Key Tax Planning Concepts and Issues

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KEY TAX PLANNING CONCEPTS AND ISSUES (KTP)
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UNIT 1

Introduction to Tax Planning Concepts

LEARNING OBJECTIVES

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

- Explain the relationship of tax planning to tax practice for a CPA.
- Outline the key issues a CPA must be aware of when undertaking a tax planning engagement.

Today, we are going to look at tax planning in general. Most often we take continuing education courses that look at a specific narrow technical area and may discuss "planning" with regard to specific transactions. But we don't often consider what exactly is that makes up tax planning?

Is tax planning merely tax minimization? Or is it something more than that? Is it something primarily undertaken during preparing a taxpayer's annual tax return or is it a separate process undertaken normally at a different time?

And, more to the point, what exactly qualifies as planning? When a new law is passed by Congress, how does the CPA recognize the tax planning opportunities that exist in that law? And how do we know when we cross the lines from acceptable tax planning that will survive an IRS challenge to overly aggressive planning that does not hold up under examination or, far worse, tax evasion?

CONCEPTS—THE THEORY UNDERLYING TAX PLANNING

This session begins with a discussion of tax planning concepts and theory in general. We hope to help you leave with additional skills to recognize tax planning opportunities beyond those that are brought to your attention by others.

As well, how do we recognize true planning opportunities as opposed to pure marketing hype that might be used to entice a client to purchase an otherwise less than suitable investment based on the promise of tax savings?

It is important to recognize that tax planning is often synonymous with tax avoidance. Tax avoidance is legal, while tax evasion is illegal.

There are various gray areas in the tax code that allow CPAs to decide on what position to take based on their judgement. Often, CPAs may need to "run the numbers" in each scenario to come up with a better position for the client based on the client's objective.

For example, a client's objective may be to purchase a house and thus the client must show higher levels of income. In this scenario, the client may not want to push for aggressive depreciation, such as the Bonus Depreciation. On the other hand, if your client's objective is to reduce tax liability then the CPA would apply all tax savings that will benefit the client.

SPECIFIC EXAMPLES OF TRANSACTIONS IMPLEMENTING PLANNING CONCEPTS

CPAs tend to want concrete examples rather than merely theory, so we spend time looking at specific tax planning transactions that fall into the categories we'll discuss. Some of these you will likely be aware of, but others might be new.

While this course is not a deep dive into these particular areas, we do plan to look at these items in enough deal to recognize when they could apply and how they involve the tax planning concepts we'll discuss.

KNOWING WHEN A LINE IS BEING CROSSED

Finally, we'll look at the professional and regulatory/law based standards that apply to CPAs and their clients when undertaking transactions that aim to achieve a tax planning goal.

EXAMPLE WARNING

We will include examples in this manual for illustrative purposes. Note that such examples, unless clearly labeled as being based on specific examples found in the regulations or other sources that have legal standing, are based solely on the author's reading of the statutes, regulations, case law and other guidance as they exist at the date this manual was written.

These examples written by the author should never be used as the sole basis for taking action by a CPA. As a tax professional you are assumed to be aware that such editorial material does not meet the standards found in Reg. §1.6662-4 for a finding of substantial authority, nor do they constitute authority that can be relied upon for the safe harbor regarding establishing a disclosed position had a reasonable basis. These examples should serve as a starting point for your research and establish your position meets the required standard. They should never serve as the totality of your work in that area. Doing that is substandard work that can result in disastrous results for the client and the CPA.

We may choose to include examples that are taken from the regulations, revenue rulings, or other binding on the IRS (at least to some extent) guidance in the materials since they do represent very useful authority assuming the taxpayer's facts aren't distinguishable. We will clearly label such examples when they appear. We include those examples, most often verbatim, because they are more valuable to the true tax professional in their practice.

Even with those examples, you should read them in the context they are found in the original material from which they are drawn and assure that the guidance has not been superseded in the interim.

KNOWLEDGE LEVEL

Tax planning requires a solid foundation in basic tax principles, including a thorough understanding of tax compliance issues, thus this course will assume that you have come here with experience in handling compliance issues under the tax law and are looking to gain skills in handling issues beyond compliance.

Ultimately, tax planning results in a reporting position (or a position that an item does not have to reported) that impacts tax return(s) of the client. Thus, attempting to do tax planning work without a thorough understanding of the item you expect the planning to influence (tax return(s) of the client) is not likely to be terribly successful.

TAX LAW CHANGES

In having the knowledge base to perform tax-planning engagements, practitioners should continually keep themselves updated with changes in the tax law.

To date, 2022 has seen limited federal tax legislation in the Inflation Reduction Act (IRA) and United States Innovation and Competition Act of 2021 (USICA aka CHIPS-plus Act). The IRA contains a multitude of energy credits, an excise tax on stock repurchases, and a new corporate alternative minimum tax (AMT). The IRA also extends the limitation on excess business losses for pass-through entities, set to expire in 2027 for an additional two years. Pass-through entities include sole proprietorships, S-Corps, some LLCs, and partnerships.

This law disallows pass-through owners from using business losses exceeding $250,000 to offset nonbusiness income. The threshold is $500,000 for married couples filing jointly. These numbers adjust for inflation and in 2022 are $270,000 and $540,000, respectively.

There is a 15% corporate alternative minimum tax on corporations with over $1 billion in revenue and a 1% excise tax on corporate share buybacks.

The provisions relating to individuals include health care provisions and, as stated earlier, are mainly energy efficient credits. The IRA includes an extension of the Affordable Care Act (ACA) funding through 2025. Extension of the American Rescue Plan Act (ARPA), temporary exception, that allows taxpayers with incomes above 400% of the Federal Poverty Level to qualify for the Premium Tax Credit.

A tax credit is more advantageous when compared to a tax deduction, as a tax credit is a dollar-for-dollar reduction of the money owed. In contrast, a tax deduction will decrease taxable income, leading to a slightly lower tax bill.

Thus, individuals should be made aware of these credits for tax planning purposes.

The Inflation Reduction Act includes the following credits:

- Energy Efficient Home Improvement Credit
- The Nonbusiness Energy Property Credit was extended through 2032 and renamed the Energy Efficient Home Improvement Credit.
- Starting in 2023, the credit will be equal to 30% of the costs of all eligible home improvements made during the year. Additionally:
- The $500 lifetime limit on the total credit amount will be replaced with a $1,200 annual limit.

The annual limits for specific types of qualifying improvements will be:

- $150 for home energy audits;
- $250 for any exterior door ($500 total for all exterior doors) that meet applicable Energy Star requirements;
- $600 for exterior windows and skylights that meet Energy Star most efficient certification requirements;
- $600 for other qualified energy property, including central air conditioners; electric panels, and certain related equipment; natural gas, propane, or oil water heaters; oil furnaces; water boilers;
- $2,000 for heat pump and heat pump water heaters; biomass stoves and boilers. This category of improvement is not limited by the $1,200 annual limit on total credits or the $600 limit on qualified energy property; and
- Roofing will no longer qualify.

For eligible home improvements using products placed in service after 2024, no credit will be allowed unless the manufacturer of any purchased item creates a product identification number for the product and the taxpayer claiming the credit includes the number on his or her return for that tax year.

Note: For 2022, the prior credit rules apply.

RESIDENTIAL CLEAN ENERGY CREDIT

The Residential Energy Efficient Property Credit, now called the Residential Clean Energy Credit, was previously scheduled to expire at the end of 2023 but has been extended through 2034. The Inflation Reduction Act also increased the credit amount, with a phaseout of the applicable percentage.

Amount of Credit:

- 30% for 2023–2032;
- 26% for 2033; and
- 22% for 2034.

The credit no longer applies to biomass furnaces and water heaters, now covered under the Energy Efficient Home Improvement Credit. Starting in 2023, however, the new credit will apply to battery storage technology with a capacity of at least three kilowatt hours.

How to Claim the Residential Energy Credits

A taxpayer needs to complete Form 5695 to claim the residential energy credits.

Form **5695**

Department of the Treasury
Internal Revenue Service

Residential Energy Credits

Go to *www.irs.gov/Form5695* for instructions and the latest information.
Attach to Form 1040, 1040-SR, or 1040-NR.

OMB No. 1545-0074
2022
Attachment Sequence No. 158

Name(s) shown on return | Your social security number

Part I **Residential Clean Energy Credit** (See instructions before completing this part.)

Note: Skip lines 1 through 11 if you only have a **credit carryforward from 2021**.

Line	Description				
1	Qualified solar electric property costs			1	
2	Qualified solar water heating property costs			2	
3	Qualified small wind energy property costs			3	
4	Qualified geothermal heat pump property costs			4	
5	Qualified biomass fuel property costs			5	
6a	Add lines 1 through 5			6a	
b	Multiply line 6a by 30% (0.30)			6b	
7a	Qualified fuel cell property. Was qualified fuel cell property installed on, or in connection with, your main home located in the United States? (See instructions.)			7a	☐ Yes ☐ No
	Caution: If you checked the “No” box, you cannot take a credit for qualified fuel cell property. Skip lines 7b through 11.				
b	Print the complete address of the main home where you installed the fuel cell property.				
	Number and street / Unit No.				
	City, State, and ZIP code				
8	Qualified fuel cell property costs	8			
9	Multiply line 8 by 30% (0.30)	9			
10	Kilowatt capacity of property on line 8 above . . . ______ . ______ x $1,000	10			
11	Enter the smaller of line 9 or line 10			11	
12	Credit carryforward from 2021. Enter the amount, if any, from your 2021 Form 5695, line 16			12	
13	Add lines 6b, 11, and 12			13	
14	Limitation based on tax liability. Enter the amount from the Residential Clean Energy Credit Limit Worksheet (see instructions)			14	
15	**Residential clean energy credit.** Enter the smaller of line 13 or line 14. Also include this amount on Schedule 3 (Form 1040), line 5			15	
16	Credit carryforward to 2023. If line 15 is less than line 13, subtract line 15 from line 13	16			

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 13540P Form **5695** (2022)

