FEDERAL TAX

FEDERAL TAXATION STUDY HINTS

Over the past several exam cycles we've seen students pass Evidence and not pass Tax; with 40% of the 2021 exam devoted to this area, Federal Taxation (sometimes referred to as Substantive Tax) can make or break your study and test efforts. Expect to answer questions on various concepts including gross income, basic tax topics, depreciation, corporations, recent Tax Court or Supreme Court cases and decisions, and recent tax law changes for the year of the exam. Be able to handle calculations related to real estate transactions, installment sales, corporations, partnerships and others that are commonly tested. A copy of the Internal Revenue Code, or selected portions of it (depending on whether the exam is given remotely or in person), is provided for use during the exam, but you don't have time to look up very much and you shouldn't rely on the 'open book' nature of this exam being useful.

In 2000 I studied tax using a Gleim book entitled <u>Federal Tax Exam Questions and Explanations</u> (available online at gleim.com or at other bookstores). I also found other useful income tax study guides from law school bookstores. The Gleim book is particularly helpful with questions on the left side and the answers on the right; the answers also cite IRC sections for further study as needed. Flash cards allowed for repetitive study of relevant code sections and cases and I answered prior exam questions using current tax law, as you will find in this text.

Using a CD-ROM from a research service (yes, it was that long ago), I opened head notes on every Tax Court and Supreme Court case from July 1998 through July 2000 (assuming a 2-3-month lead time necessary to write the current year's exam) looking for recurring issues as well as those issues where appeals courts resolving the issues differently – this can be done more easily now using ustaxcourt.gov. The Tax Court must follow precedent established by the Appeals Circuit – if the 8th Circuit treats an issue differently than the 3rd and 9th Circuits, the matter may end up before the Supreme Court for a decision. Questions that look much too difficult to be true are likely from a case that occurred near the time of the exam. Although the party's name does not appear in the question, the fact pattern will be unique.

Repetition of exam questions can occur in this area, but with constant changes in tax law, prior exams with answers valid for that year should not be the sole source of study. Anticipate seeing estate and gift questions along with questions that require that you state the amount of gross amount in various scenarios, which can test large areas of tax law in just a few minutes. Be able to discuss cash vs accrual accounting methods and know terms like cash equivalence and economic performance. Be prepared to handle questions regarding tax consequences of transactions for partners and partnerships and shareholders and corporations.

AUTHOR'S CAVEAT

The purpose of this material is to assist the tax professional in preparing to take the written United States Tax Court Admissions Exam for Non-Attorneys and is intended to be a broad look at current tax law. It is not intended to be technically comprehensive, and as such, the material is not adequate, nor is it intended to be, for use as the sole research source of tax law to utilize in your practice or as a substitute for your own research. To make the material more understandable to the reader, only one code or regulation reference is generally provided for each section. Use that reference to guide you to further research if appropriate.

HIGHLIGHTS OF NEW TAX LAWS

SECURE 2.0 ACT

1. Automatic enrollment into 401(k) or (403(b) plan beginning plan years after December 31, 2024, for employers with 10 or more employees and in existence at least three years.

2. Part-time employee eligibility after two consecutive years of service with 500 hours.

3. Starter Plans with limited salary deferrals that meet discrimination testing even if the employees opt out.

4. Increased tax credits for starting a plan.

5. Individuals turning 72 in 2013 start RMD at age 75. Those reaching age 74 after December 31, 2032 begin RMD at age 75.

6. Catch-up contribution for employer plans increased to $10,000 for tax years beginning after 2024 for individuals 60-63 years old. IRA catch-up contributions will be indexed for inflation for taxpayers over age 50.

7. An IRA account which loses exempt status due to a prohibited transaction will cause all IRAs owned by the individual to lose exempt status.

8. The excise tax for failure to take RMD is reduced to 25% for tax years beginning after 2023.

9. Student debt loan repayment can be treated as an employee’s salary deferral to a 401(k) or 403(b).

10. Beginning in 2024, 529 plans can be converted into Roth IRAs if the 529 plan was in existence 15 years, and the amount transferred does not exceed the total amount contributed to the 529 plan in the most recent five years, is also limited to the annual amount allowed as a Roth IRA contribution and is also limited to $35,000.

11. Permanently creates an exception for the 10% early withdrawal effective December 27,2020, if the individual withdraws no more than $22,000, their principal place of

residence is in federally declared disaster area, and sustains an economic loss by reason of the disaster.

12. Creates new 10% early withdrawal penalty exceptions for emergency expense distributions, terminal illness distributions, and domestic abuse distributions.

INFLATION REDUCTION ACT

1. Created and enhanced a large number of new individual and business credits related to energy efficiency

2. Doubled the amount an election to apply the R&D Credit under §41 to be applied against an employer's payroll tax liability rather than income tax, from $250,000 to $500,000.

3. Extended the §461(l) loss limitation for individuals to tax year 2028.

4. Corporate Alternative Minimum Tax is reinstated for corporations with a three-year average of annual financial statement income of more than $1 billion ($100 million if owned by foreign corporations). The tax is 15% of "book" income.

5. A 1% excise tax is imposed an companies repurchasing their own stock from investors. Exceptions apply to buybacks of less than $1 million, repurchases connected to retirement savings plans and stock ownership plans, transactions from RICs and RITS, repurchases taxed as dividends under §302, and transactions part of a nontaxable corporate reorganization under §368.

TAXPAYER FIRST ACT

1. Small taxpayers must receive access to the non-privileged case file no later than 10 days prior to the Appeals conference. A small taxpayer is one with adjusted gross income of $400,000 or less or gross receipts of $5,000,000 or less.

2. If the IRS denies Appeals review to a taxpayer who receives a notice of deficiency, then the taxpayer can protest the decision to deny access to the IRS Appeals Office.

3. There will be a multi-year effort to increase the customer-service level of the IRS so that the IRS is on par with private sector best practices.

4. The Tax Court will review innocent spouse cases de novo based on the administrative record established at the time of the determination and any additional newly discovered or previously unavailable evidence. **Know this for 2025 exam!**

5. There is a time limit for a taxpayer to request §6015(f) equitable relief. If the tax is unpaid, then the taxpayer must submit it prior to expiration of the Collection Statute of Limitations (CSOL). If the tax is paid, then the taxpayer must submit it prior to expiration of the Refund Statute of Limitations (RSOL). **Know this for 2025 exam!**

6. Two categories of taxpayers are ineligible to have tax debts assigned to private debt collectors: substantially all income is from Social Security disability or SSI or the most recent tax return shows adjusted gross income of 200% percent or less of the federal poverty line.

7. The IRS must provide a 45-day notice prior to beginning of third-party notice contact period, which cannot be greater than 1 year. The IRS can issue multiple notices with respect to the same tax liability, resulting in an aggregate period that exceed 1 year.

8. Over the next 5 years, the IRS will phase in a program to make Identity Protection PINs available to all taxpayers nationwide upon request.

9. The IRS will establish new procedures for tax-related identity theft which include a single point of contact for victims.

10. Form 990 series returns must be e-filed starting in taxable years beginning after enactment. There is transitional relief for up to 2 years for certain small organizations.

SECURE Act Plus Extenders

1. If a business has a 401(k) plan or a SIMPLE plan and implements an automatic contribution arrangement for employees, the business can get a $500 tax credit each year for three years. This change applies to tax years beginning after December 31, 2019.

2. If a taxpayer receives taxable stipends or non-tuition fellowship funds for graduate or postdoctoral study, then those amounts allow the taxpayer to contribute to a traditional IRA or Roth IRA. This change applies to tax years beginning after December 31, 2019.

3. A taxpayer can make a traditional IRA contribution, and receive a deduction, at any age; however, deductible contributions made after age 70½ reduce future tax-free qualified charitable distributions made by the taxpayer. This change applies to contributions made for tax years beginning after December 31, 2019.

4. There is a new exception to the 10% penalty for early withdrawals from an IRA or qualified retirement plan for qualified birth or adoption distributions. The taxpayer must take the distribution within 1 year of the date of birth of a child or the date of legal

adoption of an eligible adoptee. The taxpayer can repay the distribution to avoid paying tax on it. This change applies to distributions made after December 31, 2019.

5. A taxpayer must start taking required minimum distributions (RMDs) in the tax year that the taxpayer turns age 72. This change applies to RMDs after December 31, 2019 if the taxpayer turns age 70½ after December 31, 2019. – Revised in Secure Act 2.0

6. If a taxpayer adopts a stock bonus, pension, profit-sharing, or annuity plan after the close of a tax year but before the tax return due date plus extensions, then the taxpayer can elect to treat the plan as if the taxpayer adopted it on the last day of the tax year. This change applies to plans adopted for tax years beginning after December 31, 2019.

7. There are two new categories of qualified higher education expenses that allow for tax-free distributions from §529 plans:
   a) Fees, books, supplies, and equipment required for the designated beneficiary's participation in an apprenticeship program registered and certified with the Secretary of Labor under section 1 of the National Apprenticeship Act.
   b) Principal or interest payments on any qualified education loan of the designated beneficiary or his or her sibling.

   This change applies to distributions made after December 31, 2018.

8. If a taxpayer inherits a defined contribution plan or an IRA, then the taxpayer must fully distribute the plan balance by the end of the 10th calendar year following the year of the original owner's death. There is no longer a requirement to take out a certain amount each year.

   The current stretch rules, and not the new 10-year period, continue to apply to a designated beneficiary who is one of the following:
   1) A surviving spouse.
   2) A child who has not reached age of majority.
   3) Disabled as defined in §72(m)(7).
   4) A chronically ill individual as defined in § 7702B(e)(2) as modified.
   5) Not more than 10 years younger than the employee.

   This change applies to distributions with respect to plan owners that die after December 31, 2019.

9. Congress repealed the Tax Cuts and Jobs Act changes to the "kiddie tax," where a child's unearned income over a threshold amount was subject to estate and trust tax rates and restored the prior kiddie tax treatment, where a child's unearned income over a threshold amount was taxed at the parent's marginal tax rate. This provision applies

retroactively to December 31, 2017; however, a taxpayer can elect for tax year 2018 and/or 2019 for the Tax Cuts and Jobs Act treatment if the taxpayer so chooses.

10. The annual tax extenders return: Congress extended many expired tax provisions retroactively to January 1, 2018 and they now expire on December 31, 2025. The five most important ones to know are:
    1) Exclusion from income for cancellation of acquisition debt on your principal residence (up to $2,000,000).
    2) Deduction for mortgage insurance premiums as residence interest.
    3) 7.5% floor to deduct medical expenses (instead of 10%) and is now permanent.
    4) Above-the-line tuition and fees deduction.
    5) Nonbusiness energy property credit for energy efficient improvements to a residence (see the many changes from the Inflation Reduction Act of 2022).

11. Congress originally scheduled the following tax provisions to end in 2019 and now extended them through 2025:
    1) New markets tax credit.
    2) Paid family and medical leave credit.
    3) Work opportunity credit.
    4) Beer, wine, and distilled spirits provisions.
    5) Look-through rule for certain controlled foreign corporations.
    6) Health insurance coverage credit.

BASIC TAX CONCEPTS

ACCOUNTING METHODS

Accounting method rules are used to determine when income and expenses are reported; the accounting method is chosen when the first tax return is filed. Generally, taxpayers may compute their taxable income using any permissible method so long as it is consistently applied and clearly reflects income. Accounting methods include cash and accrual, along with hybrid methods that combine the two.

CASH VS ACCRUAL BASIS

Cash basis is the most common method of accounting. Income is reported when actually or constructively received and expenses are deducted when paid. Income is constructively received when it is credited to a taxpayer's account or set apart in a way that makes it available to the taxpayer.

The accrual basis method matches income and expense related to the same year. Income is reportable when earned, without regard to when cash or the cash equivalent is received.

Under the accrual basis "all events test" expenses are deductible in the tax year in which all events occur that fix the liability, the liability can be determined with reasonable accuracy, and economic performance occurred. Similarly, income is includible in the tax year in which all events fix the taxpayer's right to the income, and the amount can be determined with reasonable accuracy. Deductions are allowed in the taxable year when all the events occur that establishes a liability giving rise to such deduction, and economic performance occurred. Expenses must be prorated between tax years if an expense covers more than one taxable year.

Cash basis recognizes income when it is received or constructively received, and expenses when paid.
Accrual basis recognizes income when it is earned, and expenses when the "all events" test fixes the liability and economic performance occurs.

Under the accrual method, if an expense is paid to a related person who uses the cash basis, the expense is not deductible until actually paid to the related party.

> Example: An accrual based 100%-owned corporation shareholder cannot deduct a rent expense accrued to a related cash basis taxpayer until the cash basis taxpayer receives it into income.

PREPAID EXPENSES

Generally, an expense can't be deducted if paid in advance, regardless of whether under the cash or accrual method (including prepaid interest and prepaid insurance premium). The prepaid item is treated as an asset with a useful life extending beyond the current year. There is a twelve-month exception so the prepaid expense rule does 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.

CASH EQUIVALENT DOCTRINE

This doctrine makes income reportable by cash basis taxpayers when the equivalent of cash is received in a taxable transaction. Cash equivalent includes property, notes and marketable securities.

CONSTRUCTIVE RECEIPT

When a taxpayer has unfettered access to income, the income is considered constructively received regardless of whether the taxpayer chooses to receive it at that time or at a later time. A cash basis taxpayer is taxed on all income constructively received, regardless of whether the funds were actually deposited in the bank account or otherwise taken. Since physical possession does not determine taxability, holding a check or postponing possession from one tax year does not postpone constructive receipt. For example, in *Roberts* (TC Memo 2002-281) the taxpayer was deemed to constructively receive a lump-sum distribution from a pension plan even though it came to his residence during a time he was confined to an alcohol rehabilitation center and to prison and could not cash the check for years.

Economic Performance

Economic performance fixes certain liabilities as provided by the IRC. When the liability arises out of providing services to another person, economic performance occurs when the taxpayer provides the services. If the liability arises in connection with property used by the taxpayer, economic performance occurs as the taxpayer uses the property.

Inventories

The Tax Cuts and Jobs Act amended the tax law to allow the cash method of accounting to a C corporation if its average gross receipts over prior three taxable years do not exceed $25 million, regardless if production or sale of merchandise is an income producing factor. This threshold is indexed for inflation. Taxpayers that meet the $25 million gross receipts test are also exempt from the following three tax accounting provisions:

1) Inventory accounting rules under §471 (but can use one of two alternate methods).
2) Uniform capitalization rules under §263A.
3) Percentage-of-completion method provided that the contracts are expected to be completed within 2 years of commencement.

The accrual method is generally required for taxpayers who use inventories. They must be used whenever production, purchase or sale of merchandise of any kind is an income-producing factor (§1.446-1(a)(4)(I)). However, some business can use the cash method of accounting, even if they have inventory.

Accounting Method Changes

An accounting method is chosen on the first tax return, generally without requiring IRS approval. Revenue Procedure 2015-14 explains automatic consent procedures for applications filed after 1/15/15. The correction of a math or tax computation error is not a change in accounting method. File Form 3115, *Application for Change in Accounting Method*, even if the change is required (for example, when a cash method corporation is no longer able to use the cash method because of the average gross receipts restriction).

Hybrid Method

A taxpayer can use any combination of cash, accrual and special methods of accounting if the combination clearly reflects income and it is used consistently. A common hybrid method uses the accrual method for purchase and sales, and the cash method for services and operating expenses. Some restrictions apply:

- If inventory is necessary to account for income, the accrual method must be used for purchases and sales, unless an exception applies
- If the cash method id used to report income, the cash method must be used to report

related expenses

- If the accrual method is used to report expenses, the accrual method must be used for related income
- Any hybrid combination method that includes the cash method is treated as the cash method for purposes of the limitations for using the cash method.

  Example: A roofing contractor chooses to use the cash method and qualifies to do so. The contractor enters into a contract on 12/3/18 with the homeowner to replace the roof. The contractor purchases and delivers $5,000 in roofing raw materials on 12/28/18 but does not install the roof until 1/4/19. Taxpayer cannot deduct the $5,000 in materials until 2019.

  Example: The same roofing contractor enters into a contract on 12/3/18 to replace a homeowner's roof. The contractor purchases and delivers $5,000 in materials on 12/28/18, and completes and bills the installation on 12/30/18, but is not paid until 1/3/19. For 2018 the contractor may deduct the $5,000 in materials purchased but the income is not claimed until 2019.

§481(a) Adjustment

A §481(a) adjustment is required to determine when an adjustment to taxable income resulting from the accounting method change should be made. Under Rev Proc 2002-9 a 4-year adjustment period is generally available; however, if the additional amount to taxable income is under $25,000, or is negative (reducing taxable income), the taxpayer can make the adjustment in one year. If a taxpayer ends the business, any remaining §481(a) adjustment must be taken into taxable income in the year of termination.

ASSIGNMENT OF INCOME DOCTRINE

EXAM ALERT!

Ryan Fleischer (TC Memo 2016-238 (12/29/16)) demonstrates that income must be taxed to "him who earns it." A financial consultant who obtained various licenses to sell securities, the petitioner struck out on his own and entered into a representative agreement with Linsco/Private Ledger Financial Services (that said the relationship was that of an independent contractor). Petitioner signed the agreement in his personal capacity then incorporated his business and elected S corp status and was paid a salary. He entered into a broker contract with MassMutual Financial Group, also in his personal capacity. On his tax returns he reported wage income and either Schedule E (reporting nonpassive income) or Schedule C (showing income and expenses of the same amount). No self-employment tax was reported but he claimed self-employed health insurance deductions. Respondent issued a Notice of Deficiency determining that the gross receipts or sales by the corporation should have been properly reported by petitioner as self-employment income on Schedule C. In this instance petitioner, not the corporation, should have reported the income earned under the agreements with Linsco and MassMutual.

Under the assignment of income doctrine, one-person transfers income earned by them to another person with the intention the assignee pays tax on the transferred income. Generally, assignment of income is not permitted under the IRC and the so-called 'assigned' income is taxable to the person who earns it.

Attribution Rules

Under §1563 attribution rules, a taxpayer's stock ownership includes stock owned by the taxpayer's:

- spouse, unless they are legally separated under a decree of divorce, whether interlocutory or final, or a decree of separate maintenance, **and**
- children, grandchildren, parents, and grandparents, including a legally adopted child.

Claim of Right Doctrine

The claim of right doctrine relates to the receipt of money under a claim of right which would otherwise represent taxable income must be treated as taxable income even though the recipient may be under a contingent obligation to return it at a later time. The Supreme Court (*North American Oil Consolidated v Burnet*, 285 U.S. 417 (1932)) noted that the right applies to situations that share a "common factual element: the receipt of money or other property by a taxpayer with an imperfect right to retain it." The mere fact that income received by a taxpayer may have to be returned at some later time does not deprive it of its character as taxable income when received. When the taxpayer is required to repay some or all of the money in a later year, a deduction may be available in that later year, but the amounts are income in the year of receipt. *Richard R. Hamlett* (TC Memo 2004-78 (3/22/04); see also *Elijah Servance and Corliss Servance*, TC Summary 2022-23 (11/21/22) for a more recent case on the issue.

Dependency Exemptions

Exam Alert!

The Tax Cuts and Jobs Act suspended the deduction for exemptions for tax years beginning after 12/31/2017 and before 1/1/2026; however, the dependent definitions still exist in the tax law. In lieu of the deduction, there is an expanded child tax credit (up to $2,000 per qualifying child, refundable up to $1,400) and a family tax credit (up to $500) for family members who do not qualify for the child tax credit.

Qualifying Child

A uniform definition of Qualifying Child was added in the 2004 Working Families Tax Relief Act (04WFTRA). For tax years after 12/31/04 IRC §152 is amended to establish a uniform definition of qualifying child for purposes for the dependency exemption, the child credit, the earned income credit, the dependent care credit, and head of household filing status. Generally, a taxpayer can claim an individual who does not meet the uniform definition of qualifying child as a dependent if the prior law dependency requirements are satisfied.

Generally, a child is the taxpayer's qualifying child if these tests are satisfied:

RESIDENCY: The child has the same principal residence as the taxpayer for more than one half the taxable year;
RELATIONSHIP: The child has a specified relationship to the taxpayer.
AGE TEST: The child has not yet attained a specified age; **and**
SUPPORT TEST: The child has not provided over 50% of his or her own support for the calendar year.

Prior law governing support and gross income tests used to determine if an individual is a dependent do not generally apply to a child who meets the requirements of the uniform definition of a qualifying child. A tie-breaking rule applies if more than one taxpayer claims a child as a qualifying child.

Residency
Under the uniform definition residency test a child must have the same principal residence as the taxpayer for more than half of the taxable year (defined by the number of nights the child resides with the taxpayer). Temporary absences are permitted, including illness, education, business, vacation, or military services, and any time a child of divorced or separated parents spends with the other parent. Kidnapped children are also considered to meet the residence test.

Relationship
The child must be the taxpayer's child or stepchild (whether by blood or adoption), foster child, sibling or stepsibling or a descendant of any such individual. A legally adopted child, or one who was lawfully placed with the taxpayer for adoption by the taxpayer, is treated as a child by blood. A foster child, placed with the taxpayer by an authorized placement agency or by judgment, decree, or other order of the court of competent jurisdiction, is treated as the taxpayer's child.

Age Test
The age test varies depending upon the tax benefit involved. Generally, a child must be under age 19 (or under age 24 in the case of a full-time student – this still means at least 5 months of the year as a full-time student) to be a qualifying child. No age limit applies to individuals who are totally and permanently disabled within the meaning of §22(e)(3) at any time during the calendar year.

04WFTRA retained the prior law requirements that a child must be under age 13 (if s/he is not disabled) for purposes of the dependent care credit, and under age 17 (whether or not disabled) for purposes of the child credit.

Support Test
A child who provides over one half of his or her own support generally is not considered a qualifying child. However, if the income is not used on the child's support, it is still possible that a child may be a qualifying child. Even if the child provides more than one half of his or her own

support, he or she may remain a qualifying child of another taxpayer for purposes of the earned income credit (EIC).

Tie Breaking Rules

It is possible a child may be a qualifying child with respect to more than one individual, and more than one person claims a benefit with respect to the child, such as when a child lives with her mother and grandmother in the same residence. Special tie breaking rules applies:

> **ONE PARENT**: If only one of the individuals claiming the child as a qualifying child is the child's parent, the child is deemed to be the parent's qualifying child.
>
> **TWO PARENTS**: If both parents claim the child and do not file a joint return, the child is deemed a qualifying child first to the parent with whom the child resides the longest period of time, and second to the parent who has the highest gross income.
>
> **NO PARENTS**: If the child's parents do not claim the child, then the child is deemed a qualifying child to the claimant with the highest adjusted gross income.

The tie breaking rules do not apply when a child is the qualifying child of multiple taxpayers but only one eligible taxpayer actually claims the qualifying child.

Interaction with Prior Law

Generally, a taxpayer may claim an individual who does not meet the uniform definition of a qualifying child as a dependent if the prior law requirements, including the gross income and support tests, are satisfied.

> Example: A taxpayer may claim her parent as a dependent, if she provides more than one half of the support of the parent, and her parent's income is less than the exemption amount.
>
> Example: A grandmother may claim a dependency exemption for a grandson who does not reside with the taxpayer for more than half the year as long as she provides more than one half the support of the grandson, and his gross income is less than the exemption amount.
>
> An individual can be a qualifying relative without a family relationship between the individual and the taxpayer. A taxpayer cannot claim head of household filing status based on an individual who does not have a family relationship with the taxpayer. Also, a taxpayer may claim the dependent care credit for a qualifying relative only if the qualifying relative is physically or mentally disabled.

Citizenship and Residency

A qualifying child must be a U.S. citizen or national, or a resident of the U.S., Canada or Mexico.

PERSONAL EXEMPTION
The Tax Cuts and Jobs Act suspended the deduction for personal exemptions for tax years beginning after 12/31/2017 and before 1/1/2026.

DEPENDENT CREDIT
A $500 family credit applies for dependents who don't qualify for the child tax credit. The credit is nonrefundable, with the same phaseout threshold as the child tax credit. This credit is available for children under 17 who do not qualify for the child tax credit because they do not have an SSN and to older children, parents and other dependents.

FORM 8332
A special support rule under §152(e) favors the custodial parent where divorced or separated parents together provide more than half their child's total support and one or both of them have custody of the child for more than half the year. The custodial parent is the parent with physical custody of the child the greater portion of the year. A custodial parent is treated as meeting the support test even if the noncustodial parent provides most of the child's support. The parents may arrange for the noncustodial parent to claim the $2,000 child tax credit or other credits relating to the child; remember this requires attaching a signed Form 8332, *Release of Claim to Exemption for Child of Divorced or Separated Parents*, for each year in which a noncustodial parent claims a child.

A separate 8332 should be prepared for each child. Form 8332 may apply to one year, a set number of years, or all future years. Until 7/2/08 a divorce decree could be sufficient if it met all the requirements of Form 8332 and included:

- noncustodial parent's name and social security number;
- name of the child or children;
- applicable tax year(s);
- custodial parent's signature, social security number and date of the signature

Further, the child must receive over 50% of his/her support from the parent/s, and cannot include support provided by grandparents, relatives or welfare. The parents must be either divorced, legally separated, separated under a written separation agreement, or living apart at all times during the past 6 months of the tax year. The child must be in the custody of one or both parents more than 50% of time.

It is possible for the custodial parent to revoke the written declaration at any time by providing written notice of the revocation to the noncustodial parent. The revocation is effective in the year AFTER the custodial parent provides the written notice to the noncustodial parent (§1.152-4(d)(3)(i)). The revocation may be made on Form 8332, or on a written declaration that conforms to its substance.

Form 8332 is required even if the divorce agreement states that the dependency exemption deductions are to be divided between the former spouses (*Shenk* 140 TC (5/10/13)) – the custodial parent must still execute Form 8332.

> Example: *James Lee Hicks, Jr.* (TC Memo 2022-10 (2/23/22) had a shared parenting plan, as ordered by a state court in 2006, where the mother would claim child 1 every year and father would claim child 2 every year, unless the parties reached another agreement in writing. A state order for 2009 gave both children to petitioner, and another state order on 8/26/10, in effect for 2014, specified custody, but don't modify the dependency exemption for both children. Petitioner timely filed in 2014 return and claimed dependency deductions and child tax credits for the two children; he didn't attach Form 8332, a written declaration or any other waiver signed by the children's mother, or a pre-2008 court decree or separation agreement. He subsequently provided the court a copy of the shared parenting plan. The children's grandmother filed a return and claimed a dependency exemption for the children's mother and both children. The Tax Court found the children did not meet the qualifying child test because they did not reside with him for more than one-half of 2014. Since he was not the custodial parent he needed to attach Form 8332, *Release/Revocation of Release of Claim to Exemption for Child by Custodial Parent*, or the two state court orders (the first of which was entered into before 7/2/08). The attachment is permitted on a return that claims the child(ren), or an amended return, or to the IRS during an examination. He was allowed to claim 1 child and the related child tax credit.

> Example: *Paul Anthony Cappel, Sr* (TC Memo 2016-150 (8/10/16)) claimed dependency exemptions for his three kids (two from his first marriage, and one from the wife he is currently divorcing) plus head of household filing status and child tax credits. The court order for the divorce of first wife indicated he would receive the dependency exemption each and every year if he remained current on child support. His ex-wife claimed the two kids and the third child was claimed by his mother. The first two kids didn't live with him and he doesn't know where they lived – the third lived with his mother for more than half the year, but never with the petitioner. No executed Form 8332 was filed with his return, and he was unsuccessful in his claims.

Relative/Household Member

Relatives for this purpose include child, stepchild, adopted child, grandchild, great grandchild, son or daughter in law, father or mother-in-law, brother or sister-in-law, parent, brother, sister, grandparent, step-grandparent, stepbrother or step sister, and if related by blood, an uncle, aunt, niece or nephew. Those relatives do not need to live with the taxpayer.

A household member includes any person, related or not, who lives in taxpayer's household the entire year, except for temporary absences. The exemption is not allowed if the person was taxpayer's spouse at any time, or if the relationship with the person violates state law.

A legally adopted child is treated as the taxpayer's child. Adoption is complete when a court decree is entered; in a state that issues an interlocutory adoption decree before it is final, the adopted child can be claimed as a dependent at that time. If not adopted, a child may still be the taxpayer's dependent if he or she was placed by an authorized adoption agency and was a member of the household for the entire year. A foster child qualifies only if she or he is a household member for the entire year.

Dependent Gross Income

There no longer is a gross income test for qualifying children. Other relatives and household members must have gross income of less than $4,400 in 2023 to qualify as the taxpayer's dependent.

Gross income includes all income in the form of money, property and services that is not exempt from tax. It includes gross receipts from rental property (expenses are not deducted). For manufacturing or merchandising businesses, gross income is the total net sales minus the cost of goods sold, plus miscellaneous income from the business. For a partner, gross income includes the partner's share of gross partnership income. For this purpose, gross income includes all unemployment compensation and certain scholarship and fellowship grants. Tax exempt income, such as certain social security payments, is not includible in gross income.

Support Test

Taxpayer must contribute more than 50% of the dependent's support or must contribute more than 10% and together with others contribute more than half the support. If less than 50% support is contributed alone, or with the contributions of other, neither taxpayer nor other contributors may claim the dependency exemption. The test is met if the dependent had no financial means and taxpayer is only person providing support.

Support items include expenses for food, lodging, clothing, education, medical or dental care, auto and transportation, recreation and entertainment. Tax-exempt income must be included along with personal savings, if these are used for support items. Government benefits must be included in the determination of whether the taxpayer provides more than 50% support.

Support items do not include life insurance premiums, Medicare payments, funeral expenses, medical insurance benefits received, scholarships to children who are full-time students, or federal/state/local taxes paid by the dependent from wages or other income.

Social Security Numbers

A social security number or Individual Taxpayer Identification Number (ITIN) must be provided for each dependent. The Tax Cuts and Jobs Act now requires an SSN in order to claim the child tax credit for a dependent.

Kiddie Tax

Exam Alert!

For 2023 when a child is subject to kiddie tax, the child's **unearned income** (investment income) over $2,300 is taxed the parents' marginal rate. Investment income includes all other than earned income, including taxable Social Security and taxable pensions. If the child is under age 18, kiddie tax applies. If the child is age 18 kiddie tax applies unless the child provided more than half of his or her support with earned income. For students between 19-23 kiddie tax applies unless the child provided more than half of his/her support with earned income.

Earned income is **still taxed to the child at the single taxpayer rate on the child's separate return**. §73(a) requires inclusion of "amounts received in respect of the services of a child" in the child's own gross income rather than that of the parents. In other words, the child is taxed on income she is deemed to have earned.

> Example: *Tony Pedregon Lopez and Andrea Lopez Pedregon* (TC Memo 2017-171 (8/30/17)) had several children, including a daughter who entered into several beauty pageants in furtherance of a performing career. She had minor winnings that were put into her college savings account; the pageant expenses were deducted on the parents' return. Based on his understanding of Indiana's child labor laws, the tax preparer believed the earnings were taxable to petitioners rather than to the daughter in her own right and he prepared Schedules C reporting income and expenses from the pageant competitions. The related expenditures are also treated as belonging to the child even if a parent made the expenditure. Pageant-related remuneration is treated as compensation for services and only the daughter may deduct the related expenses. The taxpayers had good faith reliance on their preparer and were not liable for accuracy-related penalties.

Depreciation

Exam Alert!

Tax Cuts and Job Act expanded §179 to $1,000,000 (phased out beginning at $2,500,000 in purchased and subject to inflation adjustments), increased bonus depreciation, removed computers from the 'listed property' definition, classified farm equipment as 5-year property and applied it to certain tangible personal property used in connection with furnished lodging. Bonus depreciation was expanded generally to 100% through 2022, with gradual phasedown to 20% through 2026.

For 2023 tax year, bonus depreciation will drop to 80% (it drops to 60% in 2024, 40% in 2025, and 20% in 2026). The §179 amount in 2023 is $1,160,000 on a maximum equipment purchases of $2,890,000. The maximum §179 for vehicles is $28,900, if the vehicle is used for business and weighs between 6,000 and 14,000 pounds.

Depreciation is the periodic expensing of an asset over the asset's theoretical economic life. It provides a method of matching income and the related expenses by recognizing a decrease in value caused by wear and tear and obsolescence as found in §167. This closely approximates the true notion of depreciation – that an asset has determinable useful life and experiences wear and tear that can be expensed each year. Depreciation expense once depended upon the basis, estimated salvage value, and estimated useful life of the property.

Most of the provisions of §167 were replaced by §168, Accelerated Cost Recovery System. ACRS required that depreciation be taken using the applicable depreciation method over a theoretical recovery period, using the applicable convention. Under ACRS property is divided into classes, which determine the depreciable period. An Alternative Depreciation System (ADS) is required under §168 for certain property. Tax-exempt use property is defined in §168. The ACRS of §168 led to Modified Accelerated Cost Recovery System (MACRS), in use today. This method is a more artificial means of recovering costs, not marking true depreciation of assets.

Depreciation is only available after an asset is placed in service, not necessarily when obtained by the taxpayer.

> Example: A building is purchased on 12/17/22 for use in a Schedule C business. Renovations are complete and the taxpayer has the Grand Opening on 4/1/23. Taxpayer can begin to take depreciation on 4/1/23, the date the real property is first ready for occupancy.

Depreciable property must be used in a trade or business, or held for production of income, and have a definite useful life of more than one year.

EXAM ALERT!

Prior exam questions asked about the amount allowable under MACRS, and one question asked for a comparison of §167 and §168. The following table of depreciation rate for recovery periods may be useful; at least know year 1 and 2 as those are most frequently tested. Per IRC §168(e)(1) property with a class life of 10 or more years but less than 16 years is 7-year property.

YEAR	3 YR	5 YR	7 YR	10 YR	15 YR
1	33.33	20.00	14.29	10.00	5.00
2	44.45	32.00	24.49	18.00	9.50
3	14.81	19.20	17.49	14.40	8.55
4	7.41	11.52	12.49	11.52	7.70
5		11.52	8.93	9.22	6.93

Depreciation – Class Life

Exam Alert!

Sometimes class life isn't provided in a question, so this information should be helpful in figuring how what to use.

3-year property = 4-year class life or less
5-year property = more than 4, less than 10
7-year property = 10 or more but less than 16
10-year property = 16 or more but less than 20
Residential rental = 27.5 years
Nonresidential rental = 39 years

Depreciation - §179 Expense

Exam Alert!

The Tax Cuts and Jobs Act made significant changes to §179. The 2023 limit is $1,160,000 (up to $2,890,000 qualifying property with a dollar-for-dollar reduction for purchases over that amount, with the deduction eliminated at $3,500,000). SUVs under 14,000 GVW are allowed $28,900 for 2023. The deduction is limited to the aggregate taxable income of the taxpayer actively involved in a trade or business. Section 179 deductions are permitted even for property placed in service the last day of the tax year. The qualified property must be only §1245 tangible, depreciable property, acquired by purchase, used in an actively conducted trade or business.

The Tax Cuts and Jobs Act also expanded §179 expensing to:

- Certain depreciable tangible property used to furnish lodging or in connection with furnishing lodging as defined in §50(b)(2). Examples include beds and other furniture, refrigerators, ranges, and other equipment used in the living quarters of a lodging facility where sleeping accommodations are provided.
- Improvements to nonresidential real property made after the property is placed in service. The improvements that qualify include roofs, heating, ventilation, A/C property, fire protection/alarm systems, and security systems.

The election to expense assets applies to the year the property (new or used) is placed in service. The §179 limitation is determined at the partner and partnership level. A husband and wife who file a joint return are treated as one taxpayer for purposes of the §179 deduction. The deduction is not available to estates and trusts. A taxpayer who elects to expense property under §179 must reduce the depreciable basis of the elected property.

Qualified property does not include property used by a tax-exempt organization or property used outside of the U.S. and property used by governments and foreign persons.

A taxable income limitation prohibits §179 from creating a loss. The expensing election is limited to the amount of taxable income from any of taxpayer's active trade or business; these activities are netted together for this purchase. An amount disallowed because of income limitations is carried forward.

The election must be made timely. It can be made on an original return (even if filed late) or on an amended return filed within the due date, including extensions, for the original return. It cannot be made retroactively.

Earned Income Credit

The Earned Income Credit (EIC) can be claimed by childless workers in limited circumstances, or by low-income workers who have qualifying children. To qualify, childless workers must have earned income, an AGI under certain amounts, depending on if there are children, and be at least 25 years old and less than 65 years old.

Generally, the definition of qualifying child for purpose of the EIC is the same as it existed before the 2005 qualifying child rules were effective. For purposes of the EIC a qualifying child must meet the Relationship test, Residency test (without regard to the exception for children of divorced or separated parents) and the Age test. A qualifying child does not have to meet the Support test for the EIC. A qualifying child must have lived with the taxpayer in the U.S. for more than half the year, and have a social security number valid for employment in the U.S.

The 2001 Act made changes to the EIC:

- earned income includes wages, salaries, tips and other employee compensation if includible in gross income for the year, plus net earnings from self-employment (but not, for example, parsonage allowance that is not includible in gross income). Taxpayers serving in the Armed Forces in a combat zone can elect to include the nontaxable combat pay in earned income when figuring the EIC, **and**
- EIC is not reduced by an amount of the individual's AMT.

There are different phaseout ranges, one for married couples who file jointly, and another for individuals who file as single, head of household, or as qualifying widow(er).

Temporary absences do not prohibit claiming the EIC if it is reasonable to assume the taxpayer will return to the household and the taxpayer continues to maintain the household during the temporary absence. A jailed taxpayer was eligible to claim the EIC even though she was arrested on 6/5 and remained in jail the balance of the tax year. In *Rowe* (128 TC 3 (2/22/07)) the petitioner successfully argued that her absence was temporary from the date of her arrest until her conviction of murder.

Education Opportunities

The American Opportunity Credit (AOC), made permanent under PATH 2015, allows a credit of up to $2,500 for qualified education expenses paid for each eligible student. The credit is calculated as 100% of the first $2,000 in expenses plus 25% of the next $2,000 for a total of $2,500. The credit is generally refundable, but taxpayers subject to Kiddie Tax are not allowed a refundable credit in all situations. The credit is subject to income phaseout. No credit is allowed if married filing separate is claimed, or if dependent is claimed as a dependent on another person's tax return. The taxpayer is not permitted to obtain double benefits between American Opportunity and Lifetime Learning credit for same student or same fees, and a taxpayer may not use these credits when deducting education expenses as business expenses. Students must be eligible for the credit and cannot have completed the first 4 years of postsecondary education before year of the credit. Students must also be enrolled in a program leading to a degree, taking at least 50% of the normal full-time work load, and not enrolled in an elementary or secondary school. The student must not have a federal or state felony conviction for possessing or distributing a controlled substance as of 2009.

Qualified education expenses include:

- Tuition and fees
- Course supplies, which includes books, supplies and equipment needed for the course of student (whether or not purchased from the educational institution).
- Expenditure for a computer qualifies if the computer is needed for enrollment or attendance at the institution
- Activity fees included if paid to institution as condition of enrollment or attendance.
- Personal expenses (room, board, health services, etc.) do not qualify even if required
- Sports and hobbies fees are only covered if part of a degree program

There are other educational opportunities available, but it is presumed the tax professional has some basic understanding of the Lifetime Learning Credit, Tuition and Fees Deduction (expired as of 12/31/20), Qualified Tuition Programs (QTPs) and Education Savings Accounts (ESAs).

FILING STATUS

Married Filing Separate (MFS) vs Married Filing Joint (MFJ)

A married couple can choose to file separate returns. Generally, the taxpayers will pay more combined taxes on separate returns than if they filed a joint return because of special rules that apply to Married Filing Separate status:

- the exemption allowed for calculating Alternative Minimum tax is half that allowed to a joint return filer;
- no credit is allowed for child and dependent care expenses in most cases. The amount excludable from income on an employer's dependent care assistance program is limited to $2,500 ($5,000 for MFJ);
- no earned income credit is permitted;
- no exclusion or credit for adoption expenses is permitted in most cases;
- no education credits, student loan interest deduction, or the tuition and fees deduction is permitted;
- no interest is excludable from qualified U.S. savings bonds used for higher education expenses;
- the mortgage interest deduction is limited to $500K ($375k for post 12/15/17 mortgages).

If the taxpayer lived with his or her spouse at any time during the tax year,

- neither can claim the credit for the elderly or the disabled
- both taxpayers must include more in income (up to 85% of any social security or equivalent railroad retirement benefits received) than if MFJ

Additionally, these credits and deductions are reduced at income levels that are half those permitted for MFJ:

- child tax credit
- retirement savings contribution credit
- itemized deductions,
- the capital loss deduction limitation is $1,500 (not $3,000)
- if the spouse itemizes deductions, the other MFS taxpayer must also itemize, even if this amount is less than the standard deduction permitted
- if the taxpayers actively participate in a passive rental real estate activity that produces a loss, the special allowance permits a deduction of $25,000 from nonpassive income. MFS taxpayers who live together at any time during the year cannot claim any portion of this special allowance. For MFS taxpayers who live apart the entire year, the maximum special allowance permitted is $12,500.

Generally, taxpayers can change filing status by filing an amended return using Form 1040X. If taxpayers file an MFS return, generally they can choose to elect an MFJ return within 3 years from the due date of the separate return or returns, not including extension.

A separate return includes one filed by taxpayer or spouse that claims MFS, single, or Head of Household status, and a taxpayer can file a joint return after a Tax Court petition is filed (*Ibrahim*, TC Memo 2014-8 (1/13/14) was reversed by the 8th Circuit in 2015).

The Court found that a single return was not a separate return and the limitations of §6013(b)(2) is inapplicable when petitioner erroneously filed a return as "single" rather than as MFS. That meant Petitioner-H was eligible to joint tax rates and filing status for 2012 on the basis on the MFJ return petitioners filed. In *Fansu Camara and Aminata Jatta* (149 TC 13 (9/28/17)) petitioner-H claimed single filing status on his 2012 return. In the notice of deficiency, the respondent changed the filing status to MFS. After petitioning the Tax Court petitioners filed a joint 2012 income tax return. The respondent objected, claiming that §6013(b)(2) barred Camara from electing MFJ for his 2012 tax year. Petitioners were married at all relevant times, but on the 2012 Form 1040 petitioner-H erroneously checked the box for single filing status. §6013 governs whether a married couple may make a joint return and §6013(b) allows married taxpayers, under certain circumstances, to elect to switch from a 'separate return' to a joint return. The general rule is that if an individual has filed a "separate return" for a taxpayer year in which that individual and his or her spouse could have filed a joint return, that individual and his or her spouse may nevertheless "make a joint return" for that year. The term "separate return" is not defined in the Code or regulations, but the Court opined that it meant a return in which a married taxpayer has claimed the permissible status of

MFS, rather than a return on which a married taxpayer has claimed a filing status no properly available to him or her (such as filing single).

