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2020-2021 FEDERAL & CALIFORNIA TAX UPDATE

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2020 FEDERAL TAX UPDATE
INDIVIDUAL RETURNS

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INDIVIDUAL RETURNS

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TAX LEGISLATION

Tax Cuts and Jobs Act

On Dec. 22, 2017, President Donald Trump signed the Tax Cuts and Jobs Act, a 1,101-page document, into law. It is the first major reform of the Internal Revenue Code in 30 years. Unless otherwise noted, the effective date of the individual provisions of the TCJA is effective 01/01/2018 and sunsets 12/31/2025. Because the individual, but not the business, provisions sunset, the law uses the term "suspend" rather than "repeal."

The Further Consolidated Appropriations Act

The Appropriations Act was signed into law on Dec. 20, 2019. The Appropriation Act included extender provisions (some retroactive), the SECURE Act's IRA and pension reform, disaster tax relief, and the repeal of a few ACA taxes.

The CARES Act

After a lot of talk and 10 versions (one marked "final, final"), Congress agreed to stimulus legislation. President Trump signed into law on March 27, 2020, the Coronavirus Aid, Relief, and Economic Security Act (The CARES Act, HR 748), a $2.2 trillion stimulus package to mitigate the impact of the COVID-19 pandemic. The stimulus rebate payment was the major provision that affected individual clients.

EXPIRING PROVISIONS

Some Tax Provisions Expire (JCX-8-19)

Several provisions expired at the end of 2017. Although legislative proposals flourished, extenders were delayed until the Appropriations Act, signed into law Dec. 20, 2019. Provisions expiring in 2020 and later follow:

IRC	Provision	EXPIRES
§213(f)	Medical expense deduction — 7.5% AGI limit	Dec. 31, 2020
§222	Tuition Deduction	Dec. 31, 2020
§108(a)(1)(E)	Exclusion of COD of Qualified Personal Residence	Dec. 31, 2020
§25C(d)(3)	Non business energy credit	Dec. 31, 2020
§163(h)(3)	Mortgage Insurance Premium	Dec. 31, 2020
§1391(d)(1)(A)(i)	Empowerment Zone tax incentives	Dec. 31, 2020
§51(c)(4)	Work opportunity credit	Dec. 31, 2020
Var.	CARES Stimulus incentives	Dec. 31, 2020
§25D(g)	Solar credit for residential property	Dec. 31, 2021
Var.	Various individual provisions in the TCJA	Dec. 31, 2025

FORM 1040

The IRS Says Bye-Bye to the "Postcard" — Sort of

For 2018, the idea of a postcard tax return resulted in the old and trusted Form 1040 transforming into an eight-page problem. The first two pages were each printed on a half sheet of paper to resemble a postcard-sized Form 1040 (although many software companies received IRS permission to cram the two half pages into one). Six schedules to support the "postcard" followed.

For 2019, there were some improvements. First, the six 2018 schedules were cut to three for 2019. Schedule 1 reports additional income and adjustments to income. Schedule 2 reports additional taxes, and Schedule 3 reports additional credits and payments. Pages one and two of the Form 1040 each take up two-thirds of a page because of added lines. Here are a few changes of note to the 2019 Form 1040.

- In the filing status section, lines were added to report the spouse's name for the married filing separate taxpayer and for the taxpayer claiming head of household or qualifying widow(er), the child's name.
- The check box for health insurance coverage was removed since there is no individual mandate penalty beginning in 2019.
- A line was added to report foreign address information.

- A line was added to report capital gain or loss. Capital gains were reported on Schedule 1 last year.
- A line was added to report the QBI deduction. The QBI deduction was reported on Schedule 1 last year. Also see the new Form 8995 and Form 8995-A required to be attached to the 2019 return when claiming the QBI deduction.
- Separate lines were added for the Earned Income Credit, Additional Child Tax Credit, and the American Opportunity Credit.
- The signature lines were returned to page two of the return.

2020 Form 1040. Draft forms are usually released in August.

2019 Form 1040-SR released. Although the IRS eliminated the Forms 1040EZ and 1040A beginning for 2018 returns, legislation required the IRS to provide a "short" form 1040 for seniors beginning in 2019. Thus, the IRS released 2019 Form 1040-SR. If you look at the Form 1040-SR, the first thing you'll notice is the font size. Yes, that is meant to help seniors who might have failing eyesight. Does the Form 1040-SR mean anything to us? Probably not; office practice is often to force all returns to the Form 1040 to make review easier.

> **Note.** Forms 1040A and 1040EZ were discontinued beginning in 2018.

TAX RATES

Individual Tax Rates (§1, §15, §63(c)(2)(A))

The TCJA reduced the individual tax rates for 2018 through 2025. New tax rates are 10%, 12%, 22%, 24%, 32%, 35%, and 37%.

2020 Individual Tax Rates and Brackets							
2019 Taxable Income				**2020 Taxable Income**			
Tax Rate	MFJ	HOH	Single	**Tax Rate**	**MFJ**	**HOH**	**Single**
10%	not over $19,400	not over $13,850	not over $9,700	**10%**	**not over $19,750**	**not over $14,100**	**not over $9,875**
12%	over $19,400	over $13,850	over $9,700	**12%**	**over $19,750**	**over $14,100**	**over $9,875**
22%	over $78,950	over $52,850	over $39,475	**22%**	**over $80,250**	**over $53,700**	**over $40,125**
24%	over $168,400	over $84,200	over $84,200	**24%**	**over $171,050**	**over $85,500**	**over $85,525**
32%	over $321,450	over $160,700	over $160,725	**32%**	**over $326,600**	**over $163,300**	**over $163,300**

35%	over $408,200	over $204,100	over $204,100	**35%**	**over $414,700**	**over $207,350**	**over $207,350**
37%	over $612,350	over $510,300	over $510,300	**37%**	**over $622,050**	**over $518,400**	**over $518,400**

Tax practitioner planning. The marriage penalty is alive and well. Although the House and Senate bills that went into the conference committee to reconcile their differences included top rates taking effect over $1,000,000 MFJ and $500,000 single, the final TCJA reduced the MFJ number to just $100,000 over that applying to the single taxpayer.

2020 Estimated Tax Penalty (Topic No. 306 Penalty for Underpayment of Estimated Tax)

The percentage threshold to avoid a 2020 estimated tax penalty is 90% of current year tax. The penalty is waived if withholding and estimated tax payments are at least 100% (110% for some) of prior year tax.

IRS Delays Due Date of 2020 First and Second Quarter Estimated Tax Payments

The IRS automatically extended the federal income tax filing due date from April 15, 2020 to July 15, 2020. Included in the delay were the first quarter and second quarter estimate tax payments normally due April 15 and June 15.

Tax practitioner planning. The 2019 estimated tax penalty applied even though changes were made to the due date of the first and second quarter 2020 estimated tax payments.

FILING REQUIREMENTS

Filing Requirement (§6012)

An individual is required to file a tax return if the taxpayer's gross income for the taxable year exceeds the applicable standard deduction. Married individuals are required to file a return if that individual's gross income, when combined with the individual's spouse's gross income, for the taxable year is more than the standard deduction applicable to a joint return, provided that: (i) such individual and his spouse, at the close of the taxable year, had the same household as their home; (ii) the individual's spouse does not make a separate return; and (iii) neither the individual nor his spouse is a dependent of another taxpayer who has income (other than earned income) in excess of $500 (indexed for inflation).

Tax practitioner planning. Under the old law, the filing requirement was based on the exemption amount and the prior law standard deduction. It is now based on the $12,400 single, $18,650 head of household, and $24,800 MFJ (2020) standard deduction amounts.

Head of Household Filing Status (§695(g))

The TCJA required the Treasury to issue due diligence rules for paid preparers in determining the eligibility for a taxpayer to file as head of household. The IRS responded with a revised Form 8867.

> **Tax practitioner planning**. Form 8867, Paid Preparer's Due Diligence Checklist, includes HOH questions as well as the current questions regarding EIC, CTC/ACTC, and AOTC.

How a Name Change Impacts Taxpayers (Name Change? How It Impacts Taxes)

Married and now using a new spouse's last name or hyphenated name? Divorced and now back to using a former last name? All of the names on a taxpayer's tax return must match Social Security Administration records.

> **Tax practitioner planning.** A name mismatch will delay a tax refund.

- **Taxpayer changes name.** When a taxpayer changes her or his name, she or he should notify the SSA of a name change. That way the new name on IRS records will match the SSA records.
- **Dependent's name change.** Notify the SSA if a dependent has a name change. For example, notify SSA if a taxpayer adopted a child and the child's last name changed. If the child does not have a Social Security number, the taxpayer may use an Adoption Taxpayer Identification Number on their tax return. An ATIN is a temporary number. Apply for an ATIN by filing Form W-7A, Application for Taxpayer Identification Number for Pending US Adoptions with the IRS.
- **Getting a New SS card.** File Form SS-5, Application for a Social Security Card. The Form SS-5 is on SSA.gov, or the client may call 800-772-1213 for the form. The taxpayer's new card will reflect the name change.

Newly Revised IRS Publication Explains Tax Benefits for Members of the Military (IR-2020-40, Publication 3, Armed Forces' Tax Guide)

The IRS provides Tax Information for Members of the Military to help you meet the unique tax obligations of your military clients. This Publication includes topics that affect current and former military personnel, along with resources where you can go to find more information.

> **Tax practitioner planning**. If your client changes his or her mailing address, be sure to notify the IRS using Form 8822, Change of Address. Mail it to the Internal Revenue Service Center for the old address. Use Form 8822-B, Change of Address or Responsible Party — Business, if the business address changes.

PERSONAL EXEMPTIONS AND DEPENDENTS

No Exemption Deduction in 2020 (§151 - §153)

Definition of a Qualifying Child Remains the Same

The definition of a qualifying child remains the same as in prior law, but it is used for a different purpose than the personal exemption deduction. A "qualifying child" is required for the child tax credit, child care credit, and the education credits.

Five "Qualifying Child" Tests Must Be Satisfied (§152©

- **Child must be related** to taxpayer §152(f)(1).
- **Age**. The child must not have attained the age of 19 by the end of the calendar year or must be a student who has not attained the age of 24 by the end of the calendar year (§152(c)(3) and (f)(2)) and must be younger than the taxpayer (§152(c)(3)(A)). Exceptions to these requirements exist for any individual who is totally and permanently disabled at any time during the year (§152(c)(3)(B)).
- **Child must have the same principal place of abode** as the taxpayer for more than half of the year (§152(c)(1)(B)).
- **Child must not provide more than half of his or her support for the year** (§152(c)(1)(D)).
- **Joint return restriction**. The child must not have filed a joint return (other than for a claim of refund only) (§152(d)(1)(E)).

Planning: When to sign or not sign a Form 8332. The TCJA changes to the child tax credit mean many clients benefit from the $2000 tax credit that didn't before. The custodial parent is unlikely to give up her/his $2000 credit just to be nice to her/his ex-spouse. Advise the client who you represent (custodial or noncustodial) that the divorce decree should specifically address the dependency and why. If a Form 8332 is required, the noncustodial parent (but not necessarily the custodial parent) is better off securing a several year signature when the divorce is finalized, rather than begging the ex-spouse each year. The effective dates that apply for the Form 8332 are found in Part II. The instructions explain how the custodial parent can revoke her/his several year Form 8332 if circumstances change.

Divorcing Parents Will Still Argue Over the Form 8332

Since the child's exemption is no longer deductible beginning in 2018 (thanks to TCJA), what's there to argue about when the parents are divorcing? Just let the custodial parent claim whatever . . . No! That's not the right answer for the noncustodial parent since the exemption and the child tax credit go together. The new and improved child tax credit may still be worth fighting for, whether you represent the custodial or noncustodial parent.

Is Form 8332 still needed? While exemptions are no longer deductible for 2018 through 2025, the child tax credit is not only available, but expanded to such an extent that the credit will be useable by more of our clients. Does the noncustodial parent still need the Form 8832? The answer is "yes."

The dependency exemption and the child tax credit are generally allowable to the custodial parent. The custodial parent can waive those rights and allow the noncustodial parent to claim them. The custodial parent signs a Form 8332 (or a substantially similar document) that he or she will not claim the exemption for the child. The noncustodial parent must attach the Form 8832 to his or her tax return (§152(e)(2) and §1.152-4).

> **Tax practitioner planning.** Of course, if the custodial parent signs Form 8332, she is giving up the child tax credit. If you are advising the custodial parent and she has already signed a Form 8332 for future years, see the instructions to the form for directions on revoking a previous release. The custodial parent should also check the divorce agreement regarding any requirements for the release.

FAMILY TAX CREDITS §24

Family Tax Credits

The child tax credit has been expanded into a family tax credit consisting of a $2,000 credit per qualifying child who has not attained age 17 by the close of the taxable year, and a $500 credit for each dependent of the taxpayer who is not a qualifying child under age 17. The credits are not indexed for inflation.

> **Tax practitioner planning.** The $500 "other dependent" credit will replace the $4,050 exemption deduction available in 2017 for the taxpayer's college freshman, mother-in-law, disabled adult child, etc. Not a very good trade off.

"Qualifying Relative" Gross Income Test for "Other Dependent" Credit

The reduction of the exemption amount to zero in §151(d)(5)(A) for taxable years 2018-2025 does not apply to the gross income limitation in the definition of qualifying relative in §152(d)(1)(B). For 2020, the gross income limitation for a qualifying relative is $4,250 (adjusted for inflation each year).

Refundable Amount

The refundable amount for a qualifying child is increased from $1,000 to $1,400. In order to receive the child tax credit (refundable and nonrefundable), a taxpayer must include the SSN for each qualifying child for whom the credit is claimed on the tax return. For these purposes, a SSN must be issued before the due date for the filing of the return for the taxable year. The $500 credit for other dependents is not refundable, and the SSN requirement does not apply. A qualifying child who is ineligible to receive the child tax credit because that child did not have a SSN as the child's taxpayer identification number may nonetheless qualify for the nonrefundable credit of $500.

AGI Phase-out

The adjusted gross income phase-out thresholds are increased to $400,000 MFJ and $200,000 for single and HOH. The thresholds prior to 2018 were $110,000 for MFJ and $75,000 for single and HOH. The phase-out thresholds are not indexed for inflation.

> **Tax practitioner planning**. Many more clients now qualify for the child tax credit because of the increased phase-out numbers. This does add another compliance requirement for paid preparers (see Form 8867).

STIMULUS REBATE CREDIT

CARES provided stimulus payments of $1,200 for each individual and $500 for each child, defined by the child tax credit rules as under age 17.

Reconciliation on 2020 Return

Although the stimulus payments were paid based on 2019 tax return (or 2018 return if the 2019 was not yet filed), technically the stimulus rebate is a 2020 refundable tax credit. Payments received were an advance on the credit. When we prepare the 2020 Form 1040, we'll need to reconcile the advance payment to the amount computed using the 2020 AGI.

> **Tax practitioner planning**. The stimulus payments were not available to those without a SSN, nonresident aliens, or adult dependents.

Will the Client Have to Pay Back Their Advance?

Many clients will have less income in 2020 than in 2019 because of layoffs, reduced hours, and closed businesses. If the client's payment was reduced by the AGI threshold in the calculation of the advance using the 2019 income, they'll receive a credit on their 2020 return. If for some reason they receive too much of an advanced payment, they do not have to pay the advance back on their 2020 return (see the IRS FAQs).

Who and How Much?

The IRS issued advance stimulus payments based on the taxpayers' AGI from their 2019 tax return (or their 2018 tax return if the 2019 had not been filed at the time the payments were made). The payments were made using the following:

Single. Individuals with AGIs up to $75,000 a year are eligible for the full $1,200 payment. The payment is reduced by $5 for every $100 in income above $75,000. The payment amount is entirely phased out at an AGI of $99,000.

MFJ. Married filing joint couples with AGIs up to $150,000 a year are eligible for a $2,400 payment. The payment is reduced by $5 for every $100 in income above $150,000. The payment amount is entirely phased out at an AGI of $198,000 (if the taxpayers had no dependant children). Married couples also receive an additional $500 for every dependent child under 17 and is phased out of the payment at a slightly higher AGI.

HOH. Head of household filers with AGIs up $112,500 a year are eligible for the full $1,200 payment and an additional payment of $500 for each dependent child under age 17. The payment is reduced by $5 for every $100 in income above $112,500. Head of household taxpayers also receive an additional $500 per dependant child under age 17. With no eligible children, a head of household filer is phased out at AGI of $137,000. With one eligible dependent child, a head of household filer is entirely phased out of the payment at AGI of $146,400.

When Did Payments Arrive?

Direct deposits should have been in the client's bank account beginning in April. For those who did not include direct deposit information on their 2019 tax return, checks arrived during May and early June. Within 15 days of distributing a rebate payment, the IRS mailed a notice to the taxpayer's last known address stating how the payment was made, its amount, and a phone number to report any delivery problems.

> **Tax practitioner planning.** Past due child support payments that the states have reported to the Treasury Department *did* reduce the rebate. Back taxes and delinquent student loans did *not* reduce the advance payment.

CAPITAL GAINS AND DIVIDENDS

Rates for Capital Gains and Dividends (§1)

The TCJA retains the present-law maximum rates on net capital gains and qualified dividends.

2020 Long Term Capital Gains Rates and Brackets

2019 Law Taxable Income			**2020 Law Taxable Income**		
Tax Rate	MFJ	Single	**Tax Rate**	**MFJ**	**Single**
0%	not over $78,750	not over $39,375	**0%**	**not over $80,000**	**not over $40,000**
15%	over $78,750	over $39,375	**15%**	**over $80,000**	**over $40,000**
20%	over $488,850	over $434,550	**20%**	**over $496,600**	**over $441,450**

Other capital gains rates. The maximum rates for certain depreciation recapture and collectibles (e.g., precious metals) are 25% and 28%, respectively. Net capital losses are subject to the $3,000 annual limit.

Other Capital Gain/Loss Reporting Issues

Form 1099-B Includes Basis Reporting

Basis reporting for debt instruments and options. Basis reporting began for debt instruments and options acquired on or after Jan. 1, 2014 (§6045(g)(3)©.

How Is Basis Calculated for the Form 1099-B? (§6045(g)(2)(B))

Identification of securities. If a taxpayer has acquired securities on different dates or at different prices and sells less than the entire position in the security, the broker reports the sale according to the taxpayer's adequate and timely identification of the security to be sold. If no identification is provided, the sale is reported in this order:

1. any shares for which the acquisition date is unknown; then
2. the shares that were acquired first, whether they are covered or noncovered securities.

Regulations Allow "Standing Orders" for Basis Determination (§1.1012-1(c)(8))

Taxpayers may wish to specifically identify to their brokers which securities are to be sold by issuing a standing order to use a specific identification method such as last-in-first-out (LIFO) or highest-in-first-out (HIFO). The regulations clarify that taxpayers may establish specific lot selection by using such standing orders.

> **Tax practitioner planning.** Investors may find the LIFO or the HIFO accounting methods more advantageous, but such methods must be communicated to the broker before the affected securities are sold. Alternative costing methods may not be selected once the security is actually delivered to the buyer.

Other Basis Reporting Issues

Transfer statement must be provided when securities received via inheritance or gift. Estate executors must provide to estate beneficiaries a transfer statement that includes the decedent's date of death and the description, basis, and the executor's valuation for the security(ies) transferred. Those making a gift of a security must provide a transfer statement to the gift recipient disclosing the donor's purchase date and basis in the security(ies) transferred.

> **Tax practitioner planning**. If the tax practitioner knows that the stock sold was inherited, the date of death should appear in the date acquired box at 1b on Form 1099-B. If it doesn't, the basis reported by the broker will need to be corrected to FMV (or alternate valuation date, if applicable) at the date of decedent's death. Also, remember that if the stock is inherited, its holding period is automatically long-term (§1223(9)).

TCJA. Opportunity Zone Investment Reporting (Form 8997)

An investor in a Qualified Opportunity Zone Fund (QOF) uses Form 8997 to inform the IRS of the QOF investments and deferred gains held at the beginning and end of the current tax year, as well as any capital gains deferred by investing in a QOF and QOF investments disposed of during the current tax year. See Opportunity Zones Frequently Asked Questions for more information and guidance.

> **Tax practitioner planning**. Novogradac reports that an estimated $6.7 billion had been invested in QOFs as of Dec. 31, 2019.

VIRTUAL CURRENCY

SEC says actor Steven Seagal is not "Above the Law" The SEC settled charges against Steven Seagal for failing to disclose payments he received for promoting an investment in an initial Bitcoin2Gen offering. Seagal was promised $250,000 in cash and $750,000 worth of B2G tokens in exchange for promotions on his social media accounts.

Virtual Currency Transactions (Virtual Currency, FAQs on Virtual Currency Transactions)

Report virtual currency transactions or we'll audit you — and we know who you are! The IRS has begun sending letters to taxpayers with virtual currency transactions that potentially failed to report income and pay the resulting tax from virtual currency transactions or did not report their transactions properly. By the end of August 2019, 10,000 "educational letters" were delivered to taxpayers telling them to amend their returns to report their virtual currency transactions. There are three versions of the letter, often called a soft notice — *fix the problem or we'll audit you* — Letter 6173, Letter 6174, and Letter 6174-A.

Coinbase turned over customers' transactions to the IRS! Coinbase, Inc. lost its bid in federal court to stop the IRS from examining its customer records. With just 800 taxpayers reporting Bitcoin transactions from 2013 to 2015 when more than 13,000 Coinbase users bought, sold, sent, or received at least $20,000 of Bitcoin, the information that the IRS gathered produced plenty of audit targets, evidenced by the 10,000 "soft notice" letters.

> **Tax practitioner planning**. A 2019 survey estimates that 36.5 million Americans own virtual currency, twice the number in 2018.

How Is Virtual Currency Taxed?

Notice 2014-21 provided answers to frequently asked questions relating to the taxation of virtual currencies. Also see IR-2018-71, where the IRS reminded taxpayers to report virtual currency transactions.

Sales. Virtual currency is treated as property for US tax purposes. The general tax principles that apply to property transactions also apply to virtual currency. If the fair market value of property received in exchange for virtual currency exceeds the taxpayer's adjusted basis of the virtual currency, the taxpayer has taxable gain. The taxpayer has a loss if the fair market value of the property received is less than the adjusted basis of the virtual currency. The character of the gain or loss generally depends on whether the virtual currency is a capital asset in the hands of the taxpayer. A taxpayer generally realizes capital gain or loss on the sale or exchange of virtual currency that is a capital asset in the hands of the taxpayer.

> **Example**. Steve bought 10 Bitcoins for $10,000 in 2010. He sold them in July 2020 for $94,000. He must report the sale on his Schedule D as the sale of property. Steve has a long term capital gain of $84,000.

> **Tax practitioner planning.** A payment made using virtual currency is subject to information reporting to the same extent as any other payment made in property. Thus, a Form 1099-K is required if the taxpayer has more than 200 transactions or the transactions total more than $20,000.

Miners. When a taxpayer successfully "mines" virtual currency, the fair market value of the virtual currency as of the date of receipt is includible in gross income. The fair market value of virtual currency received for services performed as an independent contractor, measured in US dollars as of the date of receipt, constitutes self-employment income and is subject to the self-employment tax.

Airdrops and Hard Forks (Rev. Rul. 2019-24)

Airdrops. A taxpayer does not have gross income under §61 as a result of a hard fork of a cryptocurrency the taxpayer owns if the taxpayer does not receive units of a new cryptocurrency.

Hardfork. A hard fork is unique to distributed ledger technology and occurs when a cryptocurrency on a distributed ledger undergoes a protocol change resulting in a permanent diversion from the legacy or existing distributed ledger. A hard fork may result in the creation of a new cryptocurrency on a new distributed ledger in addition to the legacy cryptocurrency on the legacy distributed ledger. A taxpayer does have gross income under §61 as a result of an airdrop of a new cryptocurrency following a hard fork if the taxpayer receives units of new cryptocurrency.

> **Example (Situation 2 in Rev. Rul. 2019-24)**. Bob holds 50 units of Crypto R, a cryptocurrency. On Date 2, the distributed ledger for Crypto R experiences a hard fork, resulting in the creation of Crypto S. On that date, 25 units of Crypto S are airdropped to Bob's distributed ledger address, and Bob has the ability to dispose of Crypto S immediately following the airdrop. Bob now holds 50 units of Crypto R and 25 units of Crypto S. The airdrop of Crypto S is recorded on the distributed ledger on Date 2 at Time 1, and, at that date and time, the fair market value of Bobs's 25 units of Crypto S is $50. Bob receives the Crypto S solely because Bob owns Crypto R at the time of the hard fork. After the airdrop, transactions involving Crypto S are recorded on the new distributed ledger and transactions involving Crypto R continue to be recorded on the legacy distributed ledger.
>
> Bob received a new asset, Crypto S, in the airdrop following the hard fork; therefore, Bob has an accession to wealth and has ordinary income in the taxable year in which the Crypto S is received. See §§ 61 and 451. Bob has dominion and control of Crypto S at the time of the airdrop, when it is recorded on the distributed ledger, because Bob immediately has the ability to dispose of Crypto S. The amount included in gross income is $50, the fair market value of Bob's 25 units of Crypto S when the airdrop is recorded on the distributed ledger. Bob's basis in Crypto S is $50, the amount of income recognized.

Game Currency is not Virtual Currency

The IRS removed wording on its website that put game currencies as examples of a convertible virtual currency. Robux and Fortnite's V-bucks are not virtual currency. On February 14, the IRS made the following statement:

"*The IRS recognizes that the language on our page potentially caused concern for some taxpayers. We have changed the language in order to lessen any confusion. Transacting in virtual currencies as part of a game that do not leave the game environment (virtual currencies that are not convertible) would not require a taxpayer to indicate this on their tax return.*"

Virtual Currency Warning

For clients holding substantial amounts of virtual currency, planning for death or incapacity is critical. Each virtual currency has a unique electronic address that is used for transferring the virtual currency between the user's wallets. A private key is required to transfer virtual currency. If an individual dies or becomes incapacitated without another person knowing his or her private key, the virtual currency becomes inaccessible and is essentially worthless.

Tax practitioner planning. Ask *all* clients if they had any virtual currency transactions.

STOCK OPTIONS

§83(b) Election

Section 83(a) provides, generally, that if, in connection with the performance of services, property is transferred to any person other than the person for whom such services are performed, the excess of the fair market value of the property over the amount (if any) paid for the property is included in the service provider's gross income for the taxable year. If, however, upon receiving the property, the taxpayer's rights in the property are not transferable or are subject to a substantial risk of forfeiture, §83(a) provides that the taxable event does not occur until the first time that the transferee's rights in the property are:

1. transferable, or
2. not subject to a substantial risk of forfeiture, whichever occurs earlier.

Section 83(b) and §1.83-2(a) permit the taxpayer to elect to include in gross income, as compensation for services, the excess (if any) of the fair market value of the property at the time of transfer over the amount (if any) paid for the property.

Under §83(b)(2), an election made under §83(b) must be made in accordance with the regulations thereunder and must be filed with the IRS no later than 30 days after the date on which the property is transferred to the taxpayer.

IRS Issues Audit Technique Guide on Equity (Stock)-Based Compensation

For more information on equity-based compensation, see the IRS Audit Technique Guide (ATG). Along with defining the term equity-based compensation, the ATG explores both statutory and nonstatutory options, the taxation of restricted stock units (RSUs), and provides tips for where to gather appropriate documentation, including researching Securities and Exchange Commission (SEC) filings. The ATG was written before the enactment of §83(i).

Section 83(i) Election

The TCJA allows a qualified employee to elect to defer, for income tax purposes, the inclusion in income of the amount of income attributable to qualified stock transferred to the employee by the employer. An election to defer income inclusion ("inclusion deferral election") with respect to qualified stock must be made no later than 30 days after the first time the employee's right to the stock is substantially vested or is transferable, whichever occurs earlier.

> **Tax practitioner planning**. An inclusion deferral election is made in a manner similar to the manner in which an §83(b) election is made.

When income becomes taxable. If an employee elects to defer income inclusion under the provision, the income must be included in the employee's income for the taxable year that includes the earliest of:

1. the first date the qualified stock becomes transferable, including, solely for this purpose, transferable to the employer;
2. the date the employee first becomes an excluded employee (as described below);
3. the first date on which any stock of the employer becomes readily tradable on an established securities market;
4. the date five years after the first date the employee's right to the stock becomes substantially vested; or
5. the date on which the employee revokes her inclusion deferral election.

> **Tax planning provision**. The election must be made within 30 days of the exercise of the option or the settlement of the RSU.

ESSP and ISO. A qualified employee may make an inclusion deferral election with respect to qualified stock attributable to a statutory option. In that case, the option is not treated as a statutory option and the rules relating to statutory options and related stock do not apply.

Qualified employee. Under the provision, a qualified employee means an individual who is not an excluded employee and who agrees, in the inclusion deferral election, to meet the requirements necessary (as determined by the Secretary) to ensure the income tax withholding requirements of the employer corporation with respect to the qualified stock (as described below) are met. For this purpose, an excluded employee with respect to a corporation is any individual:

1. who was a 1% owner of the corporation at any time during the 10 preceding calendar years,
2. who is, or has been at any prior time, the chief executive officer or chief financial officer of the corporation or an individual acting in either capacity,
3. who is a family member of an individual described in (1) or (2), or
4. who has been one of the four highest compensated officers of the corporation for any of the 10 preceding taxable years.

Qualified stock. Qualified stock is any stock of a corporation if —

- an employee receives the stock in connection with the exercise of an option or in settlement of an RSU, and
- the option or RSU was granted by the corporation to the employee in connection with the performance of services and in a year in which the corporation was an eligible corporation.

However, qualified stock does not include any stock if, at the time the employee's right to the stock becomes substantially vested, the employee may sell the stock to, or otherwise receive cash in lieu of stock from, the corporation. Qualified stock can only be such if it relates to stock received in connection with options or RSUs, and does not include stock received in connection with other forms of equity compensation, including stock appreciation rights or restricted stock.

Eligible corporate stock. A corporation is an eligible corporation with respect to a calendar year if (1) no stock of the employer corporation (or any predecessor) is readily tradable on an established securities market during any preceding calendar year, and (2) the corporation has a written plan under which, in the calendar year, not less than 80% of all employees who provide services to the corporation in the US (or any US possession) are granted stock options, or restricted stock units ("RSUs"), with the same rights and privileges to receive qualified stock ("80% requirement"). For this purpose, in general, the determination of rights and privileges with respect to stock is determined in a similar manner as provided under the present-law ESPP rules. However, employees will not fail to be treated as having the same rights and privileges to receive qualified stock solely because the number of shares available to all employees is not equal in amount, provided that the number of shares available to each employee is more than a de minimis amount. In addition, rights and privileges with respect to the exercise of a stock option are not treated for this purpose as the same as rights and privileges with respect to the settlement of an RSU. For purposes of the provision, corporations that are members of the same controlled group are treated as one corporation.

> Notice 2018-97 clarifies that the determination of whether an employer satisfies the 80% requirement must be made on a calendar-year basis, without regard to awards granted in prior calendar years.

Notice to employee. Under the provision, a corporation that transfers qualified stock to a qualified employee must provide a notice to the qualified employee at the time (or a reasonable period before) the employee's right to the qualified stock is substantially vested (and income attributable to the stock would first be includible absent an inclusion deferral election). The notice must (1) certify to the employee that the stock is qualified stock, and (2) notify the employee (a) that the employee may (if eligible) elect to defer income inclusion with respect to the stock and (b) that, if the employee makes an inclusion deferral election, the amount of income required to be included at the end of the deferral period will be based on the value of the stock at the time the employee's right to the stock first becomes substantially vested, notwithstanding whether the value of the stock has declined during the deferral period (including whether the value of the stock has declined below the employee's tax liability with respect to such stock), and the amount of income to be included at the end of the deferral period will be subject to withholding as provided under the provision, as well as of the employee's responsibilities with respect to required withholding. Failure to provide the notice may result in the imposition of a penalty of $100 for each failure, subject to a maximum penalty of $50,000 for all failures during any calendar year.

FICA and FUTA. An inclusion deferral election applies only for income tax purposes. The application of FICA and FUTA are not affected. The provision includes specific income tax withholding and reporting requirements with respect to income subject to an inclusion deferral election.

Year of inclusion. For the taxable year for which income subject to an inclusion deferral election is required to be included in income by the employee (as described above), the amount required to be included in income is treated as wages with respect to which the employer is required to withhold income tax at a rate not less than the highest income tax rate applicable to individual taxpayers. The employer must report on Form W-2 the amount of income covered by an inclusion deferral election (1) for the year of deferral and (2) for the year the income is required to be included in income by the employee. In addition, for any calendar year, the employer must report on Form W-2 the aggregate amount of income covered by inclusion deferral elections, determined as of the close of the calendar year.

Effective date. The provision generally applies with respect to stock attributable to options exercised or RSUs settled after Dec. 31, 2017.

SOCIAL SECURITY (FICA) PAYMENTS

FICA and SE Tax Update Chart	2019	2020
Maximum FICA (OASDI) Wage Base	$132,900	**$137,700**
FICA/Medicare Tax Rate 6.2% + 1.45%	7.65%	**7.65%**
SE Tax Rate	15.3%	**15.3%**
Maximum Medicare Wage Base	Unlimited	**Unlimited**
Medicare Rate	1.45%	**1.45%**
Earned Income Ceilings for Social Security Benefits < Full Retirement Age	$17,640	**$18,240**
Medicare B and D Premiums	$135.50/mo $1,626 to $6,454.80	**144.60/mo** **$1,735.20 to $6,816.00**

Tax practitioner planning. When Social Security benefit increases are small (or nonexistent), about 70% of beneficiaries are protected from paying more for Medicare B premiums than their benefit increase.

Medicare B & D Premium Surcharge in 2020

Surcharge on Medicare B and D premiums. Medicare Part B and Part D premiums are determined based on an insured's AGI. The premium amount for a current year is determined based on the person's income from two years prior. For 2020 Medicare recipients, modified adjusted gross income for 2018 is calculated using:

1. the Medicare recipient's 2018 adjusted gross income, plus
2. any tax-exempt interest, EE bond interest used for educational purposes, and any excluded foreign earned income.

2020 Medicare Part B and D Premium Amounts Increase

If 2018 AGI is		2020 premiums are	
Individual	**Married filing joint**	**Monthly Part B premium**	**Monthly Part D surcharge**
Under $87,000	Under $174,000	$144.60	$0.00
$87,001-$109,000	$174,001 -$218,000	$202.40	$12.20
$109,001-$136,000	$218,001-$272,000	$289.20	$31.50
$136,000-$163,000	$272,001-$326,000	$376.00	$50.70
$163,001-$500,000	$326,001-$750,000	$462.70	$70.00
$500,000+	$750,000+	$491.60	$76.40

> **Example.** Emma and Ed normally have an AGI below $170,000, but in 2018, they sold their rental property at a substantial gain. Because of the extraordinary income, their 2018 AGI is in excess of $750,000. Thus, their combined Medicare B and D premiums for 2020 will be $13,632 instead of $3,470. Their 2018 gain is subject to a "hidden tax" of $10,162 two years after the sale.

Disputing the surcharge. Medicare recipients are allowed the opportunity to dispute the surcharge determination and use income from a later year if their circumstances change due to a major event such as the death of a spouse, divorce, retirement, or a significant cutback in hours worked.

Social Security and Medicare Trustees Report Projects That Social Security Trust Funds Will Be Exhausted in 2035 (2019 Annual Report)

Beginning in 2020, Social Security will begin paying out more in benefits than it receives in revenue for the first time since the Social Security trust funds were established in 1983. Over the past 35 years, the SSA trust fund has accumulated $2.9 trillion in reserves. The trust fund will be exhausted by 2035. When the funds are exhausted, Social Security will be able to pay only 77% of promised benefits from ongoing FICA taxes.

> **Comment.** The government estimates that half of all seniors will need long-term care, whether it is in-home, assisted living, or nursing home care. About one in six will pay $100,000 or more for long-term-care services.

> **Tax practitioner planning.** Social Security benefits are taxable when income exceeds $25,000 for individuals and $34,000 for married couples. The thresholds have never been indexed for inflation. When taxes on Social Security benefits were first imposed in 1983, the tax affected only about 10% of senior households. Today it affects nearly 50% of senior households.

> **Medicare**. Medicare trust fund is projected to be depleted in 2026. At that time, dedicated revenues will be sufficient to pay 89% of costs. The Trustees project that the share of cost that can be financed with dedicated revenues will decline slowly to 77% in 2046.

Full Retirement Age Increases for Social Security Benefits

The full retirement age for Social Security benefits increased to age 66 and eight months for 2020. The full retirement age will continue to increase by two months each year until it reaches age 67 (for those born in 1960 or later).

> **Tax practitioner planning.** Workers with an older full retirement age will have fewer months between age 67 and age 70 to earn delayed retirement credits toward their retirement benefit. Workers who take their Social Security at age 62 will see a bigger reduction from their full retirement benefit (i.e., 25% reduction if full retirement age is 66 and a 30% reduction if full retirement age is 67). Forty-two percent of men and 48% of women take their Social Security benefits at 62, the earliest they are eligible. Only 2% of men and 4% of women wait until 70 to collect the maximum benefits available.

CANCELLATION OF DEBT (§61(a)(12)/§108)

Cancellation of Debt Is Taxable Income Unless an Exception Applies

For those who have cancellation of debt income, exclusions apply if the debt is cancelled in bankruptcy or during insolvency, is a qualified farm debt, or is a qualified real property business debt (§108 and Form 982).

Discharge of Student Loan Indebtedness

Student loans discharged on account of death or total and permanent disability. Eligible for the exclusion include loans from: (1) US (or an instrumentality or agency), (2) a state (or political subdivision thereof), (3) certain tax-exempt public benefit corporations that control a state, county, or municipal hospital and whose employees have been deemed to be public employees under state law, (4) an educational organization that originally received the funds from which the loan was made from the U.S., a state, or a tax-exempt public benefit corporation, or (5) private education loans (§108(f)(5)(A)).

Cancellation of Student Loans

Revenue Procedure 2020-11 provides relief when the federal loans are discharged by the Department of Education under the Closed School or Defense to Repayment discharge process, or where the private loans are discharged based on settlements of certain types of legal causes of action against nonprofit or other for-profit schools and certain private lenders. The revenue procedure extends the relief provided to taxpayers who took out federal and private student loans to finance attendance at nonprofit or other for-profit schools not owned by Corinthian College, Inc. or American Career Institutes, Inc.

PERSONAL INJURY AWARD

Compensation for Injury or Sickness & Punitive Damages Taxable (§104)

Generally, compensation for personal injuries and sickness is excluded from gross income, specifically:

1. Amounts received under workers' compensation (§104(a)(1));

2. The amount of damages received (other than punitive damages) on account of personal physical injuries or physical sickness (§104(a)(2)). The exception generally excludes only physical injuries but not emotional distress (because of age, race, gender, or disability), libel, slander, and other nonphysical wrongs;
3. Amounts received through accident or health insurance (or through an arrangement having the effect of accident or health insurance) for personal injuries or sickness (§104(a)(3));
4. Amounts received as a pension, annuity, or similar allowance for personal injuries or sickness resulting from active service in the Armed Forces, Foreign Service, or Public Health Service (§104(a)(4)); and
5. Amounts received as disability income attributable to injuries incurred as a direct result of a terrorist or military action (as defined by §692(c)(2) and (§104(a)(5)).

Tax practitioner planning. More information is available from the IRS Lawsuits, Awards, and Settlements Audit Technique Guide (ATG).

Other Settlements and Awards Are Taxable

Court awards and damages. To determine if settlement amounts received by compromise or judgment are included in income, the item that the settlement replaces must be considered. Include the following as ordinary income:

1. Interest on any award.
2. Compensation for lost wages or lost profits.
3. Punitive damages, if they relate to a physical injury or physical sickness.
5. Damages for:
    a. Patent or copyright infringement,
    b. Breach of contract, or
    c. Interference with business operations.
6. Back pay and damages for emotional distress received to satisfy a claim under Title VII of the Civil Rights Act of 1964.
7. Attorney fees and costs (including contingent fees) where the underlying recovery is included in gross income.
8. Attorney fees and costs relating to whistleblower awards where the underlying recovery is included in gross income.

Legal Fees for Securing a Taxable Award

Legal fees paid to secure a taxable judgment are a miscellaneous itemized deduction subject to the 2% AGI limit. The TCJA suspended these miscellaneous itemized deductions for 2018 through 2025, thus the victim pays tax on the gross award even if he or she receives only a part after legal fees and costs.

Tax practitioner planning. Can the victim avoid tax by having the attorney fees paid directly to the attorney? The Supreme Court held that attorney fees, including those paid directly to the litigant's attorney on a contingent fee basis, are fully includible in the gross income of the litigant. *Comm. v. Banks*, 543 U.S. 426 (2005).

Exception. Section 62(a)(20) establishes an above-the-line deduction for attorney fees and court costs paid in connection with discrimination and certain other suits. Section 62(a)(21) establishes an above-the-line deduction for attorney fees and court costs associated with suits involving whistleblower claims.
The suit must involve —

- Unlawful discrimination,
- Certain claims against the federal government,
- A private cause of action under Medicare Secondary Payer statute, or
- A whistleblower award for providing information regarding violations of tax laws.

A business can no longer deduct a sex discrimination settlement or award if there is a nondisclosure agreement with the victim. The IRS clarified that the NDA does not prohibit the victim from deducting his or her legal fees above-the-line. See §162(q) FAQ.

> ***Question*:** Does §162(q) preclude me from deducting my attorney's fees related to the settlement of my sexual harassment claim if the settlement is subject to a nondisclosure agreement?
> *Answer*: No, recipients of settlements or payments related to sexual harassment or sexual abuse, whose settlement or payment is subject to a nondisclosure agreement, are not precluded by §162(q) from deducting attorney's fees related to the settlement or payment, if otherwise deductible. See Publication 525, Taxable and Nontaxable Income, for additional information on when all or a portion of attorney's fees may be deductible.

Emotional Distress Settlement Payments Taxable (*Daniel and Lynn Doyle v. Comm*., TCM 2019-8)

After Wacom Technology Corp. fired Daniel Doyle, he sued for breach of contract, antitrust violations, civil conspiracy, failure to pay wages, and wrongful discharge. The parties settled, and Wacom agreed to pay Doyle for his "alleged unpaid wages" and "alleged emotional distress." Wacom paid these amounts in two installments, and Doyle and his wife reported the payments on their 2010 and 2011 returns. However, they took "some weird deductions[1]" to zero out the emotional-distress payments.

Doyle says that he had always been "[v]ery, very healthy," but that all changed when Wacom fired him. He couldn't sleep, couldn't digest food properly, and had lots of other health problems. He struggled with chronic headaches, he couldn't concentrate, and he had neck, shoulder, and back pain. His relationship with his wife suffered, and he believes that he'll deal with some of these issues for the rest of his life. The court found that these ailments were the consequence of the emotional distress he suffered when Wacom fired him.

Settlement included $250,000 for emotional distress. Wacom agreed to pay Doyle "$350,000 as settlement for his alleged unpaid wages" and "$250,000 as settlement for his alleged emotional distress damages." Both amounts were to be paid in two installments — one in 2010 and the rest in 2011 — and the settlement agreement said Wacom would issue Doyle a Form W-2 for the "alleged unpaid wages" and a Form 1099 for the "alleged emotional distress damages." Wacom paid Doyle $125,000 of the "alleged emotional distress damages" in 2010 and the remaining $125,000 in 2011; it issued him a Form 1099-MISC for each payment.

[1] Descriptive words used by Judge Holmes in his decision.

Emotional distress settlement amount excluded as personal injury on Sch. C. The Doyles timely filed their 2010 return and attached to it a Schedule C on which they reported Wacom's first $125,000 payment. They reported on the Schedule C that their trade or business was an "unclassified establishment," and they deducted $23,584 for "legal and professional services" and $101,416 for "personal injury"— precisely enough to offset the entire $125,000 payment. They also deducted another $33,000 of legal fees on their Schedule A. The 2011 return was filed in a similar manner.

> **Note**. The return was prepared by a CPA with 40 years of experience and an MBA in finance and accounting from Cornell University.

Emotional distress payment was taxable. The court needed to determine if Doyle's "alleged emotional distress"was a personal physical injury or physical sickness. §104(a) specifically commands that "emotional distress shall not be treated as a physical injury or physical sickness," and case law tells us that emotional distress includes symptoms such as insomnia, headaches, and stomach problems that result from such distress. See *Pettit v. Comm.*, TCM 2008-87; see also HR Conf. Rept. No. 104-737, at 301 n.56 (1996), 1996-3 C.B. 741, 1041. The payment was held to be taxable. The IRS properly moved the legal fees to Schedule A as Miscellaneous Itemized Deductions. The legal fees were paid in connection with Doyle's employment, not his Schedule C.

VIATICAL SALE OF LIFE INSURANCE

Viatical Sale of Life Insurance Policy Subject to New Reporting Requirement § 6050Y; IR-2019-54, REG-10308318)

Congress is writing tax law in Latin! A viatical settlement (from the Latin "viaticum") is the sale of a policy owner's existing life insurance policy to a third party for more than its cash surrender value, but less than its net death benefit. Such a sale provides the policy owner with a lump sum.

Buyer must report purchase to the IRS! Section 6050Y(a) requires any person who acquires a life insurance contract or any interest in a life insurance contract in a reportable policy sale during any taxable year to report certain information regarding the transaction, including information about each recipient of payment in the reportable policy sale. The acquirer must also furnish written statements to each payment recipient and the issuer named in the return. The issuer, upon receiving such a statement, must file a return with the IRS and must also furnish a written statement to the seller. The IRS has released Form and Instructions for 1099-LS and Form and Instructions for Form 1099-SB, which provide specific instructions on these reporting requirements.

Health Savings Accounts

How much may be contributed to an HSA? Two types of contributions may be made to HSAs: regular and catch-up. Both have annual limits.

	2020		2019	
	Family	**Self only**	**Family**	**Self only**
Minimum health insurance deductible	**$2,800**	**$1,400**	$2,700	$1,350
Maximum out-of-pocket	**$13,800**	**$6,900**	$13,500	$6,750
Contribution limit	**$7,100**	**$3,550**	$7,000	$3,500
Additional catch-up contribution for taxpayer age 55 or older	**$1,000 per qualifying spouse**	**$1,000**	$1,000 per qualifying spouse	$1,000

> **Note**. As employees and employers struggle with higher medical costs, balances in health savings accounts increased to nearly $54 billion in 2018 from slightly more than $5 billion in 2008, according to investment-service provider Devenir.

Catch-up contributions may be made by individuals who are at least 55 years of age but not yet enrolled in Medicare. Qualified individuals with HSA-compatible health plans who are 55 or older may contribute an additional $1,000 to their HSA. These "catch-up" contributions may be made only to a person's own individual HSA account, not to a family HSA in his or her spouse's name (Pub. 969). For example, a wife may not contribute a catch-up contribution to a family HSA in the husband's name. She would have to open her own separate HSA.

HSA Contribution Limits Vary Based on Circumstances

Married couples are limited to one maximum HSA family contribution amount regardless of whether each spouse has a self-only or family HSA. For example, if the husband has a self-only HSA and the wife has a family HSA, the maximum 2020 HSA contribution is $7,100 and is split evenly between the spouses unless they agree to split the amount otherwise.

Penalty on HSA Nonqualified Distributions

There is an additional tax on distributions from an HSA that are not used for qualified medical expenses of 20% of the disbursed amount. The penalty is waived in cases of disability or death and for individuals age 65 and older. HSAs are not subject to required minimum distributions regardless of the account owner's age.

Medicare Premiums Can Be Reimbursed from an HSA (Pub. 969, pg 9)

Even though Medicare premiums are withheld from Social Security benefits, individuals who are 65 or older can use HSA money tax-free to pay premiums for Medicare parts B and D and Medicare Advantage plans (but not premiums for Medicare supplement policies), in addition to paying for other out-of-pocket medical expenses.

CARES. Over-the-Counter Drugs Can Be Reimbursed from HSA or FSA

CARES allows patients to use funds in HSAs and Flexible Spending Accounts for the purchase of over-the-counter medical products, including those needed in quarantine and social distancing, without a prescription from a physician. The change is effective retroactively to Jan. 1, 2020, and is permanent (Act §3702).

QUALIFIED STATE TUITION PROGRAMS §529

More than 13 million 529 accounts held $319.1 billion at the end of 2017. 529 plans will probably be more popular as a result of the TCJA, which allows distributions for K through 12 private school tuition.

529 Plans (§529©; Appropriations Act, Sec. 302, pg 642)

The Appropriations Act made two changes to 529 plans:

1. *Student loans.* SECURE provides that up to $10,000 (reduced by the amount of distributions so treated for all prior taxable years) may be withdrawn from a 529 plan for the purpose of paying principal or interest on any qualified education loan of the beneficiary or his or her siblings. Effective for distributions made after Dec. 31, 2018.

   Note. The loan interest paid off with the distribution is not deductible.

2. *Apprenticeship programs*. SECURE also provides that a qualified distribution includes tuition, books, supplies, and equipment required for Apprenticeship Programs if the program is properly registered and certified by the Department of Labor. Effective for distributions made after Dec. 31, 2018.

TCJA. Distributions for Elementary and Secondary School Tuition Are Qualified

The TCJA modified §529 plans to allow such plans to distribute not more than $10,000 in expenses for tuition incurred during the taxable year in connection with the enrollment or attendance of the designated beneficiary at a public, private, or religious *elementary* or *secondary* school. This limitation applies on a per-student basis, rather than a per-account basis. Thus, under the provision, although an individual may be the designated beneficiary of multiple accounts, that individual may receive a maximum of $10,000 in distributions free of tax, regardless of whether the funds are distributed from multiple accounts. Any excess distributions received by the individual would be treated as a distribution subject to tax under the general rules of §529.

K-12. The term "elementary or secondary" will be defined in future regulations to mean kindergarten through grade 12 as determined under state law, the same as for the Coverdell education savings account (Notice 2018-58).

> **Tax practitioner planning.** Most parents need to save for their children's college. Some parents are able to save so much money that they have plenty to pay for private K-12 tuition costs, as well as college costs. Rich parents, and grandparents, will find this new provision particularly attractive.

Section 529 Can Be a Gift Tax Planning Device (529 Plans: Questions and Answers)

The estate and gift tax rules applying to educational IRAs also apply to contributions to qualified tuition programs. Contributions to a qualified tuition program will be treated as a completed gift of a present interest from the contributor to the beneficiary at the time of the contribution. Annual contributions are eligible for the present law gift tax exclusion provided by §2503(b) and also are excludable for purposes of the generation-skipping transfer tax, provided that the contribution, when combined with any other contributions made by the donor to that same beneficiary, does not exceed the annual gift tax exclusion limit of $15,000, or $30,000 in the case of a married couple in 2020.

Special rule for contributions exceeding $15,000/$30,000 limit ($75,000/$150,000 for five-year gift). If a contribution in excess of $15,000 ($30,000 in the case of a married couple) is made in one year, the contributor may elect to have the contribution treated as if made ratably over five years beginning in the year the contribution is made. This rule allows donors to contribute up to $75,000 every five years ($150,000 in the case of a married couple) with no gift tax consequences, assuming no other gifts are made from the donor to the beneficiary in the five-year period. A gift tax return must be filed with respect to any contribution in excess of the annual gift-tax exclusion limit, and the election for five-year averaging must be made on the contributor's gift tax return. If a donor making an over $15,000 contribution dies during the five-year averaging period, the portion of the contribution that has not been allocated to the years prior to death is includible in the donor's estate.

> **Tax practitioner planning.** The 3.8% NII tax can be avoided if the income is used tax-free for college expenses.

ABLE PLANS §529A

The Stephen Beck, Jr., Achieving a Better Life Experience Act of 2014 (ABLE Act) was enacted on Dec. 19, 2014, as part of the Tax Increase Prevention Act of 2014. States can offer specially designed, tax-favored Achieving a Better Life Experience (ABLE) accounts to individuals who became disabled before age 26. ABLE accounts are designed to enable individuals with disabilities and their families to save for and pay for disability-related expenses. Any state can offer its residents the option of setting up one of these ABLE accounts, or if it chooses, contract with another state that offers such accounts. Contributions totaling up to the annual gift tax exclusion amount, $15,000 (2020), can be made to an ABLE account each year, and distributions are tax-free if used to pay qualified disability expenses.

> **Tax practitioner planning**. The National Disability Institute estimates that there are 58 million individuals with disabilities in the United States.

TCJA. Additional Beneficiary Contribution (§529A)

The TCJA temporarily increases the contribution limitation to ABLE accounts under certain circumstances. While the general overall limitation on contributions (the per-donee annual gift tax exclusion, e.g. $15,000 for 2020) remains the same, the limitation is temporarily increased with respect to contributions made by the designated beneficiary of the ABLE account. Under the temporary provision, after the overall limitation on contributions is reached, an ABLE account's designated beneficiary may contribute an additional amount, up to the lesser of (a) the federal poverty line[2] for a one-person household; or (b) the individual's compensation for the taxable year. Additionally, the provision temporarily allows a designated beneficiary of an ABLE account to claim the saver's credit for contributions made to his or her ABLE account.

> **Tax practitioner planning.** Although this change allows for contributions to the ABLE account for a working beneficiary, the potential of Medicaid taking funds in excess of $100,000 or taking funds at the death of the beneficiary may mean that a special needs trust is advisable for those with the means to contribute more for the beneficiaries.

Annual contribution limit. Contributions in a total amount up to the annual gift tax exclusion amount ($15,000 in 2020) can be made to an ABLE account on an annual basis, and distributions are tax-free if used to pay qualified disability expenses. Gifts to an ABLE account are considered completed gifts and are subject to annual gifting limits.

TCJA. Rollovers Between Qualified Tuition Programs and Qualified ABLE Programs (§529)

For 2018 through 2025, the TCJA allows for amounts from qualified tuition programs (§529 accounts) to be rolled over to an ABLE account without penalty, provided that the ABLE account is owned by the designated beneficiary of that §529 account, or a member of such designated beneficiary's family. Such rolled-over amounts count towards the overall limitation on amounts that can be contributed to an ABLE account within a taxable year ($15,000 for 2020). Any amount rolled over that is in excess of this limitation is includible in the gross income of the distributee in a manner provided by §72.

ABLE states. See ABLE National Resource Center website for the states that are currently working on ABLE bills or that have enacted ABLE legislation.

Qualified beneficiary. The account owner and designated beneficiary of the account is the disabled individual. In general, a designated beneficiary can have only one ABLE account at a time and must have been disabled before his or her 26th birthday.

Disability designation. For purposes of the disability designation, the proposed regulations provide that the phrase "marked and severe functional limitations" used in §529A(g)(4) means the standard of disability in

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[2] The 2020 federal poverty line for a one-person household is $12,490 in the continental US, $14,680 in Hawaii and $15,950 in Alaska.

the Social Security Act for children claiming benefits under the Supplemental Security Income for the Aged, Blind, and Disabled (SSI) program based on disability.

Qualified disability expenses. Qualified disability expenses are expenses that relate to the designated beneficiary's blindness or disability and help that person maintain or improve health, independence, and quality of life. For example, they can include housing, education, transportation, health, prevention and wellness, employment training and support, assistive technology and personal support services, and other expenses.

Means-tested programs. In general, an ABLE account is not to be counted in determining the designated beneficiary's eligibility for many federal means-tested programs, or in determining the amount of any benefit or assistance provided under those programs, except to the extent that the balance in the ABLE account exceeds $100,000.

Death of the beneficiary. A qualified ABLE program must provide that, upon the designated beneficiary's death, any state may file a claim for the amount of the total medical assistance paid for the designated beneficiary under the state's Medicaid plan after the establishment of the ABLE account.

> **Tax practitioner planning**. Because a balance in the ABLE account can be seized for medical expenses at the death of the beneficiary, the account trustee should pay out from the account in a timely manner.

IRS reporting forms. The IRS developed two new forms that ABLE account programs will use to report relevant account information annually to designated beneficiaries and the IRS: (1) Form 1099-QA for distributions and (2) Form 5498-QA for contributions.

> **Tax practitioner planning**. A Special Needs Trust is a better option for high-net-worth individuals with disabled children or grandchildren, as it allows for larger contributions. Advise your client to consult with an attorney.

DIVORCE SETTLEMENTS

Property Settlement vs. Alimony (§1041)

Generally, no gain or loss is recognized on transfers of property between spouses or on transfers of property to a former spouse that are "incident to a divorce" (§1041(a); §1041(d)). This tax-free §1041 transfer is treated as a gift, meaning that neither spouse recognizes any income as a result of the transfer. The carryover basis rules apply. Alimony, on the other hand, creates both income and deductions. Determining if the transfer of property is property settlement or alimony can often be difficult, depending on the intent of the parties. In 1984, to eliminate the questions plaguing the courts concerning the taxpayers' intent and the nature of payments, Congress amended §71 in favor of following six objective tests (including the child support override rule). If a payment satisfies all of these factors, then the payment is alimony; if it fails to satisfy any one of these factors, then the payment is not alimony.

> **Example**. Beverly and Bob are divorcing. Their marital property is valued at $2 million. They have agreed that Beverly will keep the house with a FMV of $1 million and Bob will keep the rental

property with a FMV of $1 million. While that is an equal division of the FMV of their properties, it may not be an equal division of after-tax value. Section 1041 requires the transferee to take the transferor's tax basis in the property received. If we say that Beverly and Bob have a basis of $800,000 in their personal residence and an adjusted basis (after depreciation and §1031 deferred gains) of $200,000 in the rental property, the tax consequences of a subsequent sale are very different for Beverly and for Bob.

Tax practitioner planning. Always take into consideration the tax basis of property divided in a divorce.

Definition of (1) a divorce or separation instrument and (2) the incident to divorce 6-year transfer rule. A transfer of property is treated as related to the cessation of the marriage if the transfer is pursuant to a "divorce or separation instrument" and the transfer occurs not more than 6 years after the date on which the marriage ceases. A "divorce or separation instrument" means (A) a decree of divorce or separate maintenance or written instrument incident to such a decree, (B) a written separation agreement, or © a decree requiring a spouse to make payments for the support or maintenance of the other spouse (§1.1041-1T(b), Q&A 7).

Sale of Marital Business to Ex-Wife Qualified as Transfer "Incident to a Divorce" (*Joseph R. Belot v. Comm.*, TCM 2016-113)

Joseph Belot and Ms. Belot were married from July 1, 1989, through Jan. 8, 2007. During their marriage, they owned and operated three business. At their divorce on Jan. 8, 2007, the family court entered a judgment of divorce which incorporated a property settlement agreement. The property settlement agreement gave each spouse a 50% ownership interest in each of the three businesses.

Within a few months, the taxpayers decided they couldn't live or work together. On Sep. 21, 2007, Ms. Belot filed a complaint contending that Mr. Belot had mismanaged the businesses and sought to remove him as director and employee and to compel him to sell his interests to her. On Apr. 11, 2008, Mr. Belot and Ms. Belot entered into an agreement regarding the lawsuit. Pursuant to the 2008 settlement agreement, Ms. Belot agreed to purchase from Mr. Belot all of his interests in the three businesses for a total of $1,580,000.

Is the sale taxable to Mr. Belot? Under §1041, no gain or loss is recognized on a transfer of property from an individual to (1) a spouse, or (2) a former spouse, but only if the transfer is *incident to the divorce*.

What is incident to a divorce? A transfer of property is incident to the divorce if such transfer (1) occurs within one year after the date on which the marriage ceases, or (2) is related to the cessation of the marriage. The transfer is related to the cessation of the marriage if it is pursuant to a divorce or separation instrument and the transfer occurs within six years of the divorce (§1.1041-1T(b), Q&A-7).

Why did the IRS argue that the transfer was a taxable sale? The IRS argued that because the transfer was under a second agreement, it did not qualify for nonrecognition. The IRS also argued that since the transfer was related to a business dispute, it did not qualify for nonrecognition. They were wrong.

Court ruled that the sale was a transfer incident to the divorce and not taxable. The court disagreed with the IRS arguments, saying that while the regulation provides that there is a presumption that §1041 does not apply to "[a]ny transfer not pursuant to a divorce or separation instrument," the regulation makes clear that the presumption may be rebutted "by showing that the transfer was made to effect the division of property owned by the former spouses at the time of the cessation of the marriage" (*Young v. Comm., 240 F.3d 369, 374 (4th Cir. 2001), aff'g 113 T.C. 152 (1999)*). Neither §1041, nor the regulations, limit application of §1041 to one, or the first, division of marital property. While the sale included the transfer of business interests, §1041 and the regulations apply to marital property which may consist of business-related property.

> **Tax practitioner planning**. The decision was good news for Mr. Belot, the seller, as the sales proceeds were not taxable. But what about his ex-wife? The amount she paid for Mr. Belot's interest does not increase her basis in the business interests. Her basis is the same as their basis was.

> **Also see.** PLR 201901003 where the payment to ex-spouse was transfer "incident to the divorce" even though past the usual six-year test because an amended order started the six-year presumption over again.

ALIMONY/SPOUSAL SUPPORT

Alimony Reporting Gap Continues to Increase (TIGTA 2019-040-48)

Maybe because there are discrepancies between the amount of alimony deducted by payers and alimony income reported, Congress decided to eliminate the alimony deduction and correspondingly make alimony income non-taxable.

An Aug. 19, 2019, TIGTA audit to follow up on its 2014 report on the alimony tax gap found that the discrepancy between deductions and income reported increased by 38% in six years, to $3.2 billion for tax year 2016. Despite the earlier findings and recommendations, most of which the IRS accepted more than five years ago, TIGTA stated in its latest report that the IRS still lacked sufficient systemwide processes to identify and address alimony discrepancies and "*has yet to adequately address the substantial compliance gap*."

IRS Matching Program Catches Recipient's Unreported Alimony Income (*Maria Faust v. Comm.,* TCM 2019-105)

Maria Faust separated from her spouse in 2013. The Circuit Court for the City of Virginia Beach issued a pendente lite order on Aug. 2, 2013, requiring Mr. Faust to pay Mrs. Faust $2,271 per month beginning on Aug. 2, 2013, and continuing until further order of that court. The order contained no other provisions regarding the termination of payments and made no mention of the tax treatment of the payments.

Mr. Faust claimed an alimony deduction. Mrs. Faust did not report alimony income. The IRS's (slowly deployed) matching program picked up the discrepancy and audited Mr. Faust. When the alimony deduction was found to be proper on his tax return, the IRS audited Mrs. Faust's return.

The court found that the $27,245 Mrs. Faust received as alimony or separate maintenance from her ex-husband during the 2015 tax year was taxable alimony.

1. The requirements of §71(b)(1)(A) were met because all of the payments were actually received under a divorce or separation agreement.

2. The agreement and decree provided no evidence that a non-alimony designation was intended in substance. The §71(b)(1)(B) restriction was therefore not applicable.
3. The order required Mr. Faust to pay Mrs. Faust $2,271 per month beginning on Aug. 2, 2013, and continuing until further order of the circuit court. The order had no other provisions regarding the termination of payments. Va. Code Ann. sec. 20-109(D) (2016) provides: "*Unless otherwise provided by stipulation or contract, spousal support and maintenance shall terminate upon the death of either party or remarriage of the spouse receiving support.*" Thus, Va. Code Ann. sec. 20-109(D) clarifies the spousal support termination date. The order met the requirements of §71(b)(1)(D).

TCJA. Alimony Deduction Repealed After Dec. 31, 2018 (§215)

The deduction for alimony and separate maintenance payments repealed starting in 2019. Correspondingly, alimony and separate maintenance payments are not included in income. The provision is effective for any divorce or separation instrument executed after Dec. 31, 2018, or for any divorce or separation instrument executed on or before Dec. 31, 2018, and modified after that date, if the modification expressly provides that the amendments made by this section apply to such modification. Divorce instruments executed prior to 2019 are grandfathered.

> **Note**. This is a permanent repeal, not one that sunsets like other individual provisions.

Prenuptial. Many prenuptial agreements include provisions about how much a spouse would pay in alimony in the event of a divorce. The couple had a deal, and now Congress has changed the game retroactively.

> **Tax practitioner planning.** Advise clients, especially wealthy ones who you suspect have a prenuptial, to contact their attorney.

TCJA. Alimony trusts repealed. The TCJA repealed §682 which provided, prior to the repeal of §71 for agreements executed after Dec. 31, 2018, that a spouse who is divorced or legally separated under a decree of divorce or of separate maintenance must include in income the income of any trust to which he or she is entitled to receive and which, except for this section, would be includible in the gross income of the grantor spouse.

> **Note**. Alimony trusts allowed divorcing spouses to avoid some of the restrictions imposed by §71. Section 71, prior to its repeal by the new law, required that alimony cease on the death of the payee spouse, imposed recapture requirements on excess alimony payments, and imposed restrictions on alimony payments related to contingencies related to a child. Alimony trusts were exempt from these provisions.

Divorce subsidy. The disallowance of the alimony deduction (and the corresponding change to alimony income) is expected to raise an estimated $6.9 billion over the next decade.

Acrimony rather than matrimony. Imagine the anger at the bargaining table when the payor figures out that child support AND alimony are not deductible. Will marital courts take tax into consideration when awarding child support and alimony? What kind of arguments between the divorcing spouses will arise from this drastic change to the payor spouse's after-tax income? Was the spread between the payor spouse's tax bracket and the recipient spouse's tax bracket so dramatic as to require the closing of this "loophole?"

Tax practitioner planning. Instead of alimony, perhaps a different split of marital property will help the payor, especially if the "extra" is a low basis asset or a zero basis retirement plan.

Alimony Deduction/Income for Agreements Executed Before Jan. 1, 2019 (§71 & §215)

Note. The IRS added line 18c to Schedule 1 of the 2019 Form 1040 asking taxpayers who claim a deduction for paying alimony to provide the date of their divorce or separation agreement to confirm that the deduction qualifies.

Alimony and separate maintenance payments are deductible from income by the payor spouse if includible in income of the payee spouse. For payments made to, or on behalf of, spouses (or former spouses) to qualify as deductible alimony, very specific requirements must be met:

1. Payment must be made in cash (transfer of property or services do not qualify).
2. Payments must be received by spouse (or on behalf of spouse, i.e., indirect alimony).
3. Payment is required under divorce or written separation agreement (i.e., no voluntary payments).
4. There is nothing in the agreement designating the payment is not alimony or that the payment is not taxable to the recipient spouse.
5. Payee and payor spouse cannot live together (no joint return).
6. Alimony must stop after payee spouse's death (state statutes may require if agreement silent).
7. Payments are not related to a child-related contingency (e.g., child reaches age 18).
8. Recapture may be required if "excess front-loading" (i.e., if the alimony payments in the first year exceed the average payments in the second and third year by more than $15,000 and to the extent the payments in the second year exceed the payments in the third year by more than $15,000).

Alimony Requirement #4: Payment of Sallie Mae Loan of Ex-Spouse Not Alimony (*Jerry Vanderhal v. Comm.*, TCS 2018-41)

Jerry Vanderhal divorced in 2011. The divorce agreement included a reference to a Sallie Mae student loan account that related to his former spouse. That reference was found in the "Division of Community Debts" section of the agreement and obligated Mr. Vanderhal to "assume and hold his former spouse harmless" from that debt. The agreement also included a section titled "Tax Free Transfers" that stated the parties believe and agree that the transfers of property between them required by the agreement were tax-free transfers of property between them and were therefore tax-free transfers of property made pursuant to §1041 and were not taxable sales or exchanges of property or payments for alimony, except where the agreement specifically denoted payments as such.

On his 2013 tax return, Mr. Vanderhal claimed an alimony deduction for the payments he made on the Sallie Mae student loan. The alimony was disallowed because the payments did not fit within the definition of alimony. Instead, the payments constituted a division of property. Specifically the divorce decree designated the payment as not allowable as a deduction under §215(b)(1)(B) [which was repealed in 2017].

Alimony Requirement #6: Tax Court Allowed Alimony Paid in Arrears Under Court Order (*Jeffrey and Sandra Siegel v. Comm.*, TCM 2019-11)

Jeffrey Siegel was divorced in 2003. He was required to make spousal maintenance payments of $10,110 per month and child support of $5,000 per month. After the divorce, Siegel's business went into bankruptcy, his income fell drastically, and he fell behind in making the payments required by the judgment of divorce. On Feb. 12, 2012, after several legal proceedings, the Supreme Court of New York found Siegel to be in contempt and sentenced him to 150 days in jail unless he paid $225,000 for arrearages owed to his former spouse. The sole issue for decision was whether $225,000 that Siegel paid in response to the 2012 order was deductible.

Was payment required even after former spouse's death? To be deductible as alimony, among other requirements that the IRS agreed were satisfied, there must be "no liability to make the payments for any period after the death of the payee spouse and there is no liability to make any payment (in cash or property) as a substitute for such payments after the death of the payee spouse."

Was the 2012 court order a "money judgment"? Alimony arrearages retain their character when paid and are deductible if paid in arrears. A money judgment is not alimony because the requirement to pay the judgment extends beyond the death of the former spouse. The court found that "the 2012 order entered no judgment in favor of Siegel's ex-spouse and by its terms provided her with no means of enforcing the judge's order. By its terms the 2012 order clearly is not a money judgment. The 2012 order is a contempt order to achieve the payment of alimony arrearages."

Alimony Requirement #6: Payments Did Not End at Death of Recipient Spouse (*Mark Hexum v. Comm.*, CA-7, 2018-1 USTC ¶50,168, Feb. 27, 2018)

Mark Hexum paid his ex-wife, Sherri, half of the net gain from the sale of their marital home because the Illinois family court ruled payment was required under their divorce agreement. Mark had been responsible for the house's mortgage and expenses after the divorce, and in his view, the equity accrued before the sale was not "marital property" that he should have been made to split with his ex-wife when the house was sold. He characterized the payment as alimony and deducted it on his tax return.

Mark and Sherri settled on the terms of their divorce in a dissolution agreement. As alimony, Mark agreed to pay Sherri a percentage of his salary and of the incentive-based pay that he received. The agreement provided that "*maintenance is taxable income to Sherri and deductible by Mark [under] Section[s] 71(a) and 215 of the Internal Revenue Code.*" It incorporated Section 510 of the Illinois Marriage and Dissolution of Marriage Act, which provided that unless the agreement says otherwise, "*the obligation to pay future maintenance is terminated upon the death of either party*" (750 ILCS 5/510© (2012).

In a separate paragraph regarding the marital home, Mark and Sherri agreed to sell the house and divide equally "the net equity of said property," and they agreed that Mark would "pay all expenses associated with the … property until [then]." Accordingly, from when the agreement took effect to when the house was sold, Mark paid the mortgage on the property; he also paid to replace some carpeting. In total, he paid $25,906. Mark believed that before the gain from the sale was divided, he should first be reimbursed that sum as non-marital property. Sherri moved the family court to hold Mark in civil contempt when he withheld the money. The circuit judge rejected Mark's view of the agreement and directed him to pay Sherri half of the net gain.

On his 2013 tax returns, without consulting a lawyer or accountant, Mark told his tax preparer that he paid alimony in a total amount that included the $12,953 payment to Sherri, and he claimed a deduction. The IRS determined the payment was not alimony under §71 and disallowed the deduction.

The Tax Court ruled for the Commissioner. The Tax Court said that "it is undisputed by [Mark] that he would have continued to have an obligation to make the payments on the gain from the real estate even if his former spouse had passed away before the sale." Thus, the Tax Court concluded, the payment did not qualify as alimony (§71(b)(1)(D)).

Mark appealed the Tax Court decision. Mark appealed and argued that the equity accrued in the house after the divorce was not marital property under Illinois state law, and thus, he reasoned, his payment of half of its value was necessarily alimony. He also said the payment qualified as alimony under §71(b), as described on the IRS's website, and so was properly deducted.

> **Note**. As he did in the Tax Court and in the family-court proceedings, at the Appeals Court hearing Mark leveled accusations of corruption and incompetence against the family court and his divorce attorneys and disputed the legitimacy of the dissolution agreement.

Appeals Court agrees payment wouldn't end at death. The Appeals Court found that Illinois law unambiguously provided that the payment at issue would not terminate at Sherri's death. Mark was to transfer half of the net gain from the sale. This is a fixed amount and so is categorized either as maintenance in gross or a property settlement. (And because periodic maintenance was ordered, it must be the former.) Regardless, Mark's obligation would not terminate at Sherri's death. Because the payment did not meet the requirement of §71(b)(1)(D), it is not alimony.

Alimony Requirement #6: Payment Obligation Would Not Terminate at Ex-Spouse's Death (*Derrick Davidson v. Comm.*, TCM 2018-38)

Attorney Derrick Davidson was ordered by the divorce court to pay the joint debts of Mr. Davison and his ex-spouse. The divorce court did not award Mrs. Davidson alimony. On his 2012 returns, Mr. Davidson deducted alimony payments of $22,176, representing half of the payments he made on the joint debts during that year.

Mr. Davidson was jointly and severally liable for the debts. He would normally be entitled to the right of contribution for his ex-spouse's half of their joint debt. (See *Cologne v. Comm.*, TCM 1999-102.) However, in the amended divorce decree, the divorce court divested Mr. Davidson of that right. Thus, the question the Tax Court had to decide is whether Mr. Davidson's right of contribution would be restored if his ex-spouse died. If it would be restored, then Mr. Davidson's obligation to make the payments on his ex-spouse's behalf would terminate upon her death and the payments at issue would satisfy §71(b)(1)(D). Because the divorce decree was silent as to termination at death, the divorce court looked to Arkansas law and found that Arkansas courts have the authority to allocate debt in a divorce, and nothing in Arkansas law made the payments alimony that terminated at the recipient's death. The alimony deduction was disallowed.

> **Tax practitioner planning.** The written agreement should always indicate that alimony payments end at the death of the payee-spouse, whether they are monthly or lump sum. A better drafting of the agreement might have kept this taxpayer out of court.

Alimony Requirement #7. Alimony Payments Were Child Support when Child Turned 18 (*Timothy C. Biddle v. Comm.*, TCM 2020-39)

The amount of any payment that is subject to "contingencies involving child" must be considered payment made for the support of the child (§71(c)(2)). "Child * * *attaining a specified age" is an example of such a contingency (§71(c)(2)(A)).

Court conclusion. Tim Biddle deducted alimony of $28,000 on his 2015 return because the payments to his ex-spouse were made pursuant to his obligation to pay "alimony" under the decree. The IRS contended that Biddle's alimony payments were actually nondeductible child support payments because one of the contingencies that would terminate the payments was Biddle's youngest child's 18th birthday. The decree in the instant case clearly stated that the designated alimony payments would terminate on the contingency that Mr. Biddle's youngest child turns 18. The court agreed with the IRS. The payments were child support.

MOVING EXPENSE DEDUCTION / REIMBURSEMENT

TCJA. Moving Expense Deduction Suspended (§217, §132, §82)

The deduction for moving expenses has been suspended for taxable years 2018 through 2025. However, during that suspension period, the provision retains the deduction for moving expenses and the rules providing for exclusions of amounts attributable to in-kind moving and storage expenses (and reimbursements or allowances for these expenses) for members of the Armed Forces (or their spouse or dependents) on active duty that move pursuant to a military order and incident to a permanent change of station.

There is a corresponding change to moving expense reimbursements. The TCJA suspends the exclusion from gross income and wages for qualified moving expense reimbursements except in the case of a member of the Armed Forces of the United States on active duty who moves pursuant to a military order.

> **Tax practitioner planning.** This change isn't hard on the employee of Microsoft, Apple, or other big employers. The employee will still be reimbursed for his or her move. The reimbursement will just need to be grossed up by the employer for taxes. The employee of the big company isn't hurt. Who is? The individual who moves first and then finds a job, the new employee of a small employer who can't reimburse moving expense, the new employee of a nonprofit that has limited funds to reimburse a move and expects the new employee to pay for part of the move. In other words, the small person is hurt by the suspension of the moving expense deduction.

STANDARD DEDUCTION

Standard Deduction (§1(c)(2)(A), §2(a), §32, §63©)

The standard deduction increased across all filing statuses for 2018 through 2025. The amount of the standard deduction is indexed for inflation annually after 2018.

Standard Deduction	2019	**2020**
Married Filing Joint & Qualifying Widow(er)	$24,400	**$24,800**
Head of Household	$18,350	**$18,650**
Single	$12,200	**$12,400**
Married Filing Separate	$12,200	**$12,400**
65/blind- MFJ	$1,300	**$1,300**
65/-Single	$1,650	**$1,650**

> **Tax practitioner planning.** Because of the increased standard deduction, the White House Council of Economic Advisers estimates that the number of Americans claiming itemized deductions will drop from just over 26% under prior law to less than 8% under tax reform. In other words, 92% of taxpayers will use the standard deduction.

What Does the Increase in the Standard Deduction Mean?

Fewer clients will itemize their deductions. For some clients, medical expenses, contributions, property taxes, and gambling losses will provide no tax benefit.

CARES Provides a Little Relief

Beginning in 2020, CARES adds a deduction to the calculation of gross income for the amount (not to exceed $300) of qualified charitable contributions made by an eligible individual (§62(a)(22)). An "eligible individual" is an individual who does not itemize deductions (§62(f)(1)).

> **Note**. This change is only for non itemizers.

Qualified contribution. A "qualified charitable contribution" is a §170© contribution:
1. made in cash,
2. allowable under §170 (without regard §170(b)),
3. to a §170(b)(1)(A) organization (not to a §509(a)(3) organization), and
4. not for the establishment or maintenance of a donor advised fund under §4966(d)(2).

Example. Harry and Bess had $15,000 of itemized deductions in 2017, $5,000 of which were donations to their church. In 2020, their standard deduction is $24,800, whether they give $5,000 to charity or not. As long as Harry and Bess make at least a $300 cash contribution, they will also be able to deduct $300 in arriving at their AGI.

Standard Deduction of a Dependent

In 2020, the standard deduction for an individual who may be claimed as a dependent by another taxpayer may not exceed the greater of (1) $1,100, or (2) the sum of $350 and the individuals' earned income (2019 and 2020).

ITEMIZED DEDUCTIONS

TCJA. Itemized Deductions - Phaseout (§25D)

The overall limitation on itemized deductions was suspended from 2018 through 2025.

STANDARD MILEAGE RATES

The 2020 Standard Mileage Rate for Medical, Moving, and Charity

The IRS provides optional standard mileage rates for self-employed individuals or other taxpayers to use in computing the deductible costs paid or incurred for operating a passenger automobile. In addition, employees may be reimbursed by their employers for the business use of their automobile at the business mileage rate. The 2020 medical and moving standard mileage rate is 17 cents per mile. The rate for charitable miles remains at 14 cents.

Standard Mileage Rates	2018	2019	**2020**
Medical	18¢	20¢	**17¢**
Moving	-0- except for Military move	-0- except for Military move	**-0- except for Military move**
Charity	14¢	14¢	**14¢**
Business	54.5¢	58¢	**57.5¢**

MEDICAL, DENTAL, ETC., EXPENSES

AA. Medical Expense Deduction AGI Limit is 7.5% (not 10%) for 2019 and 2020 §213(f); Appropriations Act, Sec. 103, pg 695)

AGI haircut is 7.5%, not 10%. For taxable years ending before Jan. 1, 2021, the threshold for deducting medical expenses is 7.5% (was 10% for taxable years ending after Dec. 31, 2018). This threshold also applies for AMT purposes. In 2021, the AGI threshold is scheduled to increase to 10%.

Tax practitioner planning. Higher insurance premiums and higher co-pays may mean that more clients will qualify for medical expenses, especially if we remind clients of the advantage of bunching two years of medical into one year.

Are Expenses for an Emotional Support Dog Deductible as Medical?

Maybe. Information letter 2010-0129 says that the costs of buying, training, and maintaining a service animal to assist an individual with mental disabilities may qualify as medical care if the taxpayer can establish that the taxpayer is using the service animal primarily for medical care to alleviate a mental defect or illness and that the taxpayer would not have paid the expenses but for the disease or illness. The taxpayer needs to prove both a (1) *primarily for* and (2) *but for*.

What your client will need. The client will need a letter from their doctor with a diagnosis and a prescription for the dog to treat or mitigate the diagnosed condition. Be prepared to show that the client wouldn't have had the expense of the dog "but for" the diagnosis. It would be best if the support dog was acquired after the diagnosis.

Service dog. The costs of buying, training, and maintaining a guide dog or other service animal to assist the visually impaired or hearing disabled person or other person with physical disabilities can be included in medical expenses (IRS Pub. 502).

Tax practitioner planning. Is this new? No, but are you seeing a lot of dogs in the airport and on airplanes that are emotional-support animals? It's only a matter of time until your client asks if they can deduct the vet bills for their pooch.

Long-Term Care Premium Limits

Annual long-term care insurance premiums are deductible as a medical expense up to:

Age of Individual Before Close of Tax Year	Maximum Deductible Premium		
	2018	2019	**2020**
Not more than 40	$420	$420	**$430**
More than 40 but not more than 50	$780	$790	**$810**
More than 50 but not more than 60	$1,560	$1,580	**$1,630**
More than 60 but not more than 70	$4,160	$4,220	**$4,340**
More than 70	$5,200	$5,270	**$5,430**

Tax practitioner planning. The government estimates that half of all seniors will need long-term care, whether it is in-home, assisted living, or nursing home care. About one in six will pay $100,000 or more for long-term-care services.

Tax practitioner planning. Ninety percent of the carriers that were selling long-term care insurance 10 years ago have withdrawn from the business. Those that remain are tightening underwriting standards and are raising premiums on existing policies. Sales of new stand-alone policies are down by 75% from a decade ago.

STATE AND LOCAL TAXES

Tax practitioner planning. The deduction for state and local taxes has been a feature of the US tax code since the Civil War.

TCJA. Schedule A State and Local Tax (SALT) Deduction Limited to $10,000

Limitation doesn't apply to investment and trade or business property. For 2018 through 2025, an individual, as a general matter, is allowed to deduct state, local, and foreign property taxes and state and local sales taxes only when paid or accrued in carrying on a trade or business, or an activity described in §212 (relating to expenses for the production of income). Thus, the provision allows only those deductions for state, local, and foreign property taxes, and sales taxes, that are presently deductible in computing income on an individual's Schedule C, Schedule E, or Schedule F on such individual's tax return.

$10,000 limit exception. A taxpayer may claim an itemized deduction of up to $10,000 ($5,000 for married taxpayer filing a separate return) for the aggregate of (i) state and local property taxes not paid or accrued in carrying on a trade or business, or an activity described in §212, and (ii) state and local income, war profits, and excess profits taxes (or sales taxes in lieu of income taxes, etc.) paid or accrued in the taxable year. Foreign real property taxes may not be deducted under this exception.

Tax practitioner planning. According to IRS stats, half of SALT deductions come from six states: California, New York, New Jersey, Illinois, Pennsylvania, and Texas. New York and California receive more than one-third of the deduction's total value nationwide. In 2016, New York residents who itemized their deductions had an average SALT deduction of $22,000. Eighty-eight percent of SALT deductions benefit those with income in excess of $100,000.

IRS Issues Proposed Regs to Block State Moves to Avoid SALT Limitation (NPRM REG-112176-18, Aug. 23, 2018)

States with high income taxes and high property taxes are looking for ways to avoid tax reform's $10,000 limitation on Schedule A tax deductions. The IRS issued proposed regulations to reduce charitable contributions if state tax credits are received in exchange.

The proposed regulations generally provide that if a taxpayer makes a payment or transfers property to or for the use of an entity listed in §170© and the taxpayer receives or expects to receive a state or local tax credit in return for such payment, the tax credit constitutes a return benefit, or *quid pro quo*, to the taxpayer and reduces the charitable contribution deduction.

Example. If a state grants a 70% state tax credit and Sharon contributes $1,000 to the New Jersey Charitable Foundation, she receives a $700 state tax credit. Sharon must reduce the $1,000 contribution by the $700 state tax credit, leaving an allowable contribution deduction of $300 on her federal income tax return.

The proposed regulations include a de minimis exception under which a taxpayer may disregard a state or local tax credit if such credit does not exceed 15% of the taxpayer's payment or 15% of the fair market value of the property transferred by the taxpayer. Accordingly, under the proposed regulations, a state or local tax credit that does not exceed 15% does not reduce the taxpayer's federal deduction for a charitable contribution.

Example. Karen makes a $1,000 contribution to the Santa Clara County Public School Scholarship Fund. She is not required to reduce the $1,000 deduction on her federal income tax return if the state or local tax credit received or expected to be received is no more than $150.

Tax practitioner planning. Even before tax reform's Schedule A tax limitation, 33 states had established programs that gave state or local credits for charitable contributions. South Carolina, Georgia, Alabama, and Arizona gave 100% credits for contributions to school scholarship programs.

INTEREST

The number of homeowners who benefitted from the home mortgage deduction is approximately 13.8 million, down from 32.3 million in 2017. After the law change, the deduction saves taxpayers $25 billion, down from $60 billion in 2017. Most of this decline in benefit is due to the doubling of the standard deduction.

TCJA. Mortgage Interest Deduction Modified for 2018 Through 2025

Acquisition Indebtedness (§163(h)(3)(B)(i))

$750,000 acquisition debt. The TCJA provides that, in the case of taxable years beginning after Dec. 31, 2017, and beginning before Jan. 1, 2026, a taxpayer may treat no more than $750,000 as acquisition indebtedness ($375,000 in the case of married taxpayers filing separately). In the case of acquisition indebtedness incurred before Dec. 15, 2017, this limitation is $1,000,000 ($500,000 in the case of married taxpayers filing separately). Thus, acquisition indebtedness incurred before Dec. 15, 2017, is grandfathered.

Binding contract exception. A taxpayer who entered into a binding contract before Dec. 15, 2017, to close before Dec, 31, 2017, and who did close the purchase by Apr. 1, 2018, is treated as having incurred the acquisition debt before Dec. 15, 2017.

Sunset of provision. For taxable years beginning after Dec. 31, 2025, a taxpayer may treat up to $1,000,000 ($500,000 in the case of married taxpayers filing separately) of indebtedness as acquisition indebtedness, regardless of when the indebtedness was incurred.

Tax practitioner planning. Acquisition indebtedness includes debt on both first and second homes incurred in acquiring, constructing, or substantially improving a qualified residence of the taxpayer and which is secured by the residence. The proposal to repeal the interest deduction on a second home was dropped in the final bill.

Example. Harry and Bess, a married couple, purchased their home in May 2016. Their acquisition debt was $1.5 million. Since Harry and Bess incurred their mortgage debt before Dec. 15, 2017, their mortgage is grandfathered and they may deduct interest on $1 million of acquisition debt on their 2020 tax return. If the mortgage interest paid in 2020 is $68,000, they may deduct only $45,333 of the interest (1.0/1.5 x $68,000).

Example. Harry and Bess, a married couple, purchased their home in June 2020. Their acquisition debt was $1.5 million. Since Harry and Bess incurred their mortgage debt after Dec. 15, 2017, their mortgage is not grandfathered and they may deduct interest on only $750,000 of acquisition debt on their 2020 tax return. If the mortgage interest paid in 2020 is $68,000, they may deduct only $34,000 of the interest (.750/1.5 x $68,000).

Example- continued. If Harry and Bess are unmarried, they may each deduct interest on $750,000 of acquisition debt on their 2020 tax return. Married separate taxpayers are limited to $375,000 each.

Refinancing acquisition indebtedness. The $1,000,000 limitation continues to apply to any indebtedness incurred on or after Dec. 15, 2017, to refinance a qualified residence indebtedness incurred before that date to the extent that the indebtedness resulting from the refinancing does not exceed the amount of the refinanced debt.

Example. George and Barbara refinanced their home in 2020 when their acquisition debt had a balance of $900,000. They withdrew $200,000 at the refinance to pay off personal bills. They may only deduct interest on a portion of the new mortgage (even if they used the proceeds from the refi to make improvements to their house).

Minimizing the impact on property taxes and mortgage interest with a home office. The Schedule A tax deduction is limited to $10,000. It also limits the home mortgage interest deduction to a loan of $750,000 (the prior law $1,000,000 debt limit is grandfathered for loans originating before Dec. 15, 2017). If part of the house is used for a qualifying home office, a percentage of property tax and mortgage interest is deductible on Form 8829. This allocation may help avoid some of the negative impact of the TCJA.

Example. John uses 20% of his home regularly and exclusively as the principal place of business for his consulting firm. He gets no benefit for the property taxes he pays because his state income tax exceeds the $10,000 limit. His home acquisition debt is $900,000 (exceeding the $750,000 limit by $150,000). John avoids some of the impact of the TCJA change to his Schedule A deductions as he is able to claim 20% of his property tax and mortgage interest as home office expense on his Schedule C.

Home Equity Indebtedness (§163(h)(3)(C)(i))

The deduction for interest on home equity indebtedness suspended from 2018 to 2026. Thus, for taxable years beginning after Dec. 31, 2017, a taxpayer may not claim a deduction for interest on home equity indebtedness whether the indebtedness is new or old. Equity indebtedness was not grandfathered.

What is equity debt? Your clients may believe that borrowing from the equity of their home is equity debt, but for tax law, "equity debt" has a specific meaning. It doesn't matter if "acquisition debt" is in the form of a first mortgage, second mortgage, or home equity line of credit (HELOC). Instead, it is always about where the borrowed money is used. Under the new law, for example, interest on a home equity loan used to build an addition to an existing home is typically deductible, while interest on the same loan used to pay personal living expenses, such as credit card debt, is not. As under prior law, the loan must be secured by the taxpayer's main home or second home (known as a qualified residence), not exceed the cost of the home, and meet other requirements.

> **Tax practitioner planning**. According to a 2007 Census Report, people take out home equity loans to make renovations (45%), pay off their debts (26%), buy a car (9%), or pay for medical or tuition (4%). From these figures you could extrapolate that interest paid on equity borrowing is "acquisition debt" for almost half of borrowers because the funds were used for renovations.

The following examples illustrate the change (IR-2018-32):

> **Example**: In January 2020, a taxpayer takes out a $500,000 mortgage to purchase a main home with a fair market value of $800,000. In February 2020, the taxpayer takes out a $250,000 home equity loan to put an addition on the main home. Both loans are secured by the main home, and the total does not exceed the cost of the home. Because the total amount of both loans does not exceed $750,000, all of the interest paid on the loans is deductible. However, if the taxpayer used the home equity loan proceeds for personal expenses, such as paying off student loans and credit cards, then the interest on the home equity loan would not be deductible.

> **Example**. In July 2020, Randy and Lynn borrowed $150,000 from a home equity line of credit and used the proceeds to remodel their home. Although the interest is paid on borrowing from their home's equity, it is acquisition debt since the proceeds were used to "substantially improve" their residence.

Equity borrowing for business use. Taxpayers who borrowed from their home for business purposes (and who made a §1.163-10T(o)(5) election and are able to trace borrowed funds to business, rental, or investment) may still deduct interest on that borrowing.

Election to treat debt as not secured by a qualified residence. A taxpayer may elect to treat any debt that is secured by a qualified residence as not secured by the qualified residence. An election made under this paragraph shall be effective for the taxable year for which the election is made and for all subsequent taxable years unless revoked with the consent of the Commissioner (§1.163-10T(o)(5)).

§1.163-10T(o)(5) election wording:

> "Homeowner elects to treat her home mortgage debt secured by her personal residence located at 1400 15th Avenue, Waterloo, IA, as *not* secured by said residence. This §1.163-10T(o)(5)(i) "election out" allows use of the "direct tracing" rules under §1.163-8T."

Comment: Under §1.163-8T, the proceeds of the character of the interest take the character of the proceeds, i.e., business or investment.

Tax practitioner note: There is no requirement for the §1.163-10T(o)(5)(i) election to be attached to the taxpayer's tax return.

Example. George and Mary refinanced their home in 2017 to secure funds for the down payment on a rental property. In 2017, they properly made a "§1.163-10T(o)(5) election" to trace the interest on the borrowed funds to their rental property and have been deducting the interest as rental property interest for the past years. In 2020, they may continue to deduct on their Schedule E the portion of the interest on their home mortgage that is attributable to the rental purchase.

Example - continued. In 2017, George and Mary did not make an election to trace their mortgage interest to the rental property BECAUSE their Schedule E rental deductions were limited by the passive loss rules. Instead, they claimed the interest expense on the refi proceeds as home equity borrowing on their 2017 Schedule A. For 2020, they may only claim mortgage interest on their original acquisition loan, properly amortized to what its balance would have been in 2020.

AA. Mortgage Insurance Premium (MIP) Deduction Retroactively Extended through Dec. 31, 2020 (§163)(h)(3)(E)(iv)(I); Appropriations Act, Sec. 102, pg 695)

The MIP deduction was retroactively extended through Dec. 31, 2020, instead of Dec. 31, 2017. This may mean an amended return for 2018.

In general. Premiums paid or accrued for qualified mortgage insurance by a taxpayer during the taxable year in connection with acquisition indebtedness with respect to a qualified residence of the taxpayer is treated as qualified residence interest.

Phase-out. The amount otherwise treated as interest is reduced (but not below zero) by 10% of such amount for each $1,000 ($500 in the case of a married individual filing a separate return or fraction thereof) that the taxpayer's AGI for the taxable year exceeds $100,000 as adjusted for inflation ($50,000 in the case of a married individual filing a separate return) and is entirely phased out at $110,000. If AGI is $110,000 or more for the year, this deduction is not allowed. This also holds true for married people filing separately, for whom the AGI limit is $55,000.

Investment Interest Rules Remain the Same, BUT. . .

Investment interest expense is allowed to the extent of net investment income. Use Form 4952 to calculate the amount deductible for 2020 and the amount carried forward to future years.

> **Tax practitioner planning**. A client with a small amount of investment interest expense may not get the benefit of the investment interest deduction if the client is using the standard deduction.

Other Mortgage Interest Rules Unchanged

Form 1098 Mortgage Interest Reporting Requirements

Three reporting requirements have been added to the Form 1098, Mortgage Interest Statement. Form 1098, Mortgage Interest Statement, must include:

1. the amount of outstanding principal on the mortgage at the beginning of such calendar year,
2. the date of the origination of the mortgage, and
3. the address (or other description in the case of property without an address) of the property which secures the mortgage (§6050H(b)(2) as amended).

> **Tax practitioner planning**. Adding the loan balance to the Form 1098, Mortgage Interest Statement, will provide the IRS with information allowing it to easily target returns where the mortgage balance exceeds the $1,000,000/$750,000 acquisition debt limit.

Qualified Residence and Correct Collateral

What exactly is a qualified residence? A residence may include a house, condominium, cooperative, mobile home, house trailer, boat, or similar property; a second residence must contain sleeping, cooking, and toilet facilities (§1.163-10T(p)).

The collateral must be correct. Residence mortgage interest is deductible only if the mortgage is properly secured and collateralized. A secured debt is one in which there exists a signed instrument (such as a mortgage, deed of trust, or land contract) that:

1. makes the taxpayer's ownership in a qualified home security for payment of the debt;
2. provides, in case of default, that the home could satisfy the debt; and
3. is recorded or is otherwise perfected under any state or local law that applies (§1.163-10T(o)(1)).

Mortgage Interest Is Deductible Only for the Legal or Equitable Owner of the Property

Section 163(a) provides the general rule that there shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness. To meet the requirements of §163, the mortgage must be the obligation of the taxpayer claiming the deduction, not the obligation of another. However, §1.163-1(b) provides in relevant part: "Interest paid by the taxpayer on a mortgage upon real estate of which he is the legal or *equitable* owner, even though the taxpayer is not directly liable upon the bond or note secured by such mortgage, may be deducted as interest on his indebtedness." The courts have disallowed a deduction for mortgage interest when the taxpayer is unable to establish legal, equitable, or beneficial ownership of mortgaged property (*Gabriel Daya v. Comm.*, TCM 2000-360; *Song v. Comm*., TCM 1995-446).

> **Tax practitioner planning**. Always check the Social Security number reported on the Form 1098. Does it belong to your client?

Equitable owner. Mortgage indebtedness generally must be an obligation of the taxpayer and not an obligation of another (*Golder v. Commissioner*, 604 F.2d 34, 35 (9th Cir. 1979), aff'g TCM 1976-150). However, taxpayers who are not directly liable on a mortgage may nevertheless deduct mortgage interest paid if he or she is the legal or "equitable" owner of the property subject to the mortgage (§1.163-1(b)).

"Burden and benefit" indicators. Factors established by various tax courts to determine "equitable" ownership include:

1. Who has right to possess or use property?
2. Who pays property obligations such as taxes?
3. Who pays insurance?
4. Who maintains property?
5. Can property be improved without named borrower's consent?
6. Who has risk of loss?
7. May legal title be obtained simply by paying balance of full purchase price?
8. Can "equitable title" be issued under state law (*Blanche v. Comm.,* TCM 2001-63, affd. 33 Fed. Appx. 704 (CA-5 (2002), No. 01-60153)?

> **Tax practitioner planning**. It is important that the legal and equitable owners have a written agreement as to ownership — important for tax purposes and in the case of death or irreconcilable differences resulting in separation.

Action Items for Property Where One Party Is Not on the Title
1. Include co-owner's name on title at purchase. This is a good idea, but it may not be possible if the co-owner has bad credit and would thus jeopardize the loan.
2. Add co-owner's name to title after purchase. This is a solution, but it may not work if adding someone to title calls the loan or results in substantial fees or costs in changing the title.
3. Engage a real estate attorney to write a valid sales contract (recorded or unrecorded) between the two owners.

CHARITABLE CONTRIBUTIONS

CARES. AGI Percentage Increased for 2020 with Election

Under CARES, for 2020, the 60% limit on qualifying cash contributions of individuals is disregarded, permitting individual taxpayers to take a deduction in 2020 to the extent such contributions do not exceed the excess of the individual's AGI over the amount of all other allowed charitable contributions for the year. In short, individuals can deduct qualified cash contributions in 2020 up to 100% of AGI. Any excess is carried forward as a charitable contribution in each of the succeeding five years. No connection to the Coronavirus is required for the contribution.

Qualified Contributions. Qualified contributions are charitable contributions if:
(a) paid in cash during 2020 to a §170(b) organization, and
(b) the taxpayer has elected to apply this provision.

Election. Taxpayers must make an affirmative election on their 2020 income tax return to take advantage of this provision.

AGI Percentages — Without CARES Election

The AGI percentage limit described in §170(b)(1)(A) was increased by the TCJA for certain charitable contributions by an individual taxpayer of cash to public charities and certain other organizations from 50% to 60%.

AGI Limits	Ordinary Income Property and Cash	Capital Gain Property to the Recipient	Capital Gain Property for the Use of the Recipient
Public Charities, Private Operating Foundations, and Private Distributing Foundations	60%	30%	20%
Non-Operating Private Foundations	30%	20%	20%

30% qualified conservation contribution percentage increased to 50% or 100%. In general, the 30% limit of conservation contributions to public charities of capital gain property, generally conservation easements, increased to 100% if the individual making the qualified conservation contribution is a qualified farmer or rancher and 50% if the individual is not a qualified farmer or rancher.

Contribution of capital gain property. Capital gain property contributed to public charities, private operating foundations, or private distributing foundations will be subject to the 50% limitation if the donor elects to reduce the fair market value of the property by the amount that would have been long-term capital gain if the property had been sold.

Donor Advised Funds Are a Popular Alternative to Private Foundations

A donor advised fund (DAF) allows an individual to irrevocably donate assets to a charitable entity today, receive a tax deduction now, but delay the distribution of the assets to the charity to a later time. With tax reform's doubling of the standard deduction, some clients may lose the tax benefit of their contributions unless they bunch their donations into one year. The DAF allows clients to donate several years' worth of contributions in one year but make their pledge payments over several years. That's an advantage that we talk about regularly, but there are other advantages to the DAF.

1. The DAF can be used to hold a long-term base of assets that can be used to fund gifts perpetually into the future.
2. The DAF can simplify the process of gifting appreciated stock to several charities, as a large block of stock can be donated to the DAF. The DAF can sell the stock and then distribute cash according to the donor's direction.

3. The DAF can function in a manner similar to a private non-operating, grant-making foundation, but with fewer costs, no exposure to excise tax on investment income, and higher limits on deductibility of contributions.
4. The DAF can accept donations of privately held business interest, pre-IPO shares, real estate and Bitcoin, in addition to the more traditional cash and publicly traded securities.

Tax practitioner planning. A private foundation is still appropriate if the donor wishes to make grants to individuals, retain greater control over investments, or compensate family members for foundation work.

Resources. Community Foundations offer DAFs as well as Vanguard Charitable, Schwab Charitable, and Fidelity Charitable.

Charitable Distributions from IRAs Are Still Good

An IRA owner age 70½ or over may directly transfer from his or her qualified IRA up to $100,000 per year to an eligible charitable organization. This provides an exclusion from gross income for otherwise taxable IRA distributions from a traditional or a Roth IRA in the case of qualified charitable distributions. Eligible IRA owners can take advantage of this provision, regardless of whether they itemize their deductions.

Direct trustee to charity transfer required. To qualify, the funds must be contributed directly by the IRA trustee to the eligible charity. Amounts so transferred are not taxable, but no deduction is available for the amount given to the charity.

Transfers can be part of RMD. Transferred amounts are counted in determining whether the owner has met the IRA's required minimum distribution rules. Where individuals have made nondeductible contributions to their traditional IRAs, a special rule treats transferred amounts as coming first from taxable funds, instead of proportionately from taxable and nontaxable funds, as would be the case with regular distributions. One important warning when using a Qualified Charitable Distribution (QCD) to satisfy an RMD obligation is that an RMD is presumed to be satisfied by the first distribution that comes out of the IRA for the year. Because §408(d)(3)(E) does not permit an RMD to be rolled over back into another IRA, once an RMD occurs, it is irrevocably distributed and taxable[3].

> **Example**. Leonard's IRA custodian told him he had to take a $15,000 RMD from his IRA in 2020. On Jan. 2, 2020, Leonard took a $15,000 distribution to satisfy his entire 2020 RMD (when no one knew that the 2020 RMD would be waived by CARES). In March, Leonard realized that it may have been better for him to do a QCD instead, as he was planning to contribute to charity later in the year anyway. However, he cannot undo his prior RMD, which is irrevocable once distributed. At best, Leonard can simply use the $15,000 distribution he took from his IRA, donate it to a charity, claim a $15,000 charitable deduction as an itemized deduction on Schedule A, and hope that it at least mostly offsets his January taxable distribution. Thus, take the QCD before the RMD or it ends up on Schedule A.

[3]Thanks to Michael Power for pointing out this provision at the East Bay EA "Ask the Expert" meeting. Mike. It takes a village.

Reminder. CARES waived the 2020 RMD requirement. Leonard didn't need to take an RMD.

Tax practitioner planning. If Leonard changed his mind within 60 days of taking the distribution from his IRA (and if he hadn't done another rollover within 12 months), he could roll the money back into his IRA.

More planning. Even though Leonard is not required to take a 2020 RMD, he still might want to do a QCD if he will make contributions later in the year. He would then have the standard deduction and a non-taxable distribution by the trustee to his charity. Leonard (or his beneficiaries) might find it advisable to take money out of his IRA, rather than his checkbook.

Who Benefits from an IRA Transfer to a Charity?

1. Nonitemizers get the full benefit for the contribution ***and*** the standard deduction. With the increased standard deduction, this provision is even more important.
2. Since the IRA distribution made to a charity is not included in the client's taxable income, the many AGI related phase-outs are minimized. For example, the client does not experience:
   - a 60% charitable contribution base limitation, or
   - an increase in the amount of Social Security benefits taxable if the individual takes an IRA RMD that is included in AGI and then deducts the amounts paid to charity on his or her Schedule A.
   - Since the IRA distribution made to a charity is not included in the client's AGI, the Medicare B and D premium surcharge may be reduced if an IRA transfer is made directly to the charity.
3. Clients will have to rethink the source of large charitable contributions during their lifetime. Perhaps the gift from an IRA will be a better choice than the gift of appreciated stock when considering that an IRA produces income in respect of a decedent at the death of the account owner. Leaving stock may result in less tax to the beneficiary.

SECURE. Coordination with Qualified Charitable Distributions

Because IRA contributions are now deductible for those who qualify for the qualified charitable distribution (QCD) provision, SECURE reduces the allowable QCD by the IRA deduction allowed for a taxpayer over 70½. *"The amount of distributions not includible in gross income by reason of the preceding sentence for a taxable year shall be reduced (but not below zero) by an amount equal to the excess of—(i) the aggregate amount of deductions allowed to the taxpayer under §219 for all taxable years ending on or after the date the taxpayer attains age 70½, (ii) the aggregate amount of reductions under this sentence for all taxable years preceding the current taxable year."*

Example. Joe made traditional IRA contributions at age 71 and 72 for a total of $14,000. A few years later, Joe directs the custodian of his IRA to make a qualified charitable distribution of $25,000 to the Salvation Army. The first $14,000 of the distribution is not treated as a QCD. Thus, $14,000 will be included in Joe's income as a taxable distribution, and Joe may deduct $14,000 on his Schedule A as a charitable contribution.

The Increase in the Standard Deduction May Make Charitable Deductions Less Attractive to Some

The doubling of the standard deduction will mean fewer taxpayers will benefit from itemizing their deductions. For a client using the standard deduction, making a $1,000 donation to the Salvation Army won't reduce their taxes. Charities worry that there will be a drop in donations because of tax reform.

Example. In 2020, Hans and Greta have no uninsured medical, will max out their SALT at $10,000, and have paid off their home mortgage. They contribute $10,000 each year to their church. With just $20,000 of itemized deductions, Hans and Greta will claim the $24,800 standard deduction and get tax benefit for only $300 of their contributions. They would get more benefit if they "bunched" their contributions and paid their 2020 and 2021 pledge by year-end. Or, maybe they should consider a donor advised fund to concentrate their deduction.

Reminder. CARES allows a $300 charitable deduction in arriving at AGI for non-itemizers.

Tax practitioner planning. The doubling of the standard deduction means that many clients lose the tax benefit of their charitable contributions. Planning may help.

1. Bunch deductions by paying two years of pledges in the same year, and none the next year.
2. Consider a donor advised fund to "prepay" several years of donations in one taxable year.

Required Documentation for Charitable Deductions Chart		
	Amount	**Required records**
C A S H	Single cash contribution of less than $250 and out-of-pocket expenses of less than $250	Cancelled check, bank record, credit card statement, or written acknowledgment from the charity. §1.170A-15(a)
	Single cash contribution of $250 or more	Written acknowledgment from the charity.§1.170A-15(a)
	Payroll deduction	Pledge card *and* W-2, pay stub. §1.170A-15(d)
	Out-of-pocket expenses of $250 or more	Records, receipts, and an acknowledgment from the charity. §1.170A-13(f)(10)
N O N C A S H	Noncash contributions less than $250	Written acknowledgment from the charity or other reliable record. §1.170A-16
	Noncash contribution of $250 but not more than $500	Written acknowledgment as described in §1.170A-13(f) from the charity.§1.170A-16(b)
	Noncash contribution over $500 but not more than $5,000	Written acknowledgment from the charity as described in §1.170A-13(f) and Form 8283, Section A. §1.170A-16©
	Noncash contribution of over $5,000 of similar items	Written acknowledgment from the charity, appraisal and Form 8283, Section B. §1.170A-16(d) — Regs define appraisal and appraiser at §1.170A-17(a)(1) and §1.170A-17(b)(1)
	Noncash contribution of more than $500,000	Written acknowledgment from the charity, appraisal, and Form 8283, Section B. Attach appraisal to the return. §1.170A-17(e)

	Qualified conservation easement of $5,000 or more	Written acknowledgment from the charity, appraisal, and Form 8283, Section B. A statement is required to be attached to the return of the easement. For a Facade Easement over $10,000, see Form 8283V for $500 fee. §1.170A-14(i)
OTHER GIFT	Noncash contribution of auto, boat, or airplane with a value of more than $500	Written acknowledgment from the charity. Attach Form 1098-C and Form 8283 to return. §1.170A-16(c)(4)
	Noncash contribution of publicly traded stock	Written acknowledgment from the charity and Form 8283, Section A. §1.170A-13 (c)(7)(xi)(B)
	Noncash contribution of privately traded stock of more than $5,000	Written acknowledgment from the charity, and Form 8283 Section B. If the privately traded stock is valued at $10,000 or more, attach an appraisal to the return. §1.170A-13 (c)(2)(ii)(B)(1)
	Noncash contribution of art valued at more than $20,000	Written acknowledgment from the charity, appraisal, Form 8283, Section B. Appraisal and a photo of the art must be attached to the return. Rev. Proc. 96-15.
The written acknowledgment must be received from the charity before the original return is filed or the due date of the return (including extensions), and it must include a statement regarding goods and services received in exchange for the contribution.		

Tax practitioner planning. See Tax Tip 2019-142 for a resource in answering clients' questions.

Year-end gifts. Contributions are deductible in the year made. Thus, donations charged to a credit card before the end of 2020 count for 2020, even if the credit card bill isn't paid until 2021. Also, checks count for 2020 as long as they were mailed in 2020.

Determining the Value of Donated Non-Cash Property

Refer your clients to IRS Publication 561 for examples on valuing noncash items donated to charity.

The following documentation is required.

- **Less than $250**. "Separate contributions of less than $250 are not subject to the requirements of §170(f)(8), regardless of whether the sum of the contributions made by a taxpayer to a donee organization during a taxable year equals $250 or more" (§1.170A-13(f)(1)).
- **$250 or more.** For all contributions of $250 or more, the taxpayer generally must obtain a contemporaneous written acknowledgment from the donee (§170(f)(8)).
- **$500 or more.** Additional substantiation requirements are imposed for contributions of property with a claimed value exceeding $500 (§170(f)(11)(B)).
- **More than $5,000.** Still more rigorous substantiation requirements, including the need for a "qualified appraisal," are imposed for contributions of property, or similar items of property, with a claimed value exceeding $5,000 (§170(f)(11)©).

What are "similar items"? The term "similar items of property" is defined to mean "property of the same generic category or type," such as clothing, jewelry, furniture, electronic equipment, household appliances, or kitchenware (§1.170A-13(c)(7)(iii)). "Similar items of property" must be aggregated in determining whether gifts exceed the $500 and $5,000 thresholds (§170(f)(11)(F)).

> **Tax practitioner planning**. Claiming a $6,000 contribution of "household goods" would require an appraisal. Claiming a $3,000 donation of furniture and a $3,000 donation of clothing would not. Categorize the donations carefully.

Required documentation. For any non-cash contribution exceeding $5,000, the regulations require the donor to:

1. obtain a qualified appraisal for the contributed property,
2. attach a fully completed appraisal summary (Form 8283) to the tax return on which the deduction is claimed, and
3. maintain records pertaining to the claimed deduction in accordance with §1.170A-13(b)(2)(ii) and §1.170A-13(c)(2).

Qualified Appraisal

What is a qualified appraisal? The term "qualified appraisal" means an appraisal that is:

1. prepared no earlier than 60 days prior to the donation nor later than the extended due date of the tax return for the year of the donation,
2. conducted by a qualified appraiser in accordance with generally accepted appraisal standards,
3. not prepared for a fee based on a percentage of the appraised value of the donated item (§170(f)(11)(E)(I)), and
4. appraiser certifies appraisal was prepared for tax-related IRS purposes (§1.170A-17(a)(1)).

Who is a qualified appraiser? The term "qualified appraiser" means an individual who:

1. has earned an appraisal designation from a recognized professional appraiser organization or has otherwise met minimum education and experience requirements set forth in regulations,
2. demonstrates verifiable education and experience in valuing the type of property subject to the appraisal,
3. regularly performs appraisals for which the individual receives compensation, and
4. has not been prohibited from practicing before the IRS at any time during the three-year period ending on the date of the appraisal (§1.170A-17(b)(1)).

What must be included in the qualified appraisal? The actual appraisal is required to include all of the following information:

- A detailed description of the property.
- If tangible personal property, the property's physical condition.
- The date of the donation.
- Terms of any agreement between the donor and the donee regarding the use or disposition of the donated property.
- The name, address, and ID number of the appraiser.

- The appraiser's qualifications, including education, experience, and memberships in appraisal organizations.
- A statement that the appraisal is to be used for income tax purposes.
- The date the property was appraised.
- The fair market value of the donated property on the date of the contribution (§1.170A-17(a)(3)).

In addition, the appraiser must include on his or her appraisal summary a declaration that the appraiser may be subject to a penalty if a substantial or gross valuation misstatement results from an appraisal of the value of property that the appraiser knows, or reasonably should have known, would be used in connection with a return or claim for refund.

Missing Basis Entry on Form 8283 Means Taxpayer Loses Non-Cash Charity Deduction of $7,949,000 (Oakhill Woods, LLC, Effingham Managers, LLC, Tax Matters Partner v. Comm., TCM 2020-24)

Strict substantiation requirements apply. To deduct non-cash contributions in excess of $5,000, the donor must obtain a qualified appraisal of the contributed property, attach a "fully completed" appraisal summary to the return on which the deduction is first claimed, and maintain records containing specified information (§1.170A-13(c)(2)(i)(A), (B), and ©). The Form 8283, Non-Cash Charitable Contributions, appraisal summary that Oakhill Woods attached to its 2010 return indicated that it acquired the property by purchase on Aug. 1, 2007, but Oakhill Woods did not enter an amount in the space provided for the "Donor's cost or other adjusted basis." With respect to "cost or adjusted basis" Oakhill Woods' attachment stated:

> *A declaration of the taxpayer's basis in the property is not included in * * * the attached Form 8283 because of the fact that the basis of the property is not taken into consideration when computing the amount of the deduction. Furthermore, the taxpayer has a holding period in the property in excess of 12 months and the property further qualifies as "capital gain property."*

Omission of basis on Form 8283 fatal to deduction. The required appraisal summary must provide, among other things, the adjusted cost or other basis of the donated property (§1.170A-13(c)(4)(ii)(E))[4]. Congress directed the Secretary of Treasury to adopt stricter substantiation requirements for charitable contributions to alert the Commissioner, in advance, of potential over-valuations of contributed property and thereby deter taxpayers from claiming excessive deductions in the hope that they would not be audited (S. Prt. No. 98-169 (Vol. 1), at 444; 1984 Blue Book, at 503-504). Because Oakhill's omission of its basis in the contributed property from the Form 8283 it attached to its 2010 return prevented the appraisal summary from achieving its intended purpose, Oakhill's failure to meet the requirement of §1.170A-13(c)(4)(ii)(E) could not be excused by substantial compliance. The charitable deduction was denied in full.

> **Tax practitioner planning.** Be sure to complete all required information on Form 8283. While the appraisal is the responsibility of the appraiser, the completion of Form 8283 is the responsibility of the tax preparer.

> **Tax practitioner note**. The Form 8283 was revised November 2019. Particularly see Section B, Part one, on the second page that includes a check box that describes the type of property donated.

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[4] As an exception to the rule, if the donor is "unable" to provide information on its cost basis in the donated property, the donor may substitute an explanatory statement attached to the Form 8283 (§1.170A-13(c)(4)(iv)(C)(1)). Oakhill did attach an explanation, but the attachment did not provide satisfactory excuses for its omission.

Also see.

- *RERI Holdings I, LLC v. Comm.*, US Court of Appeals for the District of Columbia, No. 17-1266 (5-24-2019), where a missing basis entry on the appraisal summary nixed charitable deduction.

Married Couple Not Entitled to Charitable Contribution Deduction (*Roderick M. and C. Sandra Campbell v. Comm.*, TCM 2020-41)

The facts. The issue was whether Rod and Sandra Campbell were entitled to a carryover charitable contribution deduction with respect to a 2007 donation of 3,432 new designer eyeglass frames to Lions in Sight of California and Nevada (Lions in Sight).

In December 2006 , Rod learned of an eyewear charitable contribution program through CPA Victor Kawana, a one-third owner of Kruse Mennillo, LLP, an accounting and management consulting firm with offices in Cerritos, California, and Kansas City, Missouri. This eyewear charitable contribution program involved ZD Products, Inc. consolidating over 170,000 designer eyeglass frames it possessed into units of approximately 3,432 frames each and selling these units to 50 buyers for $50,000 per unit; each buyer would then purportedly be eligible to donate his or her frames after a minimum one-year holding period to Lions in Sight and claim a charitable contribution deduction at the appraised fair market value at the time of donation. Mr. Campbell decided to participate in the eyewear charitable contribution program. On Dec. 22, 2006, he purchased for $50,000 "an inventory of Prescription Designer Eyewear" from ZD Products.

2007 return. On Schedule A, the Campbells reported, among other items, the purported $225,596 donation to Lions in Sight, but because of their negative AGI they could not claim a charitable contribution deduction as an itemized deduction for 2007.

> **In other words.** The Campbells paid $50,000 for "eyewear," held the eyewear for a year, and claimed a FMV of $225,596 at its donation.

2008 return. On their 2008 Schedule A, the Campbells claimed $837,577 of itemized deductions, consisting of, among other items, the carryover charitable contribution deduction from the 2007 return (which included the Lions in Sight donation).

Post-contribution Appraisal. A retrospective appraisal of the 349,629 eyeglass frames was performed by Leslie Miles of Miles Appraisals; this appraisal was dated February 24, 2012. In opining as to the fair market value of these frames, Mr. Miles reviewed a 2007 Marshall & Stevens appraisal. Mr. Miles did not sample or inspect the frames because of the retrospective nature of the assignment, and his analysis revealed that 39,709 frames "were not current in the marketplace and, therefore, not included in the valuation except at a zero amount." Using the market approach and on the basis of the wholesale price with a markup of 35% and deducting 15% for costs associated with handling and restocking the frames, Mr. Miles opined that the fair market value of the 349,629 eyeglass frames as of December 26, 2007, was $12,861,750.

The argument. The IRS contended that the Campbells were not entitled to their carryover charitable contribution deduction with respect to the Lions in Sight donation because (1) the contribution was not made with donative intent, (2) the contribution was not made in 2007 but rather in 2008, and (3) the Campbells did not comply with the substantiation requirements. The IRS contended that the Campbells did not comply with the substantiation requirements because (1) the 2007 Marshall & Stevens appraisal cited in the original offering memorandum was not a "qualified appraisal" and (2) Lions in Sight's Dec. 28, 2007, letter to Mr. Campbell was not a proper a "contemporaneous written acknowledgment."

The court agreed. The smell of tax shelter was just too much. The Court did not allow even the $50,000 cost of the donated items.

> **Tax practitioner planning**. A Coronavirus slow down will not stop the IRS from auditing such "low hanging fruit."

Congress and IRS Targeting Charitable Conservation Easement Deductions (§170(h))

The Senate Finance Committee is launching an investigation into syndicated conservation easement deals, which often result in larger tax benefits for the investor than the cash invested. The IRS says that more than 15,000 taxpayers have participated in such investments, costing the government more than $1 billion in tax revenue.

> "There are very legitimate purposes for the conservation easement provisions of the tax code," Chairman Charles Grassley said. "But when a handful of individuals cook up a scheme to cash in at the expense of federal revenue and in violation of Congress's intent, something needs to change. There's no reason that the rest of the taxpaying American public should be left with such a raw deal. This is just our first step in getting to the bottom of how these tax provisions are being abused, and it will inform what else ought to be done to fix the problem."

IRS data released in 2017 indicated that a sampling of these transactions enabled investors to claim, on average, deductions valued at nine times the amount of their original investment. The Land Trust Alliance complained that "in the most current data available, approximately $20 billion in tax deductions were claimed from 2010 to 2016. In 2016 alone, $6 billion in apparently unwarranted charitable deductions were claimed by participants from just 248 transactions."

IRS Issues Updated Conservation Easement Audit Technique Guide (ATG, Jan. 24, 2018))

If your client wants to deduct a charitable deduction for a conservation easement, and you have worked with these gifts before, read the 95 page ATG for the many strict requirements.

Special Rule for "Qualified Conservation Easement" Contributions

Generally, taxpayers are not entitled to deduct gifts of property that consist of less than the taxpayers' entire interest in that property (§170(f)(3)). An exception to this general rule is that taxpayers are permitted to deduct the value of a contribution of a partial interest in property that constitutes a "qualified conservation contribution" (§170(h)(1); §170(f)(3)(B)(iii)). For a contribution to constitute a qualified conservation contribution, the taxpayer must show that the contribution is of a "qualified real property interest," to a "qualified organization," and "exclusively for conservation purposes." For the donation to be deductible, the conservation purpose must be protected in perpetuity (§170(h)(5); §1.170A-14(a)).

Contributions of property "generally cannot constitute a charitable contribution if the contributor expects a substantial benefit in return." A taxpayer who receives goods or services in exchange for a contribution of property may still be entitled to a charitable contribution deduction if the taxpayer makes a contribution that exceeds the FMV of the benefit the taxpayer receives and makes the excess payment with the intention of making a gift.

Watch out for "quid pro quo" exchanges when conservation easements are granted. In determining whether a payment is a contribution or a gift, it must be determined if the transaction in which the payment is involved is structured as a quid pro quo exchange. The taxpayer must show that she or he intended to make a charitable contribution in an amount that exceeded the FMV of the consideration received in the exchange and that she or he actually made a charitable contribution in an amount that exceeded the FMV of that consideration (§1.170A-1(h)(1)&(2)).

Strict quid pro quo formula must be followed. A quid pro quo analysis ordinarily requires two parts: (1) the value of the contributed conservation easement and (2) the value of the consideration received in exchange for the easement (*Rolfs v. Comm.* 668 F.3d 888 (7th Cir. 2012); 2012-1 USTC ¶50,186).

> **Tax practitioner planning.** Where a substantial record of comparable easement sales exists, the FMV of a conservation easement is based on the sale prices of those comparable easements. Where there is no established market for similar conservation easements and no record exists of sales of such easements, the FMV of a conservation easement is equal to the difference between the FMV of the property it encumbers before the grant of the easement and the FMV of the encumbered property after the grant of the easement (§1.170A-14(h)(3)(I)).

Taxpayer Violated Perpetuity Requirement and Loses Conservation Easement Deduction (*Nathaniel Carter v. Comm.*, TCM 2020-21)

In 2005, Dover Hill Plantation LLC purchased a 5,245-acre tract of land in Glynn County, Georgia. Dover Hill Plantation LLC donated a conservation easement to the North American Land Trust (NALT). It covered 500 acres on the western edge of Dover Hill. The purposes of the easement are:

"(1) the preservation of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem and (2) preservation of the covered property as an open space that will provide a significant public benefit by (a) providing scenic enjoyment to the general public and (b) advancing a clearly delineated governmental conservation policy."

Notwithstanding the general restriction on the development of the property covered by the easement, Dover Hall Plantation, LLC retained the right to build a single-family dwelling on each of 11 "building areas" of no more than two acres, the locations of which were to be determined, subject to NALT's approval. This provision violates the perpetuity requirement in §170(h)(2)© by subjecting the land that was supposed to be protected in perpetuity from such development to commercial or residential development.

Also see.

- *Railroad Holdings, LLC, Railroad Land Manager, LLC, Tax Matters Partner v. Comm.*, TCM 2020-22) and *Rock Creek Property Holdings, LLC, Rock Creek Land Manager, LLC, Tax Matters Partner v. Comm.*, Docket No. 5599-17 (Feb. 7, 2020), where taxpayer's right to share in proceeds from a subsequent sale of the easement property by the charity violated the perpetuity requirement in §170(h)(2)©.

- *RP Golf, LLC*, CA-8, 2017-2 USTC ¶50,266, where the conservation purpose was not protected in perpetuity because of late subordination of loans.

Donation of Virtual Currency (FAQs on Virtual Currency Transactions)

The IRS added three FAQs regarding the charitable deduction of a donation of virtual currency.

Q33. If the taxpayer donates virtual currency to a charitable organization, income, gain, or loss from the donation is not recognized.

Q34. The charitable contribution deduction is generally equal to the fair market value of the virtual currency at the time of the donation if the taxpayer held the virtual currency for more than one year. If they have held the virtual currency for one year or less at the time of the donation, the deduction is the lesser of your basis in the virtual currency or the virtual currency's fair market value at the time of the contribution.

Q35. A charitable organization can assist a donor by providing the contemporaneous written acknowledgment that the donor must obtain if claiming a deduction of $250 or more for the virtual currency donation. A charitable organization is generally required to sign the donor's Form 8283, Non-Cash Charitable Contributions, acknowledging receipt of charitable deduction property if the donor is claiming a deduction of more than $5,000 and if the donor presents the Form 8283 to the organization for signature to substantiate the tax deduction.

> **Tax practitioner planning.** United Way Worldwide accepts virtual currency, making it one of the largest nonprofit organizations to participate in digital currency fund-raising. BitGive Foundation partners with nonprofits to raise money in the world of digital currency. BitGive Foundation is the first Bitcoin organization to be designated a 501(c)(3) nonprofit by the IRS.

MISCELLANEOUS ITEMIZED DEDUCTIONS

TCJA. Miscellaneous Itemized Deductions Subject to 2% Limit Suspended (§62, new §67(g))

The TCJA suspends all miscellaneous itemized deductions that are subject to the 2% floor under present law. Prior law and IRS guidance provided examples of items that were deductible as miscellaneous itemized deductions subject to the 2% AGI limit for 2018 through 2025.

Expenses for the collection and productions of income. The non-exhaustive list included: appraisal fees for a casualty loss or charitable contribution; casualty and theft losses from property used in performing services as an employee; clerical help and office rent in caring for investments; depreciation on home computers used for investments; excess deductions (including administrative expenses) allowed a beneficiary on termination of an estate or trust; fees to collect interest and dividends; hobby expenses, but generally not more than hobby income; indirect miscellaneous deductions from pass-through entities; investment fees and expenses; loss on deposits in an insolvent or bankrupt financial institution; loss on traditional IRAs or Roth IRAs, when all amounts have been distributed; repayments of income; safe deposit box rental fees, except for storing jewelry and other personal effects; service charges on dividend reinvestment plans; and trustee's fees for an IRA, if separately billed and paid.

Tax preparation fees (§212). The deduction for tax preparation fees for the personal tax return of the taxpayer is suspended.

> **Tax practitioner planning**. Of course, we will continue to allocate our tax preparation fees between the Schedule A, C, E, and F to protect as much of the deduction as possible.

Unreimbursed employee business expenses (§67). IRS Publication 529 included the following as a non-exhaustive list of employee business expenses: business bad debt of an employee; business liability insurance premiums; damages paid to a former employer for breach of an employment contract; depreciation on a computer a taxpayer's employer requires him to use in his work; dues to a chamber of commerce if membership helps the taxpayer perform his job; dues to professional societies; home office or part of a taxpayer's home used regularly and exclusively in the taxpayer's work; job search expenses in the taxpayer's present occupation; laboratory breakage fees; legal fees related to the taxpayer's job; licenses and regulatory fees; malpractice insurance premiums; medical examinations required by an employer; occupational taxes; passport fees for a business trip; repayment of an income aid payment received under an employer's plan; research expenses of a college professor; rural mail carriers' vehicle expenses; subscriptions to professional journals and trade magazines related to the taxpayer's work; tools and supplies used in the taxpayer's work; purchase of travel, transportation, meals, entertainment, gifts, and local lodging related to the taxpayer's work; union dues and expenses; work clothes and uniforms if required and not suitable for everyday use; and work-related education.

Other miscellaneous itemized deductions subject to the 2% floor. Other miscellaneous itemized deductions subject to the 2% floor included: repayments of income received under a claim of right (only subject to the 2% floor if less than $3,000); repayments of Social Security benefits; and the share of deductible investment expenses from pass-through entities.

> **Tax practitioner planning**. Miscellaneous itemized deductions not subject to the 2% AGI floor continue to be deductible.

Examples illustrate the breadth of the change:

> **Example — legal fees**. A San Francisco jury awarded Dewayne Johnson $250 million for punitive damages after his cancer was linked to Monsanto's Roundup weedkiller. The punitive damages are taxable (§104(a)(2) and ©), but the legal fees paid by Mr. Johnson are not deductible, thanks to a TCJA change, since they are miscellaneous itemized deductions subject to the 2% of AGI limit.
>
> **What does Mr. Johnson net from the punitive damage award?** If the attorneys' contingent fees are 50%, Mr. Johnson nets $125 million after their share. Then the IRS takes 37% of the gross award, or $92.5 million, and California (Mr. Johnson's state of residency) takes $8.75 million — California didn't conform to the elimination of the miscellaneous itemized deduction provision in the TCJA. What's left? $23.75 million of the $250 million headline in the newspaper!
>
> > **Tax practitioner planning**. Legal fees can be netted against the award only if the award is paid for federal civil rights discrimination (age, race, religion, sex). See §62(a)(20).
>
> **Example** — **financial planner fees.** In 2020, Paul paid $35,000 of financial planner fees for the management of his stock portfolio. The fees are a miscellaneous itemized deduction and not deductible.
>
> **Example** — **education expense.** Bruce is a computer science teacher at Homestead High School. Because his field is constantly changing, he spent in 2020 $9,000 to attend several professional conferences on teaching, to take a college class on advanced coding, and to buy books, supplies and software for use in his classes. None of the expenses are deductible (except for the (puny) $250 educator deduction). Bruce could ask his school district to reimburse him, but good luck with that one, considering every school's paltry budget.
>
> **Example** — **outside sales**. Jane works for a small software company as a commissioned sales representative. She is not reimbursed for her mileage, meals and entertainment, or travel. In 2020, she spent $10,000. Because employee business expenses are no longer deductible, Jane is now spending after-tax dollars. She would like to convince her employer to establish an accountable plan to reimburse her for her properly accounted for expense. But the employer wasn't paying any of Jane's expenses before, why now? Because she has lost a big tax deduction! To convince her employer to reimburse her, Jane may have to take a cut in her commission percentage (i.e., Jane was

getting commission/wages of $100,000 and paying expenses of $10,000 out of her own pocket. Maybe instead, she can take $90,000 of commission/wages and the employer can pay the $10,000 of expenses. This can result in a bonus to the employer — because wages are lower, he will pay less payroll taxes and workers' compensation insurance).

Can the Taxpayer Capitalize Investment Adviser Fees to the Cost of the Stock?

No! Investment management fees cannot be capitalized. The IRS denied investors the option of capitalizing investment management fees paid to a broker as carrying charges under §266. The investors wanted to avoid alternative minimum tax and other limitations on miscellaneous itemized deductions, the law in effect before 2018. With the suspension of miscellaneous itemized deductions, there was a big incentive to capitalize investment adviser fees (CCA 201721015).

The CCA states: *"Consulting and advisory fees are not carrying charges because they are not incurred independent of a taxpayer's acquiring property and because they are not a necessary expense of holding property. Stated differently, consulting and advisory fees are not strictly analogous to common carrying costs, such as insurance, storage, and transportation."*

Tax practitioner planning. Instead of an asset management fee, perhaps Paul can pay transaction fees. Transaction fees can be added to basis.

TCJA. Limitation of Gambling Losses (§165(d))

Gambling losses are limited to gambling winnings. The TCJA clarifies that the limitation on losses from gambling transactions applies not only to the actual costs of wagers incurred by an individual, but also to other expenses incurred by the individual in connection with the conduct of that individual's gambling activity. The provision clarifies, for instance, an individual's otherwise deductible expenses in traveling to or from a casino are subject to the limitation under §165(d).

Tax practitioner planning. This provision is meant to limit expenses of gambling professionals.

Tax practitioner planning. The doubling of the standard deduction will mean that some small, casual gamblers will not get a tax benefit from their gambling losses.

Example. Nancy has a W-2 G from Harrahs for $5,000 that she won on a poker machine. Nancy's spouse figures that Nancy spent $8,000 winning that $5,000. Wait until Nancy and her spouse find out that the gambling winning will cost them tax because they are not itemizing deductions for 2020.

CASUALTY AND OTHER LOSSES §165 & §166

The Further Consolidated Appropriations Act (AA), 2020, included Disaster Tax Relief provisions.

AA. Temporary Increase in Limitation on Qualified Contributions for Disaster-Related Relief (§170(b) & (d); Appropriations Act, Sec. 204(a), pg 709)

In the aftermath of a disaster or in other emergency hardship situations, individuals often are interested in providing assistance to victims through a charitable organization.

For individuals, the AGI percentage limit increases from 60% to 100% between Jan. 1, 2018, and Feb. 18, 2020. Any qualified contribution is allowed as a deduction only to the extent that the aggregate of such contributions does not exceed the excess of the taxpayer's contribution base over the amount of all other allowable charitable contributions. Any excess is carried over.

In the case of a partnership or S corporation, this election is made separately by each partner or shareholder.

Qualified contributions. This applies to any contribution if:

1. Contributions are paid beginning on Jan. 1, 2018, and ending on Feb. 18, 2020 (60 days after Dec. 20, 2019, the date of enactment of HR 1865), in cash to a qualified nonprofit charitable organization (see §170(b)(1)(A)) and are made for relief efforts in one or more qualified disasters,
2. Contemporaneous written acknowledgments were received stating that such contributions were used (or to be used) for disaster relief efforts, and
3. The taxpayer *elected* to use this specific disaster-related relief.

Donor advised funds can't be used. And contributions to private foundations, i.e, supporting organizations, don't qualify (§509(a)(3)).

AA. Special Rules for Qualified Personal Casualty Losses for Disaster-Related Relief (§24(d) and §32; Appropriations Act, Sec. 204(b), pg 710)

If an individual has a net disaster loss:

1. The amount of the deduction is equal to the sum of the net disaster loss and the excess that exceeds 10% of the individual's AGI,
2. Using $500 (instead of $100),
3. The standard deduction is increased by the net disaster loss, and
4. Not applying the AMT treatment of certain recoveries and standard deduction (§56(b)(1)(D) or (E)) to so much of the standard deduction as is increased by #3 above.

AA. Special Rules for Determining Earned Income for Refundable Child Tax Credit and Earned Income Credit Purposes - Disaster-Related Relief (§165(h)(2)(A)(ii); Appropriations Act, Sec. 204©, pg 711)

May use prior year's earned income. In the case of a "qualified individual," if the earned income of the taxpayer for the tax year is less than the earned income for the preceding taxable year, the credits may, at the election of the taxpayer, be determined by substituting such earned income for the preceding taxable year for such earned income for the applicable tax year.

A qualified individual is any individual whose principal residence at any time during the incident period of any qualified disaster was located in a qualified disaster zone or was displaced from such principal residence by reason of the qualified disaster.

AA. Automatic Extension of Filing Deadlines in Case of Individual Taxpayers Affected by Federally Declared Disasters (§7508A; Appropriations Act, Sec. 205, pg 712)

Automatic 60-day extension. In the case of any qualified taxpayer, a mandatory 60-day extension has been added to the one year waiver of taxes and interest option that may be granted by the Secretary of Treasury. This is effective for federally declared disasters after Dec. 20, 2019 (the date of enactment of HR 1865).

A qualified taxpayer includes:

1. An individual whose principal residence is in the disaster area,
2. Any taxpayer if the principal place of business (other than the employee) is located in a disaster area,
3. A relief worker assisting in a disaster area who is affiliated with a government or philanthropic organization,
4. A taxpayer whose records show necessity to meet certain deadlines by reason of a Presidentially declared disaster or terrorist or military actions,
5. Any individual visiting a disaster area who was killed or injured as a result of the disaster, and
6. Solely with respect to filing a joint return, any spouse of the above-mentioned individual.

Application to pension contributions. This automatic extension period also applies to making contributions to a qualified plan, including making distributions, recharacterizing contributions, and making a rollover.

TCJA. Personal Casualty Losses (§165(h))

For 2018 through 2025, the TCJA provides that a taxpayer may claim a personal casualty loss only if such loss was attributable to a presidentially declared disaster.

> **Example**. Evelyn had a house fire that destroyed a painting left to her by her father. The FMV of the painting at her father's death was $30,000. The insurance company limited reimbursement for artwork to $1,000. Evelyn's $29,000 casualty loss is not deductible.

Presidentially Declared Disaster Losses (Help During Disasters)

Wildfires, floods, and hurricanes have dominated the news in recent months. Tax relief is available for victims of presidentially declared disasters. The IRS website is updated regularly for newly designated disaster areas, including a recent addition for the California wildfires in Lake and Shasta Counties and in Paradise. The IRS also has added its recommendations on how taxpayers should prepare for natural disasters. See Tax Tip 2018-130. Tax Tip 2018-165 provides basics on reconstructing records.

> **Tax practitioner planning**. While Tax Tips do not contain technical information for the preparation of the return, they do include helpful information for a client in an area prone to disasters or to a client who has experienced the personal devastation caused by a disaster.

If the client needs money. If the client needs money to pay for living expenses after a disaster:

1. Because banks and ATMs are often closed after a fire, flood, or hurricane, stockpiling a bit of cash in a fireproof safe might be good pre-disaster planning;
2. A hardship withdrawal from one's retirement plan or 401(k) is probably available;
3. FEMA makes cash available, and FEMA relief is not taxable; and
4. The Small Business Administration has low-interest loans to help small businesses following a disaster.

ADDITIONAL TAX ON NET INVESTMENT INCOME (NII) §1411

3.8% Tax on NII Remains After Tax Reform (§1411; T.D. 9644; REG-130843-13; REG-130507-11; §1.411-0 through §1.411-10)

The 3.8% NII tax is imposed on the lesser of:

- an individual's *NII* for the tax year, or
- *MAGI in excess of a floor:*
  - $200,000 for single and head of household;
  - $250,000 for joint filers and surviving spouses; or
  - $125,000 for a married taxpayer filing separately (§1411(a)(1) & (b); §1.1411-2(b)(1); §1.1411-2(d)(1)).

These threshold amounts are not adjusted for inflation in the future.

> **Tax practitioner planning.** Combining the new top individual income tax rate of 37% with the 3.8% NII tax results in a marginal rate of 40.8%. For capital gains, the combined rate remains at 23.8%.

Definition of Gross & Net Investment Income

NII is the excess of:

1. The sum of gross income from interest (and substitute interest payments), dividends (and substitute dividend payments), annuities, royalties, and rents, and (unless such income is derived in the ordinary course of any trade or business other than from (2) or (3) below).
2. Gross income derived from a §469 passive activity trade or business.
3. Gross income derived from a trade or business of trading in financial instruments or commodities.
4. Net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in any trade or business not described in (2) or (3) above. The tax does not apply to other trades or businesses conducted by a sole proprietor, partnership, or S corporation.
5. Less: deductions properly allocable to such gross income or net gain.

NII Does Not Include:

1. Active income from partnerships and S corporations, including family entities.
2. Any item taken into account in determining self-employment income if SE tax is imposed (§1411(c)(6)).
3. Any distribution from qualified employee benefit plans or arrangements (§1411(c)(5)).
4. Interest on tax-exempt and tax-deferred vehicles such as municipal bonds, tax-deferred nonqualified annuities, life insurance, and veterans' benefits.

Exclusion and Deferral Tax Provisions Also Apply to NII Tax

Generally, gain that is excluded or not recognized under the general income tax rules is not recognized for NII purposes (i.e., gain deferred using installment method, like-kind exchanges, exclusion on personal residence sale gain, etc.). Deduction limitations and disallowance provisions also apply to the determination of NII (i.e., investment interest limitations, expenses relating to tax-exempt income, at-risk limitations, passive activity loss limitations, etc.) [Preamble, 2].

Income Derived in the Ordinary Course of a Trade or Business Is Not NII

Business income is not NII unless underlying activity is passive or trading in financial instruments or commodities. Gross income is excluded from NII if it is derived in the ordinary course of a trade or business unless the trade or business either is a passive activity or involves the trading in financial instruments or commodities. The term "trade or business," as pertinent to §1411, is defined within the meaning of §162, the rules of which are well-established by a large body of case law and administrative guidance. Section 1411 and its related regulations do not define the phrase "derived in the ordinary course," relying instead on case law and the §469 regulations (TD 9644; Preamble, 5, B, ii, a & b).

Rental Real Estate Income Generally Is Passive Income Subject to NII Tax

Interestingly, the Preamble to the Final Regulations admits that, in certain circumstances, the rental of a single property may require "regular, continuous, and substantial" involvement, resulting in the rental activity being a §162 trade or business. This admission acknowledged the holdings in *Fackler v. Comm.*, 45 BTA 708 (1941), aff'd, 133 F.2d 509 (6th Cir. 1943); *Hazard v. Comm.*, 7 T.C. 372 (1946); and *Lagreide v. Comm.*, 23 T.C. 508 (1954), that the activities of a single property can rise to the level of a trade or business (TD 9644; Preamble, 5,B,ii,a).

Facts used to determine if a real estate rental activity is a business. Key factual elements that may be relevant when determining when a rental activity rises to the level of a trade or business include, but are not limited to:

- the type of property (commercial or residential real property, personal property, etc.),
- the number of properties rented,
- the day-to-day involvement of the owner or its agent,
- the type of rental,
- a net lease vs. a traditional lease, and
- short-term vs. long-term lease (TD 9644, Preamble, 5,B,ii).

A Real Estate Professional's Rental Income May Not Be Subject to NII Tax

If a taxpayer meets the "50%/750 hours in the real property trades or businesses" requirements to be a real estate professional, the taxpayer's interest in rental real estate is no longer considered a "per se" passive rental activity; instead, the rental is treated as if a "trade or business," and the "nonrental" rental real estate activity will not be a passive activity if the taxpayer materially participates in each activity.

Relief provision for real estate professional's rental real estate. Individuals who establish that they are a real estate professional (i.e., contractors, real estate agents, landlords, property managers, etc.[5]) are only allowed to treat rental real estate activities as nonpassive if the taxpayer satisfies at least one of the seven material participation tests (see §1.469-5T(a)). The Preamble in the Final Regulations notes that not all of

[5] The term "real property trade or business" means any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business (§469(c)(7)(C)).

the material participation tests provide conclusive evidence that a taxpayer is regularly, continuously, and substantially involved in a rental trade or business, especially when the taxpayer claims material participation by performing substantially all of the work and the total time spent on the activity is under 500 hours in the year (TD 9644, Preamble, 5,E,iii).

Real estate professional safe harbor rules. The final regulations provide a safe harbor for real estate professionals**.** Real estate professionals who participate in rental real estate activities for more than 500 hours per year or for more than 500 hours per year in five of the past 10 taxable years (one or more of which may be taxable years prior to 2013) may treat the rental income, and the net gain on sale associated with that activity, as derived in the ordinary course of a trade or business exempt from the NII tax (§1.1411-4(g)(7)(i)(A) & (B); §1411(c)(1)(A)(iii); TD 9644, Preamble, 5,E,iii).

> **Tax practitioner planning.** The election to treat all rental real estate as a single activity is permitted for NII purposes (under §1.469-9(g)). However, any rental real estate grouped with a trade or business (under §1.469-4(d)(1)(i)(A) or (d)(1)(i)© is treated as a trade or business, not a rental real estate activity (§1.1411-4(g)(7)(ii)(B)).

Self-Charged Rental Income Received from a Taxpayer's Active Trade or Business Is Not NII

Rents received by a landlord from a business in which he or she materially participates must be recharacterized as income *not* from a passive activity (§1.469-2(f)(6)). This is commonly called the "self-rental" recharacterization rules. Thus, net self-charged rental income is not subject to NII tax. If passive rental property rented to a trade or business in which the taxpayer materially participates is (1) recharacterized as nonpassive or (2) the rental is properly grouped with a nonpassive trade or business activity, then such gross rental income is deemed to be derived in the ordinary course of a trade or business and not subject to the NII tax. In both of these instances, any gain or loss from the sale of assets associated with that rental activity are also treated as held in a nonpassive trade or business (§1.1411-4(g)(6)(i) & (ii); TD 9644, Preamble, 5,E,ii).

> **Tax practitioner planning.** Be sure to code the input sheet correctly as "nonpassive income."

Self-Charged Interest Received from the Taxpayer's Active Trade or Business Is Not NII

Gross income from interest that is received by the taxpayer from a nonpassive activity of such taxpayer (self-charged interest) is treated as derived in the ordinary course of a trade or business and is not NII. The amount of interest income that is excluded from NII is limited to the amount that would have been considered passive activity income if the payor was a passive activity of the taxpayer. This special rule does not apply when the interest deduction is taken into account in determining the 2.90% HI tax, that is SE tax above the FICA wage base (§1.1411-4(g)(5); TD 9644, Preamble, 5,E,i; §1401(b)).

> **Example**. Sharon is a 10% shareholder of an S corporation where she works as a physician. She lent \$100,000 to the S corporation so it could finance an equipment purchase. During the year, the corporation paid her \$8,000 of interest on her loan. \$800 of the interest (10% of the \$8,000) she received is not subject to the NII tax because it is self-charged.

> **Tax practitioner planning.** Be sure to code the input sheet correctly as "self-charged interest" and confirm that the self-charged interest income from the K-1 is not included in NII.

Net Gain Attributable to the Disposition of Property

NII includes net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in any trade or business not either a passive activity or commodity trading. Net gain attributable to the disposition of property is the gain *recognized,* reduced by §165 deductible losses (including losses attributable to casualty, theft, and abandonment or other worthlessness). Net gain also includes gain or loss attributable to the disposition of property from the investment of working capital (§1411(c)(1) and (2); §1.1411-4(d)(3)(i) & (ii); (§1.1411-6)).

> **Tax practitioner planning**. Capital loss carryforwards reduce other NII if the origin is correct**.**

Sales of Interests in Partnerships and S Corps

An interest in a partnership or S corp. is not considered trade or business property even though the underlying business could be. Therefore, when a partner/member/shareholder sells his or her interest, the pass-through entity is required to calculate how much of the owner's gain or loss is attributable to any NII assets held in the name of the pass-through entity, these assets called "§1411 Property." This recognizes that the items of property inside the pass-through entity that constitute §1411 Property might vary among transferors because a transferor may or may not be "passive."

Investment Expenses Deductible in Computing NII

Only properly allocable deductions may be taken into account in determining NII. In order to arrive at NII, gross investment income is reduced by allocable deductions, including:

- investment interest expense, and
- state and local income taxes properly allocable to items included in NII (§1.1411-4(f)(1), (3); Preamble, 5, D, i & ii).

> **Tax practitioner planning**. There isn't an answer yet on how the $10,000 cap on SALT is allocated to calculate net investment income. Is the $10,000 proportioned according to investment income/total income and state taxes? Or is the $10,000 used to the extent that there is at least $10,000 of state income taxes?

Suspended Passive Losses from a Prior Passive Activity May Reduce NII

Suspended losses from former passive activities are allowed in the calculation of NII (as properly allocable deductions or losses), but only to the extent of the nonpassive income from such former passive activity that is included in NII in that year (§1.1411-4(g)(8)).

Estates and Trusts Are Subject to the NII

Estates and trusts are subject to the NII tax if they have undistributed NII and also have adjusted gross income over the dollar amount at which the highest tax bracket for an estate or trust begins for such taxable year under §1(e) (for tax year 2020, this threshold amount is $12,951).

NII FAQs on IRS website (Q & A on the Net Investment Income Tax). Among the issues addressed are the MAGI thresholds for individuals and basic information about what is and isn't included when calculating NII.

ALTERNATIVE MINIMUM TAX AND EXEMPTIONS §55 et seq.

A Tax Policy Center report estimates that the number of AMT filers fell from 5 million in 2017 to 0.2 million in 2018. "*While more than one-quarter of households with incomes between $200,000 and $500,000 paid the AMT in 2017, hardly any households with incomes under $500,000 paid it in 2018.*"

TCJA. Alternative Minimum Tax (§55)

The TCJA temporarily increased both the exemption amount and the exemption amount phase-out thresholds for the individual AMT. For 2020, the AMT exemption amount is $113,400 for married taxpayers filing a joint return and $72,900 for all other taxpayers (other than estates and trusts). The 2020 phase-out thresholds are $1,036,800 MFJ and $518,400 for all other taxpayers (other than estates and trusts). These amounts are indexed for inflation.

Married		
	2019	**2020**
Exemption	$111,700	**$113,400**
Phase-out	$1,020,600 - $1,467,400	**1,036,800 - $1,490,400**
Unmarried		
	2019	**2020**
Exemption	$71,700	**$72,900**
Phase-out	$510,300 - $797,100	**$518,400 - $810,00**

Trusts and estates. The AMT exemption and threshold amounts were not changed by the new law.

Who pays AMT? The top three preferences impacting AMT are exemptions, state taxes, and miscellaneous itemized deductions. All three of these deductions have been suspended by the TCJA. With the increased exemptions, phase-outs and the elimination of most exclusion preferences, many clients will escape AMT beginning in 2018. Deferral preferences, like the ISO bargain element and depreciation adjustments, will be the major cause of any AMT occurring after 2017. AMT will raise about $5 billion each year, down from $39 billion in 2017. AMT will affect about 200,000 filers from 2018 through 2025, down from 5 million in 2017.

AMT credit carryforward. The AMT credit carryforward can be used to the extent that regular tax exceeds AMT. Because many clients will avoid AMT in 2020, the credits may be useable sooner than under old law.

Widow Can't Use Deceased Husband's AMT Credits (*Nadine Vichich v. Comm.*, 146 TC No. 12)

Before his marriage to Nadine Vichich, William Vichich exercised incentive stock options that resulted in AMT liability, which he reported on a 1998 tax return filed jointly with his first wife, Marla. Payment of the AMT liability in 1998 generated an AMT credit carryforward of $304,442. Ms. Vichich was married to Mr. Vichich from 2002 until his death in 2004. On her 2009 tax return, Ms. Vichich reported an AMT credit of $151,928 derived from her deceased husband's 1998 AMT credit carryforward that she used to offset her individual income tax liability. The court agreed with the IRS that Ms. Vichich was not entitled to any premarital credit carryforwards.

> **Tax practitioner planning**. Whether there is a death or a divorce, the marriage ceases to exist, and tax attributes reported on a joint return for an earlier year must be properly allocated for subsequent years to the divorced spouses or to the surviving spouse, as applicable.

Also See.

- *Calvin v. United States*, 354 F.2d 202 (10th Cir. 1965), where the taxpayers attempted to use net operating losses that originated with the taxpayer wife before their marriage to offset the taxpayer husband's income earned in their first year of marriage. Relying on §6013(d) and §1.172-7, the Court of Appeals for the 10th Circuit concluded that, for losses occurring before marriage, "the net operating loss provisions are personal to the taxpayer who incurred such loss and only available in other years to offset income of the same taxpayer."
- *Zeeman v. United States*, 395 F.2d 861 (2d Cir. 1968), where the Court of Appeals for the 2nd Circuit relied on the reasoning in *Calvin* to deny a loss carryback to the taxpayer in the "reverse situation" who sustained losses after her husband's death and then sought to carry them back to joint returns in which all of the reported income belonged to her husband. The court in Zeeman noted succinctly that "[t]he merger of * * * [married couples'] income for tax purposes is linked between different years for only so long as they are married."

KIDDIE TAX

AA. Kiddie Tax (§1(g); Appropriations Act, Sec. 301, pg 647)

For tax years beginning after Dec. 31, 2019, the unearned income of certain children is again taxed at the parents' tax rate. In 2018 and 2019, the Tax Cuts and Jobs Act taxed the unearned income of children using the much higher trust tax rates. BUT, SECURE, included in the Appropriations Act, allows a taxpayer to elect for the change to apply to taxable years beginning in 2018, 2019, or both (as specified by the taxpayer in his or her election).

How to make the election for 2018 and 2019. To make the election, complete Form 8615. If you make this election for 2019, include a statement with the return specifying "election to modify tax of unearned income." The statement can be made on the return (for example, on line 7 or at the top of Form 8615) or on an attachment filed with the return. If you make this election for 2018, include a statement with the amended return specifying "election to modify tax of unearned income" and attach a recalculated Form 8615 to the Form 1040X.

In general. Kiddie Tax applies if either parent is alive at the close of the year, the child does not file a joint return for the taxable year, and the child either (a) has not attained age 18 by the close of the year, or (b) has attained age 18 before the close of the year, but the child's earned income does not represent more than half of support needs and the child has not attained age 19 by the close of the year, or the child is a full-time student who has not attained age 24 as of the close of the year. The first $1,100 of unearned income of a child is tax-free. The next $1,100 is taxed at the child's tax rate. Kiddie tax applies above $2,100 and is computed using the trust rates.

Taxable Scholarship Income

Scholarship proceeds used for expenses other than qualified tuition and related expenses (i.e., tuition, fees, books, and equipment required for the enrollment or attendance of a student at an educational institution or for a specific course taken at the institution) are generally included in income and considered to be unearned income.

Kiddie Tax and AMT

The AMT exemption for tax years beginning in 2020 is the sum of (1) the child's earned income for the taxable year, plus (2) $7,900.

Kiddie Tax and the 3.8% NII Tax

The NII tax does not apply unless the child's AGI exceeds $200,000.

Tax practitioner planning. There is no exemption from kiddie tax for disabled children.

INDIVIDUAL TAX CREDITS

ELECTRIC VEHICLE CREDIT

Electric Vehicle Credit Starts to Phase Out for General Motors (IR-2019-57)

Section 30D provides a credit for Qualified Plug-in Electric Drive Motor Vehicles, including passenger vehicles and light trucks. For vehicles acquired after Dec. 31, 2009, the credit is equal to $2,500 plus, for a vehicle which draws propulsion energy from a battery with at least 5 kilowatt hours of capacity, $417, plus an additional $417 for each kilowatt hour of battery capacity in excess of 5 kilowatt hours. The total amount of the credit allowed for a vehicle is limited to $7,500. The credit begins to phase out for a manufacturer's vehicles when at least 200,000 qualifying vehicles have been sold for use in the United States.

> **Tax practitioner resource**. Vehicles eligible for the credit and the amount of the qualifying credit can be found here.

General Motors. General Motors sold more than 200,000 vehicles eligible for the plug-in electric drive motor vehicle credit during the fourth quarter of 2018. This triggers a phase-out of the tax credit available for purchasers of new General Motors plug-in electric vehicles beginning Apr. 1, 2019.

	General Motors credit
before Dec. 31, 2018	$7,500
Jan.1 to Mar. 31, 2019	$7,500
Apr. 1 to Sep. 30, 2019	$3,750
Oct. 1 to Mar. 31, 2020	$1,875
after Mar. 31, 2020	-0-

> **Tax practitioner planning**. The Tesla electric vehicle does not qualify for a credit in 2020. The BMW i3 Sedan and Porsche Taycan Turbo EV each qualify for the $7,500 credit in 2020.

Watch for a legislative fix. Because the phase-out affects early innovators in the electric vehicle industry, legislation has been *proposed* to allow up to a $7,000 credit for the next 400,000 vehicles sold. If your client is asking about the electric vehicle credit, suggest that he or she waits a few months to buy a Tesla or GMC vehicle to see if Congress gets around to extending the credit.

RESIDENTIAL ENERGY CREDITS

***New*. Non-Business Energy Credit Expired Dec. 31, 2019, After Two-Year Extension**

Non-business energy property credit is available for 2018 and 2019. The Appropriations Act made the non-business energy property credit available for both 2018 and 2019. The credit had expired at the end of 2017.

ADOPTION CREDIT AND ASSISTANCE PROGRAMS

Adoption Tax Credit (§36C; §137, Topic No. 607 Adoption Credit and Adoption Assistance Programs)

Taxpayers who adopt children may claim a tax credit for qualified adoption expenses. A taxpayer may also exclude from income adoption expenses paid by an employer. The credit is phased-out for taxpayers with AGI in excess of certain thresholds.

	2018	2019	**2020**
Adoption Credit	$13,810	$14,080	**$14,300**
Phase-out	$207,140 - $247,140	$211,160 - $251,160	**$214,520 - $254,520**

> **Tax practitioner planning**. The limit applies separately to the credit and the employer benefit exclusion. In other words, as long as adopting parents pay more than $28,600 in qualified 2020 adoption expenses, they may exclude an employer adoption benefit of $14,300 and also claim an adoption credit of $14,300.

Qualified adoption expenses — what? Qualified adoption expenses are defined as reasonable and necessary adoption fees, court costs, attorney fees, traveling expenses (including amounts spent for meals and lodging), and other expenses, which are directly related to, and the principal purpose of which is, the legal adoption of an eligible child by the taxpayer. All reasonable and necessary expenses required by a state as a condition of adoption are qualified adoption expenses, including the cost of construction, renovations, alterations, or purchases specifically required by the state to meet the needs of the child. Expenses are not qualified adoption expenses if they are incurred in:

1. violation of state or federal law,
2. carrying out any surrogate parenting arrangement,
3. connection with the adoption by an individual of a child who is the child of such individual's spouse, or
4. reimbursed under an employer program.

When adoption credit is allowed. The adoption credit is allowed in the earlier of (1) the taxable year following the taxable year the expenses (including expenses for an unsuccessful effort to adopt an eligible child) are paid or incurred or (2) the taxable year in which the adoption becomes final (See Notice 97-70 and Form 8839 instructions for more explanation).

Foreign adoption. For the adoption of a child who is not a citizen or resident of the United States, no credit is allowed unless the adoption becomes final. Rev. Proc. 2005-31 provides safe harbors for determining the finality of an adoption of a foreign-born child for federal income tax purposes. Foreign adoption expenses are taken into account as if such expenses were paid or incurred during the year that the adoption becomes final (§36C(e)(2)).

RDPs adopting a child. If registered domestic partners adopt a child together, one or both of the registered domestic partners qualify for the adoption credit. The partners may not both claim a credit for the same qualified adoption expenses, and the sum of the credit taken by each registered domestic partner may not exceed the total amount paid. The adoption credit is limited to $14,300 per child in 2020. Thus, if both registered domestic partners paid qualified adoption expenses to adopt the same child, and the total of those expenses exceeds $14,300, the maximum credit available for the adoption is $14,300. The registered domestic partners may allocate this maximum between them in any way they agree, and the amount of credit claimed by one registered domestic partner can exceed the adoption expenses paid by that person, as long as the total credit claimed by both registered domestic partners does not exceed the total amount paid by them. The same rules generally apply in the case of a special needs adoption.

One RDP adopts the partner's child. If a taxpayer adopts the child of his or her registered domestic partner as a second parent or co-parent, the taxpayer (adopting parent) may claim the adoption credit for the qualifying adoption expenses he or she pays to adopt the child.

> **Tax practitioner planning.** A taxpayer may not claim an adoption credit for the expenses of adopting the child of the taxpayer's spouse (§23). However, this limitation does not apply to adoptions by registered domestic partners, because registered domestic partners are not spouses for federal tax purposes. RDPs considering an adoption should do so before marrying.

Adoption Tax Tips (IRS Tax Tip 2020-33)

IRS issued a Tax Tip on the adoption credit. If your client plans on adopting a child, this Tax Tip is an easy way to promptly e-mail information on the tax benefits of adoption. Don't forget to update the numbers from 2019 to 2020.

CARES Act and Adoption Expenses

The CARES Act established a new type of penalty-free withdrawal from an IRA or defined contribution plan for childbirth or adoption expenses up to $5,000 per child. The distribution is taxable, but the 10% 10(t) penalty is waived if the distribution is within 12 months following the adoption or birth.

EDUCATION CREDITS

American Opportunity Tax Credit Made Permanent (American Opportunity Tax Credit)

Created under the American Recovery and Reinvestment Act, the American Opportunity Tax Credit is available for up to $2,500 of the cost of tuition and related expenses paid during the taxable year. Under this tax credit, taxpayers receive a tax credit based on 100% of the first $2,000 of tuition and related expenses (including course materials) paid during the taxable year and 25% of the next $2,000 of tuition and related expenses paid during the taxable year. Forty percent of the credit is refundable. This tax credit is subject to a phase-out for taxpayers with adjusted gross income in excess of $80,000 ($160,000 MFJ). The PATH Act of 2015 made the American Opportunity Tax Credit permanent.

