Current Federal Tax Developments 2022
(CFTD)

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CURRENT FEDERAL TAX DEVELOPMENTS 2022 (CFTD)
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Unit 1

Inflation Reduction Act of 2022

LEARNING OBJECTIVES

When you have completed this unit, you will be able to accomplish the following.

- Apply the changes that are effective for 2022 in the Inflation Reduction Act of 2022 in performing compliance and planning engagements for tax year 2022 returns
- Identify taxpayers that may qualify for the various clean vehicle credits as added and revised by the Inflation Reduction Act of 2022
- Use the revised energy tax credits in planning engagements for 2023 tax years

On August 16, 2022 the President signed into law the Inflation Reduction Act of 2022. This law is a much stripped down version of the Build Back Better Act that failed to gain sufficient support in the Senate last year.

While the corporate minimum tax has gotten most of the press, that tax will likely not be something that most local firm tax professionals will deal with since most have few, if any, C corporation client and, even for those that are serviced by local firms, the exclusion of C corporations that failed to average over $1 billion of adjusted financial statement in the preceding three years will serve to exclude the firms' clients.

The largest portion of the bill deals with various clean energy incentives. Most of those are mainly of direct interest to businesses in very specific niches of clean energy, but the bill does contain a significant expansion of the non-business energy property credit, along with three credits related to clean vehicles that will likely be of interest to clients of local CPA firms.

As well, taxpayers who qualify for many of the energy credits can transfer those credits to other taxpayers. That can allow a business that shows no taxable income to sell the credit to a party with a tax liability in order to gain some of the benefit of the credit.

TAX PROVISIONS PRIMARILY IMPACTING INDIVIDUALS AND SMALL BUSINESSES

The Inflation Reduction Act of 2022 does have a few provisions that impact individual taxpayers outside of the various energy related tax credits.

ARPA Premium Tax Credit Rules Remain in Effect for 2023-2025

Effective Date: *Extension will move the end of the special rules to December 31, 2025. Previously these rules would have expired at the end of 2022.*

Under the American Rescue Plan Act, the Premium Tax Credit tables were revised to temporarily provide *applicable percentages* that were lower than the inflation adjusted version of the tables originally enacted as part of the Affordable Care Act. The *applicable percentage* is used to determine the maximum amount of a taxpayer's household income for a year the taxpayer would be required to pay for premiums on the second lowest cost silver plan (SCLSP) available on the exchange covering where the taxpayer lived (with the amounts reduced to 1/12 of the annual amount to arrive at a monthly premium amount).

If such a premium exceeds that number, the taxpayer qualifies for a premium tax credit equal to the difference between that maximum amount and lesser of the SLCSP the premium or the premium for the policy the taxpayer actually selected so long as the taxpayer payer acquires a policy from the exchange. (IRC §36B)

In Revenue Ruling 2022-34 the IRS had published the inflation-indexed applicable percentage table that would have applied for 2023 without this provision included in IRA 2022. That table was:

Household income percentage of Federal poverty line:	**Initial percentage**	**Final percentage**
Less than 133%	1.92%	1.92%
At least 133% but less than 150%	2.88%	3.84%
At least 150% but less than 200%	3.84%	6.05%
At least 200% but less than 250%	6.05%	7.73%
At least 250% but less than 300%	7.73%	9.12%
At least 300% but not more than 400%	9.12%	9.12%

Under IRA 2022, the following table will continue to be used through 2025 to determine the applicable percentage for purposes of computing the premium tax credit:

Household income percentage of Federal poverty line:	**Initial percentage**	**Final percentage**
Up to 150%	0%	0%
At least 150% but less than 200%	0%	2.0%
At least 200% but less than 250%	2.0%	4.0%

Household income percentage of Federal poverty line:	Initial percentage	Final percentage
At least 250% but less than 300%	4.0%	6.0%
At least 300% but less than 400%	6.0%	8.5%
400% and higher	8.5%	8.5%

Under IRC §36B(c)(1)(A) the credit was not available to taxpayers whose household income exceeded 400% of the Federal poverty line. This produced a cliff cut-off for the credit. A taxpayer would lose the entire credit once his/her/their income went over the 400% limit.

That rule was suspended by ARPA for 2021 and 2022, so that so long as the SLCSP for a taxpayer exceeded 8.5% of the applicable household income, a taxpayer would continue to receive a tax credit.[1]

Extension of Limitation on Excess Business Losses of Noncorporate Taxpayers

Effective Date: *Taxable years beginning after December 31, 2026.*

The expiration date for the limitation on net business losses claimed by an individual taxpayer is pushed back from years beginning on or after January 1, 2027 to years beginning on or after January 1, 2029. That is, the provision's scheduled expiration has been pushed back two years.

The provision had already had its scheduled expiration pushed back one year previously and it seems likely the provision will actually be allowed to expire on its newly scheduled expiration date.[2]

Increase in Research Credit Against Payroll Taxes for Certain Small Businesses

Effective Date: *Tax years beginning after December 31, 2022*

IRA 2022 provides that a "qualified small business" may apply an addition $250,000 of qualifying research expenses against the employer share of Medicare taxes for tax years beginning after December 31, 2022.[3]

[1] IRC §36B as amended by IRA 2022

[2] IRC §461(l)(1) as amended by IRA 2022

[3] IRC §41 as amended by IRA 2022

ENERGY TAX CREDITS (GENERAL APPLICATION)

Extension, Increase, and Modifications of Nonbusiness Energy Property Credit (Act Section 13301)

Effective Date: *Generally, the new and revised provisions apply to property placed in service after December 31, 2022 and before January 1, 2033. However, the bill also moves the expiration date of the old law forward by one year so that the old rules will apply to 2022 tax returns. The requirement to provide a product identification number takes effect for property placed in service after December 31, 2024.*

IRA makes significant changes to the nonbusiness energy credit, removing the lifetime limits on the use of the credit (effective beginning in 2023). As well, the old rules are extended for one more year to cover 2022 returns.

Old Law

The nonbusiness property credit, prior to the modifications found in IRA 2022, a credit had been available for items placed in service before January 1, 2022 for a percentage of certain non-business property expenditures. (IRC §25C)

The pre-IRA credit was equal to:

- 10 percent of the amount paid or incurred by the taxpayer for *qualified energy efficiency improvements* installed during such taxable year, and
- the amount of the *residential energy property expenditures* paid or incurred by the taxpayer during such taxable year.[4]

The credit was subject to a series of lifetime limitations that were very modest and never were adjusted for inflation. The limits were:

- An overall lifetime limit of $500 for all taxable years ending after December 31, 2005
- Within that overall $500 lifetime limit, specific items were limited to smaller amounts:
  - $200 for qualifying windows,
  - $50 for an advanced main air circulating fan,
  - $150 or any qualified natural gas, propane, or oil furnace or hot water boiler, and
  - $300 for any item of energy-efficient building property.[5]

[4] IRC §25C(a)

[5] IRC §25C(b)

Qualified energy efficiency improvements for purposes of the pre-IRA credit are any *energy efficient building envelope component*, if--

- Such component is installed in or on a dwelling unit located in the United States and owned and used by the taxpayer as the taxpayer's principal residence,
- The original use of such component commences with the taxpayer, and
- Such component reasonably can be expected to remain in use for at least 5 years.[6]

An *energy efficient building envelope component* is a *building envelope component* which meets:

- Applicable Energy Star program requirements, in the case of a roof or roof products,
- Version 6.0 Energy Star program requirements, in the case of an exterior window, a skylight, or an exterior door, and
- The prescriptive criteria for such component established by the 2009 International Energy Conservation Code, as such Code (including supplements) is in effect on the date of the enactment of the American Recovery and Reinvestment Tax Act of 2009, in the case of any other component.[7]

A *building envelope component* means—

- Any insulation material or system which is specifically and primarily designed to reduce the heat loss or gain of a dwelling unit when installed in or on such dwelling unit,
- Exterior windows (including skylights),
- Exterior doors, and
- Any metal roof or asphalt roof installed on a dwelling unit, but only if such roof has appropriate pigmented coatings or cooling granules which are specifically and primarily designed to reduce the heat gain of such dwelling unit.[8]

A *residential energy property expenditure* is defined as expenditures made by the taxpayer for *qualified energy property* which is--

- Installed on or in connection with a dwelling unit located in the United States and owned and used by the taxpayer as the taxpayer's principal residence, and
- Originally placed in service by the taxpayer.

Such term includes expenditures for labor costs properly allocable to the onsite preparation, assembly, or original installation of the property.[9]

[6] IRC §25C(c)(1) before amendments by IRA 2022

[7] IRC §25C(c)(2) before amendments by IRA 2022

[8] IRC §25C(c)(3) before amendments by IRA 2022

[9] IRC §25C(d)(1) before amendments by IRA 2022

Qualified energy property means--

- Energy-efficient building property,
- A qualified natural gas, propane, or oil furnace or hot water boiler, or
- An advanced main air circulating fan (as defined at IRC §25C(d)(5)).[10]

Energy efficient building property means—

- An electric heat pump water heater which yields a Uniform Energy Factor of at least 2.2 in the standard Department of Energy test procedure,
- An electric heat pump which achieves the highest efficiency tier established by the Consortium for Energy Efficiency, as in effect on January 1, 2009,
- A central air conditioner which achieves the highest efficiency tier established by the Consortium for Energy Efficiency, as in effect on January 1, 2009, and
- A natural gas, propane, or oil water heater (as defined at IRC §25C(d)(4)) which has either a Uniform Energy Factor of at least 0.82 or a thermal efficiency of at least 90 percent.[11]

To be qualified energy property, the property must meet performance and quality standards found at IRC §25C(d)(2)(B). Air conditioners and heat pumps must meet requirements and standards found at IRC §25C(d)(2)(C).

IRA 2022 Changes

Section 13301 of the Act contains significant revisions to the provisions found in IRC §25C.

Extension of 2021 Rules Into 2022

While the major revisions described in the following sections take effect only for property placed in service after December 31, 2022 (that is, taxpayers must wait until 2023 to take advantage of most the expanded credit rules), the law does extend the prior, lifetime limited credit to cover 2022. The credit had expired on December 31, 2021.

Renaming the Credit

IRC §25C's title is changed from "Nonbusiness Energy Property" to "Energy Efficient Home Improvement Credit."[12]

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[10] IRC §25C(d)(2)(A) before amendments by IRA 2022

[11] IRC §25C(d)(3) before amendments by IRA 2022

[12] IRA 2022 Act §13301(h)

30% Credit (IRC §25(a) as Revised)

The credit is revised to provide a credit equal to 30% of the sum of—

- The amount paid or incurred by the taxpayer for qualified energy efficiency improvements installed during the taxable year,
- The amount of the residential energy property expenditures paid or incurred by the taxpayer during the taxable year, and
- the amount paid or incurred by the taxpayer during the taxable year for *home energy audits*.[13]

A *home energy audit* is an inspection and written report with respect to a dwelling unit located in the United States and owned or used by the taxpayer as the taxpayer's principal residence which:

- Identifies the most significant and cost-effective energy efficiency improvements with respect to such dwelling unit, including an estimate of the energy and cost savings with respect to each such improvement and
- Is conducted and prepared by a home energy auditor that meets the certification or other requirements specified by the IRS in regulations or other guidance. Such guidance is to be issued within 365 days of August 16, 2022.[14]

For a credit to be claimed for expenditures related to a home energy audit, the taxpayer must include with the taxpayer's return such information or documents as the IRS may require.[15]

Revised Annual Rather Than Lifetime Limitations

IRA 2022 removes the lifetime limitations on the credits under IRC §25C, instead adding a new annual limitation on the credit.

There is an overall annual limit of $1,200 on the total of all nonbusiness energy property credits under IRC §25C for a taxpayer. As before, additional, lower limits apply to specific types of nonbusiness property credits, with the credit being limited to the following amounts for various types of property:

- Qualified energy property - $600
- Exterior windows and skylights - $600
- Doors - $250 in the case of any single exterior door and $500 for all exterior doors and
- Home energy audit - $150.

Notwithstanding the above rule, the maximum credit for heat pump and heat pump water heaters & biomass stoves and boilers is $2,000.[16]

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[13] IRC §25C(a) as revised by IRA 2022

[14] IRC §25C(e) as revised by IRA 2022

[15] IRC §25C(b)(6)(B)

[16] IRC §25C(b) as revised by IRA 2022

Modifications Related to Qualified Energy Efficiency Improvements

The Act revises the standards for energy efficient building envelope components found at IRC §25C(c)(2) to:

- In the case of an exterior window or skylight, Energy Star most efficient certification requirements,
- in the case of an exterior door, applicable Energy Star requirements, and
- in the case of any other component, the prescriptive criteria for such component established by the most recent International Energy Conservation Code standard in effect as of the beginning of the calendar year which is 2 years prior to the calendar year in which such component is placed in service.[17]

Roofs are no longer treated as building envelope components.[18] Added to the list of building envelope components are air sealing materials or systems.[19]

Revision of Definition of Residential Energy Property Expenditures

The Act revises the definition of residential energy property expenditures found at IRC §25C(d). Significantly, the requirement the property be used as the taxpayer's *principal* residence (as defined by IRC §121). The new law only requires the home be used as a residence by the taxpayer.[20]

A vacation home owned by the taxpayer would now qualify for this credit. However, since the law state the property must be *used* by the taxpayer as a residence, it does not appear that these credits could be claimed on rental properties with no personal use.

Identification Number Requirement

IRA 2022 inserts new IRC§25(h) that will eventually require that each energy credit claim contain a *product identification number* and that products must be produced by a *qualified manufacturer*. The rule takes effect for property placed in service after December 31, 2024.

The rule provides that once identification number requirement goes into effect, no credit will be allowed for any item of property unless—

- Such item is produced by a qualified manufacturer, and
- The taxpayer includes the qualified product identification number of such item on the return of tax for the taxable year.[21]

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[17] IRC §25C(c)(2) as revised by IRA 2022

[18] IRC §25C(c)(3) as revised by IRA 2022

[19] IRC §25C(c)(3)(A) as revised by IRA 2022

[20] IRC §25C(d)(1)(A) as revised by IRA 2022

[21] IRC §25C(h)(1) as revised by IRA 2022

A *qualified manufacturer* means any manufacturer of specified property which enters into an agreement with the IRS which provides the manufacturer will—

- Assign a qualified product identification number to each item of specified property produced by such manufacturer utilizing a methodology that will ensure that such number (including any alphanumeric) is unique to each such item (by utilizing numbers or letters which are unique to such manufacturer or by such other method as the IRS may provide),
- Label such item with such number in such manner as the IRS may provide, and
- Make periodic written reports to the IRS (at such times and in such manner as the IRS may provide) of the product identification numbers so assigned and including such information as the IRS may require with respect to the item of specified property to which such number was so assigned.[22]

Extension and Modification of Residential Clean Energy Credit (Act §13302)

Effective Date: *Most changes are effective for property placed in service after December 31, 2021. However, changes related battery storage technology and the definition of that technology take effect for expenditures made after December 31, 2022.*

The residential energy efficient property credit found at IRC §25D applied to solar electric, solar hot water, fuel cell, small wind energy, geothermal heat pump, and biomass fuel property installed in homes prior to 2024.

The Act renames §25D from "Residential energy efficient property" to "Residential clean energy credit."[23]

The Act moves the expiration date well into the future, with the credit applying to property placed in service before 2035.[24]

The rate changes from the 26% rate that applied prior to IRA 2022 to:

- 30% for property placed in service after December 31, 2021 and before January 1, 2033,
- 26% for property placed in service after December 31, 2032 and before January 1, 2034, and
- 22% for property placed in service after December 31, 2033 and before January 1, 2035.[25]

[22] IRC §25C(h)(3) as revised by IRA 2022

[23] IRA 2022 Act §13302(c)(2)

[24] IRC §25D(h) as revised by IRA 2022

[25] IRC §25D(g) as revised by IRA 2022

The Act adds *qualified battery storage technology expenditures* to qualified expenditures for property placed in service after December 31, 2022. A *qualified battery storage technology expenditure* means an expenditure for battery storage technology which—

- Is installed in connection with a dwelling unit located in the United States and used as a residence by the taxpayer, and
- Has a capacity of not less than 3 kilowatt hours.[26]

Elective Payments and Transferable Credits for Energy Property and Electricity Produced from Certain Renewable Resources, Etc.

Effective date: *These provisions are effective for taxable years beginning after December 31, 2022.*

IRA 2022 gives entities that may not have sufficient (or any) income tax liability to absorb various energy credits a way to convert the credits to cash.

Elective Payments for Applicable Entities

The first special rule exists to allow entities that are tax exempt to treat these credits as a payment of income taxes, as opposed to simply a tax credit, rendering the amount refundable to the extent the payment is in excess of the tax actually due for the year (which likely will be zero).[27]

Credits Eligible for Elective Payment Treatment

The credits that are eligible for this election are—

- The portion of the credit for alternative fuel vehicle refueling property allowed under IRC §30C which is treated as a credit under IRC §38(b) pursuant to IRC §30C(d)(1),
- The portion of the credit under IRC §45(a) (renewable electricity production credit) attributable to qualified facilities that are originally placed in service after December 31, 2022,
- The portion of the credit under IRC §45Q(a) (credit for carbon sequestration) attributable to qualified facilities that are originally placed in service after December 31, 2022,
- The §45U(a) zero-emission nuclear power production credit,
- The portion of the credit under IRC §45V(a) (credit for production of clean hydrogen) attributable to qualified clean hydrogen production facilities that are originally placed in service after December 31, 2012,
- For tax exempt entities that qualify for the §45W credit for qualified commercial vehicles under §45W(d)(3),
- The IRC §45X(a) credit for advanced manufacturing production,

[26] IRC §25D(d)(6) as revised by IRA 2022

[27] IRC §6417(a) as added by IRA 2022

- The IRC §45Y(a) credit for clean electricity production,
- The IRC §45Z(a) credit for clean fuel production,
- The IRC §48(a) clean energy credit,
- The IRC §48C credit for qualifying advanced energy projects, and
- The IRC §48E credit for clean electricity investment.[28]

Applicable Entities

Entities eligible to make the election to treat the above credits as payment of income taxes are:

- Any organization exempt from income tax,
- Any State or local government (or political subdivision thereof),
- The Tennessee Valley Authority,
- An Indian tribal government (as defined in IRC §30D(g)(9)),
- Any Alaska Native Corporation (as defined in 43 USC 1602(m)), or
- Any corporation operating on a cooperative basis that is engaged in furnishing electric energy to persons in rural areas.[29]

Transfer of Certain Credits

The law provides that *eligible taxpayers* can transfer their credits to other taxpayers, presumably for cash or other compensation. This would allow a taxpayer without sufficient income tax to absorb the entire credit to simply sell the credits (likely at a discount) to other taxpayers who do have income tax liabilities.

Credits Eligible to Be Transferred

The energy credits eligible to be transferred at:

- The amount of the alternative fuel vehicle refueling property credit allowed under IRC §30C which, pursuant to Code Sec. 30(C)(d)(1), is treated as a credit listed in Code Sec. 38(b),
- The IRC §45(a) renewable electricity production credit,
- The IRC §45Q(a) carbon oxide sequestration credit,
- The IRC §45U(a) zero-emission nuclear power production credit,
- The IRC §45V(a) clean hydrogen production credit,

[28] IRC §6417(b) as added by IRA 2022

[29] IRC §6471(d) as added by IRA 2022

- The IRC §45X(a) advanced manufacturing production credit,
- The IRC §45Y(a) clean electricity production credit,
- The IRC §45Z(a) clean fuel production credit,
- The IRC §48 energy credit,
- The IRC §48C qualifying advanced energy project credit, and
- The IRC §48E clean electricity investment credit.[30]

The credits can be transferred by any taxpayer that is not an applicable entity eligible to elect to treat credits as a payment of income taxes under IRC §6417.[31]

Extension and Modification of the Energy Credit

CREDITS ON CLEAN ENERGY VEHICLES

New Clean Vehicle Credit

Effective date: *Applies to vehicles placed in service after December 31, 2022. The provision requiring final assembly take place in North America is effective for vehicles placed in service after August 15, 2022 except for vehicles eligible for the transition rule where the taxpayer makes the appropriate election.*

IRA 2022 substantially revises the credit previously referred to as the new qualified plug-in electric drive motor vehicle credit (NQPEDMV), now being renamed to the new clean vehicle credit.[32]

Prior Law

The NQPEDMV credit had provided for a credit of up to $7,500 for qualified vehicle placed in service during the year. The amount of the credit for the vehicle was computed as $2,500 plus In the case of a vehicle which draws propulsion energy from a battery with not less than 5 kilowatt hours of capacity, the amount determined under this paragraph is $417, plus $417 for each kilowatt hour of capacity in excess of 5 kilowatt hours (up to $5,000).[33]

The pre-IRA credit phases out over a *phaseout period* tied to each manufacturer. The phaseout period is the period beginning with the second calendar quarter following the calendar quarter which includes the first date on which the number of new qualified plug-in electric drive motor vehicles manufactured by the manufacturer of the vehicle sold for use in the United States after December 31, 2009, is at least 200,000.[34]

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[30] IRC §6418(f)(1)(A) as added by IRA 2022

[31] IRC§6418(f)(2) as added by IRA 2022

[32] IRA 2022 Act §13401(i)(1)

[33] IRC §30D(b) prior to revision by IRA 2022

[34] IRC §30D(e)(2) prior to revision by IRA 2022

Once the phaseout period began running, the credit was reduced to the following percentage of the full credit under the provision:

- 50 percent for the first 2 calendar quarters of the phaseout period,
- 25 percent for the 3rd and 4th calendar quarters of the phaseout period, and
- 0 percent for each calendar quarter thereafter.[35]

Tesla and General Motors had both triggered phase out periods beginning in 2019.[36]

IRA 2022 Provisions

Major changes are made to the new electric vehicle credit. Some will expand the availability of the credit (such as removing the per manufacturer unit caps) while others will serve to limit the availability of the credits (such as the adjusted gross income and the manufacturer's suggested retail price limitation).

Computation of the Credit for a Particular Vehicle

Although the maximum per-vehicle credit will remain at $7,500 and the credit will be the sum of two numbers, the new two numbers will either be $3,750 or zero, serving as two different specific requirements to get each half of the total $7,500 credit.

Now the credit is the total of—

- For an otherwise qualified vehicle that satisfies the *critical minerals* requirement, $3,750 and
- For an otherwise qualified vehicle that satisfies the *battery component* requirement, $3,750.[37]

To meet the *critical minerals requirement* the battery from which the electric motor of such vehicle draws electricity, the percentage of the value of the *applicable critical minerals* contained in such battery that were—

- extracted or processed—
  - in the United States, or
  - in any country with which the United States has a free trade agreement in effect, or
- recycled in North America
- is equal to or greater than the *applicable percentage*.[38]

Critical minerals are defined by IRC §45X(c)(6) to include aluminum, antimony, barite, beryllium, cerium, cesium, chromium, cobalt, dysprosium, europium, fluorspar, gadolinium, germanium,

[35] IRC §25D(e)(3) prior to amendment by IRA 2022

[36] "RIA Summary of Senate-Passed Inflation Reduction Act of 2022," *RIA Federal Tax Updates*, August 9, 2022

[37] IRC §30D(b)(2) and (3) as revised by IRA 2022

[38] IRC §30D(e)(1)(A) as revised by IRA 2022

graphite, indium, lithium, manganese, neodymium, nickel, niobium, tellurium, tin, tungsten, vanadium, yttrium, arsenic, bismuth, erbium, gallium, hafnium, holmium, iridium, lanthanum, lutetium, magnesium, palladium, platinum, praseodymium, rhodium, rubidium, ruthenium, samarium, scandium, tantalum, terbium, thulium, titanium, ytterbium, zinc, and zirconium.

The *applicable percentage* for this provision (critical minerals) is—

- In the case of a vehicle placed in service after the date on which the proposed guidance is issued by the IRS and before January 1, 2024, 40%,
- in the case of a vehicle placed in service during calendar year 2024, 50%,
- in the case of a vehicle placed in service during calendar year 2025, 60%,
- in the case of a vehicle placed in service during calendar year 2026, 70%, and
- in the case of a vehicle placed in service after December 31, 2026, 80%.[39]

Any vehicle placed in service after December 31, 2024 is not a new clean vehicle if which any of the critical minerals contained in the battery of such vehicle were extracted, processed, or recycled by a foreign entity of concern.[40]

The *battery component requirement* provides that, with respect to the battery from which the electric motor of such vehicle draws electricity, the percentage of the value of the components contained in such battery that were manufactured or assembled in North America is equal to or greater than the applicable percentage, as certified by the qualified manufacturer in the form and manner prescribed by the IRS.[41]

The *applicable percentage* for this provision (battery component) is—

- In the case of a vehicle placed in service after the date on which the proposed guidance is issued by the IRS and before January 1, 2024, 50%,
- in the case of a vehicle placed in service during calendar year 2024 or 25, 60%,
- in the case of a vehicle placed in service during calendar year 2026, 70%,
- in the case of a vehicle placed in service during calendar year 2027, 80%,
- in the case of a vehicle placed in service during calendar year 2028, 90%, and
- in the case of a vehicle placed in service after December 31, 2028, 100%.[42]

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[39] IRC §30D(e)(1)(B) as revised by IRA 2022

[40] IRC §30D(d)(7)(A) as revised by IRA 2022

[41] IRC §30D(e)(2)(A) as revised by IRA 2022

[42] IRC §30D(e)(2)(B) as revised by IRA 2022

The proposed guidance discussed for the two requirements is to be issued by the IRS no later than December 31, 2022.[43] On the IRS website for this credit, the IRS provides the following information with regard to the upcoming guidance:

> To reduce carbon emissions and invest in the energy security of the United States, the Inflation Reduction Act of 2022 significantly changes the eligibility rules for tax credits available for clean vehicles beginning in 2023. The Internal Revenue Service and the Department of the Treasury will post information and request comments from the public on various existing and new tax credit incentives in the coming weeks and months. Please look for updates on IRS.gov and other announcements from the Administration.[44]

Any vehicle placed in service after December 31, 2023 is not a new clean vehicle if which any of the components contained in the battery of such vehicle were manufactured or assembled by a foreign entity of concern.[45]

Final Assembly Requirement

The *final assembly* of a vehicle must take place in North America for the vehicle to qualify for the credit. The term *final assembly* means the process by which a manufacturer produces a new clean vehicle at, or through the use of, a plant, factory, or other place from which the vehicle is delivered to a dealer or importer with all component parts necessary for the mechanical operation of the vehicle included with the vehicle, whether or not the component parts are permanently installed in or on the vehicle.[46]

This requirement, unlike other changes made to IRC §30D, is effective for vehicles placed in service after August 15, 2022.

The U.S. Department of Energy, following the enactment of the Act, has published a list of electric vehicles assembled in North America as of August 16, 2022.[47]

Model Year	Vehicle	Note
2022	Audi Q5	
2022	BMW 3-series Plug-In	
2022	BMW X5	
2022	Chevrolet Bolt EUV	Manufacturer sales cap met
2022	Chevrolet Bolt EV	Manufacturer sales cap met
2022	Chrysler Pacifica PHEV	
2022	Ford Escape PHEV	
2022	Ford F Series	
2022	Ford Mustang MACH E	

[43] IRC §30D(e)(3) as revised by IRA 2022

[44] "Inflation Reduction Act of 2022," Alternative Fuels Data Center, U.S. Department of Energy, August 16, 2022, https://afdc.energy.gov/laws/inflation-reduction-act (retrieved August 17, 2022)

[45] IRC §30D(d)(7)(B) as revised by IRA 2022

[46] IRC §30D(d)(5) as revised by IRA 2022

[47] "Inflation Reduction Act of 2022," Alternative Fuels Data Center, U.S. Department of Energy, August 16, 2022, https://afdc.energy.gov/laws/inflation-reduction-act (retrieved August 17, 2022)

Model Year	Vehicle	Note
2022	Ford Transit Van	
2022	GMC Hummer Pickup	Manufacturer sales cap met
2022	GMC Hummer SUV	Manufacturer sales cap met
2022	Jeep Grand Cherokee PHEV	
2022	Jeep Wrangler PHEV	
2022	Lincoln Aviator PHEV	
2022	Lincoln Corsair Plug-in	
2022	Lucid Air	
2022	Nissan Leaf	
2022	Rivian EDV	
2022	Rivian R1S	
2022	Rivian R1T	
2022	Tesla Model 3	Manufacturer sales cap met
2022	Tesla Model S	Manufacturer sales cap met
2022	Tesla Model X	Manufacturer sales cap met
2022	Tesla Model Y	Manufacturer sales cap met
2022	Volvo S60	
2023	BMW 3-series Plug-In	
2023	Bolt EV	Manufacturer sales cap met
2023	Cadillac Lyriq	Manufacturer sales cap met
2023	Mercedes EQS	
2023	Nissan Leaf	

The note column indicates vehicles whose manufacturers had met the old law sales cap (vehicles made by Tesla and General Motors). The credit will not be available on those vehicles until 2023 as the provision removing the sales cap does not take effect until January 1, 2023.

The article warns:

> Note that for some manufacturers, the build location may vary based on the specific vehicle, trim, or the date in the Model Year when it was produced because some models are produced in multiple locations. The build location of a particular vehicle should be confirmed by referring to its Vehicle Identification Number (VIN) using the VIN decoder described below or an information label affixed to the vehicle.[48].

The National Highway Traffic Safety Administration VIN decoder is found at https://www.nhtsa.gov/vin-decoder.

The article also notes that manufacturers continue to supply the Department of Energy with information for the table, and it will be updated so the page should be consulted when a taxpayer is considering acquiring a vehicle that may qualify for the credit.

[48] "Inflation Reduction Act of 2022," Alternative Fuels Data Center, U.S. Department of Energy, August 16, 2022

Election to Apply Prior Rules During Transition Period

If a taxpayer, after December 31, 2021, and before August 16, 2022, purchased, or entered into a written binding contract to purchase, a new qualified plug-in electric drive motor vehicle and that vehicle is placed in service on or after August 16, 2022, the taxpayer may elect to treat such vehicle as having been placed in service on August 15, 2022.[49] Thus, the taxpayer would optionally be able to use the pre-IRA 2022 rules, presumably to obtain a credit for a vehicle that would not meet the final assembly in North America provision.

The IRS, on their updated webpage for this credit, defines a written binding contract as follows:

> In general, a written contract is binding if it is enforceable under State law and does not limit damages to a specified amount (for example, by use of a liquidated damages provision or the forfeiture of a deposit). While the enforceability of a contract under State law is a facts-and-circumstances determination to be made under relevant State law, if a customer has made a significant non-refundable deposit or down payment, it is an indication of a binding contract. For tax purposes in general, a contract provision that limits damages to an amount equal to at least 5 percent of the total contract price is not treated as limiting damages to a specified amount. For example, if a customer has made a non-refundable deposit or down payment of 5 percent of the total contract price, it is an indication of a binding contract. A contract is binding even if subject to a condition, as long as the condition is not within the control of either party. A contract will continue to be binding if the parties make insubstantial changes in its terms and conditions.[50]

On the same website, the IRS confirms that making this election applies the pre-IRA 2022 law to the vehicle when the taxpayer finally takes delivery of the vehicle, so the final assembly requirement does not apply:

> If you entered into a written binding contract to purchase a new qualifying electric vehicle before August 16, 2022, but do not take possession of the vehicle until on or after August 16, 2022 (for example, because the vehicle has not been delivered), you may claim the EV credit based on the rules that were in effect before August 16, 2022. The final assembly requirement does not apply before August 16, 2022.[51]

Definition of a New Clean Vehicle

The law makes the following changes in the definition as the law moves from an NQPEDMV to a new clean vehicle:

- The minimum battery capacity is seven kilowatt hours (increased from four kilowatt hours)[52]

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[49] IRA 2022 Act §13402(l)

[50] "Plug-In Electric Drive Vehicle Credit (IRC 30D)," IRS website, Updated August 16, 2022, https://www.irs.gov/businesses/plug-in-electric-vehicle-credit-irc-30-and-irc-30d (retrieved August 17, 2022)

[51] "Plug-In Electric Drive Vehicle Credit (IRC 30D)," IRS website, Updated August 16, 2022

[52] IRC §30D(d)(1)(F)(i) as revised by IRA 2022

- Requires the seller to provide a report to the buyer and the IRS at such time and place where the IRS provides that contains:
  - the name and taxpayer identification number of the taxpayer,
  - the vehicle identification number of the vehicle, unless, in accordance with any applicable rules promulgated by the Secretary of Transportation, the vehicle is not assigned such a number,
  - the battery capacity of the vehicle,
  - verification that original use of the vehicle commences with the taxpayer, and
  - the maximum credit under this section allowable to the taxpayer with respect to the vehicle.[53]
- The term "new clean vehicle" includes any new qualified fuel cell motor vehicle which meets the final assembly and report requirements.[54]
- The vehicle must be made by a qualified manufacturer. A qualified manufacturer is a manufacturer who agrees to make periodic written reports to the IRS providing vehicle identification numbers and such other information related to each vehicle manufactured by such manufacturer as the IRS may require.[55]

Only one new clean vehicle credit is allowed for each vehicle, determined by the vehicle identification number.[56] No credit will be allowed to the taxpayer unless the taxpayer includes the vehicle identification number of the automobile with the tax return.[57]

Limitation Based on Modified Adjusted Gross Income

A change that many clients who have previously made use of the prior version of this credit is the addition of a modified adjusted gross income limit for this credit.

No credit will be allowed for a taxable year if

- the lesser of—
  - the modified adjusted gross income of the taxpayer for such taxable year, or
  - the modified adjusted gross income of the taxpayer for the preceding taxable year, exceeds
- the *threshold amount*.[58]

[53] IRC §30D(d)(1)(H) as revised by IRA 2022

[54] IRC §30D(d)(6) as revised by IRA 2022

[55] IRC §30D(d)(1)(C) as revised by IRA 2022

[56] IRC §30D(f)(8) as revised by IRA 2022

[57] IRC §30D(f)(9) as revised by IRA 2022

[58] IRC §30D(f)(10)(A)

The *threshold amount* shall be—

- in the case of a joint return or a surviving spouse, $300,000,
- in the case of a head of household, $225,000, and
- in the case of other taxpayers, $150,000.[59]

Modified adjusted gross income for this credit is the taxpayer's adjusted gross income increased by any amount excluded from gross income under IRC §§911 (foreign earned income and foreign housing exclusion), 931 (income from sources within Guam, American Samoa, or the Northern Mariana Islands), or 933 (income from sources within Puerto Rico).[60]

While the limitation creates a cliff cut-off, the ability to make use of either the current or prior year's modified adjusted gross income will make it less of a problem than many other cliff limitations. As well, it is possible the taxpayer could arrange receipt of income via bunching or deferral to bring one tax year down below the threshold amount.

While, as discussed later, a taxpayer can assign the credit to the dealer at the time of purchase, a taxpayer who fails to meet the modified adjusted gross income test in that year will have his/her/their tax increased by the amount of the credit transferred to the dealer.[61]

Advisers may wish to warn clients who may be considering a purchase of a qualifying vehicle of the risk of having to repay the credit. Of course, if a taxpayer waits until their modified adjusted gross income for the prior tax year is known, they could safely transfer the credit and obtain a price reduction if that prior year modified adjusted income is below the threshold amount.

Manufacturer's Suggested Retail Price Limitation

In addition to restricting the credit to taxpayers with income below the threshold amounts, the law also denies the credit for vehicles whose manufacturer's suggested retail price exceeds certain levels. If the *manufacturer's suggested retail price* exceeds the *applicable limitation* no credit will be allowed.[62]

The applicable limitations are—

- Vans - $80,000,
- Sports utility vehicles - $80,000,
- Pickup trucks - $80,000, and
- Other vehicles - $55,000.[63]

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[59] IRC §30D(f)(10)(B)

[60] IRC §30D(f)(10)(C)

[61] IRC §30D(g)(10) after revision by IRC 2022

[62] IRC §30D(f)(11)(A) after revision by IRC 2022

[63] IRC §30D(f)(11)(B) after revision by IRC 2022

The IRS is directed to issue regulations or other guidance necessary for determining vehicle classifications using criteria similar to that employed by the Environmental Protection Agency and the Department of Energy to determine size and class of vehicles.[64]

Credit Transferred to Dealer to Receive Reduced Purchase Price

If the taxpayer who acquires a new clean vehicle that qualifies for this credit, the taxpayer may elect to transfer the credit to the dealer (referred to as the *eligible entity*) as long as the dealer fulfills certain conditions. [65]

For the dealer to be an *eligible entity* the dealer must be the one that sold the vehicle to the taxpayer and has—

- Registered with the IRS (in such form and at such time as the IRS may prescribe) and that registration has not been revoked by the IRS for failure to comply with the requirements of the program,
- Prior to the election by the taxpayer and not later than at the time of such sale, disclosed to the taxpayer purchasing such vehicle—
  - The manufacturer's suggested retail price,
  - The value of the credit allowed and any other incentive available for the purchase of such vehicle, and
  - The amount provided by the dealer to such taxpayer as a condition of making this election.
- Not later than at the time of such sale, made payment to such taxpayer (whether in cash or in the form of a partial payment or down payment for the purchase of such vehicle) in an amount equal to the credit otherwise allowable to such taxpayer, and
- With respect to any incentive otherwise available for the purchase of a vehicle for which a credit is allowed under this section, including any incentive in the form of a rebate or discount provided by the dealer or manufacturer, ensured that—
  - The availability or use of such incentive shall not limit the ability of a taxpayer to make the election to transfer the credit to the dealer and
  - Such election shall not limit the value or use of such incentive.[66]

The election to transfer the credit to the dealer shall be made by the taxpayer purchasing the vehicle no later than the date on which the vehicle for which the credit is allowed is purchased.[67]

[64] IRC §30D(f)(11)(C) after revision by IRC 2022

[65] IRC §30D(g) after revision by IRC 2022

[66] IRC §30D(g)(2) after revision by IRC 2022

[67] IRC §30D(g)(3) after revision by IRC 2022

The payment in cash or as a down payment/partial payment for the purchase of the vehicle when this election is made—

- Shall not be includible in the gross income of the taxpayer/buyer and
- Shall not be deductible by the dealer.[68]

Even though the credit is not claimed by the taxpayer, the taxpayer will still be required to reduce the basis of the vehicle acquired.[69]

If the taxpayer would not have been eligible to claim the credit in the year the vehicle was acquired due to failing to meet the modified adjusted gross income requirement, the taxpayer would be liable, the taxpayer's tax for the year in question will be increased by the amount of the payment made to the dealer to the taxpayer.[70]

Termination of Credit

The credit will not apply to any vehicle placed in service after December 31, 2032.[71]

Credit for Previously Owned Clean Vehicles

Effective date: *Except as for the transfer of credit to a dealer rule, the credit will apply to vehicles acquired after December 31, 2022. The transfer of credit to a dealer rule will be delayed by one year, applying to vehicles acquired after December 31, 2023.*

IRA 2022 adds a new credit for purchasers of *previously owned clean vehicles*.[72] The credit is equal to the lesser of:

- $4,000, or
- 30% of the sale price of the vehicle.

The credit is available to a *qualified buyer* for the year in which the vehicle is placed in service. [73]

Previously Owned Clean Vehicle Defined

A *previously-owned clean vehicle* is a motor vehicle—

- the model year of which is at least 2 years earlier than the calendar year in which the taxpayer acquires such vehicle,
- the original use of which commences with a person other than the taxpayer,

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[68] IRC §30D(g)(5) after revision by IRC 2022

[69] IRC §30D(g)(6)(A) after revision by IRC 2022

[70] IRC §30D(g)(10) after revision by IRC 2022

[71] IRC §30D(h) as revised by IRA 2022

[72] IRC §25E added by IRA 2022

[73] IRC §25E(a) added by IRA 2022

- which is acquired by the taxpayer in a *qualified sale*, and
- which—
  - Generally, meets the requirements to be eligible for the clean vehicle credit or
  - Is a clean fuel-cell vehicle which has a gross vehicle weight rating of less than 14,000 pounds[74]

Qualified Sale

A *qualified sale* is a sale of a motor vehicle—

- By a dealer,
- For a sales price that does not exceed $25,000, and
- Which is the first transfer since the date of the enactment of IRA to a *qualified buyer* other than the person with whom the original use of such vehicle commenced.[75]

Qualified Buyer Defined

A *qualified buyer* means, with respect to a sale of a motor vehicle, a taxpayer—

- Who is an individual,
- Who purchases such vehicle for use and not for resale,
- Who is not eligible to be claimed as a dependent by another taxpayer, and
- Who has not been allowed a credit under this section for any sale during the 3-year period ending on the date of the sale of such vehicle.[76]

Note that mere *qualification* for a person to be claimed as a dependent by another taxpayer will bar that person from being able to claim this credit. That is true even if that other party elects not to claim this person as a dependent on his/her return. And since the burden is on the taxpayer to prove qualification, on exam the person must be able to show that no other person could claim them as a dependent.

VIN Number Must Be Provided on the Tax Return on Which the Credit is Claimed

No credit will be allowed unless the taxpayer provides the vehicle identification number for the vehicle on which the credit is being claimed on that year's tax return.[77]

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[74] IRC §25E(c)(1) as added by IRA 2022

[75] IRC §25E(c)(2) as added by IRA 2022

[76] IRC §25E(c)(3) as added by IRA 2022

[77] IRC §25E(d)

Modified Adjusted Gross Income Limitation Credit

As with the new clean vehicle credit, a modified adjusted gross income (MAGI) limitation applies to be able to claim this credit. In this case the MAGI limit is significantly lower than the limit for the new clean vehicle credit.

No credit is allowed for a taxable year if the lesser of—

- the MAGI for the current taxable year or
- the MAGI for immediately preceding taxable year

exceeds the *threshold amount* for this credit.

The thresholder amount is—

- Joint return or surviving spouse, $150,000
- Head of household, $112,500 and
- Any other taxpayer, $75,000.

MAGI is computed in the same manner as it is for the new clean vehicle credit.[78]

Yet again Congress has added a cliff limit, so that $1 additional of income could cost the taxpayer an entire $4,000 credit. And, has before, that is slightly offset by the fact the taxpayer can test two years (the year the credit is being claimed or the immediately preceding year) to qualify to claim this credit.

Transfer of Credit

Again, like the new clean vehicle credit, this credit can be transferred to the dealer and used to help fund the purchase of the vehicle immediately rather than waiting for credit when a tax return is filed the following year. And, again, there is a recapture provision that could greatly surprise the unwary buyer.

IRC §25E simply references the transfer of credit provisions found in the new clean vehicle credit at IRC §30D(g).[79]

Termination of Credit

The credit will no longer be available for vehicles acquired after December 31, 2032.[80]

New Credit for Qualified Commercial Clean Vehicles

Effective date: *The credit applies to vehicles acquired after December 31, 2022.*

[78] IRC §25E(b) as added by IRA 2022

[79] IRC §25E(f) as added by IRA 2022

[80] IRC §25E(g) as added and renumbered by IRA 2022

The third clean vehicle credit modified or added by IRA 2022 is the new credit for qualified commercial clean vehicles found at IRC §45W. The credit is a component of the general business credit under IRC §38.

Amount of the Credit

The initial credit amount is the lesser of—

- 15% of the basis of such vehicle (30% in the case of a vehicle not powered by a gasoline or diesel internal combustion engine), or
- the *incremental cost* of such vehicle.[81]

The *incremental cost* of a qualified commercial clean vehicle is an amount equal to the excess of the purchase price for such vehicle over such price of a *comparable vehicle*.[82] A *comparable vehicle* means any vehicle which is powered solely by a gasoline or diesel internal combustion engine and which is comparable in size and use to such vehicle.

Note that since the credit is the lesser of the two figures, the taxpayer will always need to identify the appropriate comparable vehicle and document its purchase price.

Once the initial credit is computed, the amount is then limited to the lesser of that initial credit or—

- In the case of a vehicle which has a gross vehicle weight rating of less than 14,000 pounds, $7,500, and
- In the case of a vehicle with a weight rating of 14,000 pounds for more, $40,000.[83]

Qualified Commercial Clean Vehicle Defined

A *qualified commercial clean vehicle* means any vehicle—

- Meet the definition of new clean vehicle for purposes of the new clean vehicle credit found at IRC §30D(d)(1)(C) and is acquired for use or lease by the taxpayer and not for resale,
- Either—
  - Is treated as a motor vehicle for purposes of title II of the Clean Air Act and is manufactured primarily for use on public streets, roads, and highways (not including a vehicle operated exclusively on a rail or rails), or
  - Is mobile machinery, as defined in IRC §4053(8) (including vehicles that are not designed to perform a function of transporting a load over the public highways),

[81] IRC §45W(b)(1) as added by IRA 2022

[82] IRC §45W(b)(2) as added by IRA 2022

[83] IRC §45W(b)(4) as added by IRA 2022

- Either—
  - Is propelled to a significant extent by an electric motor which draws electricity from a battery which has a capacity of not less than 15 kilowatt hours (or, in the case of a vehicle which has a gross vehicle weight rating of less than 14,000 pounds, 7 kilowatt hours) and is capable of being recharged from an external source of electricity, or
  - Is a motor vehicle which satisfies the following requirements:
    - Which is propelled by power derived from 1 or more cells which convert chemical energy directly into electricity by combining oxygen with hydrogen fuel which is stored on board the vehicle in any form and may or may not require reformation prior to use, and
    - Which, in the case of a passenger automobile or light truck, has received on or after the date of the enactment of this section a certificate that such vehicle meets or exceeds the Bin 5 Tier II emission level established in regulations prescribed by the Administrator of the Environmental Protection Agency under section 202(i) of the Clean Air Act for that make and model year vehicle, and
- Is of a character subject to the allowance for depreciation.[84]

Certain special rules apply to tax exempt entities that may allow ignoring the requirement that the asset be of a character subject to the allowance for depreciation if the vehicle is not subject to a lease and the entity is:

- the United States, any State or political subdivision thereof, any possession of the United States, or any agency or instrumentality of any of the foregoing,
- an organization (other than a cooperative described in section 521) which is exempt from tax imposed by this chapter, or
- any Indian tribal government described in section 7701(a)(40).[85]

No Double Benefit Allowed

No credit will be allowed under this provision with respect to any vehicle to which a clean vehicle credit under IRC §30D was allowed.[86]

Vehicle Identification Number Must Be Provided

No credit will be allowed unless the taxpayer includes the vehicle identification number of such vehicle on the return of tax for the taxable year.[87]

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[84] IRC §45W(c) as added by IRA 2022

[85] IRC §45W(d)(2) as added by IRA 2022

[86] IRC §45W(d)(3) as added by IRA 2022

[87] IRC §45W(e) as added by IRA 2022

Certain Clean Vehicle Credit Rules Apply

Rules like those found in the clean vehicle credit at IRC §30D(f), except for those found at (10) and (11), will apply to this credit.[88]

Termination

The credit will not apply to any vehicle acquired after December 31, 2032.[89]

PROVISIONS MAINLY APPLICABLE TO LARGE PUBLIC CORPORATIONS

The following two provisions, while subject to much discussion in the press, will likely have little direct impact on the clients of most of those attending today's course.

The corporate alternative minimum tax may not affect a huge number of taxpayers, but it is by far the most complex provision in the bill due to various adjustments, exceptions and special cases. But the provision only applies to C corporations with average adjusted financial statement income of over $1 billion.

The excise tax on the repurchase of corporate stock is relatively simple in comparison, but the fact it only applies to public companies, while not as limiting as the income test for the corporate minimum tax, will not directly impact the clients of CPAs who do not work with public companies.

Corporate Alternative Minimum Tax (IRC §56A, Act Section 10101)

Effective Date: *Tax years beginning after December 31, 2022.*

A new corporate minimum tax, tied to financial statement income, returns following its removal in the Tax Cuts and Jobs Act in Act §10101(a)(2). A very simplified description of this tax is provided below. Fully covering the complexities of this tax is beyond the scope of this course and likely not directly relevant to most participants.

The tax applies to *applicable corporations* which is any corporation (other than an S corporation, a regulated investment company (RIC or mutual fund) or a real estate investment trust (REIT)) which meets the *average adjusted financial income test* for one or more taxable years that are:

- Prior to the current taxable year and
- End after December 31, 2021.[90]

A corporation meets the *average annual adjusted financial statement income test* for a taxable year if the average annual adjusted financial statement income of such corporation (determined without regard

[88] IRC §45W(d)(1) as added by IRA 2022

[89] IRC §45W(g) as added by IRA 2022

[90] IRC §59(k)(1)(A) as added by IRA 2022

to section 56A(d)) for the 3-taxable-year period ending with such taxable year exceeds $1,000,000,000.[91]

The tentative minimum tax applies at a rate of 15% of the *adjusted financial statement income* as determined under IRC §56A over the corporate AMT tax credit for the tax year. The tax applies to the extent the tentative minimum tax exceeds the corporation's regular income tax for the year, including the base erosion and anti-abuse tax (BEAT) for the year.[92]

The *adjusted financial statement income* begins with the net income or loss found on the taxpayer's applicable financial statement per IRC §451(b)(3).[93] Various adjustments, including substituting MACRS depreciation for GAAP depreciation are made to this income.

1% Excise Tax on Repurchase of Corporate Stock (Act Section 10201)

Effective Date: *repurchases of stock after December 31, 2022*

The law also imposes on each *covered corporation* a tax equal to 1% of the fair market value of stock the corporation repurchases. A *covered corporation* is a U.S. corporation which is traded on a established securities market (as defined in IRC §7704(b)(1)), or basically a publicly traded security.[94]

The tax does not apply in various circumstances:

- To the extent that the repurchase is part of a reorganization (within the meaning of section 368(a)) and no gain or loss is recognized on such repurchase by the shareholder under chapter 1 by reason of such reorganization,
- In any case in which the stock repurchased is, or an amount of stock equal to the value of the stock repurchased is, contributed to an employer-sponsored retirement plan, employee stock ownership plan, or similar plan,
- In any case in which the total value of the stock repurchased during the taxable year does not exceed $1,000,000,
- Under regulations prescribed by the Secretary, in cases in which the repurchase is by a dealer in securities in the ordinary course of business,
- To repurchases by a regulated investment company (as defined in section 851) or a real estate investment trust, or
- To the extent that the repurchase is treated as a dividend for income tax purposes.[95]

[91] IRC §59(k)(1)(B)(i) as added by IRA 2022.

[92] IRC §55(a) as added by IRA 2022

[93] IRC §56A as added by IRA 2022

[94] IRC §4501(b)

[95] IRC §4501(e) as added by IRA 2022

NOTES

Unit 2

Proposed Regulations for SECURE Act Required Minimum Distributions

LEARNING OBJECTIVES

When you have completed this unit, you will be able to accomplish the following.

- Calculate required minimum distributions for inherited IRAs under the proposed regulations
- Explain when trusts may make sense for IRA distribution planning and what terms must be in such trusts

The IRS issued proposed regulations[96] dealing with changes made to required minimum distributions from multiple tax-advantaged retirement accounts by 2019's Setting Every Community Up for Retirement Enhancement (SECURE) Act of 2019.

While the proposed regulations consistently refer to employees referring to participants in qualified retirement plans, these rules will also apply to individual retirement accounts. IRC §408 that deals with individual retirement accounts and individual retirement annuities cross reference IRC §401(a)(9).

The proposed regulations require distributions to be made in the year following the year of death of an employee/IRA account holder if that decedent had added his/her required beginning date prior to his/her death. This proposed requirement is at odds with how most advisers had interpreted the new law and has been the subject of much concern and comment.

This chapter looks at most, but not all of the provisions found in this set of proposed regulations.

[96] REG-105954-20; 87 F.R. 10504-10567, February 24, 2022, https://www.taxnotes.com/research/federal/proposed-regulations/proposed-regs-issued-on-required-minimum-distributions/7d6ww (retrieved April 21, 2022)

EFFECTIVE DATE ISSUES FOR SECURE DEFINED CONTRIBUTION PLAN MINIMUM DISTRIBUTION RULES (IRC §401(A)(9)(H))

The SECURE Act added IRC §401(a)(9)(H) that provided to limit life expectancy distributions for beneficiaries inheriting an interest in a defined contribution plan or IRA. Generally such balances are subjected to a "10 year" rule that will require the entire balance to be distributed to the beneficiary within 10 years after the year of death of the original employee/owner, with exceptions for certain qualified designated beneficiaries.

Generally, new IRC §401(a)(9)(H) applies with respect to employees/owners who died on or after January 1, 2020, with special delayed effective date for certain government and collectively bargained plans.[97]

Application of Provision Upon Death of Designated Beneficiary Where Employee/Owner Died Before January 1, 2020

Since a number of individuals inherited interests in plans and IRAs from decedents who died before January 1, 2020, the regulations provide that, while the new rules don't apply to that beneficiary while he/she is alive, that is not generally true once that beneficiary dies.

The regulations provide for the following if there was only a single designated beneficiary:

> ..[I]f an employee who died before the effective date described in paragraph (b)(2)(i) or (ii) of this section (whichever applies to the plan) has only one designated beneficiary and that beneficiary dies on or after that effective date, then, upon the death of the designated beneficiary, section 401(a)(9)(H) applies with respect to any beneficiary of the employee's designated beneficiary.[98]

Under this rule, the beneficiary of the individual that inherited the IRA or defined contribution plan interest will end up under the new rules, and the 10-year clock will start running. But until the original individual dies, he or she will continue to be able to take distributions under his or her life expectancy.

The regulation goes on to describe this result below:

> Section 401(b)(5) of Division O of the Further Consolidated Appropriations Act (known as the SECURE Act), provides that, if an employee dies before the effective date, then a designated beneficiary of an employee is treated as an eligible designated beneficiary. Accordingly, once the rules of section 401(a)(9)(H) apply with respect to the employee's designated beneficiary, the rules of section 401(a)(9)(H)(iii) (requiring full distribution of the employee's interest within 10 years after the death of an eligible designated beneficiary) apply upon the designated beneficiary's death.[99]

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[97] Proposed Reg. §1.401(a)(9)-1(b)(2)(i)

[98] Proposed Reg. §1.401(a)(9)-1(b)(2)(iii)(A)

[99] Proposed Reg. §1.401(a)(9)-1(b)(2)(iii)(A)

The preamble to the proposed regulations provided the following explanation of this result:

> In this situation, the designated beneficiary is treated as an eligible designated beneficiary for purposes of the 10-year payout required by section 401(a)(9)(H)(iii). Accordingly, the death of the designated beneficiary triggers a requirement to complete payment within 10 years of the death of that designated beneficiary. In contrast, if that designated beneficiary died before that effective date, then the amendments made by section 401 of the SECURE Act do not apply with respect to the employee's interest under the plan.[100]

The regulations provide the following examples of applying these rules:

EXAMPLES

Example 1, Reg. §1.401(a)(9)-1(b)(3)

Employer M maintains a defined contribution plan, Plan X. Employee A died in 2017, at the age of 68, and designated A's 40-year-old non-disabled, non-chronically ill son, B, as the sole beneficiary of A's interest in Plan X. Pursuant to a plan provision in Plan X, B elected to take distributions over B's life expectancy under section 401(a)(9)(B)(iii). B dies in 2024, after the effective date of section 401(a)(9)(H). Because section 401(b)(5) of the SECURE Act treats B as an eligible designated beneficiary, the rules of section 401(a)(9)(H)(iii) apply to B's beneficiaries. Therefore, A's remaining interest in Plan X must be distributed by the end of 2034 (within 10 years of B's death).

Example 2, Reg. §1.401(a)(9)-1(b)(3)

The facts are the same as in Example 1 in paragraph (b)(3)(i) of this section except that B died in 2019. Because A's designated beneficiary died before the effective date of section 401 of the SECURE Act, the rules of section 401(a)(9)(H) do not apply to B's beneficiaries.

Example 3, Reg. §1.401(a)(9)-1(b)(3)

The facts are the same as in Example 1 in paragraph (b)(3)(i) of this section except that, pursuant to a provision in Plan X, B elected the 5-year rule under section 401(a)(9)(B)(ii). Accordingly, A's entire interest is required to be distributed by the end of 2022. Because A died before January 1, 2020, section 401(a)(9)(H) does not apply with respect to B. Therefore, section 401(a)(9)(H)(i)(I) does not extend B's election to a 10-year period. Although B's election requires A's entire interest to be distributed by the end of 2022, the enactment of section 401(a)(9)(I)(iii)(II) (permitting disregard of 2020 when the 5-year period applies) permits distribution of A's entire interest in the plan to be delayed until the end of 2023.

If the individual who died before the beginning of these rules had more than one designated beneficiary on the account, then the regulations provide for the following results:

> If an employee described in paragraph (b)(2)(iii)(A) of this section has more than one designated beneficiary, then whether section 401(a)(9)(H) applies is determined based on the date of death of the oldest of the employee's designated beneficiaries. Thus, section 401(a)(9)(H) will apply upon the death of the oldest of the employee's designated beneficiaries if that designated beneficiary is still alive on or after the

[100] REG-105954-20; 87 F.R. 10504-10567, February 24, 2022, Explanation of Provisions, Section I.A.1

> effective date of section 401(a)(9)(H) for the plan as determined under the rules of paragraph (b)(2)(i) or (ii) of this section.[101]

So, if there were three beneficiaries, aged 50, 52 and 59, the death of the 50-year-old beneficiary would not change the speed at which funds have to come out of this account. But if the 59-year-old beneficiary dies then the new 10-year rule is triggered.

The preamble to the proposed regulations described this result as follows:

> Thus, for example, if an employee who died before January 1, 2020, named a see-through trust as the sole beneficiary of the employee's interest in the plan, and the trust has three beneficiaries who are all individuals, then the amendments made by section 401 of the SECURE Act will apply with respect to distributions to the trust upon the death of the oldest trust beneficiary, but only if that beneficiary dies on or after the section 401(a)(9)(H) effective date for that plan. However, if the oldest of the trust beneficiaries died before that effective date, then the amendments made by section 401 of the SECURE Act do not apply with respect to distributions to the trust.[102]

Again, the regulations provide examples to illustrate these provisions:

EXAMPLES

Example 4, Reg. §1.401(a)(9)-1(b)(3)

The facts are the same as in Example 1 in paragraph (b)(3)(i) of this section except that A designates a see-through trust that satisfies the requirements of §1.401(a)(9)-4(f)(2) as the sole beneficiary of A's interest in Plan X. All of the trust beneficiaries are alive as of January 1, 2020. The oldest of the trust beneficiaries, C, dies in 2022. Because section 401(b)(5) of the SECURE Act treats C as an eligible designated beneficiary, the rules of section 401(a)(9)(H)(iii) apply to the other trust beneficiaries. Thus, if the death of the oldest beneficiary is not disregarded under the rules of §1.401(a)(9)-5(f)(2)(ii), A's remaining interest in Plan X must be distributed by the end of 2032 (within 10 years of C's death).

Example 5, Reg. §1.401(a)(9)-1(b)(3)

The facts are the same as in Example 4 in paragraph (b)(3)(iv) of this section except that C dies in 2019. Because the oldest designated beneficiary died before January 1, 2020, the rules of section 401(a)(9)(H) do not apply to any of the other trust beneficiaries.

Surviving Spouse Issues

The final effective date discussion in the regulations looks at such interests that passed to the surviving spouse from a decedent who had not reached his/her required beginning date and where the surviving spouse is waiting to begin distributions until the decedent's required beginning date.

> If an employee described in paragraph (b)(2)(iii)(A) of this section dies before the employee's required beginning date and the employee's surviving spouse is waiting to begin distributions until the year for which the employee would have been

[101] Proposed Reg. §1.401(a)(9)-1(b)(2)(iii)(B)

[102] REG-105954-20; 87 F.R. 10504-10567, February 24, 2022, Explanation of Provisions, Section I.A.1

> required to begin distributions pursuant to section 401(a)(9)(B)(iv), then, in applying the rules of this paragraph (b)(2)(iii), the surviving spouse is treated as the employee.[103]

The regulation then goes on to give a brief example of how this provision would work.

> Thus, for example, if an employee with a required beginning date of April 1, 2025, names the employee's surviving spouse as the sole beneficiary of the employee's interest in the plan, both the employee and the employee's surviving spouse die before the effective date of section 401(a)(9)(H) for the plan, and that spouse's designated beneficiary dies on or after that effective date, then section 401(a)(9)(H) applies with respect to the surviving spouse's designated beneficiary upon the death of that designated beneficiary.[104]

PARTICIPANT IN MULTIPLE PLANS

The regulations bar participants from aggregating the plans for purposes of meeting the distribution requirements. The regulation states:

> If an employee is a participant in more than one plan, the plans in which the employee participates are not permitted to be aggregated for purposes of testing whether the distribution requirements of section 401(a)(9) are met. Thus, the distribution of the benefit of the employee under each plan must separately meet the requirements of section 401(a)(9). For this purpose, a plan described in section 414(k) is treated as two separate plans, a defined contribution plan to the extent benefits are based on an individual account and a defined benefit plan with respect to the remaining benefits.[105]

If you are thinking this is not a new rule, you are correct. The preamble notes that all that is happening here is that the location of this rule has moved in the proposed regulations.

> This rule is currently in §1.401(a)(9)-8, Q&A-1, but is moved to §1.401(a)(9)-1(a)(2) in these proposed regulations.[106]

DISTRIBUTIONS COMMENCING IN AN EMPLOYEE'S LIFETIME (REG. §1.401(A)(9)-2)

One of the headline features of the secure act was the pushing back of the measuring date for the required beginning date from the date on which the employee turned age 70 1/2 to the date the employee turns age 72. Again this new rule will raise certain complications with the effective date, as not all employees are required to start taking distributions on the dates shown above.

Generally, an employee's required beginning date is April 1 of the calendar year following the later of:

- The calendar year in which the employee attains age 72; or

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[103] Proposed Reg. §1.401(a)(9)-1(b)(2)(iii)(C)

[104] Proposed Reg. §1.401(a)(9)-1(b)(2)(iii)(C)

[105] Proposed Reg. §1.401(a)(9)-1(a)(2)

[106] REG-105954-20; 87 F.R. 10504-10567, February 24, 2022, Explanation of Provisions, Section I.A.2

- The calendar year in which the employee retires from employment with the employer maintaining the plan.[107]

An individual who is a "5-percent owner" is not allowed to delay the distribution until the date he/she retires from employment with the plan sponsor.[108] A "5-percent owner" is:

- If the employer is a corporation, any person who owns (or is considered as owning within the meaning of section 318) more than 5 percent of the outstanding stock of the corporation or stock possessing more than 5 percent of the total combined voting power of all stock of the corporation, or

- If the employer is not a corporation, any person who owns more than 5 percent of the capital or profits interest in the employer.[109]

However, for employees born before July 1, 1949, the old law rule applies, retaining the age 70 ½ test.[110] The preamble to the proposed regulations explained why the regulations refer to a date of birth rather than age for this purpose:

> Section 114(d) of the SECURE Act provides that the amended definition of the required beginning date applies with respect to employees who attain age 70½ on or after January 1, 2020. This effective date provision could be interpreted to require the employee to survive until age 70½ in order to have the amended definition apply (that is, if the employee died before attaining age 70½, then the amended definition would not apply with respect to distributions to that employee's beneficiary, even if the employee would have attained age 70½ on or after January 1, 2020, had the employee survived). Instead, for ease of administration, these proposed regulations interpret the effective date language to apply the amendments made by section 114 of the SECURE Act to an employee who died before attaining age 70½ if the employee would have attained age 70½ on or after January 1, 2020 (that is, the employee's date of birth is on or after July 1, 1949). This interpretation also extends to a surviving spouse who is waiting to begin distributions pursuant to section 401(a)(9)(B)(iv). Thus, for example, if an employee who was born on June 1, 1952, died in 2018, and the employee's sole beneficiary is the employee's surviving spouse, then the surviving spouse may wait until 2024 (the calendar year in which the employee would have attained age 72) to begin receiving distributions.[111]

DEATH BEFORE REQUIRED BEGINNING DATE (REG. §1.401(A)(9)-3)

The distribution rules for those that inherit their account from a taxpayer who died before his or her required beginning date are also modified to reflect the new 10-year rule.

The required distribution rules for a defined contribution plan in the situation can fall into one of 3 categories. The distribution may be required to be made under a 5-year rule, a 10-year rule, or via life

[107] Reg. §1.401(a)(9)-2(b)(1)

[108] Reg. §1.401(a)(9)-2(b)(3)(i)

[109] IRC §416(i)1)(B)(i); Reg. §1.401(a)(9)-2(b)(3)

[110] Reg. §1.401(a)(9)-2(b)(2)

[111] REG-105954-20; 87 F.R. 10504-10567, February 24, 2022, Explanation of Provisions, Section I.B

expectancy payments. The regulations provide for determining which of these rules apply in a particular case.

If the defined benefit plan does not contain one of two optional plan provisions, then the distributions must be made as follows:

- If the employee does not have a *designated beneficiary*, as determined under §1.401(a)(9)-4, distributions must satisfy the 5-year rule;

- If the employee dies on or after the effective date of the SECURE provisions (as determined under these regulations) and has a *designated beneficiary* who is not an *eligible designated beneficiary*, as determined under §1.401(a)(9)-4(e), distributions must satisfy the 10-year rule; and

- If the employee has an *eligible designated beneficiary*, distributions must satisfy the life expectancy rule described in paragraph (c)(4) of this section.[112]

The first optional provision that may be in a plan allowed under these regulations that could change that distribution hierarchy involves limiting the types of beneficiaries that are allowed to use the life expectancy distribution method. A plan can require any beneficiaries to comply with the 10-year rule even if they are an eligible designated beneficiary. It can also only allow certain eligible designated beneficiaries to use the life expectancy rule. The regulation provides:

> A defined contribution plan will not fail to satisfy section 401(a)(9) merely because it includes a provision specifying that the 10-year rule described in paragraph (c)(3) of this section (rather than the life expectancy rule described in paragraph (c)(4) of this section) will apply with respect to some or all of the employees who have an eligible designated beneficiary. Further, a plan need not have the same method of distribution for the benefits of all employees in order to satisfy section 401(a)(9).[113]

Conversely, the plan can contain an optional provision that allows an eligible designated beneficiary to elect whether to use the 10 year or life expectancy distribution method. The regulation reads:

> A defined contribution plan may include a provision, applicable to an employee who dies before the employee's required beginning date and who has an eligible designated beneficiary, that permits the employee (or eligible designated beneficiary) to elect whether the 10-year rule in paragraph (c)(3) of this section or the life expectancy rule in paragraph (c)(4) of this section applies. If a plan provides for this type of election, then —
>
> > (A) The plan must specify the method of distribution that applies if neither the employee nor the designated beneficiary makes the election;
> >
> > (B) The election must be made no later than end of the earlier of the calendar year by which distributions must be made in order to satisfy paragraph (c)(3) of this section and the calendar year in which distributions would be required to begin in order to satisfy the requirements of paragraph (c)(4) of this section or, if applicable, paragraph (d) of this section; and

[112] Reg. §1.401(a)(9)-3(c)(5)(i)

[113] Reg. §1.401(a)(9)-3(c)(5)(ii)

> (C) As of the last date the election may be made, the election must be irrevocable with respect to the beneficiary (and all subsequent beneficiaries) and must apply to all subsequent calendar years.[114]

5-Year Rule

The five-year rule is basically unchanged from the version that we have long known under the prior regulations. The regulation provides the following explanation of the rule:

> Distributions satisfy this paragraph (c)(2) if the employee's entire interest is distributed by the end of the calendar year that includes the fifth anniversary of the date of the employee's death. For example, if an employee dies on any day in 2022, the entire interest must be distributed by the end of 2027 in order to satisfy the 5-year rule in section 401(a)(9)(B)(ii).[115]

The regulation specifically provides that 2020 does not count as a year if the five year. Includes that year.

> For purposes of this paragraph (c)(2), if an employee died before January 1, 2020, then the 2020 calendar year is disregarded when determining the calendar year that includes the fifth anniversary of the date of the employee's death.[116]

10-Year Rule

The 10-year rule is very much the five year rule, just with an extra five years added. The regulation provides the following explanation of this rule:

> Distributions satisfy this paragraph (c)(3) if the employee's entire interest is distributed by the end of the calendar year that includes the tenth anniversary of the date of the employee's death. For example, if an employee dies on any day in 2021, the entire interest must be distributed by the end of 2031 in order to satisfy the 5-year rule in section 401(a)(9)(B)(ii), as extended to 10 years by section 401(a)(9)(H)(i).[117]

Life Expectancy Rule

Finally, the regulation describes the life expectancy rule. While this rule is essentially the rule that existed before, it now is available to a much smaller universe of potential beneficiaries. We will discuss that when we look at the definition of an eligible designated beneficiary later.

The regulation provides:

> Distributions satisfy this paragraph (c)(4) if distributions that satisfy the requirements of §1.401(a)(9)-5 commence on or before the end of the calendar year following the calendar year in which the employee died, except as provided in

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[114] Reg. §1.401(a)(9)-3(c)(5)(iii)

[115] Reg. §1.401(a)(9)-3(c)(2)

[116] Reg. §1.401(a)(9)-3(c)(2)

[117] Reg. §1.401(a)(9)-3(c)(3)

> paragraph (d) of this section (permitting a surviving spouse to delay the commencement of distributions).[118]

We will discuss the details of using this method later, but at this point the key thing to notice is that such distributions must commence by the end of the year following the year of death.

DETERMINATION OF THE DESIGNATED BENEFICIARY (REG. §1.401(A)(9)-4)

The rules for determining the designated beneficiary are very similar to the rules that existed under the previous regulations. However, the new regulations detail how to determine if such a designated beneficiary is an eligible designated beneficiary and also defines whom each of the categories of eligible designated beneficiary covers.

Designated Beneficiary

The basic designated beneficiary rules are very similar to those under prior law. One key provision is the general requirement that only an individual can be a designated beneficiary. The regulations provide:

> A person that is not an individual, such as the employee's estate, is not a designated beneficiary. If a person other than an individual is a beneficiary designated under the plan, the employee will be treated as having no designated beneficiary, even if individuals are also designated as beneficiaries.[119]

However, as is often the case with tax issues there are exceptions to this rule the key one being the use of a look through trust. As the regulation notes:

> However, see paragraph (f)(1) and (3) of this section for a rule under which certain beneficiaries of a see-through trust that is designated as the employee's beneficiary under the plan are treated as the employee's beneficiaries under the plan rather than the trust.[120]

Another key exception is the ability to create separate accounts for each beneficiaries, so that non-individual beneficiaries no longer "taint" the individuals so long as the accounts are established by the end of September of the year following the year of death of the original employee/account holder.

> In addition, the rules of this paragraph (b) do not apply to the extent separate account treatment applies in accordance with §1.401(a)(9)-8(a).[121]

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[118] Reg. §1.401(a)(9)-3(c)(4)

[119] Reg. §1.401(a)(9)-4(b)

[120] Reg. §1.401(a)(9)-4(b)

[121] Reg. §1.401(a)(9)-4(b)

Rules for Determining Beneficiaries

The regulations provide for determining a designated beneficiary by September 30 of the calendar year following the calendar year of the death of the employee or account owner.

> Except as provided in paragraphs (d) and (f) of this section and § 1.401(a)(9)-6(b)(2)(i), a person is a beneficiary taken into account for purposes of section 401(a)(9) if that person is a beneficiary designated under the plan as of the date of the employee's death and none of the events described in paragraph (c)(2) of this section has occurred with respect to that person by September 30 of the calendar year following the calendar year of the employee's death.[122]

The September 30 date is a key one in "cleaning up" a beneficiary list. In addition to the separate account option noted earlier, beneficiaries can be disregarded if any of the following events occur before the September 30 with regard to a beneficiary:

- The beneficiary predeceases the employee;
- The beneficiary is treated as having predeceased the employee pursuant to a simultaneous death provision under applicable State law or pursuant to a qualified disclaimer satisfying section 2518 that applies to the entire interest to which the beneficiary is entitled; or
- The beneficiary receives the entire benefit to which the beneficiary is entitled.[123]

Most often the advisor will attempt to eliminate non-individual beneficiaries by either paying out their interest, such as for a charity for which there would be no tax impact to such a distribution, or by creating a separate account to hold the interest of some other non-individual beneficiary that will not be able to be treated as a designated beneficiary.

A key part of planning following the death of a plan participant or IRA account holder is to assure that the beneficiaries are "cleaned up" so that each beneficiary that would like to delay receipt of funds from the plan is in a position to do so by September 30th of the following year.

The IRS provides a series of examples of such "cleaning up" or other elimination of certain beneficiaries before that key September 30 date.

EXAMPLES

Example 1, Reg. §1.401(a)(9)-4(c)(3)

Employer M maintains a defined contribution plan, Plan X. Employee A dies in 2022 having designated A's three children — B, C, and D — as beneficiaries, each with a one-third share of A's interest in Plan X. B executes a disclaimer within 9 months of A's death and the disclaimer satisfies the other requirements of a qualified disclaimer under section 2518. Pursuant to the qualified disclaimer, B is disregarded as a beneficiary.

[122] Reg. §1.401(a)(9)-4(c)(1)

[123] Reg. §1.401(a)(9)-4(c)(2)

Example 2, Reg. §1.401(a)(9)-4(c)(3)

The facts are the same as in Example 1 in paragraph ©(3)(i) of this section except that B does not execute a disclaimer until 10 months after A's death. Even if the disclaimer is executed by September 30 of the calendar year following the calendar year of A's death, the disclaimer is not a qualified disclaimer (because B does not meet the 9-month requirement of section 2518) and B remains a designated beneficiary of A.

Example 3, Reg. §1.401(a)(9)-4(c)(3)

The facts are the same as in Example 1 in paragraph (c)(3)(i) of this section except that, in exchange for B's disclaimer of the one-third share of A's interest in Plan X, C transfers C's interest in real property to B. Because B has received consideration for B's disclaimer of the one-third share, it is not a qualified disclaimer under section 2518 and B remains a designated beneficiary.

Example 4, Reg. §1.401(a)(9)-4(c)(3)

The facts are the same as in Example 1 in paragraph (c)(3)(i) of this section except that Charity E (an organization exempt from taxation under section 501(c)(3)) also is a beneficiary designated under the plan as of the date of A's death, with B, C, D, and Charity E each having a one-fourth share of A's interest in Plan X. Plan X distributes Charity E's one-fourth share of A's interest in the plan by September 30 of the calendar year following the calendar year of A's death. Accordingly, Charity E is disregarded as A's beneficiary, and B, C, and D are treated as A's designated beneficiaries.

Example 5, Reg. §1.401(a)(9)-4(c)(3)

The facts are the same as in Example 1 in paragraph (c)(3)(i) of this section except that A's spouse, F, also is a beneficiary designated under the plan. A and F were residents of State Z so that State Z law applies. The laws of State Z include a simultaneous death provision under which two individuals who die within a 120-hour period of one another are treated as predeceasing each other. F dies four hours after A and under the laws of State Z, F is treated as predeceasing A. Because, under applicable State law, F is treated as predeceasing A, F is disregarded as a beneficiary of A.

Example 6, Reg. §1.401(a)(9)-4(c)(3)

The facts are the same as in Example 1 in paragraph (c)(3)(i) of this section except that B, who was alive as of the date of A's death, dies before September 30 of the calendar year following the calendar year of A's death. Prior to B's death, none of the events described in paragraph (c)(2) of this section occurred with respect to B. Accordingly, B is still a beneficiary taken into account for purposes of section 401(a)(9) regardless of the identity of B's successor beneficiaries.

Eligible Designated Beneficiaries

The SECURE Act created a new subclass of designated beneficiaries referred to as eligible designated beneficiaries. The key feature such beneficiaries have is their ability to receive a life expectancy distribution, rather than being stuck with a 10-year distribution period.

The regulations provide the following list of *eligible designated beneficiaries*:

- The surviving spouse of the employee;
- A child of the employee who has not reached the age of majority;
- A disabled designated beneficiary;

- A chronically ill designated beneficiary;
- A designated beneficiary not more than 10 years younger than the; or
- A designated beneficiary of an employee if the employee died before the effective date of the 10-year rule added by the SECURE Act.[124]

Multiple Beneficiaries and the Designated Eligible Beneficiary Rules

Similar to the treatment for designated beneficiaries, even a single beneficiary who is not an eligible designated beneficiary that is a beneficiary of the account as of the September 30 measuring date will cause the account to be treated as not having any eligible designated beneficiaries. Therefore, the same measures should be taken to isolate eligible designated beneficiary balances prior to September 30th of the year following the year of death of the original account holder.[125]

However, a special exception exists if any of the designated beneficiaries are an eligible child beneficiary, as discussed next, then even if other beneficiaries are not eligible designated beneficiaries the account will be deemed as having an eligible designated beneficiary.[126]

And, as the preamble to the proposed regulations note, there is also an exception for certain multiple beneficiary see-through trusts where some beneficiaries are disabled or chronically ill:

> The second exception is if the see-through trust is a type II applicable multi-beneficiary trust, then the beneficiaries who either are disabled or chronically ill are treated as eligible designated beneficiaries without regard to whether any of the other trust beneficiaries are not eligible designated beneficiaries.[127]

Age of Majority for Minor Children of the Employee/Account Owner

One of the categories of eligible designated beneficiaries under the law is the employee's minor child. Under the law that child remains ineligible designated beneficiary until he or she reaches the age of majority. The law doesn't define age of majority, but the regulations do provide a definition.

For these purposes the child reaches the age of majority on the child's 21st birthday. That age will apply to define the age of majority regardless of what may be deemed the age of majority under any state law.[128]

Disabled Beneficiaries

Another category of eligible designated beneficiaries under the regulation are disabled beneficiaries. The regulations provide two distinct tests to determine if someone is disabled, with the difference being whether the individual has attained age 18 as of the date of the employee/account owner's death.

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[124] Proposed Reg. §1.401(a)(9)-4(e)(1)

[125] Proposed Reg. §1.401(a)(9)-4(e)(2)(i)

[126] Proposed Reg. §1.401(a)(9)-4(e)(2)(ii)

[127] REG-105954-20; 87 F.R. 10504-10567, February 24, 2022, Explanation of Provisions, Section I.D.3.a.

[128] Proposed Reg. §1.401(a)(9)-4(e)(2)(iii)

If the beneficiary has attained age 18 on or before the date that the employee or account holder dies the following test applies.

> An individual who, as of the date of the employee's death, is age 18 or older is disabled if, as of that date, the individual is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment that can be expected to result in death or to be of long-continued and indefinite duration.[129]

The reference to a substantial gainful activity refers to the ability of the individual to be employed. The regulations remove that requirement if the individual has not yet attained age 18 as of the date the employee or account holder dies.

> An individual who, as of the date of the employee's death, is not age 18 or older is disabled if, as of that date, that individual has a medically determinable physical or mental impairment that results in marked and severe functional limitations and that can be expected to result in death or to be of long-continued and indefinite duration.[130]

The regulations also provide that if the person has been determined to be disabled by the Social Security Administration the IRS will accept that determination that the individual is disabled for these purposes.

> If the Commissioner of Social Security has determined that, as of the date of the employee's death, an individual is disabled within the meaning of 42 U.S.C. 1382c(a)(3), then that individual will be deemed to be disabled within the meaning of this paragraph (e)(4).[131]

The preamble to the proposed regulations also notes that the test for disability is made as of the date the employee/account owner died:

> Pursuant to section 401(a)(9)(E)(ii), the determination of whether a beneficiary is disabled is made as of the date of the employee's death. For example, if, as of the employee's death, the employee's designated beneficiary is the employee's 10-year-old child who is not disabled but who becomes disabled 5 years after the employee's death, then pursuant to section 401(a)(9)(E)(iii) and these proposed regulations, that child's later disability will not be taken into account, and that child will cease to be an eligible designated beneficiary on the child's 21st birthday.[132]

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[129] Proposed Reg. §1.401(a)(9)-4(e)(4)(ii)

[130] Proposed Reg. §1.401(a)(9)-4(e)(4)(iii)

[131] Proposed Reg. §1.401(a)(9)-4(e)(4)(iv)

[132] REG-105954-20; 87 F.R. 10504-10567, February 24, 2022, Explanation of Provisions, Section I.D.3.b.

Chronically Ill Individual

The regulations use the definitions found in IRC §7702B(c)(2) that treats someone as chronically ill under certain conditions. Under that provision an individual is deemed to be a chronically ill individual if they have been certified by a licensed healthcare professional as:

- Being unable to perform (without substantial assistance from another individual) at least 2 *activities of daily living* for a period of at least 90 days due to a loss of functional capacity,

- Having a level of disability similar (as determined under regulations prescribed by the Secretary in consultation with the Secretary of Health and Human Services) to the previously described level of disability, or

- Requiring substantial supervision to protect such individual from threats to health and safety due to severe cognitive impairment.[133]

However, the person will not be deemed chronically ill, even if they meet the above tests, unless within the preceding 12-month period a licensed health care practitioner has certified that such individual meets such requirements.[134]

The *activities of daily living* are:

- Eating,
- Toileting,
- Transferring,
- Bathing,
- Dressing, and
- Continence.[135]

The proposed regulations further impose the restriction that "an individual will be treated as chronically ill under section 7702B(c)(2)(A)(i) only if there is a certification from a licensed health care practitioner (as that term is defined in section 7702B(c)(4)) that, as of the date of the certification, the individual is unable to perform (without substantial assistance from another individual) at least 2 activities of daily living for an indefinite period which is reasonably expected to be lengthy in nature (and not merely for 90 days)."[136]

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[133] IRC §7702B(c)(2)(A)

[134] IRC §7702B(c)(2)(A)

[135] IRC §7702B(c)(2)(B)

[136] Proposed Reg. §1.401(a)(9)-4(e)(5)

Documentation Requirements for Disabled for Disabled or Chronically Ill Status

Beneficiaries who meet the disabled or chronically ill status to be a eligible designated beneficiary do face a requirement to provide documentation to the plant administrator no later than October 31st of the calendar year following the year the employee or account owner dies.

The information to be provided is the information required to meet the definitions of disabled or chronically ill discussed above. For a chronically ill individual, that must include the certification from the licensed health care practitioner required to meet that definition.[137]

Individual Not More Than 10 Years Younger Than the Employee

While some had hoped that the test for a beneficiary that is not more than 10 years younger than the employee would only look at the years of birth, the proposed regulations look at the actual date of birth to determine if an individual is not more than 10 years younger than the decedent.

> Whether a designated beneficiary is not more than 10 years younger than the employee is determined based on the dates of birth of the employee and the beneficiary. Thus, for example, if an employee's date of birth is October 1, 1953, then the employee's beneficiary is not more than 10 years younger than the employee if the beneficiary was born on or before October 1, 1963.[138]

Example of Applying the Designated Beneficiary Rules

The proposed regulations provide the following examples of applying the designated beneficiary rules:

EXAMPLES

Example 1, Proposed Reg. §1.401(a)(9)-4(e)(9)

Employer M maintains a defined contribution plan, Plan X. Employee A designates A's child, B, as the sole beneficiary of A's interest in Plan X. B will not reach the age of majority until 2024. A dies in 2022, after A's required beginning date. As of the date of A's death, B is disabled within the meaning of paragraph (e)(4) of this section, and the documentation requirements of paragraph (e)(7) of this section are timely satisfied with respect to B. Due to B's disability, B remains an eligible designated beneficiary even after reaching the age of majority in 2024, and Plan X is not required to distribute A's remaining interest in the plan by the end of 2034 pursuant to the rules of §1.401(a)(9)- 5(e)(4), but instead may continue life expectancy payments to B during B's lifetime.