In another twist, *Patricia Marie Knez* (TC Memo 2017-205 (10/18/17)) erroneously filed her 2014 return as head of household. After the notice of deficiency was issued, she and her husband filed an MFJ return claiming an EITC – the respondent contended that §6015(b)(2)(B) barred them from filing joint. The Court specifically mentioned the Camara case where petitioner originally choose "single" and this taxpayer choose "head of household." The Court concluded that the distinction made no difference – the filing status initially selected by each married taxpayer was legally impermissible and noted that the bar in that code section didn't apply because the married taxpayer had not filed a "separate return" – in this case petitioner was entitled to file MFJ with her spouse. Petitioner and her spouse were married and live separately during the year but were not legally separated under a decree of divorce or separate maintenance.

However, once an MFJ return is filed, taxpayers cannot choose to file separate returns for that year beyond due date of the return. A personal representative for a decedent can choose from a joint return to a separate within one year from the due date of the return to make that change.

Head of Household
To qualify as Head of Household, and income tax rates that are lower than Single but higher than MFJ, the taxpayer must:

- be unmarried on the last day of the year,
- pay more than half the cost of keeping up a home for the year that was the main home for the entire year of taxpayer's parent whom can be claimed as a dependent (parent does not have to reside with the taxpayer), **or**
- pay more than half the cost of maintaining a home in which taxpayer lived for more than half of the year with either the following
    - a qualifying child, or
    - any other person taxpayer can claim as a dependent.

Taxpayer cannot use Head of Household status for a person who is a dependent only because s/he lived with the taxpayer the entire year, or taxpayer is entitled to claim him/her as a dependent under a multiple support agreement.

To be unmarried the taxpayer must meet ALL these tests:

- file a separate return,
- pay more than half the cost of keeping up the home (including mortgage interest or rent, property taxes, upkeep and repairs, insurance, food, and other household expenses) used by parent or other dependent,
- spouse does not live in the home during the last six months of the year (the spouse lives there even if she or he is absent temporarily due to special circumstances),

- the home must be the main home of a child, stepchild, grandchild or adopted child for more than half the year, or is the main home of a foster child for the entire year, **and**
- the taxpayer must be able to claim the exemption for the child.

A married person may also be considered unmarried if their spouse is a nonresident alien and they meet all of the above tests except for the living apart from their spouse.

Head of household status is possible even if the qualifying child has been kidnapped. The child must (1) be presumed by law enforcement to be kidnapped by a non-family member, (2) have lived with the taxpayer for more than half of the part of the year before the kidnapping, and the taxpayer must (3) qualify as head of household status if the child had not been kidnapped. This status applies for all years until the child is returned. The last year this treatment can apply is the earlier of:

- the year it is determined the child is dead, **or**
- the year the child would have reached age 18.

MEDICAL DEDUCTION

EXAM ALERT!

The 7.5% threshold applies for deducting qualified medical expenses.

A decedent's medical expenses can be claimed as a medical expense in the year the expenses are paid, whether this is before or after death. If the executor or administrator of the estate pays the decedent's medical expenses within one year after death, an election can be made to treat those costs as if the deceased had paid them in the year the services were rendered. If the executor makes this election the medical costs cannot be claimed as a deduction on the estate tax return. A statement must be filed with the decedent's return that the expenses were not deducted on the estate tax return.

If medical expenses are claimed on the decedent's return, the portion that falls below the applicable floor cannot be deducted on the estate return, even though the taxpayer receives no benefit for them.

> Example: Lloyd was over age 65 when he died 6/1/23. His 2022 return had been filed at the time of his death. Prior to his death in 2022 he incurred $3,000 in medical expenses. The executor paid the $8,000 in medical expenses two months after his death. The executor may file an amended 2022 return, claiming the $5,000 in costs for that year, and obtain a refund. The executor may claim the remaining $3,000 as a medical expense on Lloyd's final individual return for 2023.

Standard Deduction

Exam Alert!

The Tax Cuts and Jobs Act significantly increased the standard deductions starting in 2018. For 2023 they are to $27,700 for an MFJ return, $20,800 for a HOH return, and $13,850 for a single or MFS return.

For 2023, the standard deduction for unmarried children is the greater of:

- $1,250, or
- the dependent's earned income plus $350 (but not to exceed the $13,850 standard deduction for single taxpayers). Remember earned income is taxed at the single rate on the child's separate tax return.

2023 Standard Mileage – DO NOT MEMORIZE THESE AS THEY ARE DIFFERENT IN 2024 AND WILL BE DIFFERENT AGAIN IN 2025 FOR THE EXAM

Medical or qualified moving miles - $.22
Charitable miles - $.14 (statutory)
Business miles - $.625

Passive Activities

Under §469 the IRC defines some activities as passive, like most real estate rental activities, while others may be active or passive depending upon the taxpayer's participation. Material participation is "regular, continuous and substantial involvement in the business operations." It matters because a taxpayer cannot deduct losses from passive activities in excess of income from passive activities in any given year. Losses that are not allowed under these rules are allocated among the taxpayer's passive activities and carried forward to future years. Suspended losses are allowed as a deduction in the year the activity is fully disposed of in a taxable transaction. If the sale of a passive activity results in a gain that exceeds the activity's current and suspended losses, the excess gain is passive income which allows the deduction of suspended losses from other passive activities.

> Example: Taxpayer's salary as an employee is $129,000 per year, and Taxpayer receives $2,000 of dividends from investments. Taxpayer is also a limited partner in a Partnership A (interests in which are not traded on an established securities market and are not readily traded on a secondary market or the substantial equivalent thereof) that owns and leases aircraft, and Taxpayer's distributive share of the partnership loss is $23K.
>
> As a limited partnership, A is deemed a passive activity and losses are only permitted to the extent of other passive income. Taxpayer has no other passive income stated in the question, so the $23,000 loss is suspended until passive income exists to offset the passive losses, or the entire interest in Partnership A is disposed of. No amount can be currently deducted.

In *Garnett* (132 TC 19 (6/30/09) the petitioner owned interests in LLPs, LLCs, and as a tenant in common. TIC interests are not in a limited partnership and the §469(h)(2) passive limitations do not apply.

A limited partner is presumed not to materially participate in the activity, unless the LP participates in management. In that instance the LP is treated as a general partner rather than a limited partner.

Real estate rental activities are deemed passive unless the taxpayer is a real estate professional (discussed in the real estate section). Taxpayers who earn less than $100,000 AGI and are MFJ or Single are able to deduct a special $25,000 allowance for rental real estate against nonpassive income. Real estate activities in which the taxpayer owners less than 10% or is a limited partnership interest do not qualify for this special $25,000 allowance. Real estate professionals will be discussed in the real estate section.

AT RISK RULES

Under §465 losses are only allowed up to the amount of a taxpayer's risk of financial loss from a particular trade, business or from an activity for the production of income. At risk limitations apply to individuals (including partners and S corporation shareholders), estates, trusts and certain closely held corporations. A loss that is not allowed under at-risk rules is treated as a deduction for the activity in the next year.

Amounts considered at risk are the 1) amount of money or the adjusted basis of property contributed by the taxpayer to the activity PLUS 2) amounts borrowed with respect to the activity to which the taxpayer has economic risk of loss. Even if the taxpayer is personally liable for a loan, the at-risk basis is not increased if the amount is borrowed from a person who has an interest in the activity or from someone related to a person who has an interest in the activity. Amounts borrowed by a taxpayer in the form of a mortgaged secured by real property utilized in the activity by the taxpayers are automatically considered at-risk as qualified non-recourse debt.

TAX BENEFIT RULE

To the extent a taxpayer realizes an income tax benefit by a deduction, a recovery of that deduction in a subsequent tax year is treated as taxable income. State income tax refunds are a prime example of the tax benefit rule. If the taxpayer itemizes deductions, which include state income taxes paid or withheld, to reduce Federal taxable income, a subsequent refund of those state income taxes is taxable in the year received. If the taxpayer is subject to Alternative Minimum Tax in one year, which does not provide a benefit for state income taxes paid, a subsequent refund of those state income taxes is not taxable in the subsequent year received.

Under §213(a), the medical expense deduction is limited to unreimbursed expenses. Reimbursement received for expenses deducted in a prior tax year is includible in gross income in the year received to the extent previously deducted. If a taxpayer is reimbursed for an earlier tax year in which no deduction was claimed, he may exclude the reimbursement when he receives it under Regulations §1.213-1(g).

Worker Classification - §530 Relief

Worker classification issues have been controversial for years. Congress included §530 in the Revenue Act of 1978 to provide temporary relief until an acceptable definition of independent contractor was made. TEFRA of 1982 extended the provisions indefinitely. Please note that §530 relief refers to the 1978 Act, not the Internal Revenue Code.

The Tax Court held that it has jurisdiction to review an IRS determination that the Voluntary Classification Settlement Program (VCSP) does not apply to the computation of a corporation's employment tax liability. The court also denied the corporation's motion for summary judgment on the issue of whether its liability for employment tax and related penalties should be determined under the VCSP since a genuine dispute of material fact existed as to whether the misclassification of the sole corporate officer was uncovered as a result of an employment tax audit, thus making the corporation ineligible to participate in the VCSP. *Treece Financial Services Group v. Comm'r*, 158 TC. 6 (2022); *Treece Investment Advisory Corp. v. Comm'r*, TC Memo 2022-38.

When certain requirements are met, §530 ends the business's employment tax liability, FICA, FUTA, FIT, and any interest or penalties relating to the employment tax liability. The relief is not available for the employee/worker; misclassified employees are liable for the employee's FICA share instead of the Self-Employment tax.

To qualify for §530 relief, the employer must:

- issue Forms 1099 and other required reporting on the worker (apparently this works even for late filed 1099 forms as in *Medical Emergency Care Associates* (120 TC 15 (5/19/03), **and**
- treat all workers that hold a substantially similar position consistently.

If both those provisions are true, the following safe harbors apply if the taxpayer:

- relied on any past IRS guidance or court case,
- relied on a past IRS audit, in which no assessment was made on account of the improper treatment of any worker,
- relied on a long-standing recognized practice of a significant segment of the industry in which the individual worked, **or**
- used any other reasonable basis for treating the worker as other than an employee.

Beginning in 1997 the business has only the burden of establishing some prima facie ('on first view') that it was reasonable to treat a worker as a non-employee under the first three safe harbors. If the business cooperates with the IRS investigation, the burden of proof shifts to the IRS to provide the business was wrong. This does not apply to the 'any other reasonable basis' harbor; in other words, taxpayer retains the burden of proof on that issue.

GIFTS AND GIFT TAX (709)

Gift tax is imposed on the transfer of property or money by gift. The federal gift tax is integrated with the estate tax in a unified rate schedule and exemption amount, which results in a single tax on transfers during life and at death. The gift tax is imposed on the transfer itself, not on the property. Gift tax may apply to property that is exempt from income or other taxes. Gift tax applies to gifts of tangible or intangible, real or personal property, as long as the donor relinquishes all control to the gift. A gift exists to the extent the value of property transferred exceeds the amount of consideration received for the transfer. Gifts can be given directly or indirectly, such as when a lender cancels a debt with a donative intent.

GIFT TAX RETURNS

The donor pays any gift tax and is responsible for filing the tax returns. Gift tax returns (Form 709) are filed on a calendar year basis and are due April 15 of the year following the gift. No gift tax return is required to be filed if the only gifts are those shielded fully by the annual exclusion amount. Any gift-splitting requires filing Form 709. A taxpayer filing an extension of time to file an income tax return also receives an extension of time to file the gift tax return.

GIFT HOLDING PERIOD

The holding period of the donee tacks onto the donor's holding period, whether that is 7 months or 7 years.

BASIS IN GIFT RECEIVED

CASH OR OTHER GIFTS MADE

For gift tax purposes, a donor may exclude the first $17,000 (2023 amount) given annually to any number of donees under §2503(b). An outright gift to a minor qualifies for the annual exclusion regardless of whether the gift is made to the minor's legal guardian or to a custodian under a state statute adopting the provisions of the Uniform Gifts to Minors Act under §2503(c). Under §2523(i)(2), a donor may exclude the first $175,000 (2023 amount) given to a non-citizen-spouse, provided the gifts would qualify for the marital deduction if the spouse were a citizen.

The annual exclusion is only allowed for present value, and not for gifts of future interests. A future interest is any, vested or contingent, that is not available for the donee's use, possession, or enjoyment until some future time (as defined by §2503(b) and Regulations §25.2503-2. Reversions or remainders are examples of future interests

Generally, the donee takes the donor's basis in the property. However, as previously discussed in this text, there are certain situations where the sale of gift property results in no gain or loss.

See the section “Cash or Other Gifts Received” in Gross Income for more details. Gifts of assets with built-in losses result in gifts where neither the donor nor the donee can use the loss. It may be better for the donor to sell the asset and realize the loss, then gift the resulting cash to the donee.

Generally, the donee takes the donor’s basis in the property, but gift basis may be different if there is a gain or a loss on the sale, and in some situations, there may not be any gain or loss.

Gains on gift property: if the fair market value (FMV) of the gift property on the date of the gift exceeds or equals the donor’s basis, the donee retains the donor’s basis.

Example: stock with a basis of $4,000 is given to Les at a time when its FMV is $5,000. Les subsequently sells the stock for $7,500. He realizes a gain of $3,500 ($7,500 - $4,000).

Donor’s basis **FMV date of gift**
$4,000 **$5,000**
|__________________________|_____________|
Sale Price
$7,500 - $4,000 = $3,500
(largest gain)

Losses on gift property: if the FMV of the gift property on the date of the gift is less than the donor’s basis, the donee uses the FMV for purposes of computing losses.

Example: stock with a basis of $4,000 is given to the Andy at a time when its FMV is $3,000. Andy subsequently sells the stock for $2,500. He realizes a loss of $500 ($3,000-$2,500). For determining a loss, the basis may not exceed the FMV of the property at the time of the gift.

FMV date of gift **Donor's Basis**
$3,000 **$4,000**
|____________|_______________________________|
Sale Price
$3,000 - $2,500 = ($500)
(smallest loss)

No gain or loss on gift property: the sale of gift property may not result in a gain or loss. No gain or loss occurs if the gift is sold for more than its FMV on the date of the gift, but less than the donor’s basis. The reason is more apparent if numbers are attached to the situation.

Example: stock with a basis of $4,000 is given to Jennifer at a time the FMV is $3,000. She subsequently sells the stock for $3,300. If Jennifer uses the gain rules, the sale results in a $700 loss ($4,000-$3,300). If she uses the loss rules, the sale results in a $300 gain ($3,000-$3,300). To counteract these strange results, under the basis rules no gain or loss results for a sale of property with a lower than cost FMV at date of the gift, which is sold for a higher amount that is still less than the taxpayer's basis. (See Reg. §1.1015-1).

FMV date of gift   **Donor's Basis**
$3,000   **$4,000**
|_________|______________________|
Sale Price
$3,300
(no gain or loss if sold between FMV and donor's basis)

When selling gifted property:
Use donor's basis if FMV ≥donor's basis and property is sold at a gain.
If FMV < donor's basis, use FMV on a loss sale.
There is no gain or loss if the gift is sold for more than its FMV on the date of the gift, but less than the donor's basis.

Gift tax paid by a donor increases the property's basis in an amount that bears the same ratio to the amount of tax paid as the net appreciation in the value of the gift bears to the amount of the gift after taking into account the $17,000 annual gift exclusion. This can also be expressed as:

<u>Appreciation</u> x Gift tax paid
Gift minus annual exclusion (2023 = $17K, 2024 = $18K, concentrate on how to do the calculation for now – we'll update for the 2025 exclusion in the text)

Example: taxpayer receives a gift for which the property's FMV is $160,000 and the donor's basis is $75,000. Gift tax of $18,000 is paid.

<u>($160,000-$75,000)</u> = <u>$85,000</u> = 59% x $18,000 gift tax = $10,620
($160,000-$17,000) = $143,000

Taxpayer's basis is $85,620 ($75,000 basis plus $10,620 gift tax)

If depreciable property is received as a gift, the donee's basis for depreciation deductions is the donor's adjusted basis, plus any allocable gift tax as described.

Tax Court Jurisdiction

Under TRA 97 the Tax Court has jurisdiction for declaratory judgment relating to the value of gifts made after 8/5/97. The donor is the only one with standing to bring a petition to the Court and must first exhaust all administrative remedies within the IRS.

Exclusions

The current annual gift tax exclusion is $17,000 (2023), which is allowed for cash gifts or those of present interests only. A husband and wife together can gift-split up to $34,000 per year per donee ($17,000 per spouse). The current lifetime exclusion is $12,920,000 (2023).
A gift of future interest under §2503(b) is any interest that is not available for the donee's use, possession or enjoyment until a future time. Gifts to minors in trust qualify for the annual exclusion if the property and its income may be used by or for the minor's benefit before she or he reaches 21, and any remaining balance will pass to the minor at age 21.

There is an unlimited gift tax exclusion amount for gifts paid by the donor for the donee's medical expenses and/or tuition costs (but not room, board, books and other fees). For the unlimited exclusion to apply the payments must be made directly to the medical service provider or the educational institution. An unlimited estate and gift tax charitable deduction applies on transfers to charitable organizations, as long as the bequest or gift has a public purpose.

An unlimited gift tax marital deduction allows spouses to transfer property between themselves without gift tax. Under §2523 this not possible if donor's spouse is not a U.S. citizen – currently the limitation is $175,000 (2023).

Gift Tax Statute of Limitations

For gifts made after 8/5/97, if IRS does not audit the gift return during the 3-year statute of limitations period they are stopped from bringing up valuation issues on the subsequent estate tax audit. Gifts now truly have a three-year statute of limitation period. Previously the IRS took the position that it could challenge values of prior gifts on returns past statute when the taxpayer died. The IRS argued they were not challenging the gift tax or imposing penalties on gift tax issues, but rather challenging the value of gifts included in the estate tax return, which was within the statutory audit period.

A six-year statute still applies if an omission is greater than 25%. No statute of limitation applies to a gift that is not disclosed, or that is inadequately disclosed, as discussed below.

Gift Reporting

Final regulations under §§20.2001-1, 25.2504-2 and 301.8501(c)-1 control the reporting of gifts made after 1996, for which gift tax returns were filed after 12/3/99. The regulations require:

- a description of the gift property,
- the consideration received by the transferor,

- identify of the transferor and relationship to the donor, if any,
- if transferred to a trust, an identification of the trust and its terms,
- an appraisal that meets requirements under Reg. §301.6501(c)1(f)(3) or a detailed description of method used to determine fair market value,
- an explanation of discounts or valuation adjustments taken, **and**
- a statement of any position taken contrary to proposed, temporary or final regulations or revenue rulings.

COMPLETED GIFTS

Gifts are valued as of the date the transfer is complete. This occurs when the donor has parted with dominion and control and has no further power to change the gift's disposition for his own benefit, or for the benefit of another.

A transfer to a revocable trust is incomplete. In a revocable trust the grantor retains control over the property by reserving the right to revoke the trust or to change the beneficiaries. A transfer to an irrevocable trust can also be incomplete if the donor reserves power over the property's disposition.

Depending on state law, when a check is written the gift may be considered complete as of the date of the check, even if the check is not cashed until the following year. In *Estate of William E Demut, Jr., Deceased, Donald DeMuth, Executor* (TC Memo 2022-72 (7/12/22)), under Pennsylvania law mere delivery of a check does not complete a gift; as long as the drawer of a check can stop payment on the check, delivery is revocable. As a result, checks written and not cashed prior to decedent's death were included in his estate.

TRANSFERS SUBJECT TO GIFT TAX

The following gifts are subject to the gift tax:

- sales with inadequate consideration - the gift portion is the amount of difference between property the donor gives up and value of consideration received.
- bargain sales – the amount of gift is the bargain element (FMV - sales price). This does not apply if the sale is an arm's length transaction in normal course of business; for example, clearance sales do not count.
- assignment of life insurance policy – which is valued at the amount it would cost to buy comparable policy on gift date.
- completed gift, which assumes all ownership rights are transferred.
- forgiveness of a debt with a donative intent.
- below market loans - under §7872, the lender is treated as making a gift to the borrower and receiving interest income and the borrower is treated as paying interest expense. If the loan is a demand loan, the lender is treated as making a gift each year the loan is outstanding (the gift amount is the forgone interest income for each portion of the year the loan is outstanding).
- certain joint tenancies. In a joint bank account, a gift occurs when person draws an amount in excess of what they deposited into the account. The gift is considered to

occur when the funds are drawn, not when the account is opened.

TRANSFERS NOT SUBJECT TO GIFT TAX

The following transfers are not subject to gift tax:

- payment of medical expenses (Schedule A definition) and tuition (but not books, supplies, room or board),
- transfers to political organizations,
- transfers incident to a divorce,
- gifts to spouse, unless the spouse is not a U.S. citizen and the amount of the gift exceeds $175,000 (2023 amount), other than gifts of future interest in property, **and**
- charitable contributions, to a qualified charity.

JOINT TENANCY GIFTS

Certain joint tenancies are not gifts. If the transferor can retrieve the transfer without the cooperation or consent of the transferee, the creation of a joint tenancy does not constitute a gift. Creation of a joint bank or brokerage account is not a gift. If the donee withdraws funds for personal use from a joint tenancy account, the amount drawn that exceeds the contribution to the account becomes a gift at the time of the withdrawal.

A gift exists when joint tenancy is created for most assets because the donor cannot remove the donee's name from title without his or her cooperation and consent. Thus, gifts result when joint tenancies are established in all purchases of real estate, stocks and bonds (not when opening the brokerage account), and mutual funds.

GROSS INCOME

Remember that a simple rule under §61 governs the taxability of income: gross income means "all income from whatever source derived." In other words, income is taxable unless specifically excluded from the definition of taxable income by the IRC.

QUALIFIED DIVIDEND INCOME

Dividends paid after 2002 by most domestic corporations and many foreign ones are subject to the same preferential tax rates (0%, 15% or 20%) as net long-term capital gains. The dividends must be paid out of current or accumulated earnings of the corporation as of the end of the calendar year. A dividend is considered to have been made from earnings most recently accumulated. There are limitations based upon whether the stock is held the appropriate number of days. To qualify the foreign corporations must be traded on an established U.S. securities market or be incorporated in a U.S. possession, or certain tax treaty requirements are met regarding the nation the foreign corporation is formed in.

> Example: During 20A1 Corporation B paid dividends of $25,000. At the beginning of 20A1 it had accumulated earnings of $50,000 and during 20A1 it lost $25,000. Any

dividends paid in 20A1 are fully taxed because the corporation's net accumulated earnings and profits exceeded its dividends.

Dividends received as a member of a partnership, stockholder in an S corporation, or as a beneficiary of an estate or trust are eligible for the new rates to the extent they otherwise qualify under the new law. A distribution from a partnership or S corporation is reported as a dividend only if it is portfolio income derived from nonbusiness activities.

Stock dividends on common stock are generally not taxable, but stock dividends on preferred stock may be. Stock dividends are also taxable if the taxpayer could choose to take the dividend in either stock or cash.

Taxable Employer Paid Earnings

Taxable employer-paid earnings include bonuses, tips, commissions, salaries, sick pay, severance pay, vacation pay, prizes and awards, expense allowances or reimbursements under non-accountable plans, and payments/benefits from a leave-sharing plan. Gross W-2 earnings are taxable in the year they are received or are available to the taxpayer. Salary advances for future services generally are taxable in the year they are received, as long as the employee has free and unrestricted use of the money.

Under §83, the fair market value of property received in exchange for services is included in the employee's income.

Taxpayers cannot avoid tax by assigning the right of payment to another person or entity. Amounts distributed by the employer as charitable contributions are still taxable as income to the employee and are deductible as an itemized contribution. An exception exists for doctors who treat low-income patients when they are required to assign their fees to a foundation.

Fringe benefits are a form of payment for the performance of services. Any fringe benefit is taxable and must be included in the taxpayer's pay unless the law specifically excludes it.

Non-Taxable Employee Benefits

Accident and Health Benefits

Contributions to the cost of accidental or health insurance, or a separate trust or fund that provides accident or health benefits directly or through insurance, are not includible in the employee's taxable earnings. The exclusion also applies to payments made directly or indirectly to an employee under an accident/health plan if payment/reimbursement for medical costs, or for specific injuries or illnesses.

Achievement/Service Awards

Achievement awards are taxable unless they meet special rules for tangible personal property given to recognize length of service or safety achievement. Cash awards, gift certificates, and similar awards are taxable. Generally, if the employer is allowed to deduct the cost of a tangible personal property award, it is not taxable to the employee. Employers may deduct the cost of personal property that does not exceed $400 for awards from nonqualified plans and $1,600 for awards from qualified plans under §274(j). Qualified plans must be written and be nondiscriminatory, and awards must be given as part of a meaningful presentation under circumstances that do not create a significant likelihood that the payment is disguised compensation.

> Example: The employer paid $500 for a television with an FMV of $600. The employee is taxed on $200 ($600 FMV - $400 deductible amount for a nonqualified plan).

Safety achievement awards are not deductible if during the taxable year safety awards were previously given to more than 10% of the other employees (not including managers, administrators, clerical employee or other professional employees). Safety achievement awards made to a manager, administrator, clerical employee, or other professional employee for safety achievement do not qualify for tax-fee treatment.

Adoption Assistance Benefits
Employer paid/reimbursed qualified adoption expenses are tax-free up to $15,950 for all adoptions beginning in 2023. AGI income phase-out provisions apply. Under §137, qualified adoption expenses include reasonable and necessary adoption fees, court costs, attorney fees, and other expenses that stem directly from the legal adoption of an eligible child. The full amount is available for adoption of a special needs child, even if the actual expenses are less. "Special needs" is a designation made whenever a state determines that adoption assistance is required to place a child because of special factors, such as physical condition.

The exclusion is not an annual limit but applies to each effort to adopt an eligible child, even if the adoption effort takes more than one year. If the child is not a U.S. resident or citizen at the time the adoption process begins, the exclusion can only be used in the year the adoption becomes final.

If the taxpayer has other qualifying adoption expenses he or she may also be able to claim a separate $15,950 tax credit for the same adoption. This is subject to phase out when AGI exceeds a certain amount.

Expenses to adopt your spouse's child or for participation in a surrogate parenting arrangement are not eligible for this employer benefit, nor are they available under the adoption credit.

De Minimis Fringe Benefits - §132
Employees may exclude from gross income the value of de minimis fringe benefits, services or property that is so small that accounting for it in unreasonable or administratively impracticable. Included are:

- occasional personal use of an employer's copy machine,
- occasional cocktail parties, group meals, or picnics for employees and their guests,

- group-term life insurance payable on the death of an employee's spouse or dependent if the face amount does not exceed $2,000
- tickets to theater or sporting events,
- inexpensive birthday or holiday gifts (except cash, which is taxable),
- coffee, doughnuts, and soft drinks, **and**
- local telephone calls.

De minimis fringe benefits do not include:

- qualified transportation fringe benefits,
- season tickets to sporting or theatrical events,
- employer-provided group term life insurance on the life of the employee's spouse or child, **or**
- use of employer-owned or leased facilities, such as an apartment or boat, for a weekend.

Dependent Care Assistance
Qualifying day-care services provided by an employer under a written, nondiscriminatory plan are generally not taxable up to a limit of $5,000 ($2,500 if married, filing separately). The exclusion cannot be more than the taxpayer or spouse's earned income. Expenses are excludable only if they also qualify for the dependent care credit. No exclusion is permitted if dependent care is provided by a relative who is the taxpayer or taxpayer's spouse's relative, or by taxpayer's child under 19 years old.

Educational Assistance
Employer payments for job-related courses are tax-free as long as the courses do not satisfy the employer's minimum education standards and do not qualify the taxpayer for a new profession.

Even if not job related, the employer's payment for undergraduate or graduate courses is tax-free up to $5,250 annually as long as the plan qualifies under §127. To qualify as a tax-free employer educational assistance requires a written, non-discriminatory plan. The employer also cannot spend more than 5% of the total assistance on behalf of shareholders or owners (or their spouses or dependents) who own more than 5% of the employer's stock.

Tuition reductions offered by educational institutions are tax-free as long as the reduction is not payment for teaching or other services. Graduate students are not taxed on tuition reductions as long as they receive regular pay for the teaching or research services they provide.

If the employer does not have an educational assistance plan, or if employees are provided with assistance exceeding $5,250, the employee can exclude the value of these benefits if they are working condition benefits (in other words, if the employee paid for it, it would be deductible as a business expense).

Employee Discount
Employee discounts on company products are a tax-free benefit under §132 as long as the discount does not exceed the employer's gross profit percentage for the taxable year immediately preceding the discounted acquisition. If the employer is in its first 12 months of business, it can use the mark-up percentage or an industry standard. If a company's gross profit percentage for the previous taxable year is 35%, a 50% discount generates taxable income equal to 15% of the price charged to customers.
For services, including ones not available to the no-additional-cost exclusion above, the tax-free discount is limited to 20% of the selling price charged customers. Not all company products qualify for the employee discount. Discounts on real estate, securities, currency, and bullion are taxable. Low interest, or interest free, loans given to employees of financial institutions similarly do not qualify.

In determining the amount of an employee discount, the price at which the property or service is being offered to customers at the time of the employee's purchase is controlling. Gross profit percentage (on the prior year sales) can be calculated as:

GP% = (1 – (cost of goods sold/aggregate sales))

> Example: an employer's sales are $10,000,000 and the cost of goods sold is $8,000,000. Gross profit percentage can be calculated as: (1 – (8/10)) = (1 -.8) = .2 or 20%

Discount percentage is calculated as:

Discount % = (Retail-Paid)/Retail

> Example: if the retail amount is $4,000 and the amount paid is $2,400, the discount percentage is 40% (($4,000-$2,400)/$4,000).
>
> The taxable employee discount is calculated as the Discount % (40%) - Gross Profit % (20%) x Retail Price ($4,000) = $800 taxed to the employee for the excess discount.

Alternatively, this may be calculated as:

((COGS/Sales) x Retail) – Paid = Taxable Discount ((8/10) x $4,000) - $2,400) = $800

> Example: COGS = $4,000,000, Sales = $6,000,000, Retail = $4,000, Paid = $1,200
>
> GP% = 33%, DP% = 70%. Taxable discount equals $4,000 x 36% = $1,440 if I don't round
> Alternative: ((4/6) x $4,000)-$1,200=$1,480 if I don't round
>
> When doing these calculations, show your work if possible as rounding can affect the results.

Group Term Life Insurance Coverage
This exclusion applies to life insurance coverage that provides a general death benefit not included in income that is provided to a group of employees in a manner that prevents the individual from selecting the coverage. The policy must be carried directly or indirectly by the employer, and generally must be provided to at least 10 full-time employees at some time during the year. The exclusion applies to the cost of up to $50,000 in insurance. If the plan favors key employees as to the participation or benefits, the entire cost of the insurance is includible in the key employee's wages.

Meals and Lodging
For these purposes, meals do not include the value of any meal or meal money that has so little value (taking into account how frequently you provide meals to the employees) that accounting for it would be unreasonable or administratively impractical. This includes the cost of coffee, doughnuts, or soft drinks, and the occasional meal or meal money that is provided to enable an employee to work overtime. It also does not include the occasional party or picnic for employees or their guests.

Employees are not taxed on the value of employer-provided meals and lodging for them and their families, provided they are furnished under certain conditions. To meet those tests, meals must be furnished on the employer's premises and for the employer's convenience under §119(a). The Supreme Court has held that cash payments designated as meal allowances are not excludable under §119 (*Kowalski* (434 U.S. 77 (1977)).

To be considered as furnished for the employer's convenience, there must be a substantial non-compensatory business reason for providing the meals. Non-compensatory business purposes for providing meals include:

- food service employees can exclude the value of meals eaten during their normal work hours at their employer's premises. However, food service employees cannot exclude the value of meals eaten for free on non-work days.
- a bank employee can exclude the value of lunch eaten on the bank premises if the bank provides the meals to limit the teller's lunch period to 30 minutes in order to better serve bank customers during peak hours.
- a casino employee can similarly exclude the value of meals eaten on premises when the casino adopted a 'stay on premises' requirement for security reasons making it impossible for the employee to go elsewhere for lunch.

For the value of lodging to be excludable, it must be furnished on the employer's premises, for the employer's convenience, and must be a condition of employment under §119(a)). The condition of employment test is met if the employee must accept the lodging in order to perform his duties properly. Cash payments in lieu of lodging are not tax-free.

Lodging that meets these requirements includes:

- an apartment provided for a resident manager or maintenance person, who must be available 24 hours to respond to tenant emergencies.
- rooms provided to dorm parents and a nurse at university housing.
- a house provided for a hotel manager.

If the employee is required to live onsite, the exclusion also applies to any meals furnished without charge to the employee.

Moving Expense Reimbursements

This exclusion was suspended by the Tax Cuts and Jobs Act (except for active duty military members) for taxable years beginning after 12/31/2017 and beginning before 1/1/2026.

It applied to reimbursement, given directly or indirectly to an employee, for moving expenses and applies only to the moving expenses the taxpayer could deduct if he or she had paid or incurred them directly.

No-Additional-Cost Services

No additional cost services are tax-free if the service is:

- offered to customers in the ordinary course of business,
- in the same line of business where the employee works, **and**
- the employer does not incur substantial additional costs for providing the service.

Highly compensated employees can obtain free company services only if the services are available on a nondiscriminatory basis to other employees.

> Example: The employee works for an airline that also owns hotels. The airline employee is not taxed on the value of a regularly scheduled, commercial flight. The airline employee is taxed on the value of a free hotel room provided. On the other hand, a hotel employee would be taxed on the value of the flight, but not the hotel room.

Retirement Planning Services

The value of retirement planning advice or information given to the employee or spouse is excludable if the employer maintains a qualified plan. This exclusion does not apply to services for tax preparation, accounting, legal or brokerage services.

Transportation Benefits

The qualified bicycle commuting reimbursement exclusion was suspended by the Tax Cuts and Jobs Act for taxable years beginning after 12/31/2017 and beginning before 1/1/2026.

Generally, the following items related to vehicle usage are excluded from gross income:

- qualified parking for regular employees is tax-free up to set amount with employees taxed on the excess if the value of the right to access a parking space exceeds the allowable amount.

- employer provided transit passes and van-pooling are tax-free up to a set amount; any excess is taxable.
- company car use for business purposes is excludable, but personal use is taxable and must be calculated by the employer and reported on the W-2.
- demo car use by a full-time auto salesperson is tax-free if it facilitates job performance and there are substantial restrictions on personal use (see Rev Proc 2001-56 if interested in more details about this area). Otherwise, the personal use of a demo vehicle is taxable and can be calculated as the FMV of the vehicle if the taxpayer fails to keep records (*Whitehead* (TC Memo 2001-317)).
- company plane use is tax-free if used for business purposes.

Tuition Reduction
An educational organization can exclude the value of a qualified tuition reduction provided to an employee for undergraduate education. It must be for education of the employee, a former employee who retired or is on disability, a widow or widower of a former employee, or a dependent child or spouse of any individual listed above.

A tuition reduction for graduate education qualifies only if it is for the education of a graduate student who performs teaching or research activities for the educational organization.

Working Condition Benefits
This exclusion applies to property and services provided to an employee so the employee can perform his or her job. The employee must meet any substantiation requirements that apply to the deduction. The exclusion only applies to the amount that would be allowable by the employee if the employee paid for its use.

> Example: The employer provides Patti with a car to use for business and personal purposes. The working condition exclusion applies only to the business portion of the car's use.

All of the employee's use of a qualified nonpersonal-use vehicle is a working condition benefit because the employee is not likely to use the vehicle more than minimally for personal purposes. Examples of these vehicles include clearly marked police and fire vehicles, an ambulance or hearse used for its specific person, any vehicle designed to carry cargo with gross vehicle weight over 14,000 pounds, and school or passenger buses. It may apply to pick-up trucks or vans that have been specially modified to make it unlikely they are used more than minimally for personal purposes (cargo vans with shelving in the back and only one seat for the driver, for instance).

PRIZES/AWARDS
Although some exceptions apply, taxpayers generally must include prizes and awards in gross income under §74(a). If the prize is paid in property or services, the taxpayer must include the fair market value (not its retail price) of the goods and services in gross income under

Regulation §1.74-1(a)(2). Prizes and awards are not gambling winnings (which include lottery and raffle winnings).

Prizes and awards include those won on radio and/or television shows, door prizes, and awards from all contests.

Under §74(b), taxpayers can exclude prizes and awards from gross income if:

- prizes/awards are made primarily in recognition of religious, charitable, scientific, educational, artistic, literary, or civic achievement,
- the recipient is selected without entering the contest,
- the recipient does not have to perform substantial future services to receive the prize/award, and
- the recipient transfers the prize or award to a designated charity.

  Example: John receives $1,000,000 for winning the Nobel Prize in physics. If taxpayer accepts the money and uses it all for research, the entire award is taxable. If John transfers the award to a designated charity **without** receiving the money, it is **not taxable** to him. This can appear on the exam, so watch what happens with the funds.

Pay attention to the recipient's use of the award money to determine taxability:
if the taxpayer accepts the money first, the award is taxable
(it has been graded that way, even if transferred later).
If the award is transferred to a charity or university before taking possession,
it is not taxable.

INTEREST INCOME

Generally, taxpayers must include in gross income all interest income received or credited. This includes interest earned on bank accounts, promissory notes, mortgages, corporate debentures, legacies, refunds of Federal or state income taxes, U.S. obligations (Treasury bills, notes and bonds), U.S. Savings Bonds, and unregistered state or local bonds. There are some exceptions:

Public purpose bonds: investors owning state or local bonds may exclude interest earned on them under §103(a), if the bonds are registered and tax-exempt and are not arbitrage bonds.

Private activity bonds: these bonds are used to finance housing and student loans. There are limits on the amount of qualifying private activity bonds an authority may issue. Interest on qualifying bonds is tax free for regular income tax, but is a preference item to be added to taxable income for alternative minimum tax purposes.

Taxable municipals: these bonds, used for nonqualifying private purposes, are subject to Federal income tax but may be exempt from state and local taxes in the state where they are issued.

U.S. savings bonds: interest may be taxable when accrued or deferred until the time when the bonds either are cashed in or mature. If the bonds are issued at face value, interest checks are paid semiannually and the interest is taxable in the year received. When bonds are purchased for a discounted value, the taxpayer may elect to:

- postpone reporting the interest until he or she cashes the bonds or the bonds reach maturity, whichever is earlier, **or**
- report the increase in redemption value as interest each year.

Frozen accounts: interest allocable to bankrupt or insolvent financial institutions' frozen accounts is not taxable while withdrawals are limited. Interest becomes taxable when withdrawals are permitted. This limitation is not available to officers and owners, including relatives, with at least a 1% interest in the institution.

Early withdrawal penalties: the full amount of interest credited to the taxpayer's account is reported. The penalty is reported above-the-line on Line 31 of Form 1040.

MINISTER'S PARSONAGE ALLOWANCE

Ordained ministers, rabbis, and cantors can receive tax-free housing allowances if the entire amount is used to pay rent (furnished or unfurnished house or apartment) and utilities. An ordained individual similarly is not taxed on the rental value of a home provided as part of his or her pay. To be tax-free the payments must be so designated by an employment agreement or minutes or other means before they are paid.

Although not income-taxable, parsonage allowances are subject to self-employment tax for Social Security purposes. Ministers receiving housing allowances may still itemize on Schedule A property taxes and interest paid, even if the tax-free allowance is used to finance any of the payments.

SAVINGS BONDS USED FOR QUALIFIED HIGHER EDUCATION

Generally, investors redeeming qualified U.S. savings bonds to pay for qualified higher education expenses may exclude that amount from gross income under §135(a). Qualified bonds were those issued after 12/31/89, to an individual at least 24 years old, at a discount (something less than the bond's face value).

Qualified higher education expenses include tuition and fees to attend or enroll at an eligible educational institution paid by the investor, or his or her spouse or dependents. They do not include expenses for courses or education in sports, games, or hobbies, unless they are part of a degree program. Higher education expenses for the year are reduced for qualified scholarships and educational assistance received, and payments or reimbursements under a qualified state tuition program.

If the proceeds exceed the qualified education expenses paid, the exclusion is limited to a fraction of the redeemed amount:

<u>amount of qualified education expenses paid during the tax year</u>
aggregate proceeds of qualified U.S. savings bonds redeemed

There are further exclusion limitations based on the taxpayer's modified adjusted gross income. The exclusion is not available for individuals who are married but file separate returns under §135(d)(2).

FOUND MONEY/TREASURE TROVE

Cash found is taxable in year received if the finder keeps or spends the money. It is non-taxable if turned over to police. A purchased item that turns out to be valuable is taxable in year it is sold, not when taxpayer discovers the item's value.

A treasure trove is taxable when found.
A purchased item that is later found to be valuable retains its low basis;
the gain is taxed upon sale of the item.

> Example: Karen finds $6,000 on the street and heads immediately to California's central coast for some great California wine; the $6,000 is includible in gross income even though she shares the wonderful wine with tax colleagues at the evening tax calculation workshop.
>
> Example: Taxpayer purchases an old desk for $10 at a garage sale and later discovers the desk is a valuable antique, worth $4,000; the value does not become income until the desk is sold (the basis is $10, and the gain will be taxed using the low basis).
>
> Example: Taxpayer purchases an old table for $100 at a garage sale and later discovers a coin worth $10,000 in a drawer. The $10,000 is immediately taxable as a treasure trove; found treasure is taxable when it comes into the taxpayer's undisputed possession.

SCHOLARSHIPS/FELLOWSHIPS

Degree candidates at an educational institution may exclude from gross income any qualified scholarships they receive under §117(a). A qualified scholarship includes the amount received by the student to the extent the money is used to pay qualified tuition and related expenses. Qualified tuition and related expenses include tuition, fees, books, supplies and equipment required for instruction courses at the institution. Scholarships received in excess of qualified expenses are taxable.

Students who must teach, research, or perform other services as a condition of receiving a qualified scholarship, tuition or tuition reduction, must include in gross income that portion of the scholarship or reduction that represents payment for those services.