Requirements for Claiming the American Opportunity Tax Credit

To reduce fraudulent claims, the PATH Act and the Trade Bills (HR 2146 and HR 1295) added verification requirements and expanded penalties.

> **Note**. The Treasury Inspector General for Tax Administration (TIGTA 2015-40-27) estimated that more than 3.6 million taxpayers received more than $5.6 billion in potentially erroneous education credits in TY 2012. The report gave impetus to the following changes.

Form 1098-T for institution. Higher education information reporting is to include qualified amounts actually paid after Dec. 31, 2015. The provision strikes "or the aggregate amount billed" from the law.

> **Tax practitioner planning**. This change is supposed to stop IRS notices asking for proof of payment during the tax year.

Form 1098-T for individual. Taxpayers are not allowed to claim the American Opportunity Tax Credit or the Lifetime Learning Credit under §25A, or the tuition deduction under §222, unless the taxpayer has received a Form 1098-T from the educational institution.

FEIN required on Form 8863. No American Opportunity Tax Credit will be allowed unless the taxpayer includes the employer identification number of any institution to which qualified tuition and related expenses *were paid* for education furnished with respect to the individual.

Date for certain refunds. No refund or credit for a taxable year will be made to a taxpayer before Feb. 15 if the credit is due to the American Opportunity Tax Credit (§6402).

Prevention of retroactive claims for Earned Income Credit, Child Tax Credit, and American Opportunity Tax Credit. No American Opportunity Tax Credit will be allowed if the identifying number of the taxpayer is issued ***after*** the due date for filing the return (§32(m); §24(e); §25A(I)).

Procedures to reduce improper claims. The return preparer due diligence requirements for the EIC (and the $540 penalty for 2020) will also apply to claims for the American Opportunity Tax Credit (§32(m); §24(e); §25A(I)).

Future credits denied when taxpayers improperly claim credits in prior years. For taxpayers who improperly claimed American Opportunity Tax Credits in a prior year, no credit will be allowed for any taxable year in the disallowance period. The disallowance period is:

1. the period of 10 taxable years after the most recent taxable year for which there was a final determination that the taxpayer's claim of credit under this section was due to fraud, and
2. the period of two taxable years after the most recent taxable year for which there was a final determination that the taxpayer's claim of credit was due to reckless or intentional disregard of rules and regulations (but not due to fraud).

> **Tax practitioner planning**. This is the same restriction for improper claims of the EIC.

Comparisons of Major Features of the American Opportunity Tax Credit (25A(i)), the Lifetime Learning Credit (25A©), and the Higher Education Tuition Deduction (§222)

2020 American Opportunity Tax Credit, Lifetime Learning Credit & Tuition Deduction Comparison			
Feature	**American Opportunity Tax Credit**	**Lifetime Learning Tax Credit**	**Higher Education Tuition Deduction**
Type of benefit	40% of the credit is refundable except if a child subject to Kiddie Tax claims the credit.	Nonrefundable tax credit (cannot exceed tax liability).	Above the line tax deduction (filers do not need to itemize).
Dates applicable	Indefinite	Indefinite	**Expires Dec. 31, 2020**
Expired maximum benefit	$2,500 (100% of first $2,000 in qualified expenses, 25% of second $2,000) per student.	$2,000 (20% of first $10,000 in qualified expenses) per return.	$4,000 deduction per return (but only $2,000 maximum deduction available for higher income taxpayers).
Income limit	Credit begins to phase out at $80,000 modified AGI and is fully phased out at $90,000 ($160,000 and $180,000 thresholds for MFJ).	Credit begins to phase out at $59,000 modified AGI and is fully phased out at $69,000 ($118,000 and $138,000 thresholds for joint returns).	Deduction available to taxpayers with up to $65,000 in modified AGI ($130,000 for joint returns); taxpayers with modified AGI or more than $65,000 but less than $80,000 could claim smaller maximum deduction ($130,000 and $160,000 thresholds for joint returns).
Postsecondary education expenses qualifying for benefit	Tuition, fees, and course materials required for enrollment.	Tuition and fees required for enrollment.	Tuition and fees required for enrollment.
Type of postsecondary education	First four years of undergraduate education when enrolled on at least a half-time basis in a program leading to a degree, credential, or certificate.	For any year of undergraduate or graduate enrollment with no limit on the intensity of enrollment or the type of program.	For any year of undergraduate or graduate enrollment with no limit on the intensity of enrollment or the type of program.
Form 1098-T	Form 1098-T and FEIN of college required to claim credit.	Form 1098-T and FEIN of college required to claim credit.	Form 1098-T and FEIN of college required to claim credit.
Form	Form 8863	Form 8863	Form 8917

EARNED INCOME CREDIT §32

Earned Income Credit (EIC Home Page)

IRS Estimates That 23.8% ($15.6 Billion) EITC Paid Improperly

The IRS estimates that, for FY 2015, 23.8% ($15.6 billion) of EITC payments were issued improperly. The IRS is unlikely to achieve an improper payment rate below 10% without expanded authorities to address identified erroneous claims according to the Treasury Inspector General for Tax Administration (TIGTA).

2020 Earned Income Base Amounts, Credit Percentages, and Phase-Out Amounts

The maximum 2020 EITC is $6,660 (married filing joint with three children). The 2020 earned income and AGI must each be less than:

children	**none**	**one**	**two**	**three or more**
Single, HOH, or widowed	$15,820	$41,756	$47,440	$50,594
MFJ	$21,710	$47,646	$53,330	$56,844

Requirements for Claiming the Earned Income Tax Credit

To reduce fraudulent claims, verification requirements and expanded penalties have been added.

Date for certain refunds. No refund or credit for a taxable year will be made to a taxpayer before Feb. 15 if the credit is due to an EITC, CTC, or American Opportunity Tax Credit (§6402).

> **Tax practitioner planning**. Even with the refund delay provided by the Path Act, a February 2018 TIGTA report identified 1.4 million tax returns with a discrepancy in wages reported on the tax return and wages reported on Forms W-2 that were not reviewed by the IRS before the refunds were sent on Feb. 15, 2017. These taxpayers received approximately $8.2 billion in refunds, including $4.3 billion from EITC claims and $1.7 billion from CTC claims.

Prevention of retroactive claims for Earned Income Credit, Child Tax Credit, and American Opportunity Tax Credit. No EIC, CTC, or American Opportunity Tax Credit will be allowed if the identifying number of the taxpayer is issued ***after*** the due date for filing the return (§32(m); §24(e); §25A(I)).

Procedures to reduce improper claims. The return preparer due diligence requirements for the EIC (and the $540 penalty for 2020) will also apply to claims for the CTC and American Opportunity Tax Credit (§32(m); §24(e); §25A(I)).

Future Credits Denied When Taxpayers Improperly Claim Credits in Prior Years

For taxpayers who improperly claim CTCs and/or American Opportunity credits in a prior year, no credit will be allowed for any taxable year in the disallowance period. The disallowance period is:

- the period of 10 taxable years after the most recent taxable year for which there was a final determination that the taxpayer's claim of credit under this section was due to fraud, and
- the period of two taxable years after the most recent taxable year for which there was a final determination that the taxpayer's claim of credit was due to reckless or intentional disregard of rules and regulations (but not due to fraud).

> **Note**. This is the same restriction for improper claims of the EIC.

Treatment of credits for certain penalties. Underpayment penalties apply to the erroneous claim of the EIC unless the claim is due to reasonable cause (§6694(a); §6676(a)).

> **Note**. This change is in response to the decision in *Yitzchok D. Rand v. Comm.*, 141 TC 376 (2013), where the Tax Court ruled that the §6662(a) accuracy-related penalty applied to the tax after credits.

Disqualified Income Amount Is $3,650 in 2020

No EIC is allowed if the taxpayer has disqualified income in excess of $3,650 for the taxable year (§32(i)).

Filing Form 8867, Mandatory for All EITC Returns

Proposed regulations require paid tax return preparers to file a due diligence checklist, Form 8867, with any federal return claiming the EITC.

Be Diligent When Preparing a Return Claiming EITC (EITC Central)

The IRS continues to remind tax preparers of their responsibilities when claiming EITC. Paid preparers who prepare inaccurate returns claiming the EITC may be assessed a $540 penalty per return (2020) unless they can show they met their EITC due diligence requirements.

INTERNATIONAL ISSUES

THE FOREIGN EARNED INCOME EXCLUSION (§911)

Foreign Income Exclusion (§911, Pub 54)

The 2020 foreign earned income exclusion is $107,600 ($105,900 in 2019).

Foreign earned income exclusion. A qualified individual may exclude, subject to limitations, foreign earned income and foreign housing costs from gross income. "Foreign earned income" is defined as the amount received by an individual from sources within a foreign country attributable to income earned for services performed by the individual. The term "qualified individual" means an individual whose *tax home* is in a foreign country *and* who is a citizen:

1. of the US and who establishes that he or she was a bona fide resident of a foreign country or countries for an uninterrupted period, which includes an entire taxable year, or
2. resident of the US and who, during any period of 12 consecutive months, is present in a foreign country or countries during at least 330 full days in such period.

> **Tax practitioner planning.** Many taxpayers think that any income earned outside of the US is eligible for the exclusion. There are many restrictions. Send your client to the IRS website for more information on the Foreign Earned Income Exclusion.

Waiver exceptions allowed in some cases. Individuals who are not bona fide residents of a foreign country and fail to meet the 330-day physical presence test may be treated as a qualified individual if they are eligible for a waiver. Waivers may be issued to individuals who were:

1. bona fide residents of, or were present in, a foreign country for any period during which individuals were required to leave such foreign country because of war, civil unrest, or similar adverse conditions, which precluded the normal conduct of business by such individuals, *and*
2. able to establish to the IRS that the time requirements of the foreign earned income exclusion could reasonably have been expected to have been met, but for the conditions of war, civil unrest, or similar adverse conditions.

Tax planning idea. The IRS annually publishes a list of foreign countries where war, civil unrest, or similar adverse conditions exist for purposes of §911(d)(4)(B) for years in which such conditions exist.

Foreign Housing Costs Also Excludable or Deductible

Qualified individuals may also exclude from gross income foreign housing costs to the extent such costs exceed the base housing amount (16% of the foreign earned income exclusion — $17,216 in 2020). The maximum foreign housing exclusion is generally limited to 30% of the foreign earned income exclusion ($32,280 in 2020) but may be increased in specific locations designated by the IRS to be "high-cost" localities. The IRS provides adjustments to the foreign housing cost limitation for high-cost areas (Notice 2020-13).

Example. Gene, a US citizen, worked and resided in Iraq for all of 2020, for which he was paid a salary of $120,000. Gene's employer also provided him housing with a fair rental value of $30,000 in 2020. Gene elects the foreign earned income exclusion and the foreign housing cost exclusion, computed:

Value of housing provided by employer	$ 30,000
Less nonexcludable portion ($107,600 x 16%)	($ 17,216)
Calculated housing exclusion	$ 12,784
Maximum housing exclusion ($107,600 x 30%)	$ 32,280
Lesser of calculated or maximum	$ 12,784

Gene's foreign housing cost amount is $12,784. Because he has no income from self-employment, the entire amount is attributable to employer-provided amounts and is excludable. Gene's combined foreign earned income and foreign housing exclusion for 2020 is $120,384 ($107,600 + $12,784).

Tax planning idea. The foreign housing exclusion is only available to employees and only for employer-paid housing expenses. The separate foreign housing deduction applies to those with self-employment earnings.

Tax practitioner planning. Combat-zone contract workers may qualify for the foreign earned income exclusion (the Bipartisan Budget Act of 2018). Generally, contractors working for the US government do not qualify for the foreign earned income exclusion (see *Alfred S. Co v. Comm.*, TCM 2016-18).

Helicopter Pilot Denied Exclusion Since He Was Not a Bona Fide Resident of Saudi Arabia *(Joseph and Jacqueline Bellwood v. Comm.*, TCM 2019-135)

In 2013, 2014, and 2015, Joseph Bellwood flew helicopters in Saudi Arabia for a PHI, Inc., a US company, that provided air ambulance services for the Saudi Red Crescent Authority. He worked a 28-days-on and 28-

days-off schedule. While on duty in Saudi Arabia, Joseph lived in employer-provided housing. While off duty, he returned to his home in the US. During 2013, 2014, and 2015, Joseph retained his US citizenship, driver's license, voter registration, bank account, and US medical professionals.

Exclusion requires bona fide residency or physical presence. Joseph claimed the foreign earned income exclusion on his 2013, 2014, and 2015 tax returns. The foreign earned income exclusion is allowed only if (1) the taxpayer is an individual whose tax home is in a foreign country and establishes to the satisfaction of the IRS that he has been a bona fide resident of a foreign country or countries for an uninterrupted period which includes an entire taxable year (bona fide residence test) or (2) the individual who, during any period of 12 consecutive months, is present in a foreign country or countries during at least 330 full days in such period (physical presence test).

Helicopter pilot's "abode" determined to be in the US, not Saudi Arabia. Joseph did not meet the physical presence test as he made regular trips back to the US during the three years at issue. He argued instead that he was a bona fide resident of Saudi Arabia. An individual is not treated as having a tax home in a foreign country for any taxable period during which his abode is in the US (*Harrington v. Comm*., 93 TC 297, 303, 307 (1989)). Joseph maintained extensive familial, economic, and personal ties in the US, while his ties to Saudi Arabia were limited to his employment with a US company, PHI. He maintained a family home for his wife and son in Georgia; all of his personal bank accounts were in Georgia. Thus, the court ruled that he was not a bona fide resident of Saudi Arabia, but rather maintained his abode in the US. No foreign income exclusion for Joseph!

> **Tax practitioner planning.** The Joseph Bellwood case lists the 11 factors that courts use in determining if the taxpayer is a bona fide resident of a foreign country (citing *Howard Sochurek v. Comm*., 300 F.2d 34, 38 (7th Cir. 1962)).

Also See.

- *James Cambria v. Comm.,* TCS 2019-28, where the taxpayer's tax home was in the US even though he was employed in Afghanistan.

Foreign Earned Exclusion on Delinquent Return Disallowed by Court *(Elena and Frederick Weschenfelder v. Comm*., TCM 2019-133)

Elena Lea Morgan Weschenfelder (ELMW) and Frederick Burkhart Weschenfelder (FBW) were employed by CACI Premier Technology, Inc. (CACI) and Sycoleman Corp. in Iraq during 2004 and 2005. They lived and worked full-time on a military base, living in Republican Guard barracks. The Weschenfelders were employed as intelligence analysts. Their jobs involved strategic and tactical intelligence, and they worked with the Iraqi interim government to help identify threats and to coordinate safe passage and gatherings within the country. In 2006, they moved to Germany, where they continued to work for CACI.

Returns claiming the exclusion were delinquent. The Weschenfelders failed to file their 2004, 2005, and 2006 returns. When they failed to file US tax returns, the IRS prepared "substitute" tax returns for the Weschenfelders for the three years at issue. The Weschenfelders submitted delinquent returns on Jan. 8, 2016. Each return showed a Texas address. The return for 2004 did not include a Form 2555, although reference to such a form was made on the first page of the return. The 2005 return included separate Forms 2555 for each spouse, and the 2006 return included a Form 2555 for Mr. Weschenfelder. On line 9 of each Form 2555, the Weschenfelders reported their tax home as a Texas address established in March 2001. They claimed foreign earned income exclusions of $140,109, $103,202, and $71,929 for 2004, 2005, and 2006, respectively.

IRS disallowed foreign earned income exclusion on delinquent return. The IRS claimed that the Weschenfelders were not entitled to the foreign earned income exclusion because that exclusion is only available if a taxpayer makes an election on a timely filed income tax return, an amendment to a timely filed return, or within one year after the due date of the return (§1.911-7(a)(2)). In this case, the Weschenfelders did not file timely returns.

When is the election to exclude foreign earned income "timely filed"? The opening words of §911(a) "At the election of a qualified individual" make clear that the taxpayer must affirmatively elect to exclude the foreign earned income from his or her gross income. The regulations at §1.911-7(a)(2) provide four alternative timing methods by which a taxpayer may validly make the election. The election must be made with:

1. A later return filed within the period prescribed in §6511(a) amending the foregoing timely filed income tax return,
2. An original income tax return that is filed within one year after the due date of the return (determined without regard to extension of time to file),
3. An income tax return filed after the period described above if the taxpayer owes no federal income tax after taking into account the exclusion and files Form 1040 with Form attached either before or after the IRS discovers that the taxpayer failed to elect the exclusion, or
4. An income tax return filed after the period described above if the taxpayer owes federal income tax after taking into account the exclusion and files Form 1040 with Form attached before the IRS discovers that the taxpayer failed to elect the exclusion.

Required statement missing. Because the Weschenfelders owed tax on their delinquent 2004 and 2005 tax returns, their election was not timely filed. Although they did not owe tax on their 2006 return, the Weschenfelders' failure to type or print the statement specified in subdivision (i)(D)(3) on the top of the return for that year (and those for 2004 and 2005) was fatal.

> **Tax practitioner planning.** If filing a late return with the exclusion, print the following statement at the top of the first page of the Form 1040: "Filed Pursuant to §1.911-7(a)(2)(i)(D)."

Also see.

- *Damon Redfield v. Comm.*, (TCM 2017-71), where the exclusion was disallowed on Damon's late filing because the IRS had already filed a "substitute for return" for the year in question.

REPORTING OF FOREIGN CURRENCY & TRANSACTIONS

Offshore Tax Havens Cost the US Treasury $184 Billion a Year (Picking up the Tab Report)

A report by the US Public Interest Research Group estimates that tax havens used by corporations and wealthy individuals cost the US Treasury $184 billion each year in lost revenue. The report claims that the average small business pays an additional $3,244 each year to cover $110 billion of federal and state taxes avoided by large corporations.

> **Tax practitioner planning**. By law, all US citizens and residents must report their worldwide income. This includes income from foreign trusts and foreign bank and securities accounts.

FBAR

Reporting Foreign Bank and Financial Accounts (FBAR Info; IRS FBAR Reference Guide)

If a US person has a financial interest in or signature authority over a foreign financial account, including a bank account, brokerage account, mutual fund, trust, or other type of foreign financial account, and the account exceeds $10,000 anytime during the year, the Bank Secrecy Act requires the US person to report the account yearly by filing electronically a Financial Crimes Enforcement Network (FinCEN) Form 114, Report of Foreign Bank and Financial Accounts (FBAR).

A US person, including US citizens, residents, and domestic entities, must file his or her 2020 FinCEN Form 114 by Apr. 15, 2021 if:

1. the person has a financial interest in or signature authority (or other authority that is comparable to signature authority) over one or more accounts in a foreign country, and
2. the aggregate value of all foreign financial accounts exceeds $10,000 at any time during the calendar year.

> **Example**. Karen, a United States person, owns foreign financial accounts A, B, and C with account balances of $3,000, $1,000, and $8,000, respectively. Karen is required to report accounts A, B, and C because the aggregate value of the accounts is over $10,000. It does not matter that no single account exceeded $10,000.

> **Tax practitioner planning.** Owners of foreign accounts are required to report their accounts, even if the accounts do not generate any taxable income.

Must be filed by April 15, with extension to October 15 (no filing required for extension). Beginning with the 2016 return, the due date of FinCEN 114 was changed from June 30 to April 15. Also beginning for the 2016 return, an extension to file the FinCEN 114 was allowed for a six-month period ending on October 15.

> **Tax practitioner planning.** FinCEN will grant filers failing to meet the FinCEN 114 annual due date of April 15 (July 15, 2020, for the 2019 tax year) an automatic extension to October 15 each year.

Penalty waiver for first-time filer (2015 Highway Funding Bill). For any taxpayer required to file the FinCEN 114 for the first time, any penalty for failure to timely request for or file an extension may be waived by the IRS.

Foreign currency conversion. Need help computing the US dollars when the client sends you the foreign bank account statement? The Treasury Department issues historical currency conversion rates.

FBAR Filing Simplified for Individuals (BSA E-Filing System)

FBARs may only be filed electronically. FinCEN has streamlined the process for an individual's electronic filing an FBAR, FinCEN 114. Individuals are no longer required to register and create an account on the BSA E-Filing System prior to downloading, completing, and submitting the report to the system.

FBAR Electronic Filing by Third-Party Preparers Requires Authorization on FinCEN Form 114a.

Form 114a, Record of Authorization to Electronically File FBARs, must be signed by the filer to allow third-party preparers to e-file the FBAR form. For accounts held jointly with a spouse, each spouse must sign a Form 114a authorizing the e-file. The form is not submitted with the FBAR filing but must be retained by the third-party preparer for five years. Agents, such as attorneys, CPAs, or enrolled agents filing the FBAR on behalf of a client must register to become a BSA e-filer and file as an institution, rather than an individual.

> **Tax practitioner planning.** For questions or assistance, contact the BSA e-filing help desk at 866-346-9478 or via email at BSAEFilingHelp@fincen.gov.

Reporting Foreign Account and Trust Information on the Form 1040

For 2020, Form 1040, Sch. B, Part III had to be completed if the taxpayer (1) has over $1,500 of taxable interest or ordinary dividends; (2) has a foreign account; or (3) receives a distribution from, was a grantor of, or a transferor to a foreign trust. Line 7a of Part III asks if the taxpayer has a signature authority over financial accounts in a foreign country of more than $10,000. In other words, the IRS has tied together Schedule B, Part III and the requirement to file FinCEN Form 114.

Failure to File FBARs Was Willful (*US v. Dennis Ott,* US District Court, ED Michigan, 2020-1 USTC ¶50,125 (2/1/2020))

Dennis Ott did not file FBAR forms or report any income earned on Canadian Accounts with balances of $1,903,477 in 2007, $770,000 in 2008 and $1,766,129 in 2009. The IRS assessed penalties for willfully failing to file the required FBARs.

The district court ruled that Ott had constructive knowledge of his FBAR reporting requirements by signing his federal tax returns, supporting a finding of willfulness. Generally, a taxpayer who signs his or her tax returns "will not be heard to claim innocence for not having actually read the return, as he or she is charged with constructive knowledge of its contents." (*Greer v. Comm*, 595 F.3d 338, 347 n.4 (6th Cir. 2010)). Ott acted recklessly, and therefore willfully, towards his reporting obligations by not informing his accountant of the foreign accounts.

> **Tax practitioner planning.** In the preparation of the tax returns for the years at issue, Ott's CPA did not affirmatively check the "No" box on the Schedule B regarding Ott's ownership in foreign

accounts. Instead, the accounting software the CPA used defaulted to check the "No" box on Schedule B.

Penalties for Failure to File FBAR (FinCen Publishes Penalty Inflation Adjustments for 2020)

The civil penalty for willfully failing to file an FBAR can be as high as *the greater of* $134,806 or 50% of the total balance of the foreign account per violation. Nonwillful violations that the IRS determines are not due to reasonable cause are subject to a $13,481 penalty per violation.

> **Tax practitioner planning**. Always see an attorney for advice on unreported foreign income and unfiled FBAR and FATCA forms.

No FBAR Penalty If the Foreign *Income* Was Timely Reported

The IRS will not impose a penalty for the failure to file the delinquent FBARs if the taxpayer properly reported on his or her US tax returns, and paid all tax on, the income from the foreign financial accounts reported on the delinquent FBARs, and the taxpayer has not previously been contacted regarding an income tax examination or a request for delinquent returns for the years for which the delinquent FBARs are submitted (Delinquent FBAR Submission Procedures).

FATCA

Foreign Financial Assets Disclosure Required - (Foreign Account Tax Compliance Act (FATCA)); TD 9567; Proposed Regs. 26 CFR 1-301, 121647-10)

Form 8938 "Statement of Specified Foreign Financial Assets" must be attached to the tax return for those with assets exceeding $50,000. The Hiring Incentives to Restore Employment (HIRE) Act contained a provision that both complements and contrasts with the FBAR filing requirement. Specifically, the HIRE Act added §6038D, *requiring* individual taxpayers with an aggregate balance of more than $50,000 to $150,000 for citizens not living abroad[6] in foreign financial *assets* to file a statement with his or her income tax return. Unlike the FBAR information, which originates under Title 31 of the USC and normally is not permitted to be verified against tax return or tax return information due to privacy and disclosure concerns, the provision under §6038D has none of these restrictions. This change allows the IRS to use its full complement of tools to verify the information or lack of information filed.

Instructions for Form 8938 Revised

The update to the Form 8938 instructions reflects changes to the reporting requirements made in the final regulations under §6038D. The final regulations revise (1) the reporting rules for dual resident taxpayers, (2) accounts excluded from the definition of a financial account under an applicable Model 1 or Model 2 IGA, and (3) the rules for joint Form 5471 or Form 8865 filing.

> **Tax practitioner planning**. The IRS added a page to its website for recent developments concerning the Form 8938.

Specified Domestic Entity Reporting. Certain domestic corporations, partnerships, and trusts that are considered formed or availed of for the purpose of holding, directly or indirectly, specified foreign financial

[6] $200,000 to $600,000 for taxpayers living abroad.

assets (specified domestic entities) must file Form 8938 if the total value of those assets exceeds $50,000 on the last day of the tax year or $75,000 at any time during the tax year. For more information on domestic corporations, partnerships, and trusts that are specified domestic entities and must file Form 8938, and the types of specified foreign financial assets that must be reported, see the Form 8938 instructions.

What's required in the disclosure? Form 8938 disclosure statement requires the reporting of the *maximum value of the foreign assets* during the taxable year. The disclosure statement should also provide the following information:

1. ***Financial account*** - the name and address of the foreign financial institution in which such account is maintained and the number of such account.
2. ***Stock or security*** - the name and address of the foreign issuer and such information as is necessary to identify the class or issue of which such stock or security is part.
3. ***Contract, interest, or other instrument*** - such information as is necessary to identify such contract, interest, or other instrument and the names and addresses of all foreign issuers and counter parties with respect to such contract, interest, or other instrument.

Foreign Real Estate Is Not a Reportable Asset (Basic Questions and Answers on Form 8938)

Foreign real estate is not a specified foreign financial asset required to be reported on Form 8938. For example, a personal residence or a rental property does not have to be reported. If the real estate is held through a foreign entity, such as a corporation, partnership, trust or estate, then the interest in the entity is a specified foreign financial asset that is reported on Form 8938, if the total value of all specified foreign financial assets is greater than the reporting threshold that applies. The value of the real estate held by the entity is taken into account in determining the value of the interest in the entity to be reported on Form 8938, but the real estate itself is not separately reported on Form 8938.

Directly Held Tangible Assets Are Not Reportable (Basic Questions and Answers on Form 8938)

Directly held tangible assets, such as art, antiques, jewelry, cars, and other collectibles, are not specified foreign financial assets. Directly held precious metals, such as gold, are not specified foreign financial assets. However, gold certificates issued by a foreign person are a specified foreign financial asset. The contract with a foreign person to sell assets held for investment is a specified foreign financial asset investment asset.

A Foreign Defined Benefit Plan Is a Reportable Asset (Basic Questions and Answers on Form 8938)

A foreign pension plan or deferred compensation plan is a reportable asset. In general, the value of the taxpayer's interest in the foreign pension plan or deferred compensation plan is the fair market value of his or her beneficial interest in the plan on the last day of the year. However, if the taxpayer does not know or have reason to know based on readily accessible information the fair market value of the beneficial interest in the pension or deferred compensation plan on the last day of the year, the maximum value is the value of the cash and/or other property distributed to the taxpayer during the year. This same value is used in determining whether the taxpayer has met the FATCA reporting threshold.

If the taxpayer does not know or have reason to know based on readily accessible information the fair market value of the beneficial interest in the pension plan or deferred compensation plan on the last day of the year and he or she did not receive any distributions from the plan, the value of the interest in the plan is zero. In this circumstance, the taxpayer should also use a value of zero for the plan in determining whether he or she has met the FATCA reporting threshold. If the taxpayer has met the reporting threshold and is required to file Form 8938, report the plan and indicate that its maximum value is zero.

Foreign Financial Assets Must Exceed a Filing Threshold Before Form 8938 Is Required (Form 8938 Instructions)

As can be seen by the following chart, the IRS requires individual taxpayers with foreign financial assets in excess of a filing threshold to file a statement with his or her income tax return. For example, a single taxpayer not living abroad must file Form 8938 if the total value of his or her foreign financial assets exceeds $50,000 on the last day of the year or $75,000 at any time during the year. These amounts double for those who are married filing jointly.

	If Total Value of Foreign Financial Assets Exceed		
Not Living Abroad	**On Last Day of the Year**		**At Any Time during the Year**
Single and MFS	$50,000	OR	$75,000
Married Filing Joint	$100,000	OR	$150,000
Living Abroad	**On Last Day of the Year**		**At Any Time during the Year**
Single and MFS	$200,000	OR	$300,000
Married Filing Joint	$400,000	OR	$600,000

Foreign currency conversion. If the foreign financial asset is reported in a foreign currency, the maximum value of the asset must be determined in the foreign currency and then converted to US dollars. In most cases, the US Treasury Department's Financial Management Service foreign currency exchange rate for purchasing US dollars must be used. This rate can be found here.

Call or E-mail for Answers to Your FBAR and FATCA Questions

Help with FBAR and FFA reporting is available by phone at 866-270-0733 for callers within the US and 313-234-6146 for callers outside the US. Answers can also be found by sending an inquiry to FBARquestions@irs.gov. Call the FinCEN Resource Center at 1-800-767-2825 or (703) 905-3591 or by e-mailing your inquiry to FRC@fincen.gov.

FBAR and FATCA Reporting May Be Required for Same Foreign Asset

The reporting requirement for Form 8938 is separate from the reporting requirement for the FinCEN Form 114, Report of Foreign Bank and Financial Accounts (FBAR). An individual may have to file both forms, and separate penalties may apply for failure to file each form. Information on filing a delinquent Form 114 can be found at Delinquent FBAR Submission Procedures. See the IRS Comparison of Filing Requirements for further information.

Other Foreign Reporting Not Duplicated on Form 8938

Other foreign reporting. Taxpayers do not have to report a specified foreign financial asset on Form 8938 if it is reported on one or more of the following forms that have been timely filed for the same tax year:

- Form 3520, Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts.
- Form 5471, Information Return of US Persons with Respect to Certain Foreign Corporations.
- Form 8621, Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund.
- Form 8865, Return of US Persons with Respect to Certain Foreign Partnerships.
- Form 8891, US Information Return for Beneficiaries of Certain Canadian Registered Retirement Plans.

DELINQUENT FOREIGN ASSET REPORTING

Procedures Are the Same for Delinquent FBARs with All Foreign Income Timely Reported

No penalty. The IRS will not impose a penalty for the failure to file the delinquent FBARs if the individual properly reported on his or her US tax returns, and paid all tax on, the income from the foreign financial accounts reported on the delinquent FBARs, and he or she has not previously been contacted regarding an income tax examination or a request for delinquent returns for the years for which the delinquent FBARs are submitted. See delinquent FBAR procedures on the IRS website.

Streamlined Filing Still Available (Streamlined Procedures, FAQs on Streamlined Procedures, Streamlined Domestic Offshore Procedures, and US Taxpayers Residing Outside of the US)

The streamlined filing compliance procedures, updated Jan. 21, 2020, on the IRS website are available to taxpayers certifying that their failure to report foreign financial assets and pay all tax due in respect of those assets did not result from willful conduct on their part. The streamlined procedures are designed to provide to taxpayers in such situations with:

- a streamlined procedure for filing amended or delinquent returns, and
- terms for resolving their tax and penalty procedure for filing amended or delinquent returns, and
- terms for resolving their tax and penalty obligations.

ACA'S INDIVIDUAL MANDATE

INDIVIDUAL MANDATE HIGHLIGHTS
- Who's Required to Have Insurance
- When and How Is Marketplace Used for Health Insurance Coverage
- Who Qualifies for the Premium Tax Credit
- Individual Mandate Penalty is -0- for 2020
- How and When Health Insurance Information Is Provided to Individuals and the IRS

REPEAL AND REPLACE

President Trump and the Republican controlled Congress promised to repeal and replace Obamacare (the Affordable Care Act). Their first tries failed. For the moment, the ACA is the law of the land. A challenge to the constitutionality is in the courts.

Individual Mandate Penalty (§5000A)

TCJA. The TCJA reduces the amount of the individual responsibility payment, enacted as part of the Affordable Care Act, to zero. The provision is effective with respect to health coverage status for months beginning after Dec. 31, 2018.

> **Tax practitioner planning**. The only change to the ACA individual mandate included in the TCJA was the reduction of the individual mandate penalty to zero. The 3.8% tax on net investment income was retained. The Appropriations Act made changes to business penalties and excise taxes included in the ACA.

AA. The Appropriations Act made changes to the ACA but only in regard to Health Insurance Tax, Cadillac Tax, and the Medical Device Tax. No changes to the individual mandate were included in the Appropriations Act or the CARES Act.

WHO'S REQUIRED TO HAVE HEALTH INSURANCE

ACA's Individual Mandate Requires All to Have Health Insurance (ACA Tax Provisions for Individuals and Families)

The ACA requires individuals to have minimum health insurance for at least one day in a month. However, the TCJA made the penalty for failure to have health insurance -0- for 2019 to 2025.

> **Tax practitioner planning.** For more information, see Affordable Care Act (ACA) Tax Provisions.

WHEN AND HOW THE MARKETPLACE IS USED FOR HEALTH INSURANCE COVERAGE

> 8.3 million people signed up for 2020 ACA health insurance coverage on HealthCare.gov (a reduction of 100,000 from 2019). State exchanges account for another 3 million participants. The top three states for enrollment are Florida, California, and Texas. (*Source National Academy for State Health Policy*)

State and Federal Marketplaces

The ACA requires health insurance exchanges to be established in every state. Exchanges are marketplaces where individuals and small businesses can shop for and purchase private health insurance coverage. Exchanges may be established either by the state itself as a state-based exchange or by the HHS as a federally facilitated exchange (IRS -The Health Insurance Marketplace - updated Feb. 18, 2020). For a qualified applicant, the marketplace is the conduit for premium tax credits and a lower net health insurance premium for the individual and his or her family.

Purchasing Coverage at the Marketplace

In the case of an individual who is ineligible for coverage under an eligible employer-sponsored plan or a government plan, the required contribution is the premium for the *applicable plan*, reduced by the maximum amount of any *§36B credit* for the taxable year (determined as if the individual was covered for the entire taxable year by a qualified health plan offered through the marketplace serving the rating area where the individual resides). Applicable plan means the *single lowest cost bronze plan* available in the individual market through the marketplace that would cover all individuals in the individual's *nonexempt family*. An individual's nonexempt family means the family[7] that includes the individual, excluding any exempt family members or family members treated as eligible for coverage under an eligible employer-sponsored plan. The premium for the applicable plan takes into account rating factors (for example, an individual's age) that the marketplace would use to determine the cost of coverage. Accordingly, the premium for the lowest cost bronze plan is the same for all individuals in a nonexempt family (§5000A(e)(1)(B)(ii); §1.5000A-3(e)(4)(ii)(A); §1.5000A-3(e)(4)(ii)©; Preamble,3,e,ii).

Enrollment at HealthCare.gov for 2020 Plans

Open enrollment for 2020 at Healthcare.gov began Nov. 1, 2019, and ended Dec. 15, 2019, in all states that use HealthCare.gov. These are the same open enrollment dates as Medicare markets for those over 65.

Some states have adopted different open enrollment periods. State-run exchanges are encouraged to follow the same schedule, but several states have different enrollment periods. Check eHealth for an update for each state.

> **Note**. Some states are considering re-opening their enrollment period because of Coronavirus.

Purchasing insurance after the open enrollment ends. A 2020 marketplace health plan can be purchased after open enrollment only if the individual qualifies for a special enrollment period. Marketplaces have

[7] Individuals for whom the taxpayer properly claims a family tax credit for the year (§1.5000A-1(d)(6)).

created exceptions for "qualifying life events" (i.e., moving, loss of coverage, hospitalization, marriage, divorce, etc.). Exceptions are also available for "complex situations" like disaster and website problems. An individual can apply for Medicaid or CHIP at any time of the year.

Failure to File 2019 Tax Returns Prevents Advance Premium Assistance Payments in 2021

If an individual receives an advanced premium assistance payment from the marketplace, the individual must file a tax return reconciling the credit. The reconciliation is done on Form 8962 using the information reported on the Form 1095-A.

Individuals who do not file 2019 returns risk the loss of their 2021 advanced premium tax credit. In addition, the IRS may contact the taxpayer to pay back some or all of the advance payments of the premium tax credit.

> **Tax practitioner planning**. The individual receiving an advance premium tax credit must file a return with Form 8962 even if he or she is not otherwise required to file.

WHO QUALIFIES FOR THE PREMIUM TAX CREDIT

Premium Tax Credit Is Refundable (§36B; §1.36B-0 et seq.; Questions and Answers on the Premium Tax Credit; IRS's "Facts about the Premium Tax Credit")

The premium tax credit is refundable so taxpayers who have little or no income tax liability can still benefit. The credit also can be paid in advance to a taxpayer's insurance company to help cover the cost of premiums.

Premium tax credit helps subsidize the purchase of health insurance. The *premium tax credit* is an advanceable, refundable tax credit available for an *"applicable taxpayer"* for any month that one or more members of the applicable taxpayer's family are:

1. enrolled in qualified health insurance through the marketplace; ***and***
2. not eligible for *minimum essential health coverage* from another source, such as employer coverage or government coverage, other than the individual market in the state (§1.36B2(a), Q&A #1).

Eligibility based on income two years back. Initial eligibility for the premium tax credit is based on the individual's income for the tax year ending two years prior to the enrollment period. Participants must provide the marketplace her or his prior year's tax return. This information is used to determine the amount of any credit that will be paid to insurers in the current year. Providing incorrect information to the marketplace may subject the individual to civil penalties, ranging from $25,000 up to $250,000 for supplying fraudulent information.

Marketplace estimates current premium credit. This financial information is used to estimate the individual's required share of the premiums. The required share of premiums is then subtracted from the premiums for the second lowest-cost *silver plan* (SLCSP) adjusted for age (called the *applicable benchmark plan*) to determine the amount of the premium tax credit. This credit is adjusted for a sliding percentage of household income.

> **Tax practitioner planning.** The Henry J. Kaiser Family Foundation has a simple subsidy calculator to estimate the premium assistance for coverage from the marketplaces.

The premium tax credit is a refundable tax credit; timing is discretionary. Although the credit is generally payable in advance directly to the insurer, individuals may elect to pay for health insurance out-of-pocket and receive the credit with their tax return. The individual can decide to have all, some, or none of the estimated credit paid in advance directly to the health insurance company (Q&A #3).

> **Tax practitioner planning.** Even if the insured owes no tax and receives no advanced premium tax credit, he or she will receive the full amount of the credit as a refund as long as the insured's health coverage was purchased through the marketplace.

Too much advance payment of credit may end up as a tax due for the insured. The final credit amount for any given year is based on that year's actual income. Any advance payments of the credit received will be reconciled with the actual premium tax credit on the individual's tax return using Form 8962. If the actual allowable credit is more than the advance credit payments, the difference will be added to the individual's refund or subtracted from the balance due (Q&A #13).

Who's Eligible for the Credit — Seven Criteria (§36B(e)(2); §1.36B-2(b)):

1. Household income must fall between 100% and 400% of the FPL for the taxpayer's family size (FPL in 2020 for a family of four is $26,200 to $104,800 in continental US).
2. If married at the end of the year, a joint tax return must be filed. A qualifying individual may not file a Married Filing Separately tax return (unless the individual meets the criteria in Notice 2014-23, which allows certain victims of domestic abuse or spousal abandonment to claim the premium tax credit using the Married Filing Separately filing status) [§1.36B-2T(b)(2)(i); TDNR JL-2584; Q&A #11].
3. Affordable coverage through an eligible employer plan that provides minimum value must not be available to the taxpayer (see Q&A #8 & 9).
4. The taxpayer must not be eligible for coverage through a government program, like Medicaid, Medicare, CHIP, or TRICARE.
5. The taxpayer must not be claimed as a dependent on another taxpayer's tax return.
6. At the time of enrollment, the taxpayer must be a US citizen or national or an alien lawfully in the US and not be incarcerated.
7. The taxpayer must purchase coverage through the marketplace (Q&A #5).

Household income must be between 100% and 400% of federal poverty level. In general, individuals and families whose "household income" for the year is between 100% and 400% of the FPL for their family size may be eligible for the premium tax credits assuming all other eligibility criteria are met (Q&A #6). For purposes of premium credit eligibility, household income is measured according to the definition for MAGI. An individual whose MAGI is at or above 100% FPL, up to and including 400% FPL, may be eligible to receive premium credits. The below table displays the income levels at 400% FPL, the amount beyond which individuals and families would not be eligible for premium credits in 2020.

Income Levels at 400% FPL Applicable in 2020 Premium Credit Eligibility (HHS.gov/poverty-guidelines)

Number of Persons in Family	48 Contiguous States & DC	Alaska	Hawaii
1	$51,040	$63,800	$58,720
2	$68,960	$86,200	$79,320
3	$86,880	$108,600	$99,920
4	$104,800	$131,000	$120,520
5	$122,720	$153,400	$141,120
6	$140,640	$175,800	$161,720

Tax practitioner planning. There is no asset test included in the requirements to receive a premium tax credit, only an income test. Clients with significant wealth in assets, but incomes that are subject to some discretion, may be able to manage their income so that they qualify for subsidized health insurance (can you say farmer?). IRAs or HSAs, §179 expensing, pension and profit-sharing plans, etc., could all be used to reduce AGI in order to qualify a particular taxpayer for premium credits.

HOW THE PREMIUM TAX CREDIT IS CALCULATED

Applicable individuals report their *household income* to the marketplace and then enroll in a health plan offered through the marketplace. Financial information provided to the marketplace is used to calculate the applicable individual's required share of premiums for the health plan. The required share of premiums is then subtracted from the cost of premiums for the second lowest-cost *silver plan* (SLCSP) adjusted for age (called the *applicable benchmark plan*) to determine the amount of the premium tax credit.

Definition of Household Income When Calculating the Premium Tax Credit

For purposes of the premium tax credit, household income is defined as the sum of (§36B(d)(2)):

1. the taxpayer's *MAGI*, plus
2. the aggregate modified adjusted gross incomes of all other individuals taken into account in determining that taxpayer's family size (but only if such individuals are required to file a tax return for the taxable year).

Modified adjusted gross income is defined as adjusted gross income increased by:
1. amounts excluded from gross income for citizens or residents living abroad (§911), plus
2. any tax-exempt interest received or accrued during the tax year, plus
3. Social Security benefits excluded from gross income under §86; Q&A #7.

Extended family member's income not part of household income if not claimed as a dependent. An eligible related individual not claimed as a dependent is not treated as a related individual and the unclaimed dependent's household income is independently determined (Preamble,3,e,i,C).

The "applicable percentage" table (TR §1.36B-3T(g)). The premium tax credit operates on a sliding scale in a linear manner, the result being that as household income increases the taxpayer's required share of contribution increases. Beginning in 2015, the percentages of income were indexed in order to hold steady the share of premiums that enrollees at a given poverty level pay over time. Examples below are calculated using the Kaiser Family Foundation calculator at kff.org.

The Final Reconciliation Is Done on the Form 8962

Estimated annual premium tax credit is reconciled on [Form 8962](#). If an individual receives advance credit payments in any amount or plans to claim the premium tax credit when filing her or his tax return, a federal income tax return must be filed to reconcile the difference between the advance credit payments made on the individual's behalf and the actual amount of the credit that should have been claimed, or to initially claim the credit. This is completed by filing Form 8962 with the individual's tax return. The filing requirement applies regardless if the individual would otherwise be required to file a return (§36B(f); Q&A #3, 4 & 11).

Form 8962, Part 3: Repayment of excess advance payment of the premium tax credit. If the taxpayer's advance credit payments exceed the allowed premium tax credit, the taxpayer owes the excess as a tax liability, subject to a repayment limitation. This filing requirement applies whether or not the individual would otherwise be required to file a return (§36B(f); Q&A #3, 4 & 11).

> **Tax practitioner planning**. The additional tax credit payback may be limited to $300 - $2,500 if the taxpayer is low-income.

Changes in Circumstances That Can Affect the Amount of the Actual Premium Tax Credit Include:

- differences in household income between the projected and actual income,
- change in marital status,
- birth or adoption of a child,
- other changes to household composition, or
- gaining or losing eligibility for government-sponsored or employer-sponsored healthcare coverage (Q&A #4).

Beware of the Income Cliff That Exists in the Premium Tax Credit Calculation!

Numerous suggestions have been made to reduce household income in order to maximize the premium tax credit (PTC), including recommending the client contributes to an IRA, a pension, or an HSA. Timing differences include electing §179 when purchasing qualified depreciable assets. But what is often missed in this discussion is the income cliff. The premium tax credit is available only to qualified individuals with income below 400% of the federal poverty level (FPL). A dollar over that 400% number means the PTC is lost. The following examples using the PTC calculator at kff.org show that a $1,000 raise can cost a family more than $9,341 in premium tax credits!

> **Example.** A family of four (two mid-40 adults with two children living in Sunnyvale, California) with $104,000 of 2020 household income qualifies for a PTC of $9,341 (using zip code 94087). If the family has just $1,000 more of income, the premium tax credit drops to zero and the family must pay all of their health insurance premium of $19,414 and pay back any advanced premium tax credit received from the marketplace.

> **Tax practitioner planning**. When advising a middle-income client at year-end, keep an eye on the federal poverty level numbers so that you can adjust income where possible to maximize the credit.

Failed to Reconcile Advance Premium Tax Credit on Form 8962 (*Denine and Bryan Kerns, pro ses, v. Comm.*, TCM 2019-14)

Denine and Bryan Kerns purchased their health insurance through Covered California. They received an advanced premium tax credit (APTC) of $8,420 in 2014. They timely filed their 2014 return reporting AGI of $97,061. They claimed personal exemptions for themselves and no exemptions for dependents. The IRS determined that the Kerns were not eligible for any credit because their household income exceeded the maximum allowable under §36B(b) and (c)(1)(A). For 2014, 400% of FPL was $35,021. The Kerns' household income far exceeded that amount, and the court found that the taxpayers were ineligible for any APTC.

> **Note**. The Kerns argued that the insurance company's malfeasance nullified any tax liability arising from the APTC — a novel argument, but not valid for the court.

Premium Tax Credit Calculation Failed to Take into Account SS Benefits for Current and Prior Year (*Levon Johnson v. Comm.*, 152 TC No. 56 (Mar. 11, 2019))

In 2014 Levon Johnson received $4,460 in advance payments premium tax credits (PTC). Johnson's reported MAGI was within the amount needed to qualify him for the PTC, but Johnson did not include in his MAGI all $26,180 of Social Security benefits received during 2014, which included a lump sum payment of $19,493 attributable to 2013. In his amended 2014 tax return, Johnson made a §86(e) election to exclude a portion of the 2013 Social Security benefits received during 2014 from his gross income. Johnson's amended return showed $1,250 of excess advance payments of the PTC.

MAGI includes SS received for prior year. The court found that for purposes of determining a taxpayer's eligibility for a PTC pursuant to §36B, MAGI includes all Social Security benefits received during the taxable year irrespective of any §86(e) election. "The year of receipt, as opposed to the year to which the Social Security benefits are attributable, is the significant definitive factor."

NO PENALTY APPLIES

> **TCJA.** There is no individual mandate penalty beginning in 2019.

Annual Individual Mandate Penalty		
Year	**Percentage of Applicable Income**	**Flat Dollar Amount**
2014	1.0%	$95
2015	2.0%	$325
2016-2018	2.5%	$695
2019-2025	-0-	-0-

CLIENT LETTERS

INDIVIDUAL CLIENT LETTER

New Tax Law and What It Means for Your 2020 Personal Taxes

Dear Client:

Recent changes to the tax law including changes enacted in December 2019 and March 2020 are likely to impact your 2020 tax return and your tax planning. A highlight of a few of these changes follow:

Tax rates. Tax reform reduced tax rates. The top tax rate for 2020 is 37% for those with taxable income above $518,400 for single taxpayers and above $622,050 for married taxpayers filing a joint return. The other rates are:

- ☐ 35%, for taxable incomes over $207,350 ($414,700 for married couples filing jointly)
- ☐ 32% for taxable incomes over $163,300 ($326,600 for married couples filing jointly)
- ☐ 24% for taxable incomes over $85,525 ($171,050 for married couples filing jointly)
- ☐ 22% for taxable incomes over $40,125 ($80,250 for married couples filing jointly);
- ☐ 12% for taxable incomes over $9,875 ($19,750 for married couples filing jointly)

Kiddie tax. Beginning in 2020, the tax on the unearned income of a child is taxed at the parents' tax rate. This is a repeal of a tax reform change that took effect in 2018 where the child's unearned income was taxed at the much higher trust tax rates. You can elect to have this change apply for 2018 and 2019.

Exemptions and the child tax credit. Tax reform eliminated the deduction for personal exemptions. An expanded child tax credit helps to make up for the loss of personal exemptions for some families. The credit is $2,000 for each qualifying child under 17. For children 17 and older and for other dependents, the credit is $500.

2020 Standard deduction. Beginning in 2018, the standard deduction was doubled. The higher standard deduction ($12,400 for singles, $18,650 for heads of household, and $24,800 for married filing joint in 2020) means that fewer taxpayers will benefit from itemizing deductions.

Itemized deductions. Itemized deductions for all state and local taxes, including property taxes, are capped at $10,000. The limit on mortgage debt for purposes of the mortgage interest deduction was reduced in tax reform from $1,000,000 to $750,000 for loans made after Dec. 15, 2017. Loans made before Dec. 15, 2017, are grandfathered at the $1,000,000 debt limit. The interest on home equity borrowing is no longer deductible. Miscellaneous itemized deductions subject to the 2% of AGI limitation are not allowed. Miscellaneous itemized deductions lost because of the new law include employee business expenses, investment adviser fees, union dues, and tax preparation fees. Personal casualty losses are not allowed unless the losses were suffered in a federally declared disaster area.

Alimony. The tax reform law eliminated the alimony deduction for agreements signed after Dec. 31, 2018. Alimony income is not taxable for agreements signed after Dec. 31. 2018. There is no change to the law for agreements signed before Jan. 1, 2019. Thus for "grandfathered" agreements, alimony paid is still deductible and alimony received is still taxable income.

Moving expenses. The tax reform eliminated the moving expense deduction and made employer reimbursement of moving expenses taxable to the employee.

AMT. The new tax reform law temporarily increases the alternative minimum tax (AMT) exemption for tax years 2018 through 2026. The increase in the exemption, as well as the elimination of major tax preferences (exemptions, state taxes above $10,000, and miscellaneous itemized deductions), means that fewer people are subject to AMT under the new law.

Education. Tuition savings programs - 529 plans have changed. Funds in the 529 plan may be used to pay up to $10,000 a year for grades K to 12 private school tuition. Qualified 529 plan distributions now include up to a $10,000 lifetime withdrawal to pay off student loan principal and interest. Qualified distributions also now include tuition, books, supplies, and equipment required for Apprenticeship Programs if the program is properly registered and certified by the Department of Labor.

The above-the-line deduction for college tuition expenses has been reinstated retroactively for 2018 through 2020. The American Opportunity and the Lifetime Learning credits continue to be available.

Other Extenders. The Dec. 20, 2019, changes included individual provisions extending the 7.5% medical AGI limit (2019 and 2020), the mortgage insurance premium deduction (retroactive), the non residential energy credit (retroactive), and the cancellation of debt exclusion for principal residence indebtedness (retroactive).

Pension and IRA Reform. The Dec. 20, 2019, legislation included the Setting Up Every Community for Retirement Enhancement (SECURE) Act. SECURE changes the required minimum distribution (RMD) starting age from 70½ to 72 years, ends the 70½ age limit for a contribution to an IRA, reduces the nonspousal "stretch" period to 10 years, and requires that employers offer part-time employees 401(k) participation. The Mar. 27, 2020, legislation in response to the Coronavirus Pandemic waives all RMDs for 2020. You may take a 2020 distribution from your IRA or pension plan, but you are not required to do so.

> **Three special planning notes for you.** (1) If you named your estate as the beneficiary of your pension or IRA, the elimination of the "stretch" provisions for non-spousal beneficiaries means that you need to see your estate planning attorney for required changes to the trust document, (2) If you turn 70½ in 2020, your required minimum distribution can be delayed until you turn 72, and (3) the ability to contribute to your IRA regardless of your age, if you have earned income, has resulted in a change to the charitable distribution calculations.

2020 Form W-4. If your payroll taxes were under-withheld last year and you didn't like having tax due on April 15, you may want to file a new Form W-4 with your employer. The 2020 Form W-4 has changed from prior year versions. If you need help, give us a call.

There's more. These are just a few of the changes included in recent tax legislation. Your 2020 taxes are affected. That's guaranteed by the scope of the changes in the past few years. The degree of impact depends on your personal situation.

Questions we can answer for you.

- ☐ Will the new tax laws help me or hurt me?
- ☐ Should I amend my prior year returns for the retroactive changes in the new law?
- ☐ Is my withholding enough so that I won't have any surprises next April 15?
- ☐ Do I need to make changes to my retirement planning because of the new tax laws?

Please give us a call for answers and planning suggestions.

Sincerely,

HOMEOWNER CLIENT LETTER

Tax Reform and What It Means for Homeowners

Dear Client:

President Trump promised that he would push for tax reform legislation. On Dec. 22, 2017, he signed the Tax Cuts and Jobs Act into law, the first major tax reform in 31 years. The tax reform law made dozens of changes to the tax code. Many homeowners are impacted. A highlight of the changes follows:

Property taxes.

The deduction for all state and local taxes, including property taxes, is capped at $10,000. This limit applies to homeowners and their Schedule A property taxes. It does not apply to taxes paid on business or rental property.

- **What does this change mean?** It can mean that you get no tax benefit for the property taxes that you pay. For example, if your state income taxes exceed the $10,000 deduction limit, your federal income taxes are not reduced by the payment of property taxes. If your state income taxes are $7,000 and your property taxes are $6,000, only $3,000 of your property taxes end up deductible on your federal tax return. You get no tax benefit for the remaining property tax payment.

Mortgage interest.

Mortgage interest continues to be deductible, but the limit on debt used to purchase, construct, or substantially improve your personal residence has been reduced for new mortgages. The limit on mortgage debt for purposes of the mortgage interest deduction is reduced from $1,000,000 to $750,000 for loans made after Dec. 15, 2017. Loans made before Dec. 15, 2017, are grandfathered at the $1,000,000 debt limit.

Interest on equity debt is no longer deductible. This means that the interest paid on the borrowing from the equity of your home to pay off personal debts (such as credit card debt, auto loans, or student loans) is not deductible beginning in 2018.

Second home interest continues to be deductible. But, the combined total of the acquisition debt on your first and second home cannot exceed $750,000 ($1,000,000 if the debt is incurred prior to Dec. 16, 2017).

- **What does this change mean?** If your acquisition mortgage(s) is less than $750,000, the change does not affect you. If you purchased your home a few years ago and your acquisition mortgage(s) is less than $1,000,000, the change does not affect you because of the grandfathering provision. But if you are buying a new home this year, the interest you pay on a mortgage above $750,000 will not be deductible. If you borrowed from the equity of your home, this year or in a prior year, to pay off personal debt, the interest on the equity borrowing is not deductible.

Standard deduction.

Beginning in 2018, the standard deduction was doubled. The higher standard deduction ($12,400 for singles, $18,650 for heads of household, and $24,800 for married filing joint in 2020) means that fewer taxpayers will benefit from itemizing deductions.

- **What does this change mean?** It may mean that the standard deduction is more than your itemized deductions (medical expense, state tax and property tax, mortgage interest, and charity). For example, if you are married and file a married joint tax return, your standard deduction is $24,800. Your 2020 itemized deductions are $10,000 of taxes, $10,000 of mortgage interest, and $2,000 of charity. Since your itemized deductions are less than $24,800, you get no tax benefit from paying any of your itemized deductions, including the property taxes and mortgage interest on your home.

Home sale.

Changes were proposed to the home sale rules. No changes were included in the final tax reform law. You may still exclude up to $250,000 ($500,000 married filing joint) of the gain on the sale of your principle residence if you have owned and occupied the home for two of the prior five years.

Questions we can help you answer.

- ☐ Will the new tax reform law help me or hurt me?
- ☐ Is my withholding enough so that I won't have any surprises next April 15?
- ☐ If I buy a house, will I get any tax benefits?
- ☐ If I buy a bigger house, will I get any tax benefits?
- ☐ If I borrow from my home equity to remodel my house, will I get to deduct the interest on the debt?
- ☐ If I borrow from my home equity to pay off student loans (or my automobile or credit card loans), will I get to deduct the interest on the debt?
- ☐ Will I lose my $1 million "grandfathered" mortgage amount if I refinance my existing mortgage?
- ☐ If I refinance my first mortgage to include my prior home equity borrowing, will I be able to deduct the interest on the combined debt?

Please give us a call for answers and planning suggestions.

Sincerely,

2020 FEDERAL TAX UPDATE
INDIVIDUAL RETURNS

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FEDERAL TAX UPDATE
RETIREMENT PLANS

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2020 FEDERAL TAX UPDATE
RETIREMENT PLANS

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THE CARES ACT

Temporary Waiver of RMDs

A retirement plan or IRA owner must take a required minimum distribution (RMD) annually once the owner reaches age 72, not 70½, starting Jan 1, 2020 (§401(a)(9)). However, for calendar year 2020, CARES waives the required minimum distribution rules for certain defined contribution plans. That is, the wavier applies to all RMDs that would have been required in 2020. This includes the first RMD, which individuals may have delayed from 2019 to April 1, 2020.

> **Example**. John, who is 74 years old, has an IRA with a balance of $1,000,000 on Dec. 31, 2019. Using prior law, John's RMD for 2020 is $42,017. Currently, his IRA is worth $500,000 and he doesn't want to sell stock inside of the IRA account to take out an "inflated" RMD amount. CARES allows John to waive his 2020 RMD.

RMD rules do not apply to the following plans in 2020:

1. defined contribution plans (§403(a) or §403(b)),
2. defined contribution plans that are eligible deferred compensation plans under §457(b) and maintained by an employer, or
3. individual retirement plans (§401(a)(9)(I)(i)).

In addition, the RMD rules do not apply to any distribution required to be made in 2020 because of:
1. a required beginning date occurring in 2020, and
2. such distribution not having been made before 2020.

> **Example**. Jill turned 70½ in January 2019. She chose to take her first RMD on Apr. 1, 2020. Because of CARES, Jill is not required to take an RMD, even this one, in 2020.

Tax practitioner planning. 80% of account owners drew more than their RMD *prior* to the pandemic. Clients may need to take more money from their pension accounts, not less, during this crisis.

Remind your clients. Taxpayers *may* take a distribution from their IRA or pension plan in 2020. The new law simply does not *require* them to take a distribution in 2020.

Waiver of 10% Penalty for Coronavirus-Related Distribution

Consistent with previous disaster-related relief provisions, CARES waives the §72(t) 10% early withdrawal penalty for distributions up to $100,000 from qualified retirement accounts for coronavirus-related purposes made on or after Jan. 1, 2020, and before Dec. 31, 2020. Income attributable to such distributions is subject to tax over three years.

Three-year repayments of Coronavirus-related distributions. A Coronavirus-related distribution may, at any time during the three-year period beginning on the day after the date such Coronavirus-related distribution was received, be repaid in one or more contributions to an eligible retirement plan in which the qualified individual is a beneficiary. Such repayments will be treated as eligible trustee to trustee rollovers made within 60 days of distribution.

Coronavirus-related distribution. A Coronavirus-related distribution is one made to an individual:

1. who is diagnosed with COVID-19,
2. whose spouse or dependent is diagnosed with COVID-19, or
3. who experiences adverse financial consequences as a result of being quarantined, furloughed, laid off, having work hours reduced, being unable to work due to lack of child care due to COVID-19, closing or reducing hours of a business owned or operated by the individual due to COVID-19, or other factors as determined by the Treasury Secretary.

Qualified individual. A qualified individual is any individual:

1. diagnosed with the virus SARS-CoV-2 or with Coronavirus COVID-19 by a test approved by the CDC,
2. whose spouse or §151 defined dependent is similarly diagnosed, or
3. experiencing adverse financial consequences as a result of being:
   (a) quarantined,
   (b) furloughed or laid off or having work hours reduced due to such virus or disease, or
   (c) unable to work due to lack of child care due to such virus or disease, or the closing or reduction of hours in a business owned or operated by the individual due to such virus or disease.

Note. The retirement plan administrator can rely on an employee's certification that the employee satisfies the conditions of item (3) above.

Pension Plan Loans

The limit on retirement plan loans from a qualified employer plan made to qualified individuals during the 180-day period beginning on Mar. 27, 2020, is increased from $50,000 to $100,000,000 (or, if less, the individual's nonforfeitable benefit) [§4975(d)]. If the due date of a loan occurs between Mar. 27, 2020, and Dec. 31, 2020, it will be delayed for one year.

THE SECURE ACT

The bipartisan Setting Every Community Up for Retirement Enhancement (SECURE) Act was passed by the House in May 2019 with a 417-3 vote. It was held up by Senator Mitch McConnell for most of the year until the appropriation bill seemed a likely last minute place to attach the pension reform package.

IRA Changes

RMDs. SECURE changes the start date for required minimum distributions (RMDs) to age 72. The age change applies to distributions required to be made after Dec. 31, 2019, with respect to individuals who attain age 70½ after such date. For those who turned 70½ in 2019, their first RMD must be taken by Apr. 1, 2020. Anyone who turns 70½ in 2020 will not have to take their RMD until they turn 72.

> **Note**. Pushing the RMD age out to age 72 does not change the qualified charitable distribution (QCD) rule. Thus, a taxpayer who is 70½ may make a QCD and reduce his or her RMD. But see "coordination with QCD" discussed below.
>
> **Example**: Bill is retired, and his 70th birthday was July 1, 2019. Bill reached age 70½ after Dec. 31, 2019, so he is not required to take a minimum distribution until he reaches 72. Bill reached age 72 on July 1, 2021. He must take his first RMD (for 2021) by April 1, 2022, with subsequent RMDs on Dec. 31 annually thereafter.

Born before July 1, 1949: RMDs started at age 70½ .
Born after June 30, 1949: RMDs started at age 72.

IRA contributions allowed after age 70½. Beginning in 2020, the age limit for contributions to an IRA has been eliminated. In prior years, contributions to an IRA were not allowed beginning for the year the taxpayer turned 70½.

Coordination with QCD. Because IRA contributions are now deductible for those who qualify for the qualified charitable distribution (QCD) provision, SECURE reduces the allowable QCD by the IRA deduction allowed for a taxpayer over 70½. *"The amount of distributions not includible in gross income by reason of the preceding sentence for a taxable year shall be reduced (but not below zero) by an amount equal to the excess of— '(i) the aggregate amount of deductions allowed to the taxpayer under §219 for all taxable years ending on or after the date the taxpayer attains age 70½,' (ii) the aggregate amount of reductions under this sentence for all taxable years preceding the current taxable year."*

> **Example**. Joe made traditional IRA contributions at age 71 and 72 for a total of $14,000. A few years later, Joe directs the custodian of his IRA to make a qualified charitable distribution of $25,000 to the Salvation Army. The first $14,000 of the distribution is not treated as a QCD. Thus, $14,000 will be included in Joe's income as a taxable distribution, and Joe may deduct $14,000 on his Schedule A as a charitable contribution.

Non-spouse beneficiary. The "stretch" distribution period for non-spouse inherited IRAs is reduced to a 10-year maximum, from a lifetime distribution. Within the 10-year period, there are no required distributions. But, the entire inherited retirement account must be distributed by the end of the 10-year period. In a change from prior law, the 10-year period applies regardless of whether the plan participant or IRA owner dies before or after reaching their required beginning date for distributions.

> **Example**. Joe's father dies in 2020 and names Joe as the beneficiary of his $500,000 IRA. Joe may withdraw funds from the IRA as he wishes, but the entire account balance must be withdrawn by the end of the 10-year period.

The 10-year distribution limit does not apply to "eligible designated beneficiaries." These include:

- a surviving spouse[1];
- a minor child[2] (the exception for a minor child no longer applies once the child reaches the age of majority and the remainder of the distributions to that individual must be completed within 10 years after that date);
- a disabled individual (§72(m)(7));
- a chronically ill individual (§7702B(c)(2)); and
- an individual who is not more than 10 years younger than the deceased participant or IRA owner.

The change applies to distributions to a non-spouse beneficiary from retirement plans and IRAs made if the plan participant or IRA owner's death occurs after Dec. 31, 2019.

> **Tax practitioner planning.** For those who have named a trust as the beneficiary of their IRA or pension accounts, a review of the trust document is essential. Some "look-through trusts" have distribution provisions that may result in distributions being held up until the tenth year.

Birth and adoption distributions. Distributions for the birth or adoption of a child of up to $5,000 per individual are penalty-free withdrawals from an IRA and a qualified pension plan. To meet the requirements of the qualified birth or adoption distribution, the individual must take a distribution during the one-year period beginning on either the date of birth of the child, or the date of the final adoption of the child (under age 18). An individual taking a distribution for the birth or adoption of a child may make an additional contribution back to the plan from which the distribution was made or to an IRA. The IRS will need to provide timing rules for the repayment.

> **Tax practitioner planning**. Spouses may each take a $5,000 distribution if each has a retirement account.

A distribution is not treated as a qualified birth or adoption distribution with respect to any child or eligible adoptee unless the taxpayer includes the name, age, and TIN of such child or eligible adoptee on the taxpayer's tax return for the taxable year. This change is effective for distributions made after Dec. 31, 2019.

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[1] The spousal beneficiary may still rollover the spouse's IRA or pension account into his or her own IRA.

[2] The minor child must still take RMDs based on his or her life expectancy until the child reaches majority (and then the 10-year rule applies).

Two amounts treated as compensation for IRAs. Certain taxable non-tuition fellowship and stipend payments to graduate and post-doctoral students are treated as compensation for IRA purposes. This change is effective for taxable years beginning after Dec. 31, 2019.

Excluded difficulty of care payments (§131) are treated as compensation for determining non deductible IRA contributions. This change is effective for contributions made after Dec. 20, 2019.

IRA Publications Not Yet Updated for 2020 Law Changes

IRS Publication 590-A and 590-B have not been updated for the SECURE Act. The Feb. 24, 2020, revision to the publications is only for 2019 law.

401(k) Changes

Part-time employees. 401(k) plans are required to offer participation to long-term, part-time employees. Employers with 401(k) plans must offer employees who work between 500 and 1,000-hours a year an additional means to participate in the plan. The rule change only affects 401(k) cash or deferral arrangements, and no other qualified plans. A part-time employee is eligible to participate in the employer's 401(k) plan if the employee has at least 500 hours of service in three consecutive 12-month periods.

The change applies to plan years beginning after Dec. 31, 2020, except that the12-month periods beginning before Jan. 1, 2021, are not taken into account. Thus, the earliest that a part-time employee will be able to participate in the 401(k) plan is 2024.

Automatic enrollment credit. To encourage participation, a new tax credit of $500 for a three-year credit period is allowed for small employers adding an auto-enrollment provision to their plans. The new credit applies for taxable years beginning after Dec. 31, 2019.

Automatic enrollment percentage increased. Beginning in 2020, the SECURE Act allows the plan to set the automatic enrollment percentage to as high as 15% (was 10%).

Annuity offerings in 401(k) plans. SECURE updates the safe harbor provision for plan sponsors to offer annuities in their 401(k) plans to ease liability concerns. New ERISA §404(e) provides a Fiduciary Safe Harbor for fiduciaries selecting a "lifetime income provider." When selecting an annuity provider, the fiduciary must engage in "an objective, thorough and analytical search" of providers and obtain several written representations from the annuity provider selected.

SECURE also provides that pension plans may make a direct trustee-to-trustee transfer to another employer plan or IRA of lifetime income investments in the form of a qualified plan distribution annuity, if a lifetime income investment is no longer allowed as an investment option in a plan.

Retirement Plans for Small Employers

Several changes are made to encourage more small employers[3] to offer retirement benefits to their employees, such as:

Pension plan start-up-cost credit. The credit for a small employer starting a pension plan, such as a 401(k), 403(b), SEP IRA, or SIMPLE IRA, has been increased for taxable years beginning after Dec. 31, 2019. For the first credit year and each of the two taxable years immediately following the first credit year, the credit is the greater of —
(A) $500, or
(B) the lesser of —

> (i) $250 for each employee of the eligible employer who is not a highly compensated employee and who is eligible to participate in the eligible employer plan maintained by the eligible employer, or
> (ii) $5,000.
>
> **Example**. Sharon starts a SEP IRA in 2020 for her and one employee. She is entitled to a start-up credit of $500 (2 times $250) for 2020, 2021, and 2022.
>
> **Example**. Vern starts a 401(k) plan for him and his 20 employees. Vern is entitled to a start-up credit of $5,000 (21 times $250 limited to $5,000) for 2020, 2021, and 2022.

Multiple employer plans. Small employers of two or more employees may come together to participate in a new class of pooled multiple employer plans (MEPs). A MEP essentially allows small employers to join together to offer pension plans with (presumably) lower administrative costs. A critical factor that made employers skeptical of the MEP was the IRS's "bad apple" rule. The IRS said that if one employer in the plan defaulted, the whole plan was disqualified. The SECURE Act now provides that if a single employer defaults, the remaining plan maintains its qualified status. SECURE requires the MEP to be administered by a "pooled plan provider." Generally, changes apply to plan years beginning after Dec. 31, 2020.

Miscellaneous Changes

Establishing a retirement plan. Beginning in 2020, employers may adopt retirement plans that are entirely employer-funded up to the due date of the tax return, including extensions. Current law requires the employer to establish their plan by December 31 (or the last day of their fiscal year).

Pension Provisions in Disaster Tax Relief

New rules apply to individuals who had a principal residence in a federally declared disaster area and who suffered an economic loss as a result of the disaster. The disaster must have occurred from Jan. 1, 2018 through Jan. 19, 2020 (30 days after the enactment of the law).

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[3] Generally a small employer, as defined in §408(p)(2)(C)(i), is one that has no more than 100 employees who received at least $5,000 of compensation in the preceding year.

1. Qualified disaster distributions. The Appropriations Act also includes provisions relating to qualified disaster[4] distributions from retirement accounts. A qualified disaster distribution is one made beginning on the first day of the incident period of the qualified disaster and ending on the date which is 180 days after Dec. 20, 2019 (the date of the enactment).

   Qualified disaster distributions can be made up to $100,000 and
   - Are exempt from the 10% early withdrawal penalty,
   - Are exempt from mandatory withholding requirements,
   - Are treated as evenly distributed over a three-year period, and
   - May be repaid within three years of the distribution.

2. *Pension Plan Loans for Qualified Disasters*. The limit on loans from retirement plans for a qualified disaster increased to $100,000 (was $50,000). Disaster loan repayments are delayed for up to one year.

   Tax practitioner planning. See Tax Relief in Disaster Situations for the latest disaster-related news releases and related guidance.

TAX CUTS AND JOBS ACT

Recharacterization of IRA Contributions (§408A(d)(6)(B))

The TCJA repeals the special rule that allows IRA contributions to one type of IRA (either traditional or Roth) to be recharacterized as a contribution to the other type of IRA. Thus, for example, a conversion contribution establishing a Roth IRA during a taxable year can no longer be recharacterized as a contribution to a traditional IRA (thereby unwinding the conversion).

However, recharacterization is still permitted with respect to other contributions. For example, an individual may make a contribution for a year to a Roth IRA and, before the due date for the individual's income tax return for that year, recharacterize it as a contribution to a traditional IRA.

> **Tax practitioner planning.** The committee reports in footnote 269 on page 114 apparently allow a "back door" contribution to a Roth IRA. "*Although an individual with AGI exceeding certain limits is not permitted to make a contribution directly to a Roth IRA, the individual can make a contribution to a traditional IRA and convert the traditional IRA to a Roth IRA*."

With recharacterization gone, is it still advisable to convert? Converting a traditional IRA to a Roth IRA costs immediate tax. Under the new law, there's no look-back opportunity to change one's mind after the conversion if value falls. So, is it still advisable to convert? There are three major advantages to converting: (1) withdrawals are tax-free, as long as certain requirements are met; (2) minimum distributions at 72 are not required, so money grows tax-free longer; (3) beneficiaries inherit the Roth IRA account tax-free, as long as the account has been open for at least five years.

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[4] See page 703 for disaster tax relief provisions in the Appropriations Act.

Planning reminders when converting in 2018 and later.

- **Any dollar amount may be converted.** It is not an all-or-nothing deal. Maybe a client should just get started on a small (manageable) IRA conversion with $10,000 or $20,000.
- **Rollover prior nondeductible IRAs.** For high-income clients who are not qualified to contribute to a traditional or Roth IRA, another strategy is to recommend that clients contribute to a nondeductible IRA. Now the client can convert that nondeductible IRA into a Roth regardless of the client's high AGI, and there is little tax at the conversion since the client has a basis in the IRA. Only the earnings on the nondeductible IRA are taxable.
- **Traditional IRA basis is spread across all traditional IRAs owned by the taxpayer, not just the account where the basis was originally established.** Taxpayers with existing traditional deductible IRAs who create a new nondeductible IRA and convert only the new nondeductible IRA to a Roth IRA should note the basis from the nondeductible IRA contribution must be spread to all IRA accounts, leaving a portion of the conversion taxable.
- **Separate five-year holding periods apply for conversion contributions.** Taxpayers who convert a traditional IRA to a Roth IRA are required to meet a five-year holding period distinct from an existing Roth IRA five-year holding period. For example, if a calendar-year taxpayer who had no Roth IRAs converted a traditional IRA to a Roth IRA on Feb. 25, 2019, and also made a regular Roth IRA contribution for 2018 on the same date, the five-taxable-year period for the conversion begins on Jan. 1, 2019, while the five-taxable-year period for the Roth contribution began on Jan. 1, 2018.

Rollover Period for Plan Loan Offset Amounts (§402(c)(3))

The TCJA extended the period during which a qualified plan loan offset amount may be contributed to an eligible retirement plan as a rollover contribution from 60 days after the date of the offset to the due date (including extensions) for filing the federal income tax return for the taxable year in which the plan loan offset occurs, that is, the taxable year in which the amount is treated as distributed from the plan. A qualified plan loan offset amount is a plan loan offset amount that is treated as distributed from a qualified retirement plan, a §403(b) plan, or a governmental §457(b) plan solely by reason of the termination of the plan or the failure to meet the repayment terms of the loan because of the employee's severance from employment.

Miscellaneous Itemized Deductions

The TCJA suspended the deduction for miscellaneous itemized deductions subject to the 2% AGI limit. Prior law allowed two IRA-based deductions that are no longer allowable for taxable years 2018 through 2025: (1) trustee's fees for an IRA, if separately billed and paid, and (2) loss on traditional IRAs or Roth IRAs (when all amounts were distributed).

How Did TCJA Impact Retirement Planning?

Only minor changes were made to the taxation of retirement in the TCJA. But other changes in the new law may place new emphasis on two old tried-and-true planning ideas:

1. The reduction of the state tax deduction, and the doubling of the standard deduction, may make it more attractive to move to a low-tax state in retirement.

2. The TCJA's lower individual tax rates may make it more attractive to convert a traditional IRA to a Roth IRA, even with the recharacterization feature gone. It's hard to imagine that tax rates will be lower than they are right now.

2020 COST OF LIVING ADJUSTMENTS

IRA TRADITIONAL CONTRIBUTION LIMITS INCREASED FOR 2020

Traditional IRA Contribution Limits			
Year	2015-2018	2019	**2020**
Max IRA Contribution	$5,500	$6,000	**$6,000**
IRA Catch-Up Contribution (for those age 50 and over)	$1,000	$1,000	**$1,000**

Earned income required. Generally, a taxpayer is entitled to deduct an amount contributed to an IRA (§219(a)). The deduction, however, cannot exceed the lesser of the deductible amount or an amount equal to the taxpayer's compensation includible in gross income (§219(b)(1),(5)). Compensation includes net earnings from self-employment (as defined in §1402(a), §401(c)(2), §219(f)(1)).

Traditional IRAs

Contribution amount is $6,000. An individual can make deductible contributions to an IRA up to the lesser of $6,000 *or the individual's compensation* if neither the individual nor the individual's spouse is an active participant in an employer-sponsored retirement plan. In the case of a married couple, deductible IRA contributions of up to $6,000 can be made for each spouse (including, for example, a homemaker who does not work outside the home), if the combined compensation of both spouses is at least equal to the contributed amount.

$1,000 Additional Catch-Up IRA Contributions Are Permitted for Those 50 and Over

$7,000 annual contribution available for those age 50 or over. Both traditional and Roth IRAs allow individuals who have attained age 50 to make additional catch-up IRA contributions.

Active Participation

Active participant rules. Taxpayers with no active participation in a retirement plan are allowed to deduct the full amount of their IRA contributions, assuming the taxpayer has adequate income. If an individual (or the individual's spouse) is an active participant in an employer-sponsored retirement plan, the deduction limit is phased out for taxpayers with AGI over certain levels for the taxable year (see next table). Such taxpayers may make, but cannot deduct, IRA contributions.

> **Tax practitioner planning.** There is no AGI limit for those wishing to make non-tax-deductible IRA contributions.

Active Participant AGI Limitation		
Year	2019	**2020**
Single taxpayers	$64,000 - $74,000	**$65,000 - $75,000**
Married taxpayers	$103,000 - $123,000	**$104,000 - $124,000**
Married filing separate	$0 - $10,000	**$0 - $10,000**

What does active participation in an employer plan mean? An individual is an active participant in a defined benefit plan simply by not being excluded from the plan (§1.219-2(h), Ex. 1), even if there is no knowledge of the plan's existence (*Baumann v. Comm.*, TCM 1995-313).

Special Rules for Certain Married Individuals

Spousal IRAs. A non-working spouse may make IRA contributions based upon the earned income of his or her spouse.

The one-spouse active participant limitation. For an IRA contributor who is not covered by a workplace retirement plan and is married to someone who is covered, the deduction is phased out if the couple's income is between:

Year	2019	**2020**
AGI Phase-out	$193,000 - $203,000	**$196,000 - $206,000**

ROTH IRAs

Roth IRA Contribution Amount Is $6,000

Individuals with AGI below certain levels may make nondeductible contributions to a Roth IRA. The maximum annual contribution that may be made to a Roth IRA is the lesser of $6,000 or the individual's compensation for the year. The contribution limit is reduced to the extent an individual makes contributions to any other IRA for the same taxable year. As under the rules relating to IRAs in general, a contribution of up to $6,000 for each spouse may be made to a Roth IRA provided the combined compensation of the spouses is at least equal to the contributed amount.

Roth IRA AGI Thresholds		
Year	2019	**2020**
Single and HOH	$122,000 - $137,000	**$124,000 - $139,000**
Married Filing Joint	$193,000 - $203,000	**$196,000 - $206,000**
Married Filing Separate	$0 - $10,000	**$0 - $10,000**

Back Door Roth IRA. The TCJA Committee Report in footnote 269 on page 114 apparently allows a "back door" contribution to a Roth IRA. "*Although an individual with AGI exceeding certain limits is not permitted to make a contribution directly to a Roth IRA, the individual can make a contribution to a traditional IRA and convert the traditional IRA to a Roth IRA*."

> **Example**. Mark files a MFJ return showing $300,000 of AGI. Therefore, he is unable to contribute to a ROTH IRA. Instead, he may contribute to a nondeductible IRA and then immediately convert the nondeductible IRA to a Roth IRA.

Distributions (§408A(d)). "Qualified distributions" of designated Roth contributions are excludable from gross income. A qualified distribution is one that occurs at least five years after the year of the participant's first designated Roth contribution (counting such first year as part of the five) and is:

1. made on or after attainment of age 59½,
2. made on account of the participant's disability,
3. made to a beneficiary or estate on or after the participant's death, or
4. made for qualified first-time homebuyer expenses up to $10,000.

CPA's Error in Advising a Client on AGI Limits for Roth IRA Contribution Is Excuse for Recharacterization (PLR 201930027)

The IRS granted a taxpayer an extension of time to recharacterize her Roth IRA contributions as traditional IRA contributions. Taxpayer's modified AGI exceeded the applicable limits in the years of contribution. The IRS ruled that recharacterization was appropriate since the taxpayer reasonably relied on a qualified tax professional who failed to inform her that her gross income exceeded the income limit to make Roth IRA contributions and also failed to inform her of the time for making the election to recharacterize her Roth IRA contributions until after the deadline expired.

> **Tax practitioner planning.** If 2020 AGI exceeds $139,000 ($206,000 MFJ), the taxpayer may not make a Roth IRA contribution.

2020 RETIREMENT PLANS

2020 COLAs for Retirement Plans

Taxpayers with profit sharing and/or money purchase plans may contribute as much as $57,000 for 2020. For taxpayers with a 25% formula, $228,000 of wages will allow the maximum $57,000 contribution.

Plan Type	2019	2020
Maximum Defined Contribution Plan Contribution; §415(c)(1)(A)	$56,000	**$57,000**
SEP IRA	$56,000	**$57,000**
Maximum Annual Benefit for Defined Benefit Plan; §415(b)(1)(A)	$225,000	**$230,000**
SIMPLEs; §408(p)(2)(E)	$13,000	**$13,500**
Annual Compensation Limit: §401(a)(17); §404(j); §408(k)(3)(c)	$280,000	**$285,000**

Other 2020 limitations include:

- The dollar amount under §409(o)(1)(C)(ii) for determining the maximum account balance in an employee stock ownership plan (ESOP) subject to a five-year distribution period is $1,150,000 in 2020.
- The §414(q)(1)(B) limitation used in the definition of a highly compensated employee (HCE) is $130,000 in 2020.
- The §408(k)(2)(c) SEP minimum compensation is $600 in 2020. The 2020 SEP maximum compensation is $285,000.
- The compensation amount under §1.61-21(f)(5)(i) concerning the definition of "control employee" for fringe benefit valuation purposes is $115,000 in 2020. Compensation amount under §1.61-21(f)(5)(iii) is $230,000 in 2020.
- The dollar limitation under §416(i)(1)(A)(I) concerning the definition of a key employee in a top-heavy plan is $185,000 in 2020.

2020 Employee Elective Deferral Limited to $19,500; $13,500 for SIMPLEs

The dollar limit on annual elective deferrals under §401(k) plans, §403(b) annuities, §457 plans, salary reduction SEPs, and SIMPLE plans is increased in $500 annual inflation-adjusted increments.

Plan Type	2019	2020
401(k); 403(b); 457; salary-reduction SEP	$19,000	**$19,500**
SIMPLE IRAs	$13,000	**$13,500**

Retirement Plan Age 50 Catch-Up Contributions

Plan Type	2019	2020
401(k); 403(b); 457 Plans	$6,000	**$6,500**
SIMPLE IRAs	$3,000	**$3,000**

Only after other deferral contributions maxed out. Additional contributions may be made by an individual who has attained age 50 before the end of the plan year and with respect to whom no other elective deferrals may otherwise be made to the plan for the year because of the application of any limitation of the IRC (for example, the annual limit on elective deferrals) or of the plan.

IRA PROVISIONS §408

IRS Updates Its Retirement Plan Home Page for Tax Year 2019 (Tax Information for Retirement Plans (Mar. 27, 2020))

The home page for retirement plans has been updated by the IRS. It includes resources for individuals and for retirement plan administrators with links to retirement topics and news.

> **Tax practitioner planning**. This page is a good resource for answering your client's "quick question" on his or her retirement plan. But note, the 2020 tax changes have not been included.

IRA RULES

Contribution due date. Individuals may make contributions to their IRAs until the due date of their tax returns (if the contribution is made by April 15, it may be treated as having been made on December 31 of the prior tax year). Filing an extension does *not* extend the contribution date (§219(f)(3)).

Nondeductible IRAs always available. To the extent an individual does not make deductible contributions to an IRA or contributions to a Roth IRA, the individual may make nondeductible contributions to a traditional IRA. Even taxpayers who are eligible to make tax-deductible IRA contributions may elect to make nondeductible contributions instead (§408(o)(2)(B)). Elective nondeductible contributions must be reported on the individual's tax return.

Tax on Excess Contributions (§4973)

In the case of an individual retirement account, there is imposed for each taxable year a tax in an amount equal to 6% of the amount of the excess contributions to such individual's accounts or annuities (determined as of the close of the taxable year). The amount of tax for any taxable year will not exceed 6% of the value of the account or annuity (determined as of the close of the taxable year).

Contributions returned before due date of return. The penalty does not apply to the distribution of any contribution paid during a taxable year to an individual retirement account or for an individual retirement annuity if:

1. such distribution is received on or before the day prescribed by law (including extensions of time) for filing such individual's return for such taxable year,
2. no deduction is allowed under §219 with respect to such contribution, and
3. such distribution is accompanied by the amount of net income attributable to such contribution.

In the case of such a distribution, for purposes of §61, any net income described in subparagraph (c) shall be deemed to have been earned and receivable in the taxable year in which such contribution is made.

Also see. *Ronald Fish v. Comm.*, TCM 2015-176, where the loss showing on K-1 from IRA investment was not deductible; perhaps the return preparer didn't notice the partner was an IRA.

> **Tax practitioner planning**. Make sure your client is the owner of the K-1 interest, not his or her IRA or pension plan.

SELF-DIRECTED IRAs

While any IRA where the account owner determines where account assets are invested is, by definition, self-directed, the term "self-directed" IRA refers to a specific type of IRA that allows investments in alternative investments such as real estate, private company stock, partnership or LLC interests, bullion, etc. Most mainstream IRA custodians do not allow such investments due to the additional reporting complications, higher risks, and increased fiduciary responsibility.

Self-directed IRAs present challenges. The IRS has noted that self-directed IRAs are subject to all the traditional IRA rules, including conforming to the prohibited transaction rules, annual valuation of underlying investments, UBTI, and no loans issued to the IRA. This can present problems for account owners. For example, if real estate is the only asset owned by an IRA and the account owner is subject to RMDs, where does the cash come from to pay the RMDs? What about paying any real estate related expenses like property taxes? For that matter, how is the account value determined for purposes of calculating the RMDs? This is just one of many scenarios that taxpayers need to consider before choosing to convert their IRA to a self-directed IRA.

Disqualifying the IRA. If during any part of the tax year the individual or his beneficiary uses the IRA in a prohibited transaction under §4975, the IRA account is disqualified as of the first day of that tax year and the individual is taxed as having received a taxable distribution equal to the fair market value of all of the assets in the account as of the first day of the year (§408(e)(2)(B)).

> **Tax practitioner planning.** Currently, the self-directed IRA arena is like the wild, wild West. Taxpayers are well-advised to use extreme caution when selecting a custodian for their self-directed IRA. One slip-up could cause the entire account to become immediately taxable.

Self-Directed IRAs Require Additional Reporting for Hard-to-Value Assets

Reporting requirements apply to IRA investments with no readily available FMV (Form 5498, Box 15a and b). Responding to the increase in self-directed IRAs, the IRS amended the instructions for Forms 5498 and 1099-R to include new reporting requirements that allow the IRS to more efficiently scrutinize the hard-to-value IRA investments typically found in self-directed IRAs. Reportable investments include non-publicly traded stock, non-publicly traded notes, partnership or LLC interests, real estate options, and other hard-to-value investments. The additional reporting was mandatory beginning in 2015.

Distribution from Self-Directed IRA Not Taxable Because Taxpayer Did Everything Right (*Raymond McGaugh v. Comm.*, CA-7, 2017-2 USTC ¶50,272)

Raymond McGaugh had a self-directed IRA. Because the IRA custodian was unwilling to purchase a particular stock, the taxpayer arranged the purchase by having the custodian wire funds directly to the issuing company, which in turn issued a stock certificate in the name of the taxpayer's IRA and sent the stock certificate to the custodian. The Court of Appeals upheld the Tax Court's decision that the taxpayer was not a "payee or distributee" and that, to the extent he had control over the wired funds, he at most acted as a conduit. The taxpayer did not receive a distribution because no funds ever passed through his hands. Moreover, the taxpayer was not in constructive receipt of the funds because the funds went straight to the issuing company and the issuing company sent the stock shares to the custodian. At no time did the taxpayer have control over the funds, nor could he negotiate the stock certificate, which was issued in the name of the IRA.

Also See.

- *Mark and Julie Vandenbosch v. Comm.*, TCM 2016-29, where $125,000 distribution from self-directed SEP-IRA was taxable because of unfettered control when money was deposited into a personal bank account.
- *Terry Ellis v. Comm.*, CA, 8th Cir., 2015-1 USTC ¶ 50,328, where Ellis directed his IRA to purchase ownership in an LLC; the LLC paid wages to Ellis in a prohibited transaction, causing the IRA to be disqualified.

Tax practitioner planning. When a client starts talking about using their IRA as a funding mechanism for a business, remember the prohibited transaction rules and Ellis. It is virtually impossible to use an IRA to fund a business where the owner of the business is also the owner of the IRA. The best method to get money from one's retirement plan for a new business is to follow the strict procedures of the Rollover Business Startup plan. It costs time and money to comply (as always), but it's a better alternative than the $195,900 it cost Ellis.

IRAS AND CREDITOR CLAIMS

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, with few exceptions, exempted IRAs and retirement plans from creditors' claims if the account owner files for bankruptcy. For IRAs and Roth IRAs, there is a limit that may be protected from creditors. That limit was originally set at $1 million, but it is inflation-adjusted every three years. The amount of the exemption is $1,362,800 ($1,283,025 before Apr. 1, 2019).

Tax practitioner planning. The $1,362,800 exemption amount does not apply to SIMPLE and SEP IRAs, as *employer plan* assets are fully protected in bankruptcy without any limit. Also, there is no maximum exemption for assets in other employer retirement plans such as a §401(k). Therefore, if their employer's plan permits, an employee who owns an IRA in excess of $1.283 million should consider rolling the IRA into their employer plan to get the unlimited creditor protection. Interestingly, the $1,362,800 limit does not apply to assets rolled over from an employer plan into an IRA as these rollover funds and their earnings are fully protected from creditors, as long as any rollover amounts are kept separate from traditional or Roth IRAs.

IRA and 401(k) Funds Received in Divorce Not Protected in Bankruptcy (*Brian A. Lerbakken v. Sieloff and Associates, PA* No. 18-3415 (8th Cir. 2020))

Sieloff represented Lerbakken in his marital dissolution in Minnesota. The court's decree awarded Brian Lerbakken all of his ex-wife's IRA and half of her 401(k). Two months after the decree, the court ordered an attorney's lien against Lerbakken for Sieloff's legal services. The court expressly permitted Sieloff to recover the unpaid fees from Lerbakken's interests in his ex-wife's IRA and 401(k). The unpaid fees exceed the total of Lerbakken's interests.

Six months after the decree, Lerbakken filed for bankruptcy under Chapter 7, claiming that his interests in the IRA and 401(k) are exempt from the bankruptcy estate as "retirement funds" under 11 U.S.C. §

522(b)(3)(c). Sieloff, a scheduled creditor, objected to the exemptions. The bankruptcy court disallowed the exemptions. It ruled that Lerbakken's interests in his ex-wife's IRA and 401(k) are not "retirement funds." The Bankruptcy Appellate Panel affirmed. It ruled, relying on *Clark v. Rameker*, 573 U.S. 122, 130 (2014), that section 522(b)(3)(c) applied only to the person who created and contributed to the retirement account.

IRA Not Protected in Bankruptcy Because of Prohibited Transactions (*Keith A. Yerian v. Webber*, Trustee, No. 18-10944 (11th Cir. Jun. 26, 2019))

Keith Yerian titled IRA-owned cars in his own name and his wife's name, as well as purchased a condo in Puerto Rico with IRA funds and then used the condo for his personal travel needs. Yerian conceded that he incurred more than $100,000 in tax penalties for abusing his IRA. Ordinarily, that abuse would disqualify him from claiming the wide range of favorable treatment and exemptions typically offered to IRAs. But Yerian — now in bankruptcy proceedings — nonetheless sought to shield the IRA from distribution to his creditors. He argued that Florida has exempted IRAs from bankruptcy administration so long as they were originally established with proper documentation. The court ruled that Yerian forfeited his exemption, upholding the bankruptcy court's decision, when he engaged in self-dealing transactions prohibited by the IRA's governing instruments.

Also see.

- *Barry K. Kellerman, BC DC* Ark., 2015-1 USTC ¶50,331; Aff'd by the US District CT, Arkansas (Sep. 14, 2015), where an IRA was not protected by bankruptcy because of prohibited transactions.
- *Brandon C. Clark et ux v. William J. Rameker, Trustee. et al*, SCt; No. 13-299, June 12, 2014, where an inherited IRA was not "retirement funds" for the purpose of bankruptcy exemption.

  Tax practitioner planning. In light of the Supreme Court's decision on inherited IRAs, surviving spouses should consider rolling the deceased spouse's IRA into his or her own IRA and not keeping the IRA as an inherited IRA.

ROTH IRA PROVISIONS §408A

Distributions (§408A(d)). "Qualified distributions" of designated Roth contributions are excludable from gross income. A qualified distribution is one that occurs at least five years after the year of the participant's first designated Roth contribution (counting such first year as part of the five) and is:

1. made on or after attainment of age 59½,
2. made on account of the participant's disability,
3. made to a beneficiary or estate on or after the participant's death, or
4. made for qualified first-time homebuyer expenses up to $10,000.

Aggregation and ordering rules (§408A(d)(4)). All Roth IRA accounts owned by an individual are aggregated and treated as one account. Distributions from any Roth IRA are first treated as distributions from (1) contributions, (2) conversions (in order of conversion if multiple conversions have been made), and (3) any earnings. Distributions from Roth IRAs that are not qualified distributions are includible in income to the extent attributable to earnings and are subject to the 10% early withdrawal tax (unless an exception applies). The same exceptions to the early withdrawals that apply to IRAs apply to Roth IRAs.

Example. Mark, age 39, established a Roth IRA at Edward Jones in 2018 that is currently worth $12,000 (his contributions were $10,000). Mark opened a second Roth IRA in 2019 with Chase Bank that is currently worth $10,000 (all contributions). Mark withdrew $12,000 and closed his Edward Jones account. He did not roll the $12,000 over to another Roth IRA. Because the accounts were aggregated, the entire distribution is treated as a return of basis, not earnings. Mark's Roth IRA at Chase consisted of $8,000 of contributions and $2,000 of earnings.

IRS Explains Distribution Rule When Decedent's Roth IRA Named Marital Trust as Beneficiary (PLR 201923016)

Decedent established Trust, a living revocable trust, on Date 1. On Date 2, Decedent died after his RMD age. Decedent was survived by Spouse and Daughter. Upon Decedent's death, Trust became irrevocable and was divided into a marital deduction subtrust, a subtrust for the benefit of Daughter, and a third subtrust. The Marital Trust qualified as a Qualified Terminable Interest Property under §2056(b)(7).

At the time of his death, Decedent was the owner of Roth IRA. Pursuant to the beneficiary designation form for Roth IRA, Marital Trust was the named beneficiary.

The PLR concluded as follows:

1. Spouse is treated as the designated beneficiary (rather than the marital trust) of Roth IRA for purposes of determining the distribution period under §401(a)(9) pursuant to §1.401(a)(9)-4, Q&A-5; and

2. RMDs from Roth IRA are calculated based on the life expectancy of Spouse. Because Spouse is treated as the sole designated beneficiary, RMDs under §401(a)(9) are determined pursuant to the rule of §1.401(a)(9)-5, Q&A-5(c)(2). Nevertheless, distributions from Roth IRA that satisfy the rule of §1.401(a)(9)-5, Q&A-5(c)(1), with the first-year distribution determined based on Spouse's corresponding life expectancy factor in the year of the first distribution under the Single Life Table and, for succeeding years, the initial factor reduced by one each year, would meet the minimum distribution requirements because this method produces distributions that are greater than or equal to the applicable RMDs under §401(a)(9).

CONVERSION RULES FROM TRADITIONAL IRAS TO ROTH IRAS (§408A)

All otherwise eligible taxpayers are allowed to convert traditional IRAs (including SEPs and SIMPLEs) into Roth IRAs. The amount converted is includible in income as if a withdrawal had been made, but early withdrawal penalties are not assessed.

Warning. Recharacterizations are no longer allowed.

SIMPLE IRA exception. Amounts distributed from a SIMPLE IRA during the two-year period which begins on the date that the individual first participated in any employer maintained SIMPLE IRA cannot be converted to a Roth or any other IRA other than another SIMPLE IRA (§1.408A-4, Q-4).

IRS Explains After-Tax Rollovers from §401(k) to Roth IRAs (Rollovers of After-Tax Contributions)

When a §401(k) distribution is made to multiple accounts, the IRS requires that the pretax and after-tax amounts be allocated between accounts. This results in a sometimes surprising taxable income even if a distribution equal to the after-tax amount was deposited into a Roth IRA account.

After-tax amounts can be directed to a Roth IRA. The IRS has changed its position and now allows the recipient to select how the pretax amount in his or her §401(k) is allocated in a direct rollover to two or more accounts. To make this selection, the recipient must inform the plan administrator of the allocation of specific pretax and after-tax amounts prior to the time of the direct rollovers. "Separate recipients" does not mean separate distributions. It means a distribution sent to multiple accounts (Notice 2014-54).

> **Example.** The §401(k) distribution is $100,000 with 70% from pretax contributions and 30% from after-tax contributions. The employee directs the plan administrator to transfer the pretax amount of $70,000 to a traditional IRA and the after-tax amount of $30,000 to a Roth IRA. No taxable income results from the transfer to the Roth IRA.
>
> **Tax practitioner planning.** The change applies to pretax amounts in elective deferral accounts including §401(k), §403(b), and §457(b).

A partial distribution must include some of the pretax amounts. An account holder cannot distribute only the after-tax amounts and leave the rest in the plan. Any partial distribution from the plan must include some of the pretax amounts. This doesn't change the requirement that each plan distribution must include a proportional share of the pretax and after-tax amounts in the account. To roll over all of the after-tax contributions to a Roth IRA, the account holder could take a full distribution (all pretax and after-tax amounts) and directly roll over:

- pretax amounts to a traditional IRA or another eligible retirement plan, and
- after-tax amounts to a Roth IRA.

§401(k) Planning Strategies

1. Always contribute enough to the §401(k) to secure employer-matching contributions.
2. Contribute additional dollars to max out the statutory §401(k) pretax amount ($19,500 in 2020 plus $6,500 for those 50 or older).
3. If the plan permits, make after-tax contributions to the §401(k) plan, up to the annual defined contribution plan limits ($57,000 in 2020). After-tax contributions can later be distributed tax-free to a Roth IRA (Notice 2014-54).

Traditional IRA Compared to Roth IRA (IRA FAQs)

Features	Traditional IRA	Roth IRA
Who can contribute?	Contributions can be made at any age if the account holder has taxable compensation.	Contributions can be made at any age if the account holder has taxable compensation. AGI must be under threshold.
Are contributions deductible?	Yes, unless covered by a retirement plan at work and income exceeds threshold.	No.
How much can be contributed?	Maximum contribution for all traditional IRAs and Roth accounts is $6,000 (2020) or taxable income if less.	
What's the deadline to make contributions?	Due date of the return (not including extensions) — Apr. 15, 2021, for 2020 IRA.	
Are minimum distributions required?	Distributions must begin by April 1 following the year in which the account owner turns age 72 and by December 31 of later years.	Not required.
Are distributions taxable?	Any deductible contributions and earnings that are distributed from the traditional IRA are taxable. The 10% early withdrawal penalty may apply if the account owner is under 59½.	None if it's a qualified distribution. Otherwise, part of the distribution or withdrawal may be taxable.

DESIGNATED ROTH ACCOUNTS

(FAQs on Designated Roth Accounts)

What is a qualified Roth contribution program? Employers may offer employees the option to designate some or all of their elective contributions to §401(k), §403(b), or §457 qualified plans to a designated Roth account. If the employer chooses, eligible participants may also roll over existing plan balances to the designated Roth portion of their accounts. Any amounts contributed to a designated Roth account are included in gross income in the year of the contribution, but eligible distributions from the account (including earnings) are generally tax-free. Employers wishing to establish designated Roth accounts as part of their qualified retirement plan must:

1. establish a separate designated Roth account for the Roth contributions and the related earnings of each participant,
2. maintain separate records for each account,
3. refrain from allocating to the designated Roth account amounts from nondesignated Roth accounts unless such amounts are properly rolled over, and
4. report designated Roth account contributions separately on employees' W-2s.

Separate account required. Designated Roth accounts are separate accounts inside §401(k), §403(b), or §457(b) qualified plans that hold designated Roth contributions. Designated Roth accounts:

1. have no AGI limits for contributors, and
2. are subject to required minimum distributions when the owner reaches age 72.

> **Tax practitioner planning.** Because there is no AGI limit, designated Roth accounts are particularly attractive to high-income taxpayers. The taxpayer may roll designated Roth accounts to a Roth IRA to eliminate required minimum distributions.

Rollovers from Qualified Plans to Designated Roth Account Rules

Employers who elect to add designated Roth accounts to a §401(k), §403(b), or §457(b) plan may allow in-service rollovers by its employees (or surviving spouses) from tax-deferred plan balances to designated Roth accounts. This includes plan amounts that originated from employee elective deferrals and from employer matching and nonelective contributions. Employers may limit the type of contributions eligible for in-plan Roth rollovers and the frequency of such rollovers. Employers are also allowed to stop allowing Roth rollover contributions by amending the plan at allowable amendment periods.

Rollover contributions subject to restrictions. Amounts rolled over from qualified plans to designated Roth accounts are subject to the distribution restrictions inherent in qualified plans. For example, if a qualified plan participant who has not ceased employment makes an in-plan Roth rollover from the participant's pretax elective deferral account prior to age 59½, that rollover amount and any applicable earnings may not be distributed from the plan prior to participant attaining age 59½ or the occurrence of another event described in §401(k)(2)(B).

Rollover is taxable in the same manner as other Roth conversions. In the case of a permitted rollover contribution to a designated Roth account, the individual must include the distribution in gross income (subject to basis recovery) in the same manner as if the distribution were rolled over into a Roth IRA. The 10% additional tax will apply if the amount rolled over is subsequently distributed from the Roth account within the five-year tax period beginning with the tax year in which the rollover contribution was made and ending on the last day of the participant's fifth taxable year in the period.

> **Example.** In 2017, Evan, who is 45 years old, rolls $10,000 from his tax-deferred §401(k) plan to a designated Roth account. No other contributions were ever made to Evan's designated Roth account. Evan takes a distribution of $10,000 from his designated Roth account in 2019. While Evan will not owe any income taxes on the distribution, he will owe a penalty of $1,000 (10%) because the amount rolled over did not stay in a Roth account for at least five years before being distributed.

ONE-PERSON (SOLO) 401(k) PLANS

Is a One-Person 401(k) Plan Better Than a Profit-Sharing Plan?

Solo 401(k) comparisons — self-employed. In order to contribute $57,000 to a profit-sharing plan in 2020, a sole proprietor must have $285,000 of net self-employment income. However, a self-employed person only needs $187,500 of net self-employment income in order to contribute $57,000 to a solo 401(k).

2020 Profit Sharing Plan vs. Solo 401(k) Comparison — Self-Employed				
S/E earnings	$50,000	$100,000	$187,500	$285,000
Profit-sharing plan — net of SE tax deduction (e.g. SEP)	$10,000	$20,000	$37,500	$57,000
Single-participant 401(k) plan	$29,500	$39,500	$57,000	$57,000
Additional contribution	$19,500	$19,500	$19,500	$0

Difference even more dramatic for one-employee corporations. Assume that the sole proprietor in the above example converts the proprietorship to an S corp. and then asks you how much she can contribute at various earnings levels. With a pure profit share plan such as a SEP, she would need wages of $228,000 to contribute the $57,000 maximum. However, she needs only $146,000 of wages to contribute $57,000 to a single-participant 401(k) plan.

2020 Profit Sharing Plan vs. Solo 401(k) Comparison — S Corp. Shareholder				
S Corp. wages	$50,000	$100,000	$146,000	$228,000
Profit-sharing plan	$12,500	$25,000	$36,500	$57,000
Single-participant 401(k) plan	$32,000	$44,500	$57,000	$57,000
Additional contribution	$19,500	$19,500	$19,500	$0

> **Tax practitioner planning.** Taxpayers are limited to only one deferral amount, regardless of the number of plans in which they participate.

Other Solo 401(k) Pointers

1. Solo 401(k) plans are available to businesses with no common law employees. Thus, a business that employs only the owner qualifies (or only the owner and the owner's spouse).
2. Form 5500 is required for any 401(k) plan with assets exceeding $250,000; however, many mutual fund companies and brokerage houses offer discount preparation for solo 401(k) plans.
3. A plan participant can borrow from a 401(k) plan as long as the strict rules are followed.
4. More information is available from www.401khelpcenter.com.

MULTIPLE EMPLOYER PENSION PLANS

DOL Changes Who Can Participate in a Multiple Employer Pension Plan

38 million US employees do not have pension plans. President Trump hoped to reduce those numbers with an Aug. 31, 2018, executive order which directed the Department of Labor to "expand the circumstances under which United States employers, especially small and mid-sized businesses, may sponsor or adopt a multiple employer plan (MEP) as a workplace retirement option for their employees . . ."

A multiple employer plan is a plan maintained by two or more unrelated employers who are not members of a controlled group. The MEP requires some form of commonality among the firms, such as being in a similar industry. A new Department of Labor (DOL) rule, issued July 29 and effective Sep. 30, 2019, expands the parameters for participating in a MEP to include membership in the same association. The DOL expansion also provides that a professional employer organization (PEO) may sponsor a MEP.

For example, the San Jose Chamber of Commerce may sponsor a MEP for its members.

Open MEP. The DOL expansion does not create an "open MEP" under which multiple employers have no common characteristic, affiliation, or purpose. An "open MEP" would permit financial institutions or other persons to maintain a single defined contribution retirement plan on behalf of multiple unrelated employers. The *proposed* SECURE Act would authorize "open MEPs."

Advantages. The MEP is maintained by multiple employers for the purpose of pooling plan assets to reduce administrative costs and for advantageous investing. Plans with $10 million in assets are charged almost four times as much in investment fees as those charged to plans with $1 billion in assets.

Why do we care? Our small-business clients will be hearing from their associations that there have been changes to pension plan rules that reduce employer costs. This basic information on MEPs provides a few answers for client questions.

OTHER RETIREMENT PLAN DEVELOPMENTS

Uncashed Distribution Check Does Not Change Year of Taxability or Form 1099-R Requirement (Rev. Rul. 2019-19)

Employer M is the plan administrator of Plan X, a qualified retirement plan under § 401(a). A distribution of $900 is required to be made from Plan X to Individual A in 2019. Individual A does not cash the distribution check until 2020. The Revenue Ruling addresses when the distribution is taxable to the individual and what the employer's withholding and reporting requirements are for 2019.

1. Individual A's failure to cash the distribution check she received in 2019 does not permit her to exclude the amount of the designated distribution from her gross income in that year under §402(a).
2. Individual A's failure to cash the distribution check she received does not alter Employer M's obligations with respect to withholding under §3405.
3. Individual A's failure to cash the distribution check she received does not alter Employer M's obligations with respect to Form 1099-R reporting under §6047(d).

   Tax practitioner planning. The ruling does not address a few other problems for the individual and the employer. What happens if the check is mailed on Dec. 31, 2019, but isn't received by the individual until Jan. 2, 2020? What happens if the check is returned to the employer? What happens if the individual can't be found?

Although IRA Beneficiary Was the Estate, IRA Could Be Transferred to Two Children as Inherited IRAs (PLR 201927009)

Decedent was predeceased by his spouse and was survived by their two children. Prior to their deaths, decedent and his spouse executed a Will and Trust. Pursuant to the Will, Estate is payable to the Trust. Decedent was owner of an IRA. Decedent named his Estate as the beneficiary of the IRA. The IRA is currently titled IRA of Decedent FBO Estate. The Estate requested a ruling to allow the estate to divide the IRA, by means of trustee-to-trustee transfer, into two separate inherited IRAs for the benefit of Child 1 and Child 2, respectively.

The PLR concluded that:

1. The Estate can transfer, via trustee-to-trustee transfer, the IRA in-kind to inherited IRAs FBO Estate FBO Child 1 and Child 2, respectively (using Child 1 and Child 2's Social Security numbers), and such in-kind transfers do not constitute taxable distributions within the meaning of §408(d)(1) or constitute a rollover as that term is used in §408(d)(3).

2. The inherited IRAs created by means of trustee-to-trustee transfers which will be maintained in the name of Decedent FBO Estate FBO Child 1 and Child 2, respectively, will constitute inherited IRAs as such term is defined in section 408(d)(3)(c).

Stretch IRA Allowed for Nonspousal Beneficiaries Named in the Will Even Though Estate Was Named as Beneficiary of the IRA (PLR 201909003)

Decedent maintained an IRA. Decedent died in 2019[5], and prior to his death, decedent had received his 2019 RMD from IRA. Decedent's estate was the sole beneficiary of the IRA. Decedent was unmarried at the time of his death and was survived by three nonspousal beneficiaries. Pursuant to the decedent's will and testament, the estate's interest was bequeathed to the beneficiaries.

The executor proposed to divide the IRA, as of decedent's date of death, by trustee-to-trustee transfer into three inherited IRAs for the benefit of each beneficiary according to their equitable bequests under the decedent's will. Each inherited IRA would be titled under the decedent's name for the benefit of each beneficiary.

The PLR finds the following:

1. The division of IRA as of the decedent's date of death by means of trustee-to-trustee transfers into inherited IRAs for the benefit of the three beneficiaries, according to their equitable percentages and titled in the name of the decedent and each individual beneficiary (instead of titled to the estate), will not result in taxable distributions or payments under §408(d)(1) to the estate.

2. Because the estate was listed as the designated beneficiary of the IRA, the IRA is treated as having no designated beneficiary. Because the IRA had no designated beneficiary and the decedent died after his required beginning date, the beneficiaries can take required minimum distributions from each of their inherited IRAs for the remaining life expectancy of the decedent. The amount required to be distributed each

[5]Date added for clarity.

year is determined using the decedent's age in the calendar year of death and the applicable actuarial table. The life expectancy factor is reduced by one each subsequent calendar year. The amount required to be taken from each inherited IRA will be determined independently of any required minimum distributions required to be taken by the other beneficiaries.

3. The division of the IRA by means of trustee-to-trustee transfer into three inherited IRAs will not constitute a transfer within the meaning of §691(a)(2). The beneficiaries will each include, in their gross income, the amounts of IRD from their respective inherited IRA when the distribution or distributions from the inherited IRAs are received.

4. The beneficiaries of each respective inherited IRA are separately responsible for any tax liabilities relating to required minimum distributions from their inherited IRAs for the tax year subsequent to the year the inherited IRAs are established or the year of death if later (and all subsequent tax years). No income taxes or penalties for failure of the beneficiaries to take their required minimum distributions for the tax year subsequent to the year the inherited IRAs are established or the year of death if later (or any subsequent tax years) will be passed to the estate or the executor.

IRS Penalty Relief for Small Retirement Plans Made Permanent

The IRS made permanent a pilot program providing administrative relief to certain retirement plan administrators and sponsors from the penalties applicable under §6652(e) and §6692 for failing to timely comply with the annual retirement plan reporting requirements (Rev. Proc. 2015-24).

Failure to file penalty can be $15,000. Small businesses that fail to file required annual retirement plan returns, usually Form 5500-EZ, can face stiff penalties, up to $15,000 per return. However, by filing late returns under this program, eligible filers can avoid these penalties by paying only $500 for each return submitted, up to a maximum of $1,500 per plan. For that reason, program applicants are encouraged to include multiple late returns in a single submission. Find the details on how to participate in Rev. Proc. 2015-32.

Relief is limited. The relief under this revenue procedure is only available to the plan administrator or plan sponsor of (1) certain small business (owner-spouse) plans and plans of business partnerships (together, one-participant plans) and (2) certain foreign plans.

What is a one-participant plan? For purposes of this revenue procedure, a one-participant plan is a retirement plan with one or more participants that:

- Covers only the owner of the entire business (or the owner and the owner's spouse); or
- Covers only one or more partners (or partners and their spouses) in a business partnership; and
- Does not provide benefits for anyone except the owner (or the owner and the owner's spouse) or one or more partners (or partners and their spouses).

Filing requirements:

1. **A complete Form 5500-EZ return.** The submission must include a complete Form 5500-EZ return, including all required schedules and attachments, for each plan year for which the applicant is

seeking penalty relief. All returns submitted must be sent to the IRS in Ogden, Utah, and cannot be filed through the DOL's EFAST2 filing system.

Tax practitioner planning. A delinquent Form 5500-SF return cannot be used. The applicant must file a Form 5500-EZ.

2. **Delinquent returns must be marked.** For each delinquent Form 5500 series return submitted to the IRS, the applicant must mark in red letters in the top margin of the first page of the return (above the title of the form), "Delinquent Return Submitted under Rev. Proc. 2015–32, Eligible for Penalty Relief."

3. **Required Form 14704.** Each submission must include a completed paper copy of Form 14704. A completed Form 14704 must be attached to the front of the oldest delinquent return in the submission.

Reasonable cause may still apply. Even if the new relief procedure does not apply, no penalty is imposed if it is shown that the failure to timely file is due to reasonable cause. A request for relief due to reasonable cause may be attached to the delinquent return when the return is filed or may be filed separately. The request should state the reason why the return was late and be signed by a person in authority (§301.6652-3(b) and §301.6692-1(c)).

Tax practitioner planning. The Department of Labor offers a similar relief program for businesses with retirement plans that include employees known as the Delinquent Filer Voluntary Compliance Program.

Voluntary Correction Program Submissions Must Be Electronically Filed Beginning Apr. 1, 2019 (Voluntary Correction Program, EPCRS)

If a retirement plan isn't currently being audited by the IRS, and there are mistakes with either the language in the plan document or how that plan has been run, the plan can apply to correct the mistakes under the Voluntary Correction Program (VCP):

- Submit a written submission to the IRS and pay the user fee charged for VCP applications.
- The IRS reviews and approves the proposed correction methods for either the plan document or operational errors that, if not corrected, could result in the plan losing its tax-favored status.

IRS Reverses Itself and Says Retirees in Pay Status Can Cash Out (Notice 2019-18)

In Notice 2015-49, the IRS said it intended to amend its minimum required distribution regulation to state that cashing out annuities in pay status would be a prohibited acceleration. The IRS also said the new regulation would be effective July 9, 2015 (the regulations were never revised). In Notice 2019-18, the IRS announced that it no longer intends to amend the minimum required distribution regulation to address the practice of offering retirees and beneficiaries who are currently receiving annuity payments under a defined benefit plan a temporary option to elect a lump-sum payment in lieu of future annuity payments. Until further notice, the IRS will not assert that a window to cash out annuities in pay status violates the minimum required distribution rules.

> **Tax practitioner planning.** Is it the right decision to cash out the retirement annuity? That's a good question for the client's financial planner.

Director Fees Were Really Wages; Pension Deduction Disallowed (*David Burbach v. Comm.*, TCM 2019-17)

David Burbach funded a pension plan by taking "director fees" out of his solely owned corporation, Burbach Aquatics, Inc. (BAI), depositing them into his personal checking account, and making personal payments into a pension account. He reported the "director fees" on a Schedule C and then took offsetting deductions for contributions to a one participant defined benefit pension plan.

Wages or director fees? Section 3121(d)(1) provides that "any officer of a corporation" is an employee except one who "does not perform any services or performs only minor services and who neither receives nor is entitled to receive, directly or indirectly, any remuneration." Director fees are an exception (§31.3121(d)-1(b)). "[A] director of a corporation in his capacity as such is not an employee of the corporation." Directorial services typically include things like attending board meetings and sitting on committees, while services performed by officers generally include the fundamental everyday decisions about corporate operations.

Burbach failed to present any evidence of specific directorial services he performed for BAI, and he was involved in the everyday decisions about engineering, project management, and marketing. The court also noted that the "director fees" BAI paid Burbach in the years at issue were approximately 10 times the "wages" it paid him (in one of the years at issue, director fees were $275,000 and wages to Burbach were $21,500.) The court found that the director fees should properly be recharacterized as wages from BAI.

Pension plan should have been BAI's. Section 404(a)(1) allows only an "employer" to claim a pension deduction, unless the employer is self-employed (§404(a)(8)). Burbach can't successfully claim to be an employer, and §404(a) limits deductions under §404(a)(1) to contributions made to pension trusts by "an employer." The plan sponsor and "employer" in this case was BAI, not Burbach. The pension deduction on Burbach's individual return was disallowed.

> **Tax practitioner planning.** BAI had employees. A pension plan in BAI would have required that the employees be covered, not just the owner.

DOL Intends to Change Form 5500

In 2016, the Department of Labor announced its intent to change Forms 5500. Under the proposal, the form revisions were to begin with the Plan Year 2019 Form 5500 series returns/reports. Efforts to finalize the revisions are "suspended for now" and are likely to show up for the 2020 Form 5500.

The proposed revisions are intended to:

- Modernize the financial statements and investment information filed about employee benefit plans.
- Update the reporting requirements for service provider fee and expense information.
- Enhance accessibility and usability of data filed on the forms.
- Require reporting by all group health plans covered by Title I of ERISA.

- Improve compliance under ERISA and the IRC through new questions regarding plan operations, service provider relationships, and financial management of the plan.

The proposed regulations also would make improvements to the certification requirements for the limited scope audit requirements and allow group health plans to use the Form 5500 to satisfy certain reporting requirements in the Affordable Care Act.

Hot Topics When IRS Audits Business Retirement Plans (GAO-12-459T; GAO-12-236)

Hot topics and key issues for examiners auditing retirement plans include:

- Failure of §401(k) plans to make matching employer contributions and perform nondiscrimination testing, and allow excess elective deferrals.
- TSAs (§403(b) plans) failed to offer universal availability, improperly excluded employees from the plan, allowed excess elective deferrals, and improperly used the catch-up rules.
- International and US territorial plans.
- Abusive transactions, including promoter investigations.
- Referrals to and collaborations with the US Department of Labor and the Pension Benefit Guaranty Corporation.

Other common examination errors include the failure to amend plans for new legislation, the failure to follow plan terms, the exclusion of eligible employees, improper plan loans and hardship distributions, and inconsistent definitions of compensation (between the plan's terms and its operation).

IRS Employee Manual Revised for Form 5500 Examinations (Examining Process)

The IRS revised IRM 4.71.1, Employee Plans Examination of Returns, Overview of Form 5500 Examination Procedures. Review this guide when preparing for a pension plan audit.

ROLLOVER RULE §408(d)(3)

Rollover Contributions to SIMPLE IRAs Expanded by the 2015 PATH Act

If certain requirements are met, distributions from employer-sponsored retirement plans and IRAs may generally be rolled over on a nontaxable basis to another employer-sponsored retirement plan or IRA. However, a distribution from a SIMPLE IRA during the two-year period beginning on the date the employee first participated in the SIMPLE IRA may be rolled over only to another SIMPLE IRA. Prior to the PATH Act, the only contributions that could be made to a SIMPLE IRA were contributions under a SIMPLE plan. Distributions from other employer-sponsored retirement plans and IRAs couldn't be rolled over to a SIMPLE IRA, even after this two-year period.

For contributions to SIMPLE IRAs, the PATH Act permits rollovers of distributions from employer-sponsored retirement plans and traditional IRAs into a SIMPLE IRA after the expiration of the two-year period following the date the employee first participated in the SIMPLE IRA (the two-year period during which the additional income tax on distributions from a SIMPLE IRA is 25% instead of 10%).

IRA Distributions Are Subject to the "One-Rollover-Per-Year" Limitation (IRA One-Rollover-Per-Year Rule)

Section 408(d)(3)(A)(I) provides generally that any amount distributed from an IRA will not be included in the gross income of the distributee to the extent the amount is paid into an IRA for the benefit of the distributee no later than 60 days after the distributee receives the distribution. Section 408(d)(3)(B) provides that an individual is permitted to make only one nontaxable 60-day rollover between IRAs in any one-year period.

One-year rule applies to the aggregate of IRAs. The Tax Court in *Bobrow v. Comm.*, TCM 2014-21 held that the limitation applies on an aggregate basis, meaning that an individual cannot make more than one nontaxable 60-day rollover within each one-year period even if the rollovers involved different IRAs. In Announcement 2014-15, the IRS indicated that it would follow the interpretation of §408(d)(3)(B) in *Bobrow*.

One-rollover-per-year rule. An individual can make only one rollover from an IRA to another (or the same) IRA in any 12-month period, regardless of the number of IRAs he or she may own (Announcement 2014-107 and Announcement 2014-32). The limit will apply by aggregating all of an individual's IRAs, including SEP and SIMPLE IRAs as well as traditional and Roth IRAs, effectively treating them as one IRA for purposes of the limit.

> **Example.** George requests that his broker distribute $50,000 from his IRA on Sep. 1, 2019. George's broker mails the distribution check on September 3, and George receives it on September 10. George repays the $50,000 to his IRA on Nov. 5, 2019. George has properly executed a rollover contribution under §408(d)(3), and he does not owe any tax or penalties on the $50,000 distribution.
>
> **Tax practitioner planning.** It is the date that George actually receives the distribution that starts the 60-day repayment period, regardless of when the distribution is requested or the date the broker mails the check.
>
> **Variation.** On Mar. 10, 2019, George withdraws *another* $25,000 from his IRA. George repays $25,000 to his IRA on Apr. 20, 2019, well within the 60-day rollover period. Unfortunately for George, he may not make more than one nontaxable rollover contribution in the 12-month period, which doesn't end until Sep. 9, 2019. George must pay tax on the $25,000 and, if applicable, the 10% early withdrawal penalty.

Rollover contributions distinguished from direct transfers (Rev. Rul. 78-406). The one-rollover-per-year limitation only applies to indirect rollovers (i.e., the taxpayer actually receives the cash and then redeposits it at a later date). Direct transfers from one IRA custodian to another are not considered "rollover contributions" since such funds are not within the direct control and use of the participant. Multiple direct transfers are allowed during a single calendar year. In the event that multiple direct transfers have occurred, participants are still allowed one rollover contribution per year.

Exceptions to the one rollover rule. The one-per-year limit does not apply to:

- rollovers from traditional IRAs to Roth IRAs (conversions),
- trustee-to-trustee transfers to another IRA,

- IRA-to-plan rollovers,
- plan-to-IRA rollovers, and
- plan-to-plan rollovers.

IRA Distribution to Personal Account Taxable (*Estate of Hung-Liang Lynn Lin v. Comm.*, TCM 2017-77)

Hung-Liang Lynn Lin rolled over his IRA to a ProEquities IRA account. Mr. Lin became angry because he believed that the representative was "doing things" he did not know about and was charging a commission. Mr. Lin requested that his ProEquities account be closed, and on Mar. 29, 2012, he executed an IRA distribution request form to withdraw the $56,889 balance in the account. The form also authorized delivery of the funds via wire transfer to his bank account at Bank of America. Although ProEquities issued a Form 1099-R for $56,889, Mr. Lin did not report the amount on his tax return.

Mr. Lin's executor argued that the funds were transferred in error to a personal account and that the estate should be able to roll over the amounts to a new IRA. Because Mr. Lin signed papers authorizing the transfer to his personal account, the court found the distribution to be taxable.

Also See.

- LTR 201705009, where an individual was allowed a waiver of the 60-day rollover period for an IRA distribution because of a miscommunication with the financial institution; she understood the rollover period to be 90 days.
- LTR 201709023, where the individual was granted a waiver of the 60-day rollover period for medical reasons; she showed confusion, memory loss, and cognitive impairment during the 60 days and was unable to timely complete the rollover.

Self-Certification Procedure for Certain Failed 60-Day Rollovers

In 2016, the IRS provided a self-certification procedure designed to help recipients of retirement plan distributions who inadvertently miss the 60-day rollover time limit for properly rolling these amounts into another retirement plan or IRA. Following this guidance, eligible taxpayers who missed the time limit will now ordinarily qualify for a waiver if one or more of 11 circumstances apply to them (Rev. Proc. 2016-47).

They include:

1. an error was committed by the financial institution receiving the contribution or making the distribution to which the contribution relates;
2. the distribution, having been made in the form of a check, was misplaced and never cashed;
3. the distribution was deposited into and remained in an account that the taxpayer mistakenly thought was an eligible retirement plan;
4. the taxpayer's principal residence was severely damaged;
5. a member of the taxpayer's family died;
6. the taxpayer or a member of the taxpayer's family was seriously ill;
7. the taxpayer was incarcerated;
8. restrictions were imposed by a foreign country;
9. a postal error occurred;

10. the distribution was made on account of a levy and the proceeds of the levy have been returned to the taxpayer; or
11. the party making the distribution to which the rollover relates delayed providing information that the receiving plan or IRA required to complete the rollover despite the taxpayer's reasonable efforts to obtain the information.

Tax practitioner planning. A sample letter for self-certification for late rollover contribution is included in the appendix to Rev. Proc. 2016-47.

Contribution as soon as practical — 30-day safe harbor. The contribution must be made to the plan or IRA as soon as practical after the reason or reasons listed in the self-certification no longer prevent the taxpayer from making the contribution. This requirement is deemed to be satisfied if the contribution is made within 30 days after the reason or reasons no longer prevent the taxpayer from making the contribution.

Reporting on Form 5498. The IRS modified the instructions to Form 5498 to require that an IRA trustee that accepts a rollover contribution after the 60-day deadline report that the contribution was accepted after the 60-day deadline. The Form 5498 will then alert the IRS to the late rollover.

Sample letter for self-certification. Ordinarily, the IRS, plan administrators, and trustees will honor a taxpayer's truthful self-certification that the taxpayer qualifies for a waiver to the 60-day rule under the new revenue procedure. If the IRA custodian requires a written statement, taxpayers may make the certification by using the model letter provided in the revenue procedure on a word-for-word basis or by using a letter that is substantially similar in all material respects. A copy of the certification should be kept in the taxpayer's files and be available if requested on audit.

Tax planning point. Even if a taxpayer does not self-certify, the IRS now has the authority to grant a waiver during a subsequent examination.

Comparison Chart of Allowable Rollovers (Rollover Chart)

		ROLL TO							
		IRA	**SEP-IRA**	**SIMPLE IRA**	**ROTH IRA**[1]	**457(b)**	**403(b)**	**Qualified Plan**	**Designated Roth Account**
ROLL FROM	**IRA**	YES	YES	YES, after Dec. 18, 2015, and after two-year period.	YES, must include in income.	YES, must have separate accounts.	YES	YES	NO
ROLL FROM	**SEP-IRA**	YES	YES	YES, after Dec. 18, 2015, and after two-year period.	YES, must include in income.	YES, must have separate accounts.	YES	YES	NO

	SIMPLE IRA[6]	YES, after two years.	YES, after two years.	YES	YES, after two years. Must include in income.	YES, after two years. Must have separate accounts.	YES, after two years.	YES, after two years.	NO
	ROTH IRA	NO	NO	NO	YES	NO	NO	NO	NO
	457(b)	YES	YES	YES, after Dec. 18, 2015, and after two-year period.	YES, after Dec. 31, 1997. Must include in income.	YES	YES	YES	NO
	403(b)	YES	YES	YES, after Dec. 18, 2015, and after two-year period.	YES, after Dec. 31, 1997. Must include in income.	YES, must have separate accounts.	YES	YES	NO

[6] A distribution and rollover is only allowed after the individual has participated in the SIMPLE IRA for the two-year period during which the additional income tax on distributions from a SIMPLE IRA is 25% instead of 10%.

	QUALIFIED PLAN	YES	YES	YES, after Dec. 18, 2015, and after two-year period.	YES, after Dec. 31, 1997. Must include in income.	YES, must have separate accounts.	YES	YES	NO
	DESIGNATED ROTH ACCOUNT	NO	NO	NO	YES	NO	NO	NO	YES, if a direct trustee-to-trustee transfer.

Warning. The comparison chart shows general information that may not be applicable to all plans. Not all accounts allow rollover contributions (§1.402(a)(31)-1, Q and A 13).

Tax Planning Question — Should the Client Rollover Their 401(k) Plan Monies to an IRA?

Keep assets in the 401(k)	Rollover assets to an IRA
Distributions allowed at age 55 (rather than 59½) with no 10% penalty if separated from service	Distributions allowed at any age (rather than 59½) with no 10% penalty if taken in series of equal payments
Stronger protections against creditors	Distributions allowed without penalty for first-time home buyers, qualified education expenses, health insurance for long-term unemployed
No RMDs at 72 if still working	Trustee distributions allowed to a charity up to $100,000 per year — counted toward RMD
Borrowing allowed from plan	IRA funds can be invested in multiple accounts to facilitate beneficiary planning
Capital gain treatment available for net unrealized appreciation on lump sum distribution	Distributions can be taken at any time with tax and penalty. Many restrictions apply to taking 401(k) distribution before separation or age 59½

10% EARLY WITHDRAWAL PENALTY - §72(t)

A 10% additional tax on distributions from qualified retirement plans is imposed (§72(t)(1)). However, there are specific exceptions to the imposition of the 10% additional tax (§72(t)(2)):

Coronavirus-Related Distributions

CARES waived the 10% penalty on Coronavirus-related distributions. See the discussion at the beginning of this chapter.

Exceptions for Qualified Plans and IRAs

1. On or after the account owner reaches age 59½.
2. On or after the death of the account owner.
3. After the permanent disability of the account owner.
4. At age 55 if from an employer plan and separated from service (does not apply to IRAs).
5. A series of substantially equal periodic payments (not less frequently than annually) made for the life of the employee or the joint lives of the employee and his beneficiary.
6. Distribution made incident to a divorce or made to an alternate payee under a Qualified Domestic Relations Order (QDRO).
7. For IRS levies.
8. For extraordinary medical expense. (This exception does not require the taxpayer to itemize deductions; however, because the exception is only for deductible medical expenses, it applies to the number of medical expenses that exceed 10% of AGI.)
9. Qualified disaster-relief distribution not in excess of $100,000.
10. Public safety employees, including federal law enforcement officers, custom and border protection officers, firefighters, and air traffic controllers, taking plan distributions if separating from service and over 50.[7]
11. Reservists called to active duty for at least 179 days.

For IRAs Only

1. For health insurance premiums during long-term unemployment (12 consecutive weeks).
2. For qualified higher education expense.
3. For a qualified first-time home buyer (a $10,000 lifetime limit).

Cases and Rulings — Exceptions for Qualified Plans and IRAs

Exception #1. IRA Distribution Subject to 10% Penalty If Under 59½ (*Wilfred Omoloh v. Comm.*, TCS 2017-64)

[7] The trade bill amended §72(t)(10)(B) to include an exception to the early distribution penalty for distributions at separation of service made on or after age 50 to federal law enforcement officers, custom and border protection officers, firefighters, and air traffic controllers. The change is effective for distributions made after Dec. 31, 2015.

Wilfred Omoloh withdrew $35,000 from his IRA. He claimed he was 59½ at the time of the distribution using a recently acquired birth certificate from his home country of Kenya. The IRS assessed the 10% early withdrawal penalty relying on older records, including Mr. Omoloh's immigration and naturalization papers, his University of Georgia educational records, and his Texas driver's license. The court expressed its "concern" over the accuracy of the birth certificate and found for the IRS.

Exception #3. Compulsive Gambling Not a Disability for Early Withdrawal Penalty Exception (*Kathryn Gillette v. CIR*. No. 19-1343 (7th Cir. 2020))

Kathryn Gillette's tax troubles stem from her compulsive gambling, which Ms. Gillette says was linked to a prescription medication for restless leg syndrome. Gillette first began taking Mirapex, or its generic version, in the early 2000s. Over the years, her doctor periodically increased her dosage as the medication became less effective. After a large dosage increase in 2010, Gillette began to exhibit compulsive behavior, especially gambling. By 2012, her gambling was out of control: she often stayed at casinos for days, stopped associating with family and friends, and neglected her hygiene. To fuel her gambling, Gillette eventually made an early withdrawal of $104,001 from her IRA, less than two years before she could do so without penalty. Ms. Gillette claimed that she should not be assessed the early withdrawal penalty because of her disability (§72(t)(2)(A)(3)).

Compulsive gambling was "remediable." Under §72(m)(7), a person is "disabled" if she is "unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or to be of long-continued and indefinite duration." Even if Ms. Gillette suffered from a condition that would otherwise satisfy that definition of disability, the court concluded that she did not qualify for the exception because her impairment was "remediable" (see §1.72-17A(f)(4)). An impairment is remediable if, "with reasonable effort and safety" it can be "diminished to the extent that the individual will not be prevented by the impairment from engaging in his customary or any comparable substantial gainful activity." The record suggests that Gillette's condition did not prevent her from engaging in her "customary or any comparable substantial gainful activity" in 2012. She continued to operate her rental property business and still reported $126,465 in profit from the business on her tax return. She received treatment for compulsive gambling in a reasonable and safe manner with the help of her family and doctors without interrupting her rental property business. Thus, Ms. Gillette was not disabled by compulsive gambling in 2012 and the early withdrawal penalty applied.

Exception #3. IRA Distribution Taxable and Subject to 10% Penalty (*Christopher Totten, pro se, v. Comm.*, TSCS 2019-1)

On his 2010 return, Christopher Totten reported an IRA distribution of $43,503. However, Totten reported the IRA distribution as a nontaxable rollover on his 2010 return. §408(d)(1) provides that any amount paid or distributed out of an IRA is included in the gross income of the payee or distributee as provided under §72. An amount will not be treated as a taxable distribution from an IRA if it is a qualified rollover (§408(d)(1), (3)). A distribution is considered a qualified rollover distribution if the entire amount an individual receives is paid into a qualifying IRA or other eligible retirement plan within 60 days of the distribution (§408(d)(3)). Totten testified that he used the funds to pay medical expenses. The IRA distribution did not, therefore, meet the requirements for a qualified rollover distribution.

10% penalty applies. Totten had not attained the age of 59½ when he received the distribution at issue. The IRA distribution was therefore an early distribution subject to the additional 10% tax. The additional 10%

tax, however, does not apply for certain enumerated exceptions (§72(t)(2)). Totten asserted that the exceptions for a distribution attributable to the individual's being disabled within the meaning of §72(m)(7) and a distribution made to an individual for medical care expenses apply to his distribution (§72(t)(2)(A)(iii), (B)). §72(m)(7) provides that a person shall be considered "disabled" if "he is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or to be of long-continued and indefinite duration." Although Totten submitted evidence that sufficiently proved that during 2010 he had a serious medical illness, he was employed full-time throughout the year as a medical sales representative. Totten was therefore not "disabled" within the meaning of §72(t)(2)(A)(iii). The 10% penalty applies.

Exception #6. No Exception to 10% Early Withdrawal Penalty Even If the IRA Withdrawal Is Taken to Satisfy a Divorce Court Order (IRA FAQs - Distributions, updated Jan. 18, 2020)

The 10% additional tax for taking an early division of a traditional IRA applies even if the withdrawal is taken to satisfy a divorce court order (§72(t)). Unlike distributions made to a former spouse from a qualified retirement plan under a QDRO, there is no "divorce" exception to the 10% additional tax on early distributions from IRAs.

Use trustee-to-trustee transfer for court-ordered amounts. The only divorce-related exception for IRAs is if the account owner transfers his or her interest in the IRA to a spouse or former spouse, and the transfer is under a divorce or separation instrument (§408(d)(6)). However, the transfer must be done by:

1. changing the name on the IRA from the account owner's name to that of his or her former spouse (if transferring the entire interest in that IRA), or
2. a trustee-to-trustee transfer from the account holder's IRA to one established by the former spouse.

Sixty-day rollover rules didn't apply. An indirect rollover didn't qualify as a transfer to the former spouse even if the distributed amount was deposited into the former spouse's IRA within 60 days.

Exception #6. IRA Distribution Not Made Pursuant to a QDRO (*Jeremy Summers v. Comm.*, TCM 2017-125)

On Mar. 18, 2013, Jeremy Summers filed a petition for dissolution of marriage. At that time, he had an IRA that he believed should be split 50-50 with his wife, Karie. His petition for divorce accordingly requested that "[t]he proceeds of IRA should be divided 50% to Petitioner and 50% to Respondent." To accomplish the division of the IRA, Jeremy withdrew the total proceeds of the IRA, $17,378. He deposited a check in that amount in a Bank of America checking account that he and Karie jointly held. The next day he wrote a check for $8,618 to pay off Karie's obligation on a car loan. He later transferred another $71 to her to ensure that she received her full 50% interest in the IRA.

1099-R triggered a document matching notice. On his 2013 tax return, Jeremy reported the IRA distribution as taxable but did not report any "additional tax" attributable to the fact that it was an early distribution. The IRS received from Edward D. Jones & Co. a Form 1099-R reporting the $17,378 distribution as an "early distribution, no known exception." This triggered a document-matching audit. The IRS issued a deficiency notice determining that Jeremy was liable for the 10% additional tax under §72(t)(1).

Without a QDRO, penalty applies. Jeremy argued that the penalty did not apply because the distribution was made "to an alternate payee pursuant to a qualified domestic relations order" and thus was excepted from penalty under §72(t)(2)(c). Jeremy did not qualify for this exception to the penalty:

1. The IRA distribution was made directly to Jeremy and not to "a former spouse * * * who is recognized by a domestic relations order as having a right to receive" a share of the proceeds (§414(p)(8)), and
2. The distribution was not made "pursuant to a qualified domestic relations order." The requirements of the QDRO provisions must be "rigidly observed" because they "relate to the substance or essence of the statute."

Exception #7. IRA Early Distribution for Economic Hardship Subject to Penalty (*Candace Elaine v. Comm.*, TCM 2017-3)

In June 2009, Candace Elaine was laid off from her job of 23 years as a call center manager with a mutual fund company. At that time and during the year in issue, Ms. Elaine was a single mother, raising two daughters on her own without support from anyone else. On account of the then economic downturn, she was unable to find another job, and she remained unemployed until approximately 2014. Consequently, in order to provide for her own subsistence and that of her daughters, Ms. Elaine made a series of withdrawals from her IRA totaling $119,000. At the close of that year, she was under 59½ years of age.

Penalty applies even if economic hardship. Economic hardship is not an exception to the early withdrawal penalty imposed under §72(t). Although Ms. Elaine said that she used some of the distributions for medical expenses and to pay off student loans, she did not provide any substantiation of her claims.

Also see.

- *Richard and Beverly Fann v. Comm.*, TCS 2017-43 where the IRA distribution was subject to the early withdrawal penalty even though Mrs. Fann's unemployment created a financial hardship. The medical expense exception to the 10% penalty provided under §72(t0(2)(B) did not apply since the Fanns' medical expenses did not exceed 7.5% of their AGI.
- *David Pritchard v. Comm.*, TCM 2017-136 where the taxpayer argued that the court should grant an exception to the early distribution penalty when the taxpayers used a retirement distribution to pay outstanding federal and/or state income tax liabilities; the court declined since there was not an IRS levy with respect to Mr. Pritchard's retirement plan.

Cases and Rulings — Exceptions for IRAs Only

Exception # 3. Distribution from 401(k) Subject to 10% Penalty (*Lily Hilda Soltani-Amadi and Bahman Justin Amadi v. Comm.*, TCS 2019-19)

During 2015, Lily Hilda Soltani-Amadi worked for the State of New York and participated in a §401(k) retirement plan. In 2015, the Amadis entered into a contract to purchase their first home. In order to help finance the down-payment for its purchase, Ms. Soltani-Amadi requested a distribution of $6,686 from her §401(k). On their 2015 return they did not include in income the distribution from §401(k), nor did they treat the distribution as an early distribution from a retirement plan or report additional tax pursuant to §72(t). The IRS examined the Amadis' 2015 return and ultimately issued a notice of deficiency attributable to (1) the $6,686 distribution from Ms. Soltani-Amadi's §401(k) plan, and (2) a 10% additional tax on the distribution pursuant to §72(t).

Of course, a distribution from a §401(k) retirement plan is fully taxable pursuant to §72 because the participant's contributions to the plan are made with "pre-tax dollars." But what about the penalty for early withdrawal? Isn't there something about a house down-payment? Yes, but only distributions from IRAs (§72(t)(2)(F)). An early distribution from a §401(k) plan is subject to a 10% penalty even though the funds were used for a first-time home purchase.

OTHER DISTRIBUTION RULES

Hardship Distribution Rules Changed (The Bipartisan Budget Act of 2018)

A retirement plan may, but is not required to, provide for hardship distributions. Many plans that provide for elective deferrals provide for hardship distributions. Thus, 401(k) plans, 403(b) plans, and 457(b) plans may permit hardship distributions.

Rules changed beginning in 2019. Some plans allow a hardship distribution only after the maximum available 401(k) loan has been taken, and may prohibit new contributions to the plan for up to six months after the hardship distribution. For plan years beginning in 2019, the Bipartisan Budget Act of 2018 repealed the six-month prohibition on contributions after a hardship withdrawal. It also repealed the requirement that the account owner must take available loans before a hardship distribution.

> **Tax practitioner planning**. It's up to the employer to adopt and amend the plan. The employer is not required to change its plan.

Guidance on Safe-Harbor Hardship Distributions from 401(k) (FAQs, updated June 18, 2019; TE/GE-04-0217-0008)

Generally, §401(k) plans may provide that an employee can receive a distribution of elective contributions from the plan on account of hardship. A distribution is made on account of hardship only if the distribution is made on account of an "immediate and heavy financial need" of the employee and is necessary to satisfy the financial need (§1.401(k)-1(d)(3)(i); §1.401(k)-1(d)(3)(iii)(B)).

A distribution is deemed to be on account of an "immediate and heavy financial need" if it is for one or more of the following:

- Expenses for medical care deductible under §213(d) for the employee or the employee's spouse, children or dependents (as defined in §152), or primary beneficiary under the plan;
- Costs directly related to the purchase of a principal residence;
- Payment of tuition, related educational fees, room and board expenses for up to the next 12 months of post-secondary education for the employee or the employee's spouse, children or dependents, or primary beneficiary under the plan;
- Payments necessary to prevent the eviction of the employee from the employee's principal residence or foreclosure of the mortgage on that residence;
- Payments for burial or funeral expenses for the employee's deceased parents, spouse, children or dependents, or primary beneficiary under the plan; and/or

- Expenses for the repair of damages to the employee's principal residence that would qualify for the casualty deduction under §165. For this purpose, the new limitations suspending deductions for personal casualties (§165(h)(5)) do not apply.

Employer's reliance on employee representations. A distribution qualifies if the employee represents that the need cannot be met by insurance, reasonable liquidation of assets, cessation of deferrals, or by borrowing from commercial sources at reasonable commercial terms. *We suggest an employee sign a statement stating that he/she meets all of the hardship distribution requirements.*

Hardship Substantiation Information and Notifications for Summary of Source Documents (TE/GE-04-0217-0008, Attachment I, incorporated into IRM 4.72.2)

Getting ready for the IRS audit: documents employer *must* receive prior to distribution to substantiate the hardship. Substantiation that a distribution is for one of the above items is required to determine that a hardship distribution is deemed to be on account of an immediate and heavy financial need. The IRS agent will review distributions by determining whether the employer or third-party administrator, prior to making a distribution, obtained (a) source documents (such as estimates, contracts, bills, and statements from third parties); or (b) a summary (in paper, electronic format, or telephone records) of the information contained in source documents. If a summary of information on source documents (was) used, (the IRS agent must) determine whether the employer or third-party administrator provide(d) the employee notifications required (see discussion of Attachment I below) prior to making a hardship distribution (TE/GE-04-0217-0008).

> **Tax planning point.** Hardship distribution does not mean penalty-free. If all of the above are met, the employee pays ordinary income tax and a 10% penalty on the amount of the hardship. The employee will receive a Form 1099-R, which is used to report the distribution on her or his personal tax return on Form 5329. The only exception to the 10% penalty is for deductible medical expenses.

RULES ON LOANS TO PARTICIPANTS §4975

Qualified Plan Loans Fast Facts

Twenty percent of active participants in 401(k)-type plans have outstanding loans in any given month. Over a five-year period, 40% of participants borrow from their plans.[8] The average loan balance is $7,860. 401(k) loans normally must be repaid in full within 60 days of an employee terminating employment. Loan defaults are taxed as a deemed distribution under §72(p) and are subject to the §72(t) early withdrawal penalty, if applicable. Statistics show that almost 86% of employees who leave their jobs default on their 401(k) loans, and then come the unintended tax consequences.

Loans from Qualified Retirement Plans Subject to Amount and Time Limitations (§72(p), Retirement Plans FAQs Regarding Loans, Updated June 26, 2019)

(**125**) Generally, loans from qualified employer plans are treated as distributions from the plan (§72(p)(1)(A)). Distributions from a qualified employer plan are taxable to the distributee in the distributee's taxable year in which the distribution occurs, pursuant to §72 (§402(a); *Prince v. Comm.*, TCM 1997-324).

[8] "Borrowing from the Future," Pension Research Council Working Paper, PRC WP2015-06, April 2015.

However, a loan will **not** give rise to a deemed distribution to the extent that the loan (when added to the outstanding balance of all other loans from the plan) does not exceed the lesser of:

1. $50,000 (reduced by the excess, if any, of the highest outstanding balance of loans from the plan during the one-year period ending on the day before the date on which the loan was made, over the outstanding balance of loans from the plan on the date on which the loan was made); or
2. The greater of one-half of the present value of the participant's "nonforfeitable accrued benefit" under the plan *or* $10,000 (§72(p)(2)(A)).

   Reminder. CARES increased from $50,000 to $100,000 (or the individual's nonforfeitable benefit if less) the limit on retirement plan loans from a qualified employer plan made to qualified individuals during the 180-day period beginning on Mar. 27, 2020. Loan payments are also delayed one year for loans due between Mar. 27, 2020, and Dec. 31, 2020.

But the above exception does not apply unless:

1. The loan, by its terms, is required to be repaid within five years (§72(p)(2)(B)); and
2. "Substantially level amortization of such loan (with payments not less frequently than quarterly) is required over the term of the loan" (§72(p)(2)(c)). One exception to the five-year repayment requirement is when the loan proceeds are used to "acquire any dwelling unit . . . within a reasonable time . . . as the principal residence of the participant" (§72(p)(2)(B)(ii)).

Therefore, loans must be repaid on a periodical basis, at least quarterly or each month. These payments must be in equal amounts and generally must be made through payroll deductions. Plans can provide a grace period for late payments before the loan defaults.

Exceptions. In addition to the exception for the purchase of a principal residence (any reasonable period allowed), participants engaged in military service and participants taking a leave of absence without pay may be exempt. For example, plans can suspend the repayment requirement while a person is serving in the military, and can then extend the five-year term by tacking on the time allowed without repayment. For persons on a leave of absence, the plan can suspend payments for up to one year, but cannot extend the overall five-year term. Participants must make up the missed payments either by increasing their periodic payments or by making a lump-sum payment at the end of the term.

Loans in default are deemed distributions. A loan that is in default is generally treated as a taxable distribution from the plan of the entire outstanding balance of the loan (a deemed distribution). The plan's terms will generally specify how the plan handles a default. A plan may provide that a loan does not become a deemed distribution until the end of the calendar quarter following the quarter in which the repayment was missed (§1.72(p)-1, Q&A-10(a)).

Plans often require full repayment if the participant leaves the company. If there is a default, or if the participant does not repay the loan in full on termination of employment, the unpaid balance of the loan is treated as a deemed distribution to the participant that is taxable income.

The plan must specifically authorize participant loans. However, plans that make loans but do not authorize loans can be amended retroactively. Plans must also state the minimum and maximum loan amounts, the number of loans permitted for one participant, repayment terms, interest rate, security, and the need for spousal consent. A plan violates the prohibited transaction rules if the plan makes a loan without security.

Refinancing of qualified plan loans may be trouble, trouble, trouble. In the event a loan that satisfies §72(p)(2) is replaced by a loan that has a ***later repayment date***, both loans are treated as outstanding on the date of the transaction (§1.72(p)-1, Q-20, A-20(a)(2)). If the ***sum of both*** loans, as well as all other outstanding loans, ***exceeds the limit*** of §72(p)(2)(A), then the replacement loan results in a deemed distribution in the amount that is above that limit.

IRA-based retirement plans cannot make plan loans to plan participants. Most, but not all types of retirement plans can make loans to plan participants. For example, qualified §401(a) plans (including §401(k) plans, profit-sharing plans, and defined benefit plans), certain §403(a) and §403(b) annuity plans, and eligible §457(b) governmental deferred compensation plans can make participant loans. But, plans prohibited from making participant loans include individual retirement accounts (both traditional and Roth) and IRA-based plans such as SEPs, SARSEPs, and SIMPLE IRAs.

What happens if a loan is taken from an IRA-based plan? If the owner of an IRA-based plan borrows from the IRA, the IRA is no longer an IRA, and the value of the entire IRA is included in the owner's income (§408(e)(2) and (3)). If the owner of an IRA pledges part of the IRA as collateral, the part of the IRA that is pledged is treated as distributed (§408(e)(4)).

Plan Loans Require Documentation

Retirement plans (e.g., profit-sharing, money purchase, §401(k), §403(b), and §457(b) plans) may offer loans to their qualified participants.

> **Tax practitioner planning.** IRAs and IRA-based plans (SEP, SIMPLE IRA, and SARSEP plans) cannot offer participant loans. A loan from an IRA or IRA-based plan would result in a prohibited transaction, and documents are required.

A plan sponsor should retain these records, in paper or electronic format, for each plan loan granted to a participant:

- Maintain evidence of the loan application, review, and approval process.
- Retain an executed plan loan note.
- If applicable, retain documentation verifying that the loan proceeds were used to purchase or construct a primary residence.
- Keep evidence of loan repayments.
- Maintain evidence of collection activities associated with loans in default and the related Forms 1099-R, if applicable.
- If a participant requests a loan with a repayment period in excess of five years for the purpose of purchasing or constructing a primary residence, the plan sponsor must obtain documentation of the home purchase before the loan is approved.

> **Tax practitioner planning.** A few missed payments on a 401(k) loan can result in a deemed distribution. This is "borrower beware" tax law.

Failure to Make Timely Payment on Plan Loan Results in Taxable Deemed Distribution (*Gerard and Regina McEnroe, v. Comm*., TCS 2019-21)

In July 2014, Gerard McEnroe borrowed $26,045 from his New York City Employees Retirement System (NYCERS) retirement account to help pay college tuition expenses for one of his children. He immediately began to repay the loan through biweekly payroll withholding. On May 15, 2015, Mr. McEnroe left his NYC job and accepted a job in the private sector. He quickly grew disillusioned with his new position, however, and returned to NYC employment in September 2015. Mr. McEnroe did not make loan payments to NYCERS after he left in May. When he returned in September, Mr. McEnroe learned that NYCERS had determined that his outstanding loan balance would be treated as a distribution. He began payments again in December.

Failed to make payment over six-month period and didn't catch up late missed payments. Mr. McEnroe failed to make loan payments that were due over a roughly six-month period stretching from June to December 2015. Because he first defaulted in respect of a loan payment that was due in June 2015, which falls in the second calendar quarter, a grace period, if any, would have been required to expire no later than Sep. 30, 2015, the last day of the third calendar quarter (§1.72(p)-1, Q&A-10(a)). Mr. McEnroe did not resume making loan payments, however, until December 2015. Moreover, when he did resume making loan payments, he did not cure the earlier default (he did not make a lump-sum payment to cover the many payments (with accrued interest) that he had failed to remit earlier in the year.

Default was taxable. The court decided that under the circumstances, NYCERS properly concluded that Mr. McEnroe had defaulted on the loan during the year in issue and correctly reported his entire loan balance at the time of the default ($22,284) as a deemed distribution.

See also.

Louelia Salomon Frias and Mervyngil Salomon v. Comm., TCM 2017-139, where missed payments on a 401(k) loan resulted in deemed distribution.
Gregory Gowen v. Comm., TCS 2017-57, where a CPA's default on his 401(k) loan resulted in deemed distribution.

PROHIBITED TRANSACTIONS (§4975)

Tax on Prohibited Transactions, updated Jan. 9, 2020

(129) Certain transactions between a disqualified person and a qualified plan may be subject to a two-tiered excise tax on prohibited transactions. First, a tax equal to 15% of the amount of the prohibited transaction is due for each year (or part thereof) in the taxable period. Once the first-tier tax is assessed, if the transaction is not corrected within the taxable period, a second tax equal to 100% of the amount involved is assessed. These excise taxes are collected from the disqualified person(s) who participated in the prohibited transaction.

(130) Prohibited transactions defined. Prohibited transactions between a disqualified person and a plan include, but are not limited to, any direct or indirect:

1. Sale, exchange, or lease of property.

2. Loan or extension of credit.
3. Furnishing of goods, services, or facilities.
4. Transfer to or use by or for the benefit of the disqualified person of the income or assets of the plan.
5. Use of plan income or assets by a fiduciary for his or her own benefit or account.
6. The receipt by a plan fiduciary of consideration for his or her own account from a party who is dealing with the plan in connection with plan income or assets (§4975(c)).

    Tax practitioner planning. These enumerated prohibited transactions are not mutually exclusive; one transaction may fall within the parameters of more than one transaction type. These transactions are meant to show per se examples of the kind of self-dealing and participation that is prohibited. The fact that a transaction would qualify as a prudent investment when judged under the highest fiduciary standards is of no consequence.

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

1. fiduciary, including a person designated as a fiduciary by §405(c)(1)(B) of the Employment Retirement Income Security Act of 1974 (ERISA);
2. person providing services to the plan;
3. employer or employee organization, including a direct or indirect 50% (or more) owner of the employer or organization, whose employees or members are covered by the plan;
4. member of the family of any individual disqualified person, including spouses, ancestors, lineal descendants, and spouses of lineal descendants;
5. corporation, partnership, trust, or estate, of which 50% or more is owned by persons described in 1 through 3 above;
6. officer, director, 10% (or more) shareholder, or highly compensated employee (earning 10% or more of the annual compensation of an employer) of any person described in 3 or 5 above; or
7. 10% (or more) partner or joint venturer of a person described in 3 or 5 above (§4975(e)(2)).

Special rules for IRAs (§4975(c)(3); §408(e)(2)). IRA account beneficiaries are generally exempt from the two-tiered excise tax discussed above. Instead, if an IRA beneficiary engages in a prohibited transaction with the IRA, the account ceases to be an IRA as of the first day of the taxable year in which the prohibited transaction occurred. Effectively, this makes the entire balance in the IRA immediately taxable and, if the owner does not meet an exception, subject to the 10% early withdrawal penalty.

IRS Reminds Taxpayers that "Collectibles" Cannot Be Held in a Retirement Plan (Investments in Collectibles in Individually Directed Qualified Plan Accounts (Updated Feb. 14, 2020))

The acquisition by a self-directed account under a qualified plan of a "collectible" is treated as an immediate distribution from such account in an amount equal to the cost to the plan of such collectible (§408(m)).

What is a collectible? Collectibles under §408(m)(2) include:

- Any work of art,
- Any rug or antique,
- Any metal or gem (with limited exceptions, below),
- Any stamp or coin (with limited exceptions, below),
- Any alcoholic beverage, or

- Any other tangible personal property that the IRS determines is a "collectible" (§408(m)).

Some exceptions apply. The following coins and metals are not included in the definition of "collectible" under §408(m):

- Certain gold, silver, or platinum coins described in 31 USC §5112 (§408(m)(3)(A)) for the full definition.
- Any coin issued under the laws of any state.
- Any gold, silver, platinum, or palladium bullion of a certain fineness if a bank or approved non-bank trustee keeps physical possession of it (§408(m)(3)).

Tax practitioner planning. Acquiring a collectible may also be a prohibited transaction under §4975(c). For example, the acquisition of artwork or rugs by a self-directed account for use in the participant's own home is a prohibited transaction.

RETIREMENT PLAN RESOURCES

Extensive Retirement Plan Resources on IRS Website (Small Business Retirement Plan Resources)

Helping Taxpayers Choose, Maintain, and Operate a Plan

- Help with Choosing a Retirement Plan - Provides resources to help compare retirement plan options.
- Tips for Employers Using Pre-Approved Plans - Answers questions to ask service providers about prototype plan adoption and service agreements.
- Benefits to Starting a Retirement Plan - Helps find the right retirement plan for retirement security.
- Webcast – Easy Low-Cost Retirement Plans for Your Small Business - Learn how to start and operate a low-maintenance retirement plan.
- File a Return or Report - Learn about Form 5500 annual reports, participant notices, and more.
- Penalty Relief Program for Form 5500-EZ Late Filers - Available via a program that waives IRS late filer penalties for small employers.
- A Plan Sponsor's Responsibilities - Learn how to keep retirement plans running smoothly.
- Types of Plans - See what the rules are for SIMPLE IRA, SEP, 401(k), and other plans.
- Frequently Asked Questions - See FAQs based on plan type, rollovers, plan operations and design, and correcting plan errors.
- Articles for Employees - Retirement Savings Tips for Individuals.
- Videos - Over 30 topics.
- IRS Tax Forum Presentations - Retirement plan choices and rules.
- Small Business and Self-Employed Tax Center

Correcting Plan Errors

Website guides on how to find, fix, and avoid making common mistakes in retirement plans. Employers may choose from a variety of retirement plans for employees, including 401(k)s, SIMPLE IRAs, and SEP IRAs. The IRS recently added to its website guides intended to assist employers with plan administration issues. Each guide provides:

- an overview of the rules for each plan type;
- an overview of the IRS Employee Plans Compliance Resolution System;
- the most frequent errors found in each plan type; and
- tips on how to find, fix, and avoid these errors.
- Correcting Retirement Plan Errors - IRS programs to help fix mistakes in a retirement plan.
- Fix-It Guides - find and fix errors for SEP, SIMPLE IRA, SARSEP, and 401(k) plans.

APPENDIX
CLIENT LETTER - 2020 RETIREMENT CHANGES

Dear Client,

Two pieces of legislation made changes to IRAs and pensions for 2020. The SECURE Act was a long-awaited retirement reform finally enacted in January 2020. The March 2020 CARES Act was a response to the Coronavirus pandemic and eased some rules to help taxpayers access their IRAs and pensions. The following summary is an update on the changes that we think might be of interest to you and your family.

IRA Changes

Required Minimum Distributions

No required distribution for 2020. A retirement plan or IRA owner must take a required minimum distribution (RMD) annually once the owner reaches age 72 (it was 70½ before 2020). However, for calendar year 2020, the new law waives the requirement that you take a distribution from your IRA or pension plan.

> **Example**. John, who is 74 years of age, has an IRA that had a balance of $1,000,000 at Dec. 31, 2019. Using prior law, John's RMD for 2020 is $42,017. Currently, his IRA is worth $500,000, and he doesn't want to sell stock inside of the IRA account to take out an "inflated" RMD amount. The new law allows John to waive his 2020 RMD.
>
> **Remember.** You may take a distribution from your IRA or pension plan. The new law simply does not require you to take a distribution in 2020.

For RMDs next year. The start date for RMDs is now age 72. Anyone who turns 70½ after 2019 will not have to take their RMD until they turn 72.

Born before July 1, 1949: RMDs started at age 70½ . Born after June 30, 1949: RMDs now starts at age 72.

IRA contributions. Beginning in 2020, the age limit for contributions to an IRA has been eliminated. In prior years, contributions to an IRA were not allowed beginning in the year the taxpayer turned 70½. You and/or your spouse must have earned income to contribute to an IRA.