Example 2, Proposed Reg. §1.401(a)(9)-4(e)(9)

The facts are the same as in Example 1 in paragraph (e)(9)(i) of this section except that the documentation requirements of paragraph (e)(7) of this section are not timely satisfied with respect to B. B ceases to be an eligible designated beneficiary upon reaching the age of majority in 2024, and Plan X is required to distribute A's remaining interest in the plan by the end of 2034 pursuant to the rules of §1.401(a)(9)-5(e)(4).

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[137] Proposed Reg. §1.401(a)(9)-4(e)(7)

[138] Proposed Reg. §1.401(a)(9)-4(e)(6)

Example 3, Proposed Reg. §1.401(a)(9)-4(e)(9)

The facts are the same as in Example 1 in paragraph (e)(9)(i) of this section except that B becomes disabled in 2023 (after A's death in 2022). Because B was not disabled as of the date of A's death, B ceases to be an eligible designated beneficiary upon reaching the age of majority in 2024, and Plan X is required to distribute A's remaining interest in the plan by the end of 2034 pursuant to the rules of §1.401(a)(9)-5(e)(4).

SPECIAL RULES FOR TRUSTS (REG. §1.401(A)(9)-4(F) TO (H)

The proposed regulations also update the guidance for trusts that are designed to be used as designated beneficiaries. If the requirements are met, beneficiaries of the trust will be treated as designated beneficiaries of the retirement plan or IRA. the regulations refer to this type of trust as a see-through trust.[139]

The regulations define two types of trusts that can meet the requirements to be used as a see-through trust for this purpose:

- *Conduit trusts:* A see-through trust, the terms of which provide that, with respect to the deceased employee's interest in the plan, all distributions will, upon receipt by the trustee, be paid directly to, or for the benefit of, specified beneficiaries.[140]
- *Accumulation trusts*: Any see-through trust that is not a conduit trust.[141]

In both cases we are looking to use a beneficiary or beneficiaries as having been designated as beneficiaries of the interest in the retirement plan or IRA. Which beneficiaries qualify for that status will be different depending upon which type of trust (conduit or accumulation) are looking at.[142]

Requirements for a See-Through Trust

To qualify as a see-through trust a trust must meet all of the following requirements.

- The trust is a valid trust under state law or would be but for the fact that there is no corpus;
- The trust is irrevocable or will, by its terms, become irrevocable upon the death of the employee;
- The beneficiaries of the trust who are beneficiaries with respect to the trust's interest in the employee's interest in the plan are identifiable from the trust instrument; and
- By October 31st of the year following the year of death the trustee must either:
  - Take the following three actions:
    - Provides the plan administrator with a final list of all beneficiaries of the trust as of September 30 of the calendar year following the calendar year of the death (including

[139] Proposed Reg. §1.401(a)(9)-4(f)(1)(i)

[140] Proposed Reg. §1.401(a)(9)-4(f)(1)(ii)(A)

[141] Proposed Reg. §1.401(a)(9)-4(f)(1)(ii)(B)

[142] Proposed Reg. §1.401(a)(9)-4(f)(1)(ii)

contingent beneficiaries) with a description of the conditions on their entitlement sufficient to establish who are the beneficiaries;

    - Certifies that, to the best of the trustee's knowledge, this list is correct and complete and that the requirements of paragraph (f)(2)(i), (ii), and (iii) of this section are satisfied; and

    - Agrees to provide a copy of the trust instrument to the plan administrator upon request or

  - Provides the plan administrator with a copy of the actual trust document for the trust that is named as a beneficiary of the employee under the plan as of the employee's date of death.[143]

If the sole beneficiary of the trust is the employee's spouse, then the information will need to be provided by the employee during his or her life once required distribution start during that employee's life. The requirements are very similar to those imposed on the trustee upon the employee's death. Thus, the employee has two choices on how to comply with this rule in order to assure the plan that the employee spouse is the only other beneficiary covered by the trust.[144]

The employee must provide documentation under one of the following two options prior to the first day of the distribution year:

- Providing a copy of the plan document. The employee:

  - Provides to the plan administrator a copy of the trust instrument; and

  - Agrees that, if the trust instrument is amended at any time in the future, the employee will, within a reasonable time, provide to the plan administrator a copy of each amendment. Or

- Providing a list of beneficiaries: The employee:

  - Provides to the plan administrator a list of all of the beneficiaries of the trust (including contingent beneficiaries) with a description of the conditions on their entitlement sufficient to establish whether the spouse is the sole beneficiary;

  - Certifies that, to the best of the employee's knowledge, the list is correct and complete and that the trust satisfies the requirements to be a see-through trust;

  - Agrees that, if the trust instrument is amended at any time in the future, the employee will, within a reasonable time, provide to the plan administrator corrected certifications to the extent that the amendment changes any information previously certified; and

  - Agrees to provide a copy of the trust instrument to the plan administrator upon request.[145]

The regulations do provide a safety net for the plan administrator regarding these conduit trusts. The plan will not be determined to be out of compliance with the minimum distribution rules so long as:

- The plan administrator reasonably relied on the information provided; and

[143] Proposed Reg. §1.401(a)(9)-4(h)(3)

[144] Proposed Reg. §1.401(a)(9)-4(h)(2)(i)

[145] Proposed Reg. §1.401(a)(9)-4(h)(2)(ii) and (iii)

- The required minimum distributions for calendar years after the calendar year in which the discrepancy is discovered are determined based on the actual terms of the trust instrument.[146]

Trust Beneficiaries Treated as Beneficiaries of the Employee/IRA Owner

The following beneficiaries of a see-through trust are treated as having been designated beneficiaries under the plan:

- Any beneficiary who could receive amounts in the trust representing the employee's interest in the plan that are neither contingent upon, nor delayed until, the death of another trust beneficiary who did not predecease (and is not treated as having predeceased) the employee; and

- Any beneficiary of an accumulation trust that could receive amounts in the trust representing the employee's interest in the plan that were not distributed to beneficiaries described in the immediately preceding bullet.[147]

Normally, a beneficiary of an accumulation trust who could receive amounts from the trust that represent the employee's interest in the plan solely because of the death of one of the previously described see-through deemed designated beneficiaries is not treated as having been designated as a beneficiary of the employee under the plan. However, this rule does not apply if that other beneficiary:

- Predeceased (or is treated as having predeceased) the employee; or

- Also is a beneficiary could receive amounts in the trust representing the employee's interest in the plan that are neither contingent upon, nor delayed until, the death of another trust beneficiary who did not predecease (and is not treated as having predeceased) the employee.[148]

A special rule applies to trusts with certain young beneficiaries. The regulation provides that if any beneficiary of a see-through trust is an individual who is treated as a beneficiary of the employee whose distribution rights are neither contingent upon, nor delayed until, the death of another trust beneficiary and the terms of the trust require full distribution of amounts in the trust representing the employee's interest in the plan to that individual by the later of the end of the calendar year following the calendar year of the employee's death and the end of the tenth calendar year following the calendar year in which that individual attains the age of majority, then any other beneficiary of the trust who could receive amounts in the trust representing the employee's interest in the plan if that individual dies before full distribution to that individual is made is not treated as having been designated as a beneficiary of the employee under the plan.[149]

However, that special young beneficiary rule does not apply to the other beneficiary, if that other beneficiary who could receive benefits if the young person dies also has a separate noncontingent nor delayed right to receive benefits as described in Reg. §1.401(a)(9)-4(f)(3)(i)(A).[150]

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[146] Proposed Reg. §1.401(a)(9)-4(h)(4)

[147] Proposed Reg. §1.401(a)(9)-4(f)(3)

[148] Proposed Reg. §1.401(a)(9)-4(f)(3)(ii)(A)

[149] Proposed Reg. §1.401(a)(9)-4(f)(3)(ii)(B)

[150] Proposed Reg. §1.401(a)(9)-4(f)(3)(ii)(B)

Accumulations After Death of All Deemed Designated Beneficiaries

The proposed regulations contain a provision that allows a trust to be treated as a conduit trust even if it allows for no longer making the direct payment of benefits if all of the designated beneficiaries have died. The regulation reads:

> For purposes of this paragraph (f)(3), a trust will not fail to be treated as a conduit trust merely because the trust terms requiring the direct payment of amounts received from the plan do not apply after the death of all of the beneficiaries described in paragraph (f)(3)(i)(A) of this section.[151]

Another Trust as a Beneficiary of a See-Through Trust

It is possible to have another trust be a beneficiary of a see-through trust, and have its beneficiaries qualify as designated beneficiaries of the employee. To do this, the second trust must also meet all of the qualifications to be a see-through trust itself. This would allow forming tiered trust structures, which may be useful in certain situations.[152]

Identifiability of Trust Beneficiaries

The proposed regulations contain additional guidance on what qualifies as having beneficiaries that can be identifiable in order to qualify your trust as a see-through trust and be able to treat the beneficiaries as designated beneficiaries.

The general rule provides that beneficiaries are identifiable if it is possible to identify each person eligible to receive a portion of the employee or account owner's interest in the plan through the trust.[153] The same specificity rules apply as apply to a beneficiary directly specified via the plan, meaning that a beneficiary need not be specified by name in the trust or by the employee to the trust in order for the beneficiary to be designated under the plan, provided the person who is to be a beneficiary is identifiable pursuant to the designation.[154]

The specificity rules provide the following example:

> For example, a designation of the employee's children as beneficiaries of equal shares of the employee's interest in the plan is treated as a designation of beneficiaries under the plan even if the children are not specified by name.[155]

But note that there are areas that are off limits, such as performing the designation via a will:

> The fact that an employee's interest under the plan passes to a certain person under a will or otherwise under applicable state law does not make that person a beneficiary designated under the plan absent a designation under the plan.[156]

[151] Proposed Reg. §1.401(a)(9)-4(f)(3)(iii)

[152] Proposed Reg. §1.401(a)(9)-4(f)(4)

[153] Proposed Reg. §1.401(a)(9)-4(f)(5)

[154] Proposed Reg. §1.401(a)(9)-4(a)(3) and (f)(5),

[155] Proposed Reg. §1.401(a)(9)-4(a)(3)

[156] Proposed Reg. §1.401(a)(9)-4(a)(3)

Power of Appointment

The proposed regulations provide provisions for using powers of appointment inside of the trust and still maintaining its conduit status. The first area discuss is the exercise or release of a power appointment by September 30 of the year following the year of death of the employee or account holder.

Even though the beneficiary may not be identifiable under the standard rules since a power of appointment will be used 2 determine the beneficiary, the rules still allow for the use of this power.

The proposed regulations give two methods for exercising this power by September 30.

- If the power of appointment is exercised in favor of one or more identifiable beneficiaries by September 30 of the calendar year following the calendar year of the employee's death, then those identifiable beneficiaries are treated as beneficiaries designated under the plan.
- Alternatively, if, by that September 30, in lieu of exercising the power of appointment, the powerholder restricts it so that the power can be exercised at a later time in favor of only two or more identifiable beneficiaries (in which case, those identified beneficiaries are treated as beneficiaries designated under the plan).[157]

However, if, by that September 30, the power of appointment is not exercised (or restricted) in favor of one or more beneficiaries that are identifiable, then each taker in default (that is, any person that is entitled to the portion that represents the employee's interest in the plan subject to the power of appointment in the absence of the powerholder exercising the power) is treated as a beneficiary designated under the plan.[158]

Special rules will apply if the power is exercised after September 30 to appoint a beneficiary that will be the same as the rules that apply when a beneficiary is added after that date by modification of the trust. These rules will be discussed after discussing the rules for the modification of trust terms.

Modification of Trust Terms

Generally, under state law trust can be modified, at least in some circumstances, by a court or via other mechanisms. The regulations discuss how this potential for modification affects the trust in qualifying as conduit trust, and also indicates what happens if this action takes place before or after September 30 of the year following the year of death of the employee or the account owner.

The mere fact that state law allows for such modifications will not cause the trust to fail to satisfy the identifiability requirements. But the regulations go beyond merely allowing a trust to be treated as qualifying as a conduit trust even though it might theoretically have beneficiaries change under a modification, and go on to allow such modifications and describe how they should be handled under the requirement of distribution rules.[159]

It is possible the trust could be modified to remove trust beneficiaries such as through a court reformation or a permitted decanting. So long as this beneficiary is removed prior to September 30 of the calendar year following the calendar year of the employee or the accounts owners death, the

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[157] Proposed Reg. §1.401(a)(9)-4(f)(5)(ii)(A)

[158] Proposed Reg. §1.401(a)(9)-4(f)(5)(ii)(A)

[159] Proposed Reg. §1.401(a)(9)-4(f)(5)(iii)(A)

beneficiary that is removed is disregarded in determining the designated beneficiary that will apply to the trust.[160]

Similarly, if a trust is modified such as through a court reformation or a permitted decanting to add a new beneficiary prior to September 30 of the calendar year following calendar of the employer account owner's death, then that beneficiary will be considered in determining the trust designated beneficiary.[161]

Beneficiary Added After September 30 of Year Following Year of Death of Employee or Account Owner

The regulations discussed the handling of the addition of a new trust beneficiary after September 30 of the year of the employee or account owner's death. In that case the regulations provide that the addition of this beneficiary will not cause the trust to fail the identifiability requirements of the regulations, which would destroy its status as a conduit trust.

Rather, the look through rules for conduit trust will apply to take into account the new beneficiaries and all beneficiaries of the trust that were already treated as beneficiaries before the additional new beneficiary. At this point we apply the standard rules to determine the designated beneficiary that will be used for determining distributions from the trust.[162]

It is possible that due to the addition of new beneficiary, a distribution of the entire interest of the trust might have been required in a year prior to the year in which this beneficiary was added. For instance, if the only beneficiaries of the trust were eligible designated beneficiaries, and this new beneficiary does not qualify as such and is added after the end of the 10th year, then we turn to the special rule for such situations. in this situation the full distribution will be required in the year after this new beneficiary was added.[163]

The regulations provide the following example:

> For example, if life expectancy payments are being made to an eligible designated beneficiary and, more than 10 years after the employee's death, a beneficiary is added who is not an eligible designated beneficiary as described in paragraph (e) of this section, then the employee is treated as not having an eligible designated beneficiary for purposes of §1.401(a)(9)-5(e)(2) (so that a full distribution of the employee's entire interest in the plan would have been required within 10 years of the employee's death). However, pursuant to this paragraph (f)(5)(v), the full distribution of the employee's entire interest in the plan is not required until the end of the calendar year following the calendar year in which the new trust beneficiary was added.[164]

IRS Examples of Applying the See-Through Trust Rules

The regulations provide 5 examples of the see-through trust rules just discussed.

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[160] Proposed Reg. §1.401(a)(9)-4(f)(5)(iii)(B)

[161] Proposed Reg. §1.401(a)(9)-4(f)(5)(iii)(C)

[162] Proposed Reg. §1.401(a)(9)-4(f)(5)(iv)

[163] Proposed Reg. §1.401(a)(9)-4(f)(5)(v)

[164] Proposed Reg. §1.401(a)(9)-4(f)(5)(v)

EXAMPLES

Example 1, Reg. §1.401(a)(9)-4(f)(6)

Facts. Employer L maintains a defined contribution plan, Plan W. Unmarried Employee C died in 2022 at age 30. Prior to C's death, C named a testamentary trust (Trust T) that satisfies the requirements of paragraph (f)(2) of this section, as the beneficiary of C's interest in Plan W. The terms of Trust T require that all distributions received from Plan W, upon receipt by the trustee, be paid directly to D, C's sibling, who is 5 years older than C. The terms of Trust T also provide that, if D dies before C's entire account balance has been distributed to D, E, will be the beneficiary of C's remaining account balance.

Analysis. Pursuant to paragraph (f)(1)(ii)(A) of this section, Trust T is a conduit trust. Because Trust T is a conduit trust (meaning the residual beneficiary rule in paragraph (f)(3)(i)(B) of this section does not apply) and because E is only entitled to any portion of C's account if D dies before the entire account has been distributed, E is disregarded in determining C's designated beneficiary. Because D is an eligible designated beneficiary, D may use the life expectancy rule of §1.401(a)(9)-3(c)(4). Accordingly, even if D dies before C's entire interest in Plan W is distributed to Trust T, D's life expectancy continues to be used to determine the applicable denominator. Note, however, that because §1.401(a)(9)-5(e) applies in this situation, a distribution of C's entire interest in Plan W will be required no later than 10 years after the calendar year in which D dies.

Example 2, Reg. §1.401(a)(9)-4(f)(6)

Facts related to plan and beneficiary. Employer M maintains a defined contribution plan, Plan X. Employee A, an employee of M, died in 2022 at the age of 55, survived by Spouse B, who was 50 years old. A's account balance in Plan X is invested only in productive assets and was includible in A's gross estate under section 2039. A named a testamentary trust (Trust P) as the beneficiary of all amounts payable from A's account in Plan X after A's death. Trust P satisfies the see-through trust requirements of paragraph (f)(2) of this section.

Facts related to trust. Under the terms of Trust P, all trust income is payable annually to B, and no one has the power to appoint Trust P principal to any person other than B. A's sibling, who is less than 10 years younger than A (and thus is an eligible designated beneficiary) and is younger than B, is the sole residual beneficiary of Trust P. Also, under the terms of Trust P, if A's sibling predeceases B, then, upon B's death, all Trust P principal is distributed to Charity Z (an organization exempt from tax under section 501(c)(3)). No other person has a beneficial interest in Trust P. Under the terms of Trust P, B has the power, exercisable annually, to compel the trustee to withdraw from A's account balance in Plan X an amount equal to the income earned during the calendar year on the assets held in A's account in Plan X and to distribute that amount through Trust P to B. Plan X includes no prohibition on withdrawal from A's account of amounts in excess of the annual required minimum distributions under section 401(a)(9). In accordance with the terms of Plan X, the trustee of Trust P elects to take annual life expectancy payments pursuant to section 401(a)(9)(B)(iii). If B exercises the withdrawal power, the trustee must withdraw from A's account under Plan X the greater of the amount of income earned in the account during the calendar year or the required minimum distribution. However, under the terms of Trust P, and applicable state law, only the portion of the Plan X distribution received by the trustee equal to the income earned by A's account in Plan X is required to be distributed to B (along with any other trust income).

Analysis. Because some amounts distributed from A's account in Plan X to Trust P may be accumulated in Trust P during B's lifetime, Trust P is an accumulation trust. Pursuant to paragraph (f)(3)(i)(B) of this section, A's sibling, as the residual beneficiary of Trust P, is treated as a beneficiary designated under Plan X (even though access to those amounts is delayed until after B's death). Pursuant to paragraph (f)(2)(iii)(A) of this section, because Charity Z's entitlement to amounts in the trust is based on the death of a beneficiary described in paragraph (f)(3)(i)(B) of this section, Charity Z is disregarded as a beneficiary of A. Under

§1.401(a)(9)-5(f)(1), the designated beneficiary used to determine the applicable denominator is the oldest of the designated beneficiaries of Trust P's interest in Plan X. B is the oldest of the beneficiaries of Trust P's interest in Plan X (including residual beneficiaries). Thus, the applicable denominator for purposes of section 401(a)(9)(B)(iii) is B's life expectancy. Because A's sibling is a beneficiary of A's account in Plan X in addition to B, B is not the sole beneficiary of A's account and the special rule in section 401(a)(9)(B)(iv) and §1.401(a)(9)-3(d) is not available. Accordingly, the annual required minimum distributions from the account to Trust P must begin no later than the end of the calendar year immediately following the calendar year of A's death.

Example 3, Reg. §1.401(a)(9)-4(f)(6)

Facts. The facts are the same as in Example 2 in paragraph (f)(6)(ii) of this section except that A's sibling is more than 10 years younger than A, meaning that at least one of the beneficiaries of Trust P's interest in Plan X is not an eligible designated beneficiary.

Analysis. Pursuant to paragraph (e)(2)(i) of this section, A is treated as not having an eligible designated beneficiary. Pursuant to §1.401(a)(9)-3(c)(5), the trustee of Trust P is not permitted to make an election to take annual life expectancy distributions and the 10-year rule of §1.401(a)(9)-3(c)(3) applies.

Example 4, Reg. §1.401(a)(9)-4(f)(6)

Facts related to plan and beneficiary. Employer N maintains a defined contribution plan, Plan Y. Employee F, an employee of N, died in 2022 at the age of 60. F named a testamentary trust (Trust Q), which was established under F's will, as the beneficiary of all amounts payable from F's account in Plan X after F's death. Trust Q satisfies the see-through trust requirements of paragraph (f)(2) of this section.

(B) Facts related to trust. Under the terms of Trust Q, all trust income is payable to F's surviving spouse, G, and G has a power of appointment to name the beneficiaries of the residual in Trust Q. The power of appointment provides that, if G does not exercise the power, then upon G's death, F's descendants are entitled to the remainder interest in Trust Q, per stirpes. As of the date of F's death, F has two children, K and L, who are not disabled or chronically ill and who are both older than age 21. Before September 30 of the calendar year following the calendar year in which F died, G irrevocably restricts G's power of appointment so that G may exercise the power to appoint the remainder beneficiaries of Trust Q only in favor of G's siblings (who all are less than 10 years younger than F and thus, are eligible designated beneficiaries).

(C) Analysis. Pursuant to paragraph (f)(5)(ii)(A) of this section, because G timely restricted the power of appointment so that G may exercise the power to appoint the residual interest in Trust Q only in favor of G's siblings, the designated beneficiaries are G and G's siblings. Because all of the designated beneficiaries are eligible designated beneficiaries, annual life expectancy payments are permitted under section 401(a)(9)(B)(iii). Note, however, that because §1.401(a)(9)-5(e) applies, a distribution of the remaining interest is required by no later than 10 years after the calendar year in which the oldest of G and G's siblings dies.

Example 5, Reg. §1.401(a)(9)-4(f)(6)

Facts. The facts are the same as in Example 4 in paragraph (f)(6)(iv) of this section except that G does not restrict the power by September 30 of the calendar year following the calendar year of F's death.

Analysis. Pursuant to paragraph (f)(5)(ii)(A) of this section, G, K, and L are treated as F's beneficiaries. Pursuant to §1.401(a)(9)-3(c)(5), because K and L are not eligible designated beneficiaries, the trustee of Trust Q is not permitted to make an election to take annual life expectancy distributions, and the 10-year rule of §1.401(a)(9)-3(c)(3) applies.

REQUIRED MINIMUM DISTRIBUTIONS FROM DEFINED CONTRIBUTION PLANS

Generally, if the employee has an accrued benefit that is in the form of an individual account or defined contribution plan, the minimum amount to be distributed each *distribution calendar year* is equal to the quotient obtained by dividing the account balance by the *applicable denominator* for the year in question.[165]

A *distribution calendar year* is a calendar year in which a minimum distribution is required under these rules. Thus, years before the required beginning date while the employee or account owners alive will not be considered distribution calendar years.[166]

- For the employee or account owner one of two rules will set the first distribution calendar year:
  - If the required beginning date for the employee is April 1st of the calendar year following calendar in which the employee attains age 72, then the employees first distribution calendar year is the year the employee attains age 72. This will generally be the case for an employee who has separated from service prior to attaining age 72, one who is a 5% or greater owner or an IRA account holder.
  - If an employee is required beginning date is April 1st of the calendar year following the calendar in which employee retires, the employees first distribution calendar year is the calendar year in which the employee retires.[167]
- For a beneficiary who receives an account of employee who died before the required beginning date and to whom the life expectancy rule applies, the first distribution calendar year for the designated beneficiary is the calendar year after the calendar year in which the employee died.[168]

These rules will not apply in cases where a distribution of the employee's entire interest is required under Reg. §1.401(a)(9)-5(e) discussed later (such as under the 10-year rule added by the SECURE Act).[169]

Time for Distributions

A special timing rule applies for the first distribution calendar year of the employee or account owner. At first distribution can be made on or before April 1st of the following calendar year. So, for instance if an employee's first distribution calendar year is 2026, that initial distribution for 2026 can be made as late as April 1st 2027.[170]

For all other distribution calendar years, the distributions must be made no later than December 31st of that distribution calendar year.[171]

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[165] Proposed Reg. §1.401(a)(9)-5(a)(1)

[166] Proposed Reg. §1.401(a)(9)-5(a)(2)

[167] Proposed Reg. §1.401(a)(9)-5(a)(2)(ii)

[168] Proposed Reg. §1.401(a)(9)-5(a)(2)(iii)

[169] Proposed Reg. §1.401(a)(9)-5(a)(1)

[170] Proposed Reg. §1.401(a)(9)-5(a)(3)

[171] Proposed Reg. §1.401(a)(9)-5(a)(3)

So, to continue with our employee whose first distribution calendar year was 2026, if he or she took that distribution in March of 2027, the distribution for distribution calendar year 2027 would have to come out by December 31st of 2027, meaning that the employee would end up with two distributions in 2027. If the employee had, instead, taken the first distribution calendar year distribution by December 31st of 2026, only a single distribution would have been included in income for each taxable year.

Advisors should look to see if the advantage of delaying the inclusion of income by one year is or is not offset by a potential increase in tax due to the bunching of income in a single year and advise the client appropriately.

Determination of Account Balance (Reg. §1.401(a)(9)-5(b))

The regulations provide rules for determining the account balance, one of the key items necessary to compute the amount of the required minimum distribution. The account balance used in computing the required minimum distribution for a distribution calendar year is the account balance as of the last valuation date in the calendar year preceding distribution calendar year, referred to as the *valuation calendar year*, adjusted in accordance with other items noted below.[172]

The first adjustment relates to subsequent allocations. The account balance will be increased by the amount of any contributions or forfeitures allocated to the account balance as of dates in the *valuation calendar year* after the *valuation date*. Thus: if the valuation date occurs before December 31st of the valuation calendar year, adjustments will be made for these items.[173]

The second and final adjustment relates to distributions made in the *valuation calendar year* after the *valuation date*. The account balance will be decreased by these amounts. Again, this only matters if the *valuation date* occurs before December 31st of the *valuation calendar year*.

Determination of the Applicable Denominator During the Employee/Account Owner's Lifetime

During the employer account owner's lifetime, the applicable denominator is computed under one of two sets of rules. One set of rules applies to everyone except those who have a spousal beneficiary who is more than ten years younger than the employee or account holder, while the other covers that case with a more than 10 years younger spousal beneficiary.[174]

Under the general rule, the denominator is determined using the Uniform Life Table found at Reg. §1.401(a)(9)-9(c)(2) for the employees age as of the employee's birthday in the relevant distribution calendar year. The distribution will be calculated in accordance with that table for distribution calendar years up to and including the calendar year that includes the employee or account owner's date of death.[175]

[172] Proposed Reg. §1.401(a)(9)-5(b)(10

[173]

[174] Proposed Reg. §1.401(a)(9)-5(c)(1)

[175] Proposed Reg. §1.401(a)(9)-5(c)(1)

To the extent the required distribution has not been made to the employee or account owner prior to his or her date of death, any remaining amounts of that distribution must be taken by the beneficiary or beneficiaries prior to the end of that year.[176]

If the employee's spouse is the sole beneficiary for the entire distribution calendar year and that spouse is more than 10 years younger than the employee, then the applicable denominator is the joint and last survivor life expectancy for the employee and spouse determined the Joint and Last Survivor Life Expectancy Table in Reg. §1.401(a)(9)-9(d) for the employees and spouses ages as of their birthday in the relevant distribution calendar year. [177]

In order for this rule to apply, the spouse must be the sole beneficiary for the entire distribution calendar year. If that is not the case, then the general rule must be used to determine the applicable denominator for the distribution year in question.[178]

If the couple is married on January 1st of a distribution calendar year, but do not remain married throughout that year, that will not cause the employee to fail to have a spouse as the employee's sole beneficiary for that year if the sole reason for this is because they were not married for the entire year.179 Note that this means if the employee were to add another beneficiary to the retirement plan after the marriage had ceased due to death or divorce, this would appear to create the situation where the 10 year rule could not be used.

In the case of death or divorce during the distribution calendar year, the change will be reflected in determining the applicable denominator amount for the following calendar years.[180]

Determination of the Applicable Denominator after the Employee or Plan Owner's Death

For determining the applicable denominator amount after the employee or plan owner's death the rules are somewhat different depending upon whether the employee or account owner dies after required distributions have begun, normally after the employee or account owner's required beginning date, or if the employee or plan owner dies prior to the beginning of such distributions.[181]

[176] Proposed Reg. §1.401(a)(9)-5(c)(1)

[177] Proposed Reg. §1.401(a)(9)-5(c)(2)(i)

[178] Proposed Reg. §1.401(a)(9)-5(c)(2)(ii)

[179] Proposed Reg. §1.401(a)(9)-5(c)(2)(iii)

[180] Proposed Reg. §1.401(a)(9)-5(c)(2)(iii)

[181] Proposed Reg. §1.401(a)(9)-5(d)

Death on or After the Employee or Plan Owner's Required Beginning Date

The IRS's proposed regulations surprised many advisers by beginning these rules with the following sentence and its interpretation of this IRC provision [IRC §401(a)(9)(B)(i)]:

> (B) Required distribution where employee dies before entire interest is distributed.
>
> (i) Where distributions have begun under subparagraph (A)(ii). A trust shall not constitute a qualified trust under this section unless the plan provides that if--
>
> (I) the distribution of the employee's interest has begun in accordance with subparagraph (A)(ii), and
>
> (II) the employee dies before his entire interest has been distributed to him,
>
> *the remaining portion of such interest will be distributed at least as rapidly as under the method of distributions being used under subparagraph (A)(ii) as of the date of his death*.

Many commentators had interpreted the SECURE Act 10-year distribution rule as entirely overriding this provision when it applied. But the IRS in the proposed regulations does not agree, rather requiring that life expectancy distributions be made during the time period up to the year when the full distribution of any remaining balance is required under the 10-year rule. The regulations state:

> If an employee dies after distribution has begun as determined under §1.401(a)(9)-2(a)(3) (generally, on or after the employee's required beginning date), distributions must satisfy section 401(a)(9)(B)(i). In order to satisfy this requirement, the applicable denominator after the employee's death is determined under the rules of this paragraph (d)(1).[182]

The preamble to the proposed regulations provides the following explanation for this treatment:

> Section 401(a)(9)(B)(i) provides rules that apply if an employee dies after benefits have commenced. While the 5-year rule under section 401(a)(9)(B)(ii) (expanded to a 10-year rule in certain cases by section 401(a)(9)(H)(i)(I)) generally applies if an employee dies before the employee's required beginning date, section 401(a)(9)(H)(i)(II) provides that section 401(a)(9)(B)(ii) applies whether or not distributions have commenced. Accordingly, if an employee dies after the required beginning date, distributions to the employee's beneficiary for calendar years after the calendar year in which the employee died must satisfy section 401(a)(9)(B)(i) as well as section 401(a)(9)(B)(ii). In order to satisfy both of these requirements, these proposed regulations provide for the same calculation of the annual required minimum distribution that was adopted in the existing regulations but with an additional requirement that a full distribution of the employee's entire interest in the plan be made upon the occurrence of certain designated events (discussed in section I.E.3.c. of this Explanation of Provisions).[183]

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[182] Proposed Reg. §1.401(a)(9)-5(d)(1)

[183] REG-105954-20; 87 F.R. 10504-10567, February 24, 2022, Explanation of Provisions, Section I.E.3.a

The regulations do remind us about the rule for making sure the complete distribution for the amount due in the year of the employee or plan owner's death is taken, either by employee or plan owner prior to the date of death, or the beneficiary or beneficiaries after that date of death and before the last date such a distribution can be taken:

> The requirement to take an annual distribution in accordance with the preceding sentence applies for distribution calendar years up to and including the calendar year that includes the beneficiary's date of death. Thus, a required minimum distribution is due for the calendar year of the beneficiary's death, and that amount must be distributed during that calendar year to a beneficiary of the deceased beneficiary to the extent it has not already been distributed to the deceased beneficiary.[184]

And the regulations remind that, if there is a designated beneficiary, then the distributions will be subject to the new 10-year rule found at IRC §401(a)(9)(B)(iii) added by the SECURE act.[185] This will generally force the funds out of the plan in the 10th year following the year of death. These rules, found in Proposed Reg. §1.409(a)(9)-5(e), are discussed later.

If an employee or IRA account owner has a designated beneficiary, then the applicable denominator is the greater of:

- The designated beneficiary's remaining life expectancy; or
- The employee's or IRA account owner's remaining life expectancy.[186]

If there is no designated beneficiary, then the applicable denominator is the employee's remaining life expectancy, determined as discussed later.[187]

Death Before an Employee's Required Beginning Date

If the employee or IRA account owner dies before the required beginning date and the life expectancy rule applies to the distribution, then the applicable denominator for distribution calendar years beginning with the first distribution calendar year is the designated beneficiary's remaining life expectancy.[188]

In this case the life expectancy rule is only going to apply normally if the beneficiary is an eligible designated beneficiary (as previously discussed). Otherwise, we should be looking at a 10 year payout rule discussed later.

Determining Remaining Life Expectancies

The regulations look at three different scenarios where a remaining life expectancy must be computed under these rules. The regulations first look at computing the life expectancy of the decedent. While it may seem that somebody who has just died has no remaining life expectancy, under the law we are looking at the life expectancy per the tables ignoring the not so small detail that the individual has already died.

[184] Proposed Reg. §1.401(a)(9)-5(d)(1)

[185] Proposed Reg. §1.401(a)(9)-5(d)(1)(i)

[186] Proposed Reg. §1.401(a)(9)-5(d)(1)(ii)

[187] Proposed Reg. §1.401(a)(9)-5(d)(1)(ii)

[188] Proposed Reg. §1.401(a)(9)-5(d)(2)

The regulations then look at determining a remaining life expectancy for a designated beneficiary, looking at the case of a nonspouse designated beneficiary first and then looking at special rules that apply when a spouse is a designated beneficiary.

Life expectancies for these purposes are determined using the Single Life Table in Reg. §1.401(a)(9)-9(c)(1).[189]

Decedent's Life Expectancy (Employee or IRA Account Owner)

The employee or IRA account owner's remaining life expectancy is determined initially by using the individuals age as of the individual's birthday in the calendar year of that person's death.[190]

Well during life the employees life expectancy is effectively re computed every year, so that the denominator decreases by less than one each year, once the employee has passed away the recomputation ceases. Rather, that initial life expectancy determined based on the year of death is then reduced by one in each subsequent year.[191]

Nonspouse Designated Beneficiary

If the designated beneficiary is anybody except the employee's surviving spouse, the designated beneficiary's remaining life expectancy determine initially using the beneficiaries age as of the beneficiary's birthday in the calendar year following the year of the employee's death.[192] Note that this is one year later than the year that is used for determining the employees remaining life expectancy initially.

As was true for the employee's life expectancy computations in later years, the life expectancy for the designated beneficiary is reduced by one in each subsequent year.[193]

For instance, if the designated beneficiary's life expectancy is 12 years in the year following the year of death of the employee or IRA account owner, in the following year a life expectancy of 11 will be used. This will have the effect of assuring that the entire balance will be distributed by the end of the 12th year following the year the employee or IRA account holder died to this beneficiary.

Special Rule When the Spouse is the Designated Beneficiary

If the employee or IRA account holder's surviving spouse is the sole designated beneficiary, we no longer use the reduce by one rule for subsequent years. Rather, the surviving spouses remaining life expectancy is redetermined each distribution calendar year using the surviving spouses age as of that person's birthday in that calendar year.[194] This has the effect of assuring that the surviving spouse will never face a requirement to distribute the entire balance to him and herself in a year, as the remaining life expectancy under the tables will always be greater than one year, even if not by much.

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[189] Proposed Reg. §1.401(a)(9)-5(d)(3)(i)

[190] Proposed Reg. §1.401(a)(9)-5(d)(3)(ii)

[191] Proposed Reg. §1.401(a)(9)-5(d)(3)(ii)

[192] Proposed Reg. §1.401(a)(9)-5(d)(3)(iii)

[193] Proposed Reg. §1.401(a)(9)-5(d)(3)(iii)

[194] Proposed Reg. §1.401(a)(9)-5(d)(3)(iv)

As a practical matter, most often the surviving spouse will exercise the option to treat the account as his or her own, or roll it into an IRA account in his or her name, which will give the account access to the rules that apply before the employee or account owner dies. So most often the surviving spouse will get the deemed 10-year younger beneficiary that is built into the Standard Life Expectancy tables used by a participant prior to the participant's death.

That is, most often the surviving spouse will not treat the interest as an inherited interest. Most often we will see the use of an inherited interest for the surviving spouse in cases where a trust is being used to hold the interest, which is most often seen in the case of second marriages where the deceased wishes the surviving spouse to have access to retirement funds during his or her remaining life, but wants to ensure that any remaining balance goes to the parties the decedent wished to benefit, rather than allowing the surviving spouse to transfer those funds to the parties of his or her choosing.

The other time we will tend to see amounts stay in the account for the surviving spouse as an inherited interest is if the surviving spouse has not attained age 59 1/2 at the time of the death of the employee or account holder, and the surviving spouse wants to be able to take death benefit distributions that are not subject to the tax on early distributions from retirement plan. The additional 10% early distribution tax does not apply to distributions on inherited accounts to the beneficiaries but will apply if the surviving spouse transfers the funds into an account under his or her name and then takes distributions before the surviving spouse attains age 59 1/2.

Impact of the SECURE Act 10-Year Rule – When Distribution of the Employee or Account Holder's Entire Interest is Required

The SECURE Act added IRC §401(a)(9)(H) (referred to here as the "10-year rule") to the minimum distribution rules which applies when an employee or IRA account owner dies after December 31, 2019, or in cases following the death of a designated beneficiary after that same date.

The provision reads as follows in its entirety:

> (H) Special rules for certain defined contribution plans. In the case of a defined contribution plan, if an employee dies before the distribution of the employee's entire interest--
>
> > (i) In general. Except in the case of a beneficiary who is not a designated beneficiary, subparagraph (B)(ii)--
> >
> > > (I) shall be applied by substituting "10 years" for "5 years", and
> > >
> > > (II) shall apply whether or not distributions of the employee's interests have begun in accordance with subparagraph (A).
> >
> > (ii) Exception for eligible designated beneficiaries. Subparagraph (B)(iii) shall apply only in the case of an eligible designated beneficiary.
> >
> > (iii) Rules upon death of eligible designated beneficiary. If an eligible designated beneficiary dies before the portion of the employee's interest to which this subparagraph applies is entirely distributed, the exception under clause (ii) shall not apply to any beneficiary of such eligible designated

beneficiary and the remainder of such portion shall be distributed within 10 years after the death of such eligible designated beneficiary.

(iv) Special rule in case of certain trusts for disabled or chronically ill beneficiaries. In the case of an applicable multi-beneficiary trust, if under the terms of the trust--

(I) it is to be divided immediately upon the death of the employee into separate trusts for each beneficiary, or

(II) no individual (other than a eligible designated beneficiary described in subclause (III) or (IV) of subparagraph (E)(ii)) has any right to the employee's interest in the plan until the death of all such eligible designated beneficiaries with respect to the trust,

for purposes of a trust described in subclause (I), clause (ii) shall be applied separately with respect to the portion of the employee's interest that is payable to any eligible designated beneficiary described in subclause (III) or (IV) of subparagraph (E)(ii); and, for purposes of a trust described in subclause (II), subparagraph (B)(iii) shall apply to the distribution of the employee's interest and any beneficiary who is not such an eligible designated beneficiary shall be treated as a beneficiary of the eligible designated beneficiary upon the death of such eligible designated beneficiary.

(v) Applicable multi-beneficiary trust. For purposes of this subparagraph, the term "applicable multi-beneficiary trust" means a trust--

(I) which has more than one beneficiary,

(II) all of the beneficiaries of which are treated as designated beneficiaries for purposes of determining the distribution period pursuant to this paragraph, and

(III) at least one of the beneficiaries of which is an eligible designated beneficiary described in subclause (III) or (IV) of subparagraph (E)(ii).

(vi) Application to certain eligible retirement plans. For purposes of applying the provisions of this subparagraph in determining amounts required to be distributed pursuant to this paragraph, all eligible retirement plans (as defined in section 402(c)(8)(B), other than a defined benefit plan described in clause (iv) or (v) thereof or a qualified trust which is a part of a defined benefit plan) shall be treated as a defined contribution plan.[195]

10-Year Limit for Designated Beneficiary Who Is Not an Eligible Designated Beneficiary

The simplest situation arises for a *designated beneficiary* who is not an *eligible designated beneficiary*. Under these rules, the entire balance remaining in the plan account must be distributed in the 10th year following the calendar year of the employee or account owner's death.[196]

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[195] IRC §409(a)(9)(H) as added by the SECURE Act

[196] Proposed Reg. §1.401(a)(9)-5(e)(2)

It is important to remember that this requirement applies under the proposed regulations in addition to the requirement to take annual distributions (under the "at least as rapidly" rule) if the employee or account holder dies after that person's required beginning date. In that case, the designated beneficiary will take an amount based on their life expectancy for the first nine years, and then have to take out the entire remaining balance in year 10.

However, if the employee or IRA account owner dies before his/her required beginning date, then the designated beneficiary is not required to take distributions during the first nine years, just having to ensure the entire balance has been taken from the account by the end of the 10th year.

10-Year Limit Following the Death of an Eligible Designated Beneficiary

Eligible designated beneficiaries do not have to worry about the 10-year rule,[197] aside from the special case that arises for the decedent's minor child. However, if a balance remains in the account upon the death of the eligible designated beneficiary, then the 10-year rule does come into play yet again.

If the employee or account owners designated beneficiary is an eligible designated beneficiary, then the calendar year when all funds must be distributed will be the 10th year following the calendar year of the designated beneficiary's death.[198]

It is important to note that it does not matter if the beneficiary of the designated beneficiary would be in a class that normally would qualify for eligible designated beneficiary status. The law does not allow for the use of any extended distribution in that case. Only the beneficiary of the employee or account holder can qualify for the benefits of eligible designated beneficiary status.[199]

10-Year Limit After Minor Child of the Employee or Account Holder Reaches the Age of Majority

As was discussed earlier, the minor child of the employee or account holder who is a designated beneficiary only maintains eligible designated beneficiary status until that child reaches the age of majority, which the regulations previously defined as age 21. In this case the year in which a full distribution must be made will be the tenth calendar year following the calendar year when the child reaches age 21, the age of majority defined by these regulations.[200]

Life Expectancy Limit for Older Eligible Designated Beneficiaries

For other eligible designated beneficiaries aside from minor children of the decedent, the regulations provide that the entire balance in the account must be distributed in the calendar year where the applicable denominator would have been less than or equal to one using the designated beneficiaries remaining life expectancy calculation.[201]

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[197] IRC §409(a)(9)(H)(ii)

[198] Proposed Reg. §1.401(a)(9)-5(e)(3)

[199] IRC §409(a)(9)(H)(iii)

[200] Proposed Reg. §1.401(a)(9)-5(e)(4)

[201] Proposed Reg. §1.401(a)(9)-5(e)(5)

The IRS explains the need for this rule in the preamble to the proposed regulations:

> …[I]f an employee died at age 75 after the required beginning date and the employee's non-spouse eligible designated beneficiary was age 80 at the time of the employee's death, the applicable denominator would be determined using the employee's remaining life expectancy. However, these proposed regulations require a full distribution of the employee's remaining interest in the plan in the calendar year in which the applicable denominator would have been less than or equal to one if it were determined using the beneficiary's remaining life expectancy (even though the applicable denominator for determining the required minimum distribution is based on the remaining life expectancy of the employee). In this case, based on the beneficiary's life expectancy of 11.2 in the year of the employee's death, a full distribution would be required in the year the beneficiary reaches age 91 (because in the 11th calendar year after the employee's death the beneficiary's life expectancy would be less than or equal to one).[202]

Special Rules for Trusts with Multiple Designated Beneficiaries

In the case of a see-through trust with multiple designated beneficiaries, the general rule provides that the life expects the determination will be made using the oldest designated beneficiary of the employee or account holder.[203] Special rules are provided in the proposed regulations for trusts with multiple designated beneficiaries whose beneficiaries are chronically ill or disabled individuals, or which have qualified minor children as beneficiaries of the see through trust.[204]

Treatment of Nonvested Amounts

It is possible that the employees benefit under the defined contribution plan may not be entirely vested. In that case the required minimum distribution for each year will be initially determined without regard to the vesting percentage at the time of the distribution. However, if the total amount of the employees vested benefit is less than the required minimum distribution for the calendar year, only the vested portion, if any, of the employees benefit is required to be distributed by the end of the calendar year or if applicable by the employees required beginning date.[205]

There is a catch-up requirement, though, for later years if any part of the distribution is skipped in a prior year due to lack of vested interest to pay the distribution out of.[206] Essentially, the distribution is simply delayed until additional amounts of the interest vests, if ever.

Distributions Taken Into Account

Generally, all amounts distributed from an individual account under defined contribution plans are distributions taken into account in determining whether the minimum distribution rules are satisfied, regardless of whether the amount is includible in income.[207] the regulation goes on to state:

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[202] REG-105954-20; 87 F.R. 10504-10567, February 24, 2022, Explanation of Provisions, Section I.E.3.c

[203] Proposed Reg. §1.401(a)(9)-5(f)(1)(i)

[204] Proposed Reg. §1.401(a)(9)-5(f)

[205] Proposed Reg. §1.401(a)(9)-5(g)

[206] Proposed Reg. §1.401(a)(9)-5(g)

[207] Proposed Reg. §1.401(a)(9)-5(h)

> Thus, for example, amounts that are excluded from income as recovery of investment in the contract under section 72 are taken into account for purposes of determining whether this section is satisfied for a calendar year. Similarly, amounts excluded from income as net unrealized appreciation on employer securities also are taken into account for purposes of satisfying this section.[208]

But the regulation does note that the following amounts will not count in determining whether required minimum distributions have been made for the year:

- Elective deferrals (as defined in section 402(g)(3)) and employee contributions that, pursuant to rules prescribed by the Commissioner in revenue rulings, notices, or other guidance published in the Internal Revenue Bulletin (see §601.601(d) of this chapter), are returned to the employee (together with the income allocable thereto) in order to comply with the section 415 limitations;
- Corrective distributions of excess deferrals as described in §1.402(g)- 1(e)(3), together with the income allocable to these corrective distributions;
- Corrective distributions of excess contributions under a qualified cash or deferred arrangement described in §1.401(k)-2(b)(2) and excess aggregate contributions described in §1.401(m)-2(b)(2), together with the income allocable to these distributions;
- Loans that are treated as deemed distributions pursuant to section 72(p);
- Subject to the rules of Reg. §1.402(c)-2(c)(4), dividends paid on employer securities as described in section 404(k);
- The costs of life insurance coverage includible in the employee's income under section 72(m)(3)(B);
- Prohibited allocations that are treated as deemed distributions pursuant to section 409(p);
- Distributions that are permissible withdrawals from an eligible automatic contribution arrangement within the meaning of section 414(w);
- Distributions of premiums for accident or health insurance under §1.402(a)-1(e)(1)(i);
- Deemed distributions with respect to collectibles pursuant to section 408(m); and
- Similar items designated by the Commissioner in revenue rulings, notices, and other guidance published in the Internal Revenue Bulletin. See §601.601(d) of this chapter.[209]

Rollovers and Transfers (Proposed Reg. §1.409(a)(9)-7)

The regulations contain special rules involving the interaction of rollover and transfer rules with the minimum distribution rules discussed previously.

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[208] Proposed Reg. §1.401(a)(9)-5(h)

[209] Proposed Regs §§1.401(a)(9)-5(h), 1.402(c)-2(c)(3)

Treatment of Rollovers from Distributing Plans

The treatment of rollovers from a distributing plan is a little messy under the rules we work under. The mere fact that a part of a distribution is rolled over appropriately into another account or plan will not bar the use of the remainder of the distribution from satisfying the required minimum distribution rules. However, more importantly an amount that is a required minimum distribution is not eligible to be rolled over.[210]

What does ends up meaning is that distributions from a plan we have required minimum distribution exists cannot be rolled over until an amount equal to the required minimum distribution has been distributed. However, once that happens, any amount of the final distribution being made in the set of distributions that eventually added up to the minimum amount for that was in excess of the remaining minimum distribution can be rolled over.

For example, let's assume that there is a required minimum distribution for the employee of $10,000 for the year from the defined contribution plan. The first distribution the employee takes for the year is $5,000. Since the required minimum distribution has not yet been taken from the plan the entire $5,000 is part of that required minimum distribution and cannot be rolled over. A week later the employee takes another $10,000 distribution. In that case, the first $5000 of that distribution is considered part of the minimum distribution. However the employee is eligible to rollover the additional $5,000 he or she received since that is in excess of the required minimum distribution for the year.

It is important to remember, though, that a distribution from an inherited interest in the retirement account after the death of the employee or the IRA account owner cannot be rolled over by a non-spouse beneficiary, but only transferred directly to another account via a *direct rollover*. Once an account interest has been inherited, any distributions cannot be placed back into the same or another retirement account under the 60-day rollover rules.

Treatment of Rollover by Receiving Plan

The regulations next consider the treatment of this rolled over amount by the receiving plan. In this case the benefit of the employee or account holder under the receiving plan is increased by the amount rolled over for purposes of determining the required minimum distribution for the calendar year following the calendar year in which the amount rolled over was distributed from the other plan or account.[211]

If this rollover is received after the last valuation date in the calendar year by the receiving plan, the benefit of the employee as of that valuation date will be increased by the rollover amount valued as of the date of receipt.[212]

EXAMPLE

ABC profit sharing plan has an annual valuation date of November 30th. Mary's account is valued at $100,000 as of November 30th of year Y. on December 10th of the same year Mary rolls over $50,000 from a former employer's retirement plan into the ABC plan. For purposes of determining Mary's minimum

[210] Proposed Regs §§1.401(a)(9)-7(a)

[211] Proposed Reg. §1.401(a)(9)-7(b)

[212] Proposed Reg. §1.401(a)(9)-7(b)

distribution for the following year, ABC will add the $50,000 that was rolled into the plan in December to the $100,000 value at the valuation date to come up with an overall benefit value of $150,000 that will be used to determine Mary's minimum distribution for the following year.

If the actual rollover is not completed until the following year, the receiving plan is deemed to have received the distribution as of the last day of the calendar year in which the amount was distributed.[213] This rule prevents a participant subject to the minimum distribution requirements for the following year from putting funds in transit over a year end to reduce the amount that will be used in computing their required minimum distribution for the following year.

Treatment of Transfer Under Transferor Plan

When a balance is transferred directly from one plan to another plan, the transfer is not treated as a distribution for purposes of the minimum distribution rules. Rather, the benefit of the employee under the transferor plan is decreased by the amount transferred.[214]

However, if a transfer takes place in a distribution calendar year for the employee, in order to satisfy the minimum distribution rules the transferor plan must determine the amount of required minimum distribution with respect to that employee for the calendar year of the transfer using the benefit prior to the transfer in the transferor plan.[215]

Generally, for an employer retirement plan, the required minimum distribution rules must be met by the plan each year in order to maintain qualification status for the plan. The regulations provide that in order to assure that funds remained to be able to pay the minimum distribution, the plan may segregate the amount that must be distributed from the employee's benefit and not transfer that amount to the other plan. Rather, that amount must be distributed honor before the date required for the distribution which normally is December 31st except for the first distribution year when the payment could be delayed until April 1st of the following year.[216]

As you might expect, in computing the required minimum distribution for the calendar year following the calendar for the transfer occurs, the amount transferred out of the plan is not considered as part of that computation. If that transfer takes place after the last valuation date for the plan for the calendar year in question, then the balance used to compute the minimum distribution requirement will be reduced by the amount of the transfer.[217]

Treatment of Transfer Under Transferee Plan

In a case where a plan receives a direct transfer from another plan, the benefit of the employee in the plan receiving the transfer is increased by the amount transferred in the same manner as if it had received a rollover contribution and will be used to compute the amount of the minimum distribution for this plan for the following calendar year.[218]

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[213] Proposed Reg. §1.401(a)(9)-7(b)

[214] Proposed Reg. §1.401(a)(9)-7(c)

[215] Proposed Reg. §1.401(a)(9)-7(c)

[216] Proposed Reg. §1.401(a)(9)-7(c)

[217] Proposed Reg. §1.401(a)(9)-7(c)(2)

[218] Proposed Reg. §1.401(a)(9)-7(d)

Treatment of Spin-Off or Merger of Plans

For purposes of computing the employees benefit and required minimum distribution, a spinoff, a merger, or a consolidation of plans is treated as a transfer of the benefits of the employees involved, and the minimum distribution requirements are computed under the same rules as we would have had there been an actual transfer of the benefits between two plans.[219]

Separate Interest Rules (Reg. §1.401(a)(9))

Generally, it is in the best interest of the beneficiaries to be able to have separate application of the minimum distribution rules for each of their interests. If this is not handled in this manner, that distributions will be based on the life expectancy of the eldest beneficiary. Given the 10-year rule that most often applies after the SECURE Act, this may be less of a problem now than it was in the past, but separating interests most often also eliminates issues with disputes over the types of investments that should be made and other issues about handling the retirement account.

The separate accounts rule is discussed in this regulation. In order to be able to take advantage of the separate accounts rule, and separately determine a minimum distribution requirement for each beneficiary, separate accounting requirements must be met.[220]

The separate accounting requirements are broken into two separate categories:

- Post-death distribution accounting: A separate accounting must allocate any post-death distribution with respect to a beneficiary's interest to the separate account of the beneficiary receiving that distribution.[221]

- Allocation of other items: Two options are presented for dealing with allocating other items:

  - No separate accounts: A separate accounting must allocate all post-death investment gains and losses, contributions, and forfeitures, for the period prior to the establishment of the separate accounts on a pro rata basis in a reasonable and consistent manner among the separate accounts.

  - Use of separate accounts: In lieu of a pro rata allocation of investment gains and losses, a separate accounting may provide for the establishment of separate accounts that have separate investments under which the investment gains and losses attributable to assets held in a separate account are allocated only to that separate account.[222]

If the separate accounting rules are not satisfied until after December 31st of the year following the year of death of the employee, for distribution calendar years after the requirements are satisfied:

- The total required distribution is determined *without* regard to the separate account rule described previously. That is, the eldest eligible beneficiary's life expectancy is going to end up being used;

[219] Proposed Reg. §1.401(a)(9)-7(e)

[220] Proposed Reg. §1.401(a)(9)-8(a)(1)(i)

[221] Proposed Reg. §1.401(a)(9)-8(a)(2)(i)

[222] Proposed Reg. §1.401(a)(9)-8(a)(2)(ii)

- The aggregate required distribution is allocated among the beneficiaries based on each beneficiary's respective share of the total remaining balance of the employee's interest in the plan; and

- That allocated amount of the required distribution is required to be distributed to that particular beneficiary.[223]

As a practical matter, most advisors will see beneficiaries transfer these balances to their own individual retirement accounts unless the clients have control over the sponsor of the retirement plan. Obviously, once the funds go into a separate IRA account for each beneficiary they do end up getting the advantage of separate accounting, and they remove the problem of having to follow these separate accounting rules to avoid having distributions made over the life of the eldest designated beneficiary.

The separate accounts rule can be applied to what is referred to as a *Type I applicable beneficiary trust.* The be such a trust the terms of the trust must provide that it is to be divided immediately upon the death of the employee into separate trusts for each beneficiary. The separate accounting rules described above must be satisfied in the same manner as described for interests not in a trust.[224]

Application of Distribution Requirement Rules to Individual Retirement Accounts and Annuities (Reg. §1.408-8)

As was discussed earlier, individual retirement accounts follow much the same rules for required minimum distributions as do employer sponsored retirement plans, with a few modifications. Reg. §1.408-8 explains how the required minimum distribution rules apply to IRAs and those areas where there are differences with the treatments of employer sponsored retirement plans.

Applicability of IRC §401(a)(9)'s RMD Rules to IRAs

The regulations discussed earlier for required minimum distributions from employee retirement accounts generally need to be satisfied for individual retirement accounts. The regulation provides:

> For example, if the owner of an individual retirement account dies before the IRA owner's required beginning date, whether the 10-year rule or the life expectancy rule applies to distributions after the IRA owner's death is determined in accordance with §1.401(a)(9)-3(c), and the rules of §1.401(a)(9)-4 apply for purposes of determining an IRA owner's designated beneficiary. Similarly, the amount of the minimum distribution required for each calendar year from an individual account is determined in accordance with §1.401(a)(9)-5.[225]

The provisions discussed in the preceding paragraph were detailed earlier in this document and will apply without changes to individual retirement accounts.

The cases where individual retirement accounts are subject to different rules are found in this Reg. §1.408-8.[226]

[223] Proposed Reg. §1.401(a)(9)-8(a)(1)(ii)

[224] Proposed Reg. §1.401(a)(9)-8(a)(1)(iii)(B)

[225] Proposed Reg. §1.408-8(a)(1)

[226] Proposed Reg. §1.408-8(a)(1)

Definition of IRA and IRA Owner

Where the regulation uses the term IRA and IRA owner, the terms have the following meanings:

- IRA: an individual retirement account or annuity described in section 408(a) or (b).
- IRA owner: the individual for whom an IRA is originally established by contributions for the benefit of that individual and that individual's beneficiaries.[227]

Substitution of Certain Terms in the Plan Regulations

The IRA regulations provide the following the follow "mapping" of terms related to an IRA to the provisions in the qualified employer retirement plan regulations discussed earlier:

- The IRA trustee, custodian, or issuer is treated as the plan administrator.
- The IRA owner is substituted for the employee.[228]

SEPs and SIMPLE IRA Accounts

Although a SEP and SIMPLE IRA plan may be an employer sponsored plan, the accounts that receive funding from those plans are still considered IRAs, rather than employer plans for purposes of these distribution rules.[229]

EXAMPLE

Mary was a participant in her employer's simplified employee pension plan for 10 years and the contributions made by her employer to the plan for her benefit were to posited into an IRA in Bank A. Mary made no other contributions to that IRA account. Rather, she had an IRA with Bank B in which she deposited her own IRA contributions each year.

For purposes of these rules, both accounts are treated as IRA accounts of Mary. That is true even though her account with Bank A has only received employer contributions over the years. So even though Mary may not be a 5% owner of her employer and she may continue to work for the employer after attaining age 72, she will still be subject to the standard IRA rules that will require her to begin taking required minimum distributions from that IRA at April 1st of the year following the year in which she attained age 72. She will not be able to delay distributions related to the balance in the Bank A IRA until the year following the year in which she retires.

Similarly, the balances of both IRA accounts will be combined to compute her required minimum distribution from IRA accounts. Mary will be able to take that amount from either or both of the accounts, rather than having to take the specific minimum distribution amount computed solely on Bank A's IRA from that account each year as she would have to do for an employer qualified retirement plan such as a profit sharing plan account.

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[227] Proposed Reg. §1.408-8(a)(2)

[228] Proposed Reg. §1.408-8(a)(3)

[229] Proposed Reg. §1.408-8(a)(4)

Different Rules for IRAs and Qualified Plans

The regulation discusses three specific areas where there are different rules for IR A's and qualified retirement plans.

Determination of Required Beginning Date

As you may recall, for a qualified retirement plan an employee who is not a 5% owner is not required to take minimum distributions until the year following the year in which the employee retires from service with the plan sponsor. Only individuals who are 5% or greater owners of the plan sponsor are required to begin their distributions in the year following the year in which they attain age 72 even if they continue working for the plan sponsor.

An IRA owner is required to follow the rules that apply to 5% owners in determining the IRA owner's required beginning date for amounts in the owner's various IRA accounts. That means the IRA owner's required beginning date is April 1st of the calendar year following the calendar year in which the individual attains age 72, or age 70 1/2 in the case of an IRA owner who was born before July 1, 1949.[230]

Special rules apply to Roth IRAs in determining required minimum distributions and the required beginning date. No minimum distributions are required to be made from a Roth IRA while the owner is alive. When the Roth IRA owner dies, the required minimum distribution rules apply to the Roth IRA as though the Roth IRA owner had died before his or her required beginning date.[231]

If the sole beneficiary is the Roth IRA owner surviving spouse, and he or she decides to treat this as an inherited Roth IRA comma the surviving spouse may delay distributions until the Roth IRA owner would have attained age 72, or age 70 1/2 in the case of a Roth IRA owner who was born before July 1, 1949.[232]

It should be noted here though, that the surviving spouse will have another option to treat the Roth IRA as his or her own account, making him or her an account owner and further delay any required distributions until that surviving spouse dies. We will discuss that option here shortly.

Account Balance Determination

For purposes of determining the required minimum distribution from an IRA for the calendar year, the account balance of the IRA as of December 31st of the calendar year preceding the calendar year for which distributions are required to be made is treated as the account balance under the regulations for qualified retirement plans. Note that in this case there is no option to use a valuation date other than December 31.[233]

Because the valuation date will be December 31, generally the rules for adjusting that balance related to rollovers and transfers do not apply to IRAs except for transfers or rollovers that are not received

[230] Proposed Reg. §1.408-8(b)(1)(i)

[231] Proposed Reg. §1.408-8(b)(1)(ii)

[232] Proposed Reg. §1.408-8(b)(1)(ii)

[233] Proposed Reg. §1.408-8(b)(2)

by the receiving IRA account until the year after they were dispersed from the transferor IRA account.[234]

Determination of the Portion of Distribution That Is a Required Minimum Distribution

The portion of a distribution from an IRA that is required minimum distribution and will not be eligible for rollover is determined in the same manner as is done for a distribution from a qualified plan.[235]

Specifically, the regulation provides:

> For example, if a minimum distribution to an IRA owner is required under section 401(a)(9)(A)(ii) for a calendar year, any amount distributed during a calendar year from an IRA of that IRA owner is treated as a required minimum distribution under section 401(a)(9) to the extent that the total required minimum distribution for the year under section 401(a)(9) from all of that IRA owner's IRAs has not been satisfied (either by a distribution from the IRA or, as permitted under paragraph (e) of this section, from another IRA).[236]

Effectively, the first distributions out of an IRA account for a year are always deemed to be minimum required distributions and are not eligible to be put back into another IRA account until the total required minimum distribution for the year has been taken out of IRA accounts.

Clients who have read online about the ability to "borrow" from their IRA and replace the funds within 60 days may run into trouble with this rule. Since a large number of individuals who are subject to minimum distribution rules take those distributions late in the year, they would not be able to take money from the IRA account they intended to return within 60 days earlier in the year. Rather the funds that came out earlier in the year would be deemed to be part of the minimum distribution required for the year. Advisors may want to warn their clients about this particular issue in the year in which they first are required to take minimum distributions from their IRA accounts.

Surviving Spouse Treating IRA as Spouse's Own Account

The surviving spouse of an individual may elect to treat the surviving spouse's entire interest as a beneficiary and the decedent's IRA (or the remaining part of the interest of distributions have begun) as the surviving spouse is own IRA.[237]

Treating the IRA as a surviving spouse is own account has a couple of advantages, but potentially one significant disadvantage. So, the decision about whether or not the surviving spouse will treat the IRA as his or her own should only be made after considering any potential downsides to doing so.

The most significant problem with treating the IRA as the surviving spouse is own account occurs if that spouse has not yet attained age 59 1/2. While death benefits paid to a beneficiary of the IRA are not subject to the 10% extra tax for a premature distribution, when the spouse treats the IRA as his

[234] Proposed Reg. §1.408-8(d)(1)

[235] Proposed Reg. §1.408-8(b)(3)

[236] Proposed Reg. §1.408-8(b)(3)

[237] Proposed Reg. §1.408-8(c)(10

or her own account then the account owner rules apply. If the surviving spouse has not attained the appropriate age, the distribution will come with an extra 10% additional tax on top of any tax that already applies to the distribution.

The key advantage to treating the IRA as the spouse is all in account comes from the ability to avoid treating the account as inherited, therefore allowing the spouse to delay distributions until he or she turns age 72, and being able to use the Standard Life Expectancy tables that compute a joint and survivor life expectancy for the spouse and a theoretical beneficiary that is 10 years younger than the spouse. Even better, this life expectancy is recomputed each year. This can significantly slow down the rate of distributions required from the IR A compared to what would be true if the IRA was treated as an inherited IRA.

The election must be made by the later of the following two dates:

- The calendar year in which the surviving spouse reaches age 72; or
- The calendar year following the calendar year of the individual's death.[238]

Note that for the younger spouse who is exposed to the early distribution additional tax if he or she takes funds from the IRA after treating it as is her own, it is possible to significantly delay the election to treat the IRA as his or her own account. Therefore, the account can be left as an inherited IRA until the year in which the spouse attains age 59 1/2 and is no longer exposed to the additional 10% tax for taking a distribution. The potential negative of doing this is a possible requirement for the spouse to take distributions each year it is treated as inherited, but because the spouse is an eligible designated beneficiary the 10-year rule will not prove a problem.

In order for the spouse to be eligible to make the election to treat the IRA account as his or her own, the surviving spouse must be the sole beneficiary of the IRA and have an unlimited right to withdraw amounts from the IRA.[239]

If a trust is named as beneficiary of the IRA, the requirement is not satisfied even if the surviving spouse is the sole beneficiary of the trust.[240]

In terms of long term planning for a couple, a choice may need to be made between whether the spouses want to ensure that any funds not used required to be distributed to the surviving spouse in the IRA account go where the first to die wishes them to go, or whether they want the flexibility to have the surviving spouse name him or herself as owner of the account and be able to slow down distributions.

You are most likely to see the trust used in a situation where the spouses have children from a first marriage that they want to benefit, but still want to keep funds available for the surviving spouse to live on from their retirement account. In that case, the interest in the IRA account will be left to a see-through trust that likely will limit the distribution to solely the required minimum distribution unless, in the view of the trustee, additional funds are necessary for the surviving spouse.

[238] Proposed Reg. §1.408-8(c)(1)(ii)

[239] Proposed Reg. §1.408-8(c)(1)(iii)

[240] Proposed Reg. §1.408-8(c)(1)(iii)

There are three ways a surviving spouse may make the election to treat the interest in the decedent's IRA account as is or her own:

- The surviving spouse redesignates the account as an account in the name of the surviving spouse as IRA owner rather than as beneficiary;
- Any amount in the IRA that would be required to be distributed to the surviving spouse as beneficiary of an inherited IRA is not distributed within the time period required; or
- A contribution (other than a rollover of a distribution from an eligible retirement plan of the decedent) is made to the IRA.[241]

If the plan is to keep the account as an inherited IRA in order to allow a younger surviving spouse to take withdrawals without triggering the 10% additional tax, it is very important to ensure you avoid accidentally having the account converted to being one owned by the surviving spouse due to simply missing a required distribution. If a distribution is not timely taken in any year, under the second option the IRA becomes the surviving spouses' own IRA and, penalties will apply to distributions taken from that account up until the time the surviving spouse attains age 59 1/2.

The advisor should also be sure to ensure that the surviving spouse's investment advisor does not retitle the account as the surviving spouse's own account until enough time has passed for the advisers and surviving spouse to meet and determine the best course of action.

The regulations describe the effect of this election as follows:

> Following an election described in paragraph (c)(1) of this section, the surviving spouse is considered the IRA owner for whose benefit the trust is maintained for all purposes under the Internal Revenue Code (including section 72(t)). Thus, for example, the required minimum distribution for the calendar year of the election and each subsequent calendar year is determined under section 401(a)(9)(A) with the spouse as IRA owner and not section 401(a)(9)(B) with the surviving spouse as the deceased IRA owner's beneficiary.[242]

The regulation does describe a special rule if the decedent was required to take a minimum distribution in the year of death which had not been taken prior to when the surviving spouse converted the IRA to his or her own account:

> However, if the election is made in the calendar year during which the IRA owner's death occurs, the spouse is not required to take a required minimum distribution as the IRA owner for that calendar year. Instead, the spouse is required to take a required minimum distribution for that year, determined with respect to the deceased IRA owner under the rules of §1.401(a)(9)-5(c), to the extent the distribution was not made to the IRA owner before death.[243]

[241] Proposed Reg. §1.408-8(c)(2)

[242] Proposed Reg. §1.408-8(c)(3)

[243]

Treatment of Rollovers and IRAs

The regulations describe special rules that apply to the treatment of rollovers related to IRAs under the minimum distribution rules.

Spousal Rollovers

A surviving spouse is permitted to roll over a distribution to an IRA as beneficiary of the deceased employer IRS owner or the spouse may elect to treat that IRA as the spouse's own IRA under the rules just discussed.[244]

Rules for Death Before Required Beginning Date

A surviving spouse who decides to continue to treat the amount as an inherited account balance may find themselves stuck with some planned provisions they aren't able to get around as long as the account remains an inherited IRA account. The regulation provides:

> If an employee or IRA owner dies before the required beginning date and the surviving spouse rolls over a distribution of the employee's or IRA owner's interest to an IRA in the spouse's capacity as a beneficiary of the deceased employee or IRA owner, then, except as provided in paragraph (d)(2)(ii) of this section, the method for determining required minimum distributions that applied to that surviving spouse under the distributing plan or IRA (such as when a beneficiary makes an election described in §1.401(a)(9)-3(c)(5)(iii)) also applies to the receiving IRA.[245]

The regulation gives an example of such a provision carrying over to the IRA that the account balance was rolled to when it continues to be held as an inherited IRA by the surviving spouse:

> Thus, for example, if an employee who died before the required beginning date designated the employee's surviving spouse as a beneficiary of the employee's interest in the plan and the plan provides that the surviving spouse is subject to the 10-year rule described in §1.401(a)(9)-3(c)(4), then the 10-year rule also applies to any IRA in the name of the decedent that receives a rollover of the employee's interest.[246]

Similarly, amounts coming out of the inherited account will be subjected to the minimum distribution rules for that account in determining how much of the distribution is eligible for rollover to the surviving spouse's own IRA account:

> If an employee or IRA owner dies before the required beginning date and the surviving spouse rolls over a distribution described in paragraph (d)(2)(i) of this section from the surviving spouse's IRA in the capacity as the beneficiary of the decedent to the surviving spouse's own IRA, then, in determining the amount that is treated as a required minimum distribution under section 401(a)(9) and thus is not eligible for rollover, the rules of §1.402(c)-2(j)(3)(iii) are applied as if the distribution

[244] Proposed Reg. §1.408-8(d)(1)(ii)

[245] Proposed Reg. §1.408-8(d)(2)(i)

[246] Proposed Reg. §1.408-8(d)(2)(i)

> was made directly from the decedent's interest in the plan or IRA to the surviving spouse's own IRA.[247]

Finally, similar rules apply to direct trustee to trustee transfers for a non-spouse beneficiary to an IRA account:

> The rules of paragraphs (d)(1), (d)(2)(i) and (d)(2)(ii) of this section apply to a non-spouse beneficiary who makes an election to have a distribution made in the form of a direct trustee-to-trustee transfer as described in section 402(c)(11) in the same manner as a rollover of a distribution made by a surviving spouse.[248]

Treatment of Transfers

One way of moving funds from one IR a custodian to another is using a trustee-to-trustee transfer. This allows the beneficiary to change custodians even if, as a non spouse beneficiary, the beneficiary has no option to do a traditional rollover. Remember that an inherited IRA cannot make an eligible rollover distribution, but we can use the trustee-to-trustee transfer option to accomplish a similar.

If this transfer is not a distribution and rollover, which generally we're going to want to arrange it not to be, the transfer is not treated as a distribution by the transfer or IR a for purposes of the minimum distribution rules. Therefore, the minimum distribution rules with respect to that transfer high are a must still be satisfied.[249]

As well, after the transfer the employees account balance and the required minimum distribution under the transferee IRA is determined in the same manner that an account balance and required minimum distribution are determined for an IRA receiving a rollover contribution.[250]

Owners of Multiple IRAs

A key difference between IRAs and qualified retirement plan balances is that the minimum distribution requirements for IRAs can be satisfied with distributions from any of the individuals IRA accounts in most cases.[251] if this option is used the required minimum distribution must be computed separately for each IRA, and the separately calculated amounts may then be totaled and the total distribution taken from any one or more of the IRAs of the owner under the rules discussed in the next few paragraphs.[252]

IRAs Must Be IRAs of the Same Owner

The first requirement is that generally only amounts in IRAs the individual holds as the IRA owner may be aggregated for purposes of complying with the minimum distribution rules.[253]

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[247] Proposed Reg. §1.408-8(d)(2)(iii)

[248] Proposed Reg. §1.408-8(d)(3)

[249] Proposed Reg. §1.408-8(d)(4)

[250] Proposed Reg. §1.408-8(d)(4)

[251] Proposed Reg. §1.408-8(e)(1)

[252] Proposed Reg. §1.408-8(e)(1)

[253] Proposed Reg. §1.408-8(e)(2)

Inherited IRAs are not counted as part of this group, So if a beneficiary other than the surviving spouse receives an IRA as a result of the death of an individual, the IRA is considered to be an IRA of the decedent for purposes of these rules. However, if the surviving spouse elects to treat an IRA received on the death of his or her spouse as his or her own IRA, then that IRA will be eligible for aggregation.[254]

The IRS first notes the following examples of dealing with inherited IRAs under these rules:

> Thus, for example, for purposes of satisfying the minimum distribution requirements with respect to one IRA by making distributions from another IRA, IRAs for which the individual is the IRA owner are not aggregated with IRAs for which the individual is a beneficiary. In addition, IRAs that a person holds as a beneficiary of a decedent may be aggregated, but those amounts may not be aggregated with IRAs that the person holds as the owner or as the beneficiary of another decedent.[255]

Non-Roth IRAs Treated as Separate from §403(b) Contracts and Roth IRAs

Distributions from an IRA that is not a Roth IRA may not be used to satisfy required minimum distribution requirements with respect to either a Roth IRA or a section 403(b) contract.[256] As well, distributions from a Roth IR A do not satisfy the minimum distribution requirements with respect to either an IR a that's not a Roth IRA or a section 403 B contract.[257] Finally, a distribution from a section 403 B contract will not satisfy the minimum distribution requirements with respect to an IRA.[258]

Distributions Taken Into Account for IRAs

The rules for distributions taken into account for IRAs are similar to those that apply to qualified employer retirement plans, though obviously there are certain differences just because of the differences between an IRA and an employer retirement plan. Generally, all amounts distributed from an IRA are taken into account determining whether the minimum distribution rules are satisfied, regardless of whether these amounts are includible in income.[259]

However, the following amounts are not taken into account in determining whether the minimum distribution amount has been received for the year in question:

- Contributions returned prior to the due date of the return pursuant to section 408(d)(4), together with the income allocable to these contributions;
- Contributions returned pursuant to section 408(d)(5) (distributions of excess contributions after the due date for taxable year and certain excess rollover contributions);

[254] Proposed Reg. §1.408-8(e)(2)

[255] Proposed Reg. §1.408-8(e)(2)

[256] Proposed Reg. §1.408-8(e)(3)

[257] Proposed Reg. §1.408-8(e)(3)

[258] Proposed Reg. §1.408-8(e)(3)

[259] Proposed Reg. §1.408-8(g)(1)

- Corrective distributions of excess simplified employee pension contributions under section 408(k)(6)(C), together with the income allocable to these distributions;
- Amounts that are treated as distributed pursuant to section 408(e) (prohibited transaction issues);
- Amounts that are deemed to be distributed with respect to collectibles pursuant to section 408(m);
- Corrective distributions of excess deferrals as described in §1.402(g)-1(e)(3), together with the income allocable to these corrective distributions; and
- Similar items designated by the Commissioner in revenue rulings, notices, and other guidance published in the Internal Revenue Bulletin.[260]

[260] Proposed Reg. §1.408-8(g)(2)

NOTES

Unit

3

Individual Tax Developments

LEARNING OBJECTIVES

When you have completed this unit, you will be able to accomplish the following.

- Prepare tax returns and advise clients in planning taking into account major developments occurring in the past year

SECTION: 1
INFLATION ADJUSTED AMOUNTS ISSUED BY IRS FOR 2023

Citation: Revenue Procedure 2022-38, 10/18/22

The IRS has released Revenue Procedure 2022-38[261] that contains most of the other inflation adjusted numbers for 2023 taxes.

As the numbers relate to the law as it existed at the date of publication of the procedure, something that could change based on pending Congressional action, the procedure contains the following warning:

> This revenue procedure sets forth inflation-adjusted items for 2023 for various Code provisions as in effect on October 18, 2022. The inflation adjusted items for the Code sections set forth in section 3 of this revenue procedure are generally determined by reference to § 1(f) of the Code. To the extent amendments to the Code are enacted for 2023 after October 18, 2022, taxpayers should consult additional guidance to determine whether these adjustments remain applicable for 2023.[262]

The numbers are arranged by IRC Section number in this annual publication of inflation adjusted numbers. Some of the key figures are discussed below.

> **Kiddie Tax:** For taxable years beginning in 2023, the amount in § 1(g)(4)(A)(ii)(I), which is used to reduce the net unearned income reported on the child's return that is subject to the "kiddie tax," is $1,250. This $1,250 amount is the same as the

[261] Revenue Procedure 2022-38, October 21, 2022, https://www.irs.gov/pub/irs-drop/rp-22-38.pdf

[262] Revenue Procedure 2022-38, October 21, 2022

amount provided in § 63(c)(5)(A), as adjusted for inflation. The same $1,250 amount is used for purposes of § 1(g)(7) to determine whether a parent may elect to include a child's gross income in the parent's gross income and to calculate the "kiddie tax." For example, one of the requirements for the parental election is that a child's gross income is more than the amount referenced in § 1(g)(4)(A)(ii)(I) but less than 10 times that amount; thus, a child's gross income for 2023 must be more than $1,250 but less than $12,500.[263]

Maximum Capital Gains Rate. The procedure provides the following brackets for capital gain rates purposes for 2022.

> For taxable years beginning in 2023, the Maximum Zero Rate Amount under § 1(h)(1)(B)(i) is $89,250 in the case of a joint return or surviving spouse ($44,625 in the case of a married individual filing a separate return), $59,750 in the case of an individual who is a head of household (§ 2(b)), $44,625 in the case of any other individual (other than an estate or trust), and $3,000 in the case of an estate or trust. The Maximum 15-percent Rate Amount under § 1(h)(1)(C)(ii)(l) is $553,850 in the case of a joint return or surviving spouse ($276,900 in the case of a married individual filing a separate return), $523,050 in the case of an individual who is the head of a household (§ 2(b)), $492,300 in the case of any other individual (other than an estate or trust), and $14,650 in the case of an estate or trust.[264]

Adoption. The procedure provides the following numbers related to the adoption credit for 2023.

> For taxable years beginning in 2023, under § 23(a)(3) the credit allowed for an adoption of a child with special needs is $15,950. For taxable years beginning in 2023, under § 23(b)(1) the maximum credit allowed for other adoptions is the amount of qualified adoption expenses up to $15,950. The available adoption credit begins to phase out under § 23(b)(2)(A) for taxpayers with modified adjusted gross income in excess of $239,230 and is completely phased out for taxpayers with modified adjusted gross income of $279,230 or more. See section 3.19 of this revenue procedure for the adjusted items relating to adoption assistance programs.[265]

The related numbers for adoption assistance programs for 2023 are provided as follows.

> For taxable years beginning in 2023, under § 137(a)(2), the amount that can be excluded from an employee's gross income for the adoption of a child with special needs is $15,950. For taxable years beginning in 2023, under § 137(b)(1) the maximum amount that can be excluded from an employee's gross income for the amounts paid or expenses incurred by an employer for qualified adoption expenses furnished pursuant to an adoption assistance program for adoptions by the employee is $15,950. The amount excludable from an employee's gross income begins to phase out under § 137(b)(2)(A) for taxpayers with modified adjusted gross income in excess of $239,230

[263] Revenue Procedure 2022-38, Section 3.02, October 18, 2022

[264] Revenue Procedure 2022-38, Section 3.03, October 18, 2022

[265] Revenue Procedure 2022-38, Section 3.04, October 18, 2022

and is completely phased out for taxpayers with modified adjusted gross income of $279,230 or more. (See section 3.04 of this revenue procedure for the adjusted items relating to the adoption credit.)[266]

Alternative Minimum Tax: The exemption amounts for the alternative minimum tax for 2023 are:

- Joint Returns or Surviving Spouses - $126,500
- Unmarried Individuals (other than Surviving Spouses) - $81,300
- Married Individuals Filing Separate Returns - $63,250
- Estates and Trusts - $28,400

The exemptions start to phase out in 2023 at:

- Joint Returns or Surviving Spouses – begins at $1,156,300, completely phased out at $1,662,300
- Unmarried Individuals (other than Surviving Spouses) – begins at $578,150, completely phased out at $903,350
- Married Individuals Filing Separate Returns – begins at $578,150, completely phased out at $831,150
- Estates and Trusts – begins at $94,600, completely phased out at $208,200[267]

Classroom Expenses of Elementary and Secondary School Teachers. For taxable years beginning in 2023, under § 62(a)(2)(D) the amount of the deduction allowed under § 162 that consists of expenses paid or incurred by an eligible educator in connection with books, supplies (other than nonathletic supplies for courses of instruction in health or physical education), computer equipment (including related software and services) and other equipment, and supplementary materials used by the eligible educator in the classroom is $300.[268]

Standard Deduction. The base standard deductions for 2023 are:

- Married Individuals Filing Joint Returns and Surviving Spouses (§ 1(j)(2)(A)) - $27,700
- Heads of Households (§ 1(j)(2)(B)) - $20,800
- Unmarried Individuals (other than Surviving Spouses and Heads of Households) (§ 1(j)(2)(C) - $13,850

[266] Revenue Procedure 2022-38, Section 3.19, October 18, 2022

[267] Revenue Procedure 2022-38, Section 3.11, October 18, 2022

[268] Revenue Procedure 2022-38, Section 3.13, October 18, 2022

- Married Individuals Filing Separate Returns (§ 1(j)(2)(D)) - $13,850[269]

The standard deduction for an individual claimed as a dependent in 2023 can exceed the greater of:

- $1,250 or
- The sum of $400 and the person's earned income.[270]

The additional standard deduction for those who are aged 65 or greater or those who are blind is $1,500. This additional deduction is increased to $1,850 if the individual is also unmarried and not a surviving spouse.[271]

Cafeteria Plans: For plan years beginning in 2023, the dollar limitation for voluntary employee salary reductions for contributions to health flexible spending arrangements is $3,050. If the cafeteria plan permits the carryover of unused amounts, the maximum carryover amount is $610.[272]

Maximum Income for Qualifying Relative. For 2023, the maximum gross income for any qualifying relatives to be able to be claimed as a dependent is $4,700.[273]

Section 179 Numbers. For 2023, the following key numbers apply to IRC §179 expensing:

- Maximum cost of property for which a §179 election is made: $1,160,000
- Limit on costs for sports utility vehicle taken into account under IRC §179: $28,900
- The amount available for §179 expensing is phase out beginning when total §179 property placed in service during the year exceed $2,890,000.[274]

§199A Qualified Business Income Numbers. For 2023, the threshold amount and end of the phase in range are:

- Married Individuals Filing Joint Returns – threshold amount is $364,200 and the phase-in range ends at $464,200
- Married Individuals Filing Separate Returns – threshold amount is $182,100 and the phase-in range ends at $232,100

[269] Revenue Procedure 2022-38, Section 3.13(1), October 18, 2022

[270] Revenue Procedure 2022-38, Section 3.13(2), October 18, 2022

[271] Revenue Procedure 2022-38, Section 3.13(3), October 18, 2022

[272] Revenue Procedure 2022-38, Section 3.16, October 18, 2022

[273] Revenue Procedure 2022-38, Section 3.24, October 18, 2022

[274] Revenue Procedure 2022-38, Section 3.25, October 18, 2022

- All Other Returns - threshold amount is $182,100 and the phase-in range ends at $232,100.[275]

Small Accounting Methods. For 2023, the maximum gross receipt level to qualify for various benefits under the small accounting methods of the Tax Cuts and Jobs Act (cash basis of accounting, exemption from §163(j) interest rules, non-§471(c) inventory methods, exemption from §263A, and treatment as a small contractor) is $29,000,000.[276]

Excess Business Loss. For 2023, the limit for an excess business loss under IRC §461(l) is $289,000 ($578,000 for joint returns).[277]

Foreign Earned Income Exclusion. For 2023, the foreign earned income exclusion is $120,000.[278]

Unified Credit Against Estate Tax. The basic exclusion amount for decedents dying in 2023 is $12,920,000.[279]

Annual Exclusion for Present Interest Gifts. The annual exclusion for a gift of a present interest in 2023 will be $17,000.[280]

Qualified Small Employer Health Reimbursement Arrangement (QSEHRA). The limit on reimbursement for an employer plan to qualify as an QSEHRA is $5,850 ($11,800 for family coverage).[281]

SECTION: 61
IRS REVISES FORM 1040 QUESITON ON DIGITAL ASSETS ON 2022 FORM DRAFT

Citation: Draft 2022 Form 1040, 7/29/22

The IRS has issued a draft 2022 Form 1040[282] which contains a revised question regarding digital assets.