ILL-GOTTEN GAINS

Extortion or stolen receipts are taxable and must be included in income. §61 definition of 'all income from whatever source derived' includes both legal and illegal sources of income.

LIFE INSURANCE PROCEEDS

Life insurance dividends are not true dividends as they represent a return of premiums previously paid. They are not taxable, unless they exceed the net premiums paid on the contract, or they were deducted as a business expense in a prior year. Interest that is paid or credited on dividends left with the insurance company is taxable. Dividends on VA insurance are not taxable; interest on dividends left with the VA is also non-taxable.

Life insurance proceeds received upon the death of the insured are generally free from income tax under §101(a) but they may be reduced by applicable estate taxes. Interest paid on proceeds left with the insurer is taxable.

> **Lump-sum payment in full**: generally tax-free, but any interest earned is taxable.
>
> **Installment payments over life that were available in a lump-sum**: part of each payment is attributable to interest which is taxable. To compute the tax-free portion: the face amount of the policy is divided by the number of years the installments are payable. Anything in excess of this amount is taxed.
>
> Example: Joe's wife Eleanor died with a $30,000 life insurance. Joe elects to take proceeds over his life expectancy, 15 years when the payments commence, or $2,500 per year. Joe is entitled to receive $2,000 per year on a tax-free basis ($30,000 value/15-year life expectancy = $2,000); the remaining $500 is taxable when received.
>
> **Installment payments over a fixed term that were available in a lump-sum**: the face value is divided instead by the fixed term to calculate the tax-free amount. Anything in excess of this amount is taxed.
>
> **Universal life policy death benefits**: to be tax-free the death benefits must meet technical tests, which are determined by the insurance company.

CASH OR OTHER GIFTS RECEIVED

For income tax purposes, receiving a gift does not create a taxable event. Any income or earnings from the gift property is taxable. Generally, the donee retains the donor's basis and ownership period of the property; when computing a gain or loss on the sale of gift property, the donee may use a basis that is higher or lower than the donor's basis, depending upon the circumstances. See the Gift/Gift Tax section of the text for these calculations.

Inherited Property Received

Taxpayers exclude from gross income property inherited under a will or a state's intestacy laws under §102(a) and Regulations §1.102-1(a). Under current estate tax laws, inherited property's basis is its value on the date of the decedent's death. The basis of inherited property subject to a mortgage or a lease is still the value of the property at death, not its net equity position.

Income and earnings from inherited property are taxable. Calling something a gift or inheritance does not make it nontaxable if it is simply a disguised payment for services. Sale of an inheritance from a living person is taxable as ordinary income; the person is not dead so it is not inherited!

Distributions from an inherited IRA, 401(k) or other qualified pension or retirement plan are taxable to the recipient, subject to basis rules in the hands of the donor (some may be nontaxable recovery of basis or otherwise nontaxable under ROTH rules).

Gain on the disposition of inherited property is treated as long term regardless of how soon after the inheritance the property is sold.

Gambling Winnings/Losses

Gambling winnings are taxable. Gambling losses are deductible only to the extent of winnings, and are reported as a Schedule A, Miscellaneous Itemized Deduction (not subject to the 2% AGI limitation) for non-professional gamblers. Rev Proc 77-29 provides guidelines regarding the responsibility for maintaining adequate records to support gambling winnings and losses. An accurate diary supplemented by verifiable documentation is usually acceptable and should contain:

- date of specific wager
- name of gambling establishment
- address or location of gambling establishment
- name(s) of other persons (if any) present with taxpayer at the time
- amount won or lost

Verifiable documentation includes hotel bills, airline tickets, wagering tickets, bank withdrawals, and so forth. Slot machines should include the date and time the machine was played, including the slot machine number.

The Tax Cuts and Jobs Act nullified *Mayo* by amending the statute to limit §162 expenses to gambling wagers as well. The provision is effective for tax years beginning after 12/31/2017 and beginning before 1/1/2026. In *Mayo* (136 TC 4 (1/25/11)) the taxpayer was engaged in the trade or business of gambling on horse races during 2001. The court ruled that while wagering losses are limited to income under §165(d), the trade or business expenses incurred in the conduct of gambling as a trade or business (other than costs of the wagers) are deductible under §162(a).

Lottery Winnings
Lottery, sweepstake, and raffle winnings are taxable as 'other income' on Form 1040. The ticket cost is deductible only with itemized deductions to extent of winnings.

Casino/Lottery Installments
If winnings are payable in installments, the taxpayer is taxed as each installment is received. Merely having a cash option does not make the present value of the annuity taxable in the year the prize is won (this applies to prizes won after 10/21/98).

Whistleblower Awards
In order to receive a whistleblower award under §7623, the IRS must take an administrative or judicial action and there must be a collection of proceeds because the award is a percentage of collected proceeds, including penalties, interest, additions to tax and additional amounts. These awards taxed are ordinary income, not capital gains, to the recipients.

The collected proceeds for an award under §7623(b) also includes criminal fines and forfeitures. *Whistleblower21276-13W* (147 TC 4 (8/3/16)) sought awards which were rejected as untimely. In a previous court case the Tax Court found their claims were timely and ordered the parties to attempt to resolve their differences. Subsequently the parties agreed that petitioners (H&W) were eligible for an award of 24% of the collected proceeds. The targeted taxpayer pleaded guilty and paid $74,131,694 in tax restitution ($20,000,001), a criminal fine, and civil forfeiture to the Government. The parties disagreed whether the criminal fine and civil forfeitures counted as collected proceeds – the court found they were by examining the plain language (collected proceeds means all proceeds collected).

The Commissioner is not required to monitor a taxpayer's voluntary change in reporting for years for which there was no action because that doesn't meet the definition of 'collected proceeds.' In *Whistleblower 16158-14W* (148 TC 12 (4/17/17)) petitioner provided information regarding T's alleged failure to withhold and pay over taxes for 2006 through 2008. W supplemented the submission to add years 2009 through 2014. The IRS expanded an ongoing examination for 2006 through 2008 to address the issue W raised, but there were no collected proceeds. The IRS did not conduct an examination relating to the withholding issue for other years. T updated its recordkeeping system after 2008 and W alleged earned in that those improvements resulted in collected proceeds and the Secretary must pay an award. The Court held that change doesn't meet the definition of 'collected proceeds.'
In *Whistleblower 972-17W v. Comm'r*, (159 TC 1 (7/13/22), the Tax Court held that the IRS must provide an unredacted copy of the target's administrative file where a Whistleblower has submitted information to WBO and IRS initiated an investigation of the target and collected proceeds from the information. IRS had denied a claim by whistleblower for a mandatory award. The key takeaways here are that Tax Court has jurisdiction to review the WBO determination and that §6103(h)(4)(A) allows an exception to the normal privacy rights of the target.

In *Michael Lissack*, (157 TC 5 (8/17/21), the whistleblower provided information about the target which WBO acted on to initiate an investigation. However, IRS found no unreported income with respect to that information. As a result of the investigation, an excess deduction of $60 million was discovered, but it was unrelated to the whistleblower's information. WBO denied the whistleblower claim under Regs. §301.7623-2(b)(2), which the court upheld as being both applicable to the facts and also valid under the Chevron test.

PERSONAL INJURY AWARDS (IRC §104)

Rapid changes to this area of tax law resulted in personal injury award questions appearing repeatedly on the Tax Court Admissions examination during the period 1990-2000. This issue is largely settled now but it still shows up as an exam question.

Physical Injury to the Body

Under §104(a)(2), compensatory damages for physical injury or physical sickness are tax-free regardless of whether they are fixed by a court as part of the prosecution of a legal suit or action based on tort or tort-type rights, or by a negotiated settlement adopted by the parties in lieu of litigation.

Compensatory damages for physical injury or sickness are excludable.
Emotional distress damages are excludable only if they are related to physical injuries.
Punitive damages are never excludable and are always taxable.

In *Michael Devine and Theresa Devine* (TC Memo 2017-111 (6/13/17)) petitioners filed a joint return that excluded an award for settlement related to sexual harassment and gender discrimination the wife received from her employer. None of the settlement was paid on account of personal injury or physical sickness, so none can be excluded even though the court expressed "considerable sympathy for the petitioner's position." Petitioners were also liable for an accuracy-related penalty because a 1099-MISC form had been received for the $200K litigation settlement.

Other Damages

Damages for non-physical injuries are taxable, regardless whether they are received for back pay, injury to the reputation, discrimination, for lost profits, or due to breach of contract. Damages that compensate for the loss of property may result in taxable gain if the damages exceed the adjusted basis of the property.

Emotional Distress

Emotional distress by itself is not treated as a physical injury or sickness. Even if emotional distress damages cover physical symptoms such as headaches, stomach disorders or insomnia, damages awarded for them are taxable to the recipient. Damages for emotional distress attributable to a physical injury or sickness are tax-free. Reimbursements of medical expenses for the treatment of emotional distress may be excluded, providing the reimbursements do not exceed the expense amount under §104(a).

Punitive Damages
Punitive damages are generally taxable even if they relate to physical injury or sickness. An exception allows income exclusion for punitive damages awarded in a wrongful death case, if punitive damages are the only damages that may be awarded under a state law that was effective on or before 9/13/95.

Legal Fees
For tax years beginning after 12/31/17, the TCJA added a provision for settlements, payouts, or attorney fees related to sexual harassment or sexual abuse. If the payments in such cases are subject to a nondisclosure agreement, then no deductions are allowed for said payouts or related legal fees paid or incurred after 12/31/17 under §162(q). TCJA also expanded the types of whistleblower cases that qualify for above-the-line deductions; before TCJA, it was solely federal tax related whistleblower cases.

Legal fees paid for personal injuries are not deductible because the award is not taxable. Legal fees relating to trade or business matters are deductible on Schedule C (or the entity return). Legal fees in age, sex, racial discrimination and whistleblower cases are deductible above the line. Since the deduction is made in arriving at AGI, AMT is no longer an issue.

Payments for Permanent Injuries or Disfigurements
Subject to some limitations, employees receiving payments for the permanent loss of a body member (such as an eye), or from the use or function of a body member (such as vision in an eye), from employer-provided accident or health plan may exclude those payments from gross income. Payments for permanent disfigurements are similarly excludable from gross income under §105(c)(1).

The employee may also exclude payments from an employer-provided accident or health plan if the employee's spouse or dependent is the person suffering either the permanent disfigurement or body member or use loss.

To be excludable from gross income under §105(c)(2), payments for disfigurement or the loss or loss of use of a body member or function must be based on the nature of the injury, not how long an employee is absent from work.

CASUALTY AND THEFT LOSSES

The Tax Cuts and Jobs Act suspended the personal casualty and theft loss provisions for tax years 2018 through 2025 **except** for casualty losses in a **presidentially declared disaster area**.

Casualty and theft losses are claimed on Form 4684, *Casualties and Thefts*. Only the owner of the property can deduct a casualty loss. The tax treatment for these unreimbursed losses depends on the taxpayer's purpose for holding the property:

- **personal use property** is subject to the sudden events test, and the deduction is reduced by $100 and an additional 10% of the AGI.
- I**ncome producing property** is claimed on Form 4684 and on Schedule A as a Miscellaneous Itemized Deduction not subject to the 2% floor or the 3% reduction.
- **business or rental property** is claimed on Form 4684 and as a loss on Form 4797, Sales of Business Property. The amount of the loss is not subject to any floor or the sudden event test.

SUDDEN EVENT TEST

To be a deductible casualty loss the property must be destroyed or damaged as a result of a sudden, unexpected, or unusual event. A sudden event is swift, not gradual or progressive, which precludes damage caused by erosion, corrosion, and termite infestation. An unexpected event is one that is ordinarily unanticipated and unintended. An unusual event is one that is not a day-to-day occurrence, and chance or a natural phenomenon must be present (think earthquake, fire, winds, floods, etc.).

The property must be destroyed or damaged as a result of a sudden, unexpected, or unusual event.

WHEN TO DEDUCT

Casualty losses are deductible in the year the casualty occurs, regardless of when the property is repaired or replaced. Only the amount that is expected to remain unreimbursed should be deducted. Insurance claims must be filed if the property is covered by insurance.

FEDERAL DISASTER

If the loss occurs in a presidentially-designated disaster area the taxpayer can choose to deduct the loss in the current tax year, or to claim the loss on the prior tax year's return. There is a 90-day period to revoke an election to deduct a disaster loss in the previous year; after the 90-day period the election becomes irrevocable. If an early filed return claims the deduction, the taxpayer can change this election up to the due date of the return in which the loss was claimed.

THEFT LOSS

A theft loss can be deducted in the year the property loss is discovered. Taking the property must be illegal under state law to support a theft loss deduction. In *Wanchek* (TC Memo 2007-366 (12/11/07)) petitioner contracted for new home construction that was completed in 1995. Problems with the construction became "a living nightmare" despite repair efforts by the contractor and subs, resulting in civil litigation. Taxpayers claimed a net theft loss deduction of $172,904. Theft is determined by reference to the jurisdiction where the loss occurred and does not require a criminal conviction. In this case petitioners could not prove the builder had specific intent to cheat or deceive them when taking money in exchange for building their house. The Court has allowed theft loss deductions when contractors took money under false pretenses and either absconded or ceased construction. Here petitioners were the victims of poor workmanship, which in itself is not a crime.

CHARITABLE CONTRIBUTIONS

Tax Cuts and Jobs Act changed the charitable limitation for certain cash contributions from 50% of AGI to 60%. It also repealed the provision that stated if a payment made to a college or university provided the right to buy tickets to a sporting event, then 80% of the contribution was deductible. [https://www.irs.gov/charities-non-profits/charitable-organizations/charitable-contribution-deductions]

Charitable contributions are donations or gifts made to, or for the use of, qualified organizations. They must be voluntary and made without the expectation of receiving anything of equal value.

[https://www.irs.gov/charities-non-profits/charitable-organizations/charitable-contribution-deductions]

QUALIFIED CHARITABLE ORGANIZATIONS

A qualified organization is a nonprofit group that can be religious, charitable, educational, scientific, or literary in purpose, or one that works to prevent cruelty to children or animals. Organizations that qualify include 1) a community chest, corporation, trust, fund, or foundation organized or created under the laws of the US, District of Columbia, or any state or possession of the US, 2) war veterans' organizations, 3) domestic fraternal societies operating under the lodge system (these donations are only deductible if they are used solely for the purposes stated above), 4) certain nonprofit cemetery companies or corporations (but not if it is used for the care of a specific plot or crypt), or 5) the US or any state (but the contribution must be made solely for a public purpose).

Charitable contributions are not deductible if the money or property is given to a civic league, chamber of commerce, labor union, groups run for personal profit, groups that lobby for law changes, individuals, or political parties or candidates for public office. The costs of raffle, bingo or lottery tickets are not deductible. The value of a taxpayer's time is not deductible, nor is the value of blood donated to a blood bank.

DEDUCTIBLE CONTRIBUTION

Cash and certain noncash charitable contributions are deducted on Schedule A. If noncash charitable contributions exceed $500, Form 8283, *Noncash Charitable Contributions*, must be attached to the return or the deduction can be disallowed. Items must be in good or better condition to generate a tax deduction. The deduction may be limited to a percentage of the taxpayer's adjusted gross income if certain rules apply. Unused charitable contributions are carried forward up to 5 years.

The 60% limitation applies to all cash charitable contributions made during the year and means that taxpayers cannot deduct more than 60% of AGI. A special 30% limitation applies if the gifts are capital gain property (discussed in Appreciated Property section below). 60% limitation organizations are most recognized charities; those limited to 30% of income include veterans' organizations, fraternal societies, nonprofit cemeteries, and certain private nonoperating foundations.

If the taxpayer receives a benefit as a result of the contribution, the deduction is permitted only for the amount that exceeds the value of the benefit given.

SUBSTANTIATION REQUIRED

Regardless of the contribution amount, all cash donations of less than $250 must be substantiated with a bank record (cancelled check or bank statement showing name) or written communication from the donee. It is no longer sufficient for the taxpayer to offer reliable written records showing the amount, date and recipient of the contribution.

A qualified organization must provide a written statement if the taxpayer makes a payment that is more than $75 and is partly a contribution and partly for goods or services. The charity must advise the amount that is deductible. No statement is required if the organization is a religious one, and the only benefit provided is an intangible religious one.

To deduct cash or unreimbursed volunteer expense contributions of $250 or more, the taxpayer must retain a written acknowledgement of the contribution from the qualified organization. The acknowledgement must also state whether any goods or services were included as a result of the gift. It must be obtained the earlier of the date the taxpayer files the tax return for the year in which the contribution was made, or the due date, including extensions, of the applicable tax return.

For noncash contributions of less than $250 the taxpayer must obtain a receipt or letter from the organization showing the name, date/location of the contribution, and a reasonably detailed description of the property. No receipt is required if it is impractical to obtain one because the donation was left at an unattended drop site. The taxpayer must also have written records for each item of donated property including the name and address of the organization, date and location of the contribution, description of the property, its fair market value and how that FMV was determined, and the cost or other basis in the property.

If the noncash donation is $250 or more but less than $500 there must be a contemporaneous written acknowledgement (CWA) of the contribution from the qualified organization. This acknowledgement must identify the property and indicate whether there were any goods or services received as a result of the contribution. The charitable contribution substantiation requirements also apply to unreimbursed volunteer expenditures, so petitioner lost all foster cat expense items of $250 or more because she lacked substantiation in *Van Dusen* (138 TC 25(6/2/11)).

The contemporaneous written acknowledgement (CWA)
must state if goods or services were provided in exchange for the charitable contribution.
It must be available for each cash or noncash contribution of $250 or more
by the time the tax return is filed.
If conditions are not met, the contribution deduction is lost
in an IRS examination and/or in the Tax Court.

To claim a deduction over $500 but not over $5,000 the written records must also include how the property was obtained, when it was obtained, and the cost or adjusted basis of the property. This last requirement does not apply to publicly traded securities; they do not require an appraisal and are valued at an average of the high and low trading price on the date of the contribution. Form 8283 must be attached to the return.

If the noncash donation is more than $5,000 (except for stock, certain works of art, and automobiles and boats) the acknowledgement and written records described above are required, plus a qualified written appraisal of the donated property by a qualified appraiser, described below. The dollar amount includes any single item more than $5,000 or the aggregate of noncash items of similar nature (and they must be aggregated for purpose of the $5,000 appraisal requirement). The appraisal must be obtained no more than 60 days before the gift. The appraiser and the donor organization must sign the Form 8283.

> Example: In *Mark Ohde and Rose Ohde* (TC Memo 2017-137 (7/10/17)) the petitioners claimed that in 2011 they donated more than 20,000 distinct items to Goodwill Industries with a value of $142,250 that they deducted on their income tax return. Roughly half of the petitioners' alleged gifts consisted of clothing and accessories although they also indicated they gave Goodwill 115 chairs, 16 bedframes and 14 filing cabinets along with 3,153 books. Each receipt indicated that Goodwill had received items, but no description was provided, and no condition was noted. The receipts did indicate "Goodwill does not return goods or services in exchange for donations of property." At trial, the petitioners provided a spreadsheet generated by the TurboTax "ItsDeductible" program, but that was not prepared contemporaneously with the alleged gifts. They did not provide any cost basis for the items donated.

> Taxpayers must provide substantiation of all contributions, and must have a contemporaneous written acknowledgement from the donee. If the value exceeds $5,000 strict substantiation requirements are imposed, including an appraisal, and "similar items of property" must be aggregated to determine if that threshold is met. Petitioners' testimony was not found to be credible. They were allowed a $250 deduction, and subject to an accuracy related penalty.

Donations of art valued at $20,000 or more must have a signed appraisal and photograph. The appraisal must be attached to the return and the photo (of sufficient quality and size to fully show the object) must be provided to the IRS if requested.

For publicly traded stock an appraisal is not required if as of the date of the contribution market quotations are readily available on an established securities market. For nonpublicly traded stock contributions greater than $5,000 but less than or equal to $10,000 a partially completed appraisal summary is required (complete Form 8283, Part 1). For contributions over $10,000 a qualified appraisal must be attached to the return.

If the Form 8283 is incomplete, it may not fulfill the substantiation requirement. In *RERI Holdings I, LLC, Jeff Blau Tax Matters Partner* (149 TC 1 (7/3/17)) the petitioner, a partnership, paid $2.95 million to acquire a remainder interest in property. On 8/27/03 the partnership assigned the remainder interest to a university and it claimed a charitable contribution of more than $33,019,000. Form 8382, *Noncash Charitable Contributions*, was attached to the tax return but left blank was the space for the "donor's cost or other adjusted basis." The omission of the cost or adjusted basis information violated the substantiation requirement under the regulations. The omission cannot be excused on the grounds of substantial compliance – the disclosure would have alerted respondent to a potential overvaluation of the property, and omitting the information prevented Form 8283 from achieving its intended purpose. The petitioners' failure to comply, either strictly or substantially, with the requirements under the regulations requires denial in full of its claimed charitable contribution.

For vehicles, boats and airplanes with a value more than $500 the value is the lesser of the gross sales proceeds or the FMV of the vehicle if "no significant use or material improvement." Taxpayer needs a CWA from the donee organization, which must use Form 1098-C to report the value of the donation if the vehicle is sold. A donor may instead deduct the vehicle's FMV if the charity makes "significant use of it as part of its exempt mission." For boats that cannot include use of the vessel as a charter boat.

The contemporaneous written acknowledgement need not take any particular form and may be furnished to the donor by letter, postcard or computer-generated media. It must contain an affirmative indication that the donee provided no goods or services if none were provided (*310 Retail, LLC Zeller-310 LLC, Tax Matters Partner* (TC Memo 2017-164 (8/24/17))).

An amended return filed that contains the language required by the CWA is no effect on the taxpayer's requirement to obtain the acknowledgement prior to filing his return in *15 West 17th Street LLC, Isaac Mishan, Tax Matters Partner* (147 TC 19 (12/2/16)).

QUALIFIED APPRAISAL

A qualified appraisal is made by a qualified appraiser. Under Reg §1.170A-13(c)(7)(iii) it is a document that:

- relates to an appraisal made no earlier than 60 days prior to the date of the contribution of the appraised property,
- does not involve a prohibited appraisal fee (the fee cannot be tied to the appraised value of the property),
- includes required information, including a description of the property and its physical condition, date of the contribution, terms of the agreement as to the use, sale or disposition of the donated property, identity of the qualified appraiser (including taxpayer identification number of the appraiser and the appraiser's employer), the appraiser's qualifications, a statement that the appraisal was done for income tax purposes, the date, or dates on which the property was valued, the appraised FMV on the date of the contribution, the valuation method, and the specific basis for the valuation, **and**
- is prepared, signed and dated by a qualified appraiser.

The appraisal must be received before the due date, including extensions, of the tax return on which the contribution is first claimed for the donated property. An appraisal summary must be attached to the return.

Qualified appraisers declare on the appraisal summary they:

- hold themselves out to the public as an appraiser, or performs appraisals on a regular basis,
- are qualified to make appraisals of the type of property being valued because of qualifications described in the appraisal,
- are not an excluded individual (including the donor of the property, the donee of the property, a person employed by or married or related to any of the above, or an appraiser who regularly appraisers for one of the above persons and does not work a majority of appraisals for other people), **and**
- understand that an intentionally false overstatement of the value may subject him or her to a penalty for aiding and abetting an understatement of tax liability.

VOLUNTEER EXPENSES

Volunteers may deduct out of pocket expenses that are directly connected with the volunteer service if not personal, living, or family expenses. No deduction is permitted for value of the taxpayer's time.

Charitable deductions for travel, meals and lodging are not allowed if there is a significant element of personal pleasure. Taxpayer was denied the deduction in *Field (*TC Summary 2005-184) – he was part of a chorus group that went to Wales where sight-seeing hours (37) exceeded performing hours (24) even though petitioner testified he was either "reading, sleeping or resting from jet lag during those times and not sightseeing." The Court created an "extent and duration" test to determine how much time was available for activities with elements of personal pleasure

PROPERTY CONTRIBUTIONS

Contributions of property are generally recorded at the property's FMV at the time of the contribution. The FMV of contributed household goods or used clothing is generally significantly lower than the cost to acquire such items when new.

For encumbered property contributed, the FMV must be reduced by the value of any allowable deduction for interest the taxpayer paid, or will pay, that can be attributed to any period after the contribution. If the recipient or any other person assumes the debt, the fair market value is reduced by the amount of the outstanding debt.

CONSERVATION EASEMENT CONTRIBUTION

A charitable deduction is allowed for a qualified conservation contribution of a qualified real property interest, to a qualified organization, made exclusively for conservation purposes (in other words, it must be protected in perpetuity and cannot be subject to legally enforceable restrictions). The contribution must preserve land for outdoor recreation, protect a relatively natural habitat, or preserve open spaces or historically important land or a building facade. A statement must show the fair market value of the underlying property before and after the contribution and the conservation purpose served by the contribution. The gift must be unconditional or the charitable contribution fails.

The regulations allow that it may be impossible or impractical to continue a conservation purpose, and allow for the sale (extinguished by judicial proceeding) and that the charitable grantee will receive a proportionate share of the proceeds and use those proceeds consistently with the conservation purposes underlying the original gift.

The amount of the contribution deduction is the fair market value of the conservation easement less the value of any consideration easement. If the contribution of the easement has no effect on the value of the property, or it increases (rather than decreases) the value of the property, no charitable deduction is allowed.

Conservation easement charitable contributions under §170(h) must be given in perpetuity and cannot be subject to legally enforceable restrictions (they must be given unconditionally, in other words), or the charitable deduction will fail.

The taxpayer should obtain qualified appraisals for these values. Form 8283 must be attached to the tax return along with a statement showing the fair market value of the property before and after the contribution, and the conservation purpose served by the contribution.

Petitioners were found to be not liable for a §6662A reportable transaction understatement penalty when the Tax Court found that Notice 2017-10 didn't meet the notice and comment requirements of the Administrative Procedure Act (APA). As a result of this decision in *Green Valley Investors LLC v. Commissioner*, *LLC, Bobby Branch, TMP* (150 TC 5 (11/9/22), the IRS has issued proposed regulations regarding syndicated conservation easements as an abusive transaction. The remainder of the case regarding other valuation penalties under §6662 haven't yet gone to trial as of the writing of this text (February 2023). Notice 2017-10 identified all syndicated conservation easement transactions beginning 1/1/10, including all substantially similar transactions, as "listed transactions" for purposes of Reg §1.6011-4(b)(2). That penalty increased tax by an amount equal to 20% of the understatement, or 30% if the disclosure requirements were not met.

Dueling experts valued the conservation easement in *Kenneth Brooks and Anita Wolke Brooks* (TC Memo 2022-122 (12/19/22)) where respondent disallowed carryover charitable contributions related to a 2007 conservation easement. Respondent's value was $470,000 and petitioner's value was $3,630,000. Petitioners lost big and no carryover charitable contribution deductions were allowed (plus penalties applied for underpayment of tax and a gross valuation misstatement penalty) when the Tax Court accepted the $470,000 value.

EXAM ALERT!

Section 605 of the SECURE 2.0 Act of 2022 disallows a charitable deduction for a qualified conservation contribution if the deduction claimed exceeds 2 ½ times the sum of each partner's relevant basis in the contributing partnership, unless the contribution meets a 3-year holding period test, substantially all of the contributing partnership is owned by members of a family, or the contribution relates to the preservation of a certified historic structure. In the case of a contribution for the preservation of a certified historic structure, a new reporting requirement applies. The provision also provides taxpayers the opportunity to correct certain defects in an easement deed (excluding easements involved in abusive transactions. This change applies to contributions made after 12/27/22.

EXAM ALERT!

This concept is tested frequently. Remember that for an easement to be allowed, the donation must be given in perpetuity and must be unconditional. Currently there is a split in the Federal Circuits with regards to the validity of the regulation governing the amount of proceeds received in an extinguishment of the property under the perpetuity requirement. The 6th Circuit held in Oakbrook that the regulation is valid, but the 11th Circuit held in Hewitt that it is not and violated the APA. See *Oakbrook Land Holdings, LLC, William Duane Horton, Tax Matters Partner v CIR*, 20-2117, 3/14/22 and *Hewitt v. Comm'r*, 21 F.4th.1336, 1339 (11th Cir. 2021)

APPRECIATED PROPERTY

If property that has increased in value is contributed, the FMV of the contribution may need to be reduced by the amount of appreciation, depending upon whether the property contributed would result in ordinary or capital gain income if it was sold. For ordinary income property the amount of the deduction is the FMV less the amount that would be ordinary income or a short-term capital gain if the property was sold for its FMV; effectively this limits the deduction to the taxpayer's basis.

For capital gain property the FMV of the gift is generally applicable. However, FMV may need to be reduced by any capital gain that would be realized if the property was sold if:

- the property, other than qualified appreciated stock) is contributed to certain private nonoperating foundations
- the contributed property is tangible personal property put to an unrelated use by the charity (unrelated use refers to use that is not related to the charity's exempt purpose or function), o**r**
- the taxpayer chooses the 60% limit instead of the 30% limit.

BARGAIN SALES

A bargain sale is one made to a qualified organization for less than the property's FMV. It is partially a charitable contribution and partly a sale or exchange. To calculate the amount of the charitable contribution:

Step 1: Calculate the fair market value of the contribution by subtracting the amount received for the property from the FMV at the time of the sale

Step 2: find the adjusted basis of the contributed part

$$\textbf{Adjusted basis of entire property} \times \frac{\textbf{FMV of contributed part}}{\textbf{FMV of the entire property}}$$

Step 3: determine whether the amount of the charitable contribution is the fair market value of the contributed part (answer from Step 1), or the adjusted basis of the contributed part (answer from Step 2). Generally, this depends upon whether the sale is of ordinary income or capital gain property. If capital, the donation is the FMV; if ordinary, the donation is the adjusted basis.

Example: Arnold sells ordinary income property with a fair market value of $10,000 to a church for $2,000 during a year when he makes no other charitable contributions. His basis is $4,000 and his adjusted gross income is $20,000.

The gift's FMV is $8,000 ($10,000 - $2,000). The adjusted basis of the contributed part is $3,200 ($4,000 x ($8,000/$10,000)). Because the property is ordinary income property, the charitable contribution is limited to the adjusted basis of the contributed part, which is $3,200.

VALUATION PENALTIES

A 20% penalty applies if both apply:

- value or adjusted basis claimed on the return is 50% or more of the correct amount
- the taxpayer underpaid the tax by more than $5,000 because of the overstatement

The penalty rises to 40% for a gross overvaluation under §6662(h) if both apply:

- value or adjusted basis claimed on the return is 200% or more of the correct amount
- the taxpayer underpaid the tax by more than $5,000 because of the overstatement.

The valuation penalty applies even if the petitioner concedes the amount under a different IRC section. In *AHG investments, LLC* (140 TC 7 (3/14/13)) conceded more than $10 million in losses under §465 and tried to avoid the 40% gross valuation misstatement penalty. Taxpayers cannot avoid those penalties by conceding on grounds unrelated to the valuation issues.

CANCELLATION OF DEBT

INCLUSIONS IN INCOME

Generally, if a debt is forgiven or cancelled, other than as a gift or bequest, the debtor includes the amount in gross income (called cancellation of debt (COD) or discharge of indebtedness (DOI) income), including when the debtor:

- performs services for a creditor in exchange for cancellation of their debt,
- pays for or purchase their debts for less than the fair market value,
- relatives pay for or purchase their debts, **or**
- exchanges an old debt for a new, lower debt.

Corporations repurchasing their own bonds realize income on the repurchase (realized income is the difference between the repurchase price and the issue price, plus any discount already deducted, and less any premiums returned as income).

EXCLUSIONS FROM INCOME

Under §108(a)(1), debtors may exclude canceled debts from their gross income when the cancellation occurs:

- in a bankruptcy case,
- when the taxpayer is insolvent, but only to the extent of the insolvency,
- with seller financing (§108(e)(5)),
- when payment of the debt would result in a tax deduction to the borrower (§108(e)(2)),
- in bona fide dispute,
- for qualified farm indebtedness, **or**
- for qualified real property business indebtedness.

STUDENT LOANS

The Tax Cuts and Jobs Act extended the student loan exclusion to loans discharged due to the death or total and permanent disability of the student for taxable years 2018 through 2025.

However, for tax years 2021 through 2025, the American Rescue Plan Act expanded §108(f) to provide a general income exclusion for all student loan discharges regardless of reason.

A cancelled student loan is not taxable if the qualifying student loan is cancelled because the student worked for a specified time in a certain geographical area in certain professions. The professions may include practicing medicine in a rural area or teaching in an inner-city school.

DISCHARGES IN BANKRUPTCY

A debtor may exclude the entire amount of a debt discharged in bankruptcy, even if the debtor is solvent after the discharge under §108(a)(1)(A) and §108(a)(2)(A). Following the discharge, the debtor may either:

- apply the excludable amount towards the reduction of tax attributes, **or**
- elect to apply some or all of the excludable amount towards the reduction of basis in depreciable property, before reducing other attributes.

Tax attributes include loss carryovers, credit carryovers, basis reduction, and credits. Absent the debtor's election, tax attributes are reduced in the following order:

- net operating losses or loss carryovers,
- general business credits,
- minimum tax credits,
- capital loss carryovers,
- basis reduction,
- passive activity loss and credit carryovers, **and**
- foreign tax credit carryovers.

Usually, the attributes are reduced dollar for dollar of debt discharge. General business and foreign tax credit carryovers are reduced at $.333 of each dollar excluded. The basis of depreciable and no depreciable assets is reduced dollar for dollar of debt discharge, but not below the amount of the total undischarged liabilities. Any remaining balance of the debt discharge after the above reductions is disregarded.

An election can be made on Form 982, *Reduction of Tax Attributes …*, to first reduce the basis for any depreciable assets before reducing the other tax attributes in the order listed above. The election permits a taxpayer to retain current deductions, such as net operating losses or capital loss carryforwards, for use in the following year. Since depreciable basis is reduced, the election reduces depreciation deductions in subsequent years. If the depreciable property is sold later at a gain, the gain attributable to the basis reduction is taxable as ordinary income under depreciation recapture rules.

INSOLVENCY EXCLUSION

Debt cancellation is not taxable to the extent of any insolvency, which is applied to the reduction of tax attributes as described above. Taxpayers are considered insolvent if their liabilities exceed the fair market value of their assets immediately before the discharge. In making this determination the taxpayer must include assets that are shielded from creditors under state law.

Taxpayers are insolvent to the extent that their liabilities > FMV of their assets immediately before the debt discharge.
Debt cancellation is not taxable to the extent of the insolvency (and in other specified situations).

Example: To purchase equipment David executes a promissory note for $350,000. He is unable to make debt payments incurred in the business. On December 31, 20A1, prior to the debt discharge described below, the FMV of all equipment is $325,000, taxpayer's adjusted basis is $265,000, and the total amount of taxpayer's debts is $350,000. On December 31, 20A1 Bank forgives $40,000 of the amount owed.

David is insolvent $25,000 ($350,000 debt - $325,000 FMV). Only $15,000 of the $40,000 debt forgiven is includible in income, unless other exceptions apply.

PARTNERSHIP DEBTS

When a partnership's debt is discharged, that amount is allocated among the partners. Bankruptcy or insolvency is deemed to occur at the partner level, not the partnership level. A solvent partner cannot take advantage of the rules applicable to insolvent or bankrupt partners even if the partnership itself is insolvent or bankrupt.

S CORPORATION DEBTS

The tax consequences of a debt discharge are determined at the corporate level rather than the shareholder level. Congress changed the law in March 2002, providing that income from the discharge of indebtedness of an S corporation that is excluded from the S corporation's income is not taken into account as an item of income by any shareholder, so it does not increase the basis of any shareholders' stock in the corporation (under §108(d)(7)(A).

PURCHASE PRICE ADJUSTMENT

When an asset is purchased on credit and the seller subsequently reduces or cancels the debt arising from the purchase, the reduction is treated as a purchase price reduction that reduces basis. No discharge of indebtedness income arises from this transaction as long as the taxpayer is solvent and not in bankruptcy, and the property is still in the hands of the original buyer and the debt remains in original seller's hands.

Qualified Farm Debt

Cancellation of indebtedness income relief may be available to solvent farmers as long as the lender is not related, and the debt was incurred in operating a farm business. More than 50% of the total gross receipts from the past preceding three taxable years must be from farming. The exclusion first reduces tax attributes, then reduces basis in all property other than farmland, then reduces basis in the land used in farming.

Business Real Estate Debt

Qualifying real property business debt occurs when the fair market value of the property securing the debt falls in value. The debt must be incurred or assumed in connection with business real property, secure the property, and must be discharged after 1992. The maximum excludable is the excess of the outstanding loan principal over the property's FMV (both values stated immediately before the discharge). The excludable amount is reduced by other outstanding qualifying real property business debts secured by the property and may not exceed the taxpayer's adjusted basis for all depreciable property held before the discharge.

Qualified Mortgage Debt Relief – Update as needed

Under the Mortgage Forgiveness Debt Relief Act of 2007 up to $2,000,000 was excluded from cancellation of debt income for any discharge (in whole or in part) of qualified principal residence indebtedness (QPRI). Congress retroactively renewed this provision and it applies to QPRI discharged prior to 1/1/2026 or subject to an arrangement in writing before 1/1/2026.

1099-C Includible in Income

Unless one of the exceptions applies, 1099-C reports income includible on the tax return that can come from discharge of debt related to real estate loans, credit card companies, or other debt. The moment it becomes clear a debt will never be repaid, the debt must be viewed as having been discharged. The discharge must be manifested by an "objectively identifiable event" not just a mere bookkeeping entry by a creditor.

Identifiable events can include discharge due to a foreclosure or applying a defined creditor policy to discontinue collection. There is a rebuttable presumption that an identifiable event has occurred during a calendar year if a creditor has not received a payment at any time during an approximate 36-month testing period ending at the close of the year.

Note that if an information return (such as Form 1099-C) is the basis for the determination of a deficiency, §6201(d) may shift burden of production to the respondent. If a taxpayer asserts a reasonable dispute with respect to the income reported on the information return, and the taxpayer has fully cooperated with the Commissioner, the Commissioner has the burden of producing reasonable and probative information in addition to the information return (*Kleber*, TC Memo 2011-233 (9/28/11)). Here the petitioner argued the 1099-C for 2006 was incorrect because it should have been discharged in an earlier year.

MARRIAGE AND DIVORCE

INCIDENT TO A DIVORCE UNDER §1041

Other than exceptions noted below, all transfers between spouses are treated as tax-free exchanges. A transfer is considered to be 'incident to a divorce' if it occurs within one year after the date the marriage ends, or it is related to the end of the marriage. A transfer is related when it is made under a divorce or separation instrument and it occurs not more than six years after the date the marriage ends. Transfers that occur later are presumed to not be related to the end of the marriage under §1.1041-1T(b), unless the timely transfer was hampered by legal or business disputes. There are no tax-free transfers to a nonresident alien spouse or former spouse.

TRANSFERS OF U.S. SAVINGS BONDS

Tax-free exchanges do not apply to transfers of savings bonds. A spouse who deferred reporting of interest in E or EE bonds is taxed on the deferred interest when the bonds are transferred. The receiving spouse has basis equal to the purchase basis plus income realized on the transfer.

SOLE PROPRIETORSHIP SALE TO SPOUSE

The tax-free exchange rules may apply to a sale of business property by a sole proprietor to a spouse. The buyer spouse takes a carryover basis, even if paying fair market value for the property.

TRANSFERS IN TRUST

If trust property is mortgaged, transferor spouse reports a taxable gain to the extent that liabilities assumed by the transferee spouse and liabilities the property is subject to (whether or not assumed) exceed the transferor's adjusted basis in the property. If the transferor realizes a taxable gain under this rule, the transferee's basis is increased by the gain.

ALIMONY

The Tax Cuts and Jobs Act made significant changes to the tax treatment of alimony payments. For any divorce or separation agreements entered into before 1/1/2019, the traditional alimony rules as outlined below, including alimony recapture, continued to apply through the 2018 exam. For agreements entered into after 12/31/2018, the alimony payment is no longer deductible to the payor and no longer included in the income of the recipient.

Alimony payments may be deductible by the payor and included in the recipient's gross income if the alimony meets certain requirements. Payments cannot be deductible by the payor unless they are taxable to the recipient. A deduction is permitted even if the payor does not itemize deductions.

The parties can choose to treat alimony payments as non-taxable and non-deductible by stating this in their divorce decree or divorce agreement. A copy of that agreement should be attached to the tax return of the payee-spouse for each year the statement is applicable.
For the alimony to be deductible by the payor-spouse and includible in the payee-spouse's income the alimony must be:

- paid under a decree of divorce or legal separation agreement or decree of support. Payments under an annulment decree also qualify, but voluntary payments generally do not.
- paid in cash. A non-cash property settlement is not alimony. Cash payments may be made to third-parties on behalf of the payee spouse, including mortgage payments, tuition, property taxes, and medical bills. The payee spouse may deduct mortgage interest, property taxes and other itemized deduction amounts if the alimony payments received are includible in gross income.
- not paid for the support of the children.
- between parties who are not living in the same household. There are some exceptions: a payor-spouse can make payments while preparing to leave the common residence, but only those made within one month before the departure are deductible. Until divorce or legal separation is final, spouses can be members of the same household, but payments must be made under a divorce or separation instrument.
- scheduled to end on the death of the payee spouse. The agreement does not need to state this if the applicable state law provides for it.

The payor-spouse can deduct as alimony cash payments made directly to the lender of property where the payee-spouse resides, **unless** it is property owned by the payor-spouse. A payor-spouse cannot deduct as alimony payments that are made to maintain property owned by him or her, even if a court orders the payments be made for the home where the payee-spouse resides.

Under the old pre-2018 rules, alimony must be claimed as income in the year received and the alimony deduction can only be made in the year paid. No deduction is permitted for "advance" alimony payments which are deductible in the year paid, includible in the year received.

Child Support

Payments are not alimony if the agreement fixes part of any payment for child's support in dollar amounts or by percentage. A payment is presumed to be child support if the reduction occurs at a time "clearly associated with a contingency" such as within 6 months of the child turning 18, 21 or the age of majority, or relating to the child's attaining a certain age, leaving school, etc. See Temp Reg. §1.71-1T(c). If payments are less than the amount called for in the instrument, they are first allocated to child support.

Legal Fees for Marital Settlements

Remember that the Tax Cuts and Jobs Act suspended 2% itemized deductions for tax years 2018 through 2025.