Form 5695 (2022) Page 2

Part II **Energy Efficient Home Improvement Credit**

17a	Were the qualified energy efficiency improvements or residential energy property costs for your main home located in the United States? (see instructions)			**17a**	☐ Yes ☐ No
	Caution: If you checked the "No" box, you cannot claim the energy efficient home improvement credit. Do not complete Part II.				
b	Print the complete address of the main home where you made the qualifying improvements. **Caution:** You can only have one main home at a time. Number and street ____ Unit No. ____ City, State, and ZIP code ____				
c	Were any of these improvements related to the construction of this main home?			**17c**	☐ Yes ☐ No
	Caution: If you checked the "Yes" box, you can only claim the energy efficient home improvement credit for qualifying improvements that were not related to the construction of the home. Do not include expenses related to the construction of your main home, even if the improvements were made after you moved into the home.				
18	Lifetime limitation. Enter the amount from the Lifetime Limitation Worksheet (see instructions)			**18**	
19	Qualified energy efficiency improvements (original use must begin with you and the component must reasonably be expected to last for at least 5 years; do not include labor costs) (see instructions).				
a	Insulation material or system specifically and primarily designed to reduce heat loss or gain of your home that meets the prescriptive criteria established by the 2009 IECC			**19a**	
b	Exterior doors that meet or exceed the version 6.0 Energy Star program requirements			**19b**	
c	Metal or asphalt roof that meets or exceeds the Energy Star program requirements and has appropriate pigmented coatings or cooling granules which are specifically and primarily designed to reduce the heat gain of your home			**19c**	
d	Exterior windows and skylights that meet or exceed the version 6.0 Energy Star program requirements	**19d**			
e	Maximum amount of cost on which the credit can be figured	**19e**	*$2,000*		
f	If you claimed window expenses on your Form 5695 prior to 2022, enter the amount from the Window Expense Worksheet (see instructions); otherwise enter -0-	**19f**			
g	Subtract line 19f from line 19e. If zero or less, enter -0-	**19g**			
h	Enter the smaller of line 19d or line 19g			**19h**	
20	Add lines 19a, 19b, 19c, and 19h			**20**	
21	Multiply line 20 by 10% (0.10)			**21**	
22	Residential energy property costs (must be placed in service by you; include labor costs for onsite preparation, assembly, and original installation) (see instructions).				
a	Energy-efficient building property. Do not enter more than **$300**			**22a**	
b	Qualified natural gas, propane, or oil furnace or hot water boiler. Do not enter more than **$150**			**22b**	
c	Advanced main air circulating fan used in a natural gas, propane, or oil furnace. Do not enter more than **$50**			**22c**	
23	Add lines 22a through 22c			**23**	
24	Add lines 21 and 23			**24**	
25	Maximum credit amount. (If you jointly occupied the home, see instructions)			**25**	*$500*
26	Enter the amount, if any, from line 18			**26**	
27	Subtract line 26 from line 25. If zero or less, **stop;** you cannot take the energy efficient home improvement credit			**27**	
28	Enter the smaller of line 24 or line 27			**28**	
29	Limitation based on tax liability. Enter the amount from the Energy Efficient Home Improvement Credit Limit Worksheet (see instructions)			**29**	
30	**Energy efficient home improvement credit.** Enter the smaller of line 28 or line 29. Also include this amount on Schedule 3 (Form 1040), line 5			**30**	

Form **5695** (2022)

CLEAN VEHICLE CREDITS

The IRA extends the Clean Vehicle Credit until the end of 2032 and creates new credits for previously owned clean vehicles and qualified commercial clean vehicles.

Tax credits include up to:

- $7,500 for the purchase of new qualified commercial clean vehicles;
- $40,000 for vehicles over 14,000 pounds; and
- the lesser of 30% of the price of used electric vehicles or $4,000.

Limitations apply based on the manufacturer's suggested retail price of the vehicle. There are also limitations for the new vehicle credit based on adjusted gross income (AGI) thresholds—for single or married filing separately taxpayers, the limit is $150,000; for taxpayers filing as head of household, the limit is $225,000; and for married filing jointly, or surviving spouse taxpayers, the limit is $300,000. Reduced AGI limitations apply to the used vehicle credit.

Starting in 2024, the Inflation Reduction Act establishes a mechanism that will allow car buyers to transfer the credit to dealers at the point of sale so that it can directly reduce the purchase price.

If you buy a new plug-in electric vehicle (EV) or fuel cell vehicle (FCV) in 2023 or after, you may qualify for a clean vehicle tax credit. Find out if you qualify.

Find information on credits for used clean vehicles, qualified commercial clean vehicles, and new plug-in EVs purchased before 2023.

Credits for New Clean Vehicles Purchased in 2023 or After

Who Qualifies

You may qualify for a credit up to $7,500 under Internal Revenue Code Section 30D if you buy a new, qualified plug-in EV or fuel cell electric vehicle (FCV). The Inflation Reduction Act of 2022 changed the rules for this credit for vehicles purchased from 2023 to 2032.

The credit is available to individuals and their businesses.

To qualify, you must:

- Buy it for your own use, not for resale.
- Use it primarily in the U.S.

In addition, your modified adjusted gross income (AGI) may not exceed:

- $300,000 for married couples filing jointly
- $225,000 for heads of households
- $150,000 for all other filers

You can use your modified AGI from the year you take delivery of the vehicle or the year before, whichever is less. If your modified AGI is below the threshold in one of the two years, you can claim the credit.

The credit is nonrefundable, so you can't get back more on the credit than you owe in taxes. You can't apply any excess credit to future tax years.

Qualified Vehicles

To qualify, a vehicle must:

- Have a battery capacity of at least 7 kilowatt hours.
- Have a gross vehicle weight rating of less than 14,000 pounds.
- Be made by a qualified manufacturer. See our index of qualified manufacturers and vehicles.
  - FCVs do not need to be made by a qualified manufacturer to be eligible. See Rev. Proc. 2022-42PDF for more detailed guidance.
- Undergo final assembly in North America

The sale qualifies only if:

- You buy the vehicle new.
- The seller reports required information to you at the time of sale and to the IRS.
  - Sellers are required to report your name and taxpayer identification number to the IRS for you to be eligible to claim the credit.

In addition, the vehicle's manufacturer suggested retail price (MSRP) can't exceed:

- $80,000 for vans, sport utility vehicles, and pickup trucks
- $55,000 for other vehicles

MSRP is the retail price of the automobile suggested by the manufacturer, including options, accessories, and trim but excluding destination fees. It isn't necessarily the price you pay.

How to Claim the Clean Vehicle Credit

The taxpayer would need to complete Form 8936, Qualified Plug-In Electric Drive Motor Vehicle Credit to claim the credit.

Form **8936** (Rev. January 2022) Department of the Treasury Internal Revenue Service

Qualified Plug-in Electric Drive Motor Vehicle Credit
(Including Qualified Two-Wheeled Plug-in Electric Vehicles)
► Attach to your tax return.
► Go to *www.irs.gov/Form8936* for instructions and the latest information.

OMB No. 1545-2137
Attachment Sequence No. 69

Name(s) shown on return	Identifying number

Note:
- Use this form to claim the credit for certain plug-in electric vehicles.
- Claim the credit for certain alternative motor vehicles on Form 8910.

Part I Tentative Credit

Use a separate column for each vehicle. If you need more columns, use additional Forms 8936 and include the totals on lines 12 and 19.		**(a)** Vehicle 1	**(b)** Vehicle 2
1 Year, make, and model of vehicle	**1**		
2 Vehicle identification number (see instructions) . .	**2**		
3 Enter date vehicle was placed in service (MM/DD/YYYY)	**3**		
4a If the vehicle is a two-wheeled vehicle, enter the cost of the vehicle. If the vehicle has at least four wheels, see instructions	**4a**		
b Phase-out percentage (see instructions)	**4b**	%	%
c Tentative credit. Multiply line 4a by line 4b	**4c**		

Next: If you did NOT use your vehicle for business or investment purposes and did not have a credit from a partnership or S corporation, skip Part II and go to Part III. All others, go to Part II.

Part II Credit for Business/Investment Use Part of Vehicle

5 Business/investment use percentage (see instructions)	**5**	%	%
6 Multiply line 4c by line 5. If the vehicle has at least four wheels, leave lines 7 through 10 blank and go to line 11	**6**		
7 Section 179 expense deduction (see instructions) .	**7**		
8 Subtract line 7 from line 6	**8**		
9 Multiply line 8 by 10% (0.10)	**9**		
10 Maximum credit per vehicle	**10**	2,500	2,500
11 For vehicles with four or more wheels, enter the amount from line 6. If the vehicle is a two-wheeled vehicle, enter the smaller of line 9 or line 10 . . .	**11**		

12 Add columns (a) and (b) on line 11	**12**	
13 Qualified plug-in electric drive motor vehicle credit from partnerships and S corporations (see instructions)	**13**	
14 **Business/investment use part of credit.** Add lines 12 and 13. Partnerships and S corporations, stop here and report this amount on Schedule K. All others, report this amount on Form 3800, Part III, line 1y	**14**	

Note: Complete Part III to figure any credit for the personal use part of the vehicle.

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 37751E Form **8936** (Rev. 1-2022)

Form 8936 (Rev. 1-2022) Page 2

Part III Credit for Personal Use Part of Vehicle

			(a) Vehicle 1	(b) Vehicle 2
15	If you skipped Part II, enter the amount from line 4c. If you completed Part II, subtract line 6 from line 4c. If the vehicle has at least four wheels, leave lines 16 and 17 blank and go to line 18	15		
16	Multiply line 15 by 10% (0.10)	16		
17	Maximum credit per vehicle. If you skipped Part II, enter $2,500. If you completed Part II, subtract line 11 from line 10	17		
18	For vehicles with four or more wheels, enter the amount from line 15. If the vehicle is a two-wheeled vehicle, enter the smaller of line 16 or line 17 . . .	18		
19	Add columns (a) and (b) on line 18		19	
20	Enter the amount from Form 1040, 1040-SR, or 1040-NR, line 18		20	
21	Personal credits from Form 1040, 1040-SR, or 1040-NR (see instructions)		21	
22	Subtract line 21 from line 20. If zero or less, enter -0- and stop here. You cannot claim the personal use part of the credit		22	
23	**Personal use part of credit.** Enter the **smaller** of line 19 or line 22 here and on Schedule 3 (Form 1040), line 6f. If line 22 is smaller than line 19, see instructions . .		23	

Form **8936** (Rev. 1-2022)

Besides the IRA, taxpayers continue to wait on further guidance pertaining to the many other tax provisions enacted over the past five years. Finally, the CHIPS-plus Act includes over $52 billion for semiconductor facilities plus a 25% tax credit for semiconductor manufacturing.[1]

In 2019, Congress passed the Setting Every Community Up for Retirement Enhancement Act (SECURE Act). In 2020 alone, Congress passed two distinct tax laws: the Coronavirus Aid, Relief, and Economic Security (CARES) Act and the Consolidated Appropriation Act (CAA). Some of the provisions in these acts are sunset provisions and other provisions extended the provisions of the Tax Cuts and Jobs Act (TCJA) of 2017, while various provisions are new.

