services. Distributions to shareholders disguised as compensation are not deductible. Thus, courts closely scrutinize compensation paid by a corporation to its shareholders to ensure the payments are not disguised distributions, especially if the employees receiving the compensation are in control of the corporation.

The court found that most of the evidence indicated that the corporation paid the management fees to its three shareholders as disguised distributions. The corporation made no distributions to its shareholders. Although the management fees were not exactly pro rata among the three shareholders, the two larger shareholders always received equal amounts, and the percentages of management fees all three shareholders received roughly corresponded to their respective ownership interests. The amounts were paid as lump sums at the end of the year, instead of throughout the year as services were performed.

The court concluded that it could not identify any personal services performed by the 40% shareholders and that Aspro did not establish what amounts of the management fees paid to each shareholder were to compensate for services and whether such amounts would have been paid by like enterprises under like circumstances.

The 20% shareholder was an employee providing personal services on an ongoing basis. However, the court found that the fee paid to him appeared to be unreasonable because he was already compensated for the services he was performing as president.

Holding

The court held that Aspro was not entitled to deduct management fees paid to its three shareholders because the fees were not paid purely for services. The fees were disguised distributions and were not reasonable.

[*Aspro v. Commissioner*, T.C. Memo. 2021-8].

Mylan v. Commissioner
I.R.C. §§ 162, 263

The taxpayer could deduct patent litigation expenses.

Facts

Mylan, Inc. was a drug manufacturer. It regularly submitted applications to the FDA to obtain approval for generic drugs. As part of the applications, it was required to prepare and send notice letters to patent holders. It then sent formal notice letters explaining how the manufacture, sale, or use of the generic drugs did not infringe on the patents.

In response to the letters, some drug manufacturers sued Mylan for patent infringement, and Mylan defended those suits. It won some of the suits and launched the generic drugs immediately upon FDA approval. It lost some of the suits and converted the FDA application to an application for approval after expiration of the patent.

In issuing the notices and litigating the suits, Mylan incurred legal fees of $46,158,403; $38,211,911; and $38,618,993 in 2012, 2013, and 2014 respectively. It deducted those fees. The IRS examined the returns and determined that the expenses must be capitalized under I.R.C. § 263(a).

Analysis

Section 162(a) allows a deduction for ordinary and necessary expenses paid or incurred during the tax year in carrying on any trade or business. By contrast, I.R.C. § 263(a) provides that no deduction is allowed for a capital expenditure. Deductions are exceptions to the norm of capitalization. Whereas a deduction for an ordinary and necessary business expenditure may be taken in the current year and yields an immediate corresponding reduction in taxable income, a capital

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expenditure typically results in recovery of a taxpayer's expenditure over a longer period through amortization and depreciation deductions.

Whether an item is deductible or must be capitalized depends on the facts of the case. An expenditure generally must be capitalized where it is determined that the expenditure either creates or enhances a separate and distinct asset, or otherwise generates significant benefits for the taxpayer extending beyond the current tax year.

Treas. Reg. § 1.263(a)-4(b)(i) requires capitalization of amounts paid to acquire or create an intangible, which includes rights claimed from a government agency. Treas. Reg. § 1.263(a)-4(d)(5)(I) specifies that a taxpayer must capitalize amounts paid to a governmental agency to obtain, renew, renegotiate, or upgrade its rights under a trademark, trade name, copyright, license, permit, franchise, or other similar right granted by that governmental agency.

Treas. Reg. § 1.263(a)-4(d)(9)(I) states that a taxpayer must capitalize amounts paid to another party to defend or perfect title to intangible property if that other party challenges the taxpayer's title to the intangible property. Amounts paid to protect the property against infringement and to recover profits and damages as a result of infringement are generally deductible.

The deductibility of a legal expense generally depends upon the origin and character of the claim with respect to which the expense was incurred. Thus, legal expenses directly connected with (or pertaining to) the taxpayer's trade or business are deductible under section 162 as ordinary and necessary business expenses, while expenses arising out of the acquisition, improvement, or ownership of property are capital expenditures.

The court found that the preparation of the notice letters was a required step in obtaining FDA approval of the generic drugs. However, the litigation expenses were not part of the FDA approval process and were patent litigation expenses.

Holding

The court held that legal expenses that the taxpayer incurred to prepare notice letters to obtain FDA approval to manufacture generic drugs must be capitalized, but the legal expenses incurred in patent infringement suits were deductible as ordinary and necessary business expenses.

[*Mylan v. Commissioner*, 156 T.C. No. 10 (2021)]

Brown v. Commissioner
I.R.C. §§ 162, 274

A tax return preparer failed to substantiate car and truck expenses.

Facts

Frederica Brown prepared federal income tax returns for third parties using the business name "Gomillion Tax Service." Although she maintained an office in Charlotte, North Carolina, she conducted a significant portion of her return preparation business from her car. She drove to visit clients and potential clients, and then the clients submitted electronic versions of their tax documents through a web portal.

On her 2016 Schedule C (Form 1040), Ms. Brown reported $5,659 in income and $18,831 in deductible car and truck expenses related to the return preparation business. She calculated the car expenses using the standard mileage rate.

The IRS audited Ms. Brown's return and disallowed the entire deduction for car and truck expenses. In a notice of deficiency, the IRS determined that she owed $3,981 additional tax. In response, Ms. Brown submitted a mileage tracker log indicating the mileage driven each day. The log did not include any client names, addresses, or identifying information about the location of the meetings. The only reason given for each entry was "business." Ms. Brown did not provide any emails, calendar entries, or other documentation to corroborate or supplement the log. The IRS determined that the log was insufficient to substantiate the claimed expenses.

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Analysis

I.R.C. § 162(a) allows a taxpayer to deduct all ordinary and necessary expenses paid or incurred in carrying on a trade or business. The taxpayer must maintain records sufficient to substantiate the amounts of income and entitlement to any deduction or credits claimed. For certain types of business expenses, including automobile expenses, I.R.C. § 274(d) requires strict substantiation. If, however, a taxpayer can prove that he or she paid or incurred a deductible business expense but is unable to prove the amount of the expense, the court can estimate the amount allowable in some circumstances [*Cohan v. Commissioner*, 39 F.2d 540 (2d Cir. 1930)].

For the 2016 tax year, section 274(d)(4) provided that no deduction would be allowed with respect to any property listed in I.R.C. § 280F(d)(4) unless the taxpayer established the following:

1. The amount of the expense or other item
2. The time and place of the use of the property
3. The business purpose of the expense
4. The business relationship to the taxpayer of the person using the property

Deductions arising from property subject to the strict substantiation requirements of § 274(d) are disallowed in full unless the taxpayer established each element of the requirements.

Passenger automobiles are among the listed property included in section 280F(d)(4), and the strict substantiation requirements of section 274(d) must be met for automobile expenses even where the taxpayer uses the optional standard mileage rate [Treas. Reg. § 1.274-5(j)(2)]. To satisfy strict substantiation, a taxpayer must substantiate expenses with adequate records or by sufficient evidence that corroborates his or her own statements.

The taxpayer must maintain an account book, diary, log, statement of expense, trip sheets, or similar records and, in some cases, documentary evidence such as receipts or bills. In combination, these items must be sufficient to establish each element of an expenditure or use–specifically, the amount, time, and business use or purpose. In the absence of adequate records, a taxpayer may establish an element of expenditure or use by his or her own statement, in writing or oral, containing specific information as to each element, and other corroborative evidence sufficient to establish such element.

The court found that Ms. Brown did not substantiate her entitlement to a deduction by providing adequate records or sufficient other evidence. Her log did not list the name or location of her clients. She did not submit any emails, calendars, or other records substantiating the purpose of the trips.

Holding

The Tax Court, in a bench opinion, concluded that Ms. Brown failed to meet her burden to substantiate her car and truck expenses.

[*Brown v. Commissioner*, Docket No. 16604-19 (2021)]

C.C.A. 2021-11012
I.R.C. § 165

Section 165(d) does not apply to businesses in the trade or business of gambling.

Issue

The IRS Chief Counsel considered whether the TCJA amendment to I.R.C. § 165(d) applies to a business in the trade or business of gambling, thereby treating its ordinary and necessary business expenses as losses from wagering transactions.

Analysis

I.R.C. § 165(a) allows a deduction for any loss sustained during the tax year and not compensated for by insurance or otherwise. Section 165(c) limits the deduction under § 165(a) to: (1) losses incurred in a trade or business; (2) losses incurred in any transaction entered into for profit, though not connected with a trade or business; and (3) losses arising from fire, storm, shipwreck, or other casualty, or theft. Section 165(h)(5) limits a personal casualty loss to the extent it is attributable to a federally declared disaster for a tax year beginning after December 31, 2017, and before January 1, 2026.

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Section 165(d) provides that losses from wagering transactions are allowed as deductions only to the extent of the gains from such transactions. As amended by section 1305 of the TCJA, section165(d) also provides that in tax years beginning after December 31, 2017, and before January 1, 2026, the term *losses from wagering transactions* includes any otherwise allowable deduction incurred in carrying on any wagering transaction.

The plain language of section 165(d) does not clearly distinguish between individual gamblers who are in the trade or business of gambling (professional gamblers) and businesses in the trade or business of gambling (casinos). However, the Committee Report on the TCJA (Report 115-409) by the House Ways and Means Committee states that the Committee believes that the scope of the limitation on wagering losses should be broadened to cover expenses incurred in the conduct of the individual's gambling activity. Thus, the TCJA amendment applies only to individuals.

Ruling

The TCJA amendment to section 165(d) does not apply to the ordinary and necessary expenses of a business in the trade or business of gambling.

[C.C.A. 2021-11012 (February 16, 2021)]

Employee Business Expenses

Warque v. Commissioner
I.R.C. § 162

The taxpayer could not deduct travel expenses.

Facts

Paul Warque had an accounting degree. In 2009, he began working for the IRS as a revenue agent. He was a Nevada resident, and his home was in Nevada, but his post of duty was the IRS office in Laguna Niguel, California. The job was a permanent position.

Mr. Warque examined employee retirement and pension plans to determine if the plans met the qualifications under I.R.C. § 401(a). He also adjusted federal income tax returns to correct discrepancies between facts developed in the examination and amounts reported on the return.

In 2014, Mr. Warque applied for a hardship transfer to the IRS office in Las Vegas, Nevada. The IRS approved the hardship eligibility in 2014 and placed him on the transfer list. He received a temporary (two months) transfer in 2017 when his wife gave birth. While he was eligible for a full-time transfer if a vacancy occurred, he never received a transfer.

While he waited for a transfer, Mr. Warque lived in his home in Nevada and rented a room in California. He drove to California each Sunday and then returned to Nevada on Friday mornings. He kept track of mileage using his phone, then transferred the data to a written log. He also kept receipts for gas and car repairs.

The Warques deducted car and rental expenses as unreimbursed employee business expenses. The IRS issued a notice of deficiency disallowing the deductions.

Analysis

The taxpayer claiming deductions on a federal income tax return must demonstrate that the deduction is allowable pursuant to a statutory provision and also must substantiate the expense for which the deduction is claimed [I.R.C. § 6001]. A taxpayer substantiates claimed deductions by keeping and producing records sufficient to enable the IRS to determine the correct tax liability.

I.R.C. § 162(a) allows deductions for all ordinary and necessary business expenses paid or incurred during the tax year in carrying on a trade or business. I.R.C. § 262(a) provides that personal, living, or family expenses are not deductible unless expressly provided in the Internal Revenue Code.

Section 162(a)(2) states that expenses related to travel can be deducted if ordinary and necessary and incurred while the taxpayer is away from home in the pursuit of a trade or business. The purpose of the "away from home" provision is to mitigate the burden of a taxpayer who, because of his or her trade or business, must maintain two places of abode and incur additional and duplicate living expenses.

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For purposes of section 162(a)(2), *home* is defined as the vicinity of a taxpayer's principal place of employment rather than the location of the taxpayer's personal residence (the tax home). However, where the employment is for a temporary rather than indefinite or permanent period, taxpayers may use their personal residence locale as their tax home. A business locale is considered temporary if the employment is such that termination within a short period could be foreseen. If the employee knows that the employment will terminate within a fixed time, it is not temporary if the employment is expected to last for a substantial or indefinite duration.

Mr. Warque argued that his employment in California was temporary. However, the court found that the job in California was full-time permanent employment. He was eligible for a transfer, but he never received one. Thus, his travel expenses were personal and nondeductible.

Holding

The court held that Mr. Warque could not deduct travel expenses because his home was in California, where he had a permanent job, and not in Nevada, where he maintained a personal residence.

[*Warque v. Commissioner*, T.C. Summary Opinion 2021-18]

Geiman v. Commissioner
I.R.C. §§ 162, 274

The taxpayer could claim deductions for travel while away from home.

Facts

William Geiman was a union electrician who worked in various parts of Colorado and Wyoming. He owned a trailer home in Clifton, Colorado, and a rental property in Grand Junction, Colorado. Mr. Geiman voted, registered his vehicle, received his mail, spent time with his friends, and went whitewater rafting in the Grand Junction area. He made mortgage payments on the Clifton home.

He belonged to the local union. When work was unavailable in his local area, he traveled to work for other union employers. Traveling union members were the first to be terminated when an employer reduced its union workforce, and he worked for several employers throughout Colorado and Wyoming. He worked no more than a few months for each employer.

Mr. Geiman claimed $39,392 in unreimbursed employee business expenses. The expenses included lodging, meals, and vehicle expenses. The IRS disallowed the deductions.

Analysis

Taxpayers bear the burden of establishing entitlement to deductions and substantiating the amount of claimed deductions. Deductions generally are not allowed for personal, living, or family expenses. I.R.C. § 274(d) imposes stricter substantiation requirements for certain deductions such as travel expenses, including meals and lodging, incurred while away from home.

To deduct reasonable and necessary travel expenses, those expenses must be incurred while away from home in the pursuit of a trade or business [I.R.C. § 162(a)]. *Home* refers to the vicinity of the taxpayer's principal place of business rather than his or her personal residence. A taxpayer's residence may be treated as his or her home if the principal place of business is temporary and not indefinite. The taxpayer must have incurred substantial continuing living expenses at the permanent place of residence.

In determining whether a taxpayer has a tax home, courts often considered three factors set forth in Rev. Rul. 73-529, 1973-2 C.B. 37. Specifically, courts examine whether the taxpayer (1) incurs duplicate living expenses while traveling and maintaining the home, (2) has personal and historical connections to the home, and (3) has a business justification for maintaining the home.

The court found that given the nature of Mr. Geiman's jobs, he did not have a principal place of business. Based on the payment of the mortgage and his personal and historic ties to Clifton, the court found that his tax home was in Clifton, Colorado.

Holding

The court held that a union electrician who worked in various locations in Wyoming and Colorado had a tax home in Clifton, Colorado, and he could deduct the substantiated costs of meals, lodging, and vehicle expenses incurred while away from home.

[*Geiman v. Commissioner*, T.C. Memo. 2021-80]

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Employment Tax

Ward v. Commissioner
I.R.C. § 3403

A law firm was liable for employment taxes on compensation paid to its shareholder-employee.

Facts

Lateesa Ward was an attorney who opened her own law firm. Ward & Ward Co. was organized as an S corporation, and Ms. Ward was the sole shareholder. The firm had two employees: Ms. Ward and another attorney.

The firm reported officer compensation and employee compensation on its Form 1120S, but Ms. Ward's Form 1040 reported no wages or salary received. She reported the firm's income and expenses on Schedule C (Form 1040). Due to the mismatches, the IRS audited Ms. Ward and the law firm, and ultimately determined that there were many substantiation problems and inconsistencies, including mismatching of income and wages on the firm's 1120S and the taxpayer's Schedule C.

The IRS determined that the firm did not pay employment taxes on all the wages paid to Ms. Ward. The firm asserted that some of the compensation was salary or wages but that the rest constituted distributions of earnings and profits.

Analysis

An employer is liable for both its own portion and the employee's portion of employment taxes [I.R.C. § 3403; Treas. Reg. § 31.3403-1]. Compensation paid to Ms. Ward in her role as an officer is considered wages. The firm offered no evidence other than Ms. Ward's own testimony that any of these payments were anything but compensation, and the court concluded that the firm was liable for employment taxes on those wages.

Section 530 of the Revenue Act of 1978 relieves some firms from liability for employment tax if they have consistently not treated an individual as an employee unless the firm had no reasonable basis for not treating the individual as an employee. Here, the firm had no reasonable basis for treating Ms. Ward as anything other than an employee. The Code is clear that officers are employees [I.R.C. § 3121(d)(1)]. Ms. Ward stated that she was an employee, and by filing Forms 941, the firm showed it was aware that it had to pay employment taxes on wages paid to her.

Holding

The court held that taxpayer was an employee of her S corporation law firm and that the firm was liable for employment taxes on compensation it paid to her.

[*Ward v. Commissioner*, T.C. Memo. 2021-32]

Losses

Martin v. Commissioner
I.R.C. § 172

The taxpayers failed to substantiate their NOL carryovers.

Facts

John Martin was a mechanical engineer and a race car driver. His wife, Linda, was a part-time caregiver and the bookkeeper for the business. Mr. Martin had his own racing team. The racing business lost over $1,700,000 after a sponsor fell through. The taxpayers obtained a discharge in bankruptcy but carried the net operating losses (NOLs) from the racing business to the tax years at issue.

The IRS audited their return and disallowed the NOL deductions. At trial, the Martins argued that because the NOLs had been allowed in the past, they should be allowed in the years at issue.

Analysis

I.R.C. § 172(a) allows a deduction for an NOL for any tax year in an amount equal to the sum of the NOL carryovers to such year and the NOL carrybacks to such year. The Internal Revenue Code defines an NOL as the excess of deductions allowed over the gross income, subject to certain modifications. For the years at issue, a taxpayer must generally carry any NOL back to each of the 2 tax years before the year of the loss, and then carry it forward to each of the 20 tax years after the loss.

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The court stated that the Martins bear the burden of substantiating their NOLs by establishing their existence as well as the amount that may be carried over to the years at issue. As part of that burden, the Martins needed to have filed with their returns for the loss years a concise statement setting forth the amount of the NOL deduction claimed and all material and pertinent facts, including a detailed schedule showing how they computed their NOL deductions [Treas. Reg. § 1.172-1(c)].

The court reasoned that the Martins' bankruptcy proceedings could also affect the viability of their NOLs, because when someone files a bankruptcy petition, a bankruptcy estate takes over his or her interests in property, which includes certain tax benefits such as NOLs. A taxpayer who files for bankruptcy may elect to terminate his or her tax year after he or she files the bankruptcy petition. Then, the bankruptcy estate gets to use any existing NOLs to offset income earned during the debtor's own prepetition tax year. Also, any amount of debt that is forgiven by the discharge is excluded from a taxpayer's income but reduces his or her NOL.

The Martins offered testimony about their NOLs. However, the court found that the losses were not supported by anything other than the Martins' word.

Holding

The taxpayers were not entitled to claim carryover NOLs.

[*Martin v. Commissioner*, T.C. Memo. 2021-35]

Marijuana Businesses

San Jose Wellness v. Commissioner
I.R.C. § 280E

A medical marijuana business could not claim depreciation and charitable contribution deductions.

Facts

San Jose Wellness (SJW) is a corporation that operated a medical marijuana dispensary in California. SJW sold marijuana to individuals with a valid doctor's recommendation and sold nonmarijuana items, including T-shirts, pipes, and batteries. It also provided acupuncture, chiropractic, and other holistic services.

SJW incurred certain expenses in connection with its operations and deducted those expenses on its federal tax returns. The IRS disallowed its deductions for depreciation and charitable contributions.

Analysis

I.R.C. § 280E disallows deductions when the following three conditions are met:

1. The deduction is for an amount paid or incurred during the tax year.
2. The amount was paid or incurred in carrying on a trade or business.
3. That business consisted of trafficking in a controlled substance.

The court considered *N. Cal. Small Bus. Assistants Inc. v. Commissioner*, 153 T.C. 65 (2019), in which the taxpayer argued that section 280E limits deductions only under section 162, and not under sections 164 (taxes) and 167 (depreciation). The court agreed with the finding in that case that section 280E states that "no deduction or credit shall be allowed," and it limits all deductions.

SJW argued that because it sold nonmarijuana items and provided acupuncture and other services, its business did not consist of trafficking in a controlled substance. The court rejected that argument because section 280E denies business expense deductions for any trade or business that involves trafficking in controlled substances, even if that trade or business also engages in other activities.