Previously the portion of legal fees relating to alimony payments was deductible as a miscellaneous 2% itemized deduction if the payee-spouse receives taxable alimony. If alimony is not taxable, the related legal fees are not deductible. Amounts paid as part of a property settlement can be added to the property's basis. The payor-spouse may deduct legal fees relating to tax advice. Fees incurred for arranging a divorce or for resisting alimony demands are not deductible and fees for breach of contract related to alimony are similarly not deductible under *William M. Barry and Trudi G Swain* (TC Memo 2017-237 (11/28/17)).

ALIMONY RECAPTURE

Alimony recapture questions appeared on the Tax Court exam with some frequency but it doesn't apply to current 2023 tax law and should not be tested. We will not cover the calculation.

INNOCENT SPOUSE (§6015)

The 1998 IRS Restructuring Act expanded so-called innocent spouse rules, making this status easier to obtain. To the extent a spouse is found to be innocent, he or she is relieved of tax, interest and penalties. The innocent spouse still remains liable for any taxes, interest and penalties that do not qualify for relief. The Tax Court has jurisdiction over innocent spouse matters.

INNOCENT SPOUSE (§6015(b))

An innocent spouse request can generate a refund. Under the new §6015(b), the innocent spouse requirements include:

- a joint return was filed for the tax year in question,
- there is an understatement of tax attributable to an erroneous item by the other spouse,
- the taxpayer signed return but did not know, or have reason to know of the understatement,
- under the facts and circumstances, it is inequitable to hold the taxpayer liable for a deficiency attributable to erroneous item by other spouse, **and**
- taxpayer elects the status on Form 8857 no later than 2 years after the date the IRS began collection activities on the taxpayer.

ELECTION OF SEPARATE LIABILITY (§6015(c))

The election of separate liability seeks to allocate the appropriate tax, interest and penalties between the spouses, but this request cannot generate a refund of taxes. The requirements are:

- a joint return was filed for the tax year in question,
- there is an understatement of tax attributable to an erroneous item by other spouse, **and**
- the taxpayer at the time of the election is not married, is widowed, is legally separated from, or has lived apart for more than 12 months from the person taxpayer filed the

original joint return with.

Even if the IRS establishes the electing spouse had knowledge, he or she still qualifies for relief if the electing taxpayer was unaware of the extent of the understatement. The electing spouse remains liable only for the amount known.

Example: Husband prepares a joint income tax return with full access to Wife's financial records. Husband was still granted separation of liability because he relied on summarized information prepared by Wife; all of the taxes related to Wife's business were allocable only to her. (*Charlton* (TC Memo 2001-76).

Example: In *Jennifer Soler,* (TC Memo 2022-78 (7/18/22) petitioner requested relief for tax years 2012, 2013, 2014, and 2015. She is married to, and resides with, her husband; they've been married over 25 years and have never been legally separated. She's the primary income earner for the household with a 2-year associate's degree in fashion design. He has a bachelor's degree in accounting and was primarily a stay-at-home father during the years at issue; he also operated a couple of businesses during those years. The returns were signed by both spouses. Petitioner and her spouse didn't dispute notices of deficiency issued for the various tax years.

She filed Form 8857 in 2018, claiming she was unaware of any income tax liabilities until the IRS began levying against her wages. A spouse lacks actual knowledge if she is unaware of the circumstances that give rise to the error on the tax return. The parties do not dispute that she lacked actual knowledge of the items attributable to the nonrequesting spouse – she didn't know details of his businesses and did not participate in them.

But, did she have reason to know? The Court evaluates all facts and circumstances, including the requesting spouse's level of education, the involvement in the family's business and financial affairs, the presence of unusual or lavish expenses compared with the family's past income level and expenditures, and the nonrequesting spouse's level of evasiveness or deceit regarding the family's finances.

A requesting spouse can't satisfy the lack of knowledge requirement by simply claiming he or she did not review the return before signing – a taxpayer who signs a return is generally charged with constructive knowledge of its contents. She didn't carry the burden of proof that she lacked reason to know of the understatements; she is college educated, was the primary income earner for the years at issue, and was regularly involved in the household finances. She knew her income alone wasn't sufficient to pay all the family's routine expenses.

Ultimately the Court were not persuaded it would be inequitable to holder her liable for the tax liabilities and that the knowledge factor weighed heavily against granting relief.

This election does not work if the IRS demonstrates assets were transferred as part of fraudulent scheme, or if both taxpayers had actual knowledge of the understatement. The election also does not apply to returns jointly filed showing a liability at time of filing; in other words, the liability must arise from events that transpire after the original filing of the income tax return in question and not just because there was an amount due on the return.

The electing spouse has the burden of proof. The IRS must serve notice of the elected spouse's filing to the non-electing spouse, and the non-electing spouse can participate fully in an administrative IRS proceeding to establish separate liability. *Corson* (114 TC 24) confirmed that the Tax Court can establish rules that provide the non-electing joint filing spouse with adequate notice and the opportunity to become a party to the proceeding. A non-electing spouse is also called an intervenor.

EQUITABLE RELIEF (§6015(f))

Equitable relief can be granted even if a taxpayer does not meet the rules above if under the facts and circumstances it is simply unfair to hold taxpayer liable for any unpaid tax or deficiency. The requesting spouse must satisfy all of the following:

- a joint return was filed with either an understatement or underpayment of tax,
- relief is not available under either innocent spouse or separation of liability provisions of the code,
- liability remains unpaid, except for:
- refund claim amounts paid between 7/22/98-4/15/99
- installment payments after 7/22/98, in an un-defaulted agreement
- no fraudulent transfer of assets can occur,
- no disqualified assets were transferred to requesting spouse (if some were, relief is only available for the amount of liability that exceeds the fair market value of the transferred assets), **and**
- no fraudulent intent existed when the original return was filed.

Equitable relief usually is granted:

- if the requesting spouse no longer married (as defined above), **or**
- had no knowledge that the tax would not be paid when return was signed because it was reasonable to believe other spouse would pay, **and**
- if the requesting spouse will suffer economic hardship.

Other factors in **favor** of relief:

- abuse existed in the relationship, even if the abuse does not meet the legal standards of duress,
- the non-requesting spouse has a legal obligation to pay, **or**
- the liability is attributable to the non-requesting spouse.

Factors **against** relief:

- the liability is attributable to the requesting spouse,
- the requestion spouse has knowledge,
- the requesting spouse received a significant benefit (beyond support) from unpaid liability,
- there is no economic hardship to the requesting spouse,
- the requesting spouse has been noncompliant with Federal income tax laws since then, or
- it is the requesting spouse's legal obligation to pay the amount due.

If return is adjusted to reflect understatement of tax, relief is available only to extent of liability that existed on the return prior to the adjustment.

> Example A requesting spouse is not eligible for §6015(f) relief if the earnings are his and he promised to pay them. *William Cojocar (Petitioner) and Sally Carillo (Intervenor)* (TC Memo 2017-189 (9/26/17)) married in 2009 and filed jointly for 2011. They reported total income of $201,790, of which $170,631 was allocable to petitioner's wages. They entered into an installment agreement on the 2011 return in 2012, and each filed MFS returns for 2012. Intervenor filed for divorce on 2/4/13, and the parties entered into a mediated settlement agreement that included "Husband shall be solely responsible for and shall timely pay all and hold wife harmless from the outstanding income tax liability of the parties for the tax years 2009, 2010 and 2011." The divorce decree also ordered in part that he would be solely responsible for all federal income tax liabilities from the date of marriage through 12/31/11. On 5/1/14 respondent received petitioner's timely filed Form 8857, *Request for Innocent Spouse Relief*, in which petitioner sought relief from joint and several liability for tax years 2009-2012. Respondent denied his request for relief on 6/1/15. Petitioner had monthly income of more than $13,000 at trial but testified he believed the intervenor would not suffer economic hardship if she was ordered to pay the disputed portion of their 2011 tax liability. He had the sole legal obligation to pay the outstanding tax liability pursuant to a divorce decree. The court noted that the decision is "heavily influenced by the totality of the circumstances" and not based on a simple tally of factors – it should not be a surprise that it was not inequitable to hold him responsible to pay the tax liabilities for the 2011 return.

It matters which type of §6015 relief is granted to the taxpayer:

> Example: *Brenda Taft* (TC Memo 2017-66 (4/18/17)) is a registered nurse who was married since 1981. Her husband liquidated his $200,000 stock to fund an extramarital affair; he tried to keep both things secret, even asking that their joint return be electronically filed without petitioner's approval or review. The stock sale was reported on the 2010 return, but the husband missed reporting nearly $5K in taxable dividends, which brought the IRS into the issue. Petitioner discovered the affair and filed for divorce, only learning then that the retirement savings and stock had been wasted or liquidated. After she filed her 2012 return, the respondent credited part of her $5K

refund to the joint 2010 liability. Petitioner filed Form 8857 requesting to be relieved from the liability related to the unreported dividends and that respondent refund her money that was credited to that liability. Respondent granted her relief under §6015(c), but that provision does not provide for refunds, so she was not entitled to one.

Petitioner argued that she should have been granted relief under §6015(b), which does allow for refunds under these circumstances. Under (b) taxpayers will be relieved of liability for the understatement if a) a joint return is filed, 2) there is an understatement of tax attributable to the erroneous items of the nonrequesting spouse, c) the requesting spouse when signing the return did not know, and had no reason to know, there was such an understatement, d) taking into account all the facts and circumstances, it is inequitable to hold the requesting spouse liable, e) the requesting spouse elects this within 2 years after the date the Commissioner begins collection actions with respect to the requesting spouse. These are conjunctive – in other words, failure to satisfy any one of the elements precludes relief. Respondent argued she did not meet c and d.

EXAM ALERT!
The Taxpayer First Act of 2019 put time limits on §6015(f) requests: if a refund is sought, then the claim must be filed prior to the expiration of the refund statute of limitations (RSOL). If a refund is not sought, then the claim must be filed prior to the expiration of the collection statute of limitations (CSOL).

CAPITAL GAINS

Most gains from sales or exchanges are reportable as income and are subject to tax at either ordinary income or capital gain rates, depending upon the type of asset involved and how long the taxpayer owned it before disposition. Losses arising from the sale or exchange of property may be fully deductible, deductible subject to limitations, or not deductible, depending upon the type of asset involved.

Capital gains and losses are categorized according to how long the taxpayer held or owned the asset prior to its sale. Short-term capital gains are taxed at the taxpayer's ordinary income tax rates. Long-term capital gains are taxed at preferential rates based on the taxpayer's ordinary income tax bracket and the type of asset generating the gain. The current capital gains rate maximum is 20%. Some assets do not qualify for the reduced rates, including:

- collectibles (art, antiques, stamps and coins),
- unrecaptured §1250 gain,
- gains on qualified small business stock, **and**
- net capital gain treated as investment income for purposes of the deduction for investment interest expense.

A pass-through entity, such as a partnership, S corporation, estate or trust, reports capital gains or losses on Schedule K-1. Such losses are identified as long or short-term, which is the same classification the taxpayer uses in reporting the transactions.

CAPITAL ASSETS

Most property owned and used for personal purposes, pleasure, or investment is a capital asset, including homes, furniture, cars, stocks, digital assets/cryptocurrency, bonds and other securities. The following are not considered capital assets:

- stock in trade or other property included in inventory or held mainly for sale to customers,
- accounts or notes receivable for services performed in the ordinary course of a trade or business or as an employee, or from the sale of stock in trade or other property held mainly for sale to customers,
- depreciable property used in a trade or business, even if fully depreciated,
- real estate used in a trade or business,
- the future rights to lottery payments,
- copyrights, literary, musical, or artistic compositions, letters or memoranda, or similar property, **and**
- supplies regularly used in a trade or business.

While a forfeited deposit can be taxed at capital gain rates if the asset was held as a passive investment, the same forfeited deposit is taxed as ordinary income if the asset is used in a trade or business. In *CRI-Leslie, LLC* (147 TC 8 (9/7/16)) the petitioner received a forfeited $9.7 million deposit it received on a canceled sale of real estate. They claimed it was a capital gain under §1221(a) subject to long term capital gain tax treatment. Since it was used in its trade or business it is treated as §1231 property instead.

HOLDING PERIOD

Short-term capital gains/losses are from assets held one year or less. Long-term capital gains/losses are from assets held one year plus one day. To calculate the holding period, begin counting on the day after the property is received and include the day of disposition. Disposition of inherited property is always treated as a long-term capital gain or loss, regardless of how long the taxpayer held the property. A nonbusiness bad debt is always treated as a short-term capital loss.

GAIN/LOSS ON SALE OF CAPITAL ASSETS

Gains realized from the sale or exchange of personal-use capital assets are reportable as short or long-term, depending upon their holding period, at the applicable tax rate depending upon

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A capital gain is long-term if the holding period is 1 year + 1 day,
or if the property was acquired by inheritance.

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the nature of the capital asset. Losses from the sale or exchange of capital assets held for personal use are never deductible.

Capital losses reduce capital gains for the tax year; capital losses can never be carried back into a prior tax year. A maximum of $3,000 excess capital loss over capital gain is allowable each tax year ($1,500 if MFS). Any unused total net loss is carried forward into the next tax year where it is treated as though incurred in that year. Any unused capital loss remaining is carried forward indefinitely until used in full, or until the taxpayer's death.

A capital loss sustained by a decedent during his or her last tax year (or carried forward to that year from a previous one) is only deductible on the decedent's final return. The $3,000 annual limitation on capital loss deduction still applies. The decedent's estate cannot deduct any of the loss or carry it forward to future years. If the capital loss is incurred on a decedent's separate property, the surviving spouse cannot claim any unused capital loss carryover on a separate return. Effectively, any unused capital loss dies with the taxpayer.

If the taxpayer and spouse originally filed separate returns and now file jointly, their separate capital loss carryovers are combined. However, if taxpayer and spouse previously filed a joint return and now file separately, any capital loss carryover from the joint return can only be deducted on the return of the spouse who actually incurred the loss.

NONDEDUCTIBLE LOSSES

Losses from the direct or indirect sale or exchange of property are nondeductible if they occur between any of the following related parties:

- members of a family,
- a corporation and an individual owning more than 50% of the corporation's stock, unless the loss is from a distribution in complete liquidation of a corporation,
- a grantor and a fiduciary of a trust,
- a fiduciary and a beneficiary of the same trust,
- a fiduciary and a beneficiary of another trust created by the same grantor,
- an executor of an estate and a beneficiary of that estate, unless the sale or exchange was to satisfy a pecuniary bequest, a bequest of a sum of money, **and**
- an individual and a tax-exempt organization controlled by the individual or the individual's family.

BUSINESS AND NONBUSINESS BAD DEBTS

A bad debt exists when a borrower cannot repay the money he borrowed. In the year a debt becomes worthless, the taxpayer may be able to deduct the amount owed against taxable income. The tax treatment depends upon whether the bad debt is classified as business or nonbusiness.

A business bad debt generally arises from operating a trade or business and is deductible as an ordinary business loss, not on Schedule D. Partial business bad debts may be deducted when any part of the debt is determined to be uncollectible.

The court evaluated these issues in determining whether a bad debt existed in *William Owens and Sharon Owens* (TC Memo 2017-157 (8/10/17)): 1) was petitioner's lending from personal funds a trade or business, 2) did the loans constitute bona fide debt, and 3) did that debt become worthless in year at issue? The Court looked at factors like the number of loans made over what time period, the adequacy and nature of the records, whether the loan activities were kept separate and apart from the taxpayer's other activities, whether the taxpayer sought out the lending business, the amount of time and effort expended in the lending activity, and the relationship between the taxpayer and his debtors. The fact that his staff handled the recording keeping was not held against him and he was found to be in the moneylending business.

All other bad debts are nonbusiness bad debts. These may be deductible as short-term capital losses if certain criteria are met:

- the debt is completely worthless - no deduction is permitted for a partially worthless nonbusiness debt,
- the debt is genuine – a valid and enforceable obligation to repay a fixed or determinable sum of money establishes a true debtor-creditor relationship,
- taxpayer has basis in the loan – the taxpayer must make a cash loan or must previously have included the amount in taxable income. No bad debt deduction is permitted for court-ordered child support not paid by a former spouse. A cash-basis taxpayer cannot take a bad debt deduction for expected income such as unpaid salaries, wages, rents, fees, interest, and dividends unless these were previously included in income, **and**
- the debt is determined to be worthless, even if before its due date – the debt is determined to be worthless in the year there is no longer any chance it will be repaid. It is not necessary to go to court if the taxpayer can show that a judgment from the court would be uncollectible. Taxpayer must demonstrate that reasonable steps were taken to enforce collection. The debtor's bankruptcy generally is good evidence that some or all of an unsecured debt is worthless.

  Example: Wesley, an architect, makes personal loans to several friends who are not clients. He could not collect on some of these loans. The architect is not in the business of lending money, and the loans have no relationship to his business. They are deductible as nonbusiness, short-term capital losses, subject to limitations discussed previously.

Any time a nonbusiness bad debt deduction is taken, a statement must be attached to the tax return describing the loan, the taxpayer's relationship to the debtor, what collection efforts were made, and why the loan was determined to be worthless.

A taxpayer cannot take a bad debt deduction for:

- debts owed by political parties, any of their committees, or any association or committee that accepts contributions or spends money to influence elections.
- worthless securities. A deduction is permitted, but not as bad debt; they are reported on Schedule D as if they were a sale with $0 as the selling price, **or**
- loans made to corporations, if facts and circumstances indicate the amount actually is a capital contribution.

If a taxpayer deducts a bad debt and later recovers some or all of it, the amount recovered is includible in gross income to the extent it provided a tax benefit. The taxpayer can exclude any amount deducted that did not reduce tax.

Money lent to a relative or friend with the expectation of repayment becomes a gift if the debt is later forgiven. No bad debt deduction is available for a gift. A true creditor-debtor relationship must exist between the lender and the person or organization that borrowed the money in order to claim a deduction. No genuine debt exists when minor children borrow money from their parents to pay for their basic needs, so no bad debt deduction is allowed.

> Example: *Mary Hatcher and Bradley Hatcher* (TC Memo 2016-188 (10/6/16)) lent money to a former boyfriend prior to her marriage. She has an undergraduate business degree and an MBA in corporate finance and was employed as vice president, senior vice president and treasurer for a major corporation over a decade, responsible for investor relations, financial planning, and tax. Her boyfriend was developing a golf-themed comic strip and she advanced money to him to fund the development of his comic strip and to pay certain of his living expenses. Eventually the loan grew, he made few payments, and she obtained a judgment against the former boyfriend for $573,175 and $50,000 attorney's fees. The note was not completely worthless at the end of the tax year in question and she was still trying to collect on it 2 years later. On 10/21/10 she contributed to note to a SMLLC she formed the previous day – the principal purpose was to enhance the appearance that the note was business-related.
>
> To be eligible for a business debt taxpayer must show she was engaged in a trade or business (with continuity and regularity, with a primary purpose for income or profit) and that the debt was proximately related to the trade or business. There was no trade or business they could associate this note to – she never lent money to anyone but the former boyfriend, she never conducted credit checks or required security or sought financial information from him. Their romantic relationship during 2004-2005 led to the loan, which also funded the purchase of a Hummer and paid his personal expenses. The attempt to turn it to a business loan by putting the loan into the SMLLC failed. Next the Court looked at whether it was worthless in 2010. Even though the borrower sent an email that year saying "I have no money" petitioners commenced litigation against him to enforce repaying in 2011 and served post-judgment discovery on him in 2012 to attempt to collect on the judgment.

Petitioner W was a sophisticated financial professional – she was eligible for accuracy related penalties.

If a taxpayer guarantees a debt that becomes worthless and then makes payments against the debt, there is no bad debt deduction unless the taxpayer can show the guarantee was to protect an investment or had profit motive. Guarantees made as favors to friends without consideration are gifts, so no deduction is allowed.

Example: Henry, an officer and principal shareholder of the Spruce Corporation, guaranteed payment of a bank loan the corporation received. The corporation defaulted on the loan and Henry made full payment. Because he entered into the guarantee to protect his investment in the corporation, Henry can claim a nonbusiness bad debt deduction.

Example: Elvira and Jay are co-workers. As a favor to Jay, Elvira guarantees a loan at their local credit union. Jay does not repay the loan and declares bankruptcy. Elvira pays the loan but cannot claim a nonbusiness bad debt deduction because she did not enter into the guarantee agreement to protect an investment or to make a profit.

Sale of Personal Residence

Sales or exchanges of personal residences are reportable only if the gain exceeds the exclusion amount, or if the taxpayer does not meet the applicable tests. If a taxpayer meets the two tests below, up to $250,000 of gain is generally excludable.

When taxpayer and spouse file a joint return and either of them owned the residence for at least two years, and both spouses lived in the home as their principal residence for at least two years, and both meet Test 2, gain on the sale of a personal residence is excludable up to $500,000.

TEST 1. The residence was owned and used as the main home for 2 years or more during the 5-year period which ends on the date the property is sold or exchanged.

TEST 2. No other principal residence was sold or exchanged during the 2-year period ending on the date the property is sold or exchanged.

The gain must be reported if any of these apply:

- the taxpayer does not meet one or both tests,
- any part of the home was used for business after May 6, 1997,
- the home was used for rental purposes after May 6, 1997, **or**
- the gain realized exceeds the exclusion amount.

If the taxpayer is forced to sell a principal residence before meeting Test 1 due to a change in employment, health, or unforeseen circumstances, the exclusion is prorated on a daily basis.

> Example: In 20A1, taxpayer and spouse purchased for $250,000 (paid in cash) a residence as taxpayer's and spouse's principal residence. taxpayer and spouse own and occupy the property as their principal residence until they sell the property on 9/6/A6, for $1,050,000. Neither taxpayer nor spouse has ever owned another residence. Explain the amount of the gain recognized with respect to the sale of the residence in 20A6 if taxpayer and spouse file a joint return for 20A6.
>
> $300,000 is taxed as a long term capital gain: $1,050,000 (SP) - $250,000 (AB) - $500,000 (§121 exclusion)

Some gain from the sale of a primary residence may be ineligible for the §121 exclusion due to nonqualified use, which is defined as any use of the property other than as a primary residence. Gain allocated to the period of non-qualified use will not be excluded from taxable income. However nonqualified use after the property was held and used as a primary residence will not count as nonqualified so long as the property still qualifies for a §121 exclusion at the time of sale. For example, taxpayer buys a second residence on 1/1/2018. On 1/1/2020 he moves into the home as his primary residence and sells it on 12/31/2022. The taxpayer meets the criteria for a §121 exclusion. However, there were two years of nonqualified use of the property out of the five years it was owned. Therefore 40% of any capital gain realized on the sale of the home is not eligible for the §121 exclusion.

SHORT SALES

A short sale is a contract to sell property borrowed for delivery to a buyer. At a later date taxpayer must either buy substantially identical property and deliver it to the lender, or deliver property held at the time of sale, but not transferred then. Usually, the holding period is the amount of time taxpayer actually held the property eventually delivered to the lender to close the short sale.

The gain when closing a short sale is short term if the taxpayer held substantially identical property for one year or less on the date of the short sale, or if the taxpayer acquired property substantially identical to the property sold short after the short sale, but on or before the date the short sale closed. If the substantially identical property was held for more than one year on the date of the short sale, any loss realized is a long-term capital loss, even if the property used to close the short sale was held one year or less.

See Rev Proc 2002-44 for information on which year to record a short sale gain or loss. According to the IRS this occurs when the short sale is closed by delivery of the stock.

Short Sale and Deed in Lieu of Foreclosure

A short sale of real estate occurs when the net proceeds from the sale do not cover the outstanding mortgage and closing costs and the seller is unwilling or unable to cover the difference. A deed in lieu of foreclosure is given by a borrower to convey property voluntarily before foreclosure. In each situation the borrower is asking the lender to forgive the unpaid mortgage; the lender is not required to accept either but may to avoid the costs of foreclosure.

For the borrower with a recourse mortgage the tax consequences are comparable to foreclosure. A short sale results in gain or loss from the sale **and** cancellation of debt income. A deed in lieu is treated as a foreclosure.

Wash Sales

A wash sale occurs when the taxpayer sells or otherwise disposes of stock or securities, including a contract or option to acquire or sell stock or securities, at a loss and within 30 days (before or after the sale) directly or indirectly:

- buys substantially identical stock or securities,
- acquires substantially identical stock or securities in a fully taxable trade, **or**
- enters into a contract or option to acquire substantially identical stock or securities.

Losses from wash sales are NOT deductible unless the loss is incurred in the ordinary course of taxpayer's business as a dealer in stock or securities. Any disallowed loss increases the basis of the substantially identical property, or the contract or option to acquire such property. See §1091 for more information.

Cryptocurrency

In Notice 2014-21, the IRS concluded that convertible virtual currency, such as Bitcoin and other cryptocurrencies, are property for federal tax purposes. The sale or exchange of cryptocurrency generally creates capital gain or loss while the receipt of cryptocurrency in exchange for services generates ordinary income to the recipient.

Chief Counsel opined on January 10, 2023 in CCA 202302012 that a charitable contribution of cryptocurrency with a fair market value of greater than $5,000 was not akin to a donation of marketable securities and thus required a qualified appraisal under IRC 170(f)(11)(C) in order to claim a deduction.

TRADERS IN SECURITIES

A trader in securities is engaged in the business of buying and selling securities for his own account. To be engaged in business as a trader in securities a taxpayer must:

- seek to profit from daily market movements in the prices of securities, rather than dividends, interest, or capital appreciation,
- have substantial activity, **and**
- carry on the activity with continuity and regularity.

To determine whether the taxpayer's activity qualifies as a business, examine the applicable facts and circumstances including how long the securities' holding period, the frequency and dollar amount of annual trades, the extent to which the activity is pursued for taxpayer's livelihood and the amount of time devoted to the activity.

Taxpayers whose activities do not qualify as a business under the above tests are considered to be investors, not traders. A taxpayer's use of the term 'trader' or 'day trader' to describe his activity does not by itself determine that a business exists.

Traders may also hold securities for investment purposes, with the usual investor rules applying to those securities. Interest and other expenses are allocated between the trading business and any investment securities. Securities held for investment must be identified as such in the trader's records on the day they are acquired. Traders may wish to hold those securities in a brokerage account separate from the one used for business activity. Securities held for investment are not marked-to-market at year-end. The normal was sale rules don't apply to the end of year mark to market.

In *Cameron* (TC Memo 2007-260 (8/30/07)) the taxpayer had 46 purchases and 14 sales, which netted a short-term capital gain of $2,127 for the year. The gain was reported but he also deducted a Schedule C loss of $12,457, including $12,211 for continuing education. Taxpayer's activities were not substantial enough (frequent, regular and continuous) to rise to a trade or business, so his business expenses were not deductible under §162 (above the line). Further he was not entitled to deduct costs associated with the seminar under §274(h)(7) as it applies to §212.

MARK-TO-MARKET ELECTION FOR TRADERS

A trader may make an election under IRC §475(f) to report all gains and losses from securities held in connection with a trading business as ordinary income or loss, even if the security is held at the end of the year. Securities held at the end of the year are "marked to market" by treating them as if they were sold, then reacquired, for fair market value on the last business day of the year. Generally, the mark to market election must be made by the due date, not including extensions, of the tax return for the year prior to the year for which the election becomes effective.

> Example: To be effective for 2023, the Mark-to-Market election must be made by April 18, 2023, which is the due date of the 2022 return. The election may also be filed with a timely filed extension request for the 2022 return. If this was NOT done, it is now too late to make this election for 2023

The mark-to-market election for an existing trader requires filing Form 3115 *Application for Change in Accounting Method*. The Commissioner generally grants automatic consent, but once made, the election requires consent to revoke. Any required §481(a) adjustment must be calculated and reported over four years. Effectively all securities held at year end of the prior tax year (12/31/18 in the example above) are marked to market and the resulting gain is spread over the next four years. If the amount is less than $25,000, the taxpayer may elect to include it all in the current year.

The mark-to-market election for a new trader is considered the initial adoption of an accounting method. The new taxpayer makes this election within the first two months and 15 days of its initial tax year by placing a §475(f) election statement into its books and records, and by attaching a copy of the statement to the original federal income tax return filed for the election year.

CORPORATIONS

Under Tax Cuts and Job Act, all corporations now pay the same 21% corporate tax rate on taxable earnings, even personal service corporations.

Corporations are business entities created under state law for the purpose of conducting business. They can hire employees, acquire assets, enter into contracts, and incur liabilities. Raising capital is more easily accomplished where the owners have limited liabilities. Corporations have unlimited life and survive the death of principals.

A C corporation is a separate taxable entity that pays tax on income at the corporate rate. A C corporation may be subject to a penalty if it accumulates earnings beyond its reasonable business needs. An S corporation is a pass-through entity rather than a tax paying entity, although under certain circumstances it may pay taxes as well.

CONTRIBUTIONS TO CAPITAL

Contributions to capital whether by shareholders or others, except those by any customer or potential customer, are generally not taxable to the corporation.

Under §351 if one or more persons transfer money or property to a corporation solely in exchange for stock of that corporation, and if immediately after that exchange the transferor (group or an individual) is in control of the corporation (80% total combined voting power of all stocks eligible to vote and at least 80% of all outstanding shares of non-voting stock - attribution rules apply), there is no gain or loss recognized either to the transferor or the transferee. The transferor and corporation both need to attach a complete statement of all pertinent facts to their income tax return under Reg. § 1.351-3.

Under §351, if one or more persons transfer money or property to a corporation solely for corporate stock, and immediately after the exchange the transferor(s) control 80% of the voting/nonvoting shares, there is no gain or loss to the transferor or transferee.

Property in this definition does not include services; unless there are substantial restrictions to the stock, transferring services to the corporation results in taxable compensation. Once the restrictions lapse the value of the stock is includible in income, unless the shareholder makes an election under §83(b) to include the value in income before the restrictions lapse.

If the transferor receives property or money in addition to stock in exchange for the property transferred, the gain is taxable to the extent of the boot received.

Also, under §357 the assumption of liabilities in a property transfer that qualifies under §351 generally does not cause the transferor to recognize gain. The exceptions are if the corporation assumes liabilities that are in excess of taxpayer's adjusted basis in the property (in which case gain is recognized up to the amount of the difference) or if there is no good business reason for the liability transfer. If the liabilities are transferred or assumed for the purpose of avoiding federal income tax on the exchange, there is no good business reason.

> Example: Ted and Sue form a corporation. Sue contributes her computer with a fair market value of $3,000, basis of $0 (§179 was used when it was purchased by her sole proprietorship), and debt of $2,000. Ted contributes $3,000 in cash. Sue recognizes $2,000 worth of gain due to the debt relief exceeding her basis ($2,000 – 0).

Any loss on the exchange is not deductible if the transferor owns, directly or indirectly, more than 50% of the corporation's stock. This is true even if taxpayer does not have more than 80% control. Related party sale rules govern this result.

Under §357, assumption of liabilities in a §351 transfer generally does not mean gain to the transferor unless the corporation assumes liabilities in excess of the transferor's adjusted basis, or if there is no good business reason for the transfer.

If the taxpayer receives property or money in addition to stock in exchange for the property transferred, any gain is taxable to the extent of the money or fair market value of property received. Any property transferred other than stock in the corporation is taxable boot.

PREFERRED VS COMMON STOCK

Stock represents a shareholder's ownership interest in a corporation. Common stock is a class of stock that gives the shareholders rights to dividends and voting power in proportion to the number of shares held. Preferred stock is a class of stock that holds preference over common stock for dividend distributions and liquidation proceeds. Preferred stock generally carries no voting rights.

DIVIDENDS

Distribution of the earnings and profits (E&P) of a corporation are taxable dividends to the shareholder who receives the dividends. Distributions in excess of E&P are considered a return of capital and not taxable up to the shareholder's basis in the stock. Distributions in excess of stock basis are capital gain to the shareholder. The corporation does not recognize gain or loss upon distribution of cash to a shareholder.

A corporation does recognize a gain or loss when property is distributed to the shareholder if the property's FMV exceeds its adjusted basis. The property is considered to be sold at its FMV to the shareholder. For this purpose, the FMV is the greater of:

- the actual FMV, **or**
- the amount of any liabilities the shareholder assumed in connection with the distribution

The IRS may deem that constructive dividends were paid to a shareholder in situations where there are below-market loans, the shareholder's debt is cancelled, there are transfers of property to shareholders for less than FMV, and if the shareholder's compensation is unreasonable.

Basis of Property Contributed

If a shareholder contributes property, the corporation takes the shareholder's basis, increased by any gain recognized on the exchange. If the property is contributed by anyone other than shareholder, basis is zero.

Basis of Stock Received

Generally, the basis of stock received is the adjusted basis value of property exchanged. That amount is increased for any amount treated as a dividend, plus any gain recognized on the exchange. It is decreased by any cash received, the fair market value of any property received, any loss recognized on the exchange, and by the amount of any liability the corporation assumes unless payment of the liability gives rise to a deduction when paid.

The corporation takes shareholder's basis PLUS any gain recognized on the exchange when it receives contributed property from a shareholder.

§351 Transactions – Tom's The Easy Way

1. Is §351 applicable?

Transfer of money and/or property for at least 80% control of the voting shares AND total shares of all other classes of stock.

2. Consequences to Transferor due to Exchange of Property

- **Gain is recognized only to the extent of boot received**
- **If property is transferred subject to indebtedness, then gain is recognized only to the extent that debt relief exceeds basis**
- **Character of gain is the same as if the property transferred was disposed of in a taxable transaction**
- **Loss is not recognized**

3. Basis of Stock Received by Transferor

Adjusted basis of property contributed
PLUS gain recognized by transferor upon transfer
LESS FMV of boot received
LESS liabilities assumed by corporation [treated as cash payment for basis purposes]

4. Basis of Property Received by Corporation

Adjusted basis of property contributed
PLUS gain recognized by corporation upon transfer [allocated by FMV of the properties]

NOTE: Basis of built-in loss property cannot exceed the FMV of the property

Taxable Year

Generally, only C corporations that are not personal service corporations are able to select a non-calendar fiscal year. A personal service corporation (PSC - see separate section) generally must use a calendar year; it is possible to make a §444 election to use a different year if certain tests are met. An S corporation must generally use a calendar year unless it can show a business purpose for establishing any other tax year.

Despite that, S corporations and partnerships can make a §444 election to choose a September-November year end, but after doing so must file Form 8752 to pay a tax deposit based on certain payments to owners in the deferral period between the fiscal and calendar year end.

Organization Costs/Start-up Costs

For organizational costs prior to 10/23/04, under §248 a new corporation could elect to amortize its organizational costs over a period not less than 60 months. The election must be made on the tax return for the first year the corporation is actively engaged in business. Otherwise, the expenses were capitalized and cannot be deducted until the corporation is fully liquidated. Organization costs include accounting and legal services for incorporation, state fees paid, and expenses of temporary directors and organizational meetings. These costs do not include commissions or other fees and costs for issuing or selling stocks or securities.

Partnership organizational costs are amortized under §709. Effective 10/22/04 the AMJA permits a taxpayer to elect to deduct up to $5,000 of start-up and $5,000 of organization expenditures in the taxable year in which the trade or business begins. Each $5,000 amount is reduced dollar for dollar by the amount total start-up or organization costs exceed $50,000. Any remaining costs are amortized over a 15-year period under §195.

Start-up costs include investigating the creation or acquisition of an active trade or business, surveys of potential customers, advertisements, salaries and wages for employees who are training and those being trained, travel and other expenses to secure distributors, suppliers or customers, and rent before the business opens. The key issue is the date when business commences. Under PLR 9047032 this was defined as when:

- the business acquires assets needed to conduct business,
- assets are put to productive use, **or**
- the business is ready to receive revenue.

Specifically excluded from the definition of start-up costs are expenses incurred and paid for interest, taxes, and research and development costs.

For an individual, the expenses incurred in trying to establish a new business fall into two categories:

- those incurred before making a decision to acquire or begin a specific business are personal and nondeductible, including general search for, or a preliminary investigation of a business;
- those incurred in an attempt to acquire or begin a specific business are capital expenses and deductible as a capital loss.

If a corporation attempts to go into a new trade or business and is not successful, all investigatory costs are deductible as a loss. Any costs for assets acquired during this unsuccessful attempt are part of the basis in the assets and are recovered when the asset disposition occurs.

Accumulated Earnings Tax

C corporations may be subject to accumulated earnings tax for not distributed earnings beyond its reasonable business needs under §531. The 20% tax is on accumulated taxable income and applies to corporations that are formed or availed of to avoid tax of shareholders by accumulating earnings. Facts and circumstances determine whether the corporation is formed to avoid tax. A corporation may retain earnings and profits to meet its reasonable business needs, which may be anticipated and not just immediate. The needs must be realistic, reasonably certain, and not vague and may include:

- expansion of the business

- replacement of plant or equipment
- retirement of debt

Corporations are permitted to accumulate at least $250,000 (except some service type corporations are limited to $150,000) as an accumulated earnings credit; the upper limit of this credit is the reasonable needs of the business. A controlled group gets only one accumulated earnings credit, so forming multiple corporations will not increase the credit if there is common control.

Personal Service Corporations (PSC)

Tax Cuts and Jobs Act eliminated the special tax rate for PSCs and they now pay a flat 21% tax rate just like all other C corporation.

Under TCJA all corporations pay a flat 21% tax rate, even personal service corporations

A C corporation, substantially all of whose activities involve the performance of services in one or more of the 8 fields (health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting) described in §448(d)(2)(A) may use the cash method of accounting regardless of gross income if the function and ownership tests are met. Tax preparation is considered accounting for these purposes.

The ownership test is met if substantially (95% or more) of the stock is owned directly or indirectly by employees performing covered services. The function test is met if substantially all (95% or more) the corporation's activities are covered services.

Shareholder Loan or Dividend?

The burden of proof is on the taxpayer to demonstrate that an amount paid is a bona fide loan and not a taxable dividend. A transfer of money is treated as a loan if when the funds were transferred, the transferee unconditionally intends to repay the money and the transferor unconditionally intended to secure repayment. Other issues that are considered:

- whether the shareholder controls the corporation,
- the dividend and earnings history of the corporation,
- the magnitude of the withdrawals,
- how the parties record the withdrawals on their books,
- whether notes are executed,
- whether interest is paid or accrued,
- whether security is given for the loan,
- whether there is a set maturity date, **and**
- whether there is any indication the shareholder attempted to repay withdrawals

Stock Redemption

A stock redemption occurs when a corporation buys stock back from a shareholder using corporate funds. Redemption can be used to buy out an existing shareholder. Unlike a complete liquidation, a corporation continues to exist after a stock redemption. After the redemption the stock may be cancelled, held, or resold.

A stock redemption is classified as a fully taxable dividend if certain factors are present. Remember that dividends are generally taxable to the extent of the corporation's earnings and profits, but a stock redemption is treated as a sale of stock by the shareholder with gains eligible for the favorable capital gain tax rates.

The types of transactions that qualify as stock redemptions and capital gains treatment at the shareholder level include:

The distribution is not essentially equivalent to a dividend: the transaction creates a meaningful reduction in the shareholder's interest in the corporation. A corporation with only one class of stock that makes proportional distributions to shareholders that do not reduce the shareholder's ownership interest does not qualify.

There is a substantially disproportionate redemption of stock: after the distribution, the shareholder must hold less than 50% of voting stock and less than 80% of the interest in the corporation that the shareholder held before the redemption. The attribution rules of §318(a) are used to determine constructive ownership of the shareholder for this purpose.

Termination of a shareholder's interest: complete termination of the interest is treated as a stock redemption. The attribution rules of §318(a) are used to determine constructive ownership of the shareholder for this purpose.

Partial liquidation: if the distribution is in redemption of stock held by a noncorporate shareholder and in partial liquidation of the distributing corporation. The distribution is generally pursuant to a plan of liquidation.

In a qualified stock redemption, a portion of the distribution to the shareholder can reduce the corporation's E&P. The reduction in the corporation's E&P cannot exceed the ratable share attributable to the E&P of the stock redeemed. The ratable share is determined by the FMV of the stock redeemed and the FMV of the corporation's stock.

A corporation cannot deduct expenses paid in connection with the reacquisition of its stock or the stock of related parties.

Corporate Liquidations

Both C and S corporation liquidations are governed by §331 and §336. Each entity has taxable income on the difference between the FMV and Basis of assets at liquidations:

- under §331 the amounts received by a shareholder in a distribution in complete liquidation of a corporation are treated as in-full payment in exchange for the stock. If property is distributed its FMV is used to determine gain or loss on the transaction – if the stock basis is higher than the total distribution (cash and property), the shareholder recognizes a loss. If the distribution is higher than the stock basis, the shareholder recognizes a gain.
- under §336 a gain or loss will be recognized to a liquidating C or S corporation on the distribution of property in complete liquidation as if the property were sold to the distributee at its FMV.

The C corporation pays tax on its income as does the shareholder, who has a gain or loss on the sale of their stock, measured between the FMV of the assets distributed and the basis in the stock. Liquidating a C corporation may result in double tax – at the corporate and shareholder levels.

S Corporation

Electing to be an S corporation is a tax consideration, not a legal one. S corporations are hybrid entities that combine some of the pass-through advantages of a partnership with the liability protection available through a corporation. An S corporation is a conduit and not a tax paying entity, except:

- tax may be due on any recognized built-in gains. If the corporation previously was a C corporation, then it pays tax on excess of value of the S corporation's assets at the beginning of the first year for which the S election is in effect over the adjusted basis of the assets. The recognition period depends upon the S election: 5 years now, 7 years for S elections for 2009 and 2010 and within 10 years for tax years prior to 2009.
- if the S corporation has earnings and profits from when it was a C corporation, and its passive income exceeds 25% of its gross receipts, it must pay corporate income tax on the 'excess net passive income.' If the situation continues for 3 years, the S election is revoked.

Generally, income and deductions pass through to shareholders of an S corporation, and the item's character before the pass-through is retained at the shareholder level. Items of income, deduction or credit that might affect a shareholder are separately stated and each shareholder takes a prorata share of the item. For example, capital gains and losses to the corporation are capital gains and losses to the shareholder. Rental income to the corporation gets passed through as rental income to the shareholder.

A shareholder cannot deduct losses unless he or she has basis in the stock. Basis is the original capital contribution **increased** by corporate income taxable to the shareholder and **decreased** by nontaxable distributions and by items of loss and deductions allocated to the shareholders.

If items reduce basis to zero, the shareholder can continue to deduct items and reduce basis for any debts owed by the corporation to the shareholder. If the shareholder does this and later corporate income increases the stock basis, the basis of debt is increased to the original level.