Non-spouse beneficiary. The "stretch" distribution period for non-spouse inherited IRAs is reduced to a 10-year maximum, from a lifetime distribution. Within the 10-year period, there are no required distributions. But, the entire inherited retirement account must be distributed by the end of the 10-year period. This change applies to distributions to a non-spouse beneficiary from retirement plans and IRAs if the plan participant or IRA owner's death occurs after Dec. 31, 2019.

> **Example**. Joe's father dies in 2020 and names Joe as the beneficiary of his $500,000 IRA. Joe may withdraw funds from the IRA as he wishes, but the entire account balance must be withdrawn by the end of the 10-year period.

Some exceptions. The 10-year distribution limit does not apply to "eligible designated beneficiaries," including a surviving spouse, a minor child (once the child reaches age 18 the remainder of the distributions to that individual must be completed within 10 years), a disabled individual, a chronically ill individual, and an individual who is not more than 10 years younger than the deceased participant or IRA owner.

> **See your attorney.** For those who have named a trust as the beneficiary of their IRA or pension accounts, a review of the trust document is essential. Some "look-through trusts" have distribution provisions that may result in distributions be held up until the tenth year.

Pension and 401(k) Changes

Annuity offerings in 401(k) plans. Because defined benefit plans have been replaced with elective deferral plans like a 401(k), new law eases the restrictions on an employer adding an annuity ("a life time offering") to investment choices.

10% Penalty for Coronavirus-related distributions. The 10% early withdrawal penalty for distributions up to $100,000 from your IRA or pension plan for "Coronavirus-related purposes" has been waived. The distribution is subject to tax — only the penalty is waived— but the tax may be paid over a three-year period. The tax may be repaid in one or more payments in the three-year period. The waiver of the penalty only applies to distributions in 2020. Call if you would like more information on the definition of "Coronavirus-related."

> **Idea**. This change is to allow you to access cash if needed because of the Coronavirus shutdown.

Pension Plan Loans. The limit on retirement plan loans from a qualified employer plan during the 180-day period beginning on Mar. 27, 2020, is increased from $50,000 to $100,000. If your pension plan or 401(k) plan allows borrowing, this is a low-interest, easy-to-qualify-for loan — after all, it is your own money. The loan must be paid back generally over five years. Please call if you'd like to discuss the pros and cons of borrowing from your retirement account.

> **Idea**. This is another change meant to help you access cash if needed because of the Coronavirus shutdown. However, note this provision applies only to distributions made before Sep. 22, 2020, and does not include a "Coronavirus-related" definition.

We are here to help. Call with your questions.

Regards,

APPENDIX. 2020 SIMPLE IRA vs. SEP IRA COMPARISON CHART

PROVISIONS	SIMPLE IRA	SEP IRA
Eligible employers	Generally 100 or fewer employees earning at least $5,000 in the prior year and no other retirement plan.	Any size employer.
Eligible employees	To be eligible, employee must have earned at least $5,000 of wages in any two prior years.	To be eligible, employee must have worked for three of the prior five years and have earned at least $600 (for 2020) of compensation in the current year.
Employee deferral limit	$13,500 ($16,500 if 50 or older) in 2020.	No employee deferral.
Employer contributions	--3% of compensation if matching program. $13,500 employer contribution limit. --2% of compensation if all eligible employees covered. $5,700 ($285,000 x 2%) employer contribution limit. --Catch-up contributions must be matched.	Up to 25% of compensation. Limited to $57,000 in 2020, $63,000 for those 50 and over.
Catch-up contributions	$3,000	N/A
Payroll taxes	Elective deferral not subject to income tax but subject to FICA.	Contributions are from the employer and not subject to income or payroll taxes.
Deadline for establishing plan	Oct. 1 of the plan year.	Due date of employer's return including extensions for the plan year.
Plan year	Calendar year.	Employer's tax year (includes fiscal year if nonmodel plan year adopted).
Early withdrawal penalties	10% early withdrawal penalty applies, but increases to 25% penalty for withdrawals in the first two years after participation starts.	10% early withdrawal penalty applies.
Vesting	100%	100%

APPENDIX . 2020 KEY RETIREMENT PLAN RULES

Plan Type	Last Date for Contribution	Maximum Contribution	Maximum Deduction	When to Set Up Plan
SEP	Due date of employer's return (including extensions).	Smaller of $57,000 or 25%[1] of participant's compensation.[2]	25%[1] of all participants' compensation.[2]	Any time up to the due date of employer's return (including extensions).
SIMPLE IRA and SIMPLE 401(k)	**Salary reduction contributions:** 30 days after the end of the month for which the contributions are to be made.[4] **Matching or nonelective contributions:** Due date of employer's return (including extensions).	**Employee contribution:** Salary reduction contribution up to $13,500; $16,500 if age 50 or over. **Employer contribution:** *Either* dollar-for-dollar matching contributions, up to 3% of employee's compensation,[3] *or* fixed nonelective contributions of 2% of compensation.[2]	Same as maximum contribution.	Any time between Jan. 1 and Oct. 1 of the calendar year. For a new employer coming into existence after Oct. 1, as soon as administratively feasible.
Qualified Plan: Defined Contribution Plan	**Elective deferral:** Due date of employer's return (including extensions).[4] **Employer contribution:** Money Purchase or Profit-Sharing: Due date of employer's return (including extensions).	**Employee contribution:** Elective deferral up to $19,500; $26,000 if age 50 or over. **Employer Contribution:** Money Purchase: Smaller of $57,000 or 100%[1] of participant's compensation.[2] Profit-Sharing: Smaller of $57,000 or 100%[1] of participant's compensation.[2]	25%[1] of all participants' compensation[2], plus amount of elective deferrals made.	By the end of the tax year.
Qualified Plan: Defined Benefit Plan	Contributions must be paid in quarterly installments depending on the plan year, due 15 days after the end of each quarter.	Amount needed to provide an annual benefit no larger than the smaller of $230,000 or 100% of the participant's average compensation for his or her highest 3 consecutive calendar years.	Based on actuarial assumptions and computations.	By the end of the tax year.

[1]Net earnings from self-employment must take the contribution into account.
[2]Compensation is generally limited to $285,000 in 2020.
[3]Under a SIMPLE 401(k) plan, compensation is generally limited to $285,000 in 2020.
[4]Certain plans subject to Department of Labor rules may have an earlier due date for salary reduction contributions and elective deferrals.

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RETIREMENT PLANS

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REAL ESTATE TAXATION & INVESTMENTS

NEW LEGISLATION

Consolidated Appropriations Act (enacted Dec. 20, 2019)

The Consolidated Appropriations Act made two changes that impact real estate. The legislation retroactively extended the exclusion from income of cancelled qualified residence indebtedness for three years, from 2018 through 2020. The Act also retroactively extended the residential energy property credit for homeowners. For 2018, 2019, and 2020, an individual may claim a credit for (1) 10% of the cost of qualified energy efficiency improvements and (2) the amount of the residential energy property expenditures paid or incurred by the taxpayer during the taxable year (subject to the overall credit limit of $500).

CARES Act (enacted Mar. 27, 2020)

PPP Loans. The CARES Act funded Paycheck Protection Program loans. The PPP loan requires payroll. If your client has employees for his rental property, he or she can qualify for the PPP loan (see FAQs posted Apr. 15, 2020, by the SBA and Treasury for details). The initial $349 billion allocated for the PPP loans has been exhausted, but Congress is considering a second round of funding.

EIDL Program. For property owners who do not have employees but are seeing their rental income drop precipitously, an SBA disaster loan may help. The CARES Act modified the Economic Injury Disaster Loan (EIDL) Program for COVID-19. Check the SBA website for details.

Qualified Improvement Property. The CARES Act retroactively changed qualified improvement property (QIP) from a 39-year recovery period to a 15-year recovery period. The change is effective for tax years beginning in 2018 and now qualifies QIP for bonus depreciation. This change is attractive for your clients with commercial and retail real estate.

REAL ESTATE DEPRECIATION

IRS Can Adjust Depreciation Errors in Prior Years (*Gary and Janice Pinkston v. Comm.*, TCM 2020-44)

During 2012, the petitioners owned and rented two real estate properties in Hawaii. They purchased the first property, a beach house in Kahuku, Hawaii (beach house), in September 2003 for $1.6 million. They purchased the second property, a condominium unit in Honolulu, Hawaii (condo unit), in November 2010 for $2,692,900.

On their Schedule E, they reported their rental real estate activity as consisting of the beach house (described as “single family residence”) and the condo unit (described as “vacation/short-term rental”). The Pinkstons reported total rents received of $64,351 for the beach house and $99,200 for the condo unit. They reported related expenses totaling $685,167, attributable mainly to depreciation.

For the beach house. The Pinkstons allocated $400,000 of their cost basis to land and the balance — $1,205,137 as of 2012 — to land improvements. This allocation yielded a depreciation deduction of $43,819 for the beach house for 2012.

For the condo unit. The Pinkstons reported a total cost basis of $2,720,729. They allocated $27,830 of their reported cost basis to land and the balance to the following MACRS classes of depreciable property, claiming depreciation for 2012 as shown below:

Description	class life	depreciation basis	depreciation
distributive trades and services	5 years	$2,091,123	$476,776
information systems	5 years	$4,345	$991
residential rental property	27.5 years	$597,431	$21,723
		$2,692,899	$499,490

What might look wrong to the IRS? Land allocations don't look right. Distributive trades and services are a new category to most of us. Short-term rentals are like a hotel, and thus are 39 year recovery period, not 27.5. The IRS reallocated the purchase price of the condo to land at $291,800, five-year property at $90,537, and nonresidential real property at $2,310,563. The IRS proposed a reduction in the depreciation from $499,490 to $79,887. And, then the IRS proceeded to correct the overstated depreciation in prior years.

Change in accounting method. The Pinkstons did not challenge the correctness of the adjustments for the taxable year 2012. Rather, they challenged the IRS's invocation of §481 to "recapture" depreciation deductions that the Pinkstons had claimed for years before 2012. Of the adjustments determined in the notice of deficiency, $1,132,095 (or 67% of the total) arose from the §481 (prior years') adjustments. The court agreed with the IRS's adjustment that included prior year overstated depreciation expense.

> **Tax practitioner planning.** Since there is no mention of passive loss limitations in the case, it appears that the Pinkstons had large passive income from other properties.

LIKE-KIND EXCHANGES - §1031

Like-Kind Exchanges Allowed for Real Property Only

The Tax Cut and Job Act modified the provision providing for nonrecognition of gain in the case of like-kind exchanges by limiting its application to real property that is not held primarily for sale. The provision generally applies to exchanges completed after Dec. 31, 2017. However, an exception is provided for any exchange if the property disposed of by the taxpayer in the exchange is disposed of on or before Dec. 31, 2017, or the property received by the taxpayer in the exchange is received on or before such date.

> **Example**. In 2020, Sharon trades in her old business truck for a new business truck. She receives a $10,000 trade-in allowance. Since §1031 only applies to the exchange of real property, Sharon must recognize gain on her trade-in. The gain is ordinary income to the extent of depreciation recapture.

Example. To increase his depreciation allowances, Vern had a cost segregation study of his shopping center in 2016. In 2020, Vern exchanged his shopping center for an office building. The exchange of the shopping center building and land for the office building and land qualifies as a tax deferred exchange. However, the exchange of the personal property used in the shopping center for the personal property used in the office building is not qualified §1031 property, and a taxable transaction will result.

Tax practitioner planning. A client who has a cost segregation study at the acquisition of his property may well need another at the exchange, so that he can establish the sales price of the personal property.

Section 1031 and the Related Regulations Layout the Following Rules Related to Exchanges

1. No gain or loss will be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like-kind which is to be held either for productive use in a trade or business or for investment (§1031(a)(1)).
2. To the extent of cash or other "boot" (not like-kind property) received, gain is recognized (§1031(b)).
3. Net relief of the transferor taxpayer's mortgage debt is considered boot received (§1.1031(b)-1).
4. Amount of boot received is decreased by the taxpayer's exchange expenses (§1.1031-(d)-2, Ex. (2)).

Gain Recognized

Gain to be recognized on an exchange is the sum of:

Money or Other Boot Received	________________
Plus: Net Mortgage Relief	________________
Reduced by Exchange Expenses	________________
Gain Recognized	________________

Tax practitioner planning. Money or other boot given can offset mortgage relief. However, an increase in mortgage does not offset cash or other boot received.

LIKE-KIND PROPERTIES

The "Qualified Use" Requirement - What Property Qualifies for a Tax-Free Exchange?

Requirement. As mentioned previously, *both* the property given up and the property received by the taxpayer must be held for *productive use in a trade or business* ***or*** *for investment* (§1031(A)(1)). For confusion's sake, §1031 does not define *business* or *investment*, therefore, conventional wisdom assumes that the terms have the same meaning as elsewhere in the code, which is discussed below.

Tax practitioner planning. The *qualified use* test is determined by the use of each property, both given and received, *in the taxpayer's hands*. Therefore, the use of either property in the hands of the other party involved in the exchange is irrelevant (Rev. Rul. 75-291).

"Held for productive use in trade or business." Qualifying property must be used in a trade or business in which the taxpayer is engaged (§162; §1231). For example, trade or business property would include buildings owned and used by a business, office buildings, apartment houses, machinery and equipment, business trucks, and automobiles.

Confusion reigns in this area. Rental units are business property. For tax and exchange purposes, rental units are considered to be business property, *not* investment property. Most investors think rentals are investments, which is not true. Investment property has the negative result of creating a capital loss, whereas business property creates a fully deductible ordinary loss. So what is included in the very limited definition of *investment* property?

"Held for investment." This probably refers to property held for future use or future appreciation in value (§212). Examples of investment property include unimproved raw land, recreational property, and possibly second homes and/or condominiums.

Personal residences and certain vacation homes don't qualify. A personal residence (or a vacation home not held for investment) is not qualified use property because it is being used for personal purposes, not for business or investment purposes (*Barry E. Moore and Deborah E. Moore v. Comm.,* TCM 2007-134).

> **Tax practitioner planning.** The IRS has provided a safe harbor when an exchange involves a dwelling unit. The IRS will not challenge whether a dwelling unit qualifies under §1031 if the relinquished property was rented at fair rental value for at least 24 months immediately before the exchange (and was not used personally more than 14 days or 10% of the days rented) and the replacement property was rented for at least 24 months immediately after the exchange (and was not used personally more than 14 days or 10% of the days rented) (Rev. Proc. 2008-16).

Taxpayer Must Prove Basis Carried from Prior Exchange (*Charles and Yvonne Breland v. Comm.*, TCM 2019-59 (May 29, 2019))

Charles and Yvonne Breland acquired a shopping center in Alabama called Jubilee Pointe sometime before 2003. In 2003, they exchanged the shopping center for three properties: 1) a property in Daphne, Alabama, 2) a property in Pensacola, Florida, and 3) a property in Mobile, Alabama. They distributed the carry over basis in Jubilee Pointe proportionately across the three new properties in accordance with fair market value. The Brelands also added additional debt to the Pensacola property at the time of acquisition and added that amount to basis.

In 2004, they exchanged the Pensacola property for two new properties: 1) a lot on Dauphin Island and 2) a property in Grand Bay. Here again, they allocated basis in proportion to fair market value, increasing the basis on the Dauphin Island property by additional debt and cash contributed in the exchange. As a result, basis in Dauphin Island was $6,689,113 ($618,767 basis from Jubilee Pointe, plus $370,171 additional debt, less $237,345 allocated to Grand Bay property, plus $5,614,800 additional debt, plus $322,720 cash).

In 2009, the Brelands defaulted on the mortgage on the Dauphin Island property, and the bank foreclosed. In reconciling the loss from the foreclosure sale, the Brelands only provided a copy of the 2003 tax return depreciation schedule and Form 8824 for the exchange of Jubilee Pointe. Absent original documents verifying the basis in the original property (Jubilee Pointe), the Tax Court disallowed the carryforward basis of $618,767.

Also See.

- *Patrick A. and Jill M. Reesink v. Comm.*, TCM 2012-118, where the taxpayer used §1031 to defer a $429,000 gain on the sale of rental property by exchanging into a new rental home. The taxpayer moved into the home acquired in the exchange eight months after the exchange was completed, having never rented the home. The court ruled, because the taxpayer's intent was good, the §1031 exchange was valid, and no tax was due.
- *William P. Adams v. Comm.*, TCM 2013-7, where the taxpayer exchanged a rental home for a residence where his son could live. The taxpayer admitted the son paid below fair market value rent, but the court agreed that because the son performed all maintenance on the home that the discounted rent was justified and ruled that the residence was not a personal home.

DELAYED EXCHANGES

New. IRS Delays Time-Sensitive Action

The Secretary of the Treasury has determined that any person performing a "time-sensitive" action listed in either §301.7508A-1(c)(1)(iv) – (vi) of the Procedure and Administration Regulations or Revenue Procedure 2018-58, which is due to be performed on or after Apr. 1, 2020, and before July 15, 2020 (Specified Time-Sensitive Action), is a taxpayer affected by the Coronavirus. For an affected taxpayer, the due date for identifying the target property and completing a delayed exchange is automatically postponed to July 15, 2020, if it otherwise occurred after Apr. 1, 2020, and before July 15, 2020 (Notice 2020-23).

Exchange, Not Sale, Must Be Planned

The escrows should be part of an *integrated plan* showing that the exchanger wishes to effect a §1031 exchange. This is evidenced by showing that an integrated plan for a like-kind exchange is conceived and implemented; the exchanger's actions are consistent with exchanging; the conditions required to effect that intent are met; the contracts providing for the necessary series of transfers are interdependent; and *no cash proceeds from the sale of the original property are actually or constructively received by the exchanger* (*Garcia v. Comm.*, 80 TC 491 (1983), acq. 1984-1 CB 1).

How to Structure the Delayed Exchange Properly

Because the above escrow instructions give little assurances as to how an exchanger can, or cannot, structure a successful transaction, the IRS suggested three safe-harbor entities to be used to close exchanges (§1.1031(k)-1(g)). Use of these safe-harbor rules results in a determination that the taxpayer is not, either directly or through an accommodation that may be an agent, in actual or constructive receipt of money or other property. By far the most popular is the use of a qualified intermediary.

Qualified accommodators. This safe harbor uses intermediaries or qualified accommodation's participation in the exchange to prevent the taxpayer from constructively receiving the purchase money. Deferred exchanges are permitted to be facilitated by the use of a *qualified intermediary* **if** the taxpayer's rights to receive the money or other property held by the accommodation are limited by the previously discussed rules on substantial limitations or restrictions (§1.1031(k)-1(g)(4)(vi)). In this case, the qualified accommodation is not considered the agent of the taxpayer (an agent is normally a disqualified person) (§1.1031(k)-1(g)((4)(I)).

Qualified Intermediary's Participation

A "qualified" intermediary is one who (§1.1031(k)-1(g)(4)):

1. is not the taxpayer, ***related to the taxpayer,*** or an agent of the taxpayer in the past two years; and
2. acts to facilitate a deferred exchange by entering into a written agreement (called the exchange agreement) and, as required by the exchange agreement (1) acquires the relinquished property from the taxpayer, (2) transfers the relinquished property to the buyer, (3) acquires the replacement property from the seller, and (4) transfers the replacement property to the taxpayer.

See Also.

- *Frank J. Blangiardo, pro se v. Comm.*, TCM 2014-110, where the taxpayer couldn't use his attorney son as qualified intermediary even if money was held in trust account.
- CCA 201325011, where directing qualified intermediary to pay debts was not actual or constructive receipt of sales proceeds.

REVERSE STARKER EXCHANGES

Reverse Starker Exchanges - IRS Provides Safe Harbor (Rev. Proc. 2000-37)

Reverse Starker exchanges. To facilitate reverse like-kind exchanges, taxpayers have engaged in a wide variety of transactions including so-called "parking" transactions (i.e., one of the properties is "parked" with an accommodation party). In the parking arrangements, taxpayers attempt to arrange the transaction so that the accommodation party has enough of the benefits and burdens relating to the property so that the accommodation party will be treated as the owner for federal income tax purposes. Rev. Proc. 2000-37 provides a safe harbor that allows a taxpayer to *treat the accommodation party as the owner of the property* for federal income tax purposes, thereby enabling the taxpayer to accomplish a qualifying like-kind exchange.

Replacement property is owned by accommodation. In some situations, the desired replacement property is "parked" with an accommodation party until such time as the taxpayer arranges for the transfer of the relinquished property to the ultimate transferee in a simultaneous or deferred exchange. Once such a transfer is arranged, the taxpayer transfers the relinquished property to the accommodation party in exchange for the replacement property, and the accommodation party then transfers the relinquished property to the ultimate transferee.

Relinquished property is owned by accommodation. In other situations, an accommodation party may acquire the desired replacement property on behalf of the taxpayer and immediately exchange such property with the taxpayer for the relinquished property, thereafter holding the relinquished property until the taxpayer arranges for a transfer of such property to the ultimate transferee.

Safe harbor for qualified exchange accommodation arrangements (Rev. Proc. 2000-37). The IRS will not challenge the qualification of property as either "replacement property" or "relinquished property" (as defined in §1.1031(k)-1(a)), or the treatment of the exchange accommodation titleholder as the beneficial owner of such property for federal income tax purposes, if the property is held in a Qualified Exchange Accommodation Arrangement (QEAA). For purposes of this revenue procedure, property is held in a QEAA if all of the following six requirements are met:

1. ***Ownership not vested in taxpayer or disqualified person:*** Qualified indicia of ownership of the property is held by a person (the "exchange accommodation titleholder") who is not the taxpayer or a disqualified person and such person is subject to federal income tax. If the exchange accommodation titleholder is treated as a partnership or S corporation for federal income tax purposes, more than 90% of its interests or stock must be owned by partners or shareholders who are subject to federal income tax. Such qualified indicia of ownership must be held by the exchange accommodation titleholder at all times from the date of acquisition by the exchange accommodation titleholder until the property is transferred;
2. ***What is qualified indicia of ownership?*** For this purpose, "qualified indicia of ownership" means legal title to the property, other indicia of ownership of the property that are treated as beneficial ownership of the property under applicable principles of commercial law (e.g., a contract for deed), or interests in an entity that is disregarded as an entity separate from its owner for federal income tax purposes (e.g., a single member limited liability company) and that holds either legal title to the property or such other indicia of ownership;
3. ***Intent to qualify under §1031:*** At the time the qualified indicia of ownership of the property is transferred to the exchange accommodation titleholder, it is the taxpayer's bona fide intent that the property held by the exchange accommodation titleholder represent either replacement property or relinquished property in an exchange that is intended to qualify for nonrecognition of gain (in whole or in part) or loss under §1031;
4. ***Written agreement within five days:*** No later than five business days after the transfer of qualified indicia of ownership of the property to the exchange accommodation titleholder, the taxpayer and the exchange accommodation titleholder enter into a written agreement (the "qualified exchange accommodation agreement") that provides that the exchange accommodation titleholder is holding the property for the benefit of the taxpayer in order to facilitate an exchange under §1031 and Rev. Proc. 2000-37, and that the taxpayer and the exchange accommodation titleholder agree to report the acquisition, holding, and disposition of the property as provided in Rev. Proc. 2000-37. The agreement must specify that the exchange accommodation titleholder will be treated as the beneficial owner of the property for all federal income tax purposes. Both parties must report the federal income tax attributes of the property on their federal income tax returns in a manner consistent with this agreement;
5. ***Identification of relinquished property within 45 days:*** No later than 45 days after the transfer of qualified indicia of ownership of the replacement property to the exchange accommodation titleholder, the relinquished property is properly identified. Identification must be made in a manner consistent with the principles described in §1.1031(k)-1(c). For purposes of this section, the taxpayer may properly identify alternative and multiple properties as described in §1.1031(k)-1(c)(4);
6. ***Transfer within 180 days:*** No later than 180 days after the transfer of qualified indicia of ownership of the property to the exchange accommodation titleholder, (a) the property is transferred (either directly or indirectly through a qualified intermediary (as defined in §§1.1031(k)-1(g)(4)) to the taxpayer as replacement property; or (b) the property is transferred to a person who is not the taxpayer or a disqualified person as relinquished property; and
7. ***Maximum time in QEAA is 180 days:*** The combined time period that the relinquished property and the replacement property are held in a QEAA does not exceed 180 days.

Example. Arnold wants to exchange his four-plex for an upscale duplex. Unfortunately, he finds the duplex of his dreams before he finds a buyer for the four-plex. A qualified exchange accommodation titleholder may acquire ownership of the duplex and hold it for Arnold until he finds a buyer for his property. Once Arnold finds a buyer (must be within 180 days), he will exchange the four-plex for the duplex. Providing the requirements of Rev. Proc. 2000-37 are met, Arnold's Reverse Starker exchange qualifies under §1031.

Permissible agreements. Property will not fail to be treated as being held in a QEAA as a result of any one or more of the following legal or contractual arrangements, regardless of whether such arrangements contain terms that typically would result from arms' length bargaining between unrelated parties with respect to such arrangements:

1. ***Exchange accommodation titleholder may be qualified intermediary:*** An exchange accommodation titleholder that satisfies the general requirements of the qualified intermediary (accommodation) safe harbor (as set forth in §1.1031(k)-1(g)(4)) may enter into an exchange agreement with the taxpayer to serve as the qualified intermediary in a simultaneous or deferred exchange of the property under §1031.
2. ***Taxpayer may guarantee debt to buy property:*** The taxpayer or a disqualified person guarantees some or all of the obligations of the exchange accommodation titleholder, including secured or unsecured debt incurred to acquire the property, or indemnifies the exchange accommodation titleholder against costs and expenses.
3. ***Taxpayer may loan funds to buy property:*** The taxpayer or a disqualified person loans or advances funds to the exchange accommodation titleholder or guarantees a loan or advance to the exchange accommodation titleholder.
4. ***Taxpayer may use property:*** The property is leased by the exchange accommodation titleholder to the taxpayer or a disqualified person.
5. ***Taxpayer may improve or service property:*** The taxpayer or a disqualified person manages the property, supervises improvement of the property, acts as a contractor, or otherwise provides services to the exchange accommodation titleholder with respect to the property.
6. ***Predetermined price okay:*** The taxpayer and the exchange accommodation titleholder enter into agreements or arrangements relating to the purchase or sale of the property, including puts and calls at fixed or formula prices, effective for a period not in excess of 185 days from the date the property is acquired by the exchange accommodation titleholder.
7. ***Taxpayer may or must cover fluctuations in value:*** The taxpayer and the exchange accommodation titleholder enter into agreements or arrangements providing that any variation in the value of a relinquished property from the estimated value on the date of the exchange accommodation titleholder's receipt of the property be taken into account upon the exchange accommodation titleholder's disposition of the relinquished property through the taxpayer's advance of funds to, or receipt of funds from, the exchange accommodation titleholder.

   Tax practitioner planning. A legal document, generally called an exchange agreement, *must* exist evidencing the relationship between the exchanger and the accommodation.

See Also.

(*Estate of George H. Bartell, Jr., Deceased, et al. v. Comm.*, 147 TC No. 5, (Aug. 10, 2016); AOD-2017-6, Aug. 25, 2017), where local drugstore chain acquires and renovates replacement property before identifying and selling relinquished store. But IRS issues nonacquiescence notice.

LIKE-KIND EXCHANGES WITH A RELATED PARTY (§1031(f))

Disposition within two years of exchange triggers deferred gain. If a taxpayer exchanges property with a related party (as defined below), the original exchange will not qualify for tax deferral if either of the exchanged properties is sold or disposed of within two years of the transfer. Interestingly, the postponed gain becomes taxable at the time of the disqualifying disposition and applies to both parties. It is important to note that exchanges between related parties may still use the tax-free benefits of §1031, provided the two-year waiting period and other requirements listed below are met (§1031(f) and (g)).

Who Is a Related Party? Related parties include:

1. **Family members**. Brothers, sisters, spouse, ancestors, and lineal descendants as well as C or S corps. and over 50% shareholders, corporate controlled members, and grantors and fiduciaries of trusts (§267(b)).
2. **Partnership-partner**. The related party definition also includes over 50% partner-to-partnership attribution rules (§707(b)).

Exceptions Exist to the Two-Year Rule

Certain dispositions within two years of an exchange will not invalidate §1031 treatment (§1031(f)(2)). This includes dispositions:

1. after the earlier of the death of the taxpayer or the death of the related person,
2. in an involuntary conversion if the exchange occurred before the threat or imminence of such conversion, or
3. that the taxpayer can establish to the satisfaction of the secretary that neither the exchange nor the disposition had as one of its principal purposes the avoidance of federal income tax. The Conference Report gives three examples of this non-tax-avoidance exception: (1) transactions involving certain exchanges of undivided interests in different properties that result in each taxpayer's holding either the entire interest in a single property or a larger undivided interest in any of the properties; (2) dispositions of property in nonrecognition transactions (e.g., §1033); and (3) transactions that do not involve the shifting of basis between properties.

If risk of loss is diminished (§1031(g)). The running of the two-year holding period will be suspended during any period when a party's risk of loss with respect to the property is substantially diminished, such as: (1) the holding of a put with respect to the property; (2) the holding by another person of a right to acquire the property; or (3) a short sale or any other transaction.

> **Example.** Dan and George, who are brothers, exchange like-kind property in a §1031 transaction. The realized gain on the exchange is postponed. Dan sells the property he received 18 months after the exchange. The result is that an unqualified like-kind exchange is deemed to have occurred as of the date Dan sold the property. When Dan disposes of the property, it causes all of the postponed gain to be recognized as of the date of the disposition. Not only does Dan have to recognize the gain, but George also has to recognize the gain he postponed.
>
> What happens if Dan, 18 months after the exchange, enters into another §1031 exchange with an unrelated party? Even in this case, the second §1031 exchange is treated as a sale and will cause Dan and George to recognize the postponed gain from the first exchange.
>
> **Tax practitioner planning.** Therefore, advance tax planning is required. Strong controls must exist between the related parties to prevent unexpected tax consequences created by the unilateral actions of just one of the parties. The legal documents should include a provision specifying that if either of the parties triggers the recognition of the postponed gain within the two-year period, the innocent party will be reimbursed for the tax consequences.

Related Parties Who Exchange Must File IRS Form 8824 for the Next Two Years!

If the exchange is made with a related party, the taxpayer must file Exchange Form 8824 in the year of the exchange and for the two following years.

Multi-Member LLC Qualifies for Non-Tax Avoidance Exception on Secondary Exchange (*PLR 201834010*)

Two single-member LLCs (LLC1 and LLC2), wholly owned by Taxpayer, a multi-member LLC, acquired separate properties from an affiliate corporation as part of an initial direct like-kind exchange under §1031. The affiliate corporation was a "related person" to the Taxpayer under §1031(f)(3), but because the initial exchanges were not delayed exchanges, they were valid tax-deferred exchanges.

Taxpayer will dispose of properties within two years. The Taxpayer, though LLC1, plans to dispose of its property as part of a second like-kind exchange. The purpose of this transaction is to acquire further property as replacement property to be utilized as Taxpayer continues its trade or business. Taxpayer will not receive any cash or other non-like kind property in the second exchange.

In addition, LLC2 will dispose of its property by merger, which will be accounted for as a contribution to another LLC. The contribution will be solely in exchange for an interest in the new LLC, the value of which will equal the value of the property contributed, with no cash or other consideration received by the Taxpayer. The contribution will be treated as a contribution to a partnership under §721.

Nonrecognition transactions allowed. LLC1 will dispose of Property 1 as part of a like-kind exchange under §1031 in the second exchange and Taxpayer represented that it will not receive any cash or other non-like kind property in the second exchange. In addition, LLC2 will dispose of Property 2 in a nonrecognition transaction under §721, with no cash or other consideration received by Taxpayer. LLC1 and LLC2 are disregarded entities, so the dispositions of both properties are considered to have been made by Taxpayer. Since both dispositions are in nonrecognition transactions and Taxpayer receives neither cash nor other consideration that would trigger gain in the dispositions, the dispositions are, under §1031(f)(2)(c), ignored in determining whether §1031(f) applies to require gain recognition in the initial exchange.

ONLINE RENTALS (AIRBNB, ONE FINE STAY, HOME AWAY, VRBO)

Online rental sites allow "hosts" to list their properties securely and reach a broad audience while providing "guests" a choice of various accommodations all over the world, from a single room in a residence to an entire house or villa. Offering a wide range of lodging at a variety of price points, the popularity of online rentals has grown significantly since Airbnb was founded in 2008.

Other online services following this same model include HomeAway, Onefinestay, and VRBO.

Taxable Income - Maybe Not!

The 14-day-or-fewer rule. According to §280A(g), if a dwelling unit is used during the taxable year by the taxpayer as a residence and such dwelling unit is actually rented for fewer than 15 days during the taxable year, then the income derived from such use for the taxable year shall not be included in the gross income of such taxpayer under §61.

> **Tax practitioner planning.** Often known as "the Masters Rule," homeowners in locations where major sporting events occur have used this technique for years. In addition, taxpayers receiving remuneration from a film or television crew often have the contract drawn as a "rental agreement" to avoid tax on the income.

Is It Your Personal Residence?

If the dwelling isn't a personal residence, then the rules under §469 for rental real estate activities apply. Report the activity on Schedule E, applying the passive activity loss rules in §469.

Okay, I'm renting out my personal residence - now what? Now, §280A applies for rental of a personal use asset. If the taxpayer rents out the entire dwelling unit, treat the property the same as a vacation rental under §280A, allocating expenses to personal and rental use, then limiting deductions to total rent received. If the taxpayer is renting only a part of the dwelling unit (i.e., a room in the house), divide expenses between the part of the property used for rental purposes and the part used for personal purposes as though it were two separate pieces of property. Report the rental income and rental portion of the expenses (including depreciation) on Schedule E.

> **Tax practitioner planning.** If §280A applies to an activity, report it on Schedule E. Even if the average stay was seven or fewer days, this is not a trade or business activity, nor is it a rental activity. It is the rental of a dwelling unit that you used as a home, and that is always reported on Schedule E.

> **Tax practitioner planning.** If the taxpayer is renting only a room or portion of the personal residence, further limitations apply under §280A if the room is not kept exclusively for rental use.

But I Don't Own the Home, I'm a Tenant

The rules for reporting rental income, whether short-term or long-term, and the application of §280A for business use of a home apply to both property owners and to tenants "subletting" their homes. Moreover, taxpayers who do not own the property should be cautioned to review the terms of their leases. Arrangements with Airbnb may violate the terms of their rental contracts and subject them to eviction.

What About Occupancy Taxes?

With most services, including Airbnb, the "host" (property owner) is responsible for determining if occupancy taxes are applicable. Some Airbnb hosts may have one of the following ways to handle occupancy tax:

In some locations, like Portland and San Francisco, Airbnb collects occupancy tax from guests and sends it to the tax authority on hosts' behalf, with no action needed from the host.

You can confirm if this option is available in your area: In what areas is occupancy tax collection and remittance by Airbnb available?

In other locations, like Washoe County, Nevada, hosts have the option to turn on a feature called Opt-in for Host Remittance of Taxes. Hosts who opt in instruct Airbnb to turn on collection of occupancy taxes for their listing. The occupancy tax amounts paid by guests will be included in payouts to the host's default payout method. Hosts are solely responsible for sending the occupancy tax amounts directly to the tax authority.

Chart for Reporting Online Rentals			
	Not Personal Residence[1]	Personal Residence[2] Entire Residence	Personal Residence Room or Portion
Rented fewer than 15 days in entire year	Taxable income	Not taxable income	Not taxable income
Deductions limited?	No	Yes, per §280A	No
Passive rules apply?	Yes	No	Yes
Average stay 7 or fewer days	Schedule E[3]	Schedule E	Schedule E[3]
Average stay more than 7 days	Schedule E	Schedule E	Schedule E

Also See.

- *Wagner v. Comm.*, TCM 2015-120, where taxpayer had unreported income in the amount of $8,340 from renting a room in his house.

IRS Wants Taxpayers to Know Facts About Renting Out Residential Property

Mindful that people often rent out their residential property as a source of income, particularly during the vacation-heavy, warm summer months, the IRS released a Summertime Tax Tip FS-2018-14. To help taxpayers avoid a sweat at tax time, the IRS wants taxpayers to know the facts about reporting rental income.

VACATION HOMES §280A

Vacation Home Losses

Section 280A provides that where a dwelling unit is used by a taxpayer *as a residence*, the taxpayer cannot claim a net rental loss. In this case, deductions attributed to rental use are limited to the excess of gross rental income over the portion of the expenses otherwise allowable (such as mortgage interest and taxes which are allowable without regard to their connection to a business or investment) that are attributable to the rental activity. If the property is not used as a personal residence, all of the rental related expenses, subject to the passive activity and at-risk rules, are deductible.

[1] Property used personally less than the greater of (1) 14 days or (2) 10% of total number of days rented at fair market rent.

[2] Property used personally more than the greater of (1) 14 days or (2) 10% of total number of days rented at fair market rent.

[3] The IRS seems to be divided about reporting on Schedule C or E. But, §469(I) allowance for $25,000 losses from actively managed rental real estate does not apply.

Number of days rented impacts deductibility of rental expenses. Whether or not taxpayers may deduct rental related expenses depends on whether or not the property is used as a residence by the taxpayer during the year. A property is used as a residence if the taxpayer personally used the property more than the greater of 14 days or 10% of the total days it was rented to others at fair rental value (§280A(d)(1)).

Rent income may be tax-free. If the property was used as a personal residence and was rented for 14 days or less during the year, no rental income or expense reporting is required. Any rent income received is nontaxable, regardless of amount. Any related expenses are only allowed as itemized deductions (e.g., mortgage interest, property taxes, and casualty losses).

What are personal use days? A personal use day includes any day, or part of a day, that the property was used by:

- the owner for personal purposes;
- any other person for personal purposes if that person owns part of the property;
- any family member of the owner(s) unless rented for use as the family member's main home at fair rental value;
- anyone who pays less than fair rental value; and
- anyone under an agreement that allows the owner to use other property.

At the urging of the US Treasury Inspector General for Tax Administration, the IRS now requires taxpayers to report the number of days per year that each rental property is rented at fair rental value and the number of days of personal use.

> **Tax practitioner planning.** Personal use does not include days where the owner worked substantially full- time repairing or maintaining the property, even if family members simultaneously used the property for recreation purposes. Personal use also does not include days where the owner used the property as a primary residence before or after renting it or offering it for rent as long as the property was rented, or tried to be rented, for at least 12 consecutive months, or a period of less than 12 consecutive months if the property was sold or exchanged at the end.

Limiting Deductions Under §280A

Deductions for vacation homes cannot exceed gross rent for the year. Gross rent includes both fair market rent and below-market rent received. Expenses must first be divided into personal use and rental use. Rental use deductions are calculated based on the ratio of the number of days rented at fair market rent over the total number of days the dwelling was used for any purpose.

In determining the number of rental days, include any day the dwelling was rented at fair market rent, even if the taxpayer used it that day. Do not include any day the dwelling was available for rent but not actually rented.

> ***Caution!*** This definition of the total rental days is different for calculating deductions than the definition for determining personal use for the vacation home limitation.

That ratio is applied to all expenses of the dwelling unit, except those directly attributed to renting the property (i.e., rental commissions and advertising) (Prop. Reg. §1.280A-3).

Ordering Deductions

Deductions (after applying the rental ratio) are allowable in the following order:

1. Deductions otherwise allowed under the Code even if not for trade or business use (i.e., mortgage interest and property taxes).
2. Deductions allowed for rental use of a dwelling unit.
3. Depreciation and amortization.

Carryforward disallowed losses from a vacation rental into the next year. The carryforward expenses are deductible only against the same property's income in the subsequent year, regardless of whether the taxpayer had any personal use in the following year.

> ***Example.*** Karen owns a lakeside home, which she rents at a fair rental for 90 days during the taxable year. Karen uses the home for personal purposes on 20 other days during the taxable year and also rents it to a friend at a discount for 10 days. Thus, the home is used for some purpose (other than repair or maintenance) on 120 days during the taxable year, and the rental allocation fraction may not exceed 90/120. On the basis of the following figures, Karen determines that the sum of the rental expenses for the home for the taxable year that are deductible is $2,200. The advertising expense and the Realtor®'s fee are also deductible.

Gross receipts from rental:			
90 days at $25 per day		$2,250	
10 days at $15 per day		150	
Total		$2,400	
Computation of gross rental income:			
Gross receipts from rental		$2,400	
Less: Advertising and Realtor®'s fee		200	
Gross rental income			$2,200
Deductions allowable under #1 above:			
	Total	Allocable to rental	
Mortgage interest	$1,000	$750	
Real estate taxes	800	600	
Amount allowable			1,350
Limit on further deductions			$850
Deductions allowable under #2 above:			
Insurance	$400	$300	
Utilities	600	450	
Amount allowable			$750
Limit on further deductions			$100
Deductions allowable under #3 above:			
Depreciation	$1,500	$1,125	
Amount allowable			100
Net Rental Income (Loss)			0
Expenses carried forward:			$1,025

Tax Court Takes a More Favorable View (*Bolton v. Comm., CA-9, 82-2 USTC 9699, aff'g TC 77 TC 104, Dec. 1982*)

The Tax Court overrode the IRS's proposed regulation method of allocating interest and taxes in a case that was upheld in appeals. The service's method uses the same ratio for interest and taxes as for all other expenses. However, because interest and taxes are then deducted first under the ordering provisions, this method may unfairly limit the deduction for other expenses while allowing a deduction for those expenses that could be deducted elsewhere on the return (i.e., Schedule A).

In the *Bolton* case, the court used the ratio of the number of rental days over the total number of days in the year for the allowable interest and property tax deduction. It then applied the ratio of days at fair market rent over total days used for any purpose to the remaining expenses. The result was a smaller percentage of mortgage interest and property taxes taken against rental income, the remainder of which were deductible on Schedule A. A larger amount of the other expenses attributed to the rental were then allowed before the limitation for gross rents received was met.

	IRS Method		***Bolton* Method**	
Gross rent		$2,200		$2,200
Mortgage interest	(90 ÷ 120) x $1,000	- 750	(90 ÷ 365) x $1,000	- 247
Real estate taxes	(90 ÷ 120) x $800	- 600	(90 ÷ 365) x $800	- 197
Limit for further deductions		$850		$1,756
Insurance & utilities	(90 ÷ 120) x $1,000	- 750	(90 ÷ 120) x $1,000	- 750
Limit for further deductions		$100		$1,006
Depreciation	(90 ÷ 120) x $1,500	- 100*	(90 ÷ 120) x $1,500	- 1,006*
Net Rental Income (Loss)		0		0
* Expenses carried forward:		$1,025		$19

TCJA Makes Choice of Method More Complicated

It used to be pretty simple. If the taxpayer itemized deductions, the *Bolton* method would generally produce a better tax result. But studies say that only 8% of US taxpayers will itemize deductions under the TCJA. And for those taxpayers who will continue to itemize, the SALT limitation and limits on deductible mortgage interest may reduce or eliminate a vacation home’s deduction on Schedule A.

> **Tax practitioner planning.** If your client will now be a **standard deduction**, consider using the IRS Method. This strategy creates a larger expense carryforward, but at least it preserves the deduction if rental income is higher in a future year.
>
> If property tax deductions for your itemizing client are already limited by the **SALT limitation**, use the IRS Method for the same reason noted above.
>
> ***Note!*** Whichever method you choose, if the rental portion of mortgage interest and property taxes exceeds gross rent, those amounts are deductible anyway. This is particularly useful if mortgages between main home and vacation home exceed acquisition debt limits.

Motorhome Subject to Both §274(d) and §280a (*Dellward R. Jackson v. Comm.,* TCM 2014-160, aff'd 9th Cir., No. 14-73680; Jan. 9, 2017)

After going to RV rallies for a number of years, the Jacksons began putting up a banner and a table and selling insurance at these gatherings. Since Mr. Jackson was always selling insurance, he claimed virtually 100% business use of his luxurious motorhome. When using a motorhome for business, it is subject to the stringent substantiation requirements of §274(d), both as a vehicle and as property generally used for recreation. In addition, as a dwelling unit it is subject to the business use of home requirements of §280A.

Must meet both requirements. While the court found that the Jacksons had met the requirements of §274(d) for one of the two years in question, it did not matter. The court found that since the motorhome was used for personal functions, and no portion of the motorhome was used exclusively for business, §280A prohibited any deduction.

> **Tax practitioner planning.** Given the multi-functional nature of motorhomes and RVs, the logic of *Jackson* would indicate that personal motorhomes and RVs are virtually never tax-deductible.

Also See.

- *Susan and Peter Szanto, pro sese v. Comm*., TCM 2016-145, where taxpayers were unable to establish where else they lived for six months while the personal residence wasn't rented, reducing deductible expenses by half, and limiting deduction to amount of rental income.
- *Robert and Pamela Redisch v. Comm.*, TCM 2015-95, where a minimal effort to rent didn't convert a personal asset (vacation home) to rental property.

THE PASSIVE LOSS RULES

Do the Passive Loss Rules Apply to Me?

Prior to 1986, a taxpayer could generally deduct losses in full from rental activities and trades or businesses regardless of his or her participation. This gave rise to significant numbers of tax shelters that allowed taxpayers to deduct non-economic losses against wages and investment income. The Tax Reform Act of 1986 added §469, which limits the taxpayer's ability to deduct losses from businesses in which he or she does not materially participate and from rental activities.

The passive activity loss rules are applied at the individual level and extend beyond tax shelters to virtually every business or rental activity whether reported on Schedule C, Schedule F, or Schedule E, as well as to flow-through income and losses from partnerships, S corporations, and trusts.

> **Tax practitioner planning.** The passive loss limitations also apply in full to personal service corporations. The §469 rules also apply to closely-held C corporations but have a limited application.

The §469 Passive Loss Rules: Overview

As a giant first step toward implementing a loss deduction limitation philosophy, Congress simply states that losses (and credits) from passive trade or business activities, to the extent they exceed income from all such passive activities, generally, may not be deducted against other income such as salaries and wages or interest and dividends. The two major exceptions are (1) the exemption granted to real estate professionals (§469(c)(7)) and (2) the ability of middle-income taxpayers to deduct up to $25,000 of rental losses from "actively managed" real estate (§469(a)).

Passive losses (and credits) disallowed in the prior year are deductible against current passive income. Any passive activity loss not currently deductible (disallowed) is suspended and becomes deductible in a subsequent year in which the taxpayer *either* has net passive activity income *or* completely disposes of the passive activity property to an unrelated party in a fully taxable transaction. In addition, with exceptions, the passive loss rules continue to allow losses and credits from one passive activity to be applied against income for the taxable year from another passive activity (§469(b)).

Rental Real Estate Loss Limited by AGI (*Stewart and Shirley Oatman v. Comm*., TCM 2017-17)

On their Schedule E, Stewart and Shirley Oatman reported $42,700 of rental income and $66,296 of total expenses for rental property in Los Angeles, California, and no rental income and $877 of total expenses for vacant lots in San Luis Obispo, California. Despite reporting that their AGI exceeded $100,000, the Oatmans did not limit their Schedule E rental real estate loss deduction under §469(I) and did not attach a Form 8582, Passive Activity Loss Limitations, to the joint return.

Rental loss is limited by AGI. The Oatmans originally reported AGI of $114,802, but as a result of the audit and a disallowance of a Schedule C loss, the IRS increased their AGI to $138,452. Thus, the Oatmans claimed deduction for a rental real estate loss of $24,473 on their Schedule E was limited to $5,774, representing the application of the phaseout of the loss limitation under §469(i)(3)(A).

> **Tax practitioner planning**. The IRS didn't audit the income and expenses of the rentals. Rather, they limited their change to the mechanical limitation due to excess AGI over $100,000.
>
> **Tax practitioner planning**. The taxpayers used a paid tax preparer. Wonder what tax preparation software was being used that didn't calculate the correct rental loss?

BASIC PASSIVE LOSS RULES

Only Two Activities Are Considered Passive:

1. ***A rental activity*** without regard to whether or to what extent the taxpayer participates in such activity (therefore, a rental activity is treated as a passive activity, regardless of the level of the taxpayer's participation); and
2. ***A trade or business activity in which the taxpayer does not materially participate*** for the taxable year (§469(c)(1)).

Establishing Material Participation

An individual is treated as participating "materially" in an activity for the taxable year if the individual's participation meets *one* of seven participation tests– four time tests, two long-standing (or "look-back") tests, or a seventh residual facts and circumstances test (§1.469-5T(a)(1)-(7)).

How to "materially participate" (MP) using any of the seven tests. An individual materially participates in an activity if they and/or their spouse:

3. Works 500 or more hours in the activity.
4. Does substantially all the work (i.e., more than 70% of the total business hours for the year are performed by the owner). “Substantially all” includes services of nonowner employees.
5. Works 100 hours, and no one else does more.
6. Works 500 hours in all businesses owned. The individual is deemed to materially participate when the activity is a “significant participation activity” (SPA) for the taxable year, *and* the individual’s aggregate participation in all SPAs during such year exceeds 500 hours.
7. Materially participates in the activity for five of the last 10 years (whether or not consecutive) during the 10 taxable years that immediately precede the taxable year.
8. Participates in a personal service activity with three years of participation. Individual materially participates in a personal service activity (e.g., accountants, lawyers, doctors, etc.) for any three taxable years (whether or not consecutive) preceding the taxable year.
9. Proves facts and circumstances. Based on all of the facts and circumstances, the individual participates in the activity on a regular, continuous, and substantial basis during the tax year.

Also See.

- *Stephen and Angela Hardy v. Comm.*, TCM 2017-16, where a non-managing member of an LLC owning a surgical center was considered to have passive income because he had no operational or management control.
- *Larry Kline v. Comm.*, TCM 2015-144, where a Southwest Airlines pilot operating a charter fishing boat wins material participation on 100 hours and no one participated more.

Definition of a Rental Activity for Passive Loss Purposes

A rental activity is any transfer of property for compensation. With some major exceptions, an activity is a rental activity for a taxable year if:

1. during the taxable year, tangible property held in connection with the activity is used by customers or held for use by customers; and
2. the gross income attributable to the conduct of the activity during the tax year represents amounts paid principally for the use of the tangible property (§1.469-1T(e)(3)).

Rentals. A rental activity is treated as a per se passive activity regardless of whether the taxpayer materially participates (§469(c)(2),(4)). However, the rental activities of a taxpayer in the real property business (real estate professional) are not per se passive activities but are treated as a trade or business and subject to the material participation requirements (§469(c)(2); §469(c)(1); §469(c)(7)(B)).

Activities That Are Not Rental Activities (§1.469-1T(e)(3))

When is a rental activity really a business? The real complexity of the passive loss rules is in making the determination whether a particular activity is a “rental activity,” a “trade or business,” or an “investment.” The regulations exclude from the definition of a rental activity those activities in which the importance of providing services to customers outweighs the importance of providing tangible property to customers (e.g., a hotel is normally a business, not a rental activity). It is important to note that substance controls over form, and the use of legal documents stating that a relationship is a lease is irrelevant.

The Regulations have identified certain rental activities as not being passive rental activities. These include activities where the:

1. **Average period of customer use is seven days or less**. Those renting vacation homes may fall under this exception.
2. **Average period of customer use is 30 days or less and significant personal services are provided by or on behalf of the owner of the property**. For example, significant personal services include maid or linen services. Certain services are specifically excluded, such as cleaning public entrances, stairways, or lobbies, and collecting and removing trash.
3. **Extraordinary personal services are provided by or on behalf of the owner of the property**. For example, a hospital room.
4. **Rental of such property is treated as incidental to a non-rental activity of the taxpayer**. This exception applies to property rented to employees at the employer's convenience and investment property that is held primarily for appreciation when the gross rental income from the property is less than 2% of the lesser of the unadjusted basis or the fair market value of such property.
5. **Taxpayer customarily makes the property available during defined business hours for nonexclusive use by various customers**. An example of this would be a golf course.
6. **Provision of the property for use in an activity conducted by a partnership, S corporation, or joint venture in which the taxpayer owns an interest**.

The "average period of customer use" is determined by dividing (1) the aggregate number of days in all periods of customer use for the property (taking into account only periods that end during the taxable year or include the last day of the taxable year) by (2) the number of periods of customer use (§1.469-1(e)(3)(iii)(c). The regulations define "period of customer use" as follows:

> Each period during which a customer has a continuous or recurring right to use an item of property held in connection with the activity (without regard to whether the customer uses the property for the entire period or whether the right to use the property is pursuant to a single agreement or to renewals thereof) is treated for this purpose . . . as a separate period of customer use (§1.469-1(e)(3)(iii)(D)).

Also See.

- *Amy L. Harloff v. Comm.*, TCS 2014-20, where the average length of a customer stay at the Whistler condo was four days, making the property a business, not a rental activity.

  Warning! Although a property may be a business, not a rental activity, it still may be a passive activity! Trade or business activities in which the taxpayer does not materially participate are passive.

Schedule C and Self-Employment Tax?

Well, probably not. A trade or business activity is subject to self-employment tax if it is profitable. Section 1.1402(a)-4(c)(2) stipulates that because very short-term rentals as defined above are not rentals from real estate, profits are included in determining net earnings from self-employment. However, the IRS appears to be divided on this issue. Certain audit offices in Southern California, and at least one appeals office, have insisted on Schedule C and SE tax. But a senior §469 subject matter expert from the IRS in Washington, D.C., has told us he believes that is incorrect. We have asked him to provide clarification through chief counsel.

Tax practitioner planning. Regardless of whether it's reported as a short-term activity, it isn't rental real estate. Therefore, any losses associated with the activity are not allowed to be deducted under the special $25,000 allowance for actively managed rental real estate at §469(a).

Surgeon's Income from Surgery Center Not Subject to SE Tax (*Stephen and Angela Hardy v. Comm.*, TCM 2017-16)

Stephen Hardy is a plastic surgeon who operates in a number of surgery centers including Missoula Bone and Joint Surgery Center, LLC (MBJ), in which he owns a 12.5% interest. Dr. Hardy has never managed MBJ and has no day-to-day responsibilities there. Dr. Hardy reported his MBJ income as self-employment income. Although Dr. Hardy performs surgeries at MBJ, he is paid separately by his patients for his surgery services, and he is not involved in the operations of MBJ as a business. The court ruled that Dr. Hardy's distributive shares from MBJ are not subject to self-employment tax because he received the income in his capacity as an investor (§1402(a)(13)).

Grouping of Passive Activities

What is an activity for passive loss purposes? Is it each business separately? Or when the client owns two or more businesses, can he "group" them into one activity so that he is able to meet the material participation test?

Combining or separating multiple businesses properly is a tax disaster if the taxpayer does this wrong! When applying the passive loss rules, the first and most important determination made by a taxpayer is defining how many different businesses (i.e., activities) the taxpayer must report to the IRS on the Passive Activity Form 8582. The taxpayer may aggregate, for passive loss purposes, two or more activities reported separately elsewhere on his or her tax return (§1.469-4(c)). But defining separate activities too narrowly, or too broadly, can either lead to evasion of the passive loss rules or, more tragically, make it impossible for the investor to take advantage of the relief provisions afforded him or her under the passive loss regulations.

Reasons for identifying each activity. It is also necessary to identify every separate activity of a taxpayer for the following purposes:

- determining whether the activity is a rental activity,
- determining whether the taxpayer materially participates in the activity (may make it easier to meet the 500-hour test if the activity is a trade or business),
- determining whether the taxpayer has completely disposed of his or her entire interest in the activity (to ascertain if the triggering of loss occurs), and
- applying the transitional rules for pre-enactment interests in passive activities.

Five factors for establishing groupings. The factors given the greatest weight when determining whether activities should be grouped together or kept separate are as follows (§1.469-4(c)(2)):

1. The similarities and differences in the respective types of businesses,
2. The extent of common control between the businesses,
3. The respective geographical locations of each business,
4. The extent of common ownership between the businesses, and
5. The interdependencies between the businesses.

Any reasonable method for grouping allowed! In spite of the importance of this definition, §469 does not define the term activity (e.g., determining how many different businesses the taxpayer owns). As a general rule, the legislative history suggests a definition of activity that entails dividing economic "endeavors" into fairly small units, but Congress, in its infinite wisdom, left to the Department of the Treasury the definition of the term in regulations.

Also See.

- *Scott W. Williams v. Comm.*, TCM 2014-158, where an attorney, business owner, and private pilot bought an airplane for his business and to rent out. The court ruled that the airplane rental activity and Williams's other business activities did not constitute an appropriate economic unit, so the airplane activity must be viewed separately from Williams' other activities to determine whether the airplane rental activity was passive. The court then ruled that Williams did not materially participate in the airplane rental activity, so the related losses could not reduce other nonpassive income.

Grouping of Passive Activities Requires Statement on Tax Return

Taxpayers are required to annually report to the IRS their groupings and regroupings of activities (Rev. Proc. 2010-13). Any additions of specific activities within their existing groupings for purposes of §469 and §1.469-4 are also required (Rev. Proc. 2010-13, Sec. 4.01).

Statement required for new groupings. A taxpayer must file a written statement with his or her original income tax return for the first taxable year in which two or more trade or business activities or rental activities are originally grouped as a single activity. This statement must identify the names, addresses, and employer identification numbers, if applicable, for the trade or business activities or rental activities that are being grouped as a single activity. In addition, any statement reporting a new grouping of two or more trade or business activities or rental activities as a single activity must contain a declaration that the grouped activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of §469 (Rev. Proc. 2010-13, Sec. 4.02).

Statement required for addition of new activities to existing groupings. If a taxpayer adds a new trade or business activity or a rental activity to an existing grouping for a taxable year, the taxpayer must file a written statement with the taxpayer's original income tax return for that taxable year. This statement must identify the names, addresses, and employer identification numbers, if applicable, for the new trade or business activity or rental activity that is being added to the existing grouping, as well as the names, addresses, and employer identification numbers, if applicable, for the activity or activities within the existing grouping. In addition, the statement reporting an addition to an existing grouping must contain a declaration that the activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of §469 (Rev. Proc. 2010-13, Sec. 4.03).

Statement required for regroupings. If it is determined that the taxpayer's original grouping was clearly inappropriate or a material change in the facts and circumstances has occurred that makes the original grouping clearly inappropriate, the taxpayer must regroup the activities and a written statement must be filed with the taxpayer's original income tax return for the taxable year in which the trade or business activities or rental activities are regrouped (§1.469-4(e)(2)). This statement must identify the names, addresses, and employer identification numbers, if applicable, for the trade or business or rental activities that are being regrouped. If two or more activities are regrouped into a single activity, the regrouping statement must also contain a declaration that the regrouped activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of §469. Furthermore, an explanation of why the taxpayer's original grouping was determined to be clearly inappropriate or the nature of the material change in the facts and circumstances that makes the original grouping clearly inappropriate must be included (Rev. Proc. 2010-13, Sec. 4.04).

If taxpayer fails to report groupings, each activity is treated separately. Unless the special grouping rules by partnerships and S corporations apply, if a taxpayer is engaged in two or more trade or business activities or rental activities and fails to report whether the activities have been grouped as a single activity, then each trade or business activity or rental activity will be treated as a separate activity under §469 (Rev. Proc. 2010-13, Sec. 4.07). The Commissioner, however, may regroup a taxpayer's activities to prevent tax avoidance (§1.469-4(f); Rev. Proc. 2010-13, Sec. 4.07).

Relief provision also available if taxpayer reported but failed to make election to group. An exception to the default rules that unreported activities will be treated as separate activities is when a timely disclosure is made by a taxpayer who has filed all affected income tax returns consistent with the claimed grouping of activities and makes the required disclosure on the income tax return for the year in which the failure to disclose is first discovered by the taxpayer. If the failure to disclose is first discovered by the Service, however, the taxpayer must also have reasonable cause for not making the required disclosures (Rev. Proc. 2010-13, Sec. 4.07).

DISPOSITION OF PASSIVE ACTIVITY

Suspended Losses

Current and carryforward passive losses are fully deductible on the disposition of a passive activity. However, §469(g) sets forth three criteria to be met before losses are deductible against nonpassive income. It requires that the taxpayer disposes of **an entire interest** in a **fully taxable transaction** to **an unrelated party**. All gain realized must be recognized. If these three criteria are met, the overall net loss is fully deductible (presuming, of course, that the taxpayer has basis) [§469(g)(1)].

The overall net loss is any loss on disposition and any current or suspended losses from the activity in excess of any gain on disposition or net income from the activity, or net income from all other passive activities. If there is an overall net loss, the entire disposition is not reflected on Form 8582, and the entire loss is reflected on the appropriate schedules. If there are two dispositions, one with an overall net loss and one with an overall net gain, they should be netted.

Nonqualifying Dispositions

A taxpayer is required to dispose of an entire activity in a fully taxable transaction to an unrelated party to fully deduct the current and prior year losses. Note that §469(g) requires a ***fully taxable*** event. Transactions not meeting this requirement include like-kind exchanges, conversion to personal use, gifts, transfer due to divorce, installment sales (passive activity loss triggered in ratio to gain reported), transfer due to death, and dispositions to related parties.

Disposition Planning Pointers
• If the taxpayer disposes of an activity by **gift**, the accumulated current and prior year unallowed losses cannot be deducted in any year. Instead, the basis of the transferred interest must be increased by the unallowed losses. • A mere **change in status**, whether it be to a partnership, corporation, or limited liability company does not constitute a qualifying disposition which would trigger deductibility of suspended losses. Similarly, conversion of a business or rental activity from passive to nonpassive does not trigger losses. • The transfer of passive activities **incident to a divorce** is not considered a fully taxable transaction, and any suspended losses would not be freed-up under §469(g). Any transfer of property incident to a divorce will be treated as a gift (§1041(b)). The transfer of passive activities incident to a divorce are treated as gifts, and the losses of the "donor" spouse are added to basis. • In a **bankruptcy**, nothing is triggered until the bankruptcy is complete, in other words, when gain or loss is recognized. Furthermore, suspended passive losses must first be applied against any relief of indebtedness (debt cancellation). In many instances, the debt forgiven under §108 fully absorbs the current and suspended passive losses, and therefore nothing is deductible on the return. • On any **disposition**, be sure to verify that it is an entire disposition of "substantially all" of the property. On the sale of rental real estate, if the taxpayer made an election to group his or her rentals as one activity under §469(c)(7), the sale of one property would not constitute an entire disposition. • Only a disposition to an **unrelated party** is considered a complete disposition. The following are related parties: spouse, brother(s), sister(s), son(s), daughter(s), grandchildren; an individual and a corporation owned more than 50% by the same person; and a partnership and a partner who own more than 50%. See §267 and §707(b) for other related parties. • If the taxpayer sold a piece of rental real estate and is a **real estate professional** who meets the relief provisions of §469(c)(7), they may have made an election to treat all of the rental real estate activities as a *single* activity. If the real estate professional did make the election, they cannot trigger suspended losses as there was not a disposition of the ***entire*** activity as required by §469(g).

REAL ESTATE PROFESSIONALS AND PASSIVE LOSSES

The Passive Loss Rules and Real Estate Professionals — Deducting Real Estate Losses Against Ordinary Income (§469(c)(7))

Passive loss rules don't apply to real estate professionals. A taxpayer's rental real estate activities in which he or she materially participates are not subject to limitation under the passive loss rules if the taxpayer meets eligibility requirements relating to real property trades or businesses in which the taxpayer performs services. This means that real estate investors who qualify are permitted to deduct their rental real estate losses against other income sources (e.g., commissions, wages, etc.) (§469(c)(7)).

An Individual Satisfies the Real Estate Professional Eligibility Requirements When Three Requirements Are Met

1. **Rental real estate is owned**. The individual must own at least one interest in rental real estate (§1.469–9(b)(6)).
2. **The 50% test**. More than 50% of the individual's personal services during the tax year must be performed in real property trades or businesses (defined below) in which the individual *materially* participates (defined below).
3. **The 750-hour test**. The individual must perform more than 750 hours of service in those same trades or businesses (§469(c)(7)(B)).

> **Tax practitioner planning.** When considering the RE professional time tests, each spouse must be considered independently. Spouses' time cannot be combined to determine if the RE professional tests are met.

The Real Estate Businesses That Can Be Combined

Real property trade or business means real property involved in four general activities:

1. development, redevelopment, construction, reconstruction, acquisition, conversion;
2. rental;
3. operation, management, leasing; or
4. brokerage trade or business (§469(c)(7)(c).

> **Tax practitioner planning.** Any hourly combination in these four "blessed" businesses is permitted. For example, a taxpayer who spends 100 hours managing rentals and 651 hours selling real estate exceeds the 750-hour minimum.

Mortgage Broker Not in Qualified Real Estate Business (*Kurt and Michelle Hickam, pro sese v. Comm.,* TCS 2017-66)

During 2011 and 2012, Kurt Hickam brokered real estate mortgages and other loans as an independent contractor for a mortgage brokerage company where he was a branch manager. During 2012, Mr. Hickam was also paid wages by an employer for originating loans. In both positions, Mr. Hickam's brokered or originated loans were secured by real estate.

In addition to brokering mortgages and originating loans, Mr. Hickam managed and maintained three rental real estate properties in San Jose and Capitola, California, two single-family residences and a nine-unit apartment complex. He owned the apartment complex jointly with his brother and parents, but none of his relatives participated in the management or maintenance of the property. Mr. Hickam claimed rental real estate loss deductions of $47,730 and $48,945 for 2011 and 2012, respectively, for the three properties.

Not real property trade or business. The court held that neither Mr. Hickam's mortgage brokerage services nor his loan origination services were performed in a real property trade or business within the meaning of §469(c)(7)(c), that the hours he spent performing his mortgage brokerage services and his loan origination services are not included for purposes of the real estate professional test, and that he did not meet the definition of a real estate professional under §469(c)(7)(B) for 2011 or 2012.

Also See.

- *Rodney and Lauraine Guarino v. Comm.*, TCS 2016-12, where the court accepted that Rodney's mortgage brokerage activity constitutes a "brokerage" trade or business, but it does not constitute a "real property brokerage" trade or business.

The Time Tests Cause the Most Problems for Real Estate Professionals

It's a time test that requires proof. The total time spent in any combination of real estate-related activities is used to determine if the 50% and the 750-hour tests are met.

Only one spouse needs to be the real estate professional. In the case of a joint return, the foregoing requirements for qualification as a real estate professional are satisfied if, and only if, either spouse ***separately*** satisfies the requirements (§469(c)(7)(B)); *Tony R. and Denelda Sims Goolsby v. Comm.*, TCM 2010-64). Thus, if either spouse qualifies as a real estate professional, the rental activities of the real estate professional are not passive per se under §469(c)(2). Instead, the real estate professional's rental activities would be governed by the trade or business passive activity criteria (whether or not the taxpayer materially participated in the trade or business) under §469(c)(1).

Required work for the 50%/750-hour test is different from the required work for material participation. With two restrictions, participation is any work done by an individual *in any capacity*, management or operations, in connection with an activity in which the individual owns an interest (§469(c)(7)(B) & (D)).

Restriction for employees. When this eligibility test is applied, the personal services of an employee are not counted unless the employee is also at least a 5% owner (i.e., owns more than 5% of the outstanding stock or more than 5% of the total combined voting power) (§469(c)(7)(D)(ii)). For example, in *Gregory and Linda Bahas, pro sese v. Comm.*, TCS 2010-115, the time Linda spent as an employee/manager didn't count toward the 750-hour test, as she was not an owner of the real estate agency where she worked. Her time would have counted had she been at least a 5% owner. One more issue: the Tax Court erroneously held that the 750-hour test applied to each rental. It does not. It is only important that the taxpayer spends 750 hours cumulatively in all real estate businesses. Also, in *James F. and Lynn M. Moss v. Comm.*, 135 TC No. 18, Sep. 20, 2010, the time spent "on-call" is not counted as hours worked in a real estate profession for purposes of satisfying the 750-hour test.

Substantiation of time requirement. With respect to the evidence that may be used to establish hours of participation, the extent of an individual's participation in an activity may be established by any reasonable means. Contemporaneous daily time reports, logs, or similar documents are not required if the extent of such participation may be established by other reasonable means. Reasonable means for purposes of this paragraph may include, but are not limited to, the identification of services performed over a period of time and the approximate number of hours spent performing such services during such period, based on appointment books, calendars, or narrative summaries (§1.469-5T(f)(4)).

Lawyer Failed Real Estate Professional Tests *(Zaid Hakkak and Layia Naji v. Comm., TCM 2020-46*)

Zaid Hakkak is an attorney, licensed to practice in the State of California. Mr. Hakkak's personal injury work was conducted through an S corporation, Z Dean Hakka, Inc., that he wholly owned. During the years at issue, the S corporation had approximately five salaried employees (none of whom were attorneys and not including Mr. Hakkak) and four to five "contract attorneys." In addition to practicing law, Mr. Hakkak held ownership interests in several flow-through entities that held rental real estate.

Taxpayers offset law firm K-1 income with rental losses. On their 2011 joint return, the Hakkaks reported Mr. Hakkak's W-2 wages from Z Dean Hakka, Inc. of $98,000, and net Schedule E income from rental real estate of $135,297. On their 2011 Schedule E and Form 8582, the Hakkaks reported the K-1 income attributable to Z Dean Hakka, Inc. of $351,437 as net passive income and net losses from rental activity K-1s totaling $214,354 as allowed passive losses.

S corp K-1 income not passive. The IRS determined that the reported passive income attributable to Z Dean Hakka, Inc. was nonpassive and that therefore the Hakkaks could not net the reported passive losses from passthrough rental entities against this income.

But were rental losses deductible for RE professional? When "caught" by the IRS, Mr. Hakkak claimed that his rental activities were those of a real estate professional. The rental activities of a taxpayer in a real property trade or business who meets certain enumerated requirements (a real estate professional) are not subject to the per se rental activity rule (§469(c)(7)(A); §1.469-9(b)(6), (c)(1)).

Failed RE professional tests. The court found that Mr. Hakkak did not qualify as a real estate professional for either of the years at issue because he failed to establish with proper hourly records that he met the one-half personal service hours requirement and the 750-hour requirement.

Bad Time Records Means Manager of Self-Owned Rentals Is Not a Real Estate Professional (*Ronnie and Gloria Hairston, pro sese v. Comm.*, TCM 2019-104 (Aug. 20, 2019))

Ronnie and Gloria Hairston owned two single-family rental houses next door to their own residence. In 2014 they claimed a $27,488 loss for the two properties, citing that although they both performed work, Ronnie was the real estate professional. While the court did not require a "contemporaneous log" to substantiate Ronnie's claim of 781 hours, it did review the calendars the Hairstons produced, one for each property.

The court found: "Together the calendars include 360 separate entries. Each entry describes a task and the hours allegedly consumed in performing that task, without indicating which petitioner did the work. The handwriting on all entries seems identical. Some of these entries were recorded on the day of performance, but most were made at the end of the week or later." In addition, the calendar entries were deemed to be inflated. While the court did not simply throw out the entire record, it reduced Ronnie's hours to below 750.

Architect Allowed to be a Real Estate Professional (*Jose Franco, pro se v. Comm.*, TCS 2018-9)

Jose Franco, a licensed architect, spent 649 hours, including travel time, operating his small architectural business. Jose also owned and managed two rental properties in Burlingame, California, making weekly trips performing minor repairs at the properties, coordinating more substantial repairs with a handyman, yelling at the tenants and collecting and depositing rent, maintaining insurance policies, purchasing materials for the properties as needed, paying bills, and keeping books and records of his expenses. Jose maintained an activity time log indicating he spent 1,137 hours in managing his rentals. On Schedule E, Jose reported a net loss of $67,882. The IRS limited the loss to $25,000.

Architect spent more hours managing rentals. Although Jose worked 649 hours providing personal services as an architect, he spent more hours managing his rentals. His testimony was largely corroborated with objective evidence including a rental activity log, receipts for various rental-related expenditures, e-mails, and other business records. The court held Jose qualified as a real estate professional and his rental real estate activities were regular, continuous, and substantial. The court allowed his loss deduction.

Tax practitioner planning. Real estate professional audits are all about records. Warn your clients.

Spouse's Detailed Records Win Real Estate Professional Status (*William and Roberta Birdsong, pro sese v. Comm.*, TC Memo 2018-148)

During 2014, Roberta and William Birdsong owned two rental real estate properties. Both properties were in Oakland, California. They consisted of four and five rental units, respectively.

William works full time as an emergency physician. While Roberta is not formally employed, she divides her time between caring for their children and managing their rental properties. In 2014 Roberta was the sole party actively involved in the day-to-day management of their rental properties. These tasks included cleaning common areas, collecting coins from washing machines, performing repairs at the properties, communicating with tenants, collecting and depositing rent, maintaining insurance policies, purchasing materials for the properties as needed, paying bills, and keeping books and records for tax accounting purposes. She occasionally hired a contractor (such as a handyman or plumber) to perform tasks she could not complete herself. When she hired a contractor, Roberta spent considerable time researching and contacting contractors, obtaining price quotes, and supervising repairs. Roberta's property management duties also included inspecting units, preparing (painting and supervising contractors) units for rental, advertising vacated units, screening potential tenants, showing the units, and processing rental applications.

She has a spreadsheet for that. Roberta produced two spreadsheets detailing her rental management activities. The first spreadsheet reflects that she logged 844.75 hours managing the rental properties in 2014; the second spreadsheet shows a total of 1,136.25 hours. The second spreadsheet includes previously omitted tasks such as investor hours and driving time between the rental properties and the hardware store and other locations pertinent to the management of the units. The Birdsongs used Roberta's calendar and receipts to reconstruct the time entries on both spreadsheets for the first half of 2014. For the second half of 2014, the time entries come from a contemporaneous log Roberta maintained on her phone on which she entered the date, location, time, and description of each task she performed. Roberta supplied receipts and invoices that substantiate the hours she logged.

Court found testimony credible, detailed, and convincing. On the basis of the Birdsongs' testimony and the record as a whole, the court concluded that Roberta, pursuant to §469(c), materially participated and is a real estate professional. Accordingly, the Birdsongs' loss attributable to their rental real estate is not limited by the passive activity loss rules of §469.

Tax practitioner planning. This taxpayer won because she knew the recordkeeping rules.

"Ballpark Guesstimates" Are a Loser Every Time! (*Philip and Leanna Rose v. Comm.*, TC Memo 2019-73, June 13, 2019)

Philip and Leanna Rose owned a rental property in Idaho and Arizona while living in Alaska. Although the Roses admit their logs for Leanna's hours were created after the fact, they claim to have been prepared after "studying receipts, records, travel records and [Leanna's] excellent memory." The Tax Court found that not only were the logs not contemporaneous, but they were created from calendars that were not contemporaneous either. After examining these "guesstimates" including 18 hours on Thanksgiving and 16 hours on New Year's Day, the court found the record not plausible.

If It Isn't a Rental Activity, Management Hours Don't Count for Real Estate Professional (*Steven and Stacey Ellison, pro sese v. Comm.,* TCM 2017-134)

Steven and Stacey Ellison, residents of Washington, listed seven rental properties on Schedule E of their 2008-10 tax returns and made elections on their original 2008-10 tax returns to treat all interests in rental real estate as a single rental real estate activity for those years. In addition, the Ellisons claimed rental real estate loss deductions of $85,173, $99,068, and $78,373 for 2008, 2009, and 2010, respectively.

The Ellisons prepared activity logs for their rental real estate activities. Of their total reported hours (1,079, 1,063, and 1,080 for 2008, 2009, and 2010, respectively), they reported 57.58, 540.40, and 518.25 hours attributable to their Redmond property, one of the seven properties.

Are these rental activities? The Redmond property was not held for rent in 2008, but it was rented in 2009 and 2010 to various tenants for an average of seven days or fewer. The Ellisons rented the Dawn Street property, another of the seven properties, to Todd Fauvelle, Steven Ellison's brother, in 2008, 2009, and 2010 and reported rental income of $800, $4,550, and $8,200, respectively. The stated monthly rent for the Dawn Street property during the taxable years at issue was $1,000. Accordingly, Mr. Fauvelle did not pay fair market rent for the Dawn Street property for 2008-10.

The court rules these hours don't count. The Redmond property, which was not held out for rent in 2008, had an average customer use of seven days or fewer in 2009 and 2010. The court ruled that because it is not a rental activity for purposes of §469(c)(2), those hours don't count. Further, because the Dawn Street property was rented to Mr. Ellison's brother, who did not pay fair market rent for the property, that use is personal and is attributed to the Ellisons under §267(c)(4), 280A(d)(1) & (2)(A). Accordingly, deductions attributable to the Dawn Street property are limited to the extent of rental income, and the court declined to determine whether the losses or deductions are passive.

> **Tax practitioner planning.** This is the second case in recent years where the Tax Court has mentioned that renting to a relative at below-market rent limits the expenses to the amount of rent (see *Okonkwo, pro se v. Comm.*, TCM 2015-181 (Sep. 14, 2015)). ***But***, at least one subject matter expert at the IRS in Washington, D.C., believes the court is getting this wrong. According to him, if it was rented at below-market rent all year to a relative, that's 100% personal use. Therefore, all expenses are personal.

In the end, with the loss of the hours attributed to the Redmond and Dawn Street properties, the Ellisons were determined not to qualify as real estate professionals.

Also See.

Mohammad M. Zarrinnegar and Mary M. Dini v. Comm., TCM 2017-034, where a dentist kept sufficient logs to show real estate hours exceeded hours spent in dental practice.

- *Patricia Windham v. Comm.*, TCM 2017-68 for stockbroker who managed 12 rental properties and kept sufficient records to prove real estate professional status.
- *Paul and Patricia McNally, pro sese v. Comm.,* TCM 2017-93, where taxpayer's journal repeatedly listing hours spent "in the office" on real estate "stuff" was rejected by court.

MATERIAL PARTICIPATION IN RENTAL ACTIVITIES FOR RE PROFESSIONALS

After determining if the taxpayer is a real estate professional, the real estate professional must prove he or she materially participated in managing the real estate rentals. This is again a time test, but different, and more restrictive, than the 50%/750-hour test. An individual is treated as participating "*materially*" for the taxable year if the individual's participation meets one of the seven enumerated material participation tests (§1.469-5T(a)(1)-(7)). The three most common ways that real estate investors meet this "material participation" test are by:

1. managing and operating the rental real estate activity for more than 500 hours during the year,
2. doing substantially all the work required to manage and operate the rental real estate during the year (probably more than 70% of the total business hours are performed by the landlord), or
3. working more than 100 hours during the year with no one (including nonowner employees and independent property managers) participating more than the landlord (§1.469-5T(a)(1)-(3)).

Owner can "tack" spouse's time. Any participation by one spouse is attributed to the other spouse, even if no joint return is filed and/or the participating spouse has no ownership interest in the activity. In effect, therefore, material participant status of both spouses is determined as though the two spouses were one individual (§1.469-5T(f)(3)).

When management does not count. Management time is disregarded when determining participation if:

1. It is *not* a type "customarily performed" by owners *and* one of the principal purposes of such work is avoiding the PAL rules (§1.469-5T(f)(2)(I)).
2. The total amount of the taxpayer's involvement is studying and reviewing financial statements, or preparing or compiling summaries or analyses of the finances or operations for the individual's own use (§1.469-5T(f)(4)).

Also See.

- *Charles and Delores Gragg v. US*, CA-9, 2016-2 (Aug. 4, 2016), where the court found that being a real estate professional does not make the rental activities per se material participation. Taxpayers must substantiate both RE pro hours and material participation hours!
- *Jerome and Margie Padilla v. Comm.*, TCS 2015-38, where the taxpayer lost his job and was still not a real estate professional because of the time test and his role as a property manager on out-of-state properties.

ELIGIBLE CORPORATIONS

A closely-held C corporation satisfies the eligibility test if, during the tax year, more than 50% of the gross receipts of the corporation are derived from real property trades or businesses in which the corporation materially participates (§469(c)(7)(D)(I)).

> **Tax practitioner planning.** This relief provision does not apply to estates, trusts, or limited partnerships owning real estate rentals. It only grants relief to closely-held corporations.

AGGREGATION OF RENTAL REAL ESTATE BY A REAL ESTATE PROFESSIONAL

Each rental is a separate activity, unless all rentals are combined. Each interest of the taxpayer in rental real estate is to be considered as a separate activity, but a taxpayer may elect to treat all interests in real estate, including real estate held through passthrough entities, as one activity (§469(c)(7)(A)).

> **Tax practitioner planning**. The aggregation option permits the taxpayer to meet the material participation test after *cumulatively* materially participating (e.g., working 100 hours or 500 hours) *in all the real estate rentals*. Without the aggregation option, the investor would be required to materially participate (i.e., spend 100 hours or 500 hours) in ***each*** activity, probably an impossible task for investors owning more than four rentals!

The election must be properly made. The election to treat all interests in rental real estate as a single rental real estate activity is binding for all future years unless there is a material change in a taxpayer's facts and circumstances. The taxpayer makes the election by filing a statement with his or her original income tax return. This statement must contain a declaration that the taxpayer is a qualifying taxpayer for the taxable year and is making the election pursuant to §469(c)(7)(A) (§1.469-9(g)).

Sample election language. "In accordance with §1.469-9(g)(3), the taxpayer hereby states that he (or she) is a qualifying real estate professional under §469(c)(7) and elects under §469(c)(7)(A) to treat all interests in real estate as a single rental real estate activity."

Real Estate Professionals May Make Late Election to Group Rental Activities (Rev. Proc. 2011-34)

Eligibility for relief. A taxpayer is eligible for an extension of time to file this election late (under §1.469-9(g)) if the taxpayer represents on a statement, under penalties of perjury, that he or she meets all of the following requirements:

1. The *only* reason the aggregation election wasn't made is because the taxpayer didn't file the required statement with his or her income tax return the first year the taxpayer became a real estate professional.
2. The taxpayer filed all required federal income tax returns consistent with the requested aggregation for all of the years including and following the year the taxpayer intends the requested aggregation to be effective, and no tax returns containing positions inconsistent with the requested aggregation may have been filed by or with respect to the taxpayer during any of the taxable years.
3. The taxpayer timely filed each return that would have been affected by the election if it had been timely made. The taxpayer will be treated as having timely filed a required tax or information return if the return is filed within six months after its due date, excluding extensions.
4. The taxpayer has reasonable cause for his or her failure to meet these requirements (§1.469-9(g)).

Requesting relief on amended return. The taxpayer must attach the following statement to an amended return for the most recent tax year and mail the amended return to the IRS service center where the taxpayer will file his or her current year tax return.

Wording for Filing a Single Rental Real Estate Activity Election

LATE ELECTION FILED PURSUANT TO REV. PROC. 2011-34.
1. "In accordance with §1.469-9(g)(3), the taxpayer hereby states that he (or she) is a qualifying real estate professional under §469(c)(7) and elects under §469(c)(7)(A) to treat all interests in real estate as a single rental real estate activity." 2. This election is being filed late because . . . (e.g., the taxpayer relied on a tax professional who failed to advise him or her of the availability and benefits of this election). 3. This election applies to year _____ (i.e., the taxable year to which the taxpayer wishes the late election to apply). 4. "Under penalties of perjury I (we) declare that I (we) have examined this election, including any accompanying documents, and, to the best of my (our) knowledge and belief, the election contains all the relevant facts relating to the election, and such facts are true, correct, and complete." 5. Signed and dated by the taxpayer.

The benefit. Any taxpayer receiving relief under this revenue procedure is treated as having made a timely election to treat all interests in rental real estate as a single rental real estate activity as of the taxable year for which the late election was requested.

Tax practitioner planning. These procedures are in lieu of a letter ruling request, so user fees do not apply.

IRS Chief Counsel Says Late Grouping Election May Be Made While at Appeals

The IRS Chief Counsel has advised that, if an appeals officer otherwise has the authority to accept amended returns from a taxpayer, the appeals officer may accept the amended return required by Rev. Proc. 2011-34, §4.02 during the appeals process. See CCA 201321021.

THE RECHARACTERIZATION RULES & SELF-RENTED PROPERTY

Net Profit From Self-Rental Property Can't Be Used Against Other Passive Losses

Taxpayer renting property to the taxpayer's own business will have to recharacterize income. Gross rental income equal to net rental income (including any income from a sale) is recharacterized as active income if the property is rented to a trade or business activity in which the taxpayer materially participates for the taxable year (without regard to the limited partner rules) so long as the property is not property rented incidental to a development activity (§1.469-2(f)(6); §1.469-2(f)(9)(iii)).

> **Warning.** This rule negatively impacts more taxpayers than any other recharacterization rule. It is intended to deter taxpayers from attempting to generate passive rental income and active business rental deductions by establishing rental arrangements between their own businesses. It does that and more.

The "heads IRS wins, tails taxpayer loses" rule: Although rental income is generally characterized as "passive," the self-rental rule provides that income from rental realty is not passive income if the property is rented for use in a trade or business activity in which the taxpayer materially participates for the tax year (§1.469-2(f)(6)).

REAL ESTATE: DEALER VS. INVESTOR

Who Is a Dealer?

Excluded from the definition of a capital asset is "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business" (§1221(a)(1)).

Nine standards are used to determine if a taxpayer is a dealer or investor in real estate. Those that hold property primarily for sale to customers in the ordinary course of business are dealers. This analysis is purely factual, and to make the determination, courts must look to the taxpayer's intent at the time of the disposition of the property. The dealer-versus-investor issue must be decided on a property-by-property basis and not an individual-by-individual basis. The 6th Circuit Court of Appeals stated: "It is true * * * that a taxpayer may hold lands primarily for sale to customers in the ordinary course of his trade or business and, at the same time, hold other lands for investment" (*Stewart Mathews v. Comm.*, (63-1 USTC ¶9360) 315 F.2d 1963, aff'd, TCM 1961-213). There are no specific factors, or even a combination of factors, in the Code that are controlling for deciding the dealer-versus-investor issue. The courts have traditionally used the following factors (*Winthrop, Ada Belle v. Tomlinson,* (CA-5) 69-2 USTC ¶9686, 417 F2d 905):

1. The reason and purpose the property was acquired and/or disposed;
2. The length of time the property was held;
3. The number and frequency of sales, usually annually;
4. The continuity of sales or sales-related activity over a period of time;

5. Overall reluctance to sell the property;
6. The substantiality of the gain obtained on the sale;
7. The extent to which the taxpayer or his or her agents engaged in sales activities by developing or improving the property, soliciting customers, or advertising;
8. The substantiality of sales when compared with other sources of the taxpayer's income; and
9. The desire to liquidate unexpectedly obtained land holdings (such as by inheritance).

May a real estate broker or agent also be an investor? Sure. It is possible for the same person to simultaneously be a dealer and an investor in real estate. A dealer in real estate must be distinguished from a real estate broker or a real estate agent. A dealer has ownership interest in property, whereas a real estate broker or agent brings together a buyer and a seller of property for a fee or commission (*Williford v. Comm.,* TCM 1992-430).

Dealer vs. investor - Why do we care? There are several provisions in the Code that provide tax advantages to real estate investors. Most of these tax advantages are not available to real estate dealers. Real estate dealers:

- May not use the like-kind exchange provisions regarding nonrecognition of gain or loss on exchange of real property because they hold real property as stock-in-trade (inventory) and not for productive use in business or for investment (§1031(a)(2)).
- May not use the installment sales method of accounting for gains and losses on real estate sales.
- May not use the reduced capital gain tax rates applicable for sales of real estate by investors.

Self-employment tax. Real estate sales by dealers are considered sales of inventory and are taxed at ordinary income tax rates. Such sales are also subject to self-employment tax.

> **Tax practitioner planning.** Generally, recently subdivided real estate may not be traded tax-free for other real estate, subdivided or otherwise, as the property being traded is property held primarily for sale and, therefore, is nonqualifying property. Special rules allow the investor to subdivide property and be exempt from dealer status (§1237).

When Property Is, and Is Not, Treated as a Capital Asset

A capital asset is defined as "property held by the taxpayer * * * but does not include * * * property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business." To determine whether a real estate asset is a capital asset, the court analyzes the facts and circumstances, including factors such as the "number, extent, continuity and substantiality of the sales * * * [and] the extent of subdividing, developing, and advertising." No specific factor or combination of factors is controlling (§1221(a)(1); *US v. Winthrop*, 417 F.2d 905 (5th Cir. 1969); *Biedenharn Realty Co. v. US*, 526 F.2d 409 (5th Cir. 1976)).

Developer Is an Investor, Not a Dealer (*Barry G. and Bridget H. Conner v. Comm.*, TCM 2018-6, (Jan. 23, 2018))

One of Barry Conner's wholly-owned LLCs sold all of its land in a single sale at a loss. Barry contended that the character of the loss was ordinary because the LLC held the property in the ordinary course of business. The IRS argued that the character of the loss was capital because the land was held for investment. The problem was Barry made no effort to sell the property during the tax years at issue nor during any of the preceding years. He never advertised the property, listed the property with brokers, maintained a sales office, or employed a sales force. The sale only occurred after a third party made an unsolicited offer to Barry. The property was held for multiple years without engaging in development-related activities. Even though Barry secured permits and prepared design plans, he did nothing to further the development of the property. The length of time that the property sat idle supported capital loss treatment. The court determined that all the evidence supported the isolated nature of the transaction rather than an ongoing real estate business. For example, the expenses consisted of holding costs, such as mortgage interest and property taxes. To make matters worse, Barry placed the land in a conservation program, which prohibited development of the property. The court concluded that Barry incurred a capital loss from the transaction.

Also See.

- *Jeffrey Evans v. Comm.*, TCM 2016-7, where intent to develop property without a history of regular development business was not enough for the taxpayer to claim loss on foreclosure as ordinary.
- *Victor Fargo and Virginia King v. Comm.*, TCM 2015-96, where dormant development coupled with a long-term holding period did not change the nature or character of intent in determining "dealer" property. The taxpayer undertook substantial efforts and costs to preserve and enhance the development plans in place as well as spending energies in an attempt to obtain financing for the exclusive purpose of development.
- *Fredric Allen et al. v. US*, USDC N.D. Calif., No. 13-cv-02501-WHO, May 28, 2014, where 2.63 acres of undeveloped real estate in East Palo Alto, California, bought in 1987 to develop for sale was never developed and finally sold in 1999 to a property developer, on an installment contract, considered to be a dealer.

Sale of Property Not §1231 Gain - Not Capital Gain (*Hisham Ashkouri and Ann Draper v. Comm*, TCM 2019-95, July 30, 2019)

Hisham Ashkouri is an architect and the sole member of Cold Spring Green, LLC, which developed a condominium project on Beacon Street in Newton, Massachusetts, consisting of two units. The LLC's sole purpose and function was to acquire, hold, develop, operate, and sell the condominium complex. The LLC sold one of the units in 2011 for $1,250,622. Hisham reported a gain on sale of $15,945 as a §1231 gain from sale of assets used in a trade or business, and thus, a long-term capital gain. The IRS argued, and the Tax Court agreed, that the property was held "for sale to customers in the ordinary course of its trade or business." As a result, the gain was ordinary income.

CANCELLATION OF DEBT

Exclusion From Income (§108(a))

Cancellation of Debt (COD) is excludable from income if it occurs:

1. In bankruptcy (§108(a)(1)(A)),
2. To an insolvent borrower (§108(a)(1)(B)), but only to the extent of insolvency (§108(a)(3)),
3. With qualified farm debt (§108(a)(1)(c),
4. With qualified real property business debt (for taxpayers other than C corporations (§108(a)(1)(D); Rev. Rul. 2016-15),
5. In discharge of qualified principal residence indebtedness between Jan. 1, 2007, and Dec. 31, 2016 (§108(a)(1)(E)),
6. With seller financing (§108(e)(5)),
7. When payment of the debt would result in a tax deduction to the borrower (§108(e)(2)),

8. With certain student loans (§108(f); Rev. Rul. 2008-34), or
9. As part of a bona fide dispute.

Reduction of Certain Future Tax Benefits (Tax Attributes) [§108(b)(1)].

The exclusion of COD as a result of bankruptcy or insolvency requires a corresponding reduction of future tax benefits (§108(b)). The price (or curse) for excluding COD from current gross taxable income under any of the above three exclusions is that the borrower loses certain future tax benefits, such as net operating loss carryover and future depreciation deductions (§108(b)). However, prior to decreasing these future tax benefits, the borrower *may* elect to reduce the basis of his or her *depreciable* property. This reduction is done at the beginning of the tax year *following* the tax year of the debt discharge.

Order of reduction rule (§108(b)(2)). In the absence of an election to first reduce depreciable basis, future tax benefits (tax attributes) of the borrower shall be reduced to the extent of debt discharge income (or its equivalent) in the following order:

1. *Net operating losses:* Reduce net operating losses (NOLs) dollar for dollar.
2. *General business credit:* Reduce at a 33.3% rate for each $1 of COD excluded.
3. *Alternative minimum tax credits:* Reduce the minimum tax credits as of the beginning of the tax year *immediately after* the tax year of the discharge.
4. *Capital losses:* Reduce dollar for dollar.
5. *Basis reduction:* Reduce, dollar for dollar, the basis of both depreciable and *nondepreciable* property. But this basis cannot be reduced below total liabilities immediately after the discharge (§108(b)(2)(D)).

   Tax practitioner planning. The taxpayer may elect to first reduce depreciated basis, then basis can be reduced below total liabilities all the way to zero (108(b)(5)).

   Tax practitioner planning. The election to first reduce depreciable basis (#5) may cause tax benefits to be pointlessly eliminated when the total liabilities remaining after the COD are high in relationship to the property's basis (LTR 201718023).

6. *Passive activity losses (and credits):* Reduce the passive activity losses and credit carryovers from the tax year of the discharge.
7. *Foreign tax credit carryovers*. Reduce (at a 33.3% rate for each $1 of COD excluded).

Section 108 Exclusion for Cancellation of Acquisition Indebtedness on Principal Residences Expires Dec. 31, 2020 (§108(a)(1)(E))

A taxpayer subject to foreclosure might end up homeless and still face a nasty tax bill from Uncle Sam for cancellation of debt income. To address this frightening tax dilemma, Congress temporarily added a §108 exclusion to cancellation of debt income. Effective for discharges of indebtedness on or after Jan. 1, 2007, and before Jan. 1, 2021, (as extended by Appropriation Act) excludes from a taxpayer's gross income any discharge (in whole or in part) of qualified principal residence indebtedness (§108(a)(1)(E)).

Qualified Principal Residence Indebtedness

Principal residence. For these purposes, the term "principal residence" has the same meaning as under §121. It does not include the taxpayer's vacation home, rental, or investment property.

Qualified principal residence indebtedness means debt which is incurred in the acquisition, construction, or substantial improvement of the principal residence by the individual and is secured by the residence (see §163(h)(3)(B)), except that the dollar limit is $2 million ($1 million in the case of a separate return). Qualified principal residence indebtedness does not include home equity indebtedness.

When a portion of the mortgage is acquisition indebtedness. If, immediately before the discharge, only a portion of a discharged indebtedness is qualified principal residence indebtedness, the exclusion applies only the amount discharged that exceeds the portion of the debt which is not qualified principal residence indebtedness.

Taxpayers Allowed Both Principal Residence Exclusion and Insolvency (*Mary Bui v. Comm.*, TCM 2019-54, May 21, 2019)

As a result of performing a short sale on her primary residence in San Jose, California, in 2011, Mary Bui had cancellation of debt income of $355,488. She excluded all of it as acquisition indebtedness on qualified principal residence. However, she was only able to establish that $12,000 of the forgiven debt was used to buy, build, or improve her residence. Mary claimed that the rest of the cancelled debt was used to improve another home that she converted from a rental to her principal residence after the short sale.

Because Mary could not produce evidence of use of the other loan proceeds for improvements, the court would not allow the exclusion for the rest of the debt. However, Mary was able to show that at the time of the cancellation of debt, she was insolvent by $42,852, and the court allowed her to also exclude that amount.

IRS Website Includes Interactive Calculator for Cancellation of Debt Income on Foreclosure of Home (Do I Have Cancellation of Debt Income on My Personal Residence?)

The IRS website now includes an interactive calculator for determining taxable COD income on the foreclosure, loan modification, or short sale of a personal residence.

Basis Reduction

The basis of the individual's principal residence is reduced by the amount excluded from income, the theory being that his or her reduction will be subsequently reported as additional gain upon a future sale. Essentially this rule converts the potential COD ordinary income back into potential capital gain. This gain, of course, would become taxable only if it exceeded $250,000/$500,000 married filing jointly.

GAIN ON SALE OF RESIDENCE - §121

> Congress considered changes to the §121 gain exclusion. First, they proposed that the taxpayer own and use the home five of the past eight years to take an exclusion. Then they proposed that the exclusion phase out for high-income individuals. Neither change was included in the TCJA.

The $250,000/$500,000 Exclusion Rule

Up to $250,000 of gain ($500,000 for married filing jointly (MFJ)) realized on the sale or exchange of a principal residence on or after May 7, 1997, is not ***taxable*** (not just deferred) if certain prerequisites are satisfied. This permanent exclusion is allowed each time a homeowner meets the eligibility requirements, but generally no more frequently than once every two years (§121). But this provision is denied to disqualified expatriates (§121(e); §877(a)(1)).

Where Is the Principal Residence?

Only one "principal" residence is possible. One taxpayer cannot own two principal residences simultaneously because principal is defined as "the most important" (*McDowell v. Comm.*, 40 TCM 301 (1980)).

Determined by the facts and circumstances. There is no IRS bright-line test to identify the principal residence for sellers who have more than one residence. Whether property is used by the taxpayer as the taxpayer's *residence* and whether the property is used as the taxpayer's *principal* residence is a question of facts and circumstances (§1.121-1(b)(2)).

Normally, this is easy to determine. A taxpayer's principal residence is the land and building where the taxpayer *principally domiciles,* based upon all the facts and circumstances in each case, including the good faith of the taxpayer. It may even be located in a foreign country (Rev. Rul. 54-611, 1954-2 CB 159). As there is no requirement that a principal residence be owned, a motel room or rental apartment may end up being a principal residence (Rev. Rul. 60-189; Rev. Rul. 73-529; *Marvin Ziporyn v. Comm.,* TCM 1997-151).

When multiple homes are owned, the principal residence generally will be where the taxpayer spends the "majority of the time." In the case of a taxpayer using more than one property as a residence, if a taxpayer alternates between two properties, the property that the taxpayer uses a majority of the time during the year will ordinarily, but not necessarily, be considered the taxpayer's principal residence (§1.121-1(b)(2)). In order to meet the two-year use requirement, occupancy (with the exception of short temporary absences) of the residence is required (§1.121-1(c)(2)). In addition to the taxpayer's use of the property, relevant factors in determining a taxpayer's principal residence include but are not limited to the:

1. taxpayer's place of employment;
2. principal place of abode of the taxpayer's family members;
3. address listed on the taxpayer's federal and state tax returns, driver's license, automobile registration, and voter registration card;
4. taxpayer's mailing address for bills and correspondence;
5. location of the taxpayer's banks; and

6. location of religious organizations and recreational clubs with which the taxpayer is affiliated (§1.121-1(b)(2)(I) - (iv); also see Rev. Rul. 71-247).

Also See.

- *Lawrence L. and Mary J. Wickersham v. Comm.*, TCM 2011-178, a tale of two homes — where's the primary residence?

IRS Provides Tips About Income Taxes and Selling a Home (Summertime Tax Tip 2018-83)

The IRS has provided tips for home sellers regarding the taxation of gain on home sales. The fact sheet also includes discussion of cancelled or forgiven mortgage debt, guidelines about determining principal residence, and advice about recapturing the first-time homebuyer credit.

Loss on Sale of Personal Residence Not a Casualty Loss (*Louis S. and Sandra Shuman, pro sese v. Comm.* TC Memo 2018-135)

In 2010, Louis and Sandra Shuman claimed a casualty loss of $400,000 for loss of equity in their home in Potomac, Maryland. The Shumans declared that they were forced to sell the home at a loss in a prior year to pay tax liability from reported stock option transactions for 2005.

The taxpayers may not have owed the tax. The Shumans discovered their tax preparer had incorrectly reported basis in the option transactions, resulting in an extraordinary tax liability for 2005. In order to pay the tax that year, the Shumans sold their home at a substantial loss. Upon learning in 2010 of the error, as well as being informed that any refund claim was closed under the statute, the Shumans took this very unique approach to attempt to recoup their losses.

No loss allowed on sale of personal residence. As the IRS and the Tax Court correctly pointed out, this wasn't a casualty loss at all. Furthermore, no loss may be recognized in the sale of a personal residence.

OTHER REAL ESTATE DEVELOPMENTS

INTEREST

When Deductible Interest Must Be Capitalized (§263A; §1.263A-12)

Certain direct and indirect costs associated with producing property, including property held for investment, must be capitalized into the basis of that property. Interest expenses are capitalized to the extent that they are paid or incurred during the period in which the property is being constructed or produced, and are allocable to real property. Improvements to property, including the rehabilitation or preservation of a standing building, constitute the production of property. The production period begins on the date on which the physical production activity is first performed and ordinarily ends on the date that the property is ready to be placed in service or held for sale. The production period, however, does not end for a unit of property before the completion of physical production activities by the taxpayer even though the property is held for sale or lease.

When Interest on Real Estate Loans Must Be Capitalized (*Dr. David and Candy Keefe*, TCM 2018-28)

On Jan 21, 2000, Dr. David Keefe and his wife, Candace, purchased a historic waterfront mansion and grounds in Newport, Rhode Island, for $1.35 million, intending to restore it into two condominiums, Unit 1 (Wrentham House Mansion) and Unit 2 (Carriage House). They financed the restoration of Wrentham House Mansion through a series of loans. As restoration costs increased, the Keefes were forced to secure additional loans to continue the renovations, borrowing over $9 million at interest rates varying from 3.5% to 25%. The restoration of Wrentham House Mansion was completed at the end of May 2008, and on July 31, 2009, it was sold in a short sale for $6.51 million.

The IRS and the Keefes disagree on whether the interest paid on the loans must be capitalized. In addition, they failed to pay their federal income tax liabilities for tax years 2004, 2005, 2006, and 2007. The court concluded that Wrentham House Mansion was a capital asset and, therefore, subject to the §263A uniform capitalization rules. Their extensive restoration work was the type of improvement for which interest must be capitalized. The production period began on the date the physical restoration work began and ended on the date when it was completely finished. The date of completion of the physical construction work was the date when the renovation of Wrentham House Mansion was completed and the property was ready to be placed in service or held for sale.

CASH REAL ESTATE TRANSACTIONS

FinCen Focuses on Certain Real Estate Purchases (Geo Targeting Order)

In May 2019, the Treasury Department's Financial Crimes Enforcement Network (FinCen) expanded previous Geographic Targeting Orders (GTOs) that require US title insurance companies to identify the natural persons behind shell companies used to pay "all cash" for high-end residential real estate in six major metropolitan areas. FinCEN has found that about 30% of the transactions covered by the GTOs involve a beneficial owner or purchaser representative that is also the subject of a previous suspicious activity report.

The GTO requires title companies to report any transaction that involves each of the following elements:

1. The buyer must be a Legal Entity, defined under the GTO as a corporation, limited liability company, partnership, or other similar business entity, whether formed under the laws of a state or of the United States or a foreign jurisdiction;
2. Residential real property located in the subject counties;
3. For a purchase price of above a specific threshold in each county;
4. Without a loan or similar form of external financing from a financial institution; and
5. Any portion of the purchase price is paid using currency, cashier's check, certified check, traveler's check, money order, personal check, and bank check.

The GTOs include the following major US geographic areas: (1) all boroughs of New York City; (2) Miami-Dade County and the two counties immediately north (Broward and Palm Beach); (3) Los Angeles County; (4) three counties comprising part of the San Francisco area (San Francisco, San Mateo, and Santa Clara counties); (5) San Diego County; (6) the county that includes San Antonio, Texas (Bexar County); and (7) Honolulu. The monetary thresholds for each geographic area can be found in this table:

Tax practitioner planning. If you or a client need more information, FinCen has posted FAQs here.

Jurisdiction	Price Threshold
New York	
Borough of Manhattan	$3,000,000
Borough of Brooklyn	$1,500,000
Borough of Queens	$1,500,000
Borough of the Bronx	$1,500,000
Borough of Staten Island	$1,500,000
Florida	
Miani-Dade County	$1,000,000
Broward County	$1,000,000
Palm Beach County	$1,000,000
California	
San Diego County	$2,000,000
Los Angeles County	$2,000,000
San Francisco County	$2,000,000
San Mateo County	$2,000,000
Santa Clara County	$2,000,000
Texas	
Bexar County	$500,000
Hawaii	
Honolulu	$3,000,000

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CARES ACT

The Coronavirus Aid, Relief, and Economic Security (CARES) Act, with a $2.2 trillion price tag, was signed into law on Mar. 27, 2020, by President Trump. An "Increased CARES Act" was signed by the President on Apr. 24, 2020, to add funding to the original legislation.

CARES tax provisions are throughout the manual. Four changes are of particular interest to our business clients and, thus, are included in this chapter.

- **SBA Loans and Grants**. A stimulus provision in the CARES Act made available SBA loans for cash-strapped businesses suffering from the nationwide economic impact of COVID-19. The Paycheck Protection Program (PPP) loan is to help businesses continue paying their employees for eight weeks. Emergency Injury Disaster Loans (EIDLs) are available from SBA for operating expenses that the PPP loans don't cover. Neither loan had adequate funding in the CARES Act, but $310 billion of funding was added to the PPP loans in legislation enacted Apr. 24, 2020. Additional monies were available beginning Apr. 27, 2020. Read more about these loans at a special SBA website page and at the SBA Final Interim Rule.

  The timing and use of loan proceeds is critical to determine how much of the loan can be forgiven. The details of the PPP loan forgiveness are covered later in the chapter.

- **Interest Deductions**. For businesses with gross receipts in excess of $26 million, CARES caps the deduction for net business interest expenses at 50% of adjusted taxable income (was 30%). This is a retroactive change from prior law and may require an amended return. This provision is covered later in the chapter.

- **Net Operating losses**. Get tax refunds now. CARES provides that net operating losses (NOLs) arising in a tax year beginning after Dec. 31, 2017, and before Jan. 1, 2021, can be carried back to the five tax years preceding the tax year of such loss. In short, NOLs arising in 2018, 2019, and 2020 can be carried back to the five preceding years and can fully offset taxable income. This is a retroactive change from prior law and may require an amended return. This provision is covered later in the chapter.

- **Qualified Improvement Property**. For property placed in service in 2018 and later, CARES specifically designates qualified improvement property as 15-year cost recovery property (was 39-year) for depreciation purposes, making it eligible for bonus depreciation. This provision is covered later in the chapter.

PAYCHECK PROTECTION PROGRAM LOAN FORGIVENESS

PPP Loan Forgiveness

Section 1106 of CARES provides for forgiveness of up to the full principal amount of qualifying loans guaranteed under the Paycheck Protection Program.

The amount of loan forgiveness can be up to the full principal amount of the loan and any accrued interest. That is, the borrower will not be responsible for repayment if all of the loan proceeds are used for specified costs and payments described below and employee and compensation levels are maintained.

The actual amount of loan forgiveness will depend, in part, on the total amount of payroll costs, payments of interest (but not prepaid interest or principle) on mortgage obligations incurred before Feb. 15, 2020, rent payments on leases dated before Feb. 15, 2020, and utility payments under service agreements dated before Feb. 15, 2020, over the eight-week period following the date the lender makes the first disbursement of the loan (SBA-2020-0015; III).

75% Used for Payroll Costs

Not more than 25% of the loan forgiveness amount may be attributable to non-payroll costs. Limiting non-payroll costs to 25% of the forgiveness amount will align these elements of the program and will also help to ensure that the appropriations available for PPP loan forgiveness are directed toward payroll protection (SBA-2020-0015; III, 2.r).

What Are Payroll Costs?

Included. The definition of payroll costs is the same as it was for the computation of the maximum loan amount. Payroll costs include gross wages; cash tips; vacation; parental, family, medical or sick leave; allowance for separation or dismissal; group health insurance; retirement; and state and local taxes assessed on wages. Payroll costs do not include workers' compensation insurance or the employer's share of federal payroll tax. Payroll costs also include "the sum of payments of any compensation to or income of a sole proprietor or independent contractor that is a wage, commission, income, net earnings from self-employment, or similar compensation and that is in an amount that is not more than $100,000 in one year, as prorated for the covered period." See 15 USC 636(a)(36)(A)(viii)(I)(aa) and (bb); SBA-2020-0015; III, 2.f).

Not included. Workers compensation insurance premiums, the employer's share of federal payroll taxes, and payments to independent contractors are not included in "payroll costs" for purposes of the loan forgiveness.

> **Tax practitioner planning.** Two questions were left unanswered by the SBA and Treasury: (1) Payroll for the eight-week period must be for costs incurred and paid payroll. What does this mean? Cash and accrual or a new OCBOA? (2) What is an FTE? Is it all the hours worked by the business's employees divided by 40 hours a week?

Forgiveness Is Reduced Based on a Reduction in the Number of Employees

The amount forgiven will be reduced proportionally by any reduction in employees retained compared to the prior year and reduced by the reduction in pay of any employee beyond 25% of their prior year compensation.

- The amount of loan forgiveness is reduced, but not increased, by multiplying the expected forgiveness amount by the quotient obtained by dividing—
- (i) the average number of full-time equivalent employees per month employed by the eligible recipient during the covered period; by
- (ii) at the election of the borrower—
    - the average number of full-time equivalent employees per month employed by the eligible recipient during the period beginning on Feb.15, 2019, and ending on June 30, 2019; or
    - the average number of full-time equivalent employees per month employed by the eligible recipient during the period beginning on Jan. 1, 2020, and ending on Feb. 29, 2020; or
    - in the case of an eligible recipient that is seasonal employer, the average number of full-time equivalent employees per month employed by the eligible recipient during the period beginning on Feb. 15, 2019, and ending on June 30, 2019 (CARES Act Sec. 1106(d)(2)(A).

Example. Average FTEs during the eight-week period was 20.
Average FTEs between February 15 and June 30, 2019, was 25
Average FTEs between January 1 and Feb. 29, 2020, was 30.

The business would choose the period between Feb. 15 and June 30, 2019, because the average FTEs is lower. The calculation for loan forgiveness would be 20/25 times the loan amount. If the business borrowed $150,000, the maximum forgiveness would be $120,000.

Reduction Relating to Salary and Wages

The amount of loan forgiveness is reduced by the amount of any reduction in total salary or wages of any employee during the covered period that is in excess of 25% of the total salary or wages of the employee during the most recent full quarter during which the employee was employed before the covered period (CARES Act Sec. 1106(d)(3) & (4)).

> *$100,000 wage limit.* An employee described in this subparagraph is any employee who did not receive, during any single pay period during 2019, wages or salary at an annualized rate of pay in an amount more than $100,000.
> *Tipped workers.* An eligible recipient with tipped employees may receive forgiveness for additional wages paid to those employees.

To make the calculation, the business must look at every employee (who made less than $100,000 in 2019) individually to calculate wage reduction.

> **Example**. John makes $30 per hour per week for 40 hours per week. The business cuts his hourly rate to $20 per hour. The business was allowed to cut John's pay by 25%, or $7.50. John's reduction was $10 per hour. Penalty is calculated ($10 - 7.50 times 40 hours times 8 weeks =) as $800.

Rehired Workers

To encourage employers to rehire any employees who have already been laid off due to the COVID-19 crisis, borrowers that re-hire workers previously laid off will not be penalized for having a reduced payroll at the beginning of the period.

> *Rehired workers*. The amount of loan forgiveness will be determined without regard to a reduction in the number of full-time equivalent employees of an eligible recipient or a reduction in the salary of one or more employees of the eligible recipient, as applicable, during the period beginning on Feb. 15, 2020, and ending Apr. 26, 2020 (30 days after the date of enactment of CARES).

EIDL Advance

Because EIDL advances are forgiven, proceeds from any advance up to $10,000 on the EIDL loan will be deducted from the loan forgiveness amount on the PPP loan (Interim Final Rule, Sec. III, 2, r,vii).

Forgiveness for Self-Employed

Self-employed individuals are eligible for loan forgiveness on eight weeks' worth (8/52) of 2019 net profit, excluding both qualified sick leave and qualified family leave equivalent for which a credit is claimed under FFCRA (Interim Final Rule, Sec. III, 1, f).

Application for Forgiveness to the Lender

A borrower seeking loan forgiveness shall submit to the lender an application which includes: Documentation verifying the number of full-time equivalent employees on payroll, as well as the dollar amounts of payroll costs, covered mortgage interest payments, covered rent payments, and covered utilities for the eight-week period following this loan should be provided to the lender. The documentation should include the same documentation required to apply for loan forgiveness such as payroll tax filings, cancelled checks, and other payment documentation. The lender must issue a decision on the application for forgiveness within 60 days of receipt.

Documentation to the Lender

SBA will allow lenders to rely on certifications of the borrower in order to determine eligibility of the borrower and use of loan proceeds and to rely on specified documents provided by the borrower to determine qualifying loan amount and eligibility for loan forgiveness. Documentation verifying the number of full-time equivalent employees on payroll, as well as the dollar amounts of payroll costs, covered mortgage interest payments, covered rent payments, and covered utilities for the eight week period following this loan, should be provided to the lender. The documentation should include the same documentation required to apply for loan forgiveness such as payroll tax filings, cancelled checks, and other payment documentation

> **Tax practitioner planning**. No appeal process is provided in the law if the lender denies forgiveness.

Taxability — IRS Says PPP Loan Forgiveness Makes Expenses Not Deductible

In Notice 2020-32, the IRS says that no deduction is allowed for an expense that is otherwise deductible if the payment of the expense results in forgiveness of a PPP Loan.

A recipient of a PPP loan can receive forgiveness of indebtedness on the loan in an amount equal to the sum of payments made for the following expenses during the eight-week period beginning on the loan's origination date: (1) payroll costs, (2) any payment of interest on a covered mortgage obligation, (3) any payment on a covered rent obligation, and (4) any covered utility payment (CARES §1106(b)).

CARES specifically states that the forgiveness of the PPP loan is not includible as COD income or otherwise includible under §61. But, the IRS points out in its notice that CARES did not address whether deductions for payments of eligible expenses by a recipient of a PPP loan are allowed if the PPP loan is subsequently forgiven as a result of the payment of those expenses. Citing §265(a)(1) and §1.265-1, the IRS states in Notice 2020-32 that *"no deduction is allowed to a taxpayer for any amount otherwise allowable as a deduction to such taxpayer that is allocable to one or more classes of income other than interest wholly exempt from the taxes imposed by subtitle A of the Code."*

Does this make sense? If Congress meant the forgiveness to be tax-free (not includible in income), doesn't it appear that expenses paid with forgiven money should remain deductible? It's debits and credits — credit income or credit expenses. Isn't that the same net?

	Forgiveness taxable	Expenses not deductible
Forgiveness taxable	$100,000	-0-
Covered payroll, rent, utilities	($100,000)	$100,000
Less forgiveness not taxed	-0-	($100,000)
Net taxable	-0-	-0-

Questions? What about QBI? Do the wages reimbursed by the PPP loan still count toward the W-2 limitations in QBI? Does the Schedule C or Schedule F taxpayer have to reduce "something" by the forgiven amount related to his or her SE income? More to come . . . as complaints are relayed to Congress.

Recommendation. Recommend to your clients that the loan proceeds be deposited into a separate bank account for use only for paying payroll costs (limited to $100,000 for each employee), rent, mortgage interest, and utilities. A separate bank account will make the documentation easier for the small business client with limited accounting experience.

Tax practitioner planning. A chart comparing the PPP loan and the EIDL is at the end of the chapter, along with a business client letter for your use describing general business tax changes for 2020.

EXCESS BUSINESS LOSSES (§461)

CARES Retroactively Reinstates Excess Business Losses

For tax years 2018 through 2025, the TCJA enacted new §461(l)(1), which disallows the deduction of excess business losses by noncorporate taxpayers. An "excess business loss" is the excess of:

1. taxpayer's aggregate business deductions for the tax year, over
2. the sum of the taxpayer's aggregate business gross income or gain plus $250,000 ($500,000 for MFJ) (§461(l)(3)(A)).

2018, 2019, and 2020. CARES temporarily modifies the loss limitation for noncorporate taxpayers so they can deduct excess business losses arising in 2018, 2019, and 2020 (§461(l)(1)). Thus, CARES removes the excess business loss limitation for 2018 through 2020. As a result, taxpayers are able to use their business losses to fully offset their capital gains or non-business income.

Tax practitioner planning. The threshold amount for the 2018 taxable year was $250,000 ($500,000 MFJ). The 2019 taxable year was $255,000 ($510,000 MFJ). Individuals who were limited by this provision should amend their returns. Hooray!

Example. Larry, a single individual, owns and operates a restaurant. The 2020 gross receipts are $500,000 and the expenses are $900,000, resulting in a $400,000 loss. Larry is not limited by §461(l) on his 2020 tax return. If Larry has a similar loss in 2021, his losses will be limited. The excess losses in 2021 are carried over to 2022 and added to any other NOL that Larry has for that year. Because of the TCJA, any NOL carryover, including the excess loss from 2021, is limited to 80% of his 2022 taxable income.

NET OPERATING LOSS - §172

CARES Eases TCJA Changes to NOLs

The TCJA made drastic changes to net operating losses (NOLs) by eliminating carrybacks, allowing only carryforwards, and limiting carryforwards to 80% of taxable income in the carryforward year. Then along came the Coronavirus, and Congress changed its mind in order to provide cash to virus-strapped businesses.

The CARES Act amended §172(b)(1) to provide for a carryback of any net operating loss (NOL) arising in a taxable year beginning after Dec. 31, 2017, and before Jan. 1, 2021, to each of the five taxable years preceding the taxable year in which the loss arises. In other words, NOL carryback rules for tax years 2018, 2019, and 2020 are eased.

COVID Relief for Taxpayers Claiming NOLs

Revenue Procedure 2020-24 provides guidance to taxpayers with net operating losses that are carried back under the CARES Act by providing procedures for:

Electing to waive the carryback period. A taxpayer may elect under §172(b)(3) to waive the carryback period for an NOL arising in a taxable year beginning in 2018 or 2019. The election must be made no later than the due date, including extensions, for filing the taxpayer's federal income tax return for the first taxable year ending after Mar. 27, 2020. The election is made by attaching to the income tax return a separate statement for each of taxable years 2018 or 2019 for which the taxpayer intends to make the election. The election statement must state that the taxpayer is electing to apply §172(b)(3) under Rev. Proc. 2020-24 and the taxable year for which the statement applies.

> **Tax practitioner note.** For a calendar year individual, the election must be made by Apr. 15, 2021, plus extensions.
>
> **Tax practitioner planning.** The Rev. Proc. provides procedures for waiving a carryback period, reducing a carryback period, or revoking an election to waive a carryback period for a fiscal year taxpayer whose taxable year began before Jan. 1, 2018, and ended after Dec. 31, 2017.

Notice 2020-26 Grants an Extension of Time to File Application for Tentative Carryback Adjustment

The CARES Act did not provide additional time to file tentative carryback adjustment applications with respect to NOLs arising in a taxable year beginning on or after Jan. 1, 2018, and ending before Mar. 27, 2019, even though the time to file those applications had expired as of the date of enactment. Taxpayers whose losses in these taxable years may now be carried back to an earlier taxable year would generally be able to file amended returns to claim refunds or credits resulting from the change in the law. These taxpayers, however, would not be able to take advantage of the expedited tentative carryback adjustment procedure without an extension of time to file Form 1139 or Form 1045.

To address this problem, the IRS has granted a six-month extension of time to file Form 1045 or Form 1139, as applicable, to taxpayers that have an NOL that arose in a taxable year that began during calendar year 2018 and that ended on or before June 30, 2019.

To take advantage of the extension of time for requesting a tentative refund based on an NOL carryback, the taxpayer must perform the following actions:

- File the applicable form no later than 18 months after the close of the taxable year in which the NOL arose (that is, no later than June 30, 2020, for a taxable year ending Dec. 31, 2018); and
- Include on the top of the applicable form "Notice 2020-26, Extension of Time to File Application for Tentative Carryback Adjustment."

NOLs and the Statute of Limitations

CARES allows a five-year carryback of NOLs created in 2018, 2019, and 2020. That means an NOL from 2018 is carried back to 2013. *"But, wait. The 2013 tax year is closed by the statute of limitations, isn't it?"* NO, as long as the loss year is open, the carryback is allowed (§6501(h)).

Statute Closes Three Years After NOL Is Used, Not Three Years After NOL Is Generated

A taxpayer claiming an NOL deduction for a taxable year must file with the tax return for that year a concise statement setting forth the amount of the NOL deduction claimed and all material and pertinent facts, including a detailed schedule showing the computation of the NOL deduction (§1.172-1(c). Taxpayers bear the burden of establishing both the actual existence of an NOL and the amount of such NOL that may be carried to the year(s) at issue and are required to keep such permanent records as are sufficient to substantiate the amount and the purpose of any deductions (§6001; *Higbee v. Comm*., 116 TC 438; *Hradesky v. Comm*., 540 F.2d 821 (5th Cir. 1976); §1.6001-1(a)). The courts have applied this rule to NOL carryforwards (*Philip Lehman and Sara Merrick v. Comm*., TCM 2010-74; *Allan and Judy N. Green v. Comm*., TCM 2003-244).

> Planning. Keep as much back-up as possible in the client's tax file if there is a large NOL. Warn the client of the record retention requirements with an NOL carryback or NOL carryover. The following listed cases are evidence that the IRS is examining all NOL carrybacks and carryforwards!

Loss Year Tax Returns Not Enough to Verify NOL Carryforward (*Robert De Sylva v. Comm.*, TCM 2018-65)

The only evidence offered by Robert De Sylva to substantiate a $50,000 NOL carryforward loss claimed on his 2012 tax return consisted of unfiled federal income tax returns for 2009-2011 that De Sylva prepared. The mere introduction into evidence of these returns, even if they had been filed, is inadequate to sustain De Sylva's burden of proof with respect to the claimed NOL deduction. See *Moore v. Comm*., 8 BTA 749, 754 (1927); see also *Lawinger v. Comm*., 103 T.C. 428, 438 (1994). ("Tax returns do not establish the truth of the facts stated therein."). Accordingly, De Sylva was not entitled to an NOL carryover in any amount for 2012.

Return Didn't Include "Concise Statement" Setting Forth NOL (*Martha Smith and George Lakner, et al. v. Comm.*, TCM 2018-127)

On line 21 of their 2007-2011 returns, captioned "Other Income," Martha Smith and George Lakner claimed "net operating loss carryovers" in the following amounts: 2007 — $85,258; 2008 — $99,383; 2009 — $162,030; 2010 — $219,855; 2011 — $250,773.

Statement required. A taxpayer may generally deduct, as an NOL for a taxable year, an amount equal to the sum of the NOL carryovers and carrybacks to that year §172(a). A taxpayer claiming an NOL deduction must file with his return "a concise statement setting forth the amount of the * * * [NOL] deduction claimed and all material and pertinent facts relative thereto, including a detailed schedule showing the computation of the * * * [NOL] deduction" (§1.172-1(c). Smith and Lakner bear the burden of establishing both the existence of NOLs for prior years and the NOL amounts that may properly be carried forward to the years at issue. See Rule 142(a); *Keith v. Comm.*, [Dec. 54,169], 115 T.C. 605, 621 (2000).

No statement attached. The $85,258 NOL deduction Smith and Lakner claimed for 2007 allegedly represented the carryforward of losses Smith and Lakner had incurred in 2004-2006. Smith and Lakner did not attach to their 2007 return the explanatory statement required by the regulations. They offered no evidence that they had sustained bona fide losses during 2004-2006, apart from submitting copies of the tax returns on which they reported those losses. Merely claiming a loss does not substantiate it. See *Coburn v. Comm*., TCM 2014-113 ("A taxpayer's return is merely a statement of the taxpayer's position and cannot be used to substantiate a deduction."); see also *Gould v. Comm*., [Dec. 59,263], 139 T.C. 418, 447 (2012), aff'd, 552 F. App'x 250 (4th Cir. 2014).

IRS audit wiped out other NOL carryforwards. The NOL carryforward deductions Smith and Lakner claimed for 2008-2011 resulted from the $85,258 NOL carryforward from 2004-2006 (to which they were not entitled) and the negative AGI they reported for 2007-2010 (in the aggregate amount of $623,955). As a result of the adjustments requiring inclusion of unreported income and disallowing Smith and Lakner's claimed Schedule C loss deductions, Smith and Lakner will have substantial positive AGI for each year at issue. Because they have no operating losses to carry forward, the IRS properly disallowed all of their claimed NOL deductions.

Also see.

- *Barry Leonard Bulakites, pro se v. Comm.,* TCM 2017-79, where neither the tax return reporting the original NOL nor the accounting records supporting the original NOL was submitted to the IRS, or the court, by the taxpayer.

QUALIFIED IMPROVEMENT PROPERTY

CARES Retroactively Fixes Qualified Improvement Property "Glitch"

The TCJA eliminated pre-existing definitions for qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property, replacing those definitions with one single category called qualified improvement property. In addition, it was intended that qualified improvement property be eligible for 15-year cost recovery and first-year bonus depreciation. However, this was not reflected in the statutory text of the TCJA. As a result, qualified improvement property fell into 39-year cost recovery and became ineligible for bonus depreciation.

2018 and later. Effective for property placed in service in 2018 and later, CARES corrects this error by specifically designating qualified improvement property as 15-year cost recovery property for depreciation purposes, making it eligible for bonus depreciation (§168(e)(3)(E)(vii)).

Rev. Proc. 2020-25 explains how affected taxpayers can elect to take bonus depreciation on QIP. Affected taxpayers can file an amended return, an AAR (under §6227), or a Form 3115 to change their depreciation method on QIP placed in service after Dec. 31, 2017. The Rev. Proc. also allows the taxpayer to make a late election, or revoke or withdraw an election under §168(g)(7).

Partnerships Can File Amended Return to Get CARES Act Benefits (Rev. Proc. 2020-23). The Bipartisan Budget Act (BBA) prohibits partnerships that are subject to the centralized partnership audit regime from filing amended returns. Rather, BBA partnerships must file for an administrative adjustment request on Form 8082 (§6227). Because the CARES Act is meant to provide immediate relief to taxpayers, Rev. Proc. 2020-23 allows partnerships to file amended returns for tax years beginning in 2018 and 2019. The amended returns **must be filed by Sep. 30, 2020**, with the amended return box checked and "filed pursuant to Rev. Proc. 2020-23" written at the top of the form. If the BBA partnership misses the September 30 deadline, it must file an administrative adjustment request.

> **Tax practitioner planning**. A partnership would likely amend for the CARES provision regarding a change to the recovery period of QIP from 39 years to 15 years — "the restaurant and retail glitch." The 15-year recovery period means that QIP again qualifies for bonus depreciation.

ACCOUNTING METHODS (§446 / §468/ §263A / §280E)

TCJA. Accounting Method Use of Cash Basis Available to More Businesses (§446)

The cash method of accounting may be used by taxpayers, other than tax shelters, that satisfy the gross receipts test, regardless of whether the purchase, production, or sale of merchandise is an income-producing factor. The gross receipts test allows taxpayers with annual average gross receipts that do not exceed $26 million (for 2019 and 2020) for the three prior taxable-year periods (was $5 million pre-TCJA) to use the cash method. Farming C corporations (and farming partnerships with a C corporation partner) that meet the $26 million (2020) gross receipts test may use the cash method of accounting.

Tax practitioner planning. Qualified personal service corporations, partnerships without C corporation partners, S corporations, and other passthrough entities are allowed to use the cash method without regard to whether they meet the $26 million (2020) gross receipts test, so long as the use of the cash method clearly reflects income.

TCJA. Accounting Method — Inventories (§471(a) and new §471(c))

Taxpayers that meet the $26 million (2020) gross receipts test (was $10 million in 2017) may use a method of accounting for inventories that either (1) treats inventories as non-incidental materials and supplies, or (2) conforms to the taxpayer's financial accounting treatment of inventories effective for tax years beginning after Dec. 31, 2017. In general, for federal income tax purposes, taxpayers must account for inventories if the production, purchase, or sale of merchandise is an income-producing factor to the taxpayer (§471).

Tax practitioner planning. A deduction is generally permitted for the cost of nonincidental materials and supplies in the taxable year in which they are first used or are consumed in the taxpayer's operations (§1.162-3(a)(1)).

Example. Retail, Inc. has gross receipts in its prior three years of $4,000,000 and therefore is not required to use the accrual method of accounting, even though the sale of merchandise is an income-producing factor. Retail, Inc. buys $100,000 of merchandise at its calendar year-end. It may not include the purchase in its cost of goods sold but rather must include the purchase as incidental materials and supplies on its balance sheet. The $100,000 is deductible when the merchandise is sold.

TCJA. Accounting Method — UNICAP (New §263A(i))

The exception for small taxpayers from the uniform capitalization rules has been expanded to include any producer or reseller that meets the $26 million (2020) gross receipts test (was $10 million) effective for tax years beginning after Dec. 31, 2017. The provision retains the exemptions from the uniform capitalization rules that are not based on a taxpayer's gross receipts.

TCJA. Change of Accounting Method (§481)

Taxpayers eligible to use the cash method, certain taxpayers exempt from the requirement to keep inventories, and the exception from the uniform capitalization rules has been expanded for purposes of §481 effective for tax years beginning after Dec. 31, 2017. Application of the exception for small construction contracts from the requirement to use the percentage-of-completion method is applied on a cutoff basis for all similarly classified contracts (hence, there is no adjustment under §481(a) for contracts entered into before Jan. 1, 2018).

Tax practitioner planning. A Form 3115 is required to change accounting methods.

Section 481(a) Adjustment

When changing to a method of accounting different from the preceding taxable year, adjustments solely by reason of these changes must be taken into account in order to prevent amounts from being duplicated or omitted. Section 481 provides the mechanics of making a change in accounting method and offers some relief as to when the adjustment to taxable income resulting from the accounting method change should be made.

One-year negative and four-year positive §481(a) adjustment. If the automatic IRS consent is available to the taxpayer, a four-year positive §481(a) adjustment and a one-year negative §481(a) adjustment is allowed. However, if a positive adjustment is less than $50,000, a taxpayer may elect to take a positive adjustment into account in a single tax year. The IRS will not be so generous if they initiate the change.

> **Tax practitioner planning.** Taxpayers should generally use the four-year spread for positive adjustments (for example, increases to taxable income) and the 100% *de minimis* rule for negative adjustments (for example, decreases to taxable income).

If a taxpayer terminates the business, any remaining balance of a §481(a) adjustment must be taken into taxable income in the tax year of the termination, and the four-year spread ceases.

Section 460 — Long-Term Contracts Generally

Long-term contracts generally recognize income and expenses throughout the contract using the percentage of completion method (§460(a)). Generally, taxpayers who receive income from long-term contracts must account for that income using the percentage of completion method, which essentially requires the taxpayer to recognize income and expenses throughout the duration of a contract (§460(a) & (b); *Tutor-Saliba Corp. v. Comm.*, 115 TC 1 (2000)). One exception to this general rule is home construction contracts (§460(e)(1)(A), (6)(A)). There are several acceptable methods of accounting for home construction contracts (and other contracts exempt from the percentage-of-completion method of accounting), one of which is the completed-contract method (CCM) of accounting (§1.460-4(c)(1)).

Long-term contracts defined. A long-term contract is "any contract for the manufacture, building, installation, or construction of property if such contract is not completed within the taxable year in which such contract is entered into" (§460(f)(1)). The statute does not define "completion" for this purpose but does note it will be determined on a contract-by-contract basis (§1.460-1(f)). The regulations clarify that a contract is complete upon the earlier of when one of the two following tests is met: (1) the use and 95% completion test; or (2) the final completion and acceptance test (§1.460-1(c)(3)(i)).

(1) the use and 95% completion test*.* Under the first test, the contract is deemed completed upon the use of the subject matter of the contract by the customer for its intended purpose (other than for testing) ***and*** at least 95% of the total allocable contract costs attributable to the subject matter have been incurred by the taxpayer.

(2) the final completion and acceptance test*.* Under the second test, the contract is completed upon final completion and acceptance of the subject matter of the contract. "Final completion and acceptance" of the subject matter of a contract is a question of fact, and all relevant facts and circumstances are considered.

Secondary items*.* A further wrinkle to determining when a taxpayer completes a contract is the role of secondary items. Taxpayers are to apply the tests to determine when a contract is completed under the completed contract method "without regard to whether one or more secondary items have been used or finally completed and accepted." In applying the 95% completion test, taxpayers "must separate the portion of the gross contract price and the allocable contract costs attributable to the incomplete secondary item(s) from the completed contract" (§1.460-1(c)(3)(ii)).

Also See.

- *Shea Homes, Inc. v. Comm.*, (CA-9); 2016-2 USTC ¶50,391; No. 14-72161; affirming 142 TC No. 3), where the homebuilder was allowed by the court to use the completed contract method based on costs of entire housing development, a planned community.

TCJA. Section 460(e) — Small Construction Contract Exception Expanded

The exception for small construction contracts from the requirement to use the percentage-of-completion method has been expanded. Contracts within this exception are those contracts for the construction or improvement of real property if the contract:

1. is expected (at the time such contract is entered into) to be completed within two years of commencement of the contract, and
2. is performed by a taxpayer that (for the taxable year in which the contract was entered into) meets the $26 million (2020) gross receipts test (was $10 million).

The percentage-of-completion method change applies to contracts entered into after Dec. 31, 2017, in taxable years ending after such date.

A small construction contract. A small construction contract is where 80% of estimated total contract costs are attributable to 1-4 unit dwellings and "directly related to" real property "site" improvements. An exception exists from the requirement to use the percentage completed method of accounting for ***home construction contracts***. Qualified taxpayers may instead account for income from home construction contracts under the completed contract method (§460(e)). A "home construction contract" is any construction contract if 80% of the estimated total contract costs (as of the close of the taxable year in which the contract was entered into) are reasonably expected to be attributable to activities that are "building, construction, reconstruction, or rehabilitation of, or the installation of any integral component to, or improvements of, real property" with respect to: (1) dwelling units contained in buildings containing four or fewer dwelling units, ***and (2) improvements to real property directly related to such dwelling units and located on the site of such dwelling units***" (§460(e)(6)(A)).

IRS Audit Hit List — Land Developers Not Permitted to Use Completed Contract Method (CCM) (LB&I Compliance Issues, Updated Apr. 8, 2020)

The IRS believes that large land developers that construct in residential communities may be improperly using the Completed Contract Method (CCM) of accounting. A developer whose average annual gross receipts exceed $26 million in 2020 (was $10 million prior in 2017) may only use the CCM under a home construction contract. In some cases, developers are improperly deferring all gain until the entire development is completed. LB&I will provide training for revenue agents assigned to work this issue. The treatment stream includes development of a practice unit, issuance of soft letters, and follow-up with issue-based examinations when warranted.

GAINS

TCJA. Certain Self-Created Property Not Qualified for LTCG Treatment (§1221)

Patent, invention, model, or design. A patent, invention, model, or design (whether or not patented), and a secret formula or process which is held either by the taxpayer who created the property or a taxpayer with a substituted or transferred basis from the taxpayer who created the property (or for whom the property was created), is excluded from the definition of a "capital asset" and will not receive long-term capital gain treatment. Effective for dispositions after Dec. 31, 2017.

Musical compositions. An exception applies under prior law and the TCJA for a taxpayer who owns musical compositions or copyrights in musical works that the taxpayer created. The exception also applies to a taxpayer to which the musical compositions or copyrights have been transferred by the works' creator in a substituted basis transaction. If the taxpayer elects, gain from a sale of the compositions or copyrights is treated as capital gain, not ordinary income (§1221(b)(3)).

TCJA. Repeal of Rollover of Publicly Traded Securities Gain Into Specialized Small Business Investment Companies (§1044 Repealed)

The election to roll over tax-free capital gain realized on the sale of publicly traded securities was repealed after Dec. 31, 2017. Under prior law, a corporation or individual could elect to roll over tax-free any capital gain realized on the sale of publicly traded securities to the extent of the taxpayer's cost of purchasing common stock or a partnership interest in a specialized small business investment company within 60 days of the sale. The amount of gain that an individual could elect to roll over for a taxable year was limited to (1) $50,000 or (2) $500,000, reduced by the gain previously excluded. For corporations, these limits were $250,000 and $1 million, respectively.

OPPORTUNITY ZONES

TCJA. Opportunity Zones — Gain Deferral (new §1400Z-1, §1400Z-2)

An Opportunity Zone is an economically distressed community where new investments, under certain conditions, may be eligible for preferential tax treatment.

The temporary deferral of inclusion in gross income is available for net §1231 capital gains reinvested in a qualified opportunity fund and the permanent exclusion of capital gains from the sale or exchange of an investment in a qualified opportunity fund (QOF). The maximum amount of the deferred gain is equal to the amount invested in a QOF by the taxpayer during the 180-day period beginning on the date of sale of the asset to which the deferral pertains. For amounts of the capital gains that exceed the maximum deferral amount, the capital gains must be recognized and included in gross income as under present law.

Qualified opportunity zones. Each population census tract in each US possession that is a low-income community is deemed certified and designated as a qualified opportunity zone effective on Dec. 22, 2017. The designation of a population census tract as a qualified opportunity zone remains in effect for the period beginning on the date of the designation and ending at the close of the tenth calendar year beginning on or after the date of designation. Governors (and the mayor of Washington, D.C.) submitted nominations for a limited number of opportunity zones to the Secretary of the Treasury for certification and designation following the guidelines in Rev. Proc. 2018-16. A list of the approved zones can be found on the US Department of the Treasury's CDFI Fund website at https://www.cdfifund.gov/Pages/Opportunity-Zones.aspx.

> **Tax practitioner planning.** Find a list of available Opportunity Zone Funds compiled by the National Council of State Housing Agencies here.

IRS help on Opportunity Zones. The IRS has posted a list of FAQs that may help a client understand this new provision. For a current list of Opportunity Zones, see Opportunity Zone Resources.

Tax incentives. Two main tax incentives encourage investment in qualified opportunity zones:

> **Incentive #1 — Deferral of gain**. First, it allows for the temporary deferral of inclusion in gross income for capital gains that are reinvested in a qualified opportunity fund. A qualified opportunity fund is an investment vehicle organized as a corporation or a partnership for the purpose of investing in qualified opportunity zone property (qualified opportunity zone stock, qualified opportunity zone partnership interest, and qualified opportunity zone business property) that holds at least 90% of its assets in qualified opportunity zone property.
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> *Basis adjustment*. If the investment in the qualified opportunity zone fund is held by the taxpayer for at least five years, the basis is increased by 10% of the original gain. If the opportunity zone asset or investment is held by the taxpayer for at least seven years, the basis is increased by an additional 5% of the original gain. The deferred gain is recognized on the earlier of the date on which the qualified opportunity zone investment is disposed of or Dec. 31, 2026. Only taxpayers who roll over capital gains of non-zone assets before Dec. 31, 2026, will be able to take advantage of the special treatment of capital gains for non-zone and zone realizations.
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>> **Tax practitioner planning.** Because the deferred gain must be recognized by Dec. 31, 2026, gain invested in an Opportunity Zone after Dec. 31, 2019, will only have a basis adjustment of 10%. 2020 to 2026 is six years. It takes seven years to earn the extra 5% basis adjustment.
>
> *Percent of deferred gain.* The basis of an investment in a qualified opportunity zone fund immediately after its acquisition is zero. If the investment is held by the taxpayer for at least five years, the basis on the investment is increased by 10% of the deferred gain. If the investment is held by the taxpayer for at least seven years, the basis on the investment is increased by an additional 5% of the deferred gain.
>
> **Incentive #2 — Exclusion of gain on Zone investment**. Second, it excludes from gross income the post-acquisition capital gains on investments in opportunity zone funds that are held for at least 10 years. Specifically, in the case of the sale or exchange of an investment in a qualified opportunity zone fund held for more than 10 years, at the election of the taxpayer, the basis of such investment in the hands of the taxpayer is the fair market value of the investment at the date of such sale or exchange. Taxpayers can continue to recognize losses associated with investments in qualified opportunity zone funds as under current law.

Warning. This provision expires before 10 years. Thus, the original gain is deferred until the earlier of the sale of the fund or Dec. 31, 2026. The investor will need cash to pay taxes on the deferred gain — even though the fund may be illiquid when the tax is due. Also, the deferred gain is income in respect of a decedent. If the investor dies, his beneficiaries will need cash to pay tax on the deferred gain and should be notified accordingly.

Tax practitioner planning. There is neither a gain deferral available with respect to any sale or exchange nor an exclusion available for investments in qualified opportunity zones made after Dec. 31, 2026. Also, keep in mind that there are risks involved, namely the poor performance of the QOF itself or that capital gain rates are increased during the deferral period.

Example. In January 2019, Steve sells his Microsoft stock and realizes a $50,000 gain. Within 180 days of year-end, he invests the $50,000 gain in a qualified California Opportunity Zone Fund. On the day he invests, his basis in the fund is zero (because he has invested money on which he has not paid tax). In August 2026, he sells his interest in the fund and receives a check for $100,000. Steve must recognize $42,500 of the gain on the Microsoft stock sale from seven years earlier (since Steve held his investment for more than seven years, his basis is increased by 15% of the $50,000 deferred gain). In addition, Steve must recognize his gain on the sale of the fund of the $50,000, since he didn't hold the fund for 10 years.

If Steve instead sold his stock in 2020, his basis would only be increased by 10% and he would recognize $45,000 of his deferred gain.

Amount of investment — A taxpayer does not have to invest the entire proceeds from the sale that generated the eligible capital gain, only that portion of the gain they want to defer. If more than the eligible gain is invested, there would be two investments, one that gets the tax benefits and one that follows the normal tax rules on capital gain.

Opportunity Zone Final Regulations - Key Timing Changes

Final regulations (T.D. 9889) were released under §1400Z-2, regarding rules for investments in opportunity zones. These regulations finalize the rules in two sets of proposed regulations released in October 2018 and May 2019.

§1231 Gains

- The proposed regulations required taxpayers to start the 180-day window on December 31 each year to determine their net §1231 gains. The final regulations start the 180-day window for contributions to a QOF of §1231 gains as of the date of the transaction generating the gain (§1.1400Z(a)-1(b)(7) and §1.1400Z(a)-1(b)(11)(iii)(B)).
- If §1231 gains are deferred and the taxpayer incurs §1231 losses, the losses will not be netted against the deferred gains. The losses will be used to reduce other income (§1.1400Z(a)-1(b)(11)(i)(A))

Gains From Flow-Through Entities

- Proposed regulations began the 180-day window for partners/S corporation shareholders/trust beneficiaries on the last day of the entity's tax year, or alternatively, on the same date as the entity's transaction that generated the gain. Final regulations added a third option: elect to start the 180-day window on the unextended due date of the entity's tax return (§1.1400Z(a)-1(c)(8) & (9)).

Installment Sales

- The final regulations allow for deferral of gains from installment sales even if the original sale occurred prior to the TCJA. Taxpayers can elect to treat the 180-day window as beginning with the receipt of each installment payment or the last day of the tax year (§1.1400Z(a)-1(b)(11)(viii)).

Becoming a Qualified Opportunity Fund

To set up a QOF, an eligible corporation or partnership self-certifies by filing Form 8996A, Qualified Opportunity Fund, with its federal income tax return. Eligible entities include C corporations, S corporations, partnerships, and LLCs.

A QOF must hold at least 90% of its assets in qualified opportunity zone property (QOZP), which is either:

1. qualified opportunity zone business property (QOZBP), or
2. qualified opportunity zone stock or partnership interest.

The QOZBP must be used in a "trade or business" within the meaning of §162.

> **Warning:** This would seem to preclude triple-net-leases.

QOZBP is property:

- purchased after Dec. 31, 2017, from an unrelated party, and
- the original use of the property in the QOZ begins with the QOF or QOZB, or
- the QOF or QOZB "substantially improves" the property.

Comparing the Opportunity Zone Rules to the §1031 Exchange

	OZ Fund	§1031 Exchange
Qualifying gains	Capital gains from any kind of property can be invested in an opportunity zone fund.	Only real estate gains can be deferred in a §1031 exchange.
Qualifying investment	Pooled funds in tangible property used in a trade or business.	Like-kind real property.
Accomodator	No accomodator required.	Accomodator is required so that taxpayer doesn't have constructive receipt of sales proceeds.
Boot	Can invest any part of gains from sale of capital asset (real estate, stock, bonds).	To defer tax must trade up. Any cash or relief of mortgage is taxed.
Replacement period	180 days from sale of capital asset but if gain is §1231 gain, investment must be made within 180 days from end of year of sale.	180 days from sale of relinquished property.
Deferral period	Capital gains on initial investment are deferred until Dec. 31, 2026. Will need cash to pay tax of invested gain by Apr. 15, 2027, even if Fund illiquid.	Indefinite.
Basis step up	For initial investment, 10% after 5 years and an additional 5% after 7 years. OZ fund gain is tax-free if fund held at least 10 years. NOTE. Only gains invested by Dec. 31, 2019, will meet seven-year holding period. Deferred gain is IRD.	At death.

REPORTING CASH TRANSACTIONS

Cash Payment Reporting Helps Combat Money Laundering (FS-2019-1, IRS Form 8300 Reference Guide)

Federal law requires a person to report cash transactions of more than $10,000 by filing IRS Form 8300, Report of Cash Payments Over $10,000 Received in a Trade or Business. By law, a "person" is an individual, company, corporation, partnership, association, trust, or estate. For example, dealers in jewelry, furniture, boats, aircraft or automobiles; pawnbrokers; attorneys; real estate brokers; and insurance companies and travel agencies are among those who typically need to file Form 8300. A tax-exempt organization doesn't have to file Form 8300 for a charitable cash contribution.

Reporting cash payments. A person must file Form 8300 if he or she receives cash of more than $10,000 from the same payer or agent:

- In one lump sum.
- In two or more related payments within 24 hours.
- As part of a single transaction or two or more related transactions within 12 months.

Examples of reporting situations:

Automobile dealerships. If a husband and wife purchased two cars at one time from the same dealer, and the dealer received a total of $10,200 in cash, the dealer can view the transaction as a single transaction or two related transactions. Either way, it calls for only one Form 8300.

> **Example**. A dealership doesn't file Form 8300 if a customer pays with a $7,000 wire transfer and a $4,000 cashier check. A wire transfer is not cash.
>
> **Example**. A customer purchases a car for $9,000 cash. Within 12 months, the customer pays the dealership cash of $1,500 for accessories for that car. The dealer doesn't need to file Form 8300, unless they knew or had reason to know the transactions were connected.

Taxi company. Weekly lease payments in cash from a taxi driver to a taxi company within 12 months is considered the same transaction. The taxi company needs to file Form 8300 when the total amount exceeds $10,000. Then, if the company receives more than $10,000 cash in additional payments from the driver within 12 months, the company must file another Form 8300.

Landlords. Landlords need to file Form 8300 once they've received more than $10,000 in cash for a lease during the year. But a person not in the trade or business of managing or leasing real property, such as someone who leases their vacation home for part of the year, doesn't need to report a cash receipt of more than $10,000.

Bail-bonding agent. A bail-bonding agent must file Form 8300 when they receive more than $10,000 in cash from a person. This applies to payments from persons who have been arrested or anticipate arrest. The agent needs to file the form even though they haven't provided a service when they received the cash.

Colleges and universities. Colleges and universities must file Form 8300 if they receive more than $10,000 in cash in one or more transactions within 12 months.

Home builders. Home builders and contractors need to file Form 8300 if they receive cash of more than $10,000 for building, renovating, or remodeling.

When to file Form 8300. A business must file Form 8300 within 15 days after the date the business received the cash. If a business receives later payments toward a single transaction or two or more related transactions, the business should file Form 8300 when the total amount paid exceeds $10,000. Each time payments aggregate more than $10,000, the business must file another Form 8300.

How to file. A person can file Form 8300 electronically using the Financial Crimes Enforcement Network's BSA E-Filing System (IR-2019-20). Filers will receive an electronic acknowledgment of each submission. To file Form 8300 electronically, a business must set up an account with the Financial Crimes Enforcement Network's BSA E-Filing System. For more information, interested businesses can call the BSA E-Filing Help Desk at 866-346-9478 or e-mail them at BSAEFilingHelp@fincen.gov.

Those who prefer to mail Form 8300 can send it to IRS, Federal Building, P.O. Box 32621, Detroit, MI 48232. Filers can confirm the IRS received the form by sending it via certified mail with return receipt requested or calling the Detroit Federal Building at 866-270-0733.

Informing customers about Form 8300 filing. The business must give a customer written notice by January 31 of the year following the transaction that it filed Form 8300 to report the customer's cash transaction. A business may voluntarily file Form 8300 to report a suspicious transaction below $10,000. The law prohibits a business from informing a customer that it marked the suspicious transaction box on the form.

Intentional Disregard of Cash Reporting

§6050I(a) requires "[a]ny person … engaged in a trade or business" to file a Form 8300 to report any transaction for which it receives "more than $10,000 in cash in one transaction (or two or more related transactions)." Additionally, the business must also notify the customer who made the payment that it filed a Form 8300 (§6050I(e)). Penalties for failure to comply with these statutory reporting requirements are set forth in §6721 (failure to file the Form 8300 disclosure) and §6722 (failure to send the customer notification statement). The ordinary penalty in both sections is $50 for each failure that occurs, however, "[b]oth §6721 and §6722 provide for greatly enhanced penalties where the failure is due to 'intentional disregard' of the filing or notification requirements." If the failure to file or complete the Form 8300 is due to intentional disregard, the penalty for each failure is the greater of $25,000 or the amount of cash received in the transaction, up to $100,000 (§6721(e)(2)(c).

Intentional disregard. Section 6721 does not define the term "intentional disregard," but IRS regulations provide guidance, stating that "[a] failure is due to intentional disregard if it is a knowing or willful … [f]ailure to file timely, or … [f]ailure to include correct information" (§301.6721-1(f)(2)). "Whether a person knowingly or willfully fails to file timely or fails to include correct information is determined on the basis of all the facts and circumstances in the particular case."

Facts and circumstances. The facts and circumstances that are considered in determining whether a failure is due to intentional disregard include, but are not limited to:

I. Whether the failure to file timely or the failure to include correct information is part of a pattern of conduct by the person who filed the return of repeatedly failing to file timely or repeatedly failing to include correct information;
II. Whether correction was promptly made upon discovery of the failure;
III. Whether the filer corrects a failure to file or a failure to include correct information within 30 days after the date of any written request from the Internal Revenue Service to file or to correct; and
IV. Whether the amount of the information reporting penalties is less than the cost of complying with the requirement to file timely or to include correct information on an information return (§301.6721-1(f)(3) (the "301.6721–1 Factors").

Willfulness. Only when a party acts voluntarily in withholding requested information, rather than accidentally or unconsciously withholding information. The above four considerations are not an exhaustive or conclusive list. "Intentional disregard" is synonymous with "willfulness" (*Lefcourt v. United States* [97-2 ustc ¶50,648], 125 F.3d 79, 83 (2nd Cir. 1997)). Because of the "extreme harshness" of the penalties involved, intentional disregard in this context "is a high standard of culpability, requiring much more than merely negligent or reckless disregard."

After Three Compliance Audits, IRS Still Couldn't Prove San Diego Harley Davidson Owner *Purposely* Sold Motorcycles for Cash *Mycles Cycles, Inc. v. U.S*. Southern District of California, Case No.: 18-CV-314 JLS (AGS)

First violation, no penalty. Mycles Cycles (Mycles) is a family owned Harley Davidson Dealership operating in San Diego, California, and founded by Michael Shelby. Mycles's trouble began in August 2006, when the IRS conducted the first of several compliance audits. The compliance audit was to ensure Mycles fulfilled its §6050I reporting obligations, which requires persons engaged in business to file a Form 8300 disclosure statement any time the business receives more than $10,000 in cash in a single transaction from an individual. Two Forms 8300 were incomplete because they lacked taxpayer identification numbers (TINS). The IRS agent provided instructional materials related to the reporting requirements and assessed no penalties.

Second violation, $600 penalty and beg for forgiveness. Seven months later, the IRS returned, sending a different revenue agent, Elizabeth Arnold, who concluded that Mycles had failed to file one Form 8300; had failed to file timely four Forms 8300; had omitted TINS from three Forms 8300; and had failed to send eight customer information statements. Revenue Agent Arnold conducted an in-person closing conference outlining the compliance issues and assessed a $600 negligence penalty. Following this second visit, Mycles's general manager, Tyler Miller, sent a letter to the IRS that acknowledged there had been "a couple of items" that had been "not in compliance resulting in a penalty." The letter stated that Mycles was "taking immediate measures to become 100% compliant."

Third violation, $225,000 penalty assessed by IRS but not enforced by the court. How could that be? In 2014, the IRS conducted a third audit, and Revenue Agent Brian Kuhns found that Mycles sold 10 motorcycles for cash over $10,000. Mycles filed Forms 8300 for only nine of these transactions, all of which lacked customers' TINS. Based on these findings, in addition to the previous deficiencies found during the 2006 and 2007 visits, *intentional disregard penalties* were levied for filing the nine Forms 8300 without TINS. The IRS assessed penalties of $25,000 for each, totaling $225,000. The IRS denied Mycles administrative appeal, after which it paid one of the $25,000 penalties and requested a refund. After the IRS denied Mycles's request, Mycles filed this lawsuit.

The court concluded that Mycles did not have sufficient knowledge to intentionally disregard its obligation to file and/or complete Forms 8300. The court felt that it could conclude that, based on the prior audits, Mycles knew of its obligations yet continued its pattern of filing incomplete Forms 8300. But, knowledge alone will not lead to an automatic finding of willfulness. Indeed, despite the prior audits, the court felt that Mycles did not have sufficient knowledge to comply with the regulations. The court therefore found this was a dispute of material fact. The court could not resolve this factual dispute on summary judgment. "It is not clear" that Mycles's corrective measures — whatever they were and however effective — "were the result of ***intentional disregard*** of the law." The court concluded that Mycles met its burden to show it did not intentionally disregard its §6050I filing requirements. In sum, Mycles brought forth evidence sufficient to create a genuine dispute of material fact as to whether it intentionally disregarded its filing requirements. Thus, the IRS was not entitled to summary judgment.

> **Tax practitioner planning**. Cash businesses are a particular target of the IRS in its Form 8300 enforcement efforts. As you can guess, the cannabis industry is attracting a lot of attention from the IRS.

TAXING CANNABIS

Reporting of Illegal Income and Expenses

Section 162 ordinary and necessary business expense provisions even apply to illegal trades or businesses. Ordinary and necessary business expenses for the operation of an illegal trade or business are generally deductible, even if the payments of the expense or certain acts by employees of the business are illegal (§162(a)). In *Comm. v. Sullivan* (SCt, 58-1 USTC 9368, 356 US 27), the Supreme Court held that rents and salaries paid by a bookmaker were deductible as ordinary and necessary business expenses.

In rendering its decision in *Sullivan*, the court noted that deductions are a "matter of grace" and Congress can, of course, disallow them as it chooses. At times, the policy to disallow expenses in connection with certain condemned activities is clear. However, in the case of rents and employee wages, the court found if it enforced as federal policy the disallowance of the deductions, it would come close to making this type of business taxable on the basis of its gross receipts, while all other businesses would be taxable on the basis of net income. If that choice is to be made, Congress should do it. And, in fact, Congress has done just that when it comes to certain expenses associated with illegal activities.

Taxing a Cannabis Business — Trafficking in Drugs

Legal sales of cannabis in the US exceeded \$10.9 billion in 2019 and are expected to hit \$80 billion by 2030.

Though a cannabis business is illegal under federal law, it remains obligated to pay federal income tax on its taxable income because §61(a) does not differentiate between income derived from legal sources and income derived from illegal sources. Section 61(a) defines "gross income" broadly using 15 examples of items that are includible in gross income. Consistent with the Sixteenth Amendment, §61(a)(3) provides that gross income includes net gains derived from dealings in property, which includes controlled substances produced or acquired for resale. "Gains derived from dealings in property" means gross receipts less COGS, which is the term given to the adjusted basis of merchandise sold during the taxable year (§1.61-3(a)).

In 1982, Congress enacted §280E. Section 280E reads as follows:

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

When Congress enacted §280E in 1982, the Senate Report stated that the cost of goods sold is not affected by §280E. The COGS is computed under §263A(a) just like for any other producer or retailer. The courts have consistently applied this provision allowing a deduction for cost of goods sold, but disallowing any other expenses (*McHan v. Comm.*, TCM 2006-84; *Peyton v. Comm.*, TCM 2003-146; *Franklin v. Comm.*, TCM 1993-184; *Vasta v. Comm.*, TCM 1989-531).

Despite its legalization in 31 states (and the District of Columbia) for medical use and in nine states (and the District of Columbia) for recreational use, cannabis is still classified as a federal "controlled substance" under schedule I of the CSA. Although still illegal federally, the Justice Department has declined, to date, to enforce §841 when a person or company buys or sells cannabis in accordance with state law. In 2015 and 2016, Congress reinforced this arrangement by defunding the Justice Department's prosecution of the exchange of medical cannabis where it is legal under state law. The Court of Appeals commented: but while "today prosecutors will almost always overlook federal cannabis distribution crimes in Colorado," it does not mean the "tax man" is willing to turn a blind eye. In *The Green Solution Retail, Inc. v. USA*, (CA-10), No. 16-1281, May 2, 2017, the Court of Appeals held that Green Solution was not entitled to enjoin the IRS from obtaining information related to its initial findings that it was dispensing cannabis in violation of the Controlled Substances Act.

How a Taxpayer "Trafficking" in Cannabis Computes COGS (CCA 201504011)

When §280E was enacted in 1982, "inventoriable cost" meant a cost that was capitalized to inventories under §471 (as those regulations existed before the enactment of §263A). The specific regulations are §1.471-3(b) in the case of a reseller of property and §1.471-3(c) and §1.471-11 in the case of a producer of property.

Applying §471 rules to cannabis resellers and producers. A cannabis reseller using an inventory method would have capitalized the invoice price of the cannabis purchased, less trade or other discounts, plus transportation or other necessary charges incurred in acquiring possession of the cannabis. Similarly, a cannabis producer using an inventory method would have capitalized direct material costs (cannabis seeds or plants), direct labor costs (for example, planting; cultivating; harvesting; sorting), Category 1 indirect costs (§1.471-11(c)(2)(i)), and possibly Category 3 indirect costs (§1.471-11(c)(2)(iii)).

Applying §263A rules to cannabis resellers and producers. Section 263A increased the types of costs that are inventoriable compared to the rules under §471, but it did not revolutionize inventory costing. A reseller still is required to treat the acquisition costs of property as inventoriable. Now, a reseller also is required to capitalize purchasing, handling, and storage expenses. In addition, both resellers and producers are required to capitalize a portion of their service costs, such as the costs associated with their payroll, legal, and personnel functions. Thus, under §263A, resellers and producers of property are required to treat some deductions as inventoriable costs.

What about other costs? Nothing in §263A allows a business to capitalize otherwise nondeductible costs into inventory. Thus, for example, a cannabis producer would be permitted to include in its inventory wages, rents, and repair expenses attributable to its production activities, but would not be permitted to include wages, rents, or repair expenses attributable to its general business activities or its marketing activities.

"Pleading the Fifth" to Avoid Self-Incrimination Does Not Avoid §280E Limitations (*Neil and Andrea Feinberg v. Comm*., CA-10, 2019-1 ustc 50,161, Feb. 26, 2019)

Taxpayer operated THC, an LLC licensed by Colorado to operate two medical marijuana dispensaries. During audit, the IRS reclassified expenses THC deducted as Cost of Goods Sold (COGS). Under §280E, a taxpayer can only deduct COGS when engaged in unlawful trafficking of controlled substances. As a result, the IRS adjustment increased the taxpayer's taxable income.