[275] Revenue Procedure 2022-38, Section 3.27, October 18, 2022

[276] Revenue Procedure 2022-38, Section 3.31, October 18, 2022

[277] Revenue Procedure 2022-38, Section 3.32, October 18, 2022

[278] Revenue Procedure 2022-38, Section 3.39, October 18, 2022

[279] Revenue Procedure 2022-38, Section 3.41, October 18, 2022

[280] Revenue Procedure 2022-38, Section 3.41, October 18, 2022

[281] Revenue Procedure 2022-38, Section 3.62, October 18, 2022

[282] Draft 2022 Form 1040, July 27, 2022, https://www.irs.gov/pub/irs-dft/f1040--dft.pdf (retrieved August 5, 2022)

Revisions

The revised portion of Form 1040 appears like this:

At any time during 2022, did you: (a) receive (as a reward, award, or compensation); or
(b) sell, exchange, gift, or otherwise dispose of a digital asset (or a financial interest in a digital asset)? (See instructions.) . . ☐ **Yes** ☐ **No**

The question now specifically asks if the taxpayer has received as a reward, award or compensation any digital asset or financial interest in a digital asset. As well, the IRS added to the list of dispositions to be required a yes answer whether the taxpayer has gifted any digital asset or financial interest in a digital asset.

The reference to "digital asset" rather than "virtual currency" is also new for 2022. Although the related instructions to the form are not yet issued in draft form (and likely won't be until much later in the year if the IRS follows the same schedule they have in the past), presumably this change is meant to include coverage of NFTs and other forms of digital assets in addition to virtual currencies.

Why the Changes?

This will be the fourth tax return on which the IRS has asked a digital asset question, and third one for which the question appears on the first page of Form 1040.

The change in wording to "digital assets," in addition to clearly bringing in nonfungible tokens (NFTs) and whatever else similar might be developed, also brings the terminology in line with the terminology added to the Internal Revenue Code in the Infrastructure Investment and Jobs Act in late 2021. The term was added to the IRC as part of the new information reporting requirements that will go into effect after December 31, 2023.

The new question also focuses on various manners in which taxpayers could receive such assets in at least a potentially taxable transaction (such as rewards and awards, in addition to compensation for services performed).

The IRS also subtly broadened what must be reported by moving beyond the actual digital asset to include any financial interest in a digital asset.

SECTION: 71
$51 MILLION OF PAYMENTS RULED NOT TO BE DEDUCTIBLE ALIMONY BY LOOKING TO STATE LAW

Citation: Redleaf v. Commissioner, CA6, Cases No. 21-2209 and No. 21-2224, 8/5/22

Even though the alimony deduction/taxation issue for divorced couples is no longer an issue in divorces finalized today, the issue of exactly what is federal income tax law alimony continues to be

an issue for pre-2019 divorces. In the case of *Redleaf v. Commissoner*[283] the former spouses were disputing the treatment of payments totaling $51 million.

As is normal in a case like this, the IRS also has a protective assessment issued against the recipient spouse so the agency does not get whipsawed should the payor prevail in the court challenge, even though the agency had determined that the payments did not qualify as alimony. Thus, both former spouses were actively involved in this matter.

Pre-2019 Definition of Alimony for Federal Tax Purposes

Prior to being removed from the law effective for divorces entered into after December 31, 2018, IRC §71(b)(1) created a four-pronged test to determine if payments between divorcing spouses were or were not alimony, taxable to the recipient under IRC §71 and deductible by the payor under IRC §215. The opinion cites the rule as follows:

> Under revised § 71(b)(1), an alimony or separate maintenance payment deductible under § 215(a) means "any payment in cash if —
>
> > (A) such payment is received by (or on behalf of) a spouse under a divorce or separation instrument,
> >
> > (B) the divorce or separation instrument does not designate such payment as a payment which is not includible in gross income under this section and not allowable as a deduction under section 215,
> >
> > (C) in the case of an individual legally separated from his spouse under a decree of divorce or of separate maintenance, the payee spouse and the payor spouse are not members of the same household at the time such payment is made, and
> >
> > (D) there is no liability to make any such payment 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."[284]

Congress enacted this test in 1984 to provide for what Congress hoped would be a clear test to determine what was alimony, one that could be easily incorporated into divorce agreements. One of the key provisions of the four is the requirement that, for a payment to be alimony, the liability of the payor to make any payments must end if the recipient spouse dies. As the opinion notes:

> In making the statute more objective, Congress adopted criteria that would distinguish deductible alimony payments from property settlements:
>
> > In order to prevent the deduction of amounts which are in effect transfers of property unrelated to the support needs of the recipient, the bill provides that a payment qualifies as alimony only if the payor . . . has no liability to

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[283] *Redleaf v. Commissioner,* CA6, Cases No. 21-2209 and No. 21-2224, August 5, 2022, https://www.taxnotes.com/research/federal/court-documents/court-opinions-and-orders/eighth-circuit-affirms-denial-of-alimony-deductions/7dvny (retrieved August 7, 2022)

[284] *Redleaf v. Commissioner,* CA6, Cases No. 21-2209 and No. 21-2224, August 5, 2022

> make any such payment for any period following the death of the payee spouse.
>
> H.R. Rep. No. 98-432, Part II at 1496, 1984-3 U.S.C.C.A.N. 697, 1138.[285]

Thus, if a payor wants the payment stream to be taxable as alimony, the payor could insist a clause providing that liability for payments will cease upon the death of the recipient be added to the document to eliminate any question regarding whether state law would otherwise have the liability continue after the recipient's death with payments going to the recipient's estate or heirs.

While not enough by itself to ensure a payment stream is taxable as alimony, it makes sense to include it if the payments are intended to be treated as alimony. Normally the first test (the payment received under a written decree or order) is no problem to meet, and it's unlikely the third test is going to be a problem in many cases as the last party the potentially warring spouses may want to share a household with is each other.[286]

The second test offers up a way for the recipient spouse, who does not want to have the amounts taxed as alimony, to eliminate that possibility by insisting upon a clause that requires the payments be designated as not taxable under IRC §72 and not deductible under IRC §215. If that clause is in the agreement, the recipient spouse can be sure that the amounts will not be taxable alimony.

So you might think that the issue of whether a payment stream was or wasn't alimony would simply not arise on decrees covered by the 1984 law. But you would be wrong—quite a few divorce decrees simply ignored dealing with the tax implications of any payments, despite having methods available to ensure that the tax treatments of the payments would be clear to all parties.

There are numerous reasons why these issues were ignored, perhaps simply because they were overlooked by the parties and their counsel or those involved recognized that adding one more issue to be resolved could torpedo the potential resolution of the disputes in the divorce. But, in any event, in a number of cases that have made it to the courts the decree standing alone did not contain language that could resolve the question—so the courts then had to turn to how state law would interpret what was in the decree.

Payments with Tax Treatment in Dispute Among the Former Spouses

The key payments in dispute in this case involve the following:

> Andrew received a piano, at least three pieces of art, his personal effects, the fifth vehicle, and — most importantly in this case — his entire 84.5% ownership interest in Whitebox Advisors, LLC ("Whitebox"), a hedge fund asset management firm Andrew founded in 1999. Andrew proposed this property settlement on the day that business-valuation appraisers were scheduled to meet with Andrew and Whitebox employees to prepare a business valuation of this principal marital asset.

[285] *Redleaf v. Commissioner*, CA6, Cases No. 21-2209 and No. 21-2224, August 5, 2022

[286] There are other provisions that a payor would need to deal with to insure a payment stream is taxable as alimony, avoiding the front end loading rules or the provisions meant to surface disguised child support found in old Section 71.

> To reflect Elizabeth's interest in the Whitebox marital asset, Part VI, Paragraph 23 of the MTA, entitled "Property Settlement," provided that Andrew would pay Elizabeth some $140 million over the next five years:
>
>> A. On or before February 15, 2008, [Andrew] shall pay to [Elizabeth], as a cash property settlement, $750,000;
>>
>> B. On or before February 15, 2008, [Andrew] shall pay to [Elizabeth], as a cash property settlement, $20,000,000;
>>
>> C. Commencing March 15, 2008, [Andrew] shall pay to [Elizabeth] $1,500,000 per month . . . for sixty (60) months; and
>>
>> D. On March 15, 2013, [Andrew] shall pay to [Elizabeth] $30,000,000.[287]

I'm sure some readers will immediately object that the document called this a property settlement and so this could not be alimony. While that sounds convincing, in fact it's not necessarily determinative for the *federal* tax law treatment of these payments. If they meet the four tests found in IRC §71, they will be treated as alimony for tax purposes (assuming neither the front-end rules nor disguised child support provisions get in the way).

But, as will become clear, while what the payments are called under state law isn't, on its own, determinative of whether the payments are federal tax alimony, it may impact the rights and obligations under the agreement under state law, and those determinations could impact the four tests, especially the liability to make payments after the death of the recipient spouse.

The document contained other provisions that will be important in this case, mainly from the perspective of how the state in question (Minnesota here) will decide what are the rights and obligations under the agreement:

> The MTA also contained additional provisions relevant to this appeal in Parts V and VI:
>
>> Paragraph 15.b. provided that Elizabeth "is not employed outside the home . . . [and she] has adequate income and financial resources from the property settlement to meet her needs and the needs of the minor child when she is in her care."
>>
>> Paragraph 17 provided that each party "is capable of self support and . . . waives any right to receive temporary and/or permanent spousal maintenance . . . now or in the future. . . . The consideration for said waivers is the property division as herein described, the award of income-producing assets, and both party's ability to provide adequate self support after considering the standard of living established during the marriage. . . . [T]he parties intend to divest the Court of jurisdiction to award spousal maintenance to either party now or in the future."
>>
>> Paragraph 35 provided: "The parties have entered into the division of property . . . intending it to be an equitable division of marital property, which they believe to be co-owned by virtue of the actual contributions of

[287] *Redleaf v. Commissioner*, CA6, Cases No. 21-2209 and No. 21-2224, August 5, 2022

> each party to the acquisition of the whole and by virtue of the co-ownership property interest granted to spouses by law. Both parties accordingly agree not to take any position . . . which is inconsistent with the concept of an equitable division of jointly owned property with regard to any filing, audit, or report required by any state or federal taxing authority."
>
> Part VI listed terms that "shall be incorporated into the Judgment and Decree," including in addition to the above-quoted Property Settlement:
>
>> 11. Spousal Maintenance. . . .
>>
>>> B. [Andrew] shall pay no temporary or permanent spousal maintenance to [Elizabeth], [Elizabeth] having absolutely waived any right to have [Andrew] pay temporary or permanent spousal maintenance now or in the future.
>>>
>>> C. The Court is divested of, and shall have no jurisdiction, over spousal maintenance, therefore prohibiting the Court from modifying the [parties'] agreement at a later [date], as this right was waived pursuant to Minn. Stat. § 518.552, Subd. 5, and Karon v. Karon, 435 N.W.2d 501 (1989).
>>
>> 20. Business Interests. [Andrew] is awarded all right, title, interest and equity in and to Whitebox . . . [Elizabeth] waives all right, title and interest she may have in [Andrew's] business interests, including Whitebox. . . .

Appeals Court Panel's Analysis and Decision

The panel starts its analysis by questioning why this case exists rather than having been dealt with when the divorce was entered into:

> Rather surprisingly, given the overall sophistication of the document and the substantial state court litigation between the parties that followed, the MTA contained no provision clarifying (designating) that the payments in question were not includable in Elizabeth's gross income and allowable as a deduction to Andrew, § 71(b)(1)(B)4; and no provision unambiguously stating that Andrew had no liability to make payments for a period after Elizabeth's death, § 71(b)(1)(D).[288]

This is not the first time this author has seen this sentiment stated in court opinions on these cases over the years, though I suspect that adding this issue to a divorce that already had "substantial state court litigation between the parties" would have likely caused even more litigation. As well, it is possible that one or both parties believed that once the analysis moves to rights under state law they will get the result they prefer without needing to drag out the process of finalizing the divorce. In fact, one of the two parties would be correct in that belief.

[288] *Redleaf v. Commissioner*, CA6, Cases No. 21-2209 and No. 21-2224, August 5, 2022

In any event, the parties did not take up Congress's offer to have this solved in their agreement for whatever reason, so the panel now turned to applying Minnesota state law to what was in the agreement. As the Court noted:

> In general, "the property interests of divorcing parties are determined by state law [but] federal law governs the federal income tax treatment of that property." *Id.* at 844 (quotation omitted). Thus, the court in *Hoover* paid close attention to the role to be played by state law in applying § 71(b)(1)(D). The Tax Court has summarized the test adopted in Hoover and followed by other courts:
>
> > To determine whether a payor has liability to continue payments after the payee's death, we apply the following sequential approach: (1) the Court first looks for an unambiguous termination provision in the applicable divorce instrument; (2) if there is no unambiguous termination provision, then the Court looks to whether payments would terminate at the payee's death by operation of State law; and (3) if State law is ambiguous as to the termination of payments upon the death of the payee, the Court will look solely to the divorce instrument to determine whether the payments would terminate at the payee's death."
>
> *Logue v. Comm'r*, 114 T.C.M. (CCH) 599 (2017), citing Hoover, 102 F.3d at 847-48.

The panel notes that all parties agree that the agreement is ambiguous on the key issues, so the question moves to state law:

> The Tax Court concluded, and the parties agree, that the MTA "does not plainly state" whether the payments at issue would have survived Elizabeth's death. Therefore, applying the sequential analysis adopted in *Hoover*, we turn to Minnesota state law.[289]

Andrew (the payor) argues that these payments qualify as maintenance under Minnesota state law and, under that state law, the payments would terminate at Elizabeth's (the recipient) death:

> Under Minnesota's Marriage Dissolution law, "'Maintenance' means an award made in a dissolution . . . proceeding of payments from the future income or earnings of one spouse for the support and maintenance of the other." Minn. Stat. § 518.003, Subd. 3a. The statute further provides that, "[u]nless otherwise agreed in writing or expressly provided in the degree, the obligation to pay future maintenance is terminated upon the death of either party. . . ." Minn. Stat. § 518A.39, Subd. 3.[290]

Andrew argued that the payment should qualify for the following reasons:

> In a Minnesota dissolution proceeding, the Hennepin Country District Court could grant a maintenance order if Elizabeth:
>
> > (a) lacks sufficient property, including marital property apportioned to the spouse, to provide for reasonable needs of the spouse considering the standard of living established during the marriage . . . or

[289] *Redleaf v. Commissioner*, CA6, Cases No. 21-2209 and No. 21-2224, August 5, 2022

[290] *Redleaf v. Commissioner*, CA6, Cases No. 21-2209 and No. 21-2224, August 5, 2022

> > (b) is unable to provide adequate self-support, after considering the standard of living established during the marriage and all relevant circumstances. . . .
>
> Minn. Stat. § 518.552, Subd. 1. Conceding as he must that Elizabeth could not satisfy condition (a), Andrew argues that she satisfied condition (b) because "tens of millions of dollars" were needed to self-support her extravagant international lifestyle, established during the marriage and further enhanced in the years after their divorce.[291]

But the panel agrees with the Tax Court that the payment stream does not qualify as maintenance under Minnesota law:

> This argument simply ignores controlling Supreme Court of Minnesota precedent. In *Lyon v. Lyon*, 439 N.W.2d 18, 22 (Minn. 1989), decided well before Andrew and Elizabeth entered into the MTA, the Court held:
>
> > Because maintenance is awarded to meet need, maintenance depends on a showing of need. [Citation omitted.] This dependence on need is implicit in the second threshold requirement dealing with unemployability of the spouse seeking maintenance. Indeed, what is implicit becomes explicit when the statute goes on to state that, in awarding maintenance, the factors to be considered include 'the financial resources of the party seeking maintenance including marital property apportioned to the party, and the party's ability to meet needs independently' [citing § 518.552, Subd. 2(a)].
> >
> > . . . . Here . . . there has been an equal division of a substantial marital estate amassed over 32 years which enables the wife to continue her established high standard of living.
> >
> > We hold, therefore, that the award of spousal maintenance must be reversed.
>
> More recently, the Court has reaffirmed that, "[o]nce a spouse has made a sufficient showing of need, only then will a court consider the amount and duration of a maintenance award. . . ." *Curtis v. Curtis*, 887 N.W.2d 249, 252 (Minn. 2016) (emphasis added).
>
> We therefore conclude that Minnesota law unambiguously establishes that the MTA was not a spousal maintenance agreement. Rather, it was a contractual division of marital property. Contractual obligations under a divorce agreement fall under the general rule that causes of action survive their personal representatives. Minn. Stat. § 573.01. That being so, Minnesota law unambiguously provides that the payments in question were not deductible because Andrew's liability to make the payments would survive Elizabeth's death. This is consistent with the stated purpose of § 71(b)(1)(D) "to prevent the deduction of amounts which are in effect transfers of property *unrelated to the support needs of the recipient*" *(emphasis added)*.[292]

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[291] *Redleaf v. Commissioner*, CA6, Cases No. 21-2209 and No. 21-2224, August 5, 2022

[292] *Redleaf v. Commissioner*, CA6, Cases No. 21-2209 and No. 21-2224, August 5, 2022

And, frankly, the taxpayer had attempted to get his payments reduced which lead to a Minnesota court not finding a claim that the payments were maintenance credible given the language in the divorce settlement:

> Approximately eight months after the Hennepin County District Court approved the MTA and entered the divorce decree, Andrew advised Elizabeth that the 2008 financial crisis negatively impacted Whitebox and he could not continue to make the $1.5 million monthly payments. Elizabeth declined to reopen the MTA. Andrew stopped making payments in January 2009 and moved to "reopen[ ] the property division" in the decree on the ground that it was no longer equitable. See Minn. Stat. § 518.145, Subd. 2(5).The District Court denied the motion because Andrew failed to present an unforeseen development, only that his "prediction about the market proved inaccurate." *Redleaf v. Redleaf*, No. 27 FA 07 3480 (D. Ct. 2009), citing *Thompson v. Thompson*, 739 N.W.2d 424, 430-31 (Minn. Ct. App. 2007). One year later, the District Court for the same reason denied Andrew's renewed motion to amend the decree, observing, "This Court is at a loss . . . as to how one can construe the 'property settlement' to be 'spousal maintenance' given the clear language in paragraph seventeen (17) of the [MTA] and paragraph nineteen (19) [of the decree]." *Redleaf v. Redleaf*, No. 27 FA 07 3480, Order at 4 (D. Ct. June 22, 2010). The Minnesota Court of Appeals affirmed. Nos. A09-1805, A09-2360, A10-10, 2010 WL 3543458 (Minn. Ct. App. Sept. 14, 2010). The Court of Appeals observed that:
>
> > [Elizabeth] was entitled to one-half of the value of Whitebox. But in lieu of establishing that value based on an appraisal of the business, she agreed to [Andrew's] proposed cash settlement without any reference to Whitebox. Id. at *4.[293]

Ultimately, the panel agreed with the Tax Court's conclusion that the payments were *not* alimony as there would be a liability to continue to make the payments even if Elizabeth died before all payments were made.

SECTION: 72 UPDATED NOTICE ON SUBSTANTIALLY EQUAL PAYMENTS ISSUED BY IRS

Citation: Notice 2022-6, 1/18/22

When the IRS released the final regulations updating the required minimum distribution and other life expectancy tables, the agency noted that it would be releasing additional guidance to deal with the impact on substantially equal payments. In Notice 2022-06[294] the IRS has now released that guidance.

Effective Date

One of the more interesting items in the notice is found at the very end where the effective dates for this notice are listed.

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[293] *Redleaf v. Commissioner*, CA6, Cases No. 21-2209 and No. 21-2224, August 5, 2022

[294] Notice 2022-6, January 18, 2022, https://www.irs.gov/pub/irs-drop/n-22-06.pdf (retrieved January 18, 2022)

The guidance provides first a choice of options for a series of payments commencing in 2022:

> The guidance in this notice replaces the guidance in Rev. Rul. 2002-62 and Notice 2004-15 for any series of payments commencing on or after January 1, 2023, and it may be used for a series of payments commencing in 2022.[295]

As well, the ruling provides that, for taxpayers using the required minimum distribution method to compute their substantially equal payment amounts, using the updated tables will not be treated as an impermissible modification of the payment stream.

> In the case of a series of payments commencing in a year prior to 2023 using the required minimum distribution method, if the payments in the series are calculated by substituting the Single Life Table, the Joint and Last Survivor Table, or the Uniform Lifetime Table described in section 3.02(a) of this notice for the corresponding table that was used under Rev. Rul. 2002-62, then the substitution will not be treated as a modification within the meaning of section 72(t)(4) or section 72(q)(3).[296]

Rules Apply to IRAs as Well as Employer Retirement Accounts

Although the notice consistently refers to the employee when talking about the primary beneficiary of the retirement account, the IRS notes that:

> In the case of distributions from an IRA, the IRA owner is treated as an employee for purposes of applying this notice.[297]

Methods of Taking Substantially Equal Periodic Payments

As with prior rulings, this ruling provides that taxpayers are considered to have taken substantially equal periodic payments if they take payments using one of the following three methods as described in this ruling:

- The required minimum distribution method
- The fixed amortization method
- The fixed annuitization method.[298]

[295] Notice 2022-6, January 18, 2022, Section 4

[296] Notice 2022-6, January 18, 2022, Section 4

[297] Notice 2022-6, January 18, 2022, Section 3.02(f)

[298] Notice 2022-6, January 18, 2022, Section 3.01

Required Minimum Distribution Method

Under the *required minimum distribution method* the annual payment is determined by dividing

- The account balance for that distribution year by
- The number of years from the chosen life expectancy table (described later) for that distribution year.[299]

The guidance provides:

> Under this method, the account balance, the number of years from the chosen life expectancy table, and the resulting annual payments are redetermined for each distribution year. This redetermination of the annual payment is not considered a modification of the series of substantially equal periodic payments, provided that the required minimum distribution method continues to be used and the same life expectancy tables continue to be used, except to the extent required in section 3.02(b) of this notice.[300]

Section 3.02(b) of the notice deals with the use of the Joint and Last Survivor table for determining the appropriate life expectancy.

Fixed Amortization Method

Under the *fixed amortization method,* the annual payment is determined as the amount that will result in the level amortization of the account balance:

- Over a specified number of years using one of the life expectancy methods provided for in this Notice and
- Using an interest rate that is permitted under this notice.[301]

The Notice points out the following:

> Under this method, once the account balance, the number of years from the chosen life expectancy table, and the resulting annual payment are determined for the first distribution year, the annual payment is the same amount in each succeeding distribution year.[302]

Fixed Annuitization Method

Under the fixed annuitization method the annual payment for each year is determined by dividing the account balance by an annuity factor that is the present value of an annuity of $1 per year beginning at the employee's age and continuing for the life of the employee (or the joint lives of the employee and designated beneficiary).[303]

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[299] Notice 2022-6, January 18, 2022, Section 3.01(a)

[300] Notice 2022-6, January 18, 2022, Section 3.01(a)

[301] Notice 2022-6, January 18, 2022, Section 3.01(b)

[302] Notice 2022-6, January 18, 2022, Section 3.01(b)

[303] Notice 2022-6, January 18, 2022, Section 3.01(c)

The annuity factor is derived using:

- The mortality tables found in Reg. §1.409(a)(9)-9(e) and
- An interest rate that is permitted under this notice.[304]

Again, the notice points out the following effect of using this method:

> Under this method, once the account balance, the annuity factor, and the resulting annual payment are determined for the first distribution year, the annual payment is the same amount in each succeeding distribution year.[305]

Life Expectancy Tables

The life expectancy tables that can be used to determine distribution periods under the required minimum distribution method and fixed amortization method are:

- The Uniform Lifetime Table found in Appendix A of this notice;
- The Single Life Table in § 1.401(a)(9)-9(b); or
- The Joint and Last Survivor Table in § 1.401(a)(9)-9(d) (which can be used even if the designated beneficiary is not the spouse).[306]

The notice provides the following method for determining the employee/IRA account holder's age and, if applicable, the designated beneficiary's age:

> The number of years that is used for the required minimum distribution method for a distribution year is the entry from the table for the employee's age on the employee's birthday in that distribution year. If the Joint and Last Survivor Table is used, the age of the designated beneficiary on the designated beneficiary's birthday in the distribution year is also used.[307]

The following rules apply when the required minimum distribution method is used:

> In the case of the required minimum distribution method, except as provided section 3.02(b)[308] or section 4[309] of this notice, the same life expectancy table that is used for the first distribution year must be used in each following distribution year. Thus, if the employee uses the Single Life Table to apply the required minimum distribution method in the first distribution year, the Single Life Table must be used in subsequent distribution years.[310]

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[304] Notice 2022-6, January 18, 2022, Section 3.01(c)

[305] Notice 2022-6, January 18, 2022, Section 3.01(c)

[306] Notice 2022-6, January 18, 2022, Section 3.02(a)

[307] Notice 2022-6, January 18, 2022, Section 3.02(a)

[308] Related to the designated beneficiary under the Joint and Last Survivor table

[309] The effective date and transition rules discussed earlier

[310] Notice 2022-6, January 18, 2022, Section 3.02(a)

The following rule applies to those using the fixed amortization method:

> The number of years that is used to apply the fixed amortization method is the entry from the table for the employee's age on the employee's birthday in the first distribution year (and, if applicable, the designated beneficiary's age on the designated beneficiary's birthday in that year).[311]

Designated Beneficiary When Using the Joint and Survivor Annuity Table

The notice first provides rules for identifying the proper beneficiary when the Joint and Survivor Annuity method is used.

> If the Joint and Last Survivor Table in § 1.401(a)(9)-9(d) is used to apply the required minimum distribution method or the fixed amortization method (or if the fixed annuitization method is applied using an annuity factor determined for the joint lives of the employee and designated beneficiary), then the beneficiary whose life expectancy or expected mortality is used must be the actual designated beneficiary of the employee with respect to the account for the year of the determination.[312]

The designated beneficiary rules refer to the rules that apply for required minimum distributions from retirement plans. The notice references those provisions for determining the proper beneficiary when more than one beneficiary is designated.

> If the employee has more than one beneficiary, the identity and age of the designated beneficiary used for purposes of each of the methods described in section 3.01 of this notice are determined under the rules for determining the designated beneficiary for purposes of section 401(a)(9).[313]

The notice also provides that the beneficiary is determined as of January 1 of the distribution year in question:

> The designated beneficiary is determined for a distribution year as of January 1 of the distribution year, without regard to changes in the designated beneficiary later in that distribution year or designated beneficiary determinations in prior distribution years.[314]

The notice provides the following example to illustrate this rule.

EXAMPLE

For example, if an IRA owner starts distributions from an IRA in 2023 at age 50, and applies either the required minimum distribution method or fixed amortization method using the Joint and Last Survivor Table for the IRA owner and the designated beneficiary, and the beneficiaries on January 1, 2023 are 25 and 55 years old, the number of years used to calculate the payment for 2023 would be 40.2 (the entry from the

[311] Notice 2022-6, January 18, 2022, Section 3.02(a)

[312] Notice 2022-6, January 18, 2022, Section 3.02(b)

[313] Notice 2022-6, January 18, 2022, Section 3.02(b)

[314] Notice 2022-6, January 18, 2022, Section 3.02(b)

Joint and Last Survivor Table for ages 50 and 55), even if later in 2023 the 55-year-old is eliminated as a designated beneficiary.

However, under the required minimum distribution method, if the 55-year-old beneficiary is eliminated or dies in 2023, that individual would not be taken into account in future distribution years (and if there is no designated beneficiary in a future year, the Single Life Table in § 1.401(a)(9)-9(b) is used for that distribution year).[315]

Interest Rates

The interest rate used for the fixed amortization method or the fixed annuitization method can be no more than the greater of:

- 5% or
- 120% of the federal mid-term rate (determined in accordance with section 1274(d) for either of the two months immediately preceding the month in which the distribution begins).[316]

Analysis

The 5% rate option is added by this Notice. Previously Revenue Ruling 2002-62, which governed this calculation, only allowed a maximum rate of 120% of the federal mid-term rate.

Links to the Revenue Rulings that include the mid-term rates are found at: https://apps.irs.gov/app/picklist/list/federalRates.html.

Account Balance

The notice provides the following rules for determining the account balance:

> For purposes of applying the required minimum distribution method, the account balance for a distribution year is determined under § 1.401(a)(9)-5. For the fixed amortization and fixed annuitization methods, the account balance must be determined in a reasonable manner based on the facts and circumstances. The account balance will be treated as determined in a reasonable manner if it is the account balance on any date within the period that begins on December 31 of the year prior to the date of the first distribution and ends on the date of the first distribution.[317]

The notice provides that a taxpayer will be treated as making a modification to a series of periodic payments if there is a modification to the account balance after the valuation date chosen above. The modification will occur if, after that date, there is

- Any addition to the account balance other than by reason of investment experience,

[315] Notice 2022-6, January 18, 2022, Section 3.02(b)

[316] Notice 2022-6, January 18, 2022, Section 3.02(c)

[317] Notice 2022-6, January 18, 2022, Section 3.02(d)

- Any transfer of a portion of the account balance to another retirement plan, or
- A rollover of the amount received by the employee.[318]

If such a modification is made it will trigger the recapture tax under IRC §72(t)(4)(A), which will result in all previously avoided early distribution penalties being due.

Exception from Modification When Account Exhausted Solely By Following Allowable Distribution Method

If things go wrong for the taxpayer, it may turn out that taking the required distributions under the method selected may exhaust the entire account prematurely. The Notice provides the following relief from the recapture tax in this case:

> If, as a result of following a method of determining substantially equal periodic payments that qualifies for the exception of section 72(t)(2)(A)(iv), an individual's assets in an individual account plan or an IRA are exhausted, any resulting reduction in the amount of the final payment (and the subsequent cessation of payments) is not a modification within the meaning of section 72(t)(4). Accordingly, the recapture tax described in section 72(t)(4)(A) will not apply in this case.[319]

Permitted One Time Switch to Required Minimum Distribution Method

The Notice allows a taxpayer to make a one-time switch to the required minimum distribution method if that method was not selected initially:

> An individual who begins distributions using either the fixed amortization method or the fixed annuitization method is permitted in any subsequent distribution year to switch to the required minimum distribution method to determine the payment for the distribution year of the switch and all subsequent distribution years, and this change in method will not be treated as a modification within the meaning of section 72(t)(4). Once a change is made under this paragraph, any subsequent change from the required minimum distribution method will be a modification for purposes of section 72(t)(4).[320]

Application to Distributions from Non-Qualified Annuities

The Notice also provides that these rules can be used for non-qualified annuity substantially equal distribution payments as well:

> Taxpayers may use one of the methods set forth in section 3.01 of this notice (applying the rules in section 3.02 of this notice) to determine whether a distribution from a non-qualified annuity contract is part of a series of substantially equal periodic payments under section 72(q)(2)(D). Taxpayers may use the principles of

[318] Notice 2022-6, January 18, 2022, Section 3.02(d)

[319] Notice 2022-6, January 18, 2022, Section 3.03(a)

[320] Notice 2022-6, January 18, 2022, Section 3.03(b)

> section 3.03 of this notice to determine whether a change in substantially equal periodic payments will be treated as a modification under section 72(q)(3).[321]

SECTION: 108
LENDERS INSTRUCTED NOT TO ISSUE FORMS 1099C FOR STUDENT LOAN DISCHARGES EXCLUDED FROM INCOME BY ARPA PROVISION

Citation: Notice 2022-01, 12/21/21

American Rescue Plan Act Section 9675 revised IRC §108(f)(5) to provide a temporary rule for the exclusion from income of certain discharges of student loan debt. In Notice 2021-01[322] the IRS provides that lenders are not to issue Forms 1099-C, *Cancellation of Debt*, for discharges that qualify for this relief.

The Notice describes the income exclusion as follows:

> Under this special rule, gross income does not include any amount which would otherwise be includible in gross income by reason of the discharge (in whole or in part) after December 31, 2020, and before January 1, 2026, of loans provided for postsecondary educational expenses, whether the loan was provided through the educational institution or directly to the borrower. Such loans must have been made, insured, or guaranteed by the United States, or an instrumentality or agency thereof, a State, territory, or possession of the United States, or the District of Columbia, or any political subdivision thereof, or an eligible educational institution. Additionally, certain private education loans and loans made by certain educational organizations qualify for this special rule.[323]

The Notice provides that the lender should not issue a Form 1099-C for this discharge, explaining it is likely to generate an erroneous notice from the IRS to the borrower:

> When all or a portion of a student loan described in section 108(f)(5) is discharged after December 31, 2020, and before January 1, 2026, an applicable entity is not required to, and should not, file a Form 1099-C information return with the IRS or furnish a payee statement to the borrower under section 6050P as a result of the discharge. The filing of an information return with the IRS, although not required, could result in the issuance of an underreporter notice (IRS Letter CP2000) to the borrower through the IRS's Automated Underreporter program, and the furnishing of a payee statement to the borrower could cause confusion for a taxpayer with a tax-exempt discharge of debt.[324]

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[321] Notice 2022-6, January 18, 2022, Section 3.04

[322] Notice 2022-01, December 21, 2021, https://www.irs.gov/pub/irs-drop/n-22-01.pdf (retrieved December 21, 2021)

[323] Notice 2022-01, SECTION 2, December 21, 2021

[324] Notice 2022-01, SECTION 3, December 21, 2021

SECTION: 162
APPLICATION OF FORECLOSURE PROCEEDS COULD CREATE DEDUCTIBLE INTEREST EXPENSE, BUT TAXPAYER FAILED TO SHOW IT ACTUALLY DID SO

Citation: Howland v. Commissioner, TC Memo 2022-60, 6/13/22

The Tax Court had to look at a taxpayer's attempt to claim a deduction for interest paid on a home equity credit line by the application of funds when the property was foreclosed in the case of *Howland v. Commissioner*, TC Memo 2022-60.[325] And the Tax Court found that the answer isn't quite as clear as you might expect at first glance.

Facts of the Taxpayer's Case

This case revolves around a taxpayer who had two loans secured by his residence that ended up in foreclosure. A first mortgage was held by Bank of New York Mellon, as successor in interest to Countrywide Home Loans while a second mortgage was held by CenterState Bank. The total amounts outstanding on the loans at the time of the foreclosure for the principal, interest and fees on both loans was $624,106.

The opinion describes the case as follows:

> In June 2014 First Southern Bank merged with CenterState Bank. Since petitioners had not made any payments on the Haven Trust Bank credit agreement, First Southern Bank filed a verified complaint for foreclosure (foreclosure complaint) in the Seventh Judicial Circuit Court for St. Johns County, Florida (circuit court). When the foreclosure complaint was filed, petitioners owed $377,060 in principal on the credit agreement, plus accrued interest, fees, and other charges. In the foreclosure action First Southern Bank sought an award from the circuit court for the full amount due from petitioners, including the right to foreclose on petitioners' residence based on the granted credit agreement.
>
> As part of the foreclosure complaint, the circuit court entered a summary final judgment, resulting in a foreclosure sale of petitioners' residence on July 28, 2016. CenterState Bank was the highest bidder at the foreclosure sale and acquired the residence with a bid of $321,000. At the time of the foreclosure sale, the sum of the accrued interest on the credit agreement was $100,607.
>
> On June 9, 2016, a second foreclosure complaint regarding petitioners' residence was filed in the circuit court by the first mortgage holder, Bank of New York Mellon, as successor in interest to Countrywide Home Loans. Bank of New York Mellon claimed a balance due of principal, interest, late charges, attorney's fees, and other permitted expenses of $247,046.

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[325] *Howland v. Commissioner*, TC Memo 2022-60, June 13, 2022, https://www.taxnotes.com/research/federal/court-documents/court-opinions-and-orders/home-mortgage-interest-deduction-denied-after-foreclosure/7dkn3 (retrieved June 14, 2022)

> On December 30, 2016, CenterState Bank sold petitioners' residence to third parties for $594,000. No Internal Revenue Service (IRS) Form 1098, Mortgage Interest Statement, was issued to petitioners for tax year 2016 for the home mortgage interest in question. There is no evidence in the record as to how the sale proceeds of $594,000 were applied to petitioners' debts with First Southern Bank and Bank of New York Mellon.[326]

The taxpayers claimed over $100,000 of mortgage interest deductions for the year of the foreclosures, a year in which the only payment on the notes came from the foreclosure transactions.

Tax Court Analysis

The Court's summary of the positions of the parties reads as follows:

> Petitioners argue that the foreclosure of their mortgage constituted a taxable sale or exchange. Next, petitioners contend the fair market value of the residence is equal to the price that a willing buyer paid shortly after the foreclosure. On the basis of the terms of the credit agreement, petitioners contend the amount CenterState Bank received in the foreclosure proceedings and specifically in the subsequent sale to a third party should be applied first to their outstanding interest owed, and then to principal. …
>
> On the other hand, respondent argues that petitioners are not entitled to the home mortgage interest deduction claimed on their 2016 Form 1040. According to respondent, the foreclosure bid did not cover the principal balance due from petitioners to CenterState Bank, after payment of the first mortgage balance due to Countrywide Home Loans. Accordingly, no interest amount was paid to CenterState Bank at the time of the foreclosure sale.[327]

There is no question that if the interest in question was paid, it was otherwise home mortgage interest deductible on Schedule A. But the key question was if interest had actually been paid on the second mortgage.

The Tax Court summarized the general rule for applying payments on the mortgage, as well as the impact of a foreclosure:

> The general rule in this area is that voluntary partial payments made by a debtor to a creditor are, in the absence of any agreement between the parties, to be applied first to interest and then to principal. See *Lackey v. Commissioner*, T.C. Memo. 1977-213, 36 T.C.M (CCH) 890. However, an exception to this general rule exists in the case of an involuntary foreclosure of mortgaged property where the evidence "strongly indicates" that the mortgagor is insolvent at the time of foreclosure. See *Newhouse v. Commissioner*, 59 T.C. 783, 789 (1973).
>
> Rejecting the interest first rule, we held in *Newhouse* and *Lackey* that no portion of the proceeds from either of the foreclosure sales therein was allocable to interest since the debtors were insolvent. While in *Estate of Bowen v. Commissioner*, 2 T.C. 1 (1943), we applied the proceeds from a foreclosure sale to interest first and then to

[326] *Howland v. Commissioner*, TC Memo 2022-60, June 13, 2022

[327] *Howland v. Commissioner*, TC Memo 2022-60, June 13, 2022

> principal where the debtor was not shown to be insolvent and the payments, in spite of foreclosure, were said to be voluntary.[328]

But the court notes that this situation is not exactly like any of the prior cases:

> In this case the payments were not voluntary; however, there is no evidence petitioners were insolvent at the time of the foreclosure. Furthermore, unlike Lackey and Newhouse, this case involves a clear written agreement — namely the credit agreement — between the lender and petitioners that repayments on the note are applied first to interest. Consequently, we find our decisions in Lackey and Newhouse to be distinguishable.[329]

The court notes that the IRS argued that since, once the obligation to the first mortgage holder was satisfied, there wasn't enough funds left to pay off the second mortgage's principal balance, that meant none of the payment would count as interest expense:

> The core dispute in these cases relates to the application of the proceeds from the foreclosure sale of petitioners' home. Respondent does not dispute that the amount realized under the foreclosure proceeding by CenterState was $594,000; rather, respondent contends that petitioners ignore the property's first mortgage of $247,046, resulting in a net difference of $346,954 — which is less than the principal balance of $377,060 due to CenterState, and consequently petitioners paid no interest.
>
> We agree, in part, with respondent's argument. While respondent is correct that CenterState did not realize the full $594,000, but rather received only $346,954 after the first mortgage was satisfied, we cannot definitively conclude that CenterState received only the payment of principal from petitioners.[330]

The Court outlines how it plans to analyze the matter:

> It is undisputed that the principal balance due to CenterState was $377,060; however — as petitioners argued — under the terms of the credit agreement, delinquent payments were to be first applied to interest due from petitioners, rather than to principal. Therefore, we must analyze the terms of the foreclosure action and its tax implications here.
>
> Per the judgment issued by the circuit court, the total amounts due included principal of $377,060, interest computed to March 8, 2016, of $65,482, appraisal fees of $650, and deferred interest of $26,139. These four amounts total $469,331. At the time of the foreclosure sale, the sum of the accrued and deferred interest on the credit agreement equaled $100,607. Petitioners contend that CenterState, as successor in interest and holder of the promissory note, was contractually bound to apply the foreclosure proceeds first to interest and second to principal. Respondent, however, argues that these payment provisions found in the promissory note are not applicable here in the context of a foreclosure sale.[331]

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[328] *Howland v. Commissioner*, TC Memo 2022-60, June 13, 2022

[329] *Howland v. Commissioner*, TC Memo 2022-60, June 13, 2022

[330] *Howland v. Commissioner*, TC Memo 2022-60, June 13, 2022

[331] *Howland v. Commissioner*, TC Memo 2022-60, June 13, 2022

While the analysis seems like it may come out in the taxpayers' favor, the Court eventually found that the taxpayer failed to carry the burden of proof:

> The record before us is silent as to how CenterState applied the funds received and whether petitioners owe any remaining principal balance. These facts (if favorable) could support a finding that petitioners in fact paid home mortgage interest (in some amount) — rather than repaying principal balance. However, statements in briefs do not constitute evidence. Rule 143©; *Evans v. Commissioner*, 48 T.C. 704, 709 (1967), *aff'd per curiam*, 413 F.2d 1047 (9th Cir. 1969); *Chapman v. Commissioner*, T.C. Memo. 1997-147; *Berglund v. Commissioner*, T.C. Memo. 1995-536. Pertinent facts missing from the stipulation merely mean that the party bearing the burden of proof has failed to sustain the burden of showing them. See *Evans*, 48 T.C. at 709.
>
> Petitioners bear the burden of proof and must show, by a preponderance of the evidence, that they are entitled to a home mortgage interest deduction of $103,498, or some other amount. For the reasons discussed above, we conclude that petitioners have failed to meet their burden. Accordingly, we will sustain respondent's determination to disallow this deduction claimed by petitioners.[332]

The Court makes it clear that a deduction is possible in a case like this—but the taxpayer must show more than this taxpayer showed.

SECTION: 170 CHARITABLE DEDUCTION DISALLOWED FOR FAILURE TO MEET CONTEMPORANEOUS WRITTEN ACKNOWLEDGMENT RULES

Citation: Albrecht v. Commissioner, TC Memo 2022-53, 5/25/22

A taxpayer found her deduction for a donation of property to a museum was denied entirely for failing to meet the substantiation requirements of IRC §170(f)(8)(B) in the case of *Albrecht v. Commissioner*, TC Memo 2022-53.[333]

Substantiation Requirements

In order to obtain a charitable contribution deduction, various substantiation requirements must be made that vary based on the type of gift (cash, noncash, autos, etc.) and the amount being claimed. This case involves the substantiation provisions Congress placed in IRC §170(f)(8). The provision reads:

> (8) Substantiation requirement for certain contributions.
>
> > (A) General rule. No deduction shall be allowed under subsection (a) for any contribution of $250 or more unless the taxpayer substantiates the contribution by a contemporaneous written acknowledgment of the

[332] *Howland v. Commissioner*, TC Memo 2022-60, June 13, 2022

[333] *Albrecht v. Commissioner*, TC Memo 2022-53, May 25, 2022, https://www.taxnotes.com/research/federal/court-documents/court-opinions-and-orders/individual-can%e2%80%99t-deduct-museum-donation%2c-tax-court-says/7dj70 (retrieved May 26, 2022)

contribution by the donee organization that meets the requirements of subparagraph (B).

(B) Content of acknowledgement. An acknowledgement meets the requirements of this subparagraph if it includes the following information:

(i) The amount of cash and a description (but not value) of any property other than cash contributed.

(ii) Whether the donee organization provided any goods or services in consideration, in whole or in part, for any property described in clause (i).

(iii) A description and good faith estimate of the value of any goods or services referred to in clause (ii) or, if such goods or services consist solely of intangible religious benefits, a statement to that effect.

For purposes of this subparagraph, the term "intangible religious benefit" means any intangible religious benefit which is provided by an organization organized exclusively for religious purposes and which generally is not sold in a commercial transaction outside the donative context.

(C) Contemporaneous. For purposes of subparagraph (A), an acknowledgment shall be considered to be contemporaneous if the taxpayer obtains the acknowledgment on or before the earlier of--

(i) the date on which the taxpayer files a return for the taxable year in which the contribution was made, or

(ii) the due date (including extensions) for filing such return.

(D) Regulations. The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this paragraph, including regulations that may provide that some or all of the requirements of this paragraph do not apply in appropriate cases.[334]

In this case the IRS was questioning the content of the acknowledgement. Reg. §1.170A-13(f)(2) provides the following additional guidance for the content of this written acknowledgement:

(2) Written acknowledgement. Except as otherwise provided in paragraphs (f)(8) through (f)(11) and (f)(13) of this section, a written acknowledgment from a donee organization must provide the following information--

(i) The amount of any cash the taxpayer paid and a description (but not necessarily the value) of any property other than cash the taxpayer transferred to the donee organization;

[334] IRC §170(f)(8)

(ii) A statement of whether or not the donee organization provides any goods or services in consideration, in whole or in part, for any of the cash or other property transferred to the donee organization;

(iii) If the donee organization provides any goods or services other than intangible religious benefits (as described in section 170(f)(8)), a description and good faith estimate of the value of those goods or services; and

(iv) If the donee organization provides any intangible religious benefits, a statement to that effect.[335]

In this case, the ultimate question was if the documentation in question provided a statement regarding whether any goods or services were received as part of the donation, more specifically did it establish that no goods or services were received.

Facts of the Case

The decision describes Ms. Albrecht's donation as follows:

> On or around December 19, 2014, petitioner donated approximately 120 items from this collection (donation) to the Wheelwright Museum of the American Indian (Wheelwright Museum). In connection with the donation the Wheelwright Museum and petitioner executed a "Deed of Gift" (deed) dated December 19, 2014, that consisted of five pages. The first page stated that petitioner "hereby donates the material described below to the Wheelwright Museum of the American Indian under the terms stated in the Conditions Governing Gifts to the Wheelwright Museum of the American Indian." Immediately under this clause was the heading "Description of Material: See Attached List." The first page also included the museum's logo, petitioner's address, and her donor identification number, as well as the signatures of petitioner and a museum official.
>
> The second page of the deed was titled "Conditions Governing Gifts to the Wheelwright Museum of the American Indian" and specified conditions governing gifts to the museum. One of these conditions stipulated in relevant part that "the donation is unconditional and irrevocable; that all rights, titles and interests held by the donor in the property are included in the donation, unless otherwise stated in the Gift Agreement." The final three pages of the deed listed items of donated property. Despite "the Gift Agreement" reference on the second page of the deed, no such agreement was included with the deed, and the Wheelwright Museum did not provide petitioner with any further written documentation concerning the donation.[336]

The IRS argued that a failure to provide the Gift Agreement referenced on the deed meant the deed itself did not contain the necessary statement regarding goods or services being provided in exchange for the contribution. Thus, on exam, the IRS denied the deduction and the case ended up before the Tax Court.

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[335] Reg. §1.170A-13(f)(2)

[336] *Albrecht v. Commissioner*, TC Memo 2022-53, May 25, 2022

Tax Court's Decision

The Tax Court begins by noting that the requirement to obtain proper contemporaneous written acknowledgement (CWA) of a charitable contribution must be strictly followed or the entire deduction is lost:

> A CWA is not required to take any particular form but the requirement that a CWA be obtained "is a strict one." *15 W. 17th St. LLC*, 147 T.C. at 562; see also *Izen v. Commissioner*, 148 T.C. 71, 78 (2017) (noting that a deed of gift can serve as a de facto CWA). A taxpayer may not deduct the contribution if the donation acknowledgment fails to meet these strict demands. See *15 W. 17th St. LLC*, 147 T.C. at 562 (emphasizing that the doctrine of substantial compliance does not apply for purposes of section 170(f)(8)); see also *Addis v. Commissioner*, 374 F.3d 881, 887 (9th Cir. 2004) ("The deterrence value of . . . [a] total denial of a deduction [in the case of an improper CWA] comports with the effective administration of a self-assessment and self-reporting system."), *aff'g* 118 T.C. 528 (2002).[337]

The IRS argues that what Ms. Albrecht provided failed to meet these requirements:

> Specifically, respondent points out the reference in the deed to the "Gift Agreement" as creating ambiguity as to whether additional terms, including donee provision of goods or services, were part of the donation.[338]

The taxpayer argues that the failure to provide a Gift Agreement is not fatal to the documents that were provided meeting the CWA requirements:

> Petitioner contends that the Gift Agreement is irrelevant to the issue of whether the Wheelwright Museum provided goods or services in exchange for the donation because the sole purpose of the Gift Agreement was to describe the extent to which petitioner retained certain rights, titles, or interests in the donation. Petitioner also insists that the Wheelwright Museum's failure to provide her with a Gift Agreement "indicates the presumption that all [of] [p]etitioner's right[s], title[s] and interest[s] in the donated property [are] included in the donation."[339]

It is possible, clearly, that no such Gift Agreement exists and that, therefore there would be no modification. But the Court wasn't willing to accept that view. The Court states:

> We do not find these arguments persuasive when construing the plain text of the deed. By referencing another document that superseded the terms of the deed with respect to the donor's rights in the donation, the deed provided the donor with the ability to retain an interest in the donation, including under a potential quid pro quo arrangement.
>
> Petitioner cited no authority for the proposition that a separate agreement referenced in a deed but unattached thereto creates a presumption that the deed alone satisfies section 170(f)(8). We are unwilling to create such a rule, especially when the deed did not indicate it constituted the entire agreement of the parties or

[337] *Albrecht v. Commissioner*, TC Memo 2022-53, May 25, 2022

[338] *Albrecht v. Commissioner*, TC Memo 2022-53, May 25, 2022

[339] *Albrecht v. Commissioner*, TC Memo 2022-53, May 25, 2022

> that any prior discussions, negotiations, or understandings between them were merged into the deed. When looking exclusively at the deed and considering it as a whole, it leaves open a significant question about whether the parties had entered into a side agreement that included additional, superseding terms. See *French*, T.C. Memo. 2016-53, at *10-12 (refusing to uphold as a CWA a deed that, when analyzed as a whole, did not represent the entire agreement between the donee and donor).[340]

The Court did not indicate it believed that Ms. Albrecht had, in fact, received goods or services in exchange for the donation or had retained a substantial interest—but that wasn't the issue that would decide the case:

> We appreciate what appears to have been a good faith attempt by petitioner to substantially comply with the Code by executing the deed with the Wheelwright Museum. Substantial compliance, unfortunately for petitioner, does not satisfy the strict requirements of section 170(f)(8)(B). See *15 W. 17th St. LLC*, 147 T.C. at 562. Thus, for the reasons given above, petitioner is not entitled to a charitable contribution deduction with respect to the donation as the deed does not satisfy these requirements.[341]

This is an area where being very detail oriented and double-checking documents to assure they strictly meet the requirements is key. It matters not that the contribution was actually made and no goods or services were received unless the acknowledgment contains that statement and is received by the time prescribed.

An even more arguably unfair result is found in the 2012 case of *Durden v. Commissioner*, TC Memo 2012-140.[342] There the taxpayer had two different acknowledgments. The first, received by the taxpayer prior to the date the taxpayer timely filed his return, omitted the statement that no goods or services were received for the donation. The second, obtained when the IRS agent pointed out the flaw in the original document, added the required language but was obtained well after the date the return had been timely filed—after all, the exam didn't start until well after that date.

The Tax Court found that, in those facts, the taxpayer had not met the substantiation rules. The first acknowledgement was missing the required statement, so it could not be a proper CWA. The second, while containing all necessary information, was issued too late to be a proper CWA. With no proper CWA, the taxpayer was denied nearly $25,000 in deductions for contributions all parties agreed were made by the taxpayer to the charity in the year in question and for which he received no goods or services in exchange for making.

SECTION: 170
FIFTH CIRCUIT RULES SUBSTANTIAL COMPLIANCE CANNOT

[340] *Albrecht v. Commissioner*, TC Memo 2022-53, May 25, 2022

[341] *Albrecht v. Commissioner*, TC Memo 2022-53, May 25, 2022

[342] *Durden v. Commissioner*, TC Memo 2012-140, May 17, 2012

EXCUSE FAILURE TO FOLLOW CHARITABLE CONTRIBUTION REQUIREMENTS FOUND IN THE STATUTE

Citation: Izen v. Commissioner, CA5, Docket No. 21-60679, 6/29/22

The Fifth Circuit Court of Appeals sustained the Tax Court's decision[343] denying a taxpayer a charitable contribution deduction in the case of *Izen v. Commissioner*[344] finding that a taxpayer must strictly follow the documentation requirements set out by Congress in the statute to obtain a charitable contribution deduction.

This case was covered back when the Tax Court released its decision in 2017 on our tax update webpage[345] and involved a taxpayer's attempt to claim a deduction for a donation for an aircraft on an amended income tax return.

IRC §170(f)(12) reads:

> (12) Contributions of used motor vehicles, boats, and airplanes.
>
> (A) In general. In the case of a contribution of a qualified vehicle the claimed value of which exceeds $500--
>
> (i) paragraph (8) shall not apply and no deduction shall be allowed under subsection (a) for such contribution unless the taxpayer substantiates the contribution by a contemporaneous written acknowledgement of the contribution by the donee organization that meets the requirements of subparagraph (B) and includes the acknowledgement with the taxpayer's return of tax which includes the deduction, and
>
> (ii) if the organization sells the vehicle without any significant intervening use or material improvement of such vehicle by the organization, the amount of the deduction allowed under subsection (a) shall not exceed the gross proceeds received from such sale.
>
> (B) Content of acknowledgement. An acknowledgement meets the requirements of this subparagraph if it includes the following information:
>
> (i) The name and taxpayer identification number of the donor.
>
> (ii) The vehicle identification number or similar number.

[343] *Izen v. Commissioner*, 145 TC No. 5, March 1, 2017

[344] *Izen v. Commissioner,* CA5, Docket No. 21-60679, June 29, 2022, https://www.taxnotes.com/research/federal/court-documents/court-opinions-and-orders/fifth-circuit-affirms-denial-of-deduction-for-airplane-donation/7dlzl (retrieved June 30, 2022)

[345] Ed Zollars, CPA, "Doctrine of Substantial Compliance Did Not Apply to Taxpayer Who Failed to Meet Documentation Requirements for Donation of Used Airplane," *Current Federal Tax Developments* website, March 2, 2017, https://www.currentfederaltaxdevelopments.com/blog/2017/3/2/doctrine-of-substantial-compliance-did-not-apply-to-taxpayer-who-failed-to-meet-documentation-requirements-for-donation-of-used-airplane (retrieved June 30, 2022)

(iii) In the case of a qualified vehicle to which subparagraph (A)(ii) applies--

(I) a certification that the vehicle was sold in an arm's length transaction between unrelated parties,

(II) the gross proceeds from the sale, and

(III) a statement that the deductible amount may not exceed the amount of such gross proceeds.

(iv) In the case of a qualified vehicle to which subparagraph (A)(ii) does not apply--

(I) a certification of the intended use or material improvement of the vehicle and the intended duration of such use, and

(II) a certification that the vehicle would not be transferred in exchange for money, other property, or services before completion of such use or improvement.

(v) Whether the donee organization provided any goods or services in consideration, in whole or in part, for the qualified vehicle.

(vi) A description and good faith estimate of the value of any goods or services referred to in clause (v) or, if such goods or services consist solely of intangible religious benefits (as defined in paragraph (8)(B)), a statement to that effect.

(C) Contemporaneous. For purposes of subparagraph (A), an acknowledgement shall be considered to be contemporaneous if the donee organization provides it within 30 days of--

(i) the sale of the qualified vehicle, or

(ii) in the case of an acknowledgement including a certification described in subparagraph (B)(iv), the contribution of the qualified vehicle.

The simplest way to satisfy these documentation requirements is for the taxpayer to attach a Form 1098-C provided by the charity for the donation of the covered item to the tax return. The charity is required to provide this document both to the taxpayer and the IRS.[346]

7878 ☐ VOID ☐ CORRECTED

DONEE'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no.	1 Date of contribution	OMB No. 1545-1959 Form **1098-C** (Rev. November 2019) For calendar year 20 ____	**Contributions of Motor Vehicles, Boats, and Airplanes**
	2a Odometer mileage		
	2b Year / 2c Make / 2d Model		
DONEE'S TIN / DONOR'S TIN	3 Vehicle or other identification number		
DONOR'S name	4a ☐ Donee certifies that vehicle was sold in arm's length transaction to unrelated party		
Street address (including apt. no.)	4b Date of sale		
City or town, state or province, country, and ZIP or foreign postal code	4c Gross proceeds from sale (see instructions) $		**Copy A**

5a ☐ Donee certifies that vehicle will not be transferred for money, other property, or services before completion of material improvements or significant intervening use

5b ☐ Donee certifies that vehicle is to be transferred to a needy individual for significantly below fair market value in furtherance of donee's charitable purpose

5c Donee certifies the following detailed description of material improvements or significant intervening use and duration of use

6a Did you provide goods or services in exchange for the vehicle? . . . . ▶ Yes ☐ No ☐

6b Value of goods and services provided in exchange for the vehicle
$

6c Describe the goods and services, if any, that were provided. If this box is checked, donee certifies that the goods and services consisted solely of intangible religious benefits . . . . ▶ ☐

7 Under the law, the donor may not claim a deduction of more than $500 for this vehicle if this box is checked . . . . . . ▶ ☐

For Internal Revenue Service Center

File with Form 1096.

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Form **1098-C** (Rev. 11-2019) Cat. No. 39732R www.irs.gov/Form1098C Department of the Treasury - Internal Revenue Service

However, in this case that did not take place, so the question became whether other documents the taxpayer did provide fulfilled these requirements.

The Fifth Circuit panel's decision discussed the documents that Mr. Izen provided, but comes to the same conclusion as the Tax Court that these fell short of meeting the statutory requirements.

> Izen did not provide a satisfactory contemporaneous written acknowledgement with his Form 1040X. Izen included a letter dated December 30, 2010, from the Society discussing the donation of the airplane, but the letter was addressed to Philippe Tanguy, not Izen. The letter does not mention Izen and does not provide his taxpayer identification number. The letter cannot substantiate the contribution of

[346] IRC §170(f)(12)(D)

> the airplane under § 170(f)(12)(B)(i). Izen also included a copy of the donation agreement between him, Tanguy, and the Society, but the agreement fails to satisfy § 170(f)(12)(B)(i) as it lacks Izen's taxpayer identification number. Finally, Izen attached a Form 8283 to his Form 1040X, but the Form 8283 did not include his taxpayer number.[347]

In footnotes to the above paragraph, the court discusses additional problems with the submitted documentation. First, they reject the taxpayer's attempt to have the court look at a different letter that wasn't submitted with the claim for refund on the Form 1040X:

> Izen asks us to also examine a different letter from the Society, addressed to him but not attached to his Form 1040X, the relevant filing for our analysis. Because this alternate letter was not attached to Izen's Form 1040X, we cannot consider it; even if we could, it similarly lacks his taxpayer identification number.[348]

The panel also finds additional faults with the Form 8283 that was submitted with Mr. Izen's Form 1040X:

> Further, Izen's Form 8283 was not a contemporaneous written acknowledgment by the donee organization as it was not signed by the Society until 2016, well past thirty days of the donation. Izen argues that a written acknowledgement is contemporaneous if produced within thirty days of the filing, but this argument conflicts with the clear statutory definition. Under 26 U.S.C. § 170(f)(12)(c), an acknowledgment is contemporaneous if it is provided by the donee organization within thirty days of the contribution. Section 170(f)(12)(c) does not reference the timing of the taxpayer's filing.[349]

The panel agrees with the Tax Court that the doctrine of substantial compliance does not apply in this case, in particular because these requirements were set by Congress in the statute, rather than by Treasury in regulations:

> Izen argues that he substantially complied with the requirements and that the documents he provided should be read together with the return to substantiate his claimed deduction. The doctrine of substantial compliance may support a taxpayer's claim where he or she acted in good faith and exercised due diligence but nevertheless failed to meet a ***regulatory*** requirement. We cannot accept the argument that substantial compliance satisfies ***statutory*** requirements. Congress specifically required the contemporaneous written acknowledgment include the taxpayer identification number, but that is lacking here.[350]

The opinion, in a footnote, specifically cites a 2004 Ninth Circuit decision to support the proposition that substantial compliance does not apply to requirements found in the statute regarding charitable

[347] *Izen v. Commissioner,* CA5, Docket No. 21-60679, June 29, 2022

[348] *Izen v. Commissioner,* CA5, Docket No. 21-60679, June 29, 2022

[349] *Izen v. Commissioner,* CA5, Docket No. 21-60679, June 29, 2022

[350] *Izen v. Commissioner,* CA5, Docket No. 21-60679, June 29, 2022

contributions, no matter how minor the fault might appear (such as failing to show the taxpayer's identification number on the acknowledgement):

> See *Addis v. Comm'r*, 374 F.3d 881, 887 (9th Cir. 2004) (holding that the plain language of 26 U.S.C. § 170(f)(8) required a total denial of a charitable deduction where the taxpayer failed to comply with the statute; § 170(f)(8) is substantially similar to the provisions of § 170(f)(12) at issue here). See also *French v. Comm'r of Internal Revenue*, 111 T.C.M. (CCH) 1241 (2016) ("The doctrine of substantial compliance does not apply to excuse compliance with the strict substantiation requirements of section 170(f)(8)(B).").[351]

SECTION: 170
CONTRIBUTION DEDUCTION DISALLOWED DUE TO ASSIGNMENT OF INCOME AND FAILURE TO COMPLY WITH ACKNOWLEDGMENT REQUIREMENTS

Citation: Keefer v. United States, USDC ND TX, Case No. 3:20-cv-00836, 7/6/22

In the case of *Keefer v. United States*, USDC ND TX,[352] a taxpayer was denied a deduction for a contribution on two separate grounds. First, the Court found that the taxpayers had failed to give away the entire asset in question, resulting in an anticipatory assignment of income and, second, the taxpayers did not obtain a proper contemporary written acknowledgment of the contribution.

The Facts of the Case

The case involves the donation of an interest in a limited partnership. The opinion begins with the following facts:

> In 2015, when the events giving rise to this suit occurred, Burbank was a limited partnership existing for the purpose of owning and operating a single hotel property ("the Hotel"). See Doc. 66, Appraisal, 50, 54. Kevin was a limited partner in Burbank. Doc. 15, Am. Compl., ¶ 7; Doc. 69-5, Assignment Int., 19.
>
> On April 23, 2015, Burbank and Apple Hospitality REIT ("Apple"), exchanged a nonbinding letter of intent ("LOI") for a deal that included Apple's purchase of the Hotel.1 Doc. 66, Appraisal, 54; see Doc. 69-1, Keefer Dep., 11, 47. Burbank did not sign the LOI but continued negotiating for the Hotel's sale. Doc. 66, Appraisal, 54. Burbank was also considering other offers for the Hotel. Id. at 54–55; see Doc. 69-1, Keefer Dep., 11, 47. On June 18, 2015, Kevin assigned a 4% limited partner interest in Burbank to Pi for the purpose of establishing a donor advised fund ("DAF") at Pi. Doc. 69-5, Assignment Int., 19–20. As of that date, "[Burbank] had tentatively agreed on the sale of [the Hotel to Apple] for $54 million, but the

[351] *Izen v. Commissioner,* CA5, Docket No. 21-60679, June 29, 2022

[352] *Keefer v. United States*, USDC ND TX, Case No. 3:20-cv-00836, July 6, 2022, https://www.taxnotes.com/research/federal/court-documents/court-opinions-and-orders/couple-can't-deduct-donation%2c-not-entitled-to-refund/7dmkd?h=Keefer (retrieved July 16, 2022)

> contract for sale had not been signed and Apple had not conducted its review of the property and records." Doc. 66, Appraisal, 54; see Doc. 69-1, Keefer Dep., 11. On July 2, 2015, Burbank and Apple signed a contract for Apple to purchase the Hotel for $54 million. Doc. 69-4, Purchase Contract, 48–55; Doc. 69-5, Purchase Contract, 1; Doc. 66, Appraisal, 54. The contract provided for a 30-day review period for [Apple] to evaluate the property. Doc. 69-4, Purchase Contract, 54. The sale closed on August 11, 2015. Doc. 69-5, Closing Statement, 7–8.[353]

The opinion describes the appraisal the taxpayers commissioned to provide the value of the donation:

> To substantiate the donation, the Keefers' tax advisor commissioned an appraisal of the donated partnership interest as of June 18, 2015 ("the Appraisal"). See Doc. 66, Appraisal, 50–56. The Appraisal was performed by Katzen, Marshall & Associates, Inc. ("KM") and was prepared and signed by David Marshall ("Marshall"), a Principal of that firm. Id. at 56, 60. It included an appraiser's certification and a description of Marshall's qualifications but did not include either Marshall's or KM's tax identification numbers. See id. at 58–61. Additionally, the Appraisal included a section titled "Partnership Agreement," setting out "[c]ertain provisions of the [Burbank Partnership] Agreement[,]" including that agreement's definition of "Available Cash Flow" and the schedule for "Distribution of Available Cash Flow." Id. at 52–53.[354]

The appraisal noted an additional agreement that was part of the donation:

> The Appraisal indicated that its "purpose [was] estimating the fair market value of a 4.000% limited partnership interest, subject to an oral agreement, . . . in Burbank . . ., owned by Kevin." Id. at 50. Attached to the Appraisal was a "STATEMENT OF LIMITING CONDITIONS" describing the referenced oral agreement as follows:
>
>> [KM] ha[s] been informed that the Donor and Donee have an agreement that the Donee will only share in the next proceeds from the Seller's Closing Statement. The Donee will not share in Other Assets of the Partnership not covered in the sale.
>
> *Id.* at 57.[355]

The appraisal came to the following conclusion:

> After describing its method for calculating the donated asset's value, the Appraisal concluded that $1,257,000 "reasonably represent[ed] the fair market value, excluding Other Assets of the Partnership, of a 4.000% Limited Partnership Interest in Burbank . . . as of June 18, 2015," with "[a]ll estimates of value . . . subject to the attached Statement of Limiting Conditions and Appraisers' Certification." Id. at 56. The Appraisal indicated that "[Kevin] stated that at the Valuation Date, he was not aware of any material fact or condition that would . . . derail the sale . . . [and that] the Partnership had a second bidder at essentially the same price." Id. at 55. The Appraisal estimated a "5% probability of no sale." *Id*

[353] *Keefer v. United States*, USDC ND TX, Case No. 3:20-cv-00836, July 6, 2022

[354] *Keefer v. United States*, USDC ND TX, Case No. 3:20-cv-00836, July 6, 2022

[355] *Keefer v. United States*, USDC ND TX, Case No. 3:20-cv-00836, July 6, 2022

The taxpayers claimed a charitable deduction for the donation on their 2015 income tax return:

> In October 2016, the Keefers "timely filed their joint federal income tax return (Form 1040) for the year 2015." Doc. 15, Am. Compl., ¶ 9. "[They] deducted the Pi charitable contribution of $1,257,000 from income in their 2015 return on Schedule A." Id. Attached to the Form 1040 was Form 8283, signed by Marshall and listing KM's tax identification number. See Doc. 66, Claim for Refund, 29, 31; Doc. 66, Form 8283, 36. Also attached were the Appraisal, the DAF Packet, and the Acknowledgment Letter. See Doc. 66, Claim for Refund, 29, 31; Doc. 66, IRS Checklist, 66–71.[356]

The IRS would examine the return and would seek to disallow the deduction:

> In late July or early August of 2019 "the IRS sent plaintiffs [an examination report and] a Notice of Deficiency for the year 2015 [(collectively, 'the IRS Notice')] . . . disallow[ing the] 2015 charitable contribution to Pi, and thereby increas[ing] plaintiffs' 2015 tax by $423,304.00, along with penalties or additions of $84,660.80 plus accruing interest." Doc. 15, Am. Compl., ¶ 10; Doc. 66, IRS Notice, 4–22. The IRS Notice stated in relevant part:
>
>> It has not been established that the Taxpayers are entitled to deduct a charitable contribution in the amount of $1,257,000, [because] they did not have [a contemporaneous written acknowledgment ("CWA")] from the donee organization showing that the donor advised fund "has exclusive legal control over the assets contributed" and their appraisal did not include the identifying number of the appraiser. Therefore, this deduction is not allowable.
>
> Id. at 7.[357]

The taxpayers paid the amount of taxes and interest per the IRS assessment and then filed a claim for refund, which the IRS disallowed. The taxpayers then filed suit for refund in U.S. District Court.

The two questions that eventually decided the outcome in the case were:

- Did the agreement limiting the charity's interest to only sharing in the proceeds of the sale amount to an anticipatory assignment of income that would serve to bar the deduction? And
- Were the two documents the taxpayers submitted as their acknowledgment sufficient to meet the requirements found in IRC §170(f)(8) (the general acknowledgment rules) and (18) (special acknowledgment rules for contributions to donor advised funds)?

Anticipatory Assignment of Income

The IRS argued that the contribution made just before the sale was to close amounted to an anticipatory assignment of income from that sale, thus requiring the taxpayer to recognize the income from the sale rather than merely getting a charitable contribution deduction for the value of this noncash asset (the interest in the partnership).

[356] *Keefer v. United States*, USDC ND TX, Case No. 3:20-cv-00836, July 6, 2022

[357] *Keefer v. United States*, USDC ND TX, Case No. 3:20-cv-00836, July 6, 2022

The opinion outlines the two criteria looked at in the *Humacid* case to determine if a contribution is an anticipatory assignment of income:

> "Per *Humacid Co. v. Commissioner*, 42 T.C. 894, 913 (1964), [courts will] respect the form of [a donation of appreciated stock shares] if the donor (1) gives the property away absolutely and parts with title thereto (2) before the property gives rise to income by way of a sale." *Dickinson v. Comm'r*, 2020 WL 5249242, at *3 (T.C. Sept. 3, 2020) (first citing *Grove v. Comm'r*, 490 F.2d 241, 246 (2d Cir. 1973); then citing *Carrington v. Comm'r*, 476 F.2d 704, 708 (5th Cir. 1973); then citing *Behrend v. United States*, 1972 WL 2627, at *3 (4th Cir. 1972); and then citing *Rauenhorst v. Comm'r*, 119 T.C. 157, 162–163 (2002)).[358]

While the Court disagreed with the IRS's view that the sale was in such a state at the time of the transfer of the interest that the transfer was after the property gave rise to the income, but agreed with the IRS that the interest retained by the taxpayers meant they had not given the property away absolutely and parted with the title.

On the first issue, the IRS was attempting to get the court to find that the sale was a done deal even though there was not yet a binding obligation for the sale to go forward at the time of the transfer. The Court notes:

> In a few cases, courts have extended this doctrine to situations where the stock's redemption was so imminent and certain that "the shareholder's corresponding right to income had already crystallized at the time of the gift." *Dickinson*, 2020 WL 5249242, at *3 (emphasis omitted) (citing *Palmer v. Comm'r*, 62 T.C. 684, 694–95 (1974)); see *Ferguson v. Comm'r*, 174 F.3d 997, 1001–02 (9th Cir. 1999). These courts have generally drawn the line where the corporation's shareholders or directors have already voted to redeem shares, creating a "binding obligation" of redemption. See Dickinson, 2020 WL 5249242 at *3. But the Ninth Circuit has extended this principle to situations where, considering the facts and circumstances of a particular deal, redemption is "practically certain to proceed" without a binding obligation. See id. at *3 n.2 (quoting *Ferguson*, 174 F.3d at 1004).[359]

Specifically, the IRS wanted this Texas District Court to apply the Ninth Circuit's standard outlined in the *Ferguson* case to this fact pattern:

> The Government urges this Court to follow the Ninth Circuit's more expansive approach, as set out in *Ferguson*, in applying *Humacid* to this limited partnership interest. Doc. 68, Gov't's Br., 17. In *Ferguson*, a taxpayer donated shares of appreciated stock during an open tender offer window preceding a proposed merger. 174 F.3d at 998–1000. "[T]he tender offer, and hence the merger agreement, was conditioned on the . . . [tender] of at least 85% of the outstanding shares . . . by the expiration date of the tender offer. . . . However, this minimum tender condition was waivable at the sole discretion of [the acquiring company]." *Id.* at 999. As of the date the taxpayer assigned the shares, with "over one week remaining in the tender offer window," "over 50% of the outstanding . . . shares had been tendered, . . . [which the Tax Court found] was sufficient to ensure that [the acquiring company] would accept the tendered stock and thus unilaterally could and would proceed with the merger." *Id.* at 1004. The Tax Court therefore found this

[358] *Keefer v. United States*, USDC ND TX, Case No. 3:20-cv-00836, July 6, 2022

[359] *Keefer v. United States*, USDC ND TX, Case No. 3:20-cv-00836, July 6, 2022

> was an anticipatory assignment of the redemption income. *Id.* The Ninth Circuit affirmed the Tax Court's ruling that the anticipatory assignment doctrine applied, finding that the acquiring company's duty to consummate the merger had not been triggered as of the assignment date because the 85% tender threshold had not yet been satisfied, but that given the "momentum" of the deal and the interests of all the parties the merger was "most unlikely" to fail. Id. at 1005–1006.[360]

The Texas District Court was not bound by this Ninth Circuit precedent, since an appeal of this decision would be heard by the Fifth Circuit Court of Appeals, so the IRS was hoping this court would find the Ninth Circuit ruling persuasive even if the Court did not have to follow it.

But the District Court rejected the Ninth Circuit's analysis:

> The Court declines to extend the *Ferguson* approach to the real estate transaction at issue here. The uncontroverted evidence shows that the Keefers executed the agreement to assign the partnership interest to Pi on June 18, 2015. Doc. 69-5, Assignment Int., 19–20. The partnership executed the contract for sale of the Hotel on July 2, 2015. Doc. 69-4, Purchase Contract, 48–55; Doc. 69-5, Purchase Contract, 1–2. So, at the time of the assignment on June 18, 2015, the Hotel was not even under contract. And while Apple had sent an LOI to Burbank before that date, the LOI was nonbinding and was never signed by Burbank. Doc. 66, Appraisal, 54; see Doc. 69-1, Keefer Dep., 11; Doc. 69-1, LOI, 47–49. Moreover, even after the contract with Apple was signed, it provided Apple a 30-day review period. Doc. 69-4, Purchase Contract, 54. Until that review period elapsed, Apple had no binding obligation to close and the deal was not "practically certain" to go through. See *id.*[361]

Thus, the Court concludes that the transfer satisfied the second *Humacid* prong:

> Under these circumstances, the Partnership's right to the income from the Hotel sale had not yet vested when the Keefers assigned the interest to Pi. Thus, the pending sale — even if very likely to occur considering the presence of backup offers and as reflected in the appraiser's estimate that the risk of no sale was only 5% — does not render this donation an anticipatory assignment of income. See Doc. 66, Appraisal, 55; cf. *Caruth Corp.*, 865 F.2d at 649 ("The IRS . . . makes recourse to Justice Holmes['s] metaphor, and urges that we hold *Caruth* taxable upon the dividend because here the fruit was exceptionally ripe. . . . We fail to see why the ripeness of the fruit matters, so long as the entire tree is transplanted before the fruit is harvested.").[362]

But the last part of the final quoted sentence would prove to create problems for the first prong—the Court found that, in fact, the entire tree was not transplanted. Rather, the taxpayer retained all interests except the interest in the sales proceeds, which amounted to an effective assignment of the income only.

> However, the Court must still consider the first Humacid prong: whether by assigning the 4% interest "subject to an oral agreement" the Keefers "carve[d] . . . a partial interest out of the [assigned] asset." See *Salty Brine I, Ltd, v. United States*, 761 F.3d 484, 491 (5th Cir. 2014). If so, then they retained that partial interest in the asset

[360] *Keefer v. United States*, USDC ND TX, Case No. 3:20-cv-00836, July 6, 2022

[361] *Keefer v. United States*, USDC ND TX, Case No. 3:20-cv-00836, July 6, 2022

[362] *Keefer v. United States*, USDC ND TX, Case No. 3:20-cv-00836, July 6, 2022

> after the assignment and the anticipatory assignment of income doctrine would apply, as the whole asset was not transferred before the Hotel sale closed on August 11, 2015. See *id.*; Doc. 69-2, Closing Statement, 20–21. In other words, reverting to Justice Holmes's metaphor, did the Keefers transplant the whole tree on June 18, 2015, when Kevin assigned the interest to Pi? See *Caruth Corp.*, 865 F.2d at 649.[363]

The taxpayers argued that the oral agreement did not represent an impermissible retained interest. As the Court explained:

> The Keefers explain that "before Kevin . . . transferred the 4% partnership interest to Pi, the partnership owed money to the pre-existing partners for pre-donation earnings that had not been distributed to those pre-existing partners . . . because the partnership, as the owner of the [H]otel, was required . . . to maintain a certain amount of cash reserves . . . to comply with . . . loan and franchise obligations." Doc. 71, Pls.' Resp., 14. Kevin testified that the "oral agreement" referenced in the Appraisal was an agreement between the pre-assignment partners:
>
> > [T]he general partner had made the decision that [the reserve accounts] — since those were amounts withheld from earnings prior to the date of the gift, that the general partner was going to distribute that to the partners in their percentage of ownership prior to that date of the gift. It was his opinion and responsibility to pay those reserves in to the partners from the — where the earnings had been prior to — held back prior to the June 18th. The — what I told the Pi Foundation is we were going to distribute those reserves to a number of re — effectively a distribu — a liability at the time of the transfer to the partners. And they had — they acknowledged what we were doing and how we were gonna treat it, and so we were sure that the [appraisal] valuation was done that way. So that's what — I consider it an oral agreement in how we were treating that. We treated it as a liability at the time of the transaction, so all those reserves were distribution to the partners prior to June 135 [sic], that we had a liability to pay them, and that's why they weren't included in the valuation.
> >
> > Doc. 69-1, Keefer Dep., 30.
>
> The cash reserves in question, Kevin testified, were reflected on the partnership's balance sheet as "equipment reserves" and "working capital reserves." Id. at 32. The reason for keeping these reserves, which had been "reserved from the distributions that [the partnership had] been making from the partners," was so "if the [H]otel sale didn't go through [the partnership] would have the money to [make future renovations to the Hotel as required by the franchise agreement] because the Pi Foundation could not obviously contribute capital for the renovation," he testified. Id. at 34. So, if the Hotel sale occurred and the renovations would not be required "those reserves [would be released as] accrued distribution to those partners prior to the Pi Foundation being admitted." Id. However, Kevin testified that the franchise agreement did not require such cash reserves; they were reserved at the discretion of the general partner. Id. In sum, the Keefers argue that "[t]he partnership's payment of pre-existing liability to its pre-existing partners is not a 'carving out' from the 4% partnership interest to Pi any more than the partnership paying a liability for a pre-

[363] *Keefer v. United States*, USDC ND TX, Case No. 3:20-cv-00836, July 6, 2022

> existing light bill is a 'carving out' from some partnership interest." Doc. 74, Pls.' Reply, 4.[364]

The IRS argued that the taxpayers' own appraisal noted that they had not given away the entire partnership interest:

> The Government responds that "the Keefer's [sic] own appraisal that takes into account their side oral agreement . . . shows that they did not donate a true partnership interest . . . [but] g[a]ve away 4% of the net cash from the sale of one of the Partnership's assets . . . cash the Keefers would have otherwise received from the sale of the [H]otel. This is the classic assignment of income." Doc. 73, Gov't's Reply, 7–8.[365]

The opinion sides with the Government on this issue based on the details of the oral agreement provided by the taxpayers and their own appraisal:

> According to Kevin's testimony, the "reserve accounts" were funds that the general partner chose to maintain for compliance with "loan and franchise agreements" and that had been withheld from partner distributions at the discretion of the general partner. See Doc. 69-1, Keefer Dep., 30, 32, 34. Per his testimony, they were not liabilities like a pre-existing light bill. See id. Instead, they were a reserve of cash held back to address future potential liabilities. See id.
>
> Thus, as described by Kevin, the cash reserves fall within the Partnership Agreement's definition of "Available Cash Flow," which is set forth in the Appraisal. See Doc. 69-1, Appraisal, 207 (defining "Available Cash Flow" to include "any other funds, including, but not limited to, amounts previously set aside as reserves by the General Partner, deemed advisable in the discretion of the General Partner, for distribution as cash flow"). And per the Appraisal's recitation of the Partnership Agreement's provisions, "Available Cash Flow, if any, in each calendar quarter of a partnership year shall be allocated to and distributed among the Partners pro rata . . . at such time as the General Partner determines, but in no event later than thirty (30) days after the close of such calendar quarter of the Partnership year." *Id.* at 208. As Marshall noted: "The Agreement provides that available cash flow shall be distributed to the Partners." Id. at 209.
>
> By contrast, the Appraisal indicates that, pursuant to the "oral agreement," the interest donated to Pi would not be subject to the Partnership Agreement's Available Cash Flow provisions but to an alternative arrangement:
>
>> On June 18th, 2015, the donor transferred a 4.000% limited partnership interest in the Partnership to the Pi Foundation. By oral agreement, the Foundation and Donor agreed that the Foundation *would only share in the proceeds from Seller's Closing Statement; the Foundation would not receive its pro rata share in other net assets of the Partnership*.
>>
>> *Id.* at 209 (emphasis added).