The courts have held that a shareholder guarantee of a loan does not give additional basis to deduct corporate losses until the shareholder actually makes payment on the guarantee. When that happens, the payment is treated as a direct loan to the corporation. And taxpayers cannot increase basis in an S corporation by forming another S corporation to acquire a loan as attempted in *David Messina and Nancy Messina and Kyle Kirkland and Stephanie Layne* (TC Memo 2017-213 (10/30/17)) – the Court found that the second S corporation was neither an agent or a conduit of petitioners, and that respondent's disallowance of their pass-through deductions was proper.

> Example: *Philip Franklin* (TC Memo 2016-207 (11/14/16)) filed untimely returns for 2007 and 2008 and failed to file tax returns for 2009 and 2010. Respondent made adjustments including that petitioner lacked sufficient bases to deduct passthrough losses from either of his S corps, among other things. When he filed the petition, he was incarcerated at a Federal Correctional Institution. For 2007 petitioner reported a passthrough loss of $343,939, which respondent reduced to $43,152 then disallowed when petitioner failed to show he had basis. For 2008 petitioner reported a passthrough loss of $107,298 and another $187,503 from a different S corp, which were disallowed. Petitioner credibly testified that some of his assets were seized and sold to satisfy debt on one of the S corps – that gave him basis to take additional loss. Petitioner's guarantee of a loan does not provide additional basis. One S corp loss was disallowed because that S corp did not file a tax return for the year.

Under the 1996 Small Business Job Protection Act the following are S corporation requirements, as modified by the AJCA-2004:

- shareholders must elect S status within the statutory period (generally on or before the 15th day of the third month of the tax year in which the S election is desired),
- no more than 100 shareholders are allowed, who are individuals, estates or qualified trusts,
- all family members can elect to be treated as one shareholder,
- only one class of stock is permitted,
- no nonresident aliens are permitted, **and**
- a calendar tax filing year is required.

All members of a family can elect to be treated as one shareholder; for this purpose, a family is defined as the common ancestor and all lineal descendants of the common ancestor (back to 6 generations) and all spouses, or former spouses, of these individuals.
All shareholders must consent to the election when it is made. It is possible to have an untimely election. Effective 9/3/13 Rev Proc 2013-30 simplifies the granting or relief to late-filing entities by consolidating other revenue procedures into one, and by extending relief in

certain circumstances. Relief under this Rev Proc must be requested within 3 years and 75 days after the effective date of the intended election. Relief is granted when:

- the entity is an eligible entity and failed only because the election was not timely
- the entity has reasonable cause for its failure to make the timely election
- the entity and all shareholders reported their income consistent with an S corporation status for the year the election should have been made and all subsequent years
- less than 3 years and 75 days have passed since the intended effective date of the election.

If an entity doesn't qualify for relief under this Rev Proc it may still request relief by requesting a private letter ruling.

S corporations are generally pass-through entities
that do not pay taxes (with a few exceptions.)
They combine some advantages of a partnership with corporate liability protection.
Income and deductions retain their character at the shareholder level.
Shareholders must have basis to deduct losses; guaranteeing a loan is not enough.

Under the S corporation distribution ordering rules most distributions are tax-free to shareholder except:

- if the distribution is in excess of basis, it is treated as a capital gain.
- if the S corporation has earnings and profits from when it was a C corporation, the distribution may be taxable as dividends, **and**
- dividends in excess of AAA (accumulated adjustments account) are taxed as dividends to the extent of earnings and profits under §1368(c) and (e).

  Example: Seashore Shells is an S corporation with no earnings and profits. Seashore Shells distributes $75,000 to its only shareholder, Sue. Sue's adjusted basis in the stock is $55,000. The amount of the distribution that exceeds her basis ($20,000) is taxable as a gain from the sale or exchange of property.

  Example: Raggedy Reef is a C corporation that converts to an S corporation on 1/1/A6. It has E&P of $50,000 on that date. In 20A6 the corporation has ordinary income of $10,000 and distributes $50,000 to its shareholders.

	AAA	E&P
Balance at 1/1/A6	$ 0	$50,000
Ordinary income	10,000	0
Distribution	(10,000)	(40,000)
Ending balance	$ 0	$10,000

The $40,000 distribution is taxable as a dividend.

C Corporations that convert to S status must calculate accumulated E&P as of the date of the conversion. An S corporation with E&P can elect to treat distributions as made first out of E&P.

Among the advantages of operating as an S corporation:

- no double taxation that affects most C corporations,
- shareholders have limited liability protection,
- the tax rate on S corporate earnings may be less than the applicable corporate rate, **and**
- S corporation distributions are exempt from the payroll tax system, assuming the corporation pays adequate compensation for shareholders who perform services to the corporation.

Among the disadvantages of operating as an S corporation:

- shareholder numbers and types are limited,
- shareholders owning more than 2% of the company must pay taxes on many fringe benefits that could be tax free to an employee of a C corporation,
- the required tax year for an S corporation is the calendar year unless there is a specific exception to this requirement,
- if the S corporation was ever a C corporation that carried over C corp earnings and profit, the S corporation is subject to a 25% corporate tax ('sting') that its passive income that exceeds 25% of gross receipts. The S corporation will be terminated if the gross receipts for each of the past 3 consecutive tax years were passive investment income, **and**
- the tax rate on S corporate earnings as an individual may be higher than the applicable corporate rate (21% in 2018).

In *Grey* (*Joseph M Grey, Public Accountant* (119 TC 5) the taxpayer was paid on an as needed basis and no dividends or officer salaries were distributed; additionally, the S corporation paid for use of taxpayer's in-home office, and reported payments on Form 1099-Misc. The Court ruled that Grey was an employee of the firm and the S corporation was subject to employment taxes. A home office deduction is barred when an employee leases a portion of his own home to the employer under §280A(c)(6).

REASONABLE COMPENSATION ISSUES C/S CORPORATIONS

Because of the differences in tax structures between a C and an S corporation, the IRS seeks to find compensation is too high in a C corporation and too low in an S corporation. The taxpayer is motivated to reduce taxable income in the C corporation by paying shareholder salaries. Obviously, the IRS would prefer to recharacterize payments to the C shareholder as dividends (taxable to the shareholder but not deductible to the corporation), so will seek to establish that compensation is too high.

A shareholder's allocated share of S corporation income is not trade or business income and not subject to self-employment tax under §1402; distributions are similarly not subject to self-employment tax. Dividends are not taxed to the shareholder unless the distribution exceeds the shareholder's accumulated adjustment account so there is no incentive to increase wages. Generally, the taxpayer in the S corporation seeks to reduce the amount subject to FICA and FUTA taxation by keeping shareholder wages low.

The factors used to determine reasonable compensation arise from *Elliotts, Inc.* (T.C. 83-2) and include:

- the shareholder/employee's qualifications;
- the work performed;
- prevailing salaries for comparable work;
- prior earnings capacity as a self-employed individual;
- prior years' compensation by the corporation;
- the size of the business and its complexity;
- general economic conditions.

Keep in mind also that an officer of a corporation cannot be an independent contractor to the corporation under §3121(d). A corporation that treats an officer as other than an employee is not entitled to §530 relief because there is no reasonable basis for taking this position.

PARTNERSHIPS

Partnerships are relationships between two or more persons who join together to carry on a trade or business. The partnership is a conduit and the partners in their individual capacities are liable for any taxes due. Partnerships are required to file income tax returns under §6031. Under §761(a) a partnership includes any syndicate, group, pool, joint venture or other unincorporated organizations that carry on a trade or business that are not otherwise classified as a trust, estate or corporation. The mere sharing of expenses does not create a partnership. The mere co-ownership of property maintained and leased or rented is not a partnership, unless the owners provide services to the tenants.

Under the check the box regulations (discussed at greater length under Limited Liability Companies) a noncorporate entity with two or more owners is automatically deemed to be a partnership unless the entity makes the election to be an association taxable as a corporation.

CONTRIBUTIONS OF PROPERTY

Generally, under §721(a), a contribution of money or other property into a partnership in exchange for an interest in the partnership does not result in a gain or loss. The two exceptions:

- transfers into an investment company, as defined in §351, are not tax-free,
- disguised sales transactions are not tax-free. A disguised sale is deemed to occur if a

taxpayer transfers appreciated property into a partnership or LLC and within a short period of time, usually 2 years or less, receives a distribution of money or other property. Facts and circumstances determine if the transaction is a disguised sale rather than a tax-free contribution of property.

As with a corporation or S corporation, transfers of encumbered property to an LLC or partnership result in recognized gain on the difference between the taxpayer's basis and the amount of debt relief.

Under §721 a contribution of money or other property into a partnership in exchange for a partnership interest does not result in a gain or loss (except for transfers into an investment company, or if a disguised sales transaction and within 2 years of the contribution, money or property is transferred to the contributing partner).

§721 Transactions – Tom's The Easy Way

1. Is §721 applicable?

Transfer of property or money in exchange for a partnership interest.

2. Consequences to Partner

- **Gain or loss is not recognized**
- **Capital account, in general, is FMV (book) or adjusted basis (tax) of contribution property**

3. Basis of Partnership Interest

Adjusted basis of property
PLUS money contributed
LESS cash received (including indebtedness assumed by partners with transfer of property)
PLUS share of partnership liabilities

4. Consequences to Partnership

- **Gain or loss is not recognized**
- **Basis of contributed property is the partner's adjusted basis**

5. Built-In Gain Property

If built-in gain property is transferred to a partnership, and within 7 years either (a) the contributing partner receives a distribution of other property or (b) the built-in gain property is distributed to another partner, then the contributing partner must recognize the built-in gain upon its transfer.

Contributions of Services
A contribution of services in exchange for stock is usually taxable. Contribution of services for a capital interest in a partnership or LLC is taxable. Contribution of services for a partnership or LLC profits interest is generally not taxable.

The difference? As with partnerships, a capital interest shares in the increased (or decreased) value of the business when it is sold. A profits interest is entitled to a share of the business profits annually but does not share in the business appreciation.

Capital vs Profits Interests
A capital interest gives the holder a share of the proceeds if the partnership's assets were sold at FMV and the proceeds were distributed in a complete liquidation of the partnership.

A profits interest is any interest other than a capital interest. A profits interest can share in the partnership's profits, gains or losses in any manner agreed upon by the partners.

Limited Partnerships
Limited partnerships offer limited liability to the limited partners. They are often used for ownership of passive activities like real estate ownership. A general partner is liable for the activities of the partnership and makes the appropriate business decisions.

Family Partnerships
Family members can be partners, but to be recognized as such one of the following requirements must be met:

- if capital is a material income-producing factor, the family member must acquire the capital interest in a bona fide transaction, actually own the partnership interest and actually control the interest. The acquisition can be by gift or purchase from another family member. Capital is a material factor if the business requires substantial inventories or plant, machinery, and equipment investments.
- if capital is not a material income-producing factor they must have joined together in good faith to conduct a business. They must agree that contributions of each of them entitle them to a share of the profits and each partner must provide some capital or service. Capital is not a material factor if the income of the business principally consists of fees, commissions or other compensation for services performed by the partnership's members or employees.

If a family member or any other person receives a gift of a capital interest in a partnership in which capital is a material income-producing factor, the donee's distributive share of partnership income is limited:

- the partnership income must be reduced by reasonable compensation for services the donor provides to the partnership, **and**
- the donee-partner's share of the remaining profits allocated to donated capital must not be proportionally greater than the donor's share attributable to the donor's capital (Reg

§1.704-1(e)(1)(ii)).

If a family member purchases an interest from another family member, the fair market value of the purchased interest is considered donated capital when determining a partner's distributive share.

> Example: Cyndi sells 50% of her business to her son Tony, who does not work in the business. The partnership has a $70,000 profit during the year. Since capital is a material income-producing factor in the business, Cyndi must first be allocated reasonable compensation for her services, deemed to be $30,000. The remaining $40,000 ($70,000 - $30,000) profit must be at least 50% allocated to Cyndi as she has a 50% capital interest. Tony's share in the partnership profit cannot exceed $20,000 ($40,000 x 50%).

Partnership Tax Year

The partnership's tax year is determined by reference to its partners' tax years under §706. If one or more partners having the same tax year own a majority interest in partnership profits and capital (more than 50%) the partnership must use the tax year of those partners. If there is no majority interest tax year, the partnership must use the tax year of all its principal partners (one with 5% or greater profits or capital interest).

If there is no majority interest tax year and the principal partners do not have the same tax year, the partnership must use a tax year that results in the least aggregate deferral of income to the partners.

There are two exceptions to the required tax year rules:

- business purpose – a different tax year can be used if the partnership establishes a business purpose. Both tax and nontax considerations are used, but the deferral of income to a partner is not a valid business purpose. Natural business cycles, where the business experiences peak and nonpeak periods, are ordinarily accepted by the IRS as a substantial business purpose for a change in tax year.
- §444 election can be made if the partnership is not a member of a tiered structure (under Reg §1.444-2T), has not previously had a §444 election in effect, and it elects a year meeting the deferral period. Generally, a partnership can make this election if the deferral period is three months or less. There may be a required payment to make the election.

BBA Partnership Audit Procedures Under IRS

Effective for tax years beginning after 12/31/17 the TEFRA (Tax Equity Fiscal Responsibility Act) regime is repealed, and the Bipartisan Budget Act of 2015 rules (BBA) apply to any partnership tax return. The partnership representative has the sole authority to act on the partnership's behalf and those actions are binding on all partners. The partnership representative is the sole person who receives audit notices, and proposed or final adjustments, from IRS.

Now tax owed because of partnership adjustments is assessed and paid at the partnership level – the adjustments are not passed through to the partners.

Partnerships with 100 or less partners can elect annually out of the new audit procedures as long as the partners are not another partnership, disregarded entity, trust, nominee, or estate of an individual other than a deceased partner. The election must be timely.

PARTNERSHIP TAX COURT PROCEDURES UNDER (TAX COURT RULES 240-251)

The Final Partnership Administrative Adjustment (FPAA) occurs at the entity level to redetermine partnership level items. The Tax Matters Partner referred to by the Tax Court is the person who is responsible for keeping each partner fully informed of the partnership action. A notice partner is every partner in a partnership with less than 101 partners or a partner with 1% or more profits interest in a partnership that has more than 100 partners.
A notice group is one formed for the purpose of initiating litigation. A notice group contains non-notice partners who collectively have at least a 5% profits interest; one partner in the group is selected to receive notice.

The FPAA must be mailed to the TMP. Within the next 60 days the IRS must also mail the FPAA to all notice partners and 5% notice groups that provide their names and addresses to the IRS. The FPAA sent to partners other than the TMP usually show the date on which it was sent to the TMP; this is the date that starts running the petition time clock. The TMP has the first 90-day period to file a petition, then any partner can file a petition in the next 60 days – the partnership has a total of 150 days to file a petition.

The last known address rules do not apply in partnerships the same as for individual taxpayers. It is sufficient for the IRS to send the FPAA to the address shown on return for the year at issue. An FPAA addressed to "'The Tax Matters Partner" and mailed to the partnership address is valid even if there is no TMP (*Chomp Associates* (91 TC 1069 (1988))). It is irrelevant whether the TMP or notice partner actually receives the FPAA, as long as the IRS mailed it to the last known address.

PARTNERSHIP INCOME TAX RULES

A partnership computes its income in the same manner as individuals do, except some deductions are not allowed to the partnership and some income items must be separately stated to the partners.

Disallowed Deductions

These deductions are not allowed to partnerships:

- §151 personal exemptions,
- §164(a) deduction for §901 taxes paid to foreign countries and U.S. possessions,
- §170 charitable contributions,
- §172 net operating loss deduction,
- §§211-216 additional itemized deductions allowed for individuals, **and**

- §611 oil and gas depletion deduction.

Separately Stated Items
On its tax return a partnership must separately state the following items, which are put on the partner's tax return as separate items:

- ordinary income or loss from trade or business activities,
- net income or loss from rental real estate activities,
- net income or loss from other real estate activities,
- gains and losses from sales or exchanges of capital assets,
- gains and losses from sales or exchanges of §1231 property,
- charitable contributions,
- taxes paid or accrued to foreign countries and U.S. possession, **and**
- other items of income, gain, loss, deduction or credit as provided by the regulations.

Partnership Elections
The partnership makes elections affecting the computation of income derived from the partnership under §703(b). These elections include accounting methods, depreciation methods, accounting for specific items such as installment sales, and amortization of certain organization fees and business start-up costs.

Partner Elections
The partners separately make any election under §108(b)(5) or §108(c)(3) relating to income from discharge of indebtedness; §617 relating to deduction and recapture of mining exploration expenditures, **and** §901 relating to foreign taxes.

ORGANIZATION EXPENSES/SYNDICATION FEES
Neither the partnership nor the partner can currently deduct any amounts paid or incurred to organize a partnership, or to promote the sale of, or to sell, any interest in the partnership. The partnership can make an irrevocable election to amortize organization costs over not less than 60 months.

The partnership **cannot** amortize expenses connected with:

- acquiring assets for the partnership or transferring assets to the partnership,
- admitting or removing partners other than at the time the partnership is first organized,
- making a contract relating to the operation of the partnership trade or business (including contracts between the partnership and one of its members), **and**
- syndicating the partnership, including commissions, professional fees, and printing costs associated with the issuing and marketing of partnership interests. They cannot be deducted even if the syndication is unsuccessful (Reg §1.709-2(b)).

Partner's Distributive Share

A partner reports distributive share of partnership items on an individual income tax return, whether or not there was an actual distribution. The partner's distributive share of losses may be limited by the partner's adjusted basis.

Usually, the partnership agreement determines a partner's distributive share of partnership items. The agreement may be disregarded if the partner allocations do not have substantial economic effect. If a distributive share of a partnership item cannot be determined under the partnership agreement, it is determined by his or her interest in the partnership, including the partner's contributions, the interest of all partners in economic profits and losses, and the rights of the partners to capital distributions upon liquidation.

The partner must treat partnership items on their tax returns in the same manner as the partnership tax return treats them. A partner using an inconsistent treatment can be assessed penalties and interest, but not if the partner files Form 8082, *Notice of Inconsistent Treatment or Amended Return*, with the tax return.

Substantial Economic Effect

A partnership allocation has substantial economic effect if:

- there is reasonable possibility that the allocation will substantially affect the dollar amount of the partners' share of partnership income or loss independently of tax consequences, **and**
- the partner to whom the allocation is made actually receives the economic benefit or bears the economic burden corresponding to that allocation.

Guaranteed Payments

Partner payments that are guaranteed without regard to the partnership's income are deductible to the partnership for purposes of determining gross income and deductible business expenses. For other tax purposes they are treated as a partner's distributive share of ordinary income. They are not subject to income tax withholding.

Guaranteed payments made for organizing the partnership or syndicating interests are capital expenses and are not deductible by the partnership. They must be reported to the partners and included in their respective individual income tax returns.
Premiums for health insurance paid by a partnership on behalf of a partner are treated as a guaranteed payment. The partnership deducts the payments and the partner must include them in gross income. The partnership cannot deduct the payment if they account for insurance paid for a partner as a reduction in distribution to the partner.

At-Risk Rules

The at-risk rules apply to partnership activities and limit the amount of deductible loss to the amounts for which the partner is considered to be at risk. These include:

- money and adjusted basis of any property contributed to the activity,

- the partner's share of net income retained by the partnership, **and**
- certain partnership debt if the partner is personally liable for the repayment, or the amounts are secured by the partner's property (other than property used in the activity).
- Certain partnership debt on real property used in an activity owned by the partnership.

Passive Activity Rules

The §469 passive activity rules are determined at the partner level and limit the amount a partner can deduct for passive activity losses and credits. The partnership must separately report income, loss and credits for each activity. Passive activities include a trade or business activity in which the partner does not materially participate. A trade or business activity in which the taxpayer does not materially participate for the taxable year is also considered a passive activity. Rental activities are deemed to be passive, regardless of the partner's participation. See the Real Estate Professional section (under Real Estate) for more information on that exception.

Real Property Business Debt

Partners, other than C corporations, can elect to exclude the partner's share of income from debt cancellation of the partnership's qualified real property business debt. This is debt, other than qualified farm debt, the partnership incurs or assumes in connection with real property used in its trade or business secured by that property. Debt incurred or assumed after 1992 qualifies only if it was to acquire, construct, reconstruct, or substantially improve such property. A partner who elects the exclusion must reduce the basis of his or her depreciable real estate property by the amount excluded. If the partner reduces his or her partnership interest by the excluded amount, the partnership must make a corresponding reduction in the basis of its depreciable real property with respect to that partner.

Partner §179 Deduction

A partner can elect to deduct all or part of the cost of certain assets under §179. The partnership first determines its §179 deduction subject to the limits. The partners are then allocated their portion of that deduction. Each partner is subject to the appropriate limitations in his or her tax return. A partner must reduce the basis of his or her partnership interest by the total §179 deduction regardless of whether he or she can deduct the full amount. The partnership must reduce its basis in §179 property regardless of whether any partner is unable to deduct his or her entire share of the §179 deduction.

The partnership first determines its §179 limitation before it is allocated to the partner, who is subject to the appropriate §179 limitation on the individual income tax return. Partners must reduce basis due to §179 even if they can't deduct the full amount.

Partner-Paid Expenses

Generally, a partner cannot deduct partnership expenses paid out of personal funds unless the partnership agreement requires the partner to pay the expenses. Such expenses are usually considered incurred and deductible by the partnership.

Basis in a Partner's Interest

The basis of a partner's interest in a partnership is determined without considering any amount shown in the partnership's books as the partner's capital, equity, or similar account.

> Example: Claudia contributes property with an adjusted basis to her of $400 and a fair market value of $1,000. Her partner, Bert, contributes $1,000 cash. Each may have a capital account of $1,000 in the partnership according to their agreement, Claudia's adjusted basis is only $400 and Bert's adjusted basis is $1,000.

The basis of a partnership interest acquired by a contribution of money and or other property is the money contributed plus the adjusted basis of any property contributed under §722. If a partner must recognize gain, the gain is included in the basis of his or her interest. If a partner's individual liabilities are increased because of an assumption of partnership liabilities, the partner treats that as if it is a contribution of money to the partnership by the partner. The general basis rules govern basis if the partner acquires an interest by gift, inheritance, or any circumstance other than a contribution of money or property to the partnership.

The partner's basis is increased by the partner's:

- additional contributions to the partnership, including an increased share of or assumption of partnership liabilities,
- distributive share of taxable and nontaxable partnership income, **and**
- distributive share of the excess of depletion deductions over the basis of depletable property, unless the property is oil or gas wells whose basis has been allocated to the partners.

The partner's basis is decreased, but never below zero, by:

- distributions of money or property distributed to the partner, including a decreased share of partnership liabilities or an assumption of individual liabilities by the partnership,
- distributive share of the partnership losses, including capital losses, distributive share of nondeductible partnership expenses that are not capital expenditures,
- distributive share of charitable contributions and foreign taxes paid (added TCJA),
- the partner's deduction for depletion for any partnership oil and gas wells, up to the proportionate share of the adjusted basis of the wells allocated to the partner, **and**
- the partner's share of any §179 expenses, even if the partner cannot deduct the entire amount on his or her individual income tax return.

Example: Ernie acquires a 20% interest in a partnership by contributing property with an adjusted basis to him of $8,000 and a $4,000 mortgage. The partnership assumed payment on the mortgage. The basis of Ernie's interest is:

Adjusted basis of property	$8,000	
Less liabilities assumed by other partners	(3,200)	($4,000 x 80%)
Basis of Ernie's partnership interest	$4,800	

Example: Ernie from the above example instead contributes property subject to a $12,000 mortgage

Adjusted basis of property	$8,000	
Less liabilities assumed by other partners	(9,600)	($12,000 x 80%)
Basis of Ernie's partnership interest	$ 0	

Ernie has a capital gain of $1,600 ($9,600-8,000) from the sale or exchange of a partnership interest. The gain does not increase the basis of his partnership interest, which is $0.

CONTRIBUTION OF APPRECIATED PROPERTY

The general rule under §721(a) is that a partner recognizes no gain when contributing appreciated property for an interest in either a new or already formed partnership. The transaction may be treated as an exchange for which a gain or loss is recognized if shortly after the partner contributes the property, other property is distributed to the contributing partner and the partnership keeps his or her property.

The partnership's basis for determining depreciation, depletion and gain or loss for the property is the same as the partner's adjusted basis for the property at the time of contribution, increased by any gain recognized by the partner upon the contribution. If the fair market value of the property when contributed is different than the partner's adjusted basis, the partnership must allocate any income, deduction, gain or loss in the property in a manner that accounts for the difference.

Precontribution gain may be recognized if the contributed property is sold or distributed within 7 years.
The contributing partner recognizes gain as if the property sold for FMV on the date of the distribution.

CONTRIBUTION OF SERVICES

A partner can acquire an interest in a partnership's capital or profits as compensation for past or future services. Tax treatment depends upon whether a capital or a profits interest is acquired.

A partner contributing services for a capital interest must include the FMV of the interest in gross income in the first tax year in which the interest is not subject to a substantial risk of forfeiture. The FMV of a capital interest exchanged for service is considered a guaranteed payment.

A partner contributing services for a profits interest does not have a taxable event upon the receipt of the interest, unless:

- the profits interest relates to a substantially certain and predictable income stream from partnership assets such as high-quality debt securities or a high-quality net lease,
- within two years of receipt the partner disposes of his or her profits interest, OR
- the profits interest is a limited partnership interest in a publicly traded partnership.

PARTNERSHIP DISTRIBUTIONS

The partnership does not recognize gain or loss because of partner distributions. The partner's adjusted basis is decreased, but not below zero, by money and the adjusted basis of property distributed to the partner.

Partnership distributions include a distribution of the current or prior years' earnings, a withdrawal by the partner in anticipation of the current year's earnings, a complete or partial liquidation of a partnership's interest, and a distribution to all partners in a complete partnership liquidation.

Partnership distributions are not taken into account when determining the partner's distributive share of income or loss. Any gain or loss from the distribution is recognized by the partner and reported on the tax return for the year in which the distribution is received. Money or property withdrawn by the partner in anticipation of current earnings is treated as received on the last day of the partnership's tax year.

PARTNER'S GAIN

A partner recognizes gain on a partnership distribution only to the extent that any money included in the distribution exceeds the partner's adjusted basis in the partnership. Gain recognized is treated as capital from sale of the partnership interest on the date of the distribution. If property, other than marketable securities treated as money, is distributed to a partner he or she generally does not recognize any gain until the sale or disposition of that property.

> Example: Ron's adjusted basis in his partnership interest is $15,000. He receives a distribution of $10,000 in cash and land with an adjusted basis of $2,000 and a fair market value of $4,000.
>
> Ron does not recognize any gain on the transaction because the cash received is less than his adjusted basis in the partnership. Gain on the land is recognized when he sells

or otherwise disposes of it. The distribution reduces the adjusted basis in Ron's partnership interest to $3,000 ($15,000 - ($10,000 + $2,000)).

Marketable securities distributed after 12/8/94 are generally treated as money in determining whether gain or loss is recognized on the distribution, unless that partner contributed the securities to the partnership.

Unless there is a complete liquidation of a partner's interest, the basis of property distributed to the partner is its adjusted basis in the hands of the partnership. The basis of property to the partner cannot be more than the adjusted basis of his or her interest in the partnership, reduced by any money received in the same transaction under §732(a)(2).

> Example: Ron, from the above example, takes the land with a $2,000 basis, the same as it had in the partnership before the distribution.

> Example: Amy, who has an adjusted basis of $10,000 for her partnership interest, receives a distribution of $4,000 cash and property with an adjusted basis to the partnership of $8,000. The basis of the distributed property is limited to $6,000 ($10,000 adjusted basis - $4,000 cash received).

The basis of property received in a complete liquidation is the adjusted basis of the partner's interest in the partnership reduced by any money distributed in the same transaction.

The holding period for distributed property includes the partnership's holding period. If a partner contributed the property, the partner's holding period is included.

PARTNER'S LOSS

A partner does not recognize loss on a partnership distribution unless:

- the partner's adjusted basis in the partnership interest exceeds the distribution,
- the partner's entire interest in the partnership is liquidated, **and**
- the distribution is in money, unrealized receivables or inventory items.

PARTNERSHIPS AND SPECIFIED PERSONS

Losses are not allowed from an exchange or sale of property, other than an interest in a partnership, that occurs directly or indirectly between a partnership and a person who has a direct or indirect interest in the capital profits or profits interest of the partnership of more than 50%.

No deduction for a loss is allowed if the sale or exchange is between two partnerships in which the same persons directly or indirectly own more than a 50% interest of the capital or profits of each partnership. The basis of each partner's interest in the partnership is decreased, but not below zero, by the partner's share of the disallowed loss. If the purchaser later sells the property, only the gain realized greater than the disallowed loss is taxable. For any gain not recognized because of this rule, the basis of each partner's interest in the partnership is increased by the partner's share of that gain.

For purposes of determining if there is more than 50% ownership these rules apply:

> **RULE 1**: An interest owned by or for a partnership, corporation, estate or trust is considered to be owned proportionately by its shareholders, partners or beneficiaries.
>
> **RULE 2:** An individual is considered to own the interest owned by or for the individual's family, including brothers, sisters, half-brothers, half-sisters, spouses, ancestors and lineal descendants.

Gains are treated as ordinary, not capital, if they occur between a person and a partnership, or between two partnerships if:

- more than 50% of the partnership capital or profits interest is directly or indirectly owned by the same person, **and**
- the property in the hands of the transferee immediately after the transfer is not a capital asset, including accounts receivable, inventory, stock-in-trade, and depreciable or real property used in a trade or business.

Hot Assets

Under §751 so called "hot assets" give rise to ordinary income, not capital gains, when a partnership interest is sold. Hot assets are inventory and unrealized receivables, which include accounts receivables of a cash method partnership and rights to payment for work or goods begun but incomplete at the time of the sale or distribution of the partner's share. The ordinary income treatment does not apply to a distribution of property to the contributing partner, or to certain payments made to a retiring partner or successor in interest of a deceased partner.

Under §751, hot assets (inventory and unrealized receivables) are taxed as ordinary income, not capital gains, when the partnership interest is sold.

The partnership is required to file Form 8308, *Report of a Sale or Exchange of Certain Partnership Interests*, with its tax return when there are hot assets recognized in a partner's sale, and also disclose the amount of the §751 amount to the selling partner.

Sale/Exchange or Other Transfer of Partnership Interest

The sale or exchange of a partner's interest in a partnership usually results in a capital gain or loss, except as noted for so-called hot assets, which are ordinary income. Gain or loss is the difference between the amount realized and the adjusted basis of the partner's interest. If the selling partner is relieved of any partnership liabilities, he or she includes the liability relief as part of the amount realized for his or her interest.

A retiring or successor in interest to a deceased partner is treated as a partner until his or her partnership interest is completely liquidated. Payments made to liquidate an interest in exchange for his or her interest in partnership property are considered a distribution, not a distributive share or guaranteed payment that could give rise to a deduction to the partnership. The retiring partner or successor in interest of a deceased partner recognizes gain only to the extent that any money (and marketable securities treated as money) distributed is more than the partner's adjusted basis in the property. The partner recognizes a loss only if the distribution is in money, unrealized receivables and inventory items. No loss is recognized if any other property is received.

Other payments made to a retiring partner or successor in interest of a deceased partner that are not made in exchange for an interest in partnership property are treated as distributive shares of partnership income (if based on partnership income) or a guaranteed payment (if not based on partnership income).

INVENTORY ITEMS

Inventory includes that on hand at the end of the tax year or held primarily for sale to customers in the normal course of business. Inventory also includes any asset that would not be treated as capital or as §1231 property if sold or exchanged by the partnership. Inventory items also include accounts receivable acquired for services or from the sale of inventory and unrealized receivables.

For sales and dispositions occurring after 8/5/97, the Taxpayer Relief Act of 1997 (TRA 97) modified the treatment of inventory items for exchanges, sales or other dispositions. Under the pre-TRA 97 rules, inventory had to be 'substantially appreciated' to qualify as a hot asset. Substantially appreciated inventory occurred when the fair market value of the inventory exceeded 120% of the adjusted basis of the inventory.

Inventory must still be substantially appreciated to treat a partner receiving it in exchange for an interest in other partnership property as making a taxable sale or exchange of property rather than a nontaxable distribution under 751(b).

DISTRIBUTIVE SHARE IN DISPOSITION YEAR

A partner includes his or her distributive share of partnership items in income for the tax year in which the partner disposes of his or her entire partnership interest. The partnership's tax year is considered closed on the date the partner disposed of the interest. The partners can agree to estimate the distributive share by taking the prorated amount the partner would be entitled to take had he or she remained a partner the entire year.

LIMITED LIABILITY COMPANY

Ownership of a business entity by a Limited Liability Company (LLC) combines many of the advantages of corporate ownership with the advantages of partnership ownership, while avoiding the limitations on ownership applicable to S corporations. There are no limits to the numbers of members in an LLC. New members cannot be accepted without the agreement of existing members.

Like a general partnership, the LLC members are usually active participants in the business, although the members can select one or more members to serve as managers. If there are no designated managers, all members are treated as managers. A manager is the person(s) with continuing exclusive authority to make the necessary management decisions to operate the business for which the LLC was formed.

Limited Liability Provisions

Like a corporation, the LLC offers limited liability protection. However, the members still can be held liable for unpaid payroll trust funds, unpaid sales and use taxes, failure to maintain the formalities of an LLC, commingling LLC funds and personal funds and operating as if a sole proprietorship, and for personally guaranteed loans and leases. The members are fully liable for any other debts of the entity. And, like a corporation, the LLC form does not protect a member from liability for his or her own acts of negligence or malpractice.

Check the Box Rules AKA Domestic Entity Classifications

An LLC can be classified as either a disregarded entity, a partnership, or a corporation for federal income tax purposes, and depending upon this classification reports its annual income and expenses on either Form 1040, Form 1065, or Form 1120. Most MMLLCs are taxed following partnership rules. An LLC can elect to be taxed as an S corporation if it meets the S corp requirements and timely files Form 2553, *Election by a Small Business Corporation*.

The check-the-box final regulations under §7701 were issued effective 1/1/97. They adopt entity classification rules providing that the default treatment for an entity with two or more members is a partnership, and the default treatment for a single member entity is a disregarded entity. Both can elect to be treated as an association taxable as a corporation for federal tax purposes. Form 8832, *Entity Classification Election*, is used to elect out of a default classification or to revoke a prior election. A copy is attached to the entity's Federal tax return filed for the year election is made. If an entity wants to elect S corporation status, then it can make both the corporation election and the S election on Form 2553. Revocation of the S election reverts the entity to a corporation; at that time, Form 8832 must be filed to revoke the S corporation election.

Members wishing to accept a default classification do not need to file this form. Entities in existence prior to 1/1/97 will continue to be classified as a partnership if they filed partnership tax returns, unless they file Form 8832. New entities with more than one member are treated as a partnership or are disregarded as a single member entity, unless they file Form 8832.

For federal tax purposes, the MMLLC default is a partnership,
but it can choose to be taxed as a C or S corporation.
SMLLC is a disregarded entity (sole proprietor)
unless it chooses to be taxed as a corporation.
'Check the box" is the same as Domestic Entity Classification.

Some companies are automatically classified as corporations, including associations, insurance companies, banking entities if any of its deposits are FDIC insured, business entities wholly owned by a state or political subdivision, business entities formed in certain foreign countries, and any entity classified as a corporation under state law or statute of an Indian Tribe.

CONTRIBUTIONS OF PROPERTY

Generally, under §721(a), a contribution of money or other property into a partnership in exchange for an interest in the partnership does not result in a gain or loss. The two exceptions:

- transfers into an investment company, as defined in §351, are not tax-free,
- disguised sales transactions are not tax-free. A disguised sale is deemed to occur if a taxpayer transfers appreciated property into a partnership or LLC and within a short period of time, usually 2 years or less, receives a distribution of money or other property. Facts and circumstances determine if the transaction is a disguised sale rather than a tax-free contribution of property.

Under §721, a contribution of money or other property into a partnership solely in exchange for a partnership interest does not result in a gain or loss,
except for transfers into an investment company,
or if it is a disguised sales transaction and within 2 years of the contribution, money or property is transferred to the contributing partner.

As with a C corporation, S corporation, or partnership, transfers of encumbered property to an LLC result in recognized gain on the difference between the taxpayer's basis and the amount of debt relief.

> Example: Sylvia and Joan form an LLC where each has a 50% ownership. Sylvia contributes $3,000 cash and Joan contributes furniture and equipment that has a fair

market value of $3,000, a basis of $1,000, and a loan of $2,500. Joan's basis and recognized gain are computed as follows:

Relief of liability	$2,500
50% share of liability	(1,250)
Debt relief	$1,250
Basis	(1,000)
Recognized gain	$ 250

CONTRIBUTIONS OF SERVICES

A contribution of services in exchange for stock is usually taxable. Contribution of services for a capital interest in a partnership or LLC is taxable. Contribution of services for a partnership or LLC profits interest is generally not taxable.

The difference? As with partnerships, a capital interest shares in the increased (or decreased) value of the business when it is sold. A profits interest is entitled to a share of the business profits annually but does not share in the business appreciation.

MEMBER BASIS

Each member's initial basis in the LLC is computed as follows:

Basis = Cash + property contributed + gain recognized – liabilities relieved + liabilities assumed

LLC TAX REPORTING

The LLC uses the same tax year as a majority of its members; a §444 election is possible if there is a business purpose to adopt another tax year. The LLC may use the cash basis method of accounting, unless it is considered a tax shelter or syndicate. The LLC is a pass-through entity and income or loss retains its character as it is passed through to the members.

LLC DISTRIBUTIONS

Generally, LLC distributions are not taxable unless the money distributed exceeds the member's adjusted basis.

Basis for this purpose includes recourse liabilities of the LLC. If a member personally guarantees a debt, it is recourse debt to that member. Otherwise, non-guaranteed LLC debt is considered non-recourse.

Example: Rob is a member of Shinoda, LLC. His basis = $10,000. His share of the liabilities = $3,000. His 20A1 cash distribution = $20,000. He must report $7,000 of income in 20A1 ($20,000 distribution – $10,000 basis - $3,000 share of liabilities)

LLC Dissolution

An LLC taxed as a partnership recognizes no gain or loss on the distribution of money or other property in the complete liquidation of the member's interest under §731(b). The member recognizes gain only to the extent that the money distributed exceeds the adjusted basis of the member's interest immediately before the distribution. When property is distributed, the member does not recognize gain even when the cash distributed is less than the member's adjusted basis. Liabilities are treated as a distribution of cash.

Losses from an LLC taxed as a partnership are only recognized if the distribution is all cash, and the cash distributed is less than the member's adjusted basis. If property is also distributed, the loss is recognized when the property is disposed of, not at the time of the distribution.

> Example: Susi and Mark are LLC members who each have an adjusted basis of $8,000.
>
> Mark receives $7,000 cash and $4,000 relief of liabilities. He recognizes a gain of $3,000 ($11,000 received – $8,000 adjusted basis).
>
> Susi receives $2,000 cash and property with a fair market value of $5,000 (LLC basis of $4,000), and relief of liabilities of $4,000. She has no gain on the LLC liquidation ($2,000 + $4,000 relief of liabilities = $6,000 'cash,' which is less than her adjusted basis of $8,000).
>
> Susi's basis on the property received is $2,000 as follows:

LLC basis before distribution	$ 8,000
Less cash received	(2,000)
Less debt relief	(4,000)
Basis in the property	$ 2,000

LIMITED LIABILITY PARTNERSHIPS

Limited Liability Partnerships (LLP) are similar to LLCs, but there is a significant difference in the level of limited liability protections. In many states, the liability protection available to a partner in an LLP is not as extensive as in an LLC. Partners in an LLP are only protected from liability arising out of errors, negligence, incompetence, or wrongdoing of other partners, employees, and agents of the LLP (known as vicarious liability). However, partners in an LLP as well are members of an LLC are liable for their own errors, negligence, incompetence or wrongdoing, and that of persons working directly under their supervision. LLPs and LLCs generally have two or more partners/owners, although it is possible to have a single member LLC.

REAL ESTATE

Relevant IRC sections relating to property include:

§1231 includes **LAND**
§1245 is **PERSONAL** property
§1250 is depreciable **REAL** property

ADJUSTED BASIS

The adjusted basis of real estate is the sum of the cash acquisition cost, debt assumed, improvements, expenses to acquire the property, less depreciation allowed or allowable and less insurance amounts received.

Adjusted Basis = Cash Acquisition + Debt Assumed + New Debt Executed

CALCULATING AMOUNT REALIZED VS GAIN REALIZED

For purposes of the Tax Court exam, the amount realized is equal to the sum of all cash received from the buyer plus any mortgages assumed or debt taken subject to.

Amount Realized = Cash received + Mortgage Assumed + Mortgage taken Subject to

To compute the realized gain or loss on the sale of assets, the amount realized (selling price) is adjusted (reduced) by the costs of the sale, including commissions, escrow and title insurance fees, recording and other settlement fees.

Gain or Loss Realized = Amount realized - adjusted basis

GAIN RECOGNIZED

The realized gain may or may not be recognized gain, which is the taxable portion. This does not include anything that is tax-deferred, such as by a §1031 exchange.

TAXABLE EFFECT OF MORTGAGE FUNDS RECEIVED

Receiving borrowed funds does not give rise to a taxable event. If the funds are used to improve business property, that acquisition may add to basis and give rise to depreciation calculations, which reduce taxable income.

Amount realized = all cash from buyer + mortgages assumed or taken "subject to."
Gain or loss realized = amount realized - adjusted basis.
Gain recognized is taxable and doesn't include tax deferred exchanges.

TAX-DEFERRED §1031 EXCHANGES

The Tax Cuts and Jobs Act amended §1031 so that it only applies to real property for exchanges completed after 12/31/2017. The biggest impact will be to business vehicles, which used to qualify for §1031.

Property held for investment may be traded for other property held for investment in a tax-deferred exchange that recognizes continuation of the investment. Tax is deferred only until the time when the exchanged property is sold, at which time all the gain becomes taxable.

The nonrecognition transaction is permitted under §1031. To qualify:

- A farm can be exchanged for property in a city, unimproved property can be traded for improved property, and an apartment house can be traded for a shopping center. No tax-free exchange can be made of property located within the U.S. for property located in a foreign country.
- the property traded must have been held in the taxpayer's trade or business or for investment and must be traded for property held for productive use in business or investment. If property has been used in part for business and in part for personal use, only the business use portion qualifies for §1031 treatment because personal use property cannot be part of a tax-deferred exchange, **and**
- the trade must generally occur within a 180-day period. The property to be received by the taxpayer must be identified within 45 days after the taxpayer relinquishes the property and must be received before the earlier of the 180th day after the date the property is relinquished, or the due date of the taxpayer's return for the year of transfer of the relinquished property.