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The court also rejected SJW's arguments that its depreciation deduction was not "paid or incurred" and that it's charitable contribution deductions were not paid in carrying on a trade or business. The court found that depreciation was paid or incurred, and the charitable contributions were made within the scope of the company's business activities, which consisted of trafficking in controlled substances.

Lastly, the tax court held the dispensary liable for an accuracy-related penalty for 2015 after the IRS conceded the 2014 penalty, finding that the dispensary failed to establish that it acted with reasonable cause and good faith regarding its underpayment of tax.

Holding

The court held that a medical marijuana dispensary's depreciation and charitable contribution deductions were disallowed under section 280E.

[*San Jose Wellness v. Commissioner*, 156 T.C. No. 4 (2021)]

Purple Heart Patient Center v. Commissioner
I.R.C. §§ 143, 280E, 702

The taxpayer could not claim deductions or credits paid or incurred in operating a medical marijuana dispensary.

Facts

Purple Heart is a California nonprofit mutual benefit corporation with members and is treated as a C corporation for federal tax purposes. Purple Heart operated a medical marijuana dispensary. Its sole director, Keith Stephenson, received wages that were reported on his Form W-2, Wage and Tax Statement.

Purple Heart did not cultivate its own marijuana plants; rather, it acquired marijuana-containing products from its members, processed them, and dispensed them in various forms to other members via a closed-loop system. Although medical marijuana accounted for most of its sales, Purple Heart also sold nonmarijuana items. If also offered free health counseling or alternative health services that included assisting its members to select marijuana products and understanding the marijuana lifestyle.

Purple Heart purchased all its marijuana with cash, and its members paid cash for purchases. The business used cash registers to record marijuana purchases and sales, and nonmarijuana sales; and then used the tapes that those cash registers produced (Z-tapes) to log purchases and sales in a general ledger. Mr. Stephenson reviewed the general ledger each week to ensure that all purchases and sales were properly recorded. However, the ledger and register tapes were shredded after the tax returns were filed.

The IRS audited Purple Heart and disallowed the amounts claimed as cost of goods sold (COGS) because of lack of substantiation. The IRS also disallowed business expense deductions that Purple Heart allocated to its health counseling services because of lack of substantiation and the section 280E disallowance of deductions.

Analysis

To substantiate its estimate of income and expenses, Purple Heart offered testimony from an expert in marijuana dispensary tax and accounting matters. The expert's report consisted of three pages based on historic knowledge of the industry. The court found that the expert did not review Purple Heart's books and records or take any other steps to verify the COGS reported on the returns.

The court reasoned that all businesses, including marijuana dispensaries, may offset their gross receipts with COGS to compute gross income. Section 280E disallows only deductions of business expenses and does not preclude subtracting COGS from gross receipts. However, a taxpayer must maintain sufficient reliable records to substantiate its COGS.

The IRS argued that the taxpayers failed to maintain records to substantiate any of its claimed COGS because the director intentionally and systematically destroyed the business records. The court agreed that the director and the expert witness did not offer testimony that was precise enough to substantiate the amount of COGS that Purple Heart claimed on its tax returns. Although the court lacked evidence to estimate those amounts for some tax years, it agreed that Purple Heart could claim a lesser amount of COGS.

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Holding

The court held that although a medical marijuana dispensary lacked substantiation, it could claim a 50% reduction in gross receipts for COGS.

[*Purple Heart Patient Center v. Commissioner*, T.C. Memo. 2021-38]

Ethics

Judicial Doctrines

Complex Media. v. Commissioner
I.R.C. §§ 197, 351

The step transaction doctrine applied to disregard the issuance and immediate redemption of stock.

Facts

Complex Media, Inc. (CMI) was formed as part of a plan to expand a publishing business that included a magazine and online content. To facilitate an investment, Complex Media Holdings (CMH) transferred its assets to CMI in exchange for shares of CMI stock. Then, CMI immediately redeemed some of the shares held by CMH in exchange for $2,700,000 cash and a $300,000 debt obligation. CMI claimed a $3,000,000 basis in intangible assets it acquired from CMH and amortized those assets under I.R.C. § 197(a). The IRS disallowed the amortization deductions.

Analysis

I.R.C. § 351 generally provides nonrecognition treatment for incorporations and other transactions in which the controlling shareholders of a corporation transfer property to it in exchange for its stock. Section 351(a) provides as a general rule that no gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control.

The court found that the agreement that entitled CMH to receive shares of CMI stock in exchange for the assets of the transferred business contemplated the immediate redemption of some of those shares pursuant to another, simultaneously executed agreement. Therefore, the court must consider the redemption in determining whether CMH was in control of CMI immediately after the exchange.

Generally, if the transaction qualified as a section 351 exchange, CMI would take a carryover basis in the intangible assets. If it did not, the basis of those assets would be stepped up by gain recognized. Thus, CMI sought to disavow the form of its transactions and consider the substance. The court agreed that the substance over form doctrine is available to taxpayers and the IRS.

Applying the step transaction doctrine, the court found that the issuance of stock and immediate redemption had no economic substance. The two offsetting steps should be collapsed, and the transaction should be treated as a sale.

Holding

The court held that a corporation could disavow the form of its transaction, and the step transaction doctrine applied to disregard the issuance and immediate redemption of stock.

[*Complex Media. v. Commissioner*, T.C. Memo. 2021-14]

Privilege

IQL-Riggig v. Kingsbridge Technologies
Federal Rules of Civil Procedure
§ 26(b)(4)(D)

Communications with an attorney and accounting firm were protected under the work product doctrine.

Facts

The owners of Got Docs, LLC brought a lawsuit alleging that they are the majority owners and managers of the company. The defendant, Kingsbridge Technologies, contested that ownership. Kingsbridge served a subpoena on the plaintiff's accounting firm seeking all materials concerning the plaintiff and Got Docs.

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The accounting firm produced the amended tax returns and some redacted emails. It provided a privilege log identifying documents that it withheld based on attorney-client privilege, work product immunity, and Federal Rule of Civil Procedure § 26(b)(4).

Specifically, the accounting firm categorized the withheld information as including the following:

1. Emails between the accounting firm and a law firm representing the plaintiff and its owners
2. Emails between the attorneys about the lawsuit
3. Emails between the plaintiff's owners and the law firm

Kingsbridge sought an order compelling the accounting firm to produce the withheld information.

Analysis

The attorney client privilege protects a communication between a client and an attorney if it is made in confidence and for the purpose of obtaining legal advice. Material an attorney sends to or receives from an accountant may qualify for protection under the attorney-client privilege if the accountant acts as the attorney's agent in rendering legal advice.

For the attorney-client privilege to attach to communications between an attorney and an accounting service, the purpose of the communications must be to seek and render legal advice, not accounting services. An accountant's preparation of tax returns qualifies as an accounting service, not a legal service. Similarly, documents used both to prepare tax returns and to advance a party's interests during litigation are not privileged.

The court found that when assessing whether the attorney-client privilege applies to communications to or from an accounting service, the Seventh Circuit has regarded the engagement letter as the most important piece of evidence. The engagement letter between the law firm and the accounting firm showed that the accounting firm was hired to prepare tax returns, and the court found that the emails between the accounting firm and the law firm were not privileged.

The attorney client privilege applies to communication between an attorney and a client. Communications between attorneys at the same firm may qualify for the attorney client privilege only if they reflect privileged information relating to communications to or from the client. In its privilege log, the accounting firm asserted only that the correspondence was between plaintiff's attorneys regarding the subject litigation, but it did not establish that the correspondence included any information to or from any of its clients. The court found that the privilege applied to the emails between the plaintiff and its attorneys.

The work product doctrine protects documents prepared by an attorney or the attorney's agent to analyze and prepare a client's case. The doctrine shields from disclosure an attorney's thought processes and mental impressions and an attorney's fact-finding investigation.

The party asserting the work product doctrine bears the burden of showing that the disputed documents were prepared because of the prospect of litigation. The court found that the accounting firm was hired to prepare amended returns for purposes of litigating the case. Thus, the emails between the accounting firm and the law firm were exchanged in anticipation of litigation and protected by the work product doctrine. The doctrine also applied to internal law firm emails.

Rule 26(b)(4)(D) provides that a party may not, by interrogatories or deposition, discover facts known or opinions held by an expert who has been retained or specially employed by another party in anticipation of litigation. A party's expert is protected from having to respond to discovery requests if the expert's works product includes facts or opinions developed in anticipation of litigation. The court noted that the rule is just an extension of the work product doctrine, but the rule was not applicable because there were no interrogatories or depositions.

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Holding

The court held that the attorney client privilege applied to communication between a client and an attorney, and the work-product doctrine applied to an accounting firm that was retained to prepare amended returns in anticipation of litigation.

[*IQL-Riggig v. Kingsbridge Technologies*, 127 A.F.T.R. 2d (RIA) 2021-1410 (D.C. IL, March 29, 2021)]

Financial Distress

Hussey v. Commissioner
I.R.C. §§ 61, 108, 1017

The taxpayer was required to reduce basis for the year of the sale of property, and not in the year after the debt was discharged.

Facts

In 2009, Richard Hussey bought investment properties and assumed over $1,700,000 in outstanding loans. All the loans were held by the same bank. In 2012, he was struggling to make payments on the loans, and he sold fifteen of the properties at a loss. The lender modified the loans and issued Mr. Hussey Forms 1099-C, Cancellation of Debt, which showed discharge of $754,054 of indebtedness.

In 2013, Mr. Hussey sold seven of the properties at a loss. The bank modified the loan and showed a net charge-off of $529,665. However, the bank did not issue Forms 1099-C.

Mr. Hussey filed his 2012 return and then retained a tax attorney to prepare an amended 2012 return and to prepare the 2013 and 2014 returns. On his amended 2012 return, the taxpayer reported that he had excludable income of $685,281 for a discharge of qualified real property business indebtedness (QRPBI), which applied to reduce the basis of depreciable real property. On his 2013 return, he reported the sale of 6 investment properties and his primary residence at a loss. In 2014, he reported a net operating loss carryover.

The IRS issued a notice of deficiency for tax years 2013 and 2014, disallowing the loss deductions and the net operating loss carryover. Mr. Hussey and the IRS agreed about the exclusion for the QRPBI, but they disagreed about whether the bases in the depreciable real properties must be reduced in 2012 or 2013.

Analysis

I.R.C. §§ 61(a)(10) and 108(a)(1)(D) provide an exclusion from income for forgiveness of QRPBI. When that exclusion applies, the taxpayer must reduce his or her bases in the depreciable real properties. The parties agreed that petitioner's indebtedness on the 15 investment properties sold in 2012 was QRPBI that was excluded from income. The parties also agree that Mr. Hussey must reduce his bases in the depreciable real properties because of that exclusion. However, Mr. Hussey contended that the basis reductions must be made for 2013 and the IRS contended they must be made for 2012.

I.R.C. § 1017(a) generally provides that the basis reduction occurs in the year following the discharge of indebtedness, but section 1017(b)(3)(F) provides the following three additional rules that govern the reduction of basis following a discharge of QRPBI:

1. The reduction applies only to depreciable real property.
2. The property may not be held as inventory.
3. For property taken into account under I.R.C. § 108(c)(2)(B) the reduction occurs immediately before the disposition, if earlier than the year following the discharge.

Section 108(c)(2)(B) provides that the amount of discharged QRPBI excluded from a taxpayer's income may not exceed the aggregate bases of the taxpayer's depreciable real properties held immediately before the discharge. The bank discharged $754,054 of QRPBI in 2012. Mr. Hussey's aggregate bases in depreciable real properties for 2012 immediately before the discharge exceeded the $754,054 discharge of QRPBI. Because in 2012 Mr. Hussey received a discharge of QRPBI and sold properties that were used to show he had aggregated bases that exceeded the discharge amount, he was required to reduce his bases in the disposed properties immediately before the sales of those properties in 2012.

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Holding

The court held that the taxpayer had to reduce his bases in depreciable real property in the year that he sold the properties.

[*Hussey v. Commissioner*, 156 T.C. No. 12 (2021)]

Individual Issues

Credits

Pichardo v. Commissioner
I.R.C. § 25A

The taxpayer could not claim an education tax credit because he was not enrolled in an eligible educational institution at least half-time.

Facts

Carolina Pichardo was employed as a planning supervisor. Her husband, Abrahan, was a regional planning safety manager. He educated employers and workers in different industries about risk management and safety compliance.

Mr. Pichardo's work required him to be credentialed as a safety liaison. To achieve the necessary certifications, he took training courses every 4 years on the applicable laws and safety requirements of various industries. During the year in issue, Mr. Pichardo attended the required training courses through a program accredited by the Occupational Safety and Health Administration at the University of California San Diego Extension (UCSD Extension). Mr. Pichardo attended three training courses at UCSD Extension in 2016. Each course consisted of three credit units and cost $750, resulting in a total education expense of $2,250 during the year in issue. He paid for the courses using his employer's credit card.

The Pichardos reported $2,250 of adjusted qualified education expenses on their Form 8863, Education Credits, related to Mr. Pichardo's training courses at UCSD Extension. The reported expenses resulted in a claimed refundable American opportunity tax credit (AOTC). The IRS disallowed the education expenses.

Analysis

The AOTC provides for a credit against tax equal to 100% of qualified tuition and related expenses paid by a taxpayer during the tax year up to $2,000, plus 25% of such expenses paid that exceed $2,000 but do not exceed $4,000, allowing for a maximum credit of $2,500 [I.R.C. § 25A(i)(1)]. Up to 40% of the credit may be refundable. The credit is allowed for the first 4 years of postsecondary education for qualified tuition and expenses including required course materials. The credit is available only if (among other things) the student is enrolled at least half-time for at least one academic period that begins during the tax year.

The court found that Mr. Pichardo was not enrolled at least half time at an eligible educational institution. Also, to claim a credit, the Pichardos must show that they paid Mr. Pichardo's tuition. The Form 1098-T was addressed to Mr. Pichardo but showed that tuition was paid using his business credit card. Although he testified that he was responsible for managing and paying the bills on that card, Mr. Pichardo did not supply bank statements.

Holding

The court denied an education tax credit because the taxpayer was not enrolled in an eligible educational institution at least half-time and did not show that he paid tuition.

[*Pichardo v. Commissioner*, T.C. Summary Opinion 2021-7]

Deductions

Chancellor v. Commissioner
I.R.C. § 170

The taxpayer could not claim a deduction for unsubstantiated charitable contributions.

Facts

In 2015, Viola Chancellor received $400 for her work as a notary and paralegal. As a notary, she usually worked for veterans free of charge. As a paralegal, she worked for two paying and two nonpaying clients. She also worked on probate proceedings for her late brother's estate.

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On her 2015 Schedule A (Form 1040), Ms. Chancellor claimed deductions for $6,000 cash charitable contributions and $500 noncash charitable contributions. The IRS disallowed the deductions.

Analysis

I.R.C. § 170(a)(1) allows a deduction for a contribution made in the tax year to a donee organization described in section 170(c). Such deductions are allowable only if the taxpayer satisfies statutory and regulatory substantiation requirements under section 170(a)(1) and Treas. Reg. § 1.170A- 13.

The nature of the required substantiation depends on the type and size of the contribution. For contributions of cash, check, or other monetary gift, a donor must maintain as a record of such contribution a bank record or a written communication from the donee showing the name of the donee organization, the date of the contribution, and the amount of the contribution. Otherwise, a donor must maintain reliable written records showing the name of the donee, the date of the contribution, and the amount of the contribution.

Ms. Chancellor claimed a charitable contribution deduction of $6,000 in cash and $500 in expenditures incident to volunteer work for her church. For the deduction to be allowable, she must maintain reliable records indicating the donee organization and the value and date of the contribution. She did not substantiate either charitable contribution amount.

Holding

The court held that the taxpayer failed to substantiate her deductions for charitable contributions and other expenses.

[*Chancellor v. Commissioner*, T.C. Memo. 2021-50]

Baum v. Commissioner
I.R.C. § 165

The taxpayers could not deduct a theft loss because they failed to show there was no reasonable prospect of recovery.

Facts

Teresa Baum was self-employed as a realtor. Her husband, Ronnie, was self-employed as a consultant for Harrington Capital Partners, a company that provided management, scientific, technical, and consulting services. He was the sole owner and member of Harrington. The Baums each filed a Schedule C claiming various deductions, including meals and entertainment expenses, office expenses, and car and truck expenses. The IRS disallowed many of these deductions.

In 2012, Harrington and the Baums invested $300,000 in Globe Protect, Inc. The individual who sold them the shares in Globe Protect filed for bankruptcy in 2014. The deadline for filing nongovernment claims against the debtor was June 24, 2015, and the Baums filed a proof of claim on that date. The final bankruptcy decree was filed August 2, 2019.

On their 2015 tax return, the Baums claimed a $300,000 theft loss deduction for their investments in Globe. They did not file their 2015 tax return until March 18, 2018. They filed their 2016 tax return on May 4, 2018. The IRS disallowed the deduction.

Analysis

I.R.C. § 165(a) allows a deduction for losses sustained during the tax year and not compensated by insurance or otherwise. For an individual, the loss must be

1. incurred in a trade or business,
2. incurred in a transaction entered for profit, or
3. from other causes including casualty or theft.

To deduct a theft loss, the taxpayer must prove that a theft occurred under the laws of the jurisdiction where the alleged loss occurred and prove the amount of the loss and the date the taxpayer discovered the loss. A loss arising from theft is generally treated as sustained during the tax year in which the taxpayer discovers such loss. However, if in the year of discovery,

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the taxpayer has a reasonable prospect of recovery on a claim for reimbursement, the loss will not be sustained until the tax year in which it can be ascertained with reasonable certainty whether such reimbursement will be received [Treas. Reg. § 1.165-1(d)(3)].

The court stated that even if a theft occurred under California law, the Baums were not entitled to a theft loss in 2015 if they had a reasonable prospect of recovery on a claim for reimbursement. A reasonable prospect of recovery exists when the taxpayer has bona fide claims for recoupment from third parties, and when there is a substantial possibility that such claims will be decided in his or her favor.

At the end of 2015, the debtor's bankruptcy was ongoing. Thus, the Baums failed to show whether there was a reasonable prospect of recovery when they filed their 2015 tax return.

Holding

The court held that the Baums could not claim a theft loss deduction because their claim for reimbursement in a bankruptcy proceeding was still pending.

[*Baum v. Commissioner*, T.C. Memo. 2021-46]

Income

Holliday v. Commissioner
I.R.C. § 61

Settlement proceeds in a malpractice suit were included in the taxpayer's gross income.

Facts

In 2010, Carol Holliday's spouse filed for divorce. In 2012, Ms. Holliday's divorce attorney advised her that he would appeal the denial of a motion for a new trial, but he failed to file the appeal. In 2013, Ms. Holliday filed a malpractice lawsuit against her divorce attorney. The parties settled for $175,000. The parties did not allocate any of the settlement proceeds toward any specific claim or type of damages. Ms. Holliday paid her malpractice attorney $73,500 in attorney's fees. The malpractice attorney issued a Form 1099-MISC, Miscellaneous Income.

On her 2014 Form 1040, Ms. Holliday reported the $101,500 net settlement proceeds and then subtracted that amount as a "Misclassification of lawsuit recovery of marital assets." The IRS initially alleged that she failed to include the $101,500 in income. The IRS later argued that she should have included the $175,000 settlement proceeds in income and taken a corresponding miscellaneous itemized deduction for the payment to her malpractice attorney.

Analysis

Ms. Holliday argued that the settlement proceeds were a nontaxable return of capital because they compensated her for the portion of her marital estate that she was rightfully and legally entitled to, but did not receive, because of her divorce attorney's malpractice. I.R.C. § 61(a) broadly defines gross income as all income from whatever source derived. Exclusions from income must be narrowly construed.

Generally, when a litigant's recovery constitutes income, the litigant's income includes the portion of the recovery paid to the attorney as a contingent fee. The recovery of capital is not income. Whether a payment received in settlement of a claim represents a recovery of capital depends on the nature of the claims that were the basis of the settlement.

The settlement agreement made it clear that the settlement proceeds were in lieu of damages for legal malpractice. The court, relying on the plain language of the settlement agreement, concluded that the settlement proceeds were for attorney malpractice and not a return of capital.

Holding

The court held that settlement proceeds that the taxpayer received in a malpractice suit against her divorce attorney were included in her gross income.