An example of a sunset provision is the business meals provision in the CAA that is 100% deductible for the years 2021 and 2022.

An example of an extension of the provisions is where the employee Social Security payment portion of the payroll taxes that was deferred in 2020 and due for repayment between January and April 2021 under the CARES Act is now due by January 3, 2022, under the CAA. An explanation of changes related to the SECURE Act of 2019, the CARES Act of 2020, and the CAA of 2021 with the related tax planning strategies are discussed in a later chapter.

Without adequate knowledge of the tax law, tax regulations, and other regulatory publications, proper tax planning cannot occur, and this may lead to a detrimental impact to the CPA and the client.

For example, in 2017, the partnership return filing due date changed from April 15 to March 15. If a CPA was not aware of the change, the result would have been interest and penalties charged to the client. The CPA would likely be responsible for the charges if the CPA was

1 https://www.bakertilly.com/page/year-end-tax-planning?utm_source=googleads&utm_medium=paidsearch&utm_campaign=Team+2%3A+YETL+2022+%28+Tax+%29&utm_id=18592956450&utm_content=alwayson&gclid=CjwKCAiAp7GcBhA0EiwA9U0mtugFxmHemkfiuXrcOVkPKgvR9mVua0zBoI5Ww3WsgprVqDquP2TrlhoC5YYQAvD_BwE

unaware of these changes and the client had provided all the information required to file the partnership return before the March 15 due date.

There is therefore a constant need for CPAs to keep abreast with the continuous changes in the tax law.

There may be times that the CPA or the client may miss a deadline or may unintentionally leave out information that may negatively impact the client where the IRS will charge interest and penalties. The CPA can ask the IRS for an abatement of the interest and penalty if this is the first time the client has defaulted. That being said, the CPA must constantly keep themselves abreast with continuous changes in the tax law.

NOTES

UNIT 2

Tax Planning Concepts—The Theory

LEARNING OBJECTIVES

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

- Describe the key tax planning concepts that CPAs use in tax practice.
- Explain the impact of time value of money on tax planning concepts.
- Apply a cost/benefit analysis to a tax planning proposition.

TAX PLANNING IN GENERAL

Tax planning involves reducing the client's exposure to taxes when considered on a present value basis. One item that complicates this issue is that clients only vaguely understand the concept of time value of money and quite often see tax planning as equal to tax minimization.

While tax minimization can be part of the strategy, it's only part. Ultimately, tax planning has to make sense from a more general financial planning perspective. Almost no one wants a pure minimization strategy.

EXAMPLE

Tax Minimization Maximization Strategy

Harry wants the absolute largest tax minimization possible, as he is upset about paying taxes. Harry is an executive with a major organization, taking home a $5,000,000 annual salary. He has $40,000,000 in securities and a house worth $15,000,000. Harry insists that he wants the absolutely largest tax reduction possible, as he doesn't want the government to get one extra dollar from him going forward, if at all possible.

Well, the good news is that achieving Harry's stated goal is easy. Harry just needs to immediately quit his job, and then turn over the securities and his home to a charity. The plan eliminates Harry's exposure to additional income taxes, he will no longer face property taxes on his home and there is no longer any concern about estate taxes being imposed when Harry dies.

> The plan has met Harry's stated goal, though Harry may starve in the near future if we're crazy enough to follow this plan that maximized his stated goal.
>
> However, it is unlikely that Harry, despite his insistence to the contrary, really has a goal of pure tax minimization (Harry is not crazy). Rather, there are some constraints on what should be done to minimize tax.

The adviser's first goal needs to be to understand those unstated constraints. Some are obvious, as we can safely assume Harry is not willing to live with starvation in order to achieve tax minimization. There are often additional constraints that Harry won't say, but which will need to be uncovered by the adviser.

> **EXAMPLE**
>
> Hidden Client Constraints
>
> Harry has always been a major donor to charities in the area. Harry both sees this as a solemn duty and also, frankly, enjoys the notoriety he gains from making these donations.
>
> Harry also is taking care of his elderly parents, regularly sending them money each month. They are likely going to need long term care in the near future. Harry expects to pay for such fees for his parents, as they do not have sufficient resources to be able to pay for such care and Harry does not believe it is acceptable that his parents would need to depend on public assistance.
>
> Any tax minimization strategy for Harry would have to take into account that Harry must, in addition to not starving and having a place to live, will also need to have sufficient free funds to continue his charitable gifting at his current level and be able to provide for whatever level of assistance his parents may need.

Once the client's unstated constraints are discovered by the adviser, the adviser should next move on to educate the client on why absolute tax minimization within those constraints isn't necessary a useful goal. Tax planning should always be viewed as part of overall financial planning, which itself is just part of overall life planning.

If tax planning is undertaken in isolation, the client may not end up where he/she wants to be in life over time.

> **EXAMPLE**
>
> Proper Planning
>
> A proper plan for Harry looks first his overall life goals—that is, he feels strongly that he has a duty to provide funds to help good causes and that, as a son, he has a duty to support his elderly parents. Additional inquiries of Harry will likely uncover other life goals he may have, such as seeing his children through college, taking care of any grandchildren, and perhaps being able to spend more time with his family and less time at the office.
>
> A proper financial plan to integrate with those goals would be the next logical step in the process. This plan would involve looking at investment strategies Harry may wish to undertake to achieve those life goals, insurance needs Harry may have and various other financial goals that Harry would like to achieve. Most of this planning does not involve tax planning and the majority, and perhaps all, will not be undertaken by the adviser.

Tax Minimization vs. Tax Planning

We've broadly discussed the issues of tax planning vs. tax minimization, but now let's look at the issue in general.

Tax minimization is a simple concept to understand. A plan meets the requirement of achieving tax minimization so long as the client's total tax bill is lower after the plan is implemented than it would be if the plan were not undertaken. However, as we noted in our first example, pure tax minimization is rarely the actual goal of the client.

Tax planning is using the law concepts and concepts to help the client meet his/her financial goals which are tied to the client's life goals. It is not a goal in and of itself, but a tool to be used to help implement a financial plan and achieve the results the client actually wants (even if they don't initially see it this way).

In some cases, the most appropriate tax plan may be for the client to actually pay more taxes than he/she otherwise would, because in the overall mix of issues necessary to arrive at the client's ultimate goals, the higher tax cost is preferable to other trade-offs that would have to be met in order to achieve a goal of simply lowering taxes.

EXAMPLE

Higher Taxes the Appropriate Plan for the Client

Natalia has an option to purchase an interest in an oil drilling venture. The money she invests in the first year will be fully deductible on her return as intangible drilling costs and, under the special passive activity rules applicable to oil and gas working interests, she will be able to claim the deduction even though she would not have any significant participation in the activity.

However, Natalie is highly risk averse and concerned about losing her investment or not having easy access to the funds for a long time. While she has tried similar investments in the past, she has been very nervous all the time she was holding the investment, so much so that she had many sleepless nights until she was able to extract the funds from the investment.

In the past, she has finally pulled the trigger on disposing of these investments after seeing the price of oil drop, selling into a depressed and more than somewhat limited market for such investments.

Even though purchasing the interest in the oil drilling venture has clear tax benefits and would, without question, dramatically reduce her tax for the current year, pushing Natalia to purchase this investment most likely would not represent proper tax planning.

Rather, retaining her money and investing is more liquid, if less tax beneficial, investments would be by far the most appropriate course to enable Natalia to meet her life's goals.

CPAs who first begin moving from tax compliance work to tax planning often make the mistake of assuming that tax minimization is always the most appropriate tax planning move. But, it's important to understand that the client's financial life and overall life is impacted by far more than tax results, and any tax plan must take into account dealing with those other complications.

Tax Planning vs. Tax Compliance

The initial training most CPAs get in tax practice deals with pure compliance issues. This is not surprising for a couple of reasons.

First, even in these days of tax software and artificial intelligence, more skill is needed to properly handle compliance with all of the tax requirements. Artificial intelligence is good at dealing with situations where there is either a clear set of answers or at least the answers do not depend on interpretation of language by humans, interpretations that can and do vary widely.

When AI attempts to handle complex tax compliance situations, most often we learn more about the biases of those who trained the AI than we actually do about the eventual likely outcome of the uncertainty. After all, it may take decades before we get the initial binding court rulings on a new tax concept (say what is a real estate trade or business for §199A purposes?) and quite often we will get contradictory indications (such the different results courts have arrived at when looking at the issue of what is a trade or business of renting real estate for other purposes).

As well, a solid grounding in understanding the tax return, and therefore tax liability, that will result from a transaction is crucial to being able to undertake a tax planning analysis—in the end we almost always will want to know the before and after results of undertaking a particular action.

EXAMPLE

Applying Compliance Concepts to a Potential Planning Engagement

Marie's firm is considering advising a client about the potential benefits of investing in a qualified opportunity zone and she has been assigned the job of determining the impact on the client's tax returns for the current year (when the client has just incurred a $250,000 capital gain) and future years (where it is expected the investment will be sold in 12 years for five times the original investment).

Marie has to apply her tax compliance knowledge to provide the information requested to be used by the partner advising the client for tax planning. This planning can only be done if someone (Marie in this case) is able to apply the rules applicable to reinvestments in qualified opportunity zones.

Based on her knowledge from preparing returns, Mary knows that reinvested gain would not be taxed, so she needs to prepare a with-and-without calculation of tax due for the year of the gain, holding all other facts the same except for those things that would change due to the reinvestment.

Similarly, Marie would need to recognize the years when basis adjustments would take place under the compliance rules as the taxpayer holds this investment, as well as the computations necessary for the year when the remaining deferred gain not offset by basis increases would be subject to tax.

She also needs to recognize the treatment in the year of sale, including understanding how long the investment must be held to obtain various tax benefits.

Tax planning requires taking the knowledge gained by the CPA in handling compliance work, where the facts are known and the law is applied to those known facts, and applying them to a future situation where the facts can be changed.

Ultimately tax planning is just that—helping the client create the fact pattern that will achieve the taxpayer's goal when the compliance work is completed for the affected years. But it is key to note that changing facts may have impacts outside of just the tax arena—thus, planning has to also be aware of those other areas that may be impacted to help assure that the non-tax impacts are also understood.

EXAMPLE

Entity Selection Planning

Sarah and Rick, both California residents, are planning to start a business together. They may wish to bring in new investors in later years who will provide money only, so they will need to be able to have different types of equity holders who have different rights. They also dislike paying taxes and fees and have let you know this fact.

An entity selection decision almost always involves significant tax and non-tax issues. For instance, selecting a corporate legal structure likely will have a different impact on protecting Sarah and Rick's assets from the claims of creditors than using a limited liability company—but this is not an area that is tax related, but rather a legal issue.