A tax-deferred exchange can be partially free from current tax. If either taxpayer receives 'boot' the gain is taxed to the extent of the boot. Boot is considered to be cash or any other property that is non-like-kind. Note that the receipt of boot triggers gain, but not a loss, of the lower of the fair market value of the boot or the realized gain.

Example: Jim owns a 4-plex with a fair market value of $160,000, an adjusted basis of $140,000, and a $130,000 mortgage. He exchanges the 4-plex for Theresa's office building with a fair market value of $155,000, a $120,000 mortgage, and $8,000 cash.

Jim received:	$155,000	(fair market value office building)
	8,000	(cash)
	<u>130,000</u>	(mortgage relief)
	$293,000	**Total Received**
	(140,000)	(adjusted basis 4-plex traded)
	<u>(120,000)</u>	(mortgage assumed)
	$ 33,000	Actual Gain on the Exchange

The $33,000 actual gain is not taxed at this time, but Jim is taxed on the "boot" (cash, net mortgage relief, or non-like-kind property received) of $18,000 as calculated below:

Cash received		$ 8,000
Mortgage relieved	$130,000	
Mortgage assumed	(120,000)	10,000
Gain taxed to the extent of boot		$18,000

§1031 Advantages and Disadvantages

Taxpayers may benefit from a §1031 exchange:

- no immediate tax obligation
- improved cash flow by deferring payment of capital gains taxes
- consolidation or diversification of business or investment property holdings
- interest is earned on the sale proceeds until the new purchase is made.

There are disadvantages as well:

- nonrecognition of gain or loss in a like-kind exchange is mandatory (do not exchange property if there is a loss as it is never deductible on an exchange)
- the depreciable basis is also transferred; therefore, there are times when an outright sale may be preferable
- suspended losses remain suspended until a taxable event occurs.

Mortgages in a Tax-Deferred Exchange

When mortgaged property is exchanged, the mortgage is considered to be boot to the transferor of the mortgage property. If both properties are mortgaged, the mortgages are netted to calculate the amount of boot. The party who obtains net relief from liabilities (the one with the higher mortgage before netting occurs) is treated as receiving boot in the amount of the net liability relief. The party who gives up the lower mortgage can still receive boot in the form of cash or other non-like-kind property.

Tax-Deferred Losses

Losses may not be deducted in a tax-deferred exchange; any loss is not recognized until the property is sold in a fully taxable transaction. If the tax-deferred transaction will result in a loss, the taxpayer should be advised not to enter into a §1031 exchange. To ensure the loss is allowed, the taxpayer should sell the property and use proceeds to purchase any new property in two discrete transactions.

Basis of Property Received

The basis of any boot received is its fair market value. The basis of property received in a like-kind exchange is equal to:

BASIS of property transferred PLUS gain recognized MINUS fair market value of boot received MINUS any loss recognized PLUS any boot paid.

Three-Party Exchanges
It may be impossible for parties to find another taxpayer that has precisely the real estate each wish to acquire. Time limits for closing the transactions are restrictive and deadlines must be strictly observed. As long as the provisions of the Code are met, and care is exercised to avoid running afoul of the constructive receipt rules, a qualified intermediary can match the parties with their respective properties.

Deferred vs Reverse Exchanges
In a deferred exchange the taxpayer first relinquishes the investment or business property and then receives the like-kind investment or business property. To avoid having the transfer treated as a sale rather than as a tax-deferred exchange, the taxpayer must be careful not to receive money or unlike property in full payment of the transferred property before receiving the replacement property.

In a reverse exchange the taxpayer acquires the replacement property prior to transferring the relinquished property. The like-kind rules generally do not apply to reverse exchanges. However, there are safe harbors that allow tax-deferred exchange treatment to be obtained if either the replacement or relinquished property is held in a qualified exchange arrangement. In a qualified exchange arrangement either the replacement or the relinquished property is transferred to an exchange accommodation titleholder (previously known as the accommodator), who is treated as the beneficial owner of the property. There are technical requirements to be met including using a required written agreement, meeting the time limits for identifying and transferring the property, and that the taxpayer does not have the indicia of ownership, such as holding legal title to the property.

Related Party Transactions
The tax advantages of entering into a §1031 exchange may be lost between related parties if either of them disposes of the property received within two years after the date of the last transfer of that exchange. Gain previously not recognized on the exchange becomes taxable as of the last date the original like-kind property is disposed of within two years.

Related parties include taxpayer's children, grandchildren, parents, siblings, controlled corporations or partnerships (more than 50% ownership) and a trust in which the taxpayer is also a beneficiary. Transfers to the taxpayer's spouse are not subject to the two-year rule, unless the spouse is a nonresident alien.

Use of a prearranged plan in which taxpayer transfers property to an unrelated party first, who then transfers the property to taxpayer's relative cannot be used to defeat these limitations.

No tax is incurred:
- if the disposition is incurred because of death,
- in an involuntary conversion if the original exchange occurred before the threat of involuntary conversion was known, **or**

- if taxpayer can prove that tax avoidance was not the purpose of the exchange or the later disposition of the property.

Integrated Plan Test

When determining whether multiple party transactions satisfy the exchange requirement, the Tax Court has used an integrated plan test. A transaction qualifies for nonrecognition if the transfer and receipt of property were "interdependent parts of an overall plan, the result of which was in exchange of like-kind properties" (*F.B. Biggs*, CA-5. 91-1 USTC ¶9114). These criteria help establish it is an exchange:

- §1031 exchange intended
- actions consistent with expressed intent
- the conditions required to affect that intent were met
- the contracts providing for the necessary series of transfers were interdependent
- no cash proceeds were actually or constructively received by the taxpayer, **and**
- the court is convinced an integrated plan for an exchange was conceived and implemented.

§1031 and Residences

An individual who acquires a principal residence in a like-kind exchange must own the property for at least 5 years prior to its sale or exchange for the exclusion to apply, but homeowners may be able to use the §121 exclusion (up to $250K/$500K) and a §1031 exchange if the property was used consecutively or concurrently as a home and business (Rev Proc 2005-14).

§1031 – Tom's The Easy Way

1. Compute the *amount realized* in the exchange.

FMV of property received	**$475,000**
PLUS debt relief	**$100,000**
PLUS cash/boot received	**$75,000**
LESS debt assumed	**($50,000)**
LESS cash/boot paid	**$0**
Amount realized	**$600,000**

2. Compute the *adjusted basis*.

Adjusted basis	**$325,000**

3. Compute the *gain realized*.

Amount realized	**$600,000**
LESS adjusted basis	**($325,000)**
Gain realized	**$275,000**

4. Compute the *gain recognized*.

Gain is recognized to the extent of boot received.

Cash received	**$75,000**
Unlike property received	**$0**
Net debt relief	**$50,000**
Gain recognized	**$125,000**

Exam Alert!

After ignoring §1031 calculations since 2002, that was tested in 2021. Be sure you have a basic understanding of the concept and calculation

Rental Property

Taxpayers report most rental activities on Schedule E. If the landlord provides additional services to the tenants, such as maid service, Schedule C is used for reporting the activity.

Rent Income

Rent income is any payment received for the use or occupation of property. For a cash basis taxpayer, rent is treated as income in the year in which it is actually or constructively received. An accrual basis taxpayer treats the rent as income in the year in which he or she is entitled to receive it. Both the cash and accrual basis taxpayer count advance rentals in the year received. Both the cash and accrual basis taxpayer count a tenant's payment to cancel a lease as income in the year received. The landlord receives additional rental income if the tenant pays the landlord's expenses and the fair market value of property or services received in lieu of rent is included as rental income.

> Example: The tenant, Best Tax Service, signs a 10-year lease to rent the property and pays the Landlord $10,000, $5,000 for the first year's rent and $5,000 for the last year's rent. The Landlord must include the $10,000 rent in the year it is received.

If the tenant pays to cancel a lease, it is rent income, includible in the year received. If the tenant pays any of the landlord's expenses, those payments are includible in rent income. The landlord is entitled to deduct any expenses that are deductible.

If below market rent is charged to a friend or relative, the taxpayer may deduct expenses and depreciation only to the extent of the rental income.

SECURITY DEPOSITS

Security deposits are amounts deposited with the landlord solely as security for the tenant's performance under the rental agreement. Security deposits are not rent or other income when received. If the tenant is entitled to a full reimbursement of the security deposit upon move-out, payment of the security deposit is not deductible. A security deposit fully or partially retained is includible in the landlord's income at the time it is retained.

> Example: The tenant, Best Tax Service, signs a 10-year lease to rent the property and pays the Landlord $10,000, $5,000 for the first year's rent and $5,000 as a security deposit. The Landlord must include the $5,000 rent in the year it is received. The security deposit does not become income unless it is retained by the landlord when the tenant vacates the property.

If a security deposit is to be used as last period's rent, it is advance rent and is includible in income when received.

DEDUCTIONS

A current year deduction is permitted for:

- real estate taxes (except that special assessments for paving, sewer systems or other local improvements are added to the basis of the land rather than being deductible in the year paid),
- legal services to evict tenants,
- management expenses for collecting rent,
- maintenance expenses for repairs and maintenance of the property to keep the property is good operating condition,
- salaries and wages, **and**
- interest for mortgages and other debt.

A current year deduction is not permitted for:

- a year's insurance premium extending beyond the current year; even cash basis taxpayers must amortize and deduct the premium over life of the policy,
- commissions on long-term tenants are deducted over life of the lease,
- costs of obtaining new financing are deductible over the term of the loan,
- legal and other fees paid for long-term leases are deductible over the term of the lease, **and**
- costs of an overall improvement program are capitalized and expensed as depreciation over their useful life.

If the property is held for rental purposes, the ordinary and necessary expenses for managing, conserving, or maintaining the property are deductible while the property is vacant. Those expenses can be deducted from the time the property is made available for rent.

If the taxpayer has any personal use of a dwelling unit that is rented, the expenses must be divided between rental and personal use. If the taxpayer uses the dwelling unit as a home and rents it fewer than 15 days during the year, no income is includible and no rental expenses are deductible.

DEPRECIATION

Depreciation can be taken in the month the building is ready for tenants. Currently MACRS depreciation on real estate is 27.5 years for residential use, and 39 years for non-residential use. Furniture, carpeting and appliances used in residential rental property can be depreciated over 5 years. TCJA expanded §179 to tangible personal property used in connection to the furnishing of lodging.

RENTAL OF RESIDENCE (VACATION HOME RULES)

The number of days a taxpayer's personal residence is rented during a tax year makes a difference in how the income and expenses are reported. Days are counted by determining the total number of fair market rental days and the personal use days. Taxpayer must treat the unit as a residence if the personal use days exceed 14 days, or if greater, 10% of the days on which the unit was rented to others at a market rent.

> Example: Chris rents the guest bedroom of his home at a fair market rental during the local college's special events, for a total of 27 days. His sister-in-law stayed in the room rent-free for the last 3 weeks in July, a total of 21 days. The room is used as a home because it was used for personal purposes for 21 days, which is more than 10% of the time it was rented (27 days x 10% =3 days).

Tax law treats renting a unit to a close relative who uses it as a personal residence differently than renting a property that is not used as a personal residence. A fair market rent paid on a property used as a personal residence is not attributed to the taxpayer. Even a fair market rent paid by a relative for a vacation or second home is attributed to the taxpayer. A below market rent to a relative that uses the property as a personal residence is attributed to the taxpayer.

Why does it matter? Personal losses are not deductible.

> Example: Stephanya acquired a house from her grandmother; immediately thereafter she rented the house to her brother Murray for half the year at $500 per month plus his services in assisting with the repair and maintenance of the property. Fair market rent at that time was $700. She sold the house at a loss after her brother moved out. The below market rent to a family member prevented her from taking the rental loss; the §165(c)1 loss was also disallowed because Stephanya was not engaged in the trade or business of renting property (below market rent established her primary purpose was not income or profit). The Court denied a §165(c)2 deduction because the below market rent and the immediate placement of the property on the market were evidence the property was not held for income production (*Barranti* TC Memo 1998-427)

Counting the Days

Days a vacation home is held out for rent, but not actually rented, do not count as rental days. Any day a taxpayer spends substantially full time repairing or maintaining the property is not counted as a day of personal use, even if the taxpayer's family enjoys recreational activities on that day. Any day that the unit is rented at a fair rental price is a day of rental use, even if the taxpayer uses the property. The attribution rules apply, and days used by relatives count as the taxpayer's personal use, unless the relative pays a fair rental value to use the home as a principal residence. If a relative uses the property as a vacation home, even if paying fair rental value, their use counts towards taxpayer's personal use.

The calculations are different to determine rental use of a property that is used as a home and one that is not used as a home.

> Example: Pauline's beach cottage is available for rent from June 1 through August 31 (92 days). Her family uses the cottage during the last 2 weeks in May (14 days). She was unable to find a renter for the first week in August (7 days). The person who rented the cottage in July permitted Pauline and her family to use the cottage for a weekend during that month without a reduction in rent (2 days). The cottage was not used before May 17 or after August 31.
>
> Rental Use: The cottage was used as a rental a total of 85 days (92 available less 7) because the days it was available for rent but not rented do not count as rental use. The July weekend Pauline uses the property do count as rental use because she received fair market rents. She used the cottage for personal purposes for 14 days. The total use of the cottage was 99 days (14 personal and 85 rental). The amount of rental expenses allowed is 85/99 (or 86%).

Example: If the cottage is used as a home, the July weekend counts as personal use, which gives 16 days of personal use and 83 days of rental use. Because the cottage was used for personal purposes more than 14 days and more than 10% of the days of rental use (8 days), all the rental income is includible in income. The rental expenses are permitted only to the extent of income; the balance is carried forward into future tax years.

Rented less than 15 days
If the home is rented for less than 15 days during the taxable year the income is not reported and the only expenses reportable are those allowed on Schedule A.

Rented more than 15 days
If the home is rented for more than 15 days during the taxable year, all rental income is included in gross income, and rental expenses are deductible on Schedule E only to the extent of rental income. Expenses are also apportioned between personal and rental use. Deductible expenses are limited by:

Days of Fair Market Rental
Total Days of Rental and Personal Use

Ordering rules also apply to when the expenses are deductible. Step 1 expenses are fully deductible on Schedule E even if the total exceeds rental income and include:

- mortgage interest (if itemized, balance to Schedule A),
- real estate taxes (if itemized, balance to Schedule A),
- deductible casualty and theft losses,
- directly related expenses, which are rental expenses not related to the use or maintenance of the residence itself, including office supplies,
- rental agency fees,
- advertising, **and**
- depreciation on office equipment used in the rental activity.

If any rental income remains after the income is reduced by Step 1 expenses, the balance is offset next by the rental portion of operation expenses for the residence itself, known as Step 2 expenses, including:

- utilities,
- repairs, **and**
- insurance.

If any rental income remains after Step 2, depreciation on the rental portion of the residence may be deducted as a Step 3 expense.

Operating expenses from Step 2 and depreciation from Step 3 that exceed the balance of rental income are carried forward to the next year as rental expense for the same property. These expenses are deductible only to the extent of rental income from the property for that year, even if taxpayer's personal use of the residence does NOT exceed the 14 day/10% test for that year

Renting Residence Prior to Sale
A taxpayer renting a personal residence prior to its sale is not considered to have personal use attributed for a residence rented (or attempted to rent) at fair rental for:

- a consecutive period of 12 months or more, **or**
- a period of less than 12 months that ends with the sale or exchange of the residence.

Since personal use is not attributed during this time, deductions are not limited to rental income.

No Attribution of Personal Days
If the personal use days do not exceed the greater of 14 days or 10% of the fair market rental days, the rental deductions are not limited by the personal use test. They may be subject to the passive activity rules.

Passive Activity in Vacation Home Rental
As long as a taxpayer meets the material participation tests, if a vacation unit is rented at a loss for an average rental period of 7 days or less, the loss is treated as a business loss and not a passive activity.

Material participation generally requires:

> **TEST 1**: taxpayer participates in the activity for more than 500 hours during the tax year.
>
> **TEST 2**: taxpayer's participation constitutes substantially all of the participation in the activity of all individuals, including non-owners during the year.
>
> **TEST 3**: taxpayer participates more than 100 hours during the tax year, which is at least as great as that of any other person, including non-owners for that year.
>
> **TEST 4**: taxpayer participates in all significant participation activities for more than 500 hours and the activity is a significant participation activity (a trade or business in which taxpayer participations more than 100 hours during the year and in which he or she doesn't materially participate under any of the material participation tests, other than this test).
>
> **TEST 5**: materially participated in the activity for any 5 (whether or not consecutive) of the immediately preceding tax years.

Test 6: materially participated for any 3 (whether or not consecutive) preceding tax years in an activity which is a personal service activity (health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, or other trade or business in which capital is not a material income-producing factor)

Test 7: based on all the facts and circumstances, participates in the activity on a regular, continuous and substantial basis during the year.

If the taxpayer does not meet the material participation rules, the loss does not qualify for the up to $25,000 rental loss allowance because the property is not treated as rental property.

Example: Taxpayer purchased one of 155 cottages in a vacation and conventional resort area. The cottages were managed and marketed by an entity that was paid a management fee of 50% of all net rental income. The average rental period was less than 7 days and taxpayer reported a Schedule C loss for each year 1988-1990. During an audit the IRS determined the losses were §469(a) passive losses and disallowed them. The Tax Court decided that the 300 hours per year spent in budgeting and correspondence activities did not constitute 'material participation' in the resort operations but rather work commonly handled by investors. (*Toups* (TC Memo 1993-359))

When portions of a dwelling unit are used exclusively as a hotel, motel, inn or similar business, the portion used exclusively for business will not be considered part of the dwelling unit for purposes of the §280A disallowance rule. This does not apply to the dual-use portion of a hotel, inn, or bed and breakfast (see *Lofstrom* (125 TC 13 (2005)). Bed and breakfast owners Anderson (*Anderson* (TC Memo 2006-33)) were not allowed a deduction for portions of their inn used for both business and personal purposes; since they lived there, business deductions could only be claimed for the portion of the property used exclusively for business, and the portions also used as a residence were denied a deduction.

Example: *Christopher Cooke* (TC Memo 2017-74 (5/1/17)) is an attorney practicing law in Alaska who owned property in Indiana. He and his domestic partner formed an LLC to purchase the property for more than $787K and turned it into a B&B. Gross income fell short of expectations ($10,939 in 2008, $29,971 in 2009 and $497 in 2010) and in 2009 the property was listed for sale for nearly $2 million (it eventually sold in 2014 for $500k). As of 1/31/10 the B&B operations were discontinued. Caretakers, residing at the Indiana property during the tax years at issue, were given rent-free use of the manager's apartment in exchange for their services. No rental operations occurred from February 2010 through December 2011.

For 2010 and 2011, in addition to other deductions (advertising, insurance, taxes, repairs, landscape, telephone and cable, etc.), petitioner deducted travel and entertainment expenses for himself and his partner. On timely filed Forms 1040 petitioner reported 100% of the LLC's losses as nonpassive, and deducted those losses against other nonpassive income. Under §280A(a) no deduction is generally allowed with respect to any dwelling unit that the taxpayer uses as a residence during the taxable year. A dwelling unit is used as a residence if the taxpayer uses it for personal purposes for more than the greater of 14 days or 10% of the number of days during the taxable year that the unit is rented at a fair rental value. Days spent performing repairs do not count as personal use and travel days are not counted as personal if the principal purpose of the trip is to perform repairs and maintenance. §280A was enacted by Congress in response to a concern that the rental of property used by the taxpayer as a residence afforded the taxpayer unwarranted opportunities to obtain deductions for expenses of a personal nature.

The logbooks and testimony didn't indicate what repairs were necessary, especially given the caretakers had duties and responsibilities to maintain the property. The Court found that he used the Indiana property for personal purposes for more than 14 days during 2010 and 2011.

Passive Activity Loss Limitations

Rental income and losses are automatically treated as passive and subject to the §469 rules unless they are incurred by a real estate professional, or they are considered by law to be a business activity. Individual taxpayers may be able to deduct up to $25,000 in real estate losses if they actively participate in the management role, and their MAGI for the year is less than $100,000 (a phase out applies if the MAGI is between $100,000 and $150,000). Certain rules must be met for the $25,000 in losses to be available:

- it can only be rental real estate
- taxpayer must have at least 10% ownership
- taxpayer must actively participate in the management
- taxpayer must be an individual (not a corporation).

Real Estate Professional

Generally, §469 puts strict limits on current deductibility if taxpayer incurs expenses in a passive activity and rental activities are generally treated as per se passive activity regardless of whether taxpayer materially participates. A person may qualify as a real estate professional if 1) more than 50% of the personal services performed in trades or business by the taxpayer are performed in real property trades or businesses in which the taxpayer materially participates, **and** 2) such taxpayer performs more than 750 hours of services in real property trades or businesses in which the taxpayer materially participates. If it is a joint return, the requirements are satisfied if either spouse separately satisfies them. The time spent as an employee performing real estate activities is ignored, unless the employee is also a 5% owner.

A contemporaneous record is not required, but the use of post-event ballpark guessestimates is not sufficient. The calendar produced exaggerated the time H spent on the real estate activities in the Court's judgment.

Real estate professionals may aggregate rental real estate activities by making an election to treat all interests in rental real estate as a single rental real estate activity. Taxpayer must prove material participation rules are met at each rental if no election is made to aggregate the activities.

To qualify as a real estate professional, >50% of personal services must be in real property trades or businesses in which the taxpayer materially participates and taxpayer must perform > 750 hours of service in those trades or businesses.
Real estate losses are not limited for a real estate professional.

> Example: In *Zane Penley and Monika Penley* (TC Memo 2017-65 (4/1/17)) the petitioners claimed that H qualified as a real estate professional for the year that respondent disallowed more than $56,000 in losses from real estate activities under §469. During the year at issue H was a full-time employee who spent at least 2,194 performing his duties on his job. H also claims 2,520 hours on real estate activities; he was also actively engaged as a CO real estate broker with an active business marketing commercial and residential property and petitioners had an S corporation where they conducted a rental real estate activity. Just because a professional prepared the returns doesn't prove the petitioners acted with reasonable cause and in good faith. They were liable for the accuracy related penalty.

Installment Sale

An installment sale is a sale of property where the taxpayer receives at least one payment after the tax year of the sale. If a sale qualifies as an installment sale the gain must be reported under the installment method unless the taxpayer elects out of using it. Each payment of an installment sale consists of interest income (ordinary income taxable upon receipt) and gain on the sale plus a portion related to the recovery of basis. Although installment sales can apply to other property, we are covering this in the real estate section as that is the most commonly tested type of installment sale question.

Installment sales are reported on Form 6252, *Installment Sale Income*, which is used to report the transaction in the year of the sale and to report payments received in subsequent years. The gain calculated on Form 6252 is transferred to either Schedule D for a capital gain or to Form 4797 for the sale of property used in a trade or business.   Gain treated as ordinary income under §1245 cannot be reported under the installment method – depreciation recapture is reported in the year of sale whether or not any installment payments are received.

A taxpayer can elect out of the installment method by reporting the entire gain in the year of the sale, even if all sale proceeds were not received.

This method is not available for:

- Sales that result in a loss,
- The sale of inventory,
- Sale of personal property by a dealer,
- Sale of real property held for sale to customers in the ordinary course of a trade or business (but it is available for property used or produced in farming),
- The sale of publicly traded property (securities and stocks),
- The sale of depreciable property between related parties unless the seller can show that tax avoidance is not a principal purpose of the sale. If a taxpayer sells to a related party who then sells the property within 2 years of the first sale and before making all payments on the sale, the taxpayer must treat part or all of the amount realized by the related party on the second sale as if the amount was received by the taxpayer at the time of the second sale.

Selling Price (AKA Amount Realized)
The selling price includes any money the seller is to receive, the FMV of the property seller is to receive, any existing mortgage or debt the buyer pays, assumes or takes, and all the seller's expenses that are paid by the buyer. The selling price does not include interest.

Selling Price = Cash + Property Seller Will receive + Mortgage Paid by Buyer (assumed, taken subject to) + Buyer-Paid Seller's Expenses

Adjusted Basis
The adjusted basis for an installment sale includes the adjusted basis, selling expenses paid by the seller, and depreciation recapture income reported in the year of sale.

Adjusted Basis = Cost – Accumulated Depreciation – Seller Paid Selling Expenses + Depreciation Recaptured in Year of Sale

Gross Profit (Realized Gain)
The gross profit is the total gain reported on the installment method and may also be called realized gain. It is computed as the selling price minus the adjusted basis for installment sale purposes. If the property sold was the taxpayer's main home gross profit is reduced by any gain excluded under those rules.

Gross Profit (Realized Gain) = Selling Price – Adjusted Basis

Contract Price
The contract price includes the total of all principal payments to be made to the seller under the terms of the installment sale. It is calculated as the selling price minus existing mortgages or other debt buyer assumes plus the portion of the existing mortgages or other debt the buyer assumes in excess of the adjusted basis for installment sale purposes. If the debt is in excess of the adjusted basis, the seller also is relieved of debt.

Contract Price = Selling Price – Debt Relief <u>to Extent of Basis</u>

Gross Profit Percentage
The gross profit percentage represents the percentage of every dollar of principal collected by the seller that will be taxed as gain. It is calculated as realized gain divided by the contract price. In cases where the taxpayer has mortgage relief in excess of the taxpayer's basis, every dollar collected by the seller during the installment period represents gain and no basis recovery. In those cases, the gross profit percentage will be 100%.

Gross Profit % = Gross Profit/Contract Price

Installment Sale Income
A percentage of each payment is reported as installment sale income. The percentage is calculated as: payments received during the year x gross profit percentage. This is the amount reported as taxable income each year. Mortgage relief in excess of basis is included as a payment in the year of sale.

Installment Sales Income = Payments Received During Year x Gross Profit %

Gross profit (AKA realized gain) = selling price minus adjusted basis.
Contract price includes all principal payments made to the seller.
Gross profit percentage = realized gain/contract price.

Basis in the Contract
A portion of the remaining contract represents a recovery of the taxpayer's basis. As such, a portion of each payment received is not taxable. The gross profit percentage represents the taxable gain so 100% - GP% = Basis %. The contract price less payments the seller has received equals the remaining amount the seller will collect. That amount x the basis percentage equals the remaining basis in the contract. Remember, when the gross profit percentage is 100%, everything the seller collects will be taxable gain - the basis recovery will be zero, and the remaining basis in the contract will be zero.

Basis % = 100% - Gross Profit %

Remaining Basis in Contract = (Contract Price – Payments Received) x Basis %

A portion of the installment sale is taxable each year (equal to gross profit percentage or GP%). The amount allocable to basis in the contract (100%-GP%) is not taxable. If the GP% is 100%, everything is taxed to the seller.

§453 Computations (Installment Sales) – Tom's The Easy Way

1. Compute *gross profit*.

Total amount received
LESS adjusted basis
LESS selling expenses
LESS depreciation recapture
LESS §121 exclusion

2. Compute *contract price*.

Total amount received
LESS liabilities assumed up to the extent of basis

3. Compute *gross profit percentage*.

Gross profit
OVER contract price

4. Compute the *annual payment* for each year of the installment sale.

Amount received
PLUS liabilities assumed in excess of basis

5. Compute the *annual gain*.

Annual payment
TIMES gross profit percentage

6. Compute *basis* in installment obligation under §453B.

Remaining total payments
LESS unrecognized gain

Mortgage Interest

The Tax Cuts and Jobs Act reduced the limit on acquisition indebtedness to $750,000 for mortgages taken out after 12/15/2017; prior mortgages are grandfathered and continue to have a $1 million limit. Home equity debt is no longer deductible after 12/31/2017. Both changes expire after 12/31/2025.

Home mortgage interest is any interest paid on a loan secured by a taxpayer's main or second home. Mortgage interest can be deducted if the taxpayer is legally liable for the loan, which is secured by the qualified home. It may also be possible to deduct mortgage interest if the taxpayer is found to be the equitable or legal owner of the property (*Uslu* (TC Memo 1997-551) and *Phan* (TC Summary 2015-1). Loans secured by a taxpayer's third home are considered personal and the interest is not deductible, unless the third home is used exclusively for business or investment purposes.

A taxpayer can elect to treat debt secured by a home as not secured by a home under Reg §1.163-10T(o)(5), which may be helpful when the mortgage proceeds are used for business purposes. The election applies in the year of the election and all subsequent years and cannot be revoked without IRS consent.

Points and loan origination fees are generally deductible in full when paid to purchase a principal residence, although the taxpayer can still choose to amortize them over the life of the loan. Points paid for a loan to substantially improve the home can also be deducted. Points to refinance a mortgage are amortized over the life of the loan and points paid for a loan refinanced through the same lender continue to be amortized over the life of the loan. If a loan is otherwise paid in full the unamortized balance of points can be written off in that year.

ESTATES AND ESTATE TAX (706)

An estate tax return (Form 706) measures the wealth being transferred rather than income earned. The 706 is prepared based upon a fully accrued balance sheet, even though the taxpayer likely reported income on the cash basis. Because a death transfer tax can be avoided by making gifts while the taxpayer is alive (an inter vivos gift), the federal transfer tax is imposed on gifts made during the lifetime as well as upon the taxpayer's death; estates bring back all taxable gifts as well as all items owned or controlled by the decedent

An estate tax is an excise tax levied on the privilege of transferred property at death. This transfer tax is intended to prevent people from accumulating large amounts of wealth, which then passes from generation to generation. The excise tax is currently 40%.

The estate tax return is due nine months after the date of death, unless a six-month extension of time is obtained. Under §6161(a)(1), a twelve-month extension of time to pay an estate tax is possible, if reasonable cause exists.   The extension is generally permitted if there is a cash shortage in the estate, or if the estate's largest asset is a lawsuit award in progress and the amount is not yet known.

The fiduciary of an estate is called the executor. If the decedent died intestate (without a will) the fiduciary is called an administrator or personal representative.

Statute of Limitations

The IRS generally has three years to audit an estate tax return. The executor can make a request for early determination, which forces the IRS to audit within nine months of the filing date and releases the executor from liability. The beneficiaries remain on the hook for taxes due that are related to the estate. The statute of limitations does not begin to run if a return is not filed. Tolling of the statute may be a benefit to filing a 706 if the asset values are near the filing requirement as it limits the time in which the IRS can question estate valuations.

Valuation of Property

Property includible in an estate is valued at its fair market value on the death of date, or if appropriately elected, the alternate valuation date. Examples of how those values are computed include:

- publicly traded stocks and bonds are valued as an average of the high and low selling price on the date of death. If only the closing price is available, an average of the closing costs of the day prior to death and the day of death is used.
- closely held stocks are more difficult to value and may be subject to minority interest discounts.
- savings bonds are valued at their redemption value, which can be obtained online or from the Superintendent of Documents.

Alternate Valuation Date

Estate assets are generally valued at their fair market value on the date of death.   The alternate valuation date, six months after the date of death, can be irrevocably elected under §2032 only if the estate is a taxable one that will actually pay estate tax, and use of the alternate valuation date both:

- reduces the actual tax due, **and**
- reduces the value of the estate.

When this election is made the assets are all valued at the date of death and six months later. If assets are sold within six months after death, they are valued at their price on the date sold. Assets that are distributed or otherwise disposed of are valued at the price they were worth on the date of the disposition.

Estate values are generally at FMV on the date of death,
but the alternate valuation date (AVD),
which is 6 months after date of death can be chosen
if it is a taxable estate that will pay tax,
and the AVD both reduces the actual tax due, and the estate's value

The alternate date **cannot** be used to increase basis of assets in non-taxable estates, nor can it be used to lower valuation of assets that are 'merely affected by elapsed time' such as notes, mortgages, patents or copyrights.

A late alternate valuation date election is invalid. In *Eddy* (*Estate of Edward H Eddy* (115 TC 10 (8/16/00)) the estate lost its opportunity to use the alternate valuation date because the executor made the election more than a year after the time required for filing the return, including extensions. The judge called the opportunity to value property as of a date after death "legislative grace" that must be made in the manner and time prescribed by Congress.

ASSET UNDERVALUATION PENALTIES

Estate tax penalties are most often for undervaluation of assets. Under §6662(b)(5), a substantial estate or gift tax valuation understatement penalty of 20% applies if the claimed value is 65% or less of the actual value.

> Example: For $100,000 of actual value, the 20% penalty would apply if the claimed value was $65,000 or less (to level where 40% penalty applies).

However, a gross valuation misstatement penalty of 40% applies when the claimed value is 40% or less of the actual value under §6662(h).

> Example: For $100,000 of actual value, the 40% penalty would apply if the claimed value was $40,000 or less.

ESTATE TAX CALCULATION

Taxable estate = gross estate – allowed deductions

Estate tax = taxable estate x applicable tax rate

GROSS ESTATE (§2031)

As previously indicated, estate tax returns measure the amount of wealth transferred. All world-wide property which the decedent owned or controlled is includible in the gross estate. Examples include:

- transfers made during the decedent's life without full and adequate consideration,
- assets that are subject to probate as well as those that pass without probate,
- life insurance proceeds, even though they are payable to beneficiaries other than the estate, if the decedent retained the incidents of ownership,
- life insurance proceeds, if the policy or an incident of ownership was transferred by the decedent within three years of death,
- property over which the decedent had a general power of appointment (see below for information),

- property over which the decedent retained an interest (see below),
- the entire value of jointly held property, except the portion of the property for which the joint surviving tenant provided consideration,
- half of the value of community property is generally includible in the gross estate of the first spouse to die,
- assets over which surviving spouse has Dower rights or Curtsey interests under (§2034), **and**
- the value of QTIP trust assets.

Generally speaking, if the decedent had the right to control the passing of the asset at death, it is most likely considered to belong to the decedent and is includible in the gross estate.

In *Estate of Nancy Powell, Deceased, Jeffrey Powell, Executor* (148 TC 18 (5/18/17)) decedent's son, acting on her behalf on 8/8/08, transferred cash and securities to a limited partnership (LP) in exchange for a 99% limited partner interest. Also acting on her behalf (purportedly) on 8/8/08, the decedent's son transferred decedent's LP interest to a charitable lead annuity trust, the terms of which provided an annuity to a charitable organization for the rest of decedent's death. Under her death on 8/15/08, the corpus was to be divided equally between her two sons. The Court found that since the LP interest was transferred less than 3 years before her death (just a week before her death, actually), the value of cash and securities is includible in the value of her gross estate to the extent required by either §2036(a)(2) or §2035(a). The value included is only the excess over the value of the LP interest decedent received in return under §2043(a). The transfer her son made to the charitable organization was either void or revocable under state law because decedent's power of attorney did not authorize him to make gifts in excess of the annual Federal tax exclusion.

Determining whether a gross estate exceeds the filing requirement is done without consideration to the decedent's debts or expenses. Those are deducted to determine the amount of tax the estate pays, not whether the estate is required to file a tax return.

POWER OF APPOINTMENT §2041

The power of appointment allows the holder to direct where the assets will go at death, even though they are not in the name of the holder of the power during life. The power can be exercisable either during life or at death by will, or both. A power to appropriate or consume the principal (corpus) of a trust is a power of appointment.

A general power means the decedent can name him or herself as a beneficiary. Even if this power is never exercised, it brings the item covered by the powers into the decedent's estate. In contrast, a limited or special power of appointment grants the holder the power to name anyone but the holder to someone else's estate. There are no tax consequences from the exercise, release, or lapse of either special or limited powers of appointment.

The trust has a so called ”5 and 5” power if it provides the power to either withdraw a non-cumulative 5% of the trust principal each year, or if the corpus falls below $100,000, the power exists to withdraw $5,000. Only the unexercised power in the year of death is includible, so only 5% or $5,000 is part of the decedent's estate.

A special (or limited) power of appointment grants the holder the power to name anyone (except him or herself, estate or creditors) as beneficiaries of someone else's trust. There are no tax consequences for a limited power of appointment's lapse or use.

If the appointment power is limited by an ascertainable standard, which is exercised solely for purposes of the decedent's health, support, maintenance or education, there are no estate tax consequences.

RETAINED INTERESTS

If a decedent retains some control over gifts of property made during his or her lifetime, the property may be added back to his or her gross estate. Included in this rule are transfers in which:

- the decedent retained a life estate, or the right to income, possession, or enjoyment of the property, or the right to name someone else to enjoy the property, under §2036. This can include gifts of stock where voting rights are retained.
- the decedent retains a right to a reversionary interest exceeding 5% of the value of the transferred property, under §2037(a), **and**
- the decedent holds the power to alter, amend, revoke, or terminate a gift, under §2038(a)(1).

If the reserved right is only part of the transferred property, only that portion of the property is includible in the gross estate. If the decedent sells such property with a retained right for full and adequate consideration, the transferred property is not includible in the gross estate.

DEDUCTIONS FOR DECEDENT'S DEBTS

A deduction on the 706 is permitted for the decedent's debts, including:

- mortgages, secured/unsecured loans, credit cards, **and**
- contingent claims, if they can be valued with reasonable certainty and will be paid.

DEDUCTIONS FROM THE GROSS ESTATE

Some deductions are reportable only on the estate's Form 706, or the estate's Form 1041, or the heir's Form 1040, or the Decedent's final Form 1040. The executor can choose to make some deductions on one form or another. Some deductions can be taken on two forms.

Personal deductions permitted on a 706 **only** include:

- funeral expenses – all costs of burial or disposition of the remains, including the reasonable cost of a burial plot, tombstone, and the cost of future care.
- charitable contributions listed in the will.

- federal income tax due or refunds of tax.

Personal deductions permitted on **either** 706, 1041, or heir's 1040, include:
- state income tax due or refund.
- final 1040 preparation fees.

Personal deductions permitted on **either** 706 or decedent's 1040 include medical expenses paid within one year.

Administrative deductions permitted on **either** 706, 1041 or heir's 1040:
- probate attorney fees, executor's commissions, trustee fees.
- accounting fees, and appraisal fees.
- court costs and filing fees.
- 706 and 1040 preparation fees.
- casualty losses during administration of the estate.

Administration expenses are **probate** only expenses – all costs for appraisals, certified copies of documents, court costs, collection costs, and the costs of locating, discovering, and storing assets.

Income and Deductions in respect of a decedent, permitted on **both** 706 and 1041 include:
- alimony due to ex-spouse.
- IRD (income in respect of a decedent) including accounts payable on cash basis business, wages received after death, accrued interest and dividends, accrued real income, tax deferred benefits, installment sales contract.
- savings bond interest not reported on decedent's 1040.

PORTABILITY

The American Taxpayer Relief Act of 2012 (ATRA '12) permanently provides for a maximum estate tax rate of 40% with an inflation-adjusted exclusion of $5 million. The Tax Cuts and Jobs Act temporarily increased the exemption to $10 million ($12,920,000 in 2023) for decedents dying after 12/31/2017 and before 1/1/2026. It also continues and makes permanent the portability of the deceased spouse's unused exclusion (DSUE) of his or her predeceased spouse, thus making the unused exclusion 'portable.' The DSUE is the lesser of:
- The basic exclusion amount, **or**
- The deceased spouse's applicable exclusion amount, minus any amount of that exclusion that was used to avoid estate or gift tax.

  Example: In 20A9 Mary made a taxable gift valued at $1 million that was timely reported on Form 709. Mary died in 2023 and is survived by her husband Bill. They were married for 30 years, had no previously marriages, and had a combined estate of $14 million at the time of Mary's death. Her total estate is $2 million, which **she leaves to her children**. The executor of Mary's estate computes the DSUE:

Lesser of 2023 basic exclusion ($12,920,000) **or**	
Applicable exclusion amount	$12,920,000
Minus total estate	(2,000,000)
Minus taxable gift exclusion	(1,000,000)
DSUE	$ 9,920,000

The decedent may use the unused exclusion of his or her 'last spouse to die' which prevents surviving spouses from using the DSUE of multiple predeceased spouses. DSUE is not lost by remarrying, but if the surviving spouse remarries she or he loses any unused exclusion from the first spouse if he or she outlives the second spouse. If a surviving spouse marries again and that marriage ends in divorce of annulment, the subsequent death of the divorced spouse does not end the status as being the last deceased spouse of the surviving spouse – spouses must be married at the time of death to be a 'last deceased spouse.' See Temp Regs §§20.2010-1T for more information. The election must be made on a timely-filed estate tax return, or within nine months of the decedent's date of death unless an extension is requested.

In Rev. Proc. 2022-32, the IRS provided a procedure to make a late DSUE election provided that Form 706 is filed within five years of the date of the decedent's death. Late election relief after five years must be done via private letter ruling.

The IRS can look at a predeceased spouse's estate tax return to determine the DSUE that flowed through to the other spouse. In *Estate of Minnie Lynn Sower, Deceased, Frank W Sower, Jr. and John R. Sower, Co-Executors* (149 TC 11 (9/11/17)), H died in 2012 and H's estate reported a deceased spousal unused exclusion (DSUE) and elected portability of the DSUE under §2010. In 2013 respondent sent H's estate a letter reporting that the return had been accepted as filed. W died in 2013 and her estate claimed the DSUE reported by H's estate. As part of the examination of the estate tax return filed by W's estate, respondent also examined the estate tax return filed by H's estate and reduced the amount of the DSUE by the amount of taxable gifts given by H but did not determine or assess a deficiency against H's estate. Respondent determined an estate tax deficiency against W's estate, which filed a petition arguing that respondent should not be allowed to examine H's estate tax return to allow the proper DSUE allowable to W's estate. The Court determined that a letter accepting the estate tax return of a predeceased spouse is not a closing agreement under §7121. An examination of the estate tax return of the predeceased spouses in which the R reviews the records in his possession and asserts no additional tax is not a second examination within the meaning of §7605(b).

UNLIMITED MARITAL DEDUCTION

The 1981 Economic Recovery Tax Act granted spouses an unlimited marital deduction; this has the effect of treating a married couple as a single unit for transfer-tax purposes, which effectively postpones tax on those items until the surviving spouse dies. This does not apply to assets passing to a non-US citizen spouse and certain terminable interests. Assets that pass to a surviving spouse are included in the surviving spouse's estate and taxed upon his or her death.