[*Holliday v. Commissioner*, T.C. Memo. 2021-69]

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Blum v. Commissioner
I.R.C. § 104

A settlement payment received in a malpractice claim against the taxpayer's attorneys was not received on account of personal physical injuries or physical sickness.

Facts

Debra Jean Blum went into the hospital for knee replacement surgery. The admissions clerk directed her to sit in a broken wheelchair. She allegedly fell and sustained significant personal injuries. She hired an attorney to file a lawsuit against the hospital. The lawsuit was unsuccessful, and the trial court granted summary judgment to the hospital.

Ms. Blum filed a malpractice suit against her former attorneys. She did not allege in her complaint that she had suffered any physical injuries for which her former attorneys should be responsible, and she did not seek compensation for any physical injuries. The parties settled the lawsuit in exchange for payment of $125,000. The settlement agreement stated that Ms. Blum did not sustain any physical injuries as a result of the alleged negligence of the attorneys.

The attorneys' insurance company reported that payment to Ms. Blum on Form 1099-MISC, but she did not report the $125,000 on her federal income tax return. On examination, the IRS determined that the settlement proceeds should have been included in gross income.

Analysis

Settlement proceeds constitute gross income unless the taxpayer proves that they fall within a specific statutory exception. I.R.C. § 104(a)(2) excludes from gross income any damages (other than punitive damages) received (whether by suit or agreement) on account of personal physical injuries or physical sickness. For a taxpayer to qualify for this exclusion, he or she must show that there is a direct causal link between the damages and the personal injuries sustained.

When damages are received pursuant to a settlement agreement, the nature of the claim that was the actual basis for the settlement controls whether the damages are excludable. The nature of the claim is typically determined by reference to the terms of the agreement. If an agreement fails to state the basis for the settlement, courts look primarily to the intent of the payer. The intent of the payer may be determined by considering the amount paid, the factual circumstances leading to the settlement, and the allegations in the injured party's complaint.

In the settlement agreement, the parties made it clear that the settlement was not compensation for the personal injuries the taxpayer suffered. The settlement was for legal malpractice, which is outside of the scope of the section 104(a)(2) exclusion.

Holding

The court held that the settlement payment was not damages received on account of personal physical injuries or physical sickness and was included in the taxpayer's gross income.

[*Blum v. Commissioner*, T.C. Memo. 2021-18]

International Tax

FBAR

Kimble v. United States
31 U.S.C. §§ 5314, 5321

The taxpayer's failure to file a foreign bank account report for a Swiss bank account was willful, and the IRS did not abuse its discretion by imposing a 50% civil penalty.

Facts

Alice Kimble is a US citizen. Around 1980, her parents opened an investment account at Union Bank of Switzerland (UBS) and designated her as a joint owner. Ms. Kimble's grandparents allegedly came to the United States to escape persecution following the Holocaust. She asserted that her father kept the account a secret because he feared being persecuted in the United States and needing to flee to another country as his parents had.

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After her father's death, Ms. Kimble signed various agreements directing UBS to maintain the account as a numbered account (an account associated with a number and not a name) and to retain all correspondence at the bank. She did not disclose the account to her accountant, and it was not reported.

Ms. Kimble claims that in 2008 she read a *New York Times* article on the Treasury Department's investigation of UBS for abetting tax fraud with its numbered accounts. She retained counsel and was accepted into the Offshore Voluntary Disclosure Program (OVDP) in 2009.

In 2012, Ms. Kimble entered into an agreement with the IRS to pay a $377,309 penalty. In 2013, she withdrew from the OVDP and declined to pay the penalty. The IRS examined her tax filings and foreign accounts and determined that her failure to report the UBS account was willful. The IRS assessed a $697,299, penalty, which was 50% of the account balance.

Analysis

Congress enacted the Bank Secrecy Act to ensure that citizens pay taxes on income earned abroad. The regulations implementing 31 U.S.C. § 5314 require any US citizen having a financial interest in, or signature or authority over, a bank, securities, or other financial account in a foreign county to report certain details about the account each year. The report is made by filing a Report of Foreign Bank and Financial Accounts (FBAR) for each foreign financial account that exceeded $10,000 in the prior calendar year.

The secretary of the Treasury may impose a civil penalty for violation of the Bank Secrecy Act. Under 31 U.S.C. § 5321, if the failure to file an FBAR is willful, the secretary may impose a penalty of up to the greater of $100,000 or 50% of the balance of the account at the time of the violation. Willfulness in the context of the Bank Secrecy Act includes recklessness, and a taxpayer signing his or her returns cannot escape the requirements of the law by failing to review those tax returns.

The court found that Ms. Kimble knew about the foreign bank account and took efforts to keep it secret. She had constructive knowledge of the requirement to disclose that account, and she falsely represented that she had no such accounts.

Holding

The court held that taxpayer's failure to file a foreign bank account report for a Swiss bank account was willful and upheld imposition of the statutory maximum civil penalty.

[*Kimble v. United States*, 991 F.3d 1238 (Fed. Cir. 2021)]

United States v. Boyd
31 U.S.C. §§ 5314, 5321

The $10,000 penalty for nonwillful failure to file an FBAR applies per FBAR form even if that form reports multiple accounts.

Facts

Jane Boyd is an American citizen. She had an interest in 14 foreign financial accounts in the United Kingdom. The accounts paid her interest and dividends that she failed to report on her federal income tax return. She did not disclose the accounts to the IRS.

Ms. Boyd later filed one FBAR to disclose the 14 accounts and amended her return to include the interest and dividends. The IRS found that she violated the reporting requirements of 31 U.S.C. § 5314 and concluded that she committed 13 FBAR violations, one for each account that she failed to timely report. The IRS assessed a $47,279 penalty.

Analysis

The court considered whether 31 U.S.C. § 5321 authorizes the IRS to impose multiple nonwillful penalties for the untimely filing of a single accurate FBAR that includes multiple foreign accounts. Ms. Boyd argued that the statutory language does not support a separate penalty for each account she should have listed on the FBAR she failed to timely file. Rather, she asserted that the statutory and regulatory schemes provide that a nonwillful, untimely but accurate FBAR filing constitutes a single violation subject to a maximum penalty of $10,000. The court agreed that the statute, read with the regulations, authorizes a single nonwillful penalty for the failure to file a timely FBAR.

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Holding

The $10,000 penalty for nonwillful failure to file a foreign bank account report applies per FBAR form and not per each unreported account.

[*United States v. Boyd*, 991 F.3d 1077 (9th Cir. 2021)]

IRS Issues

Collection Alternatives

Sleeth v. Commissioner
I.R.C. § 6015

The taxpayer was not entitled to equitable innocent spouse relief.

Facts

Lori and David Sleeth were married in 1988. Mr. Sleeth was a lawyer but decided to go to medical school. In 2004, he graduated and completed a residency program. He got a job at a hospital that paid him a high salary. They bought a house, a townhouse, a car, a boat, and a plane. They titled all the assets to Mrs. Sleeth.

They could not pay the taxes owed on their 2005 joint income tax return. Mr. Sleeth set up an installment agreement. In 2006, they were again unable to pay their taxes, and the IRS canceled the installment agreement. They owed taxes for 2007 through 2011. The house and the plane were repossessed, and the boat was destroyed in a fire. They got a divorce, and Mrs. Sleeth kept the townhouse. Mr. Sleeth accepted full responsibility for the tax liabilities.

Mrs. Sleeth filed a request for innocent spouse relief. She claimed that she did not know that payments were not being made when she signed the tax returns. The IRS denied the relief, reasoning that Mrs. Sleeth did not have a reasonable expectation that Mr. Sleeth would or could pay the tax at the time she signed the returns, and that she did not show that she would experience economic hardship absent relief.

Analysis

The Internal Revenue Code imposes joint and several liability on married couples who file joint returns [I.R.C. § 6013(d)(3)]. This means that each spouse can be held liable for the entire amount of any unpaid tax liability regardless of their level of responsibility. Innocent spouses have three opportunities for relief from joint and several liability. Two of the options apply to tax understatements. The third applies only if the other two are not available.

Under I.R.C. § 6015(f), an innocent spouse may be relieved of liability for any unpaid tax or any deficiency if certain threshold conditions are met and it would be inequitable to hold the spouse liable given all the facts and circumstances. In Rev. Proc. 2013-34, 2013-43 I.R.B. 397, the IRS identified a nonexclusive list of seven factors to consider in deciding whether to grant equitable relief. The IRS will consider whether

1. the requesting spouse is still married to the nonrequesting spouse,
2. the requesting spouse would suffer economic hardship without relief,
3. the requesting spouse knew or had reason to know of the underpayment,
4. either spouse has a legal obligation to pay the tax liability,
5. the requesting spouse significantly benefitted from the underpayment,
6. the requesting spouse has since made a good faith effort to comply with income tax laws, and
7. the requesting spouse was in poor physical or mental health.

The court found that marital status, lack of significant benefit, and a later compliance with tax laws favored relief. However, economic hardship, legal obligation, and health were neutral; and the knowledge or reason to know factor weighed strongly against relief. Mrs. Sleeth signed the tax returns, was aware of the shared financial troubles, and knew of their prior problems with the IRS.

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Holding

The court upheld the IRS's denial of innocent spouse relief.

[*Sleeth v. Commissioner*, No. 20-10221 (11th Cir. 2021)]

Siebert v. Commissioner
I.R.C. § 6330

A settlement officer did not abuse her discretion in sustaining a proposed collection action and rejecting an offer in compromise and a proposed installment agreement.

Facts

Thomas L. Siebert and Deborah S. Siebert are married and resided in Washington, D.C. Mr. Siebert ran his own law practice, and Mrs. Siebert was the sole member of a consulting company. The taxpayers timely filed their 2013 return, and the IRS assessed the resulting liability. The Sieberts did not pay that liability.

On April 27, 2015, the IRS sent a notice of intent to levy, and the Sieberts timely requested a collection due process (CDP) hearing. They indicated that they wished to obtain an offer in compromise, an installment agreement, or currently-not-collectible status.

The Appeals officer requested that the Sieberts provide financial documentation to support their claims before the CDP hearing. The taxpayers failed to do so. The Appeals officer issued a notice of determination that sustained the proposed levy. The Tax Court remanded the case to give the taxpayers the opportunity to submit financial information for consideration of a collection alternative.

The Sieberts submitted an application for an offer in compromise proposing to settle their total $645,314 liability with a lump sum payment of $12,443. The basis for the offer was doubt as to collectibility.

The offer in compromise officer determined that the Sieberts underreported their income and overreported their expenses. In addition, the Sieberts had significant assets that could be used to pay their outstanding tax liability. They lived in a $4,000,000 home and paid large expenses associated with their lifestyle. He recommended rejection of the offer. The Appeals officer upheld the rejection of the proposed offer in compromise and rejected a proposed installment agreement, which called for a monthly payment of $1,000, because the Appeals financial analysis determined that the Sieberts had a greater ability to pay.

Analysis

The court reviewed the Appeals determination for abuse of discretion. The court found that the Appeals officer properly verified that the requirements of applicable law or administrative procedure were met, considered any relevant issues the Sieberts raised, and considered whether any proposed collection action balanced the government's need for efficient collection of taxes with the taxpayers' legitimate concern that any collection action be no more intrusive than necessary.

The court concluded that the Appeals determination to sustain the rejection of the offer in compromise was not arbitrary or capricious and had a sound basis in fact and law. The Sieberts had an egregious history of noncompliance and failed to pay taxes when they had the capacity to pay. Similarly, the Appeals officer did not abuse her discretion in declining the proposed installment agreement because it did not reflect their ability to pay.

Holding

The court held that the Appeals officer did not abuse her discretion in rejecting the offer in compromise and proposed installment agreement.

[*Siebert v. Commissioner*, T.C. Memo. 2021-34]

American Limousine v. Commissioner
I.R.C. § 6330

It was not an abuse of discretion for the Appeals office to reject an installment agreement that the taxpayer could not fund.

Facts

American Limousines, Inc. is a Maryland corporation that operates a limousine transportation company. It owed over $1,000,000 in employment taxes. The IRS sent a notice of intent to levy, and the company submitted a request for a CDP hearing, requesting an installment agreement and other collection alternatives.

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Appeals determined that the company's reasonable collection potential allowed for monthly installment payments of approximately $23,000. In calculating the collection potential, the Appeals office did not give the taxpayer credit for principal payments made on vehicle loans because the taxpayer voluntarily decided to increase the size of its fleet rather than make payments on the past-due employment taxes. With the vehicle loan payments, American Limousines calculated that it had a monthly cash flow deficit. However, to avoid a levy, it proposed installment payments of $2,000 per month. The Appeals office rejected the offer because the company's own evaluation concluded that it was unable to make the payments.

Analysis

The court reviews a collection determination for abuse of discretion and must uphold an Appeals determination unless it is arbitrary, capricious, or without sound basis in fact or law. The court concluded that the Appeals office did not err in rejecting the company's proposed installment agreement and other collection alternatives.

Holding

The court upheld a rejection of a proposed installment agreement.

[*American Limousines, Inc. v. Commissioner*, T.C. Memo. 2021-36]

Retirement

Distributions

Catania v. Commissioner
I.R.C. § 72(t)

The taxpayer was liable for additional tax on an early IRA distribution.

Facts

John A. Catania worked for Home Depot and participated in its 401(k) plan. In 2014, he retired from Home Depot at age 55. He transferred his section 401(k) plan account balance to a traditional IRA held at Vanguard Fiduciary Trust Co. In 2016, he withdrew $37,000 from his IRA and used the funds to pay for the maintenance of his home and other necessary living expenses. Mr. Catania was 57 years old as of December 31, 2016.

Vanguard issued Form 1099-R reporting the $37,000 distribution. Mr. Catania included the distribution on his 2016 tax return but did not include the section 72(t) 10% additional tax.

Analysis

I.R.C. § 72(t)(1) imposes a 10% additional tax on distributions from qualified retirement plans unless one of the exceptions set forth in section 72(t) applies. There is an exception for distributions made on or after the date on which the employee taxpayer attains age 59½. There is an exception for distributions made to an employee after separation from service after attainment of the age 55, but that exception is not applicable to early IRA distributions. Mr. Catania was under age 59½ in the year of the distribution, and the parties agreed that no other exception applied.

Holding

The court held that the taxpayer was liable for the section 72(t) additional tax on an early distribution from his IRA because he was under the age of 59½ when the distribution was made.

[*Catania v. Commissioner*, T.C. Memo. 2021-33]

Grajales v. Commissioner
I.R.C. §§ 72(t), 6751

The IRS did not need written supervisory approval to impose the I.R.C. § 72(t) tax on an early distribution from a qualified retirement plan.

Facts

In 2015, Kirgizia Grajales took loans from her New York state pension plan. She was 42 years old. The plan administrator sent her Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc., reporting $9,026 distributions. She did not include the distributions in her 2015 income.

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The IRS issued a notice of deficiency, included the distributions in her income, and imposed the 10% additional tax on early retirement distributions pursuant to I.R.C. § 72(t). The parties agreed that only a portion of the distributions was taxable as an early distribution.

Analysis

Ms. Grajales argued that she was not liable for the section 72(t) addition to tax because the determination of that tax lacked supervisory approval required under I.R.C. § 6751(b)(1). The IRS admitted that there was no supervisory approval but argued that the section 72(t) tax is a tax, and not a penalty, additional amount, or addition to tax within the meaning of section 6751(b) and (c). The court agreed with the IRS that the amount imposed under section 72(t) is a tax.

Holding

The amounts imposed by section 72(t) on an early distribution from a qualified retirement plan are a tax, and no IRS written supervisory approval was required.

[*Grajales v. Commissioner*, 156 T.C. No. 3 (2021)]

Tax Practice

Attorney's Fees

Dang v. Commissioner
I.R.C. § 7430

The taxpayers were not entitled to litigation costs in a collection action because the IRS's position was substantially justified.

Facts

Tung Dang and Hieu Pham Dang are husband and wife. Mr. Dang owned a corporation that purchased computers and other electronic equipment for resale to wholesalers in Vietnam. Following an audit of the taxpayers' personal and business returns, the IRS determined deficiencies of $83,292 and $24,165 for the tax years 2008 and 2009. The Dangs and the IRS came to an agreement about the amount owed.

The Dangs asked the IRS to levy against funds in Mr. Dang's IRA to avoid the additional tax on early withdrawals. IRS collections declined the request because it determined that the Dangs had alternative sources of funds that were sufficient to satisfy the liabilities.

To attempt to collect the amounts owed, the IRS issued a notice of federal tax lien filing and a notice of intent to levy. The Dangs timely filed Form 12153, Request for Collection Due Process or Equivalent Hearing, requesting a hearing under I.R.C. §§ 6320 and 6330. The Appeals office sustained the collection actions because it determined that the selection of the levy source was a discretionary matter for IRS collections.

At a supplemental hearing, Appeals determined that a levy on the IRA was appropriate. The IRS served a notice of levy on the financial institution that held Mr. Dang's IRA. Shortly thereafter, the Dangs obtained a loan on their residence and paid the balance owed. The Dangs filed a motion for reasonable litigation or administrative costs.

Analysis

I.R.C. § 7430 provides for an award of reasonable litigation and administrative costs to a taxpayer in a proceeding involving the collection of any tax, interest, or penalty. The taxpayer must demonstrate that he or she

1. is the prevailing party,
2. exhausted administrative remedies within the IRS,
3. has not unreasonably protracted the proceedings, and
4. has claimed reasonable costs.

Under section 7430(c)(4)(A)(i), a prevailing party is a party that has substantially prevailed with respect to the amount in controversy or with respect to the most significant issue(s) presented. A party is not treated as a prevailing party if the United States establishes that its position in the proceeding was substantially justified. The court presumed that the Dangs were the prevailing party, but absent a stipulation to the contrary, when the government concedes a case in its answer, its conduct is reasonable. Because the IRS conceded its error at the earliest possible opportunity, the court concluded that its position was substantially justified.

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Holding

The court held that the taxpayers were not entitled to an award of reasonable litigation costs because the IRS's position was substantially justified.

[*Dang v. Commissioner*, T.C. Memo. 2020-150]

Notices

Ramey v. Commissioner
I.R.C. § 6330

The IRS properly gave notice of an intent to levy.

Facts

As of July 13, 2018, Wiley Ramey had a balance of $247,033 in unpaid tax, interest, and penalties for the 2012 to 2016 tax years. On that date, the IRS sent him Notice LT11, Notice of Intent to Levy and Notice of Your Right to a Hearing. The notice informed Mr. Ramey that the IRS may seize his property and that if he wanted to appeal the levy action, he had to complete and mail the Form 12153, Request for a Collection Due Process or Equivalent Hearing, by August 12, 2018. The notice warned that if he did not file Form 12153 by August 12, 2018, he would lose the ability to contest Appeals's decision in the US Tax Court.

The notice was addressed to Mr. Ramey at his last known address. Mail tracking shows the IRS delivered the notice to the USPS on July 13, 2018, and showed that the IRS paid for certified mailing and a return receipt. The USPS receipt showed that the notice was delivered on July 16, 2018, at the "Front Desk/Reception/Mail Room" of the taxpayer's address. The signature is "Joel" and an illegible initial.

Mr. Ramey submitted a request for a hearing. Form 12153 was dated August 16, 2018, postmarked August 20, 2018, and the IRS received it on August 24, 2018. The IRS treated the request for a hearing as untimely and provided Mr. Ramey with an administrative equivalent hearing. IRS Appeals issued a decision letter advising him that the notice was sustained. Mr. Ramey sought review of the decision letter, claiming that although he eventually received the notice, the person who signed for the notice was not his employee and not authorized to receive mail on his behalf.

Analysis

Pursuant to I.R.C. § 6330, the taxpayer on whose property or property rights the IRS intends to levy has the right to a hearing by IRS Appeals, generally before the levy is made. The statute requires the IRS to provide the taxpayer with notice of that right not less than 30 days before the day of the first levy.

Section 6330(a)(2) states that the notice shall be given in person, left at the dwelling or usual place of business of such person, or sent by certified or registered mail, return receipt requested, to such person's last known address. Actual receipt is not a prerequisite to the validity of the notice. The court found that the USPS delivered the notice to the address that Mr. Ramey had provided to the IRS and that he admitted was his proper address.

Holding

The court held that the IRS correctly followed the statutory methods of service, which started the 30-day period for seeking a hearing under section 6330.

[*Ramey v. Commissioner*, 156 T.C. No. 1 (2021)]

Transferee Liability

United States v. Henco Holding
I.R.C. § 6901

The IRS did not have to separately assess a transferor's tax liabilities against a transferee to collect those liabilities from the transferee.