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[364] *Keefer v. United States*, USDC ND TX, Case No. 3:20-cv-00836, July 6, 2022

[365] *Keefer v. United States*, USDC ND TX, Case No. 3:20-cv-00836, July 6, 2022

> Regarding this oral agreement, Kevin testified that upon the Hotel's sale, the partnership intended to take the sale proceeds, deduct the reserve funds from the proceeds and pay them out in shares to the pre-June 18 partners but not to Pi, and then disburse to Pi its 4% share of the remaining net proceeds. See id. He also testified that the donated interest as described in the Appraisal "is what [Pi] received." Doc. 69-1. Keefer Dep., 35.[366]

The Court concludes that the agreement described above clearly meant that less than the entire interest was transferred to the charity:

> Based on this evidence, the Court finds that no genuine issue of material fact exists as to whether the Keefers carved out a portion of the 4% partnership interest before donating it to Pi. They did. After the assignment, Pi did not have the right that other partners had to share in a distribution of Available Cash Flow as described in the Partnership Agreement, but only had a right to share in the net proceeds of the Hotel sale. See *id.* at 35; Doc. 69-1, Appraisal, 209 (noting that "the Foundation would only share in the proceeds from Seller's Closing Statement; the Foundation would not receive its pro rata share in other net assets of the Partnership"). Or, in the unlikely event the Hotel sale had not been completed as planned, Pi would not have shared equally with the other limited partners in the duty to contribute funds for renovation, should additional funds be required to fulfill the partnership's obligations under the loan or franchise agreements. See Doc. 69-1, Keefer Dep., 34 (noting that the pre-assignment reserves were needed because "the Pi Foundation could not obviously contribute capital for the renovation"). Reflecting this carve out, the Appraisal calculated a lower value for the donated interest than for a full 4% interest in all of the partnership's assets. Doc. 69-9, Appraisal, 594 ("All assets not included in the $54 million [sale price] have been excluded."); id. at 595 (calculating 4% of net sale proceeds without reserves). Accordingly, the Keefers did not donate their full 4% partnership interest on June 18, 2015, but donated only a portion thereof. They did not transplant the *whole* tree.[367]

Thus, no deduction would be allowed for this contribution, as it amounted to an anticipatory assignment of income.

Contemporaneous Written Acknowledgment Issue

Although the refund claim was doomed by the finding that the transfer was an anticipatory assignment of income, the Court also found that the lack of a proper contemporaneous written acknowledgment (CWA) also would prove fatal to this refund claim.

The opinion describes the general CWA rules found at IRC §170(f)(8):

> Section 170(f)(8) provides that a charitable deduction "for any contribution of $250 or more" shall not be allowed "unless the taxpayer substantiates the contribution by a [CWA] of the contribution by the donee organization that meets the requirements of subparagraph (B)." 26 I.R.C. §170(f)(8)(A). Subparagraph B requires in relevant part that a CWA state: (1) "The amount of cash and a description (but not value) of any property other than cash contributed"; and (2) "Whether the donee organization

[366] *Keefer v. United States*, USDC ND TX, Case No. 3:20-cv-00836, July 6, 2022

[367] *Keefer v. United States*, USDC ND TX, Case No. 3:20-cv-00836, July 6, 2022

> provided any goods or services in consideration, in whole or in part, for [the donated property.]" Id. § 170(f)(8)(B)(i–ii). [368]

The charity receiving this donation was a donor advised fund. Such donations are subject to additional requirements found at IRC §170(f)(18):

> A donation to a donor advised fund must also comply with § 170(f)(18), which requires:
>
> > A deduction . . . for any contribution to a donor advised fund . . . shall only be allowed if . . . the taxpayer obtains a [CWA](determined under rules similar to the rules of paragraph (8)(C)) from the sponsoring organization. . . of such donor advised fund that such organization has exclusive legal control over the assets contributed.
> >
> > *Id.* § 170(f)(18). [369]

Finally, the Court notes that taxpayers must strictly comply with these statutory requirements—substantial compliance is not sufficient when dealing with statutory requirements.

> Importantly, "[t]he doctrine of substantial compliance does not apply to excuse compliance with the substantiation requirements of section 170(f)(8)(B*)." Averyt v. Comm'r*, 2012 WL 2891077, at *4, (T.C. July 16, 2012) (citing *Durden v. Comm'r*, 2012 WL 1758655, at *4 (T.C. May 17, 2012)). Strict compliance is required. See *id.*[370]

The taxpayers claimed the two documents they provided complied with all applicable CWA requirements:

> The Keefers claim that they obtained a statutorily compliant CWA, including Pi's acknowledgment that it had full and exclusive legal control over the donated property. Doc. 65, Pls.' Br. Am. Mot., 16. They assert that "PI prepared two documents[,] . . . [the] one page [Acknowledgment Letter] dated [September 9]6, 2015, signed by the Executive Director of PI saying PI received the 'donation' and that '[n]o goods or services were provided in exchange' . . . [and the] 12 page [DAF Packet] also on PI letterhead dated June 8, 2015" (collectively, "the Pi Documents"), containing additional terms of the agreement. *Id.* The Pi Documents, collectively, are a statutorily sufficient CWA, the Keefers argue. Id. at 16–19. They argue that the Acknowledgment Letter, which satisfies § 170(f)(8), is supplemented by the DAF Packet, which proves that Pi exercised exclusive legal control over the property after the donation and therefore satisfies § 170(f)(18). *Id.*; Doc. 71, Pls.' Resp., 24.[371]

The IRS presents a number of objections, arguing that the Keefers failed to provide the required CWA:

> The Government responds with several alternative arguments. First, it contends that multiple documents cannot be combined to constitute a CWA unless the documents contain a merger clause. Doc. 72, Gov't's Resp., 18. But even if they could be, the

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[368] *Keefer v. United States*, USDC ND TX, Case No. 3:20-cv-00836, July 6, 2022

[369] *Keefer v. United States*, USDC ND TX, Case No. 3:20-cv-00836, July 6, 2022

[370] *Keefer v. United States*, USDC ND TX, Case No. 3:20-cv-00836, July 6, 2022

[371] *Keefer v. United States*, USDC ND TX, Case No. 3:20-cv-00836, July 6, 2022

> Government argues neither the DAF Packet nor the Acknowledgment Letter contains a statement that Pi had "exclusive legal control." Doc. 72, Gov't's Resp., 16. The Government argues that this exact language is required to satisfy §170(f)(18). Id. at 17. Or, if this specific language is not required, the Pi Documents "still fail[ ] to show that Pi had exclusive legal control," it maintains, because the DAF Packet does not include a merger clause and the interest was transferred subject to an oral agreement that "could wrestle the purported 'exclusive legal control'" away from Pi and back to the Keefers. Id. at 18.[372]

The Court finds that the June 5 packet must be excluded from consideration as part of the CWA and the September 9 letter standing alone is not sufficient to meet the CWA requirements.

One key problem with the June 5 packet is that it was issued *before* the donation took place on June 18 and at a time when there was no binding legal requirement for the Keefers to make the donation—thus it could not be acknowledging anything, as that implies an event that has already taken place:

> Here, the summary-judgment evidence shows, as a matter of law, that the DAF Packet did not complete the donation or legally obligate Kevin to donate the interest to Pi. While the DAF Packet stated that "Kevin . . . hereby transfers as an irrevocable gift to [Pi] . . . the [4.00% partnership interest]," Doc. 66, DAF Packet, 38, the actual assignment did not occur when Kevin signed the DAF Packet documents on June 8, but ten days later. Doc. 69-5, Assignment Int. Further, the DAF Packet's cover letter states in relevant part: "It is [Pi's] understanding that you intend to donate to [Pi] 4.00% of interest in Burbank. . . . you agree that if 4.00% of interest in Burbank . . . is not donated to [Pi] for any reason, you will be responsible for paying the [Pi]'s legal fees and costs associated with your anticipated donation." Doc. 69-1, DAF Packet, 84 (emphasis added). This establishes that, by signing the DAF Packet, Kevin was not legally obligated to complete the donation; rather, he was only legally obligated to pay Pi's legal expenses whether the donation occurred or not. See id; Doc. 69-5. Assignment Int. So, the DAF Packet is not a CWA because it did not acknowledge a contribution. See 26 I.R.C. § 170(f)(8)(A).[373]

The Court also found that the packet could not be combined with the letter issued following the actual donation to create a CWA, finding that the cases the taxpayer and the IRS cited did not support the view that the packet could be combined with the letter to form a CWA:

First, the court notes that each of the cases cited involve deeds related to conservation easements:

> *Averyt* and *French* each involved the donation of a conservation easement. In *Averyt*, the court held that a letter acknowledging a conservation easement donation was not a CWA because it did not state what portion of the donation was deductible and (incorrectly) indicated that some benefit was provided to the donor in exchange. See *Averyt*, 2012 WL 2891077, at *4. However, the court found that the conservation easement deed itself was a CWA, even though it did not state that "no goods or services were provided" for the donation:
>
>> [T]he conservation deed was signed by a representative from [the donee organization], provided a detailed description of the property and the

[372] *Keefer v. United States*, USDC ND TX, Case No. 3:20-cv-00836, July 6, 2022

[373] *Keefer v. United States*, USDC ND TX, Case No. 3:20-cv-00836, July 6, 2022

> conservation easement, and was contemporaneous with the contribution. Additionally, the conservation deed in the instant case states that the conservation easement is an unconditional gift, recites no consideration received in exchange for it, and stipulates that the conservation deed constitutes the entire agreement between the parties with respect to the contribution of the conservation easement. Accordingly, the conservation deed, taken as a whole, provides that no goods or services were received in exchange for the contribution. Consequently, we conclude that . . . the conservation deed in the instant case satisfies the substantiation requirements of section 170(f)(8).
>
> Id. at *5 (emphasis added).

> In *French*, taxpayers who did not receive a contemporaneous letter acknowledging their conservation easement donation similarly attempted to rely on their conservation easement deed as a CWA. *French*, 2016 WL 1160152, at *4. As in *Averyt*, the deed did not state that "no goods and services were received in exchange" for the donation. *Id.* But unlike in *Averyt*, the deed did not contain a merger clause stating that it was the entire agreement between the parties. *Id.* "Without such a provision," the court concluded, "the IRS could not have determined by reviewing the conservation deed whether petitioners received consideration in exchange for the contribution of the conservation easement . . . [and] the conservation deed taken as a whole is insufficient to satisfy section 170(f)(8)(B)(ii)." *Id.* Therefore, the court denied the charitable donation deduction. *Id.*[374]

The Court, noting that these cases merely show that deeds can serve as a CWA and that neither the IRS nor the taxpayers cited any cases expanding these holdings beyond deeds, comments on how they could apply to documents other than deeds:

> If these cases can be applied to documents other than deeds — which by their nature, substantiate a completed transfer of interest — they suggest that a court might consider outside documents to supplement an otherwise-deficient CWA so long as the plain text of the CWA directs and limits the inquiry. Cf. *French*, 2016 WL 1160152, at *4 ("[T]he deed taken as a whole must prove compliance." (emphasis added)); Izen, 148 T.C. at 78; Albrecht, 2022 WL 1664509, at *3 (noting that the court construes "the plain text of the deed"). But see *Irby v. Comm'r*, 139 T.C. 371 (2012).[375]

And here the September 9 letter falls short:

> Here, as discussed above, only the September 9, 2015 Acknowledgment Letter is a CWA on which to base this inquiry. The body of this letter reads in full:
>
> > Thank you for your donation to The Pi Foundation, Inc. of a 4.00% interest in Burbank HHG Hotel, LP. The Pi Foundation, Inc., is a 501©(3) nonprofit organization. Your contribution is tax-deductible to the extent

[374] *Keefer v. United States*, USDC ND TX, Case No. 3:20-cv-00836, July 6, 2022

[375] *Keefer v. United States*, USDC ND TX, Case No. 3:20-cv-00836, July 6, 2022

> allowed by law. No goods or services were provided in exchange for your generous financial donation. Please keep this page for your records.
>
> 69-1, Acknowledgment Letter, 98.

> Critically, the Acknowledgment Letter does not incorporate by reference or otherwise refer to the DAF Packet. See *id.* It does not reference the Keefer DAF at all, state that the donated interest is destined for any DAF, or even state that Pi is a provider of DAFs. See *id.* Therefore, the text of the Acknowledgment Letter does not provide the Court any basis on which to incorporate the DAF Packet's provisions.[376]

Effectively, the Court is agreeing with the IRS that only if this acknowledgment has incorporated the provisions of the packet by explicit reference could the contents of the packet have been considered as part of the CWA.

Thus, the Court finds the taxpayers failed to comply with the requirements of IRC §170(f)(18) for donations to donor advised funds even though the acknowledgment did comply with the general rules of §IRC 170(f)(8):

> So, the Court cannot read the DAF Packet together with the Acknowledgment Letter but must consider whether the Acknowledgment Letter alone proves compliance with each requirement of § 170(f)(8) and (18). As the Keefers admit, their tax advisor testified, and the IRS reviewer noted, the Acknowledgment Letter proves compliance with § 170(f)(8) but does not prove that Pi received exclusive legal control as § 170(f)(18) requires. See Doc. 71, Pls.' Resp., 24 (arguing that the DAF Packet establishes exclusive legal control); Doc. 66, IRS Checklist, 69 (indicating no statement of exclusive legal control); Doc. 69-3, Horowitz Dep., 341 (stating that the one-page CWA was "the acknowledgment required by Section 170(f)(8) of the [C]ode" and the DAF Packet was the acknowledgment issued "[i]n accordance with Section 170(f)(18)"). Therefore, because the Acknowledgment Letter does not reference the Keefer DAF or otherwise affirm Pi's exclusive legal control, as required by § 170(f)(18), the Keefers did not obtain a CWA satisfying each statutory requirement.[377]

IRC §170(f)(18)(B), Like §170(f)(8), Requires Strict Compliance With the Statute

The Court moves on to consider if IRC §170(f)(18)(B) requires the same strict statutory compliance as IRC §170(f)(8) and concludes that answer is yes.

> The Keefers argue that § 170(f)(18)(B)'s "only requirement is that there be an acknowledgment, in writing, in some form or fashion that acknowledges the fact that the charity has exclusive legal control of the contributed asset . . . after the

[376] *Keefer v. United States*, USDC ND TX, Case No. 3:20-cv-00836, July 6, 2022

[377] *Keefer v. United States*, USDC ND TX, Case No. 3:20-cv-00836, July 6, 2022

> donation." Doc. 74, Pls.' Reply, 8. But this is not what the Tax Code says. As noted above, § 170(f)(18) provides that:
>
>> A [charitable] deduction . . . for any contribution to a donor advised fund . . . shall only be allowed if . . . (B) the taxpayer obtains a contemporaneous written acknowledgment (determined under rules similar to the rules of paragraph (8)(C)) from the sponsoring organization (as so defined) of such donor advised fund that such organization has exclusive legal control over the assets contributed.
>>
>> 26 I.R.C. § 170(f)(18) (emphasis added).
>
> By its plain text, § 170(f)(18)(B) supplements and cross references the CWA requirements of § 170(f)(8), which require strict compliance. See *Averyt*, 2012 WL 2891077, at *4; *Albrecht*, 2022 WL 1664509, at *2. Therefore, the Court holds that § 170(f)(18)(B) likewise requires strict compliance.[378]

The opinion does not agree with the IRS argument that the specific words "exclusive legal control" must appear in the document—just that the CWA must acknowledge that such control exists:

> However, strict compliance with § 170(f)(18)(B) does not mean that the exact words "exclusive legal control" must appear in the CWA, as the Government argues. See Doc. 68, Gov't's Br., 27. Instead, it means that the CWA must prove that the "organization has exclusive legal control," which might be accomplished without that specific language. Cf. *Schrimsher v. Comm'r*, 2011 WL 1135741, at *2 (T.C. 2011) (quoting H.R. Rep. No. 103–213, at 565 n.32 (1993) (Conf. Rep.) ("The contemporaneous written acknowledgment 'need not take any particular form' . . . [but] must include [the statutorily required] information.").[379]

But in this case the document falls short of meeting that standard:

> Here, as the Court has explained above, the only CWA the Keefers obtained completely fails to address legal control over the donated property. So, the CWA does not contain the information required by § 170(f)(18)(B). The IRS properly denied the deduction for this reason. See Doc. 66, IRS Checklist, 71 (indicating "not met" as to the exclusive legal control requirement).[380]

SECTION: 401
IRS DELAYS INITIAL EFFECTIVE DATE OF RMD PROPOSED

[378] *Keefer v. United States*, USDC ND TX, Case No. 3:20-cv-00836, July 6, 2022

[379] *Keefer v. United States*, USDC ND TX, Case No. 3:20-cv-00836, July 6, 2022

[380] *Keefer v. United States*, USDC ND TX, Case No. 3:20-cv-00836, July 6, 2022

REGULATIONS, GRANTS RELIEF FOR CERTAIN 2021 AND 2022 PAYMENTS

Citation: Notice 2022-53, 10/7/22

The IRS in Notice 2022-53[381] has announced that the agency will not impose penalties on failures to take *specified RMDs* for 2021 and 2022 that were required under provisions of proposed regulations issued to deal with changes in required minimum distributions (RMDs) under the SECURE Act passed in late 2019.

The notice described the provisions of the proposed regulations as follows:

> In order to satisfy section 401(a)(9)(B)(i), the beneficiary of an employee who died after the employee's required beginning date must take an annual required minimum distribution beginning in the first calendar year after the calendar year of the employee's death. In order to satisfy section 401(a)(9)(B)(ii), the remaining account balance must be distributed by the 10th calendar year after the calendar year of the employee's death (subject to an exception under section 401(a)(9)(B)(iii), if applicable). In order to satisfy both of those requirements, the proposed regulations generally provide that, in the case of an employee who dies after the employee's required beginning date with a designated beneficiary who is not an eligible designated beneficiary (and for whom the section 401(a)(9)(B)(iii) alternative to the 10-year rule is not applicable), annual RMDs must continue to be taken after the death of the employee, with a full distribution required by the end of the 10th calendar year following the calendar year of the employee's death.
>
> In accordance with section 401(a)(9)(B)(iii), in the case of a designated beneficiary who is an eligible designated beneficiary, the proposed regulations include an alternative to the 10-year rule under which annual lifetime or life expectancy payments are made to the beneficiary beginning in the year following the year of the employee's death. Under the proposed regulations, if an eligible designated beneficiary of an employee is using the lifetime or life expectancy payment alternative to the 10- year rule, then the eligible designated beneficiary (and, after the death of the eligible designated beneficiary, the beneficiary of the eligible designated beneficiary) must continue to take annual distributions after the death of the employee (with a full distribution made no later than the 10th year after the year of the eligible designated beneficiary's death). The proposed regulations provide for similar treatment (that is, continued annual RMDs with a requirement to take a full distribution no later than the 10th year after a specified event) in the case of a designated beneficiary who is a minor child of the employee (with the specified event being the child's reaching the age of majority).[382]

The IRS noted that a number of commentators indicated that they had not interpreted the law in this fashion and, for that reason, many individuals who inherited accounts from decedents in pay status had not taken such distributions in 2021. As the IRS did not release the proposed regulations until February 24, 2022, it was too late to timely take any such required distribution for 2021:

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[381] Notice 2022-53, October 7, 2022, https://www.irs.gov/pub/irs-drop/n-22-53.pdf (retrieved October 7, 2022)

[382] Notice 2022-53, October 7, 2022

> During that period, some individuals who are owners of inherited IRAs or are beneficiaries under qualified defined contribution plans or section 403(b) plans submitted comments indicating that they thought the new 10-year rule would apply differently than what was proposed in the proposed regulations. Specifically, commenters believed that, regardless of when an employee died, the 10-year rule would operate like the 5-year rule, under which there would not be any RMD due for a calendar year until the last year of the 5- or 10-year period following the specified event (the death of the employee, the death of the eligible designated beneficiary, or the attainment of the age of majority for the employee's child who is an eligible designated beneficiary). Commenters in those situations who are heirs or beneficiaries of individuals who died in 2020 explained that they did not take an RMD in 2021 and are unsure of whether they would be required to take an RMD in 2022. Commenters asserted that, if final regulations adopt the interpretation of the 10-year rule set forth in the proposed regulations, the Treasury Department and the IRS should provide transition relief for failure to take distributions that are RMDs due in 2021 or 2022 pursuant to section 401(a)(9)(H) in the case of the death of an employee (or designated beneficiary) in 2020 or 2021.[383]

Delayed Application of the Provision

In the Notice, the IRS announced that the provisions in the regulations will apply no earlier than 2023:

> Final regulations regarding RMDs under section 401(a)(9) of the Code and related provisions will apply no earlier than the 2023 distribution calendar year.[384]

Relief from the Consequences of Failing to Make or Take an RMD

Per the title of Section IV of the Notice, the guidance covers "Certain RMDs for 2021 and 2022."[385]

The notice first provides relief to defined contribution retirement plans that did not make a *specified RMD*:

> A defined contribution plan that failed to make a specified RMD (as defined in Section IV.C of this notice) will not be treated as having failed to satisfy section 401(a)(9) merely because it did not make that distribution.[386]

For individuals who failed to take a *specified RMD* the following relief is provided:

> To the extent a taxpayer did not take a specified RMD (as defined in Section IV.C of this notice), the IRS will not assert that an excise tax is due under section 4974. If a taxpayer has already paid an excise tax for a missed RMD in 2021 that constitutes a specified RMD, that taxpayer may request a refund of that excise tax.[387]

[383] Notice 2022-53, October 7, 2022

[384] Notice 2022-53, October 7, 2022

[385] Notice 2022-53, October 7, 2022

[386] Notice 2022-53, October 7, 2022

[387] Notice 2022-53, October 7, 2022

The Notice defines a *specified RMD* as follows:

> For purposes of this notice only, a specified RMD is any distribution that, under the interpretation included in the proposed regulations, would be required to be made pursuant to section 401(a)(9) in 2021 or 2022 under a defined contribution plan or IRA that is subject to the rules of 401(a)(9)(H) for the year in which the employee (or designated beneficiary) died if that payment would be required to be made to:
>
> - a designated beneficiary of an employee under the plan (or IRA owner) if: (1) the employee (or IRA owner) died in 2020 or 2021 and on or after the employee's (or IRA owner's) required beginning date, and (2) the designated beneficiary is not taking lifetime or life expectancy payments pursuant to section 401(a)(9)(B)(iii); or
>
> - a beneficiary of an eligible designated beneficiary (including a designated beneficiary who is treated as an eligible designated beneficiary pursuant to section 401(b)(5) of the SECURE Act) if: (1) the eligible designated beneficiary died in 2020 or 2021, and (2) that eligible designated beneficiary was taking lifetime or life expectancy payments pursuant to section 401(a)(9)(B)(iii) of the Code.[388]

SECTION: 415
COST OF LIVING RETIREMENT AND FRINGE BENEFIT AMOUNTS FOR 2023 PUBLISHED BY THE IRS

Citation: Notice 2022-55, 10/21/22

The IRS issued inflation adjusted retirement plan and fringe benefit numbers for 2022 in Notice 2022-55.[389]

Item	2023	2022
Annual Benefit Under a Defined Contribution Plan (IRC §415(b)(1)(A)	$ 265,000	$ 245,000
Limitation for Defined Contribution Plans (IRC §415(c)(1)(A)	66,000	61,000
Limitation on Exclusion for Elective Deferrals (IRC §402(g))	22,500	20,500
Annual Compensation Limit (IRC §§401(a)(17), 404(l), 408(k)(3)(C), and 408(k)(6)(D)(ii))	330,000	305,000

[388] Notice 2022-53, October 7, 2022

[389] Notice 2022-55, October 21, 2022, https://www.irs.gov/pub/irs-drop/n-22-55.pdf

Item	2023	2022
Key Employee in a Top Heavy Plan (IRC §416(i)(1)(A)(i)	215,000	200,000
Highly Compensated Employee (IRC §414(q)(1)(B))	150,000	135,000
Catch-up Contributions to Employer Plans Other than SIMPLEs (IRC §414(v)(2)(B)(i))	7,500	6,500
Catch-up Contributions to SIMPLE-IRAs and SIMPLE-401(k)s (IRC §414(v)(2)(B)(ii))	3,500	3,000
Annual Compensation Limitation for Certain Governmental Plans (IRC §401(a)(17))	490,000	450,000
Compensation Amount for Participation in a SEP (IRC §408(k)(2)(C))	750	650
Deferral Limitation for SIMPLE Retirement Accounts (IRC §408(p)(2)(E))	15,500	14,000
Limitation on Deferrals under IRC §457(e)(15) Governmental Plans and Tax-Exempt Organizations	22,500	20,500
Compensation Amount for an Officer Control Employee for Fringe Benefits (Reg. §1.61-21(f)(5)(i))	130,000	120,000
Compensation Amount for a Control Employee Based Solely on Compensation Reg. §1.61-21(f)(5)(iii))	265,000	245,000
IRA Deductible Contribution Amounts (IRC §219(b)(5)(A))	6,500	6,000

The Notice defines the ranges over which deductible IRA contributions phase out for individuals who are active participants in a qualified retirement plan are provided as:

Item	2023	2022
Married participants filing a joint return or qualifying widow(er)	$116,000 to $129,000	$109,000 to $119,000
Other statuses except married filing separate	$73,000 to $83,000	$68,000 to $78,0000
Married filing separate	$0 to $10,000	$0 to $10,000

Item	2023	2022
Married individual filing a joint who is not an active participant but whose spouse is an active participant	$218,000 to $228,000	$204,000 to $214,000

The adjusted gross income range over which the ability of a taxpayer to make a Roth IRA contribution phases out is as follows:

Item	2023	2022
Married participants filing a joint return or qualifying widow(er)	$218,000 to $228,000	$204,000 to $214,000
Single and head of household	$138,000 to $148,000	$129,000 to $144,000
Married filing separate	$0 to $10,000	$0 to $10,000

Unit

4

Business Tax Developments

LEARNING OBJECTIVES

When you have completed this unit, you will be able to accomplish the following.

- Prepare tax returns and advise clients in planning taking into account major developments occurring in the past year

SECTION: FINCEN
BROAD BENEFICIAL OWNER REPORTING REQUIREMENTS FOR MOST CORPORATIONS AND LLC COME INTO EFFECT IN 2024

Citation: RIN 1505-AB49, 9/30/22

Treasury's Financial Crimes Enforcement Network (FinCEN) released final regulations regarding financial transparency disclosures of beneficial corporate ownership per the Corporate Transparency Act (CTA).[390] At the same time Treasury released a "Beneficial Ownership Information Reporting Rules Fact Sheet"[391] that described the basic reporting requirements.

Entities Required to Report

Most small closely held corporations and LLCs will be required to file under this program once the program is underway. While there are a number of exempt categories, the largest exemption is for "large operating companies" under 31 CFR 1010.380(c)(2)(xiii) which is an entity that:

- Employs more than 20 full time employees in the United States,
- Has an operating presence at a physical office within the United States; and

[390] RIN 1505-AB49, September 30, 2022, https://www.govinfo.gov/content/pkg/FR-2022-09-30/pdf/2022-21020.pdf, retrieved September 30, 2022

[391] "Beneficial Ownership Information Reporting Rule Fact Sheet," Financial Crimes Enforcement Network web page, September 29, 2022, https://www.fincen.gov/beneficial-ownership-information-reporting-rule-fact-sheet (retrieved September 30, 2022)

- Filed a Federal income tax or information return in the United States for the previous year demonstrating more than $5,000,000 in gross receipts or sales.

Since most privately held companies will fall below those limitations, they will be required to file the information return with FinCEN or face large financial consequences, as the other exceptions to filing are generally very specialized and narrow.

Initial Reports

Initial reports will be required to be filed as follows:

- Any domestic reporting company created before January 1, 2024 and any entity that became a foreign reporting company before January 1, 2024 shall file a report not later than January 1, 2025,

- Any domestic reporting company created on or after January 1, 2024 shall file a report within 30 calendar days of the earlier of the date on which it receives actual notice that its creation has become effective or the date on which a secretary of state or similar office first provides public notice, such as through a publicly accessible registry, that the domestic reporting company has been created,

- Any entity that becomes a foreign reporting company on or after January 1, 2024 shall file a report within 30 calendar days of the earlier of the date on which it receives actual notice that it has been registered to do business or the date on which a secretary of state or similar office first provides public notice, such as through a publicly accessible registry, that the foreign reporting company has been registered to do business, and

- Any entity that no longer meets the criteria for any exemption under paragraph (c)(2) of this section shall file a report within 30 calendar days after the date that it no longer meets the criteria for any exemption.[392]

Obviously, that initial report will require a lot of clients of local and regional CPA firms to file a report during 2024.

Information Found in the Initial Report

The initial report will contain the following information:

- For the reporting company:

  - The full legal name of the reporting company;

  - Any trade name or "doing business as" name of the reporting company;

[392] 31 CFR 1010.308(a)(1)

  - A complete current address consisting of:
    - In the case of a reporting company with a principal place of business in the United States, the street address of such principal place of business; and
    - In all other cases, the street address of the primary location in the United States where the reporting company conducts business;
  - The State, Tribal, or foreign jurisdiction of formation of the reporting company;
  - For a foreign reporting company, the State or Tribal jurisdiction where such company first registers; and
  - The Internal Revenue Service (IRS) Taxpayer Identification Number (TIN) (including an Employer Identification Number (EIN)) of the reporting company, or where a foreign reporting company has not been issued a TIN, a tax identification number issued by a foreign jurisdiction and the name of such jurisdiction;
- For every individual who is a beneficial owner of such reporting company, and every individual who is a company applicant with respect to such reporting company:
  - The full legal name of the individual;
  - The date of birth of the individual;
  - A complete current address consisting of:
    - In the case of a company applicant who forms or registers an entity in the course of such company applicant's business, the street address of such business; or
    - In any other case, the individual's residential street address;
  - A unique identifying number and the issuing jurisdiction from one of the following documents:
    - A non-expired passport issued to the individual by the United States government;
    - A non-expired identification document issued to the individual by a State, local government, or Indian tribe for the purpose of identifying the individual;
    - A non-expired driver's license issued to the individual by a State; or
    - A non-expired passport issued by a foreign government to the individual, if the individual does not possess any of the documents described in paragraph (b)(1)(ii)(D)(1), (b)(1)(ii)(D)(2), or (b)(1)(ii)(D)(3) of this section; and
- An image of the document from which the unique identifying number in paragraph (b)(1)(ii)(D) of this section was obtained.[393]

[393] 31 CFR 1010.308(b)(1)

A beneficial owner is defined as:

> For purposes of this section, the term "beneficial owner," with respect to a reporting company, means any individual who, directly or indirectly, either exercises substantial control over such reporting company or owns or controls at least 25 percent of the ownership interests of such reporting company.[394]

The regulations contain a detailed description of items the create *substantial control* that would make an individual a beneficial owner at 31 CFR 1010.308(d)(1).

Requirement to File an Updated Report

If circumstances change and an updated report is required, it must be filed within 30 days after the date on which the change occurs.[395]

Penalties for Failure to Comply

Failure to comply with these reporting rules can lead to significant penalties. The website JDSPUPRA, reporting on Section 6403 of the CTA that provides for this reporting, noted:

> For willfully providing, or attempting to provide, false or fraudulent BOI or willfully failing to report (or provide an update report), the fines/penalties are:
>
> - Civil monetary penalties of $500 for each day that the violation continues or has not been remedied; and
>
> - Criminal penalties of not more than $10,000, imprisonment of not more than two years, or both.[396]

The article goes on to note a safe harbor exception for rapidly correcting an inaccurate report:

> There is a Safe Harbor for persons acting in good faith to correct inaccurate information submitted within 90 days of the inaccurate report.[397]

[394] 31 CFR 1010.308(d)

[395] 31 CFR 1010.308(a)(2)

[396] Baker Donelson, "Corporate Transparency Act Requires Beneficial Ownership Reports," JDSUPRA website, February 8, 2022, https://www.jdsupra.com/legalnews/corporate-transparency-act-requires-1852343/ retrieved September 30, 2022

[397] Baker Donelson, "Corporate Transparency Act Requires Beneficial Ownership Reports," JDSUPRA website, February 8, 2022

SECTION: 41
MORE INFORMATION PROVIDED BY IRS ON OPERATION OF NEW RESEARCH CREDIT AMENDED RETURN PROCEDURES

Citation: "Research Credit Claims (Section 41) on Amended Returns Frequently Asked Questions," IRS webpage, 2/9/22

The IRS has provided more information on its new policies related to claims for refund for research credits under IRC §41 in updates to its frequently asked questions (FAQ) page on research credit claims.[398] The IRS originally disclosed its new policies in FAA20214101F and an accompanying press release on October 15, 2021.

Under the revised IRS policy, every claim must contain five items of information at the time the claim is submitted. A claim omitting any of that information is deemed to not be a valid claim for refund and, in the view of the IRS, will also not qualify as an informal claim to preserve the taxpayer's right to continue the challenge if the statute of limitations has passed on filing the claim when the claim is rejected.

Research Credit Claim Based on Research Credit From a Passthrough Entity

The first addition to the FAQ deals with the situation where a taxpayer files an amended return based on a research credit from a passthrough entity. The new question reads as follows:

> **13. How do taxpayers who file a claim for refund that includes the Research Credit comply with the requirement to provide the five items of information when the claim is based on a Research Credit from a pass-through entity? (Updated February 8, 2022)[399]**

The IRS finds that the answer depends on whether this is a partnership and, if so, if it was covered by the BBA audit regime for the year in question. The answer provides that the partners in BBA covered partnership do not provide the information, but rather the partnership does in its administrative adjustment request:

> If a claim for refund that includes the Research Credit is based on a Research Credit from a BBA partnership, the BBA partnership does not file an amended return. Instead, the BBA partnership must file an administrative adjustment request (AAR) and attach the five items of information to that AAR. As part of the AAR process, the BBA partnership will also submit Forms 8985 and 8986 to the IRS and send Forms 8986 to its partners. The BBA partnership is not required to provide the five items of information again on the Forms 8985 and Forms 8986. The BBA partners

[398] "Research Credit Claims (Section 41) on Amended Returns Frequently Asked Questions," IRS webpage, Updated February 9, 2022, https://www.irs.gov/businesses/corporations/research-credit-claims-section-41-on-amended-returns-frequently-asked-questions (retrieved February 10, 2022)

[399] "Research Credit Claims (Section 41) on Amended Returns Frequently Asked Questions," IRS webpage, Updated February 9, 2022

> do not need to attach the five items of information to their original returns to which their Forms 8986 are attached.[400]

For other passthrough entities, the equity holders will need to include the information with their own amended returns claiming a refund.

> If a claim for refund that includes the Research Credit is based on a Research Credit from a non-BBA pass-through entity (such as a TEFRA partnership, S corporation, or other non-TEFRA/non-BBA partnership), the non-BBA pass-through entity may include the five items of information with its amended return. Partners or shareholders are required to include the five items of information with their amended tax return claiming the Research Credit. Partners or shareholders should receive the five items of information from the partnership or S corporation in which they are a partner or shareholder, for example, in the form of an amended Schedule K-1 (and any statements attached thereto).[401]

E-Filed Amended Returns and The Required Information

The IRS also answered a question regarding the impact electronically filing the amended return has on providing the required information:

> **14. Are taxpayers who e-file their amended tax return claiming a refund involving the Research Credit required to provide the five items of information with their e-filed amended tax return? (Updated February 8, 2022)**
>
> Yes. Please note, however, pass-through entity taxpayers (and their partners or shareholders) who e-file their amended tax returns should follow the requirements for providing the five items of information as stated in FAQ #13.[402]

Under What Conditions Can the Taxpayer Take the IRS Action Up with the Office of Appeals?

The final new question looks at when the taxpayer may challenge a determination related to a research credit claim by taking the case to Appeals. Not surprisingly, the IRS takes the position that if a claim is rejected for being deficient or unprocessible, the taxpayer does not have the right to take up that decision with the Office of Appeals:

> **15. If the IRS determines that a claim for refund involving the Research Credit is not valid, may a taxpayer challenge the determination before the IRS Independent Office of Appeals ("Appeals")? (Updated February 8, 2022)**
>
> Under existing IRS procedures, refund claims that are disallowed on the basis of a timeliness determination are eligible for consideration by Appeals. However, the

[400] "Research Credit Claims (Section 41) on Amended Returns Frequently Asked Questions," IRS webpage, Updated February 9, 2022

[401] "Research Credit Claims (Section 41) on Amended Returns Frequently Asked Questions," IRS webpage, Updated February 9, 2022

[402] "Research Credit Claims (Section 41) on Amended Returns Frequently Asked Questions," IRS webpage, Updated February 9, 2022

Appeals resolution process is not available for refund claims that are rejected on the basis that they are deficient or otherwise not processible.

Note that the IRS implemented a one-year transition period during which time taxpayers who file a claim for refund involving the Research Credit will be informed of a deficient claim for refund through Letter 6426C or 6428. The letter will indicate which of the five items of information is missing and provide the taxpayers with 45 days to perfect the filing. See FAQs 7 and 8, and the IRS Press Release for additional details. As noted in FAQ 1, the IRS continues to accept input and plans to closely monitor the process and questions during the one-year transition period to determine if any modifications are necessary. As such, comments can be sent to irs.feedback.recredit.claims@irs.gov.[403]

SECTION: 41
IRS ISSUES ADDITIONAL INFORMATION RELATED TO AND MAKES UPDATES TO PROCEDURES FOR RESEARCH CREDIT CLAIMS

Citation: "Memorandum for All Large Business and International and Small Business Self Employed Employees," LB&I-04-0122-001, 1/3/22

Following up on guidance issued in mid-October 2021 that the agency would be imposing new requirements on amended returns filed for research credit claims under IRC §41, the IRS has issued a memorandum to its employees on these new requirements[404] along with a web page of frequently asked questions (FAQ) on the issue.[405]

Contents of Original October 15 Advice

The original Field Advice[406] provided that the IRS would begin requiring specific information to be provided with each such claim and that if such information was not provided that the claim for refund would be rejected as invalid. Such a rejection would not be treated as the IRS formally denying the claim, as the Advice argued that such an invalid claim was not a proper claim for refund necessary to show that taxpayers had exhausted administrative remedies before pursuing a claim in court.

Thus, assuming the Advice's view of this issue is upheld when tested in actual litigation, taxpayers would need to submit an amended return that contained all information required in the proper form before the expiration of the statute of limitations for filing for such a claim.

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[403] "Research Credit Claims (Section 41) on Amended Returns Frequently Asked Questions," IRS webpage, Updated February 9, 2022

[404] "Memorandum for All Large Business and International and Small Business Self Employed Employees," LB&I-04-0122-001, January 3, 2022, https://www.irs.gov/pub/foia/ig/lbi-04-0122-0001.pdf (retrieved January 7, 2022)

[405] "Research Credit Claims (Section 41) on Amended Returns Frequently Asked Questions," IRS website, January 5, 2022 revision, https://www.irs.gov/businesses/corporations/research-credit-claims-section-41-on-amended-returns-frequently-asked-questions (retrieved January 7, 2022)

[406] Field Advice 20214101F, October 15, 2021

The Field Advice provided that the IRS would phase in the program as follows:

- For claims postmarked on January 10, 2022 or after,[407] the IRS will provide taxpayers with a 30-day grace period to perfect claims that did not meet the requirements before the claim would be rejected as invalid
- One year later (thus, for claims beginning January 10, 2023) the IRS will no longer provide a grace period to perfect such claims, and would rather simply reject them as invalid.

We published an article on these developments when they took place in October of 2021.[408]

January 3 Memorandum

The January 3 memorandum provides revisions to the Internal Revenue Manual to implement these procedures.

While many of the details remain the same, the IRS did change one key item—the grace period has been extended to 45 days from the 30-day period found in the original Field Advice.

> (1) For claims that include a claim for credit for increasing research activities ("research credit claim") filed January 10, 2022 through January 9, 2023 (the transition period) taxpayers will be given 45 days to perfect the claim that is timely filed but does not provide the five foundational criteria in IRM 4.46.3.7.x.
>
> …
>
> (3) During the transition period, a claim that includes a claim for research credit that would otherwise be considered timely pursuant to IRC 6511(a) but does not meet the requirements of IRM 4.46.3.7.x, will be considered timely filed if perfected within the 45-day timeframe. Taxpayers that fail to provide the required information as listed in IRM 4.46.3.7.x will be notified with Letter 6428, Claim for Credit for Increasing Research Credit Activities — Additional Information Required. The 45-day perfect period will start from the date Letter 6428 is issued. All refund claims that include a claim for research credit filed on or after January 10, 2023, will be subject to the general rules of IRC 6511(a).

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[407] "Research Credit Claims (Section 41) on Amended Returns Frequently Asked Questions," IRS website, January 5, 2022 revision

[408] Ed Zollars, "Memorandum Outlines Minimum Information That Will Be Required for a Research Credit Refund Claim to Be Accepted," *Current Federal Tax Developments* website, October 15, 2021, https://www.currentfederaltaxdevelopments.com/blog/2021/10/15/memorandum-outlines-minimum-information-that-will-be-required-for-a-research-credit-refund-claim-to-be-accepted (retrieved January 7, 2022)

The memorandum contains the following table[409] of items that any claim for refund related to a research credit must contain:

Item #	Information Needed	Description
1	Identify all the business components that form the factual basis of the IRC § 41 research credit claim for the claim year.	Business components as defined in IRC § 41(d)(2)(B) must be identified.
2	All research activities performed by business component.	This must include a description of what the taxpayer did, and how they did it, by business component. It does not need to describe the four-part test under IRC § 41(d)(1) in detail. Language that simply restates the requirements under the Code or Treasury Regulations is insufficient.
3	All individuals who performed each research activity by business component.	This can be a list, table, or narrative but must include the first and last name or title/position of the person or persons engaged in the research by business component.
4	All the information each individual sought to discover by business component.	This can be a list, table, or narrative providing the information each individual sought to discover.
5	The total qualified 1) employee wage expenses, 2) supply expenses, and 3) contract research expenses.	The claim should provide the total amount of each of these expense types. If the Form 6765 or its equivalent is properly completed, that will satisfy this item.

The memorandum also provides that:

> …a declaration signed under the penalties of perjury verifying that the facts provided are accurate is required. In most cases, the signature on Forms 1040X or 1120X serves this function.[410]

[409] "Memorandum for All Large Business and International and Small Business Self Employed Employees," LB&I-04-0122-001, January 3, 2022

[410] "Memorandum for All Large Business and International and Small Business Self Employed Employees," LB&I-04-0122-001, January 3, 2022

The memorandum directs employees who receive an invalid claim to provide the following warning to the taxpayer submitting that claim when it is rejected as invalid:

> If during an examination, the taxpayer submits a deficient claim for refund or raises an affirmative issue that does not meet the criteria for a claim for refund, examiners should advise the taxpayer to file a valid claim for refund (before the RSED expires) if they want to protect their opportunity to recover a refund related to the issue. LB&I examiners must refer to IRM 4.46.3.7.2.2, Claims Not Meeting the Standards of Treas. Reg. 301.6402-2. SB/SE examiners may generally consider the issues in a deficient claim.[411]

As the analysis in the original Field Advice concluded that the IRS had previously lost the ability to argue no valid claim had been filed to challenge a court filing by having worked the case, the memorandum warns IRS employees to avoid taking any actions involving considering the claim:

> **Exception:** For a deficient research credit claim, the claim issues must not be considered. See IRM 4.10.11.2.1.1.1 and IRM 4.46.3.7.X for additional information.
>
> (3) Examiners must not use claim letters or claim for refund language in reports (e.g., references to "disallowing the claim") for examinations where a deficient claim was raised; such language could be deemed as waiving the defects of the deficient claim.[412]

Claims Filed in the One Year from January 10, 2022 to January 9, 2023

The memorandum provides specific procedures IRS employees are to follow during the one-year transition period for claims:

- Evaluate the claim for the five criteria outlined in IRM 4.46.3.7.x and verify that it is signed under penalties of perjury to determine validity and document the results of the evaluation in the case file. This determination should generally be completed within 30 days after received in the field examination team.

- If the claim is determined to be valid, examiners will follow appropriate risking procedures and determine if an examination of the claim is warranted.

- If a claim is determined to be deficient, examiners will first issue Letter 6428, Claim for Credit for Increasing Research Credit Activities — Additional Information Required, allowing 45 days to perfect. If information that meets the requirements of IRM 4.46.3.7.x is received within the 45 days provided, the examiner will continue under normal risking procedures. If sufficient information to perfect the claim is not received pursuant to the process set forth in the letter, the claim will be considered deficient, and taxpayers will be issued Letter 6430, No Consideration, Section 41 Claim. Management (i.e. Territory Manager) and counsel must concur that the claim does not meet the criteria outlined in IRM 4.46.3.7.x prior to issuing Letter 6430.

- If the claim is deficient, do not consider the claim issues or include claim language in a report. In addition to providing the taxpayer Letter 6430, a Form 3870, Request for Adjustment, is required

[411] "Memorandum for All Large Business and International and Small Business Self Employed Employees," LB&I-04-0122-001, January 3, 2022

[412] "Memorandum for All Large Business and International and Small Business Self Employed Employees," LB&I-04-0122-001, January 3, 2022

to reverse the transaction code posted to the master file and to remove freeze code "-A." EEFax Form 3870 to CCP to input a TC 290 for zero to release the freeze code. efer to IRM 21.5.6.4.2, -A Freeze.[413]

Procedures for Claims Received on or After January 10, 2023

Following the end of the one-year transition period, the memorandum provides the following procedures for IRS employees to follow:

- Evaluate the claim for the five criteria outlined in IRM 4.46.3.7.x and verify that it is signed under penalties of perjury to determine validity and document the results of the evaluation in the case file. This determination should generally be completed within 30 days after received in the field examination team.

- If the claim is determined to be valid, examiners will follow appropriate risking procedures and determine if an examination of the claim is warranted.

- If the claim is determined to be deficient, examiners will issue Letter 6430, No Consideration, Section 41 Claim to the taxpayer. Management (i.e., Territory Manager) and counsel must concur that the claim does not meet the criteria outlined in IRM 4.46.3.7.x prior to issuing Letter 6430.

- If the claim is deficient, do not consider the claim issues or include claim language in a report. In addition to providing the taxpayer Letter 6430, a Form 3870, Request for Adjustment, is required to reverse the transaction code posted to the master file and to remove freeze code "-A." EEFax Form 3870 to CCP to input a TC 290 for zero to release the freeze code. Refer to IRM 21.5.6.4.2, -A Freeze.[414]

SECTION: 41
MEMORANDUM OUTLINES MINIMUM INFORMATION THAT WILL BE REQUIRED FOR A RESEARCH CREDIT REFUND CLAIM TO BE ACCEPTED

Citation: CCA 20214101F, 10/15/21

The IRS released a News Release[415] and 22-page Chief Counsel Memorandum[416] that set forth information a claim for refund related to the research credit under IRC §41 will be required to contain to be considered a valid claim. The News Release states:

> The IRS has set forth the information that taxpayers will be required to include for a research credit claim for refund to be considered valid. Existing Treasury

[413] "Memorandum for All Large Business and International and Small Business Self Employed Employees," LB&I-04-0122-001, January 3, 2022

[414] "Memorandum for All Large Business and International and Small Business Self Employed Employees," LB&I-04-0122-001, January 3, 2022

[415] "IRS sets forth required information for a valid research credit claim for refund", IRS News Release IR-2021-203, October 15, 2021, https://www.irs.gov/newsroom/irs-sets-forth-required-information-for-a-valid-research-credit-claim-for-refund (retrieved October 15, 2021)

[416] CCA 20214101F, October 15, 2021, https://www.irs.gov/pub/irs-lafa/20214101f.pdf (retrieved October 15, 2021)

> Regulations require that for a refund claim to be valid, it must set forth sufficient facts to apprise IRS of the basis of the claim. The Chief Counsel memorandum will be used to improve tax administration with clearer instructions for eligible taxpayers to claim the credit while reducing the number of disputes over such claims.[417]

The IRS explains the reasons for releasing this memorandum that will be used to determine if credit claims will be allowed to move forward as follows:

> Effective tax administration entails ensuring taxpayers understand what is required to support the claim for the research and experimentation (R&E) credit. Each year, the IRS receives thousands of R&E claims for credits in the hundreds of millions of dollars from corporations, businesses, and individual taxpayers. Claims for research credit under IRC Section 41 are currently examined in a substantial number of cases and consume significant resources for both the IRS and taxpayers.
>
> The Chief Counsel legal advice released today is the result of ongoing efforts to manage research credit issues and resources in the most effective and efficient manner. By requiring taxpayers to provide the information referenced below, the IRS will be better able to determine upfront if an R&E credit claim for refund should be paid immediately or whether further review is needed.[418]

The News Release summarizes the information requirements found in the memorandum as follows:

> Specifically, the opinion provides that for a Section 41 research credit claim for refund to be considered a valid claim, taxpayers are required to provide the following information at the time the refund claim is filed with the IRS:
>
> - Identify all the business components to which the Section 41 research credit claim relates for that year.
> - For each business component, identify all research activities performed and name the individuals who performed each research activity, as well as the information each individual sought to discover.
> - Provide the total qualified employee wage expenses, total qualified supply expenses, and total qualified contract research expenses for the claim year. This may be done using Form 6765, *Credit for Increasing Research Activities*.[419]

The News Release notes the IRS will phase-in the requirements, with the requirements being strictly enforced beginning in January 2023:

> The IRS will provide a grace period [until January 10, 2022] before requiring the inclusion of this information with timely filed Section 41 research credit claims for refund. Upon the expiration of the grace period, there will be a one-year transition period during which taxpayers will have 30 days to perfect a research credit claim

[417] "IRS sets forth required information for a valid research credit claim for refund", IRS News Release IR-2021-203, October 15, 2021

[418] "IRS sets forth required information for a valid research credit claim for refund", IRS News Release IR-2021-203, October 15, 2021

[419] "IRS sets forth required information for a valid research credit claim for refund", IRS News Release IR-2021-203, October 15, 2021

> for refund prior to the IRS' final determination on the claim. Further details will be forthcoming; however, taxpayers may begin immediately providing this information.[420]

Advisers who prepare claims for refund for the IRC §41 research credit should begin studying the entire memorandum so that claims will not be returned to the taxpayer beginning early next year, or simply immediately rejected beginning in early 2023.

SECTION: 61
TAXPAYER NOT QUALIFYING FOR PPP FORGIVENESS THAT APPLIES FOR AND RECEIVES IT MUST PAY TAX ON THE FORGIVEN AMOUNT

Citation: CCA 202237010, 9/16/22

In Chief Counsel Advice 202237010[421] the IRS indicated that if a taxpayer obtained forgiveness of a paycheck protection program (PPP) loan when he/she was not actually qualified to receive such forgiveness, the forgiveness would represent taxable income to the taxpayer even though the SBA would have the right to demand repayment of the loan balance.

The advice seeks to answer the following question:

> If a taxpayer makes one or more representations that he or she satisfies the conditions for forgiveness of a PPP loan under 15 U.S.C. §§ 636m and 636(a)(37)(J) ("qualifying forgiveness"), but does not factually satisfy the conditions for a qualifying forgiveness , and as a result, has the PPP loan forgiven improperly, may the taxpayer exclude the amount of the forgiven loan from gross income under 15 U.S.C. § 636m(i) or § 276(b)(1) of the COVID-related Tax Relief Act of 2020 (CTRA 2020)?[422]

The memorandum describes the situation that led to this question:

> Taxpayer X applied for and received a first draw PPP loan in 2020. Taxpayer X did not use the loan proceeds for eligible expenses and applied for forgiveness of the PPP loan in 2020 as if she were entitled to a qualifying forgiveness. In the loan forgiveness application submitted to the PPP lender, Taxpayer X failed to include all relevant facts that would indicate that she was not eligible for a qualifying forgiveness of the PPP loan. Based on the omissions and misrepresentations on that application, Taxpayer X received forgiveness of her PPP loan from the lender.[423]

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[420] "IRS sets forth required information for a valid research credit claim for refund", IRS News Release IR-2021-203, October 15, 2021

[421] CCA 202237010, September 16, 2022, https://www.irs.gov/pub/irs-wd/202237010.pdf (retrieved September 16, 2022)

[422] CCA 202237010, September 16, 2022

[423] CCA 202237010, September 16, 2022

While this is the situation this memorandum addresses, a footnote indicates that the conclusion covers all situations that lead to an improper grant of forgiveness:

> A variety of fact patterns may establish that the taxpayer was not eligible for forgiveness under the statute and related regulatory guidance. For example, the taxpayer may have used the funds for personal expenditures. No implication is intended from the facts in the Situation presented below that it limits the reasons why a particular forgiveness is not a qualifying forgiveness.[424]

The analysis notes that although the taxpayer receives cash when the loan is granted, that is not a taxable accession to wealth at that time:

> There is no accession to wealth under section 61(a) upon receipt of PPP loan proceeds, as the PPP loan is issued by a bank, includes an interest rate and maturity date, and includes an obligation for the eligible recipient to repay. See *Commissioner v. Tufts*, 461 U.S. 300, 307 (1983); *Commissioner v. Indianapolis Power & Light Co.*, 493 U.S. 203, 207-8 (1990). Once a participating lender forgives a loan originated under the PPP, however, the recipient of the loan proceeds enjoys an accession to wealth in the amount of the loan that is forgiven. Under general principles of Federal income taxation, the amount forgiven must be included in the loan recipient's gross income. However, section 636m(i) of the United States Code, Title 15, and § 276(b)(1) of the CTRA 2020 provide express exceptions to the rule that forgiveness of a PPP loan constitutes gross income.[425]

While cancellation of indebtedness is generally an accession to wealth taxable under IRC §61, the memorandum notes a special provision added in the CARES Act provides that this income is not subject to tax so long as it is a *qualifying forgiveness*:

> Thus, a taxpayer who received a PPP loan that is forgiven may exclude the forgiven amount of the PPP loan from gross income if the forgiveness is described in section 636m(i) and § 276(b)(1) of the CTRA 2020. These exclusions apply only to a qualifying forgiveness of a PPP loan. Forgiveness of a PPP loan is a qualifying forgiveness only if the use of the loan proceeds satisfies the conditions relating to specified costs (as described in 15 U.S.C. § 636m(b), (d)). To receive a qualifying forgiveness, the loan recipient must apply for the forgiveness in accordance with the specific procedures set forth in the statute and associated regulations.[426]

The IRS position is that if forgiveness is obtained when a taxpayer does not meet the conditions found in the CARES Act and later laws, it is not *qualifying forgiveness* and thus does not get excluded from income:

> Failure to meet these conditions means that there is no qualifying forgiveness, and thus the exclusions would not apply to the forgiven PPP loan. As the Second Circuit concludes in discussing the forgiveness provision of the PPP (15 U.S.C. § 636m) in *Springfield Hosp., Inc.*, 28 F.4th 403, 424 (2nd Cir. 2022):
>
> > [F]orgiveness is neither automatic nor guaranteed. A borrower must apply for forgiveness, which will only be granted if specified criteria are met, see

[424] CCA 202237010, September 16, 2022

[425] CCA 202237010, September 16, 2022

[426] CCA 202237010, September 16, 2022

> 15 U.S.C. § 636m(b)–(d), and the CARES Act places several additional conditions upon obtaining forgiveness [including that the funds are "used for statutorily authorized purposes"].[427]

The IRS then analyzes the situation in question and concludes the forgiveness in this case is not qualifying forgiveness:

> Turning to the Situation described above, because the forgiveness of Taxpayer X's PPP loan was based on omissions and misrepresentations, the loan that Taxpayer X received did not fall within the scope of loans that could be forgiven under 15 U.S.C. § 636m. The forgiveness of that loan accordingly did not constitute a qualifying forgiveness described in 15 U.S.C. § 636m, and may not be excluded from Taxpayer X's gross income under 15 U.S.C. § 636m(i). The exclusion provision applies only to a PPP loan that meets the conditions of a qualifying forgiveness. Similarly, the exclusion applies only if the loan recipient is an eligible recipient. Thus, even if the loan forgiveness is otherwise a qualifying forgiveness, the exclusion is inapplicable if the loan recipient is not an eligible recipient. [428]

The amounts must be included in income since IRC §61's broad definition of income would require including this in income:

> Because section 636m(i) does not apply to forgiveness of her PPP loan, Taxpayer X must include the forgiven amount in her gross income. This result follows from the application of the general principles of Federal income taxation to the amount forgiven in determining the proper tax treatment. [429]

Specifically, the IRS finds that this situation represents a *claim of right* as the taxpayer had complete dominion and control over the PPP loan proceeds:

> Section 61(a) generally provides that "gross income means all income from whatever source derived." This result applies to all payments that are "undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion" constitute taxable income. *Commissioner v. Glenshaw Glass Co*., 348 U.S. 426, 431 (1955). In 2020, the year of forgiveness and release from the obligation to repay, Taxpayer X had undeniable accessions to wealth, clearly realized, and over which she had complete dominion under the principles of *Glenshaw Glass*. Furthermore, notwithstanding the ability of the SBA to pursue repayment in the case of misuse of funds, Taxpayer X retained the PPP loan proceeds in 2020 under a claim of right.[430]

The memorandum continues, applying the claim of right principles to these facts:

> The claim of right doctrine derives originally from the Supreme Court decision in *North American Oil Consolidated v. Burnet*, 286 U.S. 417 (1932). The court there stated that "[i]f a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even

[427] CCA 202237010, September 16, 2022

[428] CCA 202237010, September 16, 2022

[429] CCA 202237010, September 16, 2022

[430] CCA 202237010, September 16, 2022

> though he may still be adjudged liable to restore its equivalent." Id. at 424. This doctrine applies regardless of whether the taxpayer acquires the proceeds lawfully; see *James v. United States*, 366 U.S. 213, 219 (1961) (applying the *North American Oil Consolidated* approach "[w]hen a taxpayer acquires earnings, lawfully or unlawfully, without the consensual recognition, express or implied, of an obligation to repay and without restriction as to their disposition").

The fact that the SBA may determine later that repayment is required does not change this result:

> The ability of the SBA to pursue repayment of the improperly forgiven PPP loan does not preclude the application of the claim of right doctrine to Taxpayer X in 2020. See *United States v. Lewis*, 340 U.S. 590 (1951) (taxpayer received a bonus in 1944 and was required to repay the bonus in 1946 after being informed the original payment was erroneous; the court found that the taxpayer held the bonus under a claim of right in 1944 and rejected his argument that he could amend his 1944 return to reflect the subsequent repayment).[431]

Thus, the memorandum comes to the following overall conclusion:

> If a taxpayer who does not factually satisfy the conditions for a qualifying forgiveness causes its lender to forgive the PPP loan by inaccurately representing that the taxpayer satisfies them, the taxpayer may not exclude the amount of the forgiven loan from gross income under 15 U.S.C. § 636m(i) or section 276(b)(1) of the CTRA 2020.[432]

SECTION: 61
TAXPAYER HAD ENOUGH OF A GUARANTEE BUSINESS WOULD BE ABLE TO KEEP FUNDS RECEIVED THAT THE AMOUNTS IMMEDIATELY CONSTITUTED INCOME

Citation: United States v. VanDemark, CA6, Docket No. 21-3470, 6/30/22

We don't often write about criminal tax cases here on this site, but the case of *United States v. VanDemark*[433] discusses a taxpayer who, per the beginning of the Sixth Circuit opinion "tried to hoodwink the IRS."[434] Of interest outside the criminal tax controversy context, he attempted to argue in his defense that he did not have to report cash deposits he received as income due to lack of "some guarantee" the business would keep the funds, an argument the appellate panel did not find persuasive given the facts of his case.

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[431] CCA 202237010, September 16, 2022

[432] CCA 202237010, September 16, 2022

[433] *United States v. VanDemark*, CA6, Docket No. 21-3470, June 30, 2022, https://www.taxnotes.com/research/federal/court-documents/court-opinions-and-orders/car-salesman%e2%80%99s-tax-fraud-conviction-upheld/7dm34 (retrieved July 1, 2022)

[434] *United States v. VanDemark*, CA6, Docket No. 21-3470, June 30, 2022

The opinion continues with the following broad summary:

> Gregory VanDemark owns the Used Car Supermarket, which sells cars from two lots in Amelia, Ohio. In 2013 and 2014, VanDemark funneled away his customers' down payments and left them off his tax returns. He used this stashed-away cash to finance the mortgage on his mansion. The IRS caught wind soon enough. The government charged VanDemark with crimes related to his scheme, and a jury convicted him of six counts. VanDemark moved for an acquittal on three of these counts and a new trial on all six. The district court denied both motions.[435]

The opinion has more details on the structure of Mr. VanDemark's businesses:

> Gregory VanDemark made his fortune selling cars. He's built something of a mini-business empire in Amelia, Ohio. At the center of it all is the Used Car Supermarket, a C-corporation owned solely by VanDemark. Flanking the Supermarket are VanDemark's three S-corporations: the VanDemark Group, the VanDemark Corporation, and Gregory Properties. Each supports the Supermarket in its own way.1 And because these are S-corporations, VanDemark must report flow-through income and deductions on his personal returns.
>
> The Supermarket's clientele is by and large low-income and low-credit. Customers typically finance their cars by entering into lease-to-buy agreements. The process kicks off with a large down payment. These down payments, and VanDemark's efforts to hide them, are at the heart of this appeal.[436]

The Court than outlines the actions that eventually led to the taxpayer's issues with the IRS:

> Before 2013, everything was above board at the Supermarket on the tax front. The Supermarket's protocols ensured all the down payments remained within the IRS's view. To begin with, VanDemark kept a handwritten ledger at each of the two lots. Every time a customer made a down payment, his employees recorded it in one of these ledger books. They made sure to deposit every payment into the Supermarket's bank account as well. Afterward, employees entered the bank receipts into an accounting software called QuickBooks. And as a final step, VanDemark's tax preparer used the QuickBooks files to complete the necessary tax returns.
>
> But in 2013, VanDemark began to short-circuit this process. He instructed an employee named Christopher McAfee to start stashing this cash in a safe at the main office. McAfee did as he was told. And, not surprisingly, the amount of cash deposited into the Supermarket's bank account plunged in 2013 and 2014. In 2012, VanDemark deposited $265,499.25 in cash into the account. But in 2013 and 2014, that number was much reduced to $12,194.63 and $71,150.86, respectively. Because the stashed-away cash never reached the bank account, it never made it into VanDemark's QuickBooks files. And because VanDemark's tax preparer relied on those QuickBooks files, he failed to report the cash on VanDemark's tax returns.[437]

[435] *United States v. VanDemark*, CA6, Docket No. 21-3470, June 30, 2022

[436] *United States v. VanDemark*, CA6, Docket No. 21-3470, June 30, 2022

[437] *United States v. VanDemark*, CA6, Docket No. 21-3470, June 30, 2022

Not surprisingly, Mr. VanDemark had a use in mind for this cash. The opinion notes that "VanDemark used most of this cash to pay the mortgage on his multimillion-dollar mansion."[438]

However, he was aware that the bank that held the mortgage faced requirements to report certain cash transactions, but he was unsure of the details. So, he decided to ask a bank employee about the issue:

> Wary of attracting the IRS's attention, VanDemark asked an employee at his bank to confirm the IRS reporting threshold. She told VanDemark that the bank had to report "[a]nything over 10,000 in cash" to the IRS. (R. 73, Trial Tr. (Luck), PageID 1086-87.) So with this information in hand, VanDemark began to make cash payments toward his mortgage several times a month, keeping each payment below $10,000.[439]

But his attempts to reduce his taxes did not stop with the cash from deposits being diverted to pay the mortgage. The opinion notes:

> But VanDemark's tax evasion didn't stop there. He overreported deductions on his personal returns as well. Aside from his Ohio mansion, VanDemark owned two other residences: a novelty house built in the shape of a paddleboat and an oceanfront property in Florida. VanDemark claimed construction, maintenance, and insurance expenses on these properties as business expenses for his S-corporations. He pulled this off by telling the IRS that he was building the paddleboat house as a bed and breakfast, the Florida residence was his business headquarters, and his Ohio mansion was a rental property. Thanks to these efforts, VanDemark and the Supermarket paid no federal income tax in 2013 and 2014.[440]

However, it turned out that inquiring of the bank employee about how much he could pay in cash before the bank had to notify the IRS was going to lead to the exact type of IRS attention he appeared to be attempting to avoid. Apparently, he didn't realize that the employee might consider the very act of asking such a question and then making cash payments just below those levels would look suspicious to the bank employee:

> His enquiries at the bank had raised some eyebrows. The bank employee reported her conversation with VanDemark to her Bank Secrecy Act officer. This information made its way to the IRS, which deployed a special agent to investigate.[441]

An IRS special agent approached Mr. VanDemark posing as a businessman interested in buying his business. Not surprisingly, Mr. VanDemark felt he needed to tell the potential buyer that there was a bit of "off book" activity and this business was truly more profitable than it would appear from the tax returns and his *Quickbooks* ledger:

> In December 2014, an IRS special agent contacted VanDemark. Posing undercover as a businessman, he expressed an interest in buying VanDemark's businesses. The pair spoke over the phone several times. In one of these calls, VanDemark spilled

[438] *United States v. VanDemark*, CA6, Docket No. 21-3470, June 30, 2022

[439] *United States v. VanDemark*, CA6, Docket No. 21-3470, June 30, 2022

[440] *United States v. VanDemark*, CA6, Docket No. 21-3470, June 30, 2022

[441] *United States v. VanDemark*, CA6, Docket No. 21-3470, June 30, 2022

> the beans. He boasted that he had about "$16 million in assets" and his businesses "net over $1 million a year." (R. 90, Gov't Ex. 2, PageID 1524-25, 1546.) VanDemark all but admitted to tax evasion by explaining that he "pulled out . . . 25% of that big figure" "in the last couple of years [2013 and 2014]." (Id. at PageID 1549-50.) What's more, he kept track of the stashed-away 25% "just in case." (Id. at PageID 1551.) VanDemark let slip about his deductions as well. He admitted that he "shoved all expenses on the company" so that he wouldn't "end up paying a bunch of dang taxes." (Id. at PageID 1527.) And to top it all off, VanDemark confessed he was "kind of . . . giving [the agent] information [he] shouldn't even be talking about." (Id. at PageID 1550.)[442]

At this point, the IRS decided now was the time to obtain search warrants, seize records and begin questioning Mr. VanDemark. Apparently not realizing that his "buyer" was using his conversations to obtain incriminating information that the IRS agents now questioning him were aware of, Mr. VanDemark was, shall we say, not entirely truthful with the agents per the Court's description of the events.

> The IRS had heard enough. In July 2016, it executed search warrants at VanDemark's three residential properties and the two Supermarket lots. Agents recovered the handwritten ledgers from the two lots. They found VanDemark at his paddleboat-shaped house and interviewed him for over three hours. He told the agents that his QuickBooks files contained all of his business records. At no point did he mention the ledger books. Asked whether he had skimmed cash from his dealership, VanDemark claimed that his employees deposited everything into the Supermarket's bank account.[443]

As you have probably surmised, the IRS now had enough material to obtain an indictment against Mr. VanDemark:

> Fast forward a year and a half, and a grand jury indicted VanDemark on six counts. The first four charged VanDemark with helping prepare false tax returns, in violation of 26 U.S.C. § 7206(2). Counts One and Two dealt with the Supermarket's 2013 and 2014 corporate returns. Counts Three and Four concerned VanDemark's 2013 and 2014 personal returns. Count Five charged VanDemark with structuring payments, in violation of 31 U.S.C. § 5324(a)(3). And Count Six charged VanDemark with making false statements to federal agents, in violation of 18 U.S.C. § 1001.[444]

At his trial things did not go well for Mr. VanDemark:

> The trial began in March 2020. After the government rested, VanDemark made a Rule 29(a) motion for acquittal on Counts One, Two, and Three. The district court denied the motion. But VanDemark renewed it twice before the jury reached its verdict: once at the end of his case and again after the district court instructed the jury. The district court denied the motion twice more.
>
> The trial lasted six days. In the end, the jury found VanDemark guilty on all counts. VanDemark renewed his motion for acquittal under Rule 29(c). He also moved for a

[442] *United States v. VanDemark*, CA6, Docket No. 21-3470, June 30, 2022

[443] *United States v. VanDemark*, CA6, Docket No. 21-3470, June 30, 2022

[444] *United States v. VanDemark*, CA6, Docket No. 21-3470, June 30, 2022

> new trial on all six of his counts under Rule 33. In a 17-page written order, the district court denied both motions. In May 2021, the district court entered judgment. And now, VanDemark appeals.[445]

Mr. VanDemark appealed this result, arguing that the trial court improperly denied his motion to acquit. Key to this is his argument that, in fact, those deposits were properly not reported as income. As the opinion describes his argument:

> The first two counts charged VanDemark with assisting in the preparation of false corporate returns for 2013 and 2014. VanDemark's argument begins and ends with *Commissioner v. Indianapolis Power & Light Co*., which says that a deposit isn't taxable income unless "the taxpayer has *some guarantee* that he will be allowed to keep the money."3 493 U.S. 203, 210 (1990) (emphasis added). VanDemark claims that the lease agreements tied the Supermarket's hands. If a customer decides not to purchase the car at the lease's end, says VanDemark, the customer can demand a refund of the down payment under the contract. And so, the argument goes, the Supermarket lacked the necessary "guarantee," and the down payments were never taxable as a threshold matter.[446]

This issue is more in line with what we usually discuss in these articles. So, did the appeals court agree with Mr. VanDemark's argument that the deposits were not taxable and therefore he could not have been guilty of assisting in the preparation of false income tax returns?

Well, not quite. First, the panel did not agree Mr. VanDemark did not have some guarantee he would be allowed to keep the money:

> …[T]he Supermarket issued virtually no refunds across decades. The Supermarket found ways to keep these down payments at its discretion, the contract notwithstanding. And that means the down payments were taxable upon receipt consistent with Indianapolis Power.[447]

The panel noted a number of reasons why the corporation was virtually assured that it would keep the deposits it received:

> We begin with the Supermarket's track record on refunds. Christopher McAfee worked at the Supermarket for no fewer than 30 years. And he testified that, in those 30 years, he saw the down payment refunded "maybe, one, two, three" times total. (R. 72, Trial Tr. (McAfee), PageID 1470.) The record contains additional corroboration as well. A special agent reviewed VanDemark's ledger books from 2012 to 2014 and found only one refund. What's more, that single refund wasn't even issued at the end of the lease under the contract. Instead, VanDemark refunded the deposit the same day the customer paid it. Perhaps the customer changed his or her mind before finalizing the lease, and the Supermarket issued a refund at its discretion. In any event, that single refund had nothing to do with the contract. This means that the contract terms forced VanDemark's hand a grand total of zero times from 2012 to 2014 (and maybe "one, two, three" times in 30 years).

[445] *United States v. VanDemark*, CA6, Docket No. 21-3470, June 30, 2022

[446] *United States v. VanDemark*, CA6, Docket No. 21-3470, June 30, 2022

[447] *United States v. VanDemark*, CA6, Docket No. 21-3470, June 30, 2022

> Simply put, these numbers belie VanDemark's Indianapolis Power argument. One way or another, the Supermarket engineered for itself "some guarantee" of keeping the down payments — that much is clear enough. Certainly, this conclusion is within a rational jury's reach. VanDemark's control is shown in the contract itself and in how VanDemark applied that language. True, the contract requires the Supermarket to refund the down payment if the customer returns the car at the end of the lease. But that's only if the excess mileage fee and the cost of damages to the car do not exceed the down payment amount.
>
> And as the district court emphasized, these variables are couched in significant ambiguities. The Supermarket exploited them to maintain control over the down payments. On excessive mileage, the contract imposes a fee "equal to $.50 per mile for miles to be computed at the end of the lease and balance due." (R. 59, July, 17, 2020 Op. & Order, PageID 247.) But importantly, the contract fails to specify a base mileage. As a practical matter, this allows VanDemark to define the number of excess miles after the lease ends. This theme continues with the second variable. The contract says that damages beyond "ordinary wear and tear" come out of the deposit. (Id.) As for calculating those costs, however, the contract places everything in VanDemark's hands. It specifies that "a representative from VANDEMARK . . . shall be the sole judge and arbiter as to whether or not any disputed damage is due to ordinary wear and tear or due to some other cause." (Id. at PageID 247 (emphasis added).) These ambiguities enable the Supermarket to jack up both variables on the back end to prevent a refund if it wishes.[448]

But the panel notes that even if Mr. VanDemark was correct in his view under these facts that the deposits were not immediately taxable upon receipt, Mr. VanDemark failed to treat them as taxable once any potential risk of having to return the deposits went away:

> The plot thickens even more from here, and not in VanDemark's favor. VanDemark argues that everything rises and falls with the contract's refund language. He doesn't dispute that once a customer converts the lease into a purchase, the refund provision no longer applies. In other words, the down payment is taxable by that point. If only the refund language didn't tie his hands, no doubt VanDemark would have reported everything — that's the implication of his Indianapolis Power argument, anyway. This begs the question: When those 2013 and 2014 leases were eventually bought out — whether in 2013, 2014, or later — did VanDemark report the down payments?
>
> Not quite. It turns out that at least seven customers (1) began their leases in 2013 or 2014 and (2) bought out their cars within that same window. One of these leases ended in 2013, and the remaining six in 2014. And under VanDemark's own theory, the down payments for these leases should have appeared on the Supermarket's 2013 and 2014 returns. But they did not, which means that VanDemark fails his own test. And VanDemark says nothing about the 2013 and 2014 leases that were bought out after 2014. He could have pointed the IRS to those tax returns where he eventually reported the down payments for these leases. That way, his failure to report those payments in 2013 and 2014 becomes a timing issue that falls short of a criminal prosecution. But VanDemark did no such thing. All of this shows that he never intended to report any of the down payments, with or without Indianapolis

[448] *United States v. VanDemark*, CA6, Docket No. 21-3470, June 30, 2022

> Power. The district court properly denied VanDemark's acquittal motion as to Counts One and Two.[449]

The failure to *ever* include such deposits as income could reasonably be interpreted as evidence, he acted to avoid paying tax on these funds.

SECTION: 132 RETIRED PILOT TAXABLE ON VALUE OF STANDBY TICKETS USED BY RELATIVES THAT WERE NEITHER HIS SPOUSE NOR DEPENDENT CHILDREN

Citation: Mihalik v. Commissioner, TC Memo 2022-36, 4/13/22

A retired airline pilot attempted to dispute the IRS's position that he had to pay tax on the value of airline tickets on his former employer's flights used by relatives other than his spouse in the case of *Mihalik v. Commissioner*, TC Memo 2022-36.[450]

Although many individuals believe that items that aren't cash received for services aren't taxable, that's not what the Internal Revenue Code says. In fact, IRC section 61(a)(1) provides specifically that fringe benefits are generally taxable to the employee when received.

> (a) General definition. Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:
>
> > (1) Compensation for services, including fees, commissions, fringe benefits, and similar items;[451]

So why are some fringe benefits not taxable to employees? The answer is that other provisions of the Internal Revenue Code provide limited exceptions to the general rule that fringe benefits are taxable to the employee. But those exceptions are narrow and have requirements that must be met or the value of the benefit will be taxable to the employee

Standby Flights and the No-Additional Cost Service Exclusion

This case involves the no additional cost service fringe benefit exclusion made available to certain employees of employers who have such no additional cost services available to provide to their employees. Section 132(a)(1) of the Internal Revenue Code provides that such items will not be included in the gross income of the employee.

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[449] *United States v. VanDemark*, CA6, Docket No. 21-3470, June 30, 2022

[450] *Mihalik v. Commissioner*, TC Memo 2022-36, April 13, 2022, https://www.taxnotes.com/research/federal/court-documents/court-opinions-and-orders/plane-ticket-values-not-excludable-from-retired-pilot%e2%80%99s-income/7dcwk (retrieved April 20, 2022)

[451] IRC §61(a)(1)

Internal Revenue Code section 132(b) provides the definition of a no additional cost service.

> (b) No-additional-cost service defined. For purposes of this section, the term "no-additional-cost service" means any service provided by an employer to an employee for use by such employee if—
>
> > (1) such service is offered for sale to customers in the ordinary course of the line of business of the employer in which the employee is performing services, and
> >
> > (2) the employer incurs no substantial additional cost (including forgone revenue) in providing such service to the employee (determined without regard to any amount paid by the employee for such service).[452]

In the case of an airline, the no additional cost service represents otherwise empty seats on a flight that is otherwise scheduled to be flown by the airline. Since that seat is going to travel from one location to another whether or not a person is sitting in the seat, the airline is allowed to offer the use of that empty seat to its employees and certain relatives as we will discuss next if no paying customer is available to take the seat.

The court even points out in a footnote that such seats cannot be reserved for the employee, because that would make it no longer a no additional cost service:

> If a commercial airline permits its employees to take personal flights on the airline at no charge and to receive reserved seating, employees receiving such free flights are not eligible for the no-additional-cost service exclusion. Treas. Reg. § 1.132-2(c). In such instances the airline forgoes potential revenue by permitting the employees to reserve seats, and therefore the service is not a no-additional-cost service. *Id.*[453]

IRC section 132(h) provides special definitions of "employees" for this purpose that expand those eligible for tax free use of the seats beyond just the employee him/herself. First, a retired employee, along with disabled employees and surviving spouses of employees, are treated as employees for this purpose under IRC section 132(h)(1).

> (1) Retired and disabled employees and surviving spouse of employee treated as employee. With respect to a line of business of an employer, the term "employee" includes --
>
> > (A) any individual who was formerly employed by such employer in such line of business and who separated from service with such employer in such line of business by reason of retirement or disability, and
> >
> > (B) any widow or widower of any individual who died while employed by such employer in such line of business or while an employee within the meaning of subparagraph (A).[454]

[452] IRC §132(b)

[453] *Mihalik v. Commissioner*, TC Memo 2022-36, April 13, 2022

[454] IRC §132(h)(1)

IRC section 132(h)(2) expands this definition of an employee to also cover spouses and dependent children of the employee or the retired employee. Thus, these relatives of the taxpayer in this case would qualify for the exclusion as well.

> (2) Spouses and dependent children.
>
> (A) In general. Any use by the spouse or a dependent child of the employee shall be treated as use by the employee.
>
> (B) Dependent child. For purposes of subparagraph (A), the term "dependent child" means any child (as defined in section 152(f)(1)) of the employee --
>
> (i) who is a dependent of the employee, or
>
> (ii) both of whose parents are deceased and who has not attained age 25.
>
> For purposes of the preceding sentence, any child to whom section 152(e) applies shall be treated as the dependent of both parents.[455]

Although not relevant for the current case, you should also note that parents of airline employees also qualify for this exclusion under a special rule found at section 132(h)(3).

De Minimis Fringe Benefits

Another category of excludable fringe benefits found in the Internal Revenue Code at section 132(a)(4) are de minimis fringe benefits.

IRC section 132(e)(1) defines such a benefit as follows:

> (e) De minimis fringe defined. For purposes of this section—
>
> (1) In general. The term "de minimis fringe" means any property or service the value of which is (after taking into account the frequency with which similar fringes are provided by the employer to the employer's employees) so small as to make accounting for it unreasonable or administratively impracticable.[456]

The Facts of the Case

Mr. Mihalik and his family made use of this benefit from his former employer. As the court notes:

> Mr. Mihalik, Mrs. Mihalik, and their daughter traveled extensively under the RPTP in 2016. United Airlines' records list Mrs. Mihalik's relationship to Mr. Mihalik as "Spouse" and the Mihaliks' daughter's status as "Daughter". The records also report a zero taxable "wage amount" for tickets issued to Mr. Mihalik, Mrs. Mihalik, and their daughter, and add the note "no taxation" behind each of those entries. The taxable nature of the tickets issued to each of them is not in dispute.

[455] IRC §132(h)(2)

[456] IRC §132(e)(1)

> Because of their connection to Mr. Mihalik, Sean Garth Mihalik and Jessica Marie Liening Mihalik also received tickets from United Airlines under the RPTP in 2016. United Airlines' records list Sean's and Jessica's relationships to Mr. Mihalik as "Enrolled Friend", label each as a "taxable pass rider", and report a taxable "wage amount" for each ticket issued to Sean and Jessica under the RPTP. Because Sean and Jessica have the same surname as the Mihaliks, we assume that they also share some familial relation. But the Mihaliks do not offer any information to clarify that relation and therefore, for the purposes of the Commissioner's motion, we assume that Sean and Jessica are simply relatives (to an unknown degree) of the Mihaliks. Although some dates are redacted, the records list the birth years for Sean and Jessica as 1983 and 1984, meaning Sean and Jessica were both over the age of 30 in 2016.[457]

Mr. Mihalik's former employer (United Airlines) reported the value of Sean and Jessica's flights on Form 1099-MISC:

> The value of the tickets provided to Sean and Jessica under Mr. Mihalik's RPTP in 2016 equaled $5,478.3 United Airlines reported this amount as income paid to Mr. Mihalik on the Form 1099–MISC, "Miscellaneous Income", which it filed with the IRS.[458]

On their joint return for 2016, the Mihaliks did not include the value of Sean and Jessica's flights as income. The IRS is now pursuing collection of tax on the value of those flights.

Nonqualifying Relatives Create Taxable Income

The taxpayers appeared to argue before the court that the amounts shown on the 1099-MISC for the value of Sean and Jessica's flights should not be taxable to them either because of the no additional cost service exclusion or because the benefit represented a de minimis fringe benefit.

The opinion agrees with the IRS that the value of tickets used by Sean and Jessica are taxable to the taxpayers because neither of those individuals could be the taxpayers' dependent children.

> Although we view factual inferences in the light most favorable to the Mihaliks and therefore assume Sean and Jessica were relatives of the Mihaliks because of their shared surname, United Airlines' records and the Mihaliks' 2016 return support the conclusion that neither Sean nor Jessica was the Mihaliks' dependent child in 2016. Neither Sean nor Jessica was under the age of 19 in 2016, and therefore, no matter what their relationship is to the Mihaliks, they cannot qualify as "dependents" under section 152(c) (or, necessarily, as "dependent children" under section 132(h)).
>
> To prevail against the Commissioner's motion, the Mihaliks must show that Sean and Jessica qualified as their dependent children under section 132(h) in 2016. But the Mihaliks do not dispute the Commissioner's showing that Sean and Jessica were not their dependent children in 2016, that Sean and Jessica received tickets from United Airlines under the RPTP, or that the tickets had the value calculated by United Airlines.[459]

[457] *Mihalik v. Commissioner*, TC Memo 2022-36, April 13, 2022

[458] *Mihalik v. Commissioner*, TC Memo 2022-36, April 13, 2022

[459] *Mihalik v. Commissioner*, TC Memo 2022-36, April 13, 2022

Some of you might be thinking that the full-time student rule might have applied, but the court noted in a footnote:

> The Mihaliks do not allege that Sean and Jessica were full-time students in 2016, so the age 24 threshold of section 152(c)(3)(A)(ii) is inapplicable.[460]

The court also did not find the value of the flights taken by Sean and Jessica represented an excludable de minimis fringe benefit under IRC section 132(a)(4). The opinion notes the taxpayers provided no evidence to support the view that the tickets represented a de minimis benefit under the law, but there was a more crucial problem regardless of the evidence they might have attempted to bring forward noted by the Court:

> …[A]ny argument that the airline tickets constitute a de minimis fringe benefit would manifestly fail on its merits. United Airlines' records indicate that it issued airline tickets frequently under the RPTP and the value of the airline tickets issued to Sean and Jessica ($5,478) greatly exceeds the low-fair-market-value examples provided by Treasury Regulation § 1.132-6(e). It is also clearly neither unreasonable nor administratively impracticable for United Airlines to account for tickets issued under the RPTP. To the contrary, United Airlines records document substantial data about the RPTP tickets, including the tax implications to Mr. Mihalik of the tickets provided to non-family members.[461]

Most likely the taxpayers were operating under the misconception discussed at the beginning of this article. Since the value of the tickets used by their relatives were not paid out by the airline in cash to the taxpayers, the taxpayers believed that such items could not be taxable to them. Unfortunately, that's not the way the underlying law works, something it appears from reading the case that the taxpayers never really grasped.