The IRS argued taxpayers did not meet their burden of proof to show the IRS's determination that THC unlawfully trafficked in controlled substances was incorrect. Taxpayer responded that placing the burden on them would violate their Fifth Amendment privilege against self-incrimination.

The court pointed out that in order to meet the burden that §280E does not apply, the taxpayer would be required to introduce evidence to prove THC was not unlawfully trafficking in a controlled substance, which is not incriminating. As a result, §280E precluded the deduction of the taxpayers' business expenses, and the Tax Court properly rejected their challenge to the deficiency.

Even Reasonable Wage Paid to S Corporation Owner-Employee Disallowed for Cannabis Business (*Jesse and Desa Ploughman v. Comm.*, TCM 2018-85)

Palisades, also known as Colorado Alternative Health Care LTD, is an S corporation. Jesse and Desa Ploughman were the sole owners of Palisades and also served as its officers during the years in issue: 2010, 2011, and 2012. Colorado licensed Palisades to grow and sell medical cannabis. During 2010-2012, Palisades paid and deducted wages paid to Mr. Ploughman. The Ploughmans reported the wages on their individual tax returns. Both the IRS and the taxpayers agreed that the wages were not part of cost of goods sold. Thus, the IRS disallowed the wage deduction under §280E.

Wage money doubled-taxed. The Ploughmans argued that the IRS's treatment of Mr. Ploughman's wage income as an expense subject to §280E caused the same income to be taxed twice, once as wages and a second time as S corporation income. They contended that this results in the disallowed officer wages attributable to trafficking being included in Palisades's earnings, which flow through to the taxpayers without any deduction for the wages. The Ploughmans complained that a discriminatory treatment results because an S corporation is required to pay a reasonable wage as a salary to its officers, and other entities are not subject to this reasonable wage requirement.

No help for S corporation owner. Section 1366(a) provides that income, losses, deductions, and credits of an S corporation are passed through pro rata to its shareholders on their individual tax returns. Thus, Palisades's income passes through to the Ploughmans, and they must report it on their individual tax returns. Separately, and in addition to Palisades's passthrough income, the Ploughmans must report the wage compensation they received as officers of Palisades as a part of their gross income on their individual returns (§61(a)). If Palisades had paid wages to a third party, the wages would have been taxable to the recipient whether or not they were deductible by the business.

Is an S corporation the right entity choice? The court commented in its decision that "to the extent that the Ploughmans believe they received disparate tax treatment as a result of organizing their cannabis business as an S corporation, they were free to operate as any business entity and in other trades. The Ploughmans chose to operate Palisades as an S corporation in the cannabis business. They are responsible for the tax consequences of their decision." See *Higgins v.Smith*, 308 U.S. 473, 477 (1940).

Medical Cannabis Dispensary Expenses Not Deductible (*Canna Care, Inc., a CA Not-for-Profit Corp. v. Comm.*, TCM 2016-206, affirmed by CA-9, 16-70265, July 25, 2017)

California and federal law. In 1996, California voters approved the Compassionate Use Act of 1996 (CUA) to ensure that seriously ill Californians had the right to obtain and use cannabis for medical purposes. In 2003, the Medical Cannabis Program Act was approved to promote uniform and consistent application of the CUA, clarify the scope of its application, and enhance patients' and caregivers' access to medical cannabis through collective, cooperative cultivation projects. The federal Controlled Substances Act (CSA), however, *still* classifies cannabis as a schedule I controlled substance, and cannabis is a controlled substance within the meaning of §280E (*CHAMP, Inc. v. Comm.*, 128 TC No. 14 (2007)).

Canna Care facts. Bryan and Lanette Davies are the parents of six children. After much prayer, Bryan was convinced that God wanted him to open a medical cannabis dispensary to solve his family's (including school tuition) financial woes. Canna is a mutual benefit corporation and, pursuant to California law, is prohibited from distributing cannabis for profit. Bryan, Lanette, and an acquaintance, Jeff Cowen, were Canna's officers and directors. The IRS determined deficiencies in Canna's federal income tax of $229,473, $304,090, and $339,604 for 2006, 2007, and 2008, respectively.

Three factors used to disallow operating expenses. The issue was whether the IRS properly disallowed deductions for Canna's operating expenses pursuant to §280E. The application of §280E rests on the presence of three key elements: (1) a controlled substance; (2) trafficking; and (3) trade or business.

Canna found to be a business trafficking in a controlled substance — expenses disallowed by the Tax Court and the 9th Circuit Court of Appeals. Canna's numerous arguments as to why cannabis should no longer be considered a schedule I controlled substance were rejected by the courts. "Cannabis was a schedule I controlled substance during the years at issue." The Court of Appeals for the 9th Circuit stated: "[T]he only question Congress allows us to ask is whether cannabis is a controlled substance prohibited by federal law. If Congress now thinks that the policy embodied in §280E is unwise as applied to medical cannabis sold in conformance with state law, it can change the statute. We may not (*Martin Olive v. Comm.,* 139 TC No. 19 (2012), aff'd by 9th Cir. , 139 TC 19, No. 13-70510 (2015)." Canna then argued that its actions could not be considered "trafficking" for purposes of §280E because its activities were not illegal under California law. The court held that Canna regularly bought and sold cannabis, an activity that constituted trafficking within the meaning of §280E even when permitted by state law (*CHAMP, Inc. v. Comm.*, 128 TC No. 14 at 182 (2007)). Even though California law prohibits the distribution of cannabis for profit, there was no doubt, in the court's opinion, that Bryan incorporated Canna, Inc. "to produce income." (Bryan) admitted "that he entered into the medical cannabis business in order to cure his family's financial difficulties. (Bryan) and the other shareholders received wages well in excess of those paid to (Canna's) other employees, and the payment of such wages would not have been possible if (Canna) had not had income. Whether (Canna) was operated in accordance with California law's restrictions on profiting from the distribution of cannabis is not an issue before (the court), and it does not affect (the court's) finding that (Canna, Inc.) was engaged in the business of distributing cannabis for purposes of §280E. (The courts held) that §280E prohibits (Canna) from deducting *any* amounts paid or incurred during the years at issue in connection with its trade or business that (the IRS) disallowed."

> **Tax practitioner planning.** This is certainly not the last word on the subject, as the IRS, the courts, and to a lesser extent, Congress, struggle with how to deal with this whole industry, which is still "sorta" illegal under federal law but legal under state law. Certainly more cases and developments will be coming as cannabis sales continue to become "legitimized."

EFTPS Deposit Issues

EFTPS deposit issues arise because of unallowed bank accounts (SBSE-04-0615-0045, "Interim Guidance on the Failure to Deposit Penalty under §6656 for Taxpayers Unable to get a Bank Account" (June 9, 2015), and SBSE-20-0615-1045, "FTD Penalty Relief for Unbanked Taxpayers" (June 17, 2015)). Cannabis dealers, in states that allow medical and recreational cannabis use, can have difficulty making electronic deposits because, under federal law, no bank, credit union, or financial-services company may knowingly accept business accounts with those dealers.

Interim guidance. The IRS has issued interim guidance that allows taxpayers who are unable to get a bank account, or make other arrangements for depositing their tax deposit obligations electronically, to obtain an abatement of the failure to deposit penalty if they follow certain procedures. This provision provides relief to taxpayers who legally sell cannabis under state law and are not able to get a bank account because of federal law issues.

The Electronic Federal Tax Payment System (EFTPS) must be used to deposit payroll taxes. Subject to limited exceptions, the following are required to be deposited via electronic funds transfer (EFT) through the EFTPS: FICA and FUTA taxes, withheld income taxes, and corporate income and estimated taxes (§6302(h), §31.6302-1(h)(2)(iii), §31.6302-1(h)(3)). There is a penalty for failure to deposit taxes electronically when required through EFTPS, but it will not be imposed if the taxpayer proves that the failure to deposit electronically was due to reasonable cause and not willful neglect (§6656(a)).

IRS issues interim relief. For taxpayers who are timely in meeting their tax deposit obligations, the IRS will not impose, or abate, the failure to deposit penalty if taxpayers can show they made reasonable efforts but were unable to get a bank account during the period at issue.

Establishing reasonable cause. In order to establish reasonable cause, the taxpayer must include a signed statement that explains the taxpayer's attempts to get a bank account and may include any corroborating documentation (denied account application(s), correspondence from banks, etc.). The signed statement does not have to be in a particular format, but it should clearly identify the taxpayer's name, address, and taxpayer identification number. The taxpayer should include corroborating documentation establishing at least one attempt to obtain a bank account and may use the same documentation for up to 24 months. The taxpayer should make continued efforts to obtain a bank account.

Reasonable cause for failure to deposit by EFT applies for 24 months after the taxpayer establishes reasonable cause by showing inability to obtain banking services. The guidance was effective June 9, 2015.

GROSS INCOME

Gross Income (§61) vs. Gift (§102)

Compensation for services is included in gross income for federal income tax purposes (§61(a)(1)). But, gross income does not include amounts acquired by gift (§102(a)). Whether a payment is a gift under §102(a) or gross income under §61(a) is a factual question. The Supreme Court has held that distinguishing a gift from taxable income "does not lend itself to any more definitive statement that would produce a talisman for the solution of concrete cases." The Supreme Court concluded that the transferor's intent is the most critical consideration and there must be an objective inquiry into the transferor's intent. Generally, the transfer must be made from a "'detached and disinterested generosity' * * * 'out of affection, respect, admiration, charity, or like impulses.'" We must make "an objective inquiry as to whether what is called a gift amounts to it in reality. * * * It scarcely needs adding that the parties' expectations or hopes as to the tax treatment of their conduct in themselves have nothing to do with the matter" (*Comm. v. Duberstein*, 363 US 278 (1960)).

Crowdfunding Campaigns Often Result in Taxable Income

Nearly 57 million workers (36%) earn money from the shared economy.

Are Funds Collected Through a Crowdfunding Site Taxable Income?

Everything is taxable. Section 61(a) provides the general rule that gross income includes all income from whatever source derived. Gross income includes all accessions to wealth, whether realized in the form of cash, property, or other economic benefit. However, some benefits that a taxpayer receives are excluded from income, either because they do not meet the definition of gross income or because a specific exclusion exists.

Unless it is a loan, contributed capital, or a gift. In general, money received without an offsetting liability (such as a repayment obligation), that is neither a capital contribution to an entity in exchange for a capital interest in the entity nor a gift, is includible in income. That means crowdfunding revenues are generally includible in income if they are not (1) loans that must be repaid; (2) capital contributed to an entity in exchange for an equity interest in the entity; or (3) gifts made out of detached generosity and without any "quid pro quo." So . . . what is crowdfunding? A loan? A capital contribution? A gift? Or is it reward-based in that the backer will receive something in exchange for the money contributed?

Project funding. On websites such as kickstarter.com and indiegogo.com, "creators" of a fundraising campaign seek "backers" to finance their projects. Projects include creating films, games, art, design, and a variety of inventions. Since Kickstarter's launch in 2009, more than $2 billion has been pledged by more than 10 million people, funding more than 100,000 projects. Reward-based crowdfunding is likely to be taxable income to the campaign creator.

> **Example**. Vern is the inventor of a new generation charger for iPhones. He creates a Kickstarter campaign to manufacture and market his invention and raises $100,000. Each backer will receive a charger in return for his or her contribution. The $100,000 is taxable income, as it is considered proceeds from the sale of product. As a practical matter, Vern is likely to have business expenses to offset some or all of the crowdfunding income.

Personal funding. Other sites, such as gofundme.com or causes.com, feature fund-raisers for personal or charitable endeavors. Gofundme shows current campaigns running to help fire victims, evicted families, individuals with medical tragedies, and fund-raising for the family of a Baton Rouge police officer killed in a July shooting. Funds received from donation-based crowdfunding are likely to be considered nontaxable gifts.

> **Example**. Stephanie creates a Gofundme campaign to help with medical and living expenses for her critically ill daughter. The campaign raises $22,000. The money raised is not taxable, as it is given in "disinterested generosity" and is considered a gift.

Form 1099-K problems. Reward-based and donation-based crowdfunding use third-party payment processing for collecting money. Both PayPal and Amazon Payments provide these services for crowdfunders, and both companies comply with the US Patriot Act data-collection requirements. A campaigner who collects over $20,000 and has 200 transactions in a year will receive a Form 1099-K, Payment Card and Third Party Network Transactions, reporting unadjusted gross revenues.

> **Tax practitioner planning.** Both Vern and Stephanie will receive Forms 1099-K from the third-party processors. Although the funds that Stephanie received from the crowdfunding effort went entirely to her daughter, Stephanie will receive the Form 1099-K since she is the creator of the campaign. The IRS has not provided guidance for reporting the Form 1099-K when the proceeds reported are gifts and not taxable.

IRS Opens Shared Economy Tax Center on Its Website

In recognition of the boom in the sharing economy, the IRS is beginning to address the tax issues involved. If your client (or client's child) is considering earning a little extra from Uber, Task Rabbit, or Airbnb, refer your client to the IRS website for general tax information or use the information on the site to develop a firm letter on taxing the "gig" economy.

What is the sharing economy? The sharing economy can be described as "collaborative consumption" or a "peer-to-peer market" that links a willing provider to a consumer of goods or services (coordinated through a community-based online service). Typically, there are three parties involved in a sharing economy transaction, often referred to as service providers (the freelancers who provide the goods or services), service recipients (the consumers of such goods or services), and service coordinators (the third-party platforms that facilitate the transactions).

Rentals. If a taxpayer rents out her or his home, apartment, or other dwelling but also lives in it during the year, special rules generally apply. See Publication 527, Residential Rental Property (Including Rental of Vacation Homes). Taxpayers can use the Interactive Tax Assistant Tool Is My Residential Rental Income Taxable and/or Are My Expenses Deductible? to determine if their residential rental income is taxable.

> **Also See**. "Gig economy work can affect a taxpayer's bottom line" from Tax Tip 2020-06 and "Six things that taxpayers should know about the sharing economy" from Tax Tip 2019-46.

ORDINARY & NECESSARY - §162 TRADE OR BUSINESS EXPENSES

TCJA. Repeal of Deduction for Local Lobbying Expenses (§162(e))

The exception for amounts paid or incurred related to lobbying local councils or similar governing bodies, including Indian tribal governments, has been repealed effective Dec. 22, 2017. Thus, the general disallowance rules applicable to lobbying and political expenditures will also apply to costs incurred related to such local legislation. Expenses paid or incurred in connection with lobbying and political activities (such as research for, or preparation, planning, or coordination of, any previously described activity) also are not deductible. Under prior law, an exception to the general rule for a deduction was allowed for ordinary and necessary expenses incurred in connection with any “local legislation” (§162(e)(5)(c)).

A deduction is denied for amounts paid or incurred in connection with (1) influencing legislation, (2) participation in, or intervention in, any political campaign on behalf of (or in opposition to) any candidate for public office, (3) any attempt to influence the general public, or segments thereof, with respect to elections, legislative matters, or referendums, or (4) any direct communication with a covered executive branch official in an attempt to influence the official actions or positions of such official (§162(e)).

TCJA. Denial of Deductions for Fines and Penalties (§162(f) and New §6050X)

Any otherwise deductible amount paid or incurred (whether by suit, agreement, or otherwise) to or at the direction of a government or specified nongovernmental entity in relation to the violation of any law or the investigation or inquiry by such government or entity into the potential violation of any law is denied effective on Dec. 22, 2017 (§162(f)). In addition, the TCJA disallows any deduction for investigation costs.

> **Tax practitioner planning.** The disallowance applies to governmental enforcement actions including securities, employment, environmental, Foreign Corrupt Practices Act, white collar, healthcare, government contracts, gaming, and any other regulatory claims. The law can also apply to a whistleblower action brought by a private party under a state or federal false claims act or private attorney general act.

Except for restitution. An exception applies to payments that the taxpayer establishes are either restitution (including remediation of property) or amounts required to come into compliance with any law that was violated or involved in the investigation or inquiry, that are identified in the court order or settlement agreement as restitution, remediation, or required to come into compliance. In the case of any amount of restitution for failure to pay any tax and assessed as restitution under the Code, such restitution is deductible only to the extent it would have been allowed as a deduction if it had been timely paid. No deduction is allowed unless the identification is made. Restitution or included remediation of property does not include reimbursement of government investigative or litigation costs.

Government must be complainant. This applies only when a government (or other entity treated in a manner similar to a government under the provision) is a complainant or investigator with respect to the violation or potential violation of any law. An exception also applies to any amount paid or incurred as taxes due.

> **Tax practitioner planning**. This change does not apply to payments made by one private party to another in a lawsuit between private parties because a judge, or jury acting in the capacity as a court,

directs the payment to be made. The mere fact that a court enters a judgment or directs a result in a private dispute does not cause the payment to be made "at the direction of a government."

Government agency reporting required. Government agencies (or entities treated as such agencies under the provision) are required to report to the IRS, and to the taxpayer, the amount of each settlement agreement or order entered into where the aggregate amount required to be paid, or incurred to or at the direction of the government, is at least $600. The report must separately identify any amounts that are for restitution or remediation of property, or correction of noncompliance. The report must be made at the time the agreement is entered into, as determined by the Secretary of the Treasury.

TCJA. Denial of Deduction for Settlements Subject to Nondisclosure Agreements Paid in Connection With Sexual Harassment or Sexual Abuse (New §162(q))

No deduction is allowed for any settlement, payout, or attorney fees related to sexual harassment or sexual abuse if such payments are subject to a nondisclosure agreement and made after Dec. 22, 2017. In addition, this new provision disallows a deduction for attorney fees related to the settlement of sexual harassment claims that include a nondisclosure agreement. An amount paid to settle a sexual harassment claim can be subject to this disallowance rule, even if a portion of the settlement amounts are attributable to future wages due to the claimant. Is an NDA worth the loss of the tax deduction?

How Do State Tax Credit Programs Apply to §162(a) Business Deductions?

Under the final regulations issued June 11, 2019, a taxpayer who makes a transfer to a §170(c) charity must reduce his or her contribution deduction by the amount of any state tax credits received (§1.170A-1(h)(3)(i)). In IR-2018-178, the IRS clarified that "business taxpayers who make business-related payments to charities or government entities for which the taxpayers receive state or local tax credits can generally deduct the payments as business expenses." See Rev. Proc. 2019-12.

Ordinary and Necessary Business Expense vs. Personal Expense

To qualify as a deduction allowable under §162, an expenditure must satisfy a five-part test: it must (1) be paid or incurred during the taxable year, (2) be for carrying on a trade or business, (3) be an expense, (4) be necessary, and (5) be ordinary (*Comm. v. Lincoln Savings and Loan Association*, 403 US 345, 352 (1971)). Thus, personal expenditures incurred outside of a taxpayer's trade or business are not deductible under §162. Even though a particular taxpayer may incur an expense, the expense may qualify as ***ordinary and necessary if it is appropriate and helpful*** in carrying on that business, is ***commonly and frequently incurred*** in the type of business conducted by the taxpayer, and is not a capital expenditure.

General Principles Governing Substantiation of *All* Deductions

Deductions are a matter of legislative grace, and a taxpayer is required to maintain records sufficient to substantiate expenses underlying deductions claimed on his or her return (§6001; §1.6001-1(a); *New Colonial Ice Co. v. Helvering,* 292 US 435, 440 (1934)).

The *Cohan* Rule

Approximating a business expense. If the taxpayer is able to establish that she or he paid or incurred a deductible expense but is unable to substantiate the precise amount, the court generally may approximate the deductible amount, but only if the taxpayer presents sufficient evidence to establish a rational basis for making the estimate (*Cohan v. Comm.*, 39 F.2d 540, 543-544 (2d Cir. 1930); *Vanicek v. Comm.*, 85 TC 731, 742-743 (1985)).

Requirements to use the *Cohan* rule. To qualify for the estimation treatment under *Cohan*, the taxpayer must establish that she or he is entitled to some deduction. As *Cohan* puts it: "Absolute certainty in such matters is usually impossible and is not necessary," but a court "should make as close an approximation as it can, bearing heavily if it chooses upon the taxpayer whose inexactitude is of his own making" (*Cohan v. Comm.,* 39 F.2d at 543-544). Otherwise an allowance would amount to unguided largesse (*Williams v. US*, 245 F.2d 559, 5th Cir. (1957)). The *Cohan* rule, however, is superseded — that is, estimates are not permitted — for certain expenses specified in §274, such as travel (including meals and lodging), entertainment, and "listed property" expenses (including passenger automobiles) [§274(d), §280F(d)(4)(A)(i); §1.274-5T(a); *Boyd v. Comm.*, 122 TC 18, at 305 (2004)]. Instead, these types of expenses are subject to the strict §274(d) substantiation rules (§1.274-5T(a); *James A. Venuto v. Comm.*, TCM 2017-123).

No "shoebox" records allowed! If the presentation of the taxpayer's expenses is tantamount to the "shoebox method" of substantiating them, the court will not sort through the voluminous evidence to decide whether the taxpayer substantiated each and every expense he claimed (*Terry Gene Akey, pro se v. Comm.*, TCM 2015-227, *Willie Lewis, pro se v. Comm.*, TCM 2017-117).

Court Allows Some Deduction Using *Cohan* Rule (*Ames Ray v. Comm.*, TCM 2019-36)

Although Ames Ray did not establish the amount of losses related to the legal expenses of her business, the court allowed a portion of Ms. Ray's funds management losses under the *Cohan* rule. *"When the Court applies the* Cohan *rule, the taxpayer must introduce sufficient evidence to permit us to conclude that the taxpayer paid or incurred a deductible expense in at least the amount allowed. In estimating amounts allowable pursuant to the* Cohan *rule, we bear heavily upon the taxpayer who failed to maintain the required records and to substantiate deductions as the Code requires."*

> **Tax practitioner planning.** In other words, work hard on the story of why the client should have these deductions even though the records are scanty.

Cohan Could Not Be Used to "Substantiate" COGS and Expenses (*Reliable Computer Services v. Comm.*, and *Patrick Lind, pro se v. Comm.*, TCS 2020-7)

Patrick Lind is the sole shareholder and an officer of Reliable Computer Services, a C corporation that purchased used computer parts from Fermi National Accelerator Laboratory for 13¢ a pound and sold the parts through PayPal. Since its incorporation, Reliable reported no opening or closing inventories on its tax returns; instead it treated purchases as current expenses each year. The IRS disallowed the entire amount of COGS and the deduction for other expenses reported on the Linds' Schedule C for 2010. In addition, the IRS disallowed portions of the amounts reported as COGS as well as portions of the deductions for trade or business expenses on Reliable's federal corporate income tax returns for fiscal years 2011 and 2012. Lind and Reliable were unable to adequately substantiate the amount of the expense. The court may estimate the amount of the expense, but the court must find *some* basis upon which an estimate may be made. The Linds offered no explanation for COGS or the deduction for other expenses reported on their Schedule C. Accordingly, they were not entitled to COGS or the deduction for other expenses reported on their Schedule C. In addition, the court found Reliable's position unpersuasive and inconsistent with its position that the items remaining at the end of each year had, at the very least, scrap value. Moreover, Reliable has failed to introduce any evidence contradicting the IRS's calculations of inventories, and therefore the court found that Reliable failed to carry its burden of proof.

***Cohan* Not Good Enough to Substantiate Deduction (*Daniel Imperato v. Comm*., TCM 2018-126)**

Daniel Imperato operated a consulting business in which he provided management, scientific, and technical consulting. He deducted a commission expense of $20,000 for 2009. He bears the burden of substantiating the amount and the business purpose of the expense. The court may estimate such an expense where the record provides a basis to make the estimate (*Cohan v. Comm*., 2 ustc ¶489], 39 F.2d 540, 543-544 (2d Cir. 1930)). Imperato did not present any testimony or other evidence to substantiate the amount or business purpose of the commission expense or provide a basis for us to estimate the amount of the expense. Nor did he establish that he incurred the expense. Accordingly, the court ruled that he was not entitled to the deduction.

Also see.

- *Andrew and Sara Berry v. Comm*., TCM 2018-143, where the taxpayers failed to provide a reasonable evidentiary basis for an estimate. Taxpayers provided undated and unsigned invoices, including one that was purportedly signed by the vendor, but after his death. Why didn't the court allow Steve to use the *Cohan* rule? *Because the dummy never brought up the argument in court!*

DISALLOWANCE OF CERTAIN ENTERTAINMENT EXPENSES

Meals and Entertainment Expenses Under §274 - New Proposed Regulations (Reg-100814-19)

Applicability Date

The new REG-100814-19 regulations apply for taxable years beginning on or after Feb. 26, 2020.

TCJA. Deductible vs. Non-deductible Meal and Entertainment Expenses

Entertainment, amusement, or recreation activities and deductions. New proposed regulations address the 50%/100% elimination of the §274 deductions for expenditures related to entertainment, amusement, or recreation activities and provide guidance to determine whether an activity is of a type generally considered to be entertainment. The regulations also address the limitation on the deduction of food and beverage expenses.

§274 Statutory Framework

In general, §274 limits or disallows deductions for certain meal and entertainment expenditures that otherwise would be allowable, primarily under §162(a), which permits a deduction for ordinary and necessary business expenses. The Tax Cuts and Jobs Act (TCJA) revised the rules for deducting expenditures for meals and entertainment, effective for amounts paid or incurred after Dec. 31, 2017.

TCJA Amends the 50% Limitation Rule

Prior to the amendments by the TCJA, taxpayers could deduct 50% of meal expenses and 50% of entertainment expenditures that met the directly related or business discussion exception. Distinguishing between meal expenses and entertainment expenditures was unnecessary for purposes of the 50% limitation. The TCJA repealed the directly related and business discussion exceptions to the general prohibition on deducting entertainment expenditures. Also, the TCJA amended the 50% limitation to remove the reference to entertainment expenditures.

Taxpayers may deduct 50% of an otherwise allowable business meal expense if:

1. the expense is an ordinary and necessary expense under §162(a) paid or incurred during the taxable year in carrying on any trade or business;
2. the expense is not lavish or extravagant under the circumstances;
3. the taxpayer, or an employee of the taxpayer, is present at the furnishing of the food or beverages;
4. the food and beverages are provided to a current or potential business customer, client, consultant, or similar business contact;
5. in the case of food and beverages provided during or at an entertainment activity; and
6. the food and beverages are purchased separately from the entertainment, or the cost of the food and beverages is stated separately from the cost of the entertainment on one or more bills, invoices, or receipts (Notice 2018-76).

Said another way, only 50% of business meal expenses is allowed as a deduction – with exceptions. The deduction of food or beverage expenses is generally limited, including expenses for food or beverages consumed while away from home, to 50% unless one of six exceptions applies (§274(n)(1)). The 50% of meal expenses shall not apply to any expense if such expense is described in:

1. §274(e)(2): Expenses treated as compensation;
2. §274(e)(3): Reimbursed expenses;
3. §274(e)(4): Recreational, etc., expenses for employees;
4. §274(e)(7): Items available to public;
5. §274(e)(8): Entertainment sold to customers; or
6. §274(e)(9): Expenses includible in income of persons who are not employees (§274(n)(2)(A); §274(n) in §274(e)).

However, no deduction is allowed for the expense of any food or beverages unless (a) the expense is not lavish or extravagant under the circumstances, and (b) the taxpayer (or an employee of the taxpayer) is present at the furnishing of the food or beverages (§274(k)).

Business Meals and Entertainment

A deduction for any item with respect to entertainment, amusement, or recreation (entertainment expenditures) is generally disallowed. Prior to the TCJA amendment, exceptions were provided to the disallowance if the taxpayer established that: (1) the item was directly related to the active conduct of the taxpayer's trade or business (directly related exception), or (2) in the case of an item directly preceding or following a substantial and bona fide business discussion (including business meetings at a convention or otherwise), the item was associated with the active conduct of the taxpayer's trade or business (business discussion exception) [§274(a)(1)(A)]. §274(e)(1) through (9) also provides exceptions to the rule that disallows a deduction for entertainment expenditures. The TCJA did not change the application of the §274(e) exceptions to entertainment expenditures.

Entertainment expenditures are no longer deductible unless one of the nine §274(e)(1) through (9) exceptions applies. Taxpayers generally may continue to deduct 50% of the food and beverage expenses associated with operating their trade or business, including meals consumed by employees on work travel.

Prior to the amendments by the TCJA, §274(d) provided substantiation requirements for deductions. The TCJA repealed the substantiation requirements for entertainment expenditures (Notice 2018-76). Traveling expenses (including meals and lodging while away from home) remain subject to the §274(d) substantiation requirements.

Special Rules for Travel Meals

Food or beverage expenses paid or incurred while traveling away from home in pursuit of a trade or business generally are subject to deduction limitations as well as the substantiation requirements in §274(d). In addition, travel expenses generally are subject to the luxury water transportation, travel as form of education, and travel expense limitations of spouse, dependent, or others (§1.274-12(a)(4)(I)).

Substantiation. No deduction is allowed for the expense of any food or beverages paid or incurred while traveling away from home in pursuit of a trade or business unless the taxpayer meets the substantiation requirements in §274(d) [§1.274-12(a)(4)(ii)].

Travel meal expenses of spouse, dependent, or others. No deduction is allowed, except under §217 (moving expenses) for certain members of the Armed Forces of the United States, for the expense of any food or beverages paid or incurred with respect to a spouse, dependent, or other individual accompanying the taxpayer, or an officer or employee of the taxpayer, on business travel, unless:

- The spouse, dependent, or other individual is an employee of the taxpayer;
- The travel of the spouse, dependent, or other individual is for a bona fide business purpose of the taxpayer; and

- The expenses would otherwise be deductible by the spouse, dependent, or other individual (§1.274-12(a)(4)(iii)).

  Example - travel meal expenses: Elizabeth and her spouse, Land, travel from New York to Boston to attend a series of business meetings. Land is not an employee of Elizabeth, does not travel to Boston for a bona fide business purpose of Elizabeth, and the expenses would not otherwise be deductible. While in Boston, Elizabeth and Land go out to dinner. The expenses associated with the food and beverages consumed by Land are not deductible. Therefore, the cost of Land's dinner is not deductible. Elizabeth may deduct 50% of the expense associated with the food and beverages she consumed while on business travel if the substantiation requirements are satisfied (§1.274-12(a)(4)(iii)(D)).

Definition of food or beverages. The term entertainment does not include food or beverages unless the food or beverages are provided during or at an entertainment activity. Food or beverages provided during or at an entertainment activity generally are treated as part of the entertainment activity. However, in the case of food or beverages provided during or at an entertainment activity, the food or beverages are not considered entertainment if the food or beverages are purchased separately from the entertainment, or the cost of the food or beverages is stated separately from the cost of the entertainment on one or more bills, invoices, or receipts. The amount charged for food or beverages on a bill, invoice, or receipt must reflect the venue's usual selling cost for those items if they were to be purchased separately from the entertainment, or must approximate the reasonable value of those items. Unless the food or beverages are purchased separately from the entertainment, or the cost of the food or beverages is stated separately from the cost of the entertainment on one or more bills, invoices, or receipts, no allocation can be made and the entire amount is a nondeductible entertainment expenditure (§1.274-11(b)(1)(ii)).

Certain Entertainment, Amusement, or Recreation Expenditures Paid or Incurred after Dec. 31, 2017 (§1.274-11)

With exceptions, no deduction is allowed for entertainment or with respect to a facility used in connection with an entertainment activity. Dues or fees to any social, athletic, or sporting club or organization are treated as items with respect to facilities and, thus, are not deductible. In addition, no deduction is allowed for amounts paid or incurred for membership in any club organized for business, pleasure, recreation, or other social purpose (§1.274-11(a)).

Entertainment includes any amusement or recreation activities, such as entertaining at bars, theaters, country clubs, golf and athletic clubs, sporting events, and on hunting, fishing, vacation and similar trips, including such activity relating solely to the taxpayer or the taxpayer's family, related to or associated with the active conduct of the taxpayer's trade or business. These activities are treated as entertainment, subject to the ***objective test*** (discussed in two paragraphs), regardless of whether the expenditure for the activity is related to or associated with the active conduct of the taxpayer's trade or business. The term entertainment may include an activity, the cost of which otherwise is a business expense of the taxpayer, which satisfies the personal, living, or family needs of any individual, such as a hotel suite or an automobile to a business customer or the customer's family.

Entertainment does NOT include activities which, although satisfying personal, living, or family needs of an individual, are clearly not regarded as constituting entertainment, such as a hotel room maintained by an employer for lodging of employees while in business travel status or an automobile used in the active conduct of trade or business even though used for routine personal purposes such as commuting to and from work. On the other hand, the providing of a hotel room or an automobile by an employer to an employee who is on vacation would constitute entertainment of the employee (§1.274-11(b)(1)).

***Objective test* used to classify entertainment.** An objective test is used to determine whether an activity is of a type generally considered to be entertainment. Thus, if an activity is generally considered to be entertainment, it will be treated as entertainment for this section and §274(a) regardless of whether the expenditure can also be described otherwise, and even though the expenditure relates to the taxpayer alone.

When advertising is, and is not, entertainment. This objective test precludes arguments that entertainment means only entertainment of others or that an expenditure for entertainment should be characterized as an expenditure for advertising or public relations. However, in applying this test, the taxpayer's trade or business is considered.

Theater critic; fashion show. Thus, although attending a theatrical performance generally would be considered entertainment, it would not be so considered in the case of a professional theater critic, attending in a professional capacity. Similarly, if a manufacturer of dresses conducts a fashion show to introduce its products to a group of store buyers, the show generally would not be considered entertainment. However, if an appliance distributor sponsors a fashion show, the fashion show generally would be considered to be entertainment (§1.274-11(b)(1)(iii)).

IRS Examples

> **Example - take me out to the ball game.** Todd invites Brian, a business associate, to a Yankee baseball game to discuss a proposed business deal. The baseball game is entertainment. The cost of the game tickets is an entertainment expenditure and is not deductible by Todd (§1.274-11(d), Exp 1).
>
> **Example - and buy me two beers and two hotdogs.** Todd also buys hot dogs and drinks from a concession stand. The cost of the hot dogs and drinks, which are purchased separately from the game tickets, is not an entertainment expenditure and is not subject to the §274(a)(1) disallowance. Therefore, Todd may deduct 50% of the expenses associated with the hot dogs and drinks purchased at the game (see §162 and §1.274-12) [§1.274-11(d), Exp 2].
>
> **Example - take me out to your suite**. Mitch invites Natalie, a business associate, to a Lakers basketball game. Mitch purchases suite tickets, where they have access to food and beverages. The cost of the basketball game tickets, as stated on the invoice, includes the food or beverages. The basketball game is entertainment, and, thus, the cost of the game tickets is an entertainment expenditure and is not deductible by Mitch. The cost of the food and beverages, which are not purchased separately from the game tickets, is not stated separately on the invoice. Thus, the cost of the food and beverages is an entertainment expenditure that is subject to the §274(a)(1)

disallowance. Therefore, Mitch may not deduct the cost of the tickets or the food and beverages associated with the basketball game (§1.274-11(d), Exp 3).

Example - food and beverage are separately stated from suite tickets. The Lakers invoice for basketball game tickets separately stated the cost of the food and beverages and reflected the venue's usual selling price if purchased separately. The basketball game is entertainment, and, thus, the cost of the game tickets, other than the cost of the food and beverages, is an entertainment expenditure and is not deductible by Mitch. However, the cost of the food and beverages, which is stated separately on the invoice for the game tickets, is not an entertainment expenditure and is not subject to the §274(a)(1) disallowance. Therefore, Mitch may deduct 50% of the expenses associated with the food and beverages provided at the game (§1.274-11(d), Exp 4).

Limitation on Deductions for Certain Food or Beverage Expenses Paid or Incurred after Dec. 31, 2017 (§1.274-12)

No deduction is allowed for the expense of any food or beverages provided by the taxpayer (or an employee of the taxpayer) to another person or persons unless:

I. The expense is not lavish or extravagant under the circumstances;
II. The taxpayer, or an employee of the taxpayer, is present at the furnishing of such food or beverages; and
III. The food or beverages are provided to a business associate (§1.274-12(a)(1)(I, ii, & iii)).

Only 50% of food or beverage expenses allowed as deduction. Except as provided in this section, the amount allowable as a deduction for any expense for food or beverages provided by the taxpayer, or an employee of the taxpayer, to a business associate may not exceed 50% of the amount of the expense that otherwise would be allowable (§1.274-12(a)(2)).

Examples. In each example below, the food or beverage expenses are ordinary and necessary expenses under §162(a) that are paid or incurred during the taxable year in carrying on a trade or business and are not lavish or extravagant under the circumstances (§1.274-12(a)(3)).

Example - business luncheon. Mark takes Brendan out to lunch. While eating lunch, Mark and Brendan discuss Mark's trade or business activities. Mark may deduct 50% of the food or beverage expenses (§1.274-12(a)(3)(i), Exp 1).

Example - performance review luncheon. Carmen takes Darcy out to lunch. While eating lunch, they discuss Darcy's annual performance review. Carmen may deduct 50% of the food and beverage expenses (§1.274-12(a)(3)(ii), Exp 2).

Special Travel Expenses, Including Luxury Water Transportation

The deduction for luxury water transportation expenses is generally limited to twice the highest federal per diem rate allowable at the time of travel. A deduction for expenses for travel as a form of education is generally disallowed. No deduction is allowed for travel expenses paid or incurred with respect to a spouse, dependent, or other individual accompanying the taxpayer (or an officer or employee of the taxpayer) on business travel, unless:

1. the spouse, dependent, or other individual is an employee of the taxpayer,
2. the travel of the spouse, dependent, or other individual is for a bona fide business purpose, and
3. such expenses would otherwise be deductible by the spouse, dependent, or other individual (§274(m)(1),(2) and (3)).

Separately Stated Food or Beverages Not Entertainment (Notice 2018-76)

The proposed regulations substantially incorporate the guidance in Notice 2018-76 to distinguish between entertainment expenditures and food or beverage expenses in the context of business meals provided at or during an entertainment activity. Notice 2018-76 explains that in the case of food and beverages provided during or at an entertainment activity, the taxpayer may deduct 50% of an otherwise allowable business expense if the food and beverages are purchased separately from the entertainment, or if the cost of the food and beverages is stated separately from the cost of the entertainment on one or more bills, invoices, or receipts.

§274(e) Exceptions to §274(k) and (n); (§1.274-12(c))

The technical rule: §274(k)(2) and (n)(2)(A) provide that the limitations on deductions in §274(k)(1) and (n)(1), respectively, do not apply to any expense described in §274(e)(2), (3), (4), (7), (8), and (9) [as discussed below]. The proposed regulations, therefore, provide that the deduction limitations are not applicable to expenditures for business meals, travel meals, or other food or beverages that fall within one of these exceptions.

Exceptions - in general. The limitations on the deduction of food or beverage expenses do not apply to any expense described below. These expenses are deductible to the extent allowable (§1.274-12(c)(1)).

#2: Expenses Treated As Compensation Under §274(e)(2) or (e)(9) [§274(e)(2)]

Any expense paid or incurred by a taxpayer for food or beverages, including food or beverages provided during travel, if an employee is the recipient of the food or beverages, is not subject to the deduction limitations to the extent that the expense is treated by the taxpayer:

1. On the taxpayer's income tax return as originally filed, as compensation paid to the employee; and
2. As wages to the employee for purposes of withholding relating to collection of income tax at source on wages (§274(e)(2); §1.274-12(c)(2)(i)(A)(1) & (2)).

Expenses includible in income of persons who are not employees. An expense paid or incurred by a taxpayer for food or beverages, including food or beverages provided during travel, is not subject to the deduction limitations to the extent the expenditure is includible in gross income as compensation for services rendered, or as a prize or award (§74) by a recipient of the expense who is not an employee of the taxpayer. The preceding sentence does not apply to any amount paid or incurred by the taxpayer if the amount is required to be included, or would be so required except that the amount is less than $600, in any information return filed by such taxpayer and is not so included (§1.274-12(c)(2)(i)(B)).

Expenses for which value is improperly included or for which amount required to be included is zero. The exception does not apply to expenses paid or incurred for food or beverages for which the value that is included in gross income is less than the amount required to be included in gross income (see §1.61-21) [§1.274-12(c)(2)(i)(c)].

> ***Example - company cafeteria.*** Finn, Inc. (Finn) provides food and beverages to its employees without charge at a company cafeteria on its premises. The food and beverages do not meet the definition of a de minimis fringe. Finn treats the food and beverage expenses as compensation and wages, and determines the amount of the inclusion under §1.61-21. The expenses associated with the food and beverages provided to the employees are not subject to the 50% deduction limitations. Thus, Finn may deduct 100% of the food and beverage expenses (§1.274-12(c)(2)(i)(D)(1) Exp 1).

> ***Example - providing meals for the convenience of the employer.*** Golf Pro, Inc. (Golf Pro) provides meals to its employees without charge. The meals are properly excluded from the employees' income under §119 as meals provided for the convenience of the employer. Under §1.61-21(b)(1), an employee must include in gross income the amount by which the fair market value of a fringe benefit exceeds the sum of the amount, if any, paid for the benefit by or on behalf of the recipient, and the amount, if any, specifically excluded from gross income. Because the entire value of the employees' meals is excluded from the employees' income under §119, the fair market value of the fringe benefit does not exceed the amount excluded from gross income, so there is nothing to be included in the employees' income under §1.61-21. Thus, the exception of this section does not apply, and Golf Pro may only deduct 50% of the expenses for the food and beverages provided to employees [§1.274-12(c)(2)(i)(D)(2), Exp 2].

#3: Reimbursed Food or Beverage Expenses (§274(e)(3))

The limitations on deductions apply either to the person who makes the expenditure or to the person who actually bears the expense, but not to both. In the case of expenses for food or beverages paid or incurred by one person in connection with the performance of services for another person (whether or not the other person is an employer) under a reimbursement or other expense allowance arrangement, the limitations on deductions apply either to the person who makes the expenditure or to the person who actually bears the expense, but not to both. If the services are performed for a person other than an employer, such as by an independent contractor, the exception applies only if the taxpayer, in this case, the independent contractor, accounts to such person. The proposed regulations provide that the deduction limitations apply to an independent contractor unless, under a reimbursement or other expense allowance arrangement, the contractor accounts to the client or customer with substantiation that satisfies the requirements of §274(d) [§274(e)(3); §1.274-12(c)(2)(ii)(A)].

Reimbursement arrangements involving employees. In the case of expenses paid or incurred by an employee for food or beverages in performing services as an employee under a reimbursement or other expense allowance arrangement with a payor (the employer, its agent, or a third party), the limitations on deductions apply:

1. ***To the employee to the extent the employer treats the reimbursement or other payment of the expense on the employer's income tax return as originally filed as compensation paid*** to the employee and as wages; or

2. ***To the payor to the extent the reimbursement or other payment of the expense is not treated as compensation*** and wages paid to the employee (§1.274-12(c)(2)(ii)(B)).

Reimbursement arrangements involving persons that are NOT employees. In the case of expenses for food or beverages paid or incurred by an independent contractor in connection with the performance of services for a client or customer under a reimbursement or other expense allowance arrangement with the independent contractor, the limitations on deductions apply to the party expressly identified in an agreement between the parties as subject to the limitations. If an agreement between the parties does not expressly identify the party subject to the limitations, then the deduction limitations apply:

1. ***To the independent contractor*** (which may be a payor) to the extent the independent contractor does not account to the client or customer within the meaning of §274(d); or

2. ***To the client or customer*** if the independent contractor accounts to the client or customer within the meaning of §274(d) (§1.274-12(c)(2)(ii)(c)).

§274(d) substantiation. If the reimbursement or other expense allowance arrangement involves persons who are not employees and the agreement between the parties does not expressly identify the party subject to the limitations on deductions, the limitations on deductions apply to the independent contractor unless the independent contractor accounts to the client or customer with *satisfactory substantiation* (§1.274-12(c)(2)(ii)(D)).

> ***Example 1 - employee leasing company reimbursement to worker.*** Lynn performs services under an arrangement in which Jobs, Inc. (Jobs), an employee leasing company, pays Lynn a 10x per diem allowance for each day she performs services for Jobs client Soapy Suds, while traveling away from home. The per diem allowance is a reimbursement of travel expenses for food or beverages that Lynn pays in performing services as an employee. Jobs enters into a written agreement with Soapy Suds under which Soapy Suds agrees to reimburse Jobs for any substantiated reimbursements for travel expenses, including meal expenses, that Jobs pays to Lynn. The agreement does not expressly identify the party that is subject to the limitations on deductions. Lynn performs services for Soapy Suds while traveling away from home for 10 days and provides Jobs with substantiation that satisfies the requirements of $100x of meal expenses incurred by Lynn while traveling away from home. Jobs pays Lynn $100x to reimburse those expenses pursuant to their arrangement. Jobs delivers a copy of Lynn's substantiation to Soapy Suds. Soapy Suds pays Jobs $300x, which includes $200x

compensation for services and $100x as reimbursement of Jobs's payment of Lynn's travel expenses for meals. Neither Jobs nor Soapy Suds treats the $100x paid to Lynn as compensation or wages.

Lynn and Jobs have established a reimbursement or other expense allowance arrangement. Because the reimbursement payment is not treated as compensation and wages paid to Lynn, she is not subject to the limitations on deductions. Instead, Jobs, the payor, is subject to limitations on deductions unless it can meet the requirements of section 274(e)(3)(B) and paragraph (c)(2)(ii)(c) of this section.

Because the agreement between Jobs and Soapy Suds expressly states that Soapy Suds will reimburse Jobs for substantiated reimbursements for travel expenses that it pays to Lynn, Jobs and Soapy Suds have established a reimbursement or other expense allowance arrangement. Jobs accounts to Soapy Suds for its reimbursement by delivering to Soapy Suds a copy of the substantiation Jobs received from Lynn. Therefore, Soapy Suds and not Jobs is subject to the deduction limitations (§1.274-12(c)(2)(ii)(E)(1), Exp 1).

Example 2- Business using leasing company reimburses worker. The facts are the same as in Example 1 except that, under the arrangements between Lynn and Jobs and between Jobs and Soapy Suds, Lynn provides the substantiation of the expenses directly to Soapy Suds, and Soapy Suds pays the per diem directly to Lynn.

Because Lynn substantiates directly to Soapy Suds and the reimbursement payment was not treated as compensation and wages paid to Lynn, she is not subject to the limitations on deductions. Soapy Suds, the payor, is subject to the limitations on deductions (§1.274-12(c)(2)(ii)(E)(2), Exp 2).

Example 3 - Employee leasing company agreement expressly provides that limitation applies to business. The facts are the same as in Example 1, except that the written agreement between Jobs and Soapy Suds expressly provides that the limitations will apply to Soapy Suds. Jobs and Soapy Suds have established a reimbursement or other expense allowance arrangement for purposes of this section. Because the agreement provides that the §274 deduction limitations apply to Soapy Suds, Soapy Suds and not Jobs is subject to the limitations on deductions (§1.274-12(c)(2)(ii)(E)(3), Exp 3).

Example 4 - Employee leasing company agreement DOES NOT expressly provide that limitation applies to business. The facts are the same as in Example 1, except that the agreement between Jobs and Soapy Suds does not provide that Soapy Suds will reimburse Jobs for travel expenses. The arrangement between Jobs and Soapy Suds is not a reimbursement or other expense allowance arrangement. Therefore, even though Jobs accounts to Soapy Suds for the expenses, Jobs is subject to the limitations on deductions (§1.274-12(c)(2)(ii)(E)(4), Exp 4).

#4: Recreational Expenses for Employees (§274(e)(4))

The proposed regulations provide that any food or beverage expense paid or incurred by a taxpayer for a recreational, social, or similar activity, primarily for the benefit of the taxpayer's employees, is not subject to the deduction limitations in §274(k)(1) and (n)(1). However, activities that discriminate in favor of highly compensated employees, officers, shareholders or others who own a 10% or greater interest in the business are not considered paid or incurred primarily for the benefit of employees.

The proposed regulations confirm the rules in the existing regulations that the exception in §274(e)(4) applies to food or beverage expenses for company holiday parties, annual picnics, or summer outings that do not discriminate in favor of highly compensated employees. In addition, the proposed regulations provide that the exception in §274(e)(4) does not apply to food or beverage expenses that are excludable under §119 as meals provided for the convenience of the employer. Because these food or beverages are, by definition, furnished for the employer's convenience, they cannot also be primarily for the benefit of the employees, even if some social activity occurs during the provision of food or beverages (§1.274-12(c)(2)(iii)(A) & (B)).

> ***Example - PPBG, LLC invites all employees to a holiday party in a hotel ballroom that includes a buffet dinner and an open bar.*** Under §274(e)(4), the cost of the party, including food and beverage expenses, is not subject to the deduction limitations because the holiday party is a recreational, social, or similar activity primarily for the benefit of non-highly compensated employees. Thus, PPBG may deduct 100% of the cost of the party (§1.274-12(c)(2)(iii)(C)(1), Exp 1)).

> ***Example - PPBG, LLC invites only highly compensated employees to its holiday party.*** The facts are the same as in the previous example, except that PPBG, LLC invites only highly compensated employees to the holiday party, and the invoice provided by the hotel lists the costs for food and beverages separately from the cost of the rental of the ballroom. The costs reflect the venue's usual selling price for food or beverages. The exception in this paragraph does not apply because PPBG invited only highly compensated employees to the holiday party. However, the food and beverage expenses are not treated as entertainment. PPBG may deduct 50% of the food and beverage costs that are separately stated on the invoice (§1.274-12(c)(2)(iii)(C)(2), Exp 2)).

> ***Example - Next Energy Technology, Inc. (NET) provides free coffee, soda, bottled water, chips, donuts, and other snacks in a break room available to all employees.*** The expenses associated with the food and beverages are subject to the deduction limitations because the break room is not a recreational, social, or similar activity primarily for the benefit of the employees. Thus, the exception does not apply, and NET may only deduct 50% of the expenses for food and beverages provided in the break room (§1.274-12(c)(2)(iii)(C)(3), Exp 3)).

> ***Example - Employer has a written policy that employees in a certain medical services-related position must be available for emergency calls due to the nature of the position that requires frequent emergency response.*** Because these emergencies can and do occur during meal periods, Emergency, Inc. furnishes food and beverages to employees in this position without charge in a cafeteria on its premises. Emergency, Inc. excludes food and beverage expenses from the employees' income as meals provided for the convenience of the employer excludable under §119. Because these food and beverages are furnished for the employer's convenience, and therefore are not primarily for the benefit of the employees, the exception in §274(e)(4) does not apply, even if some socializing related to the food and beverages provided occurs. Thus, Emergency, Inc. may only

deduct 50% of the expenses for food and beverages provided to employees in the cafeteria (§1.274-12(c)(2)(iii)(C)(4), Exp 4)).

Example - Business meal coupled with celebrating employee's birthday. Attorney Andy, Inc. invites an employee and a client to dinner at a restaurant. Because it is the birthday of the employee, Andy, Inc. orders a special dessert in celebration. Because the meal is a business meal, and therefore not ***primarily*** for the benefit of the employee, the exception does not apply, even though an employee social activity in the form of a birthday celebration occurred during the meal. Thus, Andy, Inc. may only deduct 50% of the meal expenses (§1.274-12(c)(2)(iii)(C)(5), Exp 5)).

#7: Items Available to the Public (§274(e)(7); §1.274-12(c)(iv))

In general. Any food or beverage expense of a taxpayer is not subject to the deduction limitations in §274(k)(1) and (n)(1) to the extent the food or beverages are made available to the general public. If a taxpayer provides food or beverages to employees, this limitation applies to the entire amount of expenses for those food or beverages if the same types of food or beverages are provided to, and are primarily consumed by, the general public.

Example - Realtor Max is a real estate agent and provides refreshments at an open house for a home available for sale to the public. The refreshments are consumed by Max's employees, potential buyers of the property, and other real estate agents. Under §274(e)(7) and this paragraph (c)(2)(iv), the expenses associated with the refreshments are not subject to the deduction limitations if over 50% of the food and beverages is primarily consumed by potential buyers and other real estate agents. If the food and beverages are not primarily consumed by the general public, only the costs attributable to the food and beverages provided to the general public are excepted (§1.274-12(c)(iv)(B)(1), Exp 1).

Example - Last Chance, Inc. is an automobile service center and provides refreshments in its waiting area. The refreshments are consumed by Last Chance's employees and customers. Under §274(e)(7) and this paragraph (c)(2)(iv), the expenses associated with the refreshments are not subject to the deduction limitations if over 50% of the food and beverages is primarily consumed by customers. If the food and beverages are not primarily consumed by the general public, only the costs attributable to the food and beverages provided to the general public are excepted under §274(e)(7) and this paragraph (c)(2)(iv) [§1.274-12(c)(iv)(B)(2), Exp 2].

Example - YYCA operates a summer camp open to the general public for children and provides breakfast and lunch, as part of the fee to attend camp, both to camp counselors, who are employees, and to camp attendees, who are customers. There are 20 camp counselors and 100 camp attendees. The same type of meal is available to each counselor and attendee, and attendees consume more than 50% of the food and beverages. Under §274(e)(7) and this paragraph (c)(2)(iv), the expenses associated with the food and beverages are not subject to the deduction limitations because over 50% of the food and beverages are primarily consumed by camp attendees. Thus, YYCA may deduct 100% of the food and beverage expenses (§1.274-12(c)(iv)(B)(3), Exp 3).

Example - ***Walnut, Inc. provides food and beverages to its employees without charge at a company cafeteria on its premises.*** Occasionally, customers or other visitors also eat without charge in the cafeteria. The occasional consumption of food and beverages at the company cafeteria by customers and visitors is less than 50% of the total amount of food and beverages consumed at the cafeteria. Therefore, only the costs attributable to the food and beverages provided to the general public are excepted under §274(e)(7) and this paragraph (c)(2)(iv) (§1.274-12(c)(iv)(B)(4), Exp 4).

#8: Goods or Services Sold to Customers (§274(e)(8); §1.274-12(c)(v))

In general - An expense paid or incurred for food or beverages, to the extent the food or beverages are sold to customers in a bona fide transaction for an adequate and full consideration in money or money's worth, is not subject to the deduction limitations. However, money or money's worth does not include payment through services provided. A restaurant or catering business may deduct 100% of its costs for food or beverage items, purchased in connection with preparing and providing meals to its paying customers, which are also consumed at the worksite by employees who work in the employee's restaurant or catering business. In addition, the term customer includes anyone, including an employee of the taxpayer, who is sold food or beverages in a bona fide transaction for an adequate and full consideration in money or money's worth (§1.274-12(c)(v)(A); §274(k)(1) and (n)(1)).

Example: A restaurant or catering business may continue to deduct 100% of its costs for food or beverage items, purchased in connection with preparing and providing meals to its paying customers, which are also consumed at the worksite by employees who work in the employer's restaurant or catering business.

Example: Buffalo Jump, Inc. (Buffalo) operates a restaurant. Buffalo provides food and beverages to its food service employees before, during, and after their shifts for no consideration. Under §274(e)(8) and this paragraph (c)(2)(v), the expenses associated with the food and beverages provided to the employees are not subject to the 50% deduction limitation because the restaurant sells food and beverages to customers in a bona fide transaction for an adequate and full consideration in money or money's worth. Thus, Buffalo may deduct 100% of the food and beverage expenses (§1.274-12(c)(v)(B)).

LISTED PROPERTY

What Is Listed Property? (§280F(d)(4); §1.280F-6(b))

The term "listed property" means —

1. *Any passenger automobile* which is defined as any four-wheeled vehicle manufactured primarily for use on public streets, roads, and highways, and rated at 6,000 pounds gross vehicle weight or less, with the exception of:
   a) Ambulance, hearse, or combination ambulance-hearse used by the taxpayer directly in a trade or business,

b) Taxi: vehicle used by the taxpayer directly in the trade or business of transporting persons or property for compensation or hire, or

c) Truck or van that is a qualified nonpersonal use vehicle (see §1.274-5T(k); (§1.280F-6(c)(1)-(3); §280F(d)(4)(A)(i)).

2. Any other *property used as a means of transportation* including trucks, buses, trains, boats, airplanes, motorcycles, and any other vehicles for transporting persons or goods (§280F(d)(4)(A)(ii));

   a) but not any qualified nonpersonal use vehicle (as defined in §274(i) and §1.274-5(k)) [§1.280F-6(b)(1)(ii), -6(b)(2)].

3. Any *property generally used for entertainment, recreation, or amusement purposes* including property such as photographic, phonographic, communication, and video recording equipment (§280F(d)(4)(A)(iii)).

4. **Computer or peripheral equipment has been deleted from the listed property list and no longer is subject to the "daily log" substantiation requirements effective Jan. 1, 2018**:

   a) Any *computer or peripheral equipment.*

      i. The term "computer or peripheral equipment" does not include any equipment which is an integral part of other property which is not a computer, typewriters, calculators, adding and accounting machines, copiers, duplicating equipment, and similar equipment, and equipment of a kind used primarily for amusement or entertainment of the user (§168(I)(2)(B), -(I)(2)(B)(iv) (I)-(III)).

      ii. The term "listed property" does not include any computer (including peripheral equipment) used exclusively at a regular business establishment or a qualified (§280A(c)(1)) office-in-home (§1.280F-6(b)(1)(iv), -6(b)(5); §168(I)(2)(B)).

Example. Holly buys a new laptop to use in her home office and at her client's office. If she purchased the laptop in 2017, she was not allowed a depreciation deduction (or §179 expensing amount) related to her laptop unless she maintained a log book on its use during the year. If she purchases the laptop in 2020, she is no longer required to provide the IRS auditor a log book to get the deduction. She instead must show the reasonableness of her business use of the laptop.

Substantiation of Listed Property: Autos, Etc. (§280F(d)(4))

Documentation required to substantiate the business use of listed property must include:

1. **Amount**

   a. **Expenditures** — The amount of each separate expenditure with respect to an item of listed property, such as the cost of acquisition, cost of capital improvements, lease payments, cost of maintenance and repairs, or other expenditures or uses.

   b. **Uses** — The amount of each business-investment use (as defined in §1.280F-6(d)(3)) based on the appropriate measure (*for example, mileage for automobiles*) and the total use of the listed property for the taxable year.

2. **Time** — The date of each expenditure or use.

3. **Business or Investment Purpose** — The business purpose for each expenditure or use (§1.274-5T(b)(6)).

The Strict Substantiation Rules of Listed Property

Detailed log with receipts. Section 274(d) imposes strict substantiation requirements for certain expenses such as vehicle expenses (§1.274-5T(a)). To substantiate by adequate records, the taxpayer must provide:

1. an account book, a log, or a similar record, and
2. documentary evidence, which together are sufficient to establish *each element* with respect to an expenditure (§1.274-5T(c)(2)(I)).

"Guesstimates" or "testimony only" not sufficient. Section 274(d) contemplates that no deduction or credit shall be allowed on the basis of mere approximations or unsupported testimony of the taxpayer.

The Alternative Recordkeeping Option

If log is not contemporaneous, "other sufficient credible evidence" required. Although a contemporaneous log is not required, corroborative evidence to support a taxpayer's reconstruction "of the elements * * * of the expenditure or use must have a high degree of probative value to elevate such statement" to the level of credibility of a contemporaneous record (§1.274-5T(c)(1)). If a taxpayer fails to substantially comply with the adequate records requirement with respect to any element of an expenditure or use, the taxpayer MUST then establish such elements by "other sufficient evidence" backed up with "other corroborative evidence."

What is meant by "other sufficient evidence corroborating the taxpayer's own statement?"

1. ***Other sufficient evidence*** is the taxpayer's own statement, whether written or oral, containing specific information in detail as to such element and other corroborative evidence sufficient to establish such element (§1.274-5T(c)(3)(I)).
2. ***Other corroborative evidence*** must be direct evidence (a written statement or oral testimony of witness) if the element is the cost, amount, time, place, or date of an expenditure or use (§1.274-5T(c)(3)(I)).

Substantiation in exceptional circumstances. The substantiation requirements do not have to be met in those exceptional circumstances where it is simply impossible to meet these requirements and other "highly probative" evidence is available (§1.274-5T(c)(4)).

Sampling may be used under certain circumstances. If a taxpayer maintains an adequate record of part of the taxable year, he or she may possibly be permitted to use such partial records to substantiate the business/investment use of listed property for the entire year if he or she demonstrates that the period covered by the adequate record is representative of the use (§1.274-5T(c)(3)(ii)(A)). This sampling may be as small as 25% of the entire year.

> ***Example — Auto log filled in for only three months:*** Leah, a sole proprietor, operates an interior decorating business out of her home. Leah uses an automobile for local business travel to visit the

homes or offices of clients, to meet with suppliers and other subcontractors, and to pick up and deliver certain items to clients when feasible. There is no other business use of the automobile, but Leah and other members of her family also use the automobile for personal purposes. Leah maintains adequate records for the first three months of the year that indicate that 75% of the use of the automobile was in Leah's business. Invoices from subcontractors and paid bills indicate that Leah's business continued at approximately the same rate for the remainder of the year. If other circumstances do not change (for example, Leah does not obtain a second car for exclusive use in her business), the determination that the business/investment use of the automobile for the taxable year is 75% is based on sufficient corroborative evidence (§1.274-5T(c)(3)(ii)(c)).

Example — Auto log filled in one week a month: The facts are the same as in the previous example, except that Leah maintains adequate records during the first week of every month, which indicate that 75% of the use of the automobile is in Leah's business. The invoices from Leah's business indicate that Leah's business continued at the same rate during the subsequent weeks of each month so that Leah's weekly records are representative of each month's business use of the automobile. Thus, the determination that the business/investment use of the automobile for the taxable year is 75% is based on sufficient corroborative evidence (§1.274-5T(c)(3)(ii)(c)).

Loss of records beyond the taxpayer's control. If the taxpayer's records are destroyed due to fire, flood, earthquake, or other casualty, the taxpayer may reconstruct the expenses using a reasonable method (§1.274-5T(c)(5)).

Strict Substantiation Requirements for Vehicle Expenses Violated (*Edwin D. Benton and Sheila E. Benton v. Comm.*, TCS 2020-12)

Edwin Benton (Benton) was engaged in a picture framing business reporting on Schedule C that he drove 15,000 miles for business purposes during 2013 and claimed a deduction of $8,475 for vehicle expenses. The IRS maintains that Benton failed to substantiate either the 15,000 miles or the $8,475 for vehicle expenses.

Benton did not produce a mileage log and explained at trial that he lost not only his original log but also two reconstructed logs. Benton produced 32 invoices from Best Picture & Frame Co. (BPFC), the third party that he hired to provide framing services for his customers, and explained that he made numerous round trips from his business address to Costco, and on to BPFC, in the course of dropping off and later picking up framing projects for his customers.

Inadequate records. Although there was little doubt to the court that Benton drove some distance for business purposes, his testimony and the spotty records that he offered amounted to little more than guesswork and failed to satisfy the strict substantiation requirements for vehicle expenses prescribed in §274(d) and related regulations. The court may not use the rule established in *Cohan v. Comm.*, 39 F.2d at 540 to estimate expenses covered by §274(d). Consequently, the IRS's determination disallowing a deduction for vehicle expenses was sustained.

Taxpayers Had Contemporaneous Records for Miles Driven (*Huirong Zhu and Tina Zhou v. Comm.*, TSCO 2019-6)

Tina Zhou managed 11 investment properties that the couple owned. During 2013, Ms. Zhou drove two cars, a Toyota Camry and a Toyota Sienna, and showed a schedule by property totaling 14,676 miles driven to manage nine of them. Ms. Zhou collected rents, carried out evictions, made minor repairs (including drywall repairs), and coordinated hiring workers for large repairs as part of managing the properties. Sometimes Ms. Zhou would visit more than one property during a trip. Other times she would travel from their home in Mountain House, California, to one property, return home, and later, in the same day, visit another property.

Log book maintained. Two or three times a week, Ms. Zhou logged her travel, including the purpose and time spent for the trip, with respect to managing the investment properties. She used a computer program to calculate the miles between their home and the investment property or properties. When the IRS examiner asked her for documentation of the miles Ms. Zhou drove, she consolidated the various contemporaneous logs into one log. On the Schedule E filed with their 2013 tax return, they claimed total auto and travel expenses of $14,416 for 11 properties.

Court allows standard mileage rate for miles driven. The taxpayers proved to the court's satisfaction that Ms. Zhou maintained contemporaneous records of the miles she drove to and from the various investment properties. The log that consolidated the various records met the requirements of §274. The court agreed that Ms. Zhou proved that she drove 14,676 miles in connection with managing their investment properties. Applying the standard mileage rate for 2013, 56.5¢, the court allowed $8,292 for auto and travel expenses with respect to their investment properties for 2013.

> **Note**. The case does not explain how the taxpayers came up with a $14,416 deduction.

No Contemporaneous Records Means No Auto Expense Deduction (*Suresh Hatte v. Comm.*, TCM 2019-109)

During 2014 and 2015, Suresh Hatte worked as a taxi driver and as a real estate appraiser in the Washington, D.C., metropolitan area. On his 2014 Schedule C for the appraisal business, he reported gross profit of $111,610 and expenses of $95,176, including $45,153 of car and truck expenses. For 2015 he reported gross profit of $183,770 and expenses of $154,979, including $64,303 of car and truck expenses. Mr. Hatte owned three vehicles allegedly used in his appraisal business: a Ford Crown Victoria, a Honda Accord, and a Nissan Maxima. For 2014 he reported on Form 4562 the following mileage on these vehicles:

Type	Ford	Honda	Nissan	Total
Business	55,800	24,830	-0-	80,630
Personal	2,200	600	-0-	2,800

No contemporaneous mileage logs. Mr. Hatte did not keep contemporaneous mileage logs or other records of the mileage he drove for the appraisal business. Rather, he created spreadsheets during the IRS examination by using Google Maps to calculate the round-trip distance from workplace to each of his alleged destinations. He did not produce at trial any notes, calendars, or other contemporaneous documents to support the entries on the spreadsheets. There was no evidence showing where Mr. Hatte actually started each trip, and the spreadsheets did not show which vehicle was used for any of the travel. According to Mr. Hatte's spreadsheet for 2014, he visited at least one appraisal site every day but one between January and October, with no trips in November or December. The spreadsheet for 2015 showed a substantially identical pattern. Many of these alleged trips were repeat visits to the same property. On at least six occasions, the spreadsheets "implausibly" showed two round trips to the same address on the same day.

Testimony not credible. The court did not find this testimony credible. The court found it "implausible" that Mr. Hatte could have recalled the details of more than 600 trips so long after the fact. The court claimed in had no alternative but to sustain the IRS's disallowance of the deductions for car and truck expenses in their entirety.

See also.

- *Zaid Hakkak and Layla Naji v. Comm.,* TCM 2020-46 and *Henry C. Williams and Sonja L. Johnson v. Comm.,* TCM 2020-48, where taxpayers had no auto log and, thus, no deduction.
- *Jesus and Juanita Rodriquez v. Comm*., TCSO 2019-4, where logs were created in anticipation of trial, and thus didn't meet the contemporaneous requirements of §274.
- *Andrew and Sara Berry v. Comm*., TCM 2018-143), where S corporation shareholder/employee auto expenses not deductible as miscellaneous itemized deduction.

Telephone, Cell Phone, and Internet Expenses

Telephone expenses with respect to the first telephone ***line*** in a personal residence are nondeductible personal expenses (§262(b)). All substantiated business long-distance calls, call-waiting, call-forwarding, mail box, cellular telephone, and beeper expenses are deductible as would be a business second telephone line, dedicated fax lines, and Internet lines. Telephones, including cellular, used mainly for personal use with only an occasional business use will be disallowed (*D.D. Lanier*, 11 TCM 439).

Cell Phones Are Not Listed Property

Because cell phones are not listed property, the burdensome substantiation requirements of §274(d)(4) do not apply. In addition, the IRS ruled that the personal use portion of the value of an employer-provided cell phone is a non-taxable de minimis fringe benefit to the employee if the "noncompensatory business purpose" rule ("I need to get hold of you outside of business hours") of Notice 2011-72 is met.

> **Tax practitioner alert**. Some tax professionals are reporting that IRS examiners are requiring taxpayers to have two cell phones in order to deduct one as a business expense. Reportedly, the IRS is relying on §262(a), which disallows the deduction for the first telephone *line* into a home regardless of how it is used. The author believes that the IRS is wrong taking this position. There is no such requirement for cellular telephones. Cell phones don't have *lines*.

Stock Broker/Real Estate Professional Denied Cell Phone Expenses As She Didn't Allocate Between Business and Personal Usage by Minutes (*Patricia Windham v. Comm.*, TCM 2017-68)

The IRS agreed that Patricia Windham, a stock broker and landlord, paid $592 in cell phone expenses, evidenced by her cell phone bills. Even though Patricia testified that she used her cell phone for her brokerage work, for her rental real estate activities, and for the charities for which she volunteered, strangely, she offered no testimony or other evidence delineating how many cell phone minutes were used for business calls, charity calls, or personal calls. Worse, the Tax Court pointed out, as she provided no evidentiary basis to allow the court to apply the *Cohan* rule to her cell phone expenses, her entire cell phone expenses for the year were disallowed.

> **Tax practitioner planning.** Patricia, who was represented by counsel, didn't introduce the *Cohan* defense supported by cell phone minutes! Why?

Also see.

- *Joseph Dwight and Dona De Primavera Jackson, pro sese v. Comm.*, TCS 2016-11, where 90% of a mechanic's cell phone bills was deductible. A mechanic who worked for several employers, and operated a small-engine repair business on the side, was not entitled to unsubstantiated deductions. However, as cellular phones are no longer included in the definition of listed property in §280F(d)(4) and, therefore, are no longer subject to the strict substantiation requirements of §274(d), the court allowed Joe to deduct approximately 90% of his estimated cell phone expenses (an amount based solely on his credible testimony).
- *Ronald G. Ezzell, Jr., pro se v. Comm.*, TCS 2015-52, where 80% of cell phone was deductible.
- *Sam D. Kilpatrick, pro se v. Comm.*, TCM 2016-166, where a CPA's cell phone deduction was denied because his evidence was the words "I guess!" Sam's exact testimony was "I would say 70-30. That's strictly a guess." The court was not " . . . persuaded of the veracity of (Sam's) guess." Furthermore, the court added "even if strict substantiation did not govern this expense, the record does not give us a reasonable basis for making a *Cohan* estimate." Accordingly, the court denied Sam's entire cell phone deduction.

> **Tax practitioner planning.** This is an unreasonably harsh result, although understandable.

Internet Is Not Listed Property

Why Was CPA's Home Internet Deduction Limited to 9% of Annual Charges? (*Sam D. Kilpatrick, pro se v. Comm.*, TCM 2016-166)

Internet is a utility expense, not a computer expense, so reasonable estimate (per *Cohan)* should be allowed. The IRS only allowed $144 of Sam Kilpatrick's $1,523 business-expense deduction for Internet-expense deduction. Sam admitted that he used the Internet in his home both for personal purposes and for his CPA business and estimated it to be 50/50. The court conceded that an estimate of a taxpayer's deductible Internet-service expenses is allowed if there was a reasonable basis for making such an estimate. The problem was the court did not find Sam's testimony "credible evidence of the percentage of home Internet use for business versus personal purposes" and agreed with the IRS's $144 limitation.

Tax practitioner planning. Nine percent ($144/$1523) of the annual Internet expense is a tough result. Other courts have allowed 75% to 80% (see below) with no better records than Sam had. Perhaps the court held this CPA to a higher standard.

Also see.

- *Ronald G. Ezzell, Jr., pro se v. Comm.*, TCS 2015-52, where 80% of bundled package for Internet/cable charge was deductible.
- *James E. Kaminski, pro se v. Comm.*, TCS 2015-7, where 75% business use of Internet charges allowed as a reasonable estimate. The court has previously characterized Internet access expenses as utility expenses
- *Verma, pro se v. Comm*., TCM 2001-132, where strict substantiation did not apply.

AUTOMOBILE EXPENSES

2020 Standard Mileage Rate Numbers Released (IR-2019-215)

The IRS provides optional standard mileage rates for employees, self-employed individuals, or other taxpayers to use in computing the deductible costs paid or incurred of operating a passenger automobile. In addition, employees may be reimbursed by their employers for the business use of their automobile at the business mileage rate. For qualification rules, see Rev. Proc. 2010-51.

	2019	**2020**
Business	58¢	**57.5¢**
Medical	20¢	**17¢**
Moving	20¢ for military moves only	**17¢ for military moves only**
Charity	14¢	**14¢**

2020 deemed depreciation per business mile is 27¢. To compute the basis of a vehicle when the standard mileage has been used (generally when the vehicle is sold), the depreciation component of the standard mileage rate is 27¢ per mile.

Year	Amount
2020	27¢
2019	26¢
2017 & 2018	25¢
2015 & 2016	24¢
2014	22¢
2012 & 2013	23¢

Luxury Auto Depreciation Limits (§280F)

The 2019 maximum (2020 numbers are not yet available) amount of allowable depreciation for passenger automobiles, if the additional first-year depreciation deduction under §168(k) is claimed, is:

****Luxury auto depreciation numbers include bonus depreciation.		
Passenger Auto	Placed in service 2019	**Placed in service 2020 (TBA)**
Year One	$18,100	
Year Two	$16,100	
Year Three	$9,700	
Year Four	$5,760	
Year Five and thereafter	$5,760	
Five year total	$55,420	

Example. Ben bought a *used* BMW sedan in 2017 for $50,000. His 2017 depreciation was limited to $3,160. If he buys the BMW sedan in 2019, his depreciation is limited to $10,100, plus bonus depreciation of $8,000 whether the auto is new or used.

When business use is less than 100%. If business use is less than 100%, the maximum depreciation deduction is reduced by the percentage of personal use (§280F(a)(2)). For example, if business use is 90%, depreciation is limited to 90% of each amount in the chart.

Autos on a truck chassis with GVW in excess of 6,000 excluded. Applicable automobiles include passenger cars weighing 6,000 gross vehicle weight (GVW) or less, which are manufactured primarily for use on public streets, roads, and highways. Therefore, light vans or trucks may be included, whereas many full-sized pickups and large vans are excluded. Vehicles that by design or nature are not considered passenger cars (for example, taxicabs, ambulances, and hearses) are also not subject to these depreciation limitations (§280F(d)(5)).

Heavy SUVs. Heavy SUVs (i.e., those that are rated at more than 6,000 pounds gross (loaded) vehicle weight) are also exempt from the luxury-auto limitations because they don't meet the specific definition of a passenger auto (see §280F(d)(5) for definition). But, certain heavy SUVs purchased in 2020 may not elect to §179 expense more than $25,900 of their cost (§179(b)(6)). The balance of the heavy SUV's cost may be depreciated as five-year MACRS property. For this purpose, a sport utility vehicle is defined to ***exclude*** any vehicle that: (1) is designed for more than nine individuals in seating rearward of the driver's seat; (2) is equipped with an open cargo area, or a covered box not readily accessible from the passenger compartment, of at least six feet in interior length; or (3) has an integral enclosure, fully enclosing the driver compartment and load carrying device, does not have seating rearward of the driver's seat, and has no body section protruding more than 30 inches ahead of the leading edge of the windshield.

Tax practitioner planning. The GVW is listed on a metal plate on the inside of the driver's door.

One table for autos and a separate table for trucks and vans. There are two sets of annual depreciation dollar limits for non-electric vehicles, one for passenger autos that are not trucks or vans and are subject to the §280F luxury-auto limits (i.e., rated at 6,000 pounds unloaded gross vehicle weight or less), and one for light trucks or vans (passenger autos built on a truck chassis, including minivans and SUVs built on a truck chassis). Light trucks or vans are subject to the §280F luxury-auto limits if they are rated at 6,000 pounds (loaded) vehicle weight or less (§280F(d)(5)(A)). For 2018 and 2019, the auto table and the light truck are the same.

Leased Vehicle Inclusion Amount — In General (Rev. Proc. 2019-26)

To prevent avoidance of the personal use and luxury car limitations that apply to owned cars, a parallel system of limitations has been put in place for leased vehicles. Under this system, a taxpayer who leases a luxury car for business may be required to include an additional amount within his or her gross income in order to offset the deduction for the rental expense. The inclusion amount is calculated using annual tables provided by the IRS. The inclusion amount, based on the cost of the vehicle, generally applies to vehicles with a fair market value in excess of the following:

The lease term began in:	And the vehicle's FMV on the 1st day of the lease exceeded:
2017 Passenger autos	$19,000
2018 and 2019 Passenger autos	$50,000

Inclusion amount — calculation. Section 1.280F-7T provides that if a taxpayer leases a passenger automobile, the taxpayer must include in gross income an inclusion amount determined for each taxable year during which the taxpayer leases the automobile.

Calculation. For the appropriate range of fair market values and the table in §1.280F-7T, select the dollar amount from the column for the taxable year in which the automobile is used under the lease (but for the last taxable year during any lease that does not begin and end in the same taxable year, use the dollar amount for the preceding year).

1. Multiply the inclusion amount by a fraction equal to the number of days the car is leased during the year divided by 365.
2. Multiply the product in #1 by the car's percentage of business and investment use during the year.

TRANSPORTATION BENEFITS DEDUCTION

Qualified Transportation Fringe Benefits (§132; §1.132-1, 5, 9)

Excluded from gross income is the value of any qualified transportation fringe benefit provided by an employer to an employee to the extent that it does not exceed the applicable statutory monthly limit (§132).

Qualified parking and transit passes. Prior to 2018, there were three categories of qualified transportation fringes for purposes of determining the amount that is excludable from gross income: (1) qualified parking, (2) transportation in a commuter highway vehicle (for example, VanPool) and transit passes, and (3) a qualified bicycle commuting reimbursement fringe benefit. Commuters can receive both the transit and parking benefits monthly; that would be up to $530 per month.

Monthly	2018	2019	**2020**
Parking	$260	$265	**$270**
Transit pass	$260	$265	**$270**
Bicycling	$0	-0-	**-0-**

TCJA. Parking and Transit Passes Are Not Deductible, But Still Qualify As a Tax-Free Fringe Benefit (§132)

The expenses associated with providing any qualified transportation fringe to employees are not deductible, and except as necessary for ensuring the safety of an employee, neither are any expenses incurred for providing transportation (or any payment or reimbursement) for commuting between the employee's residence and place of employment unless the employer treats the benefits as taxable W-2 wages. This started for amounts paid or incurred after Dec. 31, 2017 (§132(f)(1),(5)).

> **Example**. Karen provides her employees with monthly CalTrain passes of $200. Beginning in 2018, the amount that Karen pays for transportation benefits passes is not deductible, although the CalTrain passes continue to be a tax-free fringe benefit to her employees.

Parking benefit includes costs of ownership. Clearly, the cost of providing parking to employees in a downtown, high-rise office building includes the monthly lease costs paid by the business. But wonder if the business owns its parking lot? Ownership costs are not deductible, and they may include depreciation, maintenance, security, utilities, snow removal, and similar costs.

2019-2020 Federal Lodging and Meal Per Diems

For fiscal year 2019-20, the per diem options available for (1) employee reimbursements and deductions and (2) self-employed deductions have been released (GSA 2020 Per Diem Highlights; GSA Per Diem Rates Look-Up; GSA Per Diem Files; GSA 2020 Highlights; GSA FY 2020 M&IE Breakdown). The new rates are effective through Sept. 30, 2020.

Meals/Lodging Per Diem Rates	**FY 2019-20 (Notice 2019-55)**	FY 2018-19 (Notice 2018-84)
Standard CONUS Rate	**$96 Lodging; $55 M&IE**	$94 Lodging; $55 M&IE
Meals, Lodging, and Incidentals	**$151 to $304 (Telluride)**	$149 to $501

High/Low M&IE Rate	**$297/$200**	$287/$195
Transportation Meal Flat Rate	**$66 (CONUS)**	$66 (CONUS)
Incidental Expenses only	**$5**	$5

The meals per diem deduction is available to the self-employed but not lodging per diem deductions. Self-employed individuals who wish to deduct per diem on their business returns may use the meal and incidental rate to substantiate travel meals but cannot use any federal per diem method containing lodging. Methods containing the lodging per diem are available exclusively to businesses (employers, its agents, or a third party) reimbursing employees for travel-away-from-home expenses. Therefore, to deduct lodging on a personal return, the self-employed must have actual receipts (Rev. Proc. 2010-39, §1). Self-employed individuals may always use actual allowable expenses, instead of per diems, to compute the deductible costs of business lodging, meals, and incidental expenses paid while traveling away from home as long as they maintain adequate records (or other sufficient evidence).

The requirements to use the per diem option. Per diem reimbursement is not taxable wages to the employee as long as the employee and employer follow three basic rules.

1. ***Major misunderstanding! "Adequate accounting" to the employer is required.*** The employee must timely substantiate to the employer "the elements necessary to determine the amount of the allowance (for example, the number of miles driven or the number of days away from home, and the time, place, and business purpose of the travel)" [Rev. Proc. 2011-47; §7.01]. The per diem must be paid with respect to ordinary and necessary business expenses incurred, or which the payor reasonably anticipates will be incurred, by an employee for lodging, meal, and incidental expenses or for meal and incidental expenses for travel away from home in connection with the performance of services as an employee of the employer (Rev. Proc. 2011-47, §3.01). If the employee does not timely substantiate to the employer, the per diem becomes taxable income and expenses are not deductible on Form 2106 (*B.J. Baugh*, TCM 1996-70; *R. L. Evans pro se v. Comm.,* TCM 2010-7).
2. ***Per diem cannot be more than the IRS-specified rates.*** The employee may only receive or deduct a per diem amount at or below the "IRS-specified standard rates" as enumerated in the previous chart. Any excess per diem creates W-2 income. The IRS-specified per diem rates are updated every October 1, not January 1. But, businesses may choose either the prior year rate or the current year rate for the last three months of the year.
3. ***Any per diem not substantiated must be returned.*** The employee must be required to return any portion of such an allowance which relates to days, miles, or travel not substantiated.

   Tax practitioner planning. "Cut and paste" the above three requirements to create a written "accountable plan" for each of your business clients with employees.

   Tax practitioner planning. The General Services Administration final regulations define incidental expenses under the Federal Travel Regulations §300-3.1 to include only fees and tips given to porters, baggage carriers, hotel staff, and staff on ships. Transportation between places of lodging or business and places where meals are taken, and the mailing cost of filing travel vouchers and paying employer-sponsored charge card billings, are not included in incidental expenses. Accordingly, taxpayers using the per diem rates may separately deduct or be reimbursed for transportation and mailing expenses.

Per diem rates available on the Internet. ***Domestic*** per diem rates can be found at "www.gsa.gov." GSA's per diem mobile app is also available and allows travelers to look up federal government per diem rates by city/state and ZIP code in locations throughout the United States and its territories. For ***foreign*** per diem rates, go here. Converting foreign dollars to US dollars for expense purposes can be done at Oanda.com.

Outside the continental United States (OCONUS). The rates for non-foreign localities outside the continental United States are established by the Secretary of Defense (including Alaska, Hawaii, Puerto Rico, the Northern Mariana Islands, and the possessions of the United States). The Secretary of State establishes rates for foreign localities. The rates are published in the Per Diem Supplement to the Standardized Regulations (Government Civilians, Foreign Areas) and are updated monthly. The rates can be found on the Department of Defense website.

How to Treat Per Diems Paid Under Accountable Plan or Under a Nonaccountable Plan

When are per diem allowances includible in W-2 income? The treatment of payments received by an employee subject to the employer's employee business expense reimbursement plan depends upon whether the plan is an accountable plan or a nonaccountable plan. If the expenses are reimbursed by the employer pursuant to an accountable plan, then the reimbursed amount is excluded from gross income and is not considered wages or other compensation (§1.62-2(c)(4)). But if the reimbursement is not made under an accountable plan, then the amount of the reimbursement is treated as wages and is includible in the employee's gross income (§1.62-2(c)(5)).

To qualify as an accountable plan, the plan must: (1) have a business connection; (2) require substantiation of expenses; and (3) require the return of amounts exceeding expenses incurred (§1.62-2(d), (e), and (f)).

Insurance Adjuster's Per Diem Paid Under a Nonaccountable Plan Reportable on W-2 (*Gary Patrick Johnson, pro se v. Comm.*, TCS 2017-71)

Employer included per diem in employee's W-2. Gary Patrick Johnson was employed as an insurance adjuster for Pilot Catastrophe Services, Inc. (Pilot). As reported on his Form W-2, Gary's wages from Pilot for 2013 amounted to $131,884, which included a total of $42,812 per diem travel allowances for lodging, meals, and incidental expenses he paid or incurred in connection with his employment. Gary argued that Pilot should not have treated the per diem allowances as includible in his taxable income.

Employee was entitled to the per diem allowances regardless of whether he paid or incurred any qualifying expense relating to the allowances *or* whether he could substantiate that expense. Consequently, the court held, the per diem allowances were not paid to Gary pursuant to an accountable plan. "It follows that the per diem allowances (were) properly includable, and were in fact included, in (Gary's)

2013 income." The court's conclusion on this point, of course, was supported by the fact that Pilot obviously considered the reimbursement plan a nonaccountable plan, as the company treated the reimbursements as wages.

> **Tax practitioner planning.** Planning is important, considering the suspension of the employee business expense deduction. To have converted the taxable reimbursement to non-taxable, all the employee needs to do is fill in an expense report and simply put the daily per diem into the "amount" column!

Concierge CFO Not Away From Home (*Michael and Miriam Mercado Brown v. Comm*., TCM 2019-30)

Michael Brown is an independent contractor carrying on as a "concierge CFO." Brown has had clients for his CFO business since at least 1998. At times, he has had as many as three clients simultaneously. Brown, his wife, and children live in a suburb of Atlanta.

In 2012, Brown entered into a three-year contract with American Furniture Rental (AFR) and was required to work four days a week in Pennsauken, New Jersey. He returned to his home in Atlanta, Georgia, for the rest of the week. AFR was the sole source of business income reported by Brown for the period beginning when he went to work for AFR and extending through 2013. The IRS disallowed Brown's deductions of traveling expenses between Atlanta and Pennsauken for years 2012 and 2013.

Not "away from home." A taxpayer's "home," for purposes of §162(a)(2), generally means the vicinity of his principal place of employment rather than his personal residence *(Mitchell v. Comm.,* 74 T.C. 578, 581 (1980); *Zbylut v. Comm.*, TCM 2008-44). A temporary work site might have provided a deduction for Brown. But Brown's work was not temporary. It was instead "indefinite" as his contract was for three years. The travel expenses were disallowed since Brown's "home" for the years at issue was New Jersey.

SECTION 163(j) INTEREST

TCJA. Limitations on Business Interest Deductions (§163(j), REG-106089-18)

The TCJA added new §163(j). This new rule generally limits the amount of a taxpayer's business interest deduction to the sum of:

1. The taxpayer's business interest income;
2. 30% (50% for 2019 and 2020) of the taxpayer's adjusted taxable income; and
3. The floor plan financing interest of the taxpayer.

CARES Eases Limitation for 2019 and 2020

The TCJA limited the business interest deduction to 30% of adjusted taxable income (§163(j)(10)). CARES increases the limitation on the deductibility of interest expense from 30% to 50% for tax years beginning in

2019 and 2020. The §163(j) limitation change does not apply to partners in partnerships for 2019 but applies only in 2020.

Business Interest Over the Threshold

Any business interest expense in excess of this threshold is carried forward indefinitely. There is a special carryforward rule for partnerships.

> **Note**. The limitation generally does not apply to small businesses (other than tax shelters), regulated public utilities, and electing farming or real property trades or businesses.

Floor plan financing. Floor plan financing interest means interest paid or accrued on floor plan financing indebtedness.

- Floor plan financing indebtedness means indebtedness used to finance the acquisition of motor vehicles held for sale or lease to retail customers and secured by the inventory so acquired. Motor vehicle means a motor vehicle that is: any self-propelled vehicle designed for transporting persons or property on a public street, highway, or road; a boat; or farm machinery or equipment.
- Once a taxpayer takes floor plan financing interest into account in calculating its business interest limitation, the taxpayer may not claim bonus depreciation under §168(k) for property placed in service during such year and subsequent years.
- The taxpayer can choose not to take floor plan financing into account in computing its business interest limitation, in which case the taxpayer may claim bonus depreciation (if floor plan financing was not taken into account in a prior year).

Prior-law and earnings stripping. Prior-law §163(j) limited a corporation's interest deduction in circumstances that indicated the corporation was paying interest to related parties to reduce US taxable income. Generally, the rule applied to a corporation with a high debt-to-equity ratio, making large interest payments (relative to adjusted taxable income) to related parties not subject to US tax (e.g., a foreign affiliate). Adjusted taxable income for purposes of prior-law §163(j) was defined to roughly approximate earnings before interest, tax, depreciation, or amortization (EBITDA). Because of its focus on reductions in the US tax base, this rule was often referred to as addressing "earnings stripping."

Law applies more broadly. The TCJA replaced prior-law §163(j), which has broader application. The new rule:

1. Applies to business interest expense of all taxpayers (not just corporations) regardless of debt-to-equity ratio and regardless of status of the lender (i.e., related or unrelated);
2. Retains old §163(j)'s focus on the relationship between interest payments and an adjusted taxable income; and
3. Addresses debt financing generally and does not focus primarily on scenarios reflecting the potential for earnings stripping.

The limitation applies at the taxpayer level. For example, the limitation applies at the consolidated tax return filing level, because the consolidated group is a single taxpayer. For partnerships and S corporations, the limitation applies at the entity level.

Adjusted taxable income. Adjusted taxable income (ATI) means the taxable income of the taxpayer computed without regard to:

- Any item of income, gain, deduction, or loss that is not properly allocable to a trade or business;
- Any business interest or business interest income;
- The amount of any net operating loss deduction;
- The amount of any deduction allowed under §199A.

EBITDA and EBIT. For taxable years beginning before Jan. 1, 2022, ATI is computed without regard to any deduction allowable for depreciation, amortization, or depletion. This definition of ATI generally corresponds with the financial accounting concept of EBITDA. For taxable years beginning on or after Jan. 1, 2022, ATI is computed with regard to deductions for depreciation, amortization, and depletion. This definition of ATI generally corresponds with the financial accounting concept of earnings before interest and taxes, or EBIT.

> **Note**. As a result, for taxpayers with such deductions, the limitation becomes more stringent in taxable years beginning on or after Jan. 1, 2022.

Carryforward rules. For taxpayers other than partnerships, the amount of any business interest not allowed as a deduction for any taxable year is treated as business interest paid or accrued in the succeeding taxable year. The business interest carried forward is added to any business interest in the succeeding year and then subjected to the limitation for that year.

- For corporations, this carryforward is subject to limitation by §382 (change of ownership and carryforward tax attributes).
- For partnerships and S corporations, the limitation applies at the entity level. Any business interest in excess of the entity's limitation is allocated to the owners in the same manner as the owner's distributive share of the entity's interest expense.

Special carryforward rules for partnerships. In the case of a partnership, the general entity-level carryforward rule does not apply. Instead, any business interest that is not allowed as a deduction to the partnership for the taxable year is allocated to the partners.

> (1) In the current year, without regard to carryovers, the ability to deduct partnership business interest is limited by partnership business interest income, partnership ATI, and partnership floor plan financing;
> (2) Any interest that is not deductible in the current year does not carry forward at the partnership level, but rather is allocated to the partners, where future potential deductions depend on future amounts allocated from the partnership that generated the carryforward; and

(3) A partner's ability to deduct a carryforward in the future may depend not only on business interest income allocated to the partner by the partnership that generated the carryforward, but also on other activities of the partner or entities the partner owns.

Exceptions — small business. Section 163(j) does not apply to any taxpayer (other than a tax shelter) for which the average annual gross receipts for the three-taxable-year period ending with the prior taxable year does not exceed $26 million (for 2020) .

Note. The trade or business of performing services as an employee is not treated as a trade or business for purposes of the limitation. As a result, for example, the wages of an employee are not counted in the adjusted taxable income of the taxpayer for purposes of determining the limitation.

BUT §163(j) applies to a tax shelter. The small business exception does not apply to tax shelters. Tax shelters are defined in §448(d)(3) and 461(i)(3). §461(i)(3) provides that the term "tax shelter" means:

1. any enterprise (other than a C corporation) if at any time interests in such enterprise have been offered for sale in any offering required to be registered with any federal or state agency having the authority to regulate the offering of securities for sale,
2. any syndicate (within the meaning of §1256(e)(3)(B)), and
3. any tax shelter (as defined in §6662(d)(2)(C)(ii)).

Syndicate for this purpose is defined as any partnership or other entity (other than a C corporation) if more than 35% of the losses of the entity during the tax year are allocable to limited partners or limited entrepreneurs. The meaning of "limited entrepreneur" is provided in §461(k)(4) as a person who has an interest in an enterprise other than as a limited partner and who does not actively participate in the management of that enterprise. Thus, an LLC that allocates losses to members more than 35% of which are not active in the management is a tax shelter and subject to §163(j).

Elections — real property and farming. At the taxpayer's election, any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business (i.e., any electing real property trade or business[1]) is not treated as a trade or business for purposes of the limitation, and therefore the limitation does not apply to such trades or businesses.

- An electing real property trade or business is required to use the alternative depreciation system ("ADS," a slower system of cost recovery than might otherwise be available) to depreciate any of its nonresidential real property, residential rental property, qualified improvement property, qualified leasehold improvement property, qualified retail improvement property, and qualified restaurant property.

[1] Real property trade or business uses the definition in §469(c)(7)(C).

Similarly, at the taxpayer's election, any farming business[2] or any business engaged in the trade or business of a specified agricultural or horticultural cooperative, is not treated as a trade or business for purposes of the limitation, and therefore the limitation does not apply to any such trade or business.

- Examples of a farming business include the trade or business of operating a nursery or sod farm; the raising or harvesting of trees bearing fruit, nuts, or other crops; the raising of ornamental trees (other than evergreen trees that are more than six years old at the time they are severed from their roots); and the raising, shearing, feeding, caring for, training, and management of animals. A farming business also includes processing activities that are normally incident to the growing, raising, or harvesting of agricultural or horticultural products, but not contract harvesting or buying and selling animals or farm products raised by another farmer.
- An electing farming business is required to use ADS to depreciate any property with a recovery period of 10 years or more.

Rev. Proc. 2020-22 provides guidance regarding the election under §163(j)(7)(B) to be an electing real property trade or business and the election under §163(j)(7)(c) to be an electing farming business for purposes of the business interest expense deduction limitation under §163(j).

Form 8990

Use Form 8990 to figure the amount of business interest expense you can deduct and the amount to carry forward to the next year. A taxpayer with business interest expense, a disallowed business interest expense carryforward, or current year or prior year excess business interest expense generally must file Form 8990, unless an exclusion from filing applies. A pass-through entity allocating excess taxable income or excess business interest income to its owners (that is, a pass-through entity that is not a small business taxpayer) must file Form 8990. Instructions are here.

IRS Issues FAQs Regarding §163(j) (Basic Questions and Answers, Nov. 6, 2019)

The IRS has provided on its website the answers to 17 basic questions about the limitation on the deduction for business interest expense, also known as the "section 163(j) limitation." The FAQs are not updated for CARES changes.

IRS Issues Guidance on Business Interest Expense Limitations (Notice 2018-28)

Notice 2018-28 clarifies the treatment of interest disallowed and carried forward under §163(j) prior to the TCJA enactment. The notice describes aspects of the regulations that the Treasury Department and the IRS intend to issue, including rules addressing the calculation of the business interest expense limitation at the level of a consolidated group of corporations and other rules to clarify certain aspects of the law as it applies to corporations. Finally, the notice makes it clear that partners in partnerships and S corporation shareholders

[2]Farming business uses the definition in §263A(e)(4).

cannot interpret newly amended §163(j) to inappropriately "double count" the business interest income of a partnership or S corporation.

THE OFFICE-IN-HOME REQUIREMENTS - §280A

Primer on Office in Home Rules: Strict Rules Prevent Abuse (Form 8829 - Expenses for Business Use of Your Home)

> **Tax practitioner planning.** Do you need something quick to send to a client about the home office deduction? If so, see IRS Tax Tip 2019-66 titled "Home office deduction benefits eligible small business owners."

General rule. No deduction is allowed with respect to the use of a dwelling unit used by an individual or an S corporation during the taxable year as a residence (§280A(a)).

Exception for interest, taxes, casualty losses, etc. The general rule does not apply to any deduction allowable to the taxpayer without regard to its connection with his trade or business (or with his income-producing activity) [§280A(b)].

> **Tax practitioner planning.** Home office is business debt, not home acquisition debt.

Exclusive and regular. To deduct expenses related to the business use of part of the home, the taxpayer must meet specific requirements. Even then the deduction may be limited. For home office expenses to qualify for a deduction, the portion of the home that is used for business must:

1. be used *exclusively* (however, exceptions exist, see: *James A. and Joan H. Soholt v. Comm.*, TCS 2007-49, where a few personal papers in the home office didn't disqualify the home office deduction),
2. on a *regular* basis,
3. in connection with a *trade or business*, AND

in ***one*** of the following ways:

4. as the *principal place of business* for any of the taxpayer's trade or business, or
5. as a place of business for meeting or dealing with patients, clients, or customers in the ordinary course of business, or
6. in connection with the taxpayer's trade or business if the taxpayer is using a separate structure that is not attached to the dwelling (§280A(c)(1)).

No other fixed location. A home office qualifies as the taxpayer's "principal place of business" IF *there is no other fixed location of the trade or business where the taxpayer conducts substantial administrative or management activities of the trade or business* (§280A(c)(1)). This means that outside salespersons and real estate agents will often be able to deduct an office in their home.

> **Tax practitioner planning.** Miscellaneous itemized deductions have been suspended after Dec. 31, 2017, and before Jan. 1, 2026. Therefore, an employee cannot deduct home office expenses.

The meaning of "home." The term home includes a house, apartment, condominium, mobile home, or boat. It also includes structures on the property, such as an unattached garage, studio, barn, or greenhouse. However, it does not include any part of the property ***used exclusively*** as a hotel or inn (§1.280A-1(c)(2)).

Use the square-footage method because room-by-room allocation is no longer permitted. According to the instructions of Form 8829, the room-by-room method is available only if "the rooms in the house are all about the same size" (that is, each bathroom is the same size as the living room, etc.), which is a ridiculous requirement. Edward Andrews claimed a deduction based on the ratio of rooms in the house, but the court determined that the home-office expenses should more reasonably be allocated on a square-footage basis (*E. W. Andrews v. Comm.*, 60 TCM 277, TCM 1990-391; CA-1 91-1 USTC ¶50,211; *Abhimanyu Swain, pro se v. Comm.*, TCM 1996-22, (CA-4), No. 96-1170, 96-2 USTC ¶50,480).

Employee renting office-in-home to employer doesn't work. Section 280A specifically disallows the deduction of any expenses incurred when an employee rents a personal residence to his employer for business purposes (*Leslie A. and Betsy M. Roy v. Comm.,* TCM 1998-125). Therefore, a home office deduction is even barred when an employee leases a portion of his or her home to the employer at fair market value. This rule also extends to an independent contractor who attempts to lease to the party for whom he or she perform services (for example, a real estate agent should not lease office space located at home to his or her broker/owner) (§280A(c)(6)).

> **Tax practitioner planning.** IR-2017-96 is a plain language explanation of the home office deduction for providing quick information to a client's query on his or her home office, EXCEPT before using this IRS information release, be sure to note that employees cannot take a home office deduction for 2018 through 2025.

Medical Doctor (MD) Working As Hospitalist at Medical Center Not Supplied an Office at Work and Denied Office at Home (*Atul Gambhir and Rashi Gambhir, v. Comm.*, TCS 2020-4)

MD Employee. During 2012, the year at issue, Dr. Rashi Gambhir worked as a hospitalist for Northeast Georgia Medical Center (NGMC). She was paid on a per-shift basis rather than on a salary and provided services to the hospital under her own control and supervision. The hospital provided certain equipment; however, Dr. Gambhir would bring her own stethoscope and her cellphone, which was used for medical-related pages. Her daily uniform consisted of scrubs, a lab coat, and comfortable medical shoes used primarily in the hospital. Dr. Gambhir was not reimbursed for these job-related expenses; however, it is unclear whether the lack of reimbursement was due to hospital policy or her failure to seek it. Every year since joining NGMC in 2009 or 2010 Dr. Gambhir received a Form W-2, Wage and Tax Statement, that reported her income as "Wages, tips, other compensation." NGMC did not check the box for statutory employee status on Dr. Gambhir's Form W-2 for tax year 2012.

Dr. Gambhir's basement is an 850-square-foot area designated as a home office and used solely for that purpose. It is furnished with a computer, a printer, a desk, shelves with books, and a cabinet stocked with office supplies. Dr. Gambhir used the home office to take calls related to meetings she attended; complete online seminars for her continuing medical education; and provide any necessary followup on patient care. During 2012, Dr. Gambhir had one Internet account used for both the home and the home office and paid cash to have the entire house cleaned monthly.

Dr. Gambhir did not meet with patients at her home, nor is the basement home office a separate structure which is not attached to her dwelling unit. That leaves only the exception for its use exclusively and on a regular basis as the principal place of business for any trade or business. The term "principal place of business" includes a place of business which is used by the taxpayer for the administrative or management activities of any trade or business of the taxpayer if there is no other fixed location of the trade or business where the taxpayer conducts substantial administrative or management activities of the trade or business. Additionally, in the case of an employee, the exclusive use must be for the convenience of the employer (§280A(c)(1).

Court denies office in home. The Tax Court concluded that Dr. Gambhir's basement was not her principal place of business within the meaning of §280A(c)(1). The office was mainly used for continuing medical education and professional development. Accordingly, Dr. Gambhir's principal place of business was the hospital where she treated patients, not her home office.

Regular and Exclusive Use Required (*Clifton and Judith Gibbs v. Comm*., CA-4, 2019-1 ¶50,180 (Mar. 18, 2019)

Section 280A(c)(1)(A) allows a taxpayer to deduct expenses for the business use of his residence, but only to the extent the expenses are allocable to a portion of the residence which is exclusively used on a regular basis as the principal place of business for a trade or business of the taxpayer. Mr. Gibbs gave very general testimony about having a home office, but he provided no floor plan or other information to establish a portion of the house used exclusively for business, and he provided no information about the expenses incurred to maintain his residence. He proved no deductible home office expense.

Storage Space Denied Even Though Dwelling Unit Was "Principle Place of Business" (*Mohammad Najafpir, pro se v. Comm.*, TCM 2018-103)

Business location didn't have space to store smog check reports for three years, so he stored them in his apartment garage four doors away. Mohammad Najafpir (Najafpir) owned AA+ Smog Check, a smog inspection station in Burlingame, California, with a slogan "Smog and a Smile." Najafpir lived in a one-bedroom apartment four doors down the street from AA+. His rent of $1,450 per month entitled him to the use of his apartment, as well as shared laundry facilities and one-half of a shared two-car garage that was attached to the apartment building. Najafpir did not park his car in the garage but instead used the space as business storage. As an owner of a smog check business, Najafpir was required by the State of California to keep certain invoices and records regarding smog checks for at least three years. Invoices must be kept on location for purposes of immediate inspection. AA+ had no formal office or storage space, and Burlingame area real estate was expensive. Given the proximity and availability of his garage, Najafpir used it as storage for his business records, including the state-mandated smog inspection invoices. In addition to these business records, Najafpir also stored business-related items such as backup air compressors, printers, monitors for the smog machine, and various parts such as oil filters and wipers. He stored no personal items of note or value in the garage, save for some pencils and stationery.

Because invoices weren't inventory or product samples, he loses his home office deduction. Can this be correct? Judge's opinion: Generally deductions "for otherwise allowable expenses with respect to the use of an individual taxpayer's home are prohibited." This prohibition, however, does not apply to space allocable within a "dwelling unit which is used on a regular basis as a storage unit for the inventory or product samples of the taxpayer held for use in the taxpayer's trade or business of selling products at retail or wholesale, but only if the dwelling unit is the sole fixed location of such trade or business" (§280A(a); §280A(c)(2)). Najafpir argued "he is entitled to these deductions because the garage was used to store business records. (Najafpir) was required to maintain these records by the State of California, and his garage was the most convenient and inexpensive place to do so." The judge concluded Najafpir "does not fit within the exception of §280A(c)(2), nor does he qualify for any other exceptions to §280A(a). (Najafpir) is not in the trade or business of selling products at retail or wholesale, and his business records and invoices do not constitute inventory. Therefore, (Najafpir) is not entitled to a deduction for his claimed home office expenses..."

Also see.

- *Michael E. Brown v. Comm.,* 11th Cir. 19-12653 2020-1 USTC ¶50,130 (Mar. 20, 2020), where Concierge CFO was denied office in home for bad records of exclusive use.
- *Daniel Imperato v. Comm.*, TCM 2018-126, where the taxpayer deducted expenses allocable to 37.5% and 50% of his residence for 2008 and 2009, respectively, but did not maintain records to establish the business use, and the payment of the expenses. Imperato failed to produce any records to substantiate the amounts of his mortgage interest, real estate taxes, utilities, or management fees.
- *Andrew and Sara Berry v. Comm.*, TCM 2018-143), where Andrew did not provide any evidence to show that a portion of his residence was exclusively used for business or how he calculated that a portion of his residence was used for business.

Home Office Simplified Method (Rev. Proc. 2013-13)

The IRS allows an optional simplified method for home office users to calculate their deductible home office expenses. The safe harbor method is an alternative to the calculation, allocation, and substantiation of actual expenses currently required under §280A. The safe harbor is elective, and the election is made annually by simply using the safe harbor calculation.

Five dollars multiplied times maximum of 300 square feet allowed. Under the safe harbor method, qualifying taxpayers calculate the home office deduction by multiplying the square footage of the portion of the home used for business (300 square feet maximum) times the $5 prescribed rate (IRS may update the prescribed rate periodically). The maximum deduction allowed under the safe harbor method is $1,500 (300 sq. ft. x $5).

> **Tax practitioner planning.** All other home office requirements apply (for example, exclusive use, principal place of business, etc.).

How do we start and stop home office depreciation? Taxpayers who use the safe harbor method for a taxable year and use actual expenses for any subsequent taxable year must calculate the depreciation deduction allowable in subsequent years using the appropriate 39-year life. A taxpayer computes depreciation in a year subsequent to using the safe harbor method by multiplying the remaining adjusted home office depreciable basis by 39 years.

Limited double dipping allowed. Taxpayers who itemize deductions and use the safe harbor method may deduct expenses related to her or his home that were otherwise deductible (for example, mortgage interest, property taxes, and casualty losses). Additionally, taxpayers who use the safe harbor method are not required to recapture any depreciation upon the sale of the residence.

Home office deduction cannot create a deductible loss under safe harbor or actual method, but excess actual home office deductions may be carried forward. The deduction computed using the safe harbor method cannot exceed the gross income derived from the qualified business use of the home for the taxable year reduced by the business deductions unrelated to the qualified business use of the home. Any amount in excess of this gross income limitation is disallowed and **may not** be carried over to future years unless the actual expense method is used to calculate the deduction. Also, taxpayers who use the safe harbor method may not deduct any carryforward home office deductions from a prior year where the taxpayer used actual expenses. Such deductions are carried forward to the next succeeding taxable year in which the taxpayer deducts actual home office expenses.

Minimizing the impact on property taxes and mortgage interest. The Schedule A tax deduction is limited to $10,000. It also limits the home mortgage interest deduction to a loan of $750,000 (the prior law $1,000,000 debt limit is grandfathered for loans originating before Dec. 15, 2017). If part of the house is used for a qualifying home office, a percentage of property tax and mortgage interest is deductible on the Form 8829. Perhaps, this allocation will help avoid some of the negative impact.

> **Example**. John uses 20% of his home regularly and exclusively as the principal place of business for his consulting business. He gets no benefit for the property taxes he pays because his state income tax exceeds the $10,000 limit. His home acquisition debt is $900,000 (exceeding the $750,000 limit by $150,000). John avoids some of the negative impact to his Schedule A deductions as he is able to claim 20% of his property tax and mortgage interest as a home office expense on his Schedule C.

PARTIAL DISPOSITIONS

Partial Disposition Loss Allowed (§1.168(i)-8; Rev. Proc. 2014-54; FAA 20154601F)

Building owners may write off adjusted cost of a component when it is replaced. Taxpayers who replace a portion of a building or building system may write off the disposed property's remaining original basis at the time the item is replaced. These rules may be used to write off the apportioned net tax basis of any part of a building including siding, windows, roofs, HVAC systems, elevators, etc.

Example. Doug replaces an elevator in a retail building he owns. Doug makes the "partial disposition" election for the elevator. Doug reports the disposition of the old elevator on Form 4797 as a loss in the amount of any remaining basis of the old elevator.

Safe harbor provided to compute the partial disposition loss. Taxpayers may use any reasonable method to compute the amount of the cost basis and accumulated depreciation of the disposed asset and the related loss. The regulations also provide three safe harbor methods that may be used to calculate the loss:

1. ***PPI method.*** Taxpayers discount current year replacement costs back to the year the building was acquired using the Producer Price Index for finished goods or Producer Price Index for final demand to inflation adjust the amount. This method is only available if the replacement isn't an improvement or "adaption" of an asset to a new or different use.
2. ***Replacement cost method.*** Replacement cost of the disposed of asset divided by the replacement cost of the entire asset.
3. ***Cost segregation study or analysis method.*** Taxpayers may prepare a study that allocated the cost of the entire asset to its components (for example, a cost segregation study).

Audit Techniques Guide on Cost Segregation, Updated Feb. 26, 2019

Cost segregation is the process of examining all the physical components of a property, reclassifying them based on their life expectancy, and often reclassifying (27.5 or 39-year depreciable life) real property to personal property (five to 15 year depreciable life) [*AmeriSouth v. Comm.,* TCM 2012-67)]. A cost segregation study often defends the amounts being reclassified.

The Audit Techniques Guide on Cost Segregation has been updated by the IRS. Several chapters were reorganized, expanded, and updated, and special topics, including uniform capitalization and change of accounting method, were added.

Tax practitioner planning. If a client is considering a cost segregation study, this ATG is required reading, if not for the client, then for the client's tax advisors.

Tax practitioner planning. A cost segregation study is even more important now that partial disposition losses are allowed. The study helps confirm the adjusted basis of the disposed property.

Tax practitioner planning. Preparers should also be alert to review depreciation schedules for assets that are completely depreciated. Removing such depreciated assets via the partial disposition rules eliminates the corresponding depreciation recapture upon sale of the building. The result is a conversion of gains on the sale of the building from unrecaptured depreciation gain (maximum tax rate 25%) to capital gains (maximum tax rate 20%).

Calculating the Partial Disposition Loss

Example. KHS paid $100,000 to replace the plumbing in its commercial building. KHS estimated the cost to rebuild the entire building would be $1,000,000. The net tax basis of the building is

$656,450. The deductible loss on disposition of the old plumbing is $65,645 (($100,000÷$1,000,000) x $656,450).

Claiming the Partial Disposition Loss on the Tax Return

To claim a partial disposition loss on the current tax return, divide the original building into two smaller sub-assets and then "sell" the component that was replaced.

Example. The KHS depreciation schedule shows the building with an original cost basis of $800,000 and accumulated depreciation of $143,500. Divide the building into two assets and then use your tax software to sell the old plumbing with a zero sales price. This will result in a $65,645 ordinary loss showing on the Form 4797.

	Original Cost	Acc. Depreciation	Remaining Basis
Building (remaining)	$720,000	$129,195	$590,805
Old plumbing	$80,000	$14,355	$65,645
Totals	$800,000	$143,550	$656,450
New plumbing	$100,000	-0-	-0-

Section 469 warning! The passive loss rules apply to this partial disposition loss. Only in a complete disposition is the loss deductible. Otherwise, it is suspended and used in a year when there is passive income or at the complete disposition of the property.

No double dipping allowed. The partial disposition election is only allowed for items that are replaced with improvements that are capitalized. If the taxpayer treated the expenditure as a repair expense on its tax return, the partial disposition rules will not apply.

Example. KaBro spent $50,000 to replace the rubber roof membrane on its commercial building but did not make any repairs or improvement to the actual roof structure. KaBro deducted the entire $50,000 as a repair expense on its tax return. KaBro cannot not take an additional deduction for the partial disposition of the replaced roof membrane.

Variation. Assume the same facts as above except when KaBro removed its existing roof membrane, it found that there was damage to the underlying structural components of the roof. KaBro spent $150,000 to not only replace the roof membrane, but also to completely rebuild the underlying roof structure. KaBro capitalized the entire project and elected to utilize the partial disposition rules to expense the old roof structure and roof membrane.

Variation. Assume the same facts as above except KaBro expensed the new roof under the expanded §179 rules. KaBro cannot use the partial disposition rules for the old roof.

Timely election required. Taxpayers generally must make a partial disposition election on their timely filed, original tax return (including extensions).

No formal election required. The partial disposition rules are elective, and taxpayers make the election by simply deducting the loss on the return. Taxpayers making the election create a separate line on the depreciation schedule as of the beginning of the year of disposition. The new line includes a pro rata portion of the building's original cost and accumulated depreciation. The new line item is then depreciated normally in the year of acquisition, and the remaining basis of the asset disposed of is written off on Form 4797.

Late partial disposition election allowed if IRS auditor capitalizes repairs. The regulations provide some degree of "audit insurance" for taxpayers who deduct too much in repairs expense. If, under audit, the IRS disallows a portion of a taxpayer's repair deductions, the taxpayer may file Form 3115, Change in Accounting Method, and deduct the partial disposition loss as a §481(a) adjustment. While the deduction would not be allowed in the year the IRS audit adjustment was made, it would be allowed in the year for which Form 3115 was filed. This change is an automatic accounting method (may be filed by the extended due date of the return). See Rev. Proc. 2014-54 for additional partial disposition accounting method change guidance.

DEPRECIATION/MACRS §167 & §168

Apportionment of Basis (§1.167(a)-5)

If depreciable property and nondepreciable property such as real property with improvements are bought for a lump sum, the cost must be apportioned between the land and the improvements (§1.167(a)-5). In making this allocation, §1.167(a)-5 provides "(i)n the case of the acquisition . . . of a combination of depreciable and nondepreciable property for a lump sum, as for example, buildings and land, the basis for depreciation cannot exceed an amount which bears the same proportion to the lump sum as the value of the depreciable property at the time of acquisition bears to the value of the entire property at that time." The relevant inquiry is the respective fair market values of the depreciable and nondepreciable property at the time of acquisition (*Weis v. Comm.*, 94 TC 473 (1990) No. 26336-88; No. 27526-88; No. 27526-88; No. 27527-88; No. 30233-88; No. 30235-88; *Randolph Bldg. Corp. v. Comm.*, 67 TC 804, 807 (1977)).

> **Tax practitioner warning.** If part of the purchase price is allocated to personal property, such as furniture and fixtures, be careful of the new §1031 rules. §1031 no longer allows an exchange of personal property.

Boat and RV Depreciation Expenses Denied; Personal Home Not Converted to Income Producing Property (*Carlos and Pamela Langston v. Comm.*, TCM 2019-19)

Carlos and Pamela Langston owned Port Carlos Marina in Ketchum, Oklahoma, and a private residence referred to as the "75th Place" property. The court pointed out that Mr. Langston holds a bachelor's degree in accounting and a juris doctorate from the University of Tulsa. Mrs. Langston is a partner in a mid-sized law firm and is the named attorney on at least two Tax Court cases.

Boat and RV. In 2011, the Langstons bought a Meridian 580 boat for $245,920 and a Raptor RV for $69,092. In 2012, the Langstons deducted depreciation expenses on their Schedule C of $139,996 for the Meridian 580 and $30,708 for the Raptor RV. In 2013, deductions for the boat and RV were $36,421 and $10,234.

> **Note**. Their tax preparer was not provided documentation of the business use of either vehicle. The court pointed out that the preparer held a bachelor's degree in accounting, a master's degree in taxation, and a juris doctor degree from the University of Tulsa.

75th Place residence. Taxpayers purchased the 75th Place property in 1997 and lived there until 2005 when renovations were undertaken and completed in 2010. In 2011, the taxpayer were notified they would lose their homeowner insurance unless the home was occupied. The house was vacant, so Mr. Langston rented it to a fraternity brother at a rent below fair market value. In 2013, the property was sold for $540,000. On their 2013 return they claimed a Form 4797 loss deduction of $436, 633 relating to the sale of 75th Place. The loss was computed by using the original 1997 purchase price plus additions to arrive at a basis of $1,027,415. The acquisition date on the Form 4797 was in 2011, the date it was converted to income producing property and had an estimated fair market value of just below the sale price. Under audit, the boat and RV expenses were disallowed for not being ordinary and necessary for a trade or business. The loss deduction on the sale of the 75th Place property was disallowed because it was their primary residence.

Meridian 580 boat and Raptor RV not used for business. The Langstons argued both the boat and the RV were used as offices for Port Carlos Marina, where they were stored. The only evidence provided was the testimony of the Langstons and the marina general manager. In 2014, an IRS revenue agent toured the Meridian 580 and Raptor RV and found no signage identifying the vehicles as an office, nor were there any logs to indicate how they were used, which is required for listed property. In addition, upon inspection the agent noted numerous personal items, suitcases, clothing, and a pot on the stove which gave the impression neither was used as a sales office. The court agreed with the IRS and disallowed the deduction.

75th Place property not converted from personal to business. The court focused on whether the former personal residence was converted to income-producing property. Taxpayers lived in the property for eight years before moving out. Moving out of personal residence can sometime be evidence of intent to convert. However, in this case, the conversion to business use was not until seven years after they moved out of the property, which is a strong indication there was no intent to convert at that time. The rental of the property at below market value was solely for insurance purposes and not a factor that would indicate a profit motive. Based on this, the court agreed the property was not converted to income-producing purposes.

Accuracy-related penalties apply. The accuracy-related penalty will not apply where a taxpayer establishes that he or she had reasonable cause and acted in good faith. A taxpayer who relied on the advice of an independent, competent professional as to the tax treatment of an item might escape these penalties. The court repeated that the preparer is a qualified professional and that the Langstons are well-educated, sophisticated individuals. The preparer testified that she relied on oral and implied information from the Langstons without documentation. The Langstons have failed to prove they provided accurate and credible information to their preparer and therefore they cannot avail themselves of a good faith and reasonable cause penalty defense. Further, the court found that because the Langstons knew they had not provided necessary and accurate information to their tax preparer, their reliance upon her was unreasonable and not in good faith. Accuracy-related penalties of $60,894 were assessed along with a tax deficiency of $305,297.

§179 EXPENSING

TCJA. §179 Amount Increased for Tax Years Beginning After Dec. 31, 2017

The maximum amount a taxpayer may expense under §179 has been increased to $1,040,000, and the phase-out threshold amount has been increased to $2,590,000, beginning in 2020.

§179 Expensing Options				
Year	2017	2018	2019	**2020**
Maximum §179 deduction	$510,000	$1,000,000	$1,020,000	**$1,040,000**
Maximum annual property before phase-out	$2,030,000	$2,500,000	$2,550,000	**$2,590,000**

> **Tax practitioner planning**. The maximum annual qualifying property amount did not increase proportionally to the increase in the maximum §179 deduction.

TCJA. Property qualifying for §179 includes personal property in lodging facilities. The definition of §179 property was expanded to include certain depreciable tangible personal property used predominantly to furnish lodging or in connection with furnishing lodging, including beds and other furniture, refrigerators, ranges, and other equipment used in the living quarters of a lodging facility such as an apartment house, dormitory, or any other facility (or part of a facility) where sleeping accommodations are provided and let (§1.48-1(h)).

TCJA. Non-residential real property qualified. The definition of qualified real property eligible for §179 expensing has been expanded to include any of the following improvements to nonresidential real property placed in service after the date such property was first placed in service:

- roofs;
- heating, ventilation, and air-conditioning property;
- fire protection and alarm systems; and
- security systems.

TCJA. Qualified improvement property definition changed. The separate rules for restaurant improvements, retail property improvements, and leasehold improvements are gone. They've been consolidated into a "qualified improvement property" category. Qualified improvement property qualifies for §179 expensing.

BONUS DEPRECIATION (§168(k))

General Requirements

To prevent abuses, the additional first-year depreciation deduction applies only to property purchased in an arm's-length transaction. It does not apply to property received as a gift or from a decedent. In the case of trade-ins, like-kind exchanges, or involuntary conversions, bonus depreciation applies only to any money paid in addition to the traded-in property or in excess of the adjusted basis of the replaced property. It does not apply to property acquired in a nontaxable exchange such as a reorganization, to property acquired from a member of the taxpayer's family, including a spouse, ancestors, and lineal descendants, or from another related entity as defined in §267, nor to property acquired from a person who controls, is controlled by, or is under common control with, the taxpayer. It does not apply, for example, if one member of an affiliated group of corporations purchases property from another member, or if an individual who controls a corporation purchases property from that corporation.

TCJA. §168(k) Bonus Depreciation Increased to 100% (§168(k); §1.168(k); Rev. Proc. 2017-33)

TCJA. §168(k) has been extended and modified through 2026 (through 2027 for longer production period property and certain aircraft). The 50% allowance is increased to 100% for property placed in service after Sep. 27, 2017, and before Jan. 1, 2023 (Jan. 1, 2024, for longer production period property and certain aircraft), as well as for specified plants planted or grafted after Sep. 27, 2017, and before Jan. 1, 2023.

§168(k) Bonus Depreciation Chart						
1-1-15 to 9-26-17	**9-27-17 to 12-31-22**	1-1-23 to 12-31-23	1-1-24 to 12-31-24	1-1-25 to 12-31-25	1-1-26 to 12-31-26	After 12-31-26
50%	**100%**	80%	60%	40%	20%	-0-
New property	New or used property					N/A

> **Tax practitioner planning**. The taxpayer may elect out of the additional first-year depreciation for any class of property for any taxable year (§168(k)(7)). For the definition of a class of property, see §1.168(k)-1(e)(2). The additional first-year depreciation deduction is not available for any property that is required to be depreciated under the alternative depreciation system of MACRS (§168(k)(2)(D)(i)).

TCJA. New or used property. The requirement that the original use of qualified property must commence with the taxpayer has been eliminated. Thus, bonus depreciation applies to purchases of used as well as new items.

TCJA. Film, TV, and live theater qualifies. The definition of qualified property eligible for the additional first year depreciation allowance has been expanded to include qualified film, television, and live theatrical productions placed in service after Sep. 27, 2017, and before Jan. 1, 2027, for which a deduction otherwise would have been allowable under §181 without regard to the dollar limitation or termination of such section. A production is considered placed in service at the time of initial release, broadcast, or live staged performance (i.e., at the time of the first commercial exhibition, broadcast, or live staged performance of a production to an audience).

TCJA. Qualified improvement property category no longer qualifies for bonus depreciation. Qualified leasehold improvements, retail improvements, and restaurant improvements were moved to qualified improvement property. Tax writers intended to give these qualified real property improvements a 15-year recovery period and to make them eligible for bonus depreciation. Because of an apparent drafting error, the statute does not include the 15-year life. Thus, restaurant improvements, retail property improvements and leasehold improvements are depreciated over 39 years.

TCJA. AMT credits can't be accelerated. The election to accelerate AMT credits in lieu of bonus depreciation has been repealed.

Final and Proposed Regulations Released for §168(k) (TD 9874 , and REG-106808-19 (Sep. 13, 2019))

The final regulations finalize the proposed regulations issued in August 2018 which implement several provisions included in the TCJA. The final regulations provide clarifying guidance on the requirements that must be met for property to qualify for the deduction, including used property. The final regulations also provide rules for qualified film, television, and live theatrical productions.

Used property. The regulations provide that the acquisition of used property is eligible for bonus depreciation deduction if such acquisition meets the following requirements (§1.168(k)-2(b)(3)):

- the property was not used by the taxpayer or a predecessor at any time prior to the acquisition;
- the acquisition of the property meets the related party and carryover basis requirements of §179(d)(2) and §1.179-4(c)(1), or (c)(2); and
- the acquisition of the property meets the cost requirements of §179(d)(3) and §1.179-4(d).

Leaseback property. A lessee who leases an asset and acquires such asset at the end of the lease term will not be treated as having used the asset prior to its acquisition for purposes of the above rules. The lessee's depreciable interest in the improvements it has made to leased property does not taint the overall bonus eligibility of the leased property (of which those improvements are a part) that is subsequently acquired (§1.168(k)-2(b)(5)(ii)).

§734(b) adjustment. Because a §734(b) basis adjustment is made to the basis of partnership property (i.e., non-partner specific basis) and the partnership used the property prior to the partnership distribution giving rise to the basis adjustment, a §734(b) basis adjustment fails the original use clause in §168(k)(2)(A)(ii) and also fails the used property requirement in §168(k)(2)(E)(ii)(I). The regulations therefore provide that §734(b) basis adjustments are not eligible for the additional first year depreciation deduction (PR §1.168(k)-2(b)(3)(iv)(A) and (c).

§743(b) adjustment. §743(b)(1) provides that, in the case of a transfer of a partnership interest, either by sale or exchange or as a result of the death of a partner, a partnership that has a §754 election in effect, will increase the adjusted basis of partnership property by the excess of the transferee's basis in the transferred partnership interest over the transferee's share of the adjusted basis of partnership's property. Because a §743(b) basis adjustment is a partner-specific basis adjustment to partnership property, the regulations provide that, in determining whether a §743(b) basis adjustment meets the used property acquisition requirements, each partner is treated as having owned and used the partner's proportionate share of partnership property. In the case of a transfer of a partnership interest, §168(k)(2)(E)(ii)(I) will be satisfied if the partner acquiring the interest, or a predecessor of such partner, has not used the portion of the partnership property to which the §743(b) basis adjustment relates at any time prior to the acquisition (that is, the transferee has not used the transferor's portion of partnership property prior to the acquisition), notwithstanding the fact that the partnership itself has previously used the property +(§1.168(k)-2(b)(3)(iv)(D)).

- The transferee partner's basis in the transferred partnership interest may not be determined in whole or in part by reference to the transferor's adjusted basis.
- The same result will apply regardless of whether the transferee partner is a new partner or an existing partner purchasing an additional partnership interest from another. The transferee's existing interest in the underlying partnership property is distinct from the interest being transferred.

Contributed property. The regulations provide a special rule for qualified property that is placed in service in a taxable year and then contributed to a partnership under §721(a) in the same taxable year. The regulations provide that, in this situation, the additional first year depreciation deduction with respect to the contributed property is allocated based on the number of months that each held the qualified property in service in the tax year (§1.168(k)-2(g)(1)).

Like-kind exchange. With respect to like-kind exchanges and involuntary conversions, the regs provide that the exchanged basis and excess basis, if any, of the replacement property is eligible for the additional first year depreciation deduction if the replacement property is qualified property. The regs retain this rule if the replacement property also meets the original use requirement. Pursuant to §168(k)(2)(E)(ii)(II) and its cross-reference to §179(d)(3), the regulations also provide that only the excess basis, if any, of the replacement property is eligible for the additional first year depreciation deduction if the replacement property is qualified property and also meets the used property acquisition requirements (§1.168(k)-2(g)(5)).

September 2019 proposed regs. The September 2019 proposed regulations contain new provisions not addressed previously. In the proposed regulations, the Treasury Department and the IRS propose rules regarding (i) certain property not eligible for the additional first year depreciation deduction; (ii) a de minimis use rule for determining whether a taxpayer previously used property; (iii) components acquired after Sep. 27, 2017, of larger property for which construction began before Sep. 28, 2017; and (iv) other aspects not dealt with in the previous August 2018 proposed regulations. The proposed regulations also withdraw and re-propose rules regarding application of the used property acquisition requirements (i) to consolidated groups and (ii) to a series of related transactions.

CHART COMPARING §179 AND BONUS DEPRECIATION

Chart Comparing §179 Expensing and Bonus Depreciation		
	§179	**§168(k)**
New or used property	Both new or used	Both new or used
Effective dates	Permanent	100% to 12-31-22 then phases out by 12-31-26
Limited to taxable income	Yes	No
Eligible property	Generally, personal property, qualified improvement property, and, for non-residential property, roofs, HVACs, fire, alarm, and security systems	MACRS life of 20 years or less
Automobile	Limited by luxury car rules; $25,900 for heavy SUV (2020)	$8,000
Recapture for personal use	Yes, if business use drops to 50% or less	No, unless listed property
Types of activities	Active trade or business, including lodging	Same
Qualified Improvement Property	Qualifies	Same
Election can be modified	Once, on amended return	No, binding w/o IRS permission
Deduction amount limited	$1,040,000 (2020)	No
Like-kind exchange basis	New boot only	100% of basis
Purchase amount limited	Yes, phase-out starts at $2,590,000 (2020)	No, purchases are unlimited

HOBBY LOSSES (ACTIVITIES NOT ENGAGED IN FOR PROFIT) - §183

Hobby Loss Rules (§183: Activities Not Engaged in for Profit (ATG))

Must be engaged in for profit. Taxpayers are generally allowed to deduct expenses that are incurred in a trade or business (§162) or for the production or collection of income, or for the management, conservation, or maintenance of property held for the production of income (§212). For expenses to be deductible under §162 or §212, taxpayers must engage in or carry on an activity to which the expenses relate with an ***actual and honest objective of making a profit*** (*Samuel Keanini v. Comm*., USTC No. 46,354, 94 TC 41 (Jan. 30, 1990); *Maurice C, Dreicer v. Comm*., USTC No. 38,948, 78 TC 642 (Apr. 19, 1982)). Taxpayers bear the burden of proving that they are engaged in the activity with an actual and honest objective of realizing a profit and must devote time to the business in the honest belief that the business will sometime in the future become profitable.

If no profit motive, hobby rules restrict deductions ([§183(b)](#)). When taxpayers are engaged in an activity with an ***actual and honest objective of making a profit***, expenses incurred in a §162 trade or business or a §212 activity for the production of income are deductible even if such expenses exceed income from the activity. But, if no profit motive exists, the §183(b) hobby rules allow deductions only to the extent of gross income unless the deductions would have been allowed anyway (for example, mortgage interest and property taxes deductible on Schedule A). Gross income under §183 includes the total of all gains from the sale, exchange, or other disposition of property and all other gross receipts derived from such activity (§1.183-1(e)).

> **Tax practitioner planning.** Activities conducted in S corporations and partnerships are subject to the §183 loss limitations but not activities conducted in C corporations. On the other hand, the §469 passive loss limitation rules apply to all closely held entities, including C corporations.

IRS factors used to determine profit motive. Whether or not an activity is presumed to be operated for profit requires an analysis of the facts and circumstances of each case. Neither the Code nor the Regulations provides an absolute definition. As a result, deciding whether a taxpayer operates an activity with an actual and honest profit motive typically involves applying the nine nonexclusive factors contained in §1.183-2(b). These factors are as follows:

1. The manner in which the taxpayer carried on the activity.
2. The expertise of the taxpayer or his or her advisers.
3. The time and effort expended by the taxpayer in carrying on the activity.
4. The expectation that the assets used in the activity may appreciate in value.
5. The success of the taxpayer in carrying on other similar or dissimilar activities.
6. The taxpayer's history of income or loss with respect to the activity.
7. The amount of occasional profits, if any, which are earned.
8. The financial status of the taxpayer.
9. Elements of personal pleasure or recreation.

No single factor controls and the factors do not have equal weight, meaning the mere fact that the majority of factors indicate a profit objective exists (or vice versa) is not conclusive. For example, if five factors say the activity is not for profit, but four are on the profit side, the activity still could be determined to be engaged in for profit. On occasion, other factors may also be considered.

Existence of Profit Motive Presumed If Activity Profitable for at Least Three of Past Five Years (§183(d))

The "presumption" tests (§183(d)). It is presumed that activities that are profitable for at least three of the past five tax years have the requisite profit objective (two of the last seven years for activities that consist primarily of breeding, showing, training, or racing horses), and the IRS has the burden of proving otherwise.

Texas Part-Time Rancher Wins Big (*Finis Welch and Linda Waite v. Comm*, TCM 2019-229)

Finis Welch was audited on his 2007, 2008, 2009 and 2010 tax returns. The IRS found his ranching operation to be a hobby and came up with almost $5 million of tax deficiencies. Dr. Welch, with a Ph.D. in Economics from the University of Chicago, took his arguments to Tax Court.

Over the past 25 years, Dr. Welch's Center Ranch grew from 130 acres to 8,700 acres. Dr. Welch's original intent was to grow hay as a cash crop and to raise some cattle on the first 130 acres he had purchased. Center Ranch is now a multi-operational, 8,700-acre ranch with 25 full-time employees who receive annual salaries ranging from $25,000 to $115,000. Gross receipts for each of the years at issue exceeded $1.5 million.

Three B's. The Tax Court analyzed each of the nine factors in §1.183-1(d) in its decision, but the three "B's" were emphasized.

1. Books and records were maintained;
2. Bank accounts were business only; and
3. Business plan was modified regularly.

Court says only for this case. The court found Dr. Welch was engaged in Center Ranch as a for-profit activity during the years at issue. "*In so holding, the Court is not declaring Center Ranch a for-profit activity ad infinitum. If Center Ranch's future losses cannot be reined in, petitioner may again find his profit motives before this Court*."

Yacht Charter Operation Not a For-Profit Activity (*Charles and Rhoda Steiner v. Comm.*, TCM 2019-25)

Charles Steiner is a highly successful businessman and a CPA. In 1973, he acquired an electrical supply business. He was the chief executive officer, and the business grew to have nearly 1,000 employees and several hundred million dollars of revenue. Mr. Steiner acquired other companies, including a communications company and a telephone recovery company.

Triumphant Lady. In 2001, the Steiners purchased the *Triumphant Lady*, a 155-foot motor yacht, for $4,650,000. They used it for diving, and they planned to sail around the world. The *Triumphant Lady* had a full-time captain and crew. In 2006, the Steiners undertook a $10,839,000 refit of the *Triumphant Lady* that was completed in 2009. Until 2009, the Steiners used the *Triumphant Lady* exclusively for personal purposes. This changed in 2009 after John Weller, a yacht broker, approached them about making the *Triumphant Lady* available for a specific charter. The Steiners retained International Yacht Collection as the exclusive agent to charter the *Triumphant Lady* and secured a charter through Mr. Weller's contact from May 2-10, 2009.

No business plan. The Steiners did not have a formal business plan. There was no evidence that they consulted charter industry experts about the profit potential other than charter brokerage companies that would earn a commission upon charter. Between 2010 and 2012, the Steiners secured only one charter for the *Triumphant Lady*, a week-long charter for $150,000. The charter activity never produced a profit. The Steiners listed the *Triumphant Lady* for sale with an asking price of $15.95 million, and it sold in January 2012 for $4,455,000. They did not expect the yacht to appreciate in value.

Charter activity only to offset personal costs. After reviewing the nine factors in §1.183-2(b), the court found that the evidence did not show that the Steiners operated the charter activity with a profit objective within the meaning of §183(c). Rather, it appears that their primary objective was to partially offset the significant fixed costs of maintaining the yacht so that it could be sold after they stopped using it for personal purposes. The Steiners' objective was to offset their significant income with these fixed costs.

See also.

- *James and Elaine Donoghue, pro sese v. Comm.*, TCM 2019-71, where the taxpayers' horse activity that incurred, over its several years of operation, expenses totaling $1,008,303 but realized income totaling only $33,691, was held to be a hobby loss. The court also noted in its opinion that the tax preparer did not warn the taxpayers about the hobby loss rules.
- *Denise McMillan, pro se v. Comm.*, (TCM 2019-108), where horse losses were disallowed since the taxpayer didn't have a horse (her last horse died two years before the year at issue). This was Ms. McMillian's sixth Tax Court case on her horse activity.
- *Shane and Robin Robison v. Comm.*, TCM 2018-88, where the taxpayers' cattle ranch was held to be a business, but losses were suspended under the passive activity rules. The court warned that the decision was only for the years under audit and that the decision might be different in future years without changes in the operation.

REMOTE WORKER

Business Losses Were Not Passive Even Though Owner Lived Out of State *(Fred and Lisa Barbara v. Comm.*, TCM 2019-50)

Fred Barbara sold his trucking business for tens of millions of dollars. Mr. Barbara used the proceeds from the sale to start a money-lending business. The office of the lending business was in Chicago and was staffed by two full-time employees: an accountant and a secretary. During the years 2009 through 2012, Mr. Barbara split his time between Chicago and Florida, living in Florida 60% of the year.

IRS thinks losses are passive. The lending business losses were large; Mr. Barbara lived out of state the majority of the year, and he had two full-time employees working in the lending business. Those facts made the IRS suspicious that the losses were passive, and the IRS proposed taxes and penalties of more than $632,000. Does living in Florida for the winter months mean that a business owner did not (or could not) materially participate in his cold weather lending business? Not in this modern connected world.

Records were important. Mr. Barbara performed all executive functions for the lending business. He decided when to make loans. He decided how to handle defaulted loans. He managed over 40 outstanding loans during the years at issue. He had no other significant work-related demands on his time besides the lending business. The court was satisfied with Mr. Barbara's records and credible testimony that he worked enough hours during the year to satisfy the material participation requirements of §1.469-5T(a). For each year, Mr. Barbara's total hours participating in the lending business were (1) 460 hours or more while in Chicago and (2) 240 hours or more while in Florida. Thus, his total hours participating in the lending business each year were 700 or more. Both while he was in Chicago and in Florida, Mr. Barbara's participation in the lending business was regular, continuous, and substantial. The court ruled that Mr. Barbara materially participated in the lending business during each year from 2009 through 2012.

Clients can work from any place in the world. If your client is working remotely for months on end at his beach house or his mountain chalet or on a cruise ship, the client has to be able to show that he worked most every day (regular, continuous, and substantial) while he was away from the business location. Telephone records, e-mail records, and copies of correspondence are important. Advise your client accordingly.

RESEARCH AND EXPERIMENTAL EXPENSES (§174)

Research and Experimental Expenses

Business expenses associated with the development or creation of an asset having a useful life extending beyond the current year generally must be capitalized and depreciated over such useful life. Taxpayers, however, may elect to deduct currently the amount of certain reasonable research or experimentation expenditures paid or incurred in connection with a trade or business (§174(a) and (e)). Taxpayers may choose to forgo a current deduction, capitalize their research expenditures, and recover them ratably over the useful life of the research, but in no case over a period of less than 60 months (§174(b)).

> **Tax practitioner planning**. Section 174 amounts are excluded from the definition of "start-up expenditures" under §195.

TCJA. Amounts Defined As Specified Research or Experimental Expenditures Are Required to Be Capitalized and Amortized Ratably Over a Five-Year Period, beginning with the midpoint of the taxable year in which the specified research or experimental expenditures were paid or incurred, after Dec. 31, 2021.

Including software development. Specified research or experimental expenditures subject to capitalization include expenditures for software development.

But not depreciable or depletable property. Specified research or experimental expenditures do not include expenditures for land or for depreciable or depletable property used in connection with the research or experimentation, but do include the depreciation and depletion allowances of such property. Also excluded are exploration expenditures incurred for ore or other minerals (including oil and gas).

Must continue to deduct retired, abandoned, or disposed property (but it's not on the balance sheet anymore). In the case of retired, abandoned, or disposed property with respect to which specified research or experimental expenditures are paid or incurred, any remaining basis may not be recovered in the year of retirement, abandonment, or disposal, but instead must continue to be amortized over the remaining amortization period.

10-year amortization eliminated. As part of the repeal of the alternative minimum tax, taxpayers may no longer elect to amortize their research or experimental expenditures over a period of 10 years.

File change in accounting method Form 3115 before Jan. 2, 2022. This is a change in the taxpayer's method of accounting for purposes of §481, initiated by the taxpayer, and made with the consent of the Secretary. The change is applied on a cutoff basis to research or experimental expenditures paid or incurred in taxable years beginning after Dec. 31, 2021. Hence, there is no adjustment under §481(a) for research or experimental expenditures paid or incurred in taxable years beginning before Jan. 1, 2022.

Business expenses associated with the development or creation of an asset having a useful life extending beyond the current year generally must be capitalized and depreciated over such useful life. Taxpayers may elect to deduct currently the amount of certain reasonable research or experimentation expenditures paid or incurred in connection with a trade or business (§174(a) and (e)). Taxpayers may choose to forgo a current deduction, capitalize their research expenditures, and recover them ratably over the useful life of the research, but in no case over a period of less than 60 months (§174(b)). Taxpayers, alternatively, may elect to amortize their research expenditures over a period of 10 years (§174(f)(2) and §59(e)).

> **Tax practitioner planning**. Section 174 amounts are excluded from the definition of "start-up expenditures" under §195.

OTHER BUSINESS CREDITS §38 - 45R

TIGTA Releases Reports Saying the IRS Doesn't Do Enough to Verify Carryover Credits and Deductions (TIGTA Reference Number: 2019-40-044 (Aug. 28, 2019))

In its sample, TIGTA identified 19,193 taxpayers claiming a carryforward credit or deduction with discrepancies totaling more than $5 billion that was used to offset tax year 2015 tax. TIGTA made recommendations that the IRS add criteria to its risk tool to identify high-risk carryforward Research Credit claims, and also to identify and examine returns with discrepancies of General Business Credit carryforward claims. What does this mean? More audits.

> **Stats**. About 2.5 million tax year 2015 tax returns contained claims for carryforward credits totaling $81.9 billion. In addition, 6.5 million tax year 2015 tax returns claimed carryforward deductions of $55.9 billion.

> **Tax practitioner planning.** Although this report specifically recommends changes to the audit criteria for R and D and business credit carryforwards, NOL audit criteria changes cannot be far behind. TIGTA reported that in tax year 2015, there were 928,475 returns claiming $213 billion in NOL carryover deductions. NOL carryforwards might also be profitable for the IRS to look at.

Election to Accelerate AMT Credit in Lieu of Bonus Depreciation Is Repealed

The election to claim unused AMT credits in lieu of bonus depreciation was repealed by the TCJA for tax years beginning after Dec. 31, 2017.

WOTC Expires Dec. 31, 2020 (Work Opportunity Tax Credit §51; WOC Page; Form 8850)

The PATH Act retroactively allowed eligible employers to claim the Work Opportunity Tax Credit (WOTC) for all targeted group employee categories, including qualified veterans and long-term unemployed recipients, that were in effect prior to the enactment of the PATH Act, if the individual began or begins work for the employer after Dec. 31, 2014, and before Jan. 1, 2021.

New targeted group — qualified long-term unemployment recipient (hired on or after Jan. 1, 2016). The PATH Act expanded the targeted groups of individuals to include qualified long-term unemployment recipients. A qualified long-term unemployment recipient is any individual who on the day before the individual began work for the employer, or, if earlier, the day the individual completed Form 8850, Pre-Screening Notice and Certification Request for the Work Opportunity Credit, in a period of unemployment that was (i) not less than 27 weeks and (ii) includes a period (which may be less than 27 weeks) in which the individual received unemployment compensation under state or federal law.

Pre-screening and certification. An employer must obtain certification that an individual is a member of the targeted group, before the employer may claim the credit. An eligible employer must file Form 8850 with their respective state workforce agency within 28 days after the eligible worker began work (see "transitional relief" above). Employers should contact their individual state workforce agency with any specific processing questions for Form 8850.

Limitations on the credits. The credit is limited to the amount of the business income tax liability or Social Security tax owed. A taxable business may apply the credit against its business income tax liability, and the normal carryback and carryforward rules apply. See the instructions for Form 3800, General Business Credit, for more details. For qualified tax-exempt organizations, the credit is limited to the amount of employer Social Security tax owed on wages paid to all employees for the period the credit is claimed.

Unemployed veterans

Claiming the credit. Qualified tax-exempt organizations will claim the credit on Form 5884-C, Work Opportunity Credit for Qualified Tax-Exempt Organizations Hiring Qualified Veterans, as a credit against the employer's share of Social Security tax. The credit will not affect the employer's Social Security tax liability reported on the organization's employment tax return.

Taxable employers. After the required certification is secured, taxable employers claim the tax credit as a general business credit on Form 3800 against their income tax by filing the following:

- Form 5884 (with instructions)
- Form 3800 (with instructions)
- The business's related income tax return and instructions (i.e., Forms 1040, 1041, 1120, etc.)

Tax-exempt employers. Qualified tax-exempt organizations described in §501(c) and exempt from taxation under §501(a) may claim the credit for qualified veterans who begin work on or after Dec. 31, 2014, and before Jan. 1, 2020. After the required certification (Form 8850) is secured, tax-exempt employers claim the credit against the employer's Social Security tax by separately filing Form 5884-C, Work Opportunity Credit for Qualified Tax-Exempt Organizations Hiring Qualified Veterans (PDF). File Form 5884-C after filing the related employment tax return for the period that the credit is claimed. The IRS recommends that qualified tax-exempt employers do not reduce their required deposits in anticipation of any credit.

Qualified veteran. A qualified veteran is a veteran certified as any of the following:

- A member of a family receiving assistance under the Supplemental Nutrition Assistance Program (SNAP) (food stamps) for at least three months during the first year of employment.
- Unemployed for a period totaling at least four weeks (whether or not consecutive) but less than six months in the one-year period prior to the date of hire.
- Unemployed for a period or periods totaling at least six months (whether or not consecutive) in the one-year period ending on the date of hire.
- Entitled to compensation for a service-connected disability and hired not more than one year after being discharged or released from active duty in the US Armed Forces.
- Entitled to compensation for a service-connected disability and unemployed for a period totaling at least six months (whether or not consecutive) in the one-year period that ended on the date of hire.

PENALTY NOTICES

Employer Notification When Employees Receive Premium Assistance Credits — Understanding Your Letter 226-J

Penalty applies if ALE did not provide affordable and adequate insurance coverage to any employee receiving premium assistance credit. The IRS has begun enforcement of the ACA employer mandate. Applicable Large Employers (ALEs) must provide affordable, minimum essential health insurance coverage to their full-time employees or be subject to a §4980H penalty. The letter generally applies to the tax year 2016. Tax year 2015 notices went out last year.

> **Tax practitioner planning.** The IRS identified 32,240 ALEs with potential 2015 penalties of $4.37 billion. Because of "limited resources," the IRS has contacted only 6,000 of the potential 32,000 problem businesses (TIGTA ACA Report 2018-43-022).

Letter 226-J is the initial letter issued to ALEs to notify them that they may be liable for an Employer Shared Responsibility Payment (ESRP). The determination of whether an ALE may be liable for an ESRP and the amount of the proposed ESRP in Letter 226-J are based on information from Forms 1094-C and 1095-C filed by the ALE and the individual income tax returns filed by the ALE's employees.

What the Employer Needs to Do:

- Complete the response form (Form 14764) indicating the employer's agreement or disagreement with the letter within 30 days. The IRS will acknowledge receipt of the Form 14764 with Letter 227 (a series of five responses).

Tax Practitioner planning. If the employer does not respond within 30 days, the IRS will assess the penalties. Send all responses by registered mail.

- If the employer disagrees with the proposed ESRP liability, provide a full explanation of the disagreement and/or indicate changes needed on Form 14765 (Premium Tax Credit Listing). Return all documents as instructed in the letter, again **within 30 days**.
- If the employer agrees with the proposed ESRP liability, follow the instructions to sign the response form and return with full payment in the envelope provided.

Common Reasons That the Recent 2016 Penalty Notice Might Be Incorrect

1. Employer may not be an ALE for the 2016 benefit year. This could be because the employer had fewer than 50 FTE employees or the employees in 2016 that caused the employer's workforce to exceed 50 FTEs were seasonal workers working less than four months during the preceding calendar year (§54.4980H-2(b)(2)).
2. The employer is an ALE when it counts its full-time and FTE employees, but it does not have more than 50 full-time employees in 2016. Because the penalty for not providing health insurance does not apply to the first 50 full-time employees, no penalty results for 2016 (§54.4980H-4(a)).
3. The employer used the "look-back rule" and the employee was a part-time worker in the prior year (§54.4980H-3(d)(1)(i)).
4. The worker was a seasonal worker working less than six months during the year and was properly excluded from the ALE's health insurance coverage (§54.4980H-1(a)(38)).
5. The employee opted out or did not timely enroll in the employer's adequate and affordable health insurance plan (§1.5000A-3(e)(3)(i)(A) & (B)).

OTHER PROVISIONS

Appropriations Act Repeals 40% Excise Tax on Insurance Companies Offering High-Cost "Cadillac" Health Coverage

Cadillac tax repealed. The Cadillac tax on excessive employer-sponsored health insurance premiums has been repealed. It will be due to in 2022.

Medical Device Tax Repealed by the Appropriations Act

The 2.3% Medical Device Tax has been repealed. It was due to begin in 2020.

HOW TO COMPLY WITH THE EMPLOYER MANDATE REPORTING REQUIREMENTS

2020 Filing Requirement Deadlines (ACA Information Center for ALEs; Information Reporting by ALEs).

This chart provides a reminder about the upcoming filing requirements and the 2020 deadlines. This chart applies only for reporting in 2021 for coverage in 2020.

Action	**Reporting Due Dates in 2020 for:**		
	ALE — Including Those That Are Self-Insured	Self-Insured Employers That Are **NOT** ALEs	Furnished to Individuals
File 1095-B; 1094-B	Not Applicable	Paper: Feb. 28 E-file: Mar. 31	Jan. 31
File 1095-C; 1094-C	Paper: Feb. 28 E-file: Mar. 31	Not Applicable	Jan. 31

2020 information-reporting penalties increased to \$50/\$110/\$280/\$560 + \$50/\$110/\$280/\$560 per each failure to file Form 1095. An ALE member that fails to comply with the information reporting requirements may be subject to the general reporting penalty provisions under §6721 (failure to file correct information returns) and §6722 (failure to furnish correct payee statement). The waiver of penalty and special rules under §6724 and the applicable regulations, including abatement of information return penalties for reasonable cause, may apply to certain failures under §6721 or §6722.

Resources:

- ACA Information Center for Tax Professionals
- ACA Information Center for ALEs
- Information Reporting by ALEs
- Health Care Tax Tip Archive
- Treasury Fact Sheet on Information Reporting
- Questions and Answers on Employer Health Care Arrangements
- Questions and Answers on Employer Shared Responsibility Provisions (§4980H)
- Questions and Answers on Reporting of Offers of Health Insurance Coverage by Employers (§6056), including guidance on who is an ALE member
- Questions and Answers on Information Reporting by Health Coverage Providers (§6055), for additional reporting requirements applicable to sponsors of self-insured health plans
- Questions and Answers on Reporting Value of Employer-provided Coverage on Form W-2
- Questions and Answers About Information Reporting by Employers on Form 1094-C and Form 1095-C, for more information about Forms 1094-C and 1095.

Comment. A more complete discussion of the information that must be reported to the IRS (including simplified methods of reporting) can be found in the final §6055 and §6056 regulations, (T.D. 9660 and T.D. 9661), in the instructions to Form 1094-C and Form 1095-C, and the Questions and Answers on Form 1094-C and Form 1095-C.

Publications:

- Publication 5208, Affordable Care Act: Are You an Applicable Large Employer?
- Publication 5200, Affordable Care Act: What Employers Need to Know

SMALL BUSINESS HEALTH CARE TAX CREDIT §45R

Five Facts About the Small Business Health Care Tax Credit (SHOP Marketplace How-to Guides, Fact Sheets, Tools, and Other Resources)

1. The maximum credit is 50% of premiums paid for small business employers and 35% of premiums paid for small tax-exempt employers.
2. To be eligible for the credit, the employer must pay premiums on behalf of employees enrolled in a qualified health plan offered through a Small Business Health Options Program Marketplace, or qualify for an exception to this requirement.
3. The credit is available to eligible employers for two consecutive taxable years.
4. The employer can carry the credit back or forward to other tax years if the employer does not owe tax during the year.
5. The employer may get both a credit and a deduction for employee premium payments. Since the amount of the health insurance premium payments will be more than the total credit, if the employer is eligible, the employer can still claim a business expense deduction for the premiums in excess of the credit.

Small Employer Health Credit Requirements (§45R; T.D. 9672; NPRM REG-113792-13)

Who is a qualifying employer? Small employers that provide healthcare coverage to their employees and that meet certain requirements (qualified employers) generally are eligible for a federal income tax credit for health insurance premiums they pay for certain employees. To qualify, employers must:

1. Have fewer than 25 full-time equivalent employees (FTEs) for the tax year;
2. Have average annual wages of its employees below $55,200 per FTE in 2020;
3. Pay the premiums under a "qualifying arrangement"; and
4. Purchase the qualifying health insurance (QHP) through a Small Business Health Options Program (SHOP) Marketplace prior to 2018 (§1.45R-2(a)).

Fifty Percent Credit. The Small Employer Health Care Credit is 50% (35% for tax-exempt organizations) of qualified premiums. The credit is limited to 50% of ***the lesser of***:

1. The total amount of nonelective health insurance premiums the employer contributes for its employees through the Marketplace's SHOP (prior to 2018); or
2. The total amount of nonelective contributions which would have been made for each employee in #1 above at a premium determined by HHS for the small group market in the employer's state or the area within the state (§45R(a), (b) and (g)).

Tax-exempt employer maximum credit is 35%. Qualifying tax-exempt organizations are eligible for a credit of up to 35% of qualified health premiums. The credit amount, however, is limited to the total amount of income and Medicare tax the employer is required to withhold from employees' wages for the year and the employer's share of Medicare tax on employees' wages (§1.45R-3(e)(1)).

Use Form 8941 to calculate the Health Care Tax Credit (Form 8941 Instructions (2016); Form 8941, Credit for Small Employer Health Insurance Premiums). Both small businesses and tax-exempt organizations use Form 8941 to calculate the health insurance premium credit.

Small Business Health Options Program (SHOP)

The employer can work with a SHOP-registered agent or broker to enroll in Small Business Health Options Program (SHOP) insurance. Employers may use their current agent or broker to help enroll, find a new agent or broker in the area familiar with SHOP plans, or handle the enrollment themselves. When applying, the employer can search for agents and brokers registered to sell SHOP plans by ZIP code. Prior to 2018, QHP had to be purchased through a SHOP Marketplace (Overview of the SHOP Marketplace; §45R(b)(1)).

No open enrollment period restrictions. The employer can enroll in SHOP any month, any time of year. There's no restricted enrollment period when the employer can start offering a SHOP plan.

Full-Time Equivalent (FTE) Defined

The number of an employer's FTEs is determined by dividing:

1. The total hours for which the employer pays wages to employees during the year (but not more than 2,080 hours for any employee) by
2. 2,080 (§45R(d)(2)(A)).

Employers given three options to calculate annual hours worked (§1.45R-2(d); Notice 2010-44). These methods are chosen on an employee-by-employee basis and include:

1. Determine actual hours of service from records of hours worked (i.e., time cards).
2. Use a days-worked equivalency whereby the employee is credited with eight hours of service for each day the employee earned at least one hour of pay.
3 Use a weeks-worked equivalency whereby the employee is credited with 40 hours of service for each week the employee earned at least one hour of pay.

An employer with 25 or more employees can still qualify for the credit if some of its employees are part-time. Because the limitation on the number of employees is based on FTEs, an employer with 25 or more employees could qualify for the credit if some of its employees work part-time.

Some employees of the business are not counted in FTEs (§1.45R-1(a)(5)(iii)). The following individuals are not considered employees for these purposes:

1. ***Seasonal workers,*** unless the seasonal worker works for the employer more than 120 days during the tax year. However, while seasonal workers are excluded from the calculation of FTEs and average annual wages, any health insurance premiums paid on their behalf are included when determining the amount of the credit (Notice 2010-44). Employers may apply a reasonable good faith interpretation of the term seasonal worker (T.D. 9672, Preamble, II).
2. ***A self-employed sole proprietor***.
3. ***A partner in a partnership***.
4. ***A 2% shareholder of an eligible small business which is an S corporation***.
5. ***Any 5% owner of an eligible small business***.
6. ***A family member*** of any of the business owners or partners, or a member of such a business owner's or partner's household described in #2 through #5 above. For this purpose, a family member is defined as a child (or descendant of a child), a sibling or step-sibling, a parent (or ancestor of a parent), a step-parent, a niece or nephew, an aunt or uncle, or a son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law. "Family member" also includes any other member of the household who qualifies as a dependent under §152(d)(2)(H) (§45R(e)(1)).

Determining average annual wages (§1.45R-2(f)). The amount of average annual wages is determined by first dividing (1) the total wages paid by the employer to employees during the employer's tax year by (2) the number of the employer's FTEs for the year. The result is then rounded down to the nearest $1,000 (if not otherwise a multiple of $1,000). For this purpose, wages means §3121(a) wages as defined for FICA purposes (without regard to the Social Security wage base limitation). Bonuses are also included to the extent treated as wages for FICA purposes.

Calculating the reduced credit if the number of FTEs exceeds 10 or average annual wages exceed $27,600 in 2020 (Rev. Proc. 2019-44). The healthcare insurance premium credit is available only to the small employer and phases out as the employer's FTE ***or*** average salary climbs above a ceiling. In other words, two phase-outs apply:

1. First, if the number of FTEs exceeds 10, the amount of the credit is reduced (but not below zero). The reduction is determined by multiplying the otherwise applicable credit amount by a fraction, the numerator of which is the number of FTEs in excess of 10 and the denominator of which is 15.
2. Second, if average annual wages exceed $27,600, the credit is also reduced. This amount is adjusted for inflation. The reduction is determined by multiplying the otherwise applicable credit amount by a fraction, the numerator of which is the amount by which average annual wages exceed $27,600 and ***the denominator of which is $27,600*** (§45R(d)(3)(B); §1.45R-3(c)(1) & (2)).

BUSINESS CLIENT LETTER

Tax Reform and What It Means for Your Business in 2020

Dear Client:

Tax law has been changing. Four pieces of legislation, with tax provisions, have been enacted in less than three years. At the end of 2017, the Tax Cuts and Jobs Act (TCJA) was signed into law. It was the first major tax reform in 31 years and included a reduction in tax rates, a new QBI deduction against business income, an increase in depreciation, and a doubling of the §179 expensing amount. The Appropriations Act, which included tax extenders, retirement and IRA reforms, was signed into law at the end of 2019. And then COVID-19 hit. Congress began work sending bipartisan stimulus legislation to the President for his signature, including the CARES Act, signed into law at the end of March 2020.

A few highlights of the many changes that apply to businesses follow:

First, the changes related to COVID-19:

1. **Sick Pay and Family Leave.** The Families First Coronavirus Response Act (FFCRA) requires certain employers to provide employees with paid sick leave or expanded family and medical leave for specified reasons related to COVID-19. The government reimburses the employer for the cost of the leave through a temporary payroll tax credit. Read more about this at the IRS Coronavirus Tax Relief page, including its FAQs.

2. **Employee Retention Credit.** CARES allows eligible employers to receive a 50% payroll tax credit up to $5,000 ($10,000 x 50%) per employee for qualified wages paid after Mar. 12, 2020, and before Jan. 1, 2021. If the credit amount exceeds the employer's withholding tax liability, the excess is refundable. Read more about this provision at the IRS FAQs on the Employee Retention Credit.

3. **Employer Payroll Tax Delay.** Employers must withhold Social Security taxes on employee wages. Self-employed individuals are subject to self-employment tax. Under CARES, taxpayers are allowed to defer paying the 6.2% employer share of the Social Security tax (but not the 1.45% employer share of the Medicare tax) through the end of 2020. The tax would be payable over the following two years with half paid by Dec. 31, 2021, and the other half by Dec. 31, 2022. Read more about this provision at the IRS FAQs on the Deferral of Payroll Tax Deposits.