Facts

In January 1997, Henco Holding Corporation sold its sole asset, a 50.5% interest in a subsidiary, to an unrelated third party. The sale left Henco with no assets other than cash from the sale and repayment of a debt obligation. The company had approximately a $13,000,000 capital gains tax liability. Following a complicated series of transactions designed to evade taxes, the Henco shareholders received a payout and gave up their

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interests in the company. Henco then engaged in additional transactions that resulted in the company becoming insolvent, with a tax loss that offset the capital gain from the sale of the subsidiary stock.

The IRS audited Henco's return and on June 13, 2007, issued a statutory notice of deficiency disallowing the tax shelter losses. Henco did not contest the notice of deficiency, and the IRS assessed $56,356,718.77 in taxes and applicable penalties and interest. The Tax Court entered an order sustaining the liabilities against Henco.

The IRS filed suit against Henco to reduce the liability to a judgment. Henco did not answer the complaint or appear, and the court entered a default judgment. The IRS also brought claims against the former shareholders based on the state fraudulent transfer laws. The district court dismissed the complaint on the basis that the government had not timely assessed tax liabilities against the former shareholders as transferees of Henco.

Analysis

I.R.C. § 6901(a) provides that a transferee's tax liability shall be assessed, paid, and collected in the same manner and subject to the same provisions and limitations as in the case of the taxes with respect to which the liabilities were incurred. Section 6901(c)(1) further provides that, in the case of the liability of an initial transferee, the period of limitations is within 1 year after the expiration of the period of limitations for assessment against the transferor. The shareholders asserted that the time for assessment had expired.

The government asserted that it timely assessed tax liabilities against Henco under section 6502(a) and that it was not required to separately assess the former shareholders as transferees under section 6901. Section 6501–titled "Limitations on assessment and collection"–provides that the amount of any tax imposed shall be assessed within 3 years after the return was filed. Section 6502–titled "Collection after assessment"–provides that where an assessment of tax was properly made within the applicable limitation period, the tax may be collected by a court proceeding if that proceeding begins within 10 years after the assessment of the tax.

Based on those statutes and interpreting case law, the court found that the government timely assessed tax liabilities against Henco on October 26, 2007, beginning the 10-year time period for collection of those assessed taxes under section 6502. The former shareholders were liable for Henco's tax liabilities based on fraudulent transfers from Henco to the shareholders.

Once the government timely assessed the tax liabilities against Henco, it was not required to separately assess the shareholders as transferees under section 6901. That provision is simply an additional tool for the government to assess and collect from a transferee the tax liabilities owed by a transferor.

Holding

The court held that the IRS did not have to separately assess the taxpayers as transferees.

[*United States v. Henco Holding Corp.*, No. 19-12758 (11th Cir. 2021)]

Trial Procedure

Kramer v. Commissioner
Tax Court Rules of Practice and Procedure § 123

The taxpayers were in default, and the IRS carried its burdens of production and proof.

Facts

The IRS sent a notice of deficiency to Don Kramer and Lela Arabuli. The notice included tax deficiencies, a failure-to-file penalty, an accuracy-related penalty, and fraud penalties. The IRS determined that only Mr. Kramer was liable for the fraud penalties. The IRS sent another notice of deficiency to Mr. Kramer that included tax deficiencies, the failure-to-file penalty, and fraud penalties.

Trial was initially set for November 2018, but the cases were continued and consolidated at the parties' joint request. Notice of the rescheduled trial date was mailed on June 18, 2019, to Mr. Kramer and Ms. Arabuli at their last known address. A reminder notice was mailed on October 4, 2019. The taxpayers did not fully participate in the pretrial proceedings and failed to attend the trial.

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Analysis

Rule 123(a) of the Tax Court's Rules of Practice and Procedure provides that the court may hold a party in default and enter a decision against that party if he or she has failed to plead or otherwise proceed as provided by the rules or as required by the court. The taxpayers did not appear for trial, despite being warned by the trial notice, standing pretrial order, and reminder notice that failure to appear could result in dismissal of the cases and entry of decisions against them. Accordingly, the court concluded that the taxpayers were in default under Rule 123(a).

Although the taxpayers were in default, the IRS bears certain burdens of production and proof with respect to deficiencies, additions to tax, and penalties at issue. The court found that the IRS met its burdens regarding the deficiencies, additions to tax, and penalties.

Holding

The court held that the taxpayers were in default and the IRS met its burdens of production and proof of the deficiencies, additions to tax, and penalties.

[*Kramer v. Commissioner*, T.C. Memo. 2021-16 (2021)]

Quattrini v. United States
I.R.C. §§ 6061, 6065, 7422

To file suit for a refund, the taxpayer must first have filed a claim for a refund with the IRS.

Facts

Sean G. Quattrini and Lady A. Chun Quattrini are married US citizens who reside in Australia and are employed by the Raytheon Company. In 2012, they signed a closing agreement as a condition of their employment that stated that they waived their rights to claim the I.R.C. § 911 foreign earned income exclusion.

The Quattrinis retained an accounting firm to file amended tax returns for 2016 and 2017. On the amended returns, they claimed the foreign earned income exclusion and employer-provided lodging exclusion. The accounting firm timely filed the amended returns. However, the accountant signed the amended return. The Quattrinis did not sign the amended returns and they did not provide a power of attorney authorizing the accountant to sign the amended returns.

The IRS disallowed the claim for a refund because the Quattrinis had waived their right to claim the foreign earned income exclusion. The Quattrinis then filed a tax refund action. The IRS filed a motion to dismiss the action for lack of subject matter jurisdiction.

Analysis

Under I.R.C. § 7422, a taxpayer cannot bring a tax refund suit unless the taxpayer has first filed a claim for refund or credit with the IRS. A tax refund claim must also comply with the applicable requirements of the Internal Revenue Code. I.R.C. § 6061 provides that any return, statement, or other document required to be made under any provision of the internal revenue laws or regulations shall be signed in accordance with forms or regulations prescribed by the Treasury secretary. I.R.C. § 6065 further provides that any return, declaration, statement, or other document required to be made under any provision of the internal revenue laws or regulations shall contain or be verified by a written declaration that is made under the penalties of perjury.

A refund claim may only be verified by someone other than the taxpayer if a power of attorney accompanies the claim. Such a power of attorney must contain a clear expression of the taxpayer's intention concerning the scope of authority granted to the recognized representative. The taxpayer signature requirement is statutory and therefore cannot be waived

The IRS moved to dismiss the case because the Quattrinis had not duly filed the amended tax returns upon which they based their tax refund claims. The IRS argued that the failure to comply with this statutory signature verification requirement deprives the court of jurisdiction to consider the tax refund claims. The court found that the tax refund claim was not duly filed.

Holding

The court dismissed the taxpayers' tax refund claim for lack of subject matter jurisdiction because the taxpayers did not properly submit a claim for a refund.

[*Quattrini v. United States*, No. 19-1323T (Fed. Cl. March 22, 2021)]

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Estate Tax

Estate of Michael J. Jackson v. Commissioner
I.R.C. §§ 2031, 2051

The court redetermined the value of the Michael Jackson estate's intangible assets, including the value of Michael Jackson's image and likeness.

Facts

The court extensively described Michael Jackson's rising music career, followed by the criminal charges against him. Although he was acquitted, those charges damaged his reputation. In 2009, he planned for a comeback tour, but he died less than 3 weeks before the tour was to begin.

Jackson's estate filed Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return. Based on a valuation, the estate reported the value of his image and likeness at $2,105. The IRS audited the tax return and issued a notice of deficiency, concluding that the estate had underpaid estate tax by over $500,000,000. The IRS valued the image and likeness at $434,261,895 and assessed almost $197,000,000 in penalties. The estate disputed the valuations, and it produced several expert witnesses to support its valuations. The IRS presented one expert witness.

Analysis

The Internal Revenue Code imposes a tax on the transfer of the taxable estate of every decedent who is a citizen or resident of the United States [I.R.C. § 2001(a)], and it defines the taxable estate as the value of the gross estate less applicable deductions [I.R.C. § 2051]. The value of the gross estate of a decedent is the value at the time of his or her death of all property, real or personal, tangible or intangible, wherever situated, to the extent provided in sections 2033 through 2045 [I.R.C. § 2031(a)].

Section 2033 includes in the gross estate the value of all property to the extent of the interest therein of the decedent at the time of his or her death. The property must be valued at its FMV [Treas. Reg. § 20.2031-1(b)]. FMV is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts. Under this standard, the hypothetical willing buyer's knowledge extends beyond just those facts publicly known, as he or she is presumed to be reasonably informed and prudent and to have asked the hypothetical willing seller for information that is not publicly available.

Property must be valued as if in the decedent's hands at the time of its transfer by death. Because property is valued precisely at death, it is inappropriate, as a general matter, to ascribe value based on postdeath evidence. The temptation to use hindsight is usually too great. The prohibition is not absolute, however, so a court may for instance consider subsequent events to the extent that they were reasonably foreseeable at the decedent's death.

The court considered the expert testimony about valuations and questioned the credibility of the IRS's expert witness. The court found that the IRS's expert valued the wrong asset, included unforeseeable events in his valuation, and miscalculated the assets' value. The court found that the estate's experts were much closer to reality, and while the valuation of the likeness and image on the estate tax return was low, the estate reasonably relied on experts when it reported that valuation.

Holding

The court determined that for estate tax purposes, the value of Michael Jackson's image and likeness was a little over $4,000,000.

[*Estate of Michael J. Jackson v. Commissioner*, T.C. Memo. 2021-48]

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Morrissette v. Commissioner
I.R.C. §§ 2036, 2038

Transfers qualified for the bona fide sale exception and were not included in the gross estate.

Facts

The decedent, Clara M. Morrissette, lived in Virginia at the time of her death. The personal representatives of her estate were her three sons. Ms. Morrissette's husband had started a moving company in 1943, which at the time of her death was comprised of 32 companies. She owned the majority of shares in the company.

Mr. and Mrs. Morrissette had implemented an estate plan for the moving company's ownership that was intended to keep the company in the family. When Mr. Morrissette died in 1996, Mrs. Morrissette updated the plan. There were several trusts to hold the company stock during the lifetimes of Mrs. Morrissette, her children, and her grandchildren.

Mrs. Morrissette's sons worked in the family business, but their relationships with each other were strained, and there was animosity toward each other. They needed to address the conflict and begin an orderly plan to transition the business to the next generation. They were also concerned about how they would pay the estate tax upon Mrs. Morrissette's death.

The sons consulted with an estate tax planning attorney, who gave them marketing materials on a split-dollar life insurance policy. A split-dollar agreement is an arrangement between an owner and a nonowner of a life insurance contract in which one party pays all or any portion of the premiums on the life insurance contract, directly or indirectly, and is entitled to recover all or any portion of those premiums from, or payment is secured by, the proceeds of the life insurance contract.

The marketing materials included an example of a grandmother who pays a $10,000,000 life insurance premium as part of a split-dollar life insurance agreement in exchange for rights determined on the basis of the policy's cash value. The marketing materials suggested that the estate could report the value of the grandmother's rights under the split-dollar agreement for estate tax purposes at $565,000 or $1,445,000, a substantial discount from the $10,000,000 premium.

In 2006, when Mrs. Morrissette was incapacitated, her sons decided to proceed with a new estate plan for her. The plan included a shareholder's agreement with certain rights of first refusal for the company shares. The plan also included dynasty trusts that purchased life insurance on each other's lives that could be used to fund the purchase of the company shares.

Mrs. Morrissette's revocable trust (the CMM Trust) was used to fund the premiums. In exchange, the CMM Trust was entitled to receive the greater of the amount of premiums it paid or the cash surrender value of the life insurance policy upon the insured's death or the termination of a split-dollar agreement. Mrs. Morrissette reported the payment of the premiums as gifts to her sons.

Mrs. Morrissette died on September 25, 2009. Her estate filed an estate tax return. It included all assets held in the CMM Trust in the gross estate and reported a FMV of $7,479,000 for the CMM Trust's split-dollar rights as of October 30, 2009, the date on which the CMM Trust transferred the split-dollar agreements to the dynasty trusts. The IRS challenged that valuation and determined that the value of the life insurance arrangements was the $30,000,000 transferred premiums or $32,060,070, the cash surrender values of the underlying life insurance policies.

Analysis

The parties agreed that the CMM Trust was a revocable trust on the date of Ms. Morrissette's death, and the trust assets were included in the gross estate. The IRS argued that I.R.C. § 2036 or 2038 applied to include the transferred premiums in the gross estate. Sections 2036 and 2038 require that inter vivos transfers be included in the gross estate where the decedent retained certain rights or powers in the transferred property.

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Section 2036 recaptures the values of assets that the decedent transferred during his or her lifetime if the decedent retained the economic benefits of the assets or retained a right or power to designate the persons who would possess or enjoy the property or receive the income from the property. Section 2038(a) includes revocable transfers in the gross estate. It applies where the decedent had the power to alter, amend, revoke, or terminate the transferee's enjoyment of the property.

In general, sections 2036 and 2038 apply if the following three conditions are met:

1. The decedent made an inter vivos transfer of property.
2. The transfer was not a bona fide sale for adequate and full consideration.
3. The decedent retained an interest in or a right or power over the transferred property that he or she did not relinquish before his or her death.

The court found that the retained rights under the split-dollar agreement were rights to designate enjoyment under section 2036; and to alter, amend, or revoke under section 2038. However, the exceptions for a bona fide sale for adequate consideration applied because there was a nontax purpose for entering into the arrangement, and the CMM Trust paid the premiums in exchange for repayment plus interest.

Holding

The court held that I.R.C. §§ 2036 and 2038 bona fide sale exceptions applied to premiums paid on a split-dollar life insurance arrangement.

[*Morrissette v. Commissioner*, T.C. Memo. 2021-60]

Grossman v. Commissioner
I.R.C. § 2056(a)

A bequest to a surviving spouse qualified for the estate tax marital deduction.

Facts

Semone Grossman and Ziona Grossman were married in Israel in 1987. Mr. Grossman presented evidence of his divorce from a prior wife, which had been granted by an orthodox rabbinical court in New York. After they were married, Mr. and Mrs. Grossman returned to New York, had two children, and lived together for 27 years until Mr. Grossman's death in 2014. The former wife never challenged the divorce, reported on her tax return that she was single, and did not make a statutory claim for an elective share against Mr. Grossman's estate.

At the time of his death, Mr. Grossman's estate was valued at $87,000,000. He left approximately $79,000,000 to Mrs. Grossman, and the estate claimed a corresponding marital deduction under I.R.C. § 2056(a). The IRS denied the deduction and argued that Mr. Grossman's divorce from his first wife was not valid under state law.

Analysis

Under I.R.C. § 2056(a), the value of the taxable estate is reduced by the value of any interest in property that passes or has passed from the decedent to his or her surviving spouse. The identification of a decedent's surviving spouse is a federal issue that should be determined by applying state law. In this case, all the parties resided in New York, which recognizes the validity of a marriage validly entered into elsewhere.

Holding

The court held that bequest to the surviving spouse qualified for the estate tax marital deduction.

[*Grossman v. Commissioner*, T.C. Memo. 2021-65]

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2021 NEW AND EXPIRING LEGISLATION

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LEARNING OBJECTIVES

After completing this session, participants will be able to do the following:

- ✔ Advise clients about the tax laws that were enacted or changed late in 2020 and in 2021
- ✔ Identify individual and business income tax exclusions, deductions, and credits that expire in 2021; and exclusions, deductions, and credits that are expiring in future years

INTRODUCTION

Tax legislation enacted late in 2020 and in 2021 affects a variety of tax provisions. This chapter first describes these new laws and regulations. It reviews the tax provisions in the Consolidated Appropriations Act, 2021. The Consolidated Appropriations Act, 2021 (CAA), Pub. L. No. 116-260, contains Division N Subtitle B, which is the COVID-Related Tax Relief Act of 2020 (COVIDTRA); and Division EE, which is the Taxpayer Certainty and Disaster Tax Relief Act of 2020 (TCDTRA).

On March 11, 2021, the president signed into law the $1.9 trillion American Rescue Plan Act of 2021 (ARPA), Pub. L. No 117-2. This chapter discusses the tax provisions in ARPA. This chapter also reports notices and procedures issued to provide guidance and clarifications on recently enacted legislation. Finally, this chapter lists the expiration dates of tax provisions that are set to expire in 2021–2029.

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NEW LEGISLATION This section explains new laws, regulations, and procedures.

This section discusses legislation that has been enacted since the publication of the *2020 National Income Tax Workbook*. It is organized by topics and subtopics to facilitate research. Within each subtopic, entries are generally organized by code citation. NOTE: These summaries have been edited and appear in a condensed form. Tax practitioners should read the entire text before relying on it.

Agricultural and Natural Resource Issues

COVIDTRA § 281
I.R.C. § 172

Taxpayers with a farming loss for any tax year beginning in 2018, 2019, or 2020 can elect to retain the 2-year NOL carryback [elected prior to the Coronavirus Aid, Relief, and Economic Security Act (CARES Act), Pub. L. No. 116-136] instead of the 5-year carryback in the CARES Act. Farmers can also revoke an election to waive the NOL carryback.

[COVIDTRA § 281]

Rev. Proc. 2021-14
I.R.C. § 172

This revenue procedure provides guidance regarding elections and revocations of the carryback periods for 2018, 2019, or 2020 farming losses.

[Rev. Proc. 2021-14, 2021-30 I.R.B. 158]

Notice 2020-74
I.R.C. § 1033

I.R.C. § 1033(e)(1) provides that a sale or exchange of livestock (other than poultry) held by a taxpayer for draft, breeding, or dairy purposes in excess of the number that would be sold following the taxpayer's usual business practices is treated as an involuntary conversion if the livestock is sold or exchanged solely on account of drought, flood, or other weather-related conditions. Section 1033(a)(2)(A) generally provides that gain from an involuntary conversion is recognized only to the extent the amount realized on the conversion exceeds the cost of replacement property purchased during the replacement period.

If a sale or exchange of livestock is treated as an involuntary conversion under section 1033(e)(1) and is solely on account of drought, flood, or other weather-related conditions that result in the area being designated as eligible for assistance by the federal government, the replacement period ends 4 years after the close of the first tax year in which any part of the gain from the conversion is realized. Notice 2020-74 explains the circumstances under which the 4-year replacement period is extended for livestock sold because of drought. The appendix to the notice contains a list of counties that experienced exceptional, extreme, or severe drought conditions during the 12-month period ending August 31, 2020.

For a taxpayer who qualified for a 4-year replacement period for livestock sold or exchanged on account of drought and whose replacement period is scheduled to expire at the end of 2020 (or, for a fiscal year taxpayer, at the end of the tax year that includes August 31, 2020), the replacement period will be extended under section 1033(e)(2) and Notice 2006-82, 2006-2 C.B. 529, if the applicable region includes any county on this list. The extension will continue until the end of the taxpayer's first tax year ending after a drought-free year for the applicable region.

[Notice 2020-74, 2020-41 I.R.B. 887]

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Partnerships

Notice 2020-75
I.R.C. § 164

I.R.C. § 164(b)(6), which was added by the Tax Cuts and Jobs Act of 2017 (TCJA), limits an individual's deduction for state and local taxes (SALT) to $10,000 ($5,000 MFS). This SALT deduction limitation applies to tax years beginning after December 31, 2017, and before January 1, 2026, and does not apply to taxes described in section 164(a)(3) that are imposed by a foreign country or to any taxes described in section 164(a)(1) and (2) that are paid and incurred in carrying on a trade or business or an activity described in I.R.C. § 212.

Certain jurisdictions described in section 164(b)(2) have enacted or are contemplating the enactment of tax laws that impose either a mandatory or elective entity-level income tax on partnerships and S corporations that do business in the jurisdiction or have income derived from or connected with sources within the jurisdiction. In certain instances, the jurisdiction's tax law provides a corresponding or offsetting, owner-level tax benefit, such as a full or partial credit, deduction, or exclusion.

Notice 2020-75 announces that the Department of the Treasury and the IRS intend to issue proposed regulations to clarify that state and local income taxes imposed on and paid by a partnership or an S corporation on its income are allowed as a deduction by the partnership or S corporation in computing its non–separately stated taxable income or loss for the tax year of the payment. Thus, the specified income tax payments made by a partnership or an S corporation are not included when applying the SALT deduction limitation to an individual who is a partner in the partnership or a shareholder of the S corporation.