Similarly, using an LLC vs. a pure partnership certainly is likely to provide greater liability protection for Sarah and Rick than using a standard partnership structure—but the partnership structure would avoid California's tax on LLC which will, in most years[2], cost the enterprise $800 a year at a minimum for the right to be an LLC in the Golden State.

As well, Sarah and Rick may be deciding between different types of businesses to actually enter, though all may be related to a broad area in which they have expertise. Some of those business might be eligible to be treated as §1202 businesses if they operate as a C corporation, while others might clearly not qualify—and some areas may not be clear. Thus, the tax impacts might impact exactly what type of business they enter, but care has to be taken not to enter a significantly less profitable area just to gain a tax advantage.

Another area that Sarah and Rick may look at is whether the investor is a nonresident alien and the investor chooses to be a shareholder. Note that under U.S. tax law, an S corporation generally cannot have a "nonresident alien as a shareholder." [IRC §1361(b)(1)(C)] A nonresident alien is neither a citizen of the United States nor a resident alien. [Id. §7701(b)(1)(B)] A person qualifies as a "resident alien" if the person is "a lawful permanent resident of the United States," fulfills the "substantial presence test," or fulfills the "first-year election" requirements. [Id. §7701(b)(1)(A)]

Thus, this area of planning requires the CPA to think far beyond the tax issues to a much greater extent than is normally true in compliance engagements.

The other key factor is that, at least in the short term, the CPA has to realize that the law represents the most certain factor, while the facts are in flux (if they aren't, there's generally nothing to plan).

Finally, communication from the CPA to the client at the end of the job becomes far more important for the planning engagement to be successful. In compliance work, the CPA generally seeks information from the client, but the final delivered product is a tax return that represents the results. The client may not like the results, and we may need to explain those results to the client, but the successful filing of the return generally only requires the client to sign the appropriate line to authorize the electronic filing and see that the proper payments are made.

In a planning engagement, the CPA must be sure to clearly communicate the steps the client must take to ensure the facts will turn out to be what are expected to be the facts at the time the return is prepared. This is more difficult than it seems, because we often have difficulty identifying what items we may be taking for granted that the taxpayer is not aware of. As well,

2 https://www.ftb.ca.gov/file/business/types/limited-liability-company/index.html#:~:text=Every%20LLC%20that%20is%20doing,your%20first%2Dyear%20annual%20tax.

since the client is not a tax expert, even if we do tell them the steps to take, we can't assume that he or she will recognize what steps are crucial to the plan working.

EXAMPLE

The Lost Qualified Retirement Plan

Wendy, aged 50, came and talked with Linda, her CPA, about ways she might be able to reduce her taxes and save for her retirement. Wendy operates a sole proprietorship with one much younger employee. She is a professional whose income has been increasing reliably over the years and felt comfortable that her stream of income would continue into the future.

Wendy had heard about simplified employee pension plans (SEPs) and, in fact, had an article on implementing such a program with her that described how to adopt and fund such a plan and what to contribute for her employees.

Linda suggested Wendy might want to consider instead adopting a defined benefit plan, noting that significantly larger contributions could be made to the plan due to Wendy's age than to a SEP, and there would be a much lower cost added by her other employee. Linda had assured Wendy that just like the SEP, the contribution to the plan could be made after year end, though due one month earlier due to the minimum funding standard that would apply to the plan.

Linda and Wendy met with a retirement plan design adviser who gave Wendy the expected contributions that would be due under the plan. As they were leaving, Linda told Wendy as they shook hands at the end of that meeting that a decision would be needed before year end so the plan could be adopted.

Wendy wasn't sure which way she wanted to go, since she was concerned about the larger contribution to the defined benefit plan and how her assistant might react if she felt short-changed by the contribution. She continued to think about the issue following their meeting in June.

Linda did not hear back from Wendy before year end and assumed she had rejected the defined benefit plan. On January 10, she got a call from Wendy asking for the name of that plan consultant because she had decided to move forward with the defined benefit plan. When Linda told Wendy she was too late to adopt the plan for the prior year, Wendy said Linda must be in error—her article on the SEP said she had until the due date of her return to create the plan.

Linda told her that was only true for the SEP and she had told Wendy at their meeting she had to decide by December. Wendy did not recall being told that and the letter Linda had sent her did not say anything about that. At best, Linda now has an upset client.

Tax Avoidance vs. Tax Evasion

It is important to note that tax avoidance encompasses tax planning. Tax planning looks at different scenarios in which clients can avoid taxes, and various examples were noted earlier. While tax avoidance is legal, tax evasion is using illegal means to avoid paying taxes. Typically, tax evasion schemes involve an individual or corporation misrepresenting their income to the Internal Revenue Service. Misrepresentation may take the form of underreporting income, inflating deductions, or hiding money and its interest altogether in offshore accounts.

Tax evasion is a subset of tax fraud. Tax evasion occurs when the taxpayer is in violation of 26 USC §7201. Section 7201 of the Internal Revenue Code reads, "Any person who willfully attempts in any manner to evade or defeat any tax imposed by this title or the

payment thereof shall, in addition to other penalties provided by law, be guilty of a felony and, upon conviction thereof, shall be fined not more than $100,000 ($500,000 in the case of a corporation), or imprisoned not more than 5 years, or both, together with the costs of prosecution."

Proof of the crime requires the following:

- Prove that the attendant circumstances indicate that an unpaid tax liability exists.
- The prosecution must prove some affirmative act by the defendant to evade or attempt to evade a tax.
- Prosecutors most show that the defendant possessed the specific intent to evade a known legal duty to pay.

To convict, the jury must find the defendant guilty of each of these elements beyond a reasonable doubt.

EXAMPLE

In *Scott C. Cole and Jennifer A. Cole v. Commissioner of Internal Revenue*, No. 10-2194, Scott and Jennifer Cole appealed the finding that they omitted more than $1.2 million of income and more than $1.3 million of self-employment income from their 2001 joint tax return and penalties imposed for fraudulently doing so. Scott, a business planning and tax attorney, formed a partnership with his attorney brother under the Bentley Group. Scott also created other entities, some owned by him and others by family members.

In 2001, Scott performed legal work on a trust that earned him $1.2 million. He did not report the income but shifted the income among his entities. He was audited and the determination was made that he significantly understated income. Instead of reporting the income, it was shifted among the various entities. The IRS assessed a $556,187 income tax deficiency and a $417,140 fraud penalty against the couple. The Tax Court entered a final decision upholding the deficiency and penalty amounts and assessed an additional $178,000 in deficiency and fraud penalties due to this deficiency. Scott appealed this decision and lost the appeal.

It is important to note that this case was decided in 2011 even though the incident occurred in 2001. CPAs should be conversant with the statute of limitations regarding fraudulent activities.

The law that governs the statute of limitations relating to criminal tax offenses is §6531, which provides:

> No person shall be prosecuted, tried, or punished for any of the various offenses arising under the internal revenue laws unless the indictment is found or the information instituted within 3 years after the commission of the offense, except that the period of limitations shall be 6 years -
>
> (1) for offenses involving the defrauding or attempting to defraud the United States or any agency thereof, whether by conspiracy or not, and in any manner;
>
> (2) for the offense of willfully attempting in any manner to evade or defeat any tax or the payment thereof;
>
> (3) for the offense of willfully aiding or assisting in, or procuring, counseling, or advising, the preparation or presentation under, or in connection with any matter arising under, the internal revenue laws, of a false or fraudulent return, affidavit, claim, or document (whether or not such falsity or fraud is with the knowledge or

consent of the person authorized or required to present such return, affidavit, claim, or document);

(4) for the offense of willfully failing to pay any tax, or make any return (other than a return required under authority of part III of subchapter A of chapter 61) at the time or times required by law or regulations;

(5) for offenses described in sections 7206(1) and 7207 (relating to false statements and fraudulent documents);

(6) for the offense described in section 7212(a) (relating to intimidation of officers and employees of the United States);

(7) for offenses described in section 7214(a) committed by officers and employees of the United States; and

(8) for offenses arising under section 371 of Title 18 of the United States Code, where the object of the conspiracy is to attempt in any manner to evade or defeat any tax or the payment thereof.

Clients rely greatly on the knowledge base of the CPA; it is therefore extremely important that CPAs understand the implication of incorrect tax planning to prevent any issues for the client.

TIME VALUE OF MONEY

A key factor in dealing with tax planning concepts is the idea of the time value of money, a concept most CPAs first encountered in a finance course in college. This is because it's important not only how much tax is paid, but *when* it is paid.

In broad terms, most clients understand it's better to receive money today and to pay it out later. But they don't necessarily know how they would make a determination regarding taking a certain dollar amount today rather than a larger one at some date later in the future. In fact, most clients would likely convince themselves that getting more money is probably almost always better than getting less money today.

But, as we know, money you have today could be invested to earn additional funds and funds that you have to pay out today will not be available for such earnings. Or it could be that if the funds aren't available today, a client might need to borrow funds from a bank and pay interest on those funds until such time as the payment is eventually received. These concepts form the backbone of the idea of the time value of money.

EXAMPLE

Time Value of Money

Al has the option to receive $10,000 today or receive $11,000 two years from today. The party paying Al is willing to go the way Al wishes, but is not willing to change the amount that the party would pay today or the amount to be paid in two years.

For Al to decide which option makes the most sense, Al would need to determine the return he would expect to receive over two years if he had $10,000 to invest today. Assume Al determines that he expects he would earn 6% annually on the funds.

In that case, his lost earnings for year 1 if he didn't take immediate payment would be $600 ($10,000 times the 6% rate). For year 2, he would expect to earn 6% on the $10,000 again, but he'd also be able to earn 6% on the $600 of earnings from year, giving him total earnings for the year of $636. Thus, at the end of two years Al would

> have $10,000+$600+$636, or $11,236. Since that is $236 more than what he is being offered to be paid if he waits two years, Al would opt for immediate payment.

But what happens if Al is faced with the opposite decision—he has a contract to be paid $11,000 in two years, but the borrower is offering to pay off the balance today. What is the least amount Al should agree to accept? This value would be the discounted *present value* of the future payment, with the discount rate again being what Al expects of earn.