As the court noted in the opinion the taxpayers never really address the requirements to show why they met any exception from inclusion of the value of these flights in their income. They seemed to be working from the assumption that these noncash benefits would just simply not be taxable to them.

SECTION: 162
AMOUNTS PAID AS MANAGEMENT FEES BY C CORPORATION NOT DEDUCTIBLE

Citation: Aspro v. Commissioner, Case No. 21-1996, CA8, 4/26/22

In the case of *Aspro v. Commissioner*, Case No. 21-1996, CA8,[462] the Eighth Circuit Court of Appeals sustained the Tax Court's disallowance of a deduction of management fees paid to shareholders of a C corporation and the treatment of the payment as disguised distributions taxable as dividends.

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[460] *Mihalik v. Commissioner*, TC Memo 2022-36, April 13, 2022

[461] *Mihalik v. Commissioner*, TC Memo 2022-36, April 13, 2022

[462] *Aspro v. Commissioner*, Case No. 21-1996, CA8, April 26, 2022, https://www.taxnotes.com/research/federal/court-documents/court-opinions-and-orders/eighth-circuit-affirms-manager-fees-were-disguised-distributions/7df6s (retrieved April 27, 2022)

There are various reasons why some closely held entities make payments to related parties that are labeled management fees. In this case we aren't told what the ultimate goal was of such fees, but we do know that they had continued for an extremely long period of time.

The opinion summarizes the facts of the case as follows:

> Aspro, Inc. is an asphalt-paving company in Waterloo, Iowa. It is incorporated under Iowa law and treated as a subchapter C corporation for federal income-tax purposes. Between 2012 and 2014, the relevant years, Aspro stock was held by: Milton Dakovich, the president of Aspro; Jackson Enterprises Corp.; and Manatt's Enterprises, Ltd. Aspro has not paid dividends since the 1970s but, except for one year, has paid its shareholders "management fees" for at least twenty years. In addition to receiving management fees, Dakovich received a salary, director fees, and bonuses for each of the relevant years. There were no written agreements between Aspro and its three shareholders regarding fees paid for management services, nor was there an employment contract between Aspro and Dakovich. Aspro claimed deductions on its tax returns for management fees for tax years 2012 through 2014.[463]

The IRS examined the corporation's returns and denied the deduction for management fees, finding that the corporation had failed to establish that it had incurred or paid these fees for ordinary and necessary business purposes as required by IRC §162. Rather the IRS found that these payments represented disguised distributions being paid to the corporation's shareholders. The taxpayer filed a petition in the Tax Court challenging these findings of the IRS, but the Tax Court ruled in the IRS's favor. The taxpayers then appealed that decision to the Eighth Circuit Court of Appeals.

The Underlying Law for Deductibility of Such Management Fees

The panel's opinion begins by discussing the general rules for allowing a deduction for trade or business expenses of a corporation.

> …[W]e consider Aspro's challenge to the tax court's holding that none of the management fees paid by Aspro was deductible because they were instead disguised distributions of profits. See *United States v. Ellefsen*, 655 F.3d 769, 779 (8th Cir. 2011) (explaining that distributions of profits are not deductible). Whether payments made to shareholders are distributions of profits rather than compensation for services is a factual determination. *Heil Beauty Supplies, Inc. v. Comm'r*, 199 F.2d 193, 194-95 (8th Cir. 1952). We review the tax court's factual determinations for clear error and "must affirm unless left with a conviction that the tax court has committed a mistake." *Keating v. Comm'r*, 544 F.3d 900, 903 (8th Cir. 2008). We consider all the facts and circumstances when determining whether the compensation paid to a corporation's shareholders is actually a distribution of profits. See *Heil Beauty Supplies*, 199 F.2d at 195; *Charles Schneider & Co. v. Comm'r*, 500 F.2d 148, 151 (8th Cir. 1974). Aspro bore the burden of proving its entitlement to the deductions. See T.C.R. 142(a)(1).[464]

The panel discusses the differences between deductible business payments for a C corporation and amounts that represent distributions to the shareholders, including how to determine if an amount

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[463] *Aspro v. Commissioner*, Case No. 21-1996, CA8, April 26, 2022

[464] *Aspro v. Commissioner*, Case No. 21-1996, CA8, April 26, 2022

paid that claims to be for a business expense is actually a disguised distribution, structured in this manner to avoid the less favorable tax treatment of paying a distribution. That is, the negative tax consequence that the C corporation will get no deduction for this payment while it will still be taxable income to the shareholders:

> Corporations must pay federal income tax on their taxable income, 26 I.R.C. § 11(a), which is gross income less allowable deductions, § 63(a). Under § 162(a)(1), deductions are allowed for expenses that are "ordinary and necessary" in carrying on a trade or business, including "reasonable allowance for salaries or other compensation for personal services actually rendered." "Ordinary has the connotation of normal, usual, or customary," and describes expenses arising from transactions "of common or frequent occurrence in the type of business involved." *Deputy v. du Pont*, 308 U.S. 488, 495 (1940). Necessary means appropriate and helpful to the development of the business. See *Comm'r v. Heininger*, 320 U.S. 467, 471 (1943); *Welch v. Helvering*, 290 U.S. 111, 113 (1933).
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> "As the language of § 162(a)(1) suggests, a deduction may be made if salary is both (1) 'reasonable' and (2) 'in fact payments purely for services.'" *David E. Watson, P.C. v. United States*, 668 F.3d 1008, 1018 (8th Cir. 2012) (quoting Treas. Reg. § 1.162–7(a)); see also *Wy'East Color Inc. v. Comm'r*, 71 T.C.M. (CCH) 2501, 1996 WL 119492, at *6 (1996) ("A taxpayer may deduct payments for management services under section 162 if the payments are for services actually rendered and are reasonable in amount."). "Usually, courts only need to examine the first prong," although "in the rare case where there is evidence that an otherwise reasonable compensation payment contains a disguised dividend, the inquiry may expand into compensatory intent apart from reasonableness." *David E. Watson*, 668 F.3d. at 1018 (brackets omitted). However, "[t]he inquiry into reasonableness is a broad one and will, in effect, subsume the inquiry into compensatory intent in most cases." Id. In general, reasonable compensation is limited to "such amount as would ordinarily be paid for like services by like enterprises under like circumstances." Treas. Reg. § 1.162-7(b)(3); see also *Home Interiors & Gifts, Inc. v. Comm'r*, 73 T.C. 1142, 1155-56 (1980).
>
> "[C]orporations are not allowed a deduction for dividends paid to the shareholders," *Ellefsen*, 655 F.3d at 779, including distributions that are disguised as compensation. Treas. Reg. § 1.162-7(b)(1); *Charles Schneider*, 500 F.2d at 152-53. Compensation paid by the corporation to shareholders is closely scrutinized to make sure the payments are not disguised distributions. *Heil Beauty Supplies*, 199 F.2d at 194 ("Any payment arrangement between a corporation and a stockholder . . . is always subject to close scrutiny for income tax purposes, so that deduction will not be made, as purported salary, rental or the like, of that which is in the realities of the situation an actual distribution of profits.").[465]

As well, the panel notes how the law is applied to determine if compensation (in whatever form) being paid to the shareholders is reasonable, as required under IRC §162:

> To determine whether compensation paid to a shareholder-employee is reasonable, courts consider factors enumerated in *Charles Schneider*, 500 F.2d at 151-52.6 No single factor is dispositive; rather, the court is to base its decision on a careful consideration of applicable factors in light of the relevant facts. See *Mayson Mfg. Co. v. Comm'r*, 178 F.2d 115, 119 (6th Cir. 1949). Because the factors in isolation offer

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> insufficient guidance on their application, we view them in the context of the list as a whole.[466]

Why the Taxpayer Failed to Show These Were Deductible Business Expenses

The panel agreed with the Tax Court and the IRS that the taxpayer had failed to demonstrate these payments represented deductible business expenses under IRC §162. The panel pointed out a number of problems with these payments, problems that probably aren't all that unusual for many of the taxpayers that attempt to payout such management fees.

The panel begins by noting:

> Aspro did not present evidence showing what "like enterprises under like circumstances" would ordinarily pay for like management services. See Treas. Reg. § 1.162-7(b)(3). It also did not quantify the value of the management services provided, nor did it show that similar companies would pay that amount for similar services.[467]

The lack of any written agreement between the parties or any methodology being documented that was used to compute the amount of these management fees was also a major problem in the view of the panel:

> As the tax court noted, Aspro produced no written management-services agreement or other documentation of a service relationship between Aspro and either entity, no evidence of how Aspro determined the amount of the management fees, and no evidence that either entity billed Aspro or sent invoices for any services performed for Aspro. See *ASAT, Inc., v. Comm'r*, 108 T.C. 147 (1997) (holding that the taxpayer was not entitled to deduct consulting fees where there were no written agreements, no documentation providing how the management fees were calculated, and billing invoices containing almost no details); *Fuhrman v. Comm'r*, 102 T.C.M. (CCH) 347 2011-236, 2011 WL 4502290, at *2-3 (same).[468]

The nature of the actual payments appeared much more consistent with payments being made to the shareholders as a return based on their ownership interest in the corporation, something we'd normally refer to as a dividend payment:

> Further, we agree with the tax court that the management fees paid by Aspro to Jackson Enterprises Corp. and Manatt's Enterprises, Ltd. were not purely for services rendered and were instead disguised distributions of profits. See *David E. Watson*, 668 F.3d. at 1019. Aspro has made no dividend distributions since the 1970s but has paid management fees every year but one for twenty years. See *Paul E. Kummer Realty Co. v. Comm'r*, 511 F.2d 313, 315 (8th Cir. 1975) ("[T]he absence of dividends to stockholders out of available profits justifies an inference that some of the purported compensation really represented a distribution of profits as dividends."); *Charles Schneider*, 500 F.2d at 153 ("Perhaps most important [in identifying disguised distributions] is the fact that no dividends were ever paid by

[466] *Aspro v. Commissioner*, Case No. 21-1996, CA8, April 26, 2022

[467] *Aspro v. Commissioner*, Case No. 21-1996, CA8, April 26, 2022

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> any of these companies during [this time], even though they enjoyed consistent profits and immense success in the industry.").[469]

In addition to the fact that dividends never had been paid, the court noted that the actual amount in management fees seemed to be roughly in line with the percentage of ownership interest of the various owners. Again, this is more like something we would expect to see in the payment of dividends then we would for payments based on the value of services actually rendered:

> And Aspro has also paid management fees in amounts roughly proportional to the ownership interests of the stockholders. Jackson Enterprises Corp. and Manatt's Enterprises, Ltd. each owned forty percent of Aspro's stock, and each received forty-three percent of the total management fees paid in 2012, forty-six percent in 2013, and forty-four percent in 2014. See *Paul E. Kummer*, 511 F.2d at 316 (suggesting that payments to shareholders that were "almost identical" to their ownership interest indicated disguised distributions); Treas. Reg. § 1.162-7(b)(1) (stating that a disguised distribution is likely where "excessive payments correspond or bear a close relationship" to ownership interests); *RTS Inv. Corp. v. Comm'r,* 53 T.C.M. (CCH) 171, aff'd, 877 F.2d 647 (8th Cir. 1989) (per curiam). The district court correctly found that Aspro had a "process of setting management fees [that] was unstructured and had little if any relation to the services performed" and "had relatively little taxable income after deducting the management fees," and Aspro does not dispute that it paid the management fees as lump sums at the end of the tax year even though many of the services that Aspro claims justified the management fees were performed throughout the year. See *Nor-Cal Adjusters v. Comm'r*, 503 F.2d 359, 362-63 (9th Cir. 1974) (affirming in a disguised-distribution context the tax court's reliance on factors including an unstructured process of setting shareholder compensation, consistently negligible taxable income, and lump-sum payments to shareholders). Therefore, the tax court did not clearly err in concluding that the management fees paid to Jackson Enterprises Corp. and Manatt's Enterprises, Ltd. were nondeductible because Aspro failed to carry its burden of showing that the fees were reasonable and purely for services.[470]

The corporation also failed to show that overall amounts paid to the shareholders for their salaries, bonuses, directors fees and management fees represented reasonable amounts of compensation to the shareholders for services actually rendered:

> We conclude that the district court did not clearly err in finding that Aspro failed to meet its burden to show that the management fees paid to Dakovich "would ordinarily be paid for like services by like enterprises under like circumstances." See Treas. Reg. § 1.162-7(b)(3); *Home Interiors*, 73 T.C. at 1155-56. Aspro did not present evidence showing what similar companies under like circumstances would pay as management fees (over and above salary and bonuses) to an employee like Dakovich for the same type of management services. It also did not quantify the value of the management services he provided, nor did it show that like enterprises would pay that amount for them. In fact, the Commissioner's expert said the exact opposite. Nunes, an expert in valuing compensation arrangements, reviewed deposition transcripts about the services Dakovich provided to Aspro and determined the amount of reasonable compensation that a comparable enterprise would have to pay in the marketplace for the services described in the depositions.

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> He concluded that Dakovich's salary and bonus exceeded the industry average and median by a substantial margin and that management fees in addition to the salary and bonus were not reasonable. When Nunes added Dakovich's excess compensation per year to his management fees, his share of the total management fees over the three years at issue was twenty-two percent, closely aligning with his twenty-percent ownership interest in Aspro; the other two shareholders each received thirty-nine percent, which closely aligned with their approximately 40% each ownership interest in Aspro.[471]

The panel also concluded, not surprisingly, that these payments did not constitute reasonable compensation to the shareholders:

> Factors discussed in *Charles Schneider* strengthen our conclusion that the district court did not clearly err, including "the absence of profits paid back to the shareholders as dividends"; "the nature, extent and scope of the employee's work"; and "a most significant factor," "the prevailing rates of compensation for comparable positions in comparable concerns." See *Charles Schneider*, 500 F.2d at 152-54.[472]

Rather the panel concludes the facts lead to the conclusion that these payments are far more likely to be distributions of corporate profits to the equity holders, something that is not deductible at the corporate level:

> Aspro has not paid any dividends to stockholders since the 1970s, but regularly pays management fees. This "justifies an inference that . . . the purported compensation really represents a distribution of profits." See id. at 153.[473]

The court also noted that these fees were always paid at the end of the year, and generally brought the corporation's taxable income down to a relatively small amount:

> As with Jackson Enterprises Corp. and Manatt's Enterprises, Ltd., Aspro paid the management fees as lump sums at the end of the tax year even though the purported services were performed throughout the year, had an unstructured process of setting the management fees that did not relate to the services performed, and had a relatively small amount of taxable income after deducting the management fees. See *Nor-Cal Adjusters*, 503 F.2d at 362-63. Therefore, the tax court did not clearly err in finding that Aspro failed to carry its burden of showing that the management fees were reasonable and purely for services actually performed.[474]

Lessons from This Case

Advisors can take a number of lessons from studying this case. One of the key ones actually has little to do with the issue at hand, but rather to something that's often used to justify taking positions that the advisor should be aware would be unlikely to survive any sort of review by a taxing agency.

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[471] *Aspro v. Commissioner*, Case No. 21-1996, CA8, April 26, 2022

[472] *Aspro v. Commissioner*, Case No. 21-1996, CA8, April 26, 2022

[473] *Aspro v. Commissioner*, Case No. 21-1996, CA8, April 26, 2022

[474] *Aspro v. Commissioner*, Case No. 21-1996, CA8, April 26, 2022

As the panel noted, the corporation had gotten away with making these disguised dividend payments for two decades before the IRS finally examined the corporation and raised the issues. The fact that the IRS had never challenged this before, or, as clients often love to tell their tax advisor, other taxpayers have been doing this for decades and never had an issue, is of no use once the challenge is brought forth. Note that the court never even vaguely considered allowing the taxpayer to claim this deduction merely because it had gone unchallenged for so long.

Second, it is important to carefully document anything dealing with a payment to a related party where the IRS may gain advantage by restructuring that payment under a different view. The lack of any sort of documentation regarding how these management fees had been computed allowed the IRS to easily persuade the court it was likely they were being paid to bail out earnings from the corporation to avoid having a double tax situation eventually, where amounts were going to be taxed at the corporate level and later taxed when distributed to the shareholders. Even worse, there wasn't even the very basic type of documentation regarding the nature of the agreement or what exactly the services were that were to be performed in order to earn these management fees.

The fact that payments were made solely in a lump sum at the end of the year also helped the IRS persuade the court that this was such a tool being used solely to reduce taxable income in the corporation, not an actual payment related to services being rendered to the corporation.

Again, it's important to note that the taxpayers had years of what they believed was IRS acceptance of this sort of a program. But reality is that the IRS doesn't look at most returns in any detail, even when claiming deductions for things like management fees that you might think could raise some issues. And it's also important to note that the fact you got away with it for 20 years is no defense whatsoever in a year in which the agency decides to ask about the item.

Advisors need to realize that even though this corporation got away with this for 20 years, advisors working with a large number of taxpayers are going to be far more exposed to the IRS running into the issue on one or more of their clients.

So the advisor is far more exposed than any individual client to potentially bad results arising from such sloppy and aggressive tax positions being taken. Such bad results can arise from the IRS taking action against the preparer, but more likely the advisor's client will suddenly be "shocked" to discover that this position was aggressive, regardless of how hard they may have pushed for it or how much they whined that all of their friends and business acquaintances were doing the same thing and they wondered why the advisor was being such a wimp about these matters. That may result in the client either filing a civil claim against the tax advisor or filing a complaint with a licensing agency.

SECTION: 174
AICPA LETTER GIVES RECOMMENDATION ON GUIDANCE ON

UPCOMING TCJA REQUIREMENT TO AMORTIZE RATHER THAN EXPENSE R&D EXPENSES

Citation: "Comments on Research & Experimental Expenditures under section 174," Letter from AICPA Tax Executive Committee to Associate Chief Counsel Holly Porter, 5/26/22

The AICPA sent a letter[475] to IRS Associate Chief Counsel Holly Porter (Passthroughs and Special Industries) with comments regarding the need for guidance on research and experimental expenditures under IRC §174.

The Tax Cuts and Jobs Act revised IRC §174 so that, effective for tax years beginning after December 31, 2021, *specified research or experimental expenditures* are no longer currently deductible by a business, but rather must be amortized over 5 years for domestic research and 15 years for foreign research.

Stalled Attempt to Restore the Full Expensing of Such Costs

One of the regular budget games Congress has played over the years is to enact revenue raisers as part of major bills, but provide these likely unpopular revenue raising provisions won't take effect for many years. In the case of the Affordable Care Act, for example, the "Cadillac tax" on high cost medical plans was not scheduled to take effect until many years after the 2010 passage of the law.

An unstated assumption for such long delayed revenue raisers is that a later Congress will repeal the provision before it actually takes effect and begins to inflict pain. In the case of the Affordable Care Act, this implied agreement with future Congresses did eventually play out—that tax was never actually implemented.

This has the advantage of initially making the provisions in the original bill appear to have less of an overall impact on net federal spending. As the pain does not take place for years, there is less of a hue and cry about including this provision in lieu of making actual reductions in the cost of the package.

Then, years later, Congress can remove the provision once the only issue before the Congress is the pain this provision will create—a current pain that makes it easier to explain the need to incur the budget hit. Who knows, it might even help get those same Congressional members who voted for the first bill to now even get more credit for preventing these harms.

However, things aren't going so well for this provision that raised revenue by forcing companies to capitalize and amortize research or experimental expenditures in what seemed at the time the "distant" future. The expected repeal has been introduced, but it was part of the Build Back Better Act which has stalled in Congress. For now, backers of the repeal have not been able to attach the provisions to a "must pass" bill, nor have they succeeded in getting both chambers to consider a "clean" bill.

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[475] "Comments on Research & Experimental Expenditures under section 174," Letter from AICPA Tax Executive Committee to Associate Chief Counsel Holly Porter, May 26, 2022, https://us.aicpa.org/content/dam/aicpa/advocacy/tax/downloadabledocuments/56175896-aicpa-comment-letter-section-174-research-and-experimental-expenditures-final.pdf (retrieved June 3, 2022)

In the interim, C corporations looking to prepare GAAP financial statements have been forced to start trying to figure out how the law would impact their tax provisions. As well, while it seems more likely than not that Congress will eventually restore immediate expensing (albeit, potentially retroactively sometime in 2023), that cannot be guaranteed if Congress deadlocks—the repeal could become a victim of partisan battles in Congress even if clear majority on both sides of the aisle claim passing this provision is a high priority.

The Post-TCJA IRC §174

The new IRC §174 begins with the following general rule:

> (a) In general. In the case of a taxpayer's specified research or experimental expenditures for any taxable year —
>
> > (1) except as provided in paragraph (2), no deduction shall be allowed for such expenditures, and
> >
> > (2) the taxpayer shall —
> >
> > > (A) charge such expenditures to capital account, and
> > >
> > > (B) be allowed an amortization deduction of such expenditures ratably over the 5-year period (15-year period in the case of any specified research or experimental expenditures which are attributable to foreign research (within the meaning of section 41(d)(4)(F))) beginning with the midpoint of the taxable year in which such expenditures are paid or incurred.[476]

IRC §174(b) defines what are *specified research or experimental expenditures*, which is key to applying this provision:

> (b) Specified research or experimental expenditures. For purposes of this section, the term "specified research or experimental expenditures" means, with respect to any taxable year, research or experimental expenditures which are paid or incurred by the taxpayer during such taxable year in connection with the taxpayer's trade or business.[477]

[476] IRC §174(a)

[477] IRC §174(b)

Scope of the Guidance the AICPA is Requesting

The letter outlines those areas where the AICPA believes guidance is needed in the very near future. The letter reads:

> Specifically, the AICPA requests guidance and provides recommendations in the following areas.
>
> 1. Identification of categories of section 174(a) expenditures.
>
>   - Treasury and IRS should issue regulations providing that section 174(a) expenditures include direct costs, including employee compensation, contract labor, and materials, and, at the taxpayer's election, allocable indirect and overhead costs.
>
>   - Additionally, Treasury and IRS should issue regulations that illustrate, using detailed examples, which costs are "incident to" the development or improvement of a product as per Reg. § 1.174-2.
>
> 2. Issues that have arisen with regard to Rev. Proc. 2000-50.
>
>   - IRS should modify the scope limitation under section 4 of Rev. Proc. 2000-50 to clarify that the limitation on costs that a taxpayer has treated as R&E expenditures under section 174 only applies to costs previously subject to an irrevocable election under section 174, including section 174(b) or charging the expenses to capital account.
>
>   - Additionally, IRS should make a corresponding modification to the scope limitation under section 9.01(2) of Rev. Proc. 2022-14.[478]

The AICPA describes the background that leads to the need for this updated guidance:

> Pre-TCJA, section 174 provided taxpayers with the option to immediately expense R&E expenditures under section 174(a) or elect to defer and amortize the expenditures over a period of not less than 60 months under section 174(b), or charge the expenditures to capital account under Reg. § 1.174-1. In addition, taxpayers could elect under section 59(e) to amortize over 10 years expenditures otherwise allowed as a deduction under section 174(a). Prior to the changes, taxpayers that paid or incurred costs for software development could rely on Rev. Proc. 2000-50, which allowed taxpayers to treat software development costs in the same manner as under section 174, including the same options (other than charging to capital account), whether the expenditures met the requirements of section 174 or not.
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> In addition to mandatory capitalization of R&E expenditures, the TCJA changed the language in section 174 from "research or experimental expenditures" to "specified research or experimental expenditures," and added a special rule under

[478] "Comments on Research & Experimental Expenditures under section 174," Letter from AICPA Tax Executive Committee to Associate Chief Counsel Holly Porter, May 26, 2022

> section 174(c)(3) that specifies that for purposes of section 174, any amount paid or incurred in connection with the development of any software is treated as a "specified research or experimental expenditure." As a result, the TCJA effectively eliminates taxpayers' ability to rely on Rev. Proc. 2000-50 to deduct software development expenditures in the year incurred.[479]

The AICPA breaks the letter down into two sections, the first looking for overall guidance on what constitutes various §174(a) expenditures and the second dealing with issues related to software expenditures arising due to Revenue Procedure 2000-50 and the post-TCJA IRC §174.

Identification of Categories of IRC §174(a) Expenditures

The AICPA begins by noting that a large number of taxpayers have no systems in place to identify research or experimental expenditures:

> Many taxpayers that pay or incur section 174 expenditures may not have an established methodology to identify the appropriate amounts of these expenditures that are now subject to mandatory amortization because, prior to the TCJA, the tax accounting treatment of current expensing generally would have been allowable whether the expenses were deductible as ordinary and necessary trade or business expenditures under section 162(a) or R&E expenditures under section 174(a).[480]

An initial reaction some might have is that, wait a minute, a lot has been written about the IRC §41 research credit and can't that serve to provide guidance. But the AICPA notes that while the §174 definitions are relevant to the research credit, more expenses are treated as §174 expenses than are those that can be used for IRC §41's research credit:

> Taxpayers with research activities conducted in the United States may claim a research credit under section 41 for increasing these activities. The amount of the section 41 research credit by statute is a function of several variables including the amount of expenditures paid or incurred by the taxpayer that meet the definition of section 174(a) expenses. Although meeting the definition of section 174 is generally considered a threshold requirement for the section 41 research credit, the pool of costs eligible for the credit has been clearly delineated to include only wages, supplies, rental or lease of computers, and contract research expenses.[481]

The letter goes on to discuss the limitations of the regulations under IRC §174:

> In contrast to the requirements for the section 41 research credit, the regulations under Reg. § 1.174-2 do not clearly delineate the extent to which various categories of expenses, including direct and indirect costs, fall within the definition of research and experimental expenditures. Rather, the regulations focus on the nature of the activity to which the expenditures relate. The regulations further provide that the qualified activities must involve the elimination of uncertainty in the development or improvement of a product, including products to be used by the taxpayer in its trade

[479] "Comments on Research & Experimental Expenditures under section 174," Letter from AICPA Tax Executive Committee to Associate Chief Counsel Holly Porter, May 26, 2022

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> or business, or held for sale, lease, or license. With respect to defining the categories of expenses that might fall within the scope of section 174, and thus the amortization requirement provided in the TCJA, the regulations provide a very general standard for identifying section 174 expenditures. Pursuant to the regulations, section 174 applies to all costs that are "incident to" the development or improvement of a product.
>
> While the regulations do not explicitly define which costs are "incident to" the development or improvement of a product, they do provide that costs paid or incurred in the production of a product after the elimination of uncertainty do not qualify as section 174 expenditures. The regulations exclude certain expenditures from section 174 eligibility including ordinary testing for quality control, management studies, and advertising and promotions, amongst others. Additionally, interpretive guidance suggests that allocable indirect costs and overhead may be section 174 eligible.[482]

The AICPA letter then notes that while previously there was little need for such specific §174 guidance since all expenses were immediately deductible, that is no longer the case:

> Up until the TCJA, due to the current expensing option and the explicit constraints on expenses eligible for the section 41 research credit, there has been far less of a need for detailed rules addressing which categories of costs must be allocated to R&E activities and the extent to which such costs are characterized as expenses subject to section 174 treatment. Indirect costs, including overhead and general and administrative costs are of particular concern for many taxpayers, as such costs may be properly allocable to many business activities. In light of the new mandatory amortization regime, there is a need for guidance that provides taxpayers with certainty and uniformity in the accounting for these costs, and that minimizes controversies over the categories of costs associated with R&E activities that are subject to amortization. Without such guidance, some taxpayers will interpret the rules to apply narrowly to direct costs, while others may apply a full-absorption costing method like the rules of section 263A.[483]

AICPA Recommendations on Section 174(a) Expenditures

The AICPA letter contains the following two recommendations to the IRS and Treasury:

- The AICPA recommends that Treasury and IRS issue regulations providing that section 174(a) expenditures include direct costs, including employee compensation, contract labor, and materials, and, at the taxpayer's election, allocable indirect and overhead costs.
- Additionally, the AICPA recommends that Treasury and IRS issue regulations that illustrate, using detailed examples, which costs are "incident to" the development or improvement of a product as per Reg. § 1.174-2.[484]

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[484] "Comments on Research & Experimental Expenditures under section 174," Letter from AICPA Tax Executive Committee to Associate Chief Counsel Holly Porter, May 26, 2022

A key concern of the AICPA relates to how broadly the IRS might cast the net to bring in indirect expenses to be part of the amortization rules. For this reason, the AICPA argues Congress did not intend for §174 to include expenses broadly in the way that IRC §263A brings expenses into inventory:

> In contrast to section 174, the uniform capitalization rules of section 263A provide a requirement to capitalize all direct and indirect costs that directly benefit or are incurred by reason of the production or resale of specified categories of property. In enacting section 263A, Congress provided very detailed rules in the legislative history as to which categories of direct and indirect costs would be subject to capitalization under section 263A. Further, the regulations follow this mandate and provide very detailed rules with a high degree of specificity as to which categories of direct and indirect costs, including overhead and service costs, are required to be allocated to activities and capitalized to property subject to section 263A. The types of activities subject to section 263A are activities for which the capitalization of direct costs, and in some cases certain types of indirect costs, were required to be capitalized under pre-section 263A law. The enactment of section 263A represents a congressional intent to establish more uniform rules for the identification and treatment of indirect costs with respect to tangible property.
>
> Research and experimental expenses were considered a type of indirect cost associated with production of property, but by statute, preserving the current expensing option under section 174(a), this category of costs was explicitly excluded from the capitalization requirement of section 263A.[485]

The AICPA also points out that Treasury did not cast a broad §263A sized net in determining capitalization of intangible assets and benefits in response to the US Supreme Court's *INDOPCO*[486] decision:

> In 2003, in response to controversies that arose from the Supreme Court's 1992 decision in the *INDOPCO* case, the IRS and Treasury issued final regulations to provide certainty as to the capitalization of costs with respect to intangible assets and benefits, including business acquisitions and restructurings. These regulations provide that taxpayers must capitalize amounts paid to acquire or create certain enumerated categories of intangible assets, and costs that facilitate the acquisition or creation of such intangible assets. In contrast to section 263A, these regulations explicitly provide that employee compensation, overhead, and certain de minimis costs are deemed not to facilitate the acquisition or creation of the enumerated intangibles and therefore are not required to be capitalized. Taxpayers may, however, elect to capitalize employee compensation, overhead, and de minimis costs with respect to such intangibles under the regulations.[487]

[485] "Comments on Research & Experimental Expenditures under section 174," Letter from AICPA Tax Executive Committee to Associate Chief Counsel Holly Porter, May 26, 2022

[486] *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79 (1992)

[487] "Comments on Research & Experimental Expenditures under section 174," Letter from AICPA Tax Executive Committee to Associate Chief Counsel Holly Porter, May 26, 2022

The letter argues that Congress has not looked to have expansive, full-absorption style costing rules apply to new IRC §174:

> Amended section 174 takes away the option of current expensing under section 174(a). Many, if not most, taxpayers have relied on and consistently used the current expensing method for decades where they have had little need to apply a full-absorption regime. In amending section 174 to eliminate the current expensing option, and mandate amortization for all section 174(a) expenses, including all software development activities, Congress gave no indication that a switch to mandatory amortization should be subjected to a full-absorption regime such as the uniform capitalization regime under section 263A. To the contrary, as evidenced by the need to add a Code section to mandate a full-absorption type regime, it can be inferred that such a regime should be the subject of congressional action rather than administrative mandate. Further, the new mandatory amortization regime mirrors the prior elective amortization option under section 59(e) whereby, to our knowledge and experience relying upon the available guidance, taxpayers availing themselves of that election have never applied a full-absorption regime to allocate additional overhead and general and administrative costs to the pool of costs subject to the election. Similarly, under the former alternative election to either defer and amortize the costs under section 174(b) or charge the expenses to capital account, and which applied to all costs allocable to specific projects, the IRS has never sought to require taxpayers to apply a full-absorption methodology to the project costs subject to these elections. These elections have been in place for almost 70 years without any indication in our practical experience of such a requirement.[488]

The letter then returns to comparing Congress' reasons for enacting IRC §263A as compared to the reasons for enacting IRC §174:

> The legislative history leading up to the enactment of the uniform capitalization rules indicates a perception that congressional action was necessary to mandate full-absorption costing with respect to the various categories of properties subjected to those rules. As evidenced by the statutory language, regulations, and legislative history, imposing such a regime requires detailed and specific rules defining the categories of costs subject to capitalization, the categories of costs not subject to capitalization and methods of allocating costs to the appropriate property or cost objective. Congress gave no indication that in mandating that section 174 expenses be amortized rather than currently expensed, taxpayers would also be subject to a full-absorption costing regime like the one contained in section 263A. Further, given that section 263A treats section 174 expenses themselves as an indirect cost that are not required to be capitalized to property subject to section 263A, it would seem incongruous to then treat section 174 costs themselves as a direct cost that is burdened with indirect costs such as overhead and general and administrative costs. For these reasons, congressional action setting forth a specific requirement and detailed rules is necessary to require that taxpayers apply a full-absorption costing regime for purposes of defining the types and categories of costs that are classified as R&E costs under section 174(a).[489]

[488] "Comments on Research & Experimental Expenditures under section 174," Letter from AICPA Tax Executive Committee to Associate Chief Counsel Holly Porter, May 26, 2022

[489] "Comments on Research & Experimental Expenditures under section 174," Letter from AICPA Tax Executive Committee to Associate Chief Counsel Holly Porter, May 26, 2022

Thus, the AICPA concludes, the IRS and Treasury should provide guidance that limits the scope of costs mandated to be amortized under this rule:

> In the absence of such an explicit requirement referencing more detailed rules, guidance should clarify that taxpayers are required to allocate direct costs, including wages, contractor costs, other direct labor costs, and materials and supplies, to the particular costs objective and are not required to allocate indirect costs such as overhead and general and administrative costs to such activity for purposes of identifying the amount of costs required to be amortized under section 174. At the same time, it would also provide a clear reflection of income to permit taxpayers on an elective basis to allocate overhead expenses for this purpose. This election could be patterned after the election Treasury and IRS adopted in 2003 under the intangibles regulations.[490]

Revenue Procedure 2000-50 Issues Under New §174

The second part of the letter deals with Revenue Procedure 2000-50 which provided guidance for software costs under the prior law. The letter begins by summarizing the procedure, as well as the restriction that it only applied to costs not subject to amortization:

> Rev. Proc. 2000-50 provided guidance under prior law for the treatment of costs paid or incurred to develop, purchase, lease, or license computer software, and provides automatic consent for accounting method changes from one optional method to another. However, section 4 of Rev. Proc. 2000-50 explicitly states that this revenue procedure does not apply to any computer software that is subject to amortization as an "amortizable section 197 intangible" as defined in section 197(c) and the regulations thereunder, or to costs that a taxpayer has treated as a research and experimentation expenditure under section 174.[491]

The letter summarizes the provisions of the Revenue Procedure as follows:

> Section 5 of Rev. Proc. 2000-50 provides that the costs of developing computer software (whether or not the particular computer software is patented or copyrighted) in many respects so closely resemble the kind of research and experimental expenditures that fall within the purview of section 174 as to warrant similar accounting treatment. Accordingly, the IRS will not disturb a taxpayer's treatment of costs paid or incurred in developing software for any particular project, either for the taxpayer's own use or to be held by the taxpayer for sale or lease to others, where:
>
> - All of the costs properly attributable to the development of software by the taxpayer are consistently treated as current expenses and deducted in full in accordance with rules similar to those applicable under section 174(a); or
>
> - All of the costs properly attributable to the development of software by the taxpayer are consistently treated as capital expenditures that are recoverable

[490] "Comments on Research & Experimental Expenditures under section 174," Letter from AICPA Tax Executive Committee to Associate Chief Counsel Holly Porter, May 26, 2022

[491] "Comments on Research & Experimental Expenditures under section 174," Letter from AICPA Tax Executive Committee to Associate Chief Counsel Holly Porter, May 26, 2022

> through deductions for ratable amortization, in accordance with rules similar to those provided by section 174(b) and the regulations thereunder, over a period of 60 months from the date of completion of the development or, in accordance with rules provided in section 167(f)(1) and the regulations thereunder, over 36 months from the date the software is placed in service.
>
> Section 9.01 of Rev. Proc. 2022-14 provides the latest automatic method change procedures for a taxpayer that wants to change its method of accounting for the costs of computer software to a method described in Rev. Proc. 2000-50, including a taxpayer that wants to change its treatment of the costs of developing computer software to one of the methods described above (but only for software development costs incurred in taxable years for which the mandatory amortization rules under section 174 are not in effect). However, section 9.01(2) of Rev. Proc. 2022-14 similarly states that this change does not apply to any computer software that is subject to amortization as an "amortizable section 197 intangible" as defined in section 197(c) and the regulations thereunder, or to costs that a taxpayer has treated as R&E expenditures under section 174.[492]

The letter goes on to describe issues arising regarding the accounting method provisions in this area:

> There has been longstanding uncertainty regarding whether taxpayers were deemed to have historically treated the costs of computer software as R&E expenditures under section 174 that would have precluded such taxpayers from changing their methods of accounting for the costs of computer software under the automatic change procedures of Rev. Proc. 2000-50 and Rev. Proc. 2022-14. In addition, while automatic change procedures are available for a change in the treatment of section 174 costs, a change in accounting method under section 174, must be implemented on a cutoff basis rather than with a section 481(a) adjustment like a change in accounting method under Rev. Proc 2000-50.[493]

AICPA Requested Change to Scope

The letter requests the following modifications to guidance in this area:

> The AICPA recommends that the IRS modify the scope limitation under section 4 of Rev. Proc. 2000-50 to clarify that the limitation on costs that a taxpayer has treated as R&E expenditures under section 174 only applies to costs previously subject to an irrevocable election under section 174, including section 174(b) or charging the expenses to capital account.
>
> Additionally, the AICPA recommends that the IRS makes a corresponding modification to the scope limitation under section 9.01(2) of Rev. Proc. 2022-14.[494]

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[492] "Comments on Research & Experimental Expenditures under section 174," Letter from AICPA Tax Executive Committee to Associate Chief Counsel Holly Porter, May 26, 2022

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The AICPA begins its analysis by looking at the history of Revenue Procedure 2000-50:

> Section 162 allows a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business. Similarly, for tax years prior to 2022, section 174(a) allows for immediate expensing of R&E expenditures that are paid or incurred by a taxpayer during the taxable year in connection with its trade or business, although taxpayers may elect under section 174(b) to capitalize and amortize such costs ratably over a period of not less than 60 months. Regulation § 1.174-2(a)(1) defines R&E expenditures under section 174 as expenditures incurred in connection with the taxpayer's trade or business that represent research and development costs in the experimental or laboratory sense.
>
> The IRS published Rev. Proc. 2000-50 to update, modify, and restate the guidelines for the treatment of the costs of computer software. Rev. Proc. 2000-50 provides separate rules for the costs of developing computer software, costs of acquired computer software, and leased or licensed computer software. As mentioned above, the guidance provides three allowable methods of accounting for software development costs (two of which are based on rules similar to those provided by section 174). These options were provided to eliminate controversy and reduce disputes with taxpayers.[495]

The AICPA describes uncertainty created by this guidance in certain situations:

> The current guidance under Rev. Proc. 2000-50 does not apply to "costs that a taxpayer has treated as R&E expenditures under section 174." However, this specific wording has generated much uncertainty regarding whether certain taxpayers can apply the guidance under Rev. Proc. 2000-50, as illustrated by the following examples:

EXAMPLE 1

Taxpayer has historically treated various types of computer software costs (i.e., amounts paid or incurred to develop, purchase, lease, and/or license computer software) as immediate expenses. The taxpayer has now determined a method change is required under Rev. Proc. 2000-50 for the treatment of certain costs (e.g., the purchased software should be capitalized and amortized ratably over a period of 36 months in accordance with section 6.01(2) of Rev. Proc. 2000-50 and section 167(f)(1)).

EXAMPLE 2

Taxpayer previously changed its method of accounting for the costs of developing computer software under section 5.01(1) of Rev. Proc. 2000-50 to treat as current expenses *in accordance with rules similar to those applicable under section 174(a)*. The taxpayer has now decided to change its method of accounting for the costs of developing computer software to another method provided under section 5 of Rev. Proc. 2000-50 (e.g., capitalize and amortize ratably over a period of 36 months).[496]

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[495] "Comments on Research & Experimental Expenditures under section 174," Letter from AICPA Tax Executive Committee to Associate Chief Counsel Holly Porter, May 26, 2022

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The AICPA looks first at Example 1's facts and issues that arise:

> In example 1, the taxpayer historically treated the computer software costs as immediate expenses. However, has the taxpayer immediately expensed such costs as ordinary and necessary business expenses under section 162 or as R&E costs under section 174? If some of the costs actually meet the requirements of section 174 (e.g., resolving uncertainty) and others do not, would the statement only apply to the former or would it also apply if the taxpayer erroneously treated the expenses as section 174 costs? Based on this statement, could Rev. Proc. 2000-50 also be interpreted to apply only to software development expenses that do not in fact meet the requirements of section 174 (by virtue of the statement that the costs at issue "closely resemble" section 174 expenses, which creates an implication that the procedure might not apply to all software expenses but only the subset of software development expenses that do not in fact meet the requirements of section 174).
>
> It may be impossible to distinguish whether an expense was deducted as an ordinary and necessary business expense under section 162 or as R&E costs under section 174 based on how the costs were reflected on the taxpayer's federal income tax returns, and it would seem to defeat the purpose of Rev. Proc. 2000-50 to scope out of the method change any of the above situations. Furthermore, the guidance under Rev. Proc. 2000-50 was intended to simplify the accounting method treatment of computer software costs without burdening taxpayers from having to undertake an in-depth analysis to determine whether such costs are deductible as R&E expenditures under section 174. The results of such study would be highly subjective anyways given the lack of current guidance under section 174 with respect to computer software costs. In fact, the government previously issued proposed regulations under section 174 in 1983 (47 FR 2790) and 1989 (54 FR 21224) attempting to clarify the treatment of software development costs under section 174 only to withdraw those amendments to the regulations in 1993 (58 FR 15819) and instead lean on the administrative guidance contained in Rev. Proc. 69-21. See below excerpt from the preamble to the 1993 proposed regulations under section 174:
>
>> In Revenue Procedure 69-21, 1969-2 C.B. 303, the IRS announced that, as a matter of administrative practice, it would allow taxpayers to treat software development costs in a manner similar to the manner research or experimental expenditures are treated under section 174. The 1983 proposed regulation, however, would have provided additional conditions on the qualification of software development costs as research or experimental expenditures beyond those applicable to other products.
>>
>> In the preamble to the 1989 proposed regulation, the IRS announced that it is studying the continuing validity of Rev. Proc. 69-21. The IRS has no present intention of changing its administrative position contained in Rev. Proc. 69-21, but it continues to study its viability. Taxpayers may continue to rely on Rev. Proc. 69-21. The amendments proposed in this document do not provide additional conditions applicable to computer software development costs. The IRS again invites comments on the proper tax accounting treatment of software development costs that do not qualify as research or experimental expenditures.

> The AICPA does not believe it was the IRS' intent to prohibit the taxpayer in example 1 from applying Rev. Proc. 2000-50 based on its present method of accounting. In fact, allowing this taxpayer to apply the guidance in Rev. Proc. 2000-50 would result in greater compliance with the Code. Therefore, the IRS should modify the scope limitations under section 4 of Rev. Proc. 2000-50 and section 9.01(2) of Rev. Proc. 2022-14 to clarify the limitation on costs that a taxpayer has treated as an R&E expenditure under section 174 only applies to costs that have been subject to an irrevocable election under section 174, including section 174(b) or charging the expenses to capital account.[497]

The letter concludes by giving the AICPA analysis of the second example:

> In example 2, the taxpayer's present method of accounting for software development costs is in accordance with section 5.01(1) of Rev. Proc. 2000-50, which is based on "rules similar to those applicable under section 174(a)." This language has led many taxpayers and practitioners to question whether the taxpayer's present method would render them ineligible to make a subsequent change in method of accounting for software development costs under Rev. Proc. 2000-50.
>
> As mentioned above, the guidance under section 5 of Rev. Proc. 2000-50 was provided to eliminate controversy and reduce disputes with taxpayers due to the uncertainty of the extent to which software development costs actually meet the definition of R&E expenditures under section 174. In fact, section 5.01 of Rev. Proc. 2000-50 indicates that the costs of developing computer software "in many respects so closely resemble the kind of R&E expenditures that fall within the purview of section 174 as to warrant similar accounting treatment." Thus, the IRS seems to indicate that certain software development costs are not necessarily R&E costs under section 174 but should be afforded similar treatment. However, this guidance was intended to simplify the accounting method treatment of computer software costs without burdening taxpayers from having to undertake an in-depth analysis to determine which of their software development costs meet the classification criteria of section 174 requirements, and which do not.
>
> The AICPA does not believe it was the IRS' intent to prohibit the taxpayer in example 2 from making a subsequent change in method of accounting for software development costs under Rev. Proc. 2000-50 merely because it presently treats such costs as current expenses.[498]

[497] "Comments on Research & Experimental Expenditures under section 174," Letter from AICPA Tax Executive Committee to Associate Chief Counsel Holly Porter, May 26, 2022

[498] "Comments on Research & Experimental Expenditures under section 174," Letter from AICPA Tax Executive Committee to Associate Chief Counsel Holly Porter, May 26, 2022

SECTION: 223
HDHP AND HSA INFLATION ADJUSTED NUMBERS RELEASED FOR 2023

Citation: Revenue Procedure 2022-24, 4/29/22

In Revenue Procedure 2022-24[499] the IRS has announced the inflation-adjusted amounts for Health Savings Accounts (HSAs) for 2023.

Contribution Limitations for 2023

The inflation adjusted contribution limitations for HSAs in 2023 will be:

- Individual with self-only coverage: $3,850 and
- Individual with family coverage: $7,750.[500]

High Deductible Health Plan Amounts for 2023

In order for an individual to make a contribution to a health savings account, he/she must have coverage under a qualifying high deductible health plan (HDHP) and no disqualifying coverage.

For 2023, an HDHP is a health plan with an annual deductible of:

- Not less than $1,500 for an individual with self-only coverage and
- Not less than $3,000 for an individual with family coverage.[501]

As well, total out-of-pocket expenses (other than premiums) cannot exceed $7,500 for self-only coverage or $15,000 for family coverage.[502]

Excepted Benefit HSA

In 2023 the maximum amount that may be made newly available for the plan year for an excepted benefit HSA under Treasury Reg. §54.9831-1(c)(3)(viii) is $1,950.[503]

SECTION: 262
NURSE'S COMFORTABLE AND PROFESSIONAL CLOTHING WORN

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499 Revenue Procedure 2022-24, April 29, 2022, https://www.taxnotes.com/research/federal/irs-guidance/revenue-procedures/irs-announces-2023-inflation-adjusted-amounts-for-hsas/7dfqm (retrieved May 3, 2023)

500 Revenue Procedure 2022-24, April 29, 2022

501 Revenue Procedure 2022-24, April 29, 2022

502 Revenue Procedure 2022-24, April 29, 2022

503 Revenue Procedure 2022-24, April 29, 2022

OUTSIDE THE OPERATING ROOM FOUND TO BE A DEDUCTIBLE BUSINESS EXPENSE

Citation: Romana v. Commissioner, TC Summary Opinion 2022-9, 6/16/22

The Tax Court found that clothes purchased by a nurse to meet an employer's requirements that she be dressed in comfortable clothes and in a manner that reflected her profession as a nurse qualified as a deductible business expense in the case of *Romana v. Commissioner*, TC Summary Opinion 2022-9.[504]

The Law

While you might be objecting at this point that this case is no longer truly relevant, as the taxpayer claimed an employee business expense deduction that is not available at this point following changes to the law in the Tax Cuts and Jobs Act, the underlying issue is still very relevant for self-employed taxpayers and employers who are considering reimbursing employees for such expenditures or providing similar clothing to the employee to wear in a similar situation.

Clothing as a business expense has always been a bit tricky. The problem is that IRC §262(a) provides:

> (a) General rule. Except as otherwise expressly provided in this chapter, no deduction shall be allowed for personal, living, or family expenses.

Note the requirement that any item that is a personal, family or living expense will not be allowed unless *expressly provided* for in this chapter (the income tax provisions of the Internal Revenue Code).

So, this means it's not enough to show the clothing rises to an "ordinary and necessary business expense" under IRC §162, as that is a general allowance which would be barred as a deduction by IRC §262(a) if also a personal, family or living expense.

The question of whether the clothing required to be worn by Maria Romana was not also a personal, family or living expense is what the Court was looking to decide.

Facts of the Case

Maria was employed as a nurse in a Kaiser Permanente (Kaiser) plastic surgery clinic in California. Maria faced the following dress code imposed by Kaiser:

> Kaiser's dress code in effect at the location where she worked required that Mrs. Romana be dressed in "comfortable" clothes and in a manner that reflected her profession as a nurse. Neither Kaiser nor the collective bargaining agreement for her

[504] *Romana v. Commissioner*, TC Summary Opinion 2022-9, June 16, 2022, https://www.taxnotes.com/research/federal/court-documents/court-opinions-and-orders/tax-court-says-work-clothes-are-business-expenses-for-nurse/7dl0y (retrieved June 17, 2022)

> nursing union had a policy that allowed reimbursement for the expenses she incurred to purchase clothing that satisfied her employer's dress code.[505]

The Court described the clothes Maria acquired and wore at her employment:

> While at work, Mrs. Romana wore clothing that resembled scrubs that she purchased at her own expense from local department stores. In the operating room she was required to wear scrubs provided by Kaiser. Routinely, depending upon the operation schedule for any given day, she changed back and forth between her scrublike clothing and the operating room scrubs her employer provided.
>
> During 2017 Mrs. Romana also purchased, at her own expense, a white "lab" coat with "Kaiser Permanente" and her name embroidered on it. The purchase was made as part of a bulk purchase along with similar items purchased by fellow employees. The lab coat cost approximately $45, and it was dry cleaned multiple times during the year.[506]

The IRS challenged these deductions (among others claimed by Maria and her husband) and a Tax Court petition was eventually filed.

The Tax Court's View

The Tax Court notes the basic issues arising when a taxpayer attempts to claim clothes as a business expense:

> Generally, the cost of a business wardrobe, even if required as a condition of employment, is considered a nondeductible personal expense within the meaning of section 262. See, e.g., *Hynes v. Commissioner*, 74 T.C. 1266, 1290 (1980). Those costs are not deductible even when it has been shown that the particular clothes would not have been purchased but for the employment. *Id.* Clothing costs are deductible as ordinary and necessary business expenses under section 162 only if (1) the clothing is of a type specifically required as a condition of employment, (2) it is not adaptable to general use as ordinary clothing, and (3) it is not so worn. See *Yeomans v. Commissioner*, 30 T.C. 757, 767 (1958); see also *Deihl v. Commissioner,* T.C. Memo. 2005-287.[507]

Note that it's not enough for a taxpayer to claim that they would never actually wear such clothing except in a business setting. Their personal preferences in clothing aren't enough to make clothing that reasonably could be worn as ordinary clothing by those not in a business setting deductible.

Similarly, the mere fact that clothes could, theoretically, be worn in a non-business setting does not convert otherwise clearly business clothing into a nondeductible expense.

[505] *Romana v. Commissioner*, TC Summary Opinion 2022-9, June 16, 2022

[506] *Romana v. Commissioner*, TC Summary Opinion 2022-9, June 16, 2022

[507] *Romana v. Commissioner*, TC Summary Opinion 2022-9, June 16, 2022

The Tax Court, in what is always going to be a very fact specific holding, found that these particular clothes met the requirements to qualify as a business expense:

> Mrs. Romana was required to dress professionally and comfortably for her job as a nurse. To do so, she purchased shirts and pants at department stores. Because the clothing resembled scrubs, we find that the clothing was not adaptable to general use as ordinary clothing outside of her employment. Consequently, the cost of the clothing and the cost to dry clean the clothing are deductible. Mrs. Romana also purchased a white lab coat with "Kaiser Permanente" and her name embroidered on it. This lab coat was not appropriate for general use.[508]

The Tax Court allowed the expenses related to the clothes (costs to acquire them and cleaning expenses) to be treated as deductible expenses for tax purposes.

SECTION: 274
IRS ANNOUNCES 4 CENTS PER MILE INCREASE IN CERTAIN MILEAGE DEDUCTION FOR LAST 6 MONTHS OF 2022

Citation: Announcement 2022-13, 6/9/22

On May 13, eighteen members of Congress wrote the IRS asking for the agency to increase mileage rates in recognition of the rapid rise in the price of gasoline since the beginning of 2022.[509] The letter pointed out that the IRS had previously raised the rate mid-year in 2011, noting the increases this year are more substantial than those that prompted the increase in rates in 2011.

The IRS has now decided to take action to increase some mileage rates by 4 cents per mile effective July 1, announcing the change to be in effect for the last six months of 2022 in Announcement 2022-13.[510]

The revised mileage rates are:

- Business mileage: 62.5 cents per mile (previously 58.5 cents per mile)
- Medical and moving: 22 cents per mile (previously 18 cents per mile).[511]

The rate for charitable mileage will remain at 14 cents per mile, as that amount is set by the Internal Revenue Code and is not adjusted annually based on fuel costs, unlike the other two rates.[512]

The rates previously announced in Notice 2022-3 for 2022 will apply for mileage driven between January 1, 2022 to June 30, 2022.[513]

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[508] *Romana v. Commissioner*, TC Summary Opinion 2022-9, June 16, 2022

[509] "Gallego, Davids 2022 Standard Mileage Rate Letter," May 13, 2022, https://rubengallego.house.gov/sites/evo-subsites/rubengallego.house.gov/files/evo-media-document/Gallego%2C%20Davids%202022%20Standard%20Mileage%20Rate%20Letter.pdf (retrieved June 12, 2022)

[510] Announcement 2022-13, June 9, 2022, https://www.irs.gov/pub/irs-drop/a-22-13.pdf (retrieved June 12, 2022)

[511] Announcement 2022-13, June 9, 2022

[512] Announcement 2022-13, June 9, 2022; IRC §170(i)

[513] Announcement 2022-13, June 9, 2022

In a news release issued the same day, IRS Commissioner Chuck Retting explains the agency's reasons for the changes:

> "The IRS is adjusting the standard mileage rates to better reflect the recent increase in fuel prices," said IRS Commissioner Chuck Rettig. "We are aware a number of unusual factors have come into play involving fuel costs, and we are taking this special step to help taxpayers, businesses and others who use this rate."[514]

SECTION: 280F
IRS ANNOUNCES DEPRECIATION AND LEASE INCLUSION AMOUNTS ON VEHICLES FOR 2022

Citation: Revenue Procedure 2022-17, 3/16/22

The IRS has released updated depreciation limits for automobiles and light trucks in Revenue Procedure 2022-17.[515] The release also contains the table to be used for determining lease inclusion amounts with a lease term beginning in 2022.

The depreciation limits[516] for passenger automobiles acquired after September 27, 2017 and placed in service in calendar year 2022 for which bonus depreciation is claimed is:

Tax Year	Amount
1st Tax Year	$19,200
2nd Tax Year	$18,000
3rd Tax Year	$10,800
Each Succeeding Year	$6,460

For such passenger automobiles where depreciation is *not* claimed, the limits[517] are:

Tax Year	Amount
1st Tax Year	$11,200
2nd Tax Year	$18,000
3rd Tax Year	$10,800

[514] "IRS increases mileage rate for remainder of 2022," IR-2022-124, June 9, 2022, https://www.irs.gov/newsroom/irs-increases-mileage-rate-for-remainder-of-2022 (retrieved June 12, 2022)

[515] Revenue Procedure 2022-17, March 16, 2022, https://www.taxnotes.com/research/federal/irs-guidance/revenue-procedures/irs-announces-limits-on-depreciation-deductions-for-automobiles/7d8y5?h=2022-17 (retrieved March 20, 2022)

[516] Revenue Procedure 2022-17, March 16, 2022, Table 1

[517] Revenue Procedure 2022-17, March 16, 2022, Table 2

Tax Year	Amount
Each Succeeding Year	$6,460

Table 3 of the procedure contains the lease inclusion amounts for 2022.[518]

SECTION: 401
IRS ISSUES LIKELY FINAL EXTENSION OF RELIEF ALLOWING CERTAIN PLAN DOCUMENTS TO BE SIGNED REMOTELY

Citation: Notice 2022-27, 5/13/22

The IRS has again extended temporary relief from the physical presence requirement for executing certain plan documents in front of a plan representative or notary public in Notice 2022-27.[519] The relief was first provided in Notice 2020-42 as a response to the COVID-19 pandemic and most recently had been extended by Notice 2021-40 through June 30, 2022. The new notice extends this relief through the end of 2022.

This Likely is the Final Extension

This notice indicates that it is likely this will be the final extension of this relief:

> On February 18, 2022, the President determined that the COVID-19 pandemic continued to cause a significant risk to public health and safety and extended the national emergency beyond March 1, 2022. See 87 FR 10289. Accordingly, section III of this notice provides an additional 6-month extension, through December 31, 2022, of the temporary relief from the physical presence requirement provided in Notice 2021-40. However, in light of recent easing of public health precautions relating to the COVID-19 pandemic, a further extension of temporary relief from the physical presence requirement beyond the end of 2022 is not expected to be necessary.[520]

One interesting item to note is that the new Notice makes no mention of the request for comments found in Section V of Notice 2021-03, the last extension of this relief. In the preceding Notice the IRS asked for comments on the following:

> In particular, the Treasury Department and the IRS request comments on whether relief from the physical presence requirement should be made permanent and, if made permanent, what, if any, procedural safeguards are necessary in order to

[518] Revenue Procedure 2022-17, March 16, 2022, Table 3, https://www.taxnotes.com/tax-notes-today-federal/accounting-periods-and-methods/irs-announces-limits-depreciation-deductions-automobiles/2022/03/17/7d8y5#:~:text=REV.%20PROC.%202022%2D17%20TABLE%203,1%2C061

[519] Notice 2022-27, May 13, 2022, https://www.taxnotes.com/research/federal/irs-guidance/notices/irs-extends-temporary-relief-from-physical-presence-requirement/7dh9j (retrieved May 17, 2022)

[520] Notice 2022-27, May 13, 2022

> reduce the risk of fraud, spousal coercion, or other abuse in the absence of a physical presence requirement.[521]

The silence may mean that Treasury has determined, based on comments, that there is no need for any permanent relief from the physical presence requirement. While the agency could still issue proposed changes to Reg. §1.401(a)-21(d)(6), the fact that no mention is made of any plans to issue such proposed regulations and the Notice effectively states that temporary relief will not continue past December 31, 2022 suggests the most likely result is that this provision is no longer being considered for permanent modification.

Items Covered by This Extension

The Notice extends relief for those items covered by Sections III.A and B of Notice 2021-03[522] which duplicated guidance in Notice 2020-42.[523] Notice 2020-42 provided temporary relief from the physical presence requirement found in Reg. §1.401(a)-21(d)(6). That regulation provides:

> (6) Participant elections, including spousal consents, that are required to be witnessed by a plan representative or a notary public
>
>> (i) In general.
>>
>> In the case of a participant election which is required to be witnessed by a plan representative or a notary public (such as a spousal consent under section 417), the signature of the individual making the participant election is witnessed in the physical presence of a plan representative or a notary public.
>>
>> (ii) Electronic notarization permitted.
>>
>> If the requirements of paragraph (d)(6)(i) of this section are satisfied, an electronic notarization acknowledging a signature (in accordance with section 101(g) of E-SIGN and state law applicable to notary publics) will not be denied legal effect if the signature of the individual is witnessed in the physical presence of a notary public.
>>
>> (iii) Delegation to Commissioner.
>>
>> In guidance published in the Internal Revenue Bulletin, the Commissioner may provide that the use of procedures under an electronic system is deemed to satisfy the physical presence requirement under paragraph (d)(6)(i) of this section, but only if those procedures with respect to the electronic system provide the same safeguards for participant elections as are provided through the physical presence requirement. See § 601.601(d)(2)(ii)(b) of this chapter.

[521] Notice 2021-03, December 22, 2020, Section V

[522] Notice 2021-03, December 22, 2020

[523] Notice 2022-27, May 13, 2022

The relief found in the applicable provisions of Notice 2021-03 provided relief from the physical presence requirement in the following situations:

- Temporary relief from the physical presence requirement for any participant election witnessed by a notary public of a state that permits remote electronic notarization, and
- Temporary relief from the physical presence requirement for any participant election witnessed by a plan representative.[524]

The notary public relief read as below and will continue to apply through December 31, 2022, at which time it is expected to be allowed to expire:

> …[T]he physical presence requirement in § 1.401(a)-21(d)(6) is deemed satisfied for an electronic system that uses remote notarization if executed via live audio-video technology that otherwise satisfies the requirements of participant elections under § 1.401(a)-21(d)(6) and is consistent with state law requirements that apply to the notary public.[525]

For elections witnessed by a plan representative, the following provisions will continue to apply through December 31, 2022, after which they are expected to be allowed to lapse:

> …[T]he physical presence requirement in § 1.401(a)-21(d)(6) is deemed satisfied for an electronic system if the electronic system using live audio-video technology satisfies the following requirements:
>
> > (1) The individual signing the participant election must present a valid photo ID to the plan representative during the live audio-video conference, and may not merely transmit a copy of the photo ID prior to or after the witnessing;
> >
> > (2) The live audio-video conference must allow for direct interaction between the individual and the plan representative (for example, a pre-recorded video of the person signing is not sufficient);
> >
> > (3) The individual must transmit by fax or electronic means a legible copy of the signed document directly to the plan representative on the same date it was signed; and
> >
> > (4) After receiving the signed document, the plan representative must acknowledge that the signature has been witnessed by the plan representative in accordance with the requirements of this notice and transmit the signed document, including the acknowledgement, back to the individual under a system that satisfies the applicable notice requirements under § 1.401(a)-21(c).[526]

[524] Notice 2021-03, December 22, 2020, Section III

[525] Notice 2021-03, December 22, 2020, Section III.A

[526] Notice 2021-03, December 22, 2020, Section III.B

SECTION: 501
FORM 1024 MUST BE FILED ELECTRONICALLY

Citation: Revenue Procedure 2022-08, 1/3/2022

Electronic filing of Form 1024, *Application for Recognition of Exemption Under Section 501(a) or Section 521 of the Internal Revenue Code*, via https://www.pay.gov was made mandatory upon the release of Revenue Procedure 2022-08[527] on January 3, 2022. A limited 90-day transition period will allow for some submissions to continue to be submitted on paper forms for a limited time.

The form is filed by the following organizations looking for recognition as a tax-exempt entity:

- Entities described in § 501(a) (other than those described in § 501(c)(3) or § 501(c)(4)) and
- Entities described in § 521 (for organizations seeking a determination letter recognizing exempt status who submit Form 1024 in lieu of filing Form 1028 along with Form 8718)[528]

The procedure also modifies which individuals or representatives are allowed to sign the Form 1024 to allow more individuals associated with the organization to sign the form, but removes the ability to appoint a representative via a power of attorney to sign the application for the organization.

The procedure summarizes the revised submission process as follows:

> The IRS has revised and updated Form 1024 and provided for it to be electronically submitted at www.pay.gov. Organizations seeking determination under section 501(a) (other than those described in § 501(c)(3) or § 501(c)(4) and those seeking group rulings), including those organizations that have been required to submit letter requests to seek their determination (including those described in § 501(c)(11), (14), (16), (18), (21), (22), (23), (26), (27), (28) or (29), or under § 501(d)) are required to electronically submit the Form 1024 as of the effective date of this revenue procedure, except as provided in section 4. Organizations requesting determination under section 521 may also electronically submit the Form 1024 instead of Form 1028.
>
> The electronic submission process for Form 1024 replaces the paper submission process for Form 1024 on January 3, 2022, subject to the transition relief provided in section 4 of this revenue procedure. Section 3 of this revenue procedure modifies Rev. Proc. 2022-5 to set forth procedures for issuing determination letters in response to electronically submitted Form 1024 applications. Unless otherwise modified in this revenue procedure, the provisions of Rev. Proc. 2022-5 continue to apply.[529]

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[527] Revenue Procedure 2022-08, January 3, 2022, https://www.irs.gov/pub/irs-drop/rp-22-08.pdf (retrieved January 16, 2022)

[528] Revenue Procedure 2022-08, January 3, 2022

[529] Revenue Procedure 2022-08, January 3, 2022

The IRS news release issued at the same time as the notice provides the following additional information:

> Organizations requesting determinations under Section 521 are now also able to use the electronic Form 1024 instead of Form 1028, *Application for Recognition of Exemption Under Section 521 of the Internal Revenue Code*.
>
> The required user fee for Form 1024 will remain $600 for 2022. Applicants must pay the fee through Pay.gov when submitting the form. Payment can be made directly from a bank account or by credit or debit card.[530]

Individuals or Representatives Who Can Sign Form 1024

Under prior guidance, the following individuals or representatives were allowed to sign a Form 1024:

- An officer,
- A trustee who is authorized to sign, or
- A representative authorized by a power of attorney.[531]

Now the list is expanded to include the following additional individuals:

- A director and
- Another official who is authorized to sign for the organization.[532]

As well, the notice ***removes*** the option to have a representative authorized under a power of attorney sign Form 1024. The procedure provides:

> The signature of a representative authorized by a power of attorney who is not an officer, director, trustee, or other official of the organization will not satisfy the signature requirement for Form 1024.[533]

The notice also directs organizations to "[s]ee the instructions to the form for more information on who may sign the application on behalf of an organization."[534]

90 Day Transition Relief for Filing Paper Forms

The ruling notes that generally:

> "…an organization seeking recognition of tax-exempt status under § 501(a) using Form 1024, including those that previously were required to submit a letter

[530] "IRS revises Form 1024, used by most types of organizations to apply for exempt status, to allow electronic filing," IR-2022-2, January 3, 2022, https://www.irs.gov/newsroom/irs-revises-form-1024-used-by-most-types-of-organizations-to-apply-for-exempt-status-to-allow-electronic-filing (retrieved January 16, 2022)

[531] Revenue Procedure 2022-05, Section 4.02 before modification by Revenue Procedure 2022-08

[532] Revenue Procedure 2022-08, January 3, 2022

[533] Revenue Procedure 2022-08, January 3, 2022

[534] Revenue Procedure 2022-08, January 3, 2022

> application but are required under section 3.02 to use Form 1024, must electronically submit the form and user fee online at www.pay.gov."[535]

However, for a short period (90 days after January 3, 2022) the following transition relief applies:

> For the 90-day period after the effective date of this revenue procedure, the Internal Revenue Service will accept for processing a completed paper Form 1024 from an organization that previously was required to submit the paper Form 1024 and is now required to submit the electronic Form 1024. For this period, the Service will also accept for processing a letter application from an organization that previously was required to submit a letter request and is now required to submit the electronic Form 1024. The paper Form 1024 or letter application must be accompanied by the correct user fee as described in Rev. Proc. 2022-5 prior to the modifications to the payment of user fees made by this revenue procedure and postmarked on or before the date that is 90 days after the effective date of this revenue procedure.[536]

SECTION: 1202
RETAIL SALE OF DRUGS FOUND TO BE A QUALIFIED TRADE OR BUSINESS FOR §1202 PURPOSES

Citation: PLR 202221006, 5/27/22

In PLR 202221006[537] a corporation whose shareholders were negotiating a sale of their stock to an unrelated third party asked the IRS to rule that the business is a *qualified trade or business* under IRC §1202(e)(3).

§1202 Status and Benefits

IRC §1202 provides for a full or partial exclusion of gain from the disposal of *qualified small business stock* held for more than five years. The amount of the exclusion varies depending on when the stock was acquired, with stock acquired after September 27, 2010, being eligible for a 100% exclusion of gain on the sale[538] of up to the greater of $10 million or 10 times the aggregate adjusted bases of qualified small business stock issued by such corporation and disposed of by the taxpayer during the taxable year.[539]

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[535] Revenue Procedure 2022-08, January 3, 2022

[536] Revenue Procedure 2022-08, January 3, 2022

[537] PLR 202221006, May 27, 2022, https://www.irs.gov/pub/irs-wd/202221006.pdf (retrieved May 27, 2022)

[538] IRC §1202(a)(4)

[539] IRC §1202(b)(1)(A)

Only certain types of businesses can qualify as a *qualified trade or business*, something necessary for gain on the sale of the stock to qualify for a §1202 exclusion. IRC §1202(e)(3) contains the definition of a *qualified trade or business* and reads:

> (3) Qualified trade or business
>
> For purposes of this subsection, the term "qualified trade or business" means any trade or business other than--
>
> > (A) any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees,
> >
> > (B) any banking, insurance, financing, leasing, investing, or similar business,
> >
> > (C) any farming business (including the business of raising or harvesting trees),
> >
> > (D) any business involving the production or extraction of products of a character with respect to which a deduction is allowable under section 613 or 613A, and
> >
> > (E) any business of operating a hotel, motel, restaurant, or similar business.[540]

In this case the question was whether the business of the corporation was performance of services in the field of health or the principal asset of the business was the skill or reputation of one or more employees.[541]

Facts as Represented in the Ruling Request

The taxpayer in this case is involved in the sale of certain drugs:

> Taxpayer is only involved in the retail sale of a limited number of drugs and does not manufacture them. The manufacturers of these drugs prefer entering into exclusive distribution arrangements with companies such as Taxpayer.[542]

The employees involved in the business are both pharmacists and various other employees:

> Employees of Taxpayer include several pharmacists who fill prescriptions received from physicians. Other employees coordinate the insurance coverage with respect to such prescription orders. Once the insurance process is complete and the prescription is filled by the pharmacist, Taxpayer mails the prescription to the patient's home. The non-pharmacist employees will also occasionally contact individuals receiving prescriptions to inquire as to any side effects of the

[540] IRC §1202(e)(3)

[541] IRC §1202(e)(3)(A)

[542] PLR 202221006, May 27, 2022

> prescriptions and to schedule refills. Such non-pharmacist employees are not subject to state licensing requirements or classified as healthcare professionals by any applicable state, Federal or regulatory authority.[543]

The nature of the employees' interactions with the patients and physicians is outlined as follows:

> Pharmacists and other employees of Taxpayer have no contact or interaction with physicians, other than to receive prescriptions from them. With respect to patients, pharmacists interact with patients only if a patient has a question about a particular prescription. Employees are never involved in diagnosing any medical issues or recommending any treatment or drug to individuals. Their interaction with patients is limited to the filling and maintenance of prescriptions as ordered by a physician. Therefore, none of Taxpayer's employees diagnose, treat or manage any aspect of any patient's care. Taxpayer's revenues are strictly related to the sale of such drugs, and Taxpayer earns no revenues in connection with the medical care of patients.[544]

Analysis and Ruling

The analysis section of the ruling begins with a discussion of the two categories that the taxpayer was concerned the IRS might on exam argue their business falls into that would bar treatment as a *qualified trade or business*, making their gain on sale fully taxable:

> Section 1202(e)(3) excludes businesses from being a qualified trade or business if they offer value to customers primarily in the form of certain specified services, or in the form of individual expertise. A question arises as to whether Taxpayer is (i) involved in the performance of services in the field of health or (ii) where the principal asset of the trade or business is the reputation or skill of one or more of its employees.[545]

The ruling concludes that this business is not a health business as contemplated by IRC §1202(e)(3)(A) since the employee's actions don't rise to the level of diagnostic services or medical care provided to either patients or physicians:

> Taxpayer's employees are not engaged in the provision of medical services. Other than the pharmacists, such employees are not certified healthcare providers and are not otherwise regulated under state or Federal law. Taxpayer's pharmacists fill prescriptions provided by health care professionals, and other employees help manage the insurance process and occasionally communicate with patients regarding prescription issues and timely refill requests. Any interaction with patients regarding their prescriptions is merely incidental to ensuring receipt of their required prescriptions or answering a patient's question about them. Taxpayer's employees do not provide any diagnostic services or medical care to either patients or physicians, and all revenues are generated by the sale of the drugs.[546]

[543] PLR 202221006, May 27, 2022

[544] PLR 202221006, May 27, 2022

[545] PLR 202221006, May 27, 2022

[546] PLR 202221006, May 27, 2022

The IRS also found that the principal asset of the business was not the employees' reputation or skill:

> Also, Taxpayer's principal asset is not the reputation or skill of one or more employees, but its exclusive pharmaceutical distribution rights.[547]

SECTION: 1402
DEFINITION OF RENTAL FOR PASSIVE ACTIVITIES RULES DOES NOT REQUIRE SAME CLASSIFICATION FOR SELF-EMPLOYMENT INCOME TREATMENT

Citation: Chief Counsel Advice 202151005, 12/23/21

In Chief Counsel Advice 202151005[548] the IRS discusses the lack of linkage between what is a rental for passive activity purposes under IRC §469(c)(2) and the exclusion of real estate rentals from self-employment income under IRC §1402(a)(1). The memorandum also discusses the application of the self-employment tax rules to two specific situations.

Rental Activities Under §469(c)(2) and the Self-Employment Income Exclusion for Real Estate Rentals Under IRC §1402(a)(1)

The memorandum begins by looking at the question of whether a determination that an activity is a rental activity under the passive activity rules of IRC §469(c)(2) determines if the activity involves "rentals from real estate" excluded from self-employment income under IRC §1402(a)(1).

Under IRC §469(c)(2), for purposes of the passive activity rules, a rental activity is a passive activity unless it meets the real estate professional rules of IRC §469(c)(7). The IRS has issued regulations under IRC §469 that define what is and is not a rental activity for purposes of IRC §469(c)(7).

IRC §1402(a)(1) provides that there shall be excluded from self-employment income "rentals from real estate and from personal property leased with the real estate." However, the memorandum concludes that a determination that an activity is or is not a rental under the passive activity rules does not control if the income from the activity will be excluded from self-employment income as a rental from real estate under IRC §1402(a)(1).

The memorandum summarizes the rules for considering an activity as a rental under the passive activity rules for a taxpayer who is not a real estate professional:

> Under § 469(c), a passive activity is generally any trade or business activity in which the taxpayer does not materially participate or any rental activity. Treas. Reg. § 1.469-1T(e)(3)(ii)(A) provides that an activity involving the use of tangible property is not a rental activity for a taxable year if for the taxable year the average period of customer use for the property is seven days or less.[549]

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[547] PLR 202221006, May 27, 2022

[548] Chief Counsel Advice 202151005, December 23, 2021, https://www.taxnotes.com/research/federal/irs-private-rulings/legal-memorandums/label-doesn%e2%80%99t-determine-rental-self-employment-tax-exclusion/7cqp3 (retrieved December 23, 2021)

[549] Chief Counsel Advice 202151005, December 23, 2021

The memorandum goes on to note that the regulations specifically provide that characterizations under the passive activity rules do not impact the treatment of items under other IRC provisions:

> Treas. Reg. § 1.469-1T(d)(1) provides that the characterization of items of income or deduction as passive activity gross income or passive activity deductions does not affect the treatment of items of income or deduction under provisions of the Code other than § 469. Therefore, whether amounts are passive activity gross income under Treas. Reg. § 1.469-2T(c) or passive activity losses under Treas. Reg. § 1.469-2T(b) is not determinative of whether those amounts are rentals from real estate under § 1402(a)(1) and Treas. Reg. § 1.1402(a)-4.[550]

Thus, the determination under the passive activity rules won't control whether an activity is a rental of real estate for self-employment tax purposes. The memorandum concludes "whether an activity is a "rental activity" under § 469(c)(2) is not determinative of whether the exclusion in § 1402(a)(1) applies."[551]

The passive activity rules can impact whether a deduction will be considered for other tax provisions, including reducing self-employment income if the passive activity provisions suspend the deduction of a loss, as the memorandum explains:

> However, under Treas. Reg. § 1.469-1T(d)(3) a deduction that is disallowed for a taxable year under § 469 and the regulations thereunder is not taken into account as a deduction that is allowed for the taxable year in computing the amount subject to any tax imposed by subtitle A of the Internal Revenue Code.[552]

Although not directly addressed in the answers in the memorandum, if an activity was deemed to be part of self-employment income due to not meeting the rental of real estate definition in IRC §1402(a)(1), a loss still might not reduce self-employment income for a year if a deduction for the loss was barred by the passive activity rules.

Applying the Self-Employment Rental Real Estate Exclusion

So now we turn to the application of the rules under IRC §1402(a) to see if the activity is or is not part of self-employment income. The memorandum quotes from the regulations as follows:

> Treas. Reg. § 1.1402(a)-4(c)(1) provides that rentals from living quarters, where no services are rendered for the occupants, are generally considered rentals from real estate under § 1402(a)(1), except in the case of real estate dealers. However, Treas. Reg. § 1.1402(a)-4(c)(2) provides,
>
> > Payments for the use or occupancy of rooms or other space where services are also rendered to the occupant . . . are included in determining net earnings from self-employment. Generally, services are considered rendered to the occupant if they are primarily for his convenience and are other than those usually or customarily rendered in connection with the rental of rooms or other space for occupancy only.

[550] Chief Counsel Advice 202151005, December 23, 2021

[551] Chief Counsel Advice 202151005, December 23, 2021

[552] Chief Counsel Advice 202151005, December 23, 2021

> Treas. Reg. § 1.1402(a)-4(c)(2) lists examples of situations where services are rendered for the convenience of occupants, such as hotels, boarding homes, warehouses, and storage garages.[553]

The memorandum also points the reader to the Tax Court's 1978 *Bobo* decision:

> In *Bobo v. Commissioner*, 70 T.C. 706 (1978), *acq*. 1983-2 C.B. 4, the Tax Court considered a mobile home park that provided leased trailer park units with utility hookups, sewage facilities, and laundry facilities. The Tax Court held that the net rental income from the rental of the trailer park units was excluded from the owners' NESE[554] under § 1402(a)(1). The court relied on *Delno, infra*, in setting the standard for when services are considered not rendered for the occupant,
>
>> [Section 1402(a)(1)] should be applied to exclude only payments for use of space, and, by implication, such services as are required to maintain the space in condition for occupancy. If the owner performs additional services of such substantial nature that compensation for them can be said to constitute a material part of the payment made by the tenant, the "rent" received then consists in part of income attributable to the performance of labor which is not incidental to the realization of return from passive investment.
>
> *Bobo* at 709 (citing *Delno v. Celebrezze*, 347 F.2d 159, 166 (9th Cir. 1965) (relating to parallel Social Security eligibility provisions). Again relying on *Delno*, the Tax Court first determined that the phrase, "'usually or customarily rendered' . . . must be read with emphasis upon the closing phrase 'for occupancy only.'" *Bobo* at 710. The court reasoned that an analysis of whether services are rendered solely for the convenience of the occupants pursuant to Treas. Reg. § 1.1402(a)-4(c))(2) is a question of fact based on "whether [the services rendered] are required to maintain the space in condition for occupancy and, if not, whether [the services rendered] are substantial." *Id.* at 710-11; see also *Johnson v. Commissioner*, 60 T.C. 829, 832-33 (1973) (stating, "any service not clearly required to maintain the property in condition for occupancy be considered work performed for the tenant, and not for the conservation of invested capital," in support of a narrow construction of the exclusion from NESE for rental real estate).
>
> Ultimately, the court determined that, even though the trailer park furnished laundry services that were "clearly rendered for the convenience of the tenant and not to maintain the property in condition for occupancy," the tenants' payments for the laundry services were not "substantial enough to classify all the tenants' [rental] payments as received for 'services to the occupants.'" *Id.* at 711 (citing Treas. Reg. § 1.1402(a)-4(c)(2)). Accordingly, the court held the payments at issue were rental from real estate excluded from NESE.[555]

[553] Chief Counsel Advice 202151005, December 23, 2021

[554] Net self-employment income

[555] Chief Counsel Advice 202151005, December 23, 2021

Using these cited sources and others, the memorandum then looks at two fact situations. The memorandum describes the first situation as follows:

> The taxpayer is an individual who directly and solely owns and rents, in the course of a trade or business, a fully furnished vacation property via an online rental marketplace. The taxpayer is not a real estate dealer within the meaning of Treas. Reg. § 1.1402(a)-4(a). The taxpayer provides linens, kitchen utensils, and all other items to make the vacation property fully habitable for each occupant. In addition, the taxpayer provides daily maid services, including delivery of individual use toiletries and other sundries, access to dedicated Wi-Fi service for the rental property, access to beach and other recreational equipment for use during the stay, and prepaid vouchers for ride-share services between the rental property and the nearest business district. For the year at issue, the average period of customer use of the vacation property is seven days, and therefore the activity is not considered a rental activity for purposes of § 469 pursuant to Treas. Reg. § 1.469-1T(e)(3)(ii)(A) In addition, the taxpayer materially participates in the activity within the meaning of § 469(h)(1) and Treas. Reg. § 1.469-5T and, therefore, the activity is not a passive activity within the meaning of § 469(c).[556]

In this situation, the IRS finds the activity does generate self-employment income, not being an exempt rental of real estate under IRC §1402(a)(1):

> The net rental income in Fact Situation 1 is not excluded from NESE under § 1402(a)(1) because the taxpayer provides substantial services beyond those required to maintain the space in a condition suitable for occupancy. See *Bobo*, 70 T.C. at 710; Rev. Rul. 83-139. Whether services are considered rendered for the occupant is based on the particular facts and circumstances in each case. See *Hopper*, 94 T.C. at 548 (1990). Here, the payments made to the taxpayer for these services are for the convenience of the property's occupants. The services go beyond those clearly required to maintain the space in a condition for occupancy and are of such a substantial nature that the compensation for these services can be said to constitute a material portion of the rent. Thus, the payments are not excluded under § 1402(a)(1) but rather are included in NESE. The characterization of this activity as not a passive activity within the meaning of § 469(c) does not affect whether the activity is excluded from NESE under § 1402(a)(1).[557]

In a footnote, the IRS notes that if the activity was treated as a passive rental activity under §469 and incurred a loss that was suspended, that loss would not reduce self-employment income as was noted earlier:

> If the activity were a rental activity under Treas. Reg. § 1.469-1T(e)(3) and, therefore, a passive activity under § 469(c), a loss generated by this activity would still be limited for purposes of computing NESE under § 1.469-1T(d)(3).[558]

That is, while the loss is still a loss from self-employment, the fact a deduction is not allowed will serve to bar reducing self-employment income.