[Notice 2020-75, 2020-49 I.R.B. 1453]

S Corporations

T.D. 9914
I.R.C. §§ 1371, 1377

Final regulations provide guidance on the definition of an eligible terminated S corporation and rules relating to distributions of money by such a corporation after the post-termination transition period. The final regulations also amend current regulations to extend the treatment of distributions of money during the post-termination transition period to all shareholders of the corporation and clarify the allocation of current earnings and profits to distributions of money and other property. The final regulations affect C corporations that were formerly S corporations and the shareholders of those corporations.

[T.D. 9914]

Comment Request for Form 7203

The IRS is soliciting comments for Form 7203, S Corporation Shareholder Stock and Debt Basis Limitations. I.R.C. § 1366 determines the shareholder's tax liability from an S corporation. I.R.C. § 1367 details the adjustments to basis, including the increase and decrease in basis, income items included in basis, the basis of indebtedness, and the basis of inherited stock. Shareholders will use Form 7203 to calculate their stock and debt basis, and substantiate that losses and deductions are accurately claimed.

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Tax-Exempt Organizations

Form 1024-A
I.R.C. § 501

The IRS has revised Form 1024-A, Application for Recognition of Exemption Under Section 501(c)(4), and its instructions for electronic filing. Applications for recognition of exemption on Form 1024-A must be submitted electronically online at www.pay.gov.

Memorandum for Exempt Organizations Rulings and Agreements Employees
I.R.C. § 501

An organization described in I.R.C. § 501(c)(3), (9), or (17) generally must apply for recognition of tax-exempt status within 27 months from the end of the month in which it was organized to be recognized and treated as tax-exempt effective as of the date of formation. An organization that has not filed its application within the required time period may request relief under Treas. Reg. § 301.9100-3 if it provides evidence that it acted reasonably and in good faith and that the granting of relief will not prejudice the interests of the government.

In a memo to its Exempt Organizations employees, the IRS explains that for applications submitted on or after January 4, 2021, the following procedures apply:

- Consider relief requests consistent with Rev. Proc. 2021-5, 2021-1 I.R.B. 250 (updated annually).
- Do not grant relief if it would result in the organization's exemption being automatically revoked effective before the date of application.
- Do not grant relief if the period of limitations on assessment under I.R.C. § 6501(a) for any tax year for which the organization claims exemption has expired before the date of the application.
- Do not consider relief for an organization that is not required to apply for recognition of exempt status to be tax exempt.

[Memorandum for Exempt Organizations Rulings and Agreements Employees, Control No: TEGE-07-0321-0005 (March 17, 2021)]

C.C.M. 20205201F
I.R.C. § 501

Most section 501(c)(3), (9), (17), and (29) organizations are required to apply for recognition of exemption from federal income tax. Certain section 501(c)(3) organizations (e.g., churches, small public charities with gross receipts not normally more than $5,000, and organizations formed prior to October 10, 1969) are eligible to self-declare their exemption from federal income tax.

In a Chief Counsel Memo, the IRS concludes that section 501(c)(3) organizations that are eligible to self-declare are not eligible to request relief from the 27-month filing requirement because they did not fail to make a required regulatory election. In addition, applicants who have not filed required information returns for years before their application for exemption are not eligible for the late-filing relief.

[C.C.M. 20205201F (November 10, 2020)]

T.D. 9933
I.R.C. § 512

The IRS has released final regulations that provide guidance on how an exempt organization subject to the unrelated business income tax determines if it has more than one unrelated trade or business and, if so, how the exempt organization calculates its unrelated business taxable income (UBTI). The final regulations provide for the use of NAICS 2-digit codes as a method of identifying separate unrelated trades or businesses for purposes of I.R.C. § 512(a)(6).

The final regulations also clarify that the definition of an *unrelated trade or business* applies to individual retirement accounts. Additionally, the final regulations provide that inclusions of subpart F income and global intangible low-taxed income are treated in the same manner as dividends for purposes of determining UBTI.

[T.D. 9933]

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Credits

Sick Leave and Family Leave Credits

The Families First Coronavirus Response Act (Families First Act), Pub. L. No. 116-127 (March 18, 2020), required certain employers to provide paid leave to workers who are unable to work because of COVID-related situations. The CAA extended the credits through March 31, 2021.

CROSS-REFERENCE

Families First Act

See pages 538–550 in the *2020 National Income Tax Workbook* for a discussion of the credits under the Families First Act.

ARPA § 9641 codifies the I.R.C. § 3131 payroll credit for paid sick leave, I.R.C. § 3132 payroll credit for paid family leave, and I.R.C. § 3133 rule that increases the credits by the amount of social security and Medicare taxes that the employer pays on the qualified wages.

ARPA § 9641
I.R.C. §§ 3131, 3132

There is a refundable employer credit against the employer's share of Medicare tax for each calendar quarter in an amount equal to 100% of the qualified sick leave wages and qualified family leave wages paid by the employer for that quarter. The credit applies to wages paid for the period beginning on April 1, 2021, and ending on September 30, 2021.

Eligible Employers

An eligible employer is any business with fewer than 500 employees. The government of the United States or any agency or instrumentality thereof cannot claim the credit. However, an organization that is described in section 501(c)(1) and exempt from tax under section 501(a) can claim the credit. Self-employed individuals are eligible for similar tax credits under ARPA §§ 9642 and 9643.

Qualified Leave

Eligible employers can claim the tax credits for wages paid for leave taken by employees who are not able to work or telework due to reasons related to COVID-19, including leave taken for COVID-19 testing and leave to receive COVID-19 vaccinations or to recover from any injury, disability, illness, or condition related to the vaccinations.

Amount of the Credit

The tax credit for paid sick leave wages is equal to the sick leave wages paid for COVID-19 related reasons for up to 2 weeks (80 hours), limited to $511 per day and $5,110 in the aggregate, at 100% of the employee's regular rate of pay (or two-thirds, if leave is to care for someone else). The tax credit for paid family leave wages is equal to the family leave wages paid for up to 12 weeks, limited to $200 per day and $12,000 in the aggregate, at two-thirds of the employee's regular rate of pay. The amount of these tax credits is increased by allocable health plan expenses and contributions for certain collectively bargained benefits, and the employer's share of social security and Medicare taxes paid on the wages (up to the respective daily and total caps).

Claiming the Credit

Eligible employers report their total paid sick and family leave wages (plus the eligible health plan expenses and collectively bargained contributions and the eligible employer's share of social security and Medicare taxes on the paid leave wages) for each quarter on their federal employment tax return, usually Form 941, Employer's Quarterly Federal Tax Return. In anticipation of claiming the credits on Form 941, eligible employers can keep the federal employment taxes that they otherwise would have deposited, including federal income tax withheld from employees, the employees' share of social security and Medicare taxes, and the eligible employer's share of social security and Medicare taxes with respect to all employees up to the amount of credit for which they are eligible.

If an eligible employer does not have enough federal employment taxes set aside for deposit to cover amounts provided as paid sick and family leave wages (plus the eligible health plan expenses and collectively bargained contributions and the

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eligible employer's share of social security and Medicare taxes on the paid leave wages), the eligible employer may request an advance of the credits by filing Form 7200, Advance Payment of Employer Credits Due to COVID-19. The eligible employer will account for the amounts received as an advance when it files its Form 941, Employer's Quarterly Federal Tax Return, for the relevant quarter. Self-employed individuals may claim comparable tax credits on Form 1040 or by filing Form 7202, Credits for Sick Leave and Family Leave for Certain Self-Employed Individuals.

No Double Credit

To prevent a double credit, any wages included in determining the credit cannot be included for purposes of determining the credit allowed under I.R.C. §§ 45A, 45P, 45S, 51, 3131, or 3132 (as applicable), and 3134.

Employee Retention Credit

TCDTRA § 206, 207; CARES Act § 2301

Beginning on January 1, 2021, the following changes apply to the employee retention credit:

1. The credit rate increases from 50% to 70% of qualified wages.
2. Eligibility for the credit expands by reducing the required year-over-year gross receipts decline from 50% to 20%.
3. The limit on per-employee creditable wages increases from $10,000 for the year to $10,000 for each quarter.
4. The 100-employee threshold for determining the relevant qualified wage base increases to employers with 500 or fewer employees.
5. The government of the United States or any agency or instrumentality thereof cannot claim the credit. However, eligible employers include an organization that is described in section 501(c)(1) and exempt from tax under section 501(a), a college or university, or a government entity that provides medical or hospital care.

ARPA § 9651
I.R.C. § 3134

ARPA adds I.R.C. § 3134, which extends and modifies the employee retention credit for calendar quarters beginning after June 30, 2021. The employee retention credit under ARPA is a refundable credit against Medicare taxes for each calendar quarter in an amount equal to 70% of the employee's qualified wages. The qualified wages that may be considered cannot exceed $10,000 per quarter.

ARPA creates two new categories of employers. Severely financially distressed employers (gross receipts less than 10% percent of gross receipts for same quarter in 2019) can claim the credit for employees, regardless of whether they are performing services. After February 15, 2020, recovery startup businesses may claim up to a $50,000 credit per quarter, even if the business was not subject to a shutdown or did not have a significant decline in gross receipts.

Deductions

T.D. 9946
I.R.C. § 162

The IRS and Treasury issued final regulations that provide guidance on I.R.C. § 162(f), as amended in 2017, concerning the deduction of certain fines, penalties, and other amounts. The final regulations also provide guidance on the information reporting requirements under I.R.C. § 6050X with respect to those fines, penalties, and other amounts.

Prior to its amendment in 2017, section 162(f) disallowed an ordinary and necessary business expense deduction under section 162(a) for any fine or similar penalty paid to a government for the violation of any law. As amended by the TCJA, the general rule of section 162(f)(1) provides that no deduction is allowed for any amount paid or incurred (whether by suit, agreement, or otherwise) to, or at the direction of, a government or governmental entity in relation to the violation of any law or the investigation or inquiry by such government or governmental entity into the potential violation of any law. An exception to the general disallowance rule allows

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a deduction for certain amounts paid or incurred if those amounts are identified in a court order or settlement agreement as restitution, remediation, or amounts to come into compliance with a law. There is also an exception for amounts paid or incurred related to private party suits and an exception for certain taxes due.

The final regulations provide, in general, that amounts paid or incurred for routine investigations or inquiries, such as audits or inspections, required to ensure compliance with rules and regulations applicable to the business or industry, which are not related to any evidence of wrongdoing or suspected wrongdoing, are not disallowed. The final regulations also revise the definition of *restitution, remediation of property,* and *amounts paid to come into compliance with a law* to clarify that, if otherwise deductible, an amount is paid or incurred for restitution or remediation of the environment, wildlife, or natural resources if it is paid or incurred for the purpose of conserving soil, air, or water resources; protecting or restoring the environment or an ecosystem; improving forests; or providing a habitat for fish, wildlife, or plants, and has the requisite nexus with the harm that the taxpayer has caused or is alleged to have caused.

Under the proposed regulations, the section 162(f)(2) exception to the general deduction disallowance rule does not apply to forfeiture or disgorgement and those amounts are disallowed. The final regulations do not treat disgorgement of net profits or a forfeiture as, per se, nondeductible. Instead, the taxpayer's claim for a deduction for amounts paid or incurred through disgorgement or forfeiture will not be disallowed if the amount is otherwise deductible; the order or agreement identifies the payment, not in excess of net profits, as restitution, remediation, or an amount paid to come into compliance with a law; the taxpayer establishes that the amount was paid as restitution, remediation, or an amount paid to come into compliance with a law; and the origin of the taxpayer's liability is restitution, remediation, or an amount paid to come into compliance with a law. However, amounts paid or incurred through disgorgement will be disallowed if, pursuant to the order or agreement, the amounts are disbursed to the general account of the government or governmental entity for general enforcement efforts or other discretionary purposes.

The final regulations modify an example in the proposed regulations to clarify that if an order or agreement requires a taxpayer to come into compliance with a law and the taxpayer elects to upgrade equipment or property to a higher than required standard, any amount paid or incurred in excess of the amount paid or incurred to come into compliance with a law will not be disallowed. The final regulations also modify the proposed rule for payment amounts not identified in a court order or settlement agreement so that it applies to orders or agreements that impose lump sum payment judgments for restitution, remediation, and coming into compliance, or that involve multiple taxpayers or multiple damage awards.

[T.D. 9946]

T.D. 9916
I.R.C. § 168

Final regulations provide guidance regarding the I.R.C. § 168(k) bonus depreciation. These final regulations reflect and further clarify the increased deduction and the expansion of qualified property, particularly to certain classes of used property. Specifically, these final regulations provide the following:

1. Rules relevant to the definition of *qualified property* (discussed later)
2. Rules for consolidated groups
3. Rules regarding components acquired or self-constructed after September 27, 2017, for larger self-constructed property for which manufacture, construction, or production began before September 28, 2017
4. Rules regarding the application of the mid-quarter convention, as determined under section 168(d)
5. Changes to the definitions in the 2019 final regulations for the terms *qualified improvement property, predecessor*, and *class of property* (discussed later)

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Qualified Property

The regulations clarify that the 5 calendar years immediately prior to the current calendar year in which the property is placed in service by the taxpayer, and the portion of such current calendar year before the placed-in-service date of the property determined without considering the applicable convention, are used to determine if the taxpayer or a predecessor had a depreciable interest in the property at any time prior to acquisition (the lookback period). The taxpayer and the predecessor are each subject to a separate lookback period. The final regulations also clarify that if the taxpayer or a predecessor, or both, have not been in existence during the entire lookback period, then only the portion of the lookback period during which the taxpayer or a predecessor, or both, have been in existence is used to determine if the taxpayer or the predecessor had a depreciable interest in the property.

Qualified Improvement Property

The final regulations provide that for qualified improvement property, the improvement must be made by the taxpayer. An improvement is made by the taxpayer if the taxpayer makes, manufactures, constructs, or produces the improvement for itself or if the improvement is made, manufactured, constructed, or produced for the taxpayer by another person under a written contract.

Predecessor and Class of Interest

The 2019 final regulations define a predecessor as including a transferor of an asset to a transferee in a transaction in which the transferee's basis in the asset is determined, in whole or in part, by reference to the basis of the asset in the hands of the transferor. The final regulations clarify that this definition was intended to apply only with respect to the specific property transferred. Similarly, the regulations define a *class of property* [regarding basis adjustments in partnership assets under I.R.C. § 743(b)] to be partner-specific.

[T.D. 9916]

Rev. Proc. 2020-50
I.R.C. § 168

This revenue procedure provides guidance for taxpayers wishing to apply Treas. Reg. §§ 1.168(k)-2 and 1.1502-68 (the 2020 final regulations, discussed earlier), or to rely on the 2019 proposed regulations or the 2019 final regulations under I.R.C. § 168(k).

[Rev. Proc. 2020-50, 2020-48 I.R.B. 1122]

TCDTRA § 202
I.R.C. § 168

The recovery period for residential rental property placed in service before January 1, 2018, and held by an electing real property trade or business [as defined in I.R.C. § 163(j)(7)(B)] is 30 years. This provision applies only if the alternative depreciation system did not apply to such property prior to January 1, 2018.

[TCDTRA § 202]

Rev. Proc. 2021-28
I.R.C. § 168

The TCDTRA, enacted in December 2020, retroactively allows a 30-year recovery period under the alternative depreciation system (ADS) for certain residential rental property placed in service before January 1, 2018; held by an electing real property trade or business as defined in I.R.C. § 163(j)(7)(B); and not previously subject to the ADS. This revenue procedure explains how a taxpayer changes its method of computing depreciation to comply with the retroactive 30-year recovery period.

[Rev. Proc. 2021-28, 2021-27 I.R.B. 5]

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Rev. Proc. 2021-29

This draft revenue procedure allows an eligible partnership to file an amended Form 1065, U.S. Return of Partnership Income, and furnish a corresponding Schedule K-1 (Form 1065), Partner's Share of Income, Deductions, Credits, etc., to each of its partners for tax years beginning in 2018, 2019, and 2020 to change its recovery period to the 30-year period for residential rental property (discussed previously). The amended return is an alternative option to filing an administrative adjustment request (AAR).

[Rev. Proc. 2021-29, 2021-27 I.R.B. 12]

I.R. 2021-27; TCDTRA § 304
I.R.C. § 170

The TCDTRA temporarily increased the limit for corporate charitable contributions. The limit is up to 100% of a corporation's taxable income (formerly 25% for 2020). The increased limit applies to cash contributions that were paid during the period beginning on January 1, 2020, and ending on February 25, 2021 for relief efforts in qualified disaster areas.

Qualified disaster areas are those in which a major disaster has been declared under section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act. This does not include any disaster declaration related to COVID-19. Otherwise, it includes any major disaster declaration made by the president during the period beginning on January 1, 2020, and ending on February 25, 2021, as long as it is for an occurrence specified by the Federal Emergency Management Agency as beginning after December 27, 2019, and no later than December 27, 2020.

A corporation elects the increased limit by computing its deductible amount of qualified contributions using the increased limit and by claiming the amount on its return for the tax year in which the contribution was made. Corporations must meet the usual recordkeeping requirements that apply to charitable contributions, including obtaining a contemporaneous written acknowledgment from the charity. The acknowledgment must be obtained before the corporation files its return, but no later than the due date, including extensions, for filing that return.

The TCDTRA added an additional substantiation requirement and for corporations electing the increased limit, a corporation's contemporaneous written acknowledgment must include a disaster relief statement, stating that the contribution was used, or is to be used, by the eligible charity for relief efforts in one or more qualified disaster areas. IR-2021-27 states that the IRS will not challenge a corporation's deduction of any qualified contribution made before February 1, 2021, solely on the grounds that the corporation's acknowledgment does not include the disaster relief statement.

[I.R. 2021-27; TCDTRA § 304]

Notice 2021-42
I.R.C. § 170

This notice extends the federal income and employment tax treatment provided in Notice 2020-46, 2020-27 I.R.B. 7, to cash payments made to charitable organizations described in section 170(c) after December 31, 2020, and before January 1, 2022. Notice 2020-46 provided guidance on the federal income and employment tax treatment to employers and their employees of cash payments for the relief of victims of the COVID-19 pandemic in the affected geographic areas under employer-sponsored-leave-based donation programs.

Under leave-based donation programs, employees can elect to forgo vacation, sick, or personal leave in exchange for cash payments made by their employers to section 170(c) organizations. Cash payments an employer makes to section 170(c) organizations in exchange for vacation, sick, or personal leave that its employees elect to forgo will not be treated as wages (or compensation, as applicable) to the employees or otherwise be included in the employee's gross income if the payments are made for the relief of victims of the COVID-19 pandemic in the affected geographic areas.

Electing employees may not claim a charitable contribution deduction for the value of the leave. An employer can deduct the cash payments under the rules of I.R.C. § 162 or 170.

[Notice 2021-42, 2021-29 I.R.B. 19].

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T.D. 9925
I.R.C. § 274

Final regulations provide guidance under I.R.C. § 274 regarding the elimination of the deduction for expenditures related to entertainment, amusement, or recreation activities. The final regulations also address the limitation on the deduction of food and beverage expenses under section 274(k). The final regulations adopt the proposed regulations (discussed in the *2020 National Income Tax Workbook,* pages 235–240) with the following modifications:

Business Meals Provided at or during an Entertainment Activity

The final regulations clarify that the separately stated cost of food and beverages provided at or during an entertainment activity must reflect the venue's usual selling cost for those items if they were to be purchased separately from the entertainment or must approximate the reasonable value of those items. The final regulations provide that if the food or beverages provided at or during an entertainment activity are not purchased separately from the entertainment, and if the cost of the food or beverages is not stated separately from the cost of the entertainment on one or more bills, invoices, or receipts, no allocation can be made, and the entire amount is a nondeductible entertainment expenditure.

Business Meal Expenses

To deduct an otherwise allowable food or beverage expense, the expense must not be lavish or extravagant under the circumstances, and the taxpayer, or an employee of the taxpayer, must be present at the furnishing of the food or beverages. The final regulations address the general requirement that the food and beverages be provided to a business associate and adopt the definition of *business associate* in Treas. Reg. § 1.274-12(b)(3). Thus, the final regulations provide that the food or beverages must be provided to a person with whom 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. The final regulations clarify that the rules in § 1.274-12(a)(1) also apply to food or beverages provided to a taxpayer such as a sole proprietor or other business owner. Thus, the final regulations refer to food or beverages provided "to the taxpayer or a business associate."