4. **SBA Loans and Grants**. A stimulus provision in the CARES Act made available SBA loans for cash-strapped businesses suffering from the nationwide economic impact of COVID-19. The Paycheck Protection Program (PPP) loan is to help businesses continue paying their employees for eight weeks. Emergency Injury Disaster Loans (EIDLs) are available from SBA for operating expenses that the PPP loans don't cover. Neither loans had adequate funding in the CARES Act, but additional funding is anticipated. Careful, some of the CARES changes described above are not available to businesses that receive a PPP loan. Beware: the timing and use of loan proceeds is critical to determine how much of the loan can be forgiven. Misuse of the funds can subject

borrowers to fraud charges. Read more about these loans at a special SBA website page and at the SBA Final Interim Rule.

5. **Interest deductions**. For businesses with gross receipts in excess of $26 million, CARES caps the deduction for net business interest expenses at 50% of adjusted taxable income (was 30%). This is a retroactive change from prior law and may require an amended return.

6. **Net operating losses**. Get tax refunds now. CARES provides that net operating losses (NOLs) arising in a tax year beginning after Dec. 31, 2017, and before Jan. 1, 2021, can be carried back to the five tax years preceding the tax year of such loss. In short, NOLs arising in 2018, 2019, and 2020 can be carried back to the five preceding years and can fully offset taxable income. This is a retroactive change from prior law and may require an amended return.

Other Business Items to Note:

Corporate taxes. C corporation tax rate is reduced to 21%, from a top rate of 35%. Corporate alternative minimum tax was repealed.

Bonus depreciation. The bonus depreciation allowance has been temporarily increased from 50% to 100% for qualifying property placed in service after Sep. 27, 2017, and before Jan. 1, 2023. A phase-out of the deduction begins Jan. 1, 2023. The requirement that the original use of qualified property must begin with the taxpayer has been removed. Thus, bonus depreciation is allowed on the purchase of new or used property.

Qualified Improvement Property. A technical error in the TCJA was retroactively corrected in the CARES Act. Effective for qualified leasehold improvement property, qualified restaurant improvement property, and qualified retail improvement property (collectively called QIP) placed in service in 2018 and later is15-year cost recovery property for depreciation purposes, making it eligible for bonus depreciation. An amended return may be needed to take advantage of this change.

Section 179 expensing. The §179 expensing amount is $1.04 million, and the investment limitation is $2.59 million. Some property, such as a roof on a nonresidential property, can qualify for a §179 expensing deduction.

QBI Deduction for Pass-through businesses. Noncorporate taxpayers may deduct up to 20% of domestic qualified business income from an S corporation, partnership, LLC, sole proprietorship, or farm. In some situations, net rental income can qualify for some or all of the 20% deduction. Limitations apply based on wages paid or if the qualified business income is from a specified service business (like law, accounting, medical, etc.). Neither limitation applies if the taxpayer's 2020 taxable income on his or her Form 1040 is less than $163,300 for a single person ($326,600 for a married filing joint couple).

Tax-deferred exchanges. The tax-deferred exchange rules in §1031 will only apply to real property. Personal property, such as autos, machines, tractors, equipment, etc., may no longer qualify under the tax-deferred exchange rules. COVID-19 disaster declarations extended time deadlines to July 15, 2020, for taxpayers in the middle of a 1031 exchange — if the 45-day or 180-day time limits expired between Apr. 1, 2020, and July 15, 2020.

Deductions and credits. The entertainment deduction has been repealed. The cost of tickets to concerts, football games, or the ballet is no longer deductible. The TCJA retains the research and development credit but will require five-year amortization of research and development expenditures.

Stock options. The law allows qualified employees of private companies to defer tax on the exercise of options for up to five years. CEOs, CFOs, highly compensated employees, and 1% owners are not eligible for the deferral.

These are just a few of the changes included in the new tax reform law. Your 2020 business taxes will be affected. That's guaranteed by the scope of the changes.

We can answer your questions:

- Can my business qualify for the new SBA loans?
- Are there COVID-19 stimulus provisions that will help my business with its cash needs?
- How can I maximize the 20% business income deductions?
- Is this the year to buy additional equipment or a new vehicle for my business?

Please call our office, and we can look at your particular business and its tax planning needs.

Sincerely,

PPP LOAN VS. EIDL COMPARISON

COVID-19	PAYCHECK PROTECTION LOAN	EIDL LOAN
Purpose	Forgivable if used for payroll (minimum of 75% of the funds received) and the remaining for certain operating expenses	To meet financial obligations and operating expenses that could have been met had the disaster not occurred. Advance available for $1,000 per employee up to $10,000.
Term	up to $10 million	up to $2 million
Interest Rate	1%	3.75% for businesses 2.75% for non-profits
Forgivable	Yes, but amount of any EIDL advance is not forgivable from PPP loan amount	No for EIDL Loan Yes for advance
First payment due	Deferred six months	Deferred one year
Resources	SBA "Paycheck Protection Program" IRS "Paycheck Protection Program Loans FAQs"	SBA "Coronavirus Relief Options"

2020 FEDERAL TAX UPDATE
BUSINESS RETURNS

Index

2020 FEDERAL TAX UPDATE
QUALIFIED BUSINESS INCOME DEDUCTION

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2020 FEDERAL TAX UPDATE
QUALIFIED BUSINESS INCOME DEDUCTION

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- Implementing the QBI "Formula" & Three Limitations
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- Using the Aggregation Rules to Beat the QBI Deduction Restrictions
- Reviewing the Real Estate Safe Harbor
- QBI News - What Changed after We Learned the Law

20% QUALIFIED BUSINESS INCOME (QBI) DEDUCTION

The 20% QBI Deduction Affects Individuals, Partnerships, S Corporations, Trusts, and Estates Engaged in Domestic Trades or Businesses

The Tax Cuts and Jobs Act of 2017 (TCJA) provides that for taxable years beginning after Dec. 31, 2017, and before Jan. 1, 2026, an individual taxpayer generally may deduct 20% of "qualified business income" (QBI) from partnerships, S corporations, sole proprietorships or trusts and estates, as well as 20% of aggregate qualified REIT dividends and qualified publicly traded partnership (PTP) income.

Final Regs provide guidance, FAQs provide clarity

Final regulations on §199A (preamble followed by final regulations) were released on January 15, 2019. The 247-page document provides detailed rules for (1) Calculation of QBI; (2) Determining W-2 wages and Unadjusted Basis of Property Immediately After Acquisition (UBIA); (3) Defining QBI; (4) Aggregation; (5) Defining Specified Service Trade or Business; and (6) Relevant Passthrough Entities, Publicly Traded Partnerships, trusts and estates.

IRS FAQs are the easy-to-read version. The IRS newsroom covered the most popular topics in FAQs for more than a year after TCJA was enacted. There are currently 59 FAQs covering (1) Basic Information; (2) Pass-Through Entity; (3) Patrons and Cooperatives; and (4) Rental FAQs. The Rental FAQs were the last addition in November 2019.

2018 QBI calculations were unseen — 2019 Forms provided complete transparency. Starting with 2019 tax returns, taxpayers claiming a QBI deduction are required to complete Form 8995-A and up to four schedules.

- Use Form 8995 - Qualified Business Income Deduction *Simplified* Computation if:
    - the taxpayer has QBI, qualified REIT dividends, and/or qualified PTP income;

- ○ 2020 taxable income before QBI deduction is more than $163,300 ($160,700 in 2019) ($326,600 ($321,400in 2019) if married filing jointly); **and**
  - ○ the taxpayer **isn't** a patron in a specified agricultural or horticultural cooperative.
- Use Form 8995-A - Qualified Business Income Deduction if:
  - ○ the taxpayer has QBI, qualified REIT dividends, or qualified PTP income, **and**
  - ○ 2020 taxable income before QBI deduction is more than $163,300 ($160,700 in 2019) ($326,600 ($321,400in 2019) if married filing jointly); **or**
  - ○ the taxpayer **is** a patron in a specified agricultural or horticultural cooperative.
- Form 8995-A, Schedule A - Specified Service Trades or Businesses
- Form 8995-A, Schedule B - Aggregation of Business Operations
- Form 8995-A, Schedule C - Loss Netting and Carryforward
- Form 8995-A, Schedule D - Special Rules for Patrons of Agricultural or Horticultural Cooperatives

WHAT IS A *QUALIFIED* TRADE OF BUSINESS?

A *"Qualified* Trade or Business Is Any Trade or Business Other Than:

1. A "specified service trade or business" (SSTB), or
2. Performing services as an employee (§199A(d)(1)).

The final regulations define a trade or business by reference to §162. Whether a trade or business is a factual determination (*Higgins v. Comm.*, 312 U.S. 212 (1941)). Absent a statutory or regulatory definition of a §162 business we turn to the courts which have developed two definitional requirements. First, the taxpayer must enter into and carry on the activity with a good faith intention to make a profit or with the belief that a profit can be made from the activity. Second, in relation to the scope of the activity, there must be considerable, regular, and continuous activity. (*Comm. v. Robert Groetzinger*, 480 U.S. 23 (1987)

> **Comment*:*** If property is rented or licensed to a commonly controlled trade or business conducted by a taxpayer, such rental or licensing is considered a trade or business. §1.199A-1(b)(14)

WHAT IS QUALIFIED TRADE OR BUSINESS *INCOME* (QBI)?

For Any Taxable Year, Qualified Business Income (QBI) Means the Net Amount of Qualified Items of Income, Gain, Deduction, and Loss with Respect to the Qualified Trade or Business

Qualified business income is determined for each qualified trade or business. The determination of qualified items of income, gain, deduction, and loss takes into account such items only to the extent included or allowed in the determination of taxable income for the year. Thus, passive losses that are suspended by §469 do not reduce QBI. QBI is reduced when suspended passive losses are triggered.

QBI is reduced by SE tax, health insurance and retirement contributions. The following "Other Deductions" are considered attributable to a trade or business and therefore reduce QBI:

a. ½ of self-employment tax,
b. self-employed health insurance, and
c. retirement contributions (Preamble, IV (A)(5), pg 43, §1.199A-3(b)(1)(vi))

Self-employed health insurance of 2% S corporation shareholder. The deductions above are *"considered attributable to a trade or business to the extent than the individual's gross income from the trade or business is taken into account in calculating the allowable deduction, on a proportionate basis to the gross income received from the trade or business" (* §1.199A-3(b)(1)(vi)).

A more than 2% shareholder in an S corporation reports health insurance paid for, or reimbursed to the shareholder as wages on Form W-2, Box 1. The deduction for 2% shareholder's self-employed health insurance is limited by the amount of §3121 wages (subject to social security & Medicare) (§162(l)(5)). Because the S corporation income is not taken into account in calculating the allowable deduction, QBI should not be reduced by the amount of self-employed health insurance deduction included in 2% shareholder wages.

Investment items specifically excluded from QBI. The following items are not QBI: Any short-term or long-term capital gain or loss; dividends; interest income; gain or loss from controlled foreign corporations; any item of income, gain, deduction, or loss attributable to notional principal contracts; annuities; net §1231 gains taxed as capital gains; and any item of deduction or loss properly allocable to an asset described above (§199A(c)(3)(B)).

QBI Doesn't Include Guaranteed Payments Paid to Member/Partners or Reasonable Wages Paid to S Corporation Shareholder/Employees(s).

QBI does not include any amount paid or incurred by a partnership to a partner who is acting other than in his or her capacity as a partner for services or any wages paid by an S corporation that is treated as reasonable compensation of the taxpayer (§199A(c)(4)).

THE QBI DEDUCTION FORMULA & THREE LIMITATIONS

The 20% QBI deduction is the LESSER of:

1. 20% of the ***combined qualified business income amount*** of the taxpayer, OR
2. an amount equal to 20% of the excess (if any) of—
    a. the taxable income, over
    b. the net capital gain.

The combined QBI amount means an amount equal to:

1. the sum of the amounts determined above for each qualified trade or business carried on by the taxpayer, PLUS
2. 20% of the aggregate amount of the qualified REIT dividends and qualified publicly traded partnership income.

The deductible amount for each trade or business is:

1. The **LESSER of**:
    a. 20% of the ***qualified business income***, OR
    b. The **GREATER OF**:
        i. 50% of the wages with respect to the qualified trade or business, OR

i. The **SUM OF:**

(1) 25% of the W-2 wages, PLUS

(2) 2.5% of the unadjusted basis immediately after acquisition (UBIA) of all qualified property (§199A(b)(2)(B)(ii); Rev. Proc. 2019-11).

The 20% QBI deduction has three limitations:

1. 20% of taxable income
2. Specified Services Trade or Business
3. W-2 wages and/or UBIA

1. Threshold Limitation

This limitation phases in when taxable income is in excess of a *threshold amount* ***and*** fully applies when taxable income is in excess of the threshold amount plus $100,000 MFJ ($50,000 single/HOH) [§199A(b)(3)(B)].

Threshold Limits QBI Deduction for High Income Qualified Business Owners				
	Phase-in **Doesn't Apply** If Taxable Income **Below**		Phase-in **Fully Applies** If Taxable Income **Above**	
	2019	**2020**	2019	**2020**
MFJ	$321,400	**$326,600**	$421,400	**426,600**
H OF H	$160,700	**$163,300**	$210,700	**$213,300**
SINGLE	$160,700	**$163,300**	$210,700	**$213,300**

When Taxable Income Is Below the Threshold Amount

If *taxable income* is below *the threshold amount*, the QBI deduction is 20% of each trade or businesses' QBI, subject only to the taxable income limitation.

Examples are done on 2019 forms using 2019 threshold numbers, as 2020 forms will not be available until winter.

Example. Jane Plain is 25 years old, single, and owns a business that makes model airplanes. In 2019 her net income from her business was $107,602. She does not itemize and has no other deductions. Jane's QBI is $100,000 ($107,602 - ½ self-employment tax $7,602). Her taxable income before QBI is $87,800 ($107,602 - ½ self-employment tax $7,602 - standard deduction $12,200 = $87,800). Her QBI deduction is $17,560. Because Jane's taxable income before QBI is less than the threshold amount for her filing status she will calculate her QBI deduction of Form 8995, Qualified Business Income Deduction Simplified Computation.

Form 8995 Department of the Treasury Internal Revenue Service	**Qualified Business Income Deduction Simplified Computation** ► Attach to your tax return. ► Go to *www.irs.gov/Form8995* for instructions and the latest information.	OMB No. 1545-0123 **2019** Attachment Sequence No. 55

Name(s) shown on return	Your taxpayer identification number
JANE PLAIN	111-11-1111

1	**(a)** Trade, business, or aggregation name	**(b)** Taxpayer identification number	**(c)** Qualified business income or (loss)
i	PLAIN JANE'S PLANES	111-11-1111	100,000.
ii			
iii			
iv			
v			

2	Total qualified business income or (loss). Combine lines 1i through 1v, column (c)	2	100,000.		
3	Qualified business net (loss) carryforward from the prior year	3	0.		
4	Total qualified business income. Combine lines 2 and 3. If zero or less, enter -0-	4	100,000.		
5	Qualified business income component. Multiply line 4 by 20% (0.20)			5	20,000.
6	Qualified REIT dividends and publicly traded partnership (PTP) income or (loss) (see instructions)	6	0.		
7	Qualified REIT dividends and qualified PTP (loss) carryforward from the prior year	7	0.		
8	Total qualified REIT dividends and PTP income. Combine lines 6 and 7. If zero or less, enter -0-	8	0.		
9	REIT and PTP component. Multiply line 8 by 20% (0.20)			9	0.
10	Qualified business income deduction before the income limitation. Add lines 5 and 9			10	20,000.
11	Taxable income before qualified business income deduction	11	87,800.		
12	Net capital gain (see instructions)	12	0.		
13	Subtract line 12 from line 11. If zero or less, enter -0-	13	87,800.		
14	Income limitation. Multiply line 13 by 20% (0.20)			14	17,560.
15	Qualified business income deduction. Enter the lesser of line 10 or line 14. Also enter this amount on the applicable line of your return ►			15	17,560.
16	Total qualified business (loss) carryforward. Combine lines 2 and 3. If greater than zero, enter -0-			16	0.
17	Total qualified REIT dividends and PTP (loss) carryforward. Combine lines 6 and 7. If greater than zero, enter -0-			17	0.

BAA **For Privacy Act and Paperwork Reduction Act Notice, see instructions.** Form 8995 (2019)

When Taxable Income is *Above* the Threshold Minimum, but *not Above* the Threshold Maximum

If taxable income falls between the threshold and the top of the phase-in range, a limitation on the QBI deduction is phased in. The limitation phase-in reduces the QBI deduction by a percentage calculated with the numerator being the amount of taxable income in excess of threshold for the filing status and the denominator being $50,000 ($100,000 for MFJ).

> **Example.** When Jane Plain (above) comes in to pick up her tax return she asks, “Does it make a difference that I got married last year and changed my last name to Law?” The original tax return goes to the shredder. Jane’s new husband Johnny is a peace officer working for local government. On their newly prepared joint income tax return for 2019 Johnny’s wage and interest income are included resulting in taxable income before QBI of $351,400.
>
> Because their taxable income is above the threshold, the limitation on the QBI deduction will be phased in. The amount of the phase-in is calculated on Form 8995, Qualified Business Income Deduction. QBI from Jane’s business is $100,000. The limitation phase-in is 30%. (Numerator: Taxable income $351,400 minus threshold amount 321,400 = 30,000; Denominator: $100,000; 30,000/100,000 = 30%).
>
> Jane’s QBI deduction before the application of the limitation is $20,000 ($100,00 x 20%). The phase-in of the limitation will reduce the QBI deduction by $6,000 ($20,000 x 30%). The QBI deduction after phase-in of the limitation is $14,000 (20,000 - 6,000).

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

Qualified Business Income Deduction

► Attach to your tax return.

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

OMB No. 1545-0123

2019

Attachment Sequence No. 55A

Name(s) shown on return: JOHNNY AND JANE LAW

Your taxpayer identification number: 222-22-2222

Part I Trade, Business, or Aggregation Information

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

1	(a) Trade, business, or aggregation name	(b) Check if specified service	(c) Check if aggregation	(d) Taxpayer identification number	(e) Check if patron
A	JANE LAW	☐	☐	111-11-1111	☐
B		☐	☐		☐
C		☐	☐		☐

Part II Determine Your Adjusted Qualified Business Income

			A	B	C
2	Qualified business income from the trade, business, or aggregation. See instructions	2	100,000.		
3	Multiply line 2 by 20% (0.20). If your taxable income is $160,700 or less ($160,725 if married filing separately; $321,400 if married filing jointly), skip lines 4 through 12 and enter the amount from line 3 on line 13	3	20,000.		
4	Allocable share of W-2 wages from the trade, business, or aggregation	4			
5	Multiply line 4 by 50% (0.50)	5			
6	Multiply line 4 by 25% (0.25)	6			
7	Allocable share of the unadjusted basis immediately after acquisition (UBIA) of all qualified property	7			
8	Multiply line 7 by 2.5% (0.025)	8			
9	Add lines 6 and 8	9			
10	Enter the greater of line 5 or line 9	10			
11	W-2 wage and qualified property limitation. Enter the smaller of line 3 or line 10	11			
12	Phased-in reduction. Enter the amount from line 26, if any. See instructions	12	14,000.		
13	Qualified business income deduction before patron reduction. Enter the greater of line 11 or line 12	13	14,000.		
14	Patron reduction. Enter the amount from Schedule D (Form 8995-A), line 6, if any. See instructions	14			
15	Qualified business income component. Subtract line 14 from line 13	15	14,000.		
16	Total qualified business income component. Add all amounts reported on line 15 ►	16	14,000.		

BAA For Privacy Act and Paperwork Reduction Act Notice, see separate instructions. Form **8995-A** (2019)

Form 8995-A (2019) JOHNNY AND JANE LAW 222-22-2222 Page 2

Part III **Phased-in Reduction**

Complete Part III only if your taxable income is more than $160,700 but not $210,700 ($160,725 and $210,725 if married filing separately; $321,400 and $421,400 if married filing jointly) and line 10 is less than line 3. Otherwise, skip Part III.

				A	B	C
17 Enter the amounts from line 3			17	20,000.		
18 Enter the amounts from line 10			18			
19 Subtract line 18 from line 17			19	20,000.		
20 Taxable income before qualified business income deduction	20	351,400.				
21 Threshold. Enter $160,700 ($160,725 if married filing separately; $321,400 if married filing jointly)	21	321,400.				
22 Subtract line 21 from line 20	22	30,000.				
23 Phase-in range. Enter $50,000 ($100,000 if married filing jointly)	23	100,000.				
24 Phase-in percentage. Divide ln 22 by ln 23	24	30.000 %				
25 Total phase-in reduction. Multiply line 19 by line 24			25	6,000.		
26 Qualified business income after phase-in reduction. Subtract line 25 from line 17. Enter this amount here and on line 12, for the corresponding trade or business			26	14,000.		

Part IV **Determine Your Qualified Business Income Deduction**

27 Total qualified business income component from all qualified trades, businesses, or aggregations. Enter the amount from line 16	27	14,000.		
28 Qualified REIT dividends and publicly traded partnership (PTP) income or (loss). See instructions	28			
29 Qualified REIT dividends and PTP (loss) carryforward from prior years	29			
30 Total qualified REIT dividends and PTP income. Combine lines 28 and 29. If less than zero, enter -0-	30			
31 REIT and PTP component. Multiply line 30 by 20% (0.20)	31			
32 Qualified business income deduction before the income limitation. Add lines 27 and 31 ►			32	14,000.
33 Taxable income before qualified business income deduction	33	351,400.		
34 Net capital gain. See instructions	34			
35 Subtract line 34 from line 33. If zero or less, enter -0-			35	351,400.
36 Income limitation. Multiply line 35 by 20% (0.20)			36	70,280.
37 Qualified business income deduction before the domestic production activities deduction (DPAD) under section 199A(g). Enter the smaller of line 32 or line 36 ►			37	14,000.
38 DPAD under section 199A(g) allocated from an agricultural or horticultural cooperative. Don't enter more than line 33 minus line 37			38	
39 Total qualified business income deduction. Add lines 37 and 38 ►			39	14,000.
40 Total qualified REIT dividends and PTP (loss) carryforward. Combine lines 28 and 29. If zero or greater, enter -0-			40	

Form 8995-A (2019)

When Taxable Income is *Above* the Threshold Maximum

If a taxpayer's taxable income is above the threshold maximum no QBI deduction is allowed unless the taxpayer has W-2 wages or UBIA allocable to the trade or business.

Note: *The limitation phase-in and upper threshold limitation do not apply to qualified REIT dividends and qualified PTP income.*

2. Specified Services Limitation

The QBI Deduction is Not Allowed for "Specified Service" Business Income

A *"specified service trade or business"* includes personal-service-type trades or businesses involved in the following performance of services: Health, law, ~~engineering, architecture,~~ accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services (Including investing and investment management, trading, or dealing in securities, partnership interests, or commodities), and any trade or business where the principal asset is the reputation or skill of one or more of its owners or employees (§199A(d)(2)).

"Crack and pack" strategy doesn't work. The IRS is aware that some taxpayers have contemplated a strategy to separate out parts of what otherwise would be an integrated SSTB, such as the administrative functions, in an attempt to qualify those separated parts for the 20% QBI deduction. Such a strategy is inconsistent with the purpose of §199A. Therefore, an SSTB includes any trade or business with 50% or more common ownership (directly or indirectly) that provides 80% or more of its property or services to an SSTB. Additionally, if a trade or business has 50% or more common ownership with an SSTB, to the extent that the trade or business provides property or services to the commonly-owned SSTB, the portion of the property or service provided to the SSTB will be treated as an SSTB (§1.199A-5(c)(2)).

Exception for SSTB income under threshold. The exclusion of SSTBs from QBI is subject to a phase-in over the same dollar range as the taxable income limitation phase-in. For SSTBs the phase-in limitation hits twice: once when applied to SSTB income and again when the taxable income limitation applies.

Example. When Johnny and Jane come to pick up their newly prepared joint tax returns Johnny says, "I think I forgot to give you my 1099-MISC for an acting job last year. Back to the shredder. Johnny earned $32,281 as an actor. QBI for his acting job is $30,000 ($32,281 - ½ self-employment tax 2,281 = 30,000). The additional income raised their taxable income before QBI to $381,400. Because acting is an SSTB, the limitation on Johnny's QBI from the activity will be phased in. The SSTB income is reported on Form 8895-A, Schedule A.

The SSTB limitation phase-in is 60%. (Numerator: Taxable income $381,400 minus threshold amount 321,400 = 60,000; Denominator: $100,000; 60,000/100,000 = 60%). QBI before the taxable income limitation phase-in is $2,400 (30,000 x 60% = 18,000; 30,000 - 18,000 = 12,000; 12,000 x 20% = 2,400).

Form **8995-A**

Department of the Treasury
Internal Revenue Service

Qualified Business Income Deduction

► Attach to your tax return.

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

OMB No. 1545-0123

2019

Attachment Sequence No. 55A

Name(s) shown on return: JOHNNY AND JANE LAW

Your taxpayer identification number: 222-22-2222

Part I — Trade, Business, or Aggregation Information

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

1	(a) Trade, business, or aggregation name	(b) Check if specified service	(c) Check if aggregation	(d) Taxpayer identification number	(e) Check if patron
A	JANE LAW	☐	☐	111-11-1111	☐
B	JOHNNY LAW	☒	☐	222-22-2222	☐
C		☐	☐		☐

Part II — Determine Your Adjusted Qualified Business Income

			A	B	C
2	Qualified business income from the trade, business, or aggregation. See instructions	2	100,000.	12,000.	
3	Multiply line 2 by 20% (0.20). If your taxable income is $160,700 or less ($160,725 if married filing separately; $321,400 if married filing jointly), skip lines 4 through 12 and enter the amount from line 3 on line 13	3	20,000.	2,400.	
4	Allocable share of W-2 wages from the trade, business, or aggregation	4			
5	Multiply line 4 by 50% (0.50)	5			
6	Multiply line 4 by 25% (0.25)	6			
7	Allocable share of the unadjusted basis immediately after acquisition (UBIA) of all qualified property	7			
8	Multiply line 7 by 2.5% (0.025)	8			
9	Add lines 6 and 8	9			
10	Enter the greater of line 5 or line 9	10			
11	W-2 wage and qualified property limitation. Enter the smaller of line 3 or line 10	11			
12	Phased-in reduction. Enter the amount from line 26, if any. See instructions	12	8,000.	960.	
13	Qualified business income deduction before patron reduction. Enter the greater of line 11 or line 12	13	8,000.	960.	
14	Patron reduction. Enter the amount from Schedule D (Form 8995-A), line 6, if any. See instructions	14			
15	Qualified business income component. Subtract line 14 from line 13	15	8,000.	960.	
16	Total qualified business income component. Add all amounts reported on line 15 ►	16	8,960.		

BAA For Privacy Act and Paperwork Reduction Act Notice, see separate instructions. Form **8995-A** (2019)

Part III Phased-in Reduction

Complete Part III only if your taxable income is more than $160,700 but not $210,700 ($160,725 and $210,725 if married filing separately; $321,400 and $421,400 if married filing jointly) and line 10 is less than line 3. Otherwise, skip Part III.

				A	B	C
17 Enter the amounts from line 3			17	20,000.	2,400.	
18 Enter the amounts from line 10			18			
19 Subtract line 18 from line 17			19	20,000.	2,400.	
20 Taxable income before qualified business income deduction	20	381,400.				
21 Threshold. Enter $160,700 ($160,725 if married filing separately; $321,400 if married filing jointly)	21	321,400.				
22 Subtract line 21 from line 20	22	60,000.				
23 Phase-in range. Enter $50,000 ($100,000 if married filing jointly)	23	100,000.				
24 Phase-in percentage. Divide ln 22 by ln 23	24	60.000 %				
25 Total phase-in reduction. Multiply line 19 by line 24			25	12,000.	1,440.	
26 Qualified business income after phase-in reduction. Subtract line 25 from line 17. Enter this amount here and on line 12, for the corresponding trade or business			26	8,000.	960.	

Part IV Determine Your Qualified Business Income Deduction

27 Total qualified business income component from all qualified trades, businesses, or aggregations. Enter the amount from line 16	27	8,960.		
28 Qualified REIT dividends and publicly traded partnership (PTP) income or (loss). See instructions	28			
29 Qualified REIT dividends and PTP (loss) carryforward from prior years	29			
30 Total qualified REIT dividends and PTP income. Combine lines 28 and 29. If less than zero, enter -0-	30			
31 REIT and PTP component. Multiply line 30 by 20% (0.20)	31			
32 Qualified business income deduction before the income limitation. Add lines 27 and 31 ►			32	8,960.
33 Taxable income before qualified business income deduction	33	381,400.		
34 Net capital gain. See instructions	34			
35 Subtract line 34 from line 33. If zero or less, enter -0-			35	381,400.
36 Income limitation. Multiply line 35 by 20% (0.20)			36	76,280.
37 Qualified business income deduction before the domestic production activities deduction (DPAD) under section 199A(g). Enter the smaller of line 32 or line 36 ►			37	8,960.
38 DPAD under section 199A(g) allocated from an agricultural or horticultural cooperative. Don't enter more than line 33 minus line 37			38	
39 Total qualified business income deduction. Add lines 37 and 38 ►			39	8,960.
40 Total qualified REIT dividends and PTP (loss) carryforward. Combine lines 28 and 29. If zero or greater, enter -0-			40	

Form 8995-A (2019)

SCHEDULE A (Form 8995-A)

Department of the Treasury Internal Revenue Service

Specified Service Trades or Businesses

► Attach to Form 8995-A.

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

OMB No. 1545-0123

2019

Attachment Sequence No. 55B

Name(s) shown on return	Your taxpayer identification number
JOHNNY AND JANE LAW	222-22-2222

Complete Schedule A only if your trade or business is a specified service trade or business (see instructions) and your taxable income is more than $160,700 but not $210,700 ($160,725 but not $210,725 if married filing separately; $321,400 and $421,400 if married filing jointly). If your taxable income isn't more than $160,700 ($160,725 if married filing separately; $321,400 if married filing jointly) and you're not a patron of an agricultural or horticultural cooperative, don't file this form; instead, file Form 8995, Qualified Business Income Deduction Simplified Computation. Otherwise, complete Schedule D (Form 8995-A) before beginning Schedule A. If your taxable income is more than $210,700 ($210,725 if married filing separately; $421,400 if married filing jointly), your specified service trade or business doesn't qualify for the deduction. If you have more than three trades or businesses, attach as many Schedules A as needed. See instructions.

Part I Other Than Publicly Traded Partnerships (PTP)

				A	B	C
1a	Trade or business name		1a	JOHNNY LAW		
b	Taxpayer identification number		1b	222-22-2222		
2	Qualified business income or (loss) from the trade or business		2	30,000.		
3	Allocable share of W-2 wages from the trade or business		3			
4	Allocable share of the unadjusted basis immediately after acquisition (UBIA) of all qualified property		4			
5	Taxable income before qualified business income deduction	5	381,400.			
6	Threshold. Enter $160,700 ($160,725 if married filing separately; $321,400 if married filing jointly)	6	321,400.			
7	Subtract line 6 from line 5	7	60,000.			
8	Phase-in range. Enter $50,000 ($100,000 if married filing jointly)	8	100,000.			
9	Divide line 7 by line 8	9	0.60000			
10	Applicable percentage. Subtract line 9 from 100%	10	40.000%			
11	Applicable percentage of qualified business income or (loss). Multiply line 2 by line 10. Enter this amount on Schedule C (Form 8995-A) or on Form 8995-A, line 2, for the corresponding trade or business, as appropriate. See instructions		11	12,000.		
12	Applicable percentage of W-2 wages. Multiply line 3 by line 10. Enter this amount on Form 8995-A, line 4, for the corresponding trade or business, as appropriate. See instructions		12			
13	Applicable percentage of the UBIA of qualified property. Multiply line 4 by line 10. Enter this amount on Form 8995-A, line 7, for the corresponding trade or business, as appropriate. See instructions		13			

Part II Publicly Traded Partnership

			A	B	C
14	Trade or business name	14			
15	Taxpayer identification number	15			
16	Qualified PTP income or (loss)	16			

17	Total PTP specified service trade or business (SSTB) income or (loss). Combine all amounts on line 16	17	
18	Taxable income before qualified business income deduction	18	
19	Threshold. Enter $160,700 ($160,725 if married filing separately; $321,400 if married filing jointly)	19	
20	Subtract line 19 from line 18	20	
21	Phase-in range. Enter $50,000 ($100,000 if married filing jointly)	21	
22	Divide line 20 by line 21	22	
23	Applicable percentage. Subtract line 22 from 100%	23	%
24	Applicable percentage of qualified PTP income or (loss). Multiply line 17 by line 23. Include this amount on Form 8995-A, line 28	24	

BAA For Privacy Act and Paperwork Reduction Act Notice, see separate instructions. FDIA9924L 12/18/19 Schedule A (Form 8995-A) 2019

3. W-2 Wages Limitation

The 20% QBI Deduction is Limited by W-2 Wages Paid

The **GREATER OF**:

1. 50% of the wages with respect to the qualified trade or business(es), OR
2. The **SUM OF:**
   a. 25% of the W-2 wages PLUS
   b. 2.5% of the unadjusted basis immediately after acquisition of all qualified property (§199A(b)(2)(B)(ii)).

Definition of W-2 Wages. W-2 wages means, for any person for any taxable year, the sum of amounts paid by such person with respect to employment of employees by such person during the calendar year ending during such taxable year, including: the total amount of wages (§3401(a)); the total amount of elective deferrals (§402(g)(3)); the compensation deferred (§457); and the amount of designated Roth contributions (§402A; §6051(a)(3); 6051(a)(8); §199A(b)(4)(A); §199A(b)(4)(B); §1.199A-2; Rev. Proc. 2019-11, Sec. 4.01); Rev. Proc. 2019-9).

- Wages paid by third party payor, such as a PEO, are permitted. (§1.199-2(a)(2); §1.199A-2(b)(2)(ii))
- The W-2 wage limitation applies separately for each trade or business. (§1.199A-2).
- RPEs must allocate a partner's or shareholder's allocable share of wages in the same manner as the partner's allocable share or a shareholder's pro rata share of wage expenses (§199A(f)(1)(A)(iii); §1.199A-2(b)(4)).
- W-2 wages must be reported to SSA on or before the 60th day after the due date (including extensions) (§199A(b)(4)(c); §199A(b)(4)(A); §1.199A-2(b)(2)(ii); §1.199A-2(b)(2)(iv)(C)(2); §1.199A-2(b)(2)(IV)(D)).
- Statutory employees should not be included in calculating W-2 wages (§3121(d)(3); §1.199A-2(b)(2)(i)).

Three methods for calculating W-2 wages. The three methods are substantially similar to the methods provided in Rev. Proc. 2006-47, for purposes of calculating wages:

1. the *unmodified* Box 1 method allows for a simplified calculation using Box 1 of the W-2,
2. the *modified* Box 1 method provides for accuracy using Box 1 of the W-2, less amounts that are not wages, plus amounts in Box 12 coded D, E, F, G, and S, or
3. the *tracking* wage method provides for greater accuracy where the employer actually tracks wages subject to federal withholding, plus amounts in Box 12 coded D, E, F, G, and S (Rev. Proc. 2019-11, Sec. 5).

Example - S corp must pay "reasonable compensation" to qualify for QBI deduction. Jessica earns $300,000 from an S corporation. Jessica's share of the W-2 wages paid by the S corporation is $40,000. Jessica's share of the unadjusted basis of qualified property held by the S corporation is $0. Jimmy, Jessica's husband, earns wages from his job, resulting in $475,000 of taxable income.

Example - Jessica and Jimmy			
S corporation QBI (net of W-2 wages)			$300,000
QB's W-2 Wages			$40,000
LESSER OF (A) or (B):			
(A) Tentative 20% QBI	$300,000	X 20%	$60,000
OR:			
(B) 50% of W-2s	$40,000	X 50%	$20,000
LESSER OF (A) OR (B)			$20,000
20% QBI Deduction			$20,000

Tax practitioner planning. Does it make tax sense that a sole proprietor or partner can't claim the 20% QBI deduction, but an S corporation shareholder can?

The UBIA (Unadjusted Basis Immediately after Acquisition) Relief Provision

For businesses without wages, the QBI deduction would not be available except for the 2.5% qualified property provision. If there are not sufficient wages to qualify for the 20% QBI deduction, the taxpayer may use 2.5% of qualified property instead. This alternative deduction limitation is based on 25% of W-2 Wages with respect to the qualified trade or business and 2.5% of the UBIA of qualified property (§199A(b)(2)(B)(ii); §1.199A-2(c)(3); Preamble (III)(B)).

Tax practitioner planning. Thank you NAR (National Association of Realtors). This professional association is the *biggest* lobbying alligator in the swamp!

Example - Sole proprietor uses the 2.5% UBIA! Keith is a manufacturer of iphone long-lasting batteries. He bought the machines for $1,000,000. Keith has no employees. He makes $500,000 annually. The 20% QBI deduction is the greater of (a) 50% of W-2 wages ($0) or (b) the sum of 25% of W-2 wages ($0) plus 2.5% of the unadjusted basis of the machines ($1,000,000 X .025 = $25,000). Keith's 20% QBI deduction is $25,000.

QB income (Keith)			$520,000
QB expenses other than wages			-$ 20,000
QB W-2 wages			-$ 0
UBIA		$1,000,000	
***Tentative* Taxable Income**			$500,000
QB Deduction Is Lesser of (A) or (B):			
(A) QBI ($500,000) X 20% = **O R**		$100,000	

(B) GREATER OF (1) **OR** (2)			
(1) W-2 Wages ($ - 0 -) X 50% =		-$ - 0 -	
(2) W-2 Wages ($ - 0 -) + UBIA ($1,000,000) X 2.5% =		+$25,000	-$25,000
TAXABLE INCOME			$475,000

Property Is Qualified If it Is Depreciable

The term 'qualified property' means, with respect to any qualified trade or business for a taxable year, tangible property of a character subject to the allowance for depreciation (therefore inventory can't be included) under §167:

1. which is held by the business at the end of the taxable year,
2. is used **at any point in the year** in the production of QBI, and
3. the *"depreciable period"* could not have ended prior to the last day of the taxable year.

The "depreciable" period means the period beginning on the date the property is first placed in service by the taxpayer and ending on the later of:

1. the date 10 years after that date, or
2. the last day of the last full year in the applicable recovery period that would apply to the property under §168(c), regardless of §168(g) [§168A(b)(6); §199A(b)(6)); §1.199A-2(c)(2)].

Because the applicable recovery period is not changed by any additional first-year depreciation deduction, the additional first-year depreciation deduction does not affect the applicable recovery period (§1.199A-2(c)(2)(ii)).

Unadjusted Basis for UBIA Purposes Means Cost

- **Do not subtracted accumulated depreciation**, special depreciation allowance (bonus depreciation), or §179 deductions.

- **Partnership/S Corporation.** UBIA of qualified property contributed to a partnership in a §721 transaction generally equals the partnership's tax basis under §723 rather than the contributing partner's original UBIA of the property. Similarly, the UBIA of qualified property contributed to an S corporation in a §351 transaction is determined by reference to §362 (Preamble (III)(B)(2)). A partner's or shareholder's allocable share of the UBIA of qualified property is determined in the same manner as the partner's allocable share or shareholder's pro rata share of depreciation (§199A(f); §1.704-1(b)(2)(iv)(g); §1.199A-2(a)(3)).

- **Partnership §743(b) basis adjustment.** Partnership §754 special basis adjustments under §743(b) are treated as separate qualified property for purposes of the 20% QBI deduction to the extent the §743(b) basis adjustment reflects an increase in the fair market value of the underlying qualified property. (§1.199A-2(c)(1)(iii); Preamble (III)(B)(4)).

- **Inherited property.** For property inherited from a decedent and immediately placed in service by the heir, the UBIA generally will be its fair market value at the time of the decedent's death under §1014 (§1.199A-2(c)(3); Preamble (III)(B); Preamble (III)(B)(5); Preamble (III)(B)(6)).

- **Property transferred with the principal purpose of increasing the 20% QBI deduction.** Property is not qualified property if the property is acquired within 60 days of the end of the taxable year and disposed of within 120 days without having been used in a trade or business for at least 45 days prior to disposition, unless the taxpayer demonstrates that the principal purpose of the acquisition and disposition was a purpose other than increasing the 20% QBI deduction (§1.199A-2(c)(1)(iv)).

- **Like-kind exchanges and involuntary conversions.** With one exception, qualified property that is acquired in a like-kind exchange or in an involuntary conversion is treated as replacement MACRS property whose depreciable period generally is determined as of the date the relinquished property was first placed in service. The exception is if the individual or RPE makes an election under §1.168(i)-6(i)(1). Thus, unless the exception applies, qualified property acquired in a like-kind exchange or involuntary conversion will have two separate placed in service dates: (1) for purposes of determining the UBIA of the property, the relevant placed in service date will be the date the *acquired* property is actually placed in service; (2) for purposes of determining the depreciable period of the property, the relevant placed in service date generally will be the date the *relinquished* property was first placed in service (§1.199A-2(c)(2)(iii); Preamble (III)(B)(2)).

  Tax practitioner planning. The IRS does not believe that a §734(b) adjustment is an acquisition of qualified property for purposes of determining UBIA (Preamble (III)(B)(4)).

Example. Hank Plumb is a sole proprietor of a plumbing business earning $515,138; he is married and their taxable income is $475,600. He has no employees, his well-maintained truck was placed in service 11 years ago and he has expensed all of his small tools - he has $0 UBIA. Hank's QBI is $500,000 (515,138 - ½ self-employment tax 15,138 = 500,000). Because Hank's taxable income is above the threshold and limitation phase-in, he must have either W-2 wages or UBIA to claim a QBI deduction. Hank will include Form 8995-A on his tax return showing the QBI deduction for his plumbing business is $0.

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

Qualified Business Income Deduction

► Attach to your tax return.

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

OMB No. 1545-0123 | **2019** | Attachment Sequence No. 55A

Name(s) shown on return: HANK AND POLLY PLUMB | Your taxpayer identification number: 444-44-4444

Part I — Trade, Business, or Aggregation Information

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

1	(a) Trade, business, or aggregation name	(b) Check if specified service	(c) Check if aggregation	(d) Taxpayer identification number	(e) Check if patron
A	HANK'S PLUMBING	☐	☐	444-44-4444	☐
B		☐	☐		☐
C		☐	☐		☐

Part II — Determine Your Adjusted Qualified Business Income

		A	B	C
2 Qualified business income from the trade, business, or aggregation. See instructions	2	500,000.		
3 Multiply line 2 by 20% (0.20). If your taxable income is $160,700 or less ($160,725 if married filing separately; $321,400 if married filing jointly), skip lines 4 through 12 and enter the amount from line 3 on line 13	3	100,000.		
4 Allocable share of W-2 wages from the trade, business, or aggregation	4			
5 Multiply line 4 by 50% (0.50)	5			
6 Multiply line 4 by 25% (0.25)	6			
7 Allocable share of the unadjusted basis immediately after acquisition (UBIA) of all qualified property	7			
8 Multiply line 7 by 2.5% (0.025)	8			
9 Add lines 6 and 8	9			
10 Enter the greater of line 5 or line 9	10			
11 W-2 wage and qualified property limitation. Enter the smaller of line 3 or line 10	11			
12 Phased-in reduction. Enter the amount from line 26, if any. See instructions	12			
13 Qualified business income deduction before patron reduction. Enter the greater of line 11 or line 12	13			
14 Patron reduction. Enter the amount from Schedule D (Form 8995-A), line 6, if any. See instructions	14			
15 Qualified business income component. Subtract line 14 from line 13	15			
16 Total qualified business income component. Add all amounts reported on line 15 ►	16			

BAA For Privacy Act and Paperwork Reduction Act Notice, see separate instructions. Form **8995-A** (2019)

Part III Phased-in Reduction

Complete Part III only if your taxable income is more than $160,700 but not $210,700 ($160,725 and $210,725 if married filing separately; $321,400 and $421,400 if married filing jointly) and line 10 is less than line 3. Otherwise, skip Part III.

				A	B	C
17 Enter the amounts from line 3			17			
18 Enter the amounts from line 10			18			
19 Subtract line 18 from line 17			19			
20 Taxable income before qualified business income deduction	20					
21 Threshold. Enter $160,700 ($160,725 if married filing separately; $321,400 if married filing jointly)	21					
22 Subtract line 21 from line 20	22					
23 Phase-in range. Enter $50,000 ($100,000 if married filing jointly)	23					
24 Phase-in percentage. Divide ln 22 by ln 23	24	%				
25 Total phase-in reduction. Multiply line 19 by line 24			25			
26 Qualified business income after phase-in reduction. Subtract line 25 from line 17. Enter this amount here and on line 12, for the corresponding trade or business			26			

Part IV Determine Your Qualified Business Income Deduction

27 Total qualified business income component from all qualified trades, businesses, or aggregations. Enter the amount from line 16	27			
28 Qualified REIT dividends and publicly traded partnership (PTP) income or (loss). See instructions	28			
29 Qualified REIT dividends and PTP (loss) carryforward from prior years	29			
30 Total qualified REIT dividends and PTP income. Combine lines 28 and 29. If less than zero, enter -0-	30			
31 REIT and PTP component. Multiply line 30 by 20% (0.20)	31			
32 Qualified business income deduction before the income limitation. Add lines 27 and 31 ►			32	
33 Taxable income before qualified business income deduction	33	475,600.		
34 Net capital gain. See instructions	34			
35 Subtract line 34 from line 33. If zero or less, enter -0-			35	475,600.
36 Income limitation. Multiply line 35 by 20% (0.20)			36	95,120.
37 Qualified business income deduction before the domestic production activities deduction (DPAD) under section 199A(g). Enter the smaller of line 32 or line 36 ►			37	
38 DPAD under section 199A(g) allocated from an agricultural or horticultural cooperative. Don't enter more than line 33 minus line 37			38	
39 Total qualified business income deduction. Add lines 37 and 38 ►			39	
40 Total qualified REIT dividends and PTP (loss) carryforward. Combine lines 28 and 29. If zero or greater, enter -0-			40	

Form 8995-A (2019)

Example - continued. Hank is the sole owner of an S Corporation that manufactures septic systems - Hank's Tanks. The corporation was formed this year and had net income before depreciation of $500,000, including $10,00 of W-2 wages. New manufacturing equipment was purchased for $1,000,000. The entire cost was expensed under §179, limited to net income of the entity, resulting in no net income for the corporation. The QBI statement attached to his Schedule K-1 shows $500,000 of ordinary business income; $500,000 of §179 deduction; and $1,000,000 of UBIA. Even though the business has both W-2 wages and UBIA, Hank's Tanks did not produce any net income, therefor the QBI for the S corporation is $0.

Statement A—QBI Pass-through Entity Reporting (Schedule K-1, Box 17, Code V)

Pass-through entity's name: HANK'S TANKS	**Pass-through entity's EIN:** 66-6666666
Shareholder's name: HANK PLUMB	**Shareholder's identifying number:** 444-44-4444

Shareholder's share of:	HANK'S TANKS ☐ PTP ☐ Aggregated ☐ SSTB	☐ PTP ☐ Aggregated ☐ SSTB	☐ PTP ☐ Aggregated ☐ SSTB
QBI or qualified PTP items subject to shareholder-specific determinations:			
Ordinary business income (loss)	500,000.		
Rental income (loss)			
Royalty income (loss)			
Section 1231 gain (loss)			
Other income (loss)			
Section 179 deduction	500,000.		
Charitable contributions			
Other deductions			
W-2 wages	10,000.		
UBIA of qualified property	1,000,000.		
Section 199A dividends			

Shareholder's share of:	☐ PTP ☐ Aggregated ☐ SSTB	☐ PTP ☐ Aggregated ☐ SSTB	☐ PTP ☐ Aggregated ☐ SSTB
QBI or qualified PTP items subject to shareholder-specific determinations:			
Ordinary business income (loss)			
Rental income (loss)			
Royalty income (loss)			
Section 1231 gain (loss)			
Other income (loss)			
Section 179 deduction			
Charitable contributions			
Other deductions			
W-2 wages			
UBIA of qualified property			

Example - continued. Hank's wife Polly is the sole owner of an S corporation, Polly's Pipes, that sells pipes for plumbing and septic tanks. Polly's Pipes posted no profit for this past period. In 2019 the business had a loss of $(20,000). The business paid $400,000 in W-2 wages. The business had no UBIA. The QBI statement attached to her Schedule K-1 shows $(20,000) ordinary loss and $400,000 W-2 wages. Because their taxable income exceeds the threshold amount for their filing status and at least one qualified trade or business is reporting a loss, Form 8995-A, Schedule C - Loss Netting and Carryforward will be included with their tax return.

> **Note: Form 8995-A, Schedule C - Loss Netting and Carryforward** reports both current year and prior year QB Losses. In years where QBI is reported the form allocates current and prior year QB Losses to activities reporting QBI, reducing the QBI for those activities. Allocation of the losses is proportionate to the QBI reported for each activity.

Hank and Polly have three businesses generating $476,500 taxable income yet they do not have any QBI. The following pages show how the three activities are reported on Forms 8995-A and Schedule C.

Statement A—QBI Pass-through Entity Reporting (Schedule K-1, Box 17, Code V)

Pass-through entity's name: POLLY'S PIPES			Pass-through entity's EIN: 77-7777777
Shareholder's name: POLLY PLUMB			Shareholder's identifying number: 555-55-5555
	POLLY'S PIPES		
Shareholder's share of:	☐ PTP ☐ Aggregated ☐ SSTB	☐ PTP ☐ Aggregated ☐ SSTB	☐ PTP ☐ Aggregated ☐ SSTB
QBI or qualified PTP items subject to shareholder-specific determinations:			
Ordinary business income (loss)	-20,000.		
Rental income (loss)			
Royalty income (loss)			
Section 1231 gain (loss)			
Other income (loss)			
Section 179 deduction			
Charitable contributions			
Other deductions			
W-2 wages	400,000.		
UBIA of qualified property			
Section 199A dividends			

Shareholder's share of:	☐ PTP ☐ Aggregated ☐ SSTB	☐ PTP ☐ Aggregated ☐ SSTB	☐ PTP ☐ Aggregated ☐ SSTB
QBI or qualified PTP items subject to shareholder-specific determinations:			
Ordinary business income (loss)			
Rental income (loss)			
Royalty income (loss)			
Section 1231 gain (loss)			
Other income (loss)			
Section 179 deduction			
Charitable contributions			
Other deductions			
W-2 wages			
UBIA of qualified property			

Form **8995-A**

Department of the Treasury
Internal Revenue Service

Qualified Business Income Deduction

► Attach to your tax return.

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

OMB No. 1545-0123

2019

Attachment Sequence No. 55A

Name(s) shown on return: HANK AND POLLY PLUMB

Your taxpayer identification number: 444-44-4444

Part I Trade, Business, or Aggregation Information

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

1	(a) Trade, business, or aggregation name	(b) Check if specified service	(c) Check if aggregation	(d) Taxpayer identification number	(e) Check if patron
A	HANK'S PLUMBING	☐	☐	444-44-4444	☐
B	HANK'S TANKS	☐	☐	66-6666666	☐
C	POLLY'S PIPES	☐	☐	77-7777777	☐

Part II Determine Your Adjusted Qualified Business Income

		A	B	C
2 Qualified business income from the trade, business, or aggregation. See instructions	2	480,000.		
3 Multiply line 2 by 20% (0.20). If your taxable income is $160,700 or less ($160,725 if married filing separately; $321,400 if married filing jointly), skip lines 4 through 12 and enter the amount from line 3 on line 13	3	96,000.		
4 Allocable share of W-2 wages from the trade, business, or aggregation	4		10,000.	400,000.
5 Multiply line 4 by 50% (0.50)	5		5,000.	200,000.
6 Multiply line 4 by 25% (0.25)	6		2,500.	100,000.
7 Allocable share of the unadjusted basis immediately after acquisition (UBIA) of all qualified property	7		1,000,000.	
8 Multiply line 7 by 2.5% (0.025)	8		25,000.	
9 Add lines 6 and 8	9		27,500.	100,000.
10 Enter the greater of line 5 or line 9	10		27,500.	200,000.
11 W-2 wage and qualified property limitation. Enter the smaller of line 3 or line 10	11			
12 Phased-in reduction. Enter the amount from line 26, if any. See instructions	12			
13 Qualified business income deduction before patron reduction. Enter the greater of line 11 or line 12	13			
14 Patron reduction. Enter the amount from Schedule D (Form 8995-A), line 6, if any. See instructions	14			
15 Qualified business income component. Subtract line 14 from line 13	15			
16 Total qualified business income component. Add all amounts reported on line 15 ►	16			

BAA For Privacy Act and Paperwork Reduction Act Notice, see separate instructions. Form **8995-A** (2019)

Part III Phased-in Reduction

Complete Part III only if your taxable income is more than $160,700 but not $210,700 ($160,725 and $210,725 if married filing separately; $321,400 and $421,400 if married filing jointly) and line 10 is less than line 3. Otherwise, skip Part III.

				A	B	C
17 Enter the amounts from line 3			17			
18 Enter the amounts from line 10			18			
19 Subtract line 18 from line 17			19			
20 Taxable income before qualified business income deduction	20					
21 Threshold. Enter $160,700 ($160,725 if married filing separately; $321,400 if married filing jointly)	21					
22 Subtract line 21 from line 20	22					
23 Phase-in range. Enter $50,000 ($100,000 if married filing jointly)	23					
24 Phase-in percentage. Divide ln 22 by ln 23	24	%				
25 Total phase-in reduction. Multiply line 19 by line 24			25			
26 Qualified business income after phase-in reduction. Subtract line 25 from line 17. Enter this amount here and on line 12, for the corresponding trade or business			26			

Part IV Determine Your Qualified Business Income Deduction

27 Total qualified business income component from all qualified trades, businesses, or aggregations. Enter the amount from line 16	27			
28 Qualified REIT dividends and publicly traded partnership (PTP) income or (loss). See instructions	28			
29 Qualified REIT dividends and PTP (loss) carryforward from prior years	29			
30 Total qualified REIT dividends and PTP income. Combine lines 28 and 29. If less than zero, enter -0-	30			
31 REIT and PTP component. Multiply line 30 by 20% (0.20)	31			
32 Qualified business income deduction before the income limitation. Add lines 27 and 31 ►			32	
33 Taxable income before qualified business income deduction	33	475,600.		
34 Net capital gain. See instructions	34			
35 Subtract line 34 from line 33. If zero or less, enter -0-			35	475,600.
36 Income limitation. Multiply line 35 by 20% (0.20)			36	95,120.
37 Qualified business income deduction before the domestic production activities deduction (DPAD) under section 199A(g). Enter the smaller of line 32 or line 36 ►			37	
38 DPAD under section 199A(g) allocated from an agricultural or horticultural cooperative. Don't enter more than line 33 minus line 37			38	
39 Total qualified business income deduction. Add lines 37 and 38 ►			39	
40 Total qualified REIT dividends and PTP (loss) carryforward. Combine lines 28 and 29. If zero or greater, enter -0-			40	

Form 8995-A (2019)

SCHEDULE C (Form 8995-A) Department of the Treasury Internal Revenue Service	**Loss Netting and Carryforward** ► Attach to Form 8995-A. ► Go to *www.irs.gov/Form8995A* for instructions and the latest information.	OMB No. 1545-0123 **2019** Attachment Sequence No. 55D

Name(s) shown on return	Your taxpayer identification number
HANK AND POLLY PLUMB	444-44-4444

If you have more than three trades, businesses, or aggregations, complete and attach as many Schedules C as needed. See instructions.

1 Trade, business, or aggregation name	(a) Qualified business income/(loss)	(b) Reduction for loss netting (see instructions)	(c) Adjusted qualified business income (Combine (a) and (b). If zero or less, enter -0-.)
HANK'S PLUMBING	500,000.	-20,000.	480,000.
HANK'S TANKS	0.	0.	0.
POLLY'S PIPES	-20,000.	0.	0.

2	Qualified business net (loss) carryforward from prior years. See instructions	2	
3	Total of the trades, businesses, or aggregations losses. Combine the negative amounts on lines 1, column (a), and 2 for all trades, businesses, or aggregations	3	-20,000.
4	Total of the trades, businesses, or aggregations income. Add the positive amounts on line 1, column (a), for all trades, businesses, or aggregations	4	500,000.
5	Losses netted with income of other trades, businesses, or aggregations. Enter in the parentheses on line 5, the smaller of the absolute value of line 3 or line 4. Allocate this amount to each of the trades, businesses, or aggregations on line 1, column (b). See instructions	5	(20,000.)
6	Qualified business net (loss) carryforward. Subtract line 5 from line 3. If zero or more, enter -0-	6	0.

BAA For Privacy Act and Paperwork Reduction Act Notice, see separate instructions. **Schedule C (Form 8995-A) 2019**

HOW TO AGGREGATE MULTIPLE BUSINESSES

It Is Not Uncommon for a Single Trade or Business to Be Operated Across Multiple Entities

Trades or businesses may be structured across multiple entities for various legal, economic, or other non-tax reasons. Therefore, the aggregation of separate trades or businesses is permitted, provided the following requirements are satisfied and the aggregation is disclosed. For QBI purposes, the grouping rules under §469 are not appropriate for determining a trade or business (§1.446-1(d)(1); §1.199A-4).

Aggregation Rules

Requirements to aggregate. An individual may aggregate trades or businesses only if the individual can demonstrate the following requirements are satisfied. Aggregation is permitted but is not required.

1. **Each entity must be a trade or business.** Each trade or business must itself be a trade or business (§1.199A-4(b)(1)).

2. **The same person (or groups) must own 50% or more interest in each business.** The same person, or group of persons, must directly or indirectly, own 50% or more interest in each of the businesses to be aggregated for the majority of the taxable year in which the items attributable to each trade or business are included in income. The family attribution rules must be followed (§1.199A-4(b)(1)(i)).

   Tax practitioner planning. Non-majority owners may benefit from the common ownership and are permitted to aggregate.

3. **2-of-3 factors used to demonstrate integration.** Individuals and trusts must establish that the trades or businesses meet at least two of three factors, which demonstrate that the businesses are in fact part of a larger, integrated trade or business. These factors include:
   - the businesses provide products, property, or services that are the same (for example, a restaurant and a food truck) or are customarily provided together (for example, a gas station and a car wash);
   - the businesses share facilities or share significant centralized business elements (for example, common personnel, accounting, legal, manufacturing, purchasing, human resources, or information technology resources); and
   - the businesses are operated in coordination with, or reliance on, other businesses in the aggregated group (for example, supply chain interdependencies) [§1.199A-4(b)(1)(v)(A)(B)&(C)].

4. **None of the aggregated trades or businesses can be an SSTB (Specified Services Trade or Business).** Even the IRS agrees clarification is needed regarding the reduction of QBI from an SSTB when a taxpayer has multiple trades or businesses (§1.199A-4(b)(1)(iv)).

5. **Business income must be reported in same taxable year on the same tax return.** All of the items attributable to each trade or business to be aggregated are reported on returns with the same taxable year, not taking into account short taxable years (§1.199A-4(b)(1)(i),(ii)&(iii)).

Individual *and* Relevant Passthrough Entity (RPE) Consistency and Reporting Requirements

Consistency requirement. Once an individual or RPE chooses to aggregate two or more trades or businesses, the individual (or RPE) must consistently report the aggregated trades or businesses in all subsequent taxable years. A failure to aggregate will not be considered to be an aggregation for purposes of this rule. An individual (or RPE) that fails to aggregate may not aggregate trades or businesses on an amended return (other than an amended return for the 2018 taxable year). However, an individual (or RPE) may add a newly created or newly acquired (including through nonrecognition transfers) trade or business to an existing aggregated trade or business (including the aggregated trade or business of an RPE). In a subsequent year, if there is a significant change in facts and circumstances such that an individual's (or RPE's) prior aggregation of trades or businesses no longer qualifies for aggregation, then the trades or businesses will no longer be aggregated, and the individual (or RPE) must reapply the rules to determine a new permissible aggregation (if any). An individual also must report aggregated trades or businesses of an RPE in which the individual holds a direct or indirect interest (§1.199A-(4)(c)(1)).

Annual disclosure requirement. For each taxable year, individuals and RPEs must attach a statement to their returns identifying each trade or business aggregated. The statement must contain :

1. A description of each trade or business;
2. The name and EIN of each entity in which a trade or business is operated;
3. Information identifying any trade or business that was formed, ceased operations, was acquired, or was disposed of during the taxable year;
4. Information identifying any aggregated trade or business of an RPE in which the individual holds an ownership interest; and
5. Such other information as the IRS may require in forms, instructions, or other published guidance (§1.199A-(4)(c)(2)(i)).

Failure to disclose. If an individual fails to attach the required statement, the IRS may disaggregate the individual's trades or businesses. The individual may not aggregate trades or businesses that are disaggregated by the Commissioner for the subsequent three taxable years (§1.199A-(4)(c)(2)(ii)).

Making the Election and Annual Disclosure

Election and annual disclosure are both accomplished on Form 8995-A, Schedule B - Aggregation of Business Operations.

Example concluded. Hank and Polly Plumb are eager to aggregate their businesses. None of their businesses produces any QBI on its own. With their taxable income in excess of the threshold each business must rely on W-2 wages or UBIA. None of their businesses have the right combination of income, W-2 wages and/or UBIA. When aggregated, the businesses produce $480,000 of QBI; $410,000 of W-2 wages; and $1,000,000 of UBIA. Their QBI deduction after aggregating all three businesses is $95,120.

Hank and Polly Plumb Aggregation Election			
Aggregated QBI		$ 480,000	
Aggregate QB W-2 wages		410,000	
Aggregated UBIA		1,000,000	
***Tentative* Taxable Income**			$475,600
QBI Deduction Is Lesser of (A) or (B):			
(A) QBI ($480,000) X 20% = **OR**		$96,000	
(B) GREATER OF (1) **OR** (2)			
(1) W-2 Wages ($410,000) X 50% =	$205,000		
(2) W-2 Wages ($410,000) X 25% + UBIA ($1,000,000) X 2.5% =	127,500	205,000	
Combined QBI Is Lesser of (A) or (B)			96,000
Taxable Income Limitation: Lesser of (1) or (2)			
Taxable Income before QBI deduction		$475,600	
(1) 20% of Taxable Income		95,120	
(2) Tentative QBI Deduction		96,000	
QBI Deduction			$95,120

Hank and Polly will file Form 8995-A, Qualified Business Deduction and Form 8995-A, Schedule B, Aggregation of Business Operations.

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

Qualified Business Income Deduction

► Attach to your tax return.

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

OMB No. 1545-0123

2019

Attachment Sequence No. 55A

Name(s) shown on return	Your taxpayer identification number
HANK AND POLLY PLUMB	444-44-4444

Part I Trade, Business, or Aggregation Information

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

1	**(a)** Trade, business, or aggregation name	**(b)** Check if specified service	**(c)** Check if aggregation	**(d)** Taxpayer identification number	**(e)** Check if patron
A	AGGREGATION 1	☐	☒		☐
B		☐	☐		☐
C		☐	☐		☐

Part II Determine Your Adjusted Qualified Business Income

		A	B	C
2 Qualified business income from the trade, business, or aggregation. See instructions	2	480,000.		
3 Multiply line 2 by 20% (0.20). If your taxable income is $160,700 or less ($160,725 if married filing separately; $321,400 if married filing jointly), skip lines 4 through 12 and enter the amount from line 3 on line 13	3	96,000.		
4 Allocable share of W-2 wages from the trade, business, or aggregation	4	410,000.		
5 Multiply line 4 by 50% (0.50)	5	205,000.		
6 Multiply line 4 by 25% (0.25)	6	102,500.		
7 Allocable share of the unadjusted basis immediately after acquisition (UBIA) of all qualified property	7	1,000,000.		
8 Multiply line 7 by 2.5% (0.025)	8	25,000.		
9 Add lines 6 and 8	9	127,500.		
10 Enter the greater of line 5 or line 9	10	205,000.		
11 W-2 wage and qualified property limitation. Enter the smaller of line 3 or line 10	11	96,000.		
12 Phased-in reduction. Enter the amount from line 26, if any. See instructions	12			
13 Qualified business income deduction before patron reduction. Enter the greater of line 11 or line 12	13	96,000.		
14 Patron reduction. Enter the amount from Schedule D (Form 8995-A), line 6, if any. See instructions	14			
15 Qualified business income component. Subtract line 14 from line 13	15	96,000.		
16 Total qualified business income component. Add all amounts reported on line 15 ►	16	96,000.		

BAA For Privacy Act and Paperwork Reduction Act Notice, see separate instructions. Form **8995-A** (2019)

Part III Phased-in Reduction

Complete Part III only if your taxable income is more than $160,700 but not $210,700 ($160,725 and $210,725 if married filing separately; $321,400 and $421,400 if married filing jointly) and line 10 is less than line 3. Otherwise, skip Part III.

			A	B	C
17 Enter the amounts from line 3		17			
18 Enter the amounts from line 10		18			
19 Subtract line 18 from line 17		19			
20 Taxable income before qualified business income deduction	20				
21 Threshold. Enter $160,700 ($160,725 if married filing separately; $321,400 if married filing jointly)	21				
22 Subtract line 21 from line 20	22				
23 Phase-in range. Enter $50,000 ($100,000 if married filing jointly)	23				
24 Phase-in percentage. Divide ln 22 by ln 23	24 %				
25 Total phase-in reduction. Multiply line 19 by line 24		25			
26 Qualified business income after phase-in reduction. Subtract line 25 from line 17. Enter this amount here and on line 12, for the corresponding trade or business		26			

Part IV Determine Your Qualified Business Income Deduction

27 Total qualified business income component from all qualified trades, businesses, or aggregations. Enter the amount from line 16	27	96,000.		
28 Qualified REIT dividends and publicly traded partnership (PTP) income or (loss). See instructions	28			
29 Qualified REIT dividends and PTP (loss) carryforward from prior years	29			
30 Total qualified REIT dividends and PTP income. Combine lines 28 and 29. If less than zero, enter -0-	30			
31 REIT and PTP component. Multiply line 30 by 20% (0.20)	31			
32 Qualified business income deduction before the income limitation. Add lines 27 and 31 ►			32	96,000.
33 Taxable income before qualified business income deduction	33	475,600.		
34 Net capital gain. See instructions	34			
35 Subtract line 34 from line 33. If zero or less, enter -0-			35	475,600.
36 Income limitation. Multiply line 35 by 20% (0.20)			36	95,120.
37 Qualified business income deduction before the domestic production activities deduction (DPAD) under section 199A(g). Enter the smaller of line 32 or line 36 ►			37	95,120.
38 DPAD under section 199A(g) allocated from an agricultural or horticultural cooperative. Don't enter more than line 33 minus line 37			38	
39 Total qualified business income deduction. Add lines 37 and 38 ►			39	95,120.
40 Total qualified REIT dividends and PTP (loss) carryforward. Combine lines 28 and 29. If zero or greater, enter -0-			40	

Form **8995-A** (2019)

SCHEDULE B
(Form 8995-A)
Department of the Treasury
Internal Revenue Service

Aggregation of Business Operations

► Attach to Form 8995-A.
► Go to *www.irs.gov/Form8995A* for instructions and the latest information.

OMB No. 1545-0123
2019
Attachment Sequence No. 55C

Name(s) shown on return	Your taxpayer identification number
HANK AND POLLY PLUMB	444-44-4444

If you have more than one aggregated group, complete and attach as many Schedules B as needed. Number the first aggregation '1' and any additional aggregations in numerical order (2, 3, 4, etc.). See instructions.

Aggregation No.: 1

1 Provide a description of the aggregated trade or business and an explanation of the factors met that allow the aggregation in accordance with Regulations section 1.199A-4. In addition, if you hold a direct or indirect interest in a relevant pass-through entity (RPE) that aggregates multiple trades or businesses, you must attach a copy of the RPE's aggregations.

SEE STATEMENT 2

2 Has this trade or business aggregation changed from the prior year? This includes changes in the aggregation due to a trade or business being formed, acquired, disposed of, or ceasing operations. If 'Yes,' explain. If 'No,' skip line 2 and go to line 3.

NONE

3 **(a)** Name of trade or business	**(b)** Taxpayer identification number	**(c)** Qualified business income/(loss)	**(d)** W-2 wages	**(e)** Unadjusted basis immediately after acquisition
HANK'S PLUMBING	444-44-4444	500,000.	0.	0.
HANK'S TANKS	66-6666666	0.	10,000.	1,000,000.
POLLY'S PIPES	77-7777777	-20,000.	400,000.	0.
4 **Totals.** Total columns (c), (d), and (e). Enter the total amounts on Schedule C (Form 8995-A) or on Form 8995-A, Part II, for the corresponding aggregation, as appropriate. See instructions.		480,000.	410,000.	1,000,000.

BAA For Privacy Act and Paperwork Reduction Act Notice, see separate instructions. **Schedule B (Form 8995-A) 2019**

2019 **FEDERAL STATEMENTS** PAGE 1

HANK AND POLLY PLUMB 444-44-4444

FORM 8995-A, SCHEDULE B, LINE 1
EXPLANATION OF AGGREGATION

HANK'S PLUMBING PROVIDES GENERAL CONTRACTOR PLUMBING WORK, SPECIALIZING IN THE INSTALLATION OF SEPTIC SYSTEMS FOR RESIDENTIAL AND COMMERCIAL CUSTOMERS.

HANK'S TANK'S MANUFACTURES SEPTIC TANKS. HANK'S PLUMBING IS A SIGNIFICANT CUSTOMER OF HANK'S TANKS.

POLLY'S PIPES SELLS PIPES THAT CONNECT SEPTIC SYSTEMS TO RESIDENTIAL AND COMMERCIAL PROPERTIES. HANK'S PLUMBING IS A SIGNIFICANT CUSTOMER OF POLLY'S PIPES.

1. EACH AGGREGATED TRADE OR BUSINESS (HANK'S PLUMBING, HANK'S TANKS AND POLLY'S PIPES) IS A SEPARATE TRADE OR BUSINESS.

2. EACH AGGREGATED TRADE OR BUSINESS WAS OWNED 100% BY HANK AND POLLY PLUMB THROUGHOUT THE TAXABLE YEAR AND ON THE LAST DAY OF THE TAXABLE YEAR.

3. EACH AGGREGATED TRADE OR BUSINESS HAS DECEMBER 31 AS ITS YEAR END.

4. NONE OF THE AGGREGATED TRADES OR BUSINESSES ARE A SPECIFIED SERVICE TRADE OR BUSINESS.

5A. EACH OF THE AGGREGATED TRADES OR BUSINESSES PROVIDE PRODUCTS AND SERVICES THAT ARE CUSTOMARILY OFFERED TOGETHER. HANK'S TANKS SELLS SEPTIC SYSTEMS TO RESIDENTIAL AND COMMERCIAL CUSTOMERS. THE SEPTIC SYSTEMS ARE INSTALLED BY HANK'S PLUMBING USING PIPES SOLD BY POLLY'S PIPES.

5B. EACH OF THE TRADES OR BUSINESSES SHARE SIGNIFICANT CENTRALIZED BUSINESS ELEMENTS. BOTH HANK PLUMB AND POLLY PLUMB PROVIDE SERVICES TO THE BUSINESSES AS EMPLOYEES, ALL ACCOUNTING FOR ALL BUSINESSES IS PERFORMED IN THE SAME OFFICE AND ALL BUSINESSES USE THE SAME COMPUTER NETWORK FOR ALL INFORMATION TECHNOLOGY NEEDS.

5C. THE SALE AND INSTALLATION OF SEPTIC SYSTEMS, INCLUDING THE TANKS, PIPES AND LABOR RELY UPON EACH OF THE AGGREGATED TRADES OR BUSINESSES TO PROVIDE PRODUCTS OR LABOR SERVICES TO COMPLETE A JOB.

The Final Regulations and IRS FAQs Expanded, Clarified and Modified the Following:

1. **QBI is reduced by SE tax, health insurance and retirement contributions.** Deductions for the following three items reduce QBI:
   a. ½ of self-employment tax,
   b. self-employed health insurance, and
   c. retirement contributions (Preamble, IV (A)(5))

2. **Pre-2018 losses not allowed; post-2017 losses suspended.** Suspended losses allowed in a future year must be taken into account in calculating QBI. However, losses suspended from years prior to 2018 are NOT taken into account. Suspended losses include losses suspended under either §704 or §1366 (basis in a partnership or S corporation), §465 (at-risk limitation) or §469 (suspended passive loss). These losses are used on a first-in/first-out basis (Preamble, IV(A)(2)).

3. **Song or screenplay writer is a performing art "specified service".** Royalty payments to a singer, or for a screenplay or film production are classified as performing art and the business is classified as a Specified Services Trade or Business (SSTB). (Preamble, VI(A)(5); §1.199A-(5)(b)(2)(iv); §1.199A-5(b)(3), Exp 5; §1.199-(5)(b)(3), Exp 6).

4. **Health professional is a health "specified service".** Doctors, pharmacists, nurses, dentists, veterinarians, physical therapists, psychologists, and other "similar healthcare professionals" that provide health services are classified as health specified services (SSTB). In the proposed regulations, the language included "other similar healthcare professionals *who provide medical services directly to a patient*." The final regulations removed the italicized section. Proximity to patients is not a necessary component of providing services in the field of health. Thus, for example, radiologists are health professionals even though they might not meet with patients (Preamble, IV(A)(2);).

5. **Health facilities are not "services".** Examples show that an assisted living facility and a surgery center are generally not in the field of health "services" (§1.199-(5)(b)(3), Exp 2&3).

6. **Pharmacy is not a "service", but a pharmacist performs "specified services".** The sale of pharmaceuticals and medical devices by a retail pharmacy is not by itself a trade or business performing services in the field of health. However, some services provided by a retail pharmacy through a pharmacist are the performance of services in the field of health (Preamble, IV(A)(2)); §1.199A-(5)(b)(3), Exp 1).

7. **Just a little "specified services" doesn't convert a non-SSTB to an SSTB.** For a trade or business with gross receipts of less than $25 million, the business is not a "specified" services trade or business (SSTB) if 10% or less of the gross receipts are attributable to the performance of services in a disqualified field. But what if the service income is more than 10% of gross receipts? When a business has gross income from a specified service activity in excess of the threshold, *the entire business is considered an SSTB*. For example, Landscape LLC has gross receipts of $2,000,000, selling $250,000 of landscape design and the rest being landscape services (lawn care). As the gross

receipts from the consulting services exceed 10% of the total gross receipts, the entire business is considered a "specified" service (SSTB) [Preamble, IV(B); §1.199A-(5)(c)(1)&(2); §1.199A-(5)(c)(3), Exp 1&2].

Tax practitioner planning. Separable books and employees are needed or the income of the business is all SSTB.

8. **Annual disclosure election required when aggregating multiple businesses.** Individuals and Relevant Passthrough Entities (RPEs) have similar required annual reporting and disclosure rules. Form 8995-A, Schedule B should be used for the aggregation election. (FAQ #24; Preamble, V(D); §1.199A-(4)(c)(2)(I); Preamble, V(D); §1.199A-(4)(c)(2)(I))

9. **Failure to make the election when aggregating multiple businesses.** A late aggregation election is not precluded although the IRS will generally not allow the initial aggregation election to be made on an amended return as this would allow aggregation decisions to be made with the benefit of hindsight. As the IRS acknowledges that many individuals and RPEs (Relevant Passthrough Entity) may have been unaware of the aggregation rules when filing the 2018 returns, the IRS allowed initial aggregations to be made on amended returns for the 2018 taxable year (§1.199A-(4)).

10. **Aggregation election for RPE (Relevant Passthrough Entity).** A pass-through entity is allowed to aggregate its own activities. If a pass-through entity elects to aggregate, the owners are bound by that aggregation. They can, however, add to that aggregation with their own activities if conditions are met (Preamble, V(c)).

11. **Property, including real estate, may be provided to a "specified service" trade or business (SSTB).** "Property" has been added to the "products and services" listed property aggregation factors. If a trade or business provides product, *property* or services to an SSTB and there is 50% or more common ownership of the trade or business, the portion of the trade or business providing property or services to the 50% or more commonly-owned SSTB will be treated as a separate SSTB with respect to related parties. The final regulations removed the 80% threshold and allow any portion that is not provided to an SSTB to be eligible for the §199A deduction. For example, if the dentist's trade or business leased 90% of the building to her dental office and 10% to a coffee shop, the 10% would be eligible for the QBI deduction (Preamble, IV(c); Preamble, V(B); §1.199A-(4)(d), Exp 16, 17, 18].

12. **Common control of rentals and rental management.** It is not uncommon that, for legal or other non-tax reasons, taxpayers may segregate rental property from operating businesses. The rental or licensing of tangible or intangible property to a related trade or business is treated as a trade or business if the rental or licensing and the other trade or businesses are commonly controlled. This rule allows taxpayers to aggregate their trades or businesses with the associated rental or intangible property if five requirements are met (covered later). In addition, this rule attempts to prevent taxpayers from improperly allocating losses or deductions away from trades or businesses that generate income eligible for the 20% QBI deduction (§1.199A-4(b)(1)(I)).

13. **§754 Election.** A §743(b) step-up pursuant to a §754 election is included in UBIA. UBIA is not created when property basis is stepped-up because of a redemption of a partnership interest under §734(b) [Preamble, III(B)(4); §1.199A-(2)(a)(3)(iv)(D), Exp 1].

14. **Inherited property.** For inherited property, UBIA will generally be its FMV at decedent's date of death pursuant to §1014. A new depreciable period for the property commences as of the date of the decedent's death Preamble, III(B)(6)).

15. **Real estate as a trade or business.** Rental real estate may constitute a trade or business for purposes of the QBI deduction if the rental real estate:

    a. Rises to the level of a trade or business under §162,
    b. Satisfies the requirements for the safe harbor provided by Notice 2019-07, or
    c. Meets the self-rental exception (i.e., the rental or licensing of property to a commonly controlled trade or business conducted by an individual or RPE, i.e., Relevant Passthrough Entity) [FAQ #17].

16. **QBI for Co-ops.** In June 2019, the IRS added 14 FAQs on Patrons and Cooperatives (FAQs 34-47; IR-2019-115.)

17. **For a partnership or S corporation,** §199A applies at the partner or shareholder level. The 20% QBI deduction has no effect on the adjusted basis of the partner's interest in the partnership. In addition, the 20% QBI deduction has no effect on the adjusted basis of a shareholder's stock in an S corporation or the S corporation's accumulated adjustments account (§1.199A-1(b)(10)).

HOW TO REPORT QB LOSSES

Net QB Losses Reduce QBI in Next Taxable Year

QB losses must be carried forward. If the net amount of QBI reported on the individual's return is a loss, it is carried forward to the *next succeeding taxable year* and any QBI deduction allowed in a subsequent year is reduced (but not below zero). It does not retain its prior loss character [§199A(c); §1.199A-1(c)(2)(i))].

> **Tax practitioner planning**. The qualified business loss is still deductible in the year it occurred (if it didn't qualify as deductible, it would not affect QBI). This is a paper carryover to stop taxpayers from qualifying for a QBI deduction in one year by moving expenses to another.

Losses suspended before Jan. 1, 2018 do not reduce current year's QBI. Losses or deductions that were disallowed for taxable years beginning before January 1, 2018, are not taken into account for purposes of computing QBI in a later taxable year (§1.1.199A-3(b)(1)). Suspended passive losses disallowed for taxable years beginning on or after Jan. 1, 2018 reduce current QBI.

Old net operating losses do not reduce current year's QBI. A deduction under §172 for an NOL is not considered attributable to a trade or business and therefore, is not taken into account in computing QBI. However, to the extent the NOL is comprised of amounts attributable to trade or business losses in excess of $500,000 that were disallowed after Dec. 31, 2017 and before Jan. 1, 2026 under §461(l), that is excess farm losses and excess business losses, the NOL is considered attributable to that trade or business, and will constitute QBI to the extent the requirements of §199A (§1.199A-3(b)(1)(v)).

HOW DO YOU ALLOCATE QBI NOT CLEARLY ATTRIBUTABLE TO A SINGLE BUSINESS?

Must Allocate QBI among Multiple Businesses

What happens if the owner has both profit and loss businesses? If an individual has QBI of less than zero from one trade or business(s) but has overall QBI greater than zero, then the individual must offset each business(s) net income with each business(s) net loss before applying the W-2 wages and UBIA of qualified property limitations in proportion to the relative amounts of QBI in each business (§1.199A-1(d)(iii)).

Using any reasonable method. If an individual or an RPE directly conducts multiple trades or businesses, and has items of QBI that are properly attributable to more than one trade or business, the taxpayer or entity must allocate those items among the several trades or businesses to which they are attributable using a reasonable method that is consistent with the purposes of QBI (§1.199A-3(b)(5)).

Must be consistent from year to year and clearly reflect income. The chosen reasonable method for each item must be consistently applied from one taxable year to another and must clearly reflect the income of each trade or business (§1.199A-3(b)(5)).

> **Example - Accounting methods must be consistent:** If Veronica's QBI from at least one trade or business is less than zero, she must offset the QBI attributable to each trade or business that produced net positive QBI with the QBI from each trade or business that produced net negative QBI in proportion to the relative amounts of net QBI in the trades or businesses with positive QBI (Preamble (II)(B)).
>
> **Tax practitioner planning.** Yes, this is how the IRS writes!

There are several different ways to allocate expenses, such as direct tracing or allocating based on gross income, but whether these are reasonable depends on the facts and circumstances of each trade or business (1.199A-1(d)(2)(iii)(A); §1.199A-3(b)(5)).

> **Example - Allocating tenancy-in-common expenses must be reasonable.** If taxpayers who own tenancy in common interests in rental property, treat such joint interests as a trade or business for QBI purposes but do not treat "certain joint undertakings (that) give rise to entities for federal tax purpose (see §301.7701-1(a)(2)) or don't comply with the information return filing requirements (see §6041), the IRS "will consider the facts and circumstances surrounding the differing treatment" (Preamble (II)(A)(3)(e)).
>
> **Example - Allocating partnership expenses must be reasonable**. SV Partnership pays rent on a warehouse that is used by two of its businesses. The rent must be allocated in a reasonable method. Thus, SV allocates the rent by the square footage of the warehouse used by each business.

A taxpayer can use different methods of accounting for separate and distinct trades or businesses. But no trade or business will be considered separate and distinct unless a complete and separable set of books and records are kept for each trade or business (§1.446-1(d)(2); Preamble (II)(A)(3)(d)).

SECTION 199A & RENTAL REAL ESTATE

Final Regulations Provide Guidance and Safe Harbor

Issued in January 2019, final regulations at §1.199A-1(b)(14) adhered to the IRS's historical position that a "trade or business" means a §162 trade or business other than the trade or business of performing services as an employee. The Service argues that whether an activity rises to the level of a §162 trade or business is inherently a factual question and specific guidance under §162 is beyond the scope of the §199A regulations.

In determining whether a rental real estate activity is a §162 trade or business, the IRS offers that the relevant factors might include, but are not limited to (i) the type of rented property (commercial real property versus residential property), (ii) the number of properties rented, (iii) the owner's or the owner's agents day-to-day involvement, (iv) the types and significance of any ancillary services provided under the lease, and (v) the terms of the lease (for example, a net lease versus a traditional lease and a short-term lease versus a long-term lease). However, beyond these generalizations, the Service refuses to provide a bright-line test.

> **Tax practitioner planning - issue 1099s!** On the issue of using the §162 standard for taking a QBI deduction for a rental activity, the IRS cautions in the final regulations to remember to be consistent with information return filing requirements under §6041. Landlords are generally not required to issue 1099s, but trade or business owners must issue 1099s.

The Rental Activity Safe Harbor

IRS recognizes the difficulties taxpayers and practitioners may have in determining whether a taxpayer's rental real estate activity is sufficiently regular, continuous, and considerable for the activity to constitute a §162 trade or business. Accordingly, IRS issued Rev. Proc. 2019-38 providing a safe harbor under which a rental real estate enterprise may be treated as a trade or business solely for purposes of §199A. If an enterprise fails to satisfy the requirements of this safe harbor, the rental real estate enterprise may still be treated as a trade or business for purposes of§199A if the enterprise otherwise meets the definition of trade or business in §1.199A-1(b)(14).

Solely for the purposes of §199A, a rental real estate enterprise will be treated as a trade or business if the following requirements are satisfied during the taxable year with respect to the rental real estate enterprise:

A. Separate books and records are maintained to reflect income and expenses for each rental real estate enterprise;
B. For taxable years beginning prior to January 1, 2023, 250 or more hours of rental services are performed per year with respect to the rental enterprise. For taxable years beginning after December 31, 2022, in any three of the five consecutive taxable years that end with the taxable year (or in each year for an enterprise held for less than five years), 250 or more hours of rental services are performed per year with respect to the rental real estate enterprise; and
C. The taxpayer maintains contemporaneous records, including time reports, logs, or similar documents, regarding the following: (i) hours of all services performed; (ii) description of all services performed; (iii) dates on which such services were performed; and (iv) who performed the services. Such records are to be made available for inspection at the request of the IRS. The contemporaneous records' requirement will not apply to taxable years beginning prior to Jan. 1, 2020 (Rev. Proc. 2019-38; IR-2019-158).

What Counts for the 250 Hours?

Rental services for purpose of the revenue procedure include:
(i) advertising to rent or lease the real estate;
(ii) negotiating and executing leases;
(iii) verifying information contained in prospective tenant applications;
(iv) collection of rent;
(v) daily operation, maintenance, and repair of the property;
(vi) management of the real estate;
(vii) purchase of materials; and
(viii) supervision of employees and independent contractors.

Rental services may be performed by owners or by employees, agents, and/or independent contractors of the owners. The term rental services does not include financial or investment management activities, such as arranging financing; procuring property; studying and reviewing financial statements or reports on operations; planning, managing, or constructing long-term capital improvements; or hours spent traveling to and from the real estate.

> **Example.** Karen owns a 6-unit apartment building. She employs a property manager who also employs gardeners, handymen, cleaners and other maintenance personnel. Karen also oversees new tenant applications, tenant evictions and directs the property manager. Karen logs 100 hours of her own time and the property manager provides a log of 200 hours of his and his contractor's time. The combined 300 hours meet the safe harbor test.

> **Tax practitioner planning.** Who Keeps the Log? In order to use the safe harbor for 2020 and beyond, a contemporaneous log of rental services hours must be kept. Certainly the taxpayer is responsible for tracking his/her own hours and the hours of anyone the taxpayer engages to perform services. But when a property manager is involved, the taxpayer needs to rely on the manager to provide a supplemental log. A sample letter for your client to provide to his/her property manager follows.

What constitutes a "real estate enterprise" for the safe harbor? Taxpayers must either treat each property held for the production of rents as a separate enterprise or treat all similar properties held for the production of rents (with the exception of excluded real estate arrangements described below) as a single enterprise. Commercial and residential real estate may not be part of the same enterprise. Taxpayers may not vary this treatment from year-to-year unless there has been a significant change in facts and circumstances

Excluded Real Estate Arrangements

Real estate used by the taxpayer as a residence for any part of the year under §280A is not eligible for this safe harbor. Real estate rented or leased under a triple net lease is also not eligible for this safe harbor. For purposes of this revenue procedure, a triple net lease includes a lease agreement that requires the tenant or lessee to pay taxes, fees, and insurance, and to be responsible for maintenance activities for a property in addition to rent and utilities. This includes a lease agreement that requires the tenant or lessee to pay a portion of the taxes, fees, and insurance, and to be responsible for maintenance activities allocable to the portion of the property rented by the tenant.

Safe Harbor Statement Required

A taxpayer (or RPE) must attach a statement to a timely filed original return with the following information:

1. A description (including the address and rental category) of all rental real estate properties that are included in each rental real estate enterprise;
2. A description (including the address and rental category) of rental real estate properties acquired and disposed of during the taxable year; and
3. A representation that the requirements of Rev. Proc. 2019-38 have been satisfied.

RENTAL REAL ESTATE CLIENT LETTER

Letter to Property Manager from Rental Owner

Dear Property Manager:

When the Tax Cuts and Jobs Act was signed into law in December 2017, a new tax deduction was created that applies to rental real estate owners — the Section 199A Qualified Business Income (QBI) deduction. Net rental income from my property that you manage can qualify for some or all of the 20% QBI deduction. My tax advisor has informed me that I may qualify for this deduction on my 2020 tax return if you certify that you, your employees, and/or your contracted workers spent more than 250 hours working on my real estate activity during the year. (If you spent less than 250 hours during the year, please provide the number of hours that your records show here_________.)

The Rental Safe Harbor. In order to qualify for this safe harbor in 2020, I must meet the following requirements:

A. Separate books and records are maintained to reflect income and expenses for each rental;
B. 250 or more hours of rental services are performed per year with respect to the rental; and
C. I, or my agent, maintain records, including time reports, logs, or similar documents, regarding the following: (i) hours of all services performed; (ii) description of all services performed; (iii) dates on which such services were performed; and (iv) who performed the services.

Please note that for 2020, the records of rental service hours must be maintained contemporaneously. They may not be reconstructed at year end or estimated.

What Counts for the 250 Hours? Rental services for this purpose include:
(i) advertising to rent or lease the real estate;
(ii) negotiating and executing leases;
(iii) verifying information contained in prospective tenant applications;
(iv) collection of rent;
(v) daily operation, maintenance, and repair of the property;
(vi) management of the real estate;
(vii) purchase of materials; and
(viii) supervision of employees and independent contractors.

Because you are responsible for providing many of the above services (either directly or through contractors or employees), I'm counting on you to provide me with the attached letter at year-end verifying the rental services hours you and those you've hired have provided.

Thank you for your attention to this matter. Please let me know if you have any questions.

Regards,

Letter to Property Owner

Date:

Dear Property Owner:

Thank you for allowing me to serve you this year. The purpose of my letter today is to certify that I can provide a log to verify that we performed rental real estate services (as described in IRS Revenue Procedure 2019-38) of more than 250 hours for your real estate activity for the tax year 2020. (If less than 250 hours, please indicate the number of hours here_______.) These services were performed by me, my employees and various contracted workers during the year.

Please be sure to contact me if you have any questions.

Sincerely,

Property Manager

Property address: ____

____

WHAT IMPACT DOES THE 20% QBI DEDUCTION HAVE ON SE TAX OR INDIVIDUAL AMT?

No effect on SE tax. The 20% QBI deduction does not reduce net earnings from self-employment under §1402 or net investment income under §1411. Therefore, both §1402 and §1411 are calculated as though there is no 20% QBI deduction (§1.199A-1(e); FAQ #14).

Reduces AMTI. For purposes of determining alternative minimum taxable income under §55, QBI is determined without regard to any adjustments under §56 through §59. The 20% QBI deduction is equal in amount to the deduction in determining taxable income for that taxable year (§1.199A-1(e)(4)).

EFFECTIVE DATE

The 20% QBI deduction is generally effective for taxable years beginning after Dec. 31, 2017, and before Jan. 1, 2026.

A FEW QBI PLANNING IDEAS

QBI Deduction Planning

For those with taxable income *BELOW* the thresholds, planning is minimal:

- stay below the threshold.
- the LLC is better than the S corporation, as W-2 wages need not (cannot) be paid to the owner.

For those with taxable income *ABOVE* the threshold:

- Try to reduce taxable income below the threshold:
  - Purchase depreciable equipment before year end.
  - Defer income to the next year.
  - Increase pension contributions.
  - Increase charitable contributions (or bunch between two years).
  - Consider an HSA.
  - Consider married filing separate (for separate property states or separate property income).

- If wages aren't paid by the entity:
  - consider switching to an S corporation in order to pay wages to the owner.
  - consider hiring children or the spouse.
  - review independent contractor status of workers — are they really employees.
- Limit guaranteed payments or change to an S corporation and manage difference in work by owners through wages.
- Consider aggregating commonly controlled businesses if W-2 wages or UBIA are a consideration for any of the individual businesses.
- For an SSTB, analyze the business operation to see if there is a separable business that might qualify for the QBI deduction.

2020 FEDERAL TAX UPDATE
QUALIFIED BUSINESS INCOME DEDUCTION

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2020 FEDERAL TAX UPDATE
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NEW LEGISLATION

COVID-19's huge impact on businesses required Congress to act. They passed, and the President signed into law, two major pieces of legislation aimed at keeping businesses alive and their employees fed.

FAMILIES FIRST CORONAVIRUS RESPONSE ACT (FFCRA)

SICK LEAVE AND FAMILY LEAVE CREDITS (DOL FAQs)

The US has over a million (changing by the day) people diagnosed with Coronavirus. Many more have symptoms, are quarantined for exposure, and are seeking medical testing. To help those affected, Congress passed a sick leave and family leave bill.

The Families First Coronavirus Response Act (FFCRA), signed into law Mar. 18, 2020, *requires* certain employers to provide employees with paid sick leave or expanded family and medical leave for specified reasons related to COVID-19. This is an expansion of The Family and Medical Leave Act of 1993 (FMLA).

Credits for Sick and Expanded Family and Medical Leave

Eligible employers may claim tax credits for qualified leave wages paid to employees on leave due to paid sick leave or expanded family and medical leave for reasons related to COVID-19 for leave taken beginning on Apr. 1, 2020, and ending on Dec. 31, 2020.

Generally, the FFCRA provides that employees of covered employers are eligible for:

- Two weeks (up to 80 hours) of paid sick leave at the employee's regular rate of pay where the employee is unable to work because the employee is quarantined (pursuant to federal, state, or local government order or advice of a healthcare provider), and/or experiencing COVID-19 symptoms and seeking a medical diagnosis; or

- Two weeks (up to 80 hours) of paid sick leave at two-thirds the employee's regular rate of pay because the employee is unable to work because of a bona fide need to care for an individual subject to quarantine (pursuant to federal, state, or local government order or advice of a healthcare provider) or to care for a child (under 18 years of age) whose school or child care provider is closed or unavailable for reasons related to COVID-19, and/or the employee is experiencing a substantially similar condition as specified DOL and IRS; and

- Up to an additional 10 weeks of paid expanded family and medical leave at two-thirds the employee's regular rate of pay where an employee, who has been employed for at least 30 calendar days, is unable to work due to a bona fide need for leave to care for a child whose school or child care provider is closed or unavailable for reasons related to COVID-19.

  Note. Small businesses with fewer than 50 employees may qualify for exemption from the requirement to provide leave due to school closings or child care unavailability if the leave requirements would "jeopardize the viability of the business as an going concern."

Covered employers — fewer than 500 employees. The paid sick leave and expanded family and medical leave provisions of the FFCRA apply to certain public employers, and private employers with fewer than 500 employees. Count the full-time and part-time employees, including those on leave, temporary employees, and laborers provided by a temporary agency or PEO.

Typically, a corporation (including its separate establishments or divisions) is considered to be a single employer, and its employees must each be counted towards the 500-employee threshold. Where a corporation has an ownership interest in another corporation, the two corporations are separate employers unless they are "joint employers" under the FLSA with respect to certain employees. In general, two or more entities are separate employers unless they meet the "integrated employer" test under the Family and Medical Leave Act of 1993 (FMLA).

Eligible Employees. All employees of covered employers are eligible for two weeks of paid sick time for specified reasons related to COVID-19. Employees employed for at least 30 days are eligible for up to an additional 10 weeks of paid family leave to care for a child under certain circumstances related to COVID-19.

> **Tax practitioner planning.** Full-time and part-time employees are eligible for sick leave. See DOL FAQ #5 for details on calculating the amount due to a part-time employee.

Qualifying Reasons for Leave. Under the FFCRA, an employee qualifies for paid sick time if the employee is unable to work (or unable to telework) due to a need for leave because the employee:

1. Is subject to a federal, state, or local quarantine or isolation order related to COVID-19;
2. Has been advised by a healthcare provider to self-quarantine related to COVID-19;
3. Is experiencing COVID-19 symptoms and is seeking a medical diagnosis;
4. Is caring for an individual subject to an order described in (1) or self-quarantine as described in (2);

   Note. For these four categories, a full-time employee is eligible for 80 hours of leave, and a part-time employee is eligible for the number of hours of leave that the employee works on average over a two-week period; or

5. Is caring for a child whose school or place of care is closed (or child care provider is unavailable) for reasons related to COVID-19.

   Note. For this category, a full-time employee is eligible for up to 12 weeks of leave (two weeks of paid sick leave followed by up to 10 weeks of paid expanded family and medical leave) at 40 hours a week, and a part-time employee is eligible for leave for the number of hours that the employee is normally scheduled to work over that period.

6. Is experiencing any other substantially similar condition specified by the Secretary of Health and Human Services in consultation with the Secretary of the Treasury and the Secretary of Labor.

Under the FFCRA, an employee qualifies for expanded family and medical leave if the employee is caring for a child whose school or place of care is closed (or child care provider is unavailable) for reasons related to COVID-19. Remember, there is an exemption for this requirement if the employer has fewer than 50 employees.

Calculation of Pay

For leave reasons (1), (2), or (3): employees taking leave are entitled to pay at either their regular rate or the applicable minimum wage, whichever is higher, up to $511 per day and $5,110 in the aggregate (over a two-week period).

For leave reason (4): employees taking leave are entitled to pay at 2/3 their regular rate or 2/3 the applicable minimum wage, whichever is higher, up to $200 per day and $2,000 in the aggregate (over a two-week period).

For leave reason (5) or (6): employees taking leave are entitled to pay at 2/3 their regular rate or 2/3 the applicable minimum wage, whichever is higher, up to $200 per day and $12,000 in the aggregate (over a 12-week period).

Do the Employees on Leave Get Their Jobs Back?

Generally, yes. But for an employer that has less than 25 employees, the employee's job is not guaranteed if:

1. the position no longer exists because of economic conditions caused by COVID-19, and
2. the employer makes reasonable efforts to restore the employee to the position if it becomes available in the following year.

How Much Is the Employee Paid?

Paid Sick Leave. For an employee who is unable to work because of Coronavirus quarantine or self-quarantine or who has Coronavirus symptoms and is seeking a medical diagnosis, the employee will receive for each applicable hour the greater of:

- the employee's regular rate of pay,
- federal minimum wage, or

- the applicable state or local minimum wage.

The maximum sick leave is $511 per day and $5,110 in the aggregate, for a total of 10 days.

Family and medical leave. For an employee who is unable to work because of a need to care for a child whose school or child care facility is closed or whose child care provider is unavailable due to the Coronavirus, the employee is entitled to compensation equal to two-thirds of his or her regular pay, capped at $200 per day or $10,000 in the aggregate. Up to 10 weeks of qualifying leave can be counted towards the family and medical leave.

> **Tax practitioner planning**. If the employee is taking family and medical leave, the employee may take the first two weeks as sick leave (limited to no more than $200/day). For the following 10 weeks, the employee may take family and medical leave at $200/day. The employee cannot receive more than $12,000 in total for the 12 weeks.

> **Note**. Eligible employers are entitled to an additional tax credit determined based on costs to maintain health insurance coverage for the eligible employee during the leave period.

Recovering the Employer's Cost of Providing Leave

Eligible employers who pay qualifying sick leave or family and medical leave will be able to retain an amount of the payroll taxes equal to the amount of qualifying sick and family and medical leave that they paid, rather than deposit them with the IRS.

The payroll taxes that are available for retention include withheld federal income taxes, the employee share of Social Security and Medicare taxes, and the employer share of Social Security and Medicare taxes with respect to all employees. If there are not sufficient payroll taxes to cover the cost of qualified sick and child care leave paid, employers will be able file a request for an accelerated payment from the IRS. The IRS says it will process these requests for refunds in two weeks or less.

> **Example**. If an eligible employer paid $5,000 in sick leave and is otherwise required to deposit $8,000 in payroll taxes, including taxes withheld from all of its employees, the employer could use up to $5,000 of the $8,000 of taxes it was going to deposit for making qualified leave payments. The employer would only be required under the law to deposit the remaining $3,000 on its next regular deposit date.

> **Example**. If an eligible employer paid $10,000 in sick leave and was required to deposit $8,000 in taxes, the employer could use the entire $8,000 of taxes in order to make qualified leave payments and file a request for an accelerated credit for the remaining $2,000.

Form 7200. Eligible employers may claim the credits on their federal employment tax returns (e.g., Form 941, Employer's Quarterly Federal Tax Return), but they can benefit more quickly from the credits by reducing their federal employment tax deposits. If there are insufficient federal employment taxes to cover the amount of the credits, an Eligible Employer may request an advance payment of the credits from the IRS by submitting a Form 7200, Advance Payment of Employer Credits Due to COVID-19. The IRS started processing these requests during April 2020.

Self-Employed Individuals (IRS FAQs 60 to 66)

Self-employed individuals and the sick leave credit. Equivalent credits are available to self-employed individuals if the self-employed individual would be entitled to receive paid leave under the EPSLA or Expanded FMLA if the individual were an employee of an employer (other than him or herself) based on "similar circumstances."

1. For an eligible self-employed individual who is unable to work or telework because the individual:
    - Is subject to a federal, state, or local quarantine or isolation order related to COVID-19;
    - Has been advised by a healthcare provider to self-quarantine due to concerns related to COVID-19; or
    - Is experiencing symptoms of COVID-19 and seeking a medical diagnosis,
2. Then the qualified sick leave equivalent amount is equal to the number of days during the taxable year that the individual cannot perform services in the applicable trade or business for one of the three above reasons, multiplied by the lesser of $511 or 100% of the "average daily self-employment income" of the individual for the taxable year. Average daily self-employment income is an amount equal to the net earnings from self-employment for the taxable year divided by 260.

Self-employed individuals and the family leave credit. Equivalent credits are available to self-employed individuals.

- For an eligible self-employed individual who is unable to work or telework because the individual:
    - Is caring for an individual who is subject to a federal, state, or local quarantine or isolation order related to COVID-19, or has been advised by a healthcare provider to self-quarantine due to concerns related to COVID-19;
    - Is caring for a child if the child's school or place of care has been closed, or child care provider is unavailable due to COVID-19 precautions; or
    - Is experiencing any other substantially similar condition specified by the Secretary of Health and Human Services in consultation with the Secretary of the Treasury and the Secretary of Labor,
- Then the qualified family leave equivalent amount is equal to the number of days during the taxable year that the individual cannot perform services in the applicable trade or business for one of the three above reasons, multiplied by the lesser of $200 or 67% of the "average daily self-employment income" of the individual for the taxable year.

In either case, the maximum number of days a self-employed individual may take into account in determining the qualified sick leave equivalent amount is 10. The only days that may be taken into account in determining the qualified sick leave equivalent amount are days occurring during the period beginning on Apr. 1, 2020, and ending on Dec. 31, 2020.

How Does the Self-Employed Individual Fund His or Her Sick Leave or Family Equivalent Amounts Before Filing His or Her 2020 Form 1040?

The self-employed individual may fund sick leave and family leave equivalents by taking into account the credit to which the individual is entitled and will claim on Form 1040 in determining required estimated tax payments. This means that a self-employed individual can effectively reduce payments of estimated income taxes that the individual would otherwise be required to make if the individual was not entitled to the credit on the Form 1040 (IRS FAQ 66).

Coordination With Paycheck Protection Loan

The Sick Leave and Family Leave Credits are available to an employer that receives a Paycheck Protection Program loan. But, payroll covered by the credits may not be counted in the "payroll costs" that are used in the calculation of loan forgiveness.

Closed Business, Furloughed or Reduced Hours

If the employer closed the worksite before Apr. 1, 2020, because it did not have work for the employee, the employee is not entitled to sick leave or expanded family and medical leave, but the employee may be eligible for unemployment insurance benefits.

If the employer closed on or after Apr. 1, 2020, the employee will not get paid sick leave or expanded family and medical leave but may be eligible for unemployment insurance benefits. This is true whether the employer closed the worksite for lack of business or because it was required to close pursuant to a federal, state, or local directive.

If the employer closes while the employee is on paid sick leave or expanded family and medical leave, the employer must pay for any paid sick leave or expanded family and medical leave the employee used before the employer closed. As of the date the employer closes the worksite, the employee is no longer entitled to paid sick leave or expanded family and medical leave, but the employee may be eligible for unemployment insurance benefits.

If the employer furloughs the employee because it does not have enough work or business, the employee is not entitled to then take paid sick leave or expanded family and medical leave.

If the employer reduces the employee's work hours because it does not have work, the employee may not use paid sick leave or expanded family and medical leave for the hours that the employee no longer works.

Resources for Sick and Family Leave Credits

See the IRS Coronavirus Tax Relief page, including its 67 FAQs, and the Department of Labor's COVID-19 and the American Workplace, and its 88 FAQs. The DOL has also posted Paid Sick Leave and Expanded Family and Medical Leave Implementation and a 125 page Temporary Rule with more details and updates.

CORONAVIRUS AID, RELIEF, AND ECONOMIC SECURITY (CARES) ACT

The CARES Act, in response to the COVID-19 pandemic, provided two benefits to struggling businesses. The Employee Retention Payroll Tax Credit is meant to pay a small portion of an employees wages during the slowdown. The Payroll Tax Deferal is meant to provide a little extra cash to the struggling employer by postponing the employer's share of OASDI.

EMPLOYEE RETENTION PAYROLL TAX CREDIT

CARES allows eligible employers to receive a 50% payroll tax credit up to $5,000 ($10,000 x 50%) per employee for qualified wages paid after Mar. 12, 2020, and before Jan. 1, 2021. If the credit amount exceeds the employer's liability, the excess is refundable (§3111).

Reduce required payroll deposits. Employers can be immediately reimbursed for the credit by reducing their required deposits of payroll taxes that have been withheld from employees' wages by the amount of the credit. Eligible employers will report their total qualified wages and the related health insurance costs for each quarter on their quarterly employment tax returns or Form 941 beginning with the second quarter. If the employer's employment tax deposits are not sufficient to cover the credit, the employer may receive an advance payment from the IRS by submitting Form 7200, Advance Payment of Employer Credits Due to COVID-19.

> **Example**. Xcess, Inc., an eligible employer, paid $10,000 in qualified wages (including qualified health plan expenses) and is therefore entitled to a $5,000 credit, and is otherwise required to deposit $8,000 in federal employment taxes, including taxes withheld from all of its employees, for wage payments made during the same quarter as the $10,000 in qualified wages. Xcess, Inc. has no paid sick or family leave credits under the FFCRA. Xcess, Inc. may keep up to $5,000 of the $8,000 of taxes Xcess, Inc. was going to deposit, and it will not owe a penalty for keeping the $5,000. Xcess, Inc. is required to deposit only the remaining $3,000 on its required deposit date. Xcess, Inc. will later account for the $5,000 it retained when it files Form 941 for the quarter.

Eligible Employers

Employers, including non-profits, whose operations have been fully or partially suspended as a result of a government order limiting commerce, travel, or group meetings, are eligible for the credit. In addition, eligible employers include those who have experienced more than a 50% reduction in quarterly receipts measured year-over-year.

> **Example**: California Governor Gavin Newsom issues an executive order closing all restaurants, bars, and similar establishments in the state in order to reduce the spread of COVID-19. However, the executive order allows those establishments to continue food or beverage sales to the public on a carry-out, drive-through, or delivery basis. This results in a partial suspension of the operations of the trade or business due to an order of an appropriate governmental authority with respect to any restaurants, bars, and similar establishments in the state that provided full sit-down service, a dining room, or other on-site eating facilities for customers prior to the executive order.

Significant Decline in Gross Receipts Required

A significant decline in gross receipts begins with the first quarter in which an employer's gross receipts for a calendar quarter in 2020 are less than 50% of its gross receipts for the same calendar quarter in 2019. The significant decline in gross receipts ends with the first calendar quarter that follows the first calendar quarter for which the employer's 2020 gross receipts for the quarter are greater than 80 percent of its gross receipts for the same calendar quarter during 2019.

> **Example**: An employer's gross receipts were $100,000, $190,000, and $230,000 in the first, second, and third calendar quarters of 2020, respectively. Its gross receipts were $210,000, $230,000, and

$250,000 in the first, second, and third calendar quarters of 2019, respectively. Thus, the employer's 2020 first, second, and third quarter gross receipts were approximately 48%, 83%, and 92% of its 2019 first, second, and third quarter gross receipts, respectively. Accordingly, the employer had a significant decline in gross receipts commencing on the first day of the first calendar quarter of 2020 (the calendar quarter in which gross receipts were less than 50% of the same quarter in 2019) and ending on the first day of the third calendar quarter of 2020 (the quarter following the quarter for which the gross receipts were more than 80% of the same quarter in 2019). Thus, the employer is entitled to a retention credit with respect to the first and second calendar quarters.

Wages

Wages include health benefits and are capped at the first $10,000 in wages paid by the employer to an eligible employee. For employers with an average number of full-time employees in 2019 of 100 or fewer, all employee wages (including wages of those furloughed) are eligible. For employers with a larger average number of full-time employees in 2019, only the wages of furloughed or reduced hour employees apply.

Tax practitioner planning. Since the credit is limited to the first $10,000 of wages, it doesn't cover much of wages paid in a high-cost area.

Coordination With Paycheck Protection Loan

The Employee Retention Credit is not available to an employer that receives a Paycheck Protection Program (PPP) loan that is authorized under CARES. An Eligible Employer that receives a paycheck protection loan should not claim Employee Retention Credits.

Tax practitioner planning. Business owners must weigh the difference in benefits between these two new CARES benefits.

Example. Organic Sales, Inc. has a $25,000 per month payroll for its five employees. Assuming that each employee makes $5,000 per month, in two months the business will be entitled to a $25,000 Employee Retention Credit (50% of the first $10,000 of wages for each employee). Instead, Organic Sales, Inc. could apply for a PPP Loan of $62,500 ($25,000 average monthly payroll times 2.5) and have potential forgiveness of the whole loan amount if it paid $50,000 of wages and $12,500 of rent and utilities in the eight weeks after the PPP loan was funded.

Example. Doggie Spa, LLC has a $24,000 per month payroll for its 12 employees. Assuming each employee makes $2,000 per month, in five months the business will be entitled to a $60,000 Employee Retention Credit (50% of the first $10,000 of wages for each employee). Instead, Doggie Spa, Inc. could apply for a PPP Loan of $60,000 ($24,000 average monthly payroll times 2.5) and have potential forgiveness of the whole loan amount if it paid $48,000 of wages and $12,500 of rent and utilities in the eight weeks after the PPP loan was funded.

Coordination With the Sick Pay and Family Leave Credit

An eligible employer may receive both the Employee Retention Credit and the Sick Pay and Family Leave Credit, but not for the same wages.

Resources. See IR-2020-62 for more details on the Employer Retention Credit. The IRS has posted FAQs on its website.

EMPLOYER PAYROLL TAX DELAY

Employers must withhold Social Security taxes (§3111(a)) on employee wages (§3211(a) & §3221(a)). Self-employed individuals are subject to self-employment (SECA) tax (§1401(a)). Under CARES, taxpayers are allowed to defer paying the 6.2% employer share of the Social Security tax (but not the 1.45% employer share of the Medicare tax) through the end of 2020. The tax is payable over the following two years with half paid by Dec. 31, 2021, and the other half by Dec. 31, 2022.

Deferral Period

The deferral applies to deposits and payments of the employer's share of Social Security tax that would otherwise be required to be made during the period beginning on Mar. 27, 2020, and ending Dec. 31, 2020. (Section 2302 of the CARES Act calls this period the "payroll tax deferral period.")

Applicable Dates

The payment for applicable employment taxes between Mar. 27, 2020, and Jan. 31, 2021, won't be due before the applicable date. The applicable date is:

1. Dec. 31, 2021, for 50% of employment and self-employment taxes, and
2. Dec. 31, 2022, for the remaining 50% of those amounts.

An employer is treated as timely making all deposits of applicable employment taxes required if all such deposits are made by the applicable date.

Self-Employed Individuals

Self-employed individuals may defer the payment of 50% of the self-employment tax on net earnings for the period beginning on Mar. 27, 2020, and ending Dec. 31, 2020. The deferred payment amounts are due on the "applicable dates."

Paycheck Protection Loan Coordination

Employers who have received a PPP loan may defer deposit and payment of the employer's share of Social Security tax that otherwise would be required to be made beginning on Mar. 27, 2020, through the date the lender issues a decision to forgive the loan, without incurring failure to deposit and failure to pay penalties. Once an employer receives a decision from its lender that its PPP loan is forgiven, the employer is no longer eligible to defer deposit and payment of the employer's share of Social Security tax due after that date. However, the amount of the deposit and payment of the employer's share of Social Security tax that was deferred through the date that the PPP loan is forgiven continues to be deferred and will be due on the "applicable dates."

Resources

Read more about this provision at the IRS FAQs on the Deferral of Payroll Tax Deposits.

INFORMATION RETURNS

Information Return Penalties Increase for 2020 (IRM 20.1.7, Penalty Handbook; Exhibit 20.1.7(Cont.1))

Failure to File Correct Information Returns (§6721)

For information returns or statements, a penalty may be imposed for filing returns:

- After the due date,
- Without all required or correct information (including missing, incorrect, and/or not currently issued TINs),
- On paper when required to be filed on electronic media,
- When filed on paper, in a manner which does not allow them to be processed, or
- When filed on electronic media, in a manner that does not allow them to be processed or be read by machine (not processable).

Failure to Furnish Correct Payee Statements (§6722)

A penalty may be imposed when a payee statement is not timely or correctly furnished. Failures subject to penalty include:

- any failure to furnish a payee statement on or before the due date to the person to whom the statement must be furnished, and
- any failure to include all information required to be shown on a payee statement or the inclusion of incorrect information.

Section 6721 & §6722 Penalty for Small and Large Businesses		
Time of Filing	Penalty Rate	**Tax Year 2019** Filed/furnished 1-1-2020 to 12-31-2020
Not more than 30 days late	**Per return**	**$50**
	Maximum - Gross Receipts ≤ $5 Million Maximum - Gross Receipts >$5 Million	$194,500 $556,500
31 days late - Aug. 1	**Per return**	**$110**
	Maximum - Gross Receipts ≤ $5 Million Maximum - Gross Receipts >$5 Million	$556,500 $1,669,500

Section 6721 & §6722 Penalty for Small and Large Businesses		
After Aug. 1	**Per return**	**$270**
	Maximum - Gross Receipts ≤ $5 Million Maximum - Gross Receipts >$5 Million	$1,113,000 $3,339,000
Intentional Disregard*	**Per return (or 5%/10% of aggregate amount)**	**$550**
	Maximum	No Limitation
* Increased penalty amounts may apply in the case of certain failures in the case of intentional disregard (§6721(e)(2)).		

New. Non-employee Compensation Reporting Coming for 2020

Form 1099-NEC has been resurrected by the IRS after 36 years on the shelf. Non-employee compensation paid in 2020 will be reported on Form 1099-NEC instead of on Form 1099-MISC. The 2020 Form 1099-NEC is due to the contractor and the IRS by Jan. 31, 2021.

As you can guess, this change will help the IRS better target misclassified workers. If you need a brief summary of the employee versus independent contractor rules to send to a client, see the IRS's fact sheet here. If you think that your client has a problem with misclassified workers that the 1099-NEC may alert the IRS to, remember that the IRS continues to give some relief for penalties if the business voluntarily reclassifies its workers. See the details of the Voluntary Classification Settlement Program here.

The change may help us. We've all seen rent "stuck" in the wrong box on the Form 1099-MISC where it was identified as non-employee compensation. Reporting non-employee compensation on a separate form may help the issuer report more accurately.

EIN APPLICATION

EIN Application Process Changed (IR-2019-58)

Only individuals with tax identification numbers (SSN or ITIN) may request an Employer Identification Number (EIN) as the "responsible party" on the application. The change will prohibit entities from using their own EINs to obtain additional EINs. The requirement will apply to both the paper Form SS-4, Application for Employer Identification Number (PDF), and online EIN application.

The Form SS-4 Instructions provide a detailed explanation of who should be the responsible party for various types of entities. Generally, the responsible party is the person who ultimately owns or controls the entity or who exercises ultimate effective control over the entity. In cases where more than one person meets that definition, the entity may decide which individual should be the responsible party. If there are changes to the responsible party, the entity can change the responsible official designation by completing Form 8822-B, Change of Address or Responsible Party. A Form 8822-B must be filed within 60 days of a change.

> **Tax practitioner planning**. There is no change for tax professionals who may act as third-party designees for entities and complete the paper or online applications on behalf of clients.

FORMS W-2 AND W-4

The IRS Revises 2020 Form W-4 (FAQs)

Because of withholding problems in 2018, the IRS proposed a massive change to the 2019 Form W-4. The early draft of the 2019 Form W-4 had 11 pages of instructions. The expansive instructions resulted in a "projected 1040." While this method may have resulted in more accurate withholding, gathering the information and completing the calculation would have been burdensome for many taxpayers, and impossible for some. It also would have provided the employer with more income information than many employees wanted to give. After many complaints and criticisms, the IRS withdrew its 2019 draft and replaced it with a W-4 that looked like the 2018.

Something different happened between the proposed 2019 and the final 2020 Form W-4. First, the 11 pages of instructions have been replaced with two pages, which include a multiple-job worksheet and a deductions worksheet. The Form W-4 itself is on one page and is in steps that are intended to make the form more understandable to the employee.

Tax withholding estimator. In coordination with the release of the new 2020 Form W-4, the IRS also released a new Tax Withholding Estimator. According to the IRS, "the new Tax Withholding Estimator offers workers, as well as retirees, self-employed individuals and other taxpayers, a more user-friendly step-by-step tool for effectively tailoring the amount of income tax they have withheld from wages and pension payments."

> **Tax practitioner note.** The instructions for the Tax Withholding Estimator include, as IMPORTANT (in caps and bold), a warning that "people with more complex tax situations should use the instructions in Publication 505." Maybe, just maybe, the IRS could have said — see your tax professional for help.

Due Date of Forms W-2 and 1099-MISC

Forms W-2 and Forms 1099-MISC for non-employee compensation must be filed by January 31, rather than February 28 if by paper, and March 31 if filed electronically (§6071).

R&D PAYROLL CREDIT

For Small Business Startups, Option for Claiming Research Credit Against Payroll Tax Liability Instead of Income Tax Liability (IR-2017-93; Notice 2017-23)

Use current research credit against the small business's *payroll or income* tax liability (you choose). Eligible small businesses can take advantage of an option enabling them to apply part or all of their research credit against their payroll tax liability, instead of their income tax liability. Notice 2017-23 provided guidance. This option is available to any eligible small business filing its federal tax return.

Prior year reality. Before 2016, taxpayers could only take the research credit against their income tax liability. If the new business had no tax liability, the credit was carried over indefinitely. A failing business might never be able to use the credit.

A big advantage to the new business. The option to elect the new payroll tax credit may especially benefit any eligible startup that had little or no income tax liability but lots of payroll. The credit can save up to $250,000 of employer payroll tax liability (old-age, survivors, and disability insurance - OASDI). This option can improve a new business's cash flow now, rather than in some long-distant year.

Gross receipts less than $5 million. To qualify for the new option for the current tax-year, a business must have gross receipts of less than $5 million for the taxable year.

Business is new within five years. To qualify for the new option for the current tax-year, the business did not have gross receipts for any taxable year preceding the five-taxable-year period ending with such taxable year. For 2020, the business did not have gross receipts prior to 2016.

To elect the payroll credit:

1. ***Use Form 6765 to apply up to $250,000 of research credit against payroll tax liability.*** An eligible small business with qualifying research expenses may choose to apply up to $250,000 of its research credit against its payroll tax liability. An eligible small business chooses this option by filling out Form 6765, Credit for Increasing Research Activities, and attaching it to a timely filed business income tax return.
2. ***After choosing this option, a small business claims the payroll tax credit by filling out Form 8974, Qualified Small Business Payroll Tax Credit for Increasing Research Activities.*** An electing qualified small business that files quarterly employment tax returns (e.g., Form 941) will claim the payroll tax credit on the return for the first quarter that begins after it files the income tax return reflecting the election. A qualified small business claiming the credit on its employment tax return must complete Form 8974, Qualified Small Business Payroll Tax Credit for Increasing Research Activities, and attach the completed form to the employment tax return. A taxpayer filing an employment tax return claiming the credit must provide on Form 8974 the employer identification number EIN used on the Form 6765 reflecting the election.

What are qualifying research expenses? Do you need a refresher on qualifying research expenses, or do you want a resource to help your client understand qualifying research expenses? The IRS has an old audit technique guide (2008) that may help. Be careful. It has not been updated for the new law or for the new pronouncements on software, but the basics are there.

Timing Issues Related to Payroll Tax Credit for Increasing Research Activities (AM2017-003)

Claim credit for first payroll payment. An employer takes into account the payroll tax credit for the first quarter after the return is filed. The credit is claimed against liability for employer Social Security tax (6.2%) starting with the first payroll payment of the quarter that includes payments of wages subject to Social Security tax to its employees. The credit may be taken to the extent of employer Social Security tax on wages associated with the first payroll payment, and then to the extent of employer Social Security tax associated with succeeding payroll payments in the quarter until the credit is used. In determining the amount to enter on the Form 941, Record of Federal Tax Liability with respect to a payment of wages subject to Social Security taxes, the employer should reduce tax liability by the lesser of (1) the amount of the employer Social Security tax on the wages, or (2) the available payroll tax credit. If any payroll tax credit is remaining at the end of the quarter, the excess credit may be carried over to the succeeding quarter.

> **Example**. On Apr. 6, 2020, Employer X-periment, a semi-weekly schedule depositor, filed an income tax return electing a payroll tax credit under §41(h) of $5,000. Employer X-periment claimed the payroll tax credit under §3111(f) for the third quarter of 2020, the first quarter that begins after the return electing the payroll tax credit was filed.

IDENTITY THEFT ISSUES

Businesses and Payroll Service Providers Warned of Latest W-2/SSN Data Theft Scam (Updated Nov. 11, 2019)

The IRS is warning about a particularly dangerous e-mail scam. In an IRS Tax Exempt and Government Entities Division update, the IRS warned about a new e-mail scam that targets employers, including tax-exempt entities, universities and schools, government, and private-sector businesses. In this new scheme, the scammer poses as an internal executive and requests employee Forms W-2 and SSN information from company payroll or human resources departments. The scammer may even send an initial "Hi, are you in today?" message before the request. This scam is sometimes referred to as business e-mail compromise (BEC) or business e-mail spoofing.

Because time is critical, the IRS has established a process that will allow employers and payroll service providers to quickly report any data losses related to the W-2 scam. Details are available at Form W-2/SSN Data Theft: Information for Businesses and Payroll Service Providers. If notified in time, the Service can take steps to prevent employees from being victimized by identity thieves filing fraudulent returns in their names. You can also find information about how to report receiving the scam e-mail even if you did not fall victim to the scam.

Tax professionals who experience a data breach should quickly report the incident to the IRS and may contact their local stakeholder liaison. Further details can be found at Data Theft Information for Tax Professionals.

> **Tax practitioner planning.** Advise clients to share this information with their payroll, finance, and human resources employees. Clients should consider creating an internal policy, if one is lacking, on the distribution of employee W-2 information and conducting wire transfers.

If your client received a W-2 scam e-mail. If your client received a W-2 scam e-mail, please forward the e-mail to phishing@irs.gov and place "W2 Scam" in the subject line. Organizations that receive these scams or fall victim to them should file a complaint with the Internet Crime Complaint Center (IC3) operated by the FBI. Employees whose Forms W-2 have been stolen should review the recommended actions by the Federal Trade Commission at www.identitytheft.gov or the IRS at www.irs.gov/identitytheft. The W-2 scam is just one of several new variations that have appeared in the past year that focus on the large-scale thefts of sensitive tax information from tax preparers, businesses, and payroll companies.

> **Tax practitioner planning.** Tax preparers should also be leery of using search engines to find technical help with taxes or tax software. Selecting the wrong "tech support" link could lead to a loss of data or an infected computer. Also, software "tech support" will not call users randomly. This is a scam.

TAX ON SELF-EMPLOYMENT INCOME §1401-1403

How the Self-Employed Pay Into the Social Security Fund

OASDI and Medicare. Taxpayers who have self-employment (SE) income for a taxable year must pay, in addition to income taxes, an SE tax. The SE tax is comprised of an old-age, survivor's, and disability insurance tax and a hospital insurance tax — i.e., OASDI and Medicare (§1401(a) and (b)).

What is, and what is not, SE income? SE income is the net earnings from self-employment derived by an individual generally from the conduct of a trade or business (§1402(b)). The trade or business must be carried on by the individual, either personally or through agents or employees (§1.1402(a)-1(b)). The courts broadly construe treating income as earnings from self-employment (*Braddock v. Comm*., 95 TC 639 (1990); *Hennen v. Comm*., TCM 1999-306).

Is it subject to SE tax? The Supreme Court identified two key factors for determining if a trade or business exists, including for SE tax purposes. They are (1) involved in the activity with continuity and regularity, as distinguished from an occasional action, and (2) the primary purpose for being involved in the activity is for income or profit (*Comm. v. Groetzinger*, SCt, 87-1 USTC ¶9191). Therefore, SE tax is not due:

1. if the taxpayer is not considered to be in a trade or business;
2. if the taxpayer is not trying to make a profit in that activity; or
3. if the activity is not being performed on a regular basis.

SE tax rate same in 2020, but base increased to $137,700. The 2020 SE tax rate is 15.3% on the first $137,700 of net income from SE and 2.9% on SE income in excess of $137,700. In addition, because of the Affordable Care Act (ACA), there is an additional 0.9% Medicare tax for taxpayers with SE income, or with a combined total of SE income and wages in excess of $200,000 ($250,000 for MFJ).

Trade or business requirement. Whether an individual is carrying on a trade or business is a facts and circumstances test. Generally, the term "trade or business," for SE tax purposes, has the same meaning as under the §162 trade or business rules (§1.1402(c)-1)). With exceptions (e.g., newspaper vendors, certain ministers, etc.), being an employee is generally not a trade or business for SE purposes (§1.1402(c)-3)). Therefore, it needs to be determined if the taxpayer is, or is not, in a trade or business.

> **Example.** A tax professor receives an honorarium for presenting a seminar at a tax preparer organization's annual convention. SE tax will be due if it is determined that the seminar directly relates to the professor's regular teaching trade or business.

Trying to make a profit from the activity requirement. As the taxpayer is reporting income, logically it is a profit, but the taxpayer has to have an "intent to make a profit" before the income is subject to SE tax. For example, if the income is necessary for subsistence and the fee was negotiated accordingly, it is more likely to be SE income than if the taxpayer just accepted whatever was offered for the service.

Example. A tax professor, who has a hobby of growing roses, is asked to demonstrate rose pruning techniques and receives an honorarium. The payment is not subject to SE tax as the professor is not in the trade or business of growing roses, nor is the speech being presented with a "profit" motive.

Example. If our rose-growing tax professor became so good that he regularly demonstrated pruning roses, then the speaking would likely rise to the level of a trade or business, making the "miscellaneous" income subject to SE tax on Schedule C. This would especially be true if he started promoting himself as a rose expert available for speaking engagements.

A one-time event is not a regular trade or business. Income from a one-time event outside a taxpayer's regular trade or business is not subject to SE tax.

Example. Batok was an automobile mechanic who took a one-month job painting houses, earning $4,200, which he reported as other income, not on a Schedule C. The IRS charged SE tax in an audit, but the court determined that Batok wasn't "in the business of" painting houses (*John A. Batok v. Comm*., TCM 1992-727).

SE income, yes, SE tax, no. SE income for the purpose of assessing SE tax does not include:

- ***Wages reduce SE taxable income***: that part of the net earnings from a taxpayer's self-employment which is in excess of the contribution and benefit base amount effective for the calendar year less the wages paid to such individual during the taxable year; or
- ***No SE if net earnings less than $400***: the net earnings from self-employment, if such net earnings from self-employment for the taxable year are less than $400 (§1402(b)(2)).

Post-Retirement Commissions Were Subject to SE Tax (*Gary and Gwendolyn Sherman v. Comm*., TCS 2018-15)

Mrs. Sherman began her career as a beauty consultant in the 1970s. She was very successful, both at selling products and at recruiting and training other consultants. As a result, she became a sales director and then a national sales director. From 1993 until she retired in 2004, Mrs. Sherman was one of a small number of national sales directors. As a national sales director Mrs. Sherman recruited and trained beauty consultants and sales directors and received a commission from all of the wholesale purchases made by the beauty consultants and sales directors in her network. A national sales director who elects normal retirement benefits is entitled to receive monthly payments equal to one-twelfth of her final average commission for 15 years. The final average commission is the average of the national sales director's highest three years of commissions during her last five years of service.

During the years in issue, 2013 and 2014, the Shermans received $173,707 each year under the Mary Kay retirement plan. The question before the court was whether the income that Mrs. Sherman received was deferred compensation subject to self-employment tax. The Mary Kay distributions were tied to the quantity and quality of Mrs. Sherman's prior labor. Mrs. Sherman's payments under the Mary Kay retirement plan were "based on her average commissions over the five years prior to her retirement." Further, the Mary Kay retirement plan agreement describes the payments as deferred compensation, and the Shermans were explicitly informed by Mary Kay in 1995 that the payments under the Mary Kay retirement plan were deferred compensation and subject to self-employment tax.

The court held the payments to be subject to SE tax.

Also See.

- *Larry Geneser v. Comm.*, TCM 2017-110, where a life insurance agent received $903,707 in commission payments at his termination from American Income Life Insurance Co. The commission payment was subject to income tax and SE tax, as it was dependent on his length of service.

WITHHOLDING FROM WAGES, ETC. §3401-3406

Voluntary Certification Program for Professional Employer Organizations

The IRS is required to establish a voluntary certification program for professional employer organizations (PEOs). The IRS is accepting applications for PEO certification. As part of the certification program, the act requires the IRS to:

- complete background, credit, and tax compliance checks of PEOs;
- verify the PEO has an active and approved surety bond;
- verify the PEO satisfies the service agreement and financial review requirements;
- collect a user fee; and
- provide public disclosure of certified PEOs and any whose certification has been suspended or revoked.

PEOs who want IRS certification must observe ongoing reporting and record keeping responsibilities. PEOs will be required to file with the IRS audited financial statements and quarterly reports that have been approved by an independent CPA attesting to the full payment of applicable employment taxes. Certified PEOs will have the authority to pay wages to worksite employees and to collect and remit employment taxes for such wages. In addition, businesses that qualify for certain employment-related tax credits, such as the Work Opportunity Tax Credit, may claim such credits within the certified PEO relationship.

> **Tax practitioner planning**. Even if the taxpayer uses a PEO to facilitate payroll compliance, the taxpayer remains liable for payroll taxes unpaid by the PEO. A certification process may give some assurance to the taxpayer that the firm they are dealing with is reputable. No guarantees.

PEOs Certified by the IRS

The IRS issues notices of certification to organizations that applied for voluntary certification as a Certified Professional Employer Organization (CPEO). List of CPEOs as of January 2020 is here.

Taxpayer Liable for PEO's Failure to Pay Over Payroll Taxes (FAA 20171201F)

A recent IRS Field Attorney Advice held the common law employer liable for unpaid payroll taxes for employees it leased from a PEO. The taxpayer operated a limousine business and employed its workers through a PEO. The contract between the taxpayer and the PEO required the PEO to deposit withholding and employment taxes to the IRS. The PEO did not pay over the taxes it received from the taxpayer.

The taxpayer argued that (1) the PEO was liable for the taxes under a state statute licensing of employee leasing, and (2) the PEO was the statutory employer and therefore liable for the payroll taxes. The FAA explained that the state law cited by the taxpayer is superseded by the Internal Revenue Code and therefore is irrelevant. The FAA rejected the argument that the PEO was the statutory employer because the PEO lacked control over the employees. The taxpayer was held liable for the payroll taxes due.

> **Tax practitioner planning.** Urge your clients who use PEOs or other payroll service providers to exercise due diligence in selecting and monitoring a third party payer. For example, when choosing a third party payer, employers should look for one that is reputable and uses the Electronic Federal Tax Payment System (EFTPS). This allows the business owner to verify payments made on their behalf. Also, an employer should never allow their address of record with the IRS be changed to that of the third party payer.

Third Party Compensation Payor Employment Tax Liability Clarified (§3504; T.D. 9662; §31.3504-2)

The IRS has determined that, in general, a person who pays wages or compensation (payor) to individuals performing services for any client (employer) pursuant to a service agreement (between the payor and the client) is designated to perform the acts required of an employer with respect to the wages or compensation paid. Such payors are subject to all provisions of law (including penalties) applicable with respect to an employer. Accordingly, both an employer and the payor are liable for the employment taxes on wages or compensation paid by the payor (§3504).

Definitions (§31.3504-2(b)). The pertinent regulation definitions include:

- ***Payor*** — Person (including an individual, trust, estate, partnership, association, company, or corporation) that pays wages or other compensation.
- ***Client*** — Individual or entity that enters into a service agreement with the payor.
- ***Service agreement*** — Agreement to which the payor:
    - asserts (explicitly or implicitly) it is the employer of individuals performing services for the client;
    - pays wages or compensation to individuals for services performed for the client; and
    - assumes responsibility to collect, report, and pay, or assumes liability for, payroll taxes on wages paid by the payor to individuals performing services for the client.

A payor "asserts" it is the employer by agreeing to recruit and hire employees for the client, assigning employees as permanent or temporary members of the client's workforce, or participating with the client in these actions. In addition, hiring a client's employees as its own and then providing them back to the client or filing employment tax returns using its own EIN that includes wages or compensation paid to the individual performing services for the client results in the payor asserting it is the employer.

Exceptions (§31.3504-2(d)). A payor is not designated to perform the acts required of an employer for any wages paid by the payor to individuals performing services for a client if:

- The wages or compensation are reported on a return filed under the client's EIN;
- The payor is a common paymaster;

- The payor is the employer of the individuals; or
- The payor is treated as an employer under a sickness or disability plan.

Example. People 4 U enters into an agreement with JTS, an employer, effective Jan. 1, 2020. Under the agreement, People 4 U hires JTS's employees as its own employees and provides them back to JTS to perform services for it. For all pay periods in 2020, JTS provides People 4 U an amount equal to gross payroll (that is, wage and tax amounts) of the individuals and People 4 U pays wages to the individuals. People 4 U reports the wages and related payroll taxes on Form 941 using its own EIN. People 4 U is not a common paymaster, the employer of the individuals, or treated as the employer of the individuals under §3121(a)(2)(A). People 4 U is designated to perform the acts of an employer with respect to all of the wages it paid to the individuals performing services for JTS. People 4 U and JTS are each subject to all provisions of law (including penalties) applicable in respect of employers for all quarters of 2020 with respect to such wages (§31.3504-2(e), Exp. 1).

Example — variation. Assume the same facts as above, except that neither People 4 U nor JTS reports the wage and tax amounts on Form 941 for any quarter of 2020. People 4 U and JTS are each subject to all provisions of law (including penalties) applicable in respect of employers for all quarters of 2020 with respect to such wages (§31.3504-2(e), Exp. 3).

Example. Staff Up enters into an agreement with ESS under which Staff Up provides payroll services, including payment of wages to individuals performing services for ESS, and assumes responsibility for the collection, reporting, and payment of applicable payroll taxes. For all pay periods in 2020, ESS provides Staff Up with an amount equal to the gross payroll of the individuals, and Staff Up pays wages to the individuals performing services for ESS. Staff Up also reports the wage and tax amounts each quarter on Form 941 under ESS's EIN. Staff Up is not designated to perform the acts of an employer with respect to the wages it paid to the individuals performing services for ESS. Staff Up did not assert it was the employer and, accordingly, is not liable for the applicable employment taxes (§31.3504-2(e), Exp. 3).

Tax practitioner planning. The 20% QBI deduction is not available for some businesses if the business does not pay W-2 wages. Wages paid by a PEO on behalf of the business do not, at this time, qualify for the wage limitation.

OTHER MISCELLANEOUS WITHHOLDING AND WAGE ISSUES

Only an Employee Qualifies for a Nontaxable Fringe Benefit (FAA 20171202F)

Only employees can qualify for a nontaxable fringe benefit under §132(a). An employee is defined as an individual currently employed by the employer, an individual who has retired from the employer, has become disabled while working for the employer, or is an employee's widow/er or dependent child under age 25 (§132(h)). Fringe benefits provided to anyone else are a taxable fringe benefit included in the income of the employee (§1.61-21(a)(4)). Employment taxes are due on the taxable fringe benefit.

A "qualified employee discount" may be excluded from income (§132(a)(2)). The term "qualified employee discount" means an employee discount to the extent the discount does not exceed 20% of the price at which services are being offered by the employer to its customers (§132(c)(3)). If the discount exceeds 20%, the excess is taxable income to the employee.

Discount exceeded 20%. FAA 20171202F addresses a company that provided an employee discount plan that offered a 35% discount from advertised rates for the employee, his or her spouse, children under 26, and a specified number of *friends*. Discounts provided to friends were taxable to the employee, as only employees (as defined in §132(h)) can qualify for a tax-free fringe benefit. In addition, the discount exceeded the statutory amount allowed. The excess provided to the employee and qualified family was taxable to the employee.

> **Tax planning idea.** The FAA points out that if the employer kept or provided records of the prices at which it provided services to select groups of customers, the 20% discount statutory limit might apply to group rates rather than advertised rates.

HIRING MINOR CHILDREN

Paying Wages to Minor Children Is Good Tax Planning

Tax planning often includes a recommendation to the small-business owner that he or she pay wages to their minor children. Wages to the kids may mean (1) using the child's standard deduction ($12,200 in 2019) to provide some tax-free money, (2) shifting income from the parent's high tax bracket to the child's lower bracket, (3) saving FICA/SE tax on wages paid to the minor child, (4) allowing the parent (or child) to fund a Roth IRA, and, (5) as a new consideration, W-2 wages are important in the calculation of the QBI deduction. All of these are legitimate tax-savings ideas as long as the parent follows some strict rules.

1. Actually give the child a paycheck
2. Pay reasonable wages for the age of the child
3. Keep time records for the child's work
4. File all required payroll returns

IRS Rules for Wages Paid to Minor Children (Family Help)

Payments for the services of a child under age 18 who works for his or her parent in a trade or business are not subject to Social Security and Medicare taxes if the trade or business is a sole proprietorship or a partnership in which each partner is a parent of the child. Payments for the services of a child under age 21 who works for his or her parent in a trade or business are not subject to FUTA tax. Payment for the services of a child are subject to income tax withholding, regardless of age.

Covered wages. The wages for the services of a child **are** subject to income tax withholding as well as Social Security, Medicare, and FUTA taxes if he or she works for:

- A corporation, even if it is controlled by the child's parent,
- A partnership, even if the child's parent is a partner, unless each partner is a parent of the child, or
- An estate, even if it is the estate of a deceased parent.

Wages Paid to Minor Children Not Properly Documented (*John and Lisa Fisher, pro sese v. Comm.*, TCM 2016-10)

John and Lisa Fisher were attorneys practicing in New York — Mrs. Fisher as a sole proprietor and Mr. Fisher as a partner in an Albany, New York, law firm. The Fishers had three children, all of whom were under nine years old as of the close of 2008.

Mrs. Fisher's law practice. During summer school recesses, Mrs. Fisher often brought her children into her office, usually for two hours a day, two or three days a week. She did this because at times other family members were not available to care for the children and also because, according to Mrs. Fisher, "day care was cost-prohibitive for * * * [the Fishers], and so * * * [she] had the children working for * * * [her] in the office instead." While at Mrs. Fisher's office, the children provided various services to her in connection with her practice. For example, the children shredded waste, mailed things, answered telephones, photocopied documents, greeted clients, and escorted clients to the office library or other waiting areas in the office complex. The children also helped Mrs. Fisher move files from a flooded basement in 2006, they helped her remove files damaged in a bathroom flood in 2007, and they helped to move Mrs. Fisher's office to a different office in the same building in 2008.

Schedule C showed net loss. On the 2006, 2007, and 2008 Schedules C relating to Mrs. Fisher's law practice, she (1) reported gross income of $5,500, $10,953, and $12,273, respectively; (2) deducted "wages to minor children" of $10,435, $10,313, and $8,022, respectively; and (3) taking into account other deductions, reported net losses of $39,073, $36,696, and $29,220, respectively.

No W-2s issued. Mrs. Fisher did not issue a Form W-2 to any of her children for any year in issue; no payroll records regarding their employment were kept nor were any federal tax withholding payments made from any amounts that might have been paid to any of them. The court was unable to tell from what was presented how much was paid to each of Mrs. Fisher's children. Nor could it tell how many hours each worked or what the hourly rate of pay might have been. Without records showing these details, the court could not tell whether the amounts deducted were "reasonable," especially when the ages of the children were taken into account.

Court allows a small deduction for wages to kids. Taking into account their ages, generalized descriptions of their duties, generalized statements as to the time each spent in the office, and the lack of records, the court allowed a $250 deduction for wages paid to each child for each year (see *Cohan v. Comm*., 39 F.2d at 543-544).

Also See.

- *Brent and Lynette McMinn v. Comm.*, TCM 2016-136, where large year-end bonuses paid to children were not reasonable, especially since they were paid only at Christmastime.
- *Brian and Betsy Ray v. Comm*., TCM 2018-160, where Brian took no wages from a nonprofit that he founded, but had $260,000 paid to his kids for their "office work." No W-2s or 1099s were filed, and money was used for household expenses.

STATUTORY EMPLOYEE - §3121(d)(3))

Statutory Employee Rules Trump Independent Contractor Rules

General rules. If workers are independent contractors under the common law rules, such workers may nevertheless be treated as employees by statute (statutory employees) for certain employment tax purposes if they fall within any one of the following four categories and meet the three conditions described under Social Security and Medicare taxes.

Four categories. Any individual who performs services for remuneration for any person:

1. as an agent-driver or commission-driver engaged in distributing meat products, vegetable products, fruit products, bakery products, beverages (other than milk), or laundry or dry-cleaning services, for his principal;
2. as a full-time life insurance salesman;
3. as a home worker performing work, according to specifications furnished by the person for whom the services are performed, on materials or goods furnished by such person which are required to be returned to such person or a person designated by him; or
4. as a traveling or city salesman, other than as an agent-driver or commission-driver, engaged upon a full-time basis in the solicitation on behalf of, and the transmission to, his principal (except for side-line sales activities on behalf of some other person) of orders from wholesalers, retailers, contractors, or operators of hotels, restaurants, or other similar establishments for merchandise for resale or supplies for use in their business operations;

Exceptions. An individual shall not be included in the term "employee" under the statutory employee provisions if:

- such individual has a substantial investment in facilities used in connection with the performance of such services (other than in facilities for transportation), or
- if the services are in the nature of a single transaction not part of a continuing relationship with the person for whom the services are performed;

Social Security and Medicare taxes. Withhold Social Security and Medicare taxes from the wages of statutory employees if all three of the following conditions apply.

1. The service contract states or implies that substantially all the services are to be performed personally by them.
2. They do not have a substantial investment in the equipment and property used to perform the services (other than an investment in transportation facilities).
3. The services are performed on a continuing basis for the same payer.

Refer to the Salesperson section located in Publication 15-A, Employer's Supplemental Tax Guide (PDF), for additional information.

Physician Was Not Statutory Employee (*Atul and Rashi Gambhir v. Comm.*, TCSO 2020-4)

Dr. Rashi Gambhir worked as a hospitalist for Northeast Georgia Medical Center (NGMC). She was paid on a per-shift basis rather than on a salary and provided services to the hospital under her own control and supervision. The hospital provided certain equipment; however, Dr. Gambhir would bring her own stethoscope and her cell phone, which was used for medical-related pages. Her daily uniform consisted of scrubs, a lab coat, and comfortable medical shoes used primarily in the hospital. Dr. Gambhir was not reimbursed for these job-related expenses. In 2009 or 2010, Dr. Gambhir received a Form W-2 that reported her income as "Wages, tips, other compensation." NGMC did not check the box for statutory employee status on Dr. Gambhir's Form W-2 for tax year 2012.

> **Tax practitioner planning.** Dr. Gambhir reported business expenses of $13,970 on her Schedule C (and no income), claiming that she was a statutory employee of the hospital.

Not a statutory employee. A taxpayer who is a common law employee for federal income tax purposes is also an employee for employment tax purposes (§3121(d)(2)). Statutory employees are those individuals who are considered employees regardless of common law rules pursuant to§3121(d)(1), (3), or (4). Dr. Gambhir did not established that she practiced medicine under circumstances other than as an employee or in a manner that required the income and deductions attributable to her medical practice to be shown on a Schedule C. Therefore, her business expense deductions must be claimed on the Schedule A. Employee business expenses are not deductible for 2018 to 2025.

Aerospace Engineer Was Statutory Employee; Income and Expenses Reportable on Schedule C (*Slawamir J. and Alicia M. Fiedziuszko, pro sese v. Comm.*, TCM 2018-75)

Statutory employee box checked in the first year, but not the second year. Slawamir J. Fiedziuszko (Fiedziuszko) was a semi-retired aerospace engineer and worked as a consultant for Space Systems Loral (Loral). Fiedziuszko's contract with Loral began in 2011 and ended in July 2012. Fiedziuszko entered a contract to provide consulting services to Loral through West Valley Engineering Co. (West Valley), a temporary employment agency used by Loral to hire consultants. West Valley processed Fiedziuszko's pay for his work for Loral and withheld federal income tax, as well as Social Security and Medicare taxes. West Valley did not offer medical or dental insurance, paid vacation leave, or reimbursement of Fiedziuszko's expenses, but it did offer a deferred compensation plan. West Valley checked the statutory employee box on Fiedziuszko's 2011 Form W-2, Wage and Tax Statement, to indicate that he was a statutory employee for 2011. However, West Valley did not check the box on Fiedziuszko's 2012 Form W-2 to indicate that he was a statutory employee for 2012.

> **Tax practitioner planning.** An employee treated as a "statutory employee" for purposes of employment tax is not an employee for purposes of §62 and may report business income and expenses on Schedule C and avoid tax reform's disallowance of employee business expenses.

The court determined Fiedziuszko was a statutory employee. The court found that Fiedziuszko was not a common law employee of Loral and that he instead was a statutory employee. While his Form W-2 for 2012 did not indicate that he was a statutory employee, the court believed this to be a mistake. Fiedziuszko's Form W-2 for 2011 indicated that he was a statutory employee. Nothing changed between 2011 and 2012. Fiedziuszko was providing services under the same consulting contract with Loral in 2012 as he was in 2011. Further, Fiedziuszko worked primarily from his home office rather than Loral's offices and produced reports and patents according to his assignments from Loral. The court concluded that both Fiedziuszko and Loral intended to form an independent consulting relationship rather than a common law employee-employer relationship. Fiedziuszko advertised his services to several satellite companies and was hired by Loral through the temporary employment agency, West Valley, with which Loral works. Their relationship was a temporary assignment that terminated in July 2012. The weekly payroll deposits into his checking account and West Valley's withholding federal and state income taxes and Social Security and Medicare taxes from Fiedziuszko's pay were consistent with a consulting contract for services. The court concluded that the totality of the circumstances indicated that Fiedziuszko was a statutory employee pursuant to §3121(d)(3) for the 2012 tax year. Thus, Fiedziuszko was entitled to report business income and expenses on Schedule C of his Form 1040.

INDEPENDENT CONTRACTOR VS. EMPLOYEE STATUS

Treasury Inspector General (TIGTA) Says IRS Needs to Do More With DOL (Report 2018-IE-R002)

The TIGTA project was initiated to evaluate the IRS's progress in implementing a Joint Worker Misclassification Initiative with the DOL to reduce the incidence of employees misclassified as independent contractors. Overall, the IRS has not effectively implemented the worker misclassification agreement with the DOJ. The IRS cited staff turnover, resource limitations, and other competing priorities as reasons why the DOJ agreement had not been prioritized. As a result, the IRS and DOL have not developed the type of robust information exchange envisioned by the memorandum of understanding with the DOJ.

DOL referrals were less productive than worker classification examinations that originated from other sources. In fiscal years 2015 and 2016, DOL referrals resulted in approximately $800,000 in adjustments. However, DOL referrals produced approximately $4,000 in adjustments per return — substantially less than other worker classification returns, which resulted in approximately $12,000 in adjustments per return. One possible cause of the large difference in results is that DOL referrals often did not provide key pieces of information needed by the IRS, such as the number of potentially misclassified workers or the materiality of the wages potentially misclassified. Finally, IRS officials acknowledge difficulties in developing metrics to assess sharing of information's effectiveness due to a lack of available data and the small scope of DOL/IRS activities.

TIGTA recommended that the IRS work with the DOL to design a standardized referral form to provide better and more complete information to the IRS to facilitate more productive exams.

> **Tax practitioner planning.** An improvement in the DOL/IRS program will result in more independent contractors audits.

Tax Gap Includes $91 Billion of Underreported Employment Taxes (Employment Tax Enforcement by DOJ, May 1, 2018)

Tax withheld from employee wages accounts for approximately 70% of annual revenue collected by the IRS. When last measured, underreported and unpaid employment taxes represented approximately $91 billion of the overall US tax gap. As of June 30, 2016, more than $59.4 billion of tax reported on employment tax returns remained unpaid.

> **Tax practitioner planning**. The IRS has "early interaction initiatives" in place to encourage employers to comply with their tax obligations, including the current use of the Federal Tax Deposit Alert, which allowed revenue officers to know within 13 weeks of a missed deposit. In 2017, the IRS

implemented an Electronic Federal Tax Payment System that alerted revenue officers within 72 hours that an employer missed a deposit.

Independent Contractors

Contract labor and commission expenses are deductible when paid to an independent contractor (IC). Form 1099 must be issued if $600 or more was paid for services to an unincorporated individual or business. The issue involved in both the commission expense and the contract labor deduction was whether the worker was properly classified as an employee (or an IC) of the business.

> **Tax practitioner planning.** This is one of the major tax audit issues. All IRS agents must examine the tax return for employee salaries disguised as contract labor *(e.g., sales assistants, part-time workers)*.

Voluntary Classification Settlement Program (VCSP) Revised (VCSP FAQs)

What is the VCSP? In an effort to get businesses to comply voluntarily with worker reclassification, the VCSP provides partial relief from federal employment tax penalties for eligible taxpayers that agree to treat prospectively workers as employees. Under the originally adopted VCS Program, eligible employers can obtain substantial relief from prior period federal payroll taxes and related penalties if they prospectively reclassify workers as employees for federal employment tax purposes. The VCSP is optional. To participate, an employer must meet certain eligibility requirements, apply to participate in the VCSP, and enter into a closing agreement with the IRS. To participate in the revised VCSP, employers must complete an application (Form 8952) and meet the following qualifications:

- Employers consistently treated workers in the past as nonemployees.
- Employers filed all required Forms 1099 for the workers for the previous three years.
- Employers cannot be currently contesting in court the classification of the class or classes of workers from a previous audit by the IRS or the Department of Labor.
- Such employer cannot be currently under an employment tax audit by the IRS, the DOL, or a state agency. If the employer is a member of an affiliated group within the meaning of §1504(a), none of the members of the group is currently under an employment tax audit.

> **Tax practitioner planning.** The IRS eliminated the requirement in the original VCSP that an employer agree to extend the period of limitations on assessment of employment taxes.

> **Example.** In 2020, Sunset, Inc. paid $1,500,000 to workers who are the subject of the VCSP. All of the workers identified in the VCSP application were compensated at or below the Social Security wage base (e.g., under $137,700 for 2020). Sunset submits the VCSP application on Oct. 1, 2021, and wants the beginning date of the quarter for which it wants to treat the class or classes of workers as employees to be Jan. 1, 2022. Sunset looks to amounts paid to the workers in 2020 for purposes of calculating the VCSP amount, since 2020 is the most recently completed tax year at the time the application is being filed. Under §3509(a), the employment taxes applicable to $1,500,000 would be $160,200 (10.68% of $1,500,000). Under the VCSP, Sunset's payment would be 10% of $160,200, or $16,020 (FAQ 15).

> **Tax practitioner planning**. See the IRS Voluntary Classification Settlement Program website for additional information.

The IRS Common Law Approach on Worker Classification (Independent Contractor (Self-Employed) or Employee, Updated Jan. 19, 2020)

Most of the difficulty in deciding if a worker is an employee or an independent contractor stems from the fact that an employer's goals conflict with those of the IRS. Conferring independent contractor status upon a worker often benefits the employer, since the employer is not obligated to withhold income taxes, pay Social Security and unemployment taxes, or provide employee benefits. Conversely, classifying workers as employees makes it easier for the IRS to collect the worker's taxes because it shifts much of the collection burden to the employer. The IRS has developed a 20-factor test to assess this degree of control, with factors generally skewed toward concluding that the worker is an employee (see Rev. Rul. 87-41 and Form SS-8). Most of these tests have summarily been rejected by the courts and Congress. In addition, state law determinations (or other government or industry imposed regulations) are not a relevant indicator of employer-employee status.

> **Tax practitioner planning.** If the IRS auditor can get the taxpayer to fill in the Form SS-8, it is almost always to the advantage of the IRS. It would be a much better strategy to limit the employee vs. IC discussion to the three categories of evidence and referencing the IRS's worker classification training manual.

Three categories of evidence: (1) behavioral control, (2) financial control, and (3) parties' views. Recognizing the direction the wind is blowing, the IRS's worker classification training manual sets forth three categories of evidence it thinks are most significant in making a determination of a worker's status under common law. The IRS training guide moves its focus toward gathering evidence that illustrates "the extent of an employer's behavioral and financial control" over the worker *and* "how the parties view their relationship." Following is an abbreviated synopsis of each factor. With notable exceptions, the old 20 tests of Rev. Rul. 87-41 were reshuffled into the three categories. Eight of the old factors were retained, two factors were added, and seven factors were de-emphasized.

Does behavioral control over worker exist? Behavioral control focuses on whether the business has the right to direct or control **how** the work is done (e.g., **how** the worker performs the specific task for which he or she is hired). Factors include:

1. ***To what extent are instructions given and taken?*** An employee is generally subject to the business's instructions about when, where, and how to work; an IC is not. Even if no instructions are given, sufficient behavioral control may exist if the employer has the **right to control** how the work results are achieved. Pertinent evidence includes (1) needing prior approval before proceeding, (2) rendering services personally, and (3) hiring, supervising, and paying assistants.
2. ***What training does the business give the worker?*** Employees may be trained to perform services in a particular manner. Independent contractors ordinarily use their own methods. The business's orientation course, safety seminars, and voluntary unpaid educational programs are to be disregarded.

Do financial controls over worker exist? These factors illustrate whether there is a right to direct or control how the **business** aspects of the worker's activities are conducted:

1. ***Can the worker realize a profit or incur a loss?*** An IC can make a profit or loss, whereas employees can only make a profit. The IRS discloses that the worker's dependence on the job is NOT a factor.
2. ***Is the worker's investment significant?*** An IC often has a significant investment in the equipment or facilities he or she uses in performing services for someone else. However, a significant investment is not required. Pertinent evidence includes (1) amount of unreimbursed expenses, (2) payment of business and/or travel expenses, (3) furnishing of tools and materials, and (4) analysis of lease arrangements between worker and business. The IRS has listed business expenses expected to be found on the taxpayer's business return.
3. ***To what extent does the worker make services available to the general public?*** Pertinent evidence includes (1) Yellow Page advertising, (2) working for more than one firm, and (3) identifying when advertising not required (e.g., use of word-of-mouth advertising and having long-term contracts).
4. ***How does the business pay the worker?*** An employee is generally paid by the hour, week, or month. An independent contractor is generally paid a flat fee or by the job, even though it is common in some professions, such as law and accounting, to pay hourly. The payment of commissions indicates both are possible.

What type of relationship between the parties exists? These factors illustrate how the worker and the business perceive their relationship between each other:

1. ***Does a written contract exist that describes the relationship the parties intend to create?*** This factor is generally considered of lesser importance by the IRS (but more important by the courts!), as the *substance*, not the *label*, governs the worker's status. A written contract contains other evidence (e.g., method of compensation, what expenses are unreimbursed, and *how* work is to be performed).
2. ***Does the business provide the worker with employee-type benefits, such as insurance, a pension plan, vacation pay, or sick pay?*** Employee benefits are *only* paid to employees! The IRS surprisingly discloses that W-2s do not necessarily indicate employee status and that incorporated workers generally will not be recharacterized as the business's employees.
3. ***How permanent, ongoing, is this relationship?*** Permanent and indefinite relationships indicate an employer-employee relationship, whereas, the IRS divulges, long-term and temporary relationships are not important evidence (i.e., independent contractors can have long-lasting relationships).
4. ***To what extent are the services performed by the worker a key aspect of the regular business of the company?*** Is the success of the business dependent, to an appreciable degree, upon the worker's performance? If so, an employer-employee relationship exists. For example, as restaurants need cooks and cashiers and law firms need lawyers, these workers are generally employees. But, even though it is essential for an appliance store to retain good accountants, bookkeeping is NOT the store's regular business, and, therefore, this work can be done equally well by independent contractors or employees.

   Tax practitioner planning. Come to a conclusion — weigh the evidence! Once the relevant evidence in all three categories has been accumulated, each piece of evidence must be weighed before determining the worker's status. It's still a facts and circumstances test!

IRS Explains Employee vs. Contractor Rules

The IRS posted an updated fact sheet for *Understanding Employee v. Contractor Designations*. While it has nothing new for tax practitioners, it might be useful to provide to existing and potential business clients.

Misclassified workers can cost an employer as much as 50% of compensation paid to the worker when you include federal and state payroll taxes, interest, and penalties. Workers' compensation and employee benefits can add to the problem.

> **Tax practitioner planning.** The IRS tells workers who believe they are employees not contractors to file a Form 8919 to figure and report the employee's share of uncollected Social Security and Medicare taxes due on their compensation. The form, of course, reports the scofflaw employer to the IRS.

Other Factors Used by Courts to Determine If Worker Is Employee or Self-Employed

Eight factors court used. In determining whether an individual who works for another is an employee or an independent contractor, the courts have considered various factors, including the following:

1. the degree of control exercised by the person for whom the work is performed over the details of the work;
2. which party invests in the facilities used by the worker;
3. the opportunity of the worker for profit or the risk of the worker for loss;
4. whether the principal has the right to discharge the worker;
5. whether the work is part of the principal's regular business;
6. the permanency of the relationship between the principal and the worker;
7. the relationship that the principal and the worker believed they were creating; and
8. whether the principal provided the worker any so-called employee benefits.

In resolving the issue of whether a worker is an employee, all of the facts and circumstances must be considered, and no one factor is dispositive (*Weber v. Comm.*, 103 TC 378, 386; No. 94-2609; 60 F.3d 1104 (4th Cir. 1995).

Taxpayer Will Remember This Memorial Day — From Behind Bars (US Attorney's Office, Northern District of Ohio (May 6, 2019))

Richard Spencer owns RS Sewing, a company that makes American flags and sells them to veterans' groups and large retailers throughout the country. Spencer was convicted of failing to withhold taxes from workers he knowingly and willfully misclassified as independent contractors. For workers classified as W-2 employees, Spencer failed to pay over to the IRS taxes the company withheld from its employees' wages. Judge Patricia Gaughan of the US District Court in Cleveland sentenced Spencer to two years in prison and three years of supervised release. In addition, Spencer must pay restitution of $197,040.

> "*Richard Spencer did not have any problems with earning income from manufacturing the American flag, but he did have problems with paying employment taxes to the IRS that he withheld from his employees*," William Cheung, acting special agent in charge for the IRS's Cincinnati Field Office, said in the press release.

Misclassifying employees. Business clients often complain about the high cost of treating workers as employees — employment taxes, workers' compensation insurance, and benefit plans. For Mr. Spencer, who had been warned about his misclassification of workers in a prior IRS audit, his cost was not just money but also his freedom.