> **EXAMPLE**
>
> Net Present Value Concept
>
> This time the math is slightly more complicated, but not so much as to be impossible to understand. The growth of the money is computed using a compounded 6% rate (since the 6% in year two would be earned on the original principal plus the 6% earned in year one). So, the first year's earning factor would be 1.06 (1 for the principal and 0.06 for the interest at 6%). For the second year, we'd multiply that 1.06 by another 1.06.
>
> If you remember dealing with exponents in math, you'll note that that is 1.062. If we added a third year, we'd get another 1.06, so now we are at 1.063. Or, more generally, our factor is (1+interest rate) raised to the number of years.
>
> Since we know that this figure times our beginning amount gives us the value in the future, if we know the future value, we divide by that factor to get what number we'd have to start with in order to earn our way to the future number. In this case, we'd divide $11,000 (our future value) by 1.062 (or 1.1236) to arrive at our *present value* of $9,789.96.
>
> This means that if Al is offered more than $9,789.96, he should take the offer, while if the offer is less than what he would receive would not allow him to build the funds to the $11,000 he would otherwise receive without the early payment.

Of course, in the real-world things aren't quite that simple, since a payment today gets rid of the risk of default and our expected earnings likely will not end being our actual earnings. The concept of present value gives us an objective starting point after which those other issues can be taken into account.

Luckily, we don't have to work out the detailed factors to discount each payment—Excel and most other spreadsheets have built-in functions to deal with present value, future value and other financial functions that most CPAs have worked with. Below is Microsoft's current list of the financial functions in Excel through Excel 365, with those added in Excel 2013 indicated with a 2013 indicator.[3]

Function	Description
ACCRINT function	Returns the accrued interest for a security that pays periodic interest
ACCRINTM function	Returns the accrued interest for a security that pays interest at maturity
AMORDEGRC function	Returns the depreciation for each accounting period by using a depreciation coefficient
AMORLINC function	Returns the depreciation for each accounting period
COUPDAYBS function	Returns the number of days from the beginning of the coupon period to the settlement date

[3] https://support.office.com/en-us/article/financial-functions-reference-5658d81e-6035-4f24-89c1-fbf124c2b1d8, retrieved June 15, 2019.

Function	Description
COUPDAYS function	Returns the number of days in the coupon period that contains the settlement date
COUPDAYSNC function	Returns the number of days from the settlement date to the next coupon date
COUPNCD function	Returns the next coupon date after the settlement date
COUPNUM function	Returns the number of coupons payable between the settlement date and maturity date
COUPPCD function	Returns the previous coupon date before the settlement date
CUMIPMT function	Returns the cumulative interest paid between two periods
CUMPRINC function	Returns the cumulative principal paid on a loan between two periods
DB function	Returns the depreciation of an asset for a specified period by using the fixed-declining balance method
DDB function	Returns the depreciation of an asset for a specified period by using the double-declining balance method or some other method that you specify
DISC function	Returns the discount rate for a security
DOLLARDE function	Converts a dollar price, expressed as a fraction, into a dollar price, expressed as a decimal number
DOLLARFR function	Converts a dollar price, expressed as a decimal number, into a dollar price, expressed as a fraction
DURATION function	Returns the annual duration of a security with periodic interest payments
EFFECT function	Returns the effective annual interest rate
FV function	Returns the future value of an investment
FVSCHEDULE function	Returns the future value of an initial principal after applying a series of compound interest rates
INTRATE function	Returns the interest rate for a fully invested security
IPMT function	Returns the interest payment for an investment for a given period
IRR function	Returns the internal rate of return for a series of cash flows
ISPMT function	Calculates the interest paid during a specific period of an investment
MDURATION function	Returns the Macauley modified duration for a security with an assumed par value of $100
MIRR function	Returns the internal rate of return where positive and negative cash flows are financed at different rates
NOMINAL function	Returns the annual nominal interest rate
NPER function	Returns the number of periods for an investment
NPV function	Returns the net present value of an investment based on a series of periodic cash flows and a discount rate

Function	Description
ODDFPRICE function	Returns the price per $100 face value of a security with an odd first period
ODDFYIELD function	Returns the yield of a security with an odd first period
ODDLPRICE function	Returns the price per $100 face value of a security with an odd last period
ODDLYIELD function	Returns the yield of a security with an odd last period
PDURATION function 2013	Returns the number of periods required by an investment to reach a specified value
PMT function	Returns the periodic payment for an annuity
PPMT function	Returns the payment on the principal for an investment for a given period
PRICE function	Returns the price per $100 face value of a security that pays periodic interest
PRICEDISC function	Returns the price per $100 face value of a discounted security
PRICEMAT function	Returns the price per $100 face value of a security that pays interest at maturity
PV function	Returns the present value of an investment
RATE function	Returns the interest rate per period of an annuity
RECEIVED function	Returns the amount received at maturity for a fully invested security
RRI function 2013	Returns an equivalent interest rate for the growth of an investment
SLN function	Returns the straight-line depreciation of an asset for one period
SYD function	Returns the sum-of-years' digits depreciation of an asset for a specified period
TBILLEQ function	Returns the bond-equivalent yield for a Treasury bill
TBILLPRICE function	Returns the price per $100 face value for a Treasury bill
TBILLYIELD function	Returns the yield for a Treasury bill
VDB function	Returns the depreciation of an asset for a specified or partial period by using a declining balance method
XIRR function	Returns the internal rate of return for a schedule of cash flows that is not necessarily periodic
XNPV function	Returns the net present value for a schedule of cash flows that is not necessarily periodic
YIELD function	Returns the yield on a security that pays periodic interest
YIELDDISC function	Returns the annual yield for a discounted security; for example, a Treasury bill
YIELDMAT function	Returns the annual yield of a security that pays interest at maturity

Old timers may even prefer to work with a financial calculator—many a CPA prided him/herself on gaining an understanding of reverse polish notation necessary to use the workhorse Hewlett Packard 12C financial calculator. While the number in use may have declined, HP continues to sell the calculator and it is used by those who want to be able to carry out financial functions with something that fits in the pocket. HP also sells an app for smart phones that will duplicate the HP12C as well.

BROAD TAX PLANNING METHODS

Most tax planning falls into one or both of two broad categories to accomplish an effective tax reduction subject, as always, to the understanding that the advisers must consider factors other than just the net tax reduction on a present value basis before advising the client to embark on a planning strategy.

Tax Deferral

Tax deferral seeks to delay the payment of tax until a later year, hoping to take advantage of the time value of money to obtain a benefit for a client. As we noted, if the amount of tax remains the same, the time value of money concepts tell us it is preferable to pay the tax at a later date.

EXAMPLE

Paying for Deductions Before Year End

Jannelle's Bakery looks to make use of a simple deferral strategy. The gross receipts test is passed if the gross receipts of the entity for the three-taxable-year period ending with the taxable year that precedes such taxable year do not exceed $25,000,000. [IRC §448(c)(1)] Since the bakery has successfully passed the gross receipts test, it qualifies to use the cash basis of accounting for tax purposes and does use that method.

At December 31, Jannelle goes through her mail and discovers utility bills that are due for payment the first week of January. By making those payments by December 31, she obtains the benefit of the tax deductions in the current year rather than the following year. If her rates are the same both years, she'll still pay the same amount of tax over the 2-year period.

Sharp readers will note that the tax savings is not the only present value item in play here. By paying the utility bill earlier, Jannelle is giving up the ability to earn money (or pay off debt and avoid paying interest expense) for the period from December 31 until the date the item would have been paid. In this case it's likely the cost to Jannelle of lost earnings for one week on those payments would be less than what she'd gain from retaining the tax for the full year.

If a client goes overboard on this technique, not only do they risk IRS scrutiny (overly aggressive prepayments misstate income, leading to disallowance of the deduction, with taxes, penalties and interest assessed) but they also can cost themselves more than the value of being able to delay the tax payment.

Other strategies that rely wholly or partially on tax deferral include §1031 tax free exchanges, §351 incorporations, §721 partnership contributions, §1035 exchanges of annuity contracts, annuity and life insurance contracts, and retirement plan programs (IRAs and employer programs under §401(k), §403(b), and the like).

Tax Rate Shifting/Conversion

In other cases, we may look to attempt to convert income into more tax favored types of income that are taxed at a lower rate—including zero percent. In this case, rather than delaying the payment of tax, the technique looks to actually reduce the tax that is paid vs. taking certain alternative actions.

> **EXAMPLE**
>
> Municipal Bond Investments
>
> Dylan has been investing her funds in high quality corporate bonds but is concerned with what she perceives to be the high taxes she has been paying. She looks into the issue on the internet and discovers that if she buys municipal bonds issued by her state or municipalities in her state, she will not pay tax to either the IRS or her state taxing agency on this income.
>
> Dylan goes out and buys municipal bonds to obtain the zero taxes due on them. Much to her dismay, she discovers that bonds of the same quality as her corporate bonds have a significantly lower interest return to her.
>
> What Dylan should do is determine the after-tax return of both the corporate bonds and the municipal bonds of similar quality and only then determine which type of bond makes the most sense for her.

As the above example illustrates, these conversion strategies often come with "gotchas" that may impose costs (such as reduced returns in the above example) that have to be taken into account. For instance, a taxpayer who is in the lowest tax brackets (as many retirees are) most often does not come out ahead by buying municipal bonds, as high income taxpayers bid down the returns on these bonds. Higher income taxpayers are willing to take a bigger reduction in before tax return for a tax-exempt bond, since the after tax return will still be higher for them.

Another variant of tax rate shifting is the attempt to move income between tax years in order to avoid paying tax on some income at a higher rate when there was "space" available in a lower bracket in an adjacent year. A similar result takes place if Congress modifies the tax law, creating a situation where if income falls into the year before the change, it will be taxed at a different rate than the income in a later year.

In the case of other conversion strategies, the issue may be that only certain types of investments qualify for the benefit—Congress often uses special rates to encourage investments they would prefer be made and that they feel otherwise might not make economic sense without the tax subsidy. Rarely is there a pure "free lunch" for a conversion strategy unless the taxpayer will be investing in such items anyway (such as conversion strategies related to real estate for a taxpayer that will be holding the real estate in any event).

Strategies that depend partially or wholly on conversion include investments in depreciable real estate (ordinary deduction for depreciation that creates gain taxed at a maximum 25% rate), municipal bonds, investments in qualified opportunity funds, investing in equities, and Roth IRA conversions/contributions.

Tax rate shifting was a positive impact that was achieved by the CARES Act. In the years after the TCJA of 2017, the corporate tax rates reduced to a flat 21%. Prior to the TCJA, the top corporate tax rate was 35%. The provisions in the CARES Act discussed later allowed clients to benefit from shifting available tax provisions.

SKILLS NEEDED FOR TAX PLANNING

A number of special skills beyond those a CPA must have for compliance work are necessary, or must be maintained at a higher level, for CPAs undertaking tax planning engagements. As these skills often are not emphasized in education received by CPAs before undertaking their first entry-level positions, the skills must be gained later in life.

CPAs will look to obtain these skills via a formal program, such as completing a Masters in Tax program. Others will obtain these skills by working under the supervision of a more experienced professional, via their own study program (including but not limited to formal continuing education programs) or, more likely, some combination of those methods.

Applying the Tax Law (Not Tax Articles, CPE Manuals, Editorial Commentary)

Tax planning requires a CPA to take his/her tax research skills up a notch. While working from quick answer services is something CPAs come to rely on early in their career for handling return preparation, tax planning requires a different set of research skills.

Specifically, the CPA doing advanced tax planning has to understand not just explanations of the law and cases, but be able to interpret the law and cases as well to assure that the plan being developed for the client fits under the actual language of the law and cases, not the CPA's interpretation of another professional's interpretation of the law.

The ability to work with source documents, beginning with the Internal Revenue Code and working with regulations, cases and other materials interpreting that Code, is a skill that comes over time with repetition. While the author of, say, a CPE manual tries to provide reasonable guidance for the most likely situations a CPA will run into, only the CPA advising the client has the information on the facts that exist or can be arranged to exist and apply the law to those facts. As well, should the IRS challenge the planning position successfully, the quality of the CPA's research may be all that stands between the client (and the CPA for that matter) and penalties.

We will devote a unit to the requirements that apply to the research the CPA undertakes for the client for purposes of avoiding penalties against the taxpayer, or preparer penalties being assessed against the CPA.

Objectivity in Application

One of the toughest items for CPAs to deal with in tax planning engagement is making sure that while the CPA is looking to advance the client's interest (something expected in tax practice generally) that the CPA does not fail to maintain proper objectivity when handling the planning engagement.

Objectivity can become a problem when the CPA starts out with a result in mind unless the CPA is very careful. We naturally tend to be affected by *confirmation bias,* where we seek out only evidence that confirms what we already believe or want to believe, or subject evidence that suggests our view is not correct to a much higher level of scrutiny than we do for evidence which is in line with the result we are after.

EXAMPLE

Missing Reversal of Case Supporting the Taxpayer's Position

Holly's client, Project A, Inc., wants to be able to write off certain expenditures immediately rather than having to capitalize them as part of an intangible asset which would be recovered over 15 years. Holly is not certain about the proper treatment, but she knows that her client strongly believes that they should be able to write this expense off.

Holly does some research and comes up initially with two court decisions in separate U.S. District Courts that generally apply to this type of expenditure, as well as an article from *The Tax Adviser* from six years ago that discusses this issue.

One of the District Court decisions decided the expense had to be amortized. The other case, tried in the U.S. District Court that would have jurisdiction over the client's case if they took their case to the U.S. District Court, came to the opposite conclusion, allowing the current deduction. The article was written after both cases had been issued, so Holly was interested in the conclusions expressed in that article.

That article noted that the first District Court case had been reversed on appeal to a Circuit Court of Appeals. While it is not the Circuit that would have jurisdiction over Holly's client, Holly felt this really helped her case. The article also noted the contrary District Court case she had found, noting it had been decided in the way the Appeals Court panel had suggested the law should be read.

Based on this information, Holly informed her client that the amount could be deducted. She also concluded that this represented substantial authority, so no disclosure was needed on the tax return if this position was needed and she did not advise the client to make such a disclosure.

However, what Holly had not discovered was that five years ago, the IRS had announced *non-acquiescence* with the result of the appeals panel. As well, the District Court case that had been decided in favor of the position Holly had advised her client to take had also been reversed on appeal—and that Circuit Court of Appeals is the one that would have jurisdiction over Holly's client's tax matters if the matter went to Tax Court or the U.S. District Court.

Holly had been victimized by stopping her research once she the evidence she found supported the position she knew her client preferred. The article served to put Holly on notice that different courts had arrived at different conclusions and it had been written many years before. Holly failed to consider whether additional developments might have taken place since the article was written.

To serve the client's best interests, the CPA has to objectively evaluate the evidence for and against any particular position. In fact, to make sure no unpleasant surprises crop up due to the CPA's focus on attempting to achieve a result for a client, it's often best if the CPA intentionally puts him/herself into the mindset of being a party attempting to argue that the law does not support the position. Only if the potential attacks of the IRS are fully understood can the CPA advise the client properly to make a decision with regard to the position and, if the client decides to pursue that position, be ready to defend the client in the event of an IRS challenge.

Objectivity also requires that the CPA not merely passively accept the views of another expert about matters the CPA has expertise in. CPAs in tax practice are expected to be tax experts and generally need more than simply being told by client's counsel or a promoter of an investment that a particular strategy works—the CPA needs to know why that professional

believes it works and then independently evaluate if the CPA agrees with that party's conclusion after reviewing the facts.

In that case, a Bay Area CPA was convicted of aiding and abetting the filing of a false tax return based largely on accepting the client's position that the funds he had obtained were "loans" representing advances on management fees from an investment fund rather than income that should have been taxed currently.

The Justice Department issued a press release in July of 2018 publicizing the conviction.[4] *The Mercury News* reported in December of 2018 that the CPA was eventually sentenced to eight months in prison, one year of supervised release following that term and fined $20,000.[5]

The CPA was convicted of violating IRC §7206(2), which provides:

> Any person who—
>
> …
>
> (2) Aid or assistance
>
> Willfully aids or assists in, or procures, counsels, or advises the preparation or presentation under, or in connection with any matter arising under, the internal revenue laws, of a return, affidavit, claim, or other document, which is fraudulent or is false as to any material matter, whether or not such falsity or fraud is with the knowledge or consent of the person authorized or required to present such return, affidavit, claim, or document;
>
> …
>
> shall be guilty of a felony and, upon conviction thereof, shall be fined not more than $100,000 ($500,000 in the case of a corporation), or imprisoned not more than 3 years, or both, together with the costs of prosecution.

Peter J. Reilly in his *Forbes* blog described the transactions that led to the CPA's problems as follows:

> Beginning in 2007, Burrill Capital began taking its management fees a little early to deal with "cash flow" problems. By 2012, it had taken more than it could possibly earn before the fund's scheduled closing – over $18 million. In 2012, there was a capital call on the investors purportedly to fund investments. Some of that went to the prepaid management fee.[6]

The CPA handling the tax return did attempt to analyze the taxability of these "advances" on the management fee. The client insisted the payments were in the nature of loans. The CPA handling the tax return noted that the audit of the Fund which had paid this "loan" to the taxpayer's business had issued an unqualified opinion on the Fund treating these as loans. Eventually, the CPA who issued that unqualified opinion was subject to discipline by the

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[4] The United States District Attorney's Office, Northern District of California, "Bay Area CPA Convicted of Fraud," July 18, 2018, https://www.justice.gov/usao-ndca/pr/bay-area-cpa-convicted-tax-fraud

[5] "Walnut Creek Accountant Sentenced in Tax Fraud Case," *The Mercury News,* December 15, 2018, https://www.mercurynews.com/2018/12/15/sf-walnut-creek-accountant-sentenced-in-tax-fraud-case/

[6] Peter J. Reilly, "CPA Convicted Of Assisting On False Tax Return – Did He Get A Raw Deal?," *Forbes* website, November 23, 2018, https://www.forbes.com/sites/peterjreilly/2018/11/23/cpa-convicted-of-assisting-on-false-tax-return-did-he-get-a-raw-deal/#17d221346198

SEC and the California Board of Accountancy, but those actions had not begun when the tax return was being prepared.[7]

Mr. Reilly's article notes, this was not a case where the CPA simply moved an entry to loans to get rid of the income, nor did he even just accept the client's orders to report it as nontaxable:

> The deferred revenue was noticed by the staff and that raised a tax concern, because even though something might not be income under GAAP, it can be taxable income when received. The problem escalated to Mr. Berger, the tax partner on the account and it got a lot of attention. Here he is just trying to get somebody's tax return done. Somebody who has done something that he should not have done. He still has to file a tax return.
>
> At the end of the day, when you are looking at Burrill's return, you have to decide- was he borrowing from Peter to pay Paul or was he robbing from Peter to pay Paul. After a lot of agonizing Berger concluded it was the former, in which case the returns he signed were correct. He encouraged the client to document the loan status of the payments, which they did do, drafting a note from Burrill to the fund. Subsequently, the note was torn up because it was not consistent with the story coming out of the other side of the mouth that was being fed to PwC to hoodwink the investors.
>
> Berger did not believe that Burrill was avoiding tax on the $18 million – just deferring it.[8]

However, the downside was that it was pretty clear the client did want it reported as a loan and reports from the trial indicate that the client was a "demanding" client. Whether or not it truly was the case, it's not that difficult to see a jury deciding that the decision to treat it as a loan was "tainted" by the knowledge a different answer would result in the loss of a major client (and the fees related to the same).

Similarly, when the CPA discovered that there was no documentation to support the loan (and thus recommended the client draft a note), that arguably undercut the CPA's reliance on the audit report of the fund that this was truly a loan- rather, arguably, the CPA had now discovered a reason to believe there had been deficiencies in the audit with regard to these payments. That is, why hadn't the lack of documentation troubled the auditor? Again, in retrospect it's not hard to see how a prosecutor could put this to the jury in a very bad light.

The case of Burrill Capital shows the importance of communication. Many companies and individuals only rely on their CPA after the fact. It is important that a CPA is carried along when clients want to make major decisions. Communication is important.

Congress may, at times, expressly provide that loan forgiveness is not taxable income. An example is the American Rescue Plan Act of 2021, which provides that Economic Injury Disaster Loan (EIDL) grants from the U.S. Small Business Administration are not income and such treatment does not result in denial of deductions or asset basis. (As to such loans, see generally "FAQ – COVID-19 Economic Injury Disaster Loan (EIDL), sba.gov, 2/4/21.)

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[7] *Ibid*

[8] Ibid

Communication Skills

Planning involves communication with other professionals to help obtain the information necessary to determine the best approach to take, as well as communication with those parties and the client and coordinating the implementation of the plan once it is decided upon.

If a CPA fails to properly communicate with the parties involved, it's very possible that plan will not be implemented as the CPA expects—and that the results won't be obtained. Such a failure increases the risk that a CPA will face claims for damages from the client, as well as possible complaints filed with the state board of accountancy.

A CPA needs to ensure that the communication is written at the proper level of technical detail for the party that is being addressed. The communications to and from counsel will likely have the most technical details regarding the law, while communications with the client will often have fewer such technical details but have much more in the way of directions on specific steps to take.

The CPA will also be receiving information from other professionals, some of which are areas the CPA will not be skilled in. In that case, the CPA needs to make inquiries to clarify any correspondence received from other parties to ensure the CPA understands what is expected of him/her.

The CPA must communicate properly with the client to ensure the objectives of the client are met. This is also an important criterion, as oftentimes a CPA is interested in minimizing taxes without focusing on the client's objectives.

EXAMPLE

J owns J Gardening LLC. This is a disregarded entity. On November 30, 20x0, J Gardening LLC bought $1,200,000 of gardening equipment. The CPA decided to use the Section 179 depreciation deduction to give J a large deduction. The CPA does not realize that J wants to buy a house and needs to show income that he can afford to pay for the house. The $1,200,000 depreciation puts him below the affordability threshold for his home, as J Gardening is J's only source of Income.

Communication is integral and important to a successful client and CPA relationship.

EXAMPLE

Veniti, Inc., has retained earnings of $3,000,000 on its balance sheet as of December 31, 20x9. In the meeting minutes, the board had documented that it will allocate these funds to working capital and equipment as the company moves to expand into another market sector. The CPA needs to encourage the corporation to consider corporate business needs in relation to shareholder needs and expectations as to dividends, while also considering the potential for incurring the accumulated earnings tax of Section 531. This tax can apply in some circumstances if business needs for funds retention are not documented.

UNIT 3

Deferral Planning in Action

LEARNING OBJECTIVES

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

- Explain how qualified deferred compensation works as a tax planning strategy.
- Explain how non-qualified deferred compensation (NQDC) works as a tax planning strategy.
- Advise clients on year-end deduction strategies.
- Apply the provisions that apply to §1031 exchanges.

As we discussed initially, one key way to achieve a tax advantage is to engage in a tax deferral strategy. In this chapter, we will look at deferral planning strategies used by taxpayers.

QUALIFIED DEFERRED COMPENSATION

Retirement Plans

We note the post-2019 rules may vary significantly due to the SECURE Act signed into law on December 20, 2019. SECURE stands for Setting Every Community Up for Retirement Enhancement. Highlights of those changes include the following.

- Required minimum distributions begin at age 72, not age 70½. If the beneficiary turned 70½ in 2019, the required minimum distribution remains due no later than April 1, 2020. If the beneficiary is currently receiving distributions because of the familiar 70½ age rule, distributions need to continue. Those turning 70½ in 2020 or later may wait until age 72 to begin receiving distributions.
- The 2019 IRA contribution still looks to the 70½ rule. However, beginning in 2020, the SECURE Act allows contributions to traditional IRAs in the year the taxpayer turns 70½ and beyond, assuming the earned income requirement is satisfied.

While there are some exceptions, the SECURE Act generally requires non-spousal distributions be made within ten years. This rule is more taxpayer unfriendly, whereas other provisions were

decidedly favorable to taxpayers. The exceptions to the 10-year rule include a child under the age of majority; the 10-year rule applies when the child reaches majority. Other exceptions to the 10-year rule focus on circumstances of disability or chronic illness, and a beneficiary who is no more than 10 years younger than the plan owner. These new rules apply to someone who dies after 2019.

Arguably, the most textbook example of a deferral strategy is the use of qualified retirement plans, whether they be IRAs or employer plans, to defer the payment of taxes. Unlike many strategies, this strategy is available in some (and perhaps multiple) forms to business owners or employees of organizations, regardless of whether or not their employer sponsors a qualified plan.

The American Rescue Plan Act of 2021, signed March 11, 2021, generally includes multiemployer funding relief. For single-employer defined benefit plans, the new law focuses on implementing longer amortization periods, fresh start rules, and an increase in interest rates in regard to minimum funding.

Individual Retirement Accounts

All taxpayers under age 70½ have the right to establish and fund an individual retirement account. This was the 2019 and earlier rule. As indicated above, the post-2019 rules are even more liberal.

While the resulting contribution may not be deductible to the individual if the taxpayer or the taxpayer's spouse is considered to be covered by an employer sponsored plan and the taxpayer's income exceeds certain levels, a deferral of tax on the earnings in the fund is always available.

If a deduction for the contribution is available (due to having lower income or not being covered by an employer's plan), then the employee takes earned income effectively out of being subject to income taxes currently and moves the inclusion to a later year.

A summary of the amounts that can be contributed to IRAs for 2022 and 2021 are provided in the following table.[9]

Type	2022 Amounts	2021 Amounts
IRA Limitations[10]		
Maximum IRA contribution (before catch-up) (§219(b)(5)(A))	$6,000	$6,000
Deduction phases out for individuals that are an active participant in an employer plan for modified adjusted gross income between	Single and Head of Household – $68,000 to $78,000	Single and Head of Household – $66,000 to $76,000
	Married Filing Joint – $109,000 to $129,000 or a qualifying widow(er)	Married Filing Joint – $105,000 to $125,000
	Married Filing Separate – $0 to $10,000	Married Filing Separate – $0 to $10,000

9 https://www.irs.gov/newsroom/irs-announces-changes-to-retirement-plans-for-2022#:~:text=Highlights%20of%20changes%20for%20 2022,IRAs%20remains%20unchanged%20at%20%246%2C000.

10 Notice 2018-83

Type	2022 Amounts	2021 Amounts
Deduction phases out for individuals whose spouse is an active participant in an employer plan phases out between	$204,000 to $214,000	$198,000 to $208,000

The "catch-up" contribution of $1,000, which is in addition to the normal limits, is allowed to taxpayers who are age 50 or over by the end of the year.[11]

Individual retirement plan contributions can be made to such accounts by the original due date of the tax return ***not*** including any extensions that may be filed.

EXAMPLE

Contribution to IRA by Taxpayer

Jim, age 53, has earned income of $100,000 in 2022 and neither he nor his spouse is covered by an employer sponsored retirement plan. Jim's spouse is age 54.

Jim and Jim's spouse can each make a contribution of up to $7,000 before April 15, 2023, claiming that deduction on their personal income tax return for 2022.

The deferral benefit of the plan can be seen by comparing the growth of the account vs. a taxable account where a portion of the taxpayer's funds will need to be used each year to pay taxes.

EXAMPLE

Value of Deferral of IRA Funds

Assume Jim and Mary's tax rate each year is 25% federal and 5% state, for a total rate of 30%. The state in question completely conforms to federal law with regard to IRA contributions. Here is the expected value over 10 years if funds are put in the account or held outside the account, assuming earnings of 5% per year.

	IRA		Remaining Taxable		
	Earnings	Balance	Earnings	Tax	Balance
Deductible Amount Contributed		14,000		4,200	9,800
Year 1	700	14,700	490	123	10,167
Year 2	735	15,435	508	127	10,548
Year 3	772	16,207	527	132	10,943
Year 4	810	17,017	547	137	11,353
Year 5	851	17,868	568	142	11,779
Year 6	893	18,761	589	147	12,221
Year 7	938	19,699	611	153	12,679
Year 8	985	20,684	634	159	13,154
Year 9	1,034	21,718	658	165	13,647
Year 10	1,086	22,804	682	171	14,158

The $4,200 tax you see in the column for the taxable investment in the year of contribution represents the tax the couple paid on the $14,000 since they did not contribute it to a deductible IRA account.

[11] IRC §219(b)(1)

> To be fair, the $11,403 balance of the IRA will be subject to income tax when withdrawn from the IRA. However, the taxpayer may expect to be in a lower rate when the couple retires and begins withdrawing funds from the account.

The deferral seen above will work the same if the contribution is by an employee to a §401(k) plan or a contribution to an owner's account after establishing a business-related qualified retirement plan (such as a profit sharing plan, a defined benefit plan or a simplified employee pension (a SEP).

Business Based Retirement Plans

One key test for tax planning before looking at whether a business retirement plan should be suggested as a planning opportunity for owner(s) of a closely held business is whether the amounts that can be put away by the owner (and, potentially, his/her spouse if the income is high enough) in deductible IRAs maximize what the owner is willing or wants to do.

Pension and Profit Sharing Plans

Many retirement plan alternatives exist. Defined contribution plans, defined benefit plans, pension plans, profit sharing plans-all have their relative merits, but in order for an employer to evaluate their merits and determine which type of plan best suits its needs, the employer must first know what each kind of plans offers. This section describes the different basic categories of retirement plans and offers consideration for choosing the appropriate retirement plan.

As well an employer must understand what the employer expects to accomplish with the plan. A plan that is meant to be attractive to prospective employees will often need to be designed very differently than a plan whose primary goal is to provide a benefit for the owners of a closely held entity. Qualified plans can be and are designed to achieve either goal, but rarely can a design be completely successful in maximizing both objectives concurrently. Choices and trade-offs will need to be made.

The plans fall into two major categories that are based on the whether the plan provides for a specified contribution or represents an agreement to provide a future benefit.

Defined Contribution Plan

A defined contribution plan is a retirement plan that "provides for an individual account for each participant and for benefits based solely upon the amount contributed to the participant's account, and any income, expenses, gains and losses, and any forfeiture of accounts of other participants which may be allocated to such participant's account." [ERISA Section 3(34); IRC Section 414(i)]

Types of Defined Contribution Plans

The following are types of defined contribution plans:

- Profit sharing plans
- Thrift or savings plans
- 401(k) plans
- Money purchase pension plans

- Target benefit plans
- Stock bonus plans
- Employee stock ownership plans
- Simplified employee pensions

You will likely see few money purchase or target benefit pension plans in place today. Under a very old law, they were required for an employer to make the maximum contribution to defined contribution pension plans, but today the profit sharing plan variants no longer face a 15% contribution limit.

A money purchase pension plan is a defined contribution plan pursuant to which the company's contributions are mandatory and are generally based solely on each participant's compensation. For example, a money purchase pension plan might require the employer to contribute, on an annual basis, an amount equal to ten percent of each participant's compensation.

A profit sharing plan is technically not a pension plan, since there is no required annual contribution. However, for tax purposes it otherwise generally works like a defined contribution pension plan. In a profit sharing plan, the employer contribution is allocated to the employee's account as determined in the plan, and that allocation is not necessarily pro rata based on covered compensation – in fact, that very fact is the basis for "fancy" defined contribution plan designs like new comparability profit sharing plans which make of defined benefit calculations of projected benefits to determine whether allocations satisfy the requirements for comparable allocations to highly compensated and non-highly compensated employees.

Profit sharing plans (including variants such as 401(k) plans and ESOPs) allow the employer flexibility in determining how much, if any, to contribute each year up to the maximum contributions allowed under §404. Thus, an employer adopting a profit sharing plan can have the plan designed so that the employer may, in his/her discretion, avoid a contribution entirely in a year when results are poor.

Determination of Contribution

Under a defined contribution plan, plan contributions are generally determined by formula and not by actuarial requirements, plan earnings and losses are allocated to each participant's account and do not affect the company's retirement plan costs, and plan benefits are not insured by the Pension Benefit Guaranty Corporation (PBGC).

The tax law places limits on the dollar amount of contributions to retirement plans and IRAs and the amount of benefits under a pension plan. IRC Section 415 requires the limits to be adjusted annually for cost-of-living increases.[12]

12 https://www.irs.gov/retirement-plans/cola-increases-for-dollar-limitations-on-benefits-and-contributions

IRAs	2023	2022	2021	2020	2019
IRA Contribution Limit	$6,500	$6,000	$6,000	$6,000	$6,000
IRA Catch-Up Contributions	1,000	1,000	1,000	1,000	1,000

Traditional IRA AGI Deduction Phase-out Starting at	2023	2022	2021	2020	2019
Joint Return	116,000	109,000	105,000	104,000	103,000
Single or Head of Household	73,000	68,000	66,000	65,000	64,000

SEP	2023	2022	2021	2020	2019
SEP Minimum Compensation	750	650	650	600	600
SEP Maximum Contribution	66,000	61,000	58,000	57,000	56,000
SEP Maximum Compensation	330,000	305,000	290,000	285,000	280,000

SIMPLE Plans	2023	2022	2021	2020	2019
SIMPLE Maximum Contributions	15,500	14,000	13,500	13,500	13,000
Catch-up Contributions	3,500	3,000	3,000	3,000	3,000

401(k), 403(b), Profit-Sharing Plans, etc.	2023	2022	2021	2020	2019
Annual Compensation	330,000	305,000	290,000	285,000	280,000
Elective Deferrals	22,500	20,500	19,500	19,500	19,000
Catch-up Contributions	7,500	6,500	6,500	6,500	6,000
Defined Contribution Limits	66,000	61,000	58,000	57,000	56,000
ESOP Limits	1,330,000 265,000	1,230,000 245,000	1,165,000 230,000	1,150,000 230,000	1,130,000 225,000

Other	2023	2022	2021	2020	2019
HCE Threshold	150,000	135,000	130,000	130,000	125,000
Defined Benefit Limits	265,000	245,000	230,000	230,000	225,000
Key Employee	215,000	200,000	185,000	185,000	180,000
457 Elective Deferrals	22,500	20,500	19,500	19,500	19,000
Control Employee (board member or officer)	130,000	120,000	115,000	115,000	110,000
Control Employee (compensation-based)	265,000	245,000	235,000	230,000	225,000
Taxable Wage Base	160,200	147,000	142,800	137,700	132,900

Cross Tested/New Comparability Plans

In recent years, plan designs have emerged where plan benefits are "cross tested" in order to accomplish various "nondiscriminatory" allocations in favor of certain employees (such as older owners vs. younger rank and file) and/or which also make use of other more intricate allocation techniques to skew benefits in a certain direction (known as "new comparability" plans).

These techniques also allow a plan to take advantage of the higher amounts allowed to be allocated to an employee's balance in a defined contribution plan under Section 415 (up to 100% of compensation) compared to the more limited maximum contribution based on aggregate compensation of all participants under Section 404 (25% of compensation), even for plans with no §401(k) employee contributions.

Since allocations do not have to be pro rata, it is possible for an employee to be allocated over 25% of covered compensated allocated to his/her account– and, in fact, that quite often happens in plans designed for tax planning purposes for small, closely held employers where the goal of the plan is generally to benefit the owners.

Defined Benefit Pension Plan

A defined benefit plan represents a different concept entirely. Rather than placing a fund in an employee's account and then having all gains and losses be applied to that account (so that the employee simply gets whatever is in the account at retirement), a defined contribution plan promises a future benefit to the employee based on criteria defined in the plan.

While cash balance plans cloud the distinction a bit, the key issue in a defined benefit plan is that investment performance, for good or ill, affects the employer. If the plan faces a higher than expected rate of return, the employer's future contributions are reduced. Similarly, if the plan has returns that are lower than projected, the employer makes up the shortfall.

Annual Funding Amount

The cost of funding a defined benefit plan is determined by the application of actuarial science. An actuary must take into consideration many factors in determining the annual contribution needed to fund the benefits that the plan has promised. Included in most actuarial analyses are the following assumptions; interest, mortality, employee turnover, and salary scale. Each individual actuarial assumption or the contribution yield of all of the assumptions in the aggregate must be "reasonable." [IRC Section 412(c)(3)]

As will be discussed later, the plan can be a "trusteed" plan, or the employer can use insurance policies to provide for the plan.

Maximum Benefit

The maximum benefit for 2022 that can be provided under the plan to any particular employee is limited to the lesser of $245,000 or 100% of the participant's compensation average over the highest three consecutive earning years. The earnings to be considered for each year are capped at the same annual limit that would have applied in each year for the funding of a defined contribution plan for that year discussed above ($305,000 in 2022).

Note that it is the benefit to be paid and not the contribution that is capped. Thus, such a plan often provides for more significant contribution amounts if the workforce has a number

of high earning older employees (which may very well be the owner in businesses such as solo medical practices).

Funding a Trusteed Plan

In a trusteed plan, the actuarially determined contribution is invested in a common fund that is used to fund and, eventually, pay the benefits. As the amount necessary is ultimately determined by the benefits that end up being paid and the rates of return on the investments made, a plan may find itself eventually "fully funded" with future contributions limited. The more aggressively an employer funds the plan in early years, the more likely it is to run into the full funding limitation. [IRC §412(h)]

If a plan continues to grow beyond what is needed to fund the plan, the employer may face a reversion penalty if the plan is terminated. If the employer is funding the plan aggressively for a closely held enterprise, the plan needs to be monitored to consider any potential overfunding condition.

If conditions are right, the defined benefit plan may be terminated and the present value of employee benefits transferred to a successor defined contribution plan. Once the balances are in that plan, there will no longer be a limit on the earnings that will eventually go to the participants.

Most often this sort of transition takes place in a closely held entity where a principal reason for adopting the program was related to the retirement and tax planning for the owner(s).

IRC §412(e)(2) (formerly 412(i)) Plans

An alternative method of funding a defined benefit plan is to adopt a fully insured defined benefit plan, also known as a §412(e)(2) plan. In that plan, the benefits are covered completely by insurance contracts. The justification for such plans was that they allowed the employer to have a level of certainty about the cost of the benefits to be provided by shifting the risk of investment performance to the insurer.

Such a plan may make sense for an employer who has decided that it makes sense to provide a defined benefit program but does not want to take on the full risk of investment performance. Such a program eliminates the need to hire an outside actuary and find a way to manage plan investments, effectively transferring those responsibilities to the insurance carrier. As well, an annuity plan funded solely through contracts issued by an insurance company is not required to have a trustee.

Such plans are not subject to the restrictions on funding noted above, but the IRS has placed certain programs that funded such a plan with certain policies on their listed transaction list. [Revenue Ruling 2004-20] Listed transactions are subject to specific disclosure requirements and a failure to comply with those requirements triggers the imposition of significant penalties even if the tax benefits are eventually sustained.

In the cases the IRS was concerned about, the insurance policies purchased generally were designed to provide a benefit in excess of the limits, with the idea being that the policy would eventually be "rolled out" at a time when the value was artificially reduced to the present value of the accrued benefit. While legitimate 412(e)(2) plans are a useful tool, reasonable skepticism should be applied to promises that seem to allow large contributions and eventual benefits to the key employees far in excess of the general limitations.

Advisers who find a client has been pitched a "too good to be true" defined benefit plan involving paying extremely high premiums for policies under a §412(e)(2) plan should carefully examine what is being proposed due to the likelihood the program is one of these abusive plans.

Selecting the Proper Plan

Given all the options available for designing a qualified retirement plan, an employer must make a determination regarding what the goals of the plan are and which options will be allow the employer to accomplish those goals.

Characteristics of Defined Contribution Plans and Employee Demographics

Since we maintain an account for each employee that contains his/her contributions and account balance, a younger and older employee earning the same amount will get the same contribution (ignoring special methods of allocating we'll discuss later).

However, the older employee has less time for those funds to grow before he/she will draw on them for retirement and will receive fewer years of contributions. So, in a simple case, the defined contribution plan works out better for the younger worker.

Defined Contribution Pension Plans

Under most profit sharing plan arrangements, no penalties generally apply if the company fails to make a contribution; however, failure to make a contribution to a money purchase pension plan can result in the imposition of a penalty, and contributions must be made to a money purchase or target benefit pension plan even if the company does not have profits.

Due to changes made in the Economic Growth and Tax Relief Act of 2001, it is now rare to adopt a money purchase or target benefit pension plan, as the maximum contribution will be the same for a money purchase or target benefit plan and a profit sharing plan, and through the use of age-weighted allocations the bias of the target benefit plan in favor of older participants can be fairly well duplicated.

Advisers who encounter new clients with such a plan should consider inquiring if the client has a reason for having that type of plan and whether it may be appropriate to discuss changes with a plan consultant.

When a Defined Benefit Plan Should Be Considered

For many reasons, a defined benefit plan is a better choice than a defined contribution plan for a company whose key employees are close to retirement age if the goal of the plan is to maximize either employee benefits or employer contributions and the employer has consistently profitable results.

A defined contribution plan limits an employer's tax-deductible contributions to a dollar amount specified in the Internal Revenue Code. A defined benefit plan allows the company with older employees to make a larger contribution more rapidly. The contribution limitation under a defined benefit plan is the amount necessary to fund the annual promised pension. This amount may far exceed the allowable contribution to a defined contribution plan. [IRC Section 402(a)(1), 415(b), and 415(c)]

A defined benefit plan guarantees the benefit or income based on a predetermined formula. Assume the formula, which cannot discriminate, is a retirement benefit of 50 percent of salary

at age 65. Presumably, the older key employee earns more than a non-key employee at age 35. Assume that the actuaries state $10,000 of capital is needed at age 65 for every $10,000 of retirement income offered.

We need the same amount of money to fund the benefit for each employee who has the same salary, but we have a shorter period of time to fund for the older employer – thus, effectively, he "gets" a larger contribution (though, in fact, in a defined benefit plan there's not a true "account" for each participant).

Note: Recent IRS guidelines indicate to pension consultants that these types of plans are subject to inspection to see if, in fact, they are violently discriminatory. The above example is simply an example of the concept.

Of course, if the employer is more worried about the cost of the plan than maximizing benefits to older employees or is not confident regarding future profitability of the business, a defined benefit plan is much less attractive. As