Travel Meal Expenses

The final regulations apply the general rules for meal expenses from the proposed regulations to travel meals. In addition, the final regulations incorporate the substantiation requirements in section 274(d) to travel meals. Finally, the final regulations apply the limitations in section 274(m)(3) to expenses for food or beverages paid or incurred for spouses, dependents, or other individuals accompanying the taxpayer (or an officer or employee of the taxpayer) on business travel.

Exceptions to the Limitations

Section 274(e) provides exceptions to the limitations on the deduction of food or beverages in section 274(k)(1) and (n)(1). The final regulations explain how those exceptions apply. The preamble also explains that the exceptions in section 274(e)(1), (e)(5), and (e)(6) do not apply to food or beverage expenses (but apply to the disallowance of the deduction for entertainment expenses). The final regulations provide that the deduction limitation rules generally apply to all food and beverages, whether characterized as meals, snacks, or other types of food or beverage items.

In addition, unless one of the exceptions under section 274(e) applies, the deduction limitations apply regardless of whether the food or beverages are treated as de minimis fringe benefits under I.R.C. § 132(e). The exceptions are as follows:

1. Expenses provided by an employer and treated as compensation to the employee and expenses for food or beverages provided to a person who is not an employee of the taxpayer to the extent the expenses are includable in the gross income of the recipient
2. Certain reimbursement arrangements
3. Recreational expenses for employees such as company holiday parties, annual picnics, or summer outings that do not discriminate in favor of highly compensated employees

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4. Items available to and primarily consumed by the general public
5. Goods or services to customers in a bona fide transaction for adequate and full consideration in money or money's worth

Definitions

The final regulations define *food or beverage expenses* to mean the cost of food or beverages, including any delivery fees, tips, and sales tax. For employer-provided meals at an eating facility, food or beverage expenses do not include expenses for the operation of the eating facility such as salaries of employees preparing and serving meals and other overhead costs. Indirect expenses, including the cost of transportation to a meal, are not included in the definition.

[T.D. 9925]

Notice 2021-25; TCDTRA § 210
I.R.C. § 274

With some exceptions, I.R.C. § 274(n)(1) provides that a deduction for any expense for food or beverages generally is limited to 50%. A temporary exception allows a 100% deduction for business meal food and beverage expenses, including any carryout or delivery meals, provided by a restaurant that are paid or incurred in 2021 and 2022.

Notice 2021-25, 2021-17 I.R.B. 1118, explains that the term *restaurant* means a business that prepares and sells food or beverages to retail customers for immediate consumption, regardless of whether the food or beverages are consumed on the business's premises. However, a restaurant does not include a business that primarily sells prepackaged food or beverages not for immediate consumption, such as a grocery store; specialty food store; beer, wine, or liquor store; drug store; convenience store; newsstand; or a vending machine or kiosk. In addition, it does not include any eating facility located on the business premises of the employer and used in furnishing meals excluded from an employee's gross income under section 119, or any employer-operated eating facility treated as a de minimis fringe under § 132(e)(2), even if such eating facility is operated by a third party under contract with the employer.

[Notice 2021-25, 2021-17 I.R.B. 1118; TCDTRA § 210]

T.D. 9939
I.R.C. § 274

Final regulations address the elimination of the deduction under section 274 for expenses related to certain transportation and commuting benefits provided by employers to their employees. The final regulations provide guidance to determine the amount of such expenses that is nondeductible and apply certain exceptions under section 274(e) that may allow such expenses to be deductible.

Section 274(l)(1), as added by the TCJA, provides that no deduction is allowed under chapter 1 for any expense incurred for providing any transportation, or any payment or reimbursement, to an employee of the taxpayer in connection with travel between the employee's residence and place of employment, except as necessary for ensuring the safety of the employee. The final regulations explain that travel between the employee's residence and place of employment is not affected by the use of different modes of transportation, or by whether the employer pays for all modes of transportation during the commute. The final regulations also state that the disallowance under section 274(l) does not apply to business expenses under section 162(a)(2) paid or incurred while traveling away from home. Under the final regulations, the term *employee* means an employee of the taxpayer as defined in I.R.C. § 3121(d)(1) and (2) (officers of a corporate taxpayer and employees of the taxpayer under the common-law rules).

The final regulations clarify that a transportation or commuting expense is necessary for ensuring the safety of the employee if unsafe conditions, as described in Treas. Reg. § 1.61-21(k)(5), exist for the employee. Unsafe conditions exist if a reasonable person would, under the facts and circumstances, consider it unsafe for the employee to walk to or from home, or to walk to or use public transportation at the time of day the employee must commute. One of the factors indicating whether it is unsafe is the history of crime in the geographic area surrounding the employee's workplace or residence at the time of day the employee must commute.

[T.D. 9939]

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Income

ARPA § 9672

Targeted economic injury disaster loan (EIDL) advances received under section 331 of the Economic Aid to Hard-Hit Small Businesses, Nonprofits, and Venues Act (Title III of Division N of Pub. L. No. 116-260) are not included in gross income and no deduction is denied, no tax attribute is reduced, and no basis increase is denied, because of that exclusion from gross income. For a partnership or S corporation, the excluded amount is treated as tax-exempt income for purposes of I.R.C. §§ 705 and 1366.

[ARPA § 9672]

COVIDTRA § 278

Gross income does not include forgiveness of indebtedness described in section 1109(d)(2)(D) of the CARES Act, and the exclusion from gross income will not preclude any deduction or basis increase or reduce other tax attributes. Also, gross income does not include any EIDL or the EIDL advance, and the exclusion from gross income will not preclude any deduction or basis increase or reduce other tax attributes. Similar rules apply to loan assistance payments described in section 1112(c) of the CARES Act.

[COVIDTRA § 278]

ARPA § 9673

SBA restaurant revitalization grants are excluded from gross income. No deduction is denied, no tax attribute is reduced, and no basis increase is denied, because of that exclusion from gross income. For a partnership or S corporation, the excluded amount is treated as tax-exempt income.

[ARPA § 9673]

COVIDTRA § 276; Rev. Rul. 2021-2

COVIDTRA § 276 states that taxpayers whose PPP loans are forgiven do not have to include the forgiven amount in income. The taxpayer can deduct otherwise deductible expenses paid with the proceeds of a PPP loan, and the forgiveness will not preclude a basis increase or reduce other tax attributes.

Rev. Rul. 2021-2 obsoletes Notice 2020-32, 2020-21 I.R.B. 837; and Rev. Rul. 2020-27, 2050-50 I.R.B. 1552, relating to the deductibility of certain expenses paid for with proceeds from a Paycheck Protection Program loan, due to the enactment of section 276(a) of COVIDTRA.

[COVIDTRA § 276; Rev. Rul. 2021-2, 2021-4 I.R.B. 495]

Rev. Proc. 2021-20

Rev. Proc. 2021-20 provides a safe harbor for certain taxpayers that received a PPP loan and, based on guidance issued by the Treasury Department and the IRS prior to the enactment of COVIDTRA, did not deduct certain otherwise deductible expenses paid or incurred during the taxpayer's tax year(s) ending after March 26, 2020, and on or before December 31, 2020. Under the safe harbor, these taxpayers may deduct the expenses in the immediately subsequent tax year instead of filing an amended return or AAR for the taxpayer's 2020 tax year.

[Rev. Proc. 2021-20, 2021-19 I.R.B. 1150]

T.D. 9935
I.R.C. § 1031

Final regulations under I.R.C. § 1031 add a definition of *real property* to implement statutory changes limiting section 1031 treatment to like-kind exchanges of real property. The final regulations also provide a rule addressing a taxpayer's receipt of personal property that is incidental to real property the taxpayer receives in an otherwise qualifying like-kind exchange of real property.

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Definition of Real Property

The final regulations revise the definition of *real property* in the proposed regulations to provide that property is classified as real property for section 1031 purposes if, on the date it is transferred in an exchange, the property is real property under the law of the state or local jurisdiction in which that property is located. The final regulations also revise the proposed definition of real property to eliminate, for both tangible and intangible properties, any consideration of whether the property contributes to the production of income unrelated to the use or occupancy of space (the "purpose or use test").

Real property that was eligible for like-kind exchange treatment under the law in effect prior to enactment of the TCJA is still eligible for like-kind exchange treatment, and property that was ineligible for like-kind exchange treatment prior to enactment of the TCJA remains ineligible. A determination that property is personal property under state law does not preclude a determination that property is real property based on all the facts and circumstances under the various factors provided in the final regulations or if the property is specifically listed in the final regulations.

If tangible property is permanently affixed to real property and will ordinarily remain affixed for an indefinite period of time, the property is generally an inherently permanent structure, and thus is real property for section 1031 purposes. A structural component is characterized as real property under the final regulations if it is integrated into an inherently permanent structure. Thus, under the final regulations, machinery and equipment are characterized as real property if they comprise an inherently permanent structure or a structural component, or if they are real property under the state or local law test.

Stock in a cooperative housing corporation and land development rights are listed as real property. A license, permit, or other similar right that is solely for the use, enjoyment, or occupation of land or an inherently permanent structure and that is in the nature of a leasehold, an easement, or a similar right generally is an interest in real property, and thus is real property under section 1031.

Incidental Property Rule

The incidental property rule in the proposed regulations provides that for exchanges involving a qualified intermediary, personal property that is incidental to replacement real property (incidental personal property) is disregarded in determining whether a taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or non-like-kind property held by the qualified intermediary are expressly limited. However, as personal property, incidental personal property is non-like-kind property that generally results in gain recognition under section 1031(b) on the exchange.

Personal property is incidental to real property acquired in an exchange if (1) in standard commercial transactions, the personal property is typically transferred together with the real property, and (ii) the aggregate FMV of the incidental personal property transferred with the real property does not exceed 15% of the aggregate FMV of the replacement real property (15% limitation). The final regulations clarify that the 15% limitation is calculated by comparing the value of all of the incidental properties to the value of all the replacement real properties acquired in the same exchange.

[T.D. 9935]

Losses

ARPA § 9041
I.R.C. § 461

The limitation on excess business losses of noncorporate taxpayers (and the suspension of the limitation on excess farming losses) is extended from January 1, 2026, to January 1, 2027.

[ARPA § 9041]

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Marijuana Businesses

IRS Marijuana Industry Frequently Asked Questions

The IRS has issued frequently asked questions (FAQs) for marijuana businesses. The questions address income and employment tax filing obligations, payment plans, penalties, deductions, and reporting cash payments over $10,000.
[IRS Marijuana Industry Frequently Asked Questions, www.irs.gov/businesses/small-businesses-self-employed/marijuana-industry-frequently-asked-questions]

Individual Tax Issues

Credits

ARPA §§ 9631, 9632
I.R.C. §§ 21, 129

Under I.R.C. § 21, a taxpayer with one or more qualifying individuals may claim a credit against income tax liability for employment-related expenses for child and dependent care. For this purpose, employment-related expenses are expenses for household services and expenses for the care of a qualifying individual. These expenses must be incurred to enable the taxpayer to be gainfully employed. Generally, a qualifying individual is a dependent of the taxpayer who is under the age of 13, or a dependent or spouse of the taxpayer if the dependent or spouse is physically or mentally incapable of caring for himself or herself and shares the same principal place of abode with the taxpayer for over one-half the year.

ARPA § 9631 enhances the I.R.C. § 21 child and dependent care tax credit and makes it refundable. For any tax year beginning after December 31, 2020, and before January 1, 2022, if the taxpayer (either spouse, if MFJ) has a principal place of abode in the United States (determined as provided in I.R.C. § 32) for more than one-half of the tax year, the credit is refundable. Under former law, the credit was limited to 35% of employment-related expenses. The percentage limit is increased from 35% to 50%. The maximum amount of expenses that can be taken into account is $8,000 for one qualifying individual and $16,000 for two or more qualifying individuals. Thus, the maximum credit is $4,000 for one qualifying individual and $8,000 for two or more qualifying individuals.

The credit is subject to a two-part phaseout. Under the first part, the 50% credit rate is reduced, but not below 20%, by one percentage point for each $2,000 (or fraction thereof) of AGI above $125,000. Under the second part, the 20% credit rate is reduced, but not below zero, by one percentage point for each $2,000 (or fraction thereof) of AGI above $400,000. Thus, for taxpayers with AGI between $183,000 and $400,000, the credit rate is 20% and, for taxpayers with AGI above $438,000, the credit is fully phased out.

[ARPA §§ 9631, 9632]

ARPA § 9611
I.R.C. § 24

Under prior law, the child tax credit (CTC) was $2,000 for each qualifying child. A qualifying child was under age 17, could be claimed as a dependent, and was a US citizen or national, or a US resident. The CTC was partially refundable.

For tax years beginning after December 31, 2020, and before January 1, 2022, if the taxpayer (or a spouse filing MFJ) has a principal place of abode in the United States for more than one-half of the tax year or is a bona fide resident of Puerto Rico for the tax year, the age limit is increased to include children who are 17 years old. The credit amount is increased from $2,000 to $3,000 per child ($3,600 for a child who is under age 6).

The existing phaseout limits for the $2,000 credit remain the same (beginning at $400,000 MFJ and $200,000 for all other filers). The expanded credit ($1,000 per child or $1,600 per child under age 6) begins to phase out for taxpayers with MAGI above $150,000 for MFJ and QW, $112,500 for HoH, and $75,000 for other taxpayers. The expanded credit phases out by $50 for each $1,000 (or fraction thereof) above the threshold amount.

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The credit is fully refundable. In July 2021, the IRS began making periodic advance payments of the CTC. The advance payment amount is 50% of the allowed credit, calculated with reference to the taxpayer's MAGI in the preceding tax year (the second preceding tax year if the taxpayer did not file a return in the preceding tax year) and the taxpayer's qualifying children in the preceding tax year (but using age in the current year).

The IRS established an online portal that allows taxpayers to elect not to receive advance payments, and to provide information to the IRS that would be relevant to a modification of the annual advance amount, including information regarding the following:

1. A change in the number of the taxpayer's qualifying children, including the birth of a child
2. A change in the taxpayer's marital status
3. A significant change in the taxpayer's income
4. Any other factor that the IRS may provide

[www.irs.gov/credits-deductions/advance-child-tax-credit-payments-in-2021]

The advance payment is not subject to reduction or offset for certain liabilities or federal taxes.

Reconciliation

In January 2022, the IRS will send taxpayers Letter 6419 to provide the total amount of advance CTC payments that were disbursed in 2021. The advance credit must be reconciled with the allowed credit for the 2021 tax year. Any advance payment will reduce the allowed credit. If the advance payments exceed the allowed credit, the excess increases tax for 2021.

Repayment Protection

There is a safe harbor (repayment protection) that reduces the amount of the excess advance payment that must be repaid. The safe harbor amount begins to phase out if MAGI exceeds $60,000 for MFJ or QW, $50,000 HoH, and $40,000 for other taxpayers. Repayment protection is fully phased out if MAGI equals or exceeds $120,000 for MFJ or QW, $100,000 HoH, and $80,000 for other taxpayers. Repayment protection may be limited if the taxpayer's main home was not in the United States for more than one-half of 2021.

The full repayment protection amount is $2,000, multiplied by the number of qualifying children that the IRS included in determining the IRS's initial estimate of the advance CTC payments, minus the number of qualifying children properly included in determining the allowed CTC on the 2021 tax return.

Example 15.1
Calculating the Repayment Protection

Bella Cohen properly claimed the CTC for three qualifying children on her 2020 tax return but claimed only one qualifying child on her 2021 tax return. The IRS estimated her advance CTC payment based on the three qualifying children. Her 2021 AGI is $46,000 and she files as HoH. She can receive up to $4,000 in repayment protection [$2,000 × (3 − 1)].

Example 15.2
Phaseout of Repayment Protection

Miguel and Carla Garcia filed a joint return in 2020 and properly claimed the CTC for three qualifying children. The IRS estimated their total advance CTC payment based on these qualifying children. In 2021, they had $75,000 MAGI and claimed the CTC for only one qualifying child. Their $75,000 MAGI exceeds the applicable $60,000 MAGI threshold by 25%. Their $4,000 potential full repayment is reduced by 25% to $3,000.

[ARPA § 9611]

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Rev. Proc. 2021-24

Rev. Proc. 2021-24 provides two procedures for individuals who are not otherwise required to file 2020 federal income tax returns to file returns to receive advance child tax credit payments, 2020 recovery rebate credit payments, additional 2020 recovery rebate credit payments, and third-round economic impact payments. These individuals can file simplified returns. They can also file 2020 returns electronically even if they have zero adjusted gross income.

[Rev. Proc. 2021-24, 2021-29 I.R.B. 19]

T.D. 9913
I.R.C. § 24, 152

Final regulations clarify the definition of a *qualifying relative* for purposes of various provisions of the Internal Revenue Code for tax years 2018 through 2025. The provisions of the proposed regulations are adopted without substantive change to provide that the exemption amount, for purposes other than a deduction for a personal or dependency exemption under section 151, is $4,150 for tax year 2018, and for tax years 2019 through 2025, the exemption amount, as adjusted for inflation, is the section 152(d)(1)(B) exemption amount.

The regulations also provide that a payment to a spouse of alimony or separate maintenance is not treated as a payment by the payer spouse for the support of any dependent. Similarly, the distribution of income of an estate or trust to a divorced or legally separated payee spouse is not treated as a payment by the payer spouse for the support of any dependent. These rules do not apply, however, to the extent that the distribution is in satisfaction of the amount or portion of income that, by the terms of a divorce decree, a written separation agreement, or the trust instrument is fixed as payable for the support of the minor children of the payer spouse.

[T.D. 9913]

ARPA §§ 9621, 9622, 9623, 9624
I.R.C. § 32

ARPA expands eligibility for the earned income tax credit (EIC).

No Qualifying Children

For any tax year beginning after December 31, 2020, and before January 1, 2022, the minimum age for the EIC for a taxpayer with no qualifying children is reduced from age 25 to age 19. For a specified student (other than a qualified former foster youth or a qualified homeless youth), the minimum age is reduced to age 24, and for a qualified former foster youth or a qualified homeless youth, it is reduced to age 18.

A specified student is an eligible student who meets the requirements of section 484(a)(1) of the Higher Education Act of 1965 and is carrying at least one-half the normal full-time workload for the course of study the student is pursuing during at least 5 calendar months of the year.

A qualified former foster youth is an individual who attained age 14, was in foster care provided under the supervision or administration of an entity administering (or eligible to administer) a plan under part B or part E of title IV of the Social Security Act (without regard to whether federal assistance was provided with respect to such child under such part E) and gives the administering entity consent to disclose information to the IRS about the status of the individual as a qualified former foster youth. A qualified homeless youth means an individual who certifies, in a manner specified by the IRS, that such individual is either an unaccompanied youth who is a homeless child or youth, or is unaccompanied, at risk of homelessness, and self-supporting. The maximum age for the credit (previously age 65) is eliminated.

The credit and phaseout percentages are increased to 15.3% (formerly 7.65%). The earned income and phaseout amounts are increased from $4,220 to $9,820 and from $5,280 to $11,610, unadjusted for inflation.

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Taxpayers with Qualifying Children

For tax years beginning after December 31, 2020, APRA § 9622 states that taxpayers with qualifying children who fail to meet the identification requirements can claim the EIC for taxpayers without children.

Also, under former law, a married taxpayer could not claim the EIC unless he or she filed a joint return. Under ARPA, a separated spouse who is married but does not file a joint return for the year is considered unmarried if the spouse resides with his or her qualifying child for more than one-half of the tax year, and during the last 6 months of the tax year, does not have the same principal place of abode as the individual's spouse, or has a decree, instrument, or agreement (other than a decree of divorce) described in I.R.C. § 121(d)(3)(C) with respect to the individual's spouse and is not a member of the same household with the individual's spouse by the end of the tax year.

Modification of Disqualified Investment Income Test

ARPA § 9624 raises the investment income limit from $2,200 (adjusted for inflation) to $10,000 (adjusted for inflation for tax years after 2021).

U.S. Possessions

ARPA § 9625 addresses the application of the EIC rules in US possessions.

Temporary Special Rule for Determining Earned Income for Purposes of EIC

Under ARPA § 9626, if the earned income of the taxpayer for the taxpayer's first tax year beginning in 2021 is less than the earned income of the taxpayer for the taxpayer's first tax year beginning in 2019, the taxpayer can elect to calculate the EIC using 2019 income instead of 2021 income. The term *earned income* is defined in I.R.C. § 32(c) as wages, salaries, tips, other employee compensation included in income, and self-employment income. If taxpayers file MFJ, the taxpayer's 2019 earned income includes the earned income of the taxpayer's spouse.