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[556] Chief Counsel Advice 202151005, December 23, 2021

[557] Chief Counsel Advice 202151005, December 23, 2021

[558] Chief Counsel Advice 202151005, December 23, 2021

The second fact pattern is outlined as follows:

> The taxpayer is an individual who directly and solely owns and rents, in the course of a trade or business, a fully furnished room and bathroom in a dwelling via an online rental marketplace. The taxpayer is not a real estate dealer. Occupants only have access to the common areas of the home to enter and exit the room and bathroom and have no access to other common areas such as the kitchen and laundry room. The taxpayer cleans the room and bathroom in between each occupant's stay. For the year at issue, the average period of customer use of the vacation property is seven days, and therefore the activity is not considered a rental activity for purposes of § 469 pursuant to Treas. Reg. § 1.469-1T(e)(3)(ii)(A). In addition, the taxpayer materially participates in the activity within the meaning of § 469(h)(1) and Treas. Reg. § 1.469-5T, and, therefore, the activity is not a passive activity within the meaning of § 469(c).[559]

In this case, the memorandum concludes this activity is an excluded rental of real estate for purposes of determining self-employment income:

> The net rental income from Fact Situation 2 is excluded from NESE under § 1402(a)(1) because the taxpayer does not provide substantial services beyond those required to maintain the space in a condition suitable for occupancy. See *Bobo*, 70 T.C. 706 at 710; Rev. Rul. 83-139. Services the taxpayer provides to clean and maintain the property to bring it to a suitable condition for occupancy are not relevant in applying Treas. Reg. § 1.1402(a)-4(c)(2) because such services are not furnished primarily for the convenience of the property's occupants. See *Hopper*, 94 T.C. at 547. Further, services provided for the convenience of occupants must be substantial, and whether provided services are substantial depends on the facts and circumstances of each case. See *id.* at 548. Specifically, the services provided for the convenience of the occupants must be of such a substantial nature that compensation for them can be said to constitute a material part of the payments made by the occupants. See *id.* at 546 (citing *Delno*, 347 F.2d at 166). No such services are provided in Fact Situation 2. The characterization of this activity as not a passive activity within the meaning of § 469(c) does not affect whether the activity is excluded from NESE under § 1402(a)(1).[560]

SECTION: 6011
IRS PROVIDES DETAILS FOR REPORTING PPP FORGIVENESS OPTIONS UNDER REVENUE PROCEDURE 2021-48

Citation: Form 1120S 2022 Instructions, 1/20/22

In final versions of instructions to Forms 1120S[561] and Form 1065,[562] the IRS has provided additional guidance on reporting PPP loan forgiveness on those forms using the methods outlined in Revenue Procedure 2021-48.

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[559] Chief Counsel Advice 202151005, December 23, 2021

[560] Chief Counsel Advice 202151005, December 23, 2021

[561] Form 1120S Instructions, January 20, 2022, https://www.irs.gov/pub/irs-pdf/i1120s.pdf (retrieved January 14, 2022)

[562] Form 1065 Instructions, January 14, 2022, https://www.irs.gov/pub/irs-pdf/i1065.pdf (retrieved January 21, 2022)

In Section 3.04 of Revenue Procedure 2021-48 the IRS noted that further instructions would be issued on how this should be reported, though taxpayers did not have to wait to use the procedure until that guidance was released:

> 04 Reporting consistent with this revenue procedure. The IRS will publish form instructions for the 2021 filing season that will detail how taxpayers can report consistently with sections 3.01 through 3.03 of this revenue procedure. However, taxpayers do not need to wait until the instructions are published to apply this revenue procedure.[563]

The instructions for Form 1120S provide that the tax-exempt income from the forgiveness of PPP loans should be reported on Line 16b of Schedule K, Form 1120S and Schedule K-1 of Form 1120S.[564] The instructions also provide the following requirements for the attachment:

> Attach a statement to the S corporation return for each tax year in which the S corporation is applying Rev. Proc. 2021-48, sections 3.01(1), (2), or (3). The statement should also include the following information for each PPP loan.
>
> 1. The S corporation's name, address, and EIN;
>
> 2. A statement that the S corporation is applying section 3.01(1), (2), or (3) of Rev. Proc. 2021-48, as applicable;
>
> 3. The amount of tax-exempt income from forgiveness of the PPP loan that the S corporation is treating as received or accrued during the tax year; and
>
> 4. Whether forgiveness of the PPP loan has been granted as of the date the return is filed.[565]

The instructions confirm that taxpayers who reported PPP loan forgiveness on their 2020 Form 1120S in accordance with one of the methods found in the Revenue Procedure do not need to file an amended return to add the statement:

> An S corporation that reported tax-exempt income from a PPP loan on its 2020 return, the timing of which corresponds to one of the options presented in Rev. Proc. 2021-48, need not file an amended return solely to attach the statement that is described in the instructions for Schedule K, line 16(b).[566]

If the S Corporation reported forgiveness income on a tax return prior to receiving formal forgiveness and later discovers that a lesser amount was forgiven, Section 3.03 of Revenue Procedure

[563] Revenue Procedure 2022-48, Section 3.04, November 18, 2021

[564] Form 1120S Instructions, January 20, 2022, p. 34

[565] Form 1120S Instructions, January 20, 2022, p. 34

[566] Form 1120S Instructions, January 20, 2022, p. 34

2022-48 provides that an amended return should be filed.[567] The 2022 Instructions to Form 1120S provide the following guidance in that case:

> The S corporation should attach a statement to such amended return that includes the following information.
>
> > 1. The S corporation's name, address, and EIN;
> >
> > 2. A statement that the S corporation is making adjustments in accordance with section 3.03 of Rev. Proc. 2021-48; and
> >
> > 3. The tax year in which tax-exempt income was originally reported, the amount of tax-exempt income that was originally reported in such tax year, and the amount of tax-exempt income being adjusted on the amended return.[568]

The Form 1065 instructions contain similar instructions, though noting an Administrative Adjustment Request would be necessary rather than an amended return when reporting a change in the amount of PPP forgiveness exempt income if the partnership had not been eligible to or had not opted out of the BBA partnership audit regime for the year in question.[569]

The same requirement is found in the Form 1040 2021 instructions,[570] though it's not totally clear what impact this has for most issues—the timing of the recognition of the tax-exempt income would generally not have an impact in the Form 1040 context.

As well, the Revenue Procedure allows taxpayers to report exempt income in three ways that the IRS has approved—but does not indicate these are the exclusive ways to report such income (just ways that will not be challenged by the IRS on an exam). However, since failing to follow the instructions in theory opens up a theoretical finding that the taxpayer had not filed a proper return, it will be best to comply with these requirements, even in the context of a Form 1040.

SECTION: 6015 INNOCENT SPOUSE RELIEF NOT AVAILABLE FOR TRUST FUND PENALTY LIABILITY

Citation: Chavis v. Commissioner, 158 T.C. No. 8, 6/15/22

In the case of *Chavis v. Commissioner,*[571] 158 T.C. No. 8, Angela Chavis argued, in part, that she should not be liable to pay a portion of a trust fund penalty under IRC §6672 because she should qualify for

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[567] Form 1120S Instructions, January 20, 2022, p. 34, Revenue Procedure 2022-48, Section 3.03

[568] Form 1120S Instructions, January 20, 2022, pp. 34-35

[569] Form 1065 Instructions, January 14, 2022, p. 43

[570] Form 1040 Instructions, p. 23, December 22, 2021, https://www.irs.gov/pub/irs-pdf/i1040gi.pdf (retrieved January 21, 2022)

[571] *Chavis v. Commissioner,* 158 T.C. No. 8, June 15, 2022, https://www.taxnotes.com/research/federal/court-documents/court-opinions-and-orders/lien-upheld-for-trust-fund-penalties%3b-spousal-relief-unavailable/7dkwq (retrieved June 16, 2022)

innocent spouse relief. The Tax Court denied her requested relief, finding that the innocent spouse provisions only apply to amounts due on joint income tax returns.

Underlying Law

The amounts the IRS sought to collect from Angela in this case were unpaid payroll taxes for which the IRS had found her and her ex-husband to qualify as *responsible parties* under IRC §6672. IRC §6672(a) provides generally:

> (a) General rule. 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 truthfully account for and pay over such tax, or willfully attempts in any manner to evade or defeat any such tax or the 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. No penalty shall be imposed under section 6653 or part II of subchapter A of chapter 68 for any offense to which this section is applicable.

One argument Angela made in her case before the Tax Court was that if there was such a liability, she should qualify for relief as an *innocent spouse* under IRC §6015, with her former spouse being held entirely liable for the unpaid amount of the tax. IRC §6015(a) reads:

> (a) In general. Notwithstanding section 6013(d)(3)--
>
> > (1) an individual who has made a joint return may elect to seek relief under the procedures prescribed under subsection (b); and
> >
> > (2) if such individual is eligible to elect the application of subsection (c), such individual may, in addition to any election under paragraph (1), elect to limit such individual's liability for any deficiency with respect to such joint return in the manner prescribed under subsection (c).
>
> Any determination under this section shall be made without regard to community property laws.

IRC §6015(f) provide for an equitable relief option and reads:

> (f) Equitable relief.
>
> > (1) In general. Under procedures prescribed by the Secretary, if--
> >
> > > (A) taking into account all the facts and circumstances, it is inequitable to hold the individual liable for any unpaid tax or any deficiency (or any portion of either), and
> > >
> > > (B) relief is not available to such individual under subsection (b) or (c),
> > >
> > > the Secretary may relieve such individual of such liability.
> >
> > (2) Limitation. A request for equitable relief under this subsection may be made with respect to any portion of any liability that--

> (A) has not been paid, provided that such request is made before the expiration of the applicable period of limitation under section 6502, or
>
> (B) has been paid, provided that such request is made during the period in which the individual could submit a timely claim for refund or credit of such payment.

The Facts of the Case

The Tax Court provides the following description of how Angela ended up before the Court.

> Petitioner received a B.A. in economics and an M.A. in business administration, having completed coursework in finance, accounting, marketing, management, and organizational behavior. At the relevant times she and her then husband were associated with Oasys Information Systems, Inc. (Oasys), a C corporation established in 2008. Her then husband was the president of Oasys, and she held the office of secretary. According to IRS records, Oasys listed petitioner's home address as its business address.
>
> Oasys withheld payroll taxes from its employees' wages but did not pay those taxes over to the Government. Having no success in collecting these taxes from Oasys, the IRS determined penalties against petitioner and her then husband under section 6672. That section provides that "[a]ny person required to collect, truthfully account for, and pay over" payroll taxes, who willfully fails to do so, shall be liable for a penalty "equal to the total amount of the tax evaded . . . or not accounted for and paid over." § 6672(a). Penalties determined under section 6672 are commonly called trust fund recovery penalties (TFRPs).
>
> On July 13, 2015, the IRS issued petitioner Letter 1153, Notice of Trust Fund Recovery Penalty. The IRS sent this letter by certified mail to petitioner at her home address. Respondent has supplied a copy of U.S. Postal Service (USPS) Form 3811, Domestic Return Receipt, showing that petitioner received and accepted delivery of the Letter 1153 on July 16, 2015. Petitioner does not dispute that the signature on the Form 3811 is her signature.[572]

The letter and enclosed Form 2751 informed Angela of the IRS's proposed assessment of the trust fund penalty against her:

> Attached to the Letter 1153 was Form 2751, *Proposed Assessment of Trust Fund Recovery Penalty*. This form advised petitioner that Oasys had failed to pay over employment taxes totaling $146,682 for nine calendar quarters during 2011-2014. The IRS proposed to assess that sum against petitioner, determining that she, "[a]s Secretary, . . . had the responsibility of paying the employment taxes [but] paid other creditors over the US Gov't." The IRS proposed to assess joint and several liability for the same amount against her then husband, determining that he, "[a]s President, . . . had the responsibility of paying the employment taxes [but] paid other creditors over the US Gov't."

[572] *Chavis v. Commissioner,* 158 T.C. No. 8, June 15, 2022

> The Letter 1153 informed petitioner: "You may appeal your case to the local Appeals Office." The letter included detailed instructions about the steps petitioner needed to take in order to appeal the proposed assessment and the issues that would be considered during the appeal. The letter warned: "If we do not hear from you within 60 days from the date of this letter . . ., we will assess the penalty and begin collection action."
>
> Petitioner did not appeal the notice of proposed assessment.[573]

Note that the IRS asserted that she, as the corporate secretary (an officer), had responsibility to insure the tax was paid. The agency also asserted, separately, that her husband, as President, had a similar responsibility. Angela did not choose to appeal this matter to argue that she was not a responsible person in this fact pattern despite being a corporate officer.

The IRS therefore moved forward in this matter:

> On November 16, 2015, the IRS accordingly assessed the TFRPs against her. Petitioner and her husband divorced in 2016, and the IRS was apparently successful in collecting a portion of the unpaid tax from him. In an effort to collect the balance of the liability, the IRS on May 16, 2019, issued petitioner a Letter 3172, *Notice of Federal Tax Lien Filing and Your Right to a Hearing*. This letter showed an aggregate unpaid balance of $126,919 on account of Oasys's payroll tax liability.[574]

Only at this point did Angela decide to formally contest the matter via a Collections Due Process Hearing (CDP):

> On May 29, 2019, petitioner timely requested a CDP hearing. In her hearing request she checked the boxes, "I cannot pay balance" and "Innocent Spouse Relief," and she requested withdrawal of the NFTL. She urged that her ex-husband was responsible for Oasys's payroll taxes, asserted that she "never received a notice for these taxes before," and contended that she "d[id] not make enough income to put a dent in the amount presented."
>
> In July 2019 petitioner submitted Form 8857, *Request for Innocent Spouse Relief*. She sought relief from the TFRPs, alleging that she "had no dealings with Oasys." She stated that she "agreed to sign our 1040 tax return jointly [but] never signed any returns from Oasys." She did not request relief from any joint Federal income tax liability.[575]

Since an innocent spouse claim was being asserted, the matter was first referred to the IRS Cincinnati Centralized Innocent Spouse Operation (CCISO) office which handles the review of such claims:

> The IRS Cincinnati Centralized Innocent Spouse Operation (CCISO) processed petitioner's Form 8857 on July 26, 2019. On August 14, 2019, CCISO informed petitioner that she did not "meet the basic eligibility requirements" for relief under section 6015. CCISO explained that she did not qualify for relief because "[s]ection 6015 applies to jointly filed income tax returns," not payroll tax liabilities.[576]

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[573] *Chavis v. Commissioner,* 158 T.C. No. 8, June 15, 2022

[574] *Chavis v. Commissioner,* 158 T.C. No. 8, June 15, 2022

[575] *Chavis v. Commissioner,* 158 T.C. No. 8, June 15, 2022

[576] *Chavis v. Commissioner,* 158 T.C. No. 8, June 15, 2022

The CDP process then continued with a telephone conference:

> Petitioner's CDP case was then assigned to a settlement officer (SO) in the IRS Independent Office of Appeals (Appeals) in Houston, Texas. The SO reviewed CCISO's file, verified that the TFRPs had been properly assessed, and confirmed that all other legal and administrative requirements had been met. The SO scheduled a telephone conference for November 19, 2019. Petitioner participated in the telephone conference as scheduled.
>
> During the conference the SO explained that section 6015 relief was not available for TFRP liabilities. The SO also advised that petitioner could not now challenge her liability for the TFRPs because she had, but declined to take advantage of, a prior opportunity to challenge them upon receipt of the Letter 1153. Although petitioner said she did not recall receiving that letter, the SO drew her attention to her signature on the USPS Form 3811, which confirmed her receipt of the proposed assessment.[577]

Eventually the IRS determined that she was not eligible to have her account put on currently not collectible status nor did she qualify for lien withdrawal. Angela filed an appeal with the Tax Court over all of these findings, including denial of innocent spouse relief.

Why No Innocent Spouse Relief?

Angela noted the following in response to an IRS Motion for Summary Judgment in this matter:

> She concedes receiving the Letter 1153 in 2015 but urges that she was undergoing stress at that time in connection with her divorce proceedings. She alleges that she "had no involvement with the business operations of Oasys . . . and did not sign any tax filings associated with the company."[578]

The Tax Court begins by noting that Angela had a chance to challenge her underlying liability previously but did not take advantage of the opportunity:

> A taxpayer may challenge the existence or amount of her underlying tax liability in a CDP case only if she "did not receive any statutory notice of deficiency for such tax liability or did not otherwise have an opportunity to dispute" it. § 6330(c)(2)(B). TFRPs are "assessable penalties" and thus are not subject to deficiency procedures. See *Chadwick v. Commissioner*, 154 T.C. 84, 91 (2020). However, a taxpayer has the opportunity to dispute her liability for a TFRP by filing an appeal with the IRS when she receives a Letter 1153. See *Mason v. Commissioner*, 132 T.C. 301, 317-18 (2009); *Lewis v. Commissioner*, 128 T.C. 48, 61 (2007); *Thompson v. Commissioner*, T.C. Memo. 2012-87, 103 T.C.M. (CCH) 1470, 1472; Treas. Reg. § 301.6320-1(e)(3), Q&A-E2.
>
> The IRS sent petitioner a Letter 1153 in July 2015. She acknowledges having received that letter, and the USPS Form 3811 bears her signature. The Letter 1153 informed petitioner of her right to appeal the proposed TFRP assessment and outlined the steps she needed to take. Because she had an opportunity to dispute her TFRP liability upon receipt of the Letter 1153 but declined to do so, she was not

[577] *Chavis v. Commissioner,* 158 T.C. No. 8, June 15, 2022

[578] *Chavis v. Commissioner,* 158 T.C. No. 8, June 15, 2022

> entitled to challenge her underlying tax liability at the CDP hearing and may not advance such a challenge in this Court. See Chadwick, 154 T.C. at 89.[579]

It is important to note that her argument that she did not sign any payroll tax forms and was not involved with the business operations of the company were potential defenses to her *personal* liability for the trust fund penalty, arguments that, had she timely contested the matter, she might (or might not) have been able to prevail on, leading to having the potential penalty assessment removed, with only her ex-husband being held liable.

So at this point she can't contest the underlying liability. Now the Tax Court considers whether she has an option to argue she was an innocent spouse that should not be required to pay this amount, even if the liability is not subject to challenge.

The Tax Court analyzes the IRC provision that provides for such innocent spouse relief. The Court first concludes that she is not eligible for relief under either IRC §§6015(b) or (c):

> Section 6015 is captioned "Relief from joint and several liability on joint return." Section 6015(a)(1) provides that "an individual who has made a joint return may elect to seek relief under the procedures prescribed under subsection (b)," which sets forth procedures "applicable to all joint filers." Section 6015(a)(2) provides that an individual may "elect to limit [her] liability for any deficiency with respect to such joint return in the manner prescribed under subsection (c)," which sets forth procedures applicable for spouses who are legally separated or no longer living together.
>
> Subsections (b) and (c) both specify rules for obtaining relief from liabilities that are shown on (or should have been shown on) a joint Federal income tax return. See § 6015(b)(1)(A) and (B) (presupposing that "a joint return has been made" and that "on such return there is an understatement of tax"); § 6015(c)(1) (providing that a person "who has made a joint return" may be partially relieved of "liability for any deficiency which is assessed with respect to the return").
>
> Petitioner's TFRP liabilities were not shown on, and did not arise from the filing of, a joint Federal income tax return. Rather, her TFRP liabilities arose from her failure to discharge her duty, as an officer of Oasys, to ensure that payroll taxes collected from the company's workers were properly paid over to the Department of the Treasury. Petitioner was therefore not eligible for relief under section 6015(b) or (c).[580]

Her problem was simple—these provisions only apply to tax liabilities arising from a joint federal income tax return per the plain language found in the provisions. The trust fund penalty did not relate to any joint federal income tax return.

However, IRC §6015(f) provides for equitable relief even if relief is not available under either IRC §§6015(b) or (c). Initially this seems promising—assuming she could show that, in fact, she had nothing to do with the business, never signed a return and was unaware of the problem, it might seem inequitable to hold her liable. Conceivably she might have been the corporate secretary in name only, her name provided only to satisfy a state law requirement for a corporation to have a corporate secretary.

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[579] *Chavis v. Commissioner,* 158 T.C. No. 8, June 15, 2022

[580] *Chavis v. Commissioner,* 158 T.C. No. 8, June 15, 2022

The Court describes this provision:

> Subsection (f) provides that "equitable relief" may be afforded to a taxpayer if "relief is not available to such individual under subsection (b) or (c)." § 6015(f)(1). "Under procedures prescribed by the Secretary," such relief may be available if, "taking into account all the facts and circumstances, it is inequitable to hold the individual liable for any unpaid tax or any deficiency (or any portion of either)." *Ibid.*[581]

The Court refers to Rev. Proc. 2013-34 to note that the IRS has held that equitable relief is only available for income tax liabilities:

> The Commissioner has specified, in Rev. Proc. 2013-34, 2013-43 I.R.B. 397, the procedures governing equitable relief. These procedures confirm that subsection (f), like subsections (b) and (c), applies only to joint income tax liabilities. See Rev. Proc. 2013-34, § 1.01, 2013-43 I.R.B. at 397 ("This revenue procedure provides guidance for a taxpayer seeking equitable relief from income tax liability. . . ."). Indeed, the IRS will not consider a taxpayer's request for equitable relief unless she meets seven "threshold conditions," one of which is that the "income tax liability from which the requesting spouse seeks relief" is attributable to the non-requesting spouse. Id. § 4.01(7), 2013-43 I.R.B. at 399. Another condition is that "[t]he requesting spouse [must have] filed a joint return for the taxable year" for which relief is sought. Id. § 4.01(1).[582]

The Tax Court goes on to agree with the IRS position that such equitable relief only applies to income tax liabilities, noting:

> The IRS assessed TFRPs against petitioner and her ex-husband upon determining that they were both responsible for Oasys's failure to remit payroll taxes to the Government. The IRS did not determine any income tax deficiencies against petitioner and has not attempted to collect any unpaid tax shown on any joint return that she signed. Although a TFRP liability is a form of "unpaid tax," section 6015(f) applies only to unpaid taxes or deficiencies arising from joint income tax returns. See Treas. Reg. § 1.6015-1(a)(1)(iii) (stating that section 6015(f) applies only to "joint and several liability for Federal income tax"); H.R. Rep. No. 105-599, at 254 (1998) (Conf. Rep.), reprinted in 1998-3 C.B. 747, 1008 (stating that section 6015(f) applies only to "any unpaid tax or deficiency arising from a joint return"). The SO therefore did not err when she advised petitioner that innocent spouse relief was not available to her.[583]

Note that IRC §6015(f) itself never states that it only applies to income taxes arising from a joint return. However, it also does not indicate that the provision is not so limited—rather it leaves that open to interpretation. The IRS interpretation that relief is limited to income taxes from a joint return is consistent with the title of the section ("Relief from joint and several liability on joint return"), the fact that the specific relief provisions referenced in the §6015(f) are specifically limited to income taxes arising from a joint return, and Congressional committee reports that showed Congress intended this relief to apply only to joint returns.

[581] *Chavis v. Commissioner,* 158 T.C. No. 8, June 15, 2022

[582] *Chavis v. Commissioner,* 158 T.C. No. 8, June 15, 2022

[583] *Chavis v. Commissioner,* 158 T.C. No. 8, June 15, 2022

But those items are only useful if the language of the provision contains some level of ambiguity regarding which taxes the provision covers. In this reported opinion, the Tax Court has determined that sufficient ambiguity exists in the wording to allow the IRS to use that other information to provide for the interpretation that shall apply, an interpretation found in Reg. §1.6015-1(a)(1)(iii) cited in the opinion.

SECTION: ERC
AICPA ISSUES DOCUMENT OUTLINING FACT AND FICTION WHEN DEALING WITH EMPLOYEE RETENTION CREDIT

Citation: "Employee retention credit: Fact or fiction?," AICPA & CIMA, 10/3/22

The AICPA Tax Division has released a three page summary[584] of some key issues with the Employee Retention Credit that is available for download to AICPA Tax Section members.

The document does provide specific statements regarding some claims often heard from organizations involved in heavily marketed ERC study programs where businesses are tempted to pay for such a study with promises of large ERC payments that are claimed to be available to the business. It also provides a short summary document that can be useful to provide to clients confused by what they have been hearing.

A couple of key items found in the document are noted below.

The ERC Applies to Most Small Businesses

Many of the ads promoting these studies at the very least strongly imply that most small businesses will qualify for a significant ERC payment. The document begins by labeling as fiction the claim that "[g]iven GOVID-19's wide-reaching effects, many small businesses will qualify for an employee retention credit (ERG)."

The document notes that the determination of whether a business qualifies for the credit is a complex undertaking:

> Determining whether a business is eligible for the ERG can be pretty complex. Your business must meet the gross receipts test (50% or more reduction for 2020 or a 20% or more decline for 2021 qualifying quarters when compared to 2019 quarters) or experience a full or partial suspension of operations because of a government order. Whether a business experienced a partial suspension is a facts ·and circumstances determination and will vary depending on the location of the business and the government orders.[585]

However, the document notes that a business without a significant decline in revenues can qualify for the credit is a fact—but notes that "there must have been a full or partial suspension of operations BECAUSE OF A GOVERNMENT ORDER that limited commerce, travel or group meetings due

[584] "Employee retention credit: Fact or fiction?," AICPA & CIMA, October 3, 2022, https://www.aicpa.org/resources/download/employee-retention-credit-erc-fact-or-fiction (membership required)

[585] "Employee retention credit: Fact or fiction?," AICPA & CIMA, October 3, 2022

to COVID-19." As well, that order "would need to have a more. than a nominal impact on the business to qualify for the ERC."[586]

Nature of Restrictions

The documents labels as fiction many blanket claims regarding full or partial suspension some clients have reported being told by parties marketing studies to them.

These include:

- *All safety recommendations or guidelines a government agency issues should be considered government orders to suspend operation requirements.* The document notes there are requirements beyond simply recommendations to qualify as an order for these purposes, as well as noting "[n]o federal order during 2020 or 2021 would qualify businesses for the ERC…"[587]

- *My business experienced supply chain disruption, which means it qualifies for the ERC.* The document notes that merely experiencing a supply chain disruption, even if related to the pandemic in some form, wouldn't be sufficient to qualify unless all of the following are met:

  - The business's supplier cannot made deliveries of critical goods due to a qualifying government order (which, based on the previous discussion, would need to be a state or local order),

  - The business cannot purchase these critical goods from an alternative supplier, and

  - The business must experience a more than nominal effect from this issue.[588]

- *My business qualifies for the ERC because employees and clients had to wear masks.*[589] This requirement alone would not qualify as a full or partial suspension of business operations that had a more than nominal effect on the business.

- *My business was in a location where them was a stay-at-home order, and I adjusted operations based on this. This automatically means I can claim the ERC.* Voluntary changes made a business, even if in response to pandemic conditions, related to service demand do not qualify as a full or partial suspension.[590] If the issue is reduction in demand, the business would have to show it met the reduction in gross revenue test.

[586] "Employee retention credit: Fact or fiction?," AICPA & CIMA, October 3, 2022

[587] "Employee retention credit: Fact or fiction?," AICPA & CIMA, October 3, 2022

[588] "Employee retention credit: Fact or fiction?," AICPA & CIMA, October 3, 2022

[589] "Employee retention credit: Fact or fiction?," AICPA & CIMA, October 3, 2022

[590] "Employee retention credit: Fact or fiction?," AICPA & CIMA, October 3, 2022

Unit

5

Passthrough Tax Developments

LEARNING OBJECTIVES

When you have completed this unit, you will be able to accomplish the following.

- Prepare tax returns and advise clients in planning taking into account major developments occurring in the past year

SECTION: 66
TAXPAYER NOT ELIGIBLE FOR RELIEF FROM PAYING TAX ON S CORPORATION INCOME FOR YEAR OF DIVORCE

Citation: Wheeler v. Commissioner, TC Summary Opinion 2021-42, 12/9/21

In the case of *Wheeler v. Commissioner*,[591] the Tax Court did not find persuasive a taxpayer's argument that she should be granted innocent spouse relief for taxes related to income from an S corporation she held an interest in during the year before the Court, which also was the year her divorce was finalized late in the year.

The taxpayer and her ex-spouse resided in Texas, one of the nine community property states in the U.S. The spouses had filed for divorce on September 21, 2015 and the divorce was finalized by decree on December 9, 2015. The decree that was signed by the taxpayer and her ex-spouse contained the following provision related to tax issues, entitled "Treatment/Allocation of Community Income for Year of Divorce."

> IT IS ORDERED AND DECREED that, for the calendar year 2015, each party shall file an individual income tax return in accordance with the Internal Revenue Code.
>
> IT IS ORDERED AND DECREED that for calendar year 2015, each party shall indemnify and hold the other party and his or her property harmless from any tax

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[591] *Wheeler v. Commissioner*, TC Summary Opinion 2021-42, December 9, 2021, https://www.taxnotes.com/research/federal/court-documents/court-opinions-and-orders/individual-denied-relief-from-taxes-on-income-allocated-to-her/7cp60 (retrieved December 11, 2021)

> liability associated with the reporting party's individual tax return for that year unless the parties have agreed to allocate their tax liability in a manner different from that reflected on their returns.
>
> IT IS ORDERED AND DECREED that each party shall furnish such information to the other party as is requested to prepare federal income tax returns for 2015 within thirty days of receipt of a written request for the information, and in no event shall the available information be exchanged later than March 1, 2016. As requested information becomes available after that date, it shall be provided within ten days of receipt.[592]

One of the assets owned by the couple while married were shares in Turner Investments & Consulting, Inc., an S corporation. The opinion notes:

> In October 2006 Turner Investments & Consulting, Inc. (Turner Investments), was organized as an S corporation; petitioner and Mr. Turner were each designated 50% shareholders. Income reported on Schedule K-1, Shareholder's Share of Income, Deductions, Credits, etc., from Turner Investments was included on petitioner's joint return with Mr. Turner for the three years (2012-14) before the year in issue. She was also issued Forms W-2, Wage and Tax Statement, reporting income from Turner Investments in years before 2015 and during that year, and she signed several checks for Turner Investments in 2013.[593]

The final decree provided that the taxpayer "shall execute any and all documents necessary to remove her name from the corporation and/or business within 5 days of receipt of same."[594]

The Court then describes the items reported and not reported on the taxpayer's tax return for 2015 related to the corporation:

> For 2015 Turner Investments issued to petitioner a Form W-2; she reported this wage income on her 2015 Form 1040. For 2015 Turner Investments also reported for petitioner, as a 37.44856% shareholder for that year, on Schedule K-1, ordinary business income of $63,083 and a net rental real estate loss of $1,681; she did not report this net Schedule K-1 income.[595]

The IRS noticed the omission of the S corporation income from Ms. Wheeler's 2015 return and issued a notice of deficiency for taxes related to that omitted income.

Ms. Wheeler, after filing her petition with the Tax Court in this case, filed for innocent spouse relief from liabilities related to the S corporation income. She argued that she is entitled to relief under IRC §66(c). IRC §66(c) reads as follows:

> (c) Spouse relieved of liability in certain other cases
>
> Under regulations prescribed by the Secretary, if—
>
> > (1) an individual does not file a joint return for any taxable year,

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592 *Wheeler v. Commissioner*, TC Summary Opinion 2021-42, December 9, 2021

593 *Wheeler v. Commissioner*, TC Summary Opinion 2021-42, December 9, 2021

594 *Wheeler v. Commissioner*, TC Summary Opinion 2021-42, December 9, 2021

595 *Wheeler v. Commissioner*, TC Summary Opinion 2021-42, December 9, 2021

> (2) such individual does not include in gross income for such taxable year an item of community income properly includible therein which, in accordance with the rules contained in section 879(a), would be treated as the income of the other spouse,
>
> (3) the individual establishes that he or she did not know of, and had no reason to know of, such item of community income, and
>
> (4) taking into account all facts and circumstances, it is inequitable to include such item of community income in such individual's gross income,

> then, for purposes of this title, such item of community income shall be included in the gross income of the other spouse (and not in the gross income of the individual).
>
> Under procedures prescribed by the Secretary, if, taking into account all the facts and circumstances, it is inequitable to hold the individual liable for any unpaid tax or any deficiency (or any portion of either) attributable to any item for which relief is not available under the preceding sentence, the Secretary may relieve such individual of such liability.

Note that this provision provides for two separate methods for the taxpayer to be able to avoid reporting community income. The first method, which is explained in all but the last paragraph, outlines what the court refers to as the "traditional relief" under this section, which provides four requirements a taxpayer must meet to be granted relief.

But the final paragraph offers a second offer of "equitable relief" if a taxpayer did not qualify for the traditional relief, so long as it would be inequitable to require the requesting former spouse to take the income into account.

Traditional Relief – S Corporation Flow-Through Income Not Covered by IRC §879(a)

The court noted that the S corporation income would have been treated as Ms. Wheeler's under the rules of IRC §879(a), making it her income. The rules of IRC §879(a), which apply to dividing income of nonresident alien spouses, are used to determine how to divide otherwise community income when the §66(c) traditional relief is sought and provides:

> (a) General rule
>
> In the case of a married couple 1 or both of whom are nonresident alien individuals and who have community income for the taxable year, such community income shall be treated as follows:
>
> > (1) Earned income (within the meaning of section 911(d)(2)), other than trade or business income and a partner's distributive share of partnership income, shall be treated as the income of the spouse who rendered the personal services,
> >
> > *(2) Trade or business income, and a partner's distributive share of partnership income, shall be treated as provided in section 1402(a)(5),* (emphasis added)

> (3) Community income not described in paragraph (1) or (2) which is derived from the separate property (as determined under the applicable community property law) of one spouse shall be treated as the income of such spouse, and
>
> (4) All other such community income shall be treated as provided in the applicable community property law.

The Court, applying the rules for trade or business income, found:

> Under section 879(a), community income that is trade or business income is treated as provided in section 1402(a)(5). Under section 1402(a)(5)(A), gross income and deductions attributable to a jointly operated trade or business are treated as the gross income and deductions of each spouse on the basis of their respective distributive shares of the gross income and deductions. Therefore, the rules contained in section 879(a) treat income from Turner Investments, a jointly operated trade or business, as the income of petitioner and Mr. Turner on the basis of their respective distributive shares. The income from petitioner's 37.44856% ownership of Turner Investments and reported on her 2015 Schedule K-1 would not be treated as income of a nonrequesting spouse, and she therefore does not satisfy section 1.66-4(a)(1)(ii), Income Tax Regs.[596]

Based on this factor alone, the Tax Court found that Ms. Wheeler could not qualify for traditional relief. But the Court also noted that Ms. Wheeler also should have been aware of this income (another condition for traditional relief is to be unaware of the income). While Ms. Wheeler argued that the fact that she was not provided with a Schedule K-1 proves she was not aware of the income, the court found that Ms. Wheeler reasonably should have been aware of the existence of the income:

> ..[A] taxpayer's knowledge of an item of community income must be determined by considering her knowledge of the particular income-producing activity. See *McGee v. Commissioner*, 979 F.2d 66, 70 (5th Cir. 1992), *aff'g* T.C. Memo. 1991-510; sec. 1.66-4(a)(2), Income Tax Regs. Petitioner was a shareholder in Turner Investments and reported Schedule K-1 income for the three years before 2015 on her Form 1040 jointly filed with Mr. Turner, received and reported Form W-2 income from Turner Investments for 2015 (and prior years), signed several checks for Turner Investments in 2013, and signed a divorce decree that referenced Turner Investments and required her to execute documents to remove her name from it. See *Felt v. Commissioner*, T.C. Memo. 2009-245 (finding that a requesting spouse knew the source of the income because she knew the name of and had deposited checks from a nonrequesting spouse's business that generated family income), *aff'd*, 433 F. App'x 293 (5th Cir. 2011). Crediting her testimony that she did not receive a Schedule K-1 for 2015 thus would not defeat a finding that she knew of or had reason to know of Turner Investments as an income-producing activity.
>
> Moreover, the divorce decree gave petitioner the right to request information "to prepare federal income tax returns for 2015" from Mr. Turner and required Mr. Turner "to furnish such information to * * * [petitioner]" within a specified period. Petitioner introduced no evidence that she requested such information or that Mr. Turner blocked her from doing so; rather, she claims that he failed to provide the Schedule K-1 for 2015. Her right to request information under the divorce decree

[596] *Wheeler v. Commissioner*, TC Summary Opinion 2021-42, December 9, 2021

> also was a means by which petitioner could have correctly reported her portion of Turner Investments' estimated tax payments.[597]

The opinion adds a final reason why the taxpayer should have known that there was a K-1 with income that should be reported.

> Petitioner also hired a tax return preparer to assist her, mitigating her lack of tax knowledge.[598]

Tax professionals may be troubled by this statement, since it implies that having hired a tax professional was a negative factor in determining if she had acted reasonably in remaining unaware of the existence of this income. The ruling implies (likely correctly) that a competent tax professional should have noticed the K-1 income reported in prior years and made inquiries to determine if such a K-1 had been issued to Ms. Wheeler for the current year.

As the Court notes, if such inquiries had been made (which the taxpayer conceded had not been made), her former spouse would have been required under the agreement to provide her with such information.

Equitable Relief Not Available Due to the Income Being Hers

The opinion also looks at the option made available for general equitable relief under IRC §66(c) in cases where the taxpayer cannot meet the conditions for traditional relief.

The Court notes that the IRS has outlined procedures for obtaining equitable innocent spouse relief in Revenue Procedure 2013-34. And the opinion notes that the relief can normally only be made available for income that is wholly that of the nonrequesting spouse:

> The requesting spouse must satisfy five threshold conditions to be eligible to submit a request for equitable relief under section 66(c). Rev. Proc. 2013-34, sec. 4.01, 2013-43 I.R.B. at 399-400. One threshold condition is that "[t]he income tax liability from which the requesting spouse seeks relief is attributable (either in full or in part) to an item of the nonrequesting spouse or an underpayment resulting from the nonrequesting spouse's income." Id. sec. 4.01(7), 2013-43 I.R.B. at 399.[599]

In this case, the problem was that the income from her shares in the S corporation was her income:

> The income tax liability from which petitioner seeks relief is not attributable (either in full or in part) to an item or underpayment of another individual. See *id.* Rather, the liability from which she seeks relief is attributable to her status as a 37.44856% shareholder in Turner Investments (distinct from Mr. Turner's status as a 62.55144% shareholder).[600]

[597] *Wheeler v. Commissioner*, TC Summary Opinion 2021-42, December 9, 2021

[598] *Wheeler v. Commissioner*, TC Summary Opinion 2021-42, December 9, 2021

[599] *Wheeler v. Commissioner*, TC Summary Opinion 2021-42, December 9, 2021

[600] *Wheeler v. Commissioner*, TC Summary Opinion 2021-42, December 9, 2021

The opinion continues on to note why this is not one of the special cases where Ms. Wheeler could obtain relief even though the income was her own:

> The exceptions for which "the Service will consider granting relief regardless of whether the * * * deficiency * * * is attributable * * * to the requesting spouse" under Rev. Proc. 2013-34, sec. 4.01(7), 2013-43 I.R.B. at 399-400, are (a) attribution solely due to operation of community property law, (b) nominal ownership, (c) misappropriation of funds, (d) abuse, and (e) fraud committed by the nonrequesting spouse.
>
> Petitioner does not meet any of these exceptions because: (a) the Schedule K-1 income from Turner Investments is attributable to her under section 1366, not solely by the operation of community property law; (b) the Schedule K-1 is in her name, and she did not rebut the consequent presumption that the income is attributable to her; (c) her failure to claim estimated tax payments (and the IRS' subsequent refund of those excess payments to Mr. Turner pursuant to section 6402 and section 1.6654-2(e)(5)(ii), Income Tax Regs.) does not constitute misappropriation of funds; (d) she filed an individual return and did not establish how any prior abuse by Mr. Turner would result in her inability to challenge the treatment of items on a return that she filed individually after her divorce was finalized and with the help of her own return preparer; and (e) she did not argue or establish that fraud is the reason for an erroneous item. Nor are we persuaded that her failure to claim the estimated tax payments and the subsequent refund to Mr. Turner provided sufficient ground for equitable relief independent of these factors. While the facts here are unfortunate, they were not unavoidable. We therefore hold that petitioner is not entitled to equitable relief under section 66(c).[601]

Lessons from the Case

In my career as a tax professional in Arizona (a community property state), I've noticed that recently divorced spouses, or even those going through a divorce, do not appreciate the impact of community property rules on how income must be reported on either returns with a married filing separate status or those for a tax year during which the divorce decree was granted. A former (or soon to be former) spouse often believes he/she just has to report his/her income based on how items were divided in the divorce or on general non-community property law views of what income belongs to each spouse.

In many cases, even after being made aware of the requirements to report income based on state law ownership of the income unless the special requirements of IRC §66(c) are met, the client will strongly resist such reporting, either finding it "unfair" or, more often, simply not wanting to interact with the other spouse as necessary to obtain the information.

Similarly, in looking over returns prepared by other preparers, it appears often preparers either are also unaware of these rules or simply decide to prepare the return ignoring community property rules when the client balks at getting the proper information. As well, even some preparers that are generally aware of the community property rules and special rules for IRC §66(c) are unaware of the limitations on the types of income to which such relief applies under the traditional rule.

Most often such reporting does not lead to problems with the IRS, resulting in an unfortunate reinforcement for all parties that such reporting is "fine" and there's no need to worry about proper

[601] *Wheeler v. Commissioner*, TC Summary Opinion 2021-42, December 9, 2021

reporting. To be honest, if the corporation had not issued a K-1 in the ex-spouse's name, rather erroneously preparing a K-1 showing all income as the ex-husband's, it's highly likely nothing would have happened here.

But as is often the case with such "practical" decision making ("I've been doing it this way for decades and never had an issue with the IRS on this!"), if the IRS does become aware of the issue and starts looking to collect tax, the taxpayer has no practical defense against paying the tax. And, as this case made clear, the fact the client sought professional help makes the situation worse, as the taxpayer's lack of sophistication no longer is a factor that might have shown it was reasonable to conclude the taxpayer wasn't aware of her error.

SECTION: 704
LB&I DIVISION ANNOUNCES NEW CAMPAIGN FOCUSING ON LIMITS ON DEDUCTION DUE TO PARTNER'S BASIS UNDER §704(D)

Citation: Partnership Losses in Excess of Partner's Basis Campaign, Large Business and International Active Campaigns, IRS webpage, 2/8/22

The IRS has announced a new Large Business and International Division Active Campaign on partnership losses in excess of partner's basis.[602]

The limited summary on the IRS webpage states:

> Partners that report flow-through losses from partnerships must have adequate outside basis as determined pursuant to IRC § 705 to deduct the losses or else the losses are suspended per § 704(d) to the extent they exceed the partner's basis in the partnership interest.[603]

Tax Notes Today Federal described the program in an article discussing the release as follows:

> The campaign focuses on section 704(d), which states that a partner's distributive share of partnership loss will be allowed only to the extent of the partner's adjusted basis in his partnership interest — that is, his outside basis — at the end of the partnership year in which the loss occurred.
>
> The campaign notes that if the partner's share of losses exceeds his outside basis, the excess amount is suspended and may be carried over for use in another tax year in which the partner has outside basis available.[604]

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[602] Partnership Losses in Excess of Partner's Basis Campaign, Large Business and International Active Campaigns, IRS webpage, February 8, 2022 update, https://www.irs.gov/businesses/corporations/lbi-active-campaigns (retrieved February 12, 2022)

[603] Partnership Losses in Excess of Partner's Basis Campaign, Large Business and International Active Campaigns, IRS webpage, February 8, 2022 update

[604] Kristen A. Parillo, "New LB&I Campaign Focuses on Partnership Loss Limitation Rules," *Tax Notes Today Federal*, February 9, 2022, https://www.taxnotes.com/tax-notes-today-federal/basis/new-lbi-campaign-focuses-partnership-loss-limitation-rules/2022/02/09/7d5p3 (subscription required, retrieved February 12, 2022)

SECTION: 754
FINAL REGULATIONS ISSUED REMOVING REQUIREMENT FOR SIGNING AN ELECTION UNDER §754

Citation: TD 9963, 8/4/22

The IRS issued final regulations[605] that adopt proposed regulations originally issued in October 2017[606] without making any changes eliminating the requirement that the election under IRC §754 included with a partnership income tax return be signed by a partner of the partnership.

An election under IRC §754, once made, requires that the basis of partnership property be adjusted:

- For distributions, as provided in IRC §734 and
- For transfers of a partnership interest, as provided in IRC §743.

This election cannot be revoked except as provided for in regulations issued by the IRS.[607]

Prior Regulations

Before this change, Reg §1.754-1(b)(1) provided, in its fourth sentence, the following requirements for the content and form of the election under IRC §754:

> The statement required by this subparagraph shall (i) set forth the name and address of the partnership making the election, *(ii) be signed by any one of the partners, (emphasis added)* and (iii) contain a declaration that the partnership elects under section 754 to apply the provisions of section 734(b) and section 743(b).[608]

The signature requirement generally meant that the partnership needed to scan a copy of the election signed by a partner as a PDF to attach to an electronically filed partnership tax return.

Revised Regulations

The only change found in the new regulations is to replace the fourth sentence of Reg. §1.754-1(b)(1) with the following:

> The statement required by this paragraph (b)(1) must set forth the name and address of the partnership making the election and contain a declaration that the partnership elects under section 754 to apply the provisions of section 734(b) and section 743(b).[609]

The clause that required the partners' signature has been removed from this version.

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[605] TD 9963, August 5, 2022 *Federal Register* publication date, announced August 4, 2022, https://public-inspection.federalregister.gov/2022-16271.pdf (retrieved August 4, 2022)

[606] REG-116256-17, 82 FR 47408, October 12, 2017

[607] IRC §754

[608] Reg. §1.754-1(b)(1) before being revised by TD 9963

[609] Reg. §1.754-1(b)(1) after being revised by TD 9963

Effective Date

The new fourth sentence will apply to taxable years ending on or after August 5, 2022. However, taxpayers may apply the fourth sentence (that is, not having to have a partner sign the election to the return) for taxable years ending before that date, duplicating what had been temporary relief granted when the proposed regulations were issued back in 2017.

SECTION: 1361
TRUSTEES FORGET TO PUT S SHARES INTO QSST TRUST, HAVE TO ASK FOR IRS PLR TO SAVE S STATUS

Citation: PLR 202218004, 5/6/22

S Corporations may be a popular form of doing business, but they are very fragile structures. The status can be lost in various ways, leading to the corporation becoming a C corporation, quite often a much less favorable tax structure for the entity. While a taxpayer can ask the IRS for relief with a finding that the termination of the status was inadvertent, this comes with a significant user fee and a significant amount of professional time to obtain the private letter ruling.

This situation confronted an S corporation that sought and obtained relief in PLR 202218004.[610]

Trusts Eligible to Be S Corporation Shareholders

S corporations must qualify at all times to be treated as a small business corporation under IRC §1361(b). A violation of any of the requirements results in a termination of S status[611] regardless of whether such a violation was intentional or wasn't done with "bad intent" to attempt to gain some tax advantage.

One of the key problems is having an S corporation end up with an ineligible shareholder. Quite often problems arise when a shareholder dies and the decedents' assets move to various trusts under their estate plan. Only certain trusts are eligible to hold S shares. IRC §1362(c)(2)(A) provides the list of trusts that are eligible S corporation shareholders:

- A trust all of which is treated (under subpart E of part I of subchapter J of this chapter) as owned by an individual who is a citizen or resident of the United States—that is, a *grantor trust.*
- A trust which was a grantor trust under the prior bullet immediately before the death of the deemed owner and which continues in existence after such death, *but only for the 2-year period beginning on the day of the deemed owner's death.*
- A trust with respect to stock transferred to it pursuant to the terms of a will, *but only for the 2-year period beginning on the day on which such stock is transferred to it.*
- A trust created primarily to exercise the voting power of stock transferred to it.

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[610] PLR 202218004, May 6, 2022, https://www.taxnotes.com/research/federal/irs-private-rulings/letter-rulings-%26-technical-advice/termination-of-s-corp-election-inadvertent/7dgjj (retrieved May 7, 2022)

[611] IRC §1362(d)(2)

- An electing small business trust (ESBT) where the *trustee* timely elects to have the ESBT rules apply or

- A qualifying subchapter S trust when the *beneficiary* timely elects to have the QSST rules apply.

An estate plan may be drafted to provide that the shares will be held in trust for various reasons (almost all of which have nothing to do with income tax benefits), but most often this will require the shares be moved into a qualifying trust before two years elapse (note the two year limit on holding shares in formerly grantor trusts on the grantor's death or in trusts established by the decedent's will). If the qualifying trust is meant to be an ESBT or QSST, a timely election must be made once the shares are transferred to the trust.

All too often these requirements are overlooked until, at some later date (perhaps when a potential buyer of the S corporation is having a due diligence review performed) the problem is noted and action must be taken—action that will require the private letter ruling request and resulting expense.

The Facts in This Case

In this PLR, the facts were as follows:

> The information submitted states that X was incorporated under the laws of State 1 on Date 1 and elected to be an S corporation effective Date 2. On Date 3, A, a shareholder of X, died. On Date 4, A's shares of X were transferred to Trust 1 pursuant to the terms of A's will. Trust 1 qualified as a permissible S corporation shareholder under § 1361(c)(2)(A)(iii) for a 2-year period beginning on Date 4, the day on which X stock was transferred to it.[612]

Up to this point all is well, but the 2-year clock has begun to run for action to be taken to get the shares out of this trust and into the hands of a qualifying shareholder. And that's where the problems arose.

> Pursuant to A's will, the trustees of Trust 1 were supposed to have transferred X stock to a separate trust (Trust 2) that was intended to be a qualified subchapter S trust (QSST) for the benefit of B because the governing provisions of Trust 1 did not satisfy the QSST requirements under § 1361(d)(3). However, the trustees of Trust 1 failed to transfer X stock to Trust 2 and B, the income beneficiary of Trust 2, failed to file a QSST election under § 1361(d)(2) for Trust 2. Consequently, on Date 5, Trust 1 became an ineligible shareholder of X and X's S corporation election terminated.[613]

The stock ending up being inadvertently left in the original trust is not all of that unusual a situation, especially if the advisers originally involved in the estate plan aren't involved at the point the shareholder dies. But the result becomes a conversion of the S corporation to a C corporation.

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[612] PLR 202218004, May 6, 2022

[613] PLR 202218004, May 6, 2022

Fixing the Problem and Obtaining the Letter Ruling

In this case, the problem was eventually noticed. To get relief the problem is going to have to be solved which requires that a private letter ruling be obtained. The PLR continues:

> In late Date 6, X learned that its S corporation election terminated on Date 5 and that Trust 1 was an ineligible shareholder. Subsequently, trustees of Trust 1 petitioned a State 2 court to modify the terms of Trust 1 to ensure it qualified as a QSST effective Date 4. On Date 7, the State 2 court approved the requested modification.[614]

At this point the proper structures are in place to solve the problem, but we have another issue:

> After Trust 1 was modified and before X stock was transferred to Trust 2 to effectuate the State 2 court-approved modification, X ceased to exist as a corporation following a reorganization on Date 8. [615]

In the best situation the reorganization would have been delayed until after the S status was restored (or at least until after the stock was moved to Trust 2), but likely in this case the transaction that would lead to the end of corporate status was already underway and other parties were unwilling or unable to delay the transaction.

The taxpayers provided a representation that the corporation and its shareholders, in their ignorance, continued to treat this as if it had continued to be an S corporation:

> X represents that at all relevant times, X and its shareholders have filed federal tax returns consistent with X being an S corporation. X represents that the termination of its S corporation election was inadvertent and was not motivated by tax avoidance or retroactive tax planning. X and its shareholders agree to make any adjustments consistent with the treatment of X as an S corporation as may be required by the Secretary.[616]

Note that this problem did not just affect the trust and its beneficiaries. The termination of the S election would have impacted *all* of the shareholders, even if they were not aware that shares had been transferred to a trust at all, let alone that the trustees had failed to move shares to a qualified trust and timely obtain a QSST election from the beneficiary.

Note that even though the IRS may not have been harmed by this issue (the tax got paid as if the elections were made and stocks moved to the proper trusts), the taxpayer can't argue a "no harm, no foul" position on exam under the law. IRC §1362(f) and Reg. §1.1362-4 requires obtaining the consent of the IRS to be able to treat the termination as inadvertent.

As well, Revenue Ruling 93-79 provides specifically that a reformation of a trust will only be considered prospectively:

> Accordingly, the reformation of the Trust will not be recognized retroactively to cure the defective S corporation election filed by X. Because an ineligible trust held

[614] PLR 202218004, May 6, 2022

[615] PLR 202218004, May 6, 2022

[616] PLR 202218004, May 6, 2022

> shares of X stock at the time X's S corporation election was filed, X was not a small business corporation on that date (as required by section 1362(a) of the Code) and on each day of 1992 before that date (as required by section 1362(b)(2)(B)(i)). Therefore, X never became an S corporation because the S corporation election filed by X on March 15, 1992, was ineffective. Furthermore, the provision of section 1362(b)(2) permitting certain otherwise ineffective elections to be effective for the following taxable year does not permit the election filed by X to be valid for the following taxable year, 1993, because X was not a small business corporation when the election was filed.[617]

Since the trust itself needed reformation, that is another issue that requires the IRS to grant relief, as the controlling ruling will not allow the taxpayer to consider the changes retroactively.

IRS Ruling

In this case, as is most often the case, the IRS has granted the request for retroactive relief.

> Based solely on the facts submitted and the representations made, we conclude that X's S corporation election terminated on Date 5 when Trust 1 became an ineligible shareholder. We further conclude that the termination of X's S corporation election on Date 5 was inadvertent within the meaning of § 1362(f). Pursuant to the provisions of § 1362(f), X will be treated as continuing to be an S corporation from Date 5 until it ceased to exist as a corporation following the reorganization on Date 8, provided that X's S corporation election was valid and has not otherwise terminated under § 1362(d).[618]

SECTION: 1362
IRS PROVIDES RELIEF PROCEDURES FOR S ELECTIONS, ALSO PROVIDES WILL NOT ISSUE PRIVATE LETTERING RULINGS GENERALLY IN AREAS COVERED BY THE RELIEF

Citation: Revenue Procedure 2022-19, 10/11/19

In Revenue Procedure 2022-19[619] the IRS has issued a series of "taxpayer assistance procedures" to resolve certain issues involving S corporations and their shareholders without requiring the issuance of a private letter ruling (PLR).

The areas covered by this guidance are:

- Agreements and Arrangements with No Principal Purpose to Circumvent One Class of Stock Requirement
- Governing Provisions That Provide for Identical Distribution and Liquidation Rights

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[617] Revenue Ruling 93-79, November 13, 1993

[618] Revenue Ruling 93-79, November 13, 1993

[619] Revenue Procedure 2022-19, October 11, 2022, https://www.taxnotes.com/research/federal/irs-guidance/revenue-procedures/letter-rulings-not-needed-for-some-s-corp-election-requests/7f7bl (retrieved October 8, 2022)

- Procedures for Addressing Missing Shareholder Consents, Errors with Regard to a Permitted Year, Missing Officer's Signature, and Other Inadvertent Errors and Omissions
- Procedures for Verifying S Elections or QSub Elections
- Procedures for Addressing a Federal Income Tax Return Filing Inconsistent with an S Election or a QSub Election
- Procedures for Retroactively Correcting One or More Non-Identical Governing Provisions[620]

Details of the Six Areas

The procedure provides:

> Sections 2.03(1) through 2.03(6) of this revenue procedure describe the six areas for which issues are resolvable without a PLR, and for which this revenue procedure provides taxpayer assistance procedures. With regard to the sixth area described in 2.03(6) of this revenue procedure (addressing potential retroactive correction of non-identical governing provisions), the validity or continuation of a corporation's S election is not affected in certain circumstances only if the corporation and its applicable shareholders (as defined in section 3.06(1)(a) of this revenue procedure) meet the requirements of section 3.06 of this revenue procedure.[621]

Agreements and Arrangements with No Principal Purpose to Circumvent One Class of Stock Requirement.

The Procedure describes the background for the first area of relief as follows:

> **(1) One class of stock requirement and governing provisions, including "principal purpose" conditions.**
>
> **(a) Overview.** Pursuant to § 1361(b) (1)(D) and § 1.1361-1(l)(1), a corporation that has more than one class of stock does not qualify as a small business corporation. Section 1.1361-1(l)(1) provides generally that a corporation is treated as having only one class of stock if all outstanding shares of stock confer identical rights to distribution and liquidation proceeds.
>
> **(b) Governing provisions.** Section 1.1361-1(l)(2)(i) provides 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 law, and binding agreements relating to distribution and liquidation proceeds (collectively, governing provisions). A commercial contractual agreement is not a binding agreement relating to distribution and liquidation proceeds, and therefore is not a governing provision, unless a principal purpose of the agreement is to circumvent the one class of stock requirement. See § 1.1361-1(l)(2)(i).

[620] Revenue Procedure 2022-19, October 11, 2022

[621] Revenue Procedure 2022-19, SECTION 2.03, October 11, 2022

> **(c) Other agreements and arrangements**. The Income Tax Regulations identify a number of other agreements and arrangements between or among an S corporation and its shareholders that may or may not be treated as second classes of stock depending in part on whether a principal purpose of the agreement or arrangement was to circumvent the one class of stock requirement or otherwise alter shareholders' rights to distribution and liquidation proceeds. See § 1.1361-1(l)(2)(iii)(A) (buy-sell agreements among shareholders, agreements restricting the transferability of stock, and redemption agreements), § 1.1361-1(l)(4)(ii)(A) (special rules for instruments, obligations, or arrangements treated as equity under general principles of Federal tax law), § 1.1361-1(l)(4)(ii)(B)(1) (short-term unwritten advances that fail the safe harbor described in § 1.1361-1(l)(4)(ii)(B)(1)), and § 1.1361-1(l)(4)(ii)(B)(2) (obligations of the same class that are considered equity under general principles of Federal tax law but fail the safe harbor described in § 1.1361-1(l)(4)(ii)(B)(2)). See section 3.01 of this revenue procedure (providing that the IRS will not treat taxpayers who have entered into the agreements or arrangements described in this section 2.03(1)(c) as violating the one class of stock requirement of § 1361(b)(1)(D) so long as there was no principal purpose to use the agreement or arrangement as a means to circumvent the one class of stock requirement).[622]

The procedure provides the following relief regarding agreements and arrangements that had no principal purpose of circumventing the one class of stock requirement:

> **.01 Agreements and Arrangements with No Principal Purpose to Circumvent One Class of Stock Requirement.** Certain agreements and arrangements described in section 2.03(1)(c) of this revenue procedure are not governing provisions and are not treated as second classes of stock so long as there was no principal purpose to use the agreement as a means to circumvent the one class of stock requirement. Accordingly, the IRS will not treat an S corporation as violating the one class of stock requirement of § 1361(b)(1)(D) as a result of an agreement or arrangement identified in section 2.03(1)(c) of this revenue procedure that does not have a principal purpose to circumvent the one class of stock requirement. Because entering into these specific agreements in these circumstances will not result in termination of S corporation status, taxpayers do not need to seek relief from the IRS. For this reason, and because the existence of a principal purpose is inherently factual in nature, the IRS will not rule in these situations. See section 4.01(1) of this revenue procedure.[623]

Essentially, the IRS has indicated that the agency will not issue a PLR with regard to such an arrangement if the principal purpose of the arrangement is not to evade the one class of stock rules *and* the procedure specifically provides the IRS will not issue a PLR on whether an arrangement has such a principal purpose:

> **(1) Principal purpose determinations regarding the one class of stock requirement**. The IRS will not issue a PLR under § 1362(f) addressing the validity or continuation of an S election in situations regarding the one class of stock requirement that require a determination of the existence of a principal purpose because such a determination is inherently factual in nature. See section 6.02 of Rev.

[622] Revenue Procedure 2022-19, SECTION 2.03(1), October 11, 2022

[623] Revenue Procedure 2022-19, SECTION 3.01, October 11, 2022

Proc. 2022-1 (or any successor revenue procedure). Accordingly, the IRS will not issue a PLR under § 1362(f) addressing:

> (a) For purposes of determining whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds under § 1.1361-1(l)(2), whether a principal purpose of a commercial contractual agreement, buy-sell agreement, an agreement restricting the transferability of stock, or a redemption agreement is to circumvent the one class of stock requirement of § 1361(b)(1)(D) and § 1.1361-1(l) (see § 1.1361-1(l)(2)(i) and (iii)(A)(1)); or
>
> (b) For purposes of determining whether an instrument, obligation, or arrangement is treated as a second class of stock, whether:
>
> > (i) A principal purpose of issuing or entering into an instrument, obligation, or arrangement is to circumvent the rights to distribution or liquidation proceeds conferred by the outstanding shares of stock or to circumvent the limitation on eligible shareholders contained in § 1.1361-1(b)(1) (see § 1.1361-1(l)(4)(ii)(A)(2)); or
> >
> > (ii) A principal purpose of an unwritten advance or proportionately held obligation is to circumvent the rights of the outstanding shares of stock or the limitation on eligible shareholders under § 1.1361-1(l)(4)(ii)(A)(2) (see § 1.1361-1(l)(4)(ii)(B)).[624]

Governing Provisions That Provide for Identical Distribution and Liquidation Rights

The second area deemed resolvable without obtaining a private letter ruling relates to disproportionate distributions:

> **(2) Disproportionate distributions.** A "disproportionate distribution" is any distribution (including an actual distribution, a constructive distribution, or a deemed distribution) of property by a corporation with respect to shares of its stock that differs in timing or amount from the distribution with respect to any other shares of its stock. See § 1.1361-1(l)(1) and (2). Section 1.1361-1(l)(2)(i) provides that, "[a]lthough 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 or amount are to be given appropriate tax effect in accordance with the facts and circumstances." Despite this regulation providing that "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," taxpayers and practitioners have indicated concern with the language of § 1.1361-1(l)(2)(i). The articulated concern is that the word "although" in combination with the subsequent language requiring that certain disproportionate distributions "be given appropriate tax effect" creates uncertainty as to whether an S corporation has created a second class of stock — even though the governing provisions provide identical

[624] Revenue Procedure 2022-19, SECTION 4.01(1), October 11, 2022

> distribution and liquidation rights with respect to each share. Practitioners suggest that the language in § 1.1361-1(l)(2)(i) could be clarified by removing the word "[a]lthough" and point to inconsistency in PLRs in the treatment of disproportionate distributions. See section 3.02 of this revenue procedure (providing that the IRS will not treat any disproportionate distributions by a corporation as violating the one class of stock requirement of § 1361(b)(1)(D) so long as the corporation's governing provisions provide for identical distribution and liquidation rights).[625]

In this case the IRS provides for the following relief and also adds this item as one on which the agency will not issue a private letter ruling:

> **.02 Governing Provisions That Provide for Identical Distribution and Liquidation Rights.** As outlined in section 2.03(2) of this revenue procedure, § 1.1361-1(l)(2)(i) provides that 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. Accordingly, the IRS will not treat any disproportionate distributions made by a corporation as violating the one class of stock requirement of § 1361(b)(1)(D) so long as the governing provisions of the corporation provide for identical distribution and liquidation rights. Because disproportionate distributions made in these circumstances will not result in the termination of S corporation status, taxpayers do not need to seek relief from the IRS and the IRS will not rule in these situations. See section 4.01(2)(a) of this revenue procedure.[626]

Procedures for Addressing Missing Shareholder Consents, Errors with Regard to a Permitted Year, Missing Officer's Signature, and Other Inadvertent Errors and Omissions

The next section governs inadvertent errors or omissions on the Form 2553 or Form 8869:

> **(3) Certain inadvertent errors or omissions on Form 2553 or Form 8869**. An inadvertent error or omission on Form 2553 or Form 8869 does not invalidate an S election or a QSub election, unless the error or omission is with respect to a shareholder consent, a selection of a permitted year (as defined in § 1378(b) and § 1.1378-1(b)), or an officer's signature. See generally § 1362(a)(2) (an S election is valid "only if all persons who are shareholders in such corporation on the day on which such election is made consent to such election"), § 1.1378-1 (requiring that the taxable year of an S corporation must be a permitted year, which is defined to include a calendar year or any other taxable year for which the corporation establishes a business purpose to the satisfaction of the Commissioner), and § 1.1361-3(a)(2) (a QSub election form must be signed by a person authorized to sign the S corporation's return). See section 3.03 of this revenue procedure (providing procedures for a taxpayer to correct, without the receipt of a PLR, an error, an omission, or a missing required consent on a Form 2553 or Form 8869).[627]

The Procedure provides the following procedures for specific omissions and errors.

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[625] Revenue Procedure 2022-19, SECTION 2.03(2), October 11, 2022

[626] Revenue Procedure 2022-19, SECTION 3.02, October 11, 2022

[627] Revenue Procedure 2022-19, SECTION 2.03(3), October 11, 2022

Missing Shareholder Consent

The Procedure provides a set of potential methods to correct the situation where a shareholder consent is missing, only providing for a PLR if none of the others apply:

> An S election that fails to include the consent of a shareholder may be corrected pursuant to the following:
>
> > (a) Section 1.1362-6(b)(3)(iii) (providing an extension of time for filing a shareholder consent to an S election);
> >
> > (b) Rev. Proc. 2013-30 (providing a simplified method for taxpayers to request relief for late S elections);
> >
> > (c) Rev. Proc. 2004-35, 2004-1 C.B. 1029 (providing automatic relief for certain taxpayers requesting relief for late shareholder consents for S elections in community property States); or
> >
> > (d) If the remedies listed in section 3.03(1)(a) through (c) of this revenue procedure do not apply, a taxpayer or the taxpayer's authorized representative may request relief by submitting a request for a PLR under § 1362(f) to the Associate Chief Counsel (Passthroughs and Special Industries).[628]

Correction of an Error With Regard to a Permitted Year

For an error related to a permitted year, the IRS again reminds taxpayers of automatic relief options before allowing for a PLR to be issued:

> A Form 2553 that contains an inadvertent error with regard to a permitted year may be corrected pursuant to Rev. Proc. 2013-30 (providing a simplified method for taxpayers to request relief for late S elections). If a taxpayer is not eligible for relief under Rev. Proc. 2013-30, a correction may be obtained through the receipt of a PLR under § 1362(f) from the Associate Chief Counsel (Passthroughs and Special Industries).[629]

Correction of Missing Officer's Signature

In the case of a missing officer's signature, the Procedure first directs taxpayers to the existing standard late S election relief:

> A Form 2553 or Form 8869 that is missing the signature of an authorized officer of the S corporation that affects the validity of the S election or QSub election may be corrected pursuant to Rev. Proc. 2013-30 (providing a simplified method for taxpayers to request relief for late S elections and QSub elections). If a taxpayer is not eligible for relief under Rev. Proc. 2013-30, a correction may be obtained

[628] Revenue Procedure 2022-19, SECTION 3.03(1), October 11, 2022

[629] Revenue Procedure 2022-19, SECTION 3.03(2), October 11, 2022

> through the receipt of a PLR under § 1362(f) from the Associate Chief Counsel (Passthroughs and Special Industries).[630]

Correction of Other Inadvertent Errors or Omissions

The Procedure concludes with a simplified process to deal with other inadvertent errors or omissions not covered by the previous sections:

> Errors and omissions on Form 2553 or Form 8869, other than those addressed in section 3.03(1) through (3) of this revenue procedure, may be corrected by explaining in writing the error(s) or omission(s) and the necessary correction(s) and submitting the written explanation to one of the following addresses (depending on the Internal Revenue Submission Processing Center with which the S corporation files its Form 1120-S) or any successor address the IRS may provide:
>
> > (a) Internal Revenue Service, MS 6055, 333 W. Pershing Rd., Kansas City, MO 64108.
> >
> > (b) Internal Revenue Service, MS 6273, 1973 N. Rulon White Blvd., Ogden, UT 84404.[631]

No PLRs Issued for Certain Inadvertent Errors, Omissions, or Missing Required Consents

Again the Procedure provides that the IRS will not generally issue rulings for any such issues other than those where the Procedure specifically provides that a PLR should be requested:

> The IRS will not issue a PLR under § 1362(f) regarding any error or omission described in section 3.03(4) of this revenue procedure. Such inadvertent errors or omissions do not impact a corporation's S election or QSub election. See section 2.03(3) of this revenue procedure. The IRS will also not issue a PLR under § 1362(f) for a missing required consent, errors with regard to a permitted year, or a missing officer's signature where the taxpayer qualifies for relief under any of the means of relief identified in section 3.03(1) through (3) of this revenue procedure. The Associate Chief Counsel (Passthroughs and Special Industries) will consider the issuance of a PLR only if the error or omission concerns a shareholder consent, the selection of a permitted year, or a missing officer's signature, and the taxpayer has no other means of requesting relief. See section 4.02(2) of this revenue procedure.[632]

Procedures for Verifying S Elections or QSub Elections

The Procedure discusses issues where the corporation is unable to locate the letter from the IRS accepting the S election or QSub election:

> Generally, within 90 days after the IRS receives a corporation's Form 2553, the IRS mails a CP261 Notice as an acknowledgment to the corporation that the IRS has accepted the corporation's filing. For QSub elections filed on Form 8869, the IRS

[630] Revenue Procedure 2022-19, SECTION 3.03(3), October 11, 2022

[631] Revenue Procedure 2022-19, SECTION 3.03(4), October 11, 2022

[632] Revenue Procedure 2022-19, SECTION 3.03(5), October 11, 2022

> mails a CP279 Notice to the filer and a CP279A Notice to the subsidiary, generally within 60 days after the IRS accepts the QSub election. A lack of written acknowledgement that the IRS has accepted the corporation's S election or its subsidiary's QSub election (for example, because it was lost or never received) creates uncertainty for some taxpayers about the validity of the election. However, neither subchapter S of the Code nor the Income Tax Regulations thereunder provide that a lack of possession of a CP261 Notice, CP279 Notice, or CP279A Notice affects the validity of an S election or a QSub election, respectively. Rather, such notices are merely administrative acknowledgments of an effective election that can be reproduced upon the taxpayer's request. See section 3.04 of this revenue procedure (providing procedures to replace a missing CP261 Notice, CP279 Notice, or CP279A Notice).[633]

The Procedure adds an exclusive method for requesting an additional copy of these letters:

> **(1) Availability of replacement letters**. With regard to a missing administrative acceptance letter for an S election or an administrative acceptance letter for a QSub election, as appropriate, a replacement letter may be requested:
>
> > (a) For an S corporation and shareholders of an S corporation, by contacting the IRS Business and Specialty Tax Line at 800-829-4933; and
> >
> > (b) For practitioners, by contacting the IRS Practitioner Priority Service at 866-860-4259.[634]

Not surprisingly, what cannot be done is request a PLR on the issue:

> **(2) Unavailability of a PLR.** The IRS will not issue a PLR under § 1362(f) with regard to any missing administrative acceptance letter described in section 3.04(1) of this revenue procedure. See section 4.01(2) of this revenue procedure. A missing administrative acceptance letter does not impact an S election or a QSub election. See section 2.03(4) of this revenue procedure.[635]

Procedures for Addressing a Federal Income Tax Return Filing Inconsistent with an S Election or a QSub Election

The Procedure describes the following problem that sometimes arises with S corporations:

> Occasionally, a corporation files a Federal income tax return that is inconsistent with the corporation's status as an S corporation or a QSub (for example, an S corporation files a Form 1065, U.S. Return of Partnership Income, or Form 1120, U.S. Corporation Income Tax Return, instead of Form 1120-S, U.S. Income Tax Return for an S Corporation). Although an inconsistent Federal income tax return filing can create several complications for the filer, nothing in the Code or Income Tax Regulations thereunder provides that such a filing affects the validity of a corporation's S election or QSub election. For example, neither § 1362(d) nor § 1.1361-5(a) lists an inconsistent Federal income tax return filing as an event that

[633] Revenue Procedure 2022-19, SECTION 3.03(5), October 11, 2022

[634] Revenue Procedure 2022-19, SECTION 3.04, October 11, 2022

[635] Revenue Procedure 2022-19, SECTION 3.04, October 11, 2022

gives rise to a termination of an S election or a QSub election. See section 3.05 of this revenue procedure (providing procedures for taxpayers to address, without the receipt of a PLR, a Federal income tax return filing inconsistent with an S election or a QSub election, as appropriate).[636]

The Procedure provides the following method to resolve this issue:

> **(1) Filing a corrected original return or an amended return.** An S corporation, or a parent S corporation of a QSub, that files a Federal income tax return for a taxable year that is inconsistent with the status of the corporation as an S corporation, or inconsistent with the status of a subsidiary of the parent S corporation as a QSub, must file a Federal income tax return for open taxable years consistent with its status, as appropriate —
>
> (a) to reflect the status of the corporation as an S corporation or parent of a QSub; or
>
> (b) to reflect the status of the subsidiary as a QSub.[637]

The Procedure provides the following guidance regarding the federal income tax effect of a corporation's prior transactions in this case:

> Because a corporation is not treated as having terminated its S election or QSub election, as appropriate, merely due to the filing of one or more Federal income tax returns inconsistent with its S election or QSub election, the corporation's distributions and other transactions will be treated consistent with its status as an S corporation or a QSub, as appropriate. Thus, a QSub's income or deductions will be treated as income or deductions of the parent S corporation and distributions between the QSub and its parent will be disregarded.[638]

As with prior issues, the IRS provides no private letter rulings will be issued in this area:

> The IRS will not issue a PLR under § 1362(f) with regard to any inconsistent return filing described in section 3.05(1) of this revenue procedure. See section 4.01(2) of this revenue procedure. Such an inconsistent return filing does not impact an S election or a QSub election. See section 2.03(5) of this revenue procedure.[639]

Procedures for Retroactively Correcting One or More Non-Identical Governing Provisions

The most complex taxpayer assistance procedure involves a case where the governing provisions create non-identical rights to regular or liquidating distributions, triggering a second class of stock. This can happen when standard boilerplate language is added to corporate documents when having both voting and non-voting stock that can provide for separate declarations of distributions to each type of stock. This creates a problem even if no disproportionate distribution ever takes place.

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[636] Revenue Procedure 2022-19, SECTION 2.03(5), October 11, 2022

[637] Revenue Procedure 2022-19, SECTION 3.05(1), October 11, 2022

[638] Revenue Procedure 2022-19, SECTION 3.05(3), October 11, 2022

[639] Revenue Procedure 2022-19, SECTION 3.05(2), October 11, 2022

A similar problem can arise with LLC operating agreements when the "check the box" corporation takes on more than one member and the language of the operating agreement provides for any possibility of differing distribution rights.

The Procedure describes the problem as follows:

> **(6) Non-identical governing provisions.**
>
> **(a) Overview.** Section 1361(b)(1)(D) requires an S corporation to have only one class of stock. Section 1.1361-1(l) provides that a corporation is treated as having only one class of stock if all outstanding shares of the corporation's stock confer identical rights to distribution and liquidation proceeds and if the corporation has not issued any instrument or obligation, or entered into any arrangement, that is treated as a second class of stock. An S corporation in compliance with § 1.1361-1(l) is commonly referred to as having "identical governing provisions." The term "non-identical governing provision" means a governing provision, as defined by § 1.1361-1(l)(2)(i), on its own or as part of another governing provision, that for Federal income tax purposes results in the S corporation having more than one class of stock under § 1.1361-1(l)(1) (even if the S corporation never made a non-pro rata distribution or liquidating distribution).
>
> **(b) Consequences of non-identical governing provisions**. If an entity files an S election when it has more than a single class of stock, the entity does not meet the requirements to be an S corporation and its attempted election is invalid. See § 1361(a)(1). If a valid S corporation later provides for more than a single class of stock, its S election automatically terminates on the day the disqualifying event occurs. See § 1362(d)(2). See section 3.06 of this revenue procedure (providing procedures for correcting, without the receipt of a PLR, the validity or continuation of an S election with regard to one or more non-identical governing provisions, as defined in section 2.03(6)(a) of this revenue procedure).[640]

The relief provisions for this problem are much longer than those for the other areas.

Definitions

The Procedure provides the following definitions for this relief procedures:

- *Applicable shareholder*. The term "applicable shareholder" means a current or former shareholder of a corporation who owns or owned stock of the corporation at any time during the period:
  - (i) Beginning on the date on which the non-identical governing provision was adopted (on its own or as part of another governing provision); and
  - (ii) Ending on the date on which the nonidentical governing provision was removed or modified in a manner such that the governing provision complies with the one class of stock requirement.
- *Discovered by the IRS*. The term "discovered by the IRS" has the meaning given the term in § 301.9100-3(b)(1)(i) of the Procedure and Administration Regulations (26 CFR part 301).

[640] Revenue Procedure 2022-19, SECTION 2.03(6), October 11, 2022

- *Disproportionate distribution.* The term "disproportionate distribution" is defined in section 2.03(2) of this revenue procedure.

- *Non-identical governing provision.* The term "non-identical governing provision" is defined in section 2.03(6)(a) of this revenue procedure.[641]

Retroactive Corrective Relief Procedures

The Procedure provides a series of steps at Section 3.06(2) that must be followed to obtain retroactive relief. The section provides:

> **(a) Retroactive continuing validity of S election**. If an S corporation and its applicable shareholders meet the requirements of this section 3.06, an S election that is invalid or terminated solely as the result of one or more non-identical governing provisions will be treated for Federal income tax purposes as continuing from the date on which the first non-identical governing provision that invalidated or terminated the corporation's S election was adopted.[642]

To be eligible for retroactive relief, the corporation must meet the following requirements:

> **(b) Eligibility**. A small business corporation and each applicable shareholder of the corporation are eligible for corrective relief under this section 3.06 if the following requirements are satisfied:
>
> > (i) The corporation has or had one or more non-identical governing provisions;
> >
> > (ii) The corporation has not made, and for Federal income tax purposes is not deemed to have made, a disproportionate distribution to an applicable shareholder;
> >
> > (iii) The corporation timely filed a return on Form 1120-S (as required under § 6037 of the Code and § 1.6037-1 of the Income Tax Regulations) for each taxable year of the corporation beginning with the taxable year in which the first non-identical governing provision was adopted and through the taxable year immediately preceding the taxable year in which the corporation made a request for corrective relief under this section 3.06 (a corporation is treated as having timely filed a required Form 1120-S under this section 3.06(2)(b)(iii) if the Form 1120-S is filed within six months after its original due date, excluding extensions); and
> >
> > (iv) Before any non-identical governing provision is discovered by the IRS, all of the requirements described in section 3.06(2)(c) of this revenue procedure are satisfied.[643]

[641] Revenue Procedure 2022-19, SECTION 3.06(1), October 11, 2022

[642] Revenue Procedure 2022-19, SECTION 3.06(2)(a), October 11, 2022

[643] Revenue Procedure 2022-19, SECTION 3.06(2)(b), October 11, 2022

The following corrective relief statements are also required to obtain retroactive relief:

(c) Corrective relief statements.

(i) Corporate governing provision and shareholder statements. The corporation must complete a Corporate Governing Provision Statement in accordance with section 3.06(2)(c)(ii) of this revenue procedure and a Shareholder Statement signed by each applicable shareholder in accordance with section 3.06(2)(c)(iii) of this revenue procedure.

(ii) Corporate Governing Provision Statement. The Corporate Governing Provision Statement, a sample of which is provided in Appendix A, must be completed in accordance with this section 3.06(2)(c)(ii).

(A) Designation. The Corporate Governing Provision Statement must state at the top of the document: "CORPORATE GOVERNING PROVISION STATEMENT PURSUANT TO REV. PROC. 2022-19, SECTION 3.06(2)(c)(ii)".

(B) Information. The Corporate Governing Provision Statement must provide the following information:

(1) The date of the Corporate Governing Provision Statement, the corporation's name, employment identification number (EIN), address, date of formation or incorporation, and State of formation or incorporation;

(2) The actual or intended effective date of the corporation's S election filed on Form 2553 (see Form 2553, Part I, line E) that is the subject of the request for corrective relief under this section 3.06;

(3) The name, address, and social security number or taxpayer identification number of each applicable shareholder; and

(4) To establish an inadvertent termination or invalidation of the S election of the corporation, a description of all relevant facts regarding why each non-identical governing provision was adopted, how each non-identical governing provision was discovered, and each action taken to correct or remove each non-identical governing provision before any non-identical governing provision is discovered by the IRS. This description must include each action taken by the corporation and each applicable shareholder to establish that the corporation and each applicable shareholder acted reasonably and in good faith in correcting or removing each non-identical governing provision upon discovery to demonstrate reasonable cause for relief.

(C) Representations. Except as provided in section 3.06(2)(c)(ii)(D), the corporation must provide the following four representations:

(1) "The corporation's S election was inadvertently invalid or terminated solely because of the adoption of one or more non-identical governing provisions.";

(2) "The corporation and each applicable shareholder satisfy all of the requirements set forth in section 3.06 of Rev. Proc. 2022-19.";

(3) "The corporation responds in the negative to each requested statement set forth in section 7.01(4) or (5) of Rev. Proc. 2022-1, or any successor revenue procedure (statements regarding whether the same or a similar issue was previously ruled on or whether a request involving the same or a similar issue was submitted or is currently pending)."; and

(4) "The corporation and each applicable shareholder acted reasonably and in good faith in correcting or removing each non-identical governing provision upon discovery.".

(D) Explanation regarding previously ruled on, submitted, or pending PLRs. If the corporation cannot respond in the negative to any requested statement set forth in section 7.01(4) or (5) of Rev. Proc. 2022-1, or any successor revenue procedure (and therefore cannot make the representation described in section 3.06(2)(c)(ii)(C)(3) of this revenue procedure), the corporation must provide an explanation for each such response as part of the description of all relevant facts required by section 3.06(2)(c)(ii)(B)(4) of this revenue procedure.

(E) Statements. The corporation must provide the statements set forth in section 3.06(2)(c)(ii)(E)(1) through (3) of this revenue procedure:

(1) "The corporation acknowledges that the relief provided by section 3.06 of Rev. Proc. 2022-19 is limited solely to each non-identical governing provision described in this Corporate Governing Provision Statement.";

(2) "The corporation acknowledges that the relief provided by section 3.06 of Rev. Proc. 2022-19 is based solely on the information, representations, and other statements provided by the corporation pursuant to section 3.06 of Rev. Proc. 2022-19, each of which is subject to verification during IRS examination."; and

(3) "During the period between the date on which the non-identical governing provision became effective and the date on which all of the procedures described in section 3.06 of Rev. Proc. 2022-19 are completed, each applicable shareholder has reported their income on all affected returns consistent with the S corporation election for the taxable year the non-identical governing provision became effective and for all subsequent years for which each applicable shareholder owned shares of the corporation.".

(F) Signature. The Corporate Governing Provision Statement must be signed under penalties of perjury by a person authorized to sign the corporation's Federal income tax return under § 6062 of the Code. The penalties of perjury statement must be provided in the following format: "Under penalties of perjury, I declare that I have examined this Corporate Governing Provision Statement for corrective relief for one or more non-identical governing provisions, as provided by Rev. Proc. 2022-19, section 3.06, including accompanying documents, and, to the best of my knowledge and belief, the request contains all the relevant facts, and such facts are true, correct, and complete.".

(iii) Shareholder Statement. The Shareholder Statement, a sample of which is provided in Appendix B, must be completed in accordance with this section 3.06(2)(c)(iii).

(A) Designation. The Shareholder Statement must state at the top of the document: "SHAREHOLDER STATEMENT PURSUANT TO REV. PROC. 2022-19, SECTION 3.06(2)(c)(iii)".

(B) Information. The Shareholder Statement must provide:

(1) The date of the Shareholder Statement, the corporation's name, EIN, address, date of formation or incorporation, and State of formation or incorporation;

(2) The name and address of each applicable shareholder;

(3) The social security number or taxpayer identification number of each applicable shareholder;

(4) The number of shares of stock or, in the case of a limited liability company, percentage of ownership each applicable shareholder owns or owned and the date(s) the stock was acquired and, if applicable, transferred; and

(5) The date that each applicable shareholder provided their signature, as required by section 3.06(2)(c)(iii)(D) of this revenue procedure.