Court Awards Worker $5,000 for Fraudulent Form 1099 (*Vanderbilt v. Boat Bottom Express, LLC, et al.*, No. 4:2018cv10261 - Document 37 (S.D. Fla. Sep. 24, 2019))

Valerie Vanderbilt sued her employer for various employment-related issues, one of those being that the employer filed a fraudulent Form 1099. The Form 1099 claimed that Valerie was an independent contractor receiving nonemployee compensation of $48,864. Valerie's testimony convinced the court that she was an employee and that, thus, the Form 1099 was fraudulent. The court awarded Valerie $5,000 in statutory damages pursuant to 26 USC §7434, plus $8,843 in attorney fees and costs.

Property Manager Was Employee of Apartment-Complex Owner, Not Independent Contractor (*Hampton Software Development, LLC v. Comm.*, TCM 2018-87)

Oklahoma landlord hired property manager who lived at the apartment complex. William Hampton and Brent Hampton were the sole owners of Hampton Software Development, LLC (Hampton). Hampton owned and operated the Orchard Park Apartments, a 60-unit apartment complex in Tulsa, Oklahoma. Robert Herndon (Robert) served as the property manager for the apartment complex and resided in an apartment at the complex.

Degree of control. In general, the relationship of employer and employee exists under common law when the person for whom services are performed has the right to exercise control over the individual performing the services for that person with respect to not only the result to be accomplished but also the details and the means by which the result is accomplished. The courts have referred to that right by the principal as the "crucial test" in determining whether an employer and employee relationship exists between the principal and the worker (§31.3121(d)-1(c)(2); §31.3306(i)-1(b); §31.3401(c)-1(b); *Michael D. and Barbara L. Weber v. Comm.*, 103 T.C. 378, No. 14475-91; (1994); (4th Cir.) No. 94-2609 (1995)). Factor favored employee.

Investment in facilities. Where the worker has no investment in the facilities, such as tools, used in the work that the worker does for the principal, that fact generally is indicative that the worker is an employee of the principal. Where the worker provides the worker's own tools, that fact generally is indicative that the worker is an independent contractor. Factor favored employee.

Opportunity for profit and risk of loss. Where the worker does not have an opportunity for profit or risk of loss in working for the principal, that fact generally is indicative that the worker is an employee of the principal. A negotiated flat fee paid to a worker (1) insulates the worker from suffering a loss if the cost of a project exceeds the amount budgeted as the cost of the project and (2) prevents the worker from realizing a profit if after completion of the project the actual cost is less than that budgeted amount. A flat fee payment also prevents a worker from increasing through the worker's efforts the earnings that the worker will receive for his/her work (*TFT Galveston Portfolio, Ltd. v. Comm.*, 144 T.C. at 117; *Kurek v. Comm.* TCM 2013-64, at *12. Factor favored employee.

Right to discharge the worker. An employer typically has the right to terminate an employee at will. In the present case, pursuant to the work arrangement that Richard had with Hampton, Hampton had the right to discharge Richard at any time, and Richard had the right to resign at any time (*Ellison v. Comm.*, 55 T.C. 142 (1970); No. 1900-68)). Factor favored employee.

Integral part of the principal's business. Where the worker is an essential part of a principal's normal business operations, that fact generally is indicative that the worker is an employee of the principal (*TFT Galveston Portfolio, Ltd. v. Comm.*, 144 T.C. at 118). Factor favored employee.

Permanency of the relationship. Where the working relationship between the worker and the principal is a continuing, not a transitory, relationship, that fact generally is indicative that the worker is an employee of the principal. Factor favored employee.

Relationship the parties believed they created. Where the principal and the worker intend to establish an independent contractor relationship, "such an intention does not carry much weight [in determining whether the worker is an independent contract or an employee] when the common law factors compel a finding that an employer-employee relationship exists" (*TFT Galveston Portfolio, Ltd. v. Comm.*, 144 T.C. at 119). Factor is neutral.

Principal's provision of employee benefits. Where the principal provides to the worker so-called employee benefits, that fact generally is indicative that the worker is an employee of the principal (*Ewens & Miller, Inc. v. Comm.*, 117 T.C. 22; *Michael D. and Barbara L. Weber v. Comm.*, 103 T.C. 378, No. 14475-91; (1994); (4th Cir.) No. 94-2609 (1995)). Factor is neutral.

Court conclusion. The court found Robert Herndon was an employee of Hampton Software Development, LLC, not an independent contractor.

DOL Says Worker for Virtual Marketplace Company Is an Independent Contractor (FLSA2019-6)

In an Information Letter dated Apr. 29, 2019, the DOL issued an opinion that workers for the requesting virtual marketplace company (VMC) are independent contractors. Similar to an IRS private letter ruling, the name of the company requesting the opinion is not provided in the Information Letter.

A VMC is an online and/or smartphone-based referral service that connects service providers to end-market consumers to provide a wide variety of services, such as transportation, delivery, shopping, moving, cleaning, plumbing, painting, and household services. VMCs help consumers to obtain these services with greater efficiency than they would outside the virtual marketplace. VMCs accomplish this through a software platform called an analytic hierarchy process — a technological structure for organizing data that uses objective criteria to match consumers to service providers.

The requesting VMC:

1. Requires workers to acknowledge and accept a terms of use agreement and a service agreement, which states that the VMC provides only a platform for connecting providers with customers and disclaims any employment relationship between your client and the service providers. Additionally, these agreements state that only the service providers, and not the VMC, will provide services to consumers in the virtual marketplace. The agreements also classify the service providers as independent contractors and the VMC issues Forms 1099 to the workers.
2. Does not interview service providers or require them to undergo training. Once the service providers begin to use its virtual platform, it provides them with information on how the virtual marketplace works, such as tips on best practices through an online resource center, and feedback from existing users (both consumers and service providers) on the level of service that consumers generally expect.

The VMC does its entire onboarding process online and does not require service providers to review any of these materials.

3. Allows service providers to immediately begin providing work to customers once their account is activated and does not require them to report to a physical office.
4. Allows its service providers to communicate with consumers — including through mobile app messaging or masked telephone calls — to exchange details about the requested service, including adjustments to the scope, price, or time. Your client allows service providers to arrange for repeat business with a consumer, including future jobs outside the virtual marketplace.
5. Allows service providers the right to, among other things: accept, reject, or ignore any service opportunity on the virtual platform; determine whether to accept any service opportunities at all; select service opportunities by time and place; determine the tools, equipment, and materials needed to deliver their services; and hire assistants or personnel. Service providers design their own schedules and determine exactly when, where, and how much to work in the virtual marketplace.
6. Gives service providers the right to "multiapp" — that is, to simultaneously acquire work on a competitor VMC platform in order to determine the most desirable or profitable service opportunity available at any given time.

The VMC is a referral service. As such, it does not receive services from service providers but empowers service providers to provide services to end-market consumers. The service providers are not working for the VMC's virtual marketplace; they are working for consumers through the virtual marketplace.

Who is the requesting VMC? It's a secret at the moment. It could be Uber or Lyft. It could be InstaCart or GrubHub. In fact, there are dozens of possibilities. But someone is happy to know that the federal government won't be asking them to increase costs by an estimated 20% or 30% in employee costs.

> **Tax practitioner planning**. What does a DOL Info Letter mean? It just means that the DOL will not investigate the requesting VMC for violations of the FLSA. There is no word on how this will affect/influence state labor rulings.

NLRB Memo Says Uber Drivers Are Independent Contractors (NLRB Advice Memo (April 2019))

The National Labor Relations Board memo provides advice as to whether drivers providing personal transportation services using the employer's app-based ride-share platform are employees of Uber or independent contractors. Applying the common-law agency test as explicated in *SuperShuttle DFW, Inc.*[1], the memo concludes that the drivers are independent contractors.

> *"[W]here the common-law factors, considered together, demonstrate that the workers in question are afforded significant entrepreneurial opportunity, [the Board] will likely find independent-contractor status."*

[1] 367 NLRB No. 75 (Jan. 25, 2019)

CA Supreme Court Rules on Uber Employee Dispute

On April 30, 2018, the California Supreme Court issued a landmark ruling that changed the test for independent contractor status in California. The court adopted the ABC test that is used in Massachusetts and New Jersey. Under this test, the burden will be on Uber to prove that drivers do not perform services within Uber's usual course of business. In other words, if Uber cannot prove that it is not a transportation company, then its drivers would be employees under California law.

In Sep. 25, 2018, the Ninth Circuit Court of Appeals reversed the District Court's decision certifying California Uber drivers as a class and declaring Uber's arbitration clause as unenforceable. As a result of the Ninth Circuit's decision, all Uber drivers who are covered by an arbitration clause cannot be part of the lawsuit but instead can only pursue their claims through individual arbitration. Read about the UBER lawsuit in California from the drivers' attorneys here.

Paying Tax on Reclassified Workers

The Internal Revenue Code and regulations provide that an employer can be relieved of the payment of some taxes provided the employer can show that the worker, reclassified from independent contractor to employee, has reported the payments and paid the tax. Form 4669 is used to show that the worker has reported the payments and paid the tax.

In a recent decision, the Tax Court provided relief to an employer who misclassified workers as independent contractors. If your client is facing a big employment tax bill, this case may provide help in minimizing the taxes due.

Court Says That IRS Can Provide Info on Taxes Paid by Reclassified Workers *(Mescalero Apache Tribe v. Comm*., 148 TC No. 11 (Apr. 5, 2017))

The IRS reclassified hundreds of Mescalero Apache Tribe workers as employees. Reclassification made the tribe liable for taxes for its workers whom it improperly labeled as contractors during the 2009-2011 tax years.

Form 4669 to the rescue. An employer escapes tax liability if it can show the workers whom it labeled independent contractors paid income tax on their earnings (§3402; §31.3402(d)-1). One way to get relief would be for the tribe to ask each worker to complete Form 4669, Statement of Payments Received (Internal Revenue Manual pt. 4.23.8.4 (Oct. 26, 2015)).

Seventy employees failed to return the form. The tribe asked the IRS to search the records of 70 workers to determine whether they reported their Form 1099 income and paid their tax liabilities and then to adjust the tribe's liability accordingly. The IRS refused, claiming that it is barred under §6103 from providing confidential tax information from another's tax return.

> **Tax practitioner planning.** The tribe wanted to take advantage of §3402(d). But how? It tried to find its old workers and get them to fill out the form the IRS wants employers to use. The tribe argued that the information is just sitting there in the IRS's records. Maybe, the IRS should be required to look in their own records.

Tribe moves for discovery. Discovery is a legal device employed to require the adverse party to disclose information that is essential to the requesting party's case — in this instance, tax return information from the tribe's reclassified workers who failed to complete the Form 4669. The court ruled that the tax return information was disclosable under §6103(h)(4)©, as the code permits disclosure of returns or return information if such "return or return information directly relates to a transactional relationship between a person who is a party to the proceeding and the taxpayer, which directly affects the resolution of an issue in the proceeding." And even though the tribe bore the burden of proof that the employees paid their income taxes, the court found the worker information discoverable under the court's Rule 70(b).

> **Tax planning idea.** If your client's workers are reclassified as employees, first make a bona fide attempt to secure Form 4669 from each worker to show that the worker reported and paid their taxes. If some employees do not return the form, cite this case and ask the IRS to secure the workers' information from the IRS records.

> **Good people to know**. Winning attorneys were John E. Leeper and David P. Leeper from El Paso, Texas.

TRUST FUND RECOVERY PENALTY - 100% PENALTY §6672

Penalty for Failure to Pay Trust Fund Taxes (Employment Taxes and TFRP)

Responsible persons are personally liable for corporate payroll tax! The number one reason a taxpayer incorporates his or her business is to avoid personal liability for business actions. Personal liability can creep out to the taxpayer regardless of their care in structuring the corporate shield if financial troubles in the corporation led the company to "borrow" payroll trust fund amounts. Under §6672, the IRS can hold "responsible persons" personally liable for taxes withheld from employees but not deposited with the government. The liability equals 100% of the undeposited trust fund taxes (withheld FICA and federal income taxes).

> "Any person required to collect, truthfully account for, and pay over any tax imposed by this title who willfully fails to collect such tax, or attempts in any manner to evade or defeat any such tax or payment thereof, shall, in addition to other penalties provided by law, be liable to a penalty equal to the total amount of the tax evaded, or not collected, or not accounted for and paid over" (§6672).

Exceptions for volunteers and tax-exempt organizations. The IRS may not impose the trust fund recovery penalty on volunteers, unpaid members of a board of trustees, or directors of a tax-exempt organization to the extent that such members served solely in an honorary capacity, did not participate in the day-to-day or financial operations of the organization, and did not have actual knowledge of the failure to pay the trust fund taxes for which the penalty is imposed. However, the relief did not apply if it resulted in no other person being liable for the penalty and, thus, could not operate to eliminate all responsible persons from liability for the penalty (§6672(e)).

Liability under §6672 requires:

1. A *responsible* person — one who had a duty to collect and pay over the taxes. The following have been held to be responsible: board members, corporate officers, managers, payroll check signers, and payroll report signers.

2. The responsible person must have acted willfully in failing to pay and collect the taxes. "Willful" can be nothing more than knowing the liability exists and paying another creditor.

The burden of proof is on the taxpayer. The taxpayer must show that he or she is not a responsible person or did not act willfully in failing to collect and pay over the taxes.

The 100% penalty is not necessarily imposed on the most responsible person. The IRS can assess the same dollar penalty against several people it considers responsible for failing to pay over taxes without ever determining who was actually at fault. However, the IRS cannot collect more than 100% of the liability. The IRS can choose to collect from one of several responsible persons, ignoring the others. Indeed, it can collect from an individual without first pursuing collection actions against the corporation. The courts have given the IRS great latitude in performing its job of collecting delinquent trust fund taxes.

The 100% penalty does not include *pre-assessment interest or penalties* due from the corporation on its delinquent payroll taxes. Interest and penalties accrue to the individual once the individual has been assessed the penalty tax.

Preliminary notice required. Congress thought it necessary to add to the law a provision requiring the government to notify such "responsible persons" that the penalty is going to be assessed at least 60 days before the notice and demand for the penalty. This preliminary notice must now be issued or the government cannot assess the penalty.

The statute of limitations on the assessment shall not expire before the later of:

1. the date 90 days after the date on which such notice was mailed; or
2. if there is a timely protest of the proposed assessment, 30 days after the IRS makes a final administrative determination on the protest (§6672(b), for assessments made after June 30, 1996).

   Tax practitioner planning. The IRS does not need to send the notice if the collection of the tax is in jeopardy.

Disclosure required if IRS attempts to recover taxes from another. Previously, the IRS could not disclose information as to other persons it had determined to be liable for the §6672 penalty. The IRS is now authorized to disclose this information upon the written request by a person who it has determined to be liable for the trust fund recovery penalty under §6672.

The IRS must disclose in writing:

1. the name of any other person whom it has determined to be liable for such penalty, and
2. whether it has attempted to collect such penalty from such other person, the general nature of such collection activities, and the amount collected, if any (§6103(e)(9) effective on July 30, 1996).

Federal right of contribution where more than one person is liable for the penalty for failure to collect and pay over tax. If more than one person is liable for the penalty under §6672, each person who paid such penalty shall be entitled to recover from other persons who are liable for such penalty an amount equal to the excess of the amount paid by them over such person's proportionate share of the penalty. This proceeding is a "federal cause of action" separate from any IRS collection activities relating to the penalty (§6672(d)).

Tax practitioner planning. Any claim for recovery may be made only in a separate action involving such persons.

TIGTA Says IRS Needs to Do More to Collect Trust Fund Taxes (TIGTA Ref. No. 2016-30-046)

TIGTA reviewed samples of individuals owing trust recovery penalties and found that the IRS took an average of 15 months to assign the cases to collection, often did not assign the collection activity to the same revenue officer who worked the business trust fund case, and often did not file federal tax liens. The IRS agreed to emphasize prompt assessment to the same revenue officer when possible, emphasize the use of federal tax liens, and require that a Trust Fund Recovery Penalty completeness checklist is used.

Assessment of Trust Fund Recovery Penalty Declines With IRS Employee Numbers, TIGTA Reports (Ref. No. 2017-IE-R004 (Mar. 23, 2017))

In FY 2015, the IRS assessed the Trust Fund Recovery Penalty (TFRP) against approximately 27,000 responsible persons — 38% fewer than just five years before as a result of diminished revenue officer resources. In contrast, the number of employers with egregious employment tax noncompliance (20 or more quarters of delinquent employment taxes) is steadily growing — more than tripling in a 17-year period. Although the willful failure to remit employment taxes is a felony, there are fewer than 100 criminal convictions per year.

LLC Owner Liable for $56,280 of Trust Fund Penalty (*Lawrence Danduran v. US*, US District Court North Dakota, Case No. 3:17-cv-155 (Mar. 12, 2019))

Lawrence Danduran owned a 50% interest in Mill Pump & Cheers, LLC, a former North Dakota limited liability company. Mill Pump operated a convenience store located in New Rockford, North Dakota, from July 2010 until April 2014. Mill Pump failed to pay its federal income and FICA taxes withheld from its employees' wages for 11 quarters. The persons responsible for collecting, accounting for, and paying over trust fund taxes withheld from employees' wages, who willfully fail to do so, are liable for a penalty in the amount of tax withheld but not paid over §6672. On Mar. 24, 2014, the IRS assessed against Danduran a trust fund recovery penalty for the tax periods at issue. On Aug. 7, 2014, Danduran paid the full amount assessed plus interest in the amount of $56,280.

Danduran and his partner jointly managed the day-to-day operations of Mill Pump when the store first opened. Danduran had the authority to hire and fire employees. Danduran was listed as a signatory on Mill Pump's bank account and had access to the company's checkbook. In the later years of the operation, Danduran continued to come to Mill Pump most days to handle fuel management and maintenance. Danduran established the relationship with Mill Pump's fuel vendor, and he ensured that all payments from Mill Pump were made to the fuel vendor. Danduran calculated amounts due to the fuel vendor and directed his partner to make payments in the correct amount, although sometimes Danduran would sign the checks.

Note. Danduran paid a fuel vendor, rather than the IRS. That made him willful in the court's eyes.

Based upon these facts, Danduran was held to be a responsible person who willfully failed to pay over payroll trust funds for purposes of §6672.

Owner of Construction Company Owes $918,637 in Trust Fund Taxes *(Anthony Samango v. USA, US District Court for the Eastern District of Pennsylvania*, 2:2017cv02484 (June 18, 2019))

Anthony Samango held himself out to be the owner, president, and corporate officer with oversight over "entire operations on a daily basis" of a construction company known as SS Frames. He was held to be a responsible person and liable for more than $900,000 in unpaid payroll taxes.

Also See.

- *Mark Nutter v. US,* DC, SD Ohio, 2019-1 USTC ¶50,159 (Feb. 25, 2019), where the owner and president of the company was responsible and willful when he used withheld taxes to pay operating expense.
- *Robert McClendon v. US*, DC, SD Texas, 2019-1 USTC ¶50,135 (Jan. 22, 2019), where the doctor was held responsible for $4.232 million of unpaid trust fund taxes and penalties; as CFO of the medical corporation, he knew the taxes weren't paid, and he paid other creditors before the IRS.

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CARES ACT

Partnerships Can File Amended Return to Get CARES Act Benefits (Rev. Proc. 2020-23)

The Bipartisan Budget Act (BBA) prohibits partnerships that are subject to the centralized partnership audit regime from filing amended returns. Rather, BBA partnerships must file for an administrative adjustment request on Form 8082 (§6227). Because the CARES Act is meant to provide immediate relief to taxpayers, Rev. Proc. 2020-23 allows partnerships to file amended returns for tax years beginning in 2018 and 2019. The amended returns **must be filed by Sep. 30, 2020**, with the amended return box checked and "filed pursuant to Rev. Proc. 2020-23" written at the top of the form. If the BBA partnership misses the Sep. 30 deadline, it must file an administrative adjustment request.

> **Tax practitioner planning**. A partnership would likely amend for the CARES provision regarding a change to the recovery period of QIP from 39 years to 15 years — "the restaurant and retail glitch." The 15-year recovery period means that QIP again qualifies for bonus depreciation.

CARES Eases §163(j) Limitation for 2019 and 2020

The TCJA limited the business interest deduction to 30% of adjusted taxable income (§163(j)(10)). CARES increases the limitation on the deductibility of interest expense from 30% to 50% for tax years beginning in 2019 and 2020. The §163(j) limitation change does not apply to partners in partnerships for 2019 but applies only in 2020.

TCJA's TAX REFORM

TCJA. In addition to the new 20% deduction for qualified business income of a partnership, the Tax Cuts and Jobs Act of 2017 included an additional five changes to partnership tax law. A summary of each follows.

Long-Term Gains Holding Period for Partnership Profits Interests (§1061 and §83)

The TCJA provides for a three-year holding period in the case of certain net long-term capital gain with respect to any applicable partnership profits interest held by the taxpayer, notwithstanding the rules of §83 or any election in effect under §83(b).

C corporations are exempted from the holding period change — but NOT S corporations! The law, as originally written, provided that the new holding period applied to individuals rather than corporations. Probably the intent was to exclude C corporations from the change, but S corporation shareholders were inadvertently excluded. The IRS, in IR 2018-37, announced that S corporations are subject to the extended three-year holding period for applicable partnership interests and that regulations will be issued soon.

§83(b) election does not change holding period. The Conference Committee Report clarified that the fact that an individual may have included an amount in income upon acquisition of the applicable partnership interest, or that an individual may have made a §83(b) election with respect to an applicable partnership interest, does not change the three-year holding period requirement for long-term capital gain treatment with respect to the applicable partnership interest. Thus, short-term capital gain is taxed at ordinary income rates for the amount of the taxpayer's net long-term capital gain with respect to an applicable partnership interest for the taxable year that exceeds the amount of such gain calculated as if a three-year (not one-year) holding period applies. In making this calculation, the provision takes account of long-term capital losses calculated as if a three-year holding period applies.

Related party transfer. If a taxpayer transfers an applicable partnership interest to a related party, the taxpayer must include in gross income unrecognized short-term capital gains, using the three-year holding period rule, at the time of the transfer.

> **Tax practitioner planning**. The change to holding period does not apply to a third-party investor who is not and has not been actively engaged in directly or indirectly providing substantial services for the partnership or any applicable trade or business (and is (or was) not related to a person so engaged).

What is a profits interest? A profits interest (sometimes referred to as a carried interest) in a partnership is the right to receive future profits in the partnership but does not generally include any right to receive money or other property upon the immediate liquidation of the partnership. Generally the receipt of a partnership profits interest for services is not a taxable event for the partnership or the partner because the profits interests were speculative and without fair market value (see Rev. Proc. 93-27).

> **Example**. Doug is the general partner of a limited partnership formed to build, lease, and hold a shopping center. The limited partnership agreement provides that Doug will receive a profits interest equal to 25% of profits at any subsequent sale of the partnership property. The shopping center must be held for more than three years for Doug to be able to treat his share of the gain (his profits interest) as a long-term capital gain. The limited partners must hold their capital interest more than one year to have a long-term capital gain on a sale.

> **Tax practitioner planning**. A partnership capital interest received for services is includible in the partner's income under generally applicable rules relating to the receipt of property for the performance of services (see §1.721-1(b)(1)).

Tax practitioner planning. The average holding period of global hedge fund deals involving a US-based firm has increased every year for the past decade. The average holding period for investments exited last year was 5.2 years, according to London-based researcher Preqin LTD.

Repeal of Technical Termination of Partnerships (§708(b))

The TCJA repeals the §708(b)(1)(B) rule providing for technical terminations of partnerships.

Tax practitioner planning. The provision does not change the present-law rule of §708(b)(1)(A) that a partnership is considered as terminated if no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership.

What was technical termination? A partnership was treated as terminated if within any 12-month period, there was a sale or exchange of 50% or more of the total interest in partnership capital and profits. This was often referred to as a technical termination. Under regulations, the technical termination gave rise to a deemed contribution of all the partnership's assets and liabilities to a new partnership in exchange for an interest in the new partnership, followed by a deemed distribution of interests in the new partnership to the purchasing partners and the other remaining partners. The effect of a technical termination was not necessarily the end of the partnership's existence, but rather the termination of some tax attributes. Upon a technical termination, the partnership's taxable year closed, potentially resulting in a short taxable year. Partnership-level elections generally ceased to apply following a technical termination. A technical termination generally resulted in the restart of partnership depreciation recovery periods.

Tax practitioner planning. While the repeal of the technical termination is generally favorable, new partners will not be able to make new elections or restart depreciation.

Charitable Contributions Taken Into Account in Determining Basis Limitation on Allowance of Partner's Share of Loss (§704(d))

The TCJA modifies the basis limitation on partner losses to provide that the limitation takes into account a partner's distributive share of partnership charitable contributions (as defined in §170©). Thus, the amount of the basis limitation on partner losses is decreased to reflect these items. In the case of a charitable contribution by the partnership, the amount of the basis limitation on partner losses is decreased by the partner's distributive share of the adjusted basis of the contributed property. In the case of a charitable contribution by the partnership of property whose fair market value exceeds its adjusted basis, a special rule provides that the basis limitation on partner losses does not apply to the extent of the partner's distributive share of the excess. The change is effective for partnership taxable years beginning after Dec. 31, 2017.

Example. The Sharon and Karen partnership contributes appreciated stock to the Salvation Army. The partnership's basis in the stock is $20,000. The stock's FMV is $50,000. Each partner's basis limitation on partner losses is reduced by $10,000, not $25,000.

Tax practitioner planning. Similarly, basis in S corporation stock is reduced by the distributive share of the adjusted basis of the property contributed to a charity, not fair market value (§1366(d)(4)).

Treatment of Gain or Loss of Foreign Persons From Sale or Exchange of Interests in Partnerships Engaged in a US Trade or Business (§864© and §1446)

A foreign person that is engaged in a trade or business in the US is taxed on income that is "effectively connected" with the conduct of that trade or business ("effectively connected gain or loss"). Partners in a partnership are treated as engaged in the conduct of a trade or business within the United States if the partnership is so engaged.

For sales or exchanges of partnership interests after Nov. 27, 2017, the TCJA provides that the gain or loss from the sale or exchange of a partnership interest is effectively connected with a US trade or business to the extent that the transferor would have had effectively connected gain or loss had the partnership sold all of its assets at fair market value as of the date of the sale or exchange. The provision requires that any gain or loss from the hypothetical asset sale by the partnership be allocated to interests in the partnership in the same manner as nonseparately stated income and loss.

Withholding requirement. The provision also requires the transferee of a partnership interest to withhold 10% of the amount realized on the sale or exchange of a partnership interest unless the transferor certifies that the transferor is not a nonresident alien individual or foreign corporation. If the transferee fails to withhold the correct amount, the partnership is required to deduct and withhold from distributions to the transferee partner an amount equal to the amount the transferee failed to withhold. Withholding on sales or exchanges of partnership interests is effective for sales, exchanges, and dispositions after Dec. 31, 2017.

Modification of Definition of Substantial Built-in Loss (§743(d))

For transfers of partnership interest after Dec. 31, 2017, the TCJA modifies the definition of a substantial built-in loss for purposes of §743(d), affecting transfers of partnership interests. Under the provision, in addition to the present-law definition, a substantial built-in loss also exists if the transferee would be allocated a net loss in excess of $250,000 upon a hypothetical disposition by the partnership of all partnership's assets in a fully taxable transaction for cash equal to the assets' fair market value, immediately after the transfer of the partnership interest.

STREAMLINED PARTNERSHIP AUDITS

Final Regs Issued for Streamlined Partnership Audits Starting in 2018 (§6221; T.D. 9829; §301-6221-1; §301.6221(b)-1; NPRM REG-136118-15; §6223; T.D. 9839; §301.6223-1; §301.6223-2)

New "taxable partnership" audit default rules — important to both professional preparers and our clients. New final regulations, effective Jan. 1, 2018, made significant changes in the IRS audit procedures used to conduct partnership (and LLC) and their partner/members audits, changing the audit focus to the partnership instead of the partner. The new rules:

1. Change how partnership tax (including interest and penalties) is assessed and collected;
2. Increase the risk factor when taking uncertain positions on financial reports;
3. Result in nonconformity with state income tax law;
4. Require changes when drafting new partnership agreements (and LLC operating agreements) and require updating to *all* existing partnership agreements, including related documents, such as purchase and sale agreements; and

5. Increase tax professional's Circular 230 "due diligence" risks.

Starting in 2018, "centralized" audit regimes exist for partnerships with up to 100 partners. The Bipartisan Budget Act of 2015 repealed TEFRA and ELP and replaced them with a new partnership audit process (§6221(a); §6221(b); §6225(c); §6226).

1. **With up to 100 partners, a properly made "opt-out" election requires the IRS to make any audit adjustments on the individual partner's tax return.** For eligible partnerships with up to 100 eligible partners, the IRS generally assesses and collects tax at the partnership level as the result of an audit instead of assessing the partners — ***unless*** the partnership formally opts out of the streamlined audit regime.

2. **If partnership has 101+ partners, there is not an opt-out option.** For partnerships with 101 or more partners, the partnership does *not* have the option to avoid the assessment and collection of tax at the partnership level — *unless* the partnership makes an election to file an amended return and amended K-1s (the push-out election).

Determining the number of partners. A partnership has 100 or fewer partners for the tax year if it is required to furnish 100 or fewer K-1s. A partnership with a partner that is an S must take into account each K-1 required to be furnished by the S corporation to its shareholders for the taxable year of the S corporation ending with or within the partnership's taxable year (§301.6221(b)-1)

> **Tax practitioner planning**. Spouses count as two partners, not one, and community property rules are ignored.

Audit procedures more difficult for the partnership/partners and easier for the IRS auditor. The streamlined audit method is a complete change in how the IRS audits and assesses tax to a partnership and its partners. Not only did the IRS issue regulations concerning the new audit process, but it also made significant changes to its internal programs. The Internal Revenue Manual and the IRS databases that record the information and provide training to all partnership auditors changed. For example, the previous IRS database did not record "tax" on a partnership return. Now it must, as the assessment, and the resulting tax, shifts to the partnership. This also requires a new partnership collection procedure.

> **Tax practitioner planning.** The streamlined audit process now allows the IRS to assess and collect tax from the partnership as the result of an audit instead of assessing only the partner(s) with the adjustment and resulting tax, interest, and penalties. Some partnerships: (a) can elect out of this process, (b) petition the IRS for modifications, (c) assess each partner the tax due, or (d) revise the Form K-1.

The Imputed Underpayment

"**Imputed underpayment.**" The "imputed underpayment" paid by partnerships is calculated by multiplying the total net partnership audit adjustments by the highest individual or corporate tax rate (37%/21%). Partnerships with up to 100 partners that don't opt-out, and *all* partnerships with 101+ partners, must pay an "imputed underpayment." Any adjustment to partnership-related items for the taxable year is determined at the partnership level. These partnerships pay an imputed underpayment in the adjustment year (not the reviewed year). The adjustments to the distributive shares of partners are not netted when a distributive share is reallocated from one partner to another, such as an adjustment of any decrease in any item of income or gain, and any increase in any item of deduction, loss, or credit (§6625).

Reviewed year and adjustment year. "Reviewed year" means the partnership taxable year that the IRS is auditing. "Adjustment year" means the partnership taxable year in which the adjustment decision becomes final. Hence, the reviewed year and the adjustment year are different (§6225(d)(1) & (2)).

If the result is a net positive adjustment, there is an imputed underpayment. If a net nonpositive amount results, there is no imputed underpayment. The final regulations provide rules for grouping and netting adjustments when calculating the imputed payment (§6625).

Highest rate of tax in effect for the reviewed year. Whenever the IRS adjusts income, gain, loss, deduction, or credit of a partnership, or any partner's distributive share thereof, the partnership pays any imputed underpayment in the adjustment year at the highest federal income tax rate for either individuals or corporations (37%/21%). Interest, penalty, addition to tax, or additional amount for late tax payment is computed and paid by the partnership. Special rules apply for certain passive losses of PTPs (Publicly Traded Partnerships) (§1(a); §11(b)(1)(d); §6225; §6232; §6233(a)(1) & (b)(1)).

> **Tax practitioner planning.** The nondeductibility of interest for late tax payments puts partnerships under the new audit rules in a worse position than corporations, but consistent with the rules for noncorporate taxpayers (§163(h)(1)).

Partners can amend their return. If one or more partners file returns which includes the end of the reviewed year of the partnership, the returns take into account all adjustments allocable to the partners and payment of any tax due is included with such return, then the imputed underpayment amount will be determined without regard to the portion of the adjustments (§6225(c)(2)).

Or partners can use an alternative "pull-in procedure." The Consolidated Appropriations Act of 2018 added a "pull-in procedure." Rather than amend their return, reviewed-year partners (partners who held an interest in the partnership during the year under audit) can use an alternative pull-in procedure. Under the pull-in procedure, reviewed-year partners pay the tax that would be due with amended returns and provide the IRS with information necessary to show that the tax was correctly computed and paid.

A third alternative: the partnership may use a "push-out" of imputed underpayment by sending an amended K-1 to each partner (or former partner). As an alternative to a partnership-level tax, the partnership can elect to "push-out" the adjustments to its reviewed-year partners. Under the push-out election, the partnership is no longer liable at the entity level for the imputed tax underpayment. If the partnership, not later than 45 days after the date of the notice of final partnership adjustment, elects to provide an adjusted or revised Schedule K-1 showing each partner (or former partner's) adjustment, then the tax is assessed at the partner level. This requires the partners (or former partners) to amend the returns impacted by the changes. The amended K-1s must not only be issued to the partners but also to the IRS (§6226).

> **Tax practitioner planning.** Because the tax is assessed in the adjustment year, former partners would escape their share of tax if the "push-out" election was not available in the law.

If the partnership makes a push-out election, the partners are subject to interest at 5% above the federal short-term rate instead of 2% above the federal short-term rate for any tax liability pushed out. The partnership may modify the imputed underpayment through the partners' voluntary amendment of their returns and payment of the tax or adjustment of their partnership tax attributes.

Making the "push-out" election. The partnership makes the push-out election on Form 8988, Election for Alternative to Payment of the Imputed Underpayment - Section 6226, and attaches to the form:

- A copy of the Notice of Final Partnership Adjustment and indicate the date of that notice.
- A schedule listing each reviewed year that shows, direct partner's name, address, and Taxpayer Identification
- The number of reviewed year partners.
- Whether it is making the election for a general imputed underpayment or a specific imputed underpayment.
- Acknowledgment that it must furnish statements to its reviewed year partners and file a copy of the statements with the IRS.
- Acknowledgment that the election may only be revoked with the consent of IRS.

The partner uses Form 8978, Partner's Audit Liability Under §6226, and Schedule A, Form 8978 for reporting the tax paid over to the partnership.

> **Bottom line**. Qualifying partnerships: (a) can opt out of the process,(b) assess each partner the tax due, or (c) revise the Form K-1 (§6221(a), §6226, §6625).

Miscellaneous provisions not yet defined. Future procedures will provide for determining the imputed underpayment if the partnership demonstrates it is allocable to a partner that would not owe tax by reason of its status as a tax-exempt entity. Tax rates can be modified in some circumstances, and the IRS must issue guidance on when a lower rate would be applicable. Direction is needed on how to handle passive loss activities.

Election Out of the Centralized Partnership Audit Regime

The election out of the centralized partnership audit regime covers three general areas:

1. determining the number of partners of the partnership for purposes of determining whether the partnership has 100 or fewer partners;
2. determining what partners constitute eligible partners for purposes of determining whether the partnership is an eligible partnership; and
3. the mechanics of making the election (§6221(b); §301.6221(b)-1(b)).

"Partnership Representative" Replaces TMP (T.D. 9829; §301.6221(b)-1))

The partnership must designate a "Partnership Representative" (the PR), who doesn't need to be a partner. A partnership may designate itself as its own partnership representative but must appoint a designated individual that has a substantial presence in the US to act on the entity's behalf as Partnership Representative. A disregarded entity can be the partnership representative (§301.6223-1(b)(1)).

The IRS only needs to communicate with the PR. The PR has the sole authority to act on behalf of the partnership *and* all of its partners. There is no requirement that the IRS communicate with the partners. The PR's exclusive authority includes:

1. Making settlement agreements,
2. Agreeing to a notice of final partnership adjustment(s),
3. Electing to pay the partnership liability at the partner level (the §6226 election), and
4. Extending the Statute of Limitation period for making partnership adjustments (the §6235 extension).

> **Tax practitioner planning.** Since the PR's actions bind the partner and the partnership on tax matters, and the partners no longer have notice or appeal, the PR risks being sued for his or her decisions.

TIN not required for partnership representative. On page 3 of the Form 1065, the tax matters partner signature block has been replaced with the designation of partnership representative (PR) and includes the identity of the designated individual for the PR if the PR is an entity.

The streamlined process does not apply if the eligible partnership makes a valid "opt-out" election. Tax payments are not made at the partnership level if the partnership elects out of the streamlined audit process. But, only an "eligible" partnership may make the election out. A partnership is an eligible partnership if:

1. The partnership has 100 or fewer partners, and
2. The K-1s for the partnership taxable year are furnished to each partner (§6222(a) & (b); §6031(b); §301.6221(b)-1(a); §301.6221(b)-1(b)(I) & (ii); §301.6221(b)-1(b); §301.6221(b)-1(b)(2)(ii)).

> **Note**. The PR is the only one with authority to "opt-out."

Furnish K-1 statements to partners. The partnership must furnish K-1 statements to all partners in the partnership during such taxable year regardless of whether the partner is a passthrough entity, a disregarded entity, or an individual who is married to another partner. The private letter ruling process may be used, but is not required, concerning who may, or may not, be excluded (§6031(b); (§301.6221(b)-1(b)(2)(I, ii, iii)).

Special Opt-Out Election Rules for S Corporations

Special rules for the partnership to elect out S corporation shareholders. If the partner is an S corporation, the partnership must disclose the name and TIN of each shareholder who receives an S corporation K-1. The statements an S corporation is required to furnish are treated as statements furnished by the partnership. The IRS may provide for alternative identification of any foreign partners (§6037(b); §301.6221(b)-1(b)(2)(ii)).

> **Example — A partnership with an S corporation partner.** During its 2020 taxable year, TaxAndMe (TAX), a partnership with 50 partners, and Mia, Inc. (MIA), an S corporation with 50

shareholders, are both calendar year taxpayers. TAX is required to furnish 101 statements for the 2020 taxable year — one to each of TAX's 50 partners, one to MIA, and one to each of MIA's 50 shareholders. The number of statements required to be furnished by TAX to MIA's 50 shareholder must be taken into account to determine whether partnership has 100 or fewer partners. Therefore, TAX is not an eligible partnership to make any election out (§301.6661(b)-1(b)(2)(ii); §301.6221(b)-1(b)(2)(iii), Exp 4; §6031(b); §6037(b)).

The Opt-Out Election Cannot Be Made Unless All Partners Are "Eligible Partners"

Eligible partners. An eligible partner means a partner that is an individual, a C corporation, an eligible foreign entity, an S corporation, or an estate of a deceased partner. An S corporation is an eligible partner regardless of whether one or more shareholders is not an eligible partner (§301.6221(b)-1(b)(3)(I)).

Ineligible partners. A partner is not an eligible partner, and, therefore, the partnership is not eligible to opt-out, if any of the partners are:

1. a partnership,
2. a trust,
3. a foreign entity that is not an eligible foreign entity,
4. a disregarded entity (described in §301.7701-2(c)(2)(I)),
5. an estate of an individual other than a deceased partner, or
6. any person that holds an interest in the partnership on behalf of another person (§301.6221(b)-1(b)(3)(ii)).

Tax practitioner planning. This means that a partnership that has partners that are tax-exempt trusts, revocable trusts, charitable remainder trusts, grantor trusts, nongrantor trusts, IRAs, nominees, qualified pension plans, and profit sharing plans is not eligible to make the opt-out election.

Eligible foreign entity. A foreign entity is an eligible partner if the foreign entity would be treated as a domestic C corporation, is classified as a per se corporation, is classified by default as an association taxable as a corporation, or makes an election to be classified as an association taxable as a corporation. A foreign entity partner must have a US TIN in order for the partnership to make a valid election out of the regime (§301.6221(b)-1(b)(3)(iii); §301.7701-2(b)(1), (3), (4), (5), (6), (7), or (8); §301.7701-3(b)(2)(i)(B); §301.7701-3(c).

Example — One of the partners is another partnership. During its 2020 taxable year, Quadfurcate Partnership (QUAD) has four equal partners: two individuals, William and Sophia; one C corporation, Benjamin, Inc. (BEN); and one partnership, Abigail, LLC (ABBY). Because ABBY is a partnership, it is not an eligible partner. Accordingly, ABBY is not an eligible partnership and cannot make the opt-out election for its 2020 taxable year (§301.6221(b)-1(b)(3)(iv), Exp 1).

Example — One of the partners is an S corporation with ineligible shareholders. During its 2020 taxable year, Charlotte Partnership (CHAR) has four equal partners: two individuals, Abigail and Elijab; one C corporation, Emily, Inc. (EMILY); and one S corporation, Noah, Inc. (NOAH), who has 10 shareholders. One of NOAH's shareholders is a disregarded entity, and one is a qualified small-business trust. NOAH is an eligible partner even though NOAH's shareholders would not be considered eligible partners if those shareholders held direct interests in CHAR. Accordingly, the partnership meets the opt-out requirements for its 2020 taxable year (§301.6621(b)-1(b)(3)(i); §301.6221(b)-1(b)(3)(iv), Exp 2).

Example — One of the partners is a Schedule F (disregarded entity). During its 2020 taxable year, Bifurcate Partnership (BIFUR) has two equal partners: Emily, an individual, and Alexander Farms (ALEX), a disregarded entity, wholly owned by Keith, an individual. ALEX is not an eligible partner. Accordingly, BIFUR is not an eligible partnership and is ineligible to make the opt-out election for its 2020 taxable year (§301.6221(b)-1(b)(1); §1301-6221(b)-1(a); §1.301.6221(b)-1(b)(3)(i); §301.6221(b)-1(b)(3)(iv), Exp 3).

Effect of an Opt-Out Election

Generally partnership *and* all partners bound by election *unless:* The opt-out election is an action taken under the Subchapter C treatment of partnership rules (§6221 - §6241) for purposes of §6223 (partners bound by actions of partnership). Accordingly, the partnership and all partners are bound by this election unless the IRS determines that the election is invalid (§301.6223(a)-2; §301.6221(b)-1(e)(1)).

IRS determination that election is invalid. If the IRS determines that the opt-out election for a partnership taxable year is invalid, the IRS will notify the partnership in writing and the Subchapter C treatment of partnership rules (§6221 - §6241) will apply to that partnership taxable year (§301.6221(b)-1(e)(2)).

Making the Opt-Out Election

The election must be made on the eligible partnership's timely filed return, including extensions, for the taxable year to which the election applies. The election is made by including the following information on Schedule B-2 (Form 1065) and filing with the tax return.

- The name of each partner.
- The taxpayer identification number (TIN) of each partner.
- The federal tax classification for each partner.
- If an S corporation is a partner, provide the names, TINs, and federal tax classification of any shareholder of the S corporation for the tax year of the S corporation ending with or within the partnership's tax year.

Note. An election, once made, may not be revoked without the consent of the IRS (§301.6221(b)-1(c)(1)).

Partner notification. A partnership must notify each of its partners of the opt-out election within 30 days in the form and manner determined by the partnership (§301.6221(b)-1(c)(3)).

Tax practitioner planning. As the streamlined partnership audit rules apply for tax years beginning in 2018, we should begin to see these audits in the next several months.

All Partnerships Must Consider Amending Their Partnership Agreement

> Clients should discuss with their attorney a modification to the partnership agreement so the partnership representative can discuss these issues with their partners and require partners to agree. The partners no longer have notice or appeal rights. Thus, the partnership representative may have legal challenges regarding his or her decisions without partner discussion and agreement.

1. The Partnership Representative has vast new powers over the other partners, such as: (a) not notifying partners of the partnership audit developments, and (b) influencing audit concessions. Provisions should be included in partnership agreement dealing with the appointment and replacement of the Partnership Representative.
2. If the partners choose, partnership agreements should be modified to include a covenant that the Partnership Representative will make the opt-out election, if qualified, without the consent of the partners.
3. The transfer of a partnership interest to an ineligible partner should be restricted.
4. Partnerships who are not eligible to opt-out because they have ineligible partners (such as a single-member LLC) should consider restructuring alternatives.
5. The current-year partners pay, directly or indirectly, the prior year tax adjustments, not the partners in the audit year — risk prior to purchase, and the push-out option should be addressed in the partnership agreement.
6. All partnership/LLC clients should be contacted immediately and encouraged to contact their attorney on amending existing partnership agreements.
7. All attorneys who modify, or draw up, partnership/LLC agreements must include provisions responding to the new partnership audit rules.
8. The partnership's financial reporting and disclosure requirements may be impacted by the new partnership audit rules. A disclosure related to the partnership's policy to pay or push-out any tax underpayment should be considered.
9. More partnership audits will result due to the ease of assessment by the IRS examiner.

IRS AND PARTNERSHIPS

In its most recent Statistics of Income Bulletin on Partnerships, Partnerships filed more than 3.9 million returns for 2017, a 3.8% increase over the number filed for 2016. These returns represented more than 27 million partners and reported assets of $32 trillion and net income of $810 billion. Limited liability companies (LLCs) made up the majority of partnerships (69%), surpassing all other entity types for the 16th consecutive year. Limited partnerships represented only 12% of all partnerships but reported the most profits (34.4%) and had the largest share of partners (38.4%).

GAO and TIGTA Say the IRS Needs to Improve Information to Address Tax Noncompliance of Partnerships and S Corporations (TIGTA Ref. Number 2015-30-004, GAO-14-453)

Require e-file for more partnership and S corporation returns. Not all partnership and S corporation line items from paper returns are digitized, and IRS officials said that having more return information available electronically might improve examination selection. In FY 2015, approximately 81% of partnerships and S corporations e-filed. Certain large partnerships and S corporations are required by statute to e-file. Expanding the mandate would increase digitized data available for examination selection.

Acquire better statistical data on partnership returns. In 1995, the GAO found that the IRS's computer scoring system for selecting partnership returns for audit used outdated information. As of 2016, the IRS has not proposed a strategy to update and use its information to select partnerships for examination. Relatively few partnerships are examined compared to other business entities, and many examinations result in no change to taxes owed.

> **Tax practitioner note**. With this kind of a report, the IRS is encouraged to initiate National Research Program (NRP) audits on partnership returns to collect better data. NRP audits (line-by-line audits) are hard on tax preparers and their clients.

IRS Small Business and Self-Employed Division (SB/SE) Continues Its Emphasis on Partnership Audits

SB/SE announced a continued emphasis in the next 12 months on partnership audits. In the past few years, the IRS has implemented various approaches to improve the effectiveness and efficiency of partnership audits. This includes developing an initial profile of the partnership filing population to identify (1) groups of partnerships that may have compliance issues, (2) issues specific to industry type, and (3) filing trends to inform when legislative action is needed. The IRS is creating a new reference tool for Campus Tetra Function tax examiners and field examiners that contains a list of issues and accounting treatments commonly encountered in partnership audits. The IRS also updated in February 2019 its Publication 541, Partnerships, with a dedicated section on electing out of the centralized partnership regime. This publication provides information for partnerships and partners by supplementing the instructions for Form 1065 and Schedule K-1.

IRS Examinations (FY 2018 Data Book)

S corporations and partnerships continue to have the smallest chance of audit. Audit coverage for a partnership is 0.22% (less than one-quarter of 1%) of the 4.043 million Forms 1065 filed in FY 2018.

Audit Targets	FY 2015	FY2016	FY 2017	FY 2018
Corporations with total assets of up to $10 million	0.92%	0.8%	0.69%	0.57%
Corporations with total assets more than $10 million	11.15%	9.5%	7.9%	8.08%
S corporations	0.4%	0.34%	0.28%	0.22%
Partnerships	0.51%	0.38%	0.38%	0.22%

Partnership Audit "No Change" Rate at 40%

In FY 2018, the IRS audited only 8,945 partnership returns, representing 0.22% of the total partnership returns filed the previous year. The "no change" rate for field exam of partnership returns was 40% in FY 2018.

Other exams. A POA can also be secured from a limited partner or LLC member for the purposes of securing partnership item information and disclosing partnership information to the POA. In the case of an LLC that has no member who is also a manager, the nonmember manager may sign the POA for purposes of establishing that it would be appropriate and helpful to secure partnership item information including securing documents and discussing the information with the designated individual.

> **Tax practitioner planning**. Typically, the IRS will interact with the tax matters partner, as defined by §6231(a)(7), or his or her representative during a partnership-level examination. The tax matters partner is a general partner or member-manager except in limited circumstances (§6231(a)(7) and §301.6231(a)(7)-2)).

WHY CHOOSE AN LLC?

Why Be an LLC and Elect Corporate Taxation?

An LLC may elect to be taxed as a corporation and make an S election, at which point, for tax purposes, the LLC is treated in all respects as an S corporation. LLC members elect out of partnership tax treatment for many reasons, including:

- Many states impose an annual fee based on gross receipts (e.g., California and Texas),
- Many attorneys favor LLC liability protection over corporate liability protection, especially for small-business clients who are likely to ignore corporate formalities, or
- As the business grows, the members may want the employee pension and health insurance benefits of the C corporation or the potential payroll tax savings of the S corporation.

Whatever the reason, many clients who have formed LLCs want to change the default tax status.

CHECK-THE-BOX RULES

Eligible Entities Are Able to Choose Whether to Be Taxed As a Partnership or Corporation

An entity is not *required*, but may *elect*, to be classified as a corporation (§301.7701-1 through 301.7701-3).

Domestic Eligible Entities		
Owners	**No Election Made (Or Default)**	**Election**
Two or More Owners	Partnership	C corp.
Single Individual Owner	Sole Proprietor (Sch. C/E/F)	Association/C corp.
Single Corp/Partnership Owner	Operation/Division	C corp.

"Check-the-box" refers to electing out of the default classification. A new eligible entity that does not want the classification provided by the default provisions or an existing eligible entity that wants to change its classification must file Form 8832, Entity Classification Election. The effective date may be specified in the election but may not be more than 75 days prior to the date that the election is filed (§301.7701-1 through §301.7701-3).

How to Check-the-Box

IRS Form 8832, Entity Classification Election, is used to elect out of the default classification or to change a prior election. File Form 8832 for an eligible entity electing to:

- be classified as an association taxable as a corporation; or
- change its classification, even if that classification is a default classification.

> **Tax practitioner note.** Since most LLCs fit into the default classification (disregarded entity or partnership), there is no need to file Form 8832.

Mid-Year Problems

If the check-the-box election becomes effective mid-year, the LLC must file separate short-period returns for the pre- and post-reclassification parts of the taxable year.

> **Tax practitioner note**. When changing tax treatment, taxpayers must be aware of the due date for the first short-year return and corporate estimated tax payments in order to avoid penalties and interest.

Filing the Election

The Form 8832 must be signed by each member of the electing entity who is an owner at the time of the election or any officer, manager, or member authorized to make the election under local law and who makes the election under penalty of perjury. If the election is to be retroactive, all members who were members from the date of the election forward must sign. The election may take effect no more than 75 days prior to the date Form 8832 is filed and no more than 12 months following the election.

LLCs That Wish to Be Treated As an S Corp. Can Simply Timely File Form 2553 (§7701, TD 9203)

In other words, no requirement to file both Form 8832 and Form 2553. Eligible entities that timely file S corporation elections will be deemed to have elected to be classified as associations taxable as corporations.

Late Election Allowed

See details and requirements for a late entity election in Rev. Proc. 2009-41 and Rev. Proc. 2010-32.

WHEN TO USE A SINGLE-MEMBER LLC

One of the alternatives to doing business as a sole proprietor is to form and operate as a single-member LLC. An LLC offers many of the same protections as a corporation with the advantages of disregarding the entity for tax purposes.

Tax Return Preparation

All corporations, whether C or S, must file annual income tax returns with the federal and state taxing authorities. A single-member LLC has no federal filing requirement. Business or professional income is reported on the taxpayer's Schedule C, farms on Schedule F, and real estate rentals on Schedule E, etc. If the member is subject to self-employment tax, the taxpayer files Schedule SE.

Corporate Transactions

A corporation can also be the single member of an LLC. Often, a corporation enters into a transaction and wants to protect the major corporate assets. Here is an opportunity to isolate liability without creating more tax complications.

Keeping Separate Property Separate

A single-member LLC is a device that can be used to keep separate property owned before a marriage from becoming unintentionally commingled with marital property. Since the LLC is separate and distinct from the taxpayer's other investments, the assets within the umbrella of the LLC are kept apart.

Since a single-member LLC is ignored for all income tax purposes, a business purpose is not required. Thus, a single-member LLC can hold homes, stocks, rentals, personal property, or any other type of asset. At the time of a divorce, it can be very difficult to prove that premarital assets were not commingled with marital assets, thereby subjecting them to risk of loss. Segregated assets held throughout the marriage in a single-member LLC should reduce that risk substantially.

Liability Issues

If the single member is not the person operating the business (e.g., a father owns a business operated by his son), the risk of loss is limited to the investment in the LLC, just like any corporation. Where the business has a significant potential for liability (leasing helicopters, transporting explosives), the liability can be isolated.

OPERATIONAL ISSUES

2019 Form 1065 and Schedule K-1 Changed (2019 Form 1065 and Instructions)

Whether you prepare partnership and LLC returns and their accompanying K-1s or whether you input your clients' K-1 to their personal tax returns, the changes are important to note.

Form 1065

New Item K. New item K on page 1 provides check boxes to indicate if the partnership (1) aggregated activities for §465 at-risk purposes or (2) grouped activities for §469 passive activity purposes.

Schedule B. New Question 27 has been added to Schedule B to enter the number of foreign partners that transferred all or part of their interests or received a distribution subject to §864(c)(8). New Question 28 regarding disclosures for disguised sales has been added to Schedule B.

Schedule K. Schedule K and Schedule K-1, line 4, Guaranteed payments, now has three lines: a. Guaranteed payments for services, b. Guaranteed payments for capital, and c. Total.

Schedule K-1

Item E	A parenthetical has been added to caution against using the TIN of a disregarded entity.
Item H	Has been revised to request the name and TIN of a disregarded entity, if applicable.
Item J	A new checkbox has been added to indicate the sale of a partnership interest.
Item K	A new checkbox has been added to indicate whether the liabilities shown in Item K include liabilities from lower-tier partnerships.
Item L	Partners' capital accounts can be reported for 2019 using the same bases which were available for 2018. In 2020, partners' capital accounts must be reported on tax basis.
Item N	A new item has been added for reporting a partner's share of net unrecognized §704(c) gain or (loss), at the beginning and the end of the tax year. **Note**. If the basis of contributed property differs from its FMV at contribution, §704(c) requires gain (or loss) with respect to such property to be allocated to the contributing partner. The purpose of §704(c) is to prevent taxable gain or loss inherent in property at the time of contribution from being shifted to another partner.
Box 11	Code F will no longer be used for §951A income. Instead, it will now be used for any net positive income effect from §743(b) adjustments.
Box 13	New code V has been added for any net negative income effect from §743(b) adjustments.
Box 20	Codes Z through AD that were previously used to report §199A information have been changed. Only code Z will be used to report §199A information. **Note**. Section 199A information is reported on a supplemental schedule, instead of being detailed on the K-1 itself. Part III, line 20, code Z will direct the partner to the attachment. The supplemental schedule reports (1) qualified business income, (2) W-2 wages, (3) unadjusted basis - UBIA, (4) REIT dividends, and (5) PTP income. In addition, the

supplemental schedule will report if the qualified business income is from a specified service trade or business (SSTB).

Box 20	Code AA is used for the net income/loss effect for all §704(c) adjustments.
Box 20	Code AB is used for §751 gain or loss from the sale of a partnership interest.
Box 20	Code AC is used for any deemed gain or loss from §1(h)(5) collectibles from the sale of a partnership interest.
Box 20	Code AD is used for any deemed gain under §1250 from the sale of a partnership interest.
Box 20	Code AH, Other, includes net §743(b) adjustment for partners with basis adjustments.
Lines 21& 22	These new lines have check boxes to indicate that there are attachments to the Schedule K-1 related to the partnership having more than one activity for §465 at-risk purposes, or more than one activity for §469 passive activity purposes, or both.

Due Date for Partnership Tax Return Filing

Partnership Tax Return Due Date Is 15th Day of the Third Month

Returns of partnerships under §6031 made on the basis of the calendar year are due on March 15 following the close of the calendar year. Returns made on a fiscal year basis are due on the 15th day of the third month following the close of the fiscal year.

> **Tax practitioner note**. In response to COVID-19, many 2019 filing dates were delayed to July 15, 2020. Because 2019 calendar year partnerships and S corporations were due Mar. 15, 2020, they were not affected by the delay.

Due date of extended partnership tax return still September 15. The maximum extension under the prior law for calendar year partnership returns was a five-month period ending on September 15. For 2020, the maximum extension for the returns of partnerships is a six-month period ending on September 15 for calendar year taxpayers.

> **Tax practitioner note**. Since the calendar-year S corporation is due March 15, its automatic six-month extension due date remains September 15.

Late Filing Penalties

Failure to File Penalty for Partnership Returns (§6698)

$210 per partner per month for 12 months (2020). A penalty is assessed against the partnership if it is required to file a partnership return and it (a) fails to file the return by the due date, including extensions or (b) files a return that fails to show all the information required, unless such failure is due to reasonable cause. The penalty is $210 for each month or part of a month (for a maximum of 12 months) the failure continues, multiplied by the total number of persons who were partners in the partnership during any part of the partnership's tax year for which the return is due (§6698(a) and §6698(b)). A relief provision exists for partnerships with less than 10 partners.

Abatement of Small Partnership Late Filing Penalty

Small partnerships that file late returns may qualify under Rev. Proc. 84-35 for an abatement of the late filing penalties. The partnership must meet the following requirements:

- the partnership has to be a domestic partnership,
- have 10 or fewer partners (husband and wife and their estate is treated as one partner),
- all partners have to be natural persons (other than a nonresident alien) or an estate of a deceased partner,
- each partner's share of each partnership item has to be the same as their share of every other item,
- all partners need to have timely filed their income tax returns, and
- all the partners need to have fully reported their share of the income, deductions, and credits of the partnership on their timely filed income tax returns.

Exceptions to small partnership abatement. Partnerships having a trust or corporation as a partner, tier partnerships, and partnerships where each partner's interest in the capital and profits are not owned in the same proportion, or where all items or income, deductions, and credits are not allocated in proportion to the pro rata interest, do not come within the exception of §6231(a)(1)(B) and, as such, are not covered by Rev. Proc. 84-35.14.

> **Reminder**. The partners must have timely filed their personal returns for the penalty exception to apply.

Rev. Proc. 84-35 Does Not Provide an Automatic Exemption to Partnerships From the Requirement of Timely Filing a Form 1065 (CCA 201733013)

Although it seems that the IRS automatically grants relief from the late filing penalties to small partnerships, a new Chief Counsel Advice reminds us that neither §6031 nor §6698 contains an automatic exception to the general filing requirement. Although the late filing penalty may be avoided if it is shown that the failure to file a complete or timely return was due to reasonable cause, such relief may be granted under Rev. Proc. 84-35 if the partnership meets its requirements and examiners follow the procedures set forth in IRM 20.1.2.3.3.1.

> **Tax practitioner note.** The vast majority of partnerships that file late returns meet the criteria of 10 or fewer partners and either are not assessed delinquency penalties or have the penalties subsequently abated by the IRS.

Late Filing Penalty Applied for Husband and Wife LLC (*Argosy Technologies, LLC v. Comm.*, TCM 2018-35)

For tax years 2010 and 2011, John Petito and his wife were reported on Argosy Technologies's Form 1065, Schedules B-1, Information on Partners Owning 50% or More of the Partnership, as owning 100% of the LLC. The Form 1065 was filed late, and the IRS assessed late filing penalties.

§761(f) election missing. Argosy appealed, asserting that it is a single-member LLC and cannot be charged a partnership penalty. Argosy contends that Mr. and Mrs. Petitio were one partner. However, there is no evidence of an election to be treated as a qualified joint venture pursuant to §761(f). Since Argosy represented itself as a partnership on its tax returns, it may not argue that it is another entity and disclaim its validity.

What is a §761(f) election? A qualified joint venture conducted by spouses who file a joint return is not treated as a partnership for federal tax purposes. All items of income, gain, loss, deduction, and credit are divided between the spouses in accordance with their respective interests in the venture. Each spouse takes into account his or her respective share of these items as a sole proprietor. Thus, each spouse accounts for his or her respective share on the appropriate form, such as Schedule C. Spouses make the election on a jointly filed Form 1040 by dividing all items of income, gain, loss, deduction, and credit between them in accordance with each spouse's respective interest in the joint venture, and each spouse filing with the Form 1040 a separate Schedule C or Schedule F, if otherwise required, a separate Schedule SE.

A business owned and operated as an LLC does not qualify for the election. Only businesses that are owned and operated by spouses as co-owners (and not in the name of a state law entity) qualify for the election. See Rev. Proc. 2002-69 for special rules applicable to married couple state law entities in community property states. See "Election for Married Couples Unincorporated Businesses" on the IRS website.

Failure to Furnish K-1 Information Timely

$280 for failure to furnish a K-1 (2020). For each failure to furnish Schedule K-1 to a partner when due and each failure to include on Schedule K-1 all the information required to be shown (or the inclusion of incorrect information), a $280 penalty may be imposed for each Schedule K-1 for which a failure occurs. The maximum penalty for persons with average gross receipts for the most recent three years of $5 million or less is $1,130,500 (2020) for all such failures during a calendar year. If the requirement to report correct information is intentionally disregarded, each $280 penalty is increased to $560 or, if greater, 10% of the aggregate amount of items required to be reported, and the maximum doesn't apply.

Self-Employment Tax

Employee or Partner?

Will a worker being compensated on a percentage of income basis be an employee or a partner? Again, the determination will rest on an analysis of all the facts and circumstances, taking into consideration the factors discussed above. Lack of sharing of losses, ownership of capital, and participation in management will tend to indicate an employee/employer relationship.

Partners, including LLC members, are not employees (Rev. Rul. 69-184; CCA 201436049). Bona fide partners are not employees of a partnership (or LLC treated as a partnership), and withholding does not apply to partnership draws or salaries. Many attorneys preparing new LLC documents include language that an LLC member/partner is being paid "wages" by the LLC. A taxpayer considered a partner may not be treated as an employee (2020 Publication 15 (Circular E)).

> **Tax practitioner planning**. The partners (members) should take a guaranteed payment rather than payroll.

> **Tax practitioner planning**. What should you do if you find that the partnership or LLC has been paying wages to its partners (members)? Convert the wages to guaranteed payments as soon as possible. Check to see that the employee benefit deduction (health insurance and pension contribution) does not include amounts paid to partners (members). Benefit payments for partners (members) should be included in guaranteed payments or draw, not as an expense of the partnership. If there is a tax difference, discuss with the partners (members) amending prior year returns.

Final Regs Bar Partnership From Treating Partners Who Work for Disregarded Entity As Employees (TD 9869)

The IRS has issued final regulations that prohibit a partnership that owns a single member LLC (a disregarded entity) from treating partners working for the disregarded entity as employees.

> Reg. §301.7701-2(c)(2)(iv)(C)(2) provides: ****if a partnership is the owner of an entity that is disregarded as an entity separate from its owner for any purpose under this section, the entity is not treated as a corporation for purposes of employing a partner of the partnership that owns the entity; instead, the entity is disregarded as an entity separate from the partnership for this purpose and is not the employer of any partner of the partnership that owns the entity. A partner of a partnership that owns an entity that is disregarded as an entity separate from its owner for any purpose under this section is subject to the same self-employment tax rules as a partner of a partnership that does not own an entity that is disregarded as an entity separate from its owner for any purpose under this section.*

Self-Employment (SE) Tax for Partners

Distributive share and guaranteed payments SE income. A partner's net earnings from self-employment include both the distributive share of the income of the partnership and any guaranteed payment for services rendered to the partnership or for the use of capital by the partnership, to the extent the payments are determined without regard to the income of the partnership (§1.1402(a)-1(b)). In determining a partner's net income for SE tax purposes, the guaranteed payment received by the partner for the performance of services or for the use of capital is offset by the partner's distributive share of the loss of the partnership (Rev. Rul. 56-675, 1956-2 C.B. 459, and §1.1402(a)-2(c)).

Only partnership's trade or business income subject to SE tax. In order for the partner's distributive share of the income of a partnership to be considered as SE income, and thus subject to the SE tax, the partnership must be engaged in a trade or business (§1.1402(a)-1(b)). If the partnership is not engaged in a trade or business, the partner's distributive share of the income of the partnership is not subject to SE tax.

Not relevant whether partner active! If the partnership is engaged in a trade or business, such partner's distributive share of the income of the partnership is considered as SE income regardless of whether the individual partner participates in the operations of the partnership.

SE taxable even if passive. In addition, it is possible for a partner's distributive share of the partnership income to be considered as income subject to SE tax and such income to be passive under §469 where the partner does not materially participate in the activities of the partnership.

Limited Partnership Distribution Not Subject to SE Tax

If a partner owns a limited partnership interest, such partner's distributive share of the income is not income subject to SE tax. Of course, if the limited partner receives a guaranteed payment for the performance of services to the partnership, such income is SE income and subject to SE tax (§1402(a)(13)).

Is an LLC Member a Limited or General Partner for SE Tax Purposes?

Joining forces to tackle the tricky SE tax issue for partnerships and limited liability companies, the tax sections of the American Bar Association and the AICPA have developed a legislative solution. But congressional interest in the one-time political "hot potato" appears to have cooled, and it is not clear that the tax-writing committees even care about what the leadership once derided as a "stealth tax."

> **Tax practitioner planning.** FICA tax is imposed on the "self-employment income" of every individual. SE income generally includes an individual's "distributive share" of income or loss of *any* trade or business conducted by a partnership of which the individual is a member. Currently, the distributive share of income of a *general* partner is subject to SE tax, while the distributive share of income of a limited partner is *not* subject to SE tax, except to the extent that the income represents guaranteed payments for services.

IRS Discusses SE Tax for LLC Members (CCA 201436049)

A Chief Counsel Advice (CCA) addresses the issue of when LLC members are subject to SE tax on their distributive share of LLC income. Section 1402(a)(13) provides that the distributive share of income of a *limited partner* is not included in self-employment income.[1] Accordingly, limited partners are not subject to SE tax. Is an LLC member like a limited partner? If an LLC member is treated like a limited partner, the LLC member would not be subject to SE tax on his or her share of the LLC income. In 1997 (yes, 20 years ago), the IRS issued proposed regulations[2] that would have determined when the distributive share of LLC income is included in the member's SE income. The regulations were never finalized even though LLCs are now recognized in all 50 states and more than 2.1 million LLCs file Form 1065 each year. Finally, in a new CCA, the IRS discusses the SE tax issue.

> **Tax practitioner planning**. The first LLCs were established in Wyoming in 1977.

Management Company LLC provided services to a family of funds. In the CCA, the chief counsel looked at a large investment management company, organized as an LLC, that acted as the manager of a family of funds, each organized as a limited partnership. The investment management company, Management Company, LLC, generally had full authority and responsibility to manage and control the affairs and business of each fund. Thus, Management Company, LLC was primarily responsible for carrying out the extensive market research and trading activity of each of the funds. It carried on all investment activities, such as the

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[1] Guaranteed payments as described in §707(c) are included in SE income for general and limited partners.

[2] Congress imposed a "temporary" moratorium on finalizing the 1997 proposed regulations, which expired in 1998.

purchasing, managing, restructuring, and selling of the funds' investment assets. Members of Management Company, LLC and its employees provided these extensive services to the funds. Management Company, LLC's primary source of income was from fees for providing management services to the funds.

Members were treated as employees of Management Company, LLC. The members of Management Company, LLC worked full-time performing a wide range of professional services, including services related to investment management, analysis, trading, portfolio management, accounting and tax, information technology, etc. Each member was paid wages and received a Form W-2 from Management Company, LLC.

> **Tax practitioner planning**. Rev. Rul. 69-184 states that "members of a partnership are not employees of the partnership." The members should have been compensated with a guaranteed payment.

Management Company, LLC says its members should be treated like S corporation employee/shareholders. On its Form 1065, Management Company, LLC treated all of its members as limited partners not subject to SE tax on their distributive share. Management Company, LLC stated that the "wage" amounts represent "reasonable compensation" for each member and that each member is a limited partner with respect to their distributive share. Management Company, LLC reasoned that because Management Company, LLC had the same role and business as the S corporation it succeeded, it could continue to apply the same "reasonable compensation" wage rules applicable to corporations. However, if Management Company, LLC wanted its members to have the same tax treatment as S corporation shareholders, then it should have stayed an S corporation. The LLC must obey partnership tax law.

Management Company, LLC members performed services for the business. Members performed extensive investment and operational management services for the LLC in their capacity as members (i.e., acting in the manner of self-employed persons), and Management Company, LLC derived its income described in §702(a)(8) from the investment management services performed by its members. The income earned by members through Management Company, LLC was not income, which was basically of an investment nature of the sort that Congress sought to exclude from SE tax when it enacted the predecessor to §1402(a)(13). Accordingly, this CCA concluded that members of Management Company, LLC were not limited partners within the meaning of §1402(a)(13) and they were subject to SE tax on their distributive shares of Management Company, LLC's income described in §702(a)(8).

Why are limited partners different? Section 1402(a)(13) was enacted to exclude for coverage purposes certain earnings that are basically of an investment nature and akin to that of a passive investor. The applicable statute did not, and still does not, define a "limited partner."[3] In 1997, the Treasury Department and the IRS promulgated proposed regulations defining "limited partner" for §1402(a)(13) purposes. The proposed regulations (which were never finalized) generally provide that an individual is treated as a limited partner unless the individual:

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[3]At the time of the statute's enactment, the Revised Uniform Limited Partnership Act of 1976 provided that a "limited partner" would lose his limited liability protection if, in addition to the exercise of his rights and powers as a limited partner, he takes part in the control of the business (Revised Unif. Ltd. Pship. Act (1976), sec. 303(a), 6B U.L.A. 180 (2008)).

1. has personal liability for the debts of or claims against the partnership by reason of being a partner;
2. has authority to contract on behalf of the partnership; or
3. participates in the partnership's trade or business for more than 500 hours.

Additionally, the 1997 proposed regulations provided that service providers in service partnerships (e.g., law firms, accounting firms, and medical practices) may not be limited partners. The 1997 proposed regulations applied to all partnerships (including LLCs).

What did we learn from the CCA? If the member performs services in the business of the LLC, the IRS position is clearly that the member's distributive share of LLC income is subject to SE tax. If the member's ownership interest resembles that of a limited partner, in that he or she cannot participate and does not participate in the business of the LLC, the distributive share of LLC income is probably not subject to SE tax.

> **Tax practitioner planning.** For years, we've been saying, "put it in writing." If you want your member to be treated like a limited partner, then the LLC operating agreement should spell out that the member is a "non-managing member" and restrict the member's ability to participate in the management of the LLC's business. If the member's income is like a limited partner's, then it will be passive (§469) and may be subject to the 3.8% tax on net investment income.

Basis and At-Risk Rules Apply in Calculating SE Tax (CCA 202009024)

During the tax year X, the LLC had a current year operating loss. All LLC members received guaranteed payments in the tax year. To determine the amount of net income subject to SE tax for the tax year: Member A reduced his guaranteed payment by his individual share of the partnership's losses without applying the basis loss limitation under §704(d); Member B reduced his guaranteed payment by his individual share of the partnership's losses without applying the at-risk loss limitation under § 465; and Member C had sufficient basis and at-risk amounts to apply his share of the partnership loss against his guaranteed payment. In addition, Member C's share of partnership loss was not limited by the passive activity loss limitation under §469 because Member C materially participated in the LLC.

The CCA concludes that unless a specific exclusion applies under §1402(a) to the facts of a case, the basis loss limitation under §704(d) and the at-risk loss limitation under §465 apply in determining a general partner's net income under §1402 for SE tax purposes. Members A and B owed more SE tax.

All the members agree that the loss limitations apply in determining their income subject to federal income taxes. However, Member A and Member B argue that the basis loss limitation under §704(d) and the at-risk loss limitation under §465 do not apply in determining their income subject to SE tax, respectively.

Doctor's Surgery Center Income Not Subject to SE Tax (*Stephen and Angela Hardy v. Comm.*, TCM 2017-16)

Stephen Hardy is a plastic surgeon who operates in a number of surgery centers including Missoula Bone and Joint Surgery Center, LLC (MBJ), in which he owns a 12.5% interest. Dr. Hardy has never managed MBJ and has no day-to-day responsibilities there. Although he meets with the other members quarterly, he does not have any input into management decisions. He generally is not involved in hiring or firing decisions. His role and participation in MBJ have not changed since he became a member.

MBJ income reported as passive income. The Hardys filed their 2008 return and attached a Schedule E, reporting passive income from MBJ of $250,494. They attached a Form 8582, reporting a total passive activity loss of $256,411, which included carryover losses from previous years of $119,615. After netting their passive income against their passive losses, they also reported an allowable loss of $250,494, leaving $5,917 as a suspended loss. The Hardys filed their 2009 return and attached a Schedule E, reporting passive income from MBJ of $245,012. They attached a Form 8582, reporting an allowed passive activity loss of $104,224, which included a $5,917 carryover loss from the previous year. The Hardys filed their 2010 return and attached a Schedule E, reporting passive income from MBJ of $270,521. They attached a Form 8582, reporting an allowed passive activity loss of $157,187.

IRS says private practice and MBJ are one activity. The IRS claimed that the Hardys grouped Dr. Hardy's private practice with MBJ, although there was no evidence of grouping. The court ruled that the Hardys consistently treated the activities as separate economic units.

> **Tax practitioner planning**. In prior years, the Hardy's CPA treated the MBJ income as nonpassive. In a later year, the CPA determined that the income should be properly reported as nonpassive. The IRS argued that when the private practice and the MBJ income were reported as nonpassive, that was the equivalent of grouping. The court disagreed.

Suspended passive loss carryover disallowed. The court agreed that the MBJ income was passive. Thus, if the income had been reported properly in prior years, there would not have been a suspended passive loss carryover to the Hardys' 2008 return. The passive losses would have been used up against prior years' passive income. The carryover amount of $119,615 was disallowed by the court.

> **Tax practitioner planning**. The change by the CPA was approved by the court, but the CPA should have amended open years to utilize the passive losses against the reclassified passive income. Because he did not, the taxpayers lost the tax benefit from those prior years' passive losses.

MBJ income not SE income. In each of the years, the Hardys reported the MBJ income as self-employment income. Although Dr. Hardy performs surgeries at MBJ, he is paid separately by his patients for his surgery services and he is not involved in the operations of MBJ as a business. The court ruled that Dr. Hardy's distributive shares from MBJ are not subject to self-employment tax because he received the income in his capacity as an investor (§1402(a)(13)).

Attorneys' Distributive Share Subject to SE Tax (*Vincent J. Castigliola and Marie Castigliola, et al. v. Comm.*, TCM 2017-62)

Distributions were not reported as SE income. Vincent Castigliola, John Banahan, and Harry Mullen (attorneys) were all Mississippi attorneys who practiced law through a professional limited liability company (PLLC) of which they were all members. The PLLC was always member-managed and never had an operating agreement. The PLLC paid each of the attorneys a reasonable guaranteed payment commensurate with local legal salaries. Any profit in excess of the guaranteed payments was paid out to the attorneys based annually and treated as distributions not subject to SE tax.

The attorneys sought advice from a CPA, an accountant for many years who served several positions in the NASBA, including a three-year term on the board of directors. The CPA also served eight years with the Alabama State Bar of Accountancy. The CPA had prepared the income tax returns for the attorneys for several years and knew their business. On the advice of the CPA, the attorneys reported all guaranteed payments as SE income subject to SE tax but did not remit SE tax on the excess of their distributive shares over the guaranteed payments they received.

IRS treats all income as SE taxable. Taxpayers contended that the exclusion afforded limited partners applied to them. The IRS argued the attorneys were not limited partners for purposes of §1402(a)(13). Each of the attorneys was a member of a member-managed PLLC. Under Mississippi law, a limited partner loses limited liability protection if "in addition to the exercise of his rights and powers as a limited partner, he participates in the control of the business." Therefore, the Tax Court ruled that the distributive share of profit was subject to SE tax since each attorney had the ability to bind the PLLC under state law.

> **Tax practitioner planning**. For planning purposes, consider a manager-managed LLC with multiple classes. By doing so, you may be able to limit the exposure to SE tax to guaranteed payments.

Charitable Contributions of an LLC

Gift of Conservation Easement Had No Value *(Wendell Falls Development, LLC v. Comm.*, TCM 2018-45)

Wendell Falls Development, LLC planned to subdivide 1,280 acres into a master-planned community with 4,000 residential lots, commercial spaces, an elementary school, and a park. Wendell Falls planned to then sell the residential lots to homebuilders and commercial lots to commercial builders. Wendell Falls identified 125 acres of the 1,280 acres as the land upon which the park would be placed.

Conservation easement valued at $1.8M by developer. Wake County purchased the park land from the LLC for $3,020,000 based on an appraisal secured by the county from Cushfield Wake. As part of the purchase agreement, the LLC and the county agreed that the LLC would place a conservation easement on the land. On June 7, 2007, the Wake County Register of Deeds recorded the following two instruments in its deed book: (1) a conservation easement on the 125 acres granted by Wendell Falls in favor of Smokey Mountain National Land Trust and (2) a general warranty deed transferring ownership of the 125 acres from Wendell Falls to Wake County. For its 2007 tax year, the LLC reported a $1,798,000 charitable deduction for the donation of the conservation easement.

Expectation of receiving a substantial benefit. When it donated the easement, Wendell Falls owned land adjoining the eased property; i.e., the unencumbered portion of the 1,280 acres. On the unencumbered portion, Wendell Falls planned to create a master-planned community, which was designed so that all of the clusters of residential areas would have access to the 125-acre park through a system of "greenways." Wendell Falls donated the easement with the expectation of receiving a substantial benefit. The court found that a charitable-contribution deduction was not allowable because of this expectation.

An LLC Must Follow Strict Documentation Rules to Deduct Charitable Contribution (*Cave Buttes, LLC v. Comm*., 147 TC No. 10 (Sep. 20, 2016))

Cave Buttes, LLC sold property in a bargain sale to a local water district. The LLC obtained two appraisals of the FMV of the property, attached both to its Form 1065 along with a completed Form 8283. The LLC used the lower appraised value to calculate its charitable deduction and deducted $765,000 as a donation (FMV $1,500,000 less sales price $735,000).

Tax practitioner planning. A taxpayer who makes a bargain sale to charity is typically entitled to a charitable-contribution deduction equal to the difference between the fair market value of the property and the amount realized from the sale.

The IRS audited the LLC and claimed the appraisals did not meet the strict requirements of §1.170-13. Particularly, the IRS claimed that the documentation lacked the following:

1. Two appraisers signed the appraisal report, but only one of them signed the Form 8283. The judge who dismissed this argued and noted that there is only one signature line on the Form 8283.

2. The IRS argued that the appraisal report did not contain a statement that the appraisal was prepared for income-tax purposes. The report, however, states, "The purpose of this appraisal is to estimate the current Market Value of the fee simple interest in the subject property as of the date of valuation for filing with the IRS" (emphasis added). The court refused to find that there are "*magic words*" required to fulfill this requirement, and that "for filing with the IRS" was sufficient to substantially comply, if not strictly comply, with the requirement that the appraisal state it was prepared for income-tax purposes.

3. The FMV was incorrectly shown. The battle of the appraisers began. The IRS appraiser valued the property at $505,800. The taxpayer's appraiser, hired for the trial, valued the property at $2,167,000 (more than the FMV used on the return as originally filed). The court found the taxpayer's appraiser to be "*entirely reasonable*." Comparable sales should have been adjusted upward to reflect the views from the Cave Buttes property. The Cave Buttes property should have been valued as three separate lots to reflect the metes-and-bounds split, rather than as one 11-acre parcel. And the appraisal should have assumed there was legal access to the property and then made a downward adjustment to reflect the cost of obtaining that access. The court allowed an FMV of $2,167,000 in calculating the contribution included in the bargain sale.

   Tax practitioner planning. All entities must follow the same substantiation rules that an individual follows to deduct a charitable contribution.

Partnership Interests Weren't Worthless (*Robert Forlizzo and Judith Ingram v. Comm*., TCM 2018-137)

Robert Forlizzo is an attorney licensed in the state of Florida who received a master of laws in taxation from New York University and primarily practiced real estate transactions law. Forlizzo, Paradise Development Group (PDG), and other real estate professionals formed multiple partnerships which were operated as special purpose entities (SPE) to acquire and develop real property in Florida, Georgia, Iowa, Pennsylvania, and South Carolina. PDG historically sold the projects upon completion.

Recession caused cashflow problems for PDG. Because of the recession, in October 2008, PDG told its creditors that management believed that the cashflow was inadequate for PDG to remain a going concern or service the debt, and the liquidity of the principals, including PDG, had been depleted. Management, however, was concerned that the value of the projects of each of the partnerships would be destroyed if the projects were halted. The presentation provided four available courses of action:

1) cease operations/shutdown/liquidate existing projects and raw land in a chapter 7 [bankruptcy] through a Trustee, 2) deed in lieu of foreclosure on raw land and non-profitable projects and complete only profitable projects, 3) complete existing construction project and control liquidation of raw land and completed projects in chapter 11 [bankruptcy] by the existing management team, and 4) enter a consensual work out with banks to fund completion of construction projects and control liquidation of raw land and completed projects in an out-of-court restructuring.

PDG's goals for restructuring were to complete the restructuring outside of bankruptcy to maximize value for stakeholders and complete more than 20 existing projects. As of October 2008, 11 of the partnerships had a positive net stabilized value and a positive net current value, and seven of the partnerships had a negative "current lender exposure."

Forlizzo claimed losses based on worthlessness. Forlizzo's 2008 Schedules K-1 showed that during 2008, nine of the partnerships incurred losses and three generated income. Because of the October 2008 management meeting with creditors, Forlizzo reported on an amended 2008 federal income tax return that his partnership interests were worthless on Dec. 31, 2008, and claimed loss deductions relating to those interests.

No evidence of worthlessness. Forlizzo did not provide evidence (i.e., appraisals or valuations) establishing that any partnership or subject real estate was valueless at the end of 2008. After the creditors' meeting and as of Dec. 31, 2008, the underlying real estate owned by the partnerships retained value, and the lenders and mortgage holders had not foreclosed on any of the properties owned by the partnerships. Although PDG retained the services of a bankruptcy firm to assist with the restructuring, neither PDG nor the partnerships had filed for bankruptcy. PDG and the partners of each of the SPEs continued negotiating the restructuring of the debt obligations into 2011. Forlizzo failed to meet his burden of proof and did not show that his interest in any of the partnerships was worthless as of Dec. 31, 2008; accordingly, he was not allowed to claim any losses.

Tax practitioner planning. Cash flow problems, creditor restructuring meetings, and filing for chapter 11 protection or chapter 7 bankruptcy are not sufficient proof to establish worthlessness.

LLC Entitled to Worthless Debt Deduction (*2590 Associates, LLC v. Comm.*, TCM 2019-3)

Joseph Spinosa is a real estate developer who has been involved in the real estate industry for several decades. Over that time he has developed apartment, office, and retail buildings representing more than 5,000 apartment units, 1.5 million square feet of office space, and 600,000 square feet of retail space.

Saban bridge loan. Mr. Spinosa organized two companies, Perkins Rowe Associates, LLC and Perkins Rowe Associates II, LLC, to acquire and develop two adjacent 20-acre parcels of real estate into a mixed-use shopping center with 10 buildings of residential, retail, and office space. In early 2006, Perkins Rowe was in discussions with KeyBank for a construction loan to finance the development of the Perkins Rowe property. At that time, sitework had begun. Before the loan's approval, Perkins Rowe needed capital to continue the sitework. Mr. Spinosa obtained a $2 million bridge loan from his acquaintance and business associate Nick Saban.

Notoriety. Nick Saban is famous for his coaching career at LSU, the Miami Dolphins, and Alabama. His name attached to this case made some news.

Note contributed to 2590 Associates. In mid-2008, hit with a declining real estate market, contractor problems, deficient architecture plans, cost overruns, and KeyBank's refusal to refinance the construction loan, a worried Mr. Saban asked Mr. Spinosa about a plan to repay the note. Mr. Spinoza offered Mr. Saban an opportunity to contribute the note, now $3 million, including accrued interest, for a 15% interest in a Baton Rouge housing development held by 2590 Associates.

Perkins Rowe property foreclosed. On July 28, 2009, KeyBank filed a complaint against Perkins Rowe and Mr. Spinosa to collect on the loan, to foreclose on the property, and to enforce Mr. Spinosa's guaranty. After lengthy legal proceedings, KeyBank seized all of the Perkins Rowe assets.

2590 Associates claims worthless debt deduction. On its 2011 return, 2590 Associates claimed worthless debt deductions of $4,894,890, including $2,926,692 for the 2008 (Saban) note[4]. Enter the IRS. The IRS disallowed $2,926,692 of the worthless debt deduction, the amount of the 2008 note. The IRS asserted: "Since the partnership did not establish that the cash transfer was a bona fide loan, the amount has been determined to be a contribution to capital."

Section 166. For a §166 worthless business debt deduction, the taxpayers must show: (1) the deducted amount represents a bona fide debt, (2) the debt became worthless during the year, and (3) the debt was incurred in connection with a trade or business.

Bona fide debt. The court found that Mr. Saban entered into a legitimate debt with Perkins Rowe and transferred the debt to 2590 Associates. Mr. Saban's transfer of the debt to 2590 Associates did not negate the legitimacy of the debt. 2590 Associates held a promissory note with a fixed maturity date and accrued interest at an above-market rate. The interest rate increased upon default, and the note provided for an award of attorney's fees for any collection actions. At the time of the 2008 note's transfer, 2590 Associates intended to collect the debt from Perkins Rowe. For a variety of reasons, the court found the debt to be worthless in the year claimed and that the debt was incurred in connection with 2590 Associates' trade or business.

LOSSES LIMITED TO BASIS

No losses from a partnership or LLC are deductible in excess of the partner/member's basis. Start-up businesses often experience losses in the early years that are paid for with borrowed money. The owners of such a business may have other sources of income (e.g., a job), and increased debt-related basis in a partnership or LLC would permit the deduction of losses against other sources of income.

Partnership or LLC Basis Advantage Over S Corporation

One of the big advantages of partnerships or LLCs over C or S corporations is that entity debt is included in the partner or member's basis. This allocation of debt to the partner or member's basis is critical since it is the basis that determines the deductibility of losses and potential gain on distributions.

Generally, since partner/members have limited liability, they are not liable for the debts of the partnership or LLC by law. Unless a partner/member has personally guaranteed a debt, the debts of the partnership or

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[4] For its 2011 tax year, Perkins Rowe recognized cancellation of indebtedness income of $2,815,652 in connection with the 2008 (Saban) note forgiveness.

LLC are treated as nonrecourse. The at-risk limits of §1.465-6(d) provide that guarantees do not increase the partner/member's at-risk basis until the guarantee is paid by the partner/member.

There is a difference in the treatment of recourse and nonrecourse debt for the partnership or LLC partner/member. When a partnership or LLC partner/member has personally guaranteed a partnership or LLC debt, the debt is recourse. However, if the partner/member has not guaranteed the debt, it is a nonrecourse debt. Where the general partner (managing member) bears an economic risk of loss in the partnership or LLC, the general partner is considered to have recourse debt. The partnership or LLC partner/member must treat this debt as nonrecourse. The debt is nonrecourse debt unless there is a specific guarantee by any partner/member. Section 752 and the regulations therein spell out how to allocate the debt. However, generally, debt will be allocated to the partner/member in proportion to the partner/member's interest.

> **Example of losses limited to basis for S corporation and LLC**. Karen and Sharon are opening an Internet dating company. Their business plan shows them losing money for the first year or two of operation while they build their customer base. The business will have a $50,000 line of credit to draw on for negative cash flow. The bank requires both Karen and Sharon personally to guarantee the line of credit. Losses are limited to basis for both the S corporation and the LLC, but the LLC basis includes the loan balance. Thus, Karen and Sharon will have more deductible losses if they organize as a partnership or LLC.
>
> **Example of deductible loss.** Carol's K-1 from her LLC shows a loss of $10,000. Carol's K-1 capital account in the LLC is $1,000. She owns a 50% interest in the LLC and has a 50% share of liabilities for which she has cosigned. The total liabilities for the LLC are $18,000. Thus, she may include the entire loss ($1,000 capital account + $9,000 share of liabilities). Note that the at-risk rules apply.
>
> **Example of nondeductible loss.** Assume the same facts as the previous example except Carol is a shareholder in an S corporation. Her K-1 shows the same $10,000 loss. She may deduct only her basis in the S corporation, which is $1,000. She may only increase her basis for any loans she personally made to the S corporation, not her share of loans of the S corporation from/to others.

Partnership or LLC's Basis in Its Assets

Inside basis is found in §723 and is the partnership or LLC's tax basis in its assets. For tax purposes, a partnership or LLC takes a carryover basis in contributed property equal to the contributing partners' or members' adjusted basis in the property at the time of the contribution. Inside basis is the aggregate adjusted basis of all property contributed by all partners or members.

Partner's or Member's Basis in the Partnership or LLC Interest

Outside basis is found in §722 and is the individual partner or member's adjusted basis in his or her partnership/LLC interest. In general, a partner's or member's outside basis is his or her separate tax capital account, which reflects adjusted basis, plus his or her share of the partnership or LLC's debt.

Initially, outside basis is determined by including the amount of the adjusted basis in the property contributed plus any cash contributed by the partner or member. If there are liabilities, outside basis includes the partner's or member's share of all liabilities assumed. In subsequent years, the outside basis is increased and decreased by partnership or LLC operations.

Outside basis is maintained by each individual partner or partner/member outside of the partnership or LLC books. Outside basis is important because it is the basis that the taxpayer uses to limit losses, determine the taxability of partnership/LLC distributions, and compute gain/loss on the disposition of their partnership/LLC interest. Outside basis is calculated at the end of the partnership or LLC tax year.

Relationship Between Inside and Outside Basis

There is a close relationship between inside and outside basis. They both reflect the adjusted basis of assets versus the FMV. However, outside basis deals with *each* partner or member's interest in the partnership or LLC assets they contributed, and inside basis deals with *all* partner or members' interests in partnership or LLC assets aggregated together. It is logical, then, that the sum of the partnership or LLC's inside basis in all of its assets should equal the aggregate of all partner or members' outside bases at formation.

How Do Inside and Outside Basis Amounts Become Unequal?

After formation, subsequent transactions may change this equality. These may include:

- Acquisition of a partnership or LLC interest at current FMV;
- Death of a partner/member causing a basis adjustment to FMV; and/or
- Property (including cash) is distributed, and the outside tax basis does not equal the partnership or LLC's basis in the property.

Distribution Equal to Partner/Member's Basis

In general, to the extent that the partner/member withdraws his or her after-tax investment in the partnership or LLC, there is no gain or loss; it merely reduces the outside basis by the amount of the withdrawal. However, some exceptions to this general rule include:

- If a partner/member receives a distribution of cash in excess of his or her outside basis, then the partner/member must report a gain for the excess (§731(a)(1)). ***Reduction of liabilities is considered a deemed cash distribution (§752(b)).***
- If the partner/member receives a distribution of property in which the adjusted basis to the partnership or LLC (inside basis in the property) is more than the partner/member's outside basis in his or her partnership or LLC interest, then the property takes a substituted basis equal to the outside basis amount. The gain is deferred until the partner/member later disposes of the property outside of the partnership or LLC (§732(a)(2)).
- If a partnership or LLC interest is disposed of and the partner/member receives more or less than his or her after-tax investment in the partnership or LLC, he or she will report a gain or loss respectively (§731(a)(1),(2) and §741).

Partnership Distributions

Partners must report distributive share regardless of whether distribution is made. Each partner is required to take into account his or her distributive share of the partnership's income, gain, loss, deductions, and credits (§702(a)). Moreover, a partner must take into account his or her distributive share regardless of whether any actual distribution of cash or other property is made (§1.702-1(a)). A partner's distributive share is determined by the governing partnership agreement (§704(a)).

Even when the partner retires. A partner that retires or otherwise withdraws from a partnership remains a partner for tax purposes until his or her interest in the partnership has been completely liquidated (§1.736-1(a)(1)(ii)). A retiring partner's interest in a partnership is completely liquidated when the entire partnership interest is terminated through a distribution or series of distributions to the partner by the partnership (§736(b), §761(d); §1.761-1(d)). The partnership interest liquidates upon the final distribution to the partner (§1.761-1(d)).

K-1 Income Is Taxable Whether Distributed or Not (*Nik and Shayne Lamas-Richie v. Comm.*, TCM 2016-63)

In 2007, Nik Lamas-Richie started a gossip blog. As the blog gained more viewers, it attracted the attention of investors. An investor named James Grdina approached Lamas-Richie and suggested the formation of a partnership that would take over the website and supply capital to help it expand. The partnership was called "Dirty World LLC," and it began operations in September 2007. Mr. Grdina provided capital by causing Intrigue Investment Co. to lend the partnership $650,000. Mr. Grdina and Intrigue together owned a 59% interest in the partnership; Lamas-Richie received a 41% limited partnership interest.

On Sep. 17, 2012, Dirty World filed a partnership return. On line 22, the return reported for calendar year 2011 ordinary business income of $61,992 from operation of the website. Schedule K-1 reported that Lamas-Richie's distributive share of Dirty World's ordinary business income for 2011 was $25,417 (41% × $61,992). Lamas-Richie did not receive a copy of this Schedule K-1 and was not aware of the contents of Dirty World's Form 1065 until the IRS began its examination of his 2011 return. Lamas-Richie testified that Dirty World had never previously reported any net profit. The Schedule K-1 for 2011 shows no distributions to him.

Must report distributive share even if didn't know there was income or a K-1. A partner must report his distributive share of partnership income even if he was not aware that such income existed at the time it was earned. *Stamen v. Comm*., 208 F.2d 903, 905-906 (3d Cir. 1953) aff'g 12 TCM (CH) 267; see *Pridgen v. Comm*., TCM 1999-188, 77 TCM (CH) 2117, 2127-2131, aff'd, 2 F. App'x 264 (4th Cir. 2001).

OTHER PARTNERSHIP AND LLC ISSUES

Should Debt Financed Interest Be Reported As Investment Interest or Interest Paid for the Partnership's Real Estate Assets? (*William and Dale Lipnick v. Comm*., 153 TC 1 (Aug. 28, 2019))

William Lipnick's father owned interests in four D.C. area rental real estate partnerships that made debt financed distributions to William's father of $22 million. The father used the proceeds of those distributions to purchase assets that he held for investment. The father treated the interest paid by the partnerships on those debts and passed through to him as "investment interest" subject to the limitation on deductibility imposed by §163(d).

Father gifts partnership interests to son. In 2011 and 2013, the father transferred interests in the partnerships to William by gift and bequest, reporting $25 million of gain from relief of liability in excess of basis. The partnerships continued to incur interest expense on the debts, which was passed through to William as a new partner. William treated the debts as properly allocable to the partnerships' real estate assets and reported the interest expense on his 2013 and 2014 Schedules E as offsetting the passed-through real estate income.

Is interest investment or real estate? The question presented is whether the Lipnicks properly offset the interest expense in full against the real estate income on Schedules E, or whether (as the IRS contended) they should have reported the interest expense on Schedules A subject to the limitation imposed by §163(d) on "investment interest." If the interest was investment interest expense to William, since he had no investment income, the deduction would be 100% disallowed for 2013 and 2014. According to the IRS, the error in treatment of the interest expense resulted in $666,000 of proposed tax and penalties.

The court sided with the taxpayer. The court ruled that:

1. William, unlike his father, did not receive the proceeds of any debt-financed distributions and did not use partnership distributions to acquire property held for investment. Rather, he is deemed to have made a debt-financed acquisition of the partnership interests he acquired by gift and bequest, and the associated interest expense is allocated among the assets of the partnerships.
2. Because the assets owned by the partnerships were not property held for investment, none of the interest expense passed through to William was "investment interest" subject to limited deductibility under §163(d).
3. The interest expense passed through to William cannot be characterized as "investment interest" on the theory that he stepped into his father's shoes.

Bankruptcy Exclusion for Pass-Through Entities

The tax consequences upon discharge of an S corporation's debt in bankruptcy are generally determined at the entity level, unlike partnership/partner cancellation of debt (COD) consequences. Therefore, if the §108(d)(2) bankruptcy exclusion applies to the discharge of an S corporation's debt in bankruptcy, that discharge is not taken into account as an item of income by any shareholder.

Insolvency Exclusion for Pass-Through Entities

As with the bankruptcy exclusion, the §108(d)(3) insolvency exclusion applies differently to partners in an insolvent partnership and shareholders of an insolvent S corporation. When a partnership receives a discharge of debt, the insolvency is determined at the partner level; that is, if the partnership is insolvent, but the partners are not, the COD income is not excluded. As previously mentioned, if an S corporation is insolvent, then the eligibility for the exclusion is determined on the entity level. Therefore, if the COD income was excluded under the insolvency rule at the entity level, it would not flow through to the shareholders, even if the S corporation shareholder(s) is/are not insolvent.

> **Tax practitioner planning.** The IRS has announced that upcoming regulations may address how the bankruptcy/insolvency exclusion applies to pass-through entities.

Abandonment of Partnership Interest Resulted in Capital Loss (*T.E. and Mary Watts v. Comm*, TCM 2017-114)

During the three-year period of 2007-2009, Thomas E Watts claimed $754,077 in ordinary losses. On audit, the IRS determined these losses to be capital losses. Section 741 requires taxpayers to treat the disposition of a partnership interest as a capital transaction (except to the extent §751 applies). Section 165(a) treats an abandonment loss as an ordinary loss. In order to qualify for abandonment treatment, the taxpayer must prove

(1) the transaction was not a sale or exchange and (2) he or she abandoned the asset, intentionally and affirmatively, by overt act (§1.165-2).

When a partner is relieved of his or her share of partnership liabilities, the partner is deemed to receive a distribution of cash (§752(b)). Section 731(a) requires distributions to partners to be treated as payments arising from the sale or exchange of a partnership interest. Therefore, in order to claim an ordinary abandonment loss, the partner must (1) not be personally liable for the partnership's recourse debts or (2) be limited in liability and otherwise not exposed to any economic risk of loss for the partnership's nonrecourse liabilities.

Unfortunately for Mr. Watts, he did not qualify for the narrow exception afforded partners to be able to claim the ordinary abandonment loss, and the capital losses were sustained.

Properly Deducting Expenses Incurred by Employees and Partners

When a business reimburses the trade or business expenses of an employee or a partner, the accountable plan rules at §62(c) determine how to handle the reimbursement. But, when a business requires the employee or partner to pay, but not be reimbursed for trade or business expenses such as travel, meals, and lodging expenses, the reporting of the deduction has changed. Some rules:

- When an employee, including an S corporation shareholder/employee, or a partner, is reimbursed trade or business expenses that were properly documented to the business under the accountable plan rules, the reimbursement is deducted solely by the business and does not appear as income on the employee's W-2 or on the partner's K-1 as guaranteed payments.
- If an employee's, including an S corporation shareholder/employee's, expenses do not meet the accountable plan rules, the reimbursements are included in the employee's wages. The employee can no longer deduct the unreimbursed expenses. Miscellaneous itemized deduction (subject to the 2% AGI "haircut") are suspended by the TCJA.
- When a partner is *required to pay* trade or business expenses incurred in his or her capacity as a partner but is *not* reimbursed by the partnership, the partner can deduct substantiated expenses on Schedule E (above-the-line, which means it is *not* subject to the miscellaneous itemized deduction disallowance).

  Tax practitioner planning The LLC is better than an S corporation if there will be unreimbursed expenses.

Also See.

- *J.M. Probandt v. Comm.*, TCM 2016-135, where the partner was not able to deduct travel and entertainment expenses paid by personal check, as the expenses were properly partnership expenses; there was no partnership agreement specifying what business expenses he was required to pay without reimbursement.

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TAX REFORM

Although there are many changes included in the CARES Act, the Act made no changes that are limited to the S corporation. In addition to the 20% QBI deduction, the Tax Cuts and Jobs Act (TCJA) included only three small changes to the S corporation tax provisions. Thus, the basic S corporation tax law remains the same. The IRS continues to be focused on reasonable compensation and basis limitations for loss.

TCJA. Cash Distributions After Conversion

The TCJA adds a provision under new §1371(f) which provides that cash distributions made after the post-termination transition period (as defined in §1377(b)) are chargeable to accumulated earnings and profits in the same ratio that the accumulated adjustment account bears to the accumulated earnings and profits of the C corporation.

TCJA. Expansion of Qualifying Beneficiaries of an Electing Small Business Trust (§1361)

A nonresident alien individual is allowed to be a potential current beneficiary of an Electing Small Business Trust (ESBT) starting on Jan. 1, 2018. An ESBT may be a shareholder of an S corporation (§1361(c)(2)(A)(v)). Generally, the eligible beneficiaries of an ESBT include individuals, estates, and certain charitable organizations eligible to hold S corporation stock directly. A nonresident alien individual may not be a shareholder of an S corporation (and under prior law could not be a potential current beneficiary of an ESBT). The portion of an ESBT which consists of the stock of an S corporation is treated as a separate trust and generally is taxed on its share of the S corporation's income at the highest rate of tax imposed on individual taxpayers. This income (whether or not distributed by the ESBT) is not taxed to the beneficiaries of the ESBT.

TCJA. Charitable Contribution Deduction for Electing Small Business Trusts (§6429(c))

The charitable contribution deduction of an ESBT is not determined by the rules generally applicable to trusts but rather by the rules applicable to individuals for taxable years beginning after Dec. 31, 2017. Thus, the percentage limitations and carryforward provisions applicable to individuals apply to charitable contributions made by the portion of an ESBT holding S corporation stock.

> **Tax practitioner planning.** Generally, a trust is allowed a charitable contribution deduction for amounts of gross income, without limitation, which, pursuant to the terms of the governing instrument, are paid for a charitable purpose. No carryover of excess contributions is allowed, while

an individual is allowed a charitable contribution deduction limited to certain percentages of adjusted gross income generally with a five-year carryforward of amounts in excess of this limitation.

S CORPORATION ELECTION

In order to elect and maintain S corporation status pursuant to §1361(b), a small business corporation must:

1. Be a domestic corporation;
2. Have no more than 100 eligible shareholders (all family members may elect to be treated as one shareholder);
3. Have only shareholders who are individuals, estates, certain exempt organizations, or certain trusts; and
4. ***Have only one class of stock***.

One Class of Stock Guidance

One class of stock rule. Section 1361(a)(1) provides that the term "S corporation" means, with respect to any taxable year, a small business corporation for which an election under §1362(a) is in effect for the year. Section 1361(b)(1) defines a "small business corporation" as a domestic corporation which is not an ineligible corporation which does not (another other things) have more than one class of stock. Section 1362(d)(2)(A) provides that an election under §1362(a) shall be terminated whenever (at any time on or after the first day of the taxable year for which the corporation is an S corporation) such corporation ceases to be a small business corporation. Section 1362(d)(2)(B) further provides that the termination shall be effective on and after the date of cessation.

What is one class of stock? Section 1.1361-1(I)(1) provides that a corporation is generally treated as having only one class of stock if all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds. Section 1.1361-1(I)(2)(i) provides, in part, that the determination of whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds is made based on the corporate charter, articles of incorporation, bylaws, applicable state laws, and binding agreements relating to distribution and liquidation proceeds (collectively, governing provisions). Although a corporation is not treated as having more than one class of stock so long as the governing provisions provide for identical distribution and liquidation rights, any distributions (including actual, constructive, or deemed distributions) that differ in timing and amount are to be given appropriate tax effect in accordance with the facts and circumstances.

Not a second class of stock. A redemption plan that was meant to ensure that the voting power and economic ownership between shareholders' families remained approximately equal was not held to create a second class of stock (PLR 201506003). Payments related to a commercial contractual agreement, such as a lease, employment agreement, or loan agreement, did not constitute disproportionate distributions (PLR 201440021). Neither the amended buy-sell agreement nor bonus plan created a second class of stock (PLR 201309003).

The IRS does not consider payments of health insurance premiums by an S corporation on behalf of 2% shareholder-employees to be distributions for purposes of the single class of stock requirement of §1361(b)(1)(D). Thus, even though Sharon and Vern are each 50% owners of the S corporation, Sharon can be reimbursed, for example, $6,000 a year for her health insurance premiums, and Vern can be reimbursed, for example, $10,000 a year for his health insurance premiums, without disqualifying their S corporation with uneven distributions.

One Class of Stock Rule Inadvertently Violated in Revised Operating Agreement (PLR 201908017)

X was formed on Jan. 1, 2017, and immediately elected to be an S corporation. On July 15, 2019, X amended its operating agreement. The amendment provided for allocations that are not pro rata creating a second class of stock, and, thus, terminated its S corporation election effective July 15, 2019. X represents (1) that it has taken corrective action and amended the operating agreement to allow for pro rata allocations, thus correcting the second class of stock issue; (2) that neither X nor its shareholders intended to terminate X's S election and that X and its shareholders have filed consistently with being an S corporation; (3) that, other than the termination due to a second class of stock, X has qualified as a small business corporation at all times since its election on Jan. 1, 2019; (3) and, lastly, X and its shareholders agree to make any adjustments required as a condition of obtaining relief under the inadvertent termination rule as provided under §1362(f) as may be required by the IRS.

> **Tax practitioner planning.** The representations by the taxpayer may be useful if you have to file a PLR request for the same issue.

"Inadvertent" provides relief. Section 1362(f) provides in part that if (1) an election under §1362(a) by any corporation was terminated under §1362(d), (2) the Secretary determines that the circumstances resulting in the termination were inadvertent, (3) no later than a reasonable period of time after the discovery of the circumstances resulting in the termination, steps were taken so that the corporation for which the termination occurred is a small business corporation, and (4) the corporation for which the termination occurred, and each person who was a shareholder in such corporation at any time during the period of inadvertent termination of the S election, agrees to makes such adjustments (consistent with the treatment of the corporation as an S corporation) as may be required. The S corporation was allowed in the PLR to retain its S election.

S Corporation Shareholder's Unauthorized Distributions for Personal Expenses Did Not Create a Second Class of Stock (*Craig Mowry and Cricket Mowry v. Comm*., TCM 2018-105)

> **Tax practitioner planning point**. What creates a second class of stock in an S corporation? The *Mowry* case lays out the rules.

Craig Mowry and his brother, Geoff Mowry, incorporated Mowry Rebar in Oregon in 2004 and elected to treat the corporation as an S corporation for federal income tax purposes. Craig owned 49% of the shares, and his brother owned 51%. The corporation elected to be treated as an S corporation for federal income tax purposes. When Craig and his brother incorporated Mowry Rebar, they agreed that distributions would be proportional to their ownership. Craig, his brother, and his sister-in-law were the directors of Mowry Rebar, and each participated in the company's business. The brother served as Mowry Rebar's president, the sister-in-law served as corporate secretary, and Craig served as vice president. The brother and sister-in-law were responsible for managing the company's bookkeeping and accounting.

Brother withdrew large amounts for personal expenses. In August 2012, Craig noticed that certain credit cards in his name, which he maintained for business purposes, were being used without his authorization to pay personal expenses of his brother and his brother's children. Shortly thereafter, he reviewed the company's QuickBooks, and he determined that numerous items, including handwritten checks drawn on the company's bank accounts, had not been entered into the accounting records. He also obtained and reviewed online banking statements for the company's bank accounts. He determined that during 2011 and 2012, his brother had been making substantial check and ATM withdrawals from Mowry Rebar's bank accounts without his knowledge.

Did brother's disproportionate distributions create a second class of stock? Section 1361(b) defines a small business corporation as a domestic corporation which must satisfy a number of requirements, including not having "more than one class of stock." See §1361(b)(1)(D). Generally a corporation will be treated as having only one class of stock "if all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds" (§1.1361-1(l)(1)).

Taxpayer contended that S election was terminated because brother took more than his share and thus created a second class of stock. Craig did not report any income from Mowry Rebar on his 2011 and 2012 tax returns, arguing that Mowry Rebar's election to be treated as an S corporation was terminated because it ceased to be a small business corporation. Specifically, he argued that beginning in 2011, Mowry Rebar no longer satisfied the requirement that it have only one class of stock. The brother withdrew large sums of money from Mowry Rebar's bank accounts without Craig's knowledge, and the IRS examiner's computations showed that the brother and Craig received distributions for 2011 and 2012 that were not proportional to their stock ownership. Craig argued that "these substantially disproportionate distributions appear to create a preference in distributions and * * * effectively a second class of stock." Craig contended that Mowry Rebar should be treated as a C corporation and that Craig should be taxed only on distributions that he received (which should be treated as dividends).

The court wanted to know what rights were conferred in the organizational documents. In determining whether a corporation has more than one class of stock, the court considered the rights granted to shareholders in the corporation's organizational documents and other "binding agreements" between shareholders. The regulations provide that "[t]he determination of whether all outstanding shares of stock confer identical rights * * * is made based on the corporate charter, articles of incorporation, bylaws, applicable state law, and binding agreements relating to distribution and liquidation proceeds" (§1.1361-1(l)(2)(i)).

Informal, oral understanding not enough to create second class of stock. In *Minton v. Comm*. [Dec. 57,207(M)], TCM 2007-372, aff'd [2009-1 ustc ¶50,278], 562 F.3d 730 (CA-5), evidence of distributions paid to one shareholder and not to others over the course of multiple years was insufficient on its own to establish that a separate class of stock was created. The court concluded in *Minton* that the taxpayer had failed to prove that a binding agreement existed that granted the shareholder in question enhanced or disproportionate "rights to distribution and liquidation proceeds," as required by §1.1361-1(l)(1) and (2)(i). The court found that at most there had been "an informal, oral understanding among the board members/ shareholders," and there was no evidence that the directors or shareholders ever took "formal corporate action to implement that understanding."

Court ruled that brother's unauthorized withdrawals didn't change shareholders' rights to distributions. Craig argued that the brother's withdrawals "effectively changed * * * [the shareholders' agreement] by majority action." However, nothing in the corporate documents indicated that the brother intended to act as Mowry Rebar's majority shareholder to grant himself rights to disproportionate distributions. Craig offered no evidence of any actions taken at the corporate level to redefine shareholders' rights or issue a new class of stock for Mowry Rebar.

No strong proof of change to distribution rights. Craig contended that the court should regard "the substance of the actions" taken by the brother as creating a second class of stock. However, the court found that the shareholders chose to organize and operate Mowry Rebar with one class of stock, and before 2011 and 2012, the company's and the shareholders' tax obligations were determined on the basis that Mowry Rebar had elected to be treated as an S corporation. Generally taxpayers are bound by the form of the transaction that they choose unless they can provide "strong proof" that the parties intended a different transaction in substance. *Schulz v. Comm.* [61-2 ustc ¶9648], 294 F.2d 52, 55 (9th Cir. 1961), aff'g [Dec. 24,180], 34 TC 235 (1960); see also *Vandenbosch v. Comm.* [Dec. 60,533(M)], TCM 2016-29. There is no proof that either Craig or his brother intended an arrangement different from that which they agreed to and reported consistently on their prior year tax filings.

Election to be an S corporation. A corporation elects to be treated as an S corporation by filing Form 2553, Election by a Small Business Corporation. The election is effective for the current year if it is filed on or before the 15th day of the third month of that year. Elections made after that date are effective for the following year. Each shareholder who owns (or is deemed to own) stock at the time the election is made must consent to the election by signing Form 2553, including spouses with a community property interest.

IRS Consolidates Information on Rules for Late S Election (Late Election Relief)

The IRS has expanded and consolidated relief provisions that provide simplified methods for taxpayers to request relief for late S corporation or entity classification elections (Rev. Proc. 2013-30). Also addressed is relief for late Small Business Trust, Qualified Subchapter S Trust, and Qualified Subchapter S Subsidiary elections.

Form 2553 always required. A requesting entity seeking relief for a late S corporation election must file a completed Form 2553 (Instructions for Form 2553), signed by (1) an officer of the corporation authorized to sign, and (2) all persons who were shareholders at any time during the period that began on the first day of the taxable year for which the election is to be effective and ending on the day the completed Form 2553 is filed.

Additional shareholder statement required. The completed Form 2553 must include statements from all shareholders — during the period between the date the S corporation election was to have become effective and the date the completed election form is filed — that they have reported their income on all affected returns consistent with the S corporation election for the year the election should have been filed and for all subsequent years (Rev. Proc. 2013-30, Sec. 4.03(3)).

Reasonable cause statement also required. A properly completed Form 2553 must include a statement (the Reasonable Cause Statement) from the requesting entity that describes its reasonable cause for failure to timely file the election under subchapter S, and its diligent actions to correct the mistake upon its discovery. Form 2553 must state at the top of the document "FILED PURSUANT TO REV. PROC. 2013-30."

Attach late Form 2553 to the S corporation's current year Form 1120S. For an S corporation that has filed all Forms 1120S for tax years between the effective date and the current year, Form 2553 can be attached to the current year Form 1120S as long as the current year Form 1120S is filed within three years and 75 days after the effective date. An extension of time to file the current year Form 1120S will not extend the due date for relief beyond three years and 75 days following the effective date.

Attach the late Form 2553 to one of the S corporation's late-filed prior year Forms 1120S. In the case of an S corporation that has not filed Form 1120S for the tax year including the effective date or any year following the effective date, an election form may be attached to the Form 1120S for the year including the effective date as long as the Form 1120S for the year including the effective date is filed within three years and 75 days after the effective date, and all other delinquent Forms 1120S are filed simultaneously and consistently with the requested relief.

File Form 2553 independent of Form 1120S. The requesting entity can submit the Form 2553 directly to the applicable IRS service center within three years and 75 days after the effective date.

S CORPORATION LOSS LIMITATIONS

S Corporation Shareholders Are Subject to Three Loss Limitations:

1. Stock and debt basis limitations;
2. At-risk limitations; and
3. Passive activity loss limitations.

Each limitation must be met, in the order presented, before a shareholder is allowed to claim a flow-through loss.

Losses Limited to Basis (§1366; S Corporation Stock and Debt Basis, Updated Feb. 18, 2020)

Losses flow through to the taxpayer, but losses from an S corporation are deductible only to the extent of the shareholder's basis of:

- The shareholder's stock; and
- Any loans the shareholder makes to the corporation.

If the shareholder's losses and deductions reduce his or her basis of both stock and debt to zero, the shareholder cannot deduct any further losses. However, such disallowed losses can be deducted in a later year if the basis of the stock or debt rises above zero (§1366(d)).

To arrive at the adjusted basis of a shareholder's stock or loans, the shareholder's basis must first be determined. If the stock was purchased, the basis is usually its cost. If money was lent to the S corporation, the basis is usually the amount of the loan. If a shareholder received stock in the S corporation in exchange for property, his or her basis in the stock is generally the same as his or her basis in the property transferred.

> **News.** The IRS plans to release a new form to calculate basis of S corporation stock, one that is likely to be required as an attachment to the corporation return and/or K-1. No date has been announced. In the meantime, see the below worksheet.

Worksheet for determining a shareholder's stock basis. The three following worksheets to determine a shareholder's basis are from the instructions to the Form 1120S.

Tax practitioner planning. Instructions to the Schedule E require that an S corporation basis worksheet be attached to the tax return if the taxpayer is claiming a deduction for losses shown on the Form 1120S K-1. Since the same tax preparers had been preparing the taxpayer's returns for several years, it would have been prudent of them to provide a basis worksheet each year and to have confirmed that losses in excess of basis were not claimed.

"If you are claiming a deduction for your share of an aggregate loss, check the box on the appropriate line in Part II, column (e), and attach to your return a computation of the adjusted basis of your corporate stock and of any debt the corporation owes you. For details, see the Shareholder's Instructions for Schedule K-1 (Form 1120S)."

Worksheet for Figuring a Shareholder’s Stock and Debt Basis		
Part I—Shareholder Stock Basis		
1. Stock basis at the beginning of the corporation’s tax year		
2. Basis from any capital contributions made or additional stock acquired during the tax year		
3a. Ordinary business income (losses go on Part III)		
3b. Net rental real estate income (losses go on Part III)		
3c. Other net rental income (losses go on Part III)		
3d. Interest income		
3e. Ordinary dividends		
3f. Royalties		
3g. Net capital gains (losses go on Part III)		
3h. Net section 1231 gain (losses go on Part III)		
3i. Other income (losses go on Part III)		
3j. Excess depletion adjustment		
3k. Tax-exempt income		
3l. Recapture of business credits		
3m. Other items that increase stock basis		
4. Add lines 3a through 3m.		
5. Stock basis before distributions. Add lines 1, 2, and 4		
6. Distributions (excluding dividend distributions) **Note**. If line 6 is larger than line 5, subtract line 5 from line 6 and report the result as a capital gain on Form 8949 and Sch. D.		
7. Stock basis after distributions. Subtract line 6 from line 5. If the result is zero or less, enter -0-, skip lines 8 through 14, and enter -0- on line 15		
8a. Nondeductible expenses		
8b. Depletion for oil and gas		
9. Add lines 8a and 8b		
10. Stock basis before loss and deduction items. Subtract line 9 from line 7. If the result is zero or less, enter -0-, skip lines 11 through 14, and enter -0- on line 15		
11. Allowable loss and deduction items. Enter the amount from Part III, line 13, column (c)		
12. Debt basis restoration (see net increase in instructions for Part II, line 8)		
13. Other items that decrease stock basis		

Worksheet for Figuring a Shareholder's Stock and Debt Basis

14. Add lines 11, 12, and 13	
15. Stock basis at the end of the corporation's tax year. Subtract line 14 from line 10. If the result is zero or less, enter -0-	

Tax practitioner planning. See important things you should know about S corporation basis on the IRS website.

Part II—Shareholder Debt Basis				
	Debt 1 ○Formal note ○Open Ac debt	**Debt 2** ○Formal note ○Open Ac debt	**Debt 3** ○Formal note ○Open Ac debt	**Debt 4** ○Formal note ○Open Ac debt
Amount of Debt:				
1. Loan balance at the beginning of the corporation's tax year				
2. Additional loans (see instructions)				
3. Loan balance before repayment. Combine lines 1 and 2.				
4. Principal portion of debt repayment (this line doesn't include interest)	-	-	-	-
5. Loan balance at the end of the corporation's tax year. Combine lines 3 and 4.				
Adjustments to Debt Basis:				
6. Debt basis at the beginning of the corporation's tax year				
7. Enter the amount, if any, from line 2.				
8. Debt basis restoration (see instructions)				
9. Debt basis before repayment. Combine lines 6, 7, and 8.				
10. Divide line 9 by line 3.				
11. Nontaxable debt repayment. Multiply line 10 by line 4.				
12. Debt basis before nondeductible expenses and losses. Subtract line 11 from line 9.				

13. Nondeductible expenses and oil and gas depletion deductions in excess of stock basis				
14. Debt basis before losses and deductions. Subtract line 13 from line 12. If the result is zero or less, enter -0-				
15. Allowable losses in excess of stock basis. Enter the amount from Part III, line 13, column (d).				
16. **Debt basis at the end of the corporation's tax year**. Subtract line 15 from line 14. If the result is zero or less, enter -0-				
Gain on Loan Repayment:				
17. Repayment. Enter the amount from line 4.				
18. Nontaxable repayments. Enter the amount from line 11.				
19. **Reportable gain.** Subtract line 18 from line 17.				

Part III Allowable Loss and Deduction Items					
	(a) Current year losses and deductions	(b) Carryover amounts (column (e)) from the previous year	(c) Allowable loss from stock basis	(d) Allowable loss from debt basis	(e) Carryover amounts
1. Ordinary business loss					
2. Net rental real estate loss					
3. Other net rental loss					
4. Net capital loss					
5. Net section 1231 loss					
6. Other loss					
7. Section 179 deductions					
8. Charitable contributions					
9. Investment interest expense					
10. Section 59(e)(2) expenditures					
11. Other deductions					
12. Foreign taxes paid or accrued					
13. Total Loss. Combine lines 1 through 12 for each column. Enter the total loss in column (c) on line 11 of Part I and enter the total loss in column (d) on line 15 of Part II					

Adjustments to debt basis. In certain cases, a shareholder may decrease the basis of any loans he or she made to the S corporation and, in later years, restore the basis. If for any tax year the amounts specified in items 2, 3, 4, and 5 above exceed the amount required to reduce the shareholder's basis in stock to zero, the excess must be used to reduce, but not below zero, the shareholder's basis in any loans made to the S corporation. The basis of the loan is reduced even if the shareholder has no tax benefit from the deduction for the basis reduction.

Debt basis restored first. If the shareholder's basis in any loans to the S corporation is reduced, as previously explained, any net increase for a later tax year (figured, above, under adjustments to basis of the shareholder's stock) should first be used to restore the basis of the loans and next to increase the basis of the stock.

Loan repayments. If the shareholder's basis in the loan was reduced (and has not subsequently been completely restored), he or she will have income (other than interest) when the S corporation makes a payment on the loan. Each loan payment (other than interest) must be allocated in part to a return of the shareholder's basis in the loan and in part to income.

To figure the amount of income to report from the loan payments, the shareholder should do the following:

1. Figure the adjusted basis of the loan before payment.
2. Divide the adjusted basis in the loan by the outstanding loan balance.
3. Multiply the payment by the percentage from step 2. This amount is the part of the payment that will be a return of basis in the loan.
4. Take the difference between the amount of the payment and the amount from step 3.
5. Report this amount as ordinary income.

To figure the adjusted basis of the loan for a later payment, for a later restoration of basis, or for a later reduction of basis in the loan because of additional losses, the shareholder should subtract any amounts that are a return of basis from the adjusted basis of the loan.

S corporation distributions greater than basis gain are taxed as long-term capital gain (LTCG). A non-dividend distribution in excess of stock basis is taxed as a capital gain on the shareholder's personal return. Stock held for longer than one year is an LTCG (*Jess L. Miller v. Comm.*, TCM 2011-189).

Nondeductible expenses taken before loss and deduction items unless §1.1367-1(g) election made. Nondeductible expenses (such as 50% of meals and entertainment) also reduce a shareholder's stock and/or debt basis and must be deducted before either a loss or any other deduction item is deducted. If the election under §1.1367-1(g) is made, the S corporation may take the loss and deduction items *before* reducing the shareholder's stock and/or debt basis by the non-deductible expenses. Once the election is made, non-deductible expenses in excess of stock and/or debt basis are suspended and carried forward.

Distribution Owed Back to S Corporation Doesn't Create Debt Basis (*Bradford Sarvak v. Comm.*, TCM 2018-68)

Bradford Sarvak is the sole owner of Emery Financial, Inc., an S corporation incorporated in California. As Emery's president and shareholder, Sarvak authorized distributions to himself during the years in issue. In 2011, Sarvak received total distributions of $1,651,455. In 2012, he received distributions of $2,007,699. The IRS claimed that Sarvak failed to report capital gains from the distributions that he received from Emery, because for both 2011 and 2012, the distributions were in excess of Sarvak's adjusted basis in Emery's stock.

Shareholder says distributions were really debt. Sarvak contended that he did not take distributions in excess of basis. He argued that he was personally liable to Emery for the distributions that he received during the years in issue because he received them in violation of the California Corporations Code. The California Corporations Code provides that a shareholder who knowingly receives any distribution that exceeds the amount of the corporation's retained earnings immediately prior to the distribution is liable to the corporation for the amount so received. See Cal. Corp. Code secs. 500, 506 (West 2014). Since Emery's tax return showed that it had negative retained earnings, Sarvak contended that his liability to Emery under California law "increased his debt basis in the corporation." The court disagreed.

Purported obligation to repay not debt basis. Section 1367(b)(2)(A) provides that if for the taxable year certain items in §1367(a)(2) exceed the amount that would reduce a shareholder's stock basis to zero, the excess of those items shall be applied to reduce (but not below zero) the shareholder's basis in "any indebtedness of the S corporation to the shareholder." Sarvak has not argued or shown that he lent Emery funds or that he assumed direct liability for any debts that Emery owed to outside creditors. See §1.1366-2(a)(2)(i). ("The term basis of any indebtedness of the S corporation to the shareholder means the shareholder's adjusted basis * * * in any bona fide indebtedness of the S corporation that runs directly to the shareholder.") Sarvak has not established that the corporation should be indebted to him for anything. Rather, he contended that the distributions at issue created an indebtedness that he owed to the corporation. A debt for which he was liable to Emery could not have increased his basis in the indebtedness of Emery. The court ruled that Sarvak misinterpreted the cited code and regulatory provisions in arguing that his purported obligation to repay the distributions created debt basis.

Final Regulations Clarify Shareholder's Debt Basis (TD 9682)

Final regulations relate to when shareholders have basis in indebtedness that the S corporation owes to the shareholder (basis of indebtedness). The final regulations provide that basis of indebtedness of the S corporation to the shareholder means the shareholder's adjusted basis in any bona fide indebtedness of the S corporation that runs directly to the shareholder.

Economic outlay standard not applied to debt basis. Courts had developed the actual "economic outlay" standard, which requires that shareholders be made "poorer in a material sense" to increase their debt basis. Some courts concluded that an S corporation shareholder was not poorer in a material sense if the shareholder borrowed funds from a related entity and then lent those funds to another S corporation (*Donald G. Oren v. Comm*., 357 F.3d 854, No. 03-1448 (8th Cir. 2004), aff'g, TCM 2002-172). The final regulations do not apply to the actual economic outlay standard, but instead provide that shareholders receive basis of indebtedness if it is bona fide indebtedness of the S corporation to the shareholder. Whether indebtedness is bona fide indebtedness to a shareholder is determined under general federal tax principles and depends upon all of the facts and circumstances (§1.1366-2(a)(2)(i)).

Economic outlay standard applies to debt guarantees. With respect to guarantees, the final regulations retain the economic outlay standard by adopting the rule in the proposed regulations that S corporation shareholders may increase their basis of indebtedness only to the extent they actually perform under a guarantee (§1.1366-2(a)(2)(ii)).

The regulations provide the following examples:

> **Example 1. Back-to-back loan transaction.** Andrew is the sole shareholder of two S corporations, S1 and S2. S1 loaned $200,000 to Andrew. Andrew then loaned $200,000 to S2. If Andrew's loan to S2 constitutes bona fide indebtedness from S2 to Andrew, Andrew's back-to-back loan increases Andrew's basis of indebtedness in S2.
>
> **Example 2. Loan restructuring through distributions.** Alex is the sole shareholder of two S corporations, S1 and S2. In May, S1 made a loan to S2. In December, S1 assigned its creditor position in the note to Alex by making a distribution to Alex of the note. Under local law, after S1 distributed the note to Alex, S2 was relieved of its liability to S1 and was directly liable to Alex. If the note constitutes bona fide indebtedness from S2 to Alex, the note increases Alex's basis of indebtedness.
>
> **Example 3. Guarantee.** Amy is a shareholder of S, an S corporation. In the current year, S received a loan from the bank. The bank required Amy's guarantee as a condition of making the loan to S.

> Beginning in the following year, S could no longer make payments on the loan, and Amy made payments directly to the bank from Amy's personal funds until the loan obligation was satisfied. For each payment Amy made on the note, Amy obtained basis of indebtedness. Thus, Amy's basis of indebtedness is increased to the extent of Amy's payments to the bank pursuant to the guarantee agreement.

Indirect borrowing, such as acting as a guarantor, does not increase basis. Indirect borrowing, such as acting as a surety or guarantor on corporate debt, generally doesn't result in basis-producing debt until the shareholder is required to pay as a result of the guarantee (*S. Joel Suisman v. Comm.*, TCM 1989-629). Even when a shareholder is primarily liable on corporate debt to a third party, this indebtedness will not qualify as "debt of the corporation to the shareholder" (*Milton. T. Raynor v. Comm.,* 50 TC, No. 75, Aug. 26, 1968), although the 11th Circuit Court of Appeals has held that a shareholder guarantee of a loan made to an S corporation may be treated for tax purposes as an equity investment in the corporation where the lender looks to the shareholder as the primary obligator (*Edward. M. Selfe,* 86-1 USTC ¶9115). A warning: this view has not been adopted by the other circuits (also see *Timothy and Joan Miller v. Comm.*, TCM 2006-125, loans to Indiana S corporation resulted in basis in debt; *Thomas and Janice Gleason v. Comm.*, TCM 2006-191, shareholder was determined borrower on bank loan; but see *William H. Maloof v. Comm.*, (6th Cir), 05-1967, Aug. 4, 2006, 2006-2 USTC ¶50,443, taxpayer lost as neither a personal guaranty, pledge of S corporation stock, nor alleged loss of control to the lender constituted an economic outlay; TAM 200619021).

Journal Entries Not Enough to Prove S Corporation Basis (*Homero Meruelo v. Comm.*, TCM 2018-16)

As often happens with developers, who have multiple entities, expenses are not always paid from the right entity. It's often up to the hapless accountant to "fix" things at the end of the year with a journal entry here or there.

Homero Meruelo is a South Florida developer whose projects include the Akoya Condominiums, one of the tallest buildings in Miami. Mr. Meruelo owns interests in numerous S corporations, partnerships and LLCs. One of these entities is Merco of Palm Beaches, Inc., an S corporation. Mr. Meruelo incorporated Merco in 2004 to purchase a condominium complex in a bankruptcy sale. To purchase the property, he transferred to Merco $4,985,035 (proceeds from a personal bank loan).

Merco affiliates advanced $15M to Merco. During 2004-2008, Merco entered into hundreds of transactions with various partnerships, S corporations, and LLCs in which Mr. Meruelo held an interest (collectively, Merco affiliates). Merco affiliates regularly paid expenses (such as payroll costs) on each other's or on Merco's behalf to simplify accounting and enhance liquidity. The payor company recorded these payments on behalf of its affiliates as accounts receivable, and the payee company recorded such items as accounts payable. During 2004-2008, Merco affiliates made payments in excess of $15 million to or on behalf of Merco. Merco repaid its affiliates less than $6 million of these advances. On December 31 of each year, Merco's books and records showed substantial net accounts payable to its affiliates.

Advances from affiliates were treated as shareholder loan. CPA Luis Carreras prepared the tax returns filed by Mr. Meruelo, Merco, and the Merco affiliates. When preparing Merco's tax return for a given year, Mr. Carreras would net Merco's accounts payable to its affiliates, as shown on Merco's books as of the preceding Dec. 31, against Merco's accounts receivable from its affiliates. If Merco had net accounts payable as of that date, Mr. Carreras reported that amount as a "shareholder loan" on Merco's tax return and allocated a percentage of this supposed indebtedness to Mr. Meruelo, on the basis of Mr. Meruelo's ownership interests in the various affiliates that had extended credit to Merco.

Loan documents lacking. In an effort to show indebtedness from Merco to Mr. Meruelo, Mr. Carreras drafted a promissory note dated Mar. 31, 2004, whereby Mr. Meruelo made available to Merco a $10 million unsecured line of credit at a 6% interest rate. Mr. Carreras testified that, at the time he prepared Mr. Meruelo's and Merco's tax returns for 2004-2008, he would make an annual charge to Merco's line of credit for an amount equal to Mr. Meruelo's calculated share of Merco's net accounts payable to its affiliates for the preceding year. But there is no documentary evidence that such adjustments to principal were actually made or that Merco accrued interest annually on its books with respect to this alleged indebtedness. There is no evidence that Merco made any payments of principal or interest on its line of credit to Mr. Meruelo. And there is no evidence that Mr. Meruelo made any payments on the loans that Merco affiliates extended to Merco when they transferred money.

Foreclosure results in $26M loss. In 2008, Merco incurred a loss of $26,605,840 when banks foreclosed on the condominium complex it had purchased in 2004. Merco reported this loss on its Form 1120S. Merco allocated 49% of the loss to Mr. Meruelo on Schedule K-1. On his 2008 return he claimed, on Form 4797, an ordinary loss deduction of $11,795,109. This deduction reflected a $13,036,861 flow-through loss from Merco ($26,605,840 × 49%) netted against gains of $1,241,752 from two other S corporations.

Loss limited to basis. The Merco loss is limited to Mr. Meruelo's basis in his S corporation (§1366(d)(11)). The IRS determined Mr. Meruelo's basis to be $4,985,035 (his initial transfer to the S corporation). Mr. Meruelo contended that he has substantial additional basis in Merco by virtue of inter-company transfers between Merco and its affiliates, citing the regulations at §1.1366-2(a)(2)(i) promulgated in 2014.

Inter company advances did not create basis. The test set forth in the new regulation — limiting basis to "bona fide indebtedness of the S corporation that runs directly to the shareholder" — is the same test set forth in prior case law (*Hitchins*, 103 T.C. at 715). The court found no evidence that Merco and its affiliates, when booking these transactions, intended to create loans to or from Mr. Meruelo. The CPA's adjustments to a notional line of credit, uniformly made after the close of each relevant tax year, did not suffice to create indebtedness to Mr. Meruelo where none in fact existed.

> **Tax practitioner planning.** As always, a transfer of money from the affiliates to the taxpayer and then from the taxpayer to Merco is better than journal entries.

Loan Assumption at Corporate Liquidation Did Not Create Basis (*William and Amaryllis Tinsley v. Comm.*, TCS 2017-9)

William Tinsley was the sole shareholder of Command Computers, an S corporation engaged in computer design and service. On Apr. 5, 2006, Command Computers borrowed $150,000 from First City Bank of Florida. Mr. Tinsley guaranteed the loan. Command Computers was liquidated in Aug. 2010. At the time of liquidation, Command Computers owed the bank $110,480. Command Computers timely filed its 2010 Form 1120S, on which it reported an ordinary business loss of $136,243.

Bank renewed the corporation's loan even after its liquidation. After Command Computers was liquidated, the operations of the business continued under its former name. Command Computers' 2006 loan with the bank was renewed on Mar. 16, 2011. Command Computers of West Florida, Inc. remained the named borrower of the renewed loan even though it no longer legally existed. Mr. Tinsley signed the renewal note as president of Command Computers and was the guarantor of the loan.

Losses limited to basis. Mr. Tinsley conceded that he had no stock or debt basis in Command Computers at the time of its liquidation in 2010. However, he contended that upon the liquidation, he assumed the balance due on the note as guarantor, and because he was the sole remaining obligor, *this assumption was a contribution to capital*, allowing him to deduct the amount of Command Computers' losses. Further, Mr. Tinsley asserted that following Command Computers' liquidation, the bank expected him, as guarantor, to repay the loan and that the bank's expectation was sufficient to generate a basis for Mr. Tinsley in Command Computers.

Liquidation didn't make the debt the shareholder's. Because Mr. Tinsley failed to establish that the bank looked primarily to him to satisfy the debt obligation or that he had made an economic outlay with respect to the loan, he failed to prove he had a basis in Command Computers as of Dec. 31, 2010, sufficient for him to deduct the reported business losses.

> **Tax planning idea**. Perhaps if Mr. Tinsley had the bank loan rewritten into his name at the liquidation of the corporation, the answer would have been different. Why was the renewal of the loan still in the name of the defunct corporation?

Also see.

- *Rupert and Sandra Phillips v. Comm.*, TCM 2017- 61,where guarantee of loans that later defaulted were not an economic outlay. There was a lack of evidence that the bank looked to the shareholders as the primary source for repayment despite loan judgements against the shareholders. Impairment of shareholder's credit due to the judgements is not a factor; rather, the lender's intentions when the loan is made is controlling. At the time of the loan, no personal assets were pledged, the S corporation had sufficient assets as collateral, and the "guarantee" by the shareholders was merely a bank formality.
- *Bobby R. and Brenda J. Hargis v. Comm.*, TCM 2016-232, where taxpayers had insufficient basis to claim S corporation losses. Loans from related companies did not create basis.

If the Shareholder Did Not Have Sufficient Basis, What Should the Tax Practitioner Recommend?

When preparing the shareholder's tax return in April 2020 and the 2019 K-1 loss exceeds basis in the S corporation, the excess is suspended but not lost. If the shareholder can increase his or her basis in 2020, the 2019 suspended loss is released in 2020 — to the extent of that year's basis. First, tell the client that there were "wasted" S corporation losses in 2019. Next, advise the client what they can do to take the "wasted" losses in another year via the following actions:

1. Contribute capital.
2. Lend money to the corporation.
3. Borrow from the bank and lend those funds to the corporation.
4. Contribute an asset to the corporation. The shareholder's basis is increased to the extent of the adjusted basis of the contributed asset.

> **Tax practitioner planning.** When preparing a pro forma for a new client, be sure to look for suspended losses due to basis limitations.

S CORPORATION AND THE IRS

IRS Examinations (FY 2018 Data Book)

S corporations and partnerships continue to have the smallest chance of audit. Audit coverage for a partnership is 0.22% (less than one-quarter of 1%) of the 4.849 million Forms 1120S filed in FY 2018.

Audit Targets	FY 2015	FY2016	FY 2017	FY 2018
Corporations with total assets of up to $10 million	0.92%	0.8%	0.69%	0.57%
Corporations with total assets more than $10 million	11.15%	9.5%	7.9%	8.08%
S corporations	0.4%	0.34%	0.28%	0.22%
Partnerships	0.51%	0.38%	0.38%	0.22%

S Corporation Audit "No Change" Rate at 29%

In FY 2018, the IRS audited only 10,575 S corporation returns, representing 0.22% of the total S corporation returns filed the previous year. The "no change" rate for field exam of S corporation returns was 29% in FY 2018.

S CORPORATION OPERATIONS

S Corporation Returns Due on or Before 15th Day of Third Month (Highway Funding Bill)

The partnership return due date was changed to correspond to the S corporation due date. For a calendar year partnership or S corporation, the returns are due on March 15. Returns made on a fiscal year basis are due on the 15th day of the third month following the close of the fiscal year.

> **Tax practitioner planning**. We have more work compression. Partnership and S corporation returns are due at the same time, March 15. Perhaps planning a week off from individual appointments before March 15 will help manage the crush of this new deadline.

Corporate Extensions Are an Automatic Six Months

S corporation returns — six months. The maximum extension for the returns of S corporations continues to be a six-month period ending on September 15 for calendar-year filers.

Failure to File Penalty for S Corporation Returns (§6699)

$210 per shareholder per month for 12 months (2020). The penalty for a late-filed S corporation return is $210 per month per shareholder for a maximum of 12 months and is annually adjusted for inflation. Unlike partnerships, there are no automatic penalty relief provisions for small S corporations. The maximum late filing penalty is $2,520 per shareholder!

> **Tax practitioner planning**. The IRS is assessing more late filing penalties and is reluctant to waive such penalties, especially for second offenders. Bottom line, file on time or be prepared!

Serious Illness of Company's CEO and CFO Was Not Reasonable Cause for Late Filing (*Hunter Maintenance and Leasing Corp. v. US,* 2020 PTC 81 (N.D. Ill. 2020))

Hunter Maintenance & Leasing Corp., Inc. (Hunter) brought action against the US, seeking a refund with statutory interest of its payment to the IRS of $58,149 for late filing penalties assessed under §6699 for the years 2011 through 2013. Hunter claimed that the late filing penalty should be abated for reasonable cause because the corporation was disabled due to the incapacity of its Chief Executive Officer and Chief Financial Officer, each of whom were suffering from cancer from which each ultimately died.

Late filing. For 2011 through 2013, the IRC provides that an S corporation that does not timely file its annual income tax return is liable for a penalty equal to $195[1] per shareholder for every month the return is late, not to exceed 12 months (§ 6699(a)(1), (b)). Hunter did not file its returns until March 2017.

CPA was de facto CFO. In 1996, George Tapling, a CPA, was hired by Hunter. CPA Tapling functioned as, possessed and exercised the responsibilities of CFO Hunter, until his death in May 2016. Despite being called Hunter's "de facto" CFO, CPA Tapling was never an employee, officer, or director on the books and records of Hunter. Nonetheless, it was undisputed that CPA Tapling was solely responsible for preparing and filing the federal and state income tax returns, as well as preparing and issuing the Schedule K-1s to the shareholders.

Unbeknownst to Hunter, however, beginning in 2010, CPA Tapling failed to file the income tax returns for the S corporation. He did, in fact, prepare Hunter's returns, and issued the Schedule K-1s, but failed to file the 1120S forms for 2010 through 2013. After Tapling's death, unopened IRS notices were found in his desk. Hunter hired an outside firm to review the income tax filing compliance for its company. It found that CPA Tapling had prepared Hunter's tax returns but failed to file them. In March 2017, that firm filed the delinquent returns.

Was there reasonable cause? Section 6699 provides that "if any S corporation required to file a return for any taxable year – (1) fails to file such return at the time prescribed therefor . . . such S corporation shall be liable for a penalty . . . unless it is shown that such failure is due to reasonable cause." There can be no dispute that an individual taxpayer's illness and severe health problems can constitute reasonable cause to file late (see *Meyer v. Comm.*, TCM 2003-12). Whether a corporation can be incapable of timely filing based on incapacity of a corporate officer is another matter.

Company not disabled. *In the instant case, plaintiff relied on Tapling. And regardless of whether Tapling was its agent or its employee, plaintiff cannot simply rely on his illness to demonstrate the corporation's inability to file. The corporation had a president and board members independent from Tapling and Victor, all of whom had responsibility to ensure that the corporation carried out its statutory duties. Nor has plaintiff presented any evidence of any ordinary business controls to ensure that it met its responsibility. Indeed, it admits that it ceded all responsibility to Tapling without any oversight. This does not demonstrate ordinary and prudent business practice. Consequently, the court grants defendant's motion for summary judgment and denies plaintiff's motion for summary judgment.*

[1] The late filing penalty is $210 per shareholder in 2020.

S Corporation Late Filing Penalties Apply Even Though Shareholders Timely Filed Their Personal Returns *(ATL & Sons Holdings, Inc. v. Comm.*, 152 TC No 8 (Mar. 13, 2019))

ATL is an S corporation with two shareholders, Ralph and Casandra Allen. In 2012, Mr. and Mrs. Allen filed extensions for their individual returns and timely filed before the extended deadline Oct. 15, 2013. The S corporation did not file for an extension and filed late on Sep. 13, 2013.

Mr. Allen claimed that he did file for an extension for ATL to file but it must have been lost. He also argued that no one was hurt by the late filing as he and Mrs. Allen were the only shareholders and they timely filed their returns. Not good enough!

The court ruled ATL liable for the §6699 late filing penalty of $2,340, notwithstanding that shareholders obtained an extension for, and timely filed, their own tax return, and notwithstanding that the IRS allegedly excused the penalty for another year on similar facts.

Tax Imposed on Certain Built-in Gains (BIG Tax) for C to S Corporation Conversion (§1374)

Five-year recognition period for S corporation built-in gains tax made permanent by the PATH Act and H.R. - Consolidated Appropriations Act, 2016. The built-in gains (BIG) tax prevents corporations from making an S election solely to avoid double tax at liquidation. The BIG tax required an S corporation to recognize gain on appreciation at the corporate and shareholder levels in the same way it would have recognized the gain had the company been a C corporation at liquidation. Section 1374 requires the corporation to pay a corporate-level tax on certain property sales made during the recognition period following an S election by a C corporation. The recognition period has recently varied in length as shown in the table below.

	2008 and prior	2009 to 2010	2011 and beyond
Recognition period	10 years	7 years	5 years

The BIG tax does not apply to a corporation that meets any one of the following:

- It made an S election prior to 1987 and has retained that election since.
- It made an S corporation election and has never been a C corporation
- It has been an S corporation continuously for the 10 years preceding liquidation.

Tax practitioner planning. The BIG tax applies not only to liquidations but also to any appreciated assets disposed of by an S corporation that were acquired when the corporation was a C corporation.

How to compute. The BIG tax is computed by applying the highest corporate tax rate (currently 21%) to the built-in gain of the S corporation. The S corporation must pay this tax. Follow these four steps to calculate the tax:

1. Determine the net recognized built-in gain on the disposition of the asset.
2. Reduce the net recognized built-in gain (but not below zero) by any net operating loss and capital loss carryforward allowed (from prior C corporation years).
3. Compute the tentative tax by multiplying the amount in Step 2 by the highest corporate tax rate.

4. Reduce the tentative tax by any allowable credits (§1.1374-1(a)).

Maximum unrealized built-in gains. The net unrealized built-in gains are computed as if the corporation had sold all its assets for the fair market value on the date of the conversion to an S corporation. Under §1.1374-3(a), the net unrealized built-in gain is the total of:

- The amount that would be realized if, at the beginning of the first day of the recognition period, the corporation had remained a C corporation and had sold all its assets at the fair market value to an unrelated party that assumed all its liabilities; **decreased by**
- Any liability of the corporation that would be included in the amount realized on the sale but only if the corporation would be allowed a deduction on payment of the liability; **decreased by**
- The aggregate adjusted bases of the corporation's assets at the time of the sale; **increased or decreased by**
- The corporation's §481 adjustments that would be taken into account on the sale; and **increased by**
- Any recognized built-in loss that would not be allowed as a deduction under §§382, 383, or 384 on the sale.

Shareholder adjustment for tax paid. When the corporation recognizes built-in gains, the gain taxable to the shareholder is reduced by the amount of built-in gains tax paid by the corporation.

Fringe Benefits (§1372)

Generally, the partnership rules apply to S corporations for fringe benefit purposes (§1372(a)). The S corporation shall be treated as a partnership, and any 2% shareholder of the S corporation shall be treated as a partner of such partnership.

The term "2% shareholder" means any person who owns (or is considered as owning within the meaning of §318) on any day during the taxable year of the S corporation more than 2% of the outstanding stock of such corporation or stock possessing more than 2% of the total combined voting power of all stock of such corporation. S corporation 2% shareholders (including ancestors and descendants) are not allowed to take advantage of the exclusions from income for:

1. Amounts paid by an employer to an accident and health plan (§106).
2. Amounts paid for an accident and health reimbursement plan (§105(b)(d)).
3. Amounts received from a cafeteria plan (§125).
4. The cost of up to $50,000 of group term life insurance on an employee's life (§79).

Health Insurance

An S corporation may deduct health insurance premiums paid on behalf of its 2% shareholders/employees, their spouses, and their dependents. However, the cost of these premiums is included in the shareholders'/employees' wage income. Even though the premium payments are to be included in wages, these benefits are not subject to Social Security or Medicare (FICA) or Unemployment (FUTA) taxes. The additional compensation is included in box 1 (Wages) of Form W-2 issued to the shareholder-employee but is not included in boxes 3 and 5 of Form W-2.

Self-employed health insurance deduction. IRS Notice 2008-1 provides that if an S corporation pays for or reimburses premiums for individual health insurance coverage covering a 2% shareholder (as defined in

§1372(b)(2)), the payment or reimbursement is included in W-2 income, but the 2% shareholder-employee may deduct the premiums as self-employed health insurance under §162(l), provided that all other eligibility criteria for deductibility under §162(l) are satisfied. For example, if the shareholder or the shareholder's spouse is eligible to participate in any subsidized healthcare plan, then the shareholder is not entitled to the above-the-line deduction on his or her Form 1040.

> **Tax practitioner planning**. To the extent that a 2% shareholder is allowed both the above-the-line deduction and the premium tax credit, Rev. Proc. 2014-41 provides guidance on computing the deduction and the credit.

No deduction if the premiums are not paid or reimbursed by the S corporation. If the health insurance premiums are not paid or reimbursed by the S corporation and included in the 2% shareholder's/employee's gross income, a plan providing medical care coverage for the 2% shareholder/employee is *not* established by the S corporation and the 2% shareholder/employee in an S corporation is *not* allowed the self-employed health insurance deduction under §162(l).

Medicare deductions for S corporation shareholders. While the IRS has conceded that Medicare premiums paid by individuals are deductible as self-employed health insurance, a problem still exists for S corporation shareholders. In order for the Medicare premiums to qualify for the self-employed health insurance deduction, the S corporation must reimburse the S corporation shareholder by the end of the year for the Medicare premiums (and the spouse's premiums, if applicable). If the shareholder is not reimbursed, the Medicare premiums are not deductible as self-employed health insurance.

> **Comment**. This means no journal entries allowed. Write checks.

Checklist to Qualify S Corporation Shareholder/Employee for Self-Employed Health Insurance Deduction	
S corporation paid or reimbursed health insurance premiums of 2% owner and/or family member (including Medicare premiums).	√
Health insurance premiums paid or reimbursed by the S corporation are added to the W-2 of the shareholder/employee.	√
Health insurance premium payments or reimbursements included in the shareholder's/employee's W-2 are deducted on line 29, Schedule 1, of the shareholder's Form 1040 as self-employed health insurance.	√

The 2% Shareholder/Employee Self-Employed Health Insurance Deduction After ACA (Notice 2015-17, Notice 2013-54)

One-person plan not subject to ACA's market reforms. Section 9831(a)(2) provides that the market reforms do not apply to a group health plan that has fewer than two participants who are current employees on the first day of the plan year. Accordingly, an arrangement covering only a single employee (whether or not that employee is a 2% shareholder/employee) generally is not subject to the market reforms whether or not such a reimbursement arrangement otherwise constitutes a group health plan.

Small Employers Not Subject to ACA Restriction on Health Insurance Reimbursements

The 21st Century Cures Act provided for an exception from group health plan requirements for qualified small employer health reimbursement arrangements. Beginning in 2017, a small employer may again reimburse employees for individual health insurance premiums without fear of the onerous $100 per day per employee penalty assessed for violation of healthcare reform.

Plan requirements. To qualify as "a qualified small employer health reimbursement arrangement," the plan must meet certain requirements.

1. The plan must be provided on the same terms to all employees. Some employees may be excluded from the plan:
   - Employees who have not completed 90 days of service,
   - Employees who have not attained age 25,
   - Part-time (less than 30 hours a week) or seasonal employees, or
   - Employees subject to collective bargaining.
2. The plan must be funded solely by the employer, and no salary reduction contributions may be made under the arrangement.
3. The plan must provide, after the employee provides proof of minimum essential coverage, for the payment of, or the reimbursement of, medical expenses (as defined in §213(d)) of an eligible employee or the employee's eligible family members.
4. The plan must provide that payments and reimbursements for any year be no more than $5,150 (2019) for an eligible employee and $10,450 (2019) if the arrangement provided payment or reimbursement for family members. In the case of an individual who was not covered for the entire year, the limitations must be prorated. For example, an employee who was covered for nine months of the plan year may have payments and reimbursements of no more than $3,862 (9/12 of $5,150).

Small employer. An eligible employer is one that is not an applicable large employer under §4980H(c)(2). Thus, the employer may offer a qualified small employer health reimbursement arrangement if it had less than 50 full-time and full-time equivalent employees. An eligible employer may not offer a group health plan to any of its employees.

Tax-free fringe benefit. A qualified small employer health reimbursement arrangement payment or reimbursement will not be excluded from gross income if for the month in which such medical care was provided the individual did not have minimum essential health coverage.

Premium tax credit. For an employee who was provided a qualified small employer health reimbursement arrangement for any coverage month, the premium tax credit for that month must be reduced.

Other rules.

- The eligible employee must receive proper and timely notice of the plan availability (§9831(d)(4)(A)).
- The total amount of the permitted benefit must be reported on the employee's Form W-2.
- The transition relief provided in Notice 2015-17 has been extended for any plan year beginning on or before Dec. 31, 2016.

Action item. Small business clients should be advised that Congress, in a rare bipartisan effort, has granted relief to the small business that wants to help employees with insurance premiums and out-of-pocket medical expenses without going through the trouble or expense of adopting a group health plan.

Family Member Entitled to SE Health Insurance Deduction (CCA 201912001)

An individual owns 100% of an S corporation, which employs the individual's family member. The family member is considered to be a 2% shareholder pursuant to the attribution of ownership rules under §318. The S corporation provides a group health plan for all employees, and the amounts paid by the S corporation under such group health plan are included in the family member's gross income. The family member is entitled to the deduction for self-employed health insurance under §162(l) for amounts that are paid by the S corporation under a group health plan for all employees and included in the individual's gross income.

Tax practitioner planning. Section 318(a)(1) provides that an individual shall be considered as owning the stock owned, directly or indirectly, by or for (i) his spouse (other than a spouse who is legally separated from the individual under a decree of divorce or separate maintenance), and (ii) his children, grandchildren, and parents.

S CORPORATION REASONABLE COMPENSATION

Compensation Paid by S Corporations to Shareholder-Employees (§162)

The issue: compensation is subject to payroll taxes; K-1 pass-through profits are not. FICA and FUTA taxes are imposed on compensation paid by an S corporation to its employees, including shareholder employees. But, S corporation profits passed through to shareholders, whether they are employees or not, are not subject to FICA or FUTA tax.

No Official Guidance on "Reasonable Compensation" Available

As taxpayers and tax preparers have no IRS guidance on ascertaining when compensation is reasonable or even when compensation is unreasonable, IRS auditors seem to be creating their own standards in the field. In a most disturbing trend, the IRS auditors (and an Iowa District Court) are arguing that they have the authority to recharacterize dividends into *more reasonable* compensation. This is plowing a new field with no prior IRS or Tax Court guidance.

The "unreasonable" vs. "more reasonable" problem. If the S corporation reasonably selects compensation at the low end of the compensation spectrum and the IRS auditor reasonably selects compensation at the high end of the same spectrum, how does the court decide which party is correct? Historically, the IRS asked courts to decide if the amount of compensation was *unreasonable*. Prior to *Watson* (*David E. Watson, P.C. v. US* (8th Cir.) 11-1589, 668 F3d 1008, Feb. 21, 2012; US District Court, S.D. Iowa, Central Div.; 4:08-cv-442, Dec. 23, 2010), the courts were not asked to decide if the taxpayer's amount or the IRS's amount is *more reasonable.*

Thirty Years of S Corporation Compensation Cases

Salary Claimed on Return Deemed Unreasonable (1-3 years)	Case
$0	*Radtke v. US*, 90-1 USTC ¶50,113
$0, $0, $0	*Dunn & Clark*, 95-2 USTC ¶50,383
$0, $0	*Spicer Accounting, Inc. v. US,* 91-1 USTC ¶50,103
$0, $0	*Joseph M. Grey Public Acc't v. Comm.*, 119 TC No. 5
$0, $0, $0	*Specialty Transport & Delivery Service, Inc.*, TCM 2003-51
$0, $0, $0	*Veterinary Surgical Consultants*, TCM 2003-49
$0, $0, $0	*Mike J. Graham Trucking*, TCM 2003-49
$0, $0, $0	*Yeagle Drywall Co., Inc.,* 2003-1 USTC ¶50,141
$0, $0, $0	*Superior Proside, Inc.,* 2004-1 USTC ¶50,146
$0, $0, $0	*Nu-Look Design, Inc.,* 2004-1 USTC 50,138
$0	*Bradley and Kathy Cohen v. Comm.*, TCM 2003-42
$0, $0, $0	*Water-Pure Systems, Inc. v. Comm.*, TCM 2003-53
$2,000, $0, $0	*Wiley L. Barron, CPA v. Comm.*, TCS 2001-10
$0, $0	*Veterinary Surgical Consultants v. Comm.,* TCM 2003-49
$24,000, $24,000	*David E. Watson, P.C. v. US,* 2011-1 USTC ¶50,443
$2,400	*Patrick and Suzanne Herbert, pro sese v. Comm.,* TCS 2012-124
$0, $0	*Glass Blocks Unlimited v. Comm.*, TCM 2013-180
$0	*Sean McAlary Ltd., Inc. v. Comm.*, TCS 2013-62
$0, $0	*Scott Singer Installations, Inc. v. Comm*., TCM 2016-161
$0, $0, $0, $0	*Scott Goldsmith v. Comm.*, TCM 2017-20
$44,000	*Povolny Group, Inc. v. Comm*., TCM 2018-37

Profits From Personal Service S Corporation Are Not 100% Wages

Court disputes IRS position that 100% of income from professional service S corporation must be wages. The IRS argued that shareholders of S corporations that provide professional services (i.e., physicians, lawyers, accountants, etc.) must pay out all profits of the S corporation as wages to the shareholders, that no non-wage distributions were allowed. The court in *DeAngelis* specifically refuted that position (*V.R. DeAngelis M.D., P.C. v. Comm.,* CA-2 2009-2 USTC ¶50,508, No. 08-1143-ag(L), July 28, 2009, affirmed (TCM 2007-360)).

$44,000 Wasn't Reasonable Compensation (*Povolny Group, Inc. v. Comm.*, TCM 2018-37)

James Povolny is CEO of a St. Paul, Minnesota, construction company, Povolny Group, Inc., an S corporation. Povolny's 2011 W-2 from Povolny Group (PG) reported $44,000 in salary. During 2011, Povolny received $77,000 from PG — a payment he immediately used to pay other corporate debts. PG also paid $74,000 to creditors of two other companies owned by Povolny. The IRS claimed that both of these payments were additional wages to Povolny and argued that PG called them loans and distributions to avoid employment taxes. The court agreed.

With the contested payments, the IRS concluded that wages should have ben reported at $195,000, not $44,000. The court found no reason to think that the IRS's estimate was unreasonable given Povolny's decades of real-estate development experience and the fact that he singlehandedly ran three companies, one of which had hundreds of thousands of dollars in receipts and one of which had an international contract.

Distributions to Shareholder Were Return of Capital, Not Wages As IRS Claimed (*Scott Goldsmith v. Comm.*, TCM 2017-20)

Goldsmith & Associates (G&A) was a small law firm with a big accounting problem. Scott Goldsmith was its owner, and his tax troubles eventually led to 33 months in prison for failure to pay over trust fund taxes for his four employees and failure to file individual income tax returns. After Mr. Goldsmith was released, he had to face a civil audit. The IRS also examined G&A for the same years. The result was a notice of worker reclassification to G&A that determined Mr. Goldsmith was an employee of the corporation.

Failing law firm funded by shareholder. Mr. Goldsmith practiced law for almost 30 years, the last several in G&A, an S corporation. G&A mostly worked on a contingency fee basis. When a contingent-fee firm has good business, it can pile up costs much more rapidly than offsetting fees. And that's what began to happen at G&A. The firm had no credit and was unable to get a loan from a bank. Without much money coming in, Mr. Goldsmith was forced to fund its operations by taking out mortgages on his personal residence. During the years at issue, he used the proceeds to make at least 13 advances to G&A.

IRS says distributions to shareholder were wages. The IRS claimed that because Mr. Goldsmith was an employee of G&A (a fact Mr. Goldsmith conceded during trial), payments made from G&A to him during the years at issue were constructive wages. Mr. Goldsmith argued that because during those years G&A made no money, it could not have afforded to pay him wages, and any money he took out of G&A was to reimburse him for G&A expenses he himself had paid earlier. They were nontaxable loan repayments, according to Mr. Goldsmith.

Court says wages not required from failing firm. The court said that "there's no rule that an S corporation has to pay its sole shareholder a wage, especially when it's bleeding money the way G&A did. The real question is one of fact — were the payments a return of capital, repayments of loans, or wages?" And the court determined the facts to be (1) the firm was failing in the years under audit and not required to pay wages to Mr. Goldsmith; (2) there was little or no possibility that the advances would be paid back by the corporation, and, thus, the advances were not loans but a capital contribution; and (3) the distributions to Mr. Goldsmith were a return of capital.

> **Tax practitioner planning**. Return of capital is tax-free to the extent of the shareholder's basis in the S corporation, just one more reason to keep good records on basis.

Also see.