[ARPA §§ 9621, 9622, 9623, 9624]

Notice 2020-66
I.R.C. § 36B

The Treasury Department and the IRS have determined that Medicaid coverage limited to COVID-19 testing and diagnostic services under section 6004(a)(3) of the Families First Act is not minimum essential coverage under a government-sponsored program. Thus, an individual's eligibility for this coverage for one or more months does not prevent those months from qualifying as coverage months for purposes of determining eligibility for the premium tax credit (PTC) under I.R.C. § 36B.

[Notice 2020-66, 2020-40 I.R.B. 785]

T.D. 9912
I.R.C. § 36B

Final regulations clarify that the reduction of the personal exemption deduction to zero for tax years beginning after December 31, 2017, and before January 1, 2026, does not affect an individual taxpayer's ability to claim the PTC. The final regulations adopt the proposed regulations, which clarified that the term *family* means the taxpayer, including both spouses who file a joint return (except for individuals who qualify as a dependent of another taxpayer under section 152), and any other individual for whom the taxpayer is allowed a personal exemption deduction and who the taxpayer properly reports on the taxpayer's income tax return for the tax year. An individual is reported on the taxpayer's income tax return if the individual's name and taxpayer identification number are listed on the taxpayer's Form 1040 series return.

[T.D. 9912]

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ARPA §§ 9661, 9662, 9663
I.R.C. § 36B

ARPA § 9661 expands the PTC for tax years beginning in 2021 and 2022. Taxpayers with household income above 400% of the federal poverty level may be eligible for the credit. ARPA § 9662 suspends the requirement to repay the excess advance PTC for tax year 2020. A taxpayer's excess advance PTC is the amount by which the taxpayer's advance payments of the PTC exceed his or her PTC. Taxpayers with excess APTC for 2020 are not required to file Form 8962, Premium Tax Credit, or report an excess advance premium tax credit repayment on their 2020 Form 1040 or Form 1040-SR, Schedule 2, line 2. ARPA § 9663 adds a special rule to increase eligibility for, and the amount of, the PTC for taxpayers who receive unemployment compensation in 2021.

[ARPA §§ 9661, 9662, 9663]

Deductions

COVIDTRA § 275; Rev. Proc. 2021-15
I.R.C. § 62

COVIDTRA directed the Treasury to issue guidance to clarify that expenses for personal protective equipment, disinfectant, and other supplies to prevent the spread of COVID-19 that were paid or incurred after March 12, 2020, are eligible for the I.R.C. § 62(a)(2)(D)(ii) educator expense deduction. Eligible educators can claim the above-the-line deduction for books, supplies (other than nonathletic supplies for courses of instruction in health or physical education), computer equipment (including related software and services), other equipment, and supplementary materials used by the eligible educator in the classroom.

Rev. Proc. 2021-15 states that eligible educators can deduct $250 ($500 MFJ if both spouses are eligible educators, but not more than $250 each) of unreimbursed expenses paid or incurred after March 12, 2020, for COVID-19 protective items to stop the spread of COVID-19 in the classroom. COVID-19 protective items include, but are not limited to the following:

- Face masks
- Disinfectant for use against COVID-19
- Hand soap
- Hand sanitizer
- Disposable gloves
- Tape, paint, or chalk to guide social distancing
- Physical barriers (for example, clear plexiglass)
- Air purifiers
- Other items recommended by the Centers for Disease Control and Prevention (CDC) to be used for the prevention of the spread of COVID-19

[COVIDTRA § 275; Rev. Proc. 2021-15, 2021-8 I.R.B. 891]

T.D. 9907
I.R.C. §§ 162, 164, 170

Final regulations update the regulations under I.R.C. § 162 to reflect current law regarding the application of section 162 to taxpayers that make payments or transfers for business purposes to entities described in I.R.C. § 170(c). The final regulations provide safe harbors under section 162 to provide certainty with respect to the treatment of payments made by business entities to entities described in section 170(c) and provide a safe harbor under section 164 for payments made to an entity described in section 170(c) by individuals who itemize deductions and receive or expect to receive a state or local tax credit in return. The final regulations also update the application of the quid pro quo principle under section 170 to a donor who receives or expects to receive benefits from a third party.

Payments by Business Entities

The regulations retain the clarifications to Treas. Reg. § 1.162-15(a)(1) and (a)(2) regarding section 162 deductions for business payments to section 170(c) entities, and examples illustrating the rule. Generally, if the taxpayer's payment or transfer bears a direct relationship to its trade or business, and the payment is made with a reasonable expectation of financial return that is equal to the amount of the payment or transfer, the payment

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or transfer may constitute an allowable deduction as a trade or business expense under section 162, rather than a charitable contribution under section 170.

Section 162 Safe Harbor

Treas. Reg. § 1.162-15(a)(3) provides a safe harbor relief for taxpayers that receive a state or local tax credit in return for a cash or cash equivalent payment to charity. If a C corporation makes a payment to or for the use of an entity described in section 170(c) and receives or expects to receive in return a state or local tax credit that reduces a state or local tax imposed on the C corporation, the C corporation may treat the payment as meeting the requirements of an ordinary and necessary business expense for purposes of section 162(a) to the extent of the amount of the credit received or expected to be received. If a specified passthrough entity makes a payment to or for the use of an entity described in section 170(c) and receives or expects to receive in return a state or local tax credit, the specified passthrough entity may treat such payment as an ordinary and necessary business expense for purposes of section 162(a) to the extent of the amount of credit received or expected to be received. The safe harbor for specified passthrough entities does not apply if the credit received or expected to be received reduces a state or local income tax.

Section 164 Safe Harbor

An individual who itemizes deductions and who makes a cash or cash equivalent payment to or for the use of an entity described in section 170(c) in consideration for a state or local tax credit may treat such payment as a payment of state or local tax for purposes of section 164 to the extent that a charitable contribution deduction for the payment is disallowed under Treas. Reg. § 1.170A-1(h)(3). This treatment as payment of a state or local tax is allowed in the tax year in which the payment is made to the extent that the resulting credit is applied, consistent with applicable state or local law, to offset the individual's state or local tax liability for that tax year or the preceding tax year. The payment is still subject to the limitation on the SALT deduction.

Quid Pro Quo Provided by Third Party

The final regulations state that the quid pro quo principle applies regardless of whether the donor expects to receive a benefit from the donee or from a third party. Thus, the source of the consideration is immaterial in determining whether a donor has received or expects to receive a return benefit that reduces its charitable contribution deduction.

[T.D. 9907]

Information Letter 2020-0010
I.R.C. §§ 164, 216

The IRS Office of Chief Counsel states that the limitation for an individual's deduction of state and local taxes under I.R.C. § 164 (the SALT limitation) applies to the deduction under I.R.C. § 216 for a tenant-stockholder's proportionate share of real estate taxes paid or incurred by a cooperative housing corporation.

[Information Letter 2020-0010 (September 25, 2020)]

C.C.A. 2020042015
I.R.C. § 165

The IRS Chief Counsel advised that the amount paid by a daily fantasy sports player to participate in a daily fantasy sports contest constitutes an amount paid for a wagering transaction under I.R.C. § 165(d). Section 165(d) allows a deduction for losses from wagering transactions only to the extent of wagering gains.

[C.C.A. 2020042015 (September 14, 2020)]

TCDTRA §§ 212, 213; CARES Act § 2205
I.R.C. § 170

In 2021, taxpayers who do not itemize deductions can take a $300 ($600 MFJ) above-the-line deduction for cash contributions to qualified charities (not a supporting organization or a donor advised fund). The CARES Act increased charitable contribution limits are extended through 2021.

[TCDTRA §§ 212, 213; CARES Act § 2205]

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Income

COVIDTRA § 277

Students who receive a qualified emergency financial aid grant after March 26, 2020, do not have to include the grant in gross income, and the grant does not reduce the amount of qualified tuition and related expenses for purposes of the American opportunity tax credit and the lifetime learning credit.

[COVIDTRA § 277]

IRS Higher Education Emergency Grants FAQs

Emergency financial aid grants made by a federal agency, state, Indian tribe, higher education institution, or scholarship-granting organization (including a tribal organization) to a student because of an event related to the COVID-19 pandemic are not included in the student's gross income. The IRS issued FAQs on how students and higher-education institutions should report pandemic-related emergency financial aid grants.

[IRS Higher Education Emergency Grants FAQs, www.irs.gov/newsroom/higher-education-emergency-grants-frequently-asked-questions]

IRS Emergency Rental Assistance FAQs

The CAA allows states and political subdivisions, US territories, Indian tribes, and the Department of Hawaiian Home Lands to use certain funds allocated by the Department of the Treasury to provide financial assistance to households to pay rent, utilities, home energy expenses, and other related expenses. ARPA appropriates additional funds to provide emergency rental assistance. The IRS issued FAQs on the exclusion of these payments from gross income.

[IRS Emergency Rental Assistance FAQs, www.irs.gov/newsroom/emergency-rental-assistance-frequently-asked-questions]

ARPA § 9042
I.R.C. § 85

Gross income includes unemployment compensation. However, for any tax year beginning in 2020, if the taxpayer's AGI was less than $150,000, the taxpayer can exclude up to $10,200 unemployment compensation from gross income (up to $10,200 for each spouse filing MFJ). AGI is determined without the inclusion of unemployment compensation, and with the following adjustments:

1. I.R.C. § 86 partial inclusion of social security and tier 1 railroad retirement benefits
2. I.R.C. § 135 exclusion for income from US savings bonds used to pay higher-education tuition and fees
3. I.R.C. § 137 exclusion for amounts received under an adoption assistance program
4. I.R.C. § 219 deduction for retirement savings
5. I.R.C. § 221 student loan interest deduction
6. I.R.C. § 222 deduction for qualified tuition and related expenses
7. I.R.C. § 469 passive activity loss limitation and credits

For taxpayers who filed their 2020 tax return before the enactment of ARPA (March 11, 2020), the IRS announced that it would automatically adjust returns, without the need for filing an amended return. However, if the calculations make the taxpayer newly eligible for additional federal credits and deductions not already included on the original tax return, the taxpayer must file an amended return. For example, the IRS can adjust returns for those taxpayers who claimed the EIC and, because the exclusion changed the income level, may now be eligible for an increase in the EIC and a larger refund. However, if a taxpayer did not originally claim the EIC or other credits and became eligible because the exclusion changed his or her income, the taxpayer must file an amended return.

[ARPA § 9042]

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ARPA § 9675
I.R.C. § 108

ARPA modifies the treatment of student loan discharges after December 31, 2020, and before January 1, 2026. Discharges of the following loans are not included in income:

1. A loan that provided expressly for postsecondary educational expenses, and was made, insured, or guaranteed by a state, territory, or possession of the United States, or the District of Columbia, or any political subdivision thereof; or an eligible educational institution
2. Private education loans
3. Certain loans that are discharged pursuant to a program that is designed to encourage students to serve in occupations with unmet needs or in areas with unmet needs and under which the services provided by the students (or former students) are for or under the direction of a government unit or a section 501(c)(3) organization
4. Certain loans made by an educational organization or a tax-exempt organization to refinance a loan to an individual to assist the individual in attending the educational organization

A discharge of a loan made by an educational institution or a private education lender is not excluded from income if the discharge is because of the performance of services.

[ARPA § 9675]

Notice 2021-26
I.R.C. § 129

I.R.C. § 129 provides an exclusion from gross income of an employee for amounts paid or incurred by the employer for dependent care assistance benefits provided to the employee if the assistance is furnished pursuant to a dependent care assistance program. Section 129(a)(2) limits the benefits that may be excluded with respect to dependent care assistance services provided during the tax year. For 2020, the exclusion could not exceed $5,000, or $2,500 MFS. TCDA § 214(a) and (b) allow dependent care assistance plans (DCAPs) to carry over unused benefits from a plan year ending in 2020 to a plan year ending in 2021 and from a plan year ending in 2021 to a plan year ending in 2022. Alternatively, the plan can take a 12-month extension of its 2020 or 2021 claims period for unused benefits remaining in the DCAP.

This notice addresses the taxation of dependent care benefits, provided through a dependent care assistance program, available in tax years ending in 2021 and 2022 due to the application of either the carryover or the extension of a claims period under TCDRA § 214. The notice clarifies that if these dependent care benefits would have been excluded from income if used in the preceding tax year (2020 or 2021, as applicable), they will remain excludable from gross income and are not wages of the employee for the tax years ending in 2021 and 2022. In addition, the notice clarifies that these benefits will not be taken into account for purposes of the application of the limits under section 129 to other dependent care benefits available for tax years ending in 2021 and 2022.

[Notice 2021-26]

ARPA § 9632
I.R.C. § 129

ARPA increases the I.R.C. § 129 exclusion for employer provided dependent care assistance. For any tax year beginning after December 31, 2020, and before January 1, 2022, the $2,500 limit ($5,250 MFJ) is increased to $5,000 ($10,500 MFJ).

[ARPA § 9632]

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ARPA § 9601
I.R.C. § 6428B

ARPA authorized a third round of economic impact payments and inserts new I.R.C. § 6428B. Under ARPA, an eligible individual is allowed a credit for the first tax year beginning in 2021. The credit is $1,400 ($2,800 for MFJ) and $1,400 for each dependent (as defined by I.R.C. § 152) of the taxpayer for that tax year. An eligible individual is any individual who is not a nonresident alien, not a dependent of another taxpayer, and not an estate or trust. The credit starts phasing out for a taxpayer whose AGI exceeds $75,000 ($112,500 HoH and $150,000 MFJ) and is fully phased out over $80,000 AGI ($120,000 HoH and $160,000 MFJ).

To claim the credit, the taxpayer must include a valid identification number for the taxpayer and any dependents on the return. If nonmilitary taxpayers file MFJ and include only one identification number, they can claim a $1,400 credit. A valid identification number is a social security number issued on or before the due date for filing the return. For a dependent, a valid identification number also includes an adoption taxpayer identification number of such dependent.

The credit is refundable, and each taxpayer who was an eligible taxpayer for the 2019 tax year is treated as having made a tax payment equal to the advance refund amount (the amount that would have been allowed as a credit if the new law applied) for 2019 and the IRS is directed to immediately refund or credit any overpayment (with no interest) attributable to the credit. If the taxpayer has already filed a 2020 return and that return has been processed, then the credit is treated as an overpayment for the 2020 tax year. If the taxpayer has not filed a 2019 or 2020 tax return, the IRS is directed to use other available information to determine the amount of the advance refund.

The refund is not subject to reduction or offset for other certain debts or federal taxes owed that would otherwise be subject to levy or collection.

[ARPA § 9601]

IRS Issues

Cybersecurity

I.R. 2020-178

A text scam tricks people into disclosing bank account information under the guise of receiving the $1,200 economic impact payment. The scam text message states, "You have received a direct deposit of $1,200 from COVID-19 TREAS FUND. Further action is required to accept this payment into your account." This fake text message directs recipients to a fraudulent website that impersonates the IRS.gov Get My Payment website. The website then requests personal and financial account information.

[I.R. 2020-178]

Virtual Currency

C.C.A. 202003501
I.R.C. § 61

The IRS chief counsel advises that a taxpayer who receives convertible virtual currency in exchange for performing a microtask through a crowdsourcing platform has received consideration in exchange for performing a service, and the convertible virtual currency received is taxable as ordinary income. Virtual currency that has an equivalent value in real currency, or acts as a substitute for real currency, such as Bitcoin, is referred to as convertible virtual currency and is considered property for federal income tax purposes. Accordingly, general tax principles applicable to property transactions apply to transactions involving convertible virtual currency.

A taxpayer who performs a task through a crowdsourcing platform, including a microtask, has performed a service for the party that requested the task with the expectation that he or she will receive compensation. If the taxpayer receives convertible virtual currency for performing the task, regardless of the value and the manner

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in which it is received, then the taxpayer has been compensated with property. The convertible virtual currency received must be reported on the taxpayer's income tax return as ordinary income and may be subject to self-employment tax.

[C.C.A. 202035011 (June 29, 2020)]

Payroll Taxes

COVIDTRA § 274; Notice 2020-65; Notice 2021-11 I.R.C. § 3102

Notice 2020-65 provides guidance implementing the presidential memorandum issued on August 8, 2020, allowing employers to defer withholding and payment of the employee's portion of the social security tax if the employee's wages are below a certain amount. The notice states that an affected taxpayer must withhold and pay the total applicable taxes that he or she deferred under the Notice by April 30, 2021, or interest, penalties, and additions to tax will begin to accrue on May 1, 2021.

COVIDTRA § 274 extends this date to December 31, 2021. IRS guidance directs employers to report only the social security tax actually withheld from 2020 wages on Form W-2. Employers must file a Form W-2c when the 2020 social security tax is withheld in 2021.

Notice 2021-11 states that employers must withhold and pay the total deferred employee share of social security tax ratably from wages paid to the employee between January 1, 2021, and December 31, 2021. Interest, penalties, and additions to tax will begin to accrue on January 1, 2022. If necessary, the employer can arrange to otherwise collect the total deferred taxes from the employee.

[COVIDTRA § 274; Notice 2020-65, 2020-38 I.R.B. 567; Notice 2021-11, 2021-6 I.R.B. 827]

COVID Tax Tip 2021-96

Section 2302 of the CARES Act allowed employers to temporarily defer the deposit and payment of the employer's portion of social security and RRTA payroll taxes (6.2%). Self-employed individuals could defer payment of the equivalent of the employer's social security portion of Self-Employed Contributions Act (SECA) taxes. The deferral was available from March 27, 2020, through December 31, 2020.

Taxpayers must deposit 50% of the deferred tax by December 31, 2021, and the remaining 50% is due December 31, 2022. In COVID Tax Tip 2021-96, the IRS explains that self-employed individuals and household employers should make payments of deferred social security taxes through the Electronic Federal Tax Payment System or by credit or debit card, money order, or a check. The payments should be separate from other tax payments, and the taxpayer should designate the payment as "deferred Social Security tax."

Tax Tip 2021-96 also explains that a taxpayer who cannot pay the full deferred tax should pay as much as possible by the deadlines. The IRS will send the taxpayer a balance due notice. Taxpayers should follow instructions on the notice to make a payment or apply for a payment plan.

[COVID Tax Tip 2021-96]

T.D. 9924 I.R.C. § 3402

Final regulations provide guidance for employers concerning income tax withholding from employees' wages. These final regulations concern the amount of federal income tax employers withhold from employees' wages, implement changes made by the TCJA, and reflect the redesigned Form W-4.

[T.D. 9924]

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Retirement, Savings, and Investing

ABLE Accounts

T.D. 9923
I.R.C. § 529A

Final regulations provide guidance on the Stephen Beck Jr. Achieving a Better Life Experience Act of 2014 (ABLE Act). These final regulations provide guidance on the requirements that a program established and maintained by a state, or agency or instrumentality thereof, must satisfy to be considered a qualified ABLE program under section 529A. They also address the requirements for establishing an ABLE account; for qualifying as an eligible individual and thus a qualified designated beneficiary of an ABLE account; and for contributions to an ABLE account, including the limitations on the amount and investment of such contributions.

The final regulations also provide rules regarding changes in the designated beneficiary of an ABLE account, and rollovers and program-to-program transfers from one ABLE account to another. In addition, the final regulations provide guidance on the gift and GST tax consequences of contributions to an ABLE account, as well as on the federal income, gift, and estate tax consequences of distributions from, and changes in the designated beneficiary of, an ABLE account (discussed later). Finally, these final regulations provide guidance on the recordkeeping and reporting requirements of a qualified ABLE program.

Gift and GST Taxes

The final regulations provide that the designated beneficiary is the owner of the entire account, and the gift and GST tax properly applies to the entire account when there is a change of designated beneficiary. However, those taxes are inapplicable if the new designated beneficiary is an eligible individual and a sibling of the former designated beneficiary. The final regulations allow a qualified ABLE program to permit a successor designated beneficiary to be named during the lifetime of the designated beneficiary that will take effect upon the death of the designated beneficiary. The designation must be made before the designated beneficiary's death. If no successor designated beneficiary is named, the assets in the ABLE account are payable to the estate of the deceased designated beneficiary.