> **(C) Statement of consent**. Each applicable shareholder must provide the following statement of consent: "Under penalties of perjury, I declare that I consent to the election of [insert corporation's name], referred to herein as "the Corporation," located at [insert the Corporation's address], whose employment identification number (EIN) is [insert the Corporation's EIN], to be an S corporation under § 1362(a)(1) of the Code. I have examined this consent statement, including accompanying documents, and, to the best of my knowledge and belief, the request for corrective relief contains all the relevant facts, and such facts are true, correct, and complete. I understand that my consent is binding and may not be withdrawn after the Corporation receives relief pursuant to Rev. Proc. 2022-19, section 3.06. I also declare under penalties of perjury that I have reported my income on all affected returns consistent with the Corporation's election to be an S corporation for the taxable year for which the election would have been in effect but for the non-identical governing provision(s) described in the Corporate Governing Provision Statement for corrective relief and for all subsequent years I have owned shares of the Corporation.".
>
> **(D) Signature**. The Shareholder Statement must be signed under penalties of perjury by each applicable shareholder.[644]

Finally, there is a record retention requirement for this relief:

> **(d) Record retention requirement**. The corporation is required to retain the Corporate Governing Provision Statement, the Shareholder Statement(s), and the revised governing provisions in accordance with § 6001 of the Code and the Income Tax Regulations thereunder. The Corporate Governing Provision Statement, the Shareholder Statement(s), and the revised governing provisions must be retained by the corporation for inspection by authorized Internal Revenue officers or employees, and must be retained so long as the contents thereof may become material in the administration of any provision of the Code or the Income Tax Regulations. See § 1.6001-1(e).[645]

If the taxpayer does not qualify for the above retroactive relief, then the following procedures must be used to request a private letter ruling:

> **(e) Alternative relief.**
>
> **(i) General rule.** An S corporation or applicable shareholder that does not qualify for corrective relief under this section 3.06 may seek corrective relief through a request submitted by the S corporation, applicable shareholder, or authorized representative (as appropriate) to the Associate Chief Counsel (Passthroughs and Special Industries) for a PLR. The request must provide the required explanation described in section 3.06(2)(e)(ii) of this revenue procedure. See generally Rev. Proc. 2022-1 (or any successor revenue procedure).

[644] Revenue Procedure 2022-19, SECTION 3.06(2)(c), October 11, 2022

[645] Revenue Procedure 2022-19, SECTION 3.06(2)(d), October 11, 2022

> **(ii) Required explanation**. A request for a PLR by an S corporation or applicable shareholder, or authorized representative, under section 3.06(2)(e)(i) of this revenue procedure must include an explanation regarding each reason why the requirements for corrective relief under this section 3.06 could not be satisfied.[646]

SECTION: 1367
DEALING WITH MISSING S CORPORATION BASIS FOR NEW CLIENTS

Citation: Kristen A. Parillo, "New Basis Reporting Form Spotlights Role of Proper Documentation," Tax Notes Today Federal, 6/1/22

This week Kristen Parillo published an article in *Tax Notes Today Federal* looking at how the requirement to prepare and attach Form 7203 impacted this tax season that this author was quoted in.[647]

One of the key issues raised in the article was how to deal with new clients who lack basis information on their S corporation investments, either because they had been preparing their own return and had ignored basis rules (perhaps because they had no idea there were such rules) or their prior preparer had ignored the issue.

This article looks at the options that might exist to deal with these situations.

Why the IRS Created Form 7203

The IRS had been requiring S basis computations to be attached to tax returns for many years. The 1997 Schedule E instructions, the oldest version found on the IRS website, had this instruction that was to be used in preparing 1997 returns:

> If you are claiming a deduction for your share of an aggregate loss, attach to your return a computation of the adjusted basis of your corporate stock and of any debt the corporation owes you.[648]

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[646] Revenue Procedure 2022-19, SECTION 3.06(2)(e), October 11, 2022

[647] Kristen A. Parillo, "New Basis Reporting Form Spotlights Role of Proper Documentation," *Tax Notes Today Federal,* June 1, 2022, https://www.taxnotes.com/tax-notes-today-federal/basis/new-basis-reporting-form-spotlights-role-proper-documentation/2022/06/01/7djjp (retrieved June 4, 2022)

[648] 1997 Instructions for Schedule E, Supplemental Income and Loss, p. 5, https://www.irs.gov/pub/irs-prior/i1040se--1997.pdf (retrieved June 4, 2022)

The IRS made the requirement more explicit in 2018, adding a specific box that must be checked indicating if a basis calculation was required to be attached. Presumably the IRS added this because the agency noticed that such basis calculations were often not being attached.

Part II **Income or Loss From Partnerships and S Corporations – Note:** If you report a loss, receive a distribution, dispose of stock, or receive a loan repayment from an S corporation, you **must** check the box in column **(e)** on line 28 and attach the required basis computation. If you report a loss from an at-risk activity for which **any** amount is **not** at risk, you **must** check the box in column **(f)** on line 28 and attach **Form 6198** (see instructions).

27 Are you reporting any loss not allowed in a prior year due to the at-risk, excess farm loss, or basis limitations, a prior year unallowed loss from a passive activity (if that loss was not reported on Form 8582), or unreimbursed partnership expenses? If you answered "Yes," see instructions before completing this section . . . . ☐ **Yes** ☐ **No**

28	**(a)** Name	**(b)** Enter **P** for partnership; **S** for S corporation	**(c)** Check if foreign partnership	**(d)** Employer identification number	**(e)** Check if basis computation is required	**(f)** Check if any amount is not at risk
A			☐		☐	☐
B			☐		☐	☐
C			☐		☐	☐
D			☐		☐	☐

Now it appears the IRS has decided that even the check box had not gotten the attention of those filing returns, so the agency created Form 7203 that must be attached to Form 1040 if the taxpayer:

- Is claiming a deduction for their share of an aggregate loss from an S corporation (including an aggregate loss not allowed last year because of basis limitations),
- Received a non-dividend distribution from an S corporation,
- Disposed of stock in an S corporation (whether or not gain is recognized), or
- Received a loan repayment from an S corporation.[649]

[649] Instructions for Form 7203 (12/2021), January 19, 2022, https://www.irs.gov/instructions/i7203#en_US_202112_publink100045402 (retrieved June 4, 2022)

The first page of Form 7203 is reproduced below:

Form **7203** (December 2021) Department of the Treasury Internal Revenue Service

S Corporation Shareholder Stock and Debt Basis Limitations

► Attach to your tax return.
► Go to *www.irs.gov/Form7203* for instructions and the latest information.

OMB No. 1545-2302
Attachment Sequence No. **203**

Name(s) shown on return	**Identifying number**
Name of S corporation	**Employer identification number**

Stock block (see instructions) ►

Part I Shareholder Stock Basis

1	Stock basis at the beginning of the corporation's tax year			**1**	
2	Basis from any capital contributions made or additional stock acquired during the tax year			**2**	
3a	Ordinary business income (enter losses in Part III)	**3a**			
b	Net rental real estate income (enter losses in Part III)	**3b**			
c	Other net rental income (enter losses in Part III)	**3c**			
d	Interest income	**3d**			
e	Ordinary dividends	**3e**			
f	Royalties	**3f**			
g	Net capital gains (enter losses in Part III)	**3g**			
h	Net section 1231 gain (enter losses in Part III)	**3h**			
i	Other income (enter losses in Part III)	**3i**			
j	Excess depletion adjustment	**3j**			
k	Tax-exempt income	**3k**			
l	Recapture of business credits	**3l**			
m	Other items that increase stock basis	**3m**			
4	Add lines 3a through 3m			**4**	
5	Stock basis before distributions. Add lines 1, 2, and 4			**5**	
6	Distributions (excluding dividend distributions)			**6**	
	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 Schedule D. See instructions.				
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			**7**	
8a	Nondeductible expenses	**8a**			
b	Depletion for oil and gas	**8b**			
c	Business credits (sections 50(c)(1) and (5))	**8c**			
9	Add lines 8a through 8c			**9**	
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			**10**	
11	Allowable loss and deduction items. Enter the amount from line 47, column (c)			**11**	
12	Debt basis restoration (see net increase in instructions for line 23)			**12**	
13	Other items that decrease stock basis			**13**	
14	Add lines 11, 12, and 13			**14**	
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-			**15**	

Part II Shareholder Debt Basis

Section A—Amount of Debt (If more than three debts, see instructions.)

Description	**Debt 1** ☐ Formal note ☐ Open account debt	**Debt 2** ☐ Formal note ☐ Open account debt	**Debt 3** ☐ Formal note ☐ Open account debt	**Total**
16 Loan balance at the beginning of the corporation's tax year				
17 Additional loans (see instructions)				
18 Loan balance before repayment. Combine lines 16 and 17				
19 Principal portion of debt repayment (this line doesn't include interest)	( )	( )	( )	( )
20 Loan balance at the end of the corporation's tax year. Combine lines 18 and 19				

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 56396V Form **7203** (12-2021)

The page contains the full computation of stock basis in Part I and the beginning of the shareholder's basis in debt in Section A of Part II.

The second page of Form 7203 contains the following:

Form 7203 (12-2021) Page **2**

Part II Shareholder Debt Basis *(continued)*

Section B—Adjustments to Debt Basis

Description	Debt 1	Debt 2	Debt 3	Total
21 Debt basis at the beginning of the corporation's tax year				
22 Enter the amount, if any, from line 17				
23 Debt basis restoration (see instructions)				
24 Debt basis before repayment. Combine lines 21, 22, and 23				
25 Divide line 24 by line 18				
26 Nontaxable debt repayment. Multiply line 25 by line 19				
27 Debt basis before nondeductible expenses and losses. Subtract line 26 from line 24				
28 Nondeductible expenses and oil and gas depletion deductions in excess of stock basis				
29 Debt basis before losses and deductions. Subtract line 28 from line 27. If the result is zero or less, enter -0-				
30 Allowable losses in excess of stock basis. Enter the amount from line 47, column (d)				
31 **Debt basis at the end of the corporation's tax year.** Subtract line 30 from line 29. If the result is zero or less, enter -0-				

Section C—Gain on Loan Repayment

Description	Debt 1	Debt 2	Debt 3	Total
32 Repayment. Enter the amount from line 19				
33 Nontaxable repayments. Enter the amount from line 26				
34 **Reportable gain.** Subtract line 33 from line 32				

Part III Shareholder Allowable Loss and Deduction Items

Description	**(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
35 Ordinary business loss					
36 Net rental real estate loss					
37 Other net rental loss					
38 Net capital loss					
39 Net section 1231 loss					
40 Other loss					
41 Section 179 deductions					
42 Charitable contributions					
43 Investment interest expense					
44 Section 59(e)(2) expenditures					
45 Other deductions					
46 Foreign taxes paid or accrued					
47 **Total loss.** Combine lines 35 through 46 for each column. Enter the total loss in column (c) on line 11 and enter the total loss in column (d) on line 30					

Form **7203** (12-2021)

Big Deal or Not So Much?

The *Tax Notes Today Federal* article looked at the impact of this form on the past tax season. As the article notes:

> Whether preparing Form 7203 for the first time was a straightforward task or a nightmare for tax professionals seems to depend on the basis tracking history and recordkeeping skills of whoever handled the shareholder's previous tax returns.[650]

The article quotes a number of tax professionals who have found issues with both returns previously prepared by taxpayers and even those prepared by other tax professionals when taking on a new client.

[650] Kristen A. Parillo, "New Basis Reporting Form Spotlights Role of Proper Documentation," *Tax Notes Today Federal,* June 1, 2022

Taxpayers are ultimately responsible for tracking the basis in their investments. For partnerships and S corporations this requires tracking much more than simply how much the taxpayer paid for his/her interest.

For stock in an S corporation that basis is tracked under rules found at IRC §1367 after the initial basis of the interest is determined at acquisition. This basis number is used for the following purposes:

- Limiting the amount of net losses that may be deducted by the shareholder on their Form 1040
- Determining if any non-dividend distributions received from the S corporation are considered a return of capital or taxable as a capital gain and
- Computing gain or loss on the sale or exchange of the S corporation shares.

S corporation shareholders also have to track basis in any amounts they have loaned to the S corporation. Such debt basis is important as

- A source of basis for deducting losses from the S corporation should stock basis be exhausted or
- Determining the proportion of any principal repayment that is considered taxable gain vs. a return of the debt basis in the loan.

Debt basis cannot be used to convert taxable distributions in excess of stock basis to a nontaxable status. As well, if debt basis is not restored by year end (before taking into account current year losses), *any* repayment of the debt will lead to taxable income based on the ratio of the basis remaining in the debt to the outstanding principal of the debt.

Thus, basis in stock and debt must be referred to in preparing a shareholder's Form 1040 in the following cases:

- The K-1 shows a net loss being passed out to the shareholder for the tax year;
- Prior year losses suspended due to a lack of basis flow into the current year return;
- Distributions (other than tax dividends) are paid to the shareholder during the tax year;
- Any debt from the shareholder to the S corporation is fully or partially repaid during the year; or
- The S corporation interest is sold or exchanged during the year.

Not coincidentally, this list corresponds to the situations where the IRS demands that Form 7203 be attached to the tax return in order to document any of the following positions on the return:

- The losses claimed on the individual return are allowed to be claimed in the year in question;
- Some or all distributions are not taxable to the shareholder as a gain;
- Any amount of the repayment of shareholder loans is not taxable to the shareholder; and
- The gain or loss on disposition of the S corporation shares has been properly computed, which includes the disposition of the shares in a year the S corporation is liquidated.

When the New Client Hasn't Tracked Basis

If the taxpayer begins tracking basis with the first return the S corporation investment appears on, Form 7203 presents no real challenge in most cases. The *Tax Notes Today Federal* article quoted Nathan Smith of CBIZ Inc. on how difficult the Form 7203 processing was:

> "We saw a few questions come up from time to time, but by and large it was pretty much smooth sailing," said Nathan Smith of CBIZ Inc. "Unlike the Schedule K-2 and K-3 disaster, the new standardized reporting on Form 7203 was fairly seamless."[651]

But the article notes that things become a lot more difficult if the professional takes on a new client who has not been tracking the information:

> While the form wasn't a struggle for those who were already tracking basis, it highlighted the problem that tax professionals face when taking on new clients who weren't tracking it themselves and whose preparers weren't doing it either.[652]

A client who comes to the practitioner with no prior records related to basis has always required the practitioner to deal with obtaining information to determine what is beginning basis and if the taxpayer may have reported losses in the past or avoided reporting gain on distributions that means prior returns contain errors.

There are various ways a professional may obtain basis information. For now, we'll consider three options that the practitioner should consider.

Recalculate Basis from Day One

Clearly the best option to deal with obtaining basis information for a taxpayer who has not tracked basis in the past is to obtain the information for each prior year to properly compute stock and debt basis. The Form 7203 itself serves as an excellent set of worksheets to prepare for each year to obtain a comprehensive and easily defendable calculation of basis up through the beginning of the year the practitioner is first looking to prepare.

One key fact to keep in mind is the absolute rule that basis can *never* go below zero. Generally, if events occur that would push basis below zero, the "excess" reduction is taken care of either by limiting deductions to the amount that takes basis to zero (and carrying such disallowed losses to the next taxable year) or by recognizing a gain on distributions.

Later we'll discuss options to deal with this situation in closed years based on IRS documents. While these documents are not binding authority, they contain analyses that do cite to binding authority and aren't likely to be challenged by IRS examiners if the taxpayer conforms to the methods described.

But, for now, when computing basis we simply note that such "problematical" events occurred in a year but still treat ending basis as zero.

[651] Kristen A. Parillo, "New Basis Reporting Form Spotlights Role of Proper Documentation," *Tax Notes Today Federal,* June 1, 2022

[652] Kristen A. Parillo, "New Basis Reporting Form Spotlights Role of Proper Documentation," *Tax Notes Today Federal,* June 1, 2022

While this option is by far the best, in many cases it is not possible to obtain all data necessary to do the full calculation using the schedules for each year. We'll discuss some options to deal with this situation, realizing that it's very possible the IRS will challenge any such calculation on exam—and may very well succeed in pushing down the basis.

Even if it is possible to obtain the data, clients may balk at the effort and cost involved in obtaining the data. The adviser should strongly suggest the client take the steps necessary to obtain the information and have fully supported basis calculations should the IRS examine his/her return. Remember that the problem exists because the taxpayer failed to take the steps *required* of the taxpayer to prepare the prior year's returns.

While that may have been due to inadequate work done by a paid preparer, it's not due to inadequate work done by the preparer taking on the return—but if the preparer simply acquiesces in the client's whining about not wanting to have the work done to properly calculate basis, the preparer may find that he/she now will be deemed by the client to have "blessed" the less desirable method—and the client may look for compensation should the IRS successfully challenge the return later.

IRS LB&I Process Unit Methods

The *IRS Large Business & Industry Process Unit Knowledge Base – S Corporations*[653] describes a number of issues IRS examiners may encounter in examining S corporations and their shareholders. The recommendations for steps for examining agents to take when faced with imperfect information on basis are found in this document.

In the section entitled "Losses Claimed in Excess of Basis" the document suggests the following steps be taken when historical information is not available:

> When historical records are not available to substantiate the shareholder's initial stock basis or the adjustments to basis since making the S election, estimate initial stock basis by taking the earliest S corporation return available and adding:
>
> - beginning capital stock,
> - beginning additional paid-in capital,
> - beginning accumulated adjustments account, and
> - beginning other adjustments account.
>
> Multiply the total by the shareholder's ownership percentage to arrive at each individual's estimated initial stock basis[654]

The document provides two examples of performing such a calculation:

[653] *IRS Large Business & Industry Process Unit Knowledge Base – S Corporations*, Document Control Number SCO/P/53_05_01_03-06(2016), Revised April 9, 2018, https://www.irs.gov/pub/irs-utl/sco_p_53_05_01_03_06.pdf (retrieved June 5, 2022)

[654] *IRS Large Business & Industry Process Unit Knowledge Base – S Corporations*, Document Control Number SCO/P/53_05_01_03-06(2016), Revised April 9, 2018

EXAMPLE 1

Estimating Initial Stock Basis Using the Return Resulting in Positive Basis

The balance sheet and Schedule M-1 show the following information:

*Accumulated Adjustments Account (AAA)

**Other Adjustments Account (OAA)

	Beginning	Ending
Capital Stock (Line 22)	45,000	60,000
Additional Paid in Capital (Line 23)	0	0
Retained Earnings (Line 24)	(22,000)	(86,000)

	AAA*	OAA**
1. Balance at beginning of the Year	(21,000)	1,000
2. Ordinary Income from page 1, line 21	0	
3. Other additions	0	0
4. Loss from page 1, line 21	(64,000)	
5. Other reductions	0	0
6. Combined lines 1 through 5	(85,000)	1,000
7. Distributions other than dividends	0	0
8. Balance at end of year	(85,000)	1,000

Based on this information, the estimated beginning stock basis is computed as follows:

Beginning Capital Stock	45,000
Plus: Beginning Additional Paid in Capital	0
Equals: Beginning Stock Cost	45,000
Plus: Beginning AAA and OAA	(20,000)
Equals: Estimated Beginning Stock Basis	25,000

If there is more than one shareholder, multiply the $25,000 by each shareholder's ownership percentage to determine each shareholder's estimated initial stock basis. For example, if there are two equal shareholders, then take the estimated beginning stock basis of $25,000 times 50-percent ownership, which equals $12,500 of estimated beginning stock basis for each shareholder.[655]

[655] *IRS Large Business & Industry Process Unit Knowledge Base – S Corporations*, Document Control Number SCO/P/53_05_01_03-06(2016), Revised April 9, 2018

EXAMPLE 2

Estimating Initial Stock Basis Using the Return Results in Negative Basis[656]

The corporation made its S election in 2000, but the earliest S corporation return available is 2012. Therefore, the 2012 return is used to estimate initial stock basis. The balance sheet and Schedule M-1 show the following information:

	Beginning
Capital Stock (Line 22)	45,000
Additional Paid in Capital (Line 23)	0
Retained Earnings (Line 24)	(22,000)

	AAA	OAA
1. Balance at beginning of the Year	(98,000)	0
2. Ordinary Income from page 1, line 21	0	
3. Other additions	0	
4. Loss from page 1, line 21	(64,000)	
5. Other reductions	0	
6. Combined lines 1 through 5	(162,000)	0
7. Distributions other than dividends	0	
8. Balance at end of year	(162,000)	0

Based on this information, the estimated beginning stock basis is computed as follows:

Beginning Capital Stock	45,000
Plus: Beginning Additional Paid in Capital	0
Equals: Beginning Stock Cost	45,000
Plus: Beginning AAA and OAA	(98,000)
Equals: Estimated Beginning Stock Basis	(53,000)

However, IRC 1367(a)(2) states that basis cannot be decreased below zero. A negative estimated initial stock basis indicates the S corporation generated losses or paid distributions greater than the income it earned in years prior to 2012. Assuming the shareholder's 2012 return and basis computation do not report $53,000 in suspended losses, a suspense account must be established to track the ($53,000). TAM 200619021, FSA 200230030 and TAM 9304004.

This example assumes debt basis is zero. If there is debt basis of at least $53,000, then the beginning debt basis amount would be reduced by the $53,000 loss instead of establishing a suspense account. Also, if the shareholder has a NOL carryforward of at least $53,000 from an open statute year, then the NOL is decreased instead establishing a suspense account.

As in Example 1, if there is more than one shareholder, multiply the ($53,000) by the shareholder's ownership percentage to determine each shareholder's suspense account.

[656] *IRS Large Business & Industry Process Unit Knowledge Base – S Corporations*, Document Control Number SCO/P/53_05_01_03-06(2016), Revised April 9, 2018

The suspense account is entered on the Stock Basis Worksheet and the Stock & Debt Basis Workbook as follows:

For more information on the suspense account see the Audit Tool – S Corporation Shareholder Loss Limitations Issue Guide.

Name of Corporation
Shareholder's Name – Stock Basis Computation Worksheet
2012

	STOCK BASIS					
1	**Stock Basis at Beginning of Year** (cannot be negative)					$ -
2	**Increase for Capital Contribution or Additional Stock Purchase**					
	Capital Contribution				$ -	
	Stock Purchase				-	-
3	**Increase for Income & Gain Items**	*2012 Sch. K-1*				
	Ordinary Business Income	*Line 1*	$ -			
	Separately Stated Income:					
	Net Rental Real Estate Income	*Line 2*	-			
	Other Net Rental Income	*Line 3*	-			
	Interest Income	*Line 4*	-			
	Ordinary Dividends & Royalties	*Lines 5a & 6*	-			
	Net Short and Long Term Capital Gain	*Lines 7 & 8a*	-			
	Net Section 1231 Gain	*Line 9*	-			
	Other Income	*Line 10 (A-E)*	-			
	Total Income and Gain Items				-	
	Increase for Tax-Exempt Income	*Line 16 (A-B)*			-	
	Increase for Excess Depletion Adjustment	*Line 17 (R)*			-	
	Increase From Recapture of Business Credits	(see IRC §49(a), 50(a), 50(c)(2), & 1371(d))			-	
4	**Stock Basis After Increases**					-
5	**Reduced by: "Suspense Account"** (Relying on the logic of TAM 200619021)		**Beg. of Year**	**Used in Current Yr**	**Balance**	
	Suspended Basis Losses Previously Claimed in Error (Closed by Statute)		(53,000)	-	(53,000)	-
6	**Stock Basis Before Distributions** (cannot be negative)					-
7	**Reduction for Non-Dividend Distributions**	*Line 16 (D)*				-
	*Note: * Non-Taxable Distributions cannot exceed Ln. 6. If the total distributions exceed Ln. 6, the excess is treated as a deemed sale of S Corporation stock (i.e. LTCG). * If the S Corporation has C Corporation Accumulated Earning & Profits, distributions in excess of the AAA will be taxed as dividend income & will not reduce stock basis).*				**Gain** -	
8	**Stock Basis Before Non-Deductible Expenses & Depletion** (cannot be negative)					-
9	**Decrease for Non-Deductible Exp, Depletion & Business Credits**		**Current Year**	**Applied to Stock Basis**	**In Excess of Stock Basis**	

Computation of Shareholder Basis

Shareholder Name: 0 — Initials: 0
Taxpayer ID Number: 0 — Date: 1/0/1900
Income Year: Prior Years

Schedule 1

	Total Distributive Shares			Basis and Suspended Losses					Debt
	1 Prior Year Suspended Losses	2 Current Distributive Shares	3 Total [1+2]	4 Stock Basis	5 Debt Basis Schedule 1a	6 Current Losses Allowed [4+5]	7 Losses Claimed tha Can't be Adjusted	8 Current Suspended Losses [3-6-7]	9 Face Amount of Debt Schedule 1a
A. Beginning Balance				0	0				0
B. Additions				0	0				0
C. Subtotal [A+B]				0	0				0
D. Additions:									
-Ordinary Business Income		0	0						
-Net Rental Real Estate Income		0	0						
-Other Net Rental Income		0	0						
- Interest Income		0	0						
-Ordinary Dividends & Royalties		0	0						
-Net ST & LT Gain		0	0						
-Net Section 1231 Gain		0	0						
-Other Income		0	0						
-Tax Exempt Income		0	0						
-Excess Depletion Adjustment		0	0						
-Recapture of Business Credits		0	0						
E. Total Additions			0	0	0				
F. Subtotal [C+E]				0	0				
G. Suspense Account	53,000			0	0		53,000		
H. Decrease Basis for Income not reported in closed year									

Instructions | Input_Sheet | Tab 1 | Tab 2 | Tab 3 | Tab 4 | Tab 5 | Tab 6 | Tab 7 | Tab 8 | Tab 9 | Tab 10 | 1a

The document also notes that it's important to understand how the S corporation shareholder acquired his/her shares when using these estimation methods:

Note: It is important to establish how and when each shareholder acquired basis in the S corporation as the above estimate may need to be modified as a result of

> ownership changes. If the estimate appears to be unreasonable based on the facts and circumstances, then consider using zero as the initial stock basis.[657]

Other Methods – <u>Cohan</u> Case

The basic authority for the estimation methods the IRS discussed comes from the case of *Cohan v. Commissioner*.[658] That case established that if the evidence makes it clear that the taxpayer should qualify for some deduction but does not have sufficient records to document the amount, the taxpayer will still be allowed some deduction to the extent the amount he/she should be allowed can reasonably be estimated, taking into account the taxpayer's level of responsibility for a lack of adequate records.

While the IRS clearly is relying on this case to justify the proposed methods, an adviser might find some other reasonable methodology to compute basis and then be ready to defend that method if necessary.

Losses Previously Claimed in Excess of Basis

The IRS document goes on to advise examining agents regarding what to do when they discover losses in excess of basis have been claimed in prior years. Advisers may discover the same issue when looking to determine basis for new clients.

Step 2 of the process of dealing with losses claimed in excess of basis discussed first the absolute rule, noted earlier, that basis can never drop below zero, so basis becomes zero for the year following the year when excess losses are claimed:

> Stock basis can never be reduced below zero. Therefore, even if a loss is claimed in excess of basis, the stock basis at the beginning of the following year is zero.[659]

If these losses were claimed in years closed to IRS assessments by statute, you might think this reset to zero means the taxpayer "wins" in this case, but the document goes on to provide a methodology that could very well allow the IRS to recover that excess tax benefit by using a suspense account:

> National Office's position is that if a shareholder claims losses in excess of basis in a year closed by statute, then the shareholder must suspend all future tax-free distributions and losses from the S corporation until the excess losses claimed, but not allowed, are recaptured. FSA 200230030; TAM 200619021 and PLR 9304004.[660]

As is noted, the IRS has brought this concept up in documents dating back to 1993.

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[657] *IRS Large Business & Industry Process Unit Knowledge Base – S Corporations*, Document Control Number SCO/P/53_05_01_03-06(2016), Revised April 9, 2018

[658] *Cohan v. Commissioner*, 39 F.2d 540 (2d Cir. 1930)

[659] *IRS Large Business & Industry Process Unit Knowledge Base – S Corporations*, Document Control Number SCO/P/53_05_01_03-06(2016), Revised April 9, 2018

[660] *IRS Large Business & Industry Process Unit Knowledge Base – S Corporations*, Document Control Number SCO/P/53_05_01_03-06(2016), Revised April 9, 2018

The guide also provides the agent with citations to use against an attempt by the taxpayer to argue the agent has no right to look at "closed" years:

> IRC 7602(a)(1) authorizes the examiner to examine any books, papers, records, or other data which may be relevant or material to determine the correctness of any return, including information from prior years not under examination or closed by statute. IRC 6214(b) allows the Tax Court to determine the correct tax liability for the open year(s) by referring, as necessary, to facts from other years. *Lone Manor Farms, Inc. v. Commissioner* - 61 T.C. 436, 440-441 (1974); *Goldsmith v. Commissioner* - T.C. Memo. 2017-20.[661]

The document outlines how the suspense account is absorbed in open years:

> If a taxpayer claims a loss in excess of basis in a closed statue year, then a suspense account is created, pursuant to IRC 1366(d)(2), to track the excess losses. The balance in the suspense account must be reduced to zero before the taxpayer is allowed to take tax-free non-dividend distributions or report pass-through losses. TAM 200619021 explains that the "suspended basis losses claimed in error" should reduce stock basis before current year distributions, non-deductibles and losses and deductions are taken into account.[662]

The steps the LB&I document outlines for agents to take are:

- Review the basis computation schedule and identify any years for which the losses and deductions exceed the shareholder's basis.
- Compare the basis computation to the shareholder's return to determine if the losses claimed in closed statute years exceed basis.
- Establish or increase the suspense account for any losses and deductions claimed in excess of basis in closed statute years.[663]

The document provides the following example of applying these procedures:

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[661] *IRS Large Business & Industry Process Unit Knowledge Base – S Corporations*, Document Control Number SCO/P/53_05_01_03-06(2016), Revised April 9, 2018

[662] *IRS Large Business & Industry Process Unit Knowledge Base – S Corporations*, Document Control Number SCO/P/53_05_01_03-06(2016), Revised April 9, 2018

[663] *IRS Large Business & Industry Process Unit Knowledge Base – S Corporations*, Document Control Number SCO/P/53_05_01_03-06(2016), Revised April 9, 2018

EXAMPLE 3

Suspense Account[664]

Mary, the sole owner of an S corporation, reported the following income and deduction items on Form 1040 for 2013 (a closed statute year), as reported on Schedule K-1:

Ordinary Income	5,000
Section 1231 Loss	(8,000)
Charitable Contributions	(1,000)

The shareholder's beginning stock and debt basis was zero. As 2013 is a closed statute year, the suspense account is computed as follows:

Beginning Basis	0
Ordinary Income	5,000
Section 1231 Loss	(8,000)
Charitable Contributions	(1,000)
Suspense Account	(4,000)

[664] *IRS Large Business & Industry Process Unit Knowledge Base – S Corporations*, Document Control Number SCO/P/53_05_01_03-06(2016), Revised April 9, 2018

The suspense account is entered on the Stock Basis Worksheet and the Stock & Debt Basis Workbook as follows:

For more information on the suspense account see the Audit Tool – S Corporation Shareholder Loss Limitations Issue Guide.

S Corporation
Mary – Stock Basis Computation Worksheet
2013

STOCK BASIS

1 **Stock Basis at Beginning of Year** (cannot be negative)							$ -
2 **Increase for Capital Contribution or Additional Stock Purchase**							
Capital Contribution						$ -	
Stock Purchase						-	-
3 **Increase for Income & Gain Items**	***2012 Sch. K-1***						
Ordinary Business Income	*Line 1*		$ 5,000				
Separately Stated Income:							
Net Rental Real Estate Income	*Line 2*		-				
Other Net Rental Income	*Line 3*						
Decrease for Depletion	*Line 17 (R)*		-	-	-		
Decrease for Business Credits (see IRC §50(c)(1) & (5))			-	-	-		-

Note: If the above exceed stock basis, the excess is applied to the S/H's debt basis. The amount in excess of debt basis is not carried over.

10 **Stock Basis Before Allowable Losses & Deductions** (cannot be negative)							5,000
11 **Decrease for Loss & Deduction Items**	***2012 Sch. K-1***	Current Year Distributive Share	Carryover Amount #	Allowable Loss & Deductions	Losses Claimed That Can't be Adjusted @	Suspended Basis C/O	
Ordinary Business Loss	*Line 1*	-	-	-	-	-	
Separately Stated Loss & Deductions:							
Net Rental Real Estate Loss	*Line 2*		-	-	-	-	
Other Net Rental Loss	*Line 3*	-	-	-	-	-	
Net ST & LT Capital Loss	*Lines 7 & 8a*	-	-	-		-	
Net Section 1231 Loss	*Line 9*	(8,000)	-	(4,444)	(3,556)	0	
Other Loss	*Line 10 (A-E)*	-	-	-	-	-	
Section 179 Deduction	*Line 11*	-	-	-	-	-	
Charitable Contributions	*Line 12 (A-G)*	(1,000)	-	(556)	(444)	(0)	
Investment Interest Expense	*Line 12 (H)*	-	-	-	-	-	
Deductions - Royalty Income	*Line 12 (I)*	-	-	-	-	-	
Section 59(e)(2) Expenditures	*Line 12 (J)*	-	-	-	-	-	
Portfolio Income Expenses	*Line 12 (K-L)*	-	-	-	-	-	
Other Deductions	*Line 12 (M-O & S)*	-	-	-	-	-	
Foreign Taxes Paid/Accrued	*Line 14 (L-M)*	-	-	-	-	-	
					(4,000)	(0)	
Total Allocated Loss & Deductions	(9,000)						
Total Allowable Loss & Deductions							(5,000)
12 **Stock Basis at End of Year** (cannot be negative)							$ -

	Total Distributive Shares			Basis and Suspended Losses					Debt
	1 Prior Year Suspended Losses	2 Current Distributive Shares	3 Total [1+2]	4 Stock Basis	5 Debt Basis Schedule 2a	6 Current Losses Allowed [4+5]	7 Losses Claimed that Can't be Adjusted	8 Current Suspended Losses [3-6-7]	9 Face Amount of Debt Schedule 2a
A. Beginning Balance				0	0				0
B. Additions				0	0				0
C. Subtotal [A+B]				0	0				0
D. Additions:									
-Ordinary Business Income		5,000	5,000						
-Net Rental Real Estate Income		0	0						
-Other Net Rental Income	0	0					0		
-Net ST & LT Capital Loss	0	0	0	0	0		0	0	
-Net Section 1231 Loss	0	8,000	8,000	4,444	0	4,44	3,556	0	
-Other Loss	0	0	0	0	0		0	0	
-Section 179 Deduction	0	0	0	0	0		0	0	
-Charitable Contributions	0	1,000	1,000	556	0	55	444	0	
-Investment Interest Expense	0	0	0	0	0		0	0	
-Deductions - Royalty Income	0	0	0	0	0		0	0	
-Section 59(e)(2) Expenditures	0	0	0	0	0		0	0	
-Portfolio Income Expense	0	0	0	0	0		0	0	
-Other Deductions	0	0	0	0	0		0	0	
-Foreign Taxes Paid/Accrued	0	0	0	0	0		0	0	
O. Total Subtractions			9,000	5,000	0		4,000		
P. Subtotal [M-O]				0	0				
Q. Net Increase (Decrease) [E-J-L-O]			-4,000						
R. Other Stock Reductions and Debt Repayments				0	0				0
S. Ending Balance (Not Below Zero)				0	0				0

The IRS document discusses the general rules for handling losses in excess of basis

> The amount of losses and deductions taken by a shareholder for any taxable year cannot exceed the sum of the shareholder's stock basis and the adjusted basis of any S corporation indebtedness owed to the shareholder (debt basis).
>
> When stock and debt basis is insufficient, and there is more than one type of loss or deduction item that reduces basis, the amounts allowed as losses or deductions are allocated on a pro rata basis. The pro rata allocation is computed dividing the loss or deduction item by the total loss and deduction items and multiplying the resulting percentage by the available basis.
>
> Any losses or deductions disallowed for any taxable year are suspended and carried forward indefinitely until the shareholder has adequate stock or debt basis. The suspended losses retain their character and are carried forward and treated as incurred in the first succeeding year.

If the stock is sold or otherwise disposed of, then the suspended losses are no longer carried forward and are lost forever.[665]

The IRS outlines the following steps to absorb suspense accounts:

- If the shareholder has a suspense account, then reduce the shareholder's basis by the lesser of
  - the absolute value of the suspense account, or
  - the basis after the current-year increases.
- Review the basis computation schedule and identify open statute years for which the losses and deductions exceed the shareholder's basis.
- Compare the basis computation to the shareholder's return to determine if the losses claimed in open statute years exceed basis.
- Disallow any losses or deductions in excess of basis, verifying that each loss or deduction item is properly limited on a pro-rata basis.[666]

The IRS provides two examples of applying the rules:

EXAMPLE 4

Allocation of Losses and Deductions[667]

The sole owner of an S corporation has stock basis of $9,000 at the beginning of the year. During the year, the S corporation generated the following:

Ordinary Loss	(20,000)
Section 1231 Gain	4,000
Cash Charitable Contributions	5,000
Non-Deductible Travel & Entertainment	1,000

Since the items that reduce basis exceed the shareholder's stock basis, the loss is limited to the amount of stock basis. First, the stock basis ordering rules are applied to arrive at stock basis before losses and deductions. Since there is more than one type of loss and deduction item which reduces basis, the amounts allowed as a loss or deduction must be prorated as follows:

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[665] *IRS Large Business & Industry Process Unit Knowledge Base – S Corporations*, Document Control Number SCO/P/53_05_01_03-06(2016), Revised April 9, 2018

[666] *IRS Large Business & Industry Process Unit Knowledge Base – S Corporations*, Document Control Number SCO/P/53_05_01_03-06(2016), Revised April 9, 2018

[667] *IRS Large Business & Industry Process Unit Knowledge Base – S Corporations*, Document Control Number SCO/P/53_05_01_03-06(2016), Revised April 9, 2018

Beginning Stock Basis	9,000	
IRC 1231 Gain	4,000	
Stock Basis Before Non-Deductible Exp.	13,000	
Non-Deductible Travel & Entertainment	(1,000)	
Stock Basis Before Losses & Deductions	12,000	
Ordinary Loss	(9,600)	((20,000 / (20,000 + 5,000)) x 12,000
Cash Charitable Contribution	(2,400)	((5,000 / (20,000 + 5,000)) x 12,000
Ending Stock Basis	0	

The carry over to the next taxable year is:

Ordinary Loss	(10,400)	(20,000) – (9,600)
Cash Charitable Contribution	(2,600)	(5,000) – (2,400)
Total Carryover	(13,000)	(25,000) – (12,000)

Note: Even though this example uses a 100% shareholder, the allocation applies to all shareholders. If a shareholder owns 25% of the S corporation stock, the ordinary income and separately stated items are first allocated 25% to that shareholder. That shareholder then looks to his basis to see if the allocated amount is fully deductible.

EXAMPLE 5

Treatment of Suspended Loss Items[668]

Continued from Example 4, during Year 2, the S corporation generated the following:

Ordinary Income	35,000
Section 1231 Loss	(10,000)
Cash Charitable Contributions	1,000
Non-Deductible Travel & Entertainment	5,000

The shareholder's stock basis at the beginning of the year is $0. Losses suspended in a previous year are treated as being incurred in the next tax year and can only be deducted when basis is increased.

Beginning Stock Basis Year 2	0
Ordinary Income	35,000
Stock Basis Before Non-Deductible Exp.	35,000
Non-Deductible Travel & Entertainment	(5,000)
Stock Basis Before Losses & Deductions	30,000

Ordinary Loss	(10,400)	(0 + (10,400))
IRC 1231 Loss	(10,000)	
Cash Charitable Contribution	(3,600)	((1,000) + (2,600))
Ending Stock Basis Year 2	6,000	

Although the Schedule K-1 only shows the current year income items, the shareholder is allowed to take the previously suspended losses. Suspended losses may not be combined with current income amounts, but must be listed on a separate line on the Form 1040, Schedule E, Supplemental Income and Loss, or the appropriate schedule when possible. Suspended ordinary loss carryover is not netted with the current year ordinary income when applying the stock basis ordering rules. Treas. Reg. 1.1366-2(a)(3) & (4).

[668] *IRS Large Business & Industry Process Unit Knowledge Base – S Corporations*, Document Control Number SCO/P/53_05_01_03-06(2016), Revised April 9, 2018

SECTION: 1368
IRS EXPANDS ON REPORTING EXPENSES USED TO OBTAIN PPP LOAN FORGIVENESS ON FORM 1120S, SCHEDULE M-2

Citation: "2021 Instructions for Form 1120-S," 1/20/22

The IRS has added more clarification in the final Form 1120S instructions[669] about how expenses paid with PPP loan funds that lead to debt forgiveness should be treated in the computation of the accumulated adjustments account (AAA) and the other adjustments account (OAA).

On January 3, 2022, the IRS released draft instructions that first indicated that expenses paid with PPP loan proceeds should be treated as expenses related to tax exempt income under IRC §1368(e)(1)(A) and excluded from the calculation of AAA. However, some advisers weren't sure how exactly this should be reported on Schedule M-2.

Schedule M-2 **Analysis of Accumulated Adjustments Account, Shareholders' Undistributed Taxable Income Previously Taxed, Accumulated Earnings and Profits, and Other Adjustments Account** (see instructions)

		(a) Accumulated adjustments account	(b) Shareholders' undistributed taxable income previously taxed	(c) Accumulated earnings and profits	(d) Other adjustments account
1	Balance at beginning of tax year				
2	Ordinary income from page 1, line 21				
3	Other additions				
4	Loss from page 1, line 21	( )			
5	Other reductions	( )			( )
6	Combine lines 1 through 5				
7	Distributions				
8	Balance at end of tax year. Subtract line 7 from line 6				

Line 2 of Schedule M-2 places the net ordinary income from line 1, page 21 into the AAA column and that will generally already be reduced by the expenses used for forgiveness which, though related to tax exempt income, were made deductible by the Comprehensive Appropriations Act, 2021 (CAA) in December 2020.

While some (including this author) argued that the "other additions" line should be used to add the expenses back in computing AAA, not all were comfortable making that entry without explicit IRS instructions. However, there was no other way to make the worksheet come to the result specified by the IRS while still following the implied instructions to put the net ordinary income on line 2, column (a).

The IRS has now explained that, yes, that is what the agency meant should be done, expanding the "Tip" by adding additional paragraphs not found in the original draft instructions:

> **PPP loans**. An S corporation should include tax-exempt income from the forgiveness of PPP loans in column (d) on line 3 of the Schedule M-2.
>
> An S corporation should report expenses paid this year with proceeds from PPP loans that were forgiven this year in column (d) on line 5 of the Schedule M-2.

[669] 2021 Instructions for Form 1120S, January 20, 2022, https://www.irs.gov/pub/irs-pdf/i1120s.pdf (retrieved January 22, 2022)

> If column (a) on line 2 or line 4 of the Schedule M-2 includes expenses paid with proceeds from forgiven PPP loans, an S corporation should report that amount in column (a) on line 3 and in column (d) on line 5 of the Schedule M-2.
>
> If column (a) on line 1 of the Schedule M-2 includes expenses that were paid in a prior year with proceeds from PPP loans that were forgiven this year, an S corporation should report that amount in column (a) on line 3 and in column (d) on line 5 of the Schedule M-2.

Note that the last paragraph contains guidance for how to correct AAA if the amount reported on the return for the previous year erroneously had been reduced by such expenses paid in a prior year.

What the instructions do not say, but which an adviser should recognize, is that this "fix" only completely resolves the issue if the misclassified AAA did not have an impact on the prior year's tax reporting. As there was no underlying law change, this treatment should have been followed on 2020 returns as this author argued immediately following the passage of the CAA.

IRC §1368(d)(1)(A)'s wording has not been changed for many years and the IRS had consistently taken the position these expenses related to the tax-exempt income from PPP loan forgiveness during 2020. When Congress made such expenses deductible, it did not do so by making these expenses not related to tax-exempt income—the law just made that point irrelevant to claiming the deduction.

If the S corporation made distributions in 2020 and those distributions *appeared* to have exceeded AAA prematurely due to these expenses erroneously reducing AAA and the corporation had accumulated earnings and profits, amounts would have been reported as taxable dividends on Forms 1099-DIV by the S corporation and shareholders would have included these dividends in income and not used those amounts as distributions that reduced their basis in the S corporation stock.

If the Forms 1099-DIV are not reissued reporting the reduced dividends and the shareholders do not revise their returns, the IRS would still be able to reduce the shareholders' basis in their S corporation shares by those distributions, as they were distributions that reduced the shareholders' basis. The fact the shareholder paid tax on the distribution is simply a mistake made by the shareholder and would not justify adjusting the shareholder's basis upward to make up for the error.

As well, the shareholder would have likely paid additional tax on their 2020 individual income tax return he/she did not owe. So only if there were no erroneous Forms 1099-DIV issued by the S corporation for 2020 should making the adjustments as noted in the last paragraph of the IRS tip be the only step taken to adjust for the reporting issue for 2020.

SECTION: 6011
IRS PUBLISHES DRAFT OF 2022 FORM 1065 K-2 AND K-3 INSTRUCTIONS WITH REVISED EXEMPTIONS FROM FILING

Citation: Partnership Instructions for Schedules K-2 and K-3 (Form 1065), Draft as of October 25, 2022, 10/25/22

The IRS on October 25, 2022, released a draft copy of the instructions for Schedules K-2 and K-3 of Form 1065 for 2022 tax returns.[670] The draft contains a new formalized program for obtaining information from partners related to reporting on information that impacts information required to be provided to partners for possible use on Forms 1116 and 1118.

This release of the instructions was noted on the "Schedules K-2 and K-3 Frequently Asked Questions (Forms 1065, 1120S, and 8865)" FAQ on the IRS website update on October 26, which read:

> **27. When will the 2022 draft instructions for the Schedules K-2 and K-3 be released and where can I find them? (added October 26, 2022)**
>
> On October 25, 2022, the IRS released drafts of the 2022 Partnership Instructions for Schedules K-2 and K-3 and the 2022 Partner's Instructions for Schedule K-3 for the Form 1065. In response to stakeholder input, the draft instructions provide a new filing exception as described on page 3 of the 2022 Partnership Instructions for Schedules K-2 and K-3. Comments on the draft instructions can be provided to lbi.passthrough.international.form.changes@irs.gov on or before November 8, 2022.[671]

The Form Will Still Need Attention by Most Practitioners

Unfortunately, at the top of page 3 is a statement that can easily again lead practitioners to believe they can simply ignore preparing and filing the form as a matter of course:

> **Note**. Except as otherwise required by statute, regulations, or other IRS guidance, a partnership is not required to obtain information from its direct or indirect partners to determine if it needs to file each of these parts.[672]

This statement is so often contradicted by the instructions, which often require the partnership to presume an item is needed by a partner for his/her/its return in the absence of clear evidence it isn't, that it should be ignored by practitioners—far too often a "must presume" standard will come into play, and this can only be discerned by carefully studying the detailed instructions for the various sections.

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[670] Partnership Instructions for Schedules K-2 and K-3 (Form 1065), Draft as of October 25, 2022, October 25, 2022, https://www.irs.gov/pub/irs-dft/i1065s23--dft.pdf

[671] Schedules K-2 and K-3 Frequently Asked Questions (Forms 1065, 1120S, and 8865), IRS Website, October 26, 2022, https://www.irs.gov/businesses/schedules-k-2-and-k-3-frequently-asked-questions-forms-1065-1120s-and-8865

[672] Partnership Instructions for Schedules K-2 and K-3 (Form 1065), Draft as of October 25, 2022, October 25, 2022, p. 3

Domestic Filing Exception

The sections that created the most problems for domestic partnerships involved items related to information that might be necessary for partners related to reporting foreign tax credit items. In the "What's New" section of the instructions, the IRS announces they have added a *domestic filing exception* this year.

This exception is a modification of the special relief offered for 2021 filings in Question 15 of the "Schedules K-2 and K-3 Frequently Asked Questions (Forms 1065, 1120S, and 8865)" published on February 16, 2022, on the IRS website.[673] The instructions describe the new exception as follows:

> **New exception to completing Schedules K-2 and K-3.** These instructions add a new exception for filing and furnishing Schedules K-2 and K-3 for tax years beginning in 2022. See the domestic filing exception.[674]

The instructions do repeat the guidance from the prior year's instructions that warns that even some partnerships with no foreign activities may nevertheless need to complete the forms:

> **Note**. A partnership with no foreign source income, no assets generating foreign source income, no foreign partners, and no foreign taxes paid or accrued may still need to report information on Schedules K-2 and K-3. For example, if the partner claims a credit for foreign taxes paid or accrued by the partner, the partner may need certain information from the partnership to complete Form 1116 or 1118. Also, a partnership that has only domestic partners may still be required to complete Part IX when the partnership makes certain deductible payments to foreign related parties of its domestic partners.
>
> The information reported in Part IX will assist any domestic corporate partner in determining the amount of base erosion payments made through the partnership, and in determining if the partners are subject to the base erosion and anti-abuse tax (BEAT).
>
> Further, if the domestic partnership with no foreign activity or foreign partners has direct or indirect domestic corporate partners, Part IV (concerning foreign-derived intangible income (FDII)) may need to be completed.
>
> A domestic or foreign publicly traded partnership as defined in section 7704(b) (PTP) with no foreign activity or foreign partners may need to complete Part XI. See each part for applicability.[675]

But following an example dealing with the base erosion and anti-abuse tax (BEAT), something most practitioners will not be dealing with, it does describe the new domestic filing exception, beginning by outlining the benefits of meeting this exception:

> **Domestic filing exception (exception to filing Schedules K-2 and K-3).** A domestic partnership (as defined under section 7701(a)(2) and (4)) does not need to (a) complete and file with the IRS the Schedules K-2 and K-3, or (b) furnish to a

[673] Schedules K-2 and K-3 Frequently Asked Questions (Forms 1065, 1120S, and 8865), IRS Website, October 26, 2022

[674] Partnership Instructions for Schedules K-2 and K-3 (Form 1065), Draft as of October 25, 2022, October 25, 2022, p. 1

[675] Partnership Instructions for Schedules K-2 and K-3 (Form 1065), Draft as of October 25, 2022, October 25, 2022, p. 3

partner the Schedule K-3 (except where requested by a partner after the 1-month date (defined in criteria number 4, below)) if each of the following four criteria are met with respect to the partnership's tax year 2022.[676]

Foreign Activity Test

The first criteria to meet relates to foreign activities:

1. **No or limited foreign activity**. During a domestic partnership's tax year 2022, the domestic partnership either has no foreign activity (as defined below), or, if it does have foreign activity, such foreign activity is limited to

(a) passive category foreign income (determined without regard to the high-taxed income exception under section 904(d)(2)(B)(iii));

(b) upon which not more than $300 of foreign income taxes allowable as a credit under section 901 are treated as paid or accrued by the partnership; and

(c) such income and taxes are shown on a payee statement (as defined in section 6724(d)(2)) that is furnished or treated as furnished to the partnership.

Foreign activity. For purposes of the domestic filing exception, foreign activity means any of the following.

(a) foreign income taxes paid or accrued (as defined in section 901 and the regulations thereunder);

(b) foreign source income or loss (as determined in sections 861 through 865, and section 904(h), and the regulations thereunder);

(c) ownership interest in a foreign partnership (as defined in sections 7701(a)(2) and (5));

(d) ownership interest in a foreign corporation (as defined in sections 7701(a)(3) and (5));

(e) ownership of a foreign branch (as defined in Regulations section 1.904-4(f)(3)(vii));

(f) ownership interest in a foreign entity that is treated as disregarded as an entity separate from its owner (as defined in Regulations section 301.7701-3).[677]

One key change from the 2021 FAQ is that there is a *de minimis* foreign activity provision if the partnership has a very minor amount of foreign taxes withheld on stocks, mutual funds, and the like.

[676] Partnership Instructions for Schedules K-2 and K-3 (Form 1065), Draft as of October 25, 2022, October 25, 2022, p. 3

[677] Partnership Instructions for Schedules K-2 and K-3 (Form 1065), Draft as of October 25, 2022, October 25, 2022, p. 3

US Citizen/Resident Alien Partner Test

The next criteria requires that all direct partners must meet certain criteria:

> **2. U.S. citizen/resident alien partners**. During tax year 2022, all the direct partners in the domestic partnership are:
>
> (a) individuals that are U.S. citizens;
>
> (b) individuals that are resident aliens (as defined in section 7701(b)(1)(A) and the regulations thereunder);
>
> (c) domestic decedent's estates (that is, decedent's estates that are not foreign estates as defined in section 7701(a)(31)(A)), with solely U.S. citizen and/or resident alien individual beneficiaries;
>
> (d) domestic grantor trusts (that is, trusts described under sections 671 through 678) that are not foreign trusts as defined in section 7701(a)(31)(B)) and that have solely U.S. citizen and / or resident alien individual grantors and solely U.S. citizen and / or resident alien individual beneficiaries; or
>
> (e) domestic non-grantor trusts (that is, trusts subject to tax under section 641 that are not foreign trusts as defined in section 7701(a)(31)(B)) with solely U.S. citizen and/or resident alien individual beneficiaries.[678]

Note that a partnership with partnership or corporate partners will be barred from using this exception. This is more restrictive than the 2021 FAQ Question 15 exception.

Partner Notification Requirement

The test that requires the most work by advisers and their clients is the new partner notification requirement due to the strict rules on dates by which such notifications must be provided.

The instructions provide:

> **3. Partner notification**. With respect to a partnership that satisfies criteria 1 and 2, partners receive a notification from the partnership either electronically or by mail dated no later than 2 months before the due date (without extension) for filing the partnership's tax year 2022 Form 1065. The notification must state that partners will not receive Schedule K-3 from the partnership unless the partners request the schedule.[679]

This due date requirement means that the partners' notices must be sent by no later than January 15 to meet the two-month requirement for calendar year partnerships. Advisers will likely need to begin notifying clients soon about this requirement if the partnership wishes to attempt to make use of this exception unless the IRS provides relief from this requirement in the final instructions.

However, those final instructions may be released much closer to that January 15 date, so prudence suggest assuming such notices need to be issued and preparing to insure they are timely issued.

[678] Partnership Instructions for Schedules K-2 and K-3 (Form 1065), Draft as of October 25, 2022, October 25, 2022, p. 3

[679] Partnership Instructions for Schedules K-2 and K-3 (Form 1065), Draft as of October 25, 2022, October 25, 2022, p. 3

Partner Request Received by the "1-Month Date"

The final test looks to see if any partners return requests to have the form issued by what is referred to as the *1-month date*:

> **4. No 2022 Schedule K-3 requests by the 1-month date**. The partnership does not receive a request from any partner for Schedule K-3 information on or before the 1-month date. The "1-month date" is one month before the due date (without extension) of the partnership's Form 1065. *For tax year 2022 calendar year partnerships, the 1-month date is February 15, 2023*. (emphasis added)[680]

The instructions go on to provide information on what the partnership still must do if it receives such a request after the 1-month date.

> **Note**. If a partnership receives a request from a partner for the Schedule K-3 information after the 1-month date and has not received a request from any other partner for Schedule K-3 information on or before the 1-month date, the domestic filing exception is met and the partnership is not required to file the Schedules K-2 and K-3 with the IRS or furnish the Schedule K-3 to the non-requesting partners. However, the partnership is required to provide the Schedule K-3, completed with the requested information, to the requesting partner on the later of the date on which the partnership files the Form 1065 or one month from the date on which the partnership receives the request from the partner. See Example 4.[681]

Under the 2021 FAQ Question 15 exception, the key date was the date the return was filed by the partnership, so that any notice of a need for the information prior to the actual filing of the return meant the exception was not met. Under this rule, it appears that even if the partnership files for an extension of time to file its return and finally files that return on September 15, it can still escape having to file Schedule K-2 with its return even if it received a notice from a partner needing the information on February 16.

If a partnership does receive notification by the 1-month date, the instructions provide:

> **Note for partnerships that satisfy criteria 1 through 3, but do not satisfy criterion 4.** If the partnership received a request from a partner for Schedule K-3 information on or before the 1-month date and therefore the partnership does not satisfy criterion 4, the partnership is required to file the Schedules K-2 and K-3 with the IRS and furnish the Schedule K-3 to the requesting partner. The Schedules K-2 and K-3 are required to be completed only with respect to the parts and sections relevant to the requesting partner.
>
> For example, if a partner requests the information reported on Part III, Section 2 (Interest Expense Apportionment Factors), the partnership is required to complete and file Schedule K-2, Part III, Section 2 with respect to the partnership's total assets and Schedule K-3, Part III, Section 2 with respect to the requesting partner's distributive share of the assets. On the date that the partnership files Schedules K-2 and K-3 with the IRS, the partnership must provide a copy of the filed Schedule K-3 to the requesting partner.

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[680] Partnership Instructions for Schedules K-2 and K-3 (Form 1065), Draft as of October 25, 2022, October 25, 2022, p. 3

[681] Partnership Instructions for Schedules K-2 and K-3 (Form 1065), Draft as of October 25, 2022, October 25, 2022, p. 3-4

> The partnership does not need to complete, attach, file, or furnish any other parts or sections of the Schedules K-2 and K-3 to the IRS, the requesting partner, or any other partner. The partnership should keep records of the information requested by the partner. See Example 3.[682]

If this partnership later receives requests from other partners after the 1-month date, the instructions state:

> If a partnership receives requests from partners for Schedule K-3 information both on or before the 1-month date and after the 1-month date, the partnership is required to file Schedules K-2 and K-3 as described in the prior paragraph only with respect to the partner requests received on or before the 1-month date. With respect to requests received after the1-month date, the partnership is required to provide the Schedule K-3, completed with that partner's requested information, on the later of the date on which partnership files the Form 1065 or one month from the date on which the partnership receives the request from the partner. See Example 5.[683]

Examples for the Domestic Filing Exception

The instructions provide a series of examples of applying this rule. The first example looks at a partner who receives only a minor amount of foreign taxes reported to it on a Form 1099DIV from a mutual fund:

> **Example 2**. Husband and wife, U.S. citizens, each own a 50% interest in USP, a domestic partnership. USP and husband and wife each have a tax year end of December 31. USP invests in a regulated investment company (RIC). With respect to tax year 2022, USP receives a Form 1099 from the RIC reporting $100 of creditable foreign taxes paid or accrued on passive category foreign source income. USP does not have any foreign activity other than that from the RIC. Husband and wife receive notification from USP dated January 10, 2023, that they will not receive the Schedule K-3 unless they so request. Husband and wife do not request Schedule K-3 from USP for tax year 2022. USP qualifies for the domestic filing exception, and, as such, USP need not complete Schedules K-2 and K-3.[684]

The next example adds a case where there is another partner who does require certain information on Schedule K-3 and gives noticed by the 1-month date:

> **Example 3.** The facts are the same as in Example 2 except that husband and wife each own a 40% interest in USP, and A, a U.S. citizen, owns a 20% interest in USP. A receives notice from USP dated January 10, 2023, that A will not receive the Schedule K-3 unless A so requests. A requests Schedule K-3 from USP for tax year 2022 and USP receives this request on February 1, 2023. USP does not qualify for the domestic filing exception because A requested the Schedule K-3 by the 1-month date. As such, USP must complete and file with the IRS the parts and sections of the Schedules K-2 and K-3 that are relevant to A. With respect to the Schedules K-2 and K-3 filed with the IRS, USP does not need to complete, attach, or file any parts or sections relevant to husband and wife. USP must provide a copy of the filed

[682] Partnership Instructions for Schedules K-2 and K-3 (Form 1065), Draft as of October 25, 2022, October 25, 2022, p. 4

[683] Partnership Instructions for Schedules K-2 and K-3 (Form 1065), Draft as of October 25, 2022, October 25, 2022, p. 4

[684] Partnership Instructions for Schedules K-2 and K-3 (Form 1065), Draft as of October 25, 2022, October 25, 2022, p. 4

> Schedule K-3 to A on the date that USP files its Form 1065. USP does not need to furnish a Schedule K-3 to husband and wife.[685]

The next example uses the same facts, except the request is received after the 1-month date:

> **Example 4**. The facts are the same as in Example 3 except that USP receives the request from A on February 20, 2023. USP files Form 1065 on August 31, 2023. USP qualifies for the domestic filing exception because A requested the Schedule K-3 after the 1-month date. USP is not required to file the Schedules K-2 and K-3 with the IRS or furnish the Schedule K-3 to husband and wife. However, USP is required to provide the Schedule K-3, completed with the requested information, to A on August 31,2023, the later of the date on which USP files the Form 1065 or one month from February 20, 2023.[686]

The final example goes back to Example 3's facts (where A requested the information by the 1-month date) but now has the husband and wife request the information after the 1-month date:

> **Example 5.** The facts are the same as in Example 3 except that husband and wife request the Schedule K-3 and USP receives the request on February 20, 2023. USP files Form 1065 on August 31, 2023. USP does not qualify for the domestic filing exception because A requested the Schedule K-3 by the One-Month Date. As such, USP must complete and file with the IRS the parts and sections of the Schedules K-2 and K-3 that are relevant to A. With respect to the Schedules K-2 and K-3 filed with the IRS, USP does not need to complete, attach, or file any parts or sections relevant to husband and wife. USP must provide a copy of the filed Schedule K-3 to A on August 31, 2023. USP is required to provide a Schedule K-3, completed with the information requested by husband and wife, to husband and wife on August 31, 2023, the later of the date on which USP files the Form 1065 or one month from February 20, 2023.[687]

The Form 1116 Exemption

The instructions provide for a second exception to completing the forms related to foreign tax credit issues in the Form 1116 exemption. The draft notes at the end of the instructions for the domestic filing exception that:

> **Note**. If a partnership does not meet the domestic filing exception, it may meet the Form 1116 Exemption to filing the Schedules K-2 and K-3. See below.[688]

That exception is described at page 10 of the instructions:

> **Form 1116 exemption exception.** Under section 904(j), certain partners are not required to file a Form 1116 ("Form 1116 exemption"). Also see Foreign Tax Credit—How To Figure the Credit.[689]

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[685] Partnership Instructions for Schedules K-2 and K-3 (Form 1065), Draft as of October 25, 2022, October 25, 2022, p. 4

[686] Partnership Instructions for Schedules K-2 and K-3 (Form 1065), Draft as of October 25, 2022, October 25, 2022, p. 4

[687] Partnership Instructions for Schedules K-2 and K-3 (Form 1065), Draft as of October 25, 2022, October 25, 2022, p. 4

[688] Partnership Instructions for Schedules K-2 and K-3 (Form 1065), Draft as of October 25, 2022, October 25, 2022, p. 4

[689] Partnership Instructions for Schedules K-2 and K-3 (Form 1065), Draft as of October 25, 2022, October 25, 2022, p. 10

IRC §904(j) reads, in part:

> (j) Certain individuals exempt
>
> (1) In general
>
> In the case of an individual to whom this subsection applies for any taxable year—
>
> (A) the limitation of subsection (a) shall not apply,
>
> (B) no taxes paid or accrued by the individual during such taxable year may be deemed paid or accrued under subsection (c) in any other taxable year, and
>
> (C) no taxes paid or accrued by the individual during any other taxable year may be deemed paid or accrued under subsection (c) in such taxable year.
>
> (2) Individuals to whom subsection applies
>
> This subsection shall apply to an individual for any taxable year if—
>
> (A) the entire amount of such individual's gross income for the taxable year from sources without the United States consists of qualified passive income,
>
> (B) the amount of the creditable foreign taxes paid or accrued by the individual during the taxable year does not exceed $300 ($600 in the case of a joint return), and
>
> (C) such individual elects to have this subsection apply for the taxable year.

This is the exemption available to individuals who receive their entire amounts of creditable foreign tax and income as foreign tax credit passive income (generally interest and dividends) reported to them on Forms 1099, trust and estate K-1s, partnership K-3s and S corporation K-3s that allows them to claim the entire amount of tax as a credit without computing the detailed limitations on the credit on Form 1116. The amount of tax is simply reported as a tax credit on Schedule 3, Form 1040.

The instructions continue:

> A domestic partnership is not required to complete Schedules K-2 and K-3 if all partners are eligible for the Form 1116 exemption and the partnership receives notification of the partners' eligibility for such exemption by the 1-month date (as defined above).[690]

Note that the 1-month date again becomes relevant, though this time the partnership must receive the notification from the partner by the 1-month date in order to take advantage of this exception—

[690] Partnership Instructions for Schedules K-2 and K-3 (Form 1065), Draft as of October 25, 2022, October 25, 2022, p. 10

otherwise the partnership is going to be required to treat the information as needed by all partners for which the notification is not received.

> If a partnership receives notification from only some of the partners that they are eligible for the Form 1116 exemption, the partnership need not complete the Schedule K-3 for those exempt partners but must complete the Schedules K-2 and K-3 with respect to the other partners to the extent that the partnership does not qualify for the domestic filing exception.[691]

The instructions make this point clear later, noting:

> A partnership that does not have or receive sufficient information or notice regarding a direct or indirect partner must presume such partner is eligible to claim a foreign tax credit and such partner would have to file a Form 1116 or Form 1118 to claim a credit. As such, the partnership must complete the Schedules K-2 and K-3, including Parts II and III, accordingly.[692]

One interesting item to note about this additional instruction is that it mentions the partnership having or receiving "sufficient information" related to the lack of need for this data in addition to the previously described notice. It's not clear if this means that a partnership could avoid the 1-month date notification problem by receiving other information confirming that the partner will not have to file a Form 1116 or Form 1118, and thus avoid preparing the Schedules K-2 and K-3 parts II and III.

The IRS does provide an example of applying the Form 1116 exemption exception:

> **Example 7.** Husband and wife, U.S. citizens, each own a 50% interest in USP, a domestic partnership. Husband and wife and USP each have a calendar tax year.
>
> USP invests in a RIC. USP receives a Form 1099 from the RIC reporting $400 of creditable foreign taxes paid or accrued on passive category foreign source income. USP's only foreign activity is that from the RIC.
>
> Husband and wife do not pay or accrue any foreign taxes other than their distributive share of USP's foreign taxes. Husband and wife also do not have any other foreign source income. Husband and wife qualify for the Form 1116 exemption and notify USP by February 15, 2023, that they do not need the Schedule K-3.
>
> Even though USP does not qualify for the domestic filing exception because the creditable foreign taxes treated as paid or accrued by USP are greater than $300, because husband and wife notify USP by the 1-month date that they do not need the Schedule K-3 under the Form 1116 exemption, USP need not complete Schedules K-2 and K-3.[693]

[691] Partnership Instructions for Schedules K-2 and K-3 (Form 1065), Draft as of October 25, 2022, October 25, 2022, p. 10

[692] Partnership Instructions for Schedules K-2 and K-3 (Form 1065), Draft as of October 25, 2022, October 25, 2022, p. 10

[693] Partnership Instructions for Schedules K-2 and K-3 (Form 1065), Draft as of October 25, 2022, October 25, 2022, p. 10

No S Corporation Instructions Yet

As of the date this article was written (October 29, 2022) the IRS had not yet released the draft S Corporation Schedules K-2 and K-3 instructions for 2022. While likely such instructions will contain similar options, we can't know for sure until those draft instructions are issued.

SECTION: 6011
IRS ADDS MORE Q&AS TO SCHEDULES K-2 AND K-3 FAQS

Citation: Schedules K-2 and K-3 Frequently Asked Questions (Forms 1065, 1120S, and 8865), April 11, 2022 update, IRS website, 4/11/22

On April 11, 2022, the IRS expanded its page of frequently asked questions with regard to Schedules K-2 and K-3 from 18 questions and answers to 26.[694] While this falls far short of covering all of the questions many have remaining with regard to completing these forms, it does provide some additional guidance.

Not Required to Complete Irrelevant Parts of Schedules K-2 and K-3

The first new question looks at the issue of whether all parts of Schedules K-2 and K-3 must be completed if a taxpayer is required to complete those forms for any reason. The question and answer read:

> **19. The partnership or S corporation does not qualify for the exception in FAQ #15. Is the partnership or S corporation required to complete all parts of Schedules K-2 and K-3? (added April 11, 2022)**
>
> According to page 1 of the Instructions to Schedules K-2 and K-3 (Form 1065) and page 1 of the Instructions to Schedules K-2 and K-3 (Form 1120-S), a partnership and S corporation are only required to complete the relevant portions of Schedules K-2 and K-3. See FAQ #17 for a link to the instructions.[695]

Cases With an Exception to Completing Forms 5471, 8865 and/or 8858

The next question looks at the case where a taxpayer meets an exception that means it is not required to file Forms 5471, 8865 and/or 8858. The page provides:

> **20. A filer otherwise required to file Forms 5471, 8865, and/or 8858 may qualify for an exception from filing those forms based on the Internal Revenue Code, IRS guidance, and/or instructions to those respective forms (for example, the multiple filer exception). If the filer qualifies for such exception, do the Instructions to the Schedules K-2 and K-3 nevertheless**

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[694] Schedules K-2 and K-3 Frequently Asked Questions (Forms 1065, 1120S, and 8865), April 11, 2022 update, IRS website, April 11, 2022, https://www.irs.gov/businesses/schedules-k-2-and-k-3-frequently-asked-questions-forms-1065-1120s-and-8865 (retrieved April 20, 2022)

[695] Schedules K-2 and K-3 Frequently Asked Questions (Forms 1065, 1120S, and 8865), April 11, 2022 update, IRS website, April 11, 2022

require a filer to complete Forms 5471, 8865, and/or 8858? (added April 11, 2022)

No. If the filer meets such an exception to filing Forms 5471, 8865, and/or 8858, the filer is not required to complete and attach those forms. However, the filer must still attach to the Forms 1065, 1120-S, and the tax return of the U.S. person filing Form 8865, any required statements to qualify for the exception to filing the Forms 5471, 8865, and/or 8858. Further, in the case of the Form 5471 multiple filer exception, the partnership or S corporation must provide on the Schedule K-3 to its partners or shareholders any information that the partnership or S corporation receives from the person required to file the Form 5471 and that is requested by the Instructions to the Schedules K-2 and K-3, such as Schedule Q (Form 5471) information, if applicable.[696]

Use of the "RIC" Code for Mutual Fund Foreign Income Source

The unanswered question I received inquiries on most often during tax season from practitioners related to how to report the source of income received from mutual funds that also reported foreign taxes eligible for the foreign tax credit. Such funds are not required to report to their shareholders the detailed sourcing of the income by country. The instructions for individual Form 1116 provide that taxpayers can treat all such income from mutual funds as from a single source referred to with the code RIC.

The IRS's original guidance indicated that one of the two letter country codes from their webpage had to be used to designate the source of all foreign income. A number of professional tax software providers took that statement literally and did not allow designating income on Schedules K-2 or K-3 as being sourced using that three letter code. However, the expanded FAQ provides that the RIC (registered investment company) code can be used.

21. In Part II, Section 1 (Description) and Part III, Section 4, Lines 1 and 3 of Schedules K-2 and K-3 (Forms 1065, 1120-S, and 8865), is it possible to enter the code "RIC"? (added April 11, 2022)

Yes, page 8 of the Instructions to the Schedules K-2 and K-3 (Form 1065) refers to the Instructions to Forms 1116 and 1118 for exceptions from the requirement to report gross income and taxes by foreign country or U.S. possession, including for regulated investment companies. See also page 8 of the Instructions to the Schedules K-2 and K-3 (Form 1120-S) and page 7 of the Instructions to the Schedules K-2 and K-3 (Form 8865). See FAQ #17 for a link to the instructions.[697]

[696] Schedules K-2 and K-3 Frequently Asked Questions (Forms 1065, 1120S, and 8865), April 11, 2022 update, IRS website, April 11, 2022

[697] Schedules K-2 and K-3 Frequently Asked Questions (Forms 1065, 1120S, and 8865), April 11, 2022 update, IRS website, April 11, 2022

When the R&E Expenses Apportionment Factors of Part III, Section 1 Must Be Completed

The updated FAQ also provides relief from taxpayers having to provide detailed R&E expense apportionment factors in most cases.

> **22. When must a filer complete Section 1 of Part III, Schedules K-2 and K-3 (Forms 1065, 1120-S, and 8865)? (added April 11, 2022)**
>
> A filer is not required to complete Section 1 of Part III unless either (1) the partnership or S corporation incurs research & experimental expense or (2) the partner or shareholder is expected to license, sell, or transfer its intangible property to the partnership or S corporation (as provided in §1.861-17(f)(3)). This clarification will be added to the tax year 2022 instructions. However, filers may choose to follow this clarification for tax year 2021.[698]

Passive Foreign Investment Company Issues

Question 23 deals with issues related to Passive Foreign Investment Companies.

> **23. If a foreign partnership has passive foreign investment companies (PFICs) for which a mark-to-market (MTM) election described in Treas. Reg. §1.1291-1(c)(4) has been made (for example, under section 475), does the filer need to report the PFICs on Part VII of Schedules K2 and K3 (Forms 1065 and 8865)? (added April 11, 2022)**
>
> No, if a foreign partnership marks to market stock of a PFIC as described in Treas. Reg. §1.1291-1(c)(4), the filer of Form 1065 does not need to report information about the PFIC on Part VII. The filer should report the partnership's MTM gain or loss on Schedule K (Form 1065) and report the partners' shares of such amounts on Part III of Schedule K-1 (Form 1065). Similarly, a U.S. person filing Form 8865 with respect to a foreign partnership that has made an MTM election described in Treas. Reg. §1.1291-1(c)(4) for a PFIC should report the partnership's MTM gain or loss on Schedule K (Form 8865) and report the partners' share of such amounts on Part III of Schedule K-1 (Form 8865).
>
> There may, however, be instances in which the partner will need additional information from the partnership to meet its tax obligations with respect to the PFIC, such as when section 1291 rules apply because the stock was not marked in the first year of the holding period. In such instances, the partnership should provide the needed information and may use Part VII to do so.[699]

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[698] Schedules K-2 and K-3 Frequently Asked Questions (Forms 1065, 1120S, and 8865), April 11, 2022 update, IRS website, April 11, 2022

[699] Schedules K-2 and K-3 Frequently Asked Questions (Forms 1065, 1120S, and 8865), April 11, 2022 update, IRS website, April 11, 2022

Reporting for Dormant Foreign Corporations

The next question deals with reporting for dormant foreign corporations as defined in section 3 of Revenue Procedure 92-70:

> **24. Are Part VIII (Form 1065) and Part VII (1120-S) of Schedules K-2 and K-3 required to be completed for dormant foreign corporations (as defined in section 3 of Rev. Proc. 92-70)? (added April 11, 2022)**
>
> No, Part VIII (Form 1065) and Part VII (Form 1120-S) are not required to be completed with respect to dormant foreign corporations. This clarification will be added to the tax year 2022 instructions. However, filers may follow this clarification for tax year 2021.[700]

Reporting Accrued Original Issue Discount and OID Income Taxable to a Foreign Partner

The longest answer added to the page relates to the reporting to a foreign partner of accrued original issue discount and OID income taxable on a gross basis to a foreign partner.

> **25. How should a partnership report its accrued original issue discount (OID) and OID income taxable on a gross basis to a foreign partner on Section 1 of Part X of Schedules K-2 and K-3 (Form 1065)? (added April 11, 2022)**
>
> The following approach is solely a recommendation for tax year 2021, and the IRS recognizes that partnerships may have taken other approaches. The IRS appreciates comments on this approach and whether there are other approaches to reporting OID on Part X of Schedules K-2 and K-3. The IRS will take these comments into account for the tax year 2022 Instructions to the Schedules K-2 and K-3.
>
> A partnership generally reports OID on Schedules K and K-1 (Form 1065) in the taxable year the OID accrues. However, the instructions to Part X of Schedules K-2 and K-3 (Form 1065) require the partnership to report OID only when it is taxable to foreign partners (i.e., when there is a payment or gain on the OID instrument). To reconcile Schedules K-2 and K-3 reporting of OID with Schedules K and K-1 reporting of OID and to provide foreign partners with the information necessary to complete their returns, the IRS recommends the following approach for reporting OID on Part X.
>
> **Accrued OID Reported on Form 1065**
>
> The amount of accrued OID reported on Schedules K (Form 1065) which is not taxable to foreign partners should be reported as interest income in column (f) (U.S. source (other)) of Part X, Schedule K-2. The IRS recommends that the partnership attach a statement to Form 1065 with respect to Part X clarifying that these amounts are not taxable to foreign partners and need not be reported on the foreign

[700] Schedules K-2 and K-3 Frequently Asked Questions (Forms 1065, 1120S, and 8865), April 11, 2022 update, IRS website, April 11, 2022

partner's tax return. The partnership should take a similar approach for reporting distributive share amounts to a foreign partner on Schedule K-3.

OID Payments or Gains Taxable on a Gross Basis to a Foreign Partner

When the partnership receives payments on the OID instrument or gain on the sale or exchange of the OID instrument that are taxable on a gross basis to foreign partners, these amounts should be reported in column (e) (U.S. source (fixed, determinable, annual, or periodical - FDAP)) as interest income or gain, as appropriate. These amounts should also be entered as a negative adjustment in column (f) to ensure that the total OID reported on Part X reconciles with OID reported on Schedule K (Form 1065). Additionally, the IRS recommends attaching a statement explaining that the negative adjustment in column (f) is for reconciliation purposes only and is not relevant to the foreign partner's tax liability and therefore need not be reported on the foreign partner's tax return. The partnership should take a similar approach for reporting distributive share amounts to a foreign partner on Schedule K-3.

Example

In addition to other income and expense items, a partnership accrues $100 OID in year 1 reported on Schedule K (Form 1065). On Part X of Schedule K-2 for year 1, the partnership should report this amount as interest in column (f) (such amount is also included in column (a) for the total). In year 2, the partnership receives a payment with respect to the same instrument that results in $50 of gross income taxable on a gross basis to its foreign partners. On its Part X of Schedule K-2 for year 2, the partnership should report $50 as interest in column (e) and ($50) as a reconciliation adjustment in column (f). The partnership should take the same approach for reporting distributive share amounts to a foreign partner on Schedule K-3 in both years 1 and 2.[701]

Clarification for Reporting of Allocation and Apportionment Methods for Deductions

The IRS concludes the new additions to the FAQ by giving additional guidance on completing Section 3 of Part X, Schedules K-2 and K-3 (Form 1065).

26. Could you clarify the reporting on Section 3, Lines 2b, 3a, and 3b, of Part X, Schedules K-2 and K-3 (Form 1065)? (added April 11, 2022)

The tax year 2022 instructions will clarify the reporting on Section 3, lines 2b, 3a, and 3b of Part X, Schedules K-2 and K-3 (Form 1065) as follows:

- Line 2b. Average worldwide assets. Report the partnership's basis in its average worldwide assets for purposes of Treasury Regulation section 1.882-5(b) using the average amount as defined in Treasury Regulation sections 1.882-5(b)(3) and 1.884-1(d)(3)(ii).

[701] Schedules K-2 and K-3 Frequently Asked Questions (Forms 1065, 1120S, and 8865), April 11, 2022 update, IRS website, April 11, 2022

- Line 3a. Average U.S.-booked liabilities of the partnership. Enter the partnership's average U.S.-booked liabilities as defined in Treasury Regulation section 1.882-5(d)(2) using the average defined in Treasury Regulation section 1.882-5(d)(3).

- Line 3b. Directly allocated partnership indebtedness. Enter the portion of the principal amount of the partnership's indebtedness outstanding at year end that meets the requirements of Temporary Regulation section 1.861-10T(b) or (c), as limited by Temporary Regulation section 1.861-10T(d)(1), as described in Treasury Regulation section 1.882-5(a)(1)(ii)(B). See Treasury Regulation section 1.861-10T(d)(2).

A partnership may choose to follow the above instructions for tax year 2021 Schedules K-2 and K-3 (1065).[702]

SECTION: 6221
UNDERLYING ENTITY TYPE, NOT EXEMPT VS. TAXABLE STATUS, DETERMINES IF AN ORGANIZATION IS AN ELIGIBLE PARTNER FOR PARTNERSHIP ELECTION OUT OF BBA AUDIT REGIME

Citation: IRS Emailed Counsel Advice 202147012, 11/26/21

The IRS clarified, in emailed counsel advice,[703] that it does not matter if a partner is a for profit or exempt organization to determine if that partner will bar the partnership from electing out of the regime under IRC §6221(b).

The email is written in response to a question that is not disclosed in the document. However, it's fairly certain the question that was asked was whether a partnership that had a tax exempt partner could opt out of the BBA partnership audit regime when filing its return using the procedures found at IRC §6221(b)(1).

IRC §6221(b)(1) provides:

> (b) Election out for certain partnerships with 100 or fewer, etc.
>
> (1) In general
>
> This subchapter shall not apply with respect to any partnership for any taxable year if—
>
>> (A) the partnership elects the application of this subsection for such taxable year,

[702] Schedules K-2 and K-3 Frequently Asked Questions (Forms 1065, 1120S, and 8865), April 11, 2022 update, IRS website, April 11, 2022

[703] IRS Emailed Counsel Advice 202147012, November 26, 2021, https://www.irs.gov/pub/irs-wd/202147012.pdf (retrieved November 29, 2021)

(B) for such taxable year the partnership is required to furnish 100 or fewer statements under section 6031(b) with respect to its partners,

(C) each of the partners of such partnership is an individual, a C corporation, any foreign entity that would be treated as a C corporation were it domestic, an S corporation, or an estate of a deceased partner,

(D) the election—

(i) is made with a timely filed return for such taxable year, and

(ii) includes (in the manner prescribed by the Secretary) a disclosure of the name and taxpayer identification number of each partner of such partnership, and

(E) the partnership notifies each such partner of such election in the manner prescribed by the Secretary.

The email provides the following answer in response to the inquiry:

> Whether an entity is tax-exempt/not-for-profit or not has nothing to do with whether an entity is an eligible partner for purposes of election out under BBA. It solely depends on what type of entity the partner is. A tax-exempt/not-for-profit entity still has an entity type (e.g., C corp, etc).[704]

[704] IRS Emailed Counsel Advice 202147012, November 26, 2021

NOTES

Unit 6

Estate & Trust Tax Developments

LEARNING OBJECTIVES

When you have completed this unit, you will be able to accomplish the following.

- Prepare tax returns and advise clients in planning taking into account major developments occurring in the past year

SECTION: 2010
IRS EXTENDS LATE PORTABILITY ELECTION AUTOMATIC RELIEF FROM TWO TO FIVE YEARS AND PROVIDES ADDITIONAL GUIDANCE

Citation: Revenue Procedure 2022-32, 7/8/22

The IRS has issued a revised Revenue Procedure providing for a late portability election available to qualifying estates in Revenue Procedure 2022-32.[705] The procedure supersedes Revenue Procedure 2017-34 and becomes the only method by which a late election may be made for any estate that qualifies to use this procedure.

Portability Election

The portability election was added to IRC §2010 by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (Pub. L. 111-312, referred to in this article as the "2010 Act"), providing a method to prevent any applicable exclusion not used by a decedent with a surviving spouse from being lost. If an estate makes the portability election, any unused exclusion at this first death is made available to be used by the surviving spouse and/or his/her estate for subsequent transfers (subject to certain restrictions).

At the death of an individual, the IRC provides a tax credit equal to the federal transfer tax on an exclusion amount that can be used to offset the estate tax. Similarly, no transfer taxes are due on any amounts transferred to the decedent's surviving spouse.