- *Scott Singer Installations, Inc. v. Comm.*, TCM 2016-161, where S corporation shareholder advances were bona fide loans. S corporation payments of personal expenses were loan repayments and not wages.
- *Sean McAlary Ltd., Inc. v. Comm.*, TCS 2013-62, where zero salary not reasonable when net income is $231,000 and non-dividend distributions are $240,000. But court ruled $83,200 was reasonable.
- *Glass Blocks Unlimited v. Comm.*, TCM 2013-180, where Fred Blodgett, the president, sole shareholder, and sole employee of Glass Blocks Unlimited, took distributions of $30,844 in 2007 and $31,644 in 2008 but did not receive a salary either year. The IRS recharacterized 100% of the non-dividend distributions as wages. The court found what little evidence Glass Blocks provided unreliable and ruled in favor of the IRS, even though the required officer's compensation created an ordinary business loss for the S corporation.

MISCELLANEOUS S CORPORATION ITEMS

Attorney's Failure to Change Corporate Structure Resulted in Lost Deductions (*David Morowitz v. US,* US District Court, Rhode Island, 2019-1 USTC ¶50,167 (Mar. 7, 2019))

David Morowitz incorporated the Law Office of David Morowitz as an S Corporation in 1999. Mr. Morowitz was the sole shareholder of that corporation at the time of incorporation. All income and expenses of the corporation were reported on the Form 1120S until 2009, when Mr. Morowitz brought in a new shareholder. At that time, Mr. Morowitz changed the name of the corporation to Morowitz & Barry, Ltd. When Mr. Morowitz amended the name of the corporation, he did not dissolve the original corporation, amend its corporate structure, or change its FEIN. Instead, the corporation continued to operate under its amended name throughout the 2010 income tax year.

No change to documents when new shareholder joined corporation. In conjunction with Mr. Morowitz amending the name of the corporation, he entered into a Shareholder Agreement with Patrick Barry, to whom 50 shares of stock were issued. In that agreement, Mr. Morowitz and Mr. Barry agreed to segregate "[f]ees earned and monies paid on Mr. Morowitz's pre-existing cases," and those fees or monies earned would not belong to Morowitz & Barry, Ltd. The retainers for the pre-existing clients, however, were executed through the corporation prior to the agreement. Mr. Morowitz conceded that, when the corporation amended its name, the pre-existing clients did not sign a new retainer agreement with Morowitz & Barry, Ltd., nor does Mr. Morowitz offer that the pre-existing clients signed a new retainer agreement with him individually.

Claimed deductions on his Schedule C. On his 2010 individual income tax return, however, Mr. Morowitz filed a Schedule C claiming deductions for expenses relating to those pre-existing cases. The deductions included "case costs" in the amount of $9,997 and $2,137, each paid out of the corporation's bank account. Additionally, Mr. Morowitz claimed a deduction for $15,000 that he paid, out of pocket, to the corporation's legal secretaries for work performed on a pre-existing case. The IRS disallowed each of these deductions.

Never a sole proprietor. Mr. Morowitz argued that he was entitled to the deductions because the payments on the pre-existing cases were not related to the corporation but, instead, were from a separate business operation that he classified as a sole proprietorship. Mr. Morowitz did not establish that he practiced as a sole proprietor entitling him to take deductions on a Schedule C. The corporation was operating within its elected

S corporation structure. As such, the court found that a Schedule C was improperly filed, and the IRS properly disallowed the deductions on that form.

Contractual agreement did not negate S corporation structure. Mr. Morowitz argued that he entered an agreement that carved out the pre-existing cases from the benefit and the liability of the newly formed corporation. As such, he argued that the work for these pre-existing cases was conducted as a separate business from the corporation and he conducted that business as a sole proprietor, entitling him to file case fees as deductions on a Schedule C. However, "[a] shareholder cannot convert a business expense of his corporation into a business expense of his own simply by agreeing to bear such an expense" (*Harding v. Comm.,* 29 TCM (CCH) 789 (1970)).

> **Tax practitioner planning.** What happened to the disallowed deductions? The court said that the deductions were properly the corporation's, not the individual shareholder's. The two shareholders should have equalized the money in another way, and since distributions must be made on a per-stock-per-day basis, perhaps through wage adjustments.

Settlement Payment for Death of Sole Shareholder's Girlfriend Not Deductible by S Corporation (*James Cavanaugh, Jr. v. Comm*., CA-5, 2019-1 USTC ¶50,196 (Mar. 29, 2019))

James Cavanaugh, Jr. is the CEO and sole shareholder of Jani-King International, Inc., a commercial cleaning franchiser operating as an S corporation. In November 2002, Cavanaugh went on a Thanksgiving vacation to the Caribbean island of St. Maarten, where he owned a residence. With him were his girlfriend, Colony Anne (Claire) Robinson, and Jani-King employees Ronald Walker (his bodyguard) and Erika Fortner (his employee and former girlfriend). On Nov. 28, 2002, Claire died at the residence, likely of a cocaine overdose. Claire's mother, Linda Robinson, sued Cavanaugh and Jani-King, alleging that Claire's death was caused by the Jani-King employees acting in the course and scope of their employment. Robinson alleged that Cavanaugh, Walker, and Fortner facilitated Claire's access to and ingestion of cocaine, causing her death.

The parties settled the lawsuit for $2.3 million to be paid over the course of two years. Cavanaugh paid $250,000 toward the settlement, Jani-King the remainder. Jani-King reimbursed Cavanaugh for his portion of the settlement. Jani-King then deducted its settlement payment, the reimbursement payment, and its related legal expenses as ordinary and necessary business expenses. Because Jani-King is an S corporation, its deductions flowed through to and were reflected on Cavanaugh's personal tax returns.

Origin of claim results in no deduction. To allow the deductions, the court must identify the claim that gave rise to the settlement payment and legal fees, and then determine whether the claim was proximately related to the trade or business of Jani-King. The origin of the claim was the employees' providing cocaine, not their employment by Jani-King. The appellate court agreed with the Tax Court and found that the settlement payment and related legal fees arose from a claim originating in non-business activity, and Jani-King's business-expense deductions were properly disallowed.

CPA Accidentally Elects Out of Installment Sale (PLR 201909002)

All the stock in an S corporation was sold on Sep. 1, 2019, to an unrelated corporation. The buyer and the shareholders jointly made an election under §338(h)(10) to treat the sale of the stock as if the S corporation sold all of its assets and then immediately liquidated.

In return for the sale of the S corporation, the shareholders received (1) a cash payment on Sep. 1, 2019; (2) an additional cash payment placed in escrow to be paid 12 months later on Sep. 1, 2020, subject to certain claims and indemnification (escrow amount); and (3) a contingent earn-out of future payments — based on post-sale performance objectives — to be paid in increments over the three years following the end of 2019.

Soon after Sep. 1, 2019, the S corporation's accountant prepared a draft final short year Form 1120S for the year ending Sep. 30, 2019 (short year return). Shareholder 1, a corporate officer, signed the draft short year return. The S corporation's accountant filed the short year return with the IRS before the effective due date of the short year return.

Error in reporting is an election out of the installment sale. On the short year return, the S corporation's accountant reported the gain on the deemed sale of assets using both the cash payment at closing on Sep. 1, 2019, plus the escrow amount. The accountant did not include the contingent earn-out amounts to be paid over three years as part of the sale proceeds. The S corporation effectively elected out of the installment method under §453 by including the escrow amount on the short year.

Election out is irrevocable. Section 453(a) provides that, generally, a taxpayer shall report income from an installment sale under the installment method. Section 453(b) defines an installment sale as a disposition of property for which at least one payment is to be received after the close of the taxable year of the disposition. Section 15A.453-1(d)(3) provides that a taxpayer who reports an amount realized equal to the selling price including the full face amount of an installment obligation on a timely filed tax return for the taxable year in which the installment sale occurs is considered to have elected out of the installment method. Section 453(d)(2) requires a taxpayer who desires to elect out of the installment method to do so on or before the due date (including extensions) of the taxpayer's federal income tax return for the taxable year of the sale. An election under §453(d)(1) may be revoked only with the consent of the IRS.

PLR bails out the accountant's mistake. The S corporation's accountant's erroneous action when preparing the short year return led the accountant to inadvertently elect out of the installment method under §453. The shareholders were not aware of the accountant's action, nor did the shareholders plan or participate in the action. When the shareholders realized the accountant's erroneous computation, the S corporation filed a request for permission to revoke its election out of the installment method. The information submitted indicates that the S corporation's and the shareholders' desire to revoke the election out of the installment method is due to inadvertence rather than hindsight by the S corporation or of shareholders, or a purpose of avoiding federal income taxes. Thus, the PLR gives permission to the S corporation to revoke its election and provide corrected K-1s to its shareholders.

K-1 Income Taxable Even Though Shareholder Claimed Books Were Wrong (*Michael Howard Dalton v. Comm.*, TCM 2017-043)

In 1994, Michael Dalton and his brother, John, organized Resort Builders, Inc. (Resort Builders), a construction company. Michael and John were each 50% shareholders of Resort Builders, which elected to be treated as an S corporation. John served as Resort Builders' president, and from 1994 to 2007, Michael served as its vice president. In 2007, Michael told John that he wanted to resign from Resort Builders and turn in his stock. Consequently, relations between the brothers became acrimonious. John changed the locks to the corporation's offices and withheld Resort Builders' books and records from Michael. In 2008, Michael filed a lawsuit against John and Resort Builders in Florida state court seeking, among other relief, dissolution of the corporation and an accounting.

Final K-1 showed large income. After participating in mediation, the brothers agreed to settle the lawsuit. Resort Builders subsequently filed a final Form 1120S for its short taxable year beginning Jan. 1, 2008, and ending July 24, 2008. Resort Builders reported $903,063 of ordinary income and indicated that it was using the completed contract method of accounting. Resort Builders issued a Schedule K-1. The Resort Builders K-1 reported Michael's share of ordinary business income as $451,531.

Bank records not enough to show K-1 income wrong. Michael claimed that the income shown on the K-1 was wrong. Without records, the court found no factual support for a change. While Michael submitted a "check register" report and statements for a Bank Trust account owned by Resort Builders for the period January 2007 through December 2008, the deposits shown there did not necessarily reflect Resort Builders' income for the short taxable year ending July 24, 2008. Resort Builders used the completed contract method of accounting, under which taxpayers report as income the gross contract price, less all allocable contract costs, for the taxable year in which a contract is completed. See §1.460-4(d). For contracts completed in 2008, Resort Builders could have received a payment in a prior year that was reportable as income for 2008.

Debt Versus Equity (Up to 16 Factors Must Be Analyzed)

A bad debt is deductible only if there is a valid and enforceable debt. In *Fin Hay Realty Co. v. US*, 398 F.2d 694, 696 (3d Cir. 1968), the 3rd Circuit Court of Appeals enumerated 16 "criteria by which to judge the true nature of an investment which is in form a debt": (1) the intent of the parties; (2) the identity between creditors and shareholders; (3) the extent of participation in management by the holder of the instrument; (4) the ability of the corporation to obtain funds from outside sources; (5) the "thinness" of the capital structure in relation to debt; (6) the risk involved; (7) the formal indicia of the arrangement; (8) the relative position of the obligees as to other creditors regarding the payment of interest and principal; (9) the voting power of the holder of the instrument; (10) the provision of a fixed rate of interest; (11) a contingency on the obligation to repay; (12) the source of the interest payments; (13) the presence or absence of a fixed maturity date; (14) a provision for redemption by the corporation; (15) a provision for redemption at the option of the holder; and (16) the timing of the advance with reference to the organization of the corporation.

No Bad Debt Deduction for S Corporation That Couldn't Document Loans (*John and Alta Sensenig v. Comm.*, TCM 2017-1)

John Sensenig was the sole shareholder and president of Conestoga Log Cabins Leasing, Inc. (CLCL), an S corporation. CLCL provided high-risk capital to various companies. Mr. Sensenig, through CLCL, advanced money to start-up companies and to companies already in existence that had an opportunity for a new product or line of business. Mr. Sensenig never reviewed formal written projections for the companies that CLCL invested in. Mr. Sensenig did not obtain any third-party audits or request any financial statements, and CLCL did not finance any company if that company had other means to borrow, such as traditional banking.

> **Note**. Mr. Sensenig was a licensed public accountant in Pennsylvania and had prepared individual and business tax returns since 1972.

CLCL deducted $10,695,581 as a bad debt on its 2005 S corporation tax return. To be able to deduct the reported bad debt for 2005, Mr. Sensenig must show (1) that the advances made were debt (not equity); and (2) that the debt became worthless in taxable year 2005.

The court found that there was little or no form in the transfer of funds. There was no loan agreement providing for repayment of CLCL's advances; there was, in fact, no written agreement of any sort, and Mr. Sensenig never made any formal demands for repayment. "The absence of an unconditional right to demand payment is practically conclusive that an advance is an equity investment rather than a loan for which an advancing taxpayer might be entitled to claim a deduction for a bad debt loss."

Proof of worthlessness. CLCL had raised $50 million in his "investor pool." In 2005, the SEC issued a cease-and-desist order against Mr. Sensenig and CLCL for unlicensed security sales. Mr. Sensenig claimed that the cease-and-desist order was a death knell for three of the companies, that the companies would not be able to continue without additional funds, and, therefore, loans to those companies were worthless. The court accepted that the 2005 cease-and-desist order was "a major harmful event" for CLCL and the companies in which it invested, but whether and when that event caused worthlessness was not demonstrated. Mr. Sensenig submitted no evidence as to the financial condition of the three "borrower" companies as of Dec. 31, 2005, and, in fact, CLCL continued to advance money to the companies after 2005. Mr. Sensenig did not carry his burden to prove that any debts were worthless in 2005.

Corporation Engaged in Rental and Leasing Allowed S Election (LTR 201725022)

Rentals must generate business income and not passive investment income. Don't all rentals generate really good investment income? Except as provided in §1362(g), §1362(a)(1) provides that a small business corporation may elect, in accordance with the provisions of §1362, to be an S corporation. However, §1362(d)(3)(A)(i) provides that an election under §1362(a) shall be terminated whenever the corporation (1) has accumulated earnings and profits at the close of each of three consecutive taxable years, and (2) has gross receipts for each of such taxable years, more than 25% of which are passive investment income.

Doesn't passive investment income include rental income? Yes! Except as otherwise provided, §1362(d)(3)(C)(i) provides that the term "passive investment income" means gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities. Further, §1.1362-2(c)(5)(iii)B)(i) provides that "rents" means amounts received for the use of, or the right to use, property (whether real or personal) of the corporation.

When "rents" are not rents. Section 1.1362-2(c)(5)(ii)(B)(2) provides that "rents" does not include rents derived in the *active* trade or business of renting property. Rents received by a corporation are derived in the active trade or business of renting property only if, based on all of the facts and circumstances, the corporation provided significant services or incurred substantial costs in the rental business. Generally, significant services are not rendered and substantial costs are not incurred in connection with *net leases*. Whether significant services are performed or substantial costs are incurred in the rental business is determined based upon all of the facts and circumstances including, but not limited to, the number of persons employed to provide the services and the types and amounts of costs and expenses incurred (other than depreciation).

When significant services are rendered. The corporation, with the help of an independent leasing agent, negotiated new and renewal leases and oversaw post-leasing activities such as build-outs and renovations. In addition, the corporation, through its employees, its agents, and the agents' employees, provided certain services in maintaining and repairing of the buildings, common areas, and grounds. Finally, the corporation utilized a standard lease agreement for its tenants, and under the lease agreements, the corporation had the obligation to provide certain services with respect to the leasing of space and to maintain or repair the premises.

Based on the facts presented, the IRS determined that the rental income the requesting corporation received from its operations was not passive investment income under §1362(d)(3)(C)(i).

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CALIFORNIA INDEXING AND FILING

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2020 CALIFORNIA INDEXING AND FILING

INDEXING

The California rate of inflation of the period ending June 30, 2019, was 3.1%.

STANDARD DEDUCTION

The standard deduction for 2019 is as follows:

Single	$4,537
Married/RDP filing joint	$9,074
Married/RDP filing separate	$4,537
Qualifying widow(er)	$9,074
Head of household	$9,074

The minimum standard deduction for taxpayers who can be claimed as a dependent on another's return remains at $1,050. A dependent with earned income uses the lesser of the standard deduction for his/her filing status or earned income plus $300.

LIMITATION ON ITEMIZED DEDUCTIONS

California itemized deductions are limited for certain higher-income taxpayers. Deductions are limited by 6% of federal adjusted gross income (AGI) exceeding the thresholds below, not to exceed 80% of certain deductions.

Single	$200,534
Married/RDP filing joint	$401,072
Married/RDP filing separate	$200,534
Qualifying widow(er)	$401,072
Head of household	$300,805

PERSONAL EXEMPTION CREDIT

The personal exemption credits for 2019 are as follows:

Single	$122
Married/RDP filing joint	$244
Married/RDP filing separate	$122
Head of household	$122
Qualifying widow(er)	$244
Dependent (each)	$378

Blind and elderly taxpayers claim an additional exemption credit of $122 per qualified taxpayer.

PHASEOUT OF PERSONAL EXEMPTION CREDIT

Exemption credits are phased out for taxpayers with federal AGI exceeding the following amounts:

Single	$200,534
Married/RDP filing joint	$401,072
Married/RDP filing separate	$200,534
Qualifying widow(er)	$401,072
Head of household	$300,805

Exemption credits are reduced by $6 per exemption for every $2,500 (and fraction thereof) ($1,250 for MFS) of federal AGI in excess of the above thresholds for all single status taxpayers and $12 per exemption for married/RDP filing joint and qualifying widow(er). California exemption credits may phase out entirely.

OTHER CREDITS

Joint Custody Head of Household Credit

The Joint Custody Head of Household Credit for 2019 is 30% of net tax, not to exceed $484. The credit applies to singles or married/RDPs filing separately who lived apart the entire year. Taxpayer must provide a home for a child, stepchild, or grandchild for at least 146 days but not more than 219 days during the tax year.

Dependent Parent Credit

The Dependent Parent Credit for 2019 is 30% of net tax, not to exceed $484. The credit applies to married/RDPs filing separately who lived apart the last six months of the year and provided over one-half the household expenses for a dependent mother or father, whether or not the parent lived with the taxpayer. This credit cannot be used on the same return as the Joint Custody Head of Household Credit.

Senior Head of Household Credit

The Senior Head of Household Credit for 2019 is 2% of taxable income not to exceed $1,478. The credit applies to taxpayers age 65 or older at the end of the tax year who qualified for head of household in either of the two preceding tax years for a qualified individual who died in one of those years and whose AGI for 2018 does not exceed $78,441.

Renter's Credit

The Renter's Credit for 2018 is $60 for singles and married/RDPs filing separately with California AGI of $42,932 or less. The credit is $120 for married/RDPs filing jointly, head of household, and qualifying widow(er)s with AGI of no more than $85,864.

New! Young Child Tax Credit

For taxable years beginning on or after Jan. 1, 2019, **AB 91** (Burke, Stats. 2019, Ch. 39) creates the refundable Young Child Credit for a qualified taxpayer. The credit amount is limited to $1,176 multiplied by the earned income tax credit adjustment factor for the taxable year specified for §17052. The maximum credit is limited to $1,000 per taxable year.

The credit is available for each qualifying child of the taxpayer that is younger than six years old as of the last day of the taxable year.

The credit amount is reduced by $20 for every $100 by which the qualified taxpayer's earned income exceeds the threshold amount, initially set at $25,000. For taxable years after the minimum wage as defined by §1182.12 of the Labor Code is set at $15 per hour, the threshold amount would be recomputed annually for inflation.

INDIVIDUAL INCOME TAX RATES

The maximum individual rate for 2019 is 12.3%. The complete chart of individual rates by filing status can be found on page CA Appendix 1-1.

Mental Health Services Tax

The Mental Health Services Tax is 1% for taxable income in excess of $1 million. The rate applies per individual income tax return regardless of filing status.

ALTERNATIVE MINIMUM TAX

California's alternative minimum tax (AMT) rate is 7% for 2019. However, California automatically inflation adjusts some factors in the calculation of the individual AMT.

AMT Exemption Amount

The exemption amounts for California AMT for 2019 are as follows:

Single	$73,748
Married/RDP filing joint	$98,330
Married/RDP filing separate	$49,163
Qualifying widow(er)	$98,330
Head of household	$73,748

Phaseout of AMT Exemption

The exemption amounts phase out for California AMT income in excess of:

Single	$276,552
Married/RDP filing joint	$368,737
Married/RDP filing separate	$184,365
Qualifying widow(er)	$368,737
Head of household	$276,552

The phaseout is 25% for each dollar AMT income exceeds the threshold.

LIMITED LIABILITY COMPANY ANNUAL FEE

The schedule of annual fees for limited liability companies remains unchanged for 2019:

Gross Receipts		
At least	But not over	Fee
0	249,999	$ 0
250,000	499,999	$ 900
500,000	999,999	$ 2,500
1,000,000	4,999,999	$ 6,000
5,000,000	and up	$11,790

CORPORATIONS

The California rate for corporations remains unchanged for 2019 at:

Corporations other than banks & financial corporations	8.84%
Banks and financial corporations	10.84%

The California AMT rate for corporations is 6.65%.

S CORPORATIONS

The California rate for S corporations remains unchanged for 2019 at:

Corporations other than banks & financial corporations	1.5%
Banks and financial corporations	3.5%

FILING ENFORCEMENT AND COLLECTION FEES

The personal income tax fees apply to individuals, partnerships, and limited liability companies that are classified as partnerships. The bank and corporation fees apply to banks, corporations, and limited liability companies that are classified as corporations. Interest does not accrue on these cost recovery fees.

Personal income tax filing enforcement fee	$ 88
Personal income tax collection fee	$317
Bank and corporation filing enforcement fee	$ 81
Bank and corporation collection fee	$382

ELECTRONIC SERVICES

INDIVIDUAL E-FILE

California law requires individual income tax returns prepared by certain income tax preparers to be e-filed unless the individual return cannot be e-filed due to reasonable cause. Reasonable cause includes a taxpayer's election to opt out (choose not to e-file).

If you prepared more than 100 California individual income tax returns in any calendar year beginning Jan. 1, 2003, or after, and in the following calendar year prepared one or more using tax preparation software, then you must e-file all acceptable individual returns in that following year and all subsequent calendar years thereafter.

The law shall cease to apply if, during the previous calendar year, you prepared no more than 25 original California individual income tax returns.

Form 8454 E-File Opt-Out Record for Individuals

Individual taxpayers may elect to file a paper return and not electronically file. If the taxpayer elects out of e-filing, he/she must sign a new Form 8454 each year. Practitioners, do not send Form 8454 to the FTB but retain it in your records.

E-File Available Year-Round and for up to Two Prior Year Returns

The FTB allows year-round individual e-filing. It no longer shuts down its individual e-file program after Oct. 15. It also supports e-filing of up to two previous year returns through individual e-file. Check with your e-file software provider to see if it supports these individual e-file features.

Amended Individual Returns for 2017 and Beyond

Starting January 2018, beginning with tax year 2017, FTB will eliminate the Form 540X, Amended Individual Income Tax Return, for amending individual tax returns and replace it with the 540 series forms, each adapted to allow for amended return filing.

At the same time, FTB introduced new **Schedule X**, California Explanation of Amended Return Changes, which reconciles the difference between the original return and amended return to determine any additional amount owed or refund due, and to provide reasons for amending.

E-File Amended Returns? It Depends.

FTB also is ready to accept e-file amended returns for individuals on tax year 2017 Forms 540, 540NR Long, 540NR Short, and 540 2EZ, as well as new Schedule X. For tax year 2016 and prior years, amended individual returns will need to continue to be paper filed using Form 540X.

Most software providers now e-file at least 2018 and later amended 540 returns.

If your software provider isn't allowing e-file yet, you might want to encourage them to work on this for you. As a reminder, for tax year 2016 and prior years, amended individual returns will need to continue to be paper filed using Form 540X.

BUSINESS E-FILE

Business e-file began in January 2006. Currently, business taxpayers may e-file the following forms:

- **Form 100**, Corporation Franchise or Income Tax Return
- **Form 100S**, S Corporation Franchise or Income Tax Return
- **Form 100W**, Corporation Franchise or Income Tax Return - Water's Edge
- **Form 100X**, Amended Corporation Franchise or Income Tax Return (years 2010 and 2011 only)
- **Form 565**, Partnership Return of Income
- **Form 568**, Limited Liability Company Return of Income
- **Form 199N**, Small Tax-Exempt Organizations (California e-Postcard)
- **Form 199**, California Exempt Organization Annual Information Returns electronically.

MANDATORY BUSINESS E-FILE

AB 2754 (R&TC Comm., Stats. 2014, Ch. 478) requires that a business entity filing an acceptable return prepared using tax preparation software must file that return by electronic technology in a form and manner prescribed by the FTB.

A business entity required to file a return electronically may annually request a waiver of the requirement from the FTB. The FTB may grant a waiver if it determines the business entity is unable to comply with the requirements due to, but not limited to, technology constraints, where compliance would result in undue financial burden, or due to circumstances that constitute reasonable cause and not willful neglect as applicable to the penalty imposed by the provision.

The mandatory e-file requirement applies to acceptable returns that are required to be filed on or after **Jan. 1, 2015.**

Penalties Began in 2017

Additionally, for taxable years beginning on or after **Jan. 1, 2017, the law imposes a $100 penalty** for an initial failure and a penalty in the amount of $500 for each subsequent failure of a business entity to e-file a return, when required to do so, unless the failure is due to reasonable cause and not willful neglect.

In the case of a group return filed on behalf of eligible electing taxpayer members of a combined reporting group, the penalty would apply to the combined reporting group and not to a taxpayer member of the combined reporting group.

How Does California's Business E-File Compare with IRS?

Under federal regulations, certain large corporations and other business entities are required to file federal income and information returns electronically. E-filing is optional, but encouraged, for smaller entities.

The IRS mandates e-filing for the following:

- Large corporations with $10 million or more in total assets.

- A partnership with more than 100 partners. A partnership that fails to e-file Schedules K-1 is assessed a penalty of $50 for each Schedule K-1.
- Certain large tax-exempt organizations with total assets of $10 million.
- Private foundations and charitable trusts regardless of their asset size.

In addition, tax preparers that file at least 250 returns, including income tax returns, exempt organization returns, information returns, excise tax returns, and employment tax returns, are mandated to e-file.

The IRS allows for exceptions and hardship waivers from the e-filing requirement. A taxpayer may request a waiver if the taxpayer is unable to meet e-filing requirements due to technology constraints or where compliance with the requirements would result in undue financial burden on the taxpayer.

No California ID? No Problem

Did you know that you may still e-file your return even if you do not have a California ID number? New for the 2014 tax year and forward, FTB accepts returns without a California ID, as long as an explanation in lieu of a number is provided (e.g., "Applied for" or "Foreign Non-US"). Check with your software provider to see if it supports this feature.

TRUST AND ESTATE RETURNS (FORM 541) CAN BE E-FILED

Fiduciaries who file the Form 541, California Fiduciary Income Tax Return, were able to e-file their returns beginning Jan. 2, 2014.

Adding fiduciaries to the California e-file program was a long time coming. Starting in 2014, you could e-file the following forms listed below, as well as most other accompanying forms and schedules:

- Form 541 – California Fiduciary Income Tax Return
- Schedule D (541) – Capital Gain or Loss
- Schedule J (541) – Trust Allocation of an Accumulation Distribution
- Schedule K-1 (541) – Beneficiary's Share of Income, Deductions, Credits
- Schedule P (541) – Alternative Minimum Tax and Credit Limitations – Fiduciaries

The IRS began mandating e-filing for fiduciary returns in 2011, so this increased convenience for those already e-filing the federal return.

Fiduciaries are not included in California's individual e-file mandate at this time. FTB reports that it will reevaluate the fiduciary e-file program at the end of 2014 for potential inclusion in the mandate beginning in January 2016.

MAKING PAYMENTS ELECTRONICALLY

Certain Individuals Required to Pay Electronically

R&TC §19011.5 was added to the California Revenue and Taxation Code in September 2008. The law requires individuals to remit all future payments electronically once they:

- Make an estimated tax or extension payment (by check or electronic method) over $20,000 for a taxable year beginning on or after Jan. 1, 2009; OR

- File an original return with a tax liability over $80,000 for a taxable year beginning on or after Jan. 1, 2009.

Fiduciaries, estates, and trusts are not required to make payments electronically, regardless of the amount owed. Unlike corporations, there is no registration process for individuals subject to the mandatory e-pay law.

Payments Covered by the Law

If a taxpayer makes a payment or files a return meeting the mandatory requirement, the FTB will send a form **FTB 4106 MEO**, ***Mandatory e-Pay Participation Notice*** advising the taxpayer that all future payments must be remitted electronically.

> ***Note:*** If an individual does not receive notification from the FTB, he/she is still required to remit payments electronically once that individual meets either of the above thresholds.

Some tax preparation software may also remind you about e-pay. If your tax preparation software generates paper Form 540-ES vouchers when you meet the mandatory e-pay threshold, the taxpayer must still pay electronically.

Once a taxpayer meets the mandatory e-pay threshold, he/she is required to make all subsequent payments electronically, regardless of the amount, type, or taxable year.

> ***Example:*** Karen makes her first quarter estimated tax payment of $25,000 on Apr. 15, 2020, by paper check. Any payment she makes after that (e.g., a bill payment from a previous year or her second quarter estimated tax payment) must be made electronically.

> ***Example:*** Sharon files her 2019 Form 540 electronically on Apr. 1, 2020, showing a total tax liability of $95,000. Sharon must pay her 2020 estimated tax payments (including the payment due Apr. 15, 2020) electronically.

When taxpayers are required to make electronic payments but pay by other means, the FTB can assess a penalty equal to 1% of the amount paid, unless the failure to pay electronically was for reasonable cause and not willful neglect.

> ***Note:*** Making a payment using a bank's online bill payment system is not an electronic payment. The bank mails a paper check to the FTB, which does not meet the requirement to pay electronically.

FTB Notifies Taxpayers Required to E-Pay

Within a few days of a payment or return posting to the FTB that "triggers" the mandatory e-pay requirement, the FTB will send a notice to the taxpayers. The notice, **Mandatory e-Pay Program Participation Notice (FTB 4106 MEO)**, advises the taxpayers they are required to remit future payments electronically and provides them with their options. The notice includes information on how to request a waiver from the mandatory e-pay requirement.

Waiving the Mandatory E-Pay Requirement

You can request a waiver from mandatory e-pay if:

- You have not made an estimated tax or extension payment in excess of $20,000 during the current or previous income year, or
- Your total tax liability reported for the previous income year did not exceed $80,000, or
- The amount you paid is not representative of your total tax liability.

You must complete and submit form **FTB 4107**, ***Mandatory e-Pay Program Election to Discontinue or Waiver Request***. The FTB will review your waiver request and notify you in writing when it approves or denies your request.

If the FTB grants a waiver and you subsequently meet the mandatory e-pay requirements, you must resume making your payments using an electronic method.

Permanent Waiver of Mandatory E-Payment Requirement

Beginning Mar. 29, 2012, taxpayers who are subject to the mandatory e-pay requirement can request a permanent waiver of the requirement.

To request the permanent waiver, taxpayers must submit **FTB 4107, *Mandatory e-Pay Election to Discontinue or Waiver Request*** with a signed physician's affidavit that a permanent physical or mental impairment prevents the taxpayer from using a computer. The FTB will deny the taxpayer's request if the physician affidavit of permanent physical or mental impairment is incomplete or not attached to **FTB 4107**.

The FTB will inform the taxpayer in writing whether the request for a permanent waiver is approved or denied.

PAYING ELECTRONICALLY

"Stand-Alone" Electronic Payment Process Via E-File

Beginning January 2017, taxpayers and tax practitioners have the ability to submit an EFW request for extension and estimate payments using tax preparation software. These payment requests are accepted as "stand alone" and can be submitted separately from the e-file return. The return can be filed at a later date.

The following payment types are available:

- Individuals
  - Estimate
  - Extension
- Fiduciary (Estate/Trust)
  - Estimate
  - Extension
- Business Entities (Corporations/Limited Liability Companies/Partnerships)
  - Extension

- Quarterly Estimate Payments (beginning January 2018)
- LLC Annual Tax and Fee (beginning January 2018)
- LLC Estimated Fee (beginning January 2018)

Taxpayers and tax practitioners will still have the ability to submit EFW requests for return and estimate payments with the e-filed return using tax preparation software.

Contact your software provider to see if it is supporting “Stand-Alone” EFW payments.

Amended Tax Returns and Mandatory E-Payment

Once a taxpayer becomes subject to the mandatory electronic payment requirement, all payments of tax, penalties, and interest for any year must be made electronically (R&TC §19011.5). However, if a taxpayer files a paper amended tax return and makes the payment electronically, the FTB will likely refund the payment before the amended tax return is processed.

The FTB has proposed the following work-around:

If your clients file an amended return with a balance due and use Web Pay to make the payment, they should select the following payment option: **Notice of Proposed Assessment, Amended Return (Form 540X)**, or **Form 3834 Payment** (Interest Computation Under the Look-Back Method for Completed Long-Term Contracts). This payment will be reflected in their MyFTB Account as a Notice of Proposed Assessment.

MyFTB ACCOUNT

Simplify your life – get free, secure, online access to your clients’ most important California state tax information 24 hours a day, seven days a week.

TAX PROFESSIONAL ONLINE ACCOUNT ACCESS

As of January 2018, the Franchise Tax Board (FTB) now recognizes two formal relationship types to represent your client: Tax Information Authorization (TIA) and Power of Attorney (POA). The below table compares the two relationship types.

Relationship Type		
	TIA	**POA**
Authorization Definition	Grants a specific person (TIA representative) permission to obtain their client’s confidential information for all tax years.	Grants a specific person (POA representative) permission to obtain their client’s confidential information and represent them in FTB matters for the year(s) designated on the declaration.
Expiration	13 months from the: • Signature date or • Date the “TIA Client” was added on MyFTB	6 years from the signature date (for declarations submitted after Jan. 1, 2018). Note: FTB no longer revokes overlapping tax years or income periods.

Relationship Type		
	TIA	**POA**
Renewal	TIAs can be renewed for an additional 13 months, with the taxpayer's permission, on MyFTB.	Not applicable. A new declaration must be filed to continue the relationship.
Forms	• FTB 3534, Tax Information Authorization • FTB 3535, Tax Information Authorization Revocation	• FTB 3520 PIT, Individual or Fiduciary Power of Attorney Declaration • FTB 3520 BE, Business Entity or Group Nonresident Power of Attorney Declaration • FTB 3520 RVK, Power of Attorney Declaration Revocation
Online Account Access[1]	When the TIA is approved by FTB, the Tax Professional[2] will automatically receive limited online account access. A Tax Professional can request full online account access in MyFTB after the TIA is approved. Starting Jan. 1, 2019, the request for full online account access can be made on FTB 3524 or in MyFTB when adding a TIA Client.	When the POA Declaration is approved by FTB, the Tax Professional[2] will automatically receive limited online account access. A Tax Professional can request full online account access in MyFTB after the declaration is approved. Starting Jan. 1, 2019, the request for full online account access can be made on FTB 3520-PIT or FTB 3520-BE when filing a new declaration; MyFTB will be updated with these changes.
How to File	• MyFTB - Add TIA Client • Mail - FTB 3534	• MyFTB - File Power of Attorney • Mail FTB 3520 PIT or FTB 3520 BE
Need more information?	Go to ftb.ca.gov/tia	Go to ftb.ca.gov/poa

Tax Professional Online Account Access Levels in MyFTB - Limited vs. Full

Representatives with a Tax Professional MyFTB account may be able to access their client's tax information online. There are two levels of online account access that a tax professional may have to his or her client's tax information on MyFTB:

1. Limited, or
2. Full

The information available to a tax professional in MyFTB is based upon both the online account access level and the approved relationship type: TIA or POA. See the below table.

[1] Representative can receive information over the phone, in writing, by chat, or in person once the TIA or POA is approved by the FTB, regardless of the level of online account access authorized by the taxpayer.

[2] Representative with a Tax Professional account in MyFTB.

Note: The online account access level (Limited or Full) does NOT affect the information a representative can receive by phone, chat, in writing, or in person.

Online Access Levels		
Relationship Type	**Limited (Granted by the FTB when relationship is approved)**	**Full (Authorized by Taxpayer)**
TIA	• View available notices and correspondence issued from the FTB in the past 12 months.* • Chat with the FTB about confidential matters.* • Send the FTB a secure message with attachments.* • Request full online account access to client's information. * Applies to all tax years.	View information for all tax years: • Available notices and correspondence. • Account balance and tax year details. • Estimate payments and credits. California wage and withholding for individual clients only. • Payment history. • List of returns filed. • Proposed assessments. • FTB-issued 1099 for individual clients. • Chat with about confidential matters. • Send the FTB a secure message with attachments. • File a nonresident withholding waiver request. • Calculate a balance due for a date in the future.
POA	All of the above applies for the year(s) listed on the POA declaration.	All of the above applies for the year(s) listed on the POA Declaration, **plus**: • View images of tax returns. • Update contact information. • Protest a proposed assessment. • Submit a quick resolution worksheet for a filing enforcement proposed assessment.

Access granted prior to Jan. 2, 2018, has been grandfathered for all clients.

How the Process Works

- After the FTB approves the TIA or POA relationship between a taxpayer and a tax professional, you are immediately granted Limited Online Account Access to your client's MyFTB information.
- If you request Full Online Account Access, the FTB will mail your client an Authorization Code they can use to approve or deny your request.
- If your client approves your request, you will immediately have Full Online Account Access to their MyFTB account information.
- If your client denies your request or does not respond to the letter, you will retain Limited Online Account Access.

POWER OF ATTORNEY

Filing Power of Attorney Declaration Using MyFTB

The FTB will process your POA Declaration faster if you use MyFTB than if you file by paper.

Estimated Times for POA Processing

- 15 business days or less for online submissions using MyFTB.
- 45 business days or less for paper processing with qualified exception marked.
- 90 business days or more for paper processing with no exception.

If you must paper process your POA, the FTB now says you should mail it to:

POA UNIT
FRANCHISE TAX BOARD
PO BOX 2828
RANCHO CORDOVA, CA 95741-2828

Two Methods for a POA Representative to Submit a POA Declaration Using MyFTB

1. Taxpayer Approves using MyFTB

Step 1. Representative files the POA Declaration online using MyFTB and does not attach a signed copy of the POA Declaration.
Step 2. FTB reviews and processes.
Step 3. The taxpayer client then approves using their MyFTB account. The POA Declaration is now active.

2. Upload Signed POA Declaration

Step 1. Representative completes the declaration online using MyFTB AND uploads a signed, dated, and fully completed declaration. The declaration must exactly match the information entered using MyFTB.
Step 2. FTB reviews and approves. The POA Declaration is now active.

The primary reason the FTB rejects MyFTB POA Declarations is the uploaded signed copy does not match the information entered in MyFTB.

The Top Five Reasons Why the FTB Rejects a POA Declaration

1. A POA Declaration is entered online using MyFTB with a single signed declaration uploaded; however, the information entered does not match the information found on the POA Declaration (e.g., tax years, authorization, # of reps, etc.).

   Solution: The declaration must exactly match the information entered using MyFTB.

2. A POA Declaration is entered online using MyFTB with two signed declarations uploaded for related taxpayers (joint filers).

   Solution: For every declaration entered using MyFTB, there may only be one signed matching declaration uploaded per entry.

3. A POA Declaration is entered online using MyFTB with a single, signed, and matching declaration; however, additional signed declarations are also uploaded for non-related taxpayers.

   Solution: For every declaration entered using MyFTB, there may only be one signed matching declaration uploaded per entry.

4. A POA Declaration for a Business Entity is entered online using MyFTB with a single, signed, and matching declaration; however, the declaration is not signed or dated or does not appear on the appropriate signature line.

   Solution: The declaration for a business entity must exactly match the information entered using MyFTB and include the proper signature and date on the appropriate signature line.

5. A POA Declaration for Fiduciaries is entered online using MyFTB with a single, signed, and matching declaration; however, there is no supporting documentation attached.

   Solution: The declaration for a Fiduciary must exactly match the information entered using MyFTB, and the upload must include all supporting documentation.

   Acceptable forms of documentation are:

   - A legal document naming the person authorized to sign the POA on behalf of the Estate or Trust.
   - A completed copy of federal Form 56, Notice Concerning Fiduciary Relationship.
   - A Court Order.
   - A Governing Instrument.
   - A Last Will and Testament.

MyFTB Shows POA Status

You can view the status of your clients' POA declaration on MyFTB. POA clients will display with an Access Type of "POA" in the Access Type column. By default Active Individual clients, including Active Individual POA clients, will display on your Client List. You will need to perform a search to view Inactive or Pending POA clients and business, estate, or trust clients.

The POA statuses available for search are Active, Inactive, or Pending. Inactive statuses include Revoked, Rejected, Expired, and Canceled. Pending statuses include Pending and Pending Taxpayer Approval.

POA Status	Definition
Active	Declaration has been processed and accepted by FTB and is currently active.
Inactive	Declaration is not active. The declaration is revoked, rejected, expired, or canceled.

POA Status	Definition
Pending	Declaration was submitted via MyFTB and is being processed by FTB.
Pending Taxpayer Approval	Declaration was submitted via MyFTB without a signed copy of declaration attached. FTB has processed and accepted the declaration, and the declaration is pending taxpayer approval (taxpayer must log in to their MyFTB account and approve the declaration).

POA CHANGES JANUARY 2018

Effective Jan. 2, 2018, FTB will ***only accept FTB POA Forms***. In addition, FTB will separate POA forms depending on taxpayer type:

FTB 3520 PIT Individual and Fiduciary Power of Attorney Declaration
FTB 3520 BE Business Entity or Group Nonresident Power of Attorney Declaration

The FTB separated the PIT and BE forms to reduce errors being made when completing the forms. These changes will reduce rejections and the time needed to process forms. The FTB will reject prior FTB 3520 forms and non-FTB forms (including the IRS, BOE and EDD forms) submitted on or after Jan. 2, 2018.

Active POA declarations approved prior to Jan. 1, 2018, will continue to maintain the same authority as originally established and will remain in effect until they expire or are revoked.

The FTB will process prior FTB POA forms and non-FTB forms postmarked on or before Dec. 31, 2017.

> ***Exception:*** The FTB will accept a general/durable POA declaration when submitted with completed FTB 3520 attached. The FTB will accept Military Durable POA declarations as stand-alone documents, without a completed 3520; however, it recommends the 3520 be completed to ensure faster processing.

POA Wizard on MyFTB

Also as of January 2018, practitioners use a newly designed POA Wizard for establishing a POA relationship using MyFTB. The process is crafted to closely match the POA Form itself, thus reducing the instances of errors. In addition, the new wizard allows FTB staff entering POAs received by mail to more efficiently and accurately enter the form into the system.

Other important details regarding the **FTB 3520PIT** and **3520BE** forms:

- Expire six years from the signature date, or when revoked.
- Includes all matters before the FTB (including nontax debt).
- The FTB will no longer automatically revoke overlapping tax years or account periods.
- Additional Authorizations, page 2, part 4 - must check either the “yes” or “no” box for each section.
- Page 4 can be used to add additional representatives when there are more than two representatives. If additional representatives are needed, you can attach as many pages of page 4 as needed.
- If Other Acts contradicts Parts 3 or 4 on the declaration, Parts 3 and 4 prevail.

Add Associates List

In January 2018, practitioners will be able to enter and save their associates' information in MyFTB, to later be used when submitting POA declarations online. This feature should allow practitioners to expedite the completion of declarations by only needing to enter common information once for multiple representatives.

How to Revoke a POA Declaration

There are two ways to revoke a POA relationship - via MyFTB or paper

1. MyFTB - On MyFTB, review the details of the client's POA declaration and select revoke (there is no form to enter or upload)

OR

2. Paper - mail the signed and completed **FTB 3520RVK** POA Revocation form to FTB

Important details regarding **FTB 3520RVK** POA Revocation:

- **FTB 3520RVK** covers the revocation of all declarations, including **3520PIT** and **3520BE** declarations and declarations filed prior to Jan. 1, 2018.
- All representatives can delete other representatives on a POA declaration.
- The POA declaration signature date is required.

The FTB will accept revocations in all formats. However, if not using MyFTB (fastest way), **FTB 3520RVK** will expedite the revocation.

SEND A SECURE MESSAGE

The FTB introduced a new channel for communication with the implementation of the enhanced MyFTB: Send Secure Message. This new feature allows you to electronically send the FTB a secure message on behalf of your client with the option to add attachments, and in most cases, eliminate the need to mail paper.

What Are the Benefits of Using Send Secure Message?

Send Secure Message is a faster and more efficient way to communicate with the FTB. It allows you to send correspondence electronically and optionally attach supporting documentation 24/7. Once the information is submitted, it is automatically associated to your client's account, allowing any of the FTB's agents to view the information.

A great benefit of this new functionality is it allows you to send information on behalf of your client any time of day, and if you contact FTB, the agent can view this information while you are on the phone. Additionally, if an agent requests additional information during a phone call, this option allows you to upload and send the requested information while on the call. Sending a message with this option also allows the FTB to respond online.

Note: While you do not need an active POA to send a secure message to the FTB, you will need one to view any response or correspondence it sends to your client. File a POA online to view future FTB notices or correspondence sent to your client.

What Should Not Be Submitted Using This Option?

- Do not submit live tax returns.
- Do not submit a POA Declaration for processing.
- Do not submit a protest. To respond to a proposed assessment that may not be protested or viewed online, select the "send FTB a message" link from the Proposed Assessment List page. Select "Proposed Assessments" from the Account drop-down menu from your client's account.

How Do I Submit a Message?

From your client's account, select "Send Message" from the Communication drop-down menu or select the "Send Secure Message" button in the lower left of the page.

Tip: You can view messages you've initiated on your client's Notices and Correspondence page.

When Can I Expect to Receive a Response to My Message?

Allow up to 30 business days for the FTB to respond to your message. If you do not have an active POA Declaration for your client, you will not be able to see the FTB's response online. Remember, if you sent the FTB a message and then you call, any agent can access and view your message including attachments to assist you with resolving your client's tax matters.

LIVE CHAT

Live Chat is the FTB's channel of providing taxpayer assistance via an interactive Internet-based connection accessed through the FTB's home page. It serves as a means for taxpayers who would otherwise have called the contact center or corresponded with the FTB to a more convenient service channel. Initiated in 2010-11 to handle general questions, Live Chat offers a number of advantages as a service delivery channel:

- Live Chat agents handle an average of six general information chats per hour as compared to the average four calls per hour for contact center line agents and 2.4 pieces of correspondence per hour for correspondence staff.
- Live Chat offers a seamless interaction with the FTB's webpage. Whenever possible, taxpayers are referred to web pages with comprehensive information about their topic. This encourages taxpayers to self-manage follow-up questions.
- In 2014-15, the FTB engaged in over 110,000 live chats, with an access rate of 98%.

Secure Live Chat

Springboarding on the success of Live Chat, the FTB introduced Authenticated Live Chat in January 2016 as a companion to the vastly expanded MyFTB Account. With the new version of MyFTB, taxpayers have direct access to substantially more personal data. The FTB is encouraging self-service; however, many taxpayers will continue to have questions or wish to interact with the FTB. Taxpayers who might otherwise have called or corresponded with the FTB on specific account problems now have the opportunity to securely chat with the FTB through Authenticated Live Chat.

During the 2018 filing season, approximately 56,000 taxpayers were assisted through authenticated chat.

***New!* Messaging Takes Some Worry out of Chat**

The FTB updated its messaging to improve your experience while chatting with them! You'll receive "we're still here" every two minutes and show your place in line while you wait.

TAX PAYMENTS

CALIFORNIA STILL ACCELERATING PAYMENTS

The California legislature continues to balance the budget by projecting "income" that it will never recognize. Because of statutory over-withholding and accelerated estimated tax payments, California's cash flow "sleight of hand" measures force taxpayers to prepay tax they may not owe.

Individuals

Safe Harbors for Taxable Income Over $1 Million

Current federal and state tax law provides two options in determining the required annual payment for personal income taxes (PIT). The required annual payment for an individual subject to the personal income tax is the lesser of the following:

- Option 1: 90% of the tax shown on the return for the taxable year, or
- Option 2: 100% of the tax shown on the return of the taxpayer for the preceding taxable year.

Option 2 does not apply if the preceding taxable year was not a complete taxable year of 12 months or if the taxpayer failed to file a return for the prior tax year. Current federal and state tax law increases the required annual payment under option 2 from 100% to 110% of the tax shown on the return if the AGI of the taxpayer for the preceding taxable year exceeds $150,000 ($75,000 in the case of a married individual filing a separate return).

Option 2 Not Allowed for Millionaires. For taxable years beginning on or after Jan. 1, 2009, the option for individual taxpayers to make estimate payments equal to 100% of the tax shown on the taxpayer's return for the prior year is eliminated if the AGI of the taxpayer shown on the return for the current taxable year exceeds $1 million ($500,000 for taxpayers with a married filing separate filing status). These taxpayers must use the first option only, paying at least 90% of the tax shown on the return for the taxable year.

Estimated Tax Payment Schedule for 2020

The third quarter estimated tax payment was eliminated in 2010 by revising the estimated tax payment percentages for taxable years beginning on or after Jan. 1, 2010. The percentages are:

- 1st quarter installment 30% of estimated tax
- 2nd quarter installment 40% of estimated tax
- 3rd quarter installment 0% of estimated tax
- 4th quarter installment 30% of estimated tax

FTB Applies Wage Withholding Percentage Consistent with Estimate Payment Percentages

The FTB does apply wage withholding in percentages consistent with the percentages required for estimated tax payments for taxable years beginning on or after Jan. 1, 2009. In addition, the FTB is allowed to revise the percentages used to determine estimated tax payment requirements under the annualized income installment method to percentages consistent with the accelerated estimate percentages.

Corporations

Current federal law generally provides two options in determining the required annual payment for corporate income taxes. The required annual payment for corporations is the lesser of the following:

- Option 1: 100% of the tax shown on the return for the taxable year, or
- Option 2: 100% of the tax shown on the return for the preceding taxable year.

Corporations with taxable income of $1,000,000 or more are required to pay 100% of the tax for the current year.

In general, current state law requires corporations to remit four estimated tax payments totaling 100% of tax shown on the return for the taxable year. If a corporation's estimated tax does not exceed the minimum franchise tax, the entire amount of the minimum franchise tax is payable as the first estimated tax payment. If the amount of estimated tax exceeds the minimum franchise tax after the last day of the third month and before the first day of the sixth month of the corporation's taxable year, the amount of the second, third, and fourth estimated tax payments must total the tax expected to be due.

For taxable years beginning on or after Jan. 1, 2010, the legislature eliminated the third quarter estimated tax payment for corporations too. The percentages are:

- 1st quarter installment 30% of estimated tax
- 2nd quarter installment 40% of estimated tax
- 3rd quarter installment 0% of estimated tax
- 4th quarter installment 30% of estimated tax

If the corporate taxpayer is not required to make an estimate payment installment in the first quarter (*e.g.,* it only owes the minimum franchise tax), the following installment payments are required in subsequent quarters:

- 2nd quarter installment 60% of estimated tax
- 3rd quarter installment 0% of estimated tax
- 4th quarter installment 40% of estimated tax

Corporate taxpayers not required to make an estimate in either the first or second quarters would pay:

• 3rd quarter installment	70% of estimated tax
• 4th quarter installment	30% of estimated tax

LLC Annual Fees

Under current state law, an LLC not classified as a corporation must pay the $800 annual LLC tax and the annual LLC fee if it is organized, doing business, or registered in California. The annual LLC fee is based on total income from all sources derived from or attributable to this state.

For taxable years beginning on or after Jan. 1, 2009, the annual LLC fee must be estimated and paid by the 15th day of the 6th month of the current taxable year. For calendar-year LLCs the estimated fee must be paid by June 15.

A penalty of 10% of the underpayment of the estimated fee will apply if the estimated LLC fee is underpaid.

New! FTB Mails Summary of Payments

In late January/early February 2020 the FTB mailed **FTB 3713 Summary of Account Payments, Transfers, and Credits** to business entities who made an Estimated LLC Fee or Estimated Tax Payment during the 2018 tax year. The account summary will provide payment, transfer, and credit information including payment amounts and effective dates.

The summary contains the same data available to FTB call center agents and is intended to assist business entities and/or their professional tax representatives in filing accurate and timely tax returns.

This notice is part of a pilot project to proactively address the most common reason tax professionals contact the Tax Practitioner Hotline; thereby reducing the need to call to verify payments.

Payment information is also available online to businesses and their tax representatives who register for a MyFTB account.

FILING ISSUES

FILING DEADLINES EXTENDED

FTB postponed until July 15 the filing and payment deadlines for all individuals and business entities for:

- 2019 tax returns
- 2019 tax return payments
- 2020 1st and 2nd quarter estimate payments
- 2020 LLC taxes and fees
- 2020 Non-wage withholding payments

To give taxpayers a deadline consistent with that of the IRS without the federal dollar limitations, FTB is following the federal relief described in Notice 2020-17. Since California conforms to the underlying code sections that grant tax postponements for emergencies, FTB is extending the relief to all California taxpayers. Taxpayers do not need to claim any special treatment or call FTB to qualify for this relief.

In line with Governor Newsom's March 12 Executive Order, FTB previously extended the due dates for filing and payment for affected taxpayers until June 15, with the qualification that the deadlines may be extended further if the IRS grants a longer relief period, as it did.

If possible, taxpayers should continue to file tax returns on time to get their refunds timely, including claiming the Earned Income Tax Credit and Young Child Tax Credit. During this public health emergency, FTB continues to process tax returns, issue refunds, and provide phone and live chat service to taxpayers needing assistance.

§1031 EXCHANGES EXTENDED

For California tax purposes, if a taxpayer's 1031 like-kind exchange identification period or exchange period is due to expire on or after April 1, 2020, and before July 15, 2020, taxpayer's identification period and exchange period is extended until July 15, 2020.

Scenario: The 45-day period to identify a replacement property in an IRC §1031 like-kind exchange expires on May 1, 2020. Do I have an extension to July 15, 2020, to identify prospective replacement properties?

Answer: Yes, if your 45-day identification period expires between April 1, 2020, and July 15, 2020, you have until July 15, 2020, to identify prospective replacement properties.

Scenario: The period to complete an IRC §1031 like-kind exchange expires on May 1, 2020. Do I have an extension to July 15, 2020, to complete the exchange?

Answer: Yes, if the period to complete the exchange (typically a 180-day period) expires between April 1, 2020, and July 15, 2020, you have until July 15, 2020, to complete your exchange transaction.

NOTICE OF TAX RETURN CHANGE MAILING DELAYED

In early May, FTB usually reminds you that its Notice of Tax Return Change - Revised Balance (FTB 5818-B) will start going out the last week of May. These notices correct an error(s) made on a 2019 tax return and may result in your clients contacting you. Under normal circumstances FTB mails them after it processes all incoming returns and payments. So far, this year has been anything but normal.

The filing and payment due dates have been extended this year to July 15, 2020. As a result, FTB will delay its notices accordingly and anticipate these mailings to begin the last week of August. To keep up to date on this and other FTB information, visit the COVID-19 webpage.

Use the website and search notices for information about this and other FTB notices. Additionally, if you are an authorized representative, you can view your client's notice in MyFTB:

- For your POA clients, use the Client Notices page from your Tax Professional account.
- For your TIA clients, go to your client's MyFTB account and select Notices & Correspondence from the Communications drop down menu.

ORIGINAL SIGNATURES FOR PAPER RETURNS & OTHER DOCUMENTS

For paper returns and other documents that must be signed with an original signature by you and/or your taxpayer during the postponement period of March 12, 2020, through July 15, 2020, FTB will not require an original signature, except for Power of Attorneys (POAs).

FTB will accept 2 signature alternative methods for paper returns:

- **Method 1:** An attached document that must be included with the filed return that provides a copy of the original signature. The attached document should:
  - Identify what the document signature is for (Example: Corp XX, 2019 Form 100)
  - State "Refer to the attachment for a copy of the original signature" on the signature line
- **Method 2:** A paper return with a faxed signature on the signature page

For all other documents, except POAs, filed with it that require an original signature, FTB will accept documents with photographed or digital copies of required signatures.

You can also upload a document with a signature into MyFTB. Please note that only PDF and Excel documents are currently accepted.

These temporary procedures do not apply to filing a POA. Follow the procedure on Submit a power of attorney if you need to submit a POA to FTB.

INFORMATION LETTERS ARE NOT AUDIT LETTERS

Your client may receive an educational letter if they reported itemized deductions for medical expenses, charitable contributions, and/or employee business expenses.

In certain circumstances, FTB proactively contacts taxpayers to provide them with information to accurately file their returns based on their history.

Recently, FTB sent letters to individuals who appeared to qualify for the new California earned income tax credit to urge them to file a return and claim the credit. In the next few months FTB will be sending letters to certain taxpayers who may have fallen behind on their California income tax obligations. The letters will offer assistance to help taxpayers adjust withholding, change estimate tax payments, and resolve outstanding liabilities faster. For example, showing taxpayers how to save money by increasing their payments to pay off their balance sooner and reduce the amount of interest paid.

Last year FTB sent educational letters to help inform taxpayers about employee business expenses. In January 2018, it sent these "nudge" letters to taxpayers who filed and reported itemized deductions for medical expenses, charitable contributions, and/or employee business expenses. California and federal rules regarding allowable itemized deductions are similar and the letter provides several IRS resources to help taxpayers prepare and file their tax returns.

These efforts are being implemented on a pilot basis so FTB can study the results for effectiveness while keeping in mind the use of state resources. Depending upon results, FTB may expand the approach to other functional areas of the department.

WHAT TO DO IF YOU ARE A VICTIM OF IDENTITY THEFT

If you or your client suspects identity theft has occurred, there are several steps that you will need to take to help protect your client. If you or your client receives a notice from the FTB that leads you to believe someone has used your client's SSN fraudulently, contact the FTB immediately as directed in the notice.

FTB representatives will work with you to help resolve the problem. For example, you should contact the FTB if the notice shows one of the following:

- More than one tax return was filed under your client's name and SSN.
- FTB records show that your client received wages from an employer that you do not recognize.

  Note: The FTB does not send emails asking for personal taxpayer information. If your client receives this type of request, do not respond. It may be an attempt from identity thieves to get private tax information.

Contact the FTB ID Theft Resolution Coordinator if you believe your client's tax records have been affected by identity theft:

Franchise Tax Board
ID Theft Resolution Coordinator MS A-462
PO BOX 2952
Sacramento, CA 95812-2952

Telephone: (916) 845-3669
Fax: (916) 843-0561

Your client will be asked to fill out an **FTB 3552PC** Identity Theft Affidavit. He or she should also be prepared to send copies of the following documents, if available:

- Passport
- Driver license or Department of Motor Vehicles identification card
- Social Security card
- Police report
- Internal Revenue Service letter of determination

A return that was rejected by e-file will need to be submitted on paper. The processing of the return will likely take several months, so remind your clients about the delay if they are expecting a refund.

Other letters the FTB may generate in order to obtain additional information to validate a refund claim:

- **FTB 3904** - Request to Confirm Tax Return Filing: sent when FTB highly suspects ID theft. The FTB generates to the last good address on file for the taxpayer (not the address on the return).
- **FTB 4734D** - Request for Tax Information and Documents: sent to taxpayers when the FTB is unable to validate withholding claimed or identity using historical taxpayer information and/or other third party data sources.
- **FTB 4579** - Demand to Furnish Information: sent to employers when the FTB is unable to validate wages and withholding claimed based on historical information and/or other third party data sources.

- **NEW for EITC - FTB 4502** - Additional Documentation Required - Refund Pending: sent to taxpayers when unable to validate income, identity, and/or the FTB needs additional information to validate qualifying children.
-

CALLING TAX PRACTITIONER HOTLINE

The FTB continues to request (actually beg) practitioners to utilize the self-service options available on its website using "MyFTB Account." Accessing information on the website frees up hotline agents to handle cases that cannot be resolved without live contact.

☎

Tax Practitioner Hotline
(916) 845-7057

2020 FEDERAL AND CALIFORNIA TAX UPDATE
CALIFORNIA CONFORMITY & NONCONFORMITY

Table of Contents

2020 CONFORMITY AND NONCONFORMITY

In general, California income tax law is based on federal income tax law. Usually this is accomplished by conforming to specific provisions of the Internal Revenue Code (IRC) by reference as of a "specified date," which is ***Jan. 1, 2015***. However, not all provisions of the IRC are applicable for California purposes. In addition, not all federal changes to a particular provision are applicable for California purposes for the same period and to the same extent the change is applicable for federal purposes.

CORONAVIRUS AID, RELIEF & ECONOMIC SECURITY (CARES) ACT

FTB is currently analyzing and considering the impact of the Federal CARES Act on California taxpayers. However, it has provided some preliminary information regarding conformity to the CARES Act in response to questions it has received.

Non-Taxable Benefits
Economic Impact Payments received from the federal government (i.e., $1,200 [$2,400 for individuals filing a joint return] and $500 per qualifying child) under the federal CARES Act ***are not*** subject to California income tax.

Increased Unemployment Compensation Benefits (in the amount of $600 per week) that individuals receive under the federal CARES Act ***are not*** subject to California income tax.

California conforms
California generally conforms to the pension-related items such as early withdrawal penalty, minimum distribution rule changes, etc. However, California does not have automatic conformity to the changes made with regard to loans from a qualified retirement account.

California does not conform to some of the other changes made by the CARES Act, including those related to:

1. Loan forgiveness related to the Paycheck Protection program
2. NOL Carrybacks
3. Charitable contributions
4. Student loan forgiveness
5. Business interest limitations
6. Prior year alternative minimum tax liability (corporations)
7. Health-savings accounts changes (California does not conform to health-savings account rules generally speaking)

Additional information will be coming as FTB completes its analysis of the CARES Act.

SETTING EVERY COMMUNITY UP FOR RETIREMENT ENHANCEMENT (SECURE) ACT UNDER FURTHER CONSOLIDATIONS APPROPRIATIONS ACT OF 2020

Multi-Employer Plans

The Act amends the IRC rules relating to multiple employer plans to provide relief from the "one bad apple" rule for certain plans "covered multiple employer plans". California conforms.

Increase in Automatic Enrollment Safe Harbor to 15%

An automatic enrollment safe harbor plan must provide that, unless an employee elects otherwise, the employee is treated as electing to make elective deferrals at a default rate equal to a percentage of compensation as stated in the plan and at least (1) three percent of compensation for the first year the deemed election applies to the participant, (2) four percent during the second year, (3) five percent during the third year, and (4) six percent during the fourth year and thereafter. Although an automatic enrollment safe harbor plan generally may provide for default rates higher than these minimum rates, the default rate cannot exceed 10 percent for any year.

Under the SECURE Act, the 10-percent limitation on the default rates under an automatic enrollment safe harbor plan is increased to 15 percent after the first year that an employee's deemed election applies. California conforms.

Certain Taxable Non-Tuition Fellowship & Stipend Payments Treated as Compensation

Under SECURE, an amount includible in an individual's income and paid to the individual to aid the individual in the pursuit of graduate or postdoctoral study (such as a fellowship, stipend, or similar amount) is treated as compensation for purposes of IRA contributions. California conforms.

Repeal of Maximum Age for IRA Contributions

The provision repeals the prohibition on contributions to a traditional IRA by an individual who has attained age 70½. The provision also reduces the amount of qualified charitable distributions (QCDs) that may be excluded from gross income by the excess of:

1. The aggregate amount of IRA deductions allowed to the taxpayer for all taxable years ending on or after the date the taxpayer attains age 70½, over.
2. The aggregate amount of the reductions for all taxable years preceding the current taxable year.

California does not conform to the repeal of the prohibition on contributions to a traditional IRA by an individual who has attained age 70½.

Participation for Long-Term Employees Working More Than 500 Hours

SECURE requires an IRC §401(k) plan to permit an employee to make elective deferrals if the employee has worked at least 500 hours per year with the employer for at least three consecutive years and has met the age requirement (age 21) by the end of the three consecutive year period (for this proposal, an employee is referred to as a long-term part-time employee after having completed this period of service). California conforms.

Penalty-Free Withdrawals in Case of Birth of Child or Adoption

Under SECURE, an exception to the 10-percent early withdrawal tax applies in the case of a qualified birth or adoption distribution from an applicable eligible retirement plan (as defined). In addition, qualified birth or adoption distributions may be recontributed to an individual's applicable eligible retirement plans, subject to certain requirements. California conforms.

Increase in Age for Required Minimum Distributions (RMDs)

SECURE changes the age on which the required beginning date for required minimum distributions is based, from the calendar year in which the employee or IRA owner attains 70½ years to the calendar year in which the employee or IRA owner attains 72 years. Under the provision, prior law continues to apply to employees and IRA owners who attain age 70½ prior to January 1, 2020. California conforms.

Treating Excluded Difficulty of Care Payments as Compensation

SECURE amends §415(c)(3) and §408(o) to increase the contribution limit to qualified retirement plans and individual retirement accounts to include "difficulty of care" payments. California conforms.

Plans Can Be Adopted by Filing Due Date for Year

If an employer adopts a qualified retirement plan after the close of a taxable year, but before the extended due date of the return, the employer can elect to treat the plan as having been adopted as of the last day of the taxable year.

This provision does not override rules requiring certain plan provisions to be in effect during a plan year, such as the provision for elective deferrals under a qualified cash or deferral arrangement ("generally referred to as a 401(k) plan"). California conforms.

Change in After-Death Rules for Defined Contribution Plans

Under SECURE, the five-year rule is expanded to become a 10-year period instead of five years ('10-year rule'), such that the 10-year rule is the general rule for distributions to designated beneficiaries after death (regardless of whether the employee (or IRA owner) dies before, on, or after the required beginning date) unless the designated beneficiary is an eligible beneficiary as defined in the provision. Thus, in the case of an ineligible beneficiary, distribution of the employee (or IRA owner's) entire benefit is required to be distributed by the end of the tenth calendar year following the year of the employee or IRA owner's death.

Eligible beneficiaries include any beneficiary who, as of the date of death, is the surviving spouse of the employee (or IRA owner), is disabled, is a chronically ill individual, is an individual who is not more than 10 years younger than the employee (or IRA owner), or is a child of the employee (or IRA owner) who has not reached the age of majority. In the case of a child who has not reached the age of majority, calculation of the minimum required distribution under this exception is only allowed through the year that the child reaches the age of majority.
California conforms.

OTHER PROVISIONS UNDER FURTHER CONSOLIDATIONS APPROPRIATIONS ACT

Expansion of §529 Plans

The provision makes four modifications to section 529 plans.

1. The provision allows tax-free treatment applicable to distributions for higher education expenses to apply to expenses for fees, books, supplies, and equipment required for the participation of a designated beneficiary in an apprenticeship program. The apprenticeship program must be registered and certified with the Secretary of Labor under section 1 of the National Apprenticeship Act.
2. The provision allows tax-free treatment to apply to distributions made for certain expenses in connection with a homeschool. Under the provision, distributions for certain homeschool expenses are treated in the same manner as distributions for qualified higher education expenses, and like distributions for elementary and secondary school tuition, are also subject to an annual limit of $10,000 in aggregate 529 distributions, per beneficiary.
3. The provision allows tax-free treatment to apply to distributions of certain amounts used to make payments on principal or interest of a qualified education loan. No individual may receive more than $10,000 of such distributions, in aggregate, over the course of the individual's lifetime.
4. The provision adds additional qualifying expenses for distributions made on behalf of designated beneficiaries attending elementary or secondary school. Under the provision, in addition to tuition, tax-free treatment would apply to a distribution made for expenses for fees, academic tutoring, special needs services, books, supplies, and other equipment, incurred in connection with enrollment or attendance at such elementary or secondary school. Expenses for the purchase of computer technology or equipment or Internet access and related services are not considered eligible expenses under the provision.

California does not conform.

Tax on Unearned Income of Children

This Act repeals the kiddie tax provisions added by the TCJA. Therefore, the unearned income of children is taxed under the pre-TCJA laws. California never conformed to the TCJA provisions, so now federal law conforms to California.

Exclusion of Discharge of Qualified Principal Residence Indebtedness

Extends for three additional years, before January 1, 2021, the exclusion from gross income for discharges of qualified principal residence indebtedness. The provision also provides for an exclusion from gross income in the case of those taxpayers whose qualified principal residence indebtedness was discharged on or after January 1, 2021, if the discharge was pursuant to a binding written agreement entered into prior to January 1, 2021. California has modified exclusion for tax years 2007 through 2013.

Reduction in Medical Expense Deduction Floor

Extends the current 7.5 percent of AGI medical expense deduction threshold to taxable years ending before January 1, 2021. The provision also permanently changes the AMT threshold to be the same as for regular tax.

California's modified conformity allows a deduction for the amount of medical expenses unreimbursed by insurance that exceed 7.5 percent of federal AGI. The state never conformed to the 10 percent limitation. As a result, the threshold percentage of unreimbursed medical expenses is the same for both federal and state purposes for the 2017 through 2020 tax years for purposes of the personal income tax. However, for taxable years beginning on or after January 1, 2021, the threshold for deducting unreimbursed medical expenses for federal and state taxes will differ – 10 percent of federal AGI for federal taxes and 7.5 percent of federal AGI for state income taxes.

TAX CUTS AND JOBS ACT OF 2017

The 41 states and the District of Columbia that tax personal income in a broad-based manner generally link to the federal tax code by including federal exclusions, deductions, and credits into the state tax — a practice called conformity.

According to a report from the Pew Charitable Trusts, 37 states and the District of Columbia link to federal adjusted gross income (AGI). Thirty-one states and DC also link to federal itemized deductions, while six states use federal taxable income as their starting point. And then there are six states that allow filers to deduct all or a portion of their final federal tax liability.

HOW WILL THE FEDERAL LAW AFFECT THE STATES?

The Personal Income Tax

The 37 states and the District of Columbia each take one of two different methods to achieve conformity — v static or rolling. Static conformity means the state conforms to the IRC as of a specified date, for example as of Jan. 1, 2015. Rolling conformity states adopt IRC changes as they occur. Seventeen states and DC have rolling conformity and 20 states have static conformity, and these dates vary widely. Arkansas, Mississippi, New Jersey, and Pennsylvania use their own methods to calculate income.

Corporate Income Taxes

Forty-one states currently conform to the IRC for corporate income tax calculations, either using a static or rolling method of conformity. However, some states conform to federal taxable income before net operating losses, while others use taxable income after net operating losses. Arkansas, Mississippi, and New Jersey have their own calculation of corporate income. Wyoming and South Dakota do not tax corporations, and Nevada, Ohio, Texas, and Washington impose a gross receipts tax.

NEW NONCONFORMITY MEANS BIGGER SCHEDULE CA

It's true. The Schedule CA California Adjustments is now ***three pages***. In order to include all the new differences in California law created by TCJA 2017, the FTB had some serious redesigning to do.

Page 1. Contains adjustments to items of gross income and federal adjustments to AGI.
Page 2. Makes adjustments to federal itemized deductions except miscellaneous itemized deductions.
Page 3. Includes miscellaneous itemized deductions and overall limitation on deductions.

NEW CONFORMITY

STREAMLINED AUDIT PROCEDURES

SB 274 (Glazer, Stats. 2018, Ch. 729) provides for the California assessment and reporting requirements for federal audit adjustments under the new federal partnership audit rules.

The Bipartisan Budget Act of 2015 replaced the TEFRA partnership audit rules with new rules generally effective for partnership years beginning on or after Jan. 1, 2018, with the option for partnerships to elect to adopt the new rules as early as tax years beginning after Nov. 2, 2015, the date the BBA of 2015 was enacted. Generally, the new rules require adjustment of all items of income, gain, loss, deduction, or credit at the partnership level, with the partnership being liable for any resulting underpayment of tax. The following is a summary of the new rules; additional detail is included ***Chapter 8 - Partnerships and Limited Liability Companies***.

SB 274 amends existing law to prescribe the method for determining the California tax based on a federal partnership-level adjustment; specifies that unless the FTB approves a separate election, a partnership's federal election regarding audit rules is binding for state purposes; clarifies the partnership's and partners' requirements for reporting federal adjustments to the state; adds provisions specifically relating to publicly traded partnerships (PTP), and makes other technical changes.

New Rules Clarify When FTB Must Grant a Separate Election for Taxing Audit Adjustments

Under current federal law, partnership audit rules generally require adjustments of all items of income, gain, loss, deduction, or credit at the partnership level, with the partnership being liable for any resulting underpayment of tax. A partnership generally may elect to require its partners to pay the federal income tax that results from the partners including their share of the partnership audit adjustments on their own amended tax returns, in lieu of the partnership paying federal income tax on the net increase in partnership taxable income resulting from the audit adjustments. This is called the "push-out election."

SB790 (Finance, Stats. 2019, Ch. 332) requires the FTB to grant a partnership's or a tiered partnership's request to make a separate state election for purposes of reporting its federal audit adjustments under the following circumstances:

1. Where an audited partnership or a tiered partnership makes a federal election for alternative payment, which requires adjustments to be taken into account by the partners, provided that the partnership or tiered partnership properly computes the amount of the California tax due; or

2. Where an audited partnership or a tiered partnership pays the tax at the federal level, provided that the partnership or tiered partnership can demonstrate to the FTB that the FTB's ability to collect any state income or franchise taxes would not be impeded and the partnership or tiered partnership properly follows the partnership reporting provisions.

NEW CONFORMITY FOR SECTION 529 AND 529A PLANS

AB 91 (Burke, Stats. 2019 Ch. 39) conforms, with modifications, to some of the amendments to IRC §529 and §529A made by the TCJA. More specifically, the bill conforms to the allowance of rollovers between IRC §529 accounts and between §529 account and ABLE accounts.

Long Overdue Conformity for §529 and §529A Plans Included

In order to maintain account qualification for the ABLE program and the IRC §529 qualified tuition program, the language also conforms to IRC §529A and §529 changes made by the Protecting Americans from Tax Hikes (PATH) Act of 2016. More specifically, the state now conforms to the revision to the definition of qualified educational expenditures allowing computer equipment, software, and Internet expenses if primarily used by the beneficiary while enrolled at an eligible educational institution, conforms to the allowance of recontributions of refunded amounts, and conforms to the elimination of the residency requirement for qualified ABLE programs.

No Tax-Free Distributions for K-12 Education

AB 91 specifically does not conform to §11032 of the TJCA, which would provide account funding for primary and secondary education, while it maintains IRC §529 account qualification for any distributions made pursuant to §11032 of the TCJA, and clarifies the California tax treatment of distributions made under the §11032 amendments. So while under federal law tax-free distributions can be made for payments of primary and secondary school tuition, those distributions are currently taxable under California law and would remain so under this legislation. However, such distributions would not disqualify the plan for California purposes.

EXCLUSION FOR CERTAIN STUDENT LOAN INDEBTEDNESS

AB 91 (Burke, Stats. 2019 Ch. 39) conforms, with modification to effective date, to the federal treatment of student loan cancellation that are discharged on account of death or total and permanent disability of the student for discharges of indebtedness after Dec. 31, 2018.

ELIMINATION OF NOL CARRYBACKS

AB 91 (Burke, Stats. 2019 Ch. 39) disallows NOL carrybacks under the PITL and CTL, with limited exceptions, for NOLs attributable to taxable years beginning after Dec. 31, 2018.

This provision also disallows the special rules under IRC §172 for REITs, excess interest losses, and corporate equity reduction interest losses.

In addition, this provision repeals conformity to IRC §6164, related to the allowance of an extension of time for payment of taxes by corporations expecting NOL carrybacks.

AB 91 does not allow for indefinite carryforward — California's carryforward remains at 20 years. Also, the state did not conform to the 80% of taxable income limitation in the carryforward years.

SMALL BUSINESS ACCOUNTING METHOD CHANGES

AB 91 (Burke, Stats. 2019 Ch. 39) generally conforms to the TJCA's revised definition of small business for method of accounting rules as well as the small business exceptions for UNICAP rules, inventory accounting, and accounting for long-term contract rules. In addition, a taxpayer may elect to apply the provision regarding accounting for long-term contracts to contracts entered into on or after Jan. 1, 2018, in taxable years ending after Jan. 1, 2018.

Any change in method of accounting made pursuant to this provision shall be treated for purposes of applying §481 of the IRC, as applicable for California purposes under §17551, as initiated by the taxpayer and made with the consent of the FTB. California does not conform to the six year recognition period for income adjustments under §481(a).

Procedure to Elect to Apply to Tax Years Beginning Jan. 1, 2018, and Before Jan, 1, 2019

In order to make one or more of the elections to apply a California Small Business Method of Accounting provision for taxable years beginning on or after Jan. 1, 2018, and before Jan. 1, 2019, a taxpayer must complete all of the following:

1. Include a statement with their original or amended California tax return stating the taxpayer's intent to make one or more of the elections along with the specific election(s) being made.

2. On the top of the first page of the original or amended tax return, write or print "AB 91 – Small Business Method of Accounting Election" in blue or black ink.

3. Mail all "AB 91 – Small Business Method of Accounting Election" returns to:

Franchise Tax Board
PO Box 942857
Sacramento, CA 94257-0500

If a taxpayer has an electronic filing requirement under RTC §18621.10, the taxpayer may file a paper return for the purposes of making the election pursuant to this change. In that case, the taxpayer shall also include a statement with the return stating that the taxpayer is filing a paper return in lieu of an electronic return pursuant to FTB Notice 2019-03.

EXCESS BUSINESS LOSS LIMITATIONS

AB 91 (Burke, Stats. 2019 Ch. 39) generally conforms to the applicable TJCA section with regard to excess business losses with modifications for taxable years beginning after Dec. 31, 2018.

The legislation modifies the TJCA section treatment of excess business losses carryforwards. This provision will treat any disallowed excess business loss as a "carryover excess business loss" for the following taxable year as opposed to an NOL carryforward. Taxpayers will be allowed to include any "carryover excess business loss" into their calculation of excess business loss in the following tax year.

TECHNICAL TERMINATIONS

AB 91 (Burke, Stats. 2019 Ch. 39) conforms to the TJCA's repeal of the technical termination of a partnership for taxable years beginning on or after Jan. 1, 2019. A partnership may elect to have the repeal of the technical termination apply for taxable years beginning after Dec. 31, 2017, and before Jan. 1, 2019, in a manner determined by the FTB.

Procedure to Elect to Apply the Repeal to Taxable Years After 12/31/17 and Before 1/1/19

In order to make an election under RTC §17859(d)(1), a taxpayer must complete all of the following:

1. Include a statement with the original or amended California tax return, for the appropriate taxable year, stating the taxpayer's intent to make an election under RTC §17859(d)(1).

2. On the top of the first page of the original or amended tax return, write or print "AB 91 – Section 17859(d)(1) Election" in blue or black ink.

3. Mail all "AB 91 – Section 17859(d)(1) Election" returns to:

Franchise Tax Board
PO Box 1570
Rancho Cordova, CA 95741-1570

If a taxpayer has an electronic filing requirement under RTC §18621.10, the taxpayer may file a paper return for the purposes of making the election pursuant to this procedure. In that case, the taxpayer shall also include a statement with the return stating that the taxpayer is filing a paper return in lieu of an electronic return pursuant to FTB Notice 2019-04.

LIKE-KIND EXCHANGES

AB 91 (Burke, Stats. 2019 Ch. 39) conforms with modifications to the TJCA's modifications with respect to like-kind exchanges.

However, with respect to individuals, the conformity only applies to:

1. A taxpayer who is a head of household, a surviving spouse, or spouses filing a joint return with adjusted gross income, as defined in §17072, of $500,000 or more for the taxable year in which the exchange begins; or

2. For any other taxpayer with adjusted gross income, as defined in §17072, of $250,000 or more for the taxable year in which the exchange begins.

If a taxpayer does not meet one of the qualifications described above, the pre-TJCA IRC §1031 like-kind exchange rules, unless otherwise modified by the R&TC, continue to apply.

Example. In June 2019, Karen disposes of a commercial building for $1 million and a realized gain of $750,000. Of the gain, $650,000 is real property and $100,000 is tangible personal property. For federal tax purposes, Karen can defer the $650,000 gain by completing a §1031 exchange into like-kind real property of sufficient value. The $100,000 gain from the tangible personal property must be recognized.

CA result if Karen's AGI is $250,000 or more. Under new law, Karen's California tax treatment of the exchange will be the same as for federal purposes — deferral of $650,000 gain and recognition of $100,000 gain.

CA result if Karen's AGI is under $250,000. Karen can also defer the $100,000 gain from the tangible personal property by acquiring and completing an exchange into like-kind tangible personal property of sufficient value.

Preparer's Note. Could they make it any more complicated???!!

Effective date. This provision shall not apply to an exchange where the property to be disposed of by the taxpayer in the exchange is disposed of by that taxpayer on or before Jan. 10, 2019, or where the property to be received by the taxpayer in the exchange is received by that taxpayer on or before Jan. 10, 2019.

LIMITATION ON EXCESSIVE EMPLOYEE REMUNERATION

AB 91 (Burke, Stats. 2019 Ch. 39) conforms, with modifications, to the TJCA's modifications to the deduction limitation on excess employee remuneration. However, the modifications will not apply to remuneration provided pursuant to a written binding contract which was in effect on March 31, 2019.

NO SEPARATE ELECTION FOR IRC §338 ELECTION

IRC §338 allows taxpayers to elect to treat certain qualified stock purchases as asset acquisitions for federal income tax purposes. This section was not amended by the TCJA.

Under R&TC §23051.5, if a taxpayer makes an election for federal purposes, in which California conforms to the underlying election, the election is treated as being made for California tax purposes as well. Likewise, if a taxpayer does not make an election for federal purposes, the election is treated as having not been made for California tax purposes. However, unless otherwise prohibited, the taxpayer may choose to make a separate election for California tax purposes apart from their federal election treatment.

AB 91 (Burke, Stats. 2019 Ch. 39) requires taxpayers to use their federal IRC §338 election treatment for California tax purposes under R&TC §23051.5. Thus, where a taxpayer has made, or has not made, an election under IRC §338 for federal tax purposes, this law requires the taxpayer to make the same election, or not make the election, for California tax purposes.

NEW NONCONFORMITY

NEW! REPATRIATION TAX AND INCOME

The Tax Cuts and Jobs Act of 2017 amended IRC §965. Pursuant to IRC §965, US shareholders are required to pay a federal transition tax on the untaxed foreign earnings of certain specified foreign corporations as if those earnings had been repatriated to the United States. Therefore, certain taxpayers may have to pay additional federal tax under IRC §965 when filing their 2017 federal tax returns.

California does not conform to IRC §965. If IRC §965 amounts were reported on a 2017 federal tax return, make an adjustment on the 2017 California tax return using the table below.

In addition, taxpayers that reported IRC section 965 amounts on their federal tax return should write "IRC 965" on the top of their California tax return, or follow their tax software guidelines.

Taxpayer Type	Form or Schedule	Adjustment
Individual	Schedule CA (540)	Line 21f, Other Income - Column B Subtractions
Individual	Schedule CA (540NR)	Line 21f, Other Income - Column B Subtractions
Partnership	Form 565 Schedule K	Line 11b, Total Other Income - Column (c) CA Adjustments or Line 13e, Other Deductions - Column (c) CA Adjustments
Limited Liability Company	Form 568 Schedule K	Line 11b, Total Other Income - Column (c) CA Adjustments or Line 13e, Other Deductions - Column (c) CA Adjustments
S Corporation	Form 100S Schedule K	Line 10b, Total Other Income - Column (c) CA Adjustments or Line 12e, Other Deductions - Column (c) CA Adjustments

Do not include income, tax, or future installment payment amounts from the federal IRC 965 Transition Tax Statement on these forms or associated schedules.

Taxpayer Type	Form
Estate or Trust	Form 541 CA Fiduciary Income Tax Return
Corporation	Form 100 CA Corporation Franchise or Income Tax Return
Water's-Edge Filer	Form 100W CA Corporation Franchise or Income Tax Return — Water's-Edge Filers
Exempt Organization	Form 109 Exempt Organization Business Income Tax Return

Taxpayers who have already filed a 2017 California tax return and reported IRC §965 amounts should amend their 2017 California tax return and schedules to remove the IRC §965 amounts.

CALIFORNIA CONFORMITY GUIDE TO TCJA 2017

Individual provisions	Tax Cuts and Jobs Act	Conformity?
Effective date	The individual changes are generally effective for tax years beginning after 12/31/17 and before 1/1/2026.	

Individual provisions	Tax Cuts and Jobs Act	Conformity?
Individual tax rates	10%, 12%, 22%, 24%, 32%, 35% and 37%. • Highest rate applies at taxable income of $600,000 MFJ and $500,000 single and HOH. • Marriage penalty imposed at highest brackets	No
Trust tax rates	10%, 24%, 35% and 37%.	No
Kiddie tax	The unearned income of a child is taxed at trust rates, rather than the tax rates applicable to the parents beginning after 12/31/2017.	No
Exemptions	Suspends the deduction for exemptions.	No
Standard deduction	Increases standard deduction to $12,000 single, $18,000 for HOH and $24,000 MFJ.	No
Child tax credit	The child tax credit is increased to $2,000 ($1,400 refundable) for qualifying children under 17. A $500 credit is added for other dependents. • No credit is allowed unless the SSN of child is provided - ITINs are no longer accepted. • The phase-out is increased to begin at $400,000 MFJ and $200,000 single and HOH (was $75,000 and $110,000) - phaseout numbers are not indexed for inflation.	No
Capital gains	Zero, 15% and 20%, 25% and 28% rates are retained. • The zero rate applies up to taxable income of $77,200 MFJ, $51,700 HOH and $38,600 single (2018). • Basis rules retained (FIFO proposal dropped).	No
Moving expense deduction	Suspends the moving expense deduction except for military moves. There is a corresponding provision that makes moving expense reimbursement taxable.	No
Alimony deduction	Repeals the alimony paid deduction for agreements executed after Dec. 31, 2018. There is a corresponding repeal of the provisions providing inclusion of alimony in gross income.	No
Itemized deductions	Suspends the phase-out of itemized deductions.	No
Medical deduction	Allows medical expenses in excess of 7.5% of AGI for 2017 and 2018. Removes AMT preference between 7.5% and 10% for 2017 and 2018.	Conforms to CA No in 2019
State and local taxes (SALT)	Suspends all Schedule A individual state and local tax, sales tax, and property tax deductions above $10,000. • Deduction for prepaid 2018 state income taxes prohibited.	No
Mortgage interest	Reduces acquisition debt from $1,000,000 to $750,000 for debt incurred after 12-15-17. • Suspends (new and old) equity debt interest deduction. • Retains second home mortgage interest deduction.	No

Individual provisions	Tax Cuts and Jobs Act	Conformity?
Charitable contributions	Increases the 50% AGI limitation on cash contributions to public charities and certain private foundations to 60%. Suspends a charity deduction for amounts paid to a college for athletic seating rights.	No
Misc itemized deductions	Suspends all Sch. A misc itemized deductions that are subject to the 2% of AGI limitation — including employee business expenses, tax prep fees, investment advisor fees, legal fees, etc. Suspends personal casualty loss deductions except for presidentially declared casualty losses.	No
Gambling Losses	Gambling losses are limited to gambling winnings for professional gamblers.	No
AMT	Retains AMT but increases the exemption amount to $109,400 MFJ, $70,300 single and HOH. Phase-out of exemption increased to $1,000,000 MFJ and $500,000 single and HOH.	No
Adoption credit	Retains as in current law.	No
Earned income credit	Retains as in current law.	No
Education -§529	Allows a qualified distribution for K to 12 school expenses up to $10,000 from a 529 tuition savings plan per student.	No
Education - Student Loans	Retains student loan interest deduction, US savings bond exclusion, and tuition waiver exclusion.	No
Retirement- IRA recharacterization	Repeals the recharacterization rule.	Yes
Retirement- Loan default	If the taxpayer defaults on a pension plan loan, a deemed distribution occurs. The taxpayer can rollover the deemed distribution amount into an IRA by the extended due date of the return (was 60 days) if the default occurs because of termination of the plan or because of the employee's severance from employment.	Yes
Estate taxes	The estate, gift, and generation skipping tax exemption amounts are doubled to $11,180,000 (2018)	No
ACA	The individual mandate penalty is suspended after 2018. The 3.8% tax on net investment income (NII) and 0.9% additional Medicare tax are retained.	No

General business provisions	Tax Cuts and Jobs Act	Conformity?
Effective date	Unless otherwise indicated, business changes are permanent, generally, for tax years beginning after 12/31/17.	
20% Qualified business income deduction - §199A	**20% deduction**. An individual taxpayer generally may deduct 20% of qualified business income from a partnership, S corporation, or sole proprietorship, REIT dividends, cooperative dividends, and publicly traded partnerships. The deduction may not exceed 20% of the taxpayer's taxable income (reduced by net capital gains).	No
	Qualified business income. Qualified business income (QBI) is determined for each qualified trade or business. QBI is the net income of the US business. It does not include any investment income (interest, dividends, capital gains, and losses). Reasonable compensation in the S corporation and guaranteed payments in the partnership reduce QBI. If the net amount of qualified business income from all qualified trades or businesses during the taxable year is a loss, it is carried forward and reduces QBI in the next taxable year. QBI includes both passive and active income.	No
	W-2 limits. Subject to a taxable income threshold, the deductible amount for each qualified trade or business is the lesser of (a) 20% of the taxpayer's qualified business income with respect to the trade or business, or (b) the greater of 50% of the W-2 wages with respect to the trade or business or the sum of 25% of the W-2 wages with respect to the trade or business and 2.5% of the unadjusted basis, immediately after acquisition, of all qualified property.	No
	Phase-in of W-2 wages limitation. The W-2 wage limitation does not apply for a taxpayer with taxable income less than a threshold amount. The "threshold amount" is $315,000 MFJ ($157,500 if single) and is indexed for inflation. For those with income above the threshold amount, the deduction phases out over $100,000 MFJ ($50,000 single).	No

General business provisions	Tax Cuts and Jobs Act	Conformity?
	Specified service trades or businesses. Subject to a taxable income threshold, the deduction is not allowed with respect to "specified service trades or businesses." Specified service trades or businesses are any trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, including investing and investment management, trading, or dealing in securities, partnership interests, or commodities, and any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees. Engineers and architects are omitted from specified service trades or businesses. **Phase-in of specified service business limitation.** The exclusion from the definition of a qualified business for specified service trades or businesses does not apply for a taxpayer with taxable income less than a threshold amount. The "threshold amount" is $315,000 MFJ ($157,500 if single) and is indexed for inflation. For those with income above the threshold amount, the deduction phases out over $100,000 MFJ ($50,000 single). **Other items.** QBI deduction does not reduce SE tax or AGI. Trusts may qualify for the deduction on their pass through income.	No No
Corporate tax rates	21% flat tax rate. Graduated rates are repealed. 21% rate also applies to PSCs. Fiscal year corporations use a blended rate per §15.	No
Qualified equity grants - §83(i)	**Income deferral election, in general:** When made within 30 days of exercise of a vested option or upon vesting of shares under an RSU (under the rules of §409A), election allows for a deferral of income for up to a maximum of five years. **Qualified employee:** A qualified employee is an employee other than 1) a 1% owner of the corporation, 2) the CEO or CFO, 3) family members of 1) & 2), or 4) any of the four highest-compensated officers of the corporation. **Qualified stock**: Election can be applied to RSUs, ISOs, ESPPs, NQs within 30 days of taxable exercise. When made with respect to stock under a statutory option, the option is no longer treated as a statutory option. **§83(i) income tax deferred until earlier of:** 1. 5 years or	No No No

General business provisions	Tax Cuts and Jobs Act	Conformity?
	2. Occurrence of a specified event (such as (a) stock becoming readily tradeable, (b) employee becomes excluded, or (c) §83(I) election revoked). **§83(i) eligible corporation (written plan) requirement:** A corporation is an eligible corporation with respect to a calendar year if 1) no stock of the employer corporation is readily tradable on an established securities market during any preceding calendar year, and 2) the corporation has a written plan under which, in the calendar year, not less than 80% of all employees who provide services to the corporation are granted stock options, or restricted stock units ("RSUs"), with the same rights and privileges to receive qualified stock.	
Dividends received deduction	Corporations are allowed a deduction with respect to dividends received from other taxable domestic corporations. The dividend received deduction has been reduced from 70% to 50% (and from 80% to 65% for a 20% owned corporation.)	No
Territorial	The provision generally establishes a participation exemption system for foreign income. This exemption is provided for by means of a 100% deduction for the foreign-source portion of dividends received from specified 10% owned foreign corporations by domestic corporations that are United States shareholders of those foreign corporations.	No
Repatriation	All controlled foreign corporations (CFCs) and all foreign corporations (other than PFICs), in which a US person owns a 10% voting interest, must pay a 15.5% tax rate on accumulated post-1986 foreign earnings held in the form of cash or cash equivalents, and 8% tax rate on all other earnings. This increased tax liability generally may be paid over an 8-year period. This is effective for the last taxable year of a foreign corporation that begins before Jan. 1, 2018, and with respect to US shareholders, for the taxable years in which or with which such taxable years of the foreign corporations ends.	No
Corporate AMT	Repealed. AMT credit is refundable over time.	No
Carried interest	A carried interest (profits interest) is taxed at long-term capital gains rates only if the interest is held more than 3 years (was 1 year).	No

General business provisions	Tax Cuts and Jobs Act	Conformity?
Loss limitation rules §461	Excess business losses of a taxpayer other than a corporation are not allowed for the taxable year. An excess business loss for the taxable year is the excess of aggregate deductions of the taxpayer attributable to trades or businesses of the taxpayer (determined without regard to the limitation of the provision), over the sum of aggregate gross income or gain of the taxpayer plus a threshold amount. The threshold amount for a taxable year is $500,000 MFJ (250,000 single). Excess business losses not allowed are carried forward and treated as part of the taxpayer's NOL carryforward. This limit applies at the partner or shareholder level. Each partner's distributive share and each S corporation shareholder's pro rata share of items of income, gain, deduction, or loss of the partnership or S corporation are taken into account in applying this limitation. This limitation applies after the passive loss rules.	Yes with Modifications
Cash method of accounting	Taxpayers with less than $25 million in average gross receipts (was $10 million) may use the cash method of accounting regardless of entity structure or industry	Yes
Accounting for inventory	Taxpayers with average gross receipts of less than $25 million (was $10 million) may account for inventories as materials and supplies that are not incidental (or conform to the taxpayer's financial accounting treatment)	Yes
UNICAP - §263A	The threshold for the UNICAP rules (§263A) increases from $10 million to $25 million	Yes
All events test	All events occur fixing right to receive income when income can be determined with reasonable accuracy, but, no later than when item included in applicable financial statement (AFS) starting in 2018	Yes
Long-term contracts - §460	Generally, the percentage of completion method of accounting is required for long-term contracts. For business with less than $25 million in gross receipts (was $10 million), the completed contract method of accounting can be used for construction contracts lasting less than 2 years.	Yes
Self-created property	Gain or loss from the disposition of self-created property is treated as ordinary income/loss. Self-created property includes patents, inventions, and models or designs and secret formulas. Musical compositions and copyrights are still a capital asset.	No
Like-kind exchanges	The §1031 like-kind exchange rules are modified to provide that the nonrecognition is limited to real property that is not held primarily for sale. Generally applies to exchanges completed after 12/31/17. However, an exception is provided for any exchange if the property disposed of by the taxpayer in the exchange is disposed of on or before 12/31/17, or the property received by the taxpayer in the exchange is received on or before such date.	Yes for some taxpayers

General business provisions	Tax Cuts and Jobs Act	Conformity?
Meals & entertainment	Expenses for entertainment, amusement, and recreation are not deductible. Dues for a club organized for business, pleasure, or social purposes are not deductible. Meals provided for the convenience of the employer at or near the employer's premises are subject to 50% limitation until 12/31/2025 and then completely non-deductible beginning in 2026.	No
Listed property	Home computers and peripheral equipment, including laptops, are no longer listed property.	No
Luxury auto limits	For luxury autos placed in service after 12/31/17 for which the bonus depreciation is not claimed, depreciation amounts are increased. **2017** **2018** Yr 1 $3,160 $10,000 Yr 2 $5,100 $16,000 Yr 3 $3,050 $ 7,600 Yr 4+ $1,875 $ 5,760 After 5 yrs: $15,060 $47,120	No
Transportation fringe benefits	The $20/month fringe benefit provision for bicycling to work is repealed. An employer can no longer deduct parking and commuting benefits paid to an employee, but the benefits remain a tax-free fringe to the employee.	No
Interest expense	For businesses with more than $25 million of gross receipts, interest expense deductions are limited to interest income + 30% of adjusted taxable income + interest on floor plan financing. Limitations apply at the partner/shareholder level; any excess is carried forward. Allocated excess business interest reduces basis. If ownership interest is disposed of with excess business interest that reduced basis, reverse the reduction.	No
§179 amount	The §179 expensing amount is increased to $1 million (was $510,000). The phase-out starts at $2,500,000 (was $2,030,000), both being indexed for inflation, as well as the $25,000 sports utility vehicle limitation.	No
§179 qualified real property	The definition of qualified real property eligible for §179 expensing is expanded to include any of the following improvements to nonresidential real property placed in service after the date such property was first placed in service: roofs; heating, ventilation, and air-conditioning property; fire protection and alarm systems; and security systems. The definition of §179 property has been expanded to include certain depreciable tangible personal property used predominantly to furnish lodging or in connection with furnishing lodging.	No

General business provisions	Tax Cuts and Jobs Act	Conformity?
§168(k) bonus depreciation	Bonus depreciation is increased to 100% (was 50%) of qualifying property placed in service after 9/27/2017 and before 1/1/2023. A phase-out starts 1/1/2023. The requirement that property must be new to qualify for bonus depreciation has been repealed.	No
Net operating loss	The two-year carryback and the special carryback provisions have been repealed, except for a two-year carryback for farming losses. NOLs may be carried forward indefinitely. The NOL deduction is limited to 80% of taxable income (determined without regard to the deduction) for losses arising in taxable years beginning after Dec. 31, 2017.	Yes for carryback repeal
Farm changes - depreciation and excess farm losses	The 7 year recovery period for any machinery or equipment (other than any grain bin, cotton ginning asset, fence, or other land improvement) used in a farming business has been shorten to 5 years if the original use of which commences with the taxpayer and is placed in service after Dec. 31, 2017. Also repealed is the required use of the 150% declining balance method for property used in a farming business (i.e., for 3-, 5-, 7-, and 10-year property). Lastly, the excess farm losses limitation has been repealed.	No
Family leave credit	For 2018 and 2019, a new employer credit is available for wages paid under a written plan during family or medical leave if the employer pays at least 50% of normal wages. The credit is 12.5% but increases by .25% (but not above 25%) for each 1% where rate of pay exceeds 50%. Limited to 12 weeks.	No
Rehab of historic structure credits	The 10% credit for pre-1936 buildings is repealed. The 20% credit for qualified rehabilitation expenditures with respect to a certified historic structure is allowable for a taxable year during the 5 year period beginning in the taxable year in which the qualified rehabilitated building is placed in service.	No

NEWEST NONCONFORMITY

In 2019, the California legislature created several new items of nonconformity with federal law.

CALIFORNIA INDIVIDUAL HEALTHCARE MANDATE

SB 78 (Budget, Stats. 2019, Ch. 38) creates a California Individual Healthcare Mandate, a program similar to the Affordable Care Act (ACA) administered by the Internal Revenue Service (IRS), but the state program will be administered by the California Health Benefit Exchange (Exchange) and the Franchise Tax Board (FTB).

Beginning Jan. 1, 2020, California residents and their dependents are required to obtain and maintain monthly healthcare coverage, unless they qualify for an exemption from the mandate. The Exchange, the state's insurance marketplace, will provide financial assistance to households that meet certain income requirements and certify those who are exempt from the mandate.

If an individual required to obtain health insurance under the mandate fails to obtain healthcare coverage, a penalty per uninsured person may be imposed on the individual. This penalty is referred to as the Individual Shared Responsibility Penalty (Penalty).

At the end of each year, taxpayers will either verify they maintained minimum essential coverage or verify their exemption from the mandate. Those who lacked health insurance and were not exempt from the mandate will compute and pay the Penalty on their California individual tax return.

Penalty Calculation Similar to Federal Mandate Penalty

The penalty is equal to the lesser of either of the following amounts, and is computed as follows:

1. The sum of the monthly penalty amounts for months in the taxable year during which one or more failures occurred.

2. An amount equal to one-twelfth of the state average premium for qualified health plans that have a bronze level of coverage for the applicable household size involved, and are offered through the Exchange for plan years beginning in the calendar year with or within which the taxable year ends, multiplied by the number of months in which a failure occurred.

For purposes of computing (1) above, the monthly penalty amount for any month during which a failure occurred is an amount equal to one-twelfth of the greater of either of the following amounts:

- An amount equal to the lesser of either of the following:

    - The sum of the applicable dollar amounts for all applicable household members who failed to enroll in and maintain MEC during the month unless they did not maintain MEC for a continuous period of three months or less.
    - Three hundred percent of the applicable dollar amount determined for the calendar year during which the taxable year ends.

- An amount equal to 2.5 percent of the excess of the responsible individual's applicable household income for the taxable year over the amount of gross income that would trigger the responsible individual's requirement to file a state income tax return based on the applicable filing threshold for the taxable year.

The applicable dollar amount for adults is seven hundred fifty dollars ($750). If an applicable individual has not attained 18 years of age as of the beginning of the month, the applicable dollar amount with respect to that individual for that month shall be equal to one-half of the applicable dollar amount ($375).

The applicable dollar amount is subject to cost of living adjustments.

Gap Coverage

A short gap coverage exemption will apply for taxpayers who did not have coverage for 3 consecutive months or less. (The federal short gap coverage exemption was for not having coverage less than 3 consecutive months.)

Sample Penalty Amounts

Household Size	If you make less than	You may pay
Individual	$46,050	$750
Married Couple	$92,100	$1,500
Family of 4 (2 adults 2 children)	$142,000	$2,250

Penalty Calculator

FTB has a Penalty Estimator tool available on its website.

Premium Subsidies Available

In addition, taxpayers may be eligible to receive subsidies from the Exchange to help cover the cost of their required insurance.

At the end of each year, taxpayers are required to reconcile the subsidies received based on projected income against their subsidies they were entitled to based on actual income. The reconciliation may result in a refund or a liability depending on the difference between the actual subsidy received and the subsidy they were entitled to receive.

More to Come

The California Individual Healthcare Mandate takes effect Jan. 1, 2020. Forms and procedures for calculating penalties and repayment of subsidies will be coming out during the year.

For now, coverage must be either maintained, or obtained, for California residents by January 1.

STUDENT LOAN DEBT RELIEF

SB 63 (Hertzberg, Stats. 2019, Ch. 468) provides state tax relief to students who have student loans forgiven as a result of the closures of Brightwood Colleges, the Art Institute of California, and similar closures. Federal law has no such provisions.

For taxable years beginning on and after Jan. 1, 2019, and before Jan. 1, 2024, this law allows an exclusion from California gross income for income that would otherwise result from the discharge of a student loan of an eligible individual.

A student loan would mean any student obligation note or other debt evidencing a loan to any individual for the purpose of attending a for-profit higher education company or for the purpose of consolidating or refinancing a loan used to attend a for-profit higher education company, which is either a guaranteed student loan, an educational loan, or a loan eligible for consolidation or refinancing under Part B of Title IV of the Higher Education Act of 1965, as amended.

An individual would be eligible for the exclusion for a taxable year if any of the following apply during the taxable year, the individual:

- Is granted a discharge of any student loan pursuant to:
  - Subdivision (c) of Section 685.206 of Title 34 of the Code of Federal Regulations (CFR), as it read Jan. 1, 2019, because the individual successfully asserts that the school did something wrong or failed to do something that it should have done; or
  - Paragraph (1) of subdivision (a) of Section 685.214 of Title 34 of the CFR, as it read Jan. 1, 2019, because the individual could not complete a program of study due to the school closing.
- Attended a Brightwood College school on or before Dec. 5, 2018, and is granted a discharge of any student loan made in connection with attending that school that is otherwise ineligible for discharge under provisions of the bill.
- Attended a location of the Art Institute of California and is granted a discharge of any student loan made in connection with attending that school that is otherwise ineligible for discharge under provisions of the bill.

DEDUCTIONS DISALLOWED IN CERTAIN COLLEGE ADMISSIONS SCHEMES

A federal investigation, nicknamed Operation Varsity Blues, investigated an alleged conspiracy to influence undergraduate admissions decisions at several prominent American universities. The investigation alleges that the conspiracy included bribing exam administrators to facilitate cheating on college and university entrance exams and bribing coaches and administrators of elite universities to nominate unqualified applicants as elite recruited athletes, thus facilitating the applicants' admission. It is alleged that a charitable organization was used to conceal the source and nature of laundered bribery payments.

Court documents unsealed in March 2019 detail a scheme led by William Rick Singer, in which wealthy parents paid Singer to bribe admissions testing officials, athletics staff, and coaches at universities in order to have their children admitted to elite schools. Parents made payments to KWF, a nonprofit organization owned by Singer and previously granted 501(c)(3) status. Many of Singer's clients then filed personal tax returns that falsely reported the payment to the KWF as charitable donations.

The FBI's investigation is on-going.

AB 136 (Quirk-Silva, Stats. 2019, Ch. 511), for taxable years beginning on or after Jan. 1, 2014, disallows a deduction for a charitable contribution and a business expense deduction made to an educational organization that is a postsecondary institution, the KWF, or Edge College and Career Network, LLC, by a taxpayer that meets all of the following conditions:

1. They are charged as a defendant in any of the following criminal complaints filed in the United States District Court for the District of Massachusetts:

    - Criminal Complaint #19-CR-10081-IT
    - Criminal Complaint #19-CR-10078-RWZ
    - Criminal Complaint #19-CR-10075-MLW
    - Criminal Complaint #19-CR-10074-NMG
    - Criminal Complaint #19-cr-10079-RWZ
    - Criminal Complaint #1:19-cr-10117
    - Criminal Complaint #1:19-cr-10115
    - Criminal Complaint #19-cr-10131
    - Criminal Complaint #1:19-cr-10116
    - Criminal Complaint #1-19-cr-10080

2. There is a final determination of their guilt with regard to a violation of Title 18 of the United States Code, related to crimes and criminal procedures, as a result of that complaint.

3. There is a finding that they took the deduction unlawfully pursuant to the final determination of guilt or pursuant to a determination by the FTB.

The bill defines "final determination of guilt" to mean that the defendant has been convicted by verdict of a jury, accepted and recorded by the court; by a finding of the court in a case where a jury has been waived; or by a plea of guilty; and that the defendant has exhausted all appellate remedies involving these criminal matters.

DEDUCTION RELATED TO CANNABIS ACTIVITIES

Federal law states that no deduction or credit is allowed for any amount paid or incurred during the taxable year in carrying on any trade or business that consists of trafficking in specified controlled substances, including cannabis.

The treatment of deductions and credits attributable to a trade or business that is engaged in commercial cannabis activities by a licensee under state law differs depends on whether the licensee is subject to the PITL or CTL.

Personal Income Tax Law Treatment

The PITL conforms to federal law with respect to the treatment of amounts paid or incurred with respect to commercial cannabis activity in that no deduction or credit is allowed for any amount paid or incurred during the taxable year related to that activity (except cost of goods sold).

Corporation Tax Law Treatment

Under the CTL, a licensee engaged in commercial cannabis activity is allowed otherwise allowable deductions or credits assuming the entity has adequate records to substantiate these items.

Individual Cannabis Businesses Get a Break

Under the PITL, for taxable years beginning on or after Jan. 1, 2020, and before Jan. 1, 2025, **AB37** (Jones-Sawyer, Stats. 2019, Ch. 792) allows licensees engaged in commercial cannabis activity to deduct expenses and claim tax credits related to that trade or business.

"Commercial cannabis activity" and "licensee" would have the same meaning as specified in §26001 of the Business and Professions Code.

DEPRECIATION AND §179 EXPENSING

Section 179

Federal §179 Chart	**2019**	**2020**
Maximum §179 Deduction	$1,020,000	$1,040,000
Maximum Annual Qualifying Property Before Phaseout	$2,550,000	$2,590,000

California's maximum §179 expense continues to be $25,000 in 2019 and 2020. Moreover, that allowance begins to phase out when total assets placed in service exceeds $200,000.

California §179 Chart	**2019**	**2020**
Maximum §179 Deduction	$25,000	$25,000
Maximum Annual Qualifying Property Before Phase-out	$200,000	$200,000

Special Bonus Depreciation

An additional first-year depreciation deduction equal to 100% of the adjusted basis of qualified property is allowed and applies to property placed in service Sep. 27, 2017 and before Dec. 31, 2022.

> **Example.** Assume that in June 2020, Sharon purchases new depreciable property and places it in service. The property's cost is $10,000, and it is a five-year property subject to the half-year convention. The amount of additional first-year depreciation allowed under the provision is $10,000. Sharon's total 2020 depreciation deduction is $10,000.

California does not conform to the 100% first-year bonus depreciation for assets placed in service in 2020. As a result, assets placed in service in 2020 will have a reduced depreciation expense for California, a different adjusted basis beginning after the first year, and resultant different (higher) depreciation expense in subsequent years.

> **Example of California Depreciation.** Sharon, in the above example, deducts only the standard first-year MACRS depreciation of $2,000 (20% of $10,000 basis) on her California return, instead of the $10,000 deductible federally.

Luxury Automobiles

TCJA 2017 increases the depreciation limitations under IRC §280F that apply to listed property. For passenger automobiles placed in service after Dec. 31, 2017, and for which the additional first-year depreciation deduction under IRC section 168(k) is not claimed, the maximum amount of allowable depreciation is $10,000 for the year in which the vehicle is placed in service, $16,000 for the second year, $9,600 for the third year, and $5,760 for the fourth and later years in the recovery period. The limitations are indexed for inflation for passenger automobiles placed in service after 2018.

The TCJA also removes computer or peripheral equipment from the definition of listed property. Such property is therefore not subject to the heightened substantiation requirements that apply to listed property.

California does not conform to the new luxury auto limits or the modification to listed property.

HEALTH SAVINGS ACCOUNTS

California does not recognize Health Savings Accounts (HSAs). Californians with HSAs will find the following differences:

- Contributions to the HSA are not tax-deductible,
- Employer contributions are taxable wages to the employee,
- Earnings in the HSA are not tax-deferred,
- Contributions and earnings create California basis in the HSA,
- Distributions are not taxable, and
- Medical expenses paid with HSA proceeds are deductible on California return.

Should California Employers Ignore HSAs? Despite the lack of any state tax benefit, Californians can still benefit from HSAs. All of the federal benefits, particularly lower premiums, make HSAs an attractive alternative for many in the state.

REAL ESTATE PROFESSIONALS

Beginning in 1994 and for federal purposes only, rental real estate activities of taxpayers engaged in real property business are not automatically treated as passive activities (IRC §469(c)(7)). California did not conform to this provision. For California purposes, all rental activities are passive activities.

S CORPORATION BUILT-IN GAINS TAX (BIG)

Under IRC §1374(d)(7)(A), a corporate level tax at the highest marginal rate applicable to corporations (currently 35%) is imposed on an S corporation's gain that arose prior to the conversion of the C corporation to an S corporation and is recognized by the S corporation during the recognition period (i.e., the 10-year period beginning with the first day of the first taxable year for which the S election is in effect).

The BIG tax also applies to gains with respect to net recognized BIG attributable to property received by an S corporation from a C corporation in a carryover basis transaction. In the case of BIG attributable to an asset received by an S corporation from a C corporation in a carryover basis transaction, the recognition period rules are applied by substituting the date such asset was acquired by the S corporation in lieu of the beginning of the first taxable year for which the corporation was an S corporation.

Gains recognized in the recognition period are not BIG to the extent they are shown to have arisen while the S election was in effect or are offset by recognized built-in losses. The amount of the BIG tax is treated as a loss taken into account by the shareholders in computing their individual income tax.

Congress Shortens BIG Tax Recognition Period and California Does Not Conform

Under the provisions of **ARRA 2009**, for any taxable year beginning in 2009 and 2010, no tax is imposed on an S corporation under IRC §1374 if the seventh taxable year in the corporation's recognition period preceded such taxable year. Also, in the **Small Business Jobs Act of 2010** (extended by the **American Taxpayer Relief Act of 2012**, the **Tax Increase Prevention Act of 2014**, and the **PATH Act**) for taxable years beginning in 2011 and later for purposes of computing the BIG tax, the "recognition period" is the five-year period beginning with the first day of the first taxable year for which the corporation was an S corporation.

Under R&TC §17087.5, §23800, and §23809, California conforms by reference to IRC §1374, relating to tax imposed on certain BIG, as of the "specified date" of Jan. 1, 2009 (and now Jan. 1, 2015). Because the provisions in ARRA, SBJA, ATR, and TIPA (to reduce temporarily the recognition period for the BIG tax) were enacted between the "specified dates," California does not conform for 2009–2014.

CONTINUING NONCONFORMITY FOR CERTAIN BUSINESS DONATIONS

In recent years, Congress has extended and expanded charitable contribution deductions for businesses. California does not conform to the following:

- Enhanced deduction for C corporation contributions of inventory,
- Enhanced deduction for business contributions of food inventory,
- Enhanced deduction for business contributions of book inventory, and
- Enhanced deduction for corporate contributions of computer inventory.

CREDITS

CALIFORNIA EARNED INCOME TAX CREDIT

SB 80 (Budget Comm., Stats. 2015, Ch. 21) created the new California Refundable Earned Income Tax Credit (CA EITC). The new credit is operable for tax years beginning on or after Jan. 1, 2015. The CA EITC is an amount equal to an amount determined in accordance with IRC §32 as applicable for federal income tax purposes for the taxable year, except as discussed below.

The amount of the credit is multiplied by the EITC adjustment factor for the taxable year. Unless otherwise specified in the annual Budget Act, the EITC adjustment factor for taxable years beginning on or after Jan. 1, 2015, is 0%. (For taxable year 2019, the EITC adjustment factor in the Budget Act is 85%.)

Self-Employment Income Counts Starting in 2017

For taxable years beginning on or after Jan. 1, 2017, **SB 106** (Budget, Stats. 2017, Ch. 96) modifies the CA EITC by including, in the definition of earned income, net earnings from self-employment, consistent with federal law.

***New!* Maximum AGI and Age Limitation Changed**

Although **SB 855** (Budget, Stats. 2018, Ch. 52) increased the maximum AGI limits beginning in 2018 and revised the age limit for an eligible individual without a qualifying child to 18 years or older, rather than between the ages of 25 and 64 years, the 2019 budget brought more changes.

AB 91 (Burke, Stats. 2019, Ch. 39) modifies the California EITC by increasing the maximum AGI limits to $30,000 for an eligible individual with a qualifying child or without a qualifying child for taxable years beginning on or after Jan. 1, 2019. To accomplish the increase in the maximum AGI limit, this provision provides two new tables: 1) the credit and phase-out percentage table, and 2) the earned income and phase-out amount table. The $30,000 maximum AGI limit would be increased by the percentage change as calculated under R&TC section 17041(h) for any taxable year, and the following taxable years, in which the minimum wage is set at 15 dollars an hour.

Additionally, **AB 91** specifies that for taxable years beginning on or after Jan. 1, 2019, and before Jan. 1, 2020, the percentage change in the California Consumer Price Index (CCPI) would be deemed to be the greater of 3.5 percent or the percentage change in the CCPI as calculated under R&TC §17041(h) for that taxable year.

Calculating the CA EITC

The CA EITC is operative for taxable years for which resources are authorized in the annual Budget Act for the FTB to oversee and audit returns associated with the credit. The state credit percentages match the federal credit percentages (7.65% to 45%), but the CA EITC phases out at different percentages as shown in the table below:

In the Case of an Eligible Individual with:	**The Credit Percentage Is:**	**The Phaseout Percentage Is:**
No qualifying children	7.65%	7.65%
1 qualifying child	34%	34%
2 qualifying children	40%	40%
3 or more qualifying children	45%	45%

The law conforms to the federal definitions of an "eligible individual" and a "qualifying child" with the following exceptions:

- An eligible individual without a qualifying child would be required to have a principal place of abode in "this state" (rather than the US) for more than one-half of the taxable year.
- A qualifying child also would be required to have a principal place of abode in "this state" (rather than the US) for more than one-half of the taxable year.

California Conforms to Make Permanent Federal Enhanced Credit

Beginning with the 2016 tax year, the enhanced federal 45% credit rate was made permanent and added to the permanent credit-rate table. The paragraph that contained the temporary enhanced 45% credit rate was repealed.

For taxable years beginning on or after Jan. 1, 2016, **SB 1073** (Monning et al., Stats. 2016, Ch. 722) makes permanent the CA EITC's 45% credit rate for three or more qualifying children by adding the enhanced rate to the permanent credit table, consistent with recent federal changes.

COLLEGE ACCESS TAX CREDIT

In an effort to rebuild the state's funds for education, **SB 798** (DeLeon, Stats. 2014, Ch. 367) establishes an income tax credit under the Personal Income Tax Law and Corporation Tax Law for cash contributions made to the College Access Tax Credit Fund (College Fund) beginning Jan. 1, 2014, through Dec. 31, 2016.

Sunset Date for College Access Tax Credit Extended

AB 490 (Quirk-Silva, Stats. 2017, Ch. 527) extends the sunset date for the College Access Tax Credit from Jan. 1, 2018, to Jan. 1, 2023, and the repeal date from Dec. 1, 2018, to Dec. 1, 2023.

Calculation of Credit

Taxpayers, upon receipt of certification from the California Educational Facilities Authority (Authority), are allowed a tax credit for a specified percentage of cash contributions made to the College Fund. Unused credits can be carried forward to the subsequent six years. The maximum aggregate amount of credit that can be allocated and certified by the Authority for each calendar year is $500 million plus any previously unallocated and uncertified amounts.

The credit amount is calculated as

- 60% of the amount contributed that is certified and allocated for the 2014 taxable year.
- 55% of the amount contributed that is certified and allocated for the 2015 taxable year.
- 50% of the amount contributed that is certified and allocated for the 2016 and later taxable year.

No tax deduction is allowed for amounts included in the calculation of the credit.

Contributions to Fund Cal Grants

The legislation creates the College Fund as a special fund in the state treasury. The fund is used to provide additional Cal Grants to eligible students.

Amounts contributed to the College Fund would first be allocated to reimburse the General Fund for the aggregate amount of the credit allowed. The allocated funds would be considered General Fund revenues for purposes of §8 and 8.5 of Article XVI of the California Constitution. Then, upon appropriation by the state legislature, the funds would be allocated to the FTB, the Authority, the State Controller, and the

Student Aid Commission to reimburse all administrative costs incurred in connection with this credit and to the Student Aid Commission for the purpose of awarding Cal Grants.

Certification for Credit

SB 798 requires taxpayers claiming the credit to have received a certification from the California Educational Facilities Authority (CEFA). Instructions for the 2017 Forms reiterate the need for taxpayers to have obtained certification. Applications can either be filed online or downloaded and printed from CEFA's website, under the State Treasurer's oversight.

Federal Deduction for Contributions to College Access Tax Credit Fund Changes

Although in previous Chief Counsel Advisories (CCAs) the IRS suggested that these kinds of contributions in exchange for state income tax credits might create a *quid pro quo* situation, thus making them not deductible as charitable contributions, the CCAs stopped short of disallowing them. The argument at the time was that the tax credits were really just disguised tax payments, which is generally true. However, prior to 2018, whether the payments were charitable donations or state tax payments really didn't matter for purposes of the federal Schedule A deductions.

In light of TCJA 2017 and the limitation on the SALT (state and local tax) deduction federally, many state tax legislatures were considering additional credits of this type to overcome the federal SALT limits.

The IRS issued proposed regulations, adding a new paragraph (h)(3) to Reg. §1.170A-1 that limits any charitable deduction by the amount of the state tax credit received.

College Access Tax Credit Revisions

SB 81 (Budget Comm., Stats. 2015, Ch. 22) allows the College Access Tax Credit to reduce tax below the tentative minimum tax for all years beginning Jan. 1, 2014. In addition, the bill extends the credit (at 50% of amounts contributed) for taxable years beginning on or after Jan. 1, 2017, and before Jan. 1, 2018.

According to CEFA, for the 2016 taxable year, $5,369,369 in credits were allocated. As of Apr. 3, 2017, CEFA reported still had $500,000,000 credits available for 2017.

NEW! REHABILITATION OF CERTIFIED HISTORIC BUILDING CREDIT

SB 451 (Atkins, Stats. 2019, Ch. 703) creates for taxable years beginning on or after Jan. 1, 2021, and before Jan. 1, 2026, a tax credit for the rehabilitation expenses of certain homes and historic buildings determined in accordance with federal law (§47 of the IRC) except as follows:

- A general 20 percent credit would be allowed for the qualified rehabilitation expenditures of a certified historic structure (other than expenses that qualify for the 25 percent credit), and

- A 25 percent credit would be allowed for the qualified rehabilitation expenditures of a certified historic structure if that structure meets any of the following conditions:

    - The rehabilitated structure is located on certain federal surplus property, surplus state real property, or on surplus land.

- The rehabilitated structure includes affordable housing for lower-income households.
- The structure is located in a designated census tract.
- The structure is part of a military base reuse authority.
- The structure is a transit-oriented development that is a higher-density, mixed-use development within a walking distance of one-half mile of a transit station.

Unlike the federal credit;

- A state credit would be unavailable for expenditures with respect to a qualified building unless it is a certified historic structure.

- A state credit would be allowed for qualified rehabilitation expenditure amounts for an owner-occupied residence if the expenses are determined to rehabilitate the historic character and improve the integrity of the residence in the year of completion. The credit would be allowed for amounts equal to or more than $5,000 but does not exceed $25,000.

- The state credit is zero dollars unless appropriations are provided in a bill related to the Budget Act.

- "Certified historic structure" would have the same meaning as defined in §47(c)(3) of the IRC, that is a structure in this state and is listed on the California Register of Historical Resources.

- "Qualified rehabilitation expenditure" would have the same meaning as that term is defined in §47(c)(2) of the IRC, except that qualified rehabilitation expenditures may include expenditures in connection with the rehabilitation of a building without regard to whether any portion of that building is or is reasonably expected to be a tax-exempt use property.

- "Qualified rehabilitation expenditure" has the same meaning as that term is defined in §47(c)(2) of the IRC and also means rehabilitation expenditures incurred by the taxpayer with respect to a qualified residence for the rehabilitation of the exterior of the building or rehabilitation necessary for the function of that home, including, but not limited to, rehabilitation of electrical, plumbing, or foundation of the qualified residence.

In addition, this bill specifies the following:

- The Allocation Committee and the Office of Historic Preservation may charge a reasonable fee in an amount sufficient to cover expenses.

- No deduction would be allowed for that expense for which this credit is allowed, and if a credit is allowed with respect to property, the basis of that property would be reduced by the amount of the credit.

- Any unused credits could be carried over for up to eight years.

- The credit could reduce the regular tax plus the tax relating to the separate tax on lump-sum distributions, below tentative minimum tax for taxpayers subject to the PITL and the CTL.

- Section 47(c)(1)(B)(ii) of the IRC, relating to special rules for rehabilitation that may be expected to be completed in phases would not apply.

- The recapture provisions described in subsection (a) of §50 of the IRC would apply when the property (or interest in the property) is sold within the recapture period.

- The credit provisions would remain in effect regardless of the expiration or repeal of §47 of the IRC, relating to the federal rehabilitation credit.

The bill specifies that unlike the federal credit, the entire credit generated shall be claimed the year the building is placed in service.

The tax credit provisions would remain in effect until Dec. 1, 2026, and as of that date would be repealed.

LOW-INCOME HOUSING CREDIT INCREASED

Current federal tax law allows an LIHC for the costs of constructing, rehabilitating, or acquiring low-income housing. The LIHC amount varies depending on several factors including when the housing was placed in service and whether it was federally subsidized, and varies between 30% and 70% of the present value of the qualified low-income housing. The LIHC is claimed over 10 years.

Current state tax law generally conforms to federal law with respect to the LIHC, except that the state LIHC is claimed over four taxable years, is limited to projects located in California, must be allocated and authorized by the Allocation Committee, rents must be maintained at low-income levels for 30 years (15 years for federal), and the Allocation Committee must have authorized a federal credit to the taxpayer or the taxpayer must qualify for the federal credit.

For taxable years beginning on or after Jan. 1, 2009, and before Jan. 1, 2020, current law requires allocation of the LIHC to partners based upon the partnership agreement, regardless of how the federal LIHC is allocated to the partners, or whether the allocation of the credit under the terms of the agreement has substantial economic effect.

The Allocation Committee certifies the amount of LIHC allocated. In the case of a partnership or an S Corporation, a copy of the certificate is provided to each taxpayer. The taxpayer is required, upon request, to provide a copy of the certificate to the FTB.

Any unused credit may continue to be carried forward until the credit is exhausted.

Additionally, for a project that receives a preliminary reservation on or after Jan. 1, 2016, and before Jan. 1, 2020, a taxpayer may make an election in its application to the Allocation Committee to sell all or any portion of any LIHC allowed to one or more unrelated parties for each taxable year in which the LIHC is allowed, as specified in provisions administered by the Allocation Committee.

New! CA LIHC Extended and Certain Provisions Eased

For calendar years beginning in 2020, **AB 101** (Budget, Stats. 2019, Ch. 159) provides an additional $500,000,000 that may be allocated to specified low-income housing projects. For calendar years beginning in 2021 and thereafter, an annual amount up to $500,000,000 may be available for allocation pursuant to an authorization in the annual Budget Act or related legislation, and specified regulatory action by the Allocation Committee.

For taxable years beginning on or after Jan. 1, 2019, for purposes of the LIHC, the bill makes various changes to allow the credit to be claimed more easily, including changes to restrictions on the sale of the credit, the allocation of the credit among partners, and eliminating the rental passive activity loss limitation.

GOVERNOR BROWN'S 2013 ECONOMIC DEVELOPMENT INITIATIVE

Two complex budget trailer bills, **AB 93** (Budget, Stats. 2013, Ch. 69) and **SB 90** (Budget, Stats. 2013, Ch. 70), overhauled California's enterprise zone (EZ) and other economic development area (EDA) credits and incentives and replaced them with a new hiring credit (New Employment Tax Credit) and a GO-Biz credit (California Competes Tax Credit) effective with the 2014 tax year. The legislation also provides a new sales and use tax exemption for purchases of manufacturing and biotech equipment effective July 1, 2014.

New Employment Tax Credit - The New Hiring Credit

This credit is available for businesses that hire qualified full-time employees to work in a designated census tract or EDA, provided that the employer pays the employee qualified wages, applies for and receives a credit reservation from the FTB, and claims the credit on a timely filed original return.

A "designated census tract" is a census tract determined by the Department of Finance to be in the top 25% of California census tracts in terms of civilian unemployment and poverty rates. For purposes of this credit, an "EDA" is a former EZ or Local Agency Military Base Recovery Area. The credit is available for the 2014 through 2020 tax years and may continue to be claimed after the 2020 tax year for those qualified employees hired prior to 2021.

Credit Extended Through 2025

SB 855 (Budget, Stats. 2018, Ch. 52) modifies the New Hiring Credit by extending for five years the sunset date, to taxable years beginning before Jan. 1, 2026, and the repeal date, to Dec. 1, 2029.

Credit amount: The credit is equal to 35% of qualified wages paid for each qualified full-time employee hired. The number of full-time employees hired will be determined on the basis of the increased number of full-time employees statewide during the tax year over the base year, which is 2013 for currently existing businesses and businesses commencing in 2014. For businesses commencing after 2014, the base year is the taxable year immediately preceding the taxable year in which a qualified full-time employee was first hired by the qualified taxpayer. Special rules apply to businesses that relocate within California and to related taxpayers.

Qualified wages: "Qualified wages" are the amount of wages paid in excess of 150% of the minimum wage up to 350% of the minimum wage. The credit may be claimed only for wages paid during the employee's first 60 months of employment and may not be claimed for wages paid to an employee located in a census tract that is no longer classified as a designated census tract.

For qualified employees employed in a designated pilot area, qualified wages are those wages paid in excess of $10 per hour or an equivalent amount for salaried employees up to 350% of minimum wage. The Governor's Office of Business and Economic Development (GO-Biz) may designate up to a total of five pilot areas, which must be located within a designated census tract or an EDA with average wages less than the statewide average wages. Designations last for a period of four years but may be extended for an additional three years. Designations may not last beyond 2020.

Qualified employee: A qualified employee is an employee who meets the following criteria:

- Works at least 50% of the time in the designated census tract or EDA;
- Is paid wages at least equal to 150% of the minimum wage;
- Is hired after 2013;
- Is hired by a qualified taxpayer after the census tract is designated by the Department of Finance or the EDA is determined not to be in a designated census tract; and
- Works on average at least 35 hours per week or is considered a full-time salaried employee under Labor Code §515.

In addition, immediately prior to being hired, the employee must have been

- Unemployed for at least six months;
- A veteran who has not been employed since separation from service in the US Armed Forces within the 12-month period prior to being hired;
- A recipient of the federal earned income tax credit in the previous tax year;
- An ex-offender previously convicted of a felony; or
- A recipient of CalWORKs or general assistance.

Qualified taxpayer: Except for small businesses, a qualified taxpayer does not include any taxpayer involved in the following industries:

- Temporary help services;
- Retail trade;
- Theater companies and dinner theaters;
- Food or alcoholic beverage services;
- Casinos or casino-related businesses; or
- Sexually oriented businesses.

A "small business" is a trade or business that has aggregate gross receipts, less returns and allowances reportable to California, of less than $2 million during the previous taxable year but does not include a sexually oriented business.

Credit reservations and reporting requirements: Upon hiring a new employee, a taxpayer must request a tentative credit reservation from the FTB within 30 days of complying with the Employee Development Department's new hire reporting requirements on a form to be prescribed by the FTB. In addition, the taxpayer must provide the FTB with an annual certification of employment with respect to each qualified full-time employee hired in a previous taxable year by the 15th day of the third month of the taxable year.

Credit carryovers: Unused credit may be carried forward for up to four years.

Credit recapture: The credit is subject to recapture if the employee does not remain employed for at least three years, unless specified exceptions apply.

FTB Tools for the New Employment Credit

The FTB has published complete resources and applications for businesses eligible for the New Employment Credit. These include

- **New Employment Credit - Quick Facts**;
- **New Employment Credit Reservation - Online**;
- **Designated Geographic Area (DGA) Mapping Tool**; and
- **Annual Certification of Employment**.

California Competes Tax Credits - The New GO-Biz Credits

A new GO-Biz credit is also available for the 2014 through 2024 taxable years. Taxpayers must apply to GO-Biz for the credit, which will be awarded on a competitive basis based on the following criteria:

- The number of jobs to be created or retained;
- The compensation paid or proposed to be paid, including wages and benefits;
- The amount invested in California by the taxpayer;
- The unemployment or poverty level in the area where the business is located or proposed to be located;
- The incentives available to the taxpayer in California and also outside California;
- The duration of the project and how long the taxpayer commits to remaining in California; and
- Other economic factors and impacts in the locality, the region, and the state.

Proposed written agreements will be reviewed by the California Competes Tax Credit Committee (CCTCC), which is comprised of the Treasurer, the Director of Finance, and the Director of GO-Biz, or their designated representatives, and one appointee each from the Assembly and the Senate.

Prior to awarding the credit, the taxpayer must enter into a written agreement with the CCTCC specifying certain terms and conditions such as the wages to be paid, the number of jobs to be created and a minimum retention period, how the credit will be allocated, and any recapture provisions.

If the credit allocated to a taxpayer exceeds the taxpayer's net tax for the year, the excess may be carried forward for up to five years.

Generally, the total amount of the credits that may be allocated may not exceed $30 million for the 2013-2014 fiscal year, $150 million for the 2014-2015 fiscal year, and $200 million each year for the 2015-2016 to the 2017-2018 fiscal years, plus the amount of any unallocated credits from the previous fiscal year and the amount of any previously allocated credits that have been recaptured. However, the total amount of the new sales and use tax exemption, hiring credits, and GO-Biz credits in aggregate may not exceed $750 million per year. Twenty-five percent of the GO-Biz credits will be reserved for small businesses, and no more than 20% of the amount available may be awarded to any one taxpayer.

Legislation Increases Aggregate Amount of California Competes Credit

AB 1560 (Quirk-Silva, Stats. 2014, Ch. 378) increases the aggregate amount of the economic development credits that may be allocated to taxpayers each fiscal year by $25 million per fiscal year through the 2017–2018 fiscal year.

Legislation Allows California Competes Credit to Reduce Tentative Minimum Tax

AB 2754 (R&TC Comm., Stats. 2014, Ch. 478) allows the California Competes Credit to reduce the regular tax below tentative minimum tax under the Personal Income Tax and the Corporation Tax for taxable years beginning on or after Jan. 1, 2014.

Additional Factors GO-Biz May Consider

SB 836 (Budget Comm., Stats. 2016, Ch. 31) authorizes GO-Biz, when determining whether to enter into a written agreement with a taxpayer, to consider additional factors including but not limited to the following:

- The financial solvency of the taxpayer, and
- The taxpayer's compliance with state and federal laws.

***New!* Credit Extended and Modified**

SB 855 (Budget, Stats. 2018, Ch. 52) modified and extended the sunset for the California Competes Tax Credit. The credit has been extended for five years, to taxable years beginning before Jan. 1, 2030, and the repeal date has been extended to Dec. 1, 2030.

The bill also modifies the conditions for GO-Biz to consider when allocating this credit and provides for additional allocations of $180,000,000 for each fiscal year from 2018-2019 to 2022-2023, inclusive. Additional factors to be considered are:

- the extent to which the credit will influence the taxpayer's creation of jobs in California, and
- the training opportunities the taxpayer offers its employees.

Additionally, the bill removes the requirement that the FTB notify GO-Biz as to whether a business is considered a small business.

GO-Biz Announces Application Periods and Amounts

As required under the legislation, GO-Biz announced that the amount available for the California Competes Tax Credit for fiscal year 2019-2020 will be $236.8 million. In addition, for fiscal year 2019-2020, applications for the California Competes Tax Credit will be accepted during the following periods:

- July 29, 2019 - Aug. 19, 2019 ($90 million available);
- Jan. 6, 2020 - Jan. 27, 2020 ($75 million available); and
- Mar. 9, 2020 - Mar. 30, 2020 ($71.8 million plus any remaining unallocated amounts).

FAQs Available Online

GO-Biz maintains a page of Frequently Asked Questions at: GoBiz FAQs.

In addition, the FTB provides information on how to claim the credit on a tax return, the FTB's review procedures, and when and how the credit may be recaptured on its Frequently Asked Questions - California Competes Credit web page.

NEW MOTION PICTURE PRODUCTION CREDIT

For tax years beginning on or after Jan. 1, 2016, **AB 1839** (Gatto, Stats. 2014, Ch. 413) creates a New Motion Picture Credit subject to a computation, ranking, and allocation by the California Film Commission (Commission) for an amount equal to 20% or 25%, whichever is the applicable credit percentage of the qualified expenditures for the production of a qualified motion picture in California.

The bill prohibits a credit for any qualified expenditures for the production of a motion picture in California, if a credit for those same expenditures has been claimed under the Original Motion Picture Credit.

The applicable credit percentage for the New Motion Picture Credit will be as follows:

- 20% of qualified expenditures attributable to either:
  - The production of a qualified motion picture in California, including, but not limited to, a feature, up to $100 million dollars in qualified expenditures, or
  - A television series that relocated to California that is in its second or subsequent year of receiving a tax credit allocation under the New Motion Picture Credit or under the Original Motion Picture Credit.

An additional credit, in an aggregate amount not to exceed 5% of the qualified expenditures would be allowed to a qualified motion picture as follows:

- 5% of qualified expenditures relating to original photography outside the Los Angeles zone;
- 5% of qualified expenditures relating to music scoring and music track recording by musicians attributable to the production of a qualified motion picture in California; and
- 5% of the qualified expenditures relating to qualified visual effects attributable to the production of a qualified motion picture in California.

- 25% of qualified expenditures attributable to the production of a qualified motion picture where the qualified motion picture is a television series that relocated to California in its first year of receiving a tax credit allocation
- 25% of qualified expenditures, up to $10 million dollars, attributable to the production of a qualified motion picture that is an independent film

The Commission would be required to allocate tax credits to applicants as follows:

- In one or more allocation periods per fiscal year on or after July 1, 2015, and before July 1, 2016; and
- In two or more allocations periods per fiscal year on or after July 1, 2016, and before July 1, 2020.

The amount of the credit allowed to a qualified taxpayer, except as otherwise provided, would be limited to the amount specified in the credit certificate issued by the Commission. Certificates may not be issued prior to July 1, 2016.

The aggregate amount of credits that may be allocated by the Commission for a fiscal year would be the applicable amount as follows:

- $230 million in credits for the 2015-2016 fiscal year;
- $330 million in credits for the 2016-2017 fiscal year and each fiscal year thereafter, through and including the 2019-20 fiscal year, plus any amount described below:
- The unused allocation credit amount, if any, for the preceding fiscal year.
- The amount of previously allocated credit not certified.
- The amount of any credits reduced upon the application of the jobs ratio.

For pass-through entities, a "qualified taxpayer" determination would be made at the entity level and the credit would not be allowed to the pass-through (including an S corporation with respect to the tax imposed on S corporations under Corporate Tax Law), but passed through to the entity's partners or shareholders.

Sale of the Credit

A qualified taxpayer may sell any credit allowed that is attributable to an independent film to an unrelated party. A party acquiring the credit would be subject to the requirements of this bill and any credit sold by an owner of a disregarded entity would not be subject to the normal credit limitation applicable to owners of disregarded entities.

The qualified taxpayer would be required to report prior to the sale of the credit all required information regarding the purchase and sale of the credit, including the Social Security or other taxpayer identification number of the unrelated party to whom the credit has been sold, the face amount of the credit sold, and the amount of consideration received by the qualified taxpayer for the sale of the credit.

A qualified taxpayer would be prohibited from assigning or selling any tax credit to the extent the tax credit allowed is claimed on any tax return of the qualified taxpayer. In the event more than one taxpayer claims the same credit allocated by the Commission, the FTB could disallow the credit of either taxpayer if the statute of limitations remains open. An unrelated party that purchases a credit would be treated as a qualified taxpayer and subject to the requirements of this bill.

Credits in excess of the tax liability may be carried over for six years, if necessary, until the credit has been exhausted.

Assignment of the Credit

Under the Corporate Tax Law, where the credit allowed exceeds the taxpayer's tax liability, a qualified taxpayer may elect to make an irrevocable assignment of any portion of the credit allowed to one or more affiliated corporations, as defined, for each taxable year the credit is allowed. The election may be based on any method selected by the qualified taxpayer that originally receives the credit, changed for any subsequent taxable year if the election to make the assignment is expressly shown on each of the returns of the qualified taxpayer and the qualified taxpayer's affiliated corporations that assign and receive the credits and must be reported to the FTB, along with all required information regarding the assignment of the credit, as specified.

The law would treat an affiliated corporation or corporations, unrelated party or parties that are assigned a credit, as a qualified taxpayer.

The New Motion Picture Credit could reduce a corporate taxpayer's tax below tentative minimum tax.

Credit Amount Can Be Applied Against Sales and Use Tax

The legislation allows a qualified taxpayer, in lieu of claiming the New Motion Picture Credit on the income tax return, to make an irrevocable election to apply the credit amount against the qualified sales and use tax under R&TC §6902.5.

The Board of Equalization (BOE) would be required to provide an annual listing of qualified taxpayers or affiliates that made an irrevocable election, including the credit amount, or portion of the credit amount claimed by each qualified taxpayer or affiliate in a form or manner agreed upon by both the BOE and the FTB.

In the event that a qualified taxpayer fails to provide the copyright registration number on the return claiming the credit as required, the credit would be disallowed and assessed, and collected until the requirements are satisfied. A disallowed credit would be treated as a math error.

Annually, the Commission would be required to provide the Legislative Analyst's Office, the FTB, and the BOE with a list of qualified taxpayers and the tax credit amounts allocated to each qualified taxpayer by the Commission. The list would include the names and taxpayer identification numbers, including taxpayer identification numbers of each partner or shareholder, as applicable, of the qualified taxpayer.

Credit Regulations Adopted

The California Film Commission has adopted new regulations governing the film and television credit available for tax years beginning after 2015 against the state's corporate income and franchise tax, personal income tax, and sales and use tax. The regulations contain definitions for relevant terms and information concerning the application process, eligibility determinations, qualified expenditures, tax credit allocation, approved applicant responsibilities, issuance of credit certificates, job ratio ranking process, and on-screen credit and promotional requirements.

***New!* Motion Picture Credit After 2019**

SB 871 (Budget, Stats. 2018, Ch. 54) provides a new Motion Picture Credit beginning Jan. 1, 2020, that includes job growth as a criteria for receiving a credit allocation from the California Film Commission.

OTHER NONCONFORMITY

ELECTIONS

May a taxpayer make an election for California purposes that is different from the election made for federal tax purposes with regard to the same item? In FTB Notice 95-1, the FTB clarified its position regarding the circumstances in which a taxpayer may make a different election for California purposes from what was made for federal purposes.

R&TC §§17024.5(e) and 23051.5(e) state as follows:

(e) Whenever this part allows a taxpayer to make an election, the following rules shall apply:

(1) A proper election filed with the Internal Revenue Service in accordance with the Internal Revenue Code or regulations issued by “the secretary” shall be deemed to be a proper election for purposes of this part, unless otherwise expressly provided in this part or in regulations issued by the Franchise Tax Board.
(2) A copy of that election shall be furnished to the Franchise Tax Board upon request.
(3) To obtain treatment other than that elected for federal purposes, a separate election shall be filed with the Franchise Tax Board at the time and in the manner which may be required by the Franchise Tax Board.

> **Example.** In 2020, Karen, a sole proprietor, buys and places in service a piece of equipment worth $50,000. Before taking the purchase into consideration, Karen’s business has a net profit of $30,000. Instead of electing §179 expensing on her federal return, Karen elects to use special first-year bonus depreciation, deducting the full $50,000 resulting in a net loss of ($20,000).
>
> If Karen does nothing else for California, she will only deduct a maximum of $10,000 on her state return (MACRS 20% first year depreciation) resulting in a net profit of $20,000 - a difference of $40,000 from her federal return!
>
> Instead, Karen will make a separate §179 election for California, allowing her to deduct $25,000 as §179 expense plus $5,000 (MACRS 20% first year depreciation on the adjusted basis of $25,000), resulting in a net profit/loss of $0.

R&TC §§17024.5(f) and 23051.5(f) state as follows:

(f) Whenever this part allows or requires a taxpayer to file an application or seek consent, the rules set forth in subdivision (e) shall apply to that application or consent.

It is the position of the FTB that the language in R&TC §§17024.5(e)(3) and 23051.5(e)(3) generally allow taxpayers to make a different election for California purposes than for federal purposes, unless otherwise provided in the R&TC or FTB regulations. For example, R&TC §§17279(b)(2)(A) and 24355.5(b)(2)(A), pertaining to the amortization of intangible assets, specifically state that any federal election made under IRC §197 is binding for California purposes. Therefore, a different California election shall not be permitted for federal elections made under IRC §197.

In addition, under R&TC §§17024.5(f) and 23051.5(f), the general language of R&TC §§17024.5(e)(3) and 23051.5(e)(3) also applies to applications for changes of accounting periods and methods. In these instances, the FTB has the right not to approve the request to adopt a different method for California purposes than adopted for federal purposes where the adoption of such different method is for the avoidance or evasion of income tax or does not clearly reflect income.

MENTAL HEALTH SURTAX

Individuals are subject to a tax surcharge at the rate of 1% on taxable income in excess of $1 million (including the surcharge, the maximum rate is 13.3%). The mental health tax

- May not be reduced by any credits;
- Must be included in the estimated tax computation to avoid an underpayment penalty;
- Is not included for purposes of computing the other state tax credit;
- Is not included in the AMT computation (i.e., the taxpayer computes regular tax, adds AMT, and then adds the surtax); and
- Because the surcharge is based on the same taxable income for all filing statuses, married couples with income in excess of $1 million should consider filing separate returns.

File Separate Returns

R&TC §17043 provides that the surcharge is imposed on "a taxpayer's taxable income in excess of $1 million." Since a joint return is "a taxpayer," a married couple filing joint gets the use of only a single million-dollar "exemption" before the surcharge takes effect. The same couple can get the benefit twice by filing separately. At 1%, that extra $1 million benefit can save the couple up to $10,000. Remember, however, that if the couple files separately for California, they must generally file separately for federal (R&TC §18521(a)).

> **Example.** Vern and Sharon have total W-2 income of $2.5 million in 2020. They have no other income or deductions. If they file a joint return, their California tax will be $292,025. If they file separate and each report $1.25 million, they will each have a tax of $141,012.50 for a grand total of $282,025. They save exactly $10,000 in California tax.

Warning! Because federal AMT imposes harsher calculations on MFS taxpayers, this strategy may not be beneficial if the couple is already subject to federal AMT. Filing these clients separately for federal purposes may increase federal AMT as much or more than the California tax savings. Be sure to compare the combined federal and state tax results both ways.

Making the Decision to Split the Returns

It may be beneficial to split if

- California taxable income exceeds $1 million;
- Income is entirely or almost entirely made up of ordinary income; or
- Income is all community income to be split 50-50.

It probably is not beneficial to split if

- Taxpayers are already subject to federal AMT;
- Taxpayers have a federal Minimum Tax Credit carryover; or
- Most income has retained separate property status and one spouse's income is minimal or zero.

DISASTERS

AUTOMATIC DISASTER RELIEF FOR AREAS PROCLAIMED BY GOVERNOR

SB 35 (Wolk, Stats. 2015, Ch. 230) automatically allows disaster loss treatment for losses sustained in an area declared by the Governor to be in a state of emergency. The law is operative for taxable years beginning on or after Jan. 1, 2014, and before Jan. 1, 2024.

The reason for the bill was to streamline the disaster tax relief process, to reduce the burden of multiple disaster loss bills on the state legislature, and to expedite disaster-related tax relief for taxpayers that suffer losses related to governor-declared states of emergency. Prior to this legislation, if the Governor had declared a disaster area but the President had not, California law required the legislature to enact disaster relief for the affected area.

FTB GRANTED POWER TO POSTPONE DEADLINES AND ABATE INTEREST

Effective Jan. 1, 2013, **SB 1158** (Price, Stats. 2012, Ch. 382) allows the FTB to do the following:

- Postpone certain tax-related deadlines for taxpayers affected by a gubernatorially declared disaster, and
- Abate interest accrued against liabilities owed by taxpayers located within a disaster area if the accrued interest is the result of the FTB's decision to delay notices sent to the disaster area.

HOW CAN I REPLACE CALIFORNIA TAX RETURNS LOST OR DAMAGED IN A DISASTER?

If the taxpayer’s returns are lost or damaged due to a disaster, the FTB will replace the California tax returns at no cost. Complete Form FTB 3516, Request for Copy of Tax Return. Be sure to print the name of the disaster at the top of the form and the FTB will send copies of the most recently filed tax return.

For Personal Income Tax Returns:
RID UNIT PIT
Franchise Tax Board
PO BOX 1468
Sacramento, CA 95812-1468

For Business Income Tax Returns:
RID UNIT CORP
Franchise Tax Board
PO BOX 1468
Sacramento, CA 95812-1468

You can also request a copy of lost or damaged return by writing a letter that includes all of the following:

- Taxpayer’s name;
- Taxpayer’s address;
- Taxpayer’s Social Security number (for personal income tax returns);
- Taxpayer’s corporation number, California Secretary of State number, or federal employer identification number (for corporate tax returns);
- The tax year requested; and
- Taxpayer’s signature.

2020 FEDERAL AND CALIFORNIA TAX UPDATE
CALIFORNIA RESIDENCY

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2020 CALIFORNIA RESIDENCY

Residency is primarily a question of fact to be determined by examining all the circumstances of a taxpayer's particular situation.

RESIDENTS VS. NONRESIDENTS

FTB DEFINITIONS

A resident is any individual who meets any of the following:

- In California for other than a temporary or transitory purpose.
- Domiciled in California, but outside California for a temporary or transitory purpose.

A nonresident is any individual who is not a resident (CA §17014).

Domicile

The term "domicile" has a special legal definition that is not the same as residence. While many states consider domicile and residence to be the same, California makes a distinction and views them as two separate concepts even though they may often overlap. For instance, a taxpayer may be domiciled in California but not be a California resident, or he/she may be domiciled in another state but be a California resident for income tax purposes.

Domicile is defined for tax purposes as the place where an individual voluntarily establishes himself/herself and family, not merely for a special or limited purpose but with a present intention of making it a true, fixed, permanent home and principal establishment. It is the place where, whenever the individual is absent, he/she intends to return.

Change of Domicile

An individual can have only one domicile at a time. Once someone acquires a domicile, he/she retains that domicile until acquiring another. A change of domicile requires all of the following:

- Abandonment of prior domicile.
- Physically moving to and residing in the new locality.
- Intent to remain in the new locality permanently or indefinitely.

Safe Harbor

For taxable years beginning on or after Jan. 1, 1994, a safe harbor is available for certain individuals leaving California under employment-related contracts. The safe harbor provides that an individual domiciled in California who is outside California under an employment-related contract for at least 546 consecutive days will be considered a nonresident ***unless*** any of the following is met:

- The individual has intangible income exceeding $200,000 in any taxable year during which the employment-related contract is in effect.
- The principal purpose of the absence from California is to avoid personal income tax.

The spouse/RDP of the individual covered by this safe harbor rule will also be considered a nonresident while accompanying the individual outside California for at least 546 consecutive days. Return visits to California that do not exceed a total of 45 days during any taxable year covered by the employment contract are considered temporary.

Individuals not covered by this safe harbor determine residency status based on facts and circumstances. The determination of residency status cannot be solely based on an individual's occupation, business, or vocation. Instead, consider all activities to determine residency status. For instance, students who are residents of California leaving this state to attend an out-of-state school do not automatically become nonresidents nor do students who are nonresidents of California coming to this state to attend a California school automatically become residents. In these situations, individuals must determine their residency status based on their facts and circumstances.

GUIDELINES FOR DETERMINING RESIDENCY

The underlying theory of residency is that a taxpayer is a resident of the place where he/she has the closest connections. The following list shows some of the factors the FTB uses to determine residency status. Since an individual's residence is usually the place where he/she has the closest ties, the FTB will compare ties to California with ties elsewhere. In using these factors, it is the strength of the ties, not just the number of ties, that determines residency.

Factors to consider are as follows:

- Amount of time spent in California versus amount of time spent outside California.
- Location of spouse/RDP and children.
- Location of principal residence.
- Where driver's license was issued.
- Where vehicles are registered.
- Where taxpayer maintains professional licenses.
- Where registered to vote.
- Location of the banks where accounts are maintained.
- The origination point of financial transactions.
- Location of doctors, dentists, accountants, and attorneys.
- Location of the church, temple or mosque, professional associations, or social and country clubs.
- Location of real property and investments.
- Permanence of work assignments in California.
- Location of social ties.

This is only a partial list of the factors to consider. Consider all the facts of the taxpayer's particular situation to determine his/her residency status.

FTB Web Pages Dedicated to Residency and Non-Residency Issues

In the past, information for nonresidents and part-year residents required you to read the FTB's publications:

- Publication 1031 - Guidelines for Determining Resident Status, and
- Publication 1100 - Taxation of Nonresident and Individuals Who Change Residency

The FTB now has new web pages dedicated to nonresidents and part-year residents. You can view all content in one place as well as find useful links to forms and publications, sourcing information, and rules for withholding on California source income.

Temporary or Transitory Purposes

Nonresidents who are in California for temporary or transitory purposes are still nonresidents of California. For instance, if an individual comes to California for a vacation, or to complete a transaction, or is simply passing through, his/her purpose is temporary or transitory. As a nonresident, he/she is taxed only on income from California sources.

> **Example.** James and Janice are domiciled in Minnesota where they have maintained their family home for seven years. James works for a state agency in Minnesota. In October 2010, James took a six-month leave of absence to become a temporary consultant for a California company. James and Janice moved to Los Angeles in October 2010, where they rented an apartment and opened a checking account. Their home in Minnesota was left vacant and they retained their Minnesota bank accounts. They stayed in California from October 2010 to April 2011 and returned to Minnesota in April 2011.
>
> James and Janice were in California for a short period in order for James to complete a particular engagement as a temporary consultant. James and Janice are nonresidents of California because they were in California for a temporary or transitory purpose.

When someone is in California for other than a temporary or transitory purpose, he/she is a California resident. For instance, if an employer assigns the individual to an office in California for a long or indefinite period, if he/she retires and comes to California with no specific plans to leave, or if someone is ill and in California for an indefinite recuperation period, his/her stay is other than temporary or transitory. As a resident, he/she is taxed on income from all sources.

An individual will be considered to be in California for other than temporary or transitory purposes, and therefore a California resident, if he or she is in this state:

- To recuperate from injury or illness for a relatively long or indefinite period.
- For a business purpose which will require a long or indefinite period to accomplish.
- For employment in a position that may last permanently or indefinitely.
- For retirement with no definite intention of leaving shortly.

> **Example**. Bob is domiciled in Ohio and has lived there for 50 years. Two years ago, Bob developed a serious medical condition. His doctor told him to live in California until he recovers. The illness may last for several years. Bob took his doctor's advice and moved to California two years ago.

An individual will be presumed to be a California resident for any taxable year in which he/she spends more than nine months in the state. Although he/she may have connections with another state, if the stay in California is for other than a temporary or transitory purpose, that individual is a California resident. As a resident, income from all sources is taxable by California.

A resident of California continues to be a resident when absent from the state for a temporary or transitory purpose.

HYATT - THE CASE THAT NEVER ENDS

Gilbert P. Hyatt is an inventor. Prior to Sep. 26, 1991, Gil was a California resident and domiciliary living in La Palma, California. During 1991 and 1992, he earned a substantial amount of income from the licensing of patents — over $17 million in 1991 and $84 million in 1992. Gil filed a California Part-Year Resident Income Tax Return for 1991, reporting California adjusted income of $633,228 on the basis that he left California on Oct. 1, 1991, and that most of his income was earned after that date. He did not file a California return for 1992.

Did Hyatt really move to Las Vegas? According to him, Gil moved to Las Vegas on Sep. 26, 1991, and initially resided in the Continental Hotel. He contended that on Oct. 1, 1991, he sold his La Palma home to Grace Jeng, and that on Oct. 21, 1991, he moved from the Continental Hotel into an apartment at the Wagon Trails apartment building in Las Vegas. Gil argued that he resided in that apartment until Apr. 3, 1992, when he moved into his newly purchased home on Tara Avenue in Las Vegas.

In contrast, the FTB argued that Gil continued to live and work at his La Palma home throughout all of 1991 and through Apr. 2, 1992. The FTB argued that he continued to own his La Palma home throughout 1991 and that, on June 10, 1993, Gil caused a notary to backdate documents to indicate an Oct. 1, 1991, sale. The FTB further asserted that he operated a California business.

After initiating a residency audit in June 1993, on Apr. 23, 1996, the FTB issued a Notice of Proposed Assessment (NPA) to Gil for the 1991 tax year, assessing additional tax of approximately $1.9 million and a fraud penalty of $1.4 million. Further, the FTB originally determined that $52 million of the 1992 income was California source income resulting in a tax assessment of $5.6 million and a fraud penalty of $4.2 million.

After 11 hours of oral arguments on Aug. 29, 2017, the State Board decided that Gil Hyatt was a resident of California until Oct. 20, 1991. As a result, it upheld the FTB's determination of California source income up to Oct. 20, 1991, but denied California sourcing for 1992. The Board also denied the FTB's fraud penalties for both years (***Appeal of Gilbert P. Hyatt***, SBE No. 435770 & 446509, Aug. 29, 2017).

Meanwhile - Hyatt Got Mad and Sued the State of California!

In 1998, Hyatt sued the FTB in Nevada state court over the agency's handling of and investigation into his California non-residency. The jury awarded Hyatt $389 million, including $250 million in punitive damages. In September 2014, the Nevada Supreme Court reduced the amount the Clark County, Nevada, jury originally awarded Gilbert Hyatt.

After deliberating nearly two years, the Nevada Supreme Court sustained Hyatt's allegations in the main but ruled that the FTB (the state of California) was exempt from punitive damages. Hyatt's final award amount was sent back to the lower court for recalculation.

Two New Decisions on *Hyatt* in 2019

First, the tax decision. The FTB petitioned the Office of Tax Appeals (OTA) for a rehearing, citing irregularities in the State Board's 2017 proceedings and that the Board's determination was contrary to law. In January 2019, the OTA denied the FTB's petition, holding that the State Board's decision and procedures were valid (***Hyatt,*** OTA #18010244 &#18010245, Jan. 15, 2019).

Next, the US Supreme Court weighs in (again!).
In 2016, the FTB went to the US Supreme Court, requesting that it be afforded the same immunity from prosecution in Nevada that it already enjoys statutorily in California. The Court ruled then that the FTB had immunity for negligent but not intentional torts, citing its own 1979 precedent set in *Nevada v. Hall* (440 US 410, 1979). In 2018, the FTB petitioned the Court to review whether *Hall* should be overruled. This time the Court agreed in full that states retain immunity from private suits both in their own courts and in other courts. In making the FTB immune from suit in Nevada's courts, the Supreme Court reversed the judgment of the Nevada court (***FTB v. Hyatt,*** USSC #17-1299, May 13, 2019).

RESIDENT/NONRESIDENT UNDER THE PERSONAL INCOME TAX

INCOME TAXABLE BY CALIFORNIA

Residents of California are taxed on ***all*** income, including income from sources outside California.

Nonresidents of California are taxed only on income from California sources. Nonresidents of California are not taxed on pensions received after Dec. 31, 1995.

Part-year residents of California are taxed on all income received while a resident and only on income from California sources while a nonresident.

SOURCING INCOME

Under R&TC §17041(b) and (I), nonresidents and part-year residents of California are taxed on income attributable to California. Taxable income of a nonresident is determined by taking into account only gross income from sources within California (R&TC §17951).

In the case of services, it is well-settled that the source of income is determined by examining the location where services are performed, without regard to a taxpayer's state of residency (see ***Appeal of Robert C. Thomas and Marian Thomas***, 55-SBE-006, Apr. 20, 1955; ***Appeal of Charles W. and Mary D. Perelle***, 58-SBE-057, Dec. 17, 1958; ***Appeal of Janice Rule***, 76-SBE-099, Oct. 6, 1976; and ***Appeal of Oscar D. and Agatha Seltzer***, 80-SBE-154, Nov. 18, 1980). Furthermore, California Code of Regulations §17951-2 states that "income from sources within this State includes income from real or tangible personal property located in this State; from a business, trade or profession carried on within this State...."

California follows federal law, which provides special rules concerning the taxation of "qualified retirement income." Title 4 of the United States Code, §114 provides that "no state may impose tax on any retirement income of an individual who is not a resident or domiciliary of such State." R&TC §17952.5 implements that federal law by excluding "qualified retirement income" from a nonresident's

California gross income from sources within this state. Thus, regardless of source, “qualified retirement income” is not subject to California tax if it is received by a nonresident.

California’s sourcing principles apply even though the results may be contrary to the other states’ principles. The following describes the sources of various types of income:

- Compensation for services rendered by employees or independent contractors has a source where the services are performed.
- **Income from tangible personal property and real estate** has a source where the property is located.
- **Income from intangible personal property** (such as interest and dividends) generally has a source where the owner resides.
- **Business income** has a source where the sale occurred the benefit of the service was received.