[T.D. 9923]

IRAs

IRS Retirement Plans FAQs regarding Loans
I.R.C. §§ 72, 408

In a series of frequently asked questions (FAQs) regarding IRA loans, the IRS reminds taxpayers that loans are not permitted from IRAs or from IRA-based plans such as SEPs, SARSEPs, and SIMPLE IRA plans. Loans are only allowed from qualified plans that satisfy the requirements of I.R.C. § 401(a), from annuity plans that satisfy the requirements of I.R.C. § 403(a) or 403(b), and from governmental plans [I.R.C. § 72(p)(4)]. If the owner of an IRA borrows from the IRA, the IRA is no longer an IRA, and the value of the entire IRA is included in the owner's income [I.R.C. § 408(e)(2) and (3)]. If the owner of an IRA pledges part of the IRA as collateral, the part of the IRA that is pledged is treated as distributed [I.R.C. § 408(e)(4)].

[IRS Retirement Plans FAQs regarding Loans, www.irs.gov/retirement-plans/retirement-plans-faqs-regarding-loans#:~:text=A]

Notice 2020-68
SECURE Act

This notice provides questions and answers on certain provisions of Division O of the Further Consolidated Appropriations Act, 2020, Pub. L. No. 116-94, known as the Setting Every Community Up for Retirement Enhancement Act of 2019 (the SECURE Act), and on section 104 of Division M of the Further Consolidated Appropriations Act, 2020, known as the Bipartisan American Miners Act of 2019 (Miners Act). Specifically, this notice addresses issues under the following sections of the SECURE Act: section 105 (small employer automatic enrollment credit), section 107 (repeal of maximum age for traditional IRA contributions, discussed later), section 112 [participation of long-term, part-time employees in

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section 401(k) plans], section 113 (qualified birth or adoption distributions), and section 116 (allowing excluded difficulty of care payments to be taken into account as compensation for purposes of determining certain retirement contribution limitations). This notice also addresses section 104 of the Miners Act (reduction in minimum age for in-service distributions) and provides guidance on deadlines for plan amendments.

Repeal of Maximum Age for IRA Contributions

The SECURE Act repeals the maximum age for contributions to an IRA and provides that the excludable amount of qualified charitable distributions for a tax year is reduced by the aggregate amount of IRA contributions deducted for the tax year and any earlier tax years in which the individual was age 70½ or older by the last day of the year (post-age 70½ contributions). The excludable amount of qualified charitable distributions for a tax year is not reduced by the amount of post-age 70½ contributions that caused a reduction in the excludable amount of qualified charitable distributions for earlier tax years. FAQ B-5 provides the following example:

Example 15.3
Limit on Excludable Qualified Charitable Distributions

Corey Hall turned age 70½ in 2019. He deducted $5,000 for IRA contributions in 2020, $5,000 in 2021, and makes no contribution for 2022. Corey made no qualified charitable distributions for 2020 and made qualified charitable distributions of $6,000 for 2021 and $6,500 for 2022. The excludable amount of qualified charitable distributions for 2021 is the $6,000 qualified charitable distributions reduced by the $10,000 aggregate amount of post-age 70½ contributions for 2021 and earlier tax years. Corey cannot exclude any qualified charitable distributions for 2021 [$6,000 − $10,000 = ($4,000)].

The excludable amount of the qualified charitable distributions for 2022 is the $6,500 of qualified charitable distributions reduced by the portion of the $10,000 aggregate amount of post-age 70½ contributions deducted that did not reduce the excludable portion of the qualified charitable distributions for earlier tax years. Thus, $6,000 of the aggregate amount of post-age 70½ contributions deducted does not apply for 2022 because that amount has reduced the excludable amount of qualified charitable distributions for 2021. The remaining $4,000 of the aggregate amount of post-age 70½ contributions deducted reduces the excludable amount of any qualified charitable distributions for subsequent tax years. Thus, Corey's excludable amount of the qualified charitable distributions for 2022 is $2,500 ($6,500 − $4,000). Because the $4,000 amount reduced the excludable amount of qualified charitable distributions for 2022, that $4,000 amount does not apply again in later years, and no amount of post-age 70½ contributions remains to reduce the excludable amount of qualified charitable distributions for subsequent tax years.

[Notice 2020-68, 2020-38 I.R.B. 567]

Qualified Opportunity Funds

IR-2020-274
I.R.C. §§ 1400Z-1, 1400Z-2

The IRS started sending letters to taxpayers that may need to take additional actions related to qualified opportunity funds (QOFs). Taxpayers who attached or indicated they filed a Form 8996, Qualified Opportunity Fund, may receive Letter 6250, Self-certifying as Qualified Opportunity Fund (QOF). This letter lets them know that if they intended to self-certify as a QOF, they may need to take additional action to meet the annual self-certification requirement. Additionally, taxpayers may receive Letter 6251, Reporting Qualified Opportunity Fund (QOF) Investments, notifying them they may not have properly followed the instructions for Form 8949, Sales and other Dispositions of Capital Assets, or do not appear to have an eligible gain that would enable them to make a valid deferral election for gains invested in a QOF.

[IR-2020-274]

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Rollovers

Rev. Proc. 2020-46
I.R.C. §§ 402, 408

This revenue procedure modifies and updates Rev. Proc. 2016-47, 2016-37 I.R.B. 346, which provides a list of reasons for a taxpayer to self-certify eligibility for a waiver of the 60-day rollover requirement under certain eligible retirement plans. This revenue procedure adds a distribution to a state unclaimed property fund to the list of reasons.

[Rev. Proc. 2020-46, 2020-45 I.R.B. 995]

Medical Savings and Reimbursement Plans

TCDTRA § 214
I.R.C. §§ 105, 106

The temporary flexible spending account (FSA) rule does the following:

- Allows plans to permit health and dependent care flexible spending arrangements (FSAs) to carry over unused benefits up to the full annual amount from 2020 to 2021 and 2021 to 2022
- Allows plans to permit a 12-month grace period for unused benefits or contributions in health and dependent care FSAs for plan years ending in 2020 or 2021
- Allows plans to extend the maximum age of eligible dependents from 12 to 13 for dependent care FSAs for the 2020 plan year and unused amounts from the 2020 plan year carried over into the 2021 plan year
- Allows plans to permit a prospective change in election amounts for health and dependent care FSAs for plan years ending in 2021

[TCDTRA § 214]

Notice 2021-15
I.R.C. §§ 105, 106

Notice 2021-15 provides guidance on the application of TCDTRA § 214. In addition, the notice provides that a section 125 cafeteria plan may permit employees who are eligible to make salary reduction contributions under the plan to, with respect to employer-sponsored health coverage,

- make a new election on a prospective basis, if the employee initially declined to elect employer-sponsored health coverage;
- revoke an existing election and make a new election to enroll in different health coverage sponsored by the same employer on a prospective basis; and
- revoke an existing election on a prospective basis, provided that the employee attests in writing that the employee is enrolled, or immediately will enroll, in other health coverage not sponsored by the employer.

The notice also provides relief with respect to the effective date of amendments to section 125 cafeteria plans to implement the expansion under the CARES Act of allowed expenses for health FSAs and health reimbursement arrangements to include over-the-counter drugs without prescriptions and menstrual care products.

[Notice 2021-15, 2021-10 I.R.B. 898]

T.D. 9949
I.R.C. §§ 105, 4980H

Final regulations clarify the application of the employer shared responsibility provisions and certain nondiscrimination rules to health reimbursement arrangements (HRAs) and other account-based group health plans integrated with individual health insurance coverage or Medicare (individual coverage HRAs). The regulations also provide safe harbors for the application of those provisions to individual coverage HRAs.

[T.D. 9949]

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Tax Accounting

T.D. 9942
I.R.C. §§ 263A, 448, 460, 471

The TCJA increased the gross receipts test amount under I.R.C. § 448(c) to $25,000,000, adjusted for inflation, for eligibility to use the cash method and also exempting taxpayers who meet the section 448(c) gross receipts test from the UNICAP rules under I.R.C. § 263A; requirement to use the percentage-of-completion method under I.R.C. § 460 [provided the other requirements of section 460(e) are satisfied]; and the requirement to take inventories under I.R.C. § 471(a) if inventory is treated as nonincidental materials and supplies, or if the method of accounting for inventory conforms with the method reflected on the applicable financial statement (AFS), or if the taxpayer does not have an AFS, books and records prepared in accordance with their accounting procedure. Final regulations implement these simplified tax accounting provisions for certain businesses having average annual gross receipts that do not exceed $26,000,000 (in 2021).

[T.D. 9942]

Tax Practice

T.D. 9950
I.R.C. §§ 165, 7508A

The IRS and Treasury issued final regulations relating to the new mandatory 60-day postponement of certain time-sensitive tax-related deadlines because of a federally declared disaster. The final regulations also clarify the definition of *federally declared disaster*. These final regulations apply to individuals who reside in or were killed or injured in a disaster area, businesses that have a principal place of business in a disaster area, relief workers who provide assistance in a disaster area, or any taxpayer whose tax records necessary to meet a tax deadline are located in a disaster area.

Section 205 of the TCDTRA added I.R.C. § 7508A(d), which provides qualified taxpayers with a mandatory 60-day extension of certain time-sensitive tax deadlines due to a federally declared disaster. The final regulations provide, in general, that the mandatory 60-day postponement period begins on the earliest incident date specified in a disaster declaration for a federally declared disaster and ends on the date that is 60 days after the latest incident date specified in the disaster declaration. If there is a federally declared disaster that does not specify an incident date, there is no mandatory postponement period under section 7508A(d). The regulations provide several examples showing how to calculate the extension.

The final regulations define a *federally declared disaster* as any disaster subsequently determined by the president of the United States to warrant assistance by the federal government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act (Stafford Act). A federally declared disaster includes both a major disaster declared under section 401 of the Stafford Act and an emergency declared under section 501 of the Stafford Act.

[T.D. 9950]

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Deductions

T.D. 9918
I.R.C. §§ 67, 142

Final regulations clarify that the following deductions allowed to an estate or nongrantor trust are not miscellaneous itemized deductions:

- Costs paid or incurred in connection with the administration of an estate or nongrantor trust that would not have been incurred if the property were not held in the estate or trust
- The personal exemption of an estate or nongrantor trust
- The distribution deduction for trusts distributing current income
- The distribution deduction for estates and trusts accumulating income

Therefore, these deductions are not affected by the suspension of the deductibility of miscellaneous itemized deductions for tax years beginning after December 31, 2017, and before January 1, 2026.

The final regulations also provide guidance on determining the character, amount, and allocation of deductions in excess of gross income succeeded to by a beneficiary on the termination of an estate or nongrantor trust.
[T.D. 9918]

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TABLE OF EXPIRATION DATES

This section lists tax provisions that expired in 2021, will expire in 2022 to 2029, or have recently been made permanent. **Figure 15.1** is based on a list prepared by the staff of the Joint Committee on Taxation.

Certain provisions terminate on dates that refer to a taxpayer's tax year and not a calendar year. For these provisions, the expiration dates listed in this document apply with respect to calendar-year taxpayers. The expiration dates of such provisions may differ, however, with respect to fiscal-year taxpayers or taxpayers with short tax years [LIST OF EXPIRING FEDERAL TAX PROVISIONS 2021-2029, January 27, 2021, JCX-1-21].

The first column of Figure 15.1 lists the Internal Revenue Code section for each provision, in numerical order. The second column briefly describes the provision. The last column reports the date the provision expired or will expire, or says "None" if there is no sunset date.

FIGURE 15.1 Expiration Dates of Tax Provisions

I.R.C. Section	Description	Expiration Date
1(j)	Modification of individual income tax rates	2025
21, 129	Enhanced child and dependent care credit and exclusion	2021
24	Child tax credit: Increased credit amount, increased refundable amount, reduced earned income threshold, modification of identification requirements	2025
24	Child tax credit: Increased age limit, increased credit amount, fully refundable	2021
25B	ABLE account contributions eligible for saver's credit	2025
25C	Credit for nonbusiness energy property	2021
25D	Credit for residential energy property	2023
30B	Alternative motor vehicle credit for qualified fuel cell motor vehicles	2021
30C	Alternative fuel vehicle refueling property credit	2021
30D	Qualified plug-in electric drive motor vehicle credit for two-wheeled vehicles	2021
32	Earned income tax credit: Expanded eligibility and amounts	2021
35(b)	Health coverage tax credit	2021
40(b)(6)	Second-generation biofuel producer credit	2021
40A(g)	Income tax credits for biodiesel fuel, biodiesel used to produce a qualified mixture, and small agri-biodiesel producers	2022
40A(g)	Income tax credits for renewable diesel fuel and renewable diesel used to produce a qualified mixture	2022
45(d), 48(a)(5)	Beginning of construction date for wind renewable power facilities	2021
45(e)(10)	Credit for production of Indian coal	2021
45A	Indian employment tax credit	2021
45D	New markets tax credit	2025
45G(a)	Railroad track maintenance credit (50% rate)	2022
45L	Credit for constructing new energy-efficient homes	2021
45N	Mine rescue team training credit	2021
45S	Employer credit for paid family and medical leave	2025
48(a)(2)	Beginning of construction date for increased credit for business solar energy property	2023

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I.R.C. Section	Description	Expiration Date
48(a)(3)(A)	Geothermal heat pump, heat and power property, and small wind property credit	2023
48(a)(3)(A)	Credit for hybrid solar lighting system property	2023
48(c)(1)(D)	Credit for qualified fuel cell and stationary microturbine power plant property	2023
51	Work opportunity tax credit	2025
55	Increase in exemption amount and phaseout threshold of individual AMT	2025
63	Increase in standard deduction for individuals	2025
67(g)	Suspension of miscellaneous itemized deduction	2025
68(f)	Suspension of limitation on itemized deductions	2025
108	COD income exclusion for discharge of principal residence debt	2025
108(f)(5)	Tax exemption for student loan discharges because of death or disability	2025
112	Treatment of certain individuals performing services in the Sinai Peninsula of Egypt	2025
127	Exclusion for certain employer payments of student loans	2025
132(f)(8)	Suspension of exclusion for reimbursement of bicycle commuting	2025
132(g)(2)	Suspension of exclusion for moving expense reimbursement	2025
139B	Exclusions for qualified state or local tax benefits and qualified reimbursement payments provided to members of qualified volunteer emergency response organizations and qualified reimbursements	None
151(d)(5)	Suspension of deduction for personal exemptions	2025
163(h)(3)(E)	Mortgage insurance premium deduction as qualified residence interest	2021
163(h)(3)(F)	Limitation on deduction for qualified residence interest; suspension of deduction for home equity interest	2025
163(j)(8)	Computation of adjusted taxable income without regard to any deduction allowable for depreciation, amortization, or depletion for purposes of the limitation on business interest	2021
164(b)(6)	Limitation on deduction for state, local, etc., taxes	2025
165(h)	Personal casualty losses limited to federally declared disaster areas	2025
165(d)	Modification of rules relating to computation of wagering losses	2025
168(e)(3)(A)	3-year depreciation for racehorses 2 years old or younger	2021
168(e)(3)(B) and 48	5-year cost recovery for certain energy property	2023
168(i)(15)(D)	7-year recovery period for motorsports entertainment complexes	2025
168(j)	Accelerated depreciation for Indian reservation property	2021
168(k), 460	Additional first-year depreciation (bonus depreciation) and expansion of definition of eligible property to include used property	2026/2027
168(k)(5)	Election of additional depreciation for certain plants bearing fruits and nuts	2026
170(b)(1)(G)	Increased percentage limitation on cash contributions to public charities	2025
170(p)	Charitable contribution deductible by non-itemizers	2021
179D(h)	Energy-efficient commercial buildings deduction	None
181	Special expensing rules for film and television productions	2025
199A	Qualified business income deduction	2025
213(f)	7.5%-of-adjusted-gross-income (AGI) floor for individuals age 65 and older for medical expenses	None
217(k)	Suspension of deduction for moving expenses	2025

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I.R.C. Section	Description	Expiration Date
263A(d)(2)	Expensing of certain costs of replanting citrus plants lost by reason of casualty	12/22/2027
274	100% deduction for business meal food and beverage expenses, including any carryout or delivery meals, provided by a restaurant	2022
274(o)	Deductibility of employer de minimis meals and related eating facility, and meals for the convenience of the employer	2025
420	Transfer of excess pension assets to retiree health and life insurance accounts	2025
461(l)	Limitation on excess business losses of noncorporate taxpayers	2025
529	Rollovers from qualified tuition programs to ABLE accounts	2025
529A	Increased contributions limit for ABLE accounts	2025
954(c)(6)	Look-through treatment of payments between related controlled foreign corporations under the foreign personal holding company rules	2025
1391, 1394, 1396, 1397	Empowerment zone tax incentives	2025
1400Z	Election to invest capital gains in an opportunity zone	2026
2010	Increase in estate and gift tax exemption	2025
3131	Payroll credit for paid sick leave	2021
3132	Payroll credit for paid family leave	2021
3134	Employee retention and rehiring tax credit	2021
4041, 4081	All but 4.3¢ per gallon of the taxes on highway gasoline, diesel fuel, kerosene, and alternative fuels	9/30/2022
4041	Reduced rate of tax on partially exempt methanol or ethanol fuel	9/30/2022
4043	Surtax on fuel used in aircraft in a fractional ownership program	9/30/2023
4051	Tax on retail sale of heavy highway vehicles	9/30/2022
4071	Tax on heavy truck tires	9/30/2022
4041, 4042, 4081	Leaking Underground Storage Tank Trust Fund financing rate	9/30/2022
4081, 4083	All but 4.3¢ per gallon of taxes on noncommercial aviation kerosene and noncommercial aviation gasoline	9/30/2023
4121	Black Lung Disability Trust Fund: Increase in amount of excise tax on coal	2021
4261	Domestic and international air passenger ticket taxes and ticket tax exemption for aircraft in fractional ownership aircraft programs	9/30/2023
4271	Air cargo tax	9/30/2023
4375	Specified health insurance policy fee	9/30/2029
4376	Self-insured health plan fee	9/30/2029
4481	Annual use tax on heavy highway vehicles	9/30/2023
4611	Oil Spill Liability Trust Fund financing rate	2025
5001, 5041, 5051	Reduction of excise taxes for beer, wine, and distilled spirits	None
6426, 6427	Excise tax credits and outlay payments for alternative fuels and alternative fuel mixtures	2021
7652(f)	Temporary increase in limit on excise tax revenues on distilled spirits (from $10.50 to $13.25 per proof gallon) to Puerto Rico and the Virgin Islands	2021
Pub. L. No. 109-432, § 119*	American Samoa economic development credit	2021

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I.R.C. Section	Description	Expiration Date
Pub. L. No. 116-136, as amended, § 2205*	Modification of limitation on charitable contributions	2021
Pub. L. No. 116-260, § 214*	Special rule for health and dependent care flexible spending arrangements	2021
4041	Reduced rate of tax on partially exempt methanol or ethanol fuel	9/30/2022
4043	Surtax on fuel used in aircraft in a fractional ownership program	9/30/2023
4051	Tax on retail sale of heavy highway vehicles	9/30/2022
4071	Tax on heavy truck tires	9/30/2022
4041, 4042, 4081	Leaking Underground Storage Tank Trust Fund financing rate	9/30/2022
4081, 4083	All but 4.3¢ per gallon of taxes on noncommercial aviation kerosene and noncommercial aviation gasoline	9/30/2023
4121	Black Lung Disability Trust Fund: Increase in amount of excise tax on coal	2020
4261	Domestic and international air passenger ticket taxes and ticket tax exemption for aircraft in fractional ownership aircraft programs	9/20/2023
4271	Air cargo tax	9/30/2023
4375	Specified health insurance policy fee	9/30/2029
4376	Self-insured health plan fee	9/30/2029
4481	Annual use tax on heavy highway vehicles	9/30/2023
4611	Oil Spill Liability Trust Fund financing rate	2020
6426, 6427	Excise tax credits and outlay payments for alternative fuels and alternative fuel mixtures	2020
7652(f)	Temporary increase in limit on excise tax revenues on distilled spirits (from $10.50 to $13.25 per proof gallon) to Puerto Rico and the Virgin Islands	2021
Pub. L. No. 109-432, § 119*	American Samoa economic development credit	2020
Pub. L. No. 116-136, as amended, § 2205*	Modification of limitation on charitable contributions	2021
Pub. L. No. 116-260, § 214*	Special rule for health and dependent care flexible spending arrangements	2021

*This provision was not included in the Internal Revenue Code.

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Commissioner v. Groetzinger, 480 U.S. 23 (1987)

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