> Example: In 20A9 Mary made a taxable gift valued at $1 million that was timely reported on Form 709. Mary died in 2023 and is survived by her husband Bill. They were married for 30 years, had no previously marriages, and had a combined estate of $14 million at the time of Mary's death. She **left her all of her estate to her husband** Bill. The executor of Mary's estate computes the DSUE:

Lesser of 2023 basic exclusion ($12,920,000) **or**	
Applicable exclusion amount	$12,920,000
Minus taxable gift exclusion	(1,000,000)
DSUE	$11,920,000

SPECIAL USE VALUATION §2032A

Assets are normally valued at their 'highest and best use,' which may bear no relationship to their current use. Farmland may be valued for that use at a significantly lower amount than the value of the same land in another use, such as for a housing development. Forcing the heirs to pay estate taxes based on the higher valuation may require them to sell the farmland to pay the tax.

Certain estates that own real estate are granted relief under §2032A, which permits them to value the real estate at 'actual use' rather than 'highest and best use.' To qualify, the decedent must be a U.S. citizen, and the property must be located in the U.S.   The heir must be qualified, which is the surviving spouse, or a lineal member of the decedent's or decedent's spouse, including children, grandchildren, and parents, and the spouses of those lineal descendants.

The real property must have been used as farmland or in a trade or business as of the date of the decedent's death and must have been so used during 5 of the past 8 years. The decedent, or a member of his or her family, must have materially participated in the operation of the farm or business during the last 5 of 8 years prior to death. The value of the property using 'highest and best use' must account for at least 25% of the gross estate's value. This value is reduced for all debts against the property.

Additionally, at least 50% of the gross estate's adjusted gross value must consist of real and personal property used in farming or in a trade or business under the normal valuation methods. Personal property does not get the benefit of special use valuation, but it does help the estate qualify.

> Example: Decedent owned and operated a business for 12 years prior to his death. There is no debt associated with the business (if there was, it would be subtracted from the calculation).

Gross estate	$3,000,000	
Business real property (highest value)	1,000,000	(more than 25%)
Business personal property	700,000	

Because the gross estate is comprised of more than 50% of the business real and personal property combined ($1,000,000 + $700,000)/$3,000,000)), Decedent's estate qualifies for the special use valuation.

The executor must make an irrevocable election with the first tax return filed for the estate, even if that first return is filed late. A protective election can be filed by marking the box on Schedule A-1 to allow the executor to file a supplemental 706 if the election is available.

The election is subject to special limitations rules. The election establishes a special lien against the property, which is equal to the tax saved by the election.

Each beneficiary who inherits a portion of the special use real estate must sign a 10-year contract on Form 706 in which they promise to keep property in special use status for 10 full years. The benefits of §2032A are recaptured, and Form 706A must be filed to pay the additional tax, if the special use property is sold to a non-qualifying individual within 10 years of decedent's death or ceases to be 'special use.'

Qualified Conservation Easement Exclusion

Also known as the Open Sky Retention, this exclusion was created by TRA 97. It offers an estate tax exclusion the lesser of $500,000 or up to 40% of the value of land subject to a qualified conservation easement for estates of decedents who died after 12/31/97. The landowner may deduct the value of the easement, which is the difference between the FMV of the property without restriction and the FMV after the restriction. If the value exceeds $5,000 the value of the conservation easement must be computed by a certified appraiser. The landowner can deduct up to 30% of the AGI over a period of 6 years until the value of the easement is exhausted if the property has been held for more than 12 months.

There is no step-up in basis for the portion excluded from the gross estate. The 1998 Act amended §2013(c) to allow a charitable deduction, as long as no income tax deduction is also claimed.

Land qualifies if it:

- was owned by the decedent, or a member of his family, for the three-year period ending at death,
- a qualified conservation easement is made, **and**
- the land is located in or within 25 miles of a metropolitan area, OR in or within 25 miles of an area that is a national park or wilderness area, OR in or within 10 miles of an area that is an urban National Forest so designated by the Forest Service.

Often taxpayers fail to meet one or more of the requirements and thus lose the deduction. In *Belk* (140 TC 1 (1/28/13)) the taxpayer (an LLC) contributed an easement covering the land on which a golf course was located. The agreement permitted the parties to substitute what property was subject to the easement. The LLC lost the claimed $10.5 million charitable contribution deduction because the fact that the land could be substituted meant the easement was not perpetual as required under §170(h)(2)(C).

Benefits to Surviving Spouse §2056

As mentioned previously, an unlimited marital deduction allows property to pass from the estate of an individual who is married at the time of his or her death. The property must pass from the decedent to the surviving spouse who is a U.S. citizen, unless the transfer occurs under a Qualified Domestic Trust (QDOT) as discussed below.

Generally, the property cannot pass to a spouse in a terminable interest, unless the transfer qualifies under the Qualified Terminable Interest Property rules below. A terminable interest in property is one that terminates or fails due to the lapse of time or the occurrence of an event (§2056(b)(1). Since the surviving spouse can lose the property, the terminable interest does not qualify. Property interests that pass to a spouse on the condition that the spouse survive for a time period that is 6 months or less, or on the spouse's survival in a common disaster, are not subject to the terminable interest rule.

Qualified Terminable Interest Property

For the qualified terminable interest property (QTIP) exception to apply, the surviving spouse must have the right to all the income from the property, and the income must be paid no less frequently than annually. No individual may have a power of appointment to anyone other than surviving spouse for his or her lifetime. An election on Form 706 must designate the property as QTIP.

Once the QTIP election is made, the surviving spouse must include the property remaining at death in his or her gross estate, even though he or she has no control over its disposition. The estate tax attributable to the QTIP included in the surviving spouse's estate may be recovered from the QTIP under §2207A.

The amount of marital deduction is limited to the net value of property passing to the spouse. Death taxes, debts and administration expenses payable from the marital bequest, mortgages on property passing to the spouse and insufficient estate assets to fund the marital bequest all reduce the amount of the deduction.

Administration expenses allocable to the estate's income do not necessarily reduce the amount of the marital deduction. In *Hubert (Comm'r v Estate of Otis C Hubert*, 79 AFTR2d Para. 97-595) the Supreme Court ruled that an estate does not have to reduce the deductions for marital or charitable bequests by the amount of administration expenses that were paid from income generated by assets allocated to those bequests. Hubert died leaving a large estate. His wife received a marital trust she held with a general power of appointment, and a QTIP, with the balance going to charity. The estate claimed large marital and charitable deductions and allocated administration expenses to postmortem income. The IRS disallowed substantial portions of the marital and charitable deductions, reducing them by the amounts allocated to income. A divided Tax Court found for the estate and was affirmed by the Eleventh Circuit. Note the IRS brought the action to the Supreme Court. Also note that although the facts do not match the *Hubert* case, in 1994 Question S-28 specifically asked … "Discuss whether any part of the estate tax marital or charitable deductions are disallowed to the extent of administration expenses allocated to income."

QDOT- QUALIFIED DOMESTIC TRUST §2056A

If surviving spouse is not a U.S. citizen no unlimited marital deduction is available, unless the property passes via a QDOT. This rule can be avoided if the non-citizen becomes a U.S. citizen prior to filing the 706. The intention is to keep assets within the U.S. and subject to estate taxation under U.S. law. The rules do not apply to:

- assets that are owned by the non-citizen surviving spouse,
- gifts received while decedent alive, which are limited and indexed,
- the non-citizen surviving spouse's share of joint tenancy assets purchased jointly with the decedent, **and**
- the non-citizen surviving spouse's share of marital property assets (community).

Make the election by listing the entire value of QDOT trust property on Form 706, Schedule M and deducting its value. The election must be for the entire QDOT trust and is irrevocable. A QDOT must distribute all its trust accounting income only to the non-citizen surviving spouse at least annually. At least one of the trustees must be a U.S. citizen or U.S. corporation if the QDOT is $2,000,000 or less. If the QDOT exceeds $2,000,000, the U.S. trustee must be a U.S. bank or trust company. A U.S. trustee must be personally responsible to see that any additional estate tax computed on the 706-QDT is paid to the IRS.

DISCLAIMER

Property passing through a will or trust can be disclaimed under §2518. A qualified disclaimer is irrevocable and must be made in writing no later than 9 months after the transfer is made (or the disclaimer/transferee turns 21, if a minor at the time the transfer is made). The disclaimer cannot accept any property interest or any benefits, and the property must then pass to someone other than the disclaimer.

It was once generally understood that a disclaimant had no property rights in the disclaimed property as the property passed directly from a decedent to the beneficiary as though the disclaimant predeceased the decedent. The Supreme Court decision in *Drye* (*Rohn F Drye, Jr. v United States*, 84 AFTR2d Para. 99-5563) changed that result. Drye's mother died intestate with an estate of $233,000. At the time of her death her son and sole heir was insolvent and owed the IRS $325,000. The IRS had tax liens against Drye's property since 1991. Drye executed a disclaimer of the estate, which then passed to his daughter, who created a family trust that benefited the daughter and her parents.   A district court ruled that the tax liens were valid and that the disclaimer was void and fraudulent against the United States. The Eighth Circuit affirmed the lower court. The Supreme Court ruled that tax liens are not defeated by a state-law disclaimer, and found that Drye had a “valuable, transferable, legally protected right to the property” under state law.

A partial disclaimer is also possible. In *Estate of Helen Christiansen* (130 TC 1 (1/24/08)) the decedent’s child disclaimed a portion of the gross estate with a FMV of more than $6,350,000. The will provided that any disclaimed portion would pass 75% to a charitable foundation and 25% to a charitable trust that would then pay an annual annuity to the charitable foundation. The will also contained a provision that value “is finally determined for federal estate tax purposes” and a “savings clause” that said the child would take actions to the extent necessary to make the disclaimed a qualified one under §2518. The estate deducted as charitable contributions the portion passing to the foundation and a portion of the annuity interest to the charitable trust (present value interest deducted). The Court notes that the rules on partial disclaimers are complex; partial disclaimers are permitted if 1) in writing, 2) received no more than 9 months after date of transfer, 3) must not allow disclaimant to accept the disclaimed property or its benefits, and 4) must pass without any direction on the part of the person making the disclaimer to a person other than the person making the disclaimer. This last requirement is the one that caused the problem here: the uncertainty caused by the will’s provisions meant there was a partial failure of disclaimer and as a result the estate lost the deduction for the portion going to the Trust.

TRUSTS

Trusts and decedent’s estates are treated as taxable entities for income tax purposes and are separate taxable entities during the period of the estate’s administration. Generally, the deductions and credits allowed to individuals are also allowed to estates and trusts, but there are special rules for the computation of some deductions and for the allocation of credits and deductions between the estate or trust and its beneficiaries.

A fiduciary is one who occupies a position of special confidence towards another. The fiduciary of a trust is the trustee and is responsible for filing the Form 1041 and for paying tax on the taxable income of the estate or trust. A trust has a filing requirement if it has $300 or more in gross income and all income is required to be distributed at least annually, or $100 or more if the trust may distribute corpus or accumulate income, or if there is at least $1 in taxable income or any non-resident alien beneficiary.

The term “trust” as used by the IRC generally refers to an arrangement created either by will or by an inter vivos (which means while living) declaration whereby the trustee takes title to the property for the purpose of protecting or conserving it for the beneficiaries under the ordinary rules applied in probate courts.

Small Business Trusts
An electing small business trust (ESBT) is a trust without any beneficiaries other than individuals or estates eligible to be S corporation shareholders. ESBT can be shareholders in an S corporation.

Business Trusts
Business or commercial trusts are set up to carry on a profit-sharing business, usually using capital or property supplied by the beneficiaries. The trustees or other designated individuals are effectively managers of the undertaking. It more closely resembles an associated or a partnership and is not considered to be a normal trust.

Multiple Trusts
Two or more trusts will be treated as one if they have substantially the same grantor(s) and substantially the same beneficiary(ies), **and** a principal purpose of the trust is tax avoidance (§643(f)). A trust is not treated as having different primary beneficiaries just because it has different contingent beneficiaries. A trust is not treated as having different grantors by having different people make nominal transfers to the trust.

Grantor Trust
A grantor trust is usually taxed to grantor if the trust corpus reverts either to the grantor or the grantor's spouse. The grantor is taxed on the trust income if the grantor or the grantor's spouse retains administrative powers enabling the grantor to obtain non-arms-length benefits. If the grantor borrows money any year, even if repaid that year, the grantor is taxed on the trust income for that entire year.

In Rev. Rul. 2023-2, the IRS ruled that if a completed gift of property is made to an irrevocable grantor trust, and the grantor dies, the property is does not receive a step-up in basis to the FMV on the date of death because the property is not included in the decedent's gross estate.

Bankruptcy
Property held by a trustee for an individual under Chapter 7 (liquidations) or Chapter 11 (business reorganization) of the bankruptcy code is considered the estate of the debtor. There is no separate entity for Chapter 13 (individual adjustment of debts) bankruptcies.

The trust is recognized as a taxable entity until the trust property is distributed to successors, plus a reasonable time after this event to complete trust administration.

Grantor Retained Annuity Trust (GRAT)
The grantor retains an income interest based upon a percentage of the original value of the assets gifted to the irrevocable trust. The minimum income required to be paid to the grantor each year is 5% of the original value of the gift. No additions can be made to this type of trust after the initial gift.

GRANTOR RETAINED UNITRUST (GRUT)

The grantor retains an income interest based upon a percentage of the value of the gifted assets as determined at the beginning of each year. The minimum income required is 5% of the value of the assets at the beginning of each year. Additions can be made to this trust after the initial gift.

QUALIFIED PERSONAL RESIDENCE TRUST (QPERT)

The grantor retains the right to live in the grantor's house, which was gifted to an irrevocable trust. Any payment of principal on the mortgage is a new future interest gift requiring a gift tax return. The grantor must pay fair market rent if the grantor wishes to occupy the residence at the end of the reserved term. The gift fails if the grantor does not outlive the term of the right to live in the residence.

TRUST OR ESTATE GROSS INCOME

The gross income of an estate or trust is generally determined in the same manner as that of an individual. It includes income that is:

- accumulated or held for future distribution under the terms of a will or trust,
- currently distributable,
- received by a decedent's estate during administration or settlement, **and**
- accumulated or distributed in the fiduciary's discretion under §641(a)).

Income from real estate may be taxable to the estate or to the beneficiaries, depending upon whether state law vests legal title to the decedent's real property upon death directly to the beneficiaries.

Personal property title vests to the executor immediately upon appointment. It does not pass to the beneficiaries until the estate administration is complete and the court approves the distribution. Income from personal property, including gain from the sale or exchange of the property, is taxable to the estate.

If income is required to be distributed currently or is properly distributed to a beneficiary, the estate or trust is regarded as a conduit for that income and is allowed a deduction for the portion of gross income that is currently distributable to the beneficiaries or is properly paid or credited to them.

TRUST OR ESTATE DEDUCTIONS

Trusts and estates are generally entitled to the same credits and deductions as individuals. Ordinary and necessary expenses incurred in carrying on a trade or business, or in managing or conserving income-producing property, are deductible. Unless the expenses were for production or collection of tax-exempt income, the estate or trust can also deduct reasonable administrative fiduciary fees.

The 2% floor for miscellaneous itemized deductions applies to a trust or estate and expenses that would normally be subject to the 2% limitation for an individual are also not deductible by the estate or trust due to TCJA. Other expenses that occur only because the estate exists are not subject to the 2% limitation, including tax prep fees, and attorney and probably filing fees relating to the estate. The AGI is generally calculated in the same manner as for an individual, except these deductions are permitted from gross income:

- costs paid or incurred in the administration of the estate or trust,
- the personal exemption of the trust or estate, **and**
- distribution deductions permitted under §651 and §661.

Simple or Complex Trust?

Simple trusts are required to distribute all their income currently, whether or not distributions are actually made. All non-simple trusts are complex by definition.

Trust Income

Final regulations issued by the IRS were published January 2, 2004 and are applicable to trusts and estates for taxable years ending after 1/2/04. §643 governs the inclusion of income for purposes of various trusts. The final regulations state that traditional items such as dividends, interest and rents are allocated to income, and the proceeds from the sale or exchange of trust assets are allocated to principal.

Under the final regulations, gains from the sale or exchange of capital assets are excluded from distributable net income (DNI) and are ordinarily not considered paid, credited or required to be distributed to any beneficiary. This may differ if handled in a manner consistent with the trust agreement and applicable local law (or pursuant to “a reasonable and impartial exercise of discretion by the fiduciary”). Capital gains that are paid as a charitable contribution must be included in the computation of DNI. Capital losses are first netted at the trust level against capital gains.

Distributable Net Income (DNI)

DNI is an amount that sets the limit on the deduction of a domestic estate or trust for distribution to beneficiaries. This may also limit the amount of the distribution taxable to the beneficiaries.

Generally, DNI includes the same items of gross income and deductions that make up the taxable income of the estate or trust:

- no deduction allowed for distributions to beneficiaries,
- no deduction for the personal exemption is allowed,
- tax exempt interest for state/local bonds is included,
- tax exempt interest and foreign income of a foreign trust is included, reduced by disbursements, expenses, losses and so forth allocable to that income,
- capital gains excluded (not paid),
- capital losses excluded, except to extent of their use in determining the amount of

capital gains paid, credited or required to be distributed.

In simple trust, extraordinary dividends or taxable stock dividends that the fiduciary, acting in good faith, allocates to corpus are excluded.

DNI is determined by taking into account a net operating loss deduction.

> Example: (From the final regulations, Example 1). Under the terms of Trust's governing instrument, all income is to be paid to A for life. Trustee is given discretionary powers to invade principal for A's benefit and to deem discretionary distributions to be made from capital gains realized during the year. During Trust's first taxable year, Trust has $5,000 if dividend income and $10,000 of capital gain from the sale of securities. Pursuant to the terms of the governing instrument and applicable local law, Trustee allocates the $10,000 capital gain to principal. During the year, Trustee distributes to A $5,000, representing A's right to trust income. In addition, Trustee distributes to A $12,000 pursuant to the discretionary power to distribute principal. Trustee does not exercise the discretionary power to deem the discretionary distributions of principal as being paid from capital gains realized during the year. Therefore, the capital gains realized during the year are not included in distributable net income, and the $10,000 is taxed to the trust. In future years Trustee must treat all discretionary distributions as not being made from any realized capital gains.

> Example: (From the final regulations, Example 2): If instead the Trustee intended to follow a regular practice of treating discretionary distributions of principal as being paid first from any net capital gains realized by the Trust during the year, the $10,000 capital gain is included in DNI and taxed to A. That is a reasonable exercise of Trustee's discretion, and in future years trustee must treat all discretionary distributions as being made first from any realized capital gains.

TRAVEL AND ENTERTAINMENT

The Tax Cuts and Jobs Act eliminated deductions for entertainment activities for amounts paid or incurred after 12/31/2017. There is uncertainty if this prohibition now denies deductions for the client or prospect business meal; further guidance is needed from the IRS.

Business food and beverage expenses continue to be deductible and generally subject to the 50% limitation, including for those away from home while on business. In addition, meals provided on premises for the convenience of the employer are only 50% deductible through 2025 (prior to TCJA, they were 100% deductible). After 12/31/2025, they are non-deductible.

WHAT IS DEDUCTIBLE?

Deductible travel costs include:

- transportation costs including plane, railroad, and taxi,

- hotel and lodging expenses,
- meals,
- tips, telephone and telegraph costs,
- laundry and cleaning costs,
- baggage costs, including insurance, **or**
- cab or shuttle fares.

Nondeductible travel costs include:
- travel as a form of education,
- travel for spouse/dependent unless they are taxpayer's employees
- travel/attendance at investment convention or seminar unless connected with a trade or business

DEDUCTIBLE HOW?

The TCJA suspended 2% miscellaneous itemized deductions for individuals for tax years 2018 through 2025; as such, employees are unable to deduct unreimbursed employee business expenses. While what follows is correct, the employee's deduction is suspended through 2025.

When an employee is reimbursed trade or business expenses that were properly documented under an accountable plan, the reimbursement is deducted by the business and there is no income to the employee, including S corporate shareholder/employees. Similarly, a partner does not have income on the K-1 when the business reimburses such expenses.

If an employee's expenses do not qualify under an accountable plan, the reimbursements are included in the employee's FICA and FUTA wages; the employee will no longer be able to deduct substantiated expenses on Form 2106 due to TCJA. The partnership categorizes the reimbursement as a guaranteed payment reportable on the partner's K-1.

If an employee (including partners and S corporate shareholder/employees) is permitted to be reimbursed but voluntarily chooses not to be reimbursed, the business expenses cannot be deducted on the employee or partner's individual tax return. For corporate employees the payments are either capital contributions or loans to the corporation and are only deductible, if permitted, by the corporation. Similar rules apply to partnerships.

When a partner is required to pay trade or business expenses incurred in his/her capacity as a partner, but is not reimbursed by the partnership, the partner can deduct substantiated expenses on Schedule E (no 2% limitations). When a self-employed person pays trade or business expenses, they are deducted on Schedule C (or F), subject to statutory limitations, on Schedule C (or F).

SUBSTANTIATION RULES

In general, the so-called *Cohan* rule (*G.M. Cohan*, 2 USTC ¶489) permits using estimated expenses when it is apparent the taxpayer is entitled to the deduction but lacks sufficient substantiation. The Court can use its judgment in how these expenses are estimated. Congress specifically abolished use of this rule to determine expenses related to listed property, travel, meals, lodging, and entertainment expenses. Under §274 no deduction or credit is allowed unless the taxpayer substantiates by adequate records or by sufficient evidence that corroborates the taxpayer's statement. Under *Emerson* (*Emerson* (TC Memo 2001-186)) a couple was permitted some medical and Schedule C expenses disallowed by the IRS under *Cohan*. However, the Court specified that "… travel, car and truck, and computer expenses cannot be estimated under *Cohan.*"

Since there can be elements of personal pleasure and use in this area, taxpayers must meet specific substantiation rules for travel and entertainment deductions. Generally, no receipt is required if the expenditure is less than $75, however the taxpayer must maintain (contemporaneously) a diary or log that indicates:

- amount of the expenditure,
- time or date of the gift, travel, or entertainment,
- place including the destination of travel or location and type of entertainment,
- business purpose including the business reason or the business benefit derived or expected to derive from any travel, gift or entertainment, **and**
- business relationship of the person entertained or who received the gift must be described to establish the business relationship to the taxpayer.

Deductions for lodging require a receipt regardless of amount. Electronic ticket statements that establish the amount, date, place, and character of the expenditure are permissible for air travel.

The taxpayer is not required to keep substantiation when the employee gives the records to his or her employer and is reimbursed in full. There is no travel and entertainment deduction in that situation.

> Example: *Alan Brookes and Carol Brookes* (TC Memo 2017-146 (7/26/17)) had a wholly owned S corporation that reported his tax and financial services business and her art business. Petitioners travel extensively, both domestically and internationally, in 2010, 2011 and 2012, and claimed a deduction for travel expense during each of those years. To deduct travel the taxpayer must substantiate with adequate records or by sufficient evidence corroborating his own statement (1) the amount of each separate expenditure for traveling away from home (except the daily cost of the traveler's own breakfast, lunch and dinner and of expenditures incidental to such travel may be aggregated, if set forth in reasonable categories, such as for meals, gas, oil and tax fares), (2) dates of departure and return for each trip away from home and number of days away from home spent on business, (3) destinations or locality of travel, described by name of city or town or other similar designation, and (4) business reason for travel or nature of the business benefit derived or expected to be derived as a result of travel."

Here petitioners “utterly failed to substantiate their deductions for travel expenses.” They claimed they traveled to their corporate annual meeting at Wisconsin Dells to discuss for a week or more “how the past year went” and “how the future events are” and to elect corporate officers (Mr. and Mrs. Brookes were always elected as officers of the corporation). Minutes of the meeting merely listed a single date and time for the meeting (4/20 at 1 pm in all three years) with little additional detail. The court did not find the documents credible since the minutes only listed minimal information even though the meeting supposedly went on for several days. They also claimed business travel to New York City, Hawaii, Panama, Southeast Asia, and other domestic travel within the US.

There were many problems with the returns, including auto deduction on both the actual expenses method and the standard mileage rate method, and many other deductions for which no adequate records were provided to support the deduction. They were also held liable for the negligence penalty.

PER DIEM AND SUBSTANTIATION

Instead of substantiating actual travel expenses, per diem allowances may be used by an employee. However, per diem option does not relieve the employee of the requirement to provide proper timely substantiation to the employer for miles driven or days away, plus time, place and business purpose of the travel. The per diem must be paid under an accountable plan and is:

- for ordinary and necessary business expenses incurred by an employee in connection with the employee’s business travel,
- calculated not to exceed the actual amount of expenses,
- any unsubstantiated per diem must be returned to the employer,
- no higher than the current federal per diem rate (excess per diem creates W-2 income), **or**
- paid under a flat rate schedule that is uniform and an objective basis for computing travel, including based on number of days away or some other normal business practice. Allowances that are computed on the same basis as the employee’s salary do not meet the business connection requirement.

An accountable plan must meet these requirements of Reg. §1.62:

- has a business connection,
- requires adequate substantiation within a reasonable amount of time (time, place, amount and business purpose of each business expense), **and**
- requires that amounts in excess of substantiated expenses be returned by the employee within a reasonable time.

The IRS issues per diem rates to be used for reimbursement purposes:

M&IE – Meals and Incidental Expenses, which can be used by employees and self-employed individuals to cover meals and incidental expenses, **or**
Lodging Plus M&IE – Lodging, Meals and Incidental Expenses, which cannot be used by self-employed individuals (this has been tried without success in *J.L. Christia*n, TC Memo 2000-385, and *P.H. Duncan*, TC Memo 2000-269).

Incidentals include laundry, tips, but not telephone calls, cabs or other transportation, or fax or business costs.

Again, the self-employed person can only use the Meals per diem and the standard mileage rates – no high/low method or the lodging plus M&IE.

Home day care providers may opt to use a standardized per diem rate to claim the deduction for meals provided to children under their care. A daily log is required, including the name of each eligible child, dates and hours of attendance, and the type/quantity of snacks and meals served.

SUBSTANTIATION

The Tax Court routinely rules that without proper records, business deductions may be disallowed. Credit card statements without a log or diary are not sufficient to document business expenses.

AT HOME TRAVEL EXPENSES

Personal commuting costs are typically not deductible, even if the taxpayer chooses to work while commuting to the office. This includes displaying advertising material on the vehicle. A self-employed person can deduct business transportation costs, but not the cost of commuting from home to his or her office, including trips to see customers or clients.

AWAY FROM HOME TRAVEL (§162)

A taxpayer’s tax home is the vicinity of his or her principal place of employment, not where his or her personal residence is located. This finding is critical, as travel costs at home are generally considered non-deductible personal expenses, while travel away from home is often deductible under §162.

Example: Sue lives in Atlanta with her family, but works in Huntsville, Alabama. During the week Sue travels to Huntsville where she stays in a hotel and eats meals in restaurants. Sue’s tax home is Huntsville, so the travel costs to and from Atlanta and meals and lodging are personal, non-deductible expenses.

Example: Mitchell lives in Chicago and works on an ‘as needed’ basis, an average of 130 days per year, for a California magazine during 1991-95. For the last two years Mitchell rented an apartment in California and deducted the rental and travel expenses on his income tax returns for those years. The IRS disallowed those deductions. The Tax Court found in favor of Mitchell, finding that his only connection to California was the services performed for the client. Those services were temporary "due to the on-again and off-again nature of the work relationship." (*Mitchell* (TC Memo 1999-283)). Of interest: in 2000 Mitchell won an award of costs proceeding against the IRS on the accuracy-related penalties (TC Memo 2000-145).

Example: Terry, a construction worker, lives in a trailer at each job assignment. He has no other home. For tax purposes, each job location is Terry's principal place of business and he is never considered to be away from home.

If an assignment is temporary in nature, the taxpayer is considered away from home and travel deductions are 100% allowed (subject to limitations in the code, including meals are only 50% deductible). The taxpayer can deduct travel, meals, lodging and other transportation costs, telephone and fax services, and the costs of maintaining and operating a car for business purposes subject to documentation requirements. A taxpayer is away from home when:

- s/he is away from the general area of the tax home,
- for a period that is substantially longer than an ordinary workday, **and**
- it is reasonable for the taxpayer to need sleep or rest, even if the time period away is less than 24 hours.

An assignment is temporary if it is expected to last less than one year and does. An assignment is **not** temporary if expected to last more than one year, regardless of whether it actually lasts more than a year or less. If an assignment is indefinite, the taxpayer has a new tax home at the new location and cannot deduct travel costs. Assignments that are at first temporary may become indefinite due to changed circumstances or merely the passage of time. In that case, the assignment is generally considered temporary until the date it was realistic to believe the work would exceed one year.

No expenses may be deducted for taxpayer's spouse, dependent, or other traveling companion, **unless** the companion is an employee of the taxpayer who is paying or reimbursing the companion's expenses. Travel must be for a bona fide business purpose, and the companion must be otherwise able to deduct the expenses.

Example: Dave and Catherine travel by car to a convention for dentists. A hotel room costs $120 per day for a double, or $100 per day for a single. Catherine's presence at the convention is social. Dave can deduct the cost of operating the car to and from the convention city. He can also deduct $100 per day for lodging.

Example: Dave and Catherine travel by airplane to the convention. Dave can deduct his airfare only.

Taxpayer is deemed away from home if required to obtain sleep or rest: if the nature of the taxpayer's employment is such that it is reasonable for him to need to obtain sleep or rest to meet his employment or business demands, they are deductible travel expenses.

No Tax Home

It is possible for a taxpayer to have no tax home. The factors considered include: 1) is there a business connection to the alleged tax home, 2) are there duplicated living expenses incurred while traveling and maintaining the alleged tax home, and 3) whether personal connections existed at the alleged tax home. A mere hope of returning to an alleged tax home is not sufficient to provide the necessary business connection to an alleged tax home.

Foreign Travel

Under §274(c) and Reg. §1.274-4, foreign travel must be allocated between business and personal, even the costs of transportation if the travel is in excess of one week and more than 25% of the time is for nonbusiness activity.

> Example: Hilda, a self-employed consultant, flew to New York where she stayed 5 days (4 on business). Airfare was $200. Meals were $60 per day, and lodging was $100 per day. From New York, Hilda flew to Toronto, Canada where she spent 2 weeks on business and 1 week with relatives. Airfare to Toronto and back was $900. In Toronto food was $350 per week and lodging was $600 per week. What are Hilda's deductible travel expenses for the week?
>
> Since the primary purpose of the New York trip was business, Hildy is entitled to deduct the associated costs of $720 ($200 full transportation costs +(($60 meals x 4 business days) x 50%) + (($100 lodging x 4 business days). Travel outside the United States must be allocated between business and personal, including transportation costs, if the travel is in excess of 1 week, and more than 25% of the time is for personal expenses. Hildy's Toronto trip deduction is $2,150 ((900 x 2/3 weeks airfare) transportation costs + (($350 x 2) food for 2 weeks x 50%) + $(600 x 2) lodging for 2 weeks). Total deductible costs are $2,870.

No travel expenditures are allowed for conventions held outside North America unless the meeting is directly related to the active conduct of the taxpayer's trade or business, and it is as reasonable for the meeting to be held outside the U.S. as to be held within the U.S.

Cruise Ships

The deduction limit for attending a business convention on a cruise ship is limited to $2,000 per year.

Business/Pleasure Domestic travel

If the primary purpose of the domestic trip is business, travel is deductible even if some portion of the time is personal. Transportation is only deductible if the trip is primarily related to the taxpayer's trade or business; if more days are spent for personal purposes rather than business, none of the transportation is deductible.

> Example: Bob flies from Los Angeles to Cincinnati, Ohio to attend a professional convention. He spends 5 days at the convention then flies to Akron to visit his mother and sister for 2 days before returning to Cincinnati. His airfare is deductible to and from Los Angeles as are the hotel and meal expenditures while in Cincinnati. The costs of airfare to and from Akron and other travel/meals while visiting family are not deductible.

INVESTMENT TRAVEL

Investment travel expenses are not deductible. Expenses related to attendance at investment, financial planning, or other income-producing conferences or activities are not deductible, including registration fees, travel and transportation costs and meal and lodging.

BUSINESS EXPENSES

ORDINARY AND NECESSARY

To be deductible under §162, all of the following requirements must be met:

- the expense must be incurred or paid in trade or business,
- the expense must be ordinary and necessary,
- the expense is not capital in nature, **and**
- the taxpayer has proof of the expenditure.

Ordinary expenses are generally normal, customary, or usual for a business, given facts and circumstances. Necessary expenses are those that are appropriate and helpful for the trade or business. To be deductible, the expenses must relate to the business and no deductions are allowed for personal, living, or family expenses.

Contributions to a political party or candidate are not deductible as business expenses under §162(e). Fines or penalties paid to a government or government agency are generally not deductible under §162(f); however, §162(f) was updated by TCJA to allow deductions for fines and penalties paid that constitute restitution, remediation, amounts paid to come into compliance with the law, or for payments of what constitute otherwise deductible taxes under §164. New §6050X requires governmental entities and agencies to issue Form 1098-F for amounts paid of more than $50,000 and to distinguish between deductible and non-deductible amounts paid.

HOME OFFICE RULES

Under certain circumstances taxpayers can deduct costs of a portion of their residence as a home office. To deduct home office expenses the taxpayer must prove that the area is used exclusively and on a regular basis either as:

- a place of meeting with patients, clients or customers in the normal course of your

business, **or**
- the principal place of business. This occurs if the taxpayer spends most of his or her working time there and most of the business income is attributed to activities in the home office.

To qualify a home office as the principal place of business there are two tests to consider:
- Inside test – used by the taxpayer for the administrative or management activities of any trade or business of the taxpayer **and**
- Outside test – there is no other fixed location of the trade or business where the taxpayer conducts substantial administrative or management activities.

Storage space for samples or inventory also qualifies for the home office deduction.

The home office can be used regularly and exclusively for administrative or management activities if there is no other fixed location. If some administrative or management activities are carried on at sites that are not fixed, they cannot be substantial. Some administrative or management items can be conducted in the taxpayer's automobile, or in a hotel, without disqualifying the home office.

The home office does not have to be in a separate room, so long as it is an area of the home for which used exclusively as office space. A partition around the area can be helpful to define the office space but is not a requirement.

The home office can have multiple business uses, as long as each one satisfies the exclusive and regular use tests. If each use does not meet the test, the taxpayer loses the deductions for all uses.

Day care providers, or those caring for elderly, or handicapped individuals, can deduct home office expenses as a percentage of use over the entire house, not just one area of exclusive and regular use. A day care provider must be state-licensed, or must have applied for the needed certification, to qualify for the home office deduction. The home office deduction in this instance can be allocated based upon the number of hours each week the home is used for the caring of others.

Allowable direct expenses affecting only the business portion of the home are 100% deductible, including:
- painting the home office only,
- carpeting the home office area,
- repairs related to the home office, **or**
- security systems or other capital improvements in the home office.

Expenses affecting the entire property are deductible based upon the percentage the business space has to the home's entire square footage. Indirect expenses include:

- property taxes (the balance is deductible on Schedule A),
- mortgage interest (the balance is deductible on Schedule A),
- insurance,
- utilities, **and**
- repairs affecting the entire property such as a new roof, or exterior painting. The cost of these may be recovered as depreciation expense.

For depreciation purposes, the cost basis of the home is the lower of the fair market value on the date it began its business use, or the adjusted basis of the property, which must be allocated between land and building.

Business income can limit the home office deduction, which cannot exceed the applicable Schedule C net business profit after subtracting the allocable business portion of mortgage interest, real estate taxes and casualty deductions. Unused expense can be carried forward.

Basic telephone charges for the first incoming line to a home are not deductible. The cost of long-distance and toll charges is deductible as a direct business expense.

Simplified Home Office Deduction
Beginning in tax year 2013 a simplified home office deduction option allows taxpayer to deduct $5 per square foot, limited to 300 square feet. Allowable Schedule A deductions, such as mortgage interest and property taxes, are deducted in full and there is no depreciation recapture. Taxpayers can select the method for any tax year by using that method on a timely filed tax return, but once the method is selected for a tax year, it cannot be changed.

Business Gifts
A limited deduction of $25 per donee in a single year is permitted for business gifts under §274(b). Husbands and wives are considered to be a single taxpayer for these purposes, and thus subject to one $25 annual limit. An exception applies for items that do not cost the taxpayer more than $4 that have the taxpayer’s name clearly imprinted. Signs and display racks used on the recipients’ business premises are similarly not limited to $25 per year. A business gift deduction requires substantiation of the gift’s cost, date it was given, description, reason for giving the gift, and the business relationship of the recipient.

§183 Hobby Loss Rules
TCJA suspended 2% itemized deductions for tax years 2018 through 2025; therefore, no general hobby expenses are permitted for individuals, even if they exceed 2% of AGI. Taxpayers can continue to subtract hobby cost of goods sold directly from gross income; therefore, the cost of goods sold deduction, which factors directly into gross income, is retained.

Profitable hobbies or sideline businesses generate reportable taxable income. Under §183(a) losses of an individual are limited if the activity is “not engaged in for profit.” Unprofitable hobbies or sideline businesses generate deductions only to the extent there is income, and that deduction is limited on Schedule A as a miscellaneous itemized deduction subject to the 2% AGI floor. Hobby losses are personal, non-deductible losses. Sale of a hobby collection generates capital gains, but losses on such sales are not deductible.

Hobby expenses are deductible in a special priority order:

- expenses are allowed in full for those that are always deductible, including mortgage interest and real estate taxes (<u>but could be limited under new TCJA rules</u>).
- if any income remains following these deductions, the other operating expenses are claimed (<u>temporarily suspended under TCJA</u>)
- if any income remains following these deductions, the final step is to deduct depreciation (<u>temporarily suspended under TCJA</u>).

A taxpayer is presumed to be engaged in a 'for-profit' activity if there is a profit in at least three of the last five years, including the current year. For horse breeding, training, racing or showing the presumptive period is two of the last seven years. Losses are not automatically allowed as this is a rebuttable presumption. The taxpayer may still need to demonstrate a profit motive by such things as:

- considerable time and energy spent in the activity (even if taxpayer has another job, do they spend most of their free time in this endeavor?),
- elements of personal pleasure or recreation are involved (§1.183-2(b)),
- expectation that assets used may appreciate in value,
- taxpayer's history of income or loss in the activity (even if losses continue to occur, are there unforeseen circumstances beyond taxpayer's control?),
- taxpayer's success in carrying on similar or dissimilar activities,
- businesslike records kept (manner in which taxpayer carries on the activity),
- the financial status of the taxpayer (does taxpayer have large amounts of disposable income to enable funds to be spent on just a hobby?),
- reliance on expert advice and taxpayer's level of expertise, **and**
- losses are common to the taxpayer's business in start-up years.

  Example: *Urve Moyer, Incompetent, Calvin Moyer, Next Friend* (TC Memo 2016-236 (12/27/16)) worked for DuPont and began receiving a pension from the company. Her husband and other retired DuPont employees started a business in 1992 to provide DuPont with human-relations-training services as an outside contractor. They parted ways in 1994. The husband started an S corp with someone else in 1994 and began operating it as a sole owner in 1996. The business lost DuPont as a client in 2005 and had no gross receipts for 2010-2015. No contemporaneous books or records were kept and no tax returns were filed for 2004, 2005, 2006, 2007 or 2008. Delinquent returns were filed in 2014, in connection with a previous Tax Court case. No personal or corporate tax return was timely filed for 2009. At trial petitioner provided "an assortment of receipts, invoices, and order confirmations and asserted that these documents substantiated the business expenses" for the 2009 taxable year along with a monthly cable TV charge and a family talk telephone plan with 4 phone numbers.

> See the discussion starting on page 10 about active trade or business. Not for profit concerns aren't just for typical hobbies with elements of personal pleasure – it hinges on whether the taxpayer has an actual and honest objective of making a profit. A reasonable expectation of profit is not required as long as the taxpayer has an actual and honest objective of making a profit. The record indicated that petitioner used the company to claim various personal, living or family expenses and the Court was skeptical that there was an honest objective of making a profit in the year at issue.

An election can be made on Form 5213, *Election to Postpone Determination as To Whether the Presumption Applies That an Activity is Engaged in for Profit*, to postpone determination of whether a hobby or business exists. The postponement is until after the end of the fourth taxable year (sixth for horse related activities) following the first year of the activity. Filing the election waives the statute of limitations for all activity-related items in the taxable years involved and gives the IRS two additional years after the filing date for the last year in the presumptive period to issue deficiencies related to the activity. In *Wadlow* (112 TC 18 (1999)) a sharply divided (10-9) Tax Court held that this §183(e) election extends the statute of limitations on assessments as well as for claiming a refund or credit.

> Example: Steven enters a farming activity in 2013. He can elect to postpone the profit motive determination until after the end of 2017. If at that time he realized profits in at least three of the five years, the profit presumption applies.

The election must be made within three years of the due date of the return, without extensions, for the year in which taxpayer started the activity. If the IRS issues a deficiency during this three-year period that disallows the losses, the taxpayer may still make a valid election within 60 days of receiving the statutory notice of deficiency.

§195 Start Up Costs

Expenses incurred in a general search of business are not deductible, including the expenses incurred in making the decision to enter into a transaction or not. Once the taxpayer goes beyond a general search and focuses on acquiring a particular business, the start-up costs can be deducted as amortization in a period not less than 60 months.

> Example: Max seeks a business by placing newspaper advertisements, and he incurs travel expenses to look at prospective ventures. He pays for accounting and legal advice on the potential ventures. He decides to purchase a specific business in May 2018. He may not deduct any of the advertising, travel, or professional costs before he focuses on acquiring a particular business.

Expenses that are amortizable are limited to expenses during an investigation, creation, or acquisition of an active business. If the acquisition does not go through, the expenses are deductible as a capital loss.

The election to amortize these costs must be made in the tax return for the first year of the business. If no election is made the start-up costs associated with acquisition of capital assets must be capitalized and depreciated, and the start-up costs associated with other assets are added to the asset's basis and recovered only upon the sale of the asset.

By statute, costs incurred for interest, taxes paid, and research and development are excluded from the definition of start-up costs and may be deducted rather than capitalized.

PENALTIES AND INTEREST

Penalties and interest are discussed in both Practice & Procedure and Federal Taxation texts since exam questions and answers may be tested in either section. The text sections are the same, but the questions may vary.

INTEREST

A taxpayer generally must pay interest on tax underpayments beginning from the late day prescribed for payment and ending on the payment date. The interest rate is the federal short-term rate plus 3%, and interest is compounded daily. For large corporate underpayments (over $100,000), the rate is the federal short-term rate plus 5%.