Independent Contractor Had Income Sourced to California

California imposes a tax on the entire taxable income of a nonresident to the extent it is derived from sources within this state (R&TC, §§ 17041(b), 17951(a)).

Blair Blindly is a self-employed screenplay writer providing services to companies producing films and television shows. On or around Sept. 1, 2014, Blair contracted with Mindbender Enterprises, LLC (Mindbender), a motion picture producer, for his writing services to write a screenplay. The contract specifies that Blair’s work would be considered “work-for-hire” and Mindbender would therefore be considered the author and copyright owner of his screenplay. On or around Dec. 18, 2015, Blair similarly contracted with Lakeshow Films, LLC to write an original screenplay for the producer. The contract specifies that the screenplay would be considered a “work-made-for-hire” for Lakeshow. Both Mindbender and Lakeshow (collectively, “LLCs”) were headquartered and registered in California.

In 2015, Blair received $25,000 of income from Mindbender and $15,000 of income from Lakeshow but did not file a California tax return. When the FTB requested a return, Blair explained that he did not have California-source income because he performed all services for Mindbender and Lakeshow in Arizona. During the 2015 tax year, he was an Arizona resident.

The FTB held and the OTA agreed that pursuant to the provisions of R&TC §25136 and Regulation 25136-2© relating to the sale of services, Blair’s physical presence does not determine whether he had income derived from California, but rather it is determined by where the benefits of his services were received. Having established that income from Mindbender and the income from Lakeshow are sourced to California, the $40,000 was reportable to the state (***Appeal of Blair S. Bindley***, OTA No. 18032402, May 2019).

Income from Exercising Non-Qualified Stock Options (NSO)

When a taxpayer is granted an NSO while a California resident and later exercises it while a nonresident, the income from its exercise is compensation for services with a source in the state where the taxpayer performed the services — California (***Appeal of Charles W. and Mary D. Perelle*** (Dec. 17, 1958) 58-SBE-057). However, where the taxpayer performed services both within and outside of California, allocate to California only that portion of total compensation reasonably attributed to services performed in California (18 Cal. Code Regs. §§17951-5). One reasonable method is an allocation based on time.

$$\frac{\text{California workdays from date of grant to date of exercise}}{\text{Total workdays from date of grant to date of exercise}} = \text{Allocation ratio}$$

Income taxable by California = Total stock option income x Allocation ratio

The ratio applies only to options exercised after the taxpayer becomes a nonresident. If a taxpayer performs services for the corporation entirely within California but exercises the option after terminating employment and becoming a nonresident, the difference between the fair market value of the stock on the date of exercise and the option price has a source in California even though the underlying value of the stock may have increased after the taxpayer became a nonresident.

The state board decision in the ***Appeal of Spencer W. Kimball*** (Jan. 15, 2013) California State Board of Equalization Case No. 527783 follows the FTB's long-standing method of apportioning some or all of the income from NSOs as sourced to California when the options were originally awarded to a California resident but not exercised until after the taxpayer became a nonresident.

Ruling Regarding Sourcing of Restricted Stock Units (RSUs)

Following the methodology the FTB uses for reporting stock option income (above), the FTB released Chief Counsel Ruling 2013-02 (in February 2014) regarding the proper method of determining the portion of California source income received by an employee who was granted RSUs as a California resident but did not recognize income on them until he became a nonresident.

Apportion using stock option formula. According to Chief Counsel, taxpayers must use a reasonable apportionment method to determine the portion of California source income received. The most reasonable apportionment method to determine the portion of California source income received is to multiply the compensation received by a ratio of California working days from the grant date to the vest date over the total working days anywhere during the same period.

INCOME FROM TAX-EXEMPT MUTUAL FUNDS

Article XIII of the California constitution states "interest on bonds issued by the State or local government in the State is exempt from taxes on income." R&TC §17145 provides that an RIC (regulated investment company) is qualified to pay exempt interest dividends if, at the close of each quarter of its taxable year, at least 50 percent of the value of its total assets consists of obligations which, when held by an individual, the interest therefrom would be exempt from taxation.

Ronald D. and Pamela S. Mass bought shares in a company that invests in government bonds. They received dividends derived from interest on those bonds. Because RIC received 12.41% of its interest income from its holdings in California municipal bonds, the FTB assessed tax on the dividends. The Masses contend that their dividends were unconstitutionally taxed.

But the Second Court of Appeal in California disagreed on the constitutionality issue. Citing that the R&TC taxes dividends from RICs that might be derived from municipal bond income is different than actually taxing the bond income itself, the Court did not find R&TC §17145 in violation of the state's constitution (***Mass v. FTB,*** CA Court of Appeal, 2nd Dist., No. B286857, August 2019).

LIKE-KIND EXCHANGE INFORMATION REPORTING

Under federal and state law, an exchange of property, like a sale, generally is a taxable event. However, no gain or loss is recognized if property held for productive use in a trade or business or for investment is exchanged for property of a like-kind that is to be held for productive use in a trade or business or for investment; such an exchange is referred to as a "like-kind exchange."

Generally, no gain or loss is recognized at the time of the exchange. The amount of unrecognized gain or loss is deferred and will generally be recognized upon the sale of the property acquired in the exchange, unless a taxpayer subsequently exchanges property acquired in an exchange for another property of like-kind. However, if as part of the exchange a taxpayer also receives other (not like-kind) property or money, gain is recognized to the extent of the other property and money received but a loss is not recognized.

The federal rules for like-kind exchanges are under IRC §1031, and California generally conforms under R&TC §§18031 and 24941. Taxpayers are allowed to exchange California property for out-of-state property as long as the exchange meets the federal like-kind exchange requirements. A gain or loss from the exchange of real or tangible personal property located in California is sourced to California at the time the gain or loss is realized, regardless of whether or not the taxpayer that realized the gain is residing in or doing business in California at the time that the gain is recognized.

> **Example.** If Karen is a California resident and exchanges real property located in California for real property located outside of California, the deferred gain or loss is California source income. Even if Karen moves to another state and resides there for several years before the gain or loss is recognized, she is required to report to California the deferred California-sourced gain or loss in the year the gain or loss is recognized and pay any California tax attributable to the recognition of that gain or loss.

This creates an unusual record keeping burden on taxpayers, as tax records may not generally be retained beyond the normal four-year statute of limitations, and individuals may not have had a California filing requirements for several years. Thus, it is not uncommon for such individuals to neglect to file a California return and report that California-sourced gain or loss in the year it is recognized. Additionally, it is challenging for the FTB to track deferred gains or losses of individuals who have been nonresidents for several years and have not been required to file California income tax returns.

Legislation Requires Annual Reporting Starting in 2014

Effective for exchanges beginning on or after Jan. 1, 2014, **AB 92** (Budget, Stats. 2013 Ch. 26) provides an annual information reporting requirement for taxpayers that claim nonrecognition of gain or loss for a like-kind exchange when property in California is exchanged for property located outside of California. For such an exchange, taxpayers would be required to file an information return in the taxable year of the exchange and in each subsequent taxable year in which the gain or loss attributable to the exchange has not been recognized.

For taxpayers that fail to comply with that reporting requirement and fail to file a return to properly report the recognition of the gain or loss attributable to the exchange, the FTB could make an estimate of the net income from the exchange using any available information, including the amount of deferred gain or loss reported in the year of the exchange, and may propose to assess the amount of tax, interest, and penalties due in the same manner as assessments that are proposed for the failure to file a return.

Taxpayers Use FTB Form 3840

Form 3840 provides information about the relinquished California properties and the non-California replacement properties in the like-kind exchange. Form FTB 3840 must be filed in the year in which the like-kind exchange is completed and each subsequent year that the gain or loss is deferred, regardless of whether the seller/exchanger has any other California filing requirement.

Who Must File
All taxpayers who complete a like-kind exchange of California property for non-California property are required to file Form FTB 3840. The mandatory filing requirement applies to all individuals, estates, trusts, and all business entities regardless of their residency status or commercial domicile.

Where to File
As an Attachment: Taxpayers attach Form FTB 3840(s) to their California return and submit it to the normal mailing address (or e-file) with the particular California tax return being filed.

As an Information Return: Taxpayers filing Form FTB 3840 separately from the California tax return and as an information return will mail the form to:

FRANCHISE TAX BOARD
PO BOX 1998
RANCHO CORDOVA, CA 95471-1998

When to File
As an Attachment: Taxpayers with a California filing requirement must attach Form FTB 3840 to their California tax return and file by the return's due date (plus extensions).

As an Information Return: Taxpayers without a California filing requirement must file Form FTB 3840 by the return due date (plus extensions) as if the taxpayer had a California filing requirement.

Failure to File
For taxpayers required to file Form FTB 3840(s) who fail to file as required, the FTB may issue an NPA to adjust their income for the previously deferred gains plus any applicable penalties and interest.

> ***Preparer's Note!*** California conforms to IRC §1031 as of Jan. 1, 2015. Therefore, the state does not conform to the restriction that only real property qualifies for tax-deferred exchange. See the discussion in ***CA Chapter 2 - Conformity and Nonconformity*** for more information.

FTB Issues Letters for Form 3840

The FTB mailed an initial letter to over 3,000 taxpayers who either failed to file or filed an incomplete FTB 3840 for 2016. Approximately 47% responded by filing or correcting FTB 3840.

In early August, FTB sent about 1,700 follow-up letters to those taxpayers who did not respond, requesting FTB 3840 be filed or corrected within 30 days. It will be sending a third letter in the form of a Demand for Information to taxpayers who failed to respond.

The plan is to make up to three attempts to contact taxpayers to give them an opportunity to file or correct their FTB 3840. Failure to respond to the third letter by submitting a FTB 3840 or continuing to file incomplete forms may result in the FTB opening an audit to confirm the accuracy of the deferred gain(s).

If the taxpayer fails to respond to an audit request and the FTB has reason to believe the taxpayer no longer owns the property, it may issue a Notice of Proposed Assessment (NPA) including the gain in the year the FTB believes the property was sold.

INCOME FROM WORLDWIDE SOURCES FOR NONRESIDENTS

A common question nonresidents ask is "Why do I have to report my worldwide income if California can only tax California sourced income?" For tax years beginning on or after Jan. 1, 2002, the first step in calculating a nonresident or part-year resident's California tax is to calculate the taxpayer's effective tax rate as if the taxpayer were a California resident. If the taxpayer fails to report this income, a statutory adjustment will be made to the 540NR return.

These adjustments are usually made based upon information received from the IRS regarding the adjusted gross income reported on the 1040.

Why does California calculate the tax this way? Both the IRS and California assess tax based on tax brackets, which are the divisions at which tax rates change in a progressive tax system. Progressive tax systems attempt to reduce the "tax incidence" of people with a lower "ability-to-pay," as they shift the incidence increasingly to those with a higher ability-to-pay. California law requires the FTB to compute California tax at the effective tax rate that would be equal to the effective tax rate of a resident with the same level of income.

The effective tax rate, based on worldwide income, is then applied only to the California taxable income of the nonresident to determine the tax amount owed to California.

Failure to include worldwide income results in a statutory adjustment to a 540NR return. These adjustments are usually made after FTB receives information from the IRS on the adjusted gross income reported on the 1040.

GROUP NONRESIDENT RETURNS

On an individual return, a nonresident must report all income from all sources in addition to the California source income. On the group nonresident return, only the California source pass-through income or director's compensation is reported.

A full-year nonresident who meets other requirements can be included in the group nonresident return.

In filing a group nonresident return, a business entity acts as the authorized agent and may also choose to file a group nonresident return for certain nonresidents. To participate, nonresidents must receive distributive shares of income from business entities that derive income from California sources or from those who are doing business in California. The business entity pays the tax on behalf of the nonresident individuals who elect to file a group return. A group nonresident return is considered a group of individual returns that meets the California individual income tax return filing requirement. Thus, a qualified nonresident individual who elects to be included in the group nonresident return is not required to file a separate income tax return for the tax year.

The upside to the group return is that worldwide income does not need to be reported individually; however, the income reported on the group nonresident return is taxed at the highest marginal rate of 12.3%.

Does Your Taxpayer Really Want to Be Included in a Group Nonresident Return?

Lately, it seems business entities are often quick to file the group nonresident tax return on behalf of its nonresident individual shareholders/partners/members without full consideration of their specific facts and circumstances.

Election to Be Included in the Group Nonresident Tax Return is Irrevocable. If your clients are considering this option, remember this is an irrevocable election. This is an annual election in which the electing individual is authorizing the business entity to report the individual's California sourced income and pay the tax on behalf of the electing nonresident individual. Once the group nonresident tax return is filed, it cannot be amended to either include or exclude a nonresident individual.

Not all shareholders/partners/members can be included in the group nonresident tax return. To be included in the group nonresident return, all of the following requirements must be met:

1. Only individuals can be included on the group tax return.
2. The individual must be a full-year nonresident of California.
3. The income from the business entity/corporation must be the only California source income of the individual, other than California source income that is being reported on another group nonresident return.

Claiming other sources of California losses will not disqualify the individual from being included in a group nonresident tax return.

> **Example.** Karen, a nonresident individual, has California source income from the Kreider/Brosi partnership and is a partner in Hoven/Brosi partnership with a net loss. Karen does not have income from any other California source. Karen can elect to be included in the group nonresident tax return of Kreider/Brosi partnership. If Hoven/Brosi partnership had income, Karen can elect to be included in the group nonresident return of both partnerships. Karen cannot elect to be included in the group nonresident return of only one of the partnerships.

> **Example.** Sharon, a nonresident individual, has California source income from a business entity and from an individually owned California rental property. Sharon cannot be included in the group return of the business entity because the income from the business entity is not Sharon's only California source income, and that additional California source income is not going to be reported on another nonresident group tax return.

Tiered partnerships (and other tiered ownership structures) are not allowed to file a group tax return to combine all of their business entities and individual nonresident partners on one group tax return. Each partnership must file a separate group nonresident tax return for their electing individual nonresident partners and cannot include any business entities in the group nonresident tax return.

OTHER STATE TAX CREDIT (OSTC)

Taxpayers may qualify for a credit for income taxes paid to another state when the same income that is taxed by the other state is also taxed by California. Effective for all open taxable years, other state income taxes which are paid to the other state do not necessarily have to be in the same year, as long as the taxes relate to the same transaction.

In order for a California resident to claim another state tax credit (OSTC), the income subject to double taxation must be sourced to the other state pursuant to California sourcing rules. In order for a California nonresident to claim an OSTC, the income subject to double taxation must be sourced to California pursuant to California sourcing rules.

OSTC for a California Resident

An OSTC is available for net income taxes imposed by and paid to another state on income that is also taxed by California, where that income is derived from sources within the other taxing state. No credit is allowed if the other state allows California residents a credit for net income taxes paid to California.

States that allow California residents a credit for net income taxes paid to California:

- Arizona
- Oregon
- Virginia (dual residents)

Indiana No Longer a Reverse Credit State for California

Effective Jan. 1, 2017, California and Indiana dropped the agreement wherein a California resident with Indiana source income would take a credit on the nonresident Indiana return for taxes paid to California.

OSTC for a California Nonresident

An OSTC is allowed for net income taxes imposed by and paid to the taxpayer's state of residence on income that is also taxed by California, if the state of residence either:

1. does not tax the income of California residents derived from sources within that state; or
2. allows California residents an OSTC.

However, an OSTC is not allowed for taxes paid to a state which allows its residents an OSTC for net tax paid to California irrespective of whether its residents are allowed a California OSTC.

OSTC and Group Nonresident Returns

California residents included in other state composite (group) returns may claim a credit for their share of income taxes paid to the other state, as long as the state does not allow a credit for taxes paid to California for the group. Although the credit is not normally allowed for taxes paid to Arizona, Indiana, Oregon, and Virginia, the credit will be allowed for a California resident that is included in a group return filed in one of these states, unless any of these states allow a credit for taxes paid to California for the group. According to Schedule S instructions, the taxpayer must attach a composite schedule or statement explaining that he/she is included in a group return.

As a result of new validation rules, the FTB has begun adjusting or disallowing the OSTC because of incomplete or missing information on the Schedule S. Below are tips to avoid requests for additional information or an adjustment to a return during processing when claiming OSTC:

- Fill out each Schedule S completely and attach all applicable Schedule S forms.
- Do not lump all of the income or credits under "Various," "See attached," or under a particular state.

- For California residents belonging to a group, attach a composite schedule or statement that the taxpayer is in a group. Attach all applicable Schedule S forms.

Providing all complete Schedule S forms and a composite schedule or statement (if it applies) with the return will:

- Speed up the processing of the return.
- Avoid delay in any applicable refund.
- Avoid receiving a Notice of Tax Return Change.

The FTB reiterated this treatment of the OSTC for California taxpayers' share of income taxes paid to a reverse credit state in Technical Advice Memorandum 2017-01 and Technical Advice Memorandum 2017-04.

OSTC Not Allowed Simply Because Other Nonresident State Taxes Income

Residents of California may claim the OSTC only if the income taxed by the other state has a source within the other state under California law (R&TC §18001(c)). That means that in certain circumstances, a California resident who pays tax to another state may be required to pay tax to both California and the other state.

> ***Example.*** Ben is a California resident who sold property in Hawaii on an installment plan. During 2011, Ben received $10,000 in interest payments and $5,000 in taxable principal payments. Ben has no other interest in Hawaii property or business. Ben must file a Hawaii return and pay tax on $15,000 (both the principal and interest payments). Ben must report both the principal and interest payments to California because residents are taxable on income from all sources.
>
> Ben will get a credit for the tax paid on the $5,000 principal payments, but he will not get a credit for the tax he pays Hawaii on the $10,000 interest payments because under California law the interest payments are not sourced to Hawaii under Cal. Code Reg. §17952.

TAXATION OF TRUSTS WITH OUT-OF-STATE TRUSTEES

A trust is a taxable entity separate and apart from its beneficiaries. In order for California to tax the income of a trust, one or more of three separate elements must be present:

1. the trust must have income from California sources;
2. a trustee of the trust must be a resident of California; or
3. a non-contingent beneficiary of the trust must be a resident of California.

Under both federal and California law, non-grantor trusts are taxable at the trust level on accumulated income. In general, trusts receive a deduction for amounts of income distributed to beneficiaries in the taxable year and, accordingly, the tax paid by a trust will be a tax on income that is accumulated by the trust.

All of a trust's California source income is taxable by California, regardless of where the trust is managed or where the beneficiaries reside. The remaining income of a trust (i.e., the non-California source income) will be taxable by California based on a residency theory if the trust has a California resident fiduciary or

California resident non-contingent beneficiary. Essentially, if either all of the fiduciaries or all of the non-contingent beneficiaries of a trust are California residents, the trust's income will be wholly taxable by California. Where there are multiple fiduciaries or non-contingent beneficiaries with varying residencies, California taxes the trust income based on the proportion of its California resident and non-resident fiduciaries and California resident and non-resident, non-contingent beneficiaries.

In summary, a trust is taxable first on all of its California source income and is next taxed on a portion of its non-California source income that reflects the proportion of California-resident fiduciaries and non-contingent beneficiaries, and non-resident fiduciaries and non-contingent beneficiaries.

> **Example.** The Brosi Family Trust has at least one trustee that is a resident of California. Assuming the trust had no California source income and no California resident non-contingent beneficiaries, the trust would still be taxable on the portion of its non-California source income that reflects the proportion of California resident trustees (of which there is at least one) and non-resident trustees.

What Impact from the *Kaestner* Supreme Court Decision?

While it is still a "wait and see" environment, and we may see future litigation in California following the ***Kaestner*** decision, most do not believe there will be much impact. Reasons given include that the Supreme Court was carefully very limited in its decision against North Carolina, and that the California statute is based upon non-contingent beneficiaries.

DOMESTIC/FOREIGN BUSINESSES UNDER THE CORPORATE INCOME TAX

WHEN DOES AN OUT-OF-STATE CALIFORNIA BUSINESS NEED TO FILE A CALIFORNIA INCOME TAX RETURN?

Sole proprietors and business entities, not based in California, still may be subject to California taxation if they are doing business in California or have income from California sources.

California R&TC §23101 defines "doing business" as actively engaging in any transaction for the purpose of financial or pecuniary gain or profit. Unfortunately, this is often a facts and circumstance test. While we are able to discuss the facts and circumstances to consider in determining if an entity is doing business in California, taxpayers must ultimately decide if they are doing business in California.

R&TC §23101(b) does provide some "bright-line tests" for out-of-state business entities based on sales, property, and compensation. For tax years beginning on or after Jan. 1, 2011, an out-of-state business entity that is not doing business under R&TC §23101(a) may be considered doing business in California under R&TC §23101(b) if it has sales, property, or payroll compensation in California in excess of "bright-line" threshold amounts. Sales, property, and compensation of the taxpayer include the taxpayer's pro rata or distributive share from pass-through entities.

2019 Bright-Line Test Thresholds

For taxable year 2019, the relevant amounts for sales, property, and payroll that constitute "doing business" are $601,967, $60,197, and $60,197, respectively.

Public Law 86-272 and "Doing Business"

Public Law 86-272 (15 USC §381) prevents the state from asserting its right to impose a tax based on net income, such as the corporate income tax or franchise tax. Public Law 86-272 protection is available to out-of-state business entities that sell tangible personal property in this state and whose in-state activities are limited to the solicitation of orders for their goods. As a result, if a taxpayer is protected by Public Law 86-272, it will not be required to pay the franchise tax or the corporate income tax, as both are measured by net income.

However, even if protected by Public Law 86-272, an out-of-state entity is still obligated to file a tax return and pay taxes that are not measured upon net income, such as the minimum franchise tax, annual LLC tax, and the LLC fee, unless certain exceptions apply.

For further details in regards to what activities are protected by Public Law 86-272, see FTB 1050, Application and Interpretation of Public Law 86-272.

> **Example.** Tax, Inc., an out-of-state corporation that does not file a combined return, sells tangible goods over the Internet and qualifies for protection under Public Law 86-272. For the 2018 taxable year, Tax, Inc. has $1,000,000 of California sales but no property or payroll in California. Tax, Inc., though considered doing business in California because it has $1,000,000 in California sales, will not be subject to California's franchise tax as it is protected under Public Law 86-272. However, Tax, Inc. must still file a California return and pay the minimum franchise tax of $800.

> **Example.** Brosi, LLC, an out-of-state LLC, engaged in activities that are protected under Public Law 86-272 and is considered to be doing business in California for the tax year 2018. Brosi, LLC's total income from sources derived from or attributable to the state of California was $300,000. Therefore, Brosi, LLC must file a California tax return, pay the annual LLC tax of $800, and pay the LLC fee of $900. Public Law 86-272 does not protect qualified out-of-state business entities from the annual LLC tax or the LLC fee.

What Constitutes a Valid Filing?

What constitutes a valid "filing" if the business entity is filing solely for purposes of reporting the minimum/annual tax? In most cases this is a business entity that is relying on a federal provision, Public Law (PL) 86-272, that preempts states including California from taxing entities. Other times this question comes from a nonregistered foreign corporation, LLC, or limited partnership that owns an interest in another pass-through entity doing business in California.

Preparers often ask, "How can a taxpayer designate the return filing as only 'minimum tax' due and 'PL 86-272 protected' without it being considered an incomplete return for processing and/or filing enforcement purposes?" Or maybe the question is, "If a taxpayer meets the requirements of doing business under California R&TC §23101 but is protected by PL 86-272, what is the minimum amount of information required to be reported on the tax return for purposes of reporting and remitting $800 minimum tax due?"

A business entity is required to file the appropriate form (California Form 100, 568, or 565) if it is doing business within California and pay the appropriate tax and fee. Each business entity is required to fill out the necessary form including all pertinent schedules and tax forms as instructed.

Partnerships, LLCs, and S corporations are also required to fill out a California Schedule K-1 for each partner/member/shareholder. For purposes of reporting the information from Column (e) of the California Schedule K-1, the entity must complete Schedule R, to determine the entity's income from California sources.

If the activities of the business entity are protected under PL 86-272, taxpayers should provide that information on Schedule R. It is best to attach a statement explaining why the apportioning percentage and the business income are zero.

"DOING BUSINESS" CASES AND RULINGS

FTB Loses *Swart* Appeal

In January 2017, the FTB lost its appeal in ***Swart Enterprises, Inc. v. Franchise Tax Board***. The California Appellate Court ruled that holding a 0.2% interest in a California LLC did not constitute doing business in the state.

California's franchise tax is imposed on every corporation that is "doing business" within California, whether or not it is incorporated, organized, qualified, or registered under California law (R&TC §23151(a)). The phrase "doing business," for purposes of the franchise tax, means "actively engaging in any transaction for the purpose of financial or pecuniary gain or profit."

The issue was whether the franchise tax applies to an out-of-state corporation whose sole connection with California is a 0.2% ownership interest in a manager-managed California LLC investment fund. The court concluded passively holding a 0.2% ownership interest, with no right of control over the business affairs of the LLC, does not constitute "doing business" in California within the meaning of §23101. The FTB will not appeal to the California Supreme Court.

New! FTB Issues Legal Ruling Following *Swart* Decision

In July 2014,the FTB issued Legal Ruling 2014-01 to clarify its position on when a member of a multiple-member LLC was considered to be doing business in the state. Specifically, the FTB took a very broad approach to any business entity with a membership interest in a multiple-member LLC that is classified as a partnership for tax purposes, subjecting those entities to both the LLC annual tax and annual fee on California sales derived from the LLC.

In light of the ***Swart*** decision, the FTB released Legal Ruling 2018-01, modifying specific positions in the 2014 ruling. However, the FTB claims only a "narrow exception" may apply in limited circumstances. It implies that if the business entity holds larger than a 0.2% interest (as Swart held), then the exception may not apply.

Preparer's Note. How small an interest is small enough? Less than 1%?

OTA Expands Meaning of "Minority Interest"

Although FTB has stated that following the ***Swart*** decision it would only consider a 0.2% or smaller interest in determining an entity holding interest in a California business was not doing business in the state, the Office of Tax Appeal broadened that position.

Jali, LLC is a Washington state LLC never registered to do business in California. For 2012 through 2016, Jali invested in and held as much as a 4.75% interest and as low as a 1.12% interest in Bullseye Capital Real Property Opportunity Fund, LLC. Bullseye was registered with the California Secretary of State and doing business in California for all years. The FTB claimed that because Jali's interest in Bullseye was greater than the ***Swart*** percentage, Jali was doing business in California.

The OTA determined that the FTB has misconstrued the ***Swart*** decision and there is no bright line test of ownership to be used. Instead, the OTA found that under its operating agreement: (1) Bullseye is a manager-managed LLC, (2) it is managed by an elected director(s), not Jali, (3) Jali is not personally liable for any debt, obligation, or liability of Bullseye, (4) Jali has no power to participate in Bullseye's management, or bind or act on behalf of it in any way, and (5) Jali has no interest in any specific property of Bullseye. These factors led the OTA to determine Jali's interest was a minority interest and did not constitute doing business in California (***Appeal of Jali, LLC***, OTA No. 18073414, July 2019).

50% Interest in California LLC With No Operating Agreement Means Doing Business

Russell Wright is the sole member of Wright Capital Holdings, LLC, a Georgia LLC. For 2013, Wright Capital held a 50% interest in Collegiate Consulting, LLC, a multi-member LLC registered in California and doing business in California.

For 2013, Collegiate issued a K-1 to Wright with California income, but Wright did not file a tax return with the state. Absent an operating agreement, Wright failed to show it was not a managing member of Collegiate, and the OTA found that while a 50% interest is not a controlling interest, it was sufficient to give Wright significant authority over Collegiate's activities. Because Collegiate was doing business in the state, Wright was doing business in California (***Appeal of Wright Capital Holdings LLC***, OTA No. 18010842, August 2019).

APPORTIONMENT

California R&TC §25121 mandates that any taxpayer having income from business activity which is taxable both within and without this state shall allocate and apportion its net income.

Single Sales Factor Apportionment Formula Applies Beginning in 2013

Statewide Proposition 39, passed by voters in November 2012, in part enacts a single sales factor method of determining California taxable income for businesses. Starting in 2013, multistate businesses no longer are allowed to choose the method for determining their state taxable income that is most advantageous for them. Instead, most multistate businesses have to determine their California taxable income using the single sales factor method. Businesses that operate only in California are unaffected by this measure.

Proposition 39 also included rules regarding how all multistate businesses calculate the portion of some sales that are allocated to California for state tax purposes. These include a set of specific rules for certain large cable companies.

History of California's Apportionment

In 1966, California adopted the Uniform Division of Income for Tax Purposes Act (UDITPA), with certain modifications, to determine how much of an apportioning taxpayer's total income, which is earned from activities both inside and outside of California, is attributed to California and subject to California tax. UDITPA uses an apportionment formula to determine the amount of "business" income attributable to California.

The original apportionment formula. The UDITPA apportionment formula consists of property, payroll, and sales factors. Each of these factors is a fraction, the numerator of which is the value of the item in California and the denominator of which is the value of the item everywhere. The property factor includes tangible property owned or rented during the taxable year, the payroll factor includes all forms of compensation paid to employees, and the sales factor generally includes all gross receipts from the sale of tangible and intangible property.

The "double-weighted" sales formula. Prior to 1993, California subscribed to the UDITPA formula, which ascribed equal weight to three factors: property, payroll, and sales (former §25128, as added by Stats. 1966, ch. 2, §7, p. 179). Then, in 1993, the Legislature amended §25128 to give double weight to the sales factor for most business activity, specifying that "notwithstanding §38006, all business income shall be apportioned to this state by multiplying the business income by a fraction, the numerator of which is the property factor plus the payroll factor plus *twice the sales factor*, and the denominator of which is four …" (Former §25128(a), italics added, as amended by Stats. 1993, ch. 946, §1, p. 5441).

The calculation of this apportionment formula and California business income is illustrated below.

$$\frac{\dfrac{\text{Average CA Property}}{\text{Average Total Property Everywhere}} + \dfrac{\text{CA Payroll}}{\text{Total Payroll Everywhere}} + 2 \times \dfrac{\text{CA Sales}}{\text{Total Sales Everywhere}}}{4} = \text{CA Apportionment Percentage}$$

$$\text{CA Apportionment Percentage} \times \text{Total Business Income} = \text{CA Business Income}$$

Exception for certain "qualified business activity." An exception to this rule exists for taxpayers of an apportioning trade or business that derive more than 50% of its gross business receipts from conducting a "qualified business activity." These taxpayers are required to use a three-factor, single-weighted sales, apportionment formula. For this purpose, a qualified business activity is defined as an agricultural, extractive, savings and loan, and banking or financial business activity. In addition, current law requires that once a determination has been made that the apportioning trade or business is involved in a qualified business activity, all members of the apportioning trade or business use the same weighting, regardless of whether the particular entity was involved in a qualified business activity.

State law permits a departure from the standard apportionment provisions only in limited and specific cases and recognizes that the standard apportionment provisions are not appropriate when applied to certain industries and types of transactions, in which case special apportionment provisions exist for those situations.

Election to use a sales only formula. Effective for tax years beginning on or after Jan. 1, 2011, through Dec. 31, 2012, R&TC §25128.5 allowed an apportioning trade or business to make an annual, irrevocable election to utilize a single factor, 100% sales (single sales factor) apportionment formula instead of the three-factor, double-weighted sales apportionment formula described above. Qualified business activities (described above) would be specifically prohibited from electing a single sales factor apportionment formula.

The election had to be on a timely filed original return in the manner and form prescribed by the FTB.

Applying the Single Sales Factor Apportionment Method to Services and Intangibles

For taxable years beginning on or after Jan. 1, 2013, all apportioning trades or businesses must assign sales of other than tangible personal property under the new market-based rules.

This affects the way services and intangibles are assigned for sales factor purposes. You no longer look to where the service is performed but rather you need to source the receipts the taxpayer received from services to the location where the customer received the benefit of the service. This will generally be the location of the taxpayer's market for the sales.

Intangibles are no longer assigned to California where the greater cost of performance occurred; instead, you need to assign receipts from sales of intangibles to California to the extent the property was used in California.

Where Did the Customer Receive the Benefit?

R&TC §25136 (which is the provision for determining if sales of other than tangible property are sourced to California) now states (formerly R&TC §25136(b)):

1. Sales from services are in this state to the extent the purchaser of the service received the benefit of the services in this state.
2. Sales from intangible property are in this state to the extent the property is used in this state. In the case of marketable securities, sales are in this state if the customer is in this state.
3. Sales from the sale, lease, rental, or licensing of real property are in this state if the real property is located in this state.
4. Sales from the rental, lease, or licensing of tangible personal property are in this state if the property is located in this state.

Regulation §25136-2 was adopted for taxable years beginning on or after Jan. 1, 2011, to provide guidance on how to assign sales using the new market-based rules (described under former R&TC §25136, subdivision (b)).

Taxpayers who are required to follow special industry apportionment and allocation regulations (special industry taxpayers) under Regulation §25137 will follow the 25137 sales factor provisions incorporating the new 25136 rules and incorporating the exclusions in Regulation §25136-2(g)(3). Special industry taxpayers will not use the property and payroll factor rules, unless the trade or business is within one of the exceptions of R&TC §25128(b) described above.

You should also be aware that law changes that affect income sourced within California can also affect the taxation of estates and trusts (Regulation §17742).

California Isn't the Only State Applying Market-Based Sourcing

As of October 2019, there are 31 states and the District of Columbia that use market-based sourcing for sales of other than tangible property. These are:

Market-Based Sourcing States

Alabama	Minnesota
Arizona	Missouri
California	Montana
Colorado	Nebraska
Connecticut	Nevada
District of Columbia	New Jersey
Georgia	New York
Illinois	Ohio
Indiana	Oklahoma
Iowa	Oregon
Kentucky	Pennsylvania
Louisiana	Rhode Island
Maine	Tennessee
Maryland	Utah
Massachusetts	Washington
Michigan	Wisconsin

> **Tax preparer note**. States using market-based sourcing have adopted their own regulations. Be sure to check the specific rules for your apportioning state(s).

Apportionment Isn't Just for Corporations

California Regulations §§17951 through 17954 require businesses to source business income in accordance with the provisions of the corporate apportionment rules (§§25120 to 25139). These regulations also requires a partner's distributive share of partnership income derived from sources within California (with some modifications) be determined using corporate apportionment rules.

This means "an apportioning trade or business" regardless of the form of ownership (e.g., sole proprietorship, partnership, LLC, or corporation), that carries on within and out of California under Regulations §§17951 through 17954, or the provisions of §25128.7[2] is required to apportion the nonresident's business income using the single sales factor.

The same would be true for a partner's distributive share. Whether the trade or business is the partnership's business (if not unitary with the trade or business of its partner), or the partnership interest when combined with the partner's trade or business (if the partnership's activities are unitary with the activities of its partner, notwithstanding ownership requirements), the business income of the trade or business would be apportioned using the single sales factor under the provisions of §25128.7 unless the trade or business meets one of the exceptions of §25128(b).

APPORTIONMENT CASES AND RULINGS

Income from Corporation's SMLLCs Included in Apportionment Formula

Bunzl Distribution USA, Inc. is a multinational entity comprised of numerous subsidiary corporations and limited liability companies. For the year in question, Bunzl owned six separate single-member LLCs (SMLLCs) doing business in California.

None of the six SMLLCs elected to be taxed as a corporation; therefore, the income from each was properly included in Bunzl's income. As such, Bunzl was required to include the SMLLC's income in the numerator of its apportionment formula (***Appeal of Bunzl Distribution USA, Inc. v. FTB***, CA Court of Appeals, First District, No. A137887, Sep. 28, 2018).

Amended Rules on Market-Sourcing for Intangible Property Finalized

Amendments to the California Code of Regulations §25136-2 have been approved by the Office of Administrative Law and have been sent to the Secretary of State (SOS) for finalization. These amendments are effective on Jan. 1, 2017, and will be operative for most taxpayers for tax years beginning on or after Jan. 1, 2015.

The new amendments provide:

- The definition of and assignment rules for "marketable securities,"
- Assignment rules for dividends and goodwill, and
- Assignment rules for interest.

For tax year 2015, the new amendments may require some taxpayers to file an original return if he/she was not aware previously they had a filing requirement.

A taxpayer might have to amend a return when he/she did not properly assign the sale under the new assignment rules. For example, a taxpayer may have mistakenly assigned investment interest to the location of the customer, rather than the location where the investment is managed, as is required by the new rules.

Another example of when a taxpayer might need to file an amended return is when a taxpayer discovers he/she has California sales in the form of marketable securities. When the taxpayer is in the form of a partnership or LLC, the filing of the amended return will also require its partners and members to amend their returns.

***New!* Late Payment Penalty Relief**

R&TC §19132 provides the FTB is required to impose a penalty for late payment of tax when a taxpayer fails to pay the amount shown as tax on the return on or before the due date of the return, unless the taxpayer establishes the late payment was due to reasonable cause and not willful neglect.

Because the new regulatory amendments above apply to taxable years beginning on or after Jan. 1, 2015, but became final on Sep. 15, 2016, the FTB will presume reasonable cause and not willful neglect in the case of a late payment attributable to the new amendments and waive the associated penalty. Relief under Notice 2017-02 is limited to late payment penalties imposed with respect to tax liabilities shown on timely filed returns for taxable years beginning on or after Jan. 1, 2015, and before Jan. 1, 2016. The FTB will consider both prepayment requests for relief, as well as claims for refund of amounts paid in satisfaction of the penalty.

The FTB will not grant similar relief of delinquent filing penalties. The FTB will not presume reasonable cause with respect to the new amendments for tax returns filed after the due date (including any extensions). A taxpayer's remedy in the case of a delinquent return would be to submit a claim for refund of amounts paid to satisfy a delinquent filing penalty. The FTB will consider such claims in the normal course, on a case-by-case basis, to determine whether a taxpayer has established the requisite reasonable cause and lack of willful neglect for the delinquent filing.

FTB Web Page for Single-Sales Factor

The FTB continues to update its web page dedicated to assignment of sales under the Single-Sales Factor apportionment method. The new Single-Sales Factor and Assignment of Sales (Sales Factor) site includes information on the following:

- Who do the new laws affect?
- Who has a filing requirement in California?
- How is California income computed for taxpayers who do business inside and outside California?
- Who must use the single-sales factor to apportion business income to California?
- What are the rules for assigning sales to California?
- What is market assignment?

The site contains many examples and calculations for the proper use of the single-sales factor.

LIMITED LIABILITY COMPANIES

FOREIGN (OUT OF STATE) LLCs

R&TC §17941 requires LLCs "doing business" in the state, as defined by §23101, to pay the annual tax. If the member of an LLC is "doing business" in California, the LLC is "doing business" in California and subject to the annual tax. Likewise, if the LLC registers with the California SOS, it must file and pay the $800 annual tax.

So what is "doing business?" R&TC §23101 defines "doing business" as actively engaging in any transaction for the purpose of financial or pecuniary gain or profit. This is a facts and circumstances test.

The California residence of the sole member of a single member LLC, without more, does not mean that the LLC is “doing business” in California. But if that sole member, in his or her capacity as member of that LLC, has actively engaged in any transaction in California for the purpose of financial or pecuniary gain or profit, the LLC is “doing business” in California.

What about Out-of-State Rental Property Owned by a Single Member California Resident?

If the property is ever rented or even advertised for rent, then the basis for “doing business” may exist — depending on whether the member actively engaged in a rent-related activity in California. But expenses associated with mere ownership of property, such as paying taxes, do not usually rise to the level of “doing business.”

Leave the State to Conduct Business?

The managing member of Village View, LLC was a resident of California. The LLC was organized in Oregon, and its sole activity during the year in question consisted of the ownership and operation of an apartment building in Oregon. The LLC employed a property manager in Oregon.

The FTB declared and the OTA agreed that Village View was doing business in California because it was commercially domiciled in the state, in that the principal place from which the trade or business was directed or managed was the location of the managing member — a California resident (***Appeal of Village View, LLC***, OTA No. 18011300, Feb. 8, 2019).

See Also:
Appeal of Legend Plus Enterprises, LLC, SBE (2011) Case No. 486026.

CALIFORNIA LLCs

Who Can Be a California LLC?

Current state law allows domestic or foreign LLCs to engage in any lawful business except banking, insurance, or trust company business. Domestic and foreign LLCs also are not permitted to render any professional services unless expressly authorized by law.

“Professional services” is defined in the Moscone-Knox Professional Corporation Act (Corporation Act) as any type of professional services that may be lawfully rendered only pursuant to a license, certification, or registration authorized by the Business and Professions Code, the Chiropractic Act, or the Osteopathic Act. “Professional services” also means any type of professional services that may be lawfully rendered only pursuant to a license, certification, or registration authorized by the Yacht and Ship Brokers Act.

Until 2004, the SOS did not accept LLC applications from all businesses licensed under the Business and Professions Code. In 2004, SOS requested an Attorney General (AG) opinion asking if “a business that provides services requiring a license, certification, or registration pursuant to the Business and Professions Code [could] conduct its activities as [an LLC].” AG Opinion 04-103 concluded that a business could “conduct its activities as an LLC if the services rendered require only a nonprofessional, occupational license.” In its opinion, the AG declined to determine if each licensed activity specified in the Business and Professions Code was a professional or a nonprofessional occupational activity. As a result of the AG's opinion, the SOS does not deny any application on the basis that the business is licensed under the Business and Professions Code.

Contractors. SB 392 (Florez, Stats. 2010, Ch. 698) authorized the Contractor State License Board to issue a contractor's license to an LLC under the Business and Professions Code.

The act modified §17002 of the Corporations Code to allow an LLC to render services that may be lawfully rendered only pursuant to a license, certificate, or registration authorized by the Business and Professions Code if the applicable provisions of the Business and Professions Code authorize an LLC to hold that license, certificate, or registration.

This act was effective on Jan. 1, 2011, and specifically required the Contractors' State License Board (CSLB) to begin processing applications for licensure for LLCs no later than Jan. 1, 2012.

Engineers and Land Surveyors. SB 1008 (Padilla, Stats. 2010, Ch. 634) adds LLPs to the list of approved organizations that can be formed by civil, electrical, or mechanical engineers and land surveyors. It allows engineers and land surveyors to organize and operate as LLPs effective Jan. 1, 2011. **SB 284** (Cannella, Stats. 2015, Ch. 157) extends these provisions until Jan. 1, 2019.

Under the terms of the bill, however, the authority to allow engineers and land surveyors to create a new LLP or operate as an LLP would be repealed as of Jan. 1, 2019. But the bill does not include provisions that cancel any LLPs that were created or registered by civil, electrical, or mechanical engineers or land surveyors between Jan. 1, 2011, and Jan. 1, 2019. As a result, LLPs created or registered by civil, electrical, or mechanical engineers or land surveyors during that period would continue to be required to pay the $800 annual tax to Franchise Tax Board until the legal existence of the entity is extinguished.

Architects. AB 560 (Gorell, Stats. 2011, Ch. 291) extends the sunset date under which licensed architects are allowed to organize and operate as LLPs from Jan. 1, 2012, to Jan. 1, 2019.

***New!* Architects, Engineers, and Land Surveyors Extended**

SB 920 (Canella, Stats. 2018, Ch. 150) extends the sunset date from Jan. 1, 2019, to Jan. 1, 2026, on provisions allowing architects, engineers, and land surveyors that meet specified liability insurance requirements to organize and operate as registered and foreign LLPs through that date. In addition, these provisions would be repealed on Jan. 1, 2026.

LLC ANNUAL TAX AND FEE

California imposes on all LLCs classified as partnerships or disregarded entities both an annual tax of $800 and an annual fee based on the LLC's total income.

The LLC annual tax is similar to the corporate minimum franchise tax as both taxes are imposed for the privilege and protections of doing business in California. The $800 LLC annual tax is due on Apr. 15 of each year for calendar-year LLCs and on the 15th day of the fourth month of the taxable year for fiscal-year LLCs.

The annual fee, however, is a graduated fee based on the LLC's total income from all sources derived from or attributable to this state plus the cost of goods sold under R&TC §17942. Presently, the FTB is reevaluating the computation of total income under R&TC §17942.

An LLC that elects to be treated as either a C or S corporation will determine its tax under California Bank and Corporation Tax Law, so it is subject to the $800 minimum franchise tax under R&TC §23153, or the franchise tax under R&TC §23151, or the corporation income tax under R&TC §23501.

FTB LLC TAX AND FEES REGULATION

In mid-May 2014, the FTB issued **Regulation §17942** clarifying that for purposes of the calculation of an LLC's annual fee, "total income from all sources derived from or attributable to this state" includes gross income, as defined in R&TC §24271, plus the cost of goods sold that is paid in or incurred in connection with the trade or business of the taxpayer. This amount does not include, however, any allocation or attribution of income or gain or distributions made to the limited liability company in its capacity as a member or holder of an economic interest in another limited liability company, as long as the income of the limited liability company that earned the income was itself subject to the fee described in R&TC §17942.

The new regulation also stipulates that items of total income from all sources derived from or attributable to this state that an LLC receives from pass-through entities, other than other LLCs that are themselves subject to the fee, must be computed and assigned for purposes of the LLC fee calculation. This means that an LLC's distributive share of items allocated to it by another pass-through entity that is not itself an LLC must be adjusted to include cost of goods sold, if applicable, in order to compute the correct amount of total income for fee purposes.

Real Property Held for Sale to Customers

For purposes of calculating the LLC fee pursuant to California R&TC §17942, does cost of goods sold include the adjusted basis of real property held for sale to customers in the ordinary course of business (**Legal Ruling 2016-01**)?

Situation 1. Alpha is a California LLC with two or more members that is classified as a partnership for federal and California income tax purposes. Alpha holds real property for sale to customers in the ordinary course of its trade or business. Alpha owns Blackacre, a parcel of unimproved real property, for sale to customers in the ordinary course of its trade or business, and sells Blackacre during its 2016 taxable year.

Situation 2. Assume the same facts as in Situation 1, except that instead of selling Blackacre, Alpha sold Whiteacre, a parcel of unimproved real property held by Alpha for investment purposes, during its 2016 taxable year.

Legislative History. R&TC §17942 imposes a fee on LLCs based on "total income from all sources derived from or attributable to this state." Total income for purposes of calculating the LLC fee is defined in R&TC §17942, subdivision (b)(1)(A), as "gross income, as defined in §24271, plus the cost of goods sold that are paid or incurred in connection with the trade or business of the taxpayer." Therefore, the cost of goods sold is added back to gross income so that the LLC fee for such amounts is essentially calculated based on net gross receipts.

The LLC fee was originally enacted as part of comprehensive LLC authorizing legislation in **SB 469** (Stats. 1994, Ch. 1200). The legislative history of SB 469 demonstrates that the term "cost of goods sold" was intended to include the adjusted basis of real property held for sale to customers in the ordinary course of business. Originally, SB 469 had a flat $800 LLC tax which resulted in SB 469 being scored as a revenue loss. The Legislature then added a graduated LLC fee to the draft bill in order to make SB 469 revenue neutral.

The legislative history of SB 469 is clear that the LLC fee was (1) meant to be based on gross receipts for ordinary trade or business income, and (2) the Legislature properly included real property in the term "cost of goods sold" as a means to ensure the LLC fee calculation would be based on gross receipts for ordinary trade or business income.

Situation 1 Answer. Blackacre is held by Alpha for sale to customers in the ordinary course of its trade or business. Blackacre is sold during Alpha's 2016 taxable year. As a result, Alpha's adjusted basis in Blackacre will be added back to X's gross income for purposes of calculating Alpha's 2016 LLC fee under R&TC §17942.

Situation 2 Answer. Since Alpha held Whiteacre for investment purposes, rather than for sale to customers in the ordinary course of its trade or business, Alpha's adjusted basis in Whiteacre will not be added back to Alpha's gross income for purposes of calculating Alpha's 2016 LLC fee under R&TC §17942.

TIERED LLCs (LLCs OWNING LLCs)

When it comes to tiered LLCs, each entity will have an annual tax. But, when it comes time to determine whether or not the LLC will have to pay a fee, the process is not always clear cut.

California R&TC §17942 imposes an annual fee on every LLC that has "Total California Income" of $250,000 or more. "Total Income" for this purpose means gross income, plus the cost of goods sold, paid, or incurred in connection with the trade or business of the taxpayer attributable to California; and specifically excludes all allocations, distributions, or gains from another LLC that was already subject to the LLC fee.

So when you are looking to determine the LLC's "Total California Income," don't include gross receipts received from another LLC that were included in that LLC's calculation of the fee. If the income has already been reported by another LLC, do not enter the amounts on the Schedule IW (LLC Income Worksheet).

The Schedule IW is now Side 6 of the California Form 568, and it must always be included with the Form 568 even if the LLC does not have income derived from or attributable to California. If the LLC is wholly within California, the total income amount is assigned to California and is entered beginning with line 1a. If a single-member LLC (SMLLC) does not meet the $3 million criteria for filing Schedule B (Form 568) and Schedule K (Form 568), the SMLLC is still required to complete Schedule IW.

Disregarded entities that do not meet the filing requirements to complete Schedule B or Schedule K should prepare Schedule IW by entering the California amounts attributable to the disregarded entity from the member's federal Schedule B, C, E, F (Form 1040), or additional schedules associated with other activities.

Example. Kreider, LLC has $1,200,000 of total California sourced income during the 2019 taxable year. Brosi, LLC has a 50% member interest in Kreider, LLC. Brosi, LLC has $900,000 of total California sourced income during 2019. Brosi, LLC's income includes $600,000 ($1,200,000 x 50% member interest) from Kreider, LLC. For taxable year 2019, Brosi, LLC excludes $600,000 of total income because it was already used to calculate the fee of Kreider, LLC.

Entity	2019 Form	Annual Tax	Total Income	Annual Fee
Kreider, LLC	568	$800	$1,200,000	$6,000
Brosi, LLC	568	$800	$300,000	$900

NEW! DEPLOYED MILITARY GET A BREAK ON ANNUAL & MINIMUM FRANCHISE TAX

AB 308 (Muratsuchi, et al, Stats. 2019, Ch. 421) replaces the existing Jan. 1, 2018, inoperative date with Jan. 1, 2030, and re-establishes for taxable years beginning on or after Jan. 1, 2020, and before Jan. 1, 2030, an exemption from the annual tax or minimum franchise tax as applicable, for LLCs and corporations that are small businesses that meet all of the following:

- Is solely owned by a deployed member of the US Armed Forces,
- Is a small business, and
- Operates at a loss or ceases operation for the taxable year.

The following definitions would apply for purposes of the exemption:

- "Deployed" means being called to active duty or active service during a period when a Presidential Executive Order specifies that the United States is engaged in combat or homeland defense. Deployed would specifically exclude temporary duty for the sole purpose of training or processing, or a permanent change of station.
- "Operates at a loss" means:
    - Expenses exceed receipts with respect to an LLC.
    - Negative net income as defined in R&TC section 24341 with respect to a corporation.
- "Small business" means an LLC or a corporation with total income from all sources derived from or attributable to California of $250,000 or less.

LLC ANNUAL FEES CASES AND RULINGS

SMLLC Must File and Pay Tax and Fee Even If Owner Is Not Required to File

An SMLLC organized in California is classified as a disregarded entity for federal tax purposes. In a request for clarification to FTB, the LLC states that it owns raw land and vineyards in California, where it grows and sells grapes. It further states that it is "doing business" in California within the meaning of R&TC §23101. The LLC is wholly owned by a single-employer pension and retirement fund.

The IRS issued a determination letter stating that the retirement fund is a trust qualified and exempt from federal income taxes, under IRC §501(a) as a governmental benefit plan under §401(a).

In Chief Counsel Ruling 2015-02, the FTB determined that the LLC has a filing requirement in California and is subject to LLC annual tax and fee. However, the owner of the LLC (the retirement fund) does not have a filing requirement in California because of its federal tax-exempt status under IRC §501(a) as a governmental benefit plan under §401(a).

Company Claims "Other Income" Represented Expense Reimbursements

Breitburn Management Co., LLC reported $3,569,286 of "other income" on Schedule B of Form 568 for 2006, which resulted in an annual fee of $6,000. But Breitburn claimed that over $3.4 million of the "other income" was from expense reimbursements and shouldn't be included in gross receipts.

The FTB prevailed in including the amount in gross revenue because Breitburn failed to explain the manner in which these payments were made or which expenses were being reimbursed. In the end, because the LLC was in the business of providing general and administrative services, and the claimed business expenses were for salaries and wages, the state board agreed that the payments were compensation and correctly included in gross receipts (***Breitburn Management Co., LLC***, SBE No. 488021, June 25, 2014).

OTHER RESIDENT/NONRESIDENT BUSINESS ITEMS

FIRST YEAR FREE?

Each year, any C or S corporation doing business in California must file a state tax return and pay the greater of the $800 minimum tax (R&TC §23153) or the franchise tax (R&TC §23151). This is true even if the corporation is formed in a different state and has not qualified by registering with the California SOS.

Most entrepreneurs know that for their corporation's first tax year, the $800 minimum tax is waived and the smaller franchise tax, if any, is paid. This is only if their corporation qualified or incorporated with the SOS. This first-year relief is also available to LLCs if they elect to be treated as either a C or S corporation.

However, what many entrepreneurs may not know is that when a corporation does not qualify by registering with the SOS (referred to as a non-qualified corporation), it is not eligible for the first-year minimum tax waiver. This is often the case with corporations formed in a different state that are doing business in California.

> ***Example.*** ABC Corporation, formed in North Carolina on Nov. 1, 2010, began doing business in California in 2010 and had taxable income of $1,000 from this state. However, ABC Corporation did not register with the SOS until July 2011. Accordingly for 2010, ABC Corporation is a nonqualified corporation and must file a California corporate return and pay the $800 minimum tax.

The good news is that a nonqualified corporation may still be able to receive first-year relief. Back in 2002, the FTB issued TAM 20020138 that states, in part:

"… [R&TC §23153(f)(1)] permits a nonqualified corporation the first year exemption of minimum franchise tax if … it commences doing business in California even though it thereafter qualifies with the Secretary of State within the SOL [statute of limitations]."

So, back to the example, after ABC Corporation registers with the SOS in July 2011, it may then file a claim for refund of $711.60 for its 2010 return. The refund amount is the difference between the $800 minimum franchise tax and the franchise tax of $88.40 ($1,000 x 8.84%). Since the claim would be filed within the statute of limitations, the FTB would refund the $711.60 plus interest.

More good news is that this year, the FTB began allowing corporations to e-file the Form 100X Amended Corporation Franchise or Income Tax Return.

No "First Year Free" for LLC

Scott Electronic Services, LLC filed its articles of organization with the California SOS on Mar. 7, 1997. The company filed a timely 2008 tax return, reporting a liability of $800, but did not make a payment with the return. The 2008 return was marked as "initial." On Aug. 21, 2009, Scott Electronic Services' status as an LLC was canceled by the SOS.

On Jan. 4, 2010, the FTB issued an LLC past due notice assessing Scott Electronic Services' 2008 tax liability, a late payment penalty, and applicable interest. The company made a full payment on Jan. 20, 2010. The managing member filed an amended return reporting no tax liability for the 2008 tax year. This return was marked as "final." The FTB treated the amended return as a claim for refund and on Nov. 4, 2011, denied the claim for refund.

R&TC §17946 and §17947 provide exceptions from LLC taxes. R&TC §17946 provides an exemption from LLC taxes if two conditions are satisfied:

1. the LLC did no business in this state during the year, and
2. the taxable year was 15 days or less.

R&TC §17947 provides an LLC shall not be subject to R&TC §17941 if the LLC:

1. files with the FTB a timely final annual tax return for the preceding taxable year;
2. does no business in this state after the end of the taxable year for which the final annual tax return was filed; and
3. files a certificate of cancellation with the SOS before the end of the 12-month period beginning with the date the final annual tax return was filed.

The R&TC does not provide a "reasonable cause" exception to the annual minimum LLC tax imposed under R&TC §17941.

Scott Electronic Services was issued a certificate of registration by the SOS in 1997, which was not cancelled until 2009. Therefore, it was operating in the state during the 2008 taxable year and owed the annual minimum LLC tax on Apr. 15, 2009. Therefore, it can only be excused from the annual minimum LLC tax if either one of the exclusions (R&TC §17946 or §17947) can be applied. R&TC §17946 is not applicable as an exemption from the tax because the second prong requires that the taxable year be 15 days or less. The company's certificate of registration was not cancelled until 2009. Therefore, its taxable year totaled all 366 days in 2008, exceeding the 15 days or less requirement in R&TC §17946 (***Scott Electronic Services, LLC***, SBE No. 600574, Oct. 29, 2013).

CONTRACT VOIDABILITY

Under existing federal law, business entities are not subject to contract voidability for failure to pay taxes, penalties, fees, or interest, or for failure to file required tax returns with the IRS. Nor does the IRS offer relief from contract voidability for any business entities.

Under existing state law, domestic or foreign registered (qualified) LLCs or domestic or foreign qualified corporations may be subject to suspension or forfeiture for failure to file a tax return or for failure to pay delinquent taxes, penalties, fees, or interest within 60 days of the FTB mailing a final notice. One consequence of suspension or forfeiture is being subject to contract voidability for the period in which the entity is suspended or forfeited.

Foreign nonqualified corporations may be subject to contract voidability in two ways depending on whether or not the corporation has an FTB-assigned account number. The two ways are as follows:

- **Foreign nonqualified corporations that do not have an FTB-assigned account number** because the FTB is unaware of the entities' business activities within the state, may be subject to contract voidability beginning on the first day of the taxable year for which the taxpayer has failed to file a required return.
- **Foreign nonqualified corporations that have an FTB-assigned account number** may be subject to contract voidability for failure to file a tax return or for failure to pay delinquent taxes, penalties, fees, or interest within 60 days of the FTB mailing a final notice before contract voidability.

Unlike foreign nonqualified corporations, foreign nonregistered (nonqualified) LLCs are not subject to contract voidability for failure to file tax returns or for failure to pay taxes, penalties, fees, or interest. Consequently, foreign nonqualified LLCs do not need to obtain relief from contract voidability.

All business entities that enter into a contract while subject to contract voidability may have the contract voided by another party to the contract. The third party may exercise the right to declare a contract void only in a lawsuit brought by either party with respect to the contract. A court shall not issue a final judgment rescinding the contract unless the taxpayer subject to contract voidability is provided a reasonable opportunity to cure the voidability. In no event shall a court order a contract rescinded without providing the taxpayer full restitution of the benefits provided by the taxpayer under the contract.

Entities that are subject to contract voidability may elect to obtain relief from contract voidability. If obtained during the revivor process, the entity may choose relief for a portion of the time in which the entity was subject to contract voidability by choosing the starting tax year for which the relief period will begin. If an entity elects to obtain relief from contract voidability outside of the revivor process, the entity must choose relief for the entire period for which the entity was subject to contract voidability. Relief from contract voidability is granted at a cost of $100 a day for the period of relief granted. The amount cannot exceed the amount of tax due for the relief period. When a return is not due, the minimum franchise tax is considered the tax due for that period.

FTB Updates Revivor Web Page

Do you have clients with suspended or forfeited business entities? The FTB suspends or forfeits business entities when they fail to file a return or pay their tax liability (tax, penalties, interest, or fees). Suspended business entities lose their rights, powers, and privileges to conduct business in California.

The FTB has recently updated its Revive My Business web page. The updated web page provides easier access to revivor information for suspended/forfeited business entities.

The web page includes the following information:

- Suspension causes and effects.
- What is needed to revive a suspended entity.
- How to revive an entity at an FTB field office.
- How to qualify for a walk-through revivor at an FTB field office.
- Explanation of contract voidability and how to purchase relief from it.

Schedule an Appointment for Walk-Through Revivor

In Public Service Bulletin 16-26, the FTB announced that effective July 1, 2016, all field offices will implement an appointment process for business entity customers. The process will provide the option to schedule an appointment for a walk-through revivor at any of the field offices.

DISSOLVING AN ENTITY

Does your client plan to dissolve, surrender, or cancel business operations in California? If so, your clients may be able to avoid the minimum franchise tax or annual tax.

To terminate their legal existence, business entities registered with the California SOS can dissolve, surrender, or cancel their businesses in California as follows:

- **Domestic corporations** (those originally incorporated in California) may legally dissolve.
- **Foreign corporations** (those originally incorporated outside California) may legally surrender.
- **Limited liability companies and partnerships** (both domestic and foreign) may legally cancel.

Avoiding Subsequent Years Minimum Tax or Annual Tax

Entities may be able to avoid the minimum franchise tax or annual tax for current and subsequent years if all of the following requirements are met:

- The entity filed its final franchise or annual tax return timely, including extension, for the preceding taxable year.
- Conducted no business after the last day of the preceding year.
- Filed the appropriate documents with SOS within 12 months of the filing date of its final tax return.

Steps to Dissolve, Surrender, or Cancel a Business Entity

1. File any delinquent tax returns.

2. File the final/current year tax return. On this tax return's first page, write FINAL at the top of the page and check the box labeled "Final Return."

   Exception for a Nonprofit Tax-Exempt Church or Tax-Exempt Corporation
   It does not have to file a final return if its three-year gross receipts average is under $25,000. But it must file a final return if it exceeds this average, if it's a private foundation, or if it has non-member or unrelated business income.

3. Pay all tax balances, including any penalties, fees, and interest.
4. File the appropriate dissolution, surrender, or cancellation forms with the SOS within 12 months of filing the business's final tax return. To get the correct forms, go to

sos.ca.gov

or call the SOS at
(916) 657-5448

Suspended or forfeited business - You must revive the business before you file dissolution, surrender, or cancellation forms with the SOS.

Public benefit and religious corporations, and mutual benefit corporations holding charitable assets - You must obtain a dissolution waiver from the Office of the AG before filing dissolution forms with the SOS. For more information, go to

ag.ca.gov/charities

or call the Office of the Attorney General at

(916) 445-2021

CERTAIN LLCs ALLOWED SHORT FORM CANCELLATION

California Corporations Code §17350.5 and R&TC §17941(e) have provisions that allow LLCs to cancel and not be required to pay the first year annual tax if they meet certain conditions.

Requirements to Obtain a Short Form Cancellation

A domestic LLC may use the SOS **Form LLC-4/8**, LLC Short Form Certificate of Cancellation, to cancel if it is filed within 12 months from the date the Articles of Organization were filed with the SOS, and the LLC meets the following requirements:

1. The LLC has no debts or liabilities, other than for FTB taxes.
2. A timely final tax return has been or will be filed with FTB.
3. The LLC has not conducted any business since organizing.
4. All remaining assets have been distributed to the entitled persons after payment of, or providing payment for all debts and liabilities.
5. A majority of the managers, members, or persons that signed the articles of organization have voted to dissolve the LLC.
6. All payments the LLC received for interests have been returned to the investors.

The short form cancellation is operative for LLCs that filed Articles of Organization with the SOS on or after Jan. 1, 2004.

LLC Annual Tax Exclusion

Effective for taxable years beginning on or after Jan. 1, 2005, the LLC annual tax is not required for the first taxable year if an LLC filed the short form cancellation with SOS and is classified as a partnership or disregarded entity.

If an LLC files SOS **Form LLC-4/7** LLC Certificate of Cancellation or is involved in a merger or conversion, it does not qualify for LLC short form cancellation even if it meets all of the requirements.

Currently, the minimum tax is not required for the first taxable year if the LLC is classified as a corporation.

LLC Annual Tax and Fee Refund

The FTB can only refund the annual tax or fee that was paid on or after the date the LLC filed the SOS Form LLC-4/8, LLC Short Form Certificate of Cancellation with the SOS.

LLC CAN DISSOLVE WITH 50% VOTE INSTEAD OF MAJORITY

AB 1722 (Wagner, Stats. 2016, Ch. 66) requires the vote of 50% or more of the voting interests of the members of the LLC to dissolve. The bill also replaces that majority requirement to cancel the articles of organization with 50% or more of the voting interests of the members or managers, or 50% or more of the persons signing the articles of incorporation, as applicable.

> **Note**. Now a two-member LLC can dissolve through the action of only one of the members.

NEW! ADMINISTRATIVE DISSOLUTION FOR CORPORATIONS AND LLCs

The FTB lacks statutory authority to administratively dissolve business entities that fail to complete the process required to legally dissolve; thus, these entities remain on the department's accounting system, continuing to accrue taxes, interest, and penalties. In general, if the FTB is unable to collect a debt from a taxpayer, current state law allows the FTB to extinguish the uncollected debt after 20 years. However, the entity will continue to exist and accrue taxes, interest, and penalties, until it is properly dissolved.

AB 2503 (Irwin, Stats. 2018, Ch. 679) provides two options for administrative dissolution of qualified entities when there is unpaid minimum franchise or annual tax.

Option 1: FTB-Initiated Administrative Dissolution (Involuntary)

This option would allow the FTB to administratively dissolve those domestic corporations and domestic LLCs that are suspended by the FTB, have ceased doing business, have been suspended for 60 or more consecutive months, and have paid all taxes and filed all returns due as of the date the entity ceased doing business.

Prior to the administrative dissolution under this option, the FTB would be required to provide written notice to the business entity of the pending administrative dissolution. The FTB would transmit to the Secretary of State (SOS) the names and SOS file numbers of domestic corporations and domestic LLCs subject to the administrative dissolution. Upon receipt of the transmission, the SOS would also be required to provide on its website a 60 calendar-day notice of a pending administrative dissolution by listing the corporation or LLC name, and the SOS's file number, as applicable.

The notified corporation or LLC would be allowed to file a written objection with the FTB to object to the administrative dissolution. If a timely written objection is received by the FTB, the domestic corporation or domestic LLC would have an additional 90 days to pay or otherwise satisfy all accrued taxes, penalties, and interest, file a current Statement of Information with the SOS, fulfill any other requirements to be eligible, and apply for revivor. The 90-day period may be extended for no more than one period of up to 90 days, by the FTB. If there is no written objection or the written objector fails to revive, the domestic corporation or domestic LLC would be administratively dissolved.

Upon administrative dissolution, the FTB would abate the domestic corporation's or domestic LLC's liabilities for qualified taxes, interest, and penalties.

The administrative dissolution of a corporation would not diminish or adversely affect the ability of the Attorney General to enforce liability as otherwise provided by law.

No administrative appeal, writ, or other judicial action may be taken based on the FTB's or the SOS's action, except if related to repayment of amounts erroneously received after administrative dissolution has occurred.

Upon administrative dissolution, the corporate rights, powers, and privileges of the corporation would cease.

Option 2: Taxpayer-Initiated Administrative Dissolution (Voluntary)

This option would be available to domestic corporations and domestic LLCs that have never done business or have ceased doing business within California, have paid all taxes due for years when the business was in operation, and filed all required returns prior to the cessation of business operations.

Under this option, taxpayers applying for administrative dissolution would be required to do all of the following:

- Request in writing from the FTB abatement of any unpaid qualified taxes, interest, and penalties.
- File dissolution paperwork with the SOS prior to the abatement of unpaid qualified tax, interest, and penalties by the FTB.
- Establish that it has ceased all business activity and has no remaining assets at the time of filing the request for abatement.

Forms for Voluntary Administrative Dissolution/Cancellation

The qualified domestic corporation may file a **FTB 3715**, Domestic Corporation Request for Voluntary Administrative Dissolution.

The qualified domestic limited liability company may file **FTB 3716**, Domestic Limited Liability Company Request for Voluntary Administrative Cancellation.

These forms are used to assist FTB to determine whether the qualified entity has established that it has ceased all business operations and has no remaining assets at the time of filing the request for abatement. The following items must be completed in order to be considered for Voluntary Administrative Dissolution/Cancellation:

- Submit a completed and signed request for a Voluntary Administrative Dissolution/Cancellation form; and
- All tax returns filed up to the date the entity ceased business; and
- All taxes, penalties, and interest paid up to the date the entity ceased doing business.

Note: The FTB will review the entity's account and other available information to determine if all tax returns have been filed and all taxes, penalties, and interest have been paid up to the date the entity ceased doing business. It is not a requirement to have the above items completed in order to request a Voluntary Administrative Dissolution/Cancellation; however, it will be a requirement to be approved for Voluntary Administrative Dissolution/Cancellation. In addition, file a Certificate of Dissolution or Certificate of Cancellation with the California Secretary of State.

Mailing Instructions

Mail or Fax the completed and signed FTB 3715 (Corp) or FTB 3716 (LLC) to:

BUSINESS ENTITY CORRESPONDENCE
FRANCHISE TAX BOARD
PO BOX 942857
SACRAMENTO CA 94257-4040

Fax
(916) 855-5519

STREAMLINED DISSOLUTION FOR NONPROFITS

AB 557 (Irwin, Stats. 2015, Ch. 363) creates a streamlined process to dissolve efficiently a nonprofit corporation. The existing dissolution process, which involves the FTB, the SOS, and possibly the AG office, is cumbersome and protracted.

This bill subjects a nonprofit corporation to administrative dissolution or administrative surrender, as specified, if the nonprofit corporation's corporate powers are suspended or forfeited by the FTB and have been suspended or forfeited for a specified period of time.

Prior to the administrative dissolution or administrative surrender of the nonprofit corporation, the bill requires the FTB to provide written notice to the nonprofit corporation of the pending administrative dissolution or administrative surrender. The FTB would transmit to the SOS and the AG the names and SOS file numbers of nonprofit corporations and foreign corporations subject to the administrative dissolution or administrative surrender. Additionally, the SOS would be required to provide 60 calendar-days notice of a pending administrative dissolution or administrative surrender on its website by listing the corporation name, and the SOS's file number, as applicable.

A nonprofit corporation would be allowed to file a written objection to the administrative dissolution or administrative surrender. If a timely written objection is received by the FTB, the nonprofit corporation would have an additional 90 days to pay or satisfy all accrued taxes, penalties, and interest, and to file a current Statement of Information with the SOS. The 90-day period may be extended for no more than one period of up to 90 days by the FTB. If there is no written objection or the written objection fails, the nonprofit corporation would be administratively dissolved or administratively surrendered and the certificate of the SOS would be *prima facie* evidence of the administrative dissolution or administrative surrender. Upon administrative dissolution or administrative surrender, the law also abates the nonprofit corporation's liabilities for qualified taxes, interest, and penalties.

Short Form Certificate of Dissolution

AB 557 also enacts provisions applicable to nonprofit corporations similar to General Corporation Law provisions that allow a domestic corporation that meets certain requirements to file a shortened form of dissolution. The bill would additionally provide that liability to creditors, if any, would not be discharged, the liability of the directors of the dissolved nonprofit corporation would not be discharged, and the dissolution of a nonprofit corporation would not diminish or adversely affect the ability of the AG to enforce specified liabilities.

Streamlined Voluntary Dissolution

AB 557 requires the FTB to abate, upon written request by a qualified corporation, as defined, unpaid qualified taxes, interest, and penalties, as defined, for the taxable years in which the nonprofit corporation certifies, under penalty of perjury, that it was not doing business, as defined. Abatement would be conditional on the dissolution of the qualified corporation within a specified period of time of filing the request for abatement. The bill would require the FTB to prescribe rules and regulations to carry out these abatement provisions and would exempt these rules and regulations from the Administrative Procedures Act.

NOTICES OF PROPOSED DISSOLUTION MAILED TO NONPROFIT CORPORATIONS

In September 2019, the FTB sent more than 8,500 proposed dissolution notices to certain nonprofit corporations.

As of Jan. 1, 2016, California nonprofit public benefit, mutual benefit, religious, and registered foreign nonprofit corporations are subject to the FTB administrative dissolution (California nonprofit corporations) or administrative surrender (registered foreign nonprofit corporations) if the entity's corporate powers have been suspended or forfeited by the FTB at least 48 continuous months.

Once the administrative dissolution process is initiated, the nonprofit corporation has 60 calendar days to act before the corporation administratively is dissolved/surrendered permanently.

A searchable list of the 8,500+ nonprofit corporations was posted to the California Secretary of State's (SOS) website on Sept. 9, 2019, the same day the letters were mailed. The list includes the corporation name on record and corporation file number issued by the SOS. The website also provides information about how to avoid administrative dissolution or surrender.

If one or more of your clients are nonprofit corporations, and they have not been active for a while, it may be a good idea to check whether they are on the list.

2020 FEDERAL AND CALIFORNIA TAX UPDATE
CALIFORNIA AUDITS AND ADMINISTRATION

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2020 CALIFORNIA AUDITS AND ADMINISTRATION

COVID-19 CHANGES

To assist taxpayers and tax professionals impacted by COVID-19 pandemic, FTB has made some temporary modifications to its:

- Collection actions
- Filing compliance
- Audit programs

COLLECTION ACTIONS

Similar to the IRS, FTB implemented a temporary suspension on a number of collection activities within its personal income tax, business entity tax, and nontax debt (court-ordered debt and vehicle registration collection) programs through July 15, 2020:

- Wage attachments, bank levies, liens, and field agent calls/visits are suspended
- Suspension of business entities with the Secretary of State (SOS) are delayed
- The Top 500 Delinquent Taxpayers List is delayed
- An extension has been granted to taxpayers whose financial hardship was scheduled to expire

Offsetting Income Tax Refunds

The offset program collects money from tax refunds or other government payments owed by taxpayers to FTB and other government agencies.

Most new and existing offset requests are suspended, including:

- Offsets of California Income Tax Refunds to state and local agencies.
- Offsets of Lottery prizes and unclaimed property
- Offsets of Federal Treasury (IRS) refunds (including the Federal Economic Impact Payment Checks)

Monthly Payments on Installment Agreements

Existing payment plans. If you currently can't comply with the terms of an existing installment agreement (payment plan), you may request to skip your payments. You can request to skip payments online or by phone at **(800) 689-4776.**

For court-ordered debt installment agreements, you can request to skip payments online by logging into your court-ordered debt account or by phone at **(916) 845-4064.**

If you're able to meet your monthly payments, FTB encourages you to still pay because interest continues to accrue on all unpaid balances. If you're not able to make your monthly payments, FTB will not default your installment agreement during this extension period through July 15, 2020.

New payment plans. You can apply for a payment plan if you're unable to fully pay your state taxes (as usual). If you have court-ordered debt, you can also apply for a payment plan. You can apply online, by phone, or mail.

FILING COMPLIANCE

FTB suspended Requests, Demands, and related Notices of Proposed Assessment for prior year returns until July 15.

Reminder: If you have not filed your return for tax years before 2019, you should file your delinquent returns - especially if you'll receive refunds.

FTB will continue to handle Filing Enforcement protests. Protests submitted on or before July 15, 2020, by mail or as a message in MyFTB will be considered timely. To use the MyFTB protest service, you would need to do so by the "protest by" date on the notice.

AUDIT PROGRAMS

Audit, claims and protest programs for the most part continue with some modifications:

- FTB is using various alternate communication methods to interact with taxpayers and representatives vs. in-person meetings
- FTB is accepting, on a temporary basis, electronically signed waivers to extend the statute of limitations
- FTB is granting extensions of time to respond to document requests
- FTB will generally not start a new field or correspondence audit case through April
- During this time, FTB encourages taxpayers to respond to any requests for information they have already received or may receive on audit activity

Please note FTB is still issuing Notices of Proposed Assessment and Notices of Action. The "protest by" or "appeal by" dates that appear on the notices will not reflect the extended timeframes. However, FTB will allow for the extended time to protest or appeal through 7/15/2020. Visit Notice of Proposed Assessment and Notice of Actions FAQs and FTB Notice 2020-02 for more information.

OFFICE OF TAX APPEALS

The OTA has been established in state government to serve as a fair and impartial adjudicatory appellate body and, beginning Jan. 1, 2018, began conducting appeals on taxes and fees that are not related to the constitutional authority of the Board, such as franchise and personal income tax (PIT) appeals, sales and use tax, and other special taxes and fees. Each appeal will be heard by a panel of three administrative law judges, who will issue written decisions for each appeal decided. The OTA is an independent body and will not report to the California Government Operations Agency.

Appeals are heard in Sacramento, Fresno, and Los Angeles.

Starting the Appeal Process

Taxpayers may file an appeal once the FTB or the CDTFA issues a Notice of Action or Appeals Bureau Decision with an "appeal-by" date. You must file a written appeal with the OTA by that time by mailing or faxing in the following:

- Your completed OTA Request for Appeal Form or a written request for an appeal with specific grounds or reasons supporting your position that you do not owe the tax or fee.
- A copy of the notice from either the FTB or the CDTFA
- Any documents such as bank statements or receipts that support your case.
- Please see draft regulations for more information.

Appeals Process Assistance

Taxpayers who have questions about the appeal process or would like additional information should contact the office and OTA staff will be happy to assist you. For specific questions about the process, OTA's Ombudsperson, Dana Holmes, may be reached at:

(916) 206-4355
or at
dana.holmes@ota.ca.gov.

Financial Hardship

If your taxpayer is experiencing financial hardship, you have options that do not involve filing an appeal. Both the FTB and the CDTFA accept installment plans for taxpayers who need to pay tax obligations over time. Both tax agencies also have Offer-In-Compromise (OIC) programs, which allow taxpayers in certain circumstances to pay a reduced amount to the state..

Legal Assistance

Taxpayers who have filed appeals with the California Department of Tax and Fee Administration (CDTFA) are able to seek free legal assistance through the CDTFA's Tax Appeals Assistance Program, which is managed by the Taxpayers' Rights Advocate.

NEW! HEARING BEFORE ONE JUDGE INSTEAD OF PANEL

SB 92 (Budget, Stats. 2019, Ch. 34) requires the OTA to establish a process under which, through 2030, a person filing an appeal may opt to appear before one administrative law judge, rather than a tax appeal panel. The process will be available for an individual taxpayer, when the total amount in dispute, including penalties and fees, is less than $5,000 with respect to personal income taxes, fees, or penalties. For an entity filing the appeal, it must have gross receipts of less than $20,000,000 with respect to taxes, fees, and penalties administered by the California Department of Tax and Fee Administration, and the total amount in dispute, including penalties and fees, is less than $50,000. The decision of one administrative law judge made pursuant to these provisions does not have precedential effect.

PROCESSING OF DOCKETED PROTESTS

A taxpayer receiving a Notice of Proposed Assessment may request an administrative review by the department of that proposed assessment by filing a "protest," as provided for in R&TC §19041. Protests are assigned to a hearing officer either in the Audit Division or the Legal Division. Protests assigned to the Legal Division are designated as "docketed protests."

In **FTB Notice 2018-01**, the FTB recently revised internal procedures for processing docketed protests. These internal procedures are intended to complement the Legal Division's continuing efforts to reduce the length of time necessary to review and make a final determination on docketed protests.

In general, Legal Division staff will contact taxpayers or their representatives in each assigned docketed protest to establish a case development plan. The goal is for staff to work together with the taxpayer or taxpayer's representative to design a plan to accomplish all necessary factual development, if required, conduct any requested hearing, and issue a determination in the protest within a time frame that will allow the processing of a docketed protest to be finally determined within 36 months.

The goal will be for staff to make initial contact with the taxpayer or the taxpayer's representative within 120 days, or less, of the filing of the protest. At a minimum, this initial contact will take the form of an initial letter with contact information for the attorney assigned to work the case, identification of the issues involved in the case, and a request to establish an agreed hearing date if a hearing has been requested. It may include a preliminary information/document request (IDR). Granting requests for extensions of time to respond to IDRs, if needed, will be kept to a minimum in order to complete the docketed protest in a timely manner. Staff will endeavor to substantively follow-up as necessary on all IDRs within 30 days of receipt of requested information.

TAX PROFESSIONALS

CALIFORNIA TAX EDUCATION COUNCIL (CTEC)

New Legislation Extends Sunset Date and Requires Reporting

AB 3143 (Low, Stats. 2018, Ch. 597) requires a tax preparer, on and after July 1, 2019, to report a paid claim against its surety bond to CTEC, which would be required to post a notice of the claim on its Internet website. The bill also establishes public protection as the council's highest priority in exercising its registration and disciplinary authority and other functions.

Additional consumer protections coming. AB 3143 extends the definition of client to the term "customer." It requires CTEC to establish and maintain on its Internet website a searchable public registry of registrants with specified information about each registrant. It also requires a tax preparer to include the address of CTEC's Internet website in the information the tax preparer is required to provide to a customer before rendering services.

The new law also directs CTEC to require an applicant, beginning July 1, 2020, to submit fingerprint images for submission to the Department of Justice, and would require the Department of Justice to compile and disseminate a fitness determination regarding the applicant based on the applicant's criminal offender record information. The Department of Justice and CTEC may charge a fee sufficient to cover the costs of processing the request for state- and federal-level criminal offender record information.

Finally, the new law renames the provisions as "The Tax Preparation Act" and extends the operation of the act's provisions to Jan. 1, 2023. It also makes the meetings of the CTEC board of directors subject to the Bagley-Keene Open Meeting Act.

CERTIFIED PUBLIC ACCOUNTANTS

Practice Privilege Made Permanent

California's mobility laws allow qualified CPAs who are licensed in other states to practice in California without providing notice or paying a fee. The California Board of Accountancy (CBA) has been carefully and diligently implementing this program since it took effect in 2013. In December 2017, the CBA issued a report titled *California's Mobility Program for Accountancy — Implementation, Enforcement and its Consumer Benefits*. As detailed in the report, the CBA determined that through its implementation of this program, the amount of protection offered to consumers increased, or remained equivalent, in comparison to the prior practice privilege program.

As a result, the CBA supported **SB 795** (Galgiani, Stats. 2018 Ch. 447), which makes the mobility program permanent.

AUDITS

For the past fiscal year, the FTB Audits Division reports performing approximately 232,000 audits, nearly 99% of which were automated audits. What follows is a list of the top audit areas at this time.

CAPITAL GAINS AND LOSSES

The FTB verifies whether gains and losses were reported correctly for a variety of audit issues, including sales of stock, business property, casualty losses, and amounts flowing through from pass-through entities. In an audit of this type, be sure to provide supporting documents for all basis calculations (not just the broker's 1099-B). In addition, be prepared to support and substantiate capital loss carryovers.

Partnership Distributions in Excess of Basis Creates Gain

Scott Shafer was a member of three LLCs holding real property in Santa Monica, California. In 2007, each of the three LLCs sold their properties under imminence of condemnation to the City. The LLCs reported no gains on the transactions under the provisions of IRC §1033.

Subsequent to receiving the proceeds of sale, each LLC paid off mortgage debt and made distributions of cash to members, including Scott. Debt relief in 2007 totaled $2,239,252, and cash distributions totaled $2,277,079. Scott had no outside basis in any of the LLCs and his inside basis, including his share of the debt totaled $1,936,348. He reported no gain on his 2007 tax return.

The FTB assessed and the OTA upheld the determination of taxable gain for distributions in excess of partner basis (***Appeal of Scott L. Shafer***, OT No. 18010886, July 2019).

LIKE-KIND EXCHANGES

One of the FTB's top audit issues continues to be like-kind exchanges, also known as 1031 exchanges. Under IRC §1031, and conforming California laws, if certain conditions are met, taxpayers may defer gain from the sale of property, either in part or full.

The source of the original deferred gain on California property will remain with California, regardless of the location of the replacement property. When the replacement property is ultimately sold in a taxable transaction, the gain originally deferred on the California property will have its source in and be taxable by California.

Common 1031 Audit Issues

Common 1031 issues include the following:

7. Gain computation errors (e.g., taxable boot due to debt netting and non-exchange expense items included in the computation).
8. Invalid identifications (e.g., failing the three-property and 200/95% tests; not acquiring substantially the same property that was identified; and identifying a partial interest and acquiring a higher percentage interest).
9. Including the cost of property improvements made after the exchange closed in the exchange (boot) calculation.
10. Withdrawing cash out of the proceeds from the relinquished property.

HEAD OF HOUSEHOLD (HOH) FILING STATUS

Common errors include the following:

- The qualifying individual's income exceeds the gross income test of $3,700.
- Taxpayers who do not meet the requirements to be considered unmarried or considered not a registered domestic partner.

  Note! The FTB implemented new Form 3532, Head of Household Filing Status Schedule, in 2015. Failure to complete this form can result in an audit. For 2016 returns, an electronic filing will reject if the form is not included with the return.

EMPLOYEE BUSINESS EXPENSES

The FTB noticed a large number of taxpayers who claim unreimbursed employee business expenses (EBE) on Schedule A that appear questionable.

In August 2015, the FTB increased the number of audits for taxpayers deducting EBE on PIT returns, starting with the 2011 and 2012 tax years. The FTB anticipates sending approximately 10,000 to 50,000 letters over a period of time.

R&TC §17201, except as otherwise provided, permits the deduction of all ordinary and necessary business expenses in accordance with IRC §162.

Valid EBE are defined as follows:

- Paid or incurred during your tax year;
- Required to carry on a trade or business;
- Ordinary and necessary;
- Not reimbursed by your employer; and

- Not eligible to obtain reimbursement from your employer.

The FTB will request taxpayers who claim these expenses to provide their employer's reimbursement policy and other documentation to substantiate their claims.

Your clients can file amended tax return(s) if their business expenses do not qualify.

PASS-THROUGH ENTITY AUDIT AREAS

Partnership/LLC Property Dispositions

Issues involving property dispositions reported by partnerships and LLCs include like-kind exchanges (IRC §1031), foreclosures of real estate, and cancellation of debt income.

Termination of Partnership/LLC

Issues include partnership and LLC liquidations reported by both partnerships and partners.

Transfer of Partnership Interest

Issues include disposition of partnership and LLC interests by the partners/members of partnerships and LLCs. The FTB continues to identify taxpayers who transfer partnership interests between related entities to create a higher basis.

Shareholder/Partner/Owner's Basis in a Pass-Through Entity

The FTB verifies shareholder's basis to determine the correct flow-through income, losses, deductions, and credits. It uses the correct basis to determine taxability of distributions, debt repayments, and dispositions.

S Corporation Liquidations

Common S corporation liquidation issues include the following:

- S corporation taxpayers that do not accelerate the recognition of installment gain for California purposes in the final year;
- S corporation shareholders that do not report the gain recognized under IRC §331(a); and
- Nonresident shareholders that do not report their share of the gain that was recognized by the S corporation on the sale of intangible assets.

Charitable Deductions for Trusts

The FTB verifies that the amount donated is from the gross income of the trust and is paid pursuant to the terms of the governing instrument.

Charitable Remainder Trusts

The FTB verifies that the trust is operated pursuant to the terms of the governing instrument and that the trust meets statutory requirements. A charitable remainder trust that is not operated correctly may lose its tax-exempt status, and the previously untaxed income may be subject to income tax. In some cases, a disqualified charitable remainder trust will be treated as a grantor trust, and the income of the trust will be reported on the grantor's individual tax return.

Apportionment of Trust Income

A trust will be subject to taxation if the fiduciary is a California resident or a beneficiary whose interest in such trust is noncontingent as a California resident. When trust apportionment of income is within and without California, the FTB looks at how the income is sourced to California and the residency status of the trustee.

CREDITS

Corporation Credits

The FTB verifies that credits, such as Enterprise Zone and Research and Development Credits, are reported correctly. In addition, it verifies that the assignment of credits is properly reported by the assignor and the assignee.

Other State Tax Credit (OSTC)

The FTB uses third-party data to verify that tax payments were made to other states and to disallow credits claimed to those states that do not have a reciprocal agreement with California.

Expired Credits

Some of the expired credits the FTB disallows include the Ridesharing, Recycling Equipment, Solar Energy, Political Contribution, Employer Ridesharing, and Water Conservation credits.

CORPORATION AUDIT AREAS

Cost of Performance and Sourcing of Intangible Sales

For tax years beginning before Jan. 1, 2011, sales from intangible sales and services are assigned based on the cost of performance. The complex rules of identifying income-producing activities and documentation necessary to do a cost-of-performance analysis may result in incorrect assignment of sales from intangibles and services. For tax years beginning on or after Jan. 1, 2011, taxpayers who elect a single sales factor for apportioning business income to California will use market rules for assigning sales from intangibles and services instead of cost-of-performance rules.

Sales Factor and Gross Receipts

The FTB continues to see items in the sales factor denominator that do not meet the definition of "gross receipts" or that result in distortion.

OTHER AUDIT AREAS

Have You Considered a Closing Agreement?

Closing agreements are formal written agreements the FTB enters into with a taxpayer to finalize some aspect of a tax liability, such as one or more disputed issues. A closing agreement is generally final and conclusive for the issue involved with some exceptions. Closing agreements are discretionary, and the FTB will only agree if the resolution is in the state's best interest.

In order for the FTB to consider a closing agreement, both parties must agree to the facts of the case. Closing agreements can be entered into at any time during the audit, protest, or appeal process to resolve issues and may add certainty as to treatment in future years. The closing agreement process can definitely be a time-saver for a taxpayer.

If your client is interested in a closing agreement for an audit, protest, or appeal issue, contact the staff member assigned to the case.

COLLECTIONS

REQUEST A 30-DAY DELAY

Beginning June 20, 2017, PIT taxpayers who receive an Income Tax Due Notice or Final Notice Before Levy and Lien can use a self-service option through the FTB's interactive voice response (IVR) system to request a one-time, 30-calendar-day delay to pay their bill balance in full. Interest and penalties apply until the balance is paid in full.

The self-service option can be utilized by calling

(800) 689-4776

and is available 24 hours a day, 7 days a week.

Thirty-Day Delay Also Available Through MyFTB

Representatives who have a valid power of attorney (POA) on file may request a one-time, 30-day delay online through MyFTB.

When a taxpayer requests an IVR bill payment delay, their eligibility will be verified up front.

They may be eligible if

- They recently received an Income Tax Due Notice or Final Notice Before Levy and Lien dated within the last 45 days;
- They have not received a delay in the last 90 days;
- They do not have an Earnings Withholding Order, Continuous Order to Withhold, or Order to Withhold in place; and
- They do not have an existing installment agreement (IA).

Ineligible taxpayers will only have the option to make a payment, go to the main menu to "self-help," or during normal business hours, request to be transferred to a customer service representative.

NEW FINANCIAL HARDSHIP EVALUATION ENHANCEMENTS

Available June 1, 2018, you are able to use a new form, **FTB 3561C, Financial Statement**, to evaluate your clients' financial status and ability to pay. The form, when coupled with the FTB's evaluation procedures, is aimed at providing a consistent process and reducing the burden for documenting income and expenses used to determine an individual's ability to pay personal income tax liabilities.

In instances where taxpayers are unable to pay their tax liability in full or enter into an Installment Agreement (IA), the FTB may need to substantiate their financial situation. However, that does not mean that the process has to be difficult or a mystery to maneuver. With that in mind, the FTB created a form and evaluation procedures that are proposed to be:

- fair and consistent
- similar to IRS's financial hardship evaluation process, and
- simple to use

The new Financial Statement includes detailed instructions on how to complete the form and expenses have been organized to match the Collection Financial Standards. In addition, the FTB has updated its online Collection Procedure Manual with the new Financial Hardship Evaluation Procedures to provide clear direction and guidance.

COURT-ORDERED DEBT

The Court-Ordered Debt (COD) Collections Program collects delinquent court fines, fees, and forfeitures, as well as victims' restitution, on behalf of California courts and state agencies. The courts and state agencies refer these debts to the FTB, and it assists them by collecting delinquent debt.

A My COD Account gives you and your client the ability to view, monitor, and manage their debt online 24 hours a day, seven days a week.

Logging into the secure My COD Account is easy and only requires the billing number, client's last name, and Social Security number. Once logged into the My COD Account, you will be able to do the following:

- View the current balance due.
- View the balance due summary for each active case.
- View the last 25 payments applied to the balance due.
- Make an online payment using a bank account or credit card.
- Apply for an IA.
- Skip an IA payment.
- Delay the payment due date.

You or your client may contact the FTB at (916) 845-4064 for assistance with a My COD Account.

Court-Ordered Debt Authority Expanded

AB 3249 (Judiciary, Stats. 2018, Ch. 659) adds certain amounts imposed by the Supreme Court of the State of California for debts due to the State Bar under Business and Professions Code §6086.10 (relating to disciplinary proceeding costs and expenses) and §6140.5 (relating to reimbursement to the Client Security Fund) to the debt types that can be referred to the FTB COD collection program.

INSTALLMENT AGREEMENTS

To start the IA process, an individual must first fill out a simple form to request an IA. **FTB Form 3567, Installment Agreement Request**, can be completed online or mailed to the FTB. An IA can also be applied for by calling the FTB at

(800) 689-4776

The FTB normally grants an agreement without requiring financial information if an individual taxpayer

- Owes a balance of $25,000 or less;
- Agrees to pay the full amount in 60 months or less; and
- Has filed all required PIT returns.

For the client who does not meet the above parameters, once he or she has applied for an IA, the FTB will either approve or deny the agreement. In some cases, the FTB will request additional financial information from your client. The decision to approve the agreement is based on ability to pay and compliance history. When applying for the IA, the client should provide complete information, including bank information for an automatic debit. Failure to provide complete information will delay the process and possibly cause the FTB to deny the application.

If the application is completed online, the status can be checked by using the client's Social Security number and confirmation number found on the IA confirmation page. If the application was mailed or requested by phone, the FTB will send a written notification within 30 days. If you do not hear from the FTB after 30 days, call the above phone number during business hours. During this time, you should advise your client to begin making payments as proposed in the agreement application. If the IA is approved, this amount will be due on a specific day each month for the duration of the agreement. Missing a payment or having a payment dishonored may result in the IA being revoked or cancelled.

If your client is a business entity, the entity may also qualify for an IA. Business entities must call

(888) 635-0494

FTB May Let You Skip an IA Payment

On its Help with Payment Plans page, the FTB outlines the procedures for taxpayers to make a request to skip an IA payment. Eligible taxpayers can make the request online.

A taxpayer may be eligible to skip an IA payment if the following criteria is met:

- The taxpayer is in an existing, active IA.
- The taxpayer has less than two previous skipped payments.

- The taxpayer submits his or her request more than five days but less than 30 days from the next payment due date.

The IA balance will continue to accrue interest and applicable penalties. The FTB will extend the original IA repayment period until the taxpayer pays the IA balance in full. In all other respects, the taxpayer will be subject to the original terms and conditions of the IA.

Log in to MyFTB and select “Skip Installment Agreement Payment” from the “Services” drop-down menu.

PAYING CASH AT A FIELD OFFICE

In February 2016, the FTB announced that its field offices will allow exceptions to the “no cash policy.” All field offices will accept cash in situations where the No Cash Policy would create an undue hardship for tax and non-tax customers. If the customer cannot pay by any means other than cash, as of July 1, 2016, the new exemption policy was implemented as follows:

- A taxpayer who needs to pay in cash must request an exemption to the No Cash Policy using the No Cash Policy Exemption Request form (**FTB 3711-PC**).
- To request an exemption, the taxpayer will need to provide an explanation for his or her inability to pay using FTB-provided methods. The No Cash Policy Exemption Request form must be signed by the taxpayer, partner, corporate officer, or POA.
- The FTB will review the exemption request and mail a letter of determination to the taxpayer within two business days.
- If the exemption is approved, the taxpayer is responsible for contacting one of the six FTB field offices to make an appointment prior to making a cash payment.
- An approved exemption is good for all future transactions at any of the FTB’s six offices.

STATUTE OF LIMITATIONS

The general time limit for a taxpayer to file a **claim for credit or refund** of California state income and franchise taxes is provided by R&TC §19306. Section 19306 states that no credit or refund shall be allowed after four years from the original due date of the return, four years from the date the return was filed (if filed within the extension period), or one year from the date of the overpayment, whichever is later, unless a claim is filed by the taxpayer prior to the expiration of that period.

The general time limit for the FTB to **assess** additional California state income and franchise taxes is provided by R&TC §19057. The law generally requires the FTB to mail a proposed deficiency assessment to the taxpayer within four years after the filing date of the taxpayer’s return. Returns filed before the original due date of a PIT return (Apr. 15 of the year after the tax year) are considered as filed on the original due date.

Tax Returns Filed Late or Not at All

For tax years 1992 and after, the FTB must assess tax within four years from the original Apr. 15 due date of the return if the taxpayer filed the return on or before that date. If the taxpayer did not file the return on or before the original Apr. 15 due date, the FTB has four years from the date the return was filed to assess tax.

If the taxpayer did not file a tax return, or files a false or fraudulent tax return, there is no time limit for the FTB to assess tax. The FTB will estimate net income from any available information and assess tax based on that estimate.

Assessments may be allowed after the general time limit in special circumstances, such as if the IRS made federal adjustments, or if the taxpayer failed to report 25% or more of the gross income required to be reported on a tax return.

Statute Following IRS Audit

If the IRS audits your client, he or she has a requirement to notify the FTB of the outcome. Once the IRS completes an examination of the tax return and issues a revenue agent report, you or your client should notify the FTB within six months of the final federal determination.

Notification Requirements

You or your client are required to notify the FTB if the IRS adjusts or corrects gross income or deductions. Your notification should include any IRS assessed penalties, adjustments, or corrections resulting from math errors, tax credit adjustments, other tax adjustments, or supplemental income even if the IRS did not examine these adjustments.

The final federal determination is the date each IRS examination adjustment or resolution is assessed, as described in IRC §6203. If the FTB receives the federal changes within the six-month period, it has two years from the date it receives a report of the federal changes to apply the federal changes to the California tax return. Notification of a change or correction by the taxpayer or IRS must be sufficiently detailed to allow computation of the resulting California tax change.

If you or the IRS notify the FTB more than six months after the date of the final federal determination, the FTB considers the notification untimely. In that case, it has four years from the date it receives "sufficiently-detailed" information to apply the federal changes to the California return. "Sufficiently-detailed" information is defined as enough information to allow the FTB to compute the resulting California tax return change.

If your client receives an assessment from the FTB because the IRS has notified it of the federal adjustment, you may call the practitioner hotline, or your client may call the general line, to find out the date of notification for purposes of the two year or four year statute of limitations.

If FTB Is Not Notified by the Taxpayer or the IRS

If neither the taxpayer nor the IRS provides the FTB timely notification of the federal changes, the statute of limitations for assessment remains open, and therefore, the FTB may issue an assessment at any time. Interest accrues from the original tax year due date until the tax liabilities and penalties are paid in full.

When FTB is properly notified, it may be able to resolve the case without the need to request more information. Notification also ensures prompt assessment of any additional tax, which may reduce the amount of interest charged.

Statute Did Not Run out Because Taxpayers Failed to Notify FTB

Joseph and Patricia West filed a joint 2005 California Resident Income Tax Return on Oct. 15, 2006. On Apr. 4, 2013, the FTB learned that the IRS disallowed $71,891 of the $112,594 mortgage interest claimed as a deduction on the Wests' Schedule A due to limitations under IRC §163(h) and that the IRS had imposed a federal accuracy related penalty (ARP). The Wests did not report the federal adjustment to the FTB.

On Oct. 16, 2013, the FTB issued an NPA that conformed to the federal adjustment by adding $71,891 to the Wests' 2005 California taxable income. The NPA set forth an additional tax of $6,686 and an ARP of $1,337, plus applicable interest.

Although the Wests appealed, the State Board agreed that the FTB was not barred under the statute following an IRS determination (***Appeal of Joseph and Patricia West***, SBE No. 923264, June, 2017).

OFFERS IN COMPROMISE

The Offer in Compromise (OIC) Program offers taxpayers who do not have, and will not have in the foreseeable future, the money, assets, or means to pay their tax liability in full. It allows a taxpayer to offer a lesser amount for complete satisfaction of a nondisputed final tax liability. The FTB's OIC program is authorized by R&TC §19443.

The FTB requires taxpayers to prove that the amount offered is the most it could expect to receive based on their present assets and income. In addition, the FTB determines whether taxpayers have reasonable prospects of acquiring additional income or assets that would allow them to satisfy a greater amount of the liability than the offered amount within a reasonable period (depending on other factors, five years is usually considered a reasonable period). Furthermore, the FTB must determine that acceptance of the offer is in the best interest of the state.

You may use the following publications to assist your clients in applying for an OIC:

- **4905 PIT Booklet, Offer in Compromise for Individuals**
- **4905 BE Booklet, Offer in Compromise for Business Entities**
- **DE 999CA, Multi-Agency Form for Offer in Compromise**

You may call the OIC staff directly at

(916) 845-4787

CDTFA Offers Online Tool for OIC Eligibility

In October 2019, the California Department of Tax and Fee Administration (CDTFA) released an online screening tool to help people determine if they are eligible to apply for an Offer-in-Compromise (OIC).

The CDTFA's OIC program is for taxpayers that do not have, and will not have in the foreseeable future, the income, assets, or means to pay a tax liability in full. Taxpayers may be eligible for the program if they:

- Have a final tax or fee liability

- Are no longer associated with the business that incurred the liability or a similar type of business
- Do not dispute the amount of tax or fee owed
- Cannot pay the full amount owed in a reasonable amount of time

The new eligibility screening tool can help taxpayers quickly determine if they are eligible to apply for an OIC by entering financial information to calculate a preliminary offer amount. Taxpayers can use the preliminary offer amount when they submit an application for an OIC.

INNOCENT SPOUSE

When a taxpayer files a joint liability tax return with his or her spouse, the individuals are each responsible for paying the entire liability due. However, if an individual meets certain criteria, he or she may qualify for relief from having to pay all or part of the liability.

To obtain relief from the obligation to pay the tax due from a joint personal tax return, complete the following steps:

- Ask the court to issue an order granting relief, if the taxpayer is divorcing his or her spouse.
- Ask the FTB to determine if the taxpayer qualifies for innocent spouse relief.

Relief by Court Order

A taxpayer may qualify for relief by court order if the following conditions are met:

- He or she is obtaining a divorce from a spouse, and the court issues an order relieving the individual of the unpaid tax due from a joint liability.
- He or she is in the process of divorcing and joint gross income exceeds $150,000 or the taxpayer owes more than $7,500 for the year he or she is seeking relief. Send the FTB a letter requesting a Tax Revision Clearance Certificate. Make sure your letter includes name, address, telephone number, and Social Security number. After the court issues its order, provide the FTB with a copy of the court order, and it will determine the amount of relief.

Innocent Spouse Relief

A taxpayer may qualify for innocent spouse relief if the following conditions are met:

- He or she has an unpaid tax that was reported on a joint California income tax return, and the taxpayer had no reason to know that the tax shown on the return was not paid when the return was filed, or
- He or she owes a joint liability for underreported income or erroneous deductions that are attributable to the spouse, and the taxpayer had no reason to know of those items when he or she signed the return.

To request relief, complete form **FTB 705** and send it with a statement of the reasons why the taxpayer thinks he or she qualifies for relief. The statement should include name, address, telephone number, Social Security number, and the tax years or years for which you are asking for relief.

If the IRS allowed innocent spouse relief for the same tax years that the taxpayer is asking the FTB for relief, please make sure that you provide the FTB with the IRS information when you make your request. To submit a request for innocent spouse relief, contact the FTB at the following address:

Innocent Spouse Unit
Franchise Tax Board A-452
PO Box 2966
Rancho Cordova, CA 95741-2966

California Innocent Spouse Relief Conforms to Federal Relief Provisions

SB 1065 (Walters, Stats. 2010, Ch 318), enacted Sep. 27, 2010, provides the following:

- Reenacts and makes permanent the statutory requirement that the FTB grant innocent spouse relief when the IRS has granted relief under the same facts and circumstances.
- Allows a taxpayer to appeal the FTB's determination on an "equitable relief" request for innocent spouse relief.
- Removes the obsolete transition rule that refers to a four-year period for submitting a request for innocent spouse relief.

The provisions of **SB 1065** are effective Jan. 1, 2011, and specifically apply to the following:

1. Requests for state relief that are based on an IRS request for similar relief made on or after Jan. 1, 2009, and
2. Requests for equitable relief received by the FTB on or after Jan. 1, 2011.

PENALTIES

REASONABLE CAUSE FOR PENALTY ABATEMENT

Penalty abatement requests are considered based on the individual facts and circumstances surrounding each case. Taxpayers most often request waivers of penalties based upon reasonable cause for the following penalties:

- Late payment of tax;
- Failure to file a return;
- ARP;
- Failure to furnish information; and
- File after notice of demand.

Late Payment of Tax

In order to establish reasonable cause for the *late payment of tax*, the taxpayer must show that his failure to pay the proper amount of tax by the original due date occurred despite the exercise of ordinary business care and prudence (*Appeal of Roger W. Sleight* (83-SBE-244), Oct. 26, 1983).

In a recent decision, the Board determined that a taxpayer did not show reasonable cause in a case where the taxpayer paid his tax late because of a dispute he had with his partnership over the amount of income reported on a Schedule K-1. The Board ruled the taxpayer had not explained with adequate precision the nature and extent of the steps that he allegedly took to gather the information he considered necessary to confirm the correctness of the income reported on the K-1. The Board also reasoned that the taxpayer failed to obtain by independent inquiry the information he needed from the partnership to calculate accurately the tax that he owed before the due date of his return. As a result, the Board concluded that the taxpayer failed to exercise ordinary business care and prudence when he paid his tax after the due date.

Failure to File a Return

In order to establish reasonable cause for *failing to file a return* on or before the due date, the taxpayer must show that his failure was due to reasonable cause and not due to willful neglect. To establish reasonable cause, the taxpayer "must show that the failure to file a timely return occurred despite the exercise of ordinary business care and prudence, or that cause existed as would prompt an ordinary intelligent and prudent businessman to have so acted under similar circumstances" (*Appeal of Howard G. and Mary Tons* (79-SBE-027), Jan. 9, 1979). The burden is on taxpayers to prove that reasonable cause exists to support abatement of the penalty for filing a late tax return.

Accuracy Related Penalty

The FTB may impose the ARP on any portion of an underpayment of tax that should be shown on the return (R&TC §19164). The penalty is equal to 20% (or 40% for amnesty eligible year) of the underpayment of tax. R&TC §19164 imposes a 20% ARP on any portion of an underpayment attributable to one or more of the following:

- Negligence or disregard of rules or regulations;
- Substantial understatement of income tax;
- Substantial valuation misstatement; and
- Substantial overstatement of pension liabilities.

A 40% penalty may be assessed for gross valuation misstatements.

The reasonable cause and good faith defense applies to negligence or disregard of rules or regulations, substantial understatement of income tax, substantial valuation misstatement, and gross valuation misstatement. However, under certain circumstances the defense does not apply to an underpayment attributable to a substantial or gross valuation understatement regarding charitable deduction property.

IRC §6664(c)(1) provides that no penalty under IRC §6662 will be imposed if the taxpayer can show that there was reasonable cause and that the taxpayer acted in good faith with respect to the underpayment. Treas. Reg. §1.6664-4 provides guidance on what constitutes reasonable cause and good faith and whether those standards are met for purposes of eliminating the ARP. The determination of reasonable cause is made on a case-by-case basis, taking into account all facts and circumstances.

Failure to Furnish Information or File after Notice and Demand

Failure to furnish information or file after notice and demand penalty can only be abated by showing reasonable cause and not willful neglect. To establish reasonable cause, a taxpayer must show that the failure to reply to the notice and demand or request for information occurred despite the exercise of ordinary business care and prudence such that an ordinarily intelligent and prudent businessperson would have acted similarly under the circumstances.

Examples	
Reasonable Cause	**Not Reasonable Cause**
Credible and competent proof of illness or other personal difficulty completely prevented taxpayer from complying.	Ignorance of the law.
	Reliance on agent to respond on taxpayer's behalf.
Relied on tax professional with competency in the subject of tax law, and tax professional's advice is based on taxpayer's full disclosure of relevant facts and documents.	Lost, lacking, inaccurate, or difficult to obtain information.
	Complexity of tax law.
Proof that the notice and demand/request for information was not mailed to taxpayer's last known address.	Pressures of business affairs or work.
	Claim that taxpayer did not receive notice.

TWO REASONABLE CAUSE ABATEMENT REQUEST FORMS

In September 2014, the FTB rolled out two forms with instructions regarding reasonable cause and statute of limitations:

- **FTB 2917**, Reasonable Cause – Individual and Fiduciary Claim for Refund; and
- **FTB 2924**, Reasonable Cause – Business Entity Claim for Refund.

The FTB standardized the layout of the forms to make it easier for taxpayers to provide all the information the FTB needs in order to carry out the following:

- Evaluate a reasonable cause abatement request;
- Prevent unneeded correspondence; and
- Scan and route incoming forms to speed claims processing.

Although the FTB recommends using these two forms for a quicker response, it continues to accept and process hand-written reasonable cause abatement requests.

MISCELLANEOUS PENALTY CASES

Bad Professional Advice Can Create Reasonable Cause

On April 14, 2016, Harry Moren received an e-mail and attachment from the accountant for his relative's estate. The e-mail stated that the attachment was a summary of the current accounting status of the estate, and indicated that the information contained therein affected each of the recipients, including Harry, and their individual tax obligations. Although the e-mail references a summary of accounting, the April 2016 letter provides no actionable data and instead states that determinations and revisions were still to be made. Accordingly, Harry's 2015 tax liability resulting from the estate distributions was still undetermined as of April 2016.

After several requests from Harry and other beneficiaries, the estate's accountant sent another e-mail on Aug. 17, 2016 indicating that K-1s had been filed but that there were still open issues and the accountant anticipated the need to file amendments reducing taxable income. Harry received his K-1 a week later. He subsequently made several phone and e-mail requests for clarification and, receiving no reply, finally filed his 2015 return on Oct. 15, 2016. At that time, Harry paid $20,525, which was all attributed to the income from the estate K-1.

Harry appealed the FTB's assessment of $1,642 late payment penalty. The OTA found Harry has shown that he exercised ordinary business care and prudence in attempting to pay his entire tax liability by the due date with the information available to him. He made efforts to acquire the information necessary to determine the tax liability associated with the distributions from the estate, despite the nonresponsive nature of the third-party's accountant that was withholding the necessary information, and has therefore shown that he acted in a manner matching that of an ordinarily intelligent and prudent businessperson given the situation in which he was placed. Accordingly, Harry has shown that he had reasonable cause for the late payment of that portion of his tax liability that was based on the distributions from the estate, and that the late payment was not due to willful neglect (***Appeal of Harry J. Moren***, OTA No. 18011276, June 2019).

Can't Rely on Professional Advice If You Withhold Facts

In 2004, Alan R. Brayton, an experienced plaintiffs' attorney and founding partner of Brayton Purcell LLP (Law Firm), owned 99% of Brayton Purcell APC (S Corporation), an S corporation formed on May 3, 2004. All of the profits and losses of the Law Firm flowed through to the S Corporation, and 99% of the S Corporation's profits or losses were allocated to Brayton.

After consulting tax and estate planning advisors, Alan engaged in a complex series of transactions beginning in July 2004, which generated a reported $49,450,000 in tax deductions for the S Corporation as ordinary and necessary business expenses, which in turn substantially reduced Alan's taxable income from the S Corporation and reduced his personal taxable income by more than 75%. The FTB disallowed the claimed deduction at audit and issued a proposed assessment for additional tax and a 20% ARP.

Brayton contends, however, that the underpayment was due to reasonable cause and that he acted in good faith. He asserts that he relied on the use of tax professionals to structure the transactions and to prepare his tax return. However, the legal opinion he obtained did not provide advice regarding the legitimacy of the nearly $50 million deduction. The State Board declared that Brayton must have known it was inappropriate to claim a nearly $50 million deduction by engaging in a paper transaction in which he caused his corporation to pay nearly $50 million to controlled LLCs for services that he agreed to provide to the LLCs for $180,000 — essentially claiming a deduction for amounts he paid to himself (***Brayton,*** SBE No. 852168, Mar. 28, 2017).

ADMINISTRATION

VOLUNTARY DISCLOSURE PROGRAM EXPANDED

California allows an applicant requesting a "voluntary disclosure agreement" (VDA) to remain anonymous until the signed voluntary disclosure program (VDP) is returned to the FTB. Existing law allows qualifying entities, certain LLCs, qualified trusts, qualified shareholders, qualified members of LLCs, and qualified beneficiaries of qualified trusts to participate in the VDP. These entities are defined as follows:

- A “qualified entity” includes any corporation, including an S corporation, an LLC not classified as a corporation, and a qualified trust that has never filed a California income or franchise tax or LLC return and that voluntarily applies for a VDA prior to any contact from the FTB regarding income, franchise, or LLC tax liability.

- A “qualified shareholder” is a nonresident shareholder of an S corporation on the signing date of the VDA and for which the S corporation has disclosed all material facts pertaining to the shareholder’s liability.

- A “qualified member” is an individual who is a nonresident on the signing date or a corporation or LLC that is not organized in California nor qualified or registered with the office of the Secretary of State (SOS). A qualified member in all cases is a member of an LLC that has applied for a VDA and disclosed all material facts pertaining to the member’s liability.

- A “qualified trust” is a trust that meets both of the following requirements:
    - The administration of the trust has never been performed in California, except for inconsequential in-state administrative services; and
    - For the six taxable years immediately preceding the signing date of the VDA, the trust has had no California resident beneficiaries, except for a California beneficiary whose interest in that trust during such period was always contingent.
    - If the trust has made any distribution to a California resident beneficiary at any time during the six taxable years before the signing date of the VDA, that beneficiary’s trust interest is non-contingent.

- A “qualified beneficiary” is an individual who is a beneficiary of a qualified trust and is a nonresident on the signing date of the VDA and for each of the prior six taxable years.

Under the VDP, the following penalties may be waived:

- Failure to make and file a tax return.
- Failure to pay any amount due by the date prescribed for payment.
- Underpayment of estimated tax.
- SOS-imposed penalties, pursuant to Corporations Code §6810 and §8810(a).
- Failure to furnish information or maintain records, as provided in R&TC §19141.5.
- Underpayment of tax.
- Late filing of partnership tax returns, except for LLCs classified as partnerships.
- Failure to file information tax returns.
- Relief from contract voidability.

To satisfy the terms of the VDA, approved applicants must return a signed VDA to the FTB, make all payments, and submit all returns to the FTB within 30 days from the signing date of the VDA. The FTB may grant an extension for filing tax returns and paying amounts due to 120 days from the signing date of the VDA, or the latest extended due date of the tax return for a tax year where relief is granted, whichever is later. Failure to adhere to the terms of the VDA renders the VDA null and void.

Additional Penalty Relief

AB 1719 (R&TC Comm., Stats. 2017, Ch. 175) modifies the VDP's provisions to allow penalty relief for S corporations or LLCs classified as a partnership for late filing penalties for VDAs entered into on or after Jan. 1, 2017.

Additional Entities Eligible

SB 813 (Finance, Stats. 2017, Ch. 288) further modifies the VDP's provisions to allow the following:

- Eligibility for out-of-state partnerships with nonresident partners of GPs, LPs, and LLPs; and
- Eligibility for out-of-state trusts with California resident beneficiaries to participate in the VDP.

Additionally, the bill duplicates the penalty relief for S corporations or LLCs classified as a partnership for failure to file a timely return, as enacted by **AB 1719.**

CONTACTING THE TAXPAYERS' RIGHTS ADVOCATE

You may contact the Taxpayers' Rights Advocate if you have an ongoing state income tax problem that you have been unable to resolve through normal channels. Representatives in Executive and Advocate Services (EAS) coordinate resolution of taxpayer complaints and problems. Depending on your issue, EAS may either help you get in contact with the appropriate business area or ask you to provide a written request for assistance.

Susan Maples
Taxpayers' Rights Advocate
(916) 843-6022
Susan.Maples@ftb.ca.gov

Or visit the Taxpayers' Rights Advocate page on the FTB's website.

STALE-DATED WARRANTS

The FTB now requires your clients to submit a signed claim form for stale-dated warrants (expired checks) more than three years old from the date of issuance. The claim forms available are as follows:

- **FTB 3900A** for PIT, and
- **FTB 3900B** for Business Entities.

Prior to June 27, 2016, the law provided that taxpayers who sought the replacement of a stale-dated warrant older than three years from the date of issuance must make a government claim to the Victim Compensation and Government Claims Board. Upon passage of Senate Bill (SB) 836 (2016), the responsibility for reissuance of stale-dated warrants returned to the FTB.

When your client requests a reissuance of a stale-dated or replacement warrant, the FTB asks for your client to return the original warrant and send their signed claim form to the following address:

RETURNED WARRANT DESK
FRANCHISE TAX BOARD
PO BOX 942867
SACRAMENTO, CA 94267-0001

If the bank is unable to return the original stale-dated warrant to your client, under the "Check 21" law, the bank can give the taxpayer a copy of the warrant or a substitute check. The FTB will accept either in lieu of the original stale-dated warrant.

> **Tax Preparer Note**: The FTB will not process warrants that are more than three years old without a signed claim form. The FTB will contact your client.

2020 FEDERAL AND CALIFORNIA TAX UPDATE
CALIFORNIA PAYROLL, SALES & PROPERTY TAXES

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2020 PAYROLL, SALES & PROPERTY TAXES

PAYROLL TAXES

SDI, UI, AND ETT RATES FOR 2020

State Disability Insurance (SDI)

The Employment Development Department (EDD) announced the SDI rate and wage limits for 2020.

Year	SDI Rate	Maximum Wage Base	Maximum Payment
2019	1.0%	$118,371	$1,183.71
2020	1.0%	$122,909	$1,229.09

Unemployment Insurance (UI)

The UI rate schedule in effect for 2019 is Schedule "F+." This is Schedule F plus a 15% emergency surcharge, rounded to the nearest tenth. Schedule F+ provides for UI tax rates from 1.5% to 6.2 %. The taxable wage limit is $7,000 per employee. The UI rate schedule for 2020 will remain the same.

New employers: The UI tax rate is 3.4% for up to three years. If the taxpayer purchased an established business, he/she has the option of acquiring the previous owner's UI tax rate.

> **Note.** The Voluntary UI program is not in effect for 2019 or 2020.

Employment Training Tax (ETT)

The ETT rate for 2019 is 0.1%. The UI and ETT taxable wage limit remains at $7,000 per employee per calendar year. The ETT rate for 2020 will remain the same.

UI, ETT, and SDI tax rates are combined on a single rate notice, Notice of Contribution Rates and Statement of UI Reserve Account (DE 2088). The DE 2088 will be mailed in December, with a mailing date of Dec. 30. Employers will have 60 days from the Dec. 30 mailing date to protest any item on the DE 2088 except SDI and ETT, which are specifically set by law.

WORKER CLASSIFICATION CALIFORNIA STYLE

Generally, whether a worker is an employee or an independent contractor can be determined through the application of the factors contained in common law or employment and statutory provisions of the California Unemployment Insurance Code.

Under California tax law, there is no statutory definition of an "independent contractor", therefore, the determination of whether a worker is an employee or an independent contractor relies on federal income tax law, judicial tests and administrative guidelines. There is a rebuttable presumption under Labor Code §3357 that a worker is an employee.

However, in order to rebut the presumption, a number of factors must be considered, none of which is controlling by itself.

The *Borello* Standards

The California Supreme Court in the case of ***S.G. Borello & Sons, Inc. v Department of Industiral Relations*** ((1989) 48 Cal.3d 341) (Borello) adopted the "economic realities" test. In applying this test, a significant factor to be considered is whether the person to whom service is rendered has the right to control the manner and means of the work performed.

Additional factors that may be considered under this test include:

1. Whether the person performing services is engaged in an occupation or business distinct from that of the principal;
2. Whether or not the work is a part of the regular business of the principal or alleged employer;
3. Whether the principal or the worker supplies the instrumentalities, tools, and the place for the person doing the work;
4. The alleged employee's investment in the equipment or materials required by his or her task or his or her employment of helpers;
5. Whether the service rendered requires a special skill;
6. The kind of occupation, with reference to whether, in the locality, the work is usually done under the direction of the principal or by a specialist without supervision;
7. The alleged employee's opportunity for profit or loss depending on his or her managerial skill;
8. The length of time for which the services are to be performed;
9. The degree of permanence of the working relationship;
10. The method of payment, whether by time or by the job; and
11. Whether or not the parties believe they are creating an employer-employee relationship may have some bearing on the question, but is not determinative since this is a question of law based on objective tests.

However, as stated above, all of the factors must be considered in light of the facts and circumstances surrounding the worker's relationship with its employer and no one factor is given more weight than another.

California Supreme Court Makes Up a New Test

In a rather alarming decision in April, 2018, the California Supreme Court found in favor of a delivery service's drivers as employees for purposes of the state's Industrial Welfare Commission (IWC) wage orders. In doing so, the Court chose to disregard the long-used 11-factor common law test from ***Borello*** and limit the factors to determine the "suffer or permit to work" standard.

It concluded it is appropriate, and most consistent with the history and purpose of the suffer or permit to work standard in California's wage orders, to interpret that standard as:

1. placing the burden on the hiring entity to establish that the worker is an independent contractor who was not intended to be included within the wage order's coverage; and
2. requiring the hiring entity, in order to meet this burden, to establish each of the three factors embodied in the "ABC test" — namely:

A. that the worker is free from the control and direction of the hiring entity in connection with the performance of the work, both under the contract for the performance of the work and in fact; and
B. that the worker performs work that is outside the usual course of the hiring entity's business; and
C. that the worker is customarily engaged in an independently established trade, occupation, or business of the same nature as the work performed.

While this is not a brand new standard, in that several other states have been using the ABC Test (Illinois and Massachusetts for example), it is the first time it has been applied in California (***Dynamex Operations West, Inc v. Superior Court of Los Angeles***, No. S222732, Apr. 30, 2018).

The Legislature Jumps on the Bandwagon

In enacting **AB 5** (Gonzalez, Stats. 2019, Ch. 296) state legislators decided to codify a portion of the ***Dynamex*** case that presumes a worker is an employee unless a hiring entity satisfies the factors of the "ABC" test in order to determine the status of a worker as an employee or independent contractor for selected provisions of the Labor Code and Unemployment Insurance Code.

The bill is effective January 1, 2020, and operative as of that date. And the law expressly states that no provision of the bill shall permit an employer to reclassify an individual who was an employee on January 1, 2019, to an independent contractor due to enactment of this bill.

Presumptive Employee Status Unless All Factors are Satisfied

According to **AB 5**, under the Labor Code, Unemployment Insurance Code, and for the purpose of wage orders of the Industrial Welfare Commission, except for specified statutory exemptions, a person providing labor or services for remuneration shall be considered an employee unless the hiring entity demonstrates that all three of the conditions are satisfied.

Any exceptions to the terms "employee," "employer," "employ," or independent contractor as defined in the Labor Code, Unemployment Insurance Code, or an applicable order of the Industrial Welfare Commission remain in effect.

For purposes of this bill, an individual is defined as an individual providing services through a sole proprietorship or other business entity. The individual must:

- Maintain a business location separate from the hiring entity. An individual is not prohibited from choosing to perform services at the location of the hiring entity.
- Have a business license in addition to any required professional licenses or permits for the individual to practice in their profession if work is performed more than six months after the effective date of this provision.
- Have the ability to set or negotiate their own rates for the services performed.
- Have the ability to set their own hours outside of project completion dates and reasonable business hours.
- Be customarily engaged in the same type of worked performed under contract with another hiring agency or holds themselves out to other potential customers as available to perform the same type of work.
- Customarily and regularly exercise independent judgment in the performance of the services.

How Good is Your Lobbyist? Certain Professions Excluded

AB 5 provides that the ABC test outlined in ***Dynamex*** will not apply to specified occupations and instead ***Borello*** will apply. The professions subject to the ***Borello*** test include:

- A person or organization **licensed by the Department of Insurance**.
- A **physician, surgeon, dentist, podiatrist, psychologist or veterinarian** licensed by the State of California pursuant to the Business and Professions Code, performing professional or medical services provided to or by a health care entity, except for employment settings currently or potentially governed by collective bargain agreements for these licensees.
- A practicing **lawyer, architect, engineer, private investigator, or accountant** who holds an active license from California.
- A **securities broker-dealer or investment adviser or their agents and representatives** registered with the Securities and Exchange Commissions, the Financial Industry Regulatory Authority or licensed by the State of California.
- A **direct sales salesperson**.
- A **commercial fisherman** working on an American vessel, as defined, through December 31, 2022.
    - A commercial fisherman working on an American vessel is eligible for unemployment insurance benefits if they met the definition of "employment" under the Unemployment Insurance Code.
    - The Employment Development Department shall issue an annual report to the Legislature on or before March 1, 2021 and each March 1 thereafter.
    - This subdivision shall become inoperative on January 1, 2023, unless extended by the Legislature.
- **Professional services**, performed under contract by an individual, in the following professions:
    - **Marketing,** under specified conditions.
    - **Administrator of human resources**, under specified conditions.
    - **Travel agent** services.
    - **Graphic design**.
    - **Grant Writer**.
    - **Fine Artist**.
    - **Enrolled agent** services.
    - **Payment processing agent** through an independent sales organization.
    - Services provided by a **still photographer or photojournalist** who does not license content submissions to the putative employer more than 35 times per year. A photographer or artist is not prevented from displaying their work product for sale.
    - Services provided by a **freelance writer, editor, or newspaper cartoonist** who does not provide content submissions to the putative employer more than 35 times per year.
    - Services provided by a **licensed esthetician, licensed electrologist, licensed manicurist, licensed barber, or licensed cosmetologist** if the individual sets their own rates, processes their own payments, is paid directly by the client, sets their own hours and has discretion to decide which clients to provide services to, has their own book of business and maintains their own business license. If the individual is performing services at the hiring entity location, then the individual issues a 1099 form to the salon or business owner from which they rent their space. The provision specific to licensed manicurist becomes inoperative on January 1, 2022.

AB 5 also provides that the ABC Test outlined in the holding in ***Dynamex*** will not apply to the following professions:

- A **real estate licensee** licensed by the state of California. If the section of the BPC that governs employee or independent contractor is not applicable then the determination is governed by the following:
  - Unemployment Insurance Code;
  - For purposes of workers compensation §3200 et seq; and
  - For all other purposes, in the Labor Code by ***Borello***.
- A **repossession agency**.

Other Special Rules Apply to Certain Business Relationships

AB 5 also provides rules for:

- Bona fied business to business contracting relationships
- Individuals performing construction work - contractor or subcontractor
  Reminder: in California a subcontractor can only be considered to be an independent contractor of the contractor if the sub holds a valid contractor's license.
- Construction trucking services
- Referral agencies and
- Motor clubs

What If the Worker is Now an Employee for California, But a Federal Independent Contractor?

FTB has provided limited guidance in this area. While it is possible for a worker now classified as an employee for California purposes to continue to be treated as an independent contractor for federal law, such a position is fraught with benefits and dangers for both the company and the worker. Some of these include:

- **Social Security taxes.** Companies can save on employer FICA, shifting the full burden to a federally claimed independent contractor.
- **Health insurance premiums**. Even a large employer can exclude independent contractors under its ACA mandated plan, but the worker must have minimum essential coverage under new California law.
- **Retirement savings**. Independent contractors generally cannot participate in company sponsored 401(k) plans. Thus the worker also loses any company matching contributions. But what happens under California tax if the independent contractor funds SEP or other self-employed pension plan?
- **Out-of-pocket expenses**. In light of TCJA 2017 and employee can no longer deduct unreimbursed expenses on his/her federal tax return, but an independent contractor reports expenses on Schedule C.

These are just a few of the potential discussion areas awaiting further clarification in California.

> ***Practitioner Note:*** Please see a sample client letter to send to your business clients regarding their potential need to reclassify independent contractors in the Appendix to this chapter.

FAQs on AB 5 and Worker Classification

FTB launched an entire page of FAQs regarding the enactment of AB 5 in 2019.

FTB Addresses Issues of Different State vs. Federal Classification

Among the areas addressed by the FTB, some of the toughest are questions about reporting income, worker benefits and pensions. For example:

Q. If the worker is issued a W-2 reporting earnings because the worker is an employee under California law, and a Form 1099-K or 1099-MISC reporting the same earnings because the worker is an independent contractor under federal law, should the payor file a Form 1099-K or 1099-MISC showing zero income to the Franchise Tax Board?

A. The payor is not required to file the Form 1099-K or 1099-MISC with California and would file the form with the Internal Revenue Service. The payor would be required to report information on the Form 1099-K or 1099-MISC in accordance with the federal Form 1099 filing requirements.

Q. Will California follow the federal pension plan qualification rules through automatic conformity regardless of its determination if a worker is an employee or independent contractor?

A. §401 through §424 of the Internal Revenue Code provide rules regarding deferred compensation plans, including the qualification rules regarding employer provided pension plans. California, pursuant to §17501 of the R&TC, automatically conforms to §401 through §424 of the IRC and any modifications to those code sections. Thus, California would follow the federal determination if a pension plan is a qualified plan. Therefore, if a pension plan is a qualified plan under the IRC, the pension plan would be considered a qualified plan for the purposes of the R&TC.

These, and all of the FAQs are downloadable in pdf format in the worker classification and AB 5 FAQs section of the FTB's website.

CALSAVERS PROGRAM

In 2012, the California legislature enacted **SB 1234** (De Leon, Stats. 2012, Ch. 734) and **SB 923** (De Leon, Stats. 2012, Ch. 737) that would provide the framework for the eventual implementation of the CalSavers program. In 2016 Governor Brown signed **SB 1234** (De Leon, Stats. 2016, Ch. 804) implementing the plan.

CalSavers Provides Access to Saving for Retirement for All Employees

State law requires that California employers, who don't already offer an employer-sponsored retirement plan and who have five or more employees, either sponsor a retirement plan or participate in CalSavers. The three-year phased rollout includes staggered deadlines for registration based on employer size. All eligible employers are encouraged to join at any time prior to their registration deadline.

The program launched in July 2019. Employer implementation deadlines are:

June 30, 2020 for employers with more than 100 employees

June 30, 2021 for employers with more than 50 employees
June 30, 2022 for employers with 5 or more employees

Employers Pay No Fees and Have No Fiduciary Responsibility

The CalSavers Retirement Savings Program is an automatic enrollment payroll deduction IRA overseen by the California Secure Choice Retirement Savings Investment Board ("Board"). Ascensus College Savings Recordkeeping Services, LLC ("ACSR") is the program administrator. ACSR and its affiliates are responsible for day-to-day program operations. Participants saving through CalSavers beneficially own and have control over their IRAs, as provided in the Program Disclosure Booklet available at the CalSavers website. CalSavers is not sponsored by the employer, and therefore the employer is not responsible for the Program or liable as a Program sponsor. Employers are not permitted to endorse the Program or encourage or advise employees on whether to participate, how much (if any) to contribute or provide investment help.

CalSavers offers investment options selected by the Board.

OTHER EDD NEWS

EDD Wants to Help Cannabis Industry

The EDD is trying to help business owners in the cannabis industry comply with California's payroll tax laws and avoid unforeseen tax liabilities. California businesses that hire employees to perform services are required by law to withhold, report, and pay payroll taxes to the EDD. Cannabis businesses include but are not limited to, distributors, transporters, and dispensaries, and would include employees such as managers, plant caretakers, budtenders, security guards, salespersons, and delivery persons.

DE 643 Cannabis Industry Businesses explains state employment payroll tax reporting as it applies to the cannabis industry.

FAQs - Cannabis Industry Payroll Tax Reporting provides online answers to frequently asked questions regarding state payroll compliance for the cannabis industry.

EDD Taxpayer Advocate

Did you know that the EDD has a Taxpayers' Rights Advocate? When you've exhausted your alternatives through EDD's normal chain of command or when you just don't know to whom you can turn, contact **Bradley Hodges**:

Telephone:
(916) 654-8161

Email:
Bradley.Hodges@edd.ca.gov

SALES AND USE TAXES

GOVERNOR ORDERS SALES AND USE TAX RELIEF FOR SMALL BUSINESSES

In accordance with the Executive Order issued by Governor Newsom in late March, 2020 to expand tax relief for small business taxpayers, the CDTFA announced that all small businesses will have an additional three months to file returns and pay taxes administered by the department. Additionally, all businesses will have an extra 60 days to file claims for refund from CDTFA or to appeal a CDTFA decision to the Office of Tax Appeals.

CDTFA is providing a three-month extension for a tax return or tax payment to any businesses filing a return for less than $1 million in tax. For the approximate 99.5% of business taxpayers below the $1 million threshold for their current California sales and use tax obligation, returns for the 1st Quarter 2020 will now be due on July 31, 2020. The same provisions apply to the other tax and fee programs administered by CDTFA. Qualifying taxpayers are not required to file a request for extension or request relief from penalty or interest. This automatic extension will remain in effect through the reporting of taxes and fees due on or before July 31, 2020.

Interest-Free Payment Plans Also Available

Governor Newsom also ordered a new relief effort that gives all businesses with less than $5 million in annual taxable sales the ability to defer payment on up to $50,000 in sales and use tax liability without incurring any penalties or interest.

Under the program released on April 3, 2020, qualifying businesses can enter into payment plans to distribute up to $50,000 of sales tax liability over a 12-month period, interest-free. For taxpayers choosing to defer their 1st quarter 2020 liability, for example, up to $50,000 of the obligation would now be paid in twelve equal monthly installments, with the first payment not due until July 31, 2020.

NEW COLLECTION REQUIREMENTS DUE TO THE *WAYFAIR* DECISION

In 2019, California passed **AB 147** (Burke, Stats. 2019, Ch. 5). **AB 147** amended R&TC §6203 to require retailers located outside of California (remote sellers, including foreign sellers located outside of the United States) to register with the California Department of Tax and Fee Administration (CDTFA) and collect California use tax if, during the preceding or current calendar year, the total combined sales of tangible personal property for delivery in California by the retailer and all persons related to the retailer exceed $500,000.

> ***Important Note:*** In general, the requirements to register and collect California use tax prior to **AB 147** remain in effect. That is, retailers with a physical presence in California are still generally required to be registered with the CDTFA. Examples of a physical presence in this state include, but are not limited to:
>
> - Maintaining inventory or office locations in California.
> - Having representatives in California for purposes of taking orders, making sales or deliveries, or installing or assembling tangible personal property.
> - Leasing equipment, including a computer server in California.

AB 147 also amended R&TC §7262 to require all retailers, whether located inside or outside of California, to collect district use tax on all sales made for delivery in any district that imposes a district tax if, during the preceding or current calendar year, the total combined sales of tangible personal property in California or for delivery in California by the retailer and all persons related to the retailer exceed $500,000. This new collection requirement is operative April 25, 2019.

What Started All This? The US Supreme Court Decision in *South Dakota v. Wayfair Inc.*

South Dakota, like many states, taxes the retail sales of goods and services in the State. Sellers are required to collect and remit the tax to the State, but if they do not then in-state consumers are responsible for paying a use tax at the same rate. Under ***National Bellas Hess, Inc. v. Department of Revenue of Ill***., (386 U. S. 753), and ***Quill Corp. v. North Dakota***, (504 U. S. 298), states may not require a business that has no physical presence in the State to collect its sales tax.

South Dakota Responds to Low Compliance Rates

Consumer compliance rates are notoriously low, and it is estimated that ***Bellas Hess*** and ***Quill*** cause South Dakota to lose between $48 and $58 million annually. Concerned about the erosion of its sales tax base and corresponding loss of critical funding for state and local services, the South Dakota Legislature enacted a law requiring out-of-state sellers to collect and remit sales tax "as if the seller had a physical presence in the State." The Act covers only sellers that, on an annual basis, deliver more than $100,000 of goods or services into the State or engage in 200 or more separate transactions for the delivery of goods or services into the State.

Top Online Retailers Rebel

Several top online retailers with no employees or real estate in South Dakota, who each met the Act's minimum sales or transactions requirement, did not collect the State's sales tax. South Dakota filed suit in state court, seeking a declaration that the Act's requirements are valid and applicable to those retailers and an injunction requiring them to register for licenses to collect and remit the sales tax. The retailers sought summary judgment, arguing that the Act is unconstitutional. The trial court granted their motion. The State Supreme Court affirmed on the ground that ***Quill*** is controlling precedent.

US Supreme Court Overturns the State Courts

In a 5-4 split, the US Supreme Court held that the physical presence rule of ***Quill*** is unsound and incorrect, and that both ***Quill*** and ***Bellas Hess*** are outdated methods of determining nexus. In their absence, the Court ruled that South Dakota's statute establishes sufficient nexus. The Act applies only to sellers who engage in a significant quantity of business in the State, and respondents are large, national companies that undoubtedly maintain an extensive virtual presence (***South Dakota v. Wayfair, Inc., et al***, US No. 17-494, Jun 21, 2018).

More Legislation Regarding Marketplace Facilitators

Beginning October 1, 2019, more new California law generally provides that a marketplace facilitator is responsible for collecting and paying the tax on retail sales made through their marketplace for delivery to California customers. A marketplace includes a physical or online place where marketplace sellers sell or offer for sale tangible merchandise for delivery in California. A marketplace facilitator is generally the operator of the marketplace. This new law is referred to as the **Marketplace Facilitator Act**, added by **AB 147** and amended by **SB 92** (Budget, Stats. 2019, Ch. 34).

The following are the general definitions for terms used in the Marketplace Facilitator Act:

Marketplace: a physical or electronic place where a marketplace seller sells or offers for sale tangible merchandise for delivery in this state.
Marketplace facilitator: in general, a person who contracts with marketplace sellers to facilitate the sale of the marketplace sellers' products through a marketplace operated by the person or a related person when other statutory requirements are met.
Marketplace seller: a person who has an agreement with a marketplace facilitator and makes retail sales of tangible merchandise through a marketplace owned, operated, or controlled by a marketplace facilitator.
Delivery network company: a business entity that maintains an internet website or mobile application used to facilitate delivery services for the sale of local products to customers within a 75 mile range from the local merchant. A delivery network company, as defined in the Marketplace Facilitator Act, is not a marketplace facilitator unless it elects to be a marketplace facilitator.

General Registration Requirements

A person, including a marketplace facilitator or a marketplace seller that is actively engaged in selling tangible personal property in this state is required to register with the CDTFA for a seller's permit. Additionally, a person who is engaged in business in this state under R&TC §6203 because they have a sufficient physical presence in California or economic nexus with California is required to register with the CDTFA for a Certificate of Registration – Use Tax, collect use tax from their purchasers, and file regular sales and use tax returns.

Marketplace Facilitators' Requirements

Beginning October 1, 2019, a marketplace facilitator is considered the seller and retailer for each sale facilitated through its marketplace, for example, an Internet shopping website, to determine whether the marketplace facilitator is required to register with the CDTFA for a seller's permit or Certificate of Registration – Use Tax.

Marketplace Sellers' Requirements

If you are a marketplace seller, beginning October 1, 2019, you will no longer be considered the retailer of your sales of tangible merchandise facilitated through a marketplace, as defined by statute, provided the marketplace facilitator is registered or required to be registered for a seller's permit or Certificate of Registration – Use Tax.

Sales Tax Economic Nexus following the *Wayfair* Decision

In addition to California, many other states have now passed legislation adopting a similar statute. Below, to help you advise your California businesses selling online, is a chart of those states.

State Sales Tax Economic Nexus Chart			
State	**Economic Nexus**	**State**	**Economic Nexus**
Alabama	$250,000	Mississippi	$250,000
Alaska (city of Nome)	$100,000 !	Nebraska	$100,000*
Arizona	$150,000 (2019)	Nevada	$100,000*
Arkansas	$100,000*	New Jersey	$100,000*
California	$500,000	New Mexico	$100,000
Colorado	$100,000	New York	$500,000!
Connecticut	$100,000#	North Carolina	$100,000*
District of Columbia	$100,000*	North Dakota	$100,000
Florida	$100,000*	Ohio	$100,000*
Georgia	$100,000*	Oklahoma	$100,000
Hawaii	$100,000*	Pennsylvania	$100,000
Idaho	$100,000	Rhode Island	$100,000*
Illinois	$100,000*	South Carolina	$100,000
Indiana	$100,000*	South Dakota	$100,000*
Iowa	$100,000*	Tennessee	$500,000
Kansas	no thresholds	Texas	$500,000
Kentucky	$100,000*	Utah	$100,000*
Louisiana (by 7/1/20)	$100,000*	Vermont	$100,000*
Maine	$100,000*	Virginia	$100,000*
Maryland	$100,000*	Washington	$100,000*
Massachusetts	$100,000	West Virginia	$100,000*
Michigan	$100,000*	Wisconsin	$100,000*
Minnesota	$100,000*	Wyoming	$100,000*

* State economic nexus if sales meet or exceed dollar threshold or 200 separate transactions.
! State economic nexus if sales meet or exceed dollar threshold and 100 transactions.
State economic nexus if sales meet or exceed dollar threshold and 200 separate transactions.

DIAPERS & MENSTRUAL HYGIENE PRODUCTS EXEMPT FROM SALES AND USE TAXES 1/1/20 THROUGH 12/31/21

Beginning January 1, 2020 and through December 31, 2021, the sale and use of diapers and menstrual hygiene products are exempt from tax. Accordingly, retailers of these items should not charge or collect sales or use tax on these items during this period.

SB 92 (Budget, Stats. 2019, Ch. 34), signed into law on June 27, 2019, provides the exemption for the below products:

- Diapers means diapers that are designed, manufactured, processed, fabricated, or packaged for use by infants, toddlers, and children.
- Menstrual Hygiene Products means tampons, sanitary napkins primarily designedand labeled for menstrual hygiene use, menstrual sponges, and menstrual cups.

If you are a retailer who sells diapers and/or menstrual hygiene products, you should continue to include your sales of these items in your reported total gross sales on your sales and use tax return. However, you will claim the deduction for these sales on your return as "diapers" and/or "menstrual hygiene products" on and after January 1, 2020 through December 31, 2021.

TAXPAYERS MUST CERTIFY ZERO REPORTING ON INCOME TAX RETURN

The California Department of Tax & Fee Administration (CDTFA) is responsible for collecting sales and use tax. California use tax is imposed on any person who purchases tangible personal property for use, consumption, or storage in this state where the purchase is not subject to California sales tax. Generally, use tax is owed when the purchase is made outside of California, and the property is used in California. A typical purchase subject to California use tax is a purchase shipped from an out-of-state retailer to a California consumer. The use tax rate is the same as the sales tax rate that varies depending on the county and city within California in which the taxpayer resides.

Taxpayers may report and pay use tax directly to the CDTFA or report and pay use tax on their California income tax return.

Individual taxpayers that have made one or more single non-business purchases of individual items of tangible personal property, each with a sales price of less than $1,000, can report the use tax liability by using a use tax table shown in the instructions for the individual tax return or they can report the actual use tax due. In addition, utilization of the use tax table precludes the CDTFA from making any determinations for understatements of use tax against any person with qualified purchases who utilizes the use tax table in accordance with the accompanying instructions.

Payments Applied to Use Tax First

The amount of payments or credits reported on an income tax return of a person who reports use tax, is applied first to the use tax liability reported on the tax return and then to the income taxes, penalties, or interest.

When Reporting Zero, Taxpayer Must Certify

AB 1593 (Ridley-Thomas, Stats. 2017, Ch. 563) makes changes to income tax returns and instructions beginning Jan. 1, 2018, to require

- That a taxpayer enter a number on the use tax line of personal income tax (PIT) returns.

- That a taxpayer who entered a zero on the use tax line check one of two boxes to validate that the taxpayer has either remitted the use tax due for the taxable year to the CDTFA or that the taxpayer owes no use tax.

"Acceptable Tax Return" Means Original Return

AB 1717 (R&TC Comm., Stats. 2017, Ch. 175) defines an acceptable tax return to mean an original return, clarifying that use tax can be reported on an original return regardless of the date the original return is filed.

CANNABIS INDUSTRY

Growing and selling cannabis is illegal under federal law. Cannabis remains classified as a Schedule I substance under the Controlled Substances Act. California was the first state to establish a medical marijuana program, enacted by Proposition 215 in 1996 and Senate Bill 420 in 2003. Prop. 215 (also known as the Compassionate Use Act) was approved by initiative with a 55% majority, allowing people with cancer, AIDS, and other chronic illnesses the right to grow or obtain marijuana for medical purposes when recommended by a doctor. SB 420, or the Medical Marijuana Protection Act, was signed into law by Governor Gray Davis and established an identification card system for medical marijuana patients.

In November 2016, the people of the state of California passed Proposition 64, Adult Use of Marijuana Act. Under the new law, adults 21 and over may purchase, possess, and consume up to 1 oz. of marijuana in their private residence or in an establishment licensed for marijuana consumption. Adults also will be allowed to grow up to six marijuana plants and keep the herb that is produced, as long as it is done in a secure space not visible to the public.

While most criminal sanctions for marijuana were lifted immediately after the general election, the regulation of businesses, production facilities, and marijuana consumption establishments will be phased in over time. Licenses are scheduled to be granted in January 2018.

***New*! Bureau of Cannabis Control**

The Bureau of Cannabis Control is the lead agency in developing regulations for medical and adult-use cannabis in California. The Bureau is responsible for licensing retailers, distributors, testing labs, and micro-businesses.

Growers and Sellers of Cannabis Must Register and File Returns with the CDTFA

If a person sells cannabis, the law requires him or her to register with the CDTFA for a seller's permit. This includes growers and dispensaries. One can register for a seller's permit on CDTFA's website using its online registration system or in person at one of the Board of Equalization's (BOE's) field offices. There is no cost to obtain a seller's permit.

Once registered, sellers must also file sales and use tax returns and pay any tax due. If one does not file timely returns, he or she may be subject to penalties and interest. Sales and use tax returns are filed using CDTFA's online filing services.

Even if all cannabis sales are nontaxable (for instance, sales for resale), returns must still be filed.

Certain Sales of Medical Marijuana Are Exempt from Sales and Use Tax

Retail sales of medicinal cannabis to persons who have a valid Medical Marijuana Identification Card (MMIC) issued by the California Department of Public Health (CDPH) and a valid government-issued identification card (ID) are exempt from sales and use tax.

To obtain the sales and use tax exemption, qualified patients or their primary caregivers must show their valid MMIC and valid ID to the retailer at the time of purchase. The card must be issued by the CDPH; other marijuana or cannabis cards or recommendations from physicians are not sufficient to qualify for the sales and use tax exemption.

To claim exempt sales, a seller must maintain specific information for his or her records. For information on recordkeeping requirements, see CDTFA's online Tax Guide for Cannabis Businesses.

New Cannabis Taxes Effective Jan. 1, 2018

Under the provisions of Proposition 64, distributors of cannabis and cannabis products must also register with the CDTFA for a cannabis tax permit to report and pay the two new cannabis taxes to the CDTFA. The cannabis tax permit is in addition to a seller's permit.

Beginning Jan. 1, 2018, two new cannabis taxes are in effect:

- A 15% excise tax is imposed upon purchasers of cannabis and cannabis products. Retailers are required to collect the excise tax from the purchaser and pay it to the cannabis distributor.
- A tax on the cultivation of cannabis that enters the commercial market is imposed upon cultivators. Cultivators are required to pay the cultivation tax to either a distributor or a manufacturer depending upon the nature of the transaction. The cultivation tax rates are
    - $9.25 per dry-weight ounce of cannabis flowers, and
    - $2.75 per dry-weight ounce of cannabis leaves.

Additional categories and rates may be specified at a later date.

All cannabis businesses making sales are required to

- Register online with the CDTFA for a seller's permit.
- File sales and use tax returns electronically and pay any sales and use tax to the CDTFA. Even if none of the sales are subject to sales tax, you are still required to file a return and report your activities on your return to the CDTFA.

***New!* Certain Streamlined Procedures Apply to Collection and Remittance of Cannabis Taxes**

SB 94 (Budget, Stats. 2017, Ch. 27) amended several provisions in the cannabis tax law as enacted by Proposition 64. SB 94 provides that

- Distributors must collect the cannabis excise tax from retailers and the cultivation tax from cultivators or manufacturers.
- Distributors must report and pay the cannabis excise tax and the cultivation tax to the CDTFA.

Marijuana Dispensaries Are Allowed to Remit Taxes Other than by EFT

AB 1741 (Bonta, Stats. 2018, Ch. 228) extends to recreational cannabis dispensaries the provisions **AB 821** (Gipson, Stats. 2016, Ch 821) allows marijuana dispensaries to remit sales and use taxes by means other than an EFT until Jan. 1, 2022.

Under existing law, California's sales tax is paid by retailers engaged in business in the state and applies to all retail transactions involving sales of tangible personal property except those the law specifically exempts or excludes. Retail sales of marijuana are subject to the tax to the same extent as any other retail sale of tangible personal property in this state.

Taxpayers with monthly tax liabilities that average $10,000 or more must remit their tax payments via an EFT under BOE-prescribed procedures. Failure to remit the funds under those procedures subjects taxpayers to specified penalties.

The new legislation is designed to encourage compliance in the cannabis industry by enabling dispensaries to pay their tax liability using cash without incurring a mandatory penalty.

For more information on requirements for California's Cannabis Industry, see the CDTFA's Tax Guide for Cannabis Businesses.

SALES TAX CASES AND RULINGS

Club Membership Fees Subject to Sales Tax

City Tower Club 2200, LLC operated Tower Club (or the club), a members-only facility located in Oxnard, California, from April 2011, until it was sold on or about February 15, 2015. The club consisted of a restaurant, bar, lounge and banquet facility located on the top floor of a high-rise building.

The Club's members paid monthly membership fees of $90 - $100 per month, and it required its members to purchase a minimum amount of food and drinks of $120 per quarter. During the audit period, the Club had revenue from only two sources, the sale of food and drinks and membership fees, which represented $2,911,563 and $1,231,139, respectively, for the audit period, with a total revenue of $4,142,702. Thus, the Club derived 70% of its revenue from the sale of food and beverages.

The Club did not collect sales tax reimbursement from its members or remit or report tax in connection with its membership fees. CDTFA determined that the membership fees were charged in connection with anticipated sales of tangible personal property (i.e., food and drinks) and were subject to sales tax. Accordingly, CDTFA issued an NOD that proposed tax of $97,886.72, plus applicable interest, based on a deficiency measure of $1,231,141. The Club filed a timely petition for redetermination, arguing that the membership fees are not subject to tax because the fees were related to the sale of services rather than to the anticipated sale of tangible personal property.

OTA found that the members primarily used the Club's restaurant and bar and that dining and beverage service (ie., sales of food and beverage) were the purpose of the membership fees, making the fees subject to sale tax (***Appeal of City Tower Club 2200, LLC,*** OTA No. 18093832, August 2019).

Buyer Responsible for Payment of Seller's Unpaid Taxes

In September 2013 Abirami Baskarapandian purchased the equipment, operations and goodwill of Mr. G's pizzeria in Diamond Bar, CA. At the time, Mr. G had unpaid sales and use tax liabilities in excess of $20,000. Abirami failed to request a tax clearance from CDTFA prior to purchasing the business or to withhold from the purchase price an amount sufficient to satisfy Mr. G's unpaid tax liability.

CDTFA issued a Notice of Successor Liability to Abirami for the $20,000. Under R&TC §6812, if the purchaser of a business or stock of goods fails to withhold from the purchase price as required, he or she becomes personally liable for the payment of the amount required to be withheld to the extent of the purchase price, valued in money (***Appeal of Abirami Baskarapandian,*** OTA No. 18011966, August 2019).

Company Executive Held Personally Liable for Unpaid Sales Taxes

OTA agreed with CDTFA that Dean Woerner, an executive and owner of Western Plywood, Inc. in San Francisco was personally liable for the company's unpaid sales taxes. Dean admitted that: (1) the corporation's business has been terminated, dissolved, or abandoned; (2) the corporation collected sales tax reimbursement on its sales of tangible personal property and failed to remit such tax reimbursement to CDTFA; (3) Dean had control or supervision of, or was charged with the responsibility for, the filing of returns or the payment of tax, or was under a duty to act for the corporation in complying with the Sales and Use Tax Law; and (4) he willfully failed to pay taxes due from the corporation or willfully failed to cause such taxes to be paid (***Appeal of Dean Woerner***, OTA No. 18012007, August 2019).

TAX REBATES AND CREDITS FOR PLUG-IN ELECTRIC VEHICLES

The Clean Vehicle Rebate Project (CVRP) California created by **AB 118** (Nunez, Stats. 2007, Ch. 750) established rebates available for the purchase or lease of a qualified plug-in electric vehicle as of Mar. 15, 2010. Purchasers of these vehicles may also be eligible for a federal tax incentive through the American Recovery and Reinvestment Act. Rebates are available up to $5,000 for zero-emission light-duty vehicles and plug-in hybrid vehicles and up to $20,000 for zero-emission commercial vehicles. However, none of these rebate credits reduce the amount on which sales or use tax is due.

Example: The retail selling price of a zero-emission commercial vehicle is $45,000 and the sale qualifies for a $15,000 rebate. The sales or use tax due would be computed on the $45,000 retail selling price.

For more information about the CVRP, visit the Clean Vehicle Rebate Project.

CDTFA TAXPAYERS' RIGHTS ADVOCATE

The CDTFA Taxpayers' Rights Advocate is William Hain. Contact him at:

(916) 323-3319

PROPERTY TAXES

COVID-19 RELIEF

On May 6, 2020, Governor Newsom issued Executive Order N-61-20 extending the tax filing deadline for business personal property statements from May 7, 2020 to May 31, 2020. The deadline extension suspends the 10-percent penalty that would have been imposed on a taxpayer for late filings. Taxpayers impacted by the stay-at-home order, due to the COVID-19 pandemic, got more time to file their statements with their local County Assessors.

The State Board of Equalization (BOE) has issued guidance to County Assessors regarding the deadline extension, the suspension of penalties, and clarifying that since May 31, 2020 falls on a Sunday, a property statement that is mailed and postmarked on the next business day, which is Monday, June 1, 2020, shall be deemed to have been filed timely. This extension applies to all County Assessors in the state of California.

DISABLED VETERANS' EXEMPTION INCREASES FOR 2020

R&TC §205.5, subdivisions (g) and (h) provide that the exemption amounts and the household income limit for the disabled veterans' exemption shall be compounded annually by an inflation factor.

Applying this factor, the 2020 exemption amounts are $143,273/$214,910. The 2020 household income limit is $64,337.

Definition of Veteran Revised

SB 1458 (Bates, Stats. 2016, Ch. 871) expands disabled veterans' exemption eligibility by changing the requirement that a veteran's character of discharge from military service be under "honorable" conditions to a lower threshold of under "other than dishonorable" conditions. The bill also extends the use of roll corrections to process disabled veteran-related refunds to eight years.

OTHER PROPERTY TAX ITEMS

Relief for Taxpayers Affected by Fires and Erosion

If your property has been damaged by the recent fires, and erosion, you may be eligible for property tax relief. In many cases, the damaged property can be reappraised in its current condition, with some taxes refunded to the property owner. Once rebuilt, the property's pre-damaged value will be restored.

To qualify for property tax relief, you must file a claim with your county assessors' office within 12 months from the date of damage or destruction. The loss estimate must be at least $10,000 of current market value to qualify.

Owners of eligible property may also apply for deferral of the next property tax installment on the regular secured roll or tax payments on the supplemental roll, without penalties or interest. The disaster must be the result of a Governor-proclaimed state of emergency. When a timely claim for deferral is filed, the next property tax installment payment is deferred without penalty or interest until the county assessor has reassessed the property and a corrected tax bill has been sent to the property owner.

For further information on property tax disaster relief, please see BOE's Disaster Relief web page with helpful information including Frequently Asked Questions (FAQs).

Refund Process Changed

SB 1246 (Gaines, Stats. 2018, Ch 358) allows, pursuant to the board of supervisors of a county adopting a resolution or ordinance that so provides, a refund of property taxes or assessments without a verified claim if there has been no transfer of the property in the fiscal year that the taxes were levied and if the refund amount is less than $5,000.

Manufactured Homes Added to Senior Citizens & Disabled Citizens Property Tax Postponement Law

Existing law authorizes a claimant to file a claim with the Controller to postpone the payment of property taxes that are due on the residential dwelling of the claimant pursuant to the Senior Citizens and Disabled Citizens Property Tax Postponement Law. Existing law, for purposes of these laws, defines a "residential dwelling" to mean a dwelling occupied as the principal place of residence of the claimant and owned by the claimant, the claimant and spouse, or by the claimant and another individual, as specified, including condominiums that are assessed as realty for local property tax purposes.

SB 1130 (Leyva, Stats. 2018, Ch. 896) expands the definition of a "residential dwelling" to include a manufactured home, thereby authorizing a claimant who is the owner of a manufactured home to postpone the payment of property taxes. The bill, on July 1, 2019, and on July 1 each year thereafter, would require up to 1% of the amount available in the Senior Citizens and Disabled Citizens Property Tax Postponement Fund for disbursements relating to postponement of property taxes to be available for residential dwellings that are manufactured homes.

Retrospective Change of Ownership Exemption for Transfers between Local RDPs

Prior to 2006, a change in ownership between domestic partners was not eligible for the same exclusion that applied to married couples. Subsequent legislation fixed the discrepancy to allow domestic partners registered at the state level to qualify for tax exclusion. However, domestic partners registered only with a county, city or other local jurisdiction were ineligible for the exclusion. **AB 2663** (Friedman, Stats. 2018, Ch. 919) creates parity in the law so that every domestic partnership has equal access to full and equal benefits, regardless of where they originally registered.

Persons who are local RDPs and did not subsequently register as state RDPs after January 1, 2000, may have had property reassessed if a transfer of property between the two was otherwise ineligible for any other available exclusion. This bill provides the same tax relief to local RDPs as previously provided to similarly situated state RDPs. In the case of any prior reassessment due to transfers occurring within the time frame of January 1, 2000 through June 26, 2015 between local RDPs, the county assessor would reverse the prior reassessment and restore the property's Proposition 13 protected value on a prospective basis if the local RDP files the necessary application with the county assessor by June 30, 2022.

Construction of Rain-Capture Systems Will Not Cause Reassessment

Proposition 72, passed by voters on the June, 2018 ballot, excludes newly constructed rain-capture systems from the property tax reassessment requirement.

BOARD OF EQUALIZATION TAXPAYERS' RIGHTS ADVOCATE

Lisa Thompson is the current BOE Taxpayers' Rights Advocate. Contact her at:

(916) 327-2217

SAMPLE AB 5 CLIENT LETTER

RE: New California Law Classifying Independent Contractors and Employees

Dear Client:

The purpose of my letter today is to inform you about new California law that may affect how you classify your workers. Assembly Bill 5 (AB 5), amended by Assembly Bill 170 (AB 170), was signed September 18, 2019 and takes effect January 1, 2020. It could mean certain independent contractors you currently use may have to be reclassified as employees.

By way of background, the state legislature came to apply the changes in AB 5 based upon a California Supreme Court case from 2018. In the case of Dynamex Operations West, Inc. v. the Superior Court of Los Angeles County (Dynamex), the court was asked to determine if Dynamex's delivery drivers were employees or independent contractors. Instead of using the 11 common law factors that have long been used in the state for worker classification, the court in Dynamex used a different standard known as the ABC test.

The ABC test is not new, but Dynamex was the first time it was applied here in California. Now, our lawmakers have decided to use this standard by making it the law in AB 5. The ABC test assumes any worker is an employee unless the hiring business can establish that the worker meets ***all three*** tests:

> A. The person is free from the control and direction of the hiring entity in connection with the performance of the work, both under the contract for the performance of the work and in fact.
>
> B. The person performs work that is outside the usual course of the hiring entity's business.
>
> C. The person is customarily engaged in an independently established trade, occupation, or business of the same nature as that involved in the work performed.

It is the "B" test that is causing so much concern. "Of course," you say, "the worker is performing work that is my usual course of business. That's what I need help with!" Now, even if the worker is part-time and able to set his or her own work schedule and work load, that factor alone will mean employee status.

The law as written is quite complicated and contains many exceptions based upon type of profession. It also contains significant penalties for misclassification.

Proper worker classification is ultimately a legal issue. I encourage you to discuss the impact of AB5 on your business with an attorney who specializes in labor law. Please contact me if you need a referral.

Very truly yours,

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