For many couples, they would prefer for all assets to be transferred to the surviving spouse's control at the passing of the first spouse, with assets not passing to their children or other descendants until

[705] Revenue Procedure 2022-32, July 8, 2022, https://www.irs.gov/pub/irs-drop/rp-22-32.pdf (retrieved July 8, 2022)

the passing of the second spouse. But that "wasted" the exclusion that was available to the first spouse to die in terms of eventually transferring assets to succeeding generations at the death of the second spouse.

The standard method of "saving" that exclusion prior to 2010 was to transfer assets up to the exclusion in place at the death of the first spouse to die to a trust that provided income from the assets would be paid to the surviving spouse for his/her life with the principal of the trust passing to the succeeding generation(s) at the death of the surviving spouse. This structure is referred to as a bypass trust.

The bypass trust, as the name suggests, allows the assets inside the trust to bypass inclusion in the surviving spouse's estate. At the survivor's death, the assets in the bypass trust should pass transfer tax free to the couple's descendants (or whatever other parties they have chosen to pass their wealth to). That is true regardless of the value of the assets in this trust at the date of death—so in addition to preserving the use of the decedent's exclusion, it also removes all appreciation of those assets from being subject to transfer taxes at the surviving spouse's passing.

But the bypass trust does have some negative features. The key one is that the surviving spouse loses direct access to assets that used to be available to the couple to do with as they wished prior to the first death. While the bypass trusts almost always provide a method to distribute trust principal to the surviving spouse in certain situations to maintain his/her standard of living, the spouse often is, at best, annoyed by this loss of full control.

As well, the trust incurs certain ongoing costs, such as having annual accountings prepared to determine what is trust accounting income (which is not the same as taxable income) and to make proper distributions, along with the preparation of an annual fiduciary income tax return. And we can't forget that the actual trust document itself must be drafted and kept updated, incurring both initial and continuing costs.

While a bypass trust still works under the current law, the portability option provides a different method to preserve the decedent's exclusion at the death of the first spouse. In this case, the unused portion of the decedent's exclusion can, if a proper election is filed, be used to increase the exclusion available at the death of the surviving spouse, allowing both spouses' exclusion amounts to be used in full.

But the need to make an election to use this option creates a deadline that can be easily missed if the estate and/or surviving spouse does not receive timely advice. Generally, this election is made on a Form 706 that is originally due 9 months after the date of death of the decedent, though that can be extended to 15 months if a timely extension is requested.

Original IRS Relief

In 2017 the IRS published the first version of this relief. Congress provided in IRC §2010(c)(5)(A) that the portability had to be made on the estate tax return that is filed within the time prescribed by law for filing the estate tax return. Since estates with reportable assets below the exclusion amounts are not required to file an estate tax return, the IRS had to come up with a due date for those returns in the regulations for the portability provision:

> For estates that are not required to file an estate tax return under § 6018(a) of the Code (as determined based on the value of the gross estate and adjusted taxable gifts), § 20.2010-2(a)(1) of the Estate Tax Regulations clarifies that the due date of an estate tax return required to elect portability is nine months after the decedent's

> date of death or the last day of the period covered by an extension (if an extension of time for filing has been obtained).[706]

While the IRS's position is that the agency is not authorized to extend the time to make an election whose due date is prescribed by Congress, the agency's position is that it can provide relief for a due date set by the agency via regulations:

> Section 20.2010-2(a)(1) further provides that an extension of time under § 301.9100-3 to elect portability may be available to an estate that is not required to file an estate tax return under § 6018(a).[707]

Normally, taxpayers must make a private letter ruling request (and pay the associated fee) to obtain late election relief under IRC §301.9100-3. However, after the IRS began to get hit with a large number of private letter ruling requests for late portability election relief, the agency released its first automatic late portability election ruling in Revenue Procedure 2017-34:

> On June 26, 2017, the Department of the Treasury (Treasury Department) and the Internal Revenue Service (IRS) published Rev. Proc. 2017-34, which provides a method for obtaining an extension of time under § 301.9100-3 to make a portability election under § 2010(c)(5)(A) that is available to the estates of decedents dying after December 31, 2010, if that estate was not required by § 6018(a) to file an estate tax return and if such a decedent was survived by a spouse. Under Rev. Proc. 2017-34, this method is a simplified method that is to be used in lieu of the letter ruling process and is available for a period extending to the second anniversary of the decedent's date of death.[708]

IRS Decision to Modify Late Election Relief

While the ruling provided relief for those estates that realized they wanted to make a portability election within 2 years of the date of death for the decedent, the IRS discovered that they were still receiving a number of requests for those who failed to meet the 2-year deadline.

> Since the publication of Rev. Proc. 2017-34, the IRS has continued to issue numerous letter rulings under § 301.9100-3 granting an extension of time to elect portability under § 2010(c)(5)(A) in situations in which the decedent's estate was not required by § 6018(a) to file an estate tax return and the time for obtaining relief under the simplified method had expired. The IRS has observed that a significant percentage of these ruling requests have been from estates of decedents who died within five years preceding the date of the request. The number of these requests continues to place a significant burden on the available resources of the IRS.[709]

The IRS has decided to extend this relief to five years and make certain other changes in order to attempt to reduce the number of PLR requests the agency receives in this area:

> The Treasury Department and the IRS have determined that the considerable number of ruling requests for an extension of time to elect portability received since

[706] Revenue Procedure 2022-32, July 8, 2022

[707] Revenue Procedure 2022-32, July 8, 2022

[708] Revenue Procedure 2022-32, July 8, 2022

[709] Revenue Procedure 2022-32, July 8, 2022

the publication of Rev. Proc. 2017-34 indicates a need for continuing relief for the estates of decedents having no filing requirement under § 6018(a). Accordingly, this revenue procedure supersedes Rev. Proc. 2017-34 and updates the procedures set forth therein by extending the period within which the estate of a decedent may make the portability election under that simplified method to on or before the fifth anniversary of the decedent's date of death.[710]

Revised Relief – What Estates Qualify?

Section 3 of the Revenue Procedure outlines the scope of this relief. The relief is available to the executor of a qualified estate or, if no executor has been appointed, a "non-appointed executor" as provided for in the regulations at Treasury Reg. §20.2010-2(a)(6). Such "non-appointed executors" are defined by the regulation as "any person in actual or constructive possession of any property of the decedent."[711]

Such an election may be made if the following conditions are met:

- The decedent
  - was survived by a spouse;
  - died after December 31, 2010; and
  - was a citizen or resident of the United States on the date of death
- The executor was not required to file a federal estate tax return based on the value of the gross estate and adjusted taxable gifts and without regard to the need to file for portability purposes,
- The executor did not file an estate tax return within the time required by § 20.2010-2(a)(1) for filing an estate tax return; and
- The executor files Form 706 under the procedures outlined in this Revenue Procedure to make a late portability election.[712]

The steps the executor must take to file this special Form 706 is outlined by the procedure as follows:

- A person permitted to make the election on behalf of the estate of a decedent-- that is, an executor or non-appointed executor described earlier--must file a complete and properly prepared Form 706, *United States Estate (and Generation-Skipping Transfer) Tax Return*, on or before the fifth annual anniversary of the decedent's date of death. The Form 706 will be considered complete and properly prepared if it is prepared in accordance with § 20.2010-2(a)(7) (including the simplified filing procedures for returns filed solely to elect portability if applicable).
- The authorized party filing the Form 706 on behalf of the decedent's estate must state at the top of the Form 706 that the return is "FILED PURSUANT TO REV. PROC. 2022- 32 TO ELECT PORTABILITY UNDER § 2010(c)(5)(A)."

[710] Revenue Procedure 2022-32, July 8, 2022

[711] Treasury Reg. §20.2010-2(a)(6)

[712] Revenue Procedure 2022-32, July 8, 2022

The relief provided if these steps are followed are described in the procedure as follows:

> Satisfaction of the requirements for relief provided in section 4.01 of this revenue procedure, by an executor for whom the relief is available pursuant to section 3.01 of this revenue procedure, is deemed to satisfy the requirements for relief under § 301.9100-3 and upon that satisfaction, relief is granted under the provisions of § 301.9100-3 to extend the time to elect portability under § 2010(c)(5)(A). Accordingly, for purposes of electing portability, the Form 706 of that decedent's estate will be considered to have been filed timely in accordance with § 20.2010-2(a)(1).[713]

Or, to put it more succinctly, the portability election will be treated as properly made by estate and, subject to the standard rules related to use of the deceased spouse unused exclusion amount (DSUE), the DSUE is available to the surviving spouse and/or his/her estate.

This procedure is not available if either of the following are true:

- *A Timely Estate Tax Return Was Filed by the Estate*. The ruling provides:

> The simplified method of this revenue procedure is not available to the estate of a decedent whose executor filed an estate tax return within the time prescribed by § 20.2010-2(a)(1). Such an executor either will have elected portability of the DSUE amount by timely filing that estate tax return or will have affirmatively opted out of portability in accordance with § 20.2010-2(a)(3)(i).[714]

- *Estates That Were Otherwise Required to File a Form 706*. The procedure states:

> As set forth in § 20.2010-2(a)(1), an extension of time to elect portability under § 301.9100-3, including through the simplified method of this revenue procedure, is not available to an estate that is required to file an estate tax return under § 6018(a) (as determined based on the value of the gross estate and adjusted taxable gifts) because, in that case, the due date of the election is prescribed by statute and not by regulation.[715]

The late election is also treated as void if it is later determined the estate did have an estate tax return filing requirement independent of making the portability election:

> If, subsequent to the grant of relief pursuant to this revenue procedure, it is determined that, based on the value of the gross estate and taking into account any taxable gifts, the executor was required to file an estate tax return under § 6018(a), the grant of an extension as provided in section 4.02 of this revenue procedure is deemed null and void *ab initio*.[716]

As the burden of showing that the estate qualified for this election will remain with the estate and the surviving spouse or the surviving spouse's estate when the DSUE is used to reduce the transfer tax due, the surviving spouse and his/her estate should be sure to maintain records documenting that the

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[713] Revenue Procedure 2022-32, July 8, 2022

[714] Revenue Procedure 2022-32, July 8, 2022

[715] Revenue Procedure 2022-32, July 8, 2022

[716] Revenue Procedure 2022-32, July 8, 2022

estate of the first spouse to die was not of such a size to require the filing of an estate tax return. It will *not* be sufficient to merely have a copy of the Form 706 to document this fact, so other supporting documents will need to be maintained as well.

The expanded five-year relief is effective as of July 8, 2022. Thus, relief would be available now for estates that had missed their two-year late election date under Revenue Procedure 2017-34 but who file the Form 706 to make the late portability election within five years of the date of death of the decedent.

If an estate is not eligible for this relief solely because the executor failed to file the required Form 706 within the five-year period, the procedure provides:

> The executor of an estate not within the scope described in section 3.01 of this revenue procedure only because the executor does not satisfy the requirements of section 4.01 of this revenue procedure may request an extension of time to make the portability election under § 2010(c)(5)(A) by requesting a letter ruling under the provisions of § 301.9100-3. The requirements for requesting a letter ruling are described in Rev. Proc. 2022-1 (or any successor revenue procedure).[717]

Impact on the Surviving Spouse

The procedure provides the following general description of the impact of the late election on the surviving spouse:

> If the decedent's estate is granted relief under this revenue procedure so that the estate tax return is considered to have been timely filed for purposes of electing portability, the DSUE amount of that decedent is available to the decedent's surviving spouse or the estate of the surviving spouse for application to the surviving spouse's transfers made on or after the decedent's date of death in accordance with the rules prescribed under § 20.2010-3 of the Estate Tax Regulations and § 25.2505-2 of the Gift Tax Regulations.[718]

But what if the surviving spouse had made taxable gifts prior to the estate taking advantage of this relief and paid gift tax on that transfer? Or, perhaps, estate tax had been paid on the estate tax return of the surviving spouse?

The procedure provides that, *if the statute of limitations for filing a claim for refund of the gift or estate tax has not expired*, the surviving spouse may file a claim for refund of the gift tax that would have been offset by the DSUE or the surviving spouse's estate could file a similar claim for excess estate taxes paid. But any taxes paid at a time that is now beyond the statute for filing a claim will not be available for refund:

> However, if the increase in the surviving spouse's applicable exclusion amount attributable to the addition of the decedent's DSUE amount as of the decedent's date of death results in an overpayment of gift or estate tax by the surviving spouse or his or her estate, no claim for credit or refund may be made if the period of limitations under § 6511(a) of the Code for filing a claim for credit or refund of an overpayment of tax with respect to such transfer has expired. That is, an extension of time to elect portability granted under this revenue procedure does not extend

[717] Revenue Procedure 2022-32, July 8, 2022

[718] Revenue Procedure 2022-32, July 8, 2022

> the period during which the surviving spouse or the surviving spouse's estate may make a claim for credit or refund under § 6511(a).[719]

The procedure also provides that if a surviving spouse files a claim for refund prior to the actual filing of the Form 706 under this Revenue Procedure, that filing will be treated as a protective claim for refund:

> Because a surviving spouse has no DSUE amount from a deceased spouse to apply to such surviving spouse's transfers until the portability election has been made by the deceased spouse's executor (see §§ 20.2010-3(a)(2) and 25.2505-2(a)(2)), a claim for credit or refund of tax filed within the time prescribed in § 6511(a) by the surviving spouse or the estate of the surviving spouse in anticipation of a Form 706 being filed to elect portability pursuant to this revenue procedure, and otherwise meeting applicable legal requirements, will be considered a protective claim for credit or refund of tax.[720]

A surviving spouse (or the spouse's estate) would likely consider taking this step if the statute on claiming a refund of gift or estate tax was about to expire and there did not remain sufficient time to insure the Form 706 would be completed before the statute on the claim for refund of the gift or estate tax expired.

Note that such a protective claim would not extend the five-year period to make use of the automatic relief found in this Revenue Procedure. But the protective claim should still allow for a refund if the estate applied for and obtained a private letter ruling to make the late election after the five year period for the automatic relief had expired.

The procedure provides examples of applying these claim for refund rules.

EXAMPLES

Example 1, Revenue Procedure 2022-32

Predeceasing Spouse (S1) dies on January 1, 2018, survived by Surviving Spouse (S2). The assets includible in S1's gross estate consist of cash on deposit in bank accounts held jointly with S2 with rights of survivorship in the amount of $4,500,000. S1 made no taxable gifts during life. S1's executor is not required to file an estate tax return under § 6018(a) and does not file such a return.

S2 dies on January 29, 2021. S2's taxable estate is $17,000,000 and S2 made no taxable gifts during life. S2's executor files a Form 706 on behalf of S2's estate on October 29, 2021, claiming an applicable exclusion amount of $11,700,000. S2's executor includes payment of the estate tax with the Form 706.

Pursuant to this revenue procedure, S1's executor files a complete and properly prepared Form 706 on behalf of S1's estate on December 1, 2022, reporting a DSUE amount of $11,180,000. The executor includes at the top of the Form 706 the statement required by section 4.01(2) of this revenue procedure. The filing of the return satisfies the requirements for a grant of relief under this revenue procedure and S1's estate is deemed to have made a valid portability election. The IRS accepts the return of S1's estate with no changes.

To recover the estate tax paid, S2's executor must file a claim for credit or refund of tax by October 29, 2024 (the end of the period of limitations prescribed in § 6511(a)), even though a Form 706 to elect portability

[719] Revenue Procedure 2022-32, July 8, 2022

[720] Revenue Procedure 2022-32, July 8, 2022

was not filed on behalf of S1's estate at the time S2's estate filed its Form 706. Such a claim filed on Form 843, Claim for Refund and Request for Abatement, in anticipation of the filing of the Form 706 by S1's executor will be considered a protective claim for credit or refund of tax. Accordingly, as long as the Form 843 is filed on or before October 29, 2024, the IRS can consider and process that claim for credit or refund of tax once S1's estate is deemed to have made a valid portability election and S2's estate notifies the IRS that the claim for credit or refund is ready for consideration.

Example 2, Revenue Procedure 2022-32

The facts relating to S1 and S1's estate are the same as in Example 1. S2 makes a gift to Child of $13,000,000 on December 1, 2020. S2 has made no prior taxable gifts. On April 15, 2021, S2's executor files a Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return, claiming an applicable exclusion amount of $11,580,000. S2's executor tenders payment of the gift tax with the Form 709.

To recover the gift tax paid, S2's executor must file a claim for credit or refund of tax (protective or otherwise) within the time prescribed in § 6511(a) for filing a claim for credit or refund; in this case, April 15, 2024.

Example 3, Revenue Procedure 2022-32

The facts are the same as in Example 2 except that S2's Form 709 claims an applicable exclusion amount of $22,760,000, including a DSUE amount of $11,180,000 from S1's estate. As a result, the Form 709 reports no tax due and S2's executor tenders no gift tax.

Although the portability election, once made, makes S1's DSUE amount available to S2 retroactively to S1's date of death, that DSUE amount is not available until the election is made. Because S2's executor files the Form 709 before S1's estate makes the portability election, the claimed application of the DSUE amount will be denied and gift tax on the transfer will be assessed. S2's executor pays the gift tax assessed. To recover that gift tax once the portability election has been made by S1's estate, S2's executor must file a claim for credit or refund of tax (protective or otherwise) within the time prescribed in § 6511(a) for filing a claim for credit or refund.

As Example 3 makes clear, an original Form 709 or 706 filed before the portability election is made will *not* be treated as a protective claim. Rather, the tax must be paid with such an original Form 709 or 706 if the due date for filing the form arrives before the late portability election is made by the prior decedent's estate or by obtaining a private letter ruling if the prior decedent's estate did not qualify for the automatic relief.

In such a case, the surviving spouse or executor may wish to follow up the original Form 709 or 706 with a protective claim for refund pending the later processing of the late portability election.

No Letter Rulings to Be Issued If an Estate Qualifies for This Relief

The IRS has also clarified that if an estate qualifies for relief under this Revenue Procedure, the IRS will not issue a private letter ruling even if the estate pays the user fee and asks for such a ruling.

The procedure provides:

> On or before the fifth anniversary of a decedent's date of death, the exclusive procedure for obtaining an extension of time under § 301.9100-3 to make a portability election under § 2010(c)(5)(A) for the estate of a decedent, if the decedent and executor meet the requirements of section 3.01(1) through (3) of this

> revenue procedure, is the procedure described in section 4.01 of this revenue procedure.[721]

The IRS will return the user fees and close the file on any letter ruling requests pending as of the date of this procedure that fall within that five-year time period:

> If an executor of such an estate has filed a request for a letter ruling seeking an extension of time under § 301.9100-3 to make a portability election under § 2010(c)(5)(A) and that letter ruling is pending in the National Office on July 8, 2022, the Office of the Associate Chief Counsel (Passthroughs & Special Industries) will close its file on the ruling request and refund the user fee, and the estate may obtain the relief granted by this revenue procedure only by complying with section 4.01 of this revenue procedure.[722]

SECTION: 2010
IRS PROVIDES RULES TO LIMIT THE APPLICATION OF THE ANTI-CLAWBACK RULES FOR CERTAIN GIFTS INCLUDABLE IN A DECEDENT'S ESTATE

Citation: REG-118913-21; 87 F.R. 24918-24923, 4/27/22

In proposed regulations, the IRS sought to block potential methods that might be used to extend the increased basic exclusion amount should it be allowed to drop back to a lower level after the end of 2025.[723]

The IRS had previously released what have been referred to as *anti-clawback* regulations in 2019. The regulations sought to prevent an estate from facing a tax bill if the basic exclusion amount (BEA) drops below amounts that have been gifted during life that were covered by the BEA applicable at the time of the gift, when the BEA has now dropped below the amount of those gifts. The regulations explain this as follows:

> On November 26, 2019, the Treasury Department and the IRS published final regulations under section 2010 (TD 9884) in the Federal Register (84 FR 64995) to address situations described in section 2001(g)(2) (final regulations). The final regulations adopted §20.2010-1(c), a special rule (special rule) applicable in cases where the credit against the estate tax that is attributable to the BEA is less at the date of death than the sum of the credits attributable to the BEA allowable in computing gift tax payable within the meaning of section 2001(b)(2) with regard to the decedent's lifetime gifts. In such cases, the portion of the credit against the net tentative estate tax that is attributable to the BEA is based on the sum of the credits attributable to the BEA allowable in computing gift tax payable regarding the decedent's lifetime gifts. The rule ensures that the estate of a donor is not taxed on

[721] Revenue Procedure 2022-32, July 8, 2022

[722] Revenue Procedure 2022-32, July 8, 2022

[723] REG-118913-21; 87 F.R. 24918-24923, April 27, 2022, https://www.taxnotes.com/research/federal/proposed-regulations/proposed-regs-limit-application-of-higher-basic-exclusion-amount/7df65 (retrieved July 27, 2022)

> completed gifts that, as a result of the increased BEA, were free of gift tax when made.[724]

However, the IRS was aware that it might be possible to use that special rule to make certain gifts during the period a higher BEA applied, but retain significant benefits past the date the new lower BEA took effect. To attempt to stop taxpayers from arranging transactions to make gifts with significant retained level of control to continue to benefit from the higher BEA the IRS has now issued these proposed changes:

> The preamble to the final regulations stated that further consideration would be given to the issue of whether gifts that are not true inter vivos transfers, but rather are includible in the gross estate, should be excepted from the special rule, and that any proposal addressing this issue would benefit from notice and comment.[725]

Proposed Effective Date

The proposed regulations provide for the following effective date:

> Once these regulations have been published as final regulations, it is proposed that these regulations be applicable to the estates of decedents dying on or after April 27, 2022. The special rule will not be needed until the basic exclusion amount has been decreased by statute; under current law, that is scheduled to occur for the estates of decedents dying after 2025. However, if such a decrease is enacted on or after April 27, 2022, but before the issuance of final regulations, the best way to ensure that all estates will be subject to the same rules is to make this proposed exception to the special rule applicable to the estates of decedents dying on or after April 27, 2022.[726]

Items Subject to the Special Rule

The regulations provide that the increase in the BEA under the special rule of Reg. §20.2010-1(c) does not apply to transfers includible in the gross estate, or treated as includible in the gross estate for purposes of IRC §2001(b). Such transfers will include, without limit, the following transfers:

- Transfers includible in the gross estate pursuant to section 2035, 2036, 2037, 2038, or 2042, regardless of whether all or any part of the transfer was deductible pursuant to section 2522 or 2523;
- Transfers made by an enforceable promise to the extent they remain unsatisfied as of the date of death;
- Transfers described in Regs. §25.2701-5(a)(4) (Section 2701 interest) or §25.2702-6(a)(1) (indirect holding of interests under Section 2701); or
- Transfers that would have been described in the prior three bullets but for the transfer, relinquishment, or elimination of an interest, power, or property, effectuated within ***18 months*** of

[724] REG-118913-21; 87 F.R. 24918-24923, April 27, 2022, Supplementary Information, Background

[725] REG-118913-21; 87 F.R. 24918-24923, April 27, 2022, Supplementary Information, Background

[726] REG-118913-21; 87 F.R. 24918-24923, April 27, 2022, Supplementary Information, Background

the date of the decedent's death by the decedent alone, by the decedent in conjunction with any other person, or by any other person.[727]

Note that the regulation provides that the affected items *includes* those specific items. Thus, the list is not meant to be taken as an exclusive list of what would be covered by this rule. So if Congress adds other provisions to the law that are similar in nature, they would be caught by this rule even if the IRS doesn't update the regulation.

However, the *special rule* (expansion of the BEA) will continue to apply to the following transactions (so they are exempted from the new rules meant to limit the applicability of the special rule):

- Transfers includible in the gross estate in which the value of the taxable portion of the transfer, determined as of the date of the transfer, was 5 percent or less of the total value of the transfer (a *de minimis* rule); and

- Transfers, relinquishments, or eliminations described in the last bullet point of the previous list effectuated by the termination of the durational period described in the original instrument of transfer by either the mere passage of time or the death of any person.[728]

The 18 month rule does provide for an option to terminate such interests if it becomes clear the donor is likely to pass away in the near, but not too near, future. However, it is clear this step would need to be taken to allow enough time for 18 months to pass before the decedent passed away, something that obviously can't be assured at the time the interest is terminated. But it is important to note that 18 months is a shorter period than the three years that otherwise would apply to certain of these transactions to bring them back into the decedent's estate.

IRS Examples of Applying the Proposed Regulations

The IRS provides the following examples of applying the newly proposed regulations:

EXAMPLES

Example 1, Reg. §20.2010-1(c)(3)(iii)

Individual A made a completed gift of A's promissory note in the amount of $9 million. The note remained unpaid as of the date of A's death. The assets that are to be used to satisfy the note are part of A's gross estate, with the result that the note is treated as includible in the gross estate for purposes of section 2001(b) and is not included in A's adjusted taxable gifts. Because the note is treated as includible in the gross estate and does not qualify for the 5 percent de minimis rule in paragraph (c)(3)(ii)(A) of this section, the exception to the special rule found in paragraph (c)(3) of this section applies to the gift of the note. The credit to be applied for purposes of computing A's estate tax is based on the $6.8 million basic exclusion amount as of A's date of death, subject to the limitation of section 2010(d). The result would be the same if A or a person empowered to act on A's behalf had paid the note within the 18 months prior to the date of A's death.

Example 2, Reg. §20.2010-1(c)(3)(iii)

Assume that the facts are the same as Example 1 except that A's promissory note had a value of $2 million and, on the same date that A made the gift of the promissory note, A also made a gift of $9 million in cash.

[727] Proposed Reg. §20.2010-1(c)(3)(i)

[728] Proposed Reg. §20.2010-1(c)(3)(ii)

The cash gift was paid immediately, whereas the $2 million note remained unpaid as of the date of A's death. The assets that are to be used to satisfy the note are part of A's gross estate, with the result that the note is treated as includible in the gross estate for purposes of section 2001(b) and is not included in A's adjusted taxable gifts. Because the $2 million note is treated as includible in the gross estate and does not qualify for the 5 percent de minimis rule in paragraph (c)(3)(ii)(A) of this section, the exception to the special rule found in paragraph (c)(3) of this section applies to the gift of the note. On the other hand, the $9 million cash gift was paid immediately, and no portion of that gift is includible or treated as includible in the gross estate. Because the amount allowable as a credit in computing the gift tax payable on A's $9 million cash gift exceeds the credit based on the $6.8 million basic exclusion amount allowable on A's date of death, the special rule of paragraph (c) of this section applies to that gift. The credit to be applied for purposes of computing A's estate tax is based on a basic exclusion amount of $9 million, the amount used to determine the credit allowable in computing the gift tax payable on A's $9 million cash gift.

Example 3, Reg. §20.2010-1(c)(3)(iii)

Assume that the facts are the same as in Example 1 except that, prior to A's gift of the note, the executor of the estate of A's predeceased spouse elected, pursuant to §20.2010-2, to allow A to take into account the predeceased spouse's $2 million DSUE amount. Assume further that A's promissory note had a value of $2 million on the date of the gift, and that A made a gift of $9 million in cash a few days later. The cash gift was paid immediately, whereas the $2 million note remained unpaid as of the date of A's death. The assets that are to be used to satisfy the note are part of A's gross estate, with the result that the note is treated as includible in the gross estate for purposes of section 2001(b) and is not included in A's adjusted taxable gifts. Because A's DSUE amount was sufficient to shield the gift of the note from gift tax, no basic exclusion amount was applicable to the $2 million gift pursuant to paragraph (c)(1)(ii)(A) of this section and the special rule of paragraph (c) of this section does not apply to that gift. On the other hand, the $9 million cash gift was paid immediately, and no portion of that gift is includible or treated as includible in the gross estate. Because the amount allowable as a credit in computing the gift tax payable on A's $9 million cash gift exceeds the credit based on the $6.8 million basic exclusion amount allowable on A's date of death, the special rule of paragraph (c) of this section applies to that gift. The credit to be applied for purposes of computing A's estate tax is based on A's $11 million applicable exclusion amount, consisting of the $2 million DSUE amount plus the $9 million amount used to determine the credit allowable in computing the gift tax payable on A's $9 million cash gift.

Example 4, Reg. §20.2010-1(c)(3)(iii)

Individual B transferred $9 million to a grantor retained annuity trust (GRAT), retaining a qualified annuity interest within the meaning of §25.2702-3(b) of this chapter valued at $8,550,000. The taxable portion of the transfer valued as of the date of the transfer was $450,000. B died during the term of the GRAT. The entire GRAT corpus is includible in the gross estate pursuant to §20.2036-1(c)(2). Because the value of the taxable portion of the transfer was 5 percent or less of the total value of the transfer determined as of the date of the gift, the 5 percent de minimis rule in paragraph (c)(3)(ii)(A) of this section is met and the exception to the special rule found in paragraph (c)(3) of this section does not apply to the gift. However, because the total of the amounts allowable as a credit in computing the gift tax payable on B's post-1976 gift of $450,000 is less than the credit based on the $6.8 million basic exclusion amount allowable on B's date of death, the special rule of paragraph (c) of this section does not apply to the gift. The credit to be applied for purposes of computing B's estate tax is based on the $6.8 million basic exclusion amount as of B's date of death, subject to the limitation of section 2010(d).

Example 5, Reg. §20.2010-1(c)(3)(iii)

Assume that the facts are the same as in Example 4 except that B's qualified annuity interest is valued at $8 million. The taxable portion of the transfer valued as of the date of the transfer was $1 million. Because the value of the taxable portion of the transfer was more than 5 percent of the total value of the transfer determined as of the date of the gift, the 5 percent de minimis rule in paragraph (c)(3)(ii)(A) of this section is

not met and the exception to the special rule found in paragraph (c)(3) of this section applies to the gift. The credit to be applied for purposes of computing B's estate tax is based on the $6.8 million basic exclusion amount as of B's date of death, subject to the limitation of section 2010(d).

Example 6, Reg. §20.2010-1(c)(3)(iii)

Assume that the facts are the same as in Example 4 except that B's qualified annuity interest is valued at $2 million. The taxable portion of the transfer valued as of the date of the transfer was $7 million. B survived the term of the GRAT. Because B survived the original unaltered term of the GRAT, no part of the value of the assets transferred to the GRAT is includible in B's gross estate, and the exception to the special rule found in paragraph (c)(3) of this section does not apply to the gift. Moreover, because the amount allowable as a credit in computing the gift tax payable on B's $7 million gift exceeds the credit based on the $6.8 million basic exclusion amount allowable on B's date of death, the special rule of paragraph (c) of this section applies to the gift. The credit to be applied for purposes of computing B's estate tax is based on a basic exclusion amount of $7 million, the amount used to determine the credit allowable in computing the gift tax payable on B's transfer to the GRAT.

Example 7, Reg. §20.2010-1(c)(3)(iii)

Individual C transferred $9 million to a grantor retained income trust (GRIT), retaining an income interest valued at $0 pursuant to section 2702(a)(2)(A). The taxable portion of the transfer valued as of the date of the transfer was $9 million. C died during the term of the GRIT. The entire GRIT corpus is includible in C's gross estate pursuant to section 2036(a)(1) because C retained the right to receive all of the income of the GRIT. Because the transferred assets are includible in the gross estate and do not qualify for the 5 percent de minimis rule in paragraph (c)(3)(ii)(A) of this section, the exception to the special rule found in paragraph (c)(3) of this section applies to the gift. The credit to be applied for purposes of computing C's estate tax is based on the $6.8 million basic exclusion amount as of C's date of death, subject to the limitation of section 2010(d).

SECTION: 2055
TRUST TERMS BLOCK ABILITY OF ESTATE TO CLAIM EITHER CHARITABLE OR MARITAL DEDUCTION ON PORTION OF CHARITABLE REMAINDER TRUST

Citation: CCA 202233014, 8/19/2022

Including an option in a purported charitable remainder trust for the trustee to choose between making distributions of the annual unitrust payment to the surviving spouse or a charity ended up with the decedent's estate not being able to claim either a charitable contribution or marital deduction by the estate for these amounts, the IRS ruled in a Chief Counsel Advice.[729]

[729] CCA 202233014, August 19, 2022, https://www.taxnotes.com/research/federal/irs-private-rulings/legal-memorandums/no-deduction-allowed-for-distributed-portion-of-unitrust-interest/7dyrw?h=202233014 (retrieved August 28, 2022)

Terms of the Trust

The CCA provides the following summary of the facts of this situation:

> Decedent died, survived by Spouse, leaving a portion of his estate to a testamentary trust that is a charitable remainder unitrust described in § 664 ("CRUT"). CRUT provides for annual unitrust payments of five percent for the term of Spouse's life. CRUT provides that the trustee must distribute 25 percent of the unitrust amount (i.e., 1.25 percent of CRUT) to Spouse. The trustee may distribute the remaining 75 percent of the unitrust amount (i.e., 3.75 percent of CRUT) to either Charity or Spouse at Trustee's complete discretion. Upon Spouse's death, the trustee must distribute the remainder of CRUT to Charity.[730]

IRS Ruling on the Impact of These Provisions

The IRS begins by finding that a charitable deduction would be available to the estate for the present value of the remainder interest:

> In this case, the terms of CRUT create two charitable interests: a discretionary interest in a portion of the unitrust amount and a remainder interest. Decedent's estate may claim an estate tax charitable deduction for the value of the remainder interest under § 2055(a), because CRUT is a charitable remainder unitrust described in § 664. See §2055(e)(2)(A).[731]

However, the portion of the unitrust where it could go either to the surviving spouse or the charity does not qualify for any charitable deduction:

> However, Decedent's estate may not claim an estate tax charitable deduction under § 2055(a) for the value of any portion of the unitrust interest that may be distributed to Charity in the discretion of the trustee because Charity's interest is not in the form of a fixed unitrust amount to be distributed annually and no part of the unitrust interest is ascertainable or severable from Spouse's noncharitable interest. See § 2055(e)(2)(B) and § 20.2055-2(a).[732]

The 25% interest in the unitrust payments that must be paid to the surviving spouse qualify for the marital deduction:

> With regard to the marital interests in CRUT, because the interest in the 25 percent portion of the unitrust amount must be distributed to and will be received by Spouse pursuant to the terms of CRUT, this interest is considered to pass from Decedent to Spouse as beneficial owner for purposes of § 2056(a). Under § 2056(b)(8), because Spouse is the only beneficiary of CRUT who is not a charitable beneficiary the interest in the 25 percent portion of the unitrust amount is not subject to the terminable interest rule in § 2056(b)(1). Accordingly, Decedent's estate may claim an estate tax marital deduction for the value of this interest under § 2056.[733]

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[730] CCA 202233014, August 19, 2022

[731] CCA 202233014, August 19, 2022

[732] CCA 202233014, August 19, 2022

[733] CCA 202233014, August 19, 2022

But the 75% of the interest that could go to either the charity or the surviving spouse will not qualify at the date of death for the marital deduction:

> In contrast, the extent of Spouse's interest in the remaining 75 percent portion of the unitrust amount cannot be established as of Decedent's date of death and, therefore, is not considered to pass from Decedent to Spouse as beneficial owner for purposes of § 2056(a). The extent of Spouse's interest cannot be established because the amount to be distributed to Spouse annually is within the sole and complete discretion of the trustee. It is not possible to ascertain as of the date of death whether spouse will receive any of the 75 percent portion of the unitrust amount each year since all of such portion of the unitrust interest may be distributed to charity. Because the interest is not treated as passing to Spouse for purposes of § 2056(a), Decedent's estate may not claim an estate tax marital deduction for the value of this interest under § 2056(a).1 See § 20.2056(c)-2(a). See also Estate of Turner v. Commissioner, 138 T.C. 306, 316 (2012) ("property that passed to a person other than a surviving spouse cannot also be considered as passing to the surviving spouse").[734]

In a footnote, the memorandum notes that the result would be the same if the transfer were via gift made while the decedent had been alive:

> The analysis and conclusion would be the same under § 2523 for a completed gift transfer to a CRUT with similar terms.[735]

[734] CCA 202233014, August 19, 2022

[735] CCA 202233014, August 19, 2022

NOTES

Unit

7

Tax Practice Developments

LEARNING OBJECTIVES

When you have completed this unit, you will be able to accomplish the following.

- Prepare tax returns and advise clients in planning taking into account major developments occurring in the past year

SECTION: FBAR REPORTING

SUPREME COURT TO RESOLVE SPLIT AMONG CIRCUITS ON HOW TO APPLY FBAR PENALTIES

Citation: Supreme Court Grant of Cert. 21-1195 BITTNER V. UNITED STATES, 6/21/22

The US Supreme Court has agreed to hear the taxpayer's appeal of the Fifth Circuit Court of Appeals decision in the case of *Bittner v. United States*.[736] The key issue is whether, in assessing penalties for failing to report interests in foreign accounts on an annual FBAR, the penalties apply on a per-account or per-reporting form basis, a matter which was decided differently in 2021 cases heard by the Fifth and Ninth Circuits.

The Court summarized the issue to be decided as follows:

> Whether a "violation" under the Act is the failure to file an annual FBAR (no matter the number of foreign accounts), or whether there is a separate violation for each individual account that was not properly reported.[737]

[736] Supreme Court Grant of Cert. 21-1195 BITTNER V. UNITED STATES, June 21, 2022, https://www.supremecourt.gov/qp/21-01195qp.pdf (retrieved June 25, 2022), *Bittner v. United States,* CA5, Docket No. 20-40597, November 30, 2021, https://www.taxnotes.com/research/federal/court-documents/court-opinions-and-orders/fifth-circuit-holds-non-willful-fbar-penalties-apply-per-account/7cn4d?h=Bittner (retrieved June 25, 2022)

[737] Supreme Court Grant of Cert. 21-1195 BITTNER V. UNITED STATES, June 21, 2022

The document granting certiorari provides the following information regarding the case and why the Supreme Court is taking up the matter:

> This case presents a direct and acknowledged conflict regarding an important question of statutory construction under the Bank Secrecy Act, 31 U.S.C. 5311 *et seq.*, which generally requires taxpayers to report their interests in foreign bank accounts.
>
> Under the Act, Congress instructed the Treasury Secretary to "require a resident or citizen of the United States * * * to keep records, file reports, or keep records and file reports, when the * * * person makes a transaction or maintains a relation for any person with a foreign financial agency." 31 U.S.C. 5314(a). The Secretary's corresponding regulations require filing a single annual report (called an "FBAR") for anyone with an aggregate balance over $10,000 in foreign accounts. 31 C.F.R. 1010.350(a), 1010.306(c). The Act authorizes a $10,000 maximum penalty for any non-willful violation of Section 5314. See 31 U.S.C. 5321(a)(5)(A)-(B).
>
> In the decision below, the Fifth Circuit held that there is a separate violation (with its own $10,000 penalty) for each foreign account not timely reported on an annual FBAR; it thus authorized a penalty on "a per-account, not a per-form, basis." In so holding, the Fifth Circuit expressly rejected a contrary decision of the Ninth Circuit, which held the failure to file an annual FBAR constitutes a single violation, "no matter the number of accounts." This critical issue arises all the time, and the Act's penalties for identically situated parties will now turn on whether the taxpayer is from California or Texas.[738]

The Ninth Circuit opinion referenced by the Supreme Court was for the case of *United States v. Boyd*.[739]

For the taxpayer whose case is before the Supreme Court, applying the penalty on a per account basis added up to a total penalty of $2.72 million, while if the Ninth Circuit's per FBAR report basis had been followed the penalty would have amounted to $50,000.

No date has been given for oral arguments, but the Court just ended its current term. Its new term will begin in October.

SECTION: 6031
NINTH CIRCUIT PANEL RULES THAT PROVIDING RETURN TO IRS

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[738] Supreme Court Grant of Cert. 21-1195 BITTNER V. UNITED STATES, June 21, 2022

[739] *United States v. Boyd*, CA9, Docket No. 19-55585, March 24, 2021, https://cdn.ca9.uscourts.gov/datastore/opinions/2021/03/24/19-55585.pdf (retrieved November 30, 2021)

AGENT BEGINS STATUTE OF LIMITATIONS IF RETURN NOT PREVIOUSLY FILED

Citation: Seaview Trading LLC v. Commissioner, CA9, Case No. 20-72416, 5/11/22

The IRS in 2005 sends a partnership a notice that they have no record of their 2001 income tax return being filed. The taxpayer's accountant, in response to the notice faxes a signed copy of the Form 1065 to the IRS at the response number in the notice along with a certified mail receipt to show timely filing. A month later the IRS began an examination of the partnership. As part of the examination, in July 2007 the partnership's counsel mailed another signed copy of the return and certified mail receipt to an IRS attorney.

In October of 2010, the IRS issued the partnership a Final Partnership Administrative Adjustment, more than three years after the second signed copy of the tax return had been provided to IRS personnel per their requests. While you might be thinking that the IRS is too late now, since the statute for issuing the FPAA was three years after the return was filed, the IRS argued that the FPAA was timely as the return was never filed in accordance with the regulations, so the statute never began to run.

The Tax Court agreed with the IRS,[740] finding that the taxpayer had not complied with the requirements found in Treasury Reg. §1.6031(a)-1(e)(1) as the return was not filed with the IRS Service Center designated to receive the return. However, in a split decision with a long dissent, a Ninth Circuit panel overruled the Tax Court,[741] finding the return had been filed more than 3 years prior to the date the FPAA was issued when a copy of the return was provided to an IRS employee who had requested the return.

Filing a Tax Return

The case depends solely on what constitutes the filing of a tax return, which requires looking to the Code and Regulations first to see what they provide.

IRS §6230(i), which applied to TEFRA partnerships for 2001, provided a partnership return "shall be filed or made at such time, in such manner, and at such place as may be prescribed in regulations."

Reg. §1.6031(a)-1(e) provides:

> (e) Procedural requirements
>
> > (1) Place for filing.
> >
> > The return of a partnership must be filed with the service center prescribed in the relevant IRS revenue procedure, publication, form, or instructions to the form (see section 601.601(d)(2)).

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[740] *Seaview Trading LLC v. Commissioner*, TC Memo 2019-122, September 19, 2019

[741] *Seaview Trading LLC v. Commissioner*, CA9, Case No. 20-72416, May 11, 2022, https://www.taxnotes.com/research/federal/court-documents/court-opinions-and-orders/ninth-circuit-holds-return-was-filed%2c-irs-adjustments-untimely/7dh1s (retrieved May 12, 2022)

(2) Time for filing.

The return of a partnership must be filed on or before the date prescribed by section 6072(b).

(3) Magnetic media filing.

For magnetic media filing requirements with respect to partnerships, see section 6011(e)(2) and the regulations thereunder.

For 2001 the instructions for Form 1065 provided that the partnership return in question was to be filed with the Ogden Service Center of the IRS.

Facts of the Case

The case begins with the taxpayers' filing of their 2001 return for the partnership, a filing the IRS claimed it never received:

> Seaview believed it filed its partnership tax return—also known as a Form 1065—for the 2001 tax year back in July 2002. In its Form 1065 for 2001, Seaview reported a $35,459,542 loss from a tax-shelter transaction. Seaview claims it mailed the return to the IRS service center in Ogden, Utah—the correct place to send timely returns. But the IRS has no record of receiving such a filing.[742]

The first inkling the taxpayers had that the IRS did not have a record of their partnership return being filed occurred in 2005:

> In July 2005, an IRS revenue agent sent Seaview a letter notifying the partnership that the IRS had not received its 2001 federal income tax return. Attached to that letter was a request to "[p]lease produce the following information and documents":
>
> > 1. Did Seaview Trading file a Form 1065 (U.S. Return of Partnership Income) or other Federal Income tax return for its taxable year 2001? If so, what type of form did it file, what service center was the return filed with, and when was the return filed?
> >
> > 2. Provide copies of all retained copies of the return referred to in paragraph 1, above.
> >
> > 3. Provide copies of all receipts and other proof of mailing of the return referred to in paragraph 1, above.[743]

The taxpayer's accountant promptly responded to this request and provided the requested information:

> In response, in September 2005, Seaview's accountant faxed the IRS revenue agent a signed copy of Seaview's 2001 Form 1065 return, along with the certified mail receipt purporting to show its delivery to the IRS. In the cover letter to the IRS

[742] *Seaview Trading LLC v. Commissioner*, CA9, Case No. 20-72416, May 11, 2022

[743] *Seaview Trading LLC v. Commissioner*, CA9, Case No. 20-72416, May 11, 2022

> revenue agent, Seaview's accountant stated: "As we discussed, I have attached the 2001 tax return for Seaview Trading LLC as well as the certified mailing."[744]

The IRS then began an examination of the partnership. During this examination, the IRS confirmed that it had received the faxed copy of the Form 1065 from the accountant:

> As part of its examination, the IRS interviewed Seaview's accountant in January 2006. During the interview, the IRS noted that the accountant had "previously provided" Seaview's signed 2001 tax return and introduced the Form 1065 as an exhibit. In June 2007, the IRS also interviewed Robert Kotick. Again, the IRS acknowledged that it "obtained from [Seaview's accountant] a Form 1065 prepared for Seaview Trading, LLC, for its tax year 2001." The IRS also entered the Form 1065 as an exhibit for the interview.[745]

As well, in July 2007 the IRS obtained yet another copy of the return in question:

> In July 2007, Seaview's counsel mailed another signed copy of the 2001 tax return to an IRS attorney "[p]ursuant to [their] prior conversation."[746]

However, the IRS released their Final Partnership Administrative Adjustment (FPAA) for the partnership more than 3 years after the second copy of the return that the agency agrees it received was transmitted to the agency, holding that neither of those returns had been properly filed, thus the statute of limitations never began running:

> More than three years later, in October 2010, the IRS issued Seaview a Final Partnership Administrative Adjustment for the 2001 tax year. In that notice, the IRS stated that "[p]er Internal Revenue Service records, no tax return was filed by [Seaview] for 2001," but said, "[d]uring the examination," the partnership provided "a copy of a 2001 tax return which taxpayer claimed to have filed." The IRS then determined that "none of the income/loss/expense amounts reflected on the 2001 unfiled tax return provided by [Seaview was] allowable." It then informed Seaview that it would adjust its 2001 reported loss from over $35 million to zero dollars.[747]

The Tax Court Ruling – the Return Was Never Filed

The matter went to the Tax Court which had to decide if, in fact, a return was filed when the signed copy was faxed to the IRS agent. The Tax Court analysis began by noting:

> Generally, a limitations period "runs against the United States only when they assent and upon the conditions prescribed." *Lucas v. Pilliod Lumber Co.*, 281 U.S. 245, 249 (1930). For a taxpayer to secure the benefit of a limitations period bar, there must be "meticulous compliance by the taxpayer with all named conditions." *Winnett v. Commissioner*, 96 T.C. 802, 807-808 (1991) (quoting *Lucas v. Pilliod Lumber Co.*, 281 U.S. at 249). One such requirement is that a return be filed at the designated place of filing returns. See id. at 808. However, if a taxpayer submits a return to the wrong place but the return is later forwarded to designated place for filing, the limitations

[744] *Seaview Trading LLC v. Commissioner*, CA9, Case No. 20-72416, May 11, 2022

[745] *Seaview Trading LLC v. Commissioner*, CA9, Case No. 20-72416, May 11, 2022

[746] *Seaview Trading LLC v. Commissioner*, CA9, Case No. 20-72416, May 11, 2022

[747] *Seaview Trading LLC v. Commissioner*, CA9, Case No. 20-72416, May 11, 2022

> period commences when the return is received at the designated place for filing. See *id.*[748]

The Tax Court found that no return ever made its way to the Ogden Service Center:

> Section 1.6031(a)-1(e)(1), Income Tax Regs., designates the proper place to file a Federal partnership income tax return. The designated place for filing is the "service center prescribed in the relevant IRS revenue procedure, publication, form, or instructions to the form". The instructions for Form 1065 for 2001 state that the proper service center for filing was the Ogden, Utah, service center. Thus, Seaview did not submit a return to the proper place for filing when it faxed a copy to Agent Johnson in 2005 or when it sent a copy to respondent's counsel in 2007. Neither of the purported returns was forwarded to the Ogden service center. Additionally, there is a plethora of caselaw holding that a revenue agent is not a designated filing place. *W.H. Hill Co. v. Commissioner*, 64 F.2d 506 (6th Cir. 1933), *aff'g* 22 B.T.A. 1351 (1931) and 23 B.T.A. 605 (1931); *Green v. Commissioner*, T.C. Memo. 1993-152, 1993 Tax Ct. Memo LEXIS 154, at *20, *aff'd,* 33 F.3d 1378 (5th Cir. 1994); see *Metals Ref., Ltd. v. Commissioner*, T.C. Memo. 1993-115, 1993 Tax Ct. Memo LEXIS 113, at *20-*21.[749]

The Tax Court also distinguished this case from a criminal case where the return was given to the Criminal Investigation Division (CID) agent:

> With respect to Seaview's faxing of the return, petitioner maintains that the Internal Revenue Manual requires revenue agents to process delinquent returns that they receive. In support, petitioner relies on *Dingman v. Commissioner*, T.C. Memo. 2011-116, 2011 Tax Ct. Memo LEXIS 112. *Dingman* is inapplicable to the present case. In *Dingman*, we held, in a unique factual situation, that a taxpayer filed his returns when his counsel provided delinquent returns to the IRS Criminal Investigation Division (CID). *Id.* at *31-*43. In sum, we held that in the precise situation in Dingman, the CID was an appropriate place to hand-deliver a return. *Id. Dingman* is applicable only to hand-delivery of returns arising under the facts present in that case.[750]

The Tax Court also notes that, unlike *Dingman*, in this case the taxpayer continued to take the position it had timely filed the 2001 return.

> In *Dingman* the taxpayer clearly intended that the returns submitted to the CID be delinquent returns with payments, and the IRS processed them as such and assessed the taxpayer's payments. Those facts are not present in the instant case. Indeed, petitioner continues to maintain that Seaview timely filed its 2001 return.[751]

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[748] *Seaview Trading LLC v. Commissioner*, TC Memo 2019-122, September 19, 2019

[749] *Seaview Trading LLC v. Commissioner*, TC Memo 2019-122, September 19, 2019

[750] *Seaview Trading LLC v. Commissioner*, TC Memo 2019-122, September 19, 2019

[751] *Seaview Trading LLC v. Commissioner*, TC Memo 2019-122, September 19, 2019

The Tax Court argues that *Dingman* does not override the regulation in question:

> *Dingman* did not create a blanket rule that a taxpayer can file a return by whatever method he chooses; nor did it create an additional place for taxpayers to file returns beyond the places specifically designated in the Code or the regulations.[752]

The Tax Court also noted that even if such a submission could constitute a filing, what the taxpayer had submitted was not, in the view of the Tax Court, intended to be a tax return, but rather was presented solely as a copy of an already filed return:

> The relevant question in this case is whether the purported copy of the return Seaview either faxed to Agent Johnson in 2005 or mailed to respondent's counsel in 2007 purported to be a return. In *Friedman v. Commissioner*, T.C. Memo. 2001-207, 2001 Tax Ct. Memo LEXIS 240, at *5, aff'd, 80 F. App'x 285 (3d Cir. 2003), a revenue agent requested from a taxpayer copies of his returns for 1989 and 1990. The revenue agent believed that the taxpayer filed returns for those years although the taxpayer had not. *Id.* at *5-*6. The taxpayer provided copies of the returns to the revenue agent but did not tell him that he had failed to file the returns. *Id.* at *6. And the revenue agent received the returns thinking that they had already been filed. Id. We therefore held, in part, that the taxpayer had not intended his delivery of the documents to constitute the filing of returns. *Id.* at *24.
>
> The situation in the present case is similar. When Seaview's accountant faxed a purported copy of the return to Agent Johnson in 2005, he enclosed a copy of certified mail receipt purporting to show that the return had been previously filed in 2002. Seaview's accountant thus led respondent to believe that the return had been previously filed in 2002. Therefore, Seaview did not intend to file a return when it faxed a copy to Agent Johnson.
>
> Seaview has the same problem with respect to the mailing of the purported copy of the return in 2007. Seaview's attorney enclosed with the document a cover letter stating that the document was a "copy of its 2001 Form 1065". This indicates that Seaview believed it had previously filed its return and, thus, Seaview did not intend to file a return when it mailed a copy to respondent's counsel.[753]

There is one very interesting point to note here—the taxpayer was not, at this point in time, arguing that the 2001 return had been timely filed despite having sent along a certified mail receipt to show the return had been filed in July of 2002.

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[752] *Seaview Trading LLC v. Commissioner*, TC Memo 2019-122, September 19, 2019

[753] *Seaview Trading LLC v. Commissioner*, TC Memo 2019-122, September 19, 2019

IRC Section 7502(c) provides:

> (c) Registered and certain mailing; electronic filing.
>
> > (1) Registered mail. For purposes of this section, if any return, claim, statement, or other document, or payment, is sent by United States registered mail--
> >
> > > (A) such registration shall be prima facie evidence that the return, claim, statement, or other document was delivered to the agency, officer, or office to which addressed; and
> > >
> > > (B) the date of registration shall be deemed the postmark date.
> >
> > (2) Certified mail; electronic filing. The Secretary is authorized to provide by regulations the extent to which the provisions of paragraph (1) with respect to prima facie evidence of delivery and the postmark date shall apply to certified mail and electronic filing.

Reg. §301.7502-1(e)(2) provides the regulations to allow the use of certified mail to give *prima facie* evidence that the document was delivered to the office to which it was addressed:

> (i) Registered and certified mail. In the case of a document (but not a payment) sent by registered or certified mail, proof that the document was properly registered or that a postmarked certified mail sender's receipt was properly issued and that the envelope was properly addressed to the agency, officer, or office constitutes prima facie evidence that the document was delivered to the agency, officer, or office.

This means that if the taxpayer has a certified mail receipt with a proper postmark and evidence the document was addressed to the Ogden Service Center, the presumption now shifts to the IRS to show that the document was not actually delivered to the IRS—a virtually impossible task.

But the taxpayer did not use this obvious route to show the return was properly mailed and delivered to the Ogden Service Center in July 2002. Establishing the return had been delivered to the Ogden Service Center would have meant the FPAA had clearly been issued well after the statute had closed.

But at the Tax Court the taxpayer only reserved the right to later argue the return had been timely filed and, by the time the case got to the Ninth Circuit panel, "Seaview concedes that it can't prove its Form 1065 was ever received by the service center in Ogden."[754]

Presumably, despite having a certified mailing receipt of some sort, the taxpayer was unable to provide the items required by Reg. §301.7502-1(e)(2) to gain the presumption of delivery to Ogden. The issues to prove would appear to have been, at a minimum:

- A certified mailing receipt issued by the U.S. Postal Service (a receipt issued by a UPS Store or similar service that will mail documents for a taxpayer would not be sufficient);
- The receipt must contain a proper postmark, applied by a USPS employee that contains the date of the mailing, which will be treated as the postmark date under IRC §7502; and

[754] *Seaview Trading LLC v. Commissioner*, CA9, Case No. 20-72416, May 11, 2022

- The address that the document was addressed to must be able to be shown and it needs to be the proper address to which the return should have been delivered.[755]

Another reason to believe that there was some issue with the certified mail receipt is that the IRS was clearly aware of the existence of this receipt, but still acted as if no return had ever been filed.

Finally, when the Tax Court did not find that the copies represented timely filing, the taxpayer apparently did not go forward with showing it had sufficient information to obtain the presumption that the return had been delivered to the Ogden Service Center in July 2002. Rather, the taxpayer and IRS settled all other issues and only the question of whether providing the second or third copy of the return represented a filing was taken up with the Ninth Circuit Court of Appeals.

Unfortunately, since the taxpayer never asked a Court to rule upon the issue of the certified mail proof of filing and eventually simply conceded the issue away, we won't know what issue prevented the use of the certified mail receipt to resolve the matter.

The Ninth Circuit Majority Opinion

The taxpayer appealed this decision to the Ninth Circuit Court of Appeals and the case was heard by a three judge panel. Two of the judges ruled that the provision of the signed copy of the return to the IRS agent by the partnership was the filing of a proper income tax return which began the running of the statute of limitations, overturning the Tax Court decision. As that was more than three years before the FPAA was issued, the FPAA had been issued too late.

The opinion finds that the regulations govern only the filing of a *timely* return:

> …[T]he IRS regulations expressly govern the time and place to file timely partnership returns. They must be filed by April 15 following the tax year and, for partnerships with a principal place of business in California, sent to the IRS Service Center in Ogden, Utah. *See* Form 1065, Instructions. If Seaview was seeking to show a *timely* filing of its partnership return, it could not do so.[756]

Remember that the taxpayer had, by this time, conceded it could not show the form had been delivered to the Ogden Service Center (nor, it would appear, could it provide the necessary evidence to obtain the *prima facie* presumption with certified mail).

But the panel argues that the issue before it is not if Seaview timely filed its return, but whether it had properly filed the return late:

> The question is whether Seaview *belatedly* "filed" its tax return by following the instructions of IRS officials and delivering the returns to them.[757]

The majority finds that the regulations don't govern the question of whether a late return was filed:

> Section 1.6031(a)-1(e) doesn't expressly establish how taxpayers are to file delinquent returns. Nothing in the text says that the time and place requirements apply to untimely returns. Indeed, by definition, if a taxpayer files a return after

[755] Reg. §301.7502-1(e)(2)

[756] *Seaview Trading LLC v. Commissioner*, CA9, Case No. 20-72416, May 11, 2022

[757] *Seaview Trading LLC v. Commissioner*, CA9, Case No. 20-72416, May 11, 2022

> April 15, the taxpayer can't comply with § 1.6031(a)- 1(e) since the regulation specifies that date as when the return "must be filed." 26 C.F.R. § 1.6031(a)-1(e)(2). So, at most, the regulation is silent on filing procedures for late returns.[758]

The majority found no regulation prevented the filing of a tax return with an IRS official who had actually requested the return:

> As the IRS itself noted, there is more than one place for a partnership to properly file a return. For example, the law permits partnerships to hand-carry returns to certain IRS offices. See 26 U.S.C. § 6091(b)(4) (2000) (allowing filing by hand-carrying to an appropriate internal revenue district); 26 C.F.R. § 1.6091-2(d)(1) (allowing filing by hand-carrying to "any person assigned the responsibility to receive hand-carried returns in the local Internal Revenue Service office"). So an IRS service center isn't the only place a partnership can file its returns—even when timely.[759]

The majority argues that the ordinary meaning of filing should be used since the regulations fail to define the term in this context, holding:

> Based on the ordinary meaning of "filing," we hold that a delinquent partnership return is "filed" under § 6229(a) when an IRS official authorized to obtain and process a delinquent return asks a partnership for such a return, the partnership delivers the return to the IRS official in the manner requested, and the IRS official receives the return.[760]

The majority opinion goes on to note that the IRS actually *encourages* that returns be filed with IRS agents and other employees in various internal IRS guidance (the Internal Revenue Manual, a 2006 IRS Policy Statement and a 1999 Chief Counsel Advice).[761] The opinion notes that the Chief Counsel Advice[762] states a preference for such returns to be filed with the IRS agent:

> What's more, the memorandum expressed a preference for delinquent returns being filed with IRS officers. Given the costs and delays with sending a return to a service center, the Chief Counsel advised that "it is generally in the taxpayer's best interest[] to file the delinquent return directly with the revenue officer instead of mailing it to the appropriate Service Center." Id. (emphasis added); see also id. at 4 n.2. So even the IRS Chief Counsel recognizes that taxpayers can and should file a late return directly with the revenue officer rather than send it to a service center.[763]

The majority, while admitting these documents aren't necessarily binding on the IRS, uses the documents to buttress support for the idea that even the IRS sees filing as including cases where returns are delivered to IRS agents:

> The IRS doesn't deny that its internal procedures conflict with its current litigation position, but only claims that its internal "procedures are primarily for the benefit of

[758] *Seaview Trading LLC v. Commissioner*, CA9, Case No. 20-72416, May 11, 2022

[759] *Seaview Trading LLC v. Commissioner*, CA9, Case No. 20-72416, May 11, 2022

[760] *Seaview Trading LLC v. Commissioner*, CA9, Case No. 20-72416, May 11, 2022

[761] *Seaview Trading LLC v. Commissioner*, CA9, Case No. 20-72416, May 11, 2022

[762] Chief Counsel Advice No. 199933039, *Filing Delinquent Returns Directly With Revenue Officers*, August 20, 1999

[763] *Seaview Trading LLC v. Commissioner*, CA9, Case No. 20-72416, May 11, 2022

> the IRS, not taxpayers." That may be so, but the point is not whether these internal documents benefit taxpayers. The point is that the IRS's own directives confirm the plain language of the Tax Code and IRS regulations—that taxpayers may file delinquent returns with authorized officials. And the inconsistency of the IRS's position is troubling: The IRS wants the ability to direct taxpayers to submit delinquent returns to its authorized officials, while maintaining the power to unilaterally decide whether the returns are "filed" for statute-of-limitations purposes. We reject this nonsensical position and instead follow the ordinary meaning of the Tax Code.[764]

In addressing the dissent the opinion does note that several Tax Court cases support the IRS's view in this case, as well as noting cases decided outside the Ninth Circuit that held submitting a return to IRS personnel or to the wrong place doesn't constitute a filing. But in the out of circuit cases, the panel indicates that the facts aren't quite the same as the ones in this case, though the panel does not distinguish why these differences would be important and lead to a different decision (or even if they would do so in the majority's view).

The Dissent

The case comes with a rather lengthy (52 page) dissent that argues the original Tax Court decision was correct, noting:

> For many years—indeed, in all its communications with the IRS and in litigating this case before the Tax Court— Seaview maintained that it had filed its 2001 partnership return in 2002, and that it had filed the return to the correct location, the IRS service center in Ogden, Utah.1 See 26 C.F.R. § 1.6031(a)-1(e) (2001); IRS, Instructions for Form 1065 at 4 (2001). Now, Seaview acknowledges that it cannot show that its return ever reached the Ogden service center. It is therefore undisputed that Seaview failed to file its return to the correct location, either on time or belatedly. That conclusion should end our inquiry, and we should affirm the Tax Court.[765]

The dissent argues that the majority opinion sought to address what it perceived as an unfairness in the Tax Court's result:

> The majority, however, goes to great lengths to avoid the result that the plain text of the Tax Code and the IRS regulations compel, taking issue with what it sees as the IRS's "inconsistency." Maj. Op. 6–7, 16, 19. The majority relies on IRS internal guidance documents to conclude that requiring Seaview to file its partnership return at the time and place designated in the regulations is unfair. Maj. Op. 16–19.[766]

In a footnote, the dissent clarifies this reading of the majority opinion:

> To be sure, the majority avoids explicitly complaining that the Tax Code and regulations are "unfair." But the opening paragraphs of the opinion—in which the majority asks its readers to "imagine" that they, like Seaview, were mistreated when the IRS did not treat unfiled returns as properly filed returns, and laments "How can

[764] *Seaview Trading LLC v. Commissioner*, CA9, Case No. 20-72416, May 11, 2022

[765] *Seaview Trading LLC v. Commissioner*, CA9, Case No. 20-72416, Dissent, May 11, 2022

[766] *Seaview Trading LLC v. Commissioner*, CA9, Case No. 20-72416, Dissent, May 11, 2022

> this be?"—expose the majority's underlying angst that the filing requirements are unfair. Maj. Op. 6–7.[767]

The dissent goes on to argue that the majority ignores binding law and precedent to achieve its result:

> In its attempt to remedy this perceived unfairness, the majority brushes aside all sources of binding and persuasive legal authority. For the majority, it matters little that the Tax Code and regulations specify the mandatory time and place for filing a tax return, 26 U.S.C. § 6230(i) (2000); 26 C.F.R. § 1.6031(a)-1 (2001), and that Seaview never complied with those provisions. Maj. Op. 10–15. And to reach its desired result, the majority disregards Supreme Court precedent holding that taxpayers must meticulously comply with filing requirements to benefit from the statute of limitations, *Lucas v. Pilliod Lumber Co*., 281 U.S. 245, 249 (1930), and that we must strictly construe the statute of limitations in favor of the government, *Badaracco v. Comm'r*, 464 U.S. 386 (1984). Maj. Op. 19, 22 n.6. The majority also tramples the overwhelming body of case law from our sister circuits and the Tax Court rejecting the result it reaches. Maj. Op. 20– 21.

The dissent focuses on the fact that Seaview gets the return treated as filed only after failing to timely file the return:

> How does the majority manage to sidestep so much binding and persuasive legal authority? In what can only be described as an astonishing and unprecedented holding, the majority decides that because Seaview violated some subsections of the applicable statute and regulation, the remaining provisions do not apply to it. Maj. Op. 13–15 & n.2. In other words, the majority reasons that the parts of the law governing where to file a partnership return do not apply in this case because Seaview did not comply with the parts of the law governing when to file a partnership return. Maj. Op. 13–15 & n.2.
>
> … Under the majority's sweeping holding, as long as a taxpayer does not comply with the regulatory deadlines for filing a return (or in other words as long as the taxpayer submits a return late), the taxpayer is not subject to the regulation's other provisions and can "file" its return by sending it to virtually any IRS employee. Maj. Op. 10, 21 & n.4. The majority thus effects a sea change in the interpretation of long-standing, and previously uncontroversial, filing regulations.[768]

So What Do We Make of This

At this point it is important to note that the IRS may yet ask for a rehearing of this decision by a larger panel of the Ninth Circuit. But assuming the IRS does not do that or the Ninth Circuit declines to have a larger panel hear the case, for now this rule would only appear to be binding in the Ninth Circuit.

It's also important to note the unique facts of this case. Our lack of information on why no argument was made regarding the certified mail receipt being *prima facie* evidence of receipt of the return by the Ogden Service Center is an important missing fact.

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[767] *Seaview Trading LLC v. Commissioner*, CA9, Case No. 20-72416, Dissent, May 11, 2022

[768] *Seaview Trading LLC v. Commissioner*, CA9, Case No. 20-72416, Dissent, May 11, 2022

It's not clear why the IRS was so confident that the certified mail receipt would not meet the requirement of the timely filing regulations that the agency went forward with the exam even though the statute would have just expired if that delivery to Ogden took place.

Nor is it clear why the taxpayers never put the issue of the certified mail receipt before the Tax Court for a determination, rather going ahead with completing the entire exam and then going to the Court of Appeals to only argue over the question of whether this submission that initially sought to show timely filing now should be counted as an original late filing of the return.

But it probably does suggest that if a taxpayer wishes to begin the running of the statute for a late filed return that the IRS has contacted the client about, it may be best to mail a copy of that return to the appropriate IRS processing center and only provide the agent with a copy and notice that the filed return has been sent to the Service Center even if the IRS agent specifically asks the taxpayer not to send the return to the Service Center but rather give it to him/her.

The IRS position that there must be strict compliance with the regulations to begin the running of the statute would seem to mandate sending all such returns to the Service Center.

SECTION: 6651
IRS ANNOUNCES BROAD PENALTY RELIEF FOR SPECIFIED 2019 AND 2020 TAX AND INFORMATION RETURNS

Citation: Notice 2022-36, 8/24/22

In Notice 2022-36[769] the IRS has announced broad relief from certain penalties for taxpayers filing specified tax and information returns for taxable years 2019 and 2020.

Justification for Relief

Why is the IRS taking this action currently? While the Notice discussed COVID-19 related issues in general, the background concludes with what is likely the most significant factor driving this relief—the fact that, due to the backlog of unprocessed documents and returns, this is being done to hopefully clear out a lot of issues the IRS otherwise has to deal with before the agency could get back to pre-pandemic processing and response times:

> The COVID-19 pandemic has also had an unprecedented effect on the IRS's personnel and operations. The agency was called upon to support emergency relief for taxpayers, such as distributing economic impact payments, while sustaining its regular operations in a pandemic environment with limited resources, where employees were sometimes unable to be physically present to process tax returns and correspondence. In response to these challenges, the IRS has been working aggressively to process backlogged returns and taxpayer correspondence to return to normal operations for the 2023 filing season. The Treasury Department and the IRS have determined that the penalty relief described in this notice will allow the IRS to focus its resources more effectively, as well as provide relief to taxpayers affected by the COVID-19 pandemic.[770]

[769] Notice 2022-36, August 24, 2022, https://www.irs.gov/pub/irs-drop/n-22-36.pdf (retrieved August 24, 2022)

[770] Notice 2022-36, Section 2, August 24, 2022

A footnote references the additional work given the IRS to process the three rounds of economic impact payments:

> The IRS, in coordination with the Bureau of the Fiscal Service, issued more than 476.1 million payments through three rounds of economic impact payments, totaling more than $814.4 billion during 2020 and 2021. IRS Data Book, 2021, Publication 55-B.[771]

Relief Granted-Waiver and Abatement of Penalties

The relief applies from penalties specified in the Notice for the specified tax returns for taxable years 2019 and 2020 that are filed before September 30, 2022. The penalties "will be automatically abated, refunded, or credited, as appropriate without any need for taxpayers to request this relief."[772]

Failure to File Penalty Under IRC §6651(a)(1)

The additions to tax for failure to file under IRC §6651(a)(1) are abated and waived for the following income tax returns:

- Form 1040, *U.S. Individual Income Tax Return*;
- Form 1040-C, *U.S. Departing Alien Income Tax Return*;
- Form 1040-NR, *U.S. Nonresident Alien Income Tax Return*;
- Form 1040-NR-EZ, *U.S. Income Tax Return for Certain Nonresident Aliens With No Dependents*;
- Form 1040 (PR), *Federal Self-Employment Contribution Statement for Residents of Puerto Rico*;
- Form 1040-SR, U.S. Tax Return for Seniors;
- Form 1040-SS, *U.S. Self-Employment Tax Return (Including the Additional Child Tax Credit for Bona Fide Residents of Puerto Rico)*;
- Form 1041, *U.S. Income Tax Return for Estates and Trusts*;
- Form 1041-N, *U.S. Income Tax Return for Electing Alaska Native Settlement Trusts*;
- Form 1041-QFT, *U.S. Income Tax Return for Qualified Funeral Trusts*;
- Form 1041, *U.S. Income Tax Return for Estates and Trusts*;
- Form 1041-N, *U.S. Income Tax Return for Electing Alaska Native Settlement Trusts*;
- Form 1041-QFT, *U.S. Income Tax Return for Qualified Funeral Trusts*;
- Form 1120, *U.S. Corporation Income Tax Return*;

[771] Notice 2022-36, Section 2, August 24, 2022

[772] Notice 2022-36, Section 3.A, August 24, 2022

- Form 1120-C, *U.S. Income Tax Return for Cooperative Associations*;
- Form 1120-F, *U.S. Income Tax Return of a Foreign Corporation*;
- Form 1120-FSC, *U.S. Income Tax Return of a Foreign Sales Corporation*;
- Form 1120-H, *U.S. Income Tax Return for Homeowners Associations*;
- Form 1120-L, *U.S. Life Insurance Company Income Tax Return*;
- Form 1120-ND, *Return for Nuclear Decommissioning Funds and Certain Related Persons*;
- Form 1120-PC, *U.S. Property and Casualty Insurance Company Income Tax Return*;
- Form 1120-POL, *U.S. Income Tax Return for Certain Political Organizations*;
- Form 1120-REIT, *U.S. Income Tax Return for Real Estate Investment Trusts*;
- Form 1120-RIC, *U.S. Income Tax Return for Regulated Investment Companies*;
- Form 1120-SF, *U.S. Income Tax Return for Settlement Funds (Under Section 468B)*;
- Form 1066, *U.S. Real Estate Mortgage Investment Conduit (REMIC) Income Tax Return*;
- Form 990-PF, *Return of Private Foundation or Section 4947(a)(1) Trust Treated as Private Foundation*; and
- Form 990-T, *Exempt Organization Business Income Tax Return (and Proxy Tax Under Section 6033(e))*.[773]

Certain Penalties Under IRC §§6038, 6038A, 6038C, 6039F and 6677 for Failure to File Certain International Information Returns

The following penalties for failure to timely file the following international information returns will be abated and waived by the IRS:

- Penalties systematically assessed when a Form 5471, *Information Return of U.S. Persons With Respect To Certain Foreign Corporations*, and/or Form 5472, *Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business*, is attached to a late-filed Form 1120 or Form 1065; and
- Penalties assessed by the campus assessment program with respect to filings on Form 3520, *Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts*, and on Form 3520-A, *Annual Information Return of Foreign Trust With a U.S. Owner (Under section 6048(b))*.[774]

[773] Notice 2022-36, Section 3.A(1), August 24, 2022

[774] Notice 2022-36, Section 3.A(2), August 24, 2022

Partnership and S Corporation Late Filing

Also waived and abated are:

- Penalties under section 6698(a)(1) for failure to timely file and under section 6698(a)(2) for failure to show the required information on a Form 1065, *U.S. Return of Partnership Income* and

- Penalties under section 6699(a)(1) for failure to timely file and under section 6699(a)(2) for failure to show the required information on a Form 1120-S, *U.S. Income Tax Return for an S corporation*.[775]

Information Returns

The IRS also will not impose penalties for failure to timely file an information return under IRC §6721(a)(2)(A) that meet the following criteria:

- 2019 returns that were filed on or before August 1, 2020, with an original due date of January 31, 2020; February 28, 2020 (if filed on paper) or March 31, 2020 (if filed electronically); or March 15, 2020; or

- 2020 returns that were filed on or before August 1, 2021, with an original due date of January 31, 2021; February 28, 2021 (if filed on paper) or March 31, 2021 (if filed electronically); or March 15, 2021.[776]

Penalties for Which Relief is Not Granted

The IRS provides the following information regarding penalties that won't be waived or abated under this Notice:

> The penalty relief described in this notice does not apply to any penalties that are not specifically listed in the grant of relief under section 3.A of this notice. In addition, the penalty relief described in section 3.A of this notice is not available with respect to any return to which the penalty for fraudulent failure to file under section 6651(f) or the penalty for fraud under section 6663 applies. The penalty relief described in this notice also does not apply to any penalties in an accepted offer in compromise under section 7122 because acceptance of the offer conclusively settled all of the liabilities in the offer under § 301.7122-1(e)(5) of the Procedure and Administration Regulations. The penalty relief described in this notice does not apply to any penalty settled in a closing agreement under section 7121 or finally determined in a judicial proceeding.[777]

In News Release 2022-155, released at the same time as the Notice, the IRS described what taxpayers who have previously paid these penalties should expect:

> Penalty relief is automatic. This means that eligible taxpayers need not apply for it. If already assessed, penalties will be abated. If already paid, the taxpayer will receive a credit or refund.

[775] Notice 2022-36, Section 3.A(3), August 24, 2022

[776] Notice 2022-36, Section 3.A, August 24, 2022

[777] Notice 2022-36, Section 3.B, August 24, 2022

> As a result, nearly 1.6 million taxpayers who already paid the penalty are receiving refunds totaling more than $1.2 billion. Most eligible taxpayers will receive their refunds by the end of September.[778]

SECTION: 6651
NATIONAL TAXPAYER ADVOCATE PUBLISHES BLOG POST TO EXPLAIN IRS PENALTY RELIEF

Citation: "NTA Blog: Good News: The IRS Is Automatically Providing Late Filing Penalty Relief for Both 2019 and 2020 Tax Returns. Taxpayers Do Not Need to Do Anything to Receive this Administrative Relief," NTA Blog, 8/24/22

The National Taxpayer Advocate published a blog post[779] that discussed the impact of Notice 2022-36 that was issued by the IRS. The information in the blog clarifies issues related to the Notice.

Failure to File Penalty is Waived, But Not Failure to Pay

The Notice did not provide a waiver for all penalties, and the blog begins by noting that while the failure to file penalty under IRC §6651(a)(1) is waived under the Notice, the relief does not apply to the failure to pay penalty under IRC §6651(a)(2) that such taxpayers would generally also be subject to.

The blog post notes:

> A *failure-to-file penalty* (IRC § 6651(a)(1)) is charged on returns filed after the due date or extended due date, absent a reasonable cause for filing late. The penalty is generally calculated at five percent of the tax liability for each month the return is filed late, up to a maximum of 25 percent. For example, if you owe $10,000, the penalty is $500 per month, up to a maximum of $2,500. Beyond the failure-to-file penalty, there are additional penalties for failure to file information returns that fall under various IRC sections. Many taxpayers subject to failure-to-file penalties also receive penalties under IRC § 6651(a)(2) for failing to pay the tax due by the due date of the return. These are two distinct penalty categories.
>
> These failure-to-file penalties generated additional account inquiries and requests for relief, which only further strained already-inadequate customer service resources and increased the paper correspondence awaiting processing. Because of the scale of the problem, the National Taxpayer Advocate, members of Congress, and tax

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[778] "COVID tax relief: IRS provides broad-based penalty relief for certain 2019 and 2020 returns due to the pandemic; $1.2 billion in penalties being refunded to 1.6 million taxpayers," IRS News Release IR-2022-155, August 24, 2022, https://www.irs.gov/newsroom/covid-tax-relief-irs-provides-broad-based-penalty-relief-for-certain-2019-and-2020-returns-due-to-the-pandemic-1-point-2-billion-in-penalties-being-refunded-to-1-point-6-million-taxpayers (retrieved August 24, 2022)

[779] "NTA Blog: Good News: The IRS Is Automatically Providing Late Filing Penalty Relief for Both 2019 and 2020 Tax Returns. Taxpayers Do Not Need to Do Anything to Receive this Administrative Relief," NTA Blog, August 24, 2022, https://www.taxpayeradvocate.irs.gov/news/nta-blog-the-irs-is-automatically-providing-late-filing-penalty-relief-for-both-2019-and-2020-tax-returns/ (retrieved August 28, 2022)

> practitioner groups called on the IRS to implement a comprehensive remedy, including reversing and removing penalties. To its credit, the IRS has acted and today announced a broad late-filing administrative penalty relief program. This program only applies to penalties for late filing and does not apply to penalties for failing to pay the tax due by the original deadline.[780]

Mechanics of the Relief Program

The blog indicates how the program will process relief:

> The IRS's penalty relief program commences on August 25, 2022, and automatically provides late-filing penalty relief without the need for taxpayers to request the relief and will continue to be applied to returns received through September 30, 2022. Notices and refunds are being initiated now and many of the refunds will be completed by the end of September. Certain penalties abated manually, such as those associated with the late filing of Forms 3520 and 3520-A, will take somewhat longer to process.[781]

The post also notes that refunds for penalties already paid will most likely be made by check:

> If penalties have been assessed, they will be removed, and if a request for abatement was denied, it will now be automatically granted. If the abatement or removal of penalties generates a refund, it will first be applied to any outstanding liabilities and the balance will be paid by check and mailed to taxpayers' current address in the IRS's system. There is no option for direct deposit or debit card. In very rare circumstances, a small percentage of taxpayers will receive their refund via direct deposit, but the overwhelming majority of refunds will be distributed via check.[782]

Impact on First Time Abatement of This Program

The blog also clarifies how this relief affects first time abatement relief:

> **First Time Abatement and reasonable cause not impacted**. This unprecedented program is conceptualized as broad administrative penalty relief and is designed specifically to meet the exigent circumstances of the pandemic. The relief does not fall into the category of either the First Time Abatement (FTA) or reasonable cause relief. FTA is an administrative waiver that provides otherwise-compliant taxpayers relief from penalties if certain criteria are met. The policy behind FTA is to reward taxpayers for having a clean compliance history, while recognizing that taxpayers occasionally make a mistake. The reasonable cause defense to the assertion of penalties, which is defined in the Internal Revenue Code, generally is based on the taxpayer's facts and circumstances in determining if a taxpayer exercised ordinary business care and prudence.

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[780] "NTA Blog: Good News: The IRS Is Automatically Providing Late Filing Penalty Relief for Both 2019 and 2020 Tax Returns. Taxpayers Do Not Need to Do Anything to Receive this Administrative Relief," NTA Blog, August 24, 2022

[781] "NTA Blog: Good News: The IRS Is Automatically Providing Late Filing Penalty Relief for Both 2019 and 2020 Tax Returns. Taxpayers Do Not Need to Do Anything to Receive this Administrative Relief," NTA Blog, August 24, 2022

[782] "NTA Blog: Good News: The IRS Is Automatically Providing Late Filing Penalty Relief for Both 2019 and 2020 Tax Returns. Taxpayers Do Not Need to Do Anything to Receive this Administrative Relief," NTA Blog, August 24, 2022

> The current penalty relief program will neither preclude taxpayers from receiving FTA for the next three years nor require justification, as would be the case with a request for reasonable cause. It is simply a favorable grant of administrative forbearance that the IRS is providing to benefit taxpayers and to address its own administrative burdens.

SECTION: 7701
IRS INFORMATION LETTER ADDRESSES CASES WHERE A CONTROLLER IS AND IS NOT A PAID PREPARER OF RETURNS

Citation: INFO 2021-0029, 12/30/21

In IRS Information Letter 2021-0029[783] the agency addresses an issue that CPAs employed as a controller in small, closely held businesses with various related businesses run into. If they are asked to prepare a number of returns for individuals and other related entities that aren't their employer, at what point does the controller become a paid preparer with regard to some or all of those returns.

The letter addresses this specific concern of the party to whom the letter is addressed:

> As we understand the facts provided, you prepare a number of income tax returns for your employer, an S-Corporation, for whom you have been employed for over seven years. The entities you prepare returns for include partnerships and individuals. You state that these partnerships are Limited Liability Companies related to your employer, and that these individuals are employed by the taxpayer. You ask whether you are required to sign these returns as a tax preparer.[784]

The letter first addresses the general rule governing such situations:

> The definition of "tax return preparer" found in section 7701(a)(36)(A) of the Internal Revenue Code (Code) includes any person who prepares a return for compensation. Section 7701(a)(36)(B) of the Code states that a person is not a preparer merely because they prepare returns for an employer for whom they are continuously employed. This exception includes persons who prepare returns for officers and other employees of the employer.[785]

The letter then provides detailed information on how the party to whom the letter is addressed can resolve his/her situation:

> Treasury Regulation § 301.7701-15(f)(1)(ix) states that individuals preparing returns for an employer, including returns prepared for an officer, general partner, member, shareholder, or employee, are not considered tax return preparers.

Thus, if the individuals for whom the controller is preparing a return fits one of those categories, the controller is not a paid preparer for that return. But if an individual does not fit into one of those categories, then the controller would be a paid preparer for that return.

[783] INFO 2021-0029, December 30, 2021, https://www.irs.gov/pub/irs-wd/21-0029.pdf (retrieved January 7, 2022)

[784] INFO 2021-0029, December 30, 2021

[785] INFO 2021-0029, December 30, 2021

The letter continues to look at related *corporations* where an employee of one will be considered an employee of the other:

> Treasury Regulation § 301.7701-15(f)(4) further states that the employee of a corporation owning more than 50 percent of the voting power of another corporation, or the employee of a corporation more than 50 percent of the voting power of which is owned by another corporation, is considered the employee of the other corporation as well. Treasury Regulation § 301.7701-15(f)(1)(ix) therefore applies to an employee preparing a return for an entity described in Treasury Regulation § 301.7701-15(f)(4) as well.[786]

As noted above, Treasury Regulation § 301.7701-15(f)(1)(ix) would allow preparing returns for an officer, general partner, member, shareholder, or employee of those organizations as well. But note that the regulation only refers to related corporations. This would appear to make the limited liability companies taxed as partnerships entities not covered by this exception, making the controller a paid preparer with regard to returns for those entities under the general rule found at Treasury Regulation § 301.7701-15(a) which states:

> A tax return preparer is any person who prepares for compensation, or who employs one or more persons to prepare for compensation, all or a substantial portion of any return of tax or any claim for refund of tax under the Internal Revenue Code (Code).[787]

[786] INFO 2021-0029, December 30, 2021

[787] Treasury Regulation §301.7701-15(a)

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