A taxpayer can make a deposit under §6603 to suspend the running of interest on a potential underpayment; for example, if the taxpayer is under examination, or has a pending Tax Court deficiency case.

In addition, the §6654 individual estimated tax penalty is essentially an interest charge from the date of the required payment to the unextended due date of the tax return.

On the other hand, the IRS is generally required to pay interest on certain overpayments that are not promptly refunded to taxpayer. The interest rate is the federal short-term rate plus 3% (2% for corporations; 0.5% if corporate overpayment over $10,000), and interest is compounded daily.

The IRS may have to pay interest on an original return refund if the refund is not paid within 45 days after the unextended due date (if filed prior to that date) or 45 days after an original return or claim for refund is filed.

INTEREST ABATED

If an unreasonable error or delay by an IRS employee who is performing managerial or ministerial act created the interest, it can be abated. A ministerial act is a procedural or mechanical act, one that does not involve the exercise of judgment or discretion that occurs during the processing of a case after all the prerequisites take place.

Interest cannot be abated if the taxpayer or anyone related to taxpayer contributed significantly to the delay or error. An interest reduction can only be considered if the error or delay occurs after the IRS contacts the taxpayer in writing; an audit notification letter is considered a contact in writing.

Only interest on income, estate, gift generations skipping, and some excise taxes qualifies.

Interest is suspended after eighteen months if the IRS does not send the taxpayer a deficiency notice within 18 months of the later of:

- the original due date of the return, **or**
- the date taxpayer timely files return.

Interest resumes 21 days after the IRS sends notice and demand for payment.

PENALTIES

While there is also a discussion of penalties in Practice and Procedure, they are mentioned here as well since they may be tested in that part of the exam. The IRS can levy civil penalties for violations of the tax law and they are used to encourage compliance. Generally, the IRS does not impose penalties if the taxpayer's failure to comply or omission is reasonable. Reasonable cause and good faith are determined on a case-by-case basis, taking into account all relevant facts.

Reasonable cause exists if the taxpayer exercised ordinary business care and prudence but nevertheless could not file or pay the tax when due. Willful neglect means a "conscious intentional failure or reckless indifference." The Court has found taxpayers not liable for the failure to file/failure to pay penalty where illness or family hardship effectively prevented timely filing of a tax return.

> Example: *Barry Leonard Bulakites* (TC Memo 2017-79 (5/1/17) is an insurance consultant whose clients are accountants, but he relied only on TurboTax when preparing his own returns which, according to the IRS, claimed a few too many deductions. He argued the software lured him into claiming deductions. Petitioner didn't turn over some evidence to the Respondent until the eve of trial, which he blamed on a flood in his home (which turned out to be three years before trial). That narrative affected the court's view of his credibility. He was not allowed the increased alimony that he voluntarily paid (it must be subject to a decree of divorce or separate maintenance or a written instrument incident to such a decree), nor was he allowed interest deductions because he could not show that he made a payment AND show what portion was interest and what portion was repayment of principal (he made payments, but the payments didn't match the tax returns and the discrepancy was not explained). And of $185,673 "other expenses" he was permitted $142. Not surprisingly, despite his attempts to blame TurboTax for his mistakes, he was subject to accuracy

related penalties. According to Judge Holmes, "tax preparation software is only as good as the information one inputs into it."

Reasonable cause includes:

- reliance on the advice of the IRS or a tax expert,
- irregularities in mail delivery,
- death or serious illness, **or**
- acts of war, casualty or disaster.

To reasonably rely on professional advice the adviser must be a competent pro, with sufficient expertise to justify the reliance, the taxpayer must provide necessary and accurate info, and the taxpayer must actually rely in good faith on the adviser's judgment.

In order for it to be reasonable reliance on a professional advice 1) the adviser must be a competent professional with sufficient expertise to justify the reliance, 2) the taxpayer must provide necessary and accurate information to the adviser, and 3) the taxpayer must actually rely in good faith on the adviser's judgment. The taxpayer has the burden of proving that his or her failure to comply was not willful and was reasonable under the facts and circumstances.

Under the *Boyle* Supreme Court decision (469 U.S. 241 (1985)), a taxpayer cannot use reliance on a tax professional as reasonable cause for a failure-to-file penalty if the taxpayer relied on the professional to file the return or extension. A taxpayer has a non-delegable duty to ensure their return (or an extension) is filed. However, it may be possible to use tax professional reliance as reasonable cause for non-filing if the tax professional provided advice on the filing requirement that the taxpayer relied on in good faith. In *Est. of Hake v. U.S.*, 2017 PTC 74 (M.D. Pa. 2017), a case which is appealable to the Third Circuit, a district court also rejected the IRS's reliance on *Boyle* and held that an estate was not liable for penalties for late filing of an estate tax return where the late filing was due to erroneous professional advice. This is an unsettled area of law

Example: *Carolyn Whitsett* (TC Memo 2017-100 (6/1/17)) a 70-year-old physician specializing in blood transfusions. She and her then husband purchased 4000 shares of stock for $11,000 in 1982 that she was given in their divorce in 1998. In July 2011, an offer was made of $27 per share – she then owned 63,594 shares – and she advised her longtime tax preparer that she would accept the offer. The check was dated 1/4/12, but it was accompanied with a document that showed a "payment date" as 8/19/11, and the preparer put the stock transaction on the 2011 return, which was apparently never efiled. She made payments based upon his erroneous calculation on the long-term capital gains of just over $1,070,000. In 2013 petitioner received Form 1099-B showing the gross proceeds of $1,717,038 and a sale date of 1/4/12 – the tax preparer determined no tax was due because the sale had been reported in 2011. Notices were sent by IRS and forwarded to the tax preparer until petitioner became alarmed enough to obtain new counsel and a 2011 return was prepared requesting that the overpayment be applied to 2012. The parties stipulated that petitioner is liable for a deficiency for 2012, but disagree about imposition of the 20% accuracy related penalty.

While taxpayer is a highly education person and skilled physician, she had no knowledge of Federal income taxation. Although her preparer was not a CPA, she assumed he was because he was a member of several accounting societies. Errors made by the preparer cannot be used retroactively to demonstrate the adviser's lack of competence – he had 25 years' experience and she had a long-standing history of relying on him. Petitioner gave him all the facts she knew and all the forms she received, and her reliance was reasonable. She was not subject to the accuracy related penalty.

MEMORY TOOL - CAR

Reasonable reliance on a tax professional for penalty relief elements.

CAR

C - Competent professional

A - All information (accurate and relevant) provided

R - Relied in good faith on the adviser's judgment

Not all penalties are jurisdictional.
If the tax is not subject to the deficiency notice requirements of §6212,
the Tax Court does not have jurisdiction over the penalty
unless it comes through a CDP hearing review.

FAILURE TO FILE-6651(A)(1)/FAILURE TO PAY - §6651(A)(2)

When included in a notice of deficiency, the Tax Court has authority to redetermine these penalties. Failure to file penalty is 5% of the tax due as shown on the return for the first month and an additional 5% for each month, or part of month, the failure continues, not to exceed 25%. If the late filing is due to fraud the penalty increases to 15% per month (or part of a month) up to a maximum of 75% (§6651(f)).

Failure to pay penalty is .5% of the amount shown for each month, or part a month, the taxpayer does not pay the tax, not to exceed 25%. If the IRS issues a notice of intent to levy, the penalty increases to 1% per month, not to exceed 25%.

If both are owed at the same time, a maximum of 5% is charged.

Taxpayer cannot reasonably rely on a separated spouse to file for an extension or file the return and avoid a failure to file penalty. *James Plato* (TC Memo 2018-7 (1/24/18)) separated from his wife in 12/07 and they have not lived together since. Petitioner prepared and signed Form 1040 for 2007 reporting filing status of MFJ and tax liability of $46,073 – he left the joint return and a check for $46,073 "under the mat at the front door" of his wife's residence for her to sign and mail to the IRS. The check was never negotiated and the return was not mailed. Petitioner didn't request an extension of time but he asked his wife to request the extension. The IRS prepared an SFR for 2007 and after the notice of deficiency (dated 5/5/14) petitioner submitted Form 1040 for 2007 and tendered a payment of $43,490 with the separate return. Petitioner argued that his attempt to file the joint return coupled with his history of compliance amount to reasonable cause for his failure to file the return, but petitioner did not do everything possible to see that the return was filed with the IRS. He took no further action once he asked his wife to handle the details. The Court has held that the failure to obtain a spouse's signature on an MFJ return when the couple is separated doesn't always constitute reasonable cause for failure to file a tax return.

ACCURACY-RELATED PENALTIES- §6662

Accuracy-related penalties may apply when any part of the underpayment is:

- due to negligence or a disregard of the rules and regulations, but not with the intent to defraud under §6662(c),
- attributable to a substantial understatement of income tax, self-employment tax, or unrelated business income tax under §6662(d),
- attributable to a substantial misstatement of value, including those for income, gift and estate tax valuations under §6662(h), **or**
- attributable to overstating pension liabilities under §6662(f).

"Negligence" includes any failure to make a reasonable attempt to comply with the law, including a failure to keep adequate books and records or to make reasonable inquiry into the correctness of a deduction, credit or exclusion that seems "too good to be true." "Disregard" includes any careless, reckless or intentional disregard of the law.

When included in a notice of deficiency, the Tax Court has authority to redetermine these penalties.

Negligence §6662(c)

The penalty for negligence or disregard of the rules and regulations, but without the intent to defraud, is 20% of the portion of the underpayment attributable to negligence.

A position with a reasonable basis that is adequately disclosed (which can be done with Form 8275, *Disclosure Statement*) is not treated as attributable to negligence. If the taxpayer's position is contrary to a revenue ruling or notice published in the Internal Revenue Bulletin, it must have a realistic possibility of being sustained on its merits to avoid the negligence penalty.

“Reasonable basis” is less stringent than “realistic possibility.”

Substantial Understatement §6662(d)
A 20% penalty is imposed on any portion of an underpayment of tax that is attributable to any substantial understatement of income tax, self-employment tax, or unrelated business income tax. An understatement is substantial if it exceeds the greater of:

- 10% of the tax required to be shown on the return, or
- $5,000 ($10,000 for corporations other than S corporations and personal holding companies).

TCJA reduced the one prong of the penalty threshold to 5% of the tax required to be shown for any return claiming a §199A deduction. For example, under the normal rule, a taxpayer with $60,000 of tax required to be shown on the return would be subject to §6662(d) with a $6,000 understatement; however, now, if the taxpayer takes a §199A deduction, the penalty is triggered with a $5,000 understatement.

The penalty is reduced to the extent it is attributable to any item for which there is or was substantial authority, or the relevant facts are disclosed on the return or on Form 8275, and there is a reasonable basis for the taxpayer’s treatment. Relevant factors include the taxpayer’s efforts to assess the property tax liability, including their reasonable and good faith reliance on the advice of a tax professional. Blind reliance on a tax professional is not reasonable.

Substantial Authority
Substantial authority exists if the weight of the authorities supporting the treatment is substantial in relation to the weight of the authorities supporting contrary positions under the appropriate facts and circumstances. Under §1.6662-4(d)(3)(iii) substantial authority includes the Internal Revenue Code and other statutory provisions, proposed, temporary and final regulations construing those statutes, revenue rulings and revenue procedures, tax treaties and regulations, Treasury Department and other official explanations of such treaties, court cases, congressional intent as reflected in committee reports, joint explanatory statements of managers included in conference committee reports, private letter rulings and technical advice memoranda, general counsel memorandum, IRS information on press releases, and notices, announcements and other administrative pronouncements publishes by the Service in the Internal Revenue Bulletin. Conclusions reached in treatises, legal periodicals, legal opinions or opinions rendered by tax professionals are not authority. An authority stops being an authority to the extent it is overruled or modified by a body with the power to overrule or modify the earlier authority. The type of document is considered so a revenue ruling would have more weight than a private letter ruling addressing the same issue.

A Tax Court opinion is not considered overruled or modified by a 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.

Substantial authority exists if the weight of the authorities that support the treatment is substantial in relation to the weight of the authorities supporting contrary opinions, under the appropriate facts and circumstances.

Substantial Understatement §6662(h)

For income tax purposes, §6662(b)(3) imposes a substantial valuation misstatement penalty of 20% if the claimed value is 150% or more of the actual value.

> Example: For $100,000 of actual value, the penalty would apply if the claimed value was $250,000 or more.

However, a gross valuation misstatement penalty of 40% applies when the claimed value is 200% or more of the actual value under §6662(h).

> Example: For $100,000 of actual value, the penalty would apply if the claimed value was $300,000 or more.

When there is a gross valuation misstatement in a partnership, it is determined at the partnership level. The gross valuation misstatement penalty applies when the Tax Court determines that an underpayment stems from deductions or credits that are disallowed because a transaction lacks economic substance or a participant is a sham (but there is a split in the Courts of Appeal, according to *Blak Investments, et al* (TC Memo 2012-273 (9/25/12))).

FRAUD §6663

Civil fraud penalties can be asserted when there is clear and convincing evidence (a higher standard than more likely than not) to indicate that some part of an underpayment of tax is due to civil fraud. This evidence must show the taxpayer's intent to evade the payment of tax that the taxpayer believed was owed. Intent is distinguished from inadvertence, reliance on incorrect technical advice, honest difference of opinion, negligence or carelessness.

The IRS must show the taxpayer knew the content of the tax return was false, and that he or she made the return with the intent to evade tax. To make this determination, the Tax Court generally evaluates whether certain "badges of fraud" exist and to what extent they exist. Internal Revenue Manual 25.1.6.4 (6-10-2021) lists the following common badges of fraud:

- Understatement of income (e.g., omissions of specific items or entire sources of income, failure to report substantial amounts of income received)
- Fictitious or improper deductions (e.g., overstatement of deductions, personal items

deducted as business expenses)
- Accounting irregularities (e.g., two sets of books, false entries on documents)
- Obstructive actions of the taxpayer (e.g., false statements, destruction of records, transfer of assets, failure to cooperate with the examiner, concealment of assets)
- A consistent pattern over several years of underreporting taxable income
- Implausible or inconsistent explanations of behavior
- Engaging in illegal activities (e.g., drug dealing), or attempting to conceal illegal activities
- Inadequate records
- Dealing in cash, and
- Failure to file returns.

The civil fraud penalty is 75% of the portion of any underpayment that is attributable to fraud. The IRS may only impose this penalty if a tax return is filed.

On a joint return the civil fraud penalty does not apply to a spouse unless some part of the underpayment is due to civil fraud on the part of that spouse (IRC §6663(c)). When spouses file separate returns then amend to a joint return, any fraud on either separate return is deemed to be fraud on the joint return.

The civil fraud penalty is not asserted for failure to file a return or for a late-filed return. The fraudulent failure to file penalty under §6651(f) was added by OBRA 89 for this purpose.

The civil fraud penalty cannot be asserted on the same underpayment, or portion of an underpayment, to which the accuracy-related penalties are asserted under §6662. Only one penalty can be applied to any portion of an underpayment of tax.

When included in a notice of deficiency, the Tax Court has authority to redetermine these penalties.

> Example: *Michael Kohn and Catherine Kohn* (TC Memo 2017-159 (8/14/17)) the petitioner W is a practicing attorney, admitted to the Tax Court bar. Petitioner H is also an attorney who was convicted in 2002 of one count of violating §7212 for obstructing the administration of the internal revenue laws by creating fictitious debenture transactions to reduce clients' Federal income tax and crafting fee arrangements based on tax reduction. They timely filed their 1991 federal return which did not report cancellation of indebtedness income or any capital gains. Their 1992 return claimed a $121,000 casualty loss for dock units (in a presidentially declared disaster area, but they were purchased for $144,000 and sold for $142,000 without any improvements, which the Court felt reflected fair market value immediately before and after the casualty). By 1994 respondent commenced an audit of both returns and the notice of deficiency was issued on 6/27/96 reflecting many adjustments to those returns. In an amendment to his answer, respondent conceded the §6662(a) accuracy-related penalty for 1992 and instead asserted that petitioners were liable for a §6663 fraud penalty.

For fraud, the respondent bears burden of proof by clear and convincing evidence that an 1) underpayment of tax exists, and 2) some portion of the underpayment is due to fraud. Clear and convincing is "that measure or degree of proof which will produce in the mind of the trier of facts a firm belief or conviction as to the allegations sought to be established. It is immediate, being more than a mere preponderance, but not to the extent of such certainty as is required beyond a reasonable doubt as in criminal cases. It does not mean clear and unequivocal." Fraud does not include negligence, carelessness, misunderstand, or unintentional understatement of income. Fraud is a question that must be resolved upon consideration of the entire record, and it is typically proved by circumstantial evidence. The Court noted that this is one of the rare instances where fraud is established in the first instance by direct, not circumstantial, proof – they knew that the docks they were claiming as worthless would be sold in a matter of weeks for approximately what they had paid for them. Indeed, they signed the contract to sell the docks for $142,000 on 10/4/93, and signed their 1992 return 10 days later where they took the position that the docks had become worthless during 1993, giving rise to a loss deductible for 1992.

§6663(b) provides that if any portion of an underpayment is attributable to fraud, the entire underpayment is treated as attributable to fraud unless the taxpayer establishes by a preponderance of the evidence that some portion of the underpayment is not attributable to fraud.

PREPARER PENALTIES §6694-95

An income tax preparer can be subject to penalties for:

- understating tax liability due to a position with no realistic possibility of being sustained on its merits under §6694(a) – penalty of the greater of $1,000 per return or 50% of the income derived from the return – or under §6694(b) – penalty of the greater of $5,000 per return or 50% of the income derived from the return, for understatement of tax caused by the preparer's reckless or intentional disregard of the rules or regulations, **or**
- failure to give a taxpayer a copy of the return, or sign a return, or retain a copy of a return, or file correct information returns under §6695 (various penalties apply).

The Tax Court has no direct jurisdiction over these penalties; however, liability for these penalties can be considered by the Tax Court via a CDP hearing if the requirements for the underlying liabilities to be at issue are met.

RESPONSIBLE PERSON PENALTY - §6672

This civil trust fund recovery penalty is 100% of the total trust fund taxes (payroll taxes) evaded or not accounted for and paid over. The Tax Court has no jurisdiction over this penalty, but they do have jurisdiction over CDP hearings on §6672.

FRIVOLOUS RETURN - §6702
A penalty of $5,000 applies to frivolous returns. The frivolous return penalty applies where three conditions are met: 1) the taxpayer must have filed a document that "purports to be a return of tax imposed" by Title 26, 2) the purported return must be a document that either doesn't contain information on which the substantial correctness of the self-assessment may be judged, or on its face indicates the self-assessment is substantially incorrect, and 3) taxpayer's conduct must either be based on a position that the Secretary has identified as frivolous, or must reflect a desire to delay or impede the administration of Federal tax laws. If the taxpayer files a frivolous return he can be penalized even if he was not required to file a return or owes no tax for the year in question.

These are assessable penalties that are not subject to deficiency procedures, so no notice of deficiency can be issued for this liability.

TAX SHELTER - §6707A
75% of the decrease in tax shown on the return as a result of engaging in a tax shelter is the penalty, with a maximum $100,000 for a natural person ($200,000 not for natural person). If it relates to a reportable transaction, the penalty is $10,000 for a natural person (or $50,000 for a non-natural person). The reportable transaction must be disclosed on Form 8886, *Reportable Transaction Disclosure Statement*.

§6707A penalties are not subject to deficiency procedures and the Tax Court does not have jurisdiction except through a CDP hearing.

ADMINISTRATIVE WAIVER - §6751(b)
"No penalty under this title shall be assessed unless the initial determination of such assessment is personally approved (in writing) by the immediate supervisor of the individual making such determination or such higher level official as the Secretary may designate." This does not apply to penalties under §§6651, 6654, and 6655 as well as automatically generated penalties. IRS has burden of production to show §6751(b) compliance in Tax Court or the penalty will not be upheld.

There are three Tax Court cases related to *Lawrence and Lorna Graev* (2013, 2016 and 2017) and the issue of §6751(b) and when supervisory approval must be obtained for penalties. Taxpayers deducted cash and noncash charitable contributions that were disallowed resulting in large deficiencies for 2004 and 2005. In TC 140 23 (12/20/17) the respondent conceded the 40% penalties after the petition and answer were filed, then amended his answer to reassert the 20% penalty for the noncash contribution and for the first time asserted 20% §6662(a) accuracy-related penalties related to disallowance of a cash contribution deduction. The penalties were approved in writing by the immediate supervisor. It all comes down to timing – when must the written approval be obtained? In *Chai v Commissioner* (2d Cir 2017) the 2nd Circuit Court held that it must be determined no later than 1) the date the IRS issues the notice of deficiency, or 2) files an answer or amended answer, asserting such penalty. Taking Chai into account, the Tax Court concluded that §6751(b) does not bar assessment of the accuracy-related penalties.

Legislative history makes it clear that §6751(b)(1) is intended to prevent the IRS from improperly using penalties that are within its power to determine in order to coerce settlements. The Tax Court is not mentioned in §6751 or its legislative history - §6673(a)(1) is designed to deter bad behavior in litigation before the Tax Court, and to conserve judicial resources, not to restrain the Tax Court (*Benton Williams* (151 TC 1 (7/3/18))).

Respondent must show that written supervisory approval was obtained before the first formal communication to the taxpayers of the initial determination to assess penalties in *James Clay and Audrey Osceola* (152 TC 13 (4/24/19)). For purposes of §6751(b) the Revenue Agent Report and the 30-day letter, to which the RAR was attached, constitute the first formal communication of the initial determination to assess penalties. However, some Circuit Courts of Appeals have taken positions more friendly to the government on when the initial determination must be made.

No supervisory penalty of a penalty under §6699 for an S corporation late filing penalty is required for §6751(b) purposes in *ATL & Sons Holdings, Inc* (152 TC 8 (3/13/19)).

The IRS can generate “automatically calculated through electronic means” penalties, which are exempted from the written supervisory approval requirement under §6751(b) in *Craig Walquist and Maria Walquist* (152 TC 3 (2/25/19)).

There is no requirement that the initial determination of all penalties be made at the same time or by the same individual for §6751(b) purposes in *Palmolive Building Investors, LLC* (152 TC 4 (2/28/19)). When the IRS asserts multiple penalties, under §6751(b) they are not required to be made by the same person at the same time or even that supervisory approval be made on a particular form.

A Letter 1087 and summary report of the Exam Division’s tentative proposed adjustments is not the “initial determination” of a penalty in *Belair Woods, LLC* (154 TC 1 (1/6/20)).

§6751(b)(1) does apply to Trust Fund Recovery Penalties in *David Chadwick* (154 TC 5 (1/21/20)), despite a district court’s finding in 2014 that §6751(b)(1) doesn’t apply to TRFP. Letter 1153, Trust Fund Penalty Letter, notifies taxpayer of respondent’s determination to assess the TFRP and supervisory approval is required before this is sent to the taxpayer.

IRS bears the initial burden of production under §7491 to offer evidence of compliance with the §6751(b)(1) compliance and that the individual initially determining accuracy-related penalties obtain written supervisory approval in *Charles L Frost* (154 TC 2 (1/7/20)). Once respondent satisfies the initial burden of production under §7491(c), petitioner must come forward with contradictory evidence suggesting that respondent’s agent didn’t comply with §6751(b)(1).

The written supervisory approval requirement of §6751(b)(1) applies to the §6707A penalty in *Laidlaw's Harley Davidson Sales, Inc* (154 TC 4 (1/16/20) when a corporation failed to disclosed a listed transaction on its corporate tax return.

> **NOTE: In April 2023, the IRS issued proposed regulations to standardize the application of §6751(b) nationwide since some circuits have taken positions contrary to the Tax Court.**

CRIMINAL TAX EVASION - §7201

Willful attempt to evade tax is a penalty with a maximum penalty of $250,000 (for an individual, $500,000 for a corporation and/or up to 5 years in prison.

FORM 5471 PENALTY UNDER §6038, §6046

Information reporting requirements are imposed under §6038(a)(1) on any US person who controls a foreign corporation, which is when he or she owns or constructively owns stock that is more than 50% of the total combined voting power or total value of all classes of stock. §6046 requires information reporting by each US citizen or resident who is at any time an officer or director of a foreign corporation where more than 10% (by vote or value) of stock is owned by a US person. The penalty for failure to file a complete and timely 5471, *Information Return of US Persons with Respect to Certain Foreign Corporations*, is $10,000 per annual accounting period and there are additional penalties once the Secretary notifies the taxpayer of the requirement. The Tax Court has jurisdiction over CDP hearings related to these penalties.

> **NOTE: According to the *Farhy* decision (160 TC 6, *Alon Farhy*, (4/3/23), the IRS does not have statutory authority to assess penalties provided by §6038(b). This could be as big an issue for the IRS as §6751(b).**

MISCELLANEOUS TAX TOPICS

§280E

This provision disallows all deductions on a federal return for a business that consists of trafficking in a control substance, regardless of whether the business operates legally under state law. Marijuana is a controlled substance within the meaning of Schedules I and II of the Controlled Substances Act, even when it is medical marijuana recommended by a physician. As such, the manufacture, distribution, dispensation or possession of marijuana is prohibited.

§280E is a tax on gross income and is directed at persons who operate a business in violation of state or federal law; this was enacted in 1982 and never has been held to be a penalty by any federal court (despite a challenge by *Northern California Small Business Assistants, Inc* (153 TC 4 (10/23/19)) on just that issue).

Harborside is permitted to pay tax on gross income (gross receipts minus the cost of goods sold, which is the cost of acquiring inventory through either purchase or production) in *Patients Mutual Assistance Collective Corporation dba Harborside Health Center* (151 TC 11 (11/29/18)).

§280E precludes both a C and an S corporation from deducting §162 expenses, even when the dispensary operates legally under state law in *Alternative Health Care Advocates* (151 TC 13 (12/20/18)). The C corporation deducted §162 business expenses and later adjusted its cost of goods sold to include indirect expenses, neither of which is permitted (in 1988 Congress amended §263A(a)(2) to say that taxpayers can't capitalize costs that are otherwise nondeductible).

AFFORDABLE CARE ACT

Effective 2014, all non-exempt US citizens and legal residents are required to maintain minimum essential health insurance coverage or pay a penalty tax on their individual income tax returns. Individuals are exempt if income is below the filing requirement, coverage is unaffordable, the individual suffered a hardship making him or her unable to obtain coverage, or other circumstances. The Tax Cuts and Jobs Act reduced the individual shared responsibility payment (the ACA individual penalty) to $0 starting in tax year 2019.

Nonexempt US citizens and legal residents who do not have the minimum essential health care coverage (or have an exemption) make a shared responsibility payment with their tax return, which is computed on a month by month basis.

Effective 2015, applicable large employers must pay a penalty if they do not offer health insurance coverage to employees, offer insurance that is unaffordable or pay less than 60% of the cost to insure their employees. The penalty only applies if a full-time employee is certified as having purchased health insurance through a state exchange with respect to which a tax credit or cost-sharing subsidy is allowed or paid to the employee. An employer is an applicable large employer if it has an average of at least 50 full time employees during the preceding calendar year (full time employees work an average of at least 30 hours or more each week – those working less than 30 hours are counted on a pro-rated basis). This is delayed to 2016 for some employers with more than 50 but less than 100 full time employees.

Effective 2015 if a taxpayer or member of a taxpayer's family had health coverage in 2015, the provider of that coverage is required to send a Form 1095-A, 1095-B or 1095-C to the taxpayer.

AMT

Alternative minimum tax (AMT) was intended to maintain tax equality to ensure that taxpayers pay their fair share of tax. It addresses situations in which high-income individual taxpayers otherwise realize large tax savings through specific tax exemptions and deductions. Without AMT these individuals may not pay any income tax at all. In essence, with AMT the tax breaks are not available, so these individuals pay at least a minimum amount of tax. AMT is now indexed.

The Tax Cuts and Jobs Act eliminated AMT for C corporation while increasing the exemptions and exemption phase-outs for individuals. The Inflation Reduction Act reintroduced AMT for certain large corporations.

AMT for the year is the excess tentative minimum tax over regular tax liability. Taxpayer pays the higher of AMT or the regular tax.

AMTI (alternative minimum taxable income) must be computed. This is the regular taxable income computed without personal exemptions, increased or decreased by adjustments, and increased by tax preferences.

AMT adjustments include:

- itemized deductions for taxes, certain interest, and most miscellaneous deductions are disallowed,
- personal exemptions and the standard deduction are not allowed,
- MACRS depreciation is figured using the alternative MACRS for real estate using 40-year straight line recovery, and the 150% declining balance method for personal property,
- incentive stock options, which are not taxed when exercised for income tax purposes, are AMT taxable on the fair market value of the stock when it first became transferable over the amount paid for the stock, **and**
- other adjustments required for pollution control facilities, mining exploration and developing, circulation expenditures, and research and experimental expenditures.

AMT preference items generally increase AMTI and include:

- most tax-exempt interest from private activity bonds issued after 8/7/86,
- accelerated depreciation on real property and leased personal property placed in service before 1987, **and**
- qualified small business stock qualifying for the 50% exclusion results in 42% as an AMT preference item.

The Second Circuit affirmed the Tax Court ruling in *Ostrow v Comm'r* (2nd Cir. 2006-1 USTC ¶50,116). Taxpayer was a tenant-stockholder in a cooperative housing corporation who deducted her share of real estate taxes both for regular tax and for purpose of computing AMTI. She was not allowed to deduct it for purpose of AMTI.

Even though qualified dividends receive favorable tax treatment, the amount of the dividends is included in the alternative minimum taxable income (AMTI). The petitioners felt the AMT calculation on dividends was ambiguous, so in *Weiss* (129 TC 18 (2007)) they calculated their own "qualified dividend tax" and reported it on the AMT line of the return. Taxpayers felt they acted consistent with the literal terms for Form 1040, but tax form instructions cannot be relied upon as authoritative sources of law.

In *Marcus* (129 TC 4 (8/15/07)) the petitioner exercised ISOs in 2000 to acquire stock and sold some shares in 2001. The petitioner claimed that the regular tax basis on the shares sold is an adjustment under §55(b)(3) that creates an ANTOL that may be carried back to reduce AMTI in 2000. However, the AMT adjustment occurs in the year of exercise, not in the year of sale. The sale of stock acquired through exercise of ISOs is a capital asset sale and does not create an ATNOL.

EMPLOYEE STOCK OPTIONS

Stock options permit, but do not obligate, an employee to buy a specified number of shares of stock from a company for a specified price during a specified period of time. There are two types of stock options: incentive stock options (ISO, also known as statutory options) and nonstatutory (nonqualified) stock options. Important terminology includes:

Grant date – when company grants the option to the employee
Exercise date – when employee purchases the stock
Exercise price – AKA strike or option price, this is amount employee must pay to purchase the stock
Substantially vested stock – is not subject to a substantial risk of forfeiture
Restricted stock – is not transferable or is subject to a substantial risk of forfeiture

Statutory options have more restrictions than nonstatutory, but the tax treatment may be more advantageous. If requirements are met, income from sale of stock acquired by exercising the option is eligible for capital gain or loss treatment:

- Individual receiving the grant must be an employee of company granting the option from the time the option is granted until 3 months before the option is exercised (for an ISO, one year before if the individual is disabled)
- The option must be nontransferable except at the employee's death
- The employee purchasing shares cannot sell or dispose of the stock within one year of the exercise date or within 2 years of the grant date

After 10/22/04 the exercise of ISOs and employee stock purchase plans is not includible in wages for purposes of social security, Medicare, and FUTA (also the disposition of stock acquired by such an exercise).

Generally, there is no income recognized upon the grant or exercise of an ISO. A taxpayer may defer tax liability resulting from the exercise of ISOs until the shares are sold but may still incur AMT liability. No AMT adjustment is required if the stock is sold in the same year the option is exercised. For purpose of computing alternative minimum taxable income (AMTI) the spread between the exercise price and the FMV of the stock on the date of exercise is treated as an item of adjustment and included in AMTI. As a result, the taxpayer has two different bases in stock acquired through ISO – one for regular tax (the exercise price) and an adjusted AMT basis (increased by amount of income included in AMTI due to the exercise).

If the aggregate FMV of exercisable stock for any individual exceeds $100K during the calendar year, the excess is treated as nonstatutory stock options under §422(d).

If the ISO holding period is not met:

- **ordinary gain** if stock sold at gain
- **capital** if stock is sold at a loss

Nonstatutory options have fewer restrictions. If the FMV of the option is readily available, income is recognized at option grant date. The value is readily determined if the option is actively traded on an established market or if 1) the employee can transfer the option, 2) the employee can exercise the option immediately in full, 3) the option is not subject to any condition or restriction that affects FMV **and** the FMV of the option privilege can be readily determined.

Generally, income is recognized as ordinary (not capital) when the option is exercised. The FMV (less exercise price) is included in wages (Box 12, code V), subject to social security, Medicare, FUTA and federal income tax withholding at the time of the exercise. IRC §421-423 and regulations provides more information about employee stock options.

MEDICARE TAX (ADDITIONAL)

A .9% additional Medicare tax applies to a taxpayer's combined Medicare wages, other compensation, self-employment income and Railroad Retirement Tax Act compensation above certain threshold amounts based on filing status. The threshold amounts are the same as for the NII ($250,000 MFJ, $125,000 MFS, $200,000 other filing status). Medicare wages and self-employment income are combined to see if the taxpayer's income exceeds the threshold, but a self-employment loss does not reduce W-2 wages and the tax must be separately calculated for each type of income.

NET INVESTMENT INCOME TAX

Individuals owe an additional 3.8% Medicare tax (net investment income tax, or NII) if they have net investment income and their modified AGI is over the threshold amount of $250K (MFJ) or $125K (MFS) or $200K (other filing status). NII tax applies to interest, dividends, capital gains (from sale of stock, bonds, mutual funds, and investment real estate), capital gain distributions from mutual funds, rental and royalty income, nonqualified annuities and business income from passive activities.

NET OPERATING LOSS (NOL)

An individual, estate or trust may have a Net Operating Loss (NOL) if deductions for the year exceed income. NOLs are caused by losses from trades or businesses, casualty and theft losses, moving expenses (if allowed), and rental property. Taxpayers must prove the existence of an NOL and that it has not been used subsequent to its creation.

> Example: *Naren Chaganti* (TC Memo 2016-222 (12/7/16)), an attorney with clients in MO and CA, deducted expenses associated with his legal services and a net operating loss carryforward from prior years to offset his 2007 income. The Commissioner determined he was not entitled to deductions for many of his expenses or a foreign earned income tax credit he claimed, and that he was not entitled to deduct the NOL.

Although petitioner could show prior tax returns that contained losses, he didn't elect to forgo the NOL carryback for those years and the deductions could not be substantiated. Taxpayers bear the burden of establishing both the actual existence of an NOL for another year and the amount of that NOL that may be carried to the years in issue – a taxpayer's return is merely a statement of the taxpayer's position and cannot be used to substantiate a deduction. The court has jurisdiction to consider facts related to years other than the years in issue in order to redetermine the liability for the periods before the Court. Petitioner failed to act with reasonable cause and in good faith for his failure to maintain adequate records to substantiate many of the expenses he reported.

Example: In *Betty Amos* (TC Memo 2022-109, affirmed by the 11th Circuit) a CPA who could not establish the existence of NOL deductions she claimed were carried forward from 1999 and 2000 to her 2014 and 2015 tax returns was denied the deductions.

TCJA made several changes to NOLs, which may now only be carried back for farming (2 years) and otherwise are carried forward indefinitely. In addition, the NOL deduction in a taxable year cannot exceed 80% of taxable income. These new provisions only apply to losses arising in tax years beginning after 12/31/2017.

The CARES Act temporarily changed the tax treatment of NOLs for tax years beginning in 2018, 2019, and 2020. These NOLs are subject to a 5-year carryback which can be waived with an election timely filed with the taxpayer's first tax return with a tax year ending after March 27, 2020. In addition, the 80% of taxable income limitation is suspended for tax years beginning in 2018, 2019, and 2020. These changes are no longer in effect.

QUALIFIED OFFER

§7430(c)(4)(E) provides that a party to a court proceeding who otherwise satisfies the requirements for an award of costs is treated as the prevailing party if the liability of the taxpayer is equal to or less than the liability that would be determined had the IRS accepted the last qualified offer made by the party. Final regulations regarding an award of attorneys' fees and other costs based upon qualified offers were published on December 29, 2003. In the final regulations the specified amount of the qualified offer can be either a specific dollar amount, or a percentage of the adjustments at issue. A qualified offer may be made in for less than all of the tax years involved in the proceeding, but the qualified offer must resolve all of the issues for the tax years covered by the offer and must cover all tax years in the proceeding affected by those issues. A prevailing party may not recover fees under the qualified offer rule for any issue that is settled (the point of this rule is to encourage settlements). The award of costs only includes those costs incurred on or after the date of the last qualified offer and is limited to the costs attributable to the adjustments at issue when the last qualified offer was made.

A qualified offer is made during the qualified offer period, specifies the offered amount of the liability, is designated as a qualified offer under §7430(g), and by its terms remains open during the period beginning on the date it is made, and ending on the earliest of the date it is rejected, the date the trial begins, or the 90th day after the date the offer is made.

The qualified offer period begins on the date the first letter of proposed deficiency that allows the taxpayer an Appeals conference and ends on the date which is 30 days before the date the case is first set for trial (the calendar call), unless it is removed from the calendar call at least 30 days before that date.

> Example (from Final Regulations, Example 12): Taxpayer F has petitioned the Tax Court in response to the issuance of a notice of deficiency. F receives notice that the case will be heard on the July trial session in F's city of residence. The scheduled date for the calendar call for that trial session is July 1st. On May 15, F's motion to remove the case from the July trial session and place it on the October trial session for that city is granted. The scheduled date for the calendar call for the October trial session is October 1st. On May 31st F delivers a qualified offer and another qualified offer on August 31st. Neither offer is accepted. The final judgment is an amount more than the May 31st qualified offer but less than the August 31st qualified offer. The qualified offer period ended September 1, and the August 31st qualified offer is the last one taxpayer made. Taxpayer is the prevailing party under the qualified offer rules because F's liability under the August 31 offer equaled or exceeded F's liability under the judgment.
>
> Example (from Final Regulations, Example 13): If the case was removed from the trial calendar less than 30 days, June 1st was the qualified offer period end. The May 31st qualified offer was taxpayer's last; F is not the prevailing party under these rules and must satisfy the requirements of §7430(c)(4)(A) to qualify for an award of reasonable administrative and litigation costs.

SAME SEX MARRIAGE

This was legalized by the Supreme Court on 6/26/15 in *Obergefell v Hodges* so all married couples file tax returns either MFJ or MFS, unless the taxpayer otherwise qualifies to file as Head of Household. Individuals of the same sex are considered married if they were legally married in a state or jurisdiction whose laws authorized the marriage of two individuals of the same sex at the time of the marriage.

§199 DOMESTIC PRODUCTION DEDUCTION

§199 was repealed for tax years beginning after 12/31/2017 and was replaced by §199A.

§199A QUALIFIED BUSINESS INCOME DEDUCTION

Under TCJA new §199A provides a general 20% deduction for the qualified business income from certain pass-through entities. The deduction applies to the ordinary business income from sole proprietorships, partnerships, and S corporations and is taken at the owner/partner/shareholder level. The deduction reduces taxable income and does not affect AGI or self-employment tax.

S corporation reasonable compensation and partner guaranteed payments do not qualify for the §199A deduction.

If the owner/partner/shareholder has a taxable income over $182,100 or $364,200 MFJ (2023), then limitations on §199A are phased-in based on wages paid by the business and the business's unadjusted basis in property. In addition, if the business is a "specified service" trade or business, the deduction begins to phase-out starting at the same threshold.

At taxable income of $232,100 or $464,200 MFJ (2023) the wage and property limitations fully apply, and specified services no longer qualify for the deduction.

At taxable income of $213,300 or $426,600 MFJ (2020) the wage and property limitations fully apply, and specified services no longer qualify for the deduction.

Health Savings Account

A Health Savings Account (HSA) is a tax-exempt trust or custodial account set up with a U.S. financial institution that permits payment or reimbursement of certain medical expense. The account must be used in conjunction with a high-deductible health plan (HDHP). One-time distributions from an IRA may be used to fund the HSA – distributions from HSA to pay medical expenses are not taxable, but distributions from an IRA for the same purpose are.

The advantages of an HSA:

- tax deductions for contributions can be claimed even if the taxpayer does not itemize
- contributions made by the employer may be excludable from gross income
- contributions remain in the account until used
- interest or other earnings on the assets are tax free
- distributions may be tax free if used to pay qualified medical expenses
- the HSA is portable and stays with the taxpayer even after changing employers or leaving the work force

To qualify for an HSA the taxpayer must have a HDHP, have no other health insurance, be not entitled to Medicare benefits, and cannot be claimed as a dependent on someone else's tax return. HSA contributions can be made until 4/15 of the following year.

Long-Term Care Costs of Chronically Ill

Long-term care services are broadly defined as those necessary for diagnosis, prevention, therapy, curing, treating and rehabilitation, including maintenance and personal services. If the services are provided under a plan of care prescribed by a licensed health-care practitioner, the costs may be deducted as medical expenses, subject to the AGI limitation, even if paid to an unlicensed care giver (*Estate of Lillian Baral* (137 TC 1 (7/5/11))). Expenses qualify as long-term care if they are required by a chronically ill individual and provided pursuant to a plan of care prescribed by a licensed health care practitioner. Chronically ill means they are unable to perform at least 2 of 6 specified activities of daily living (eating, toileting, transferring, bathing, dressing and incontinence) for a period of at least 90 days due to a loss of functional capacity or requiring substantial supervision to protect the individual from threats to health and safety due to sever cognitive impairment.

Premiums for a qualified long-term care policy may also be deductible as a medical expense; the deductible amount depends upon the taxpayer's age at the end of the tax year.

Benefits received from a qualified long-term care policy are tax-free to the extent they pay or reimburse long-term care expenses.

Employees may exclude employer-provided coverage for qualified long-term care services, to the extent that the coverage comes through a flexible spending arrangement or other similar arrangement under §106(c)(1).

SELF-EMPLOYED HEALTH INSURANCE

Premiums paid by a self-employed person for health insurance are 100% deductible beginning in 2003 as an adjustment to income, to the extent there is self-employment income. If taxpayer or spouse is also an employee of another person, a self-employed person cannot take the deduction for any month in which either one is eligible to participate in a subsidized health plan maintained by taxpayer's employer or taxpayer's spouse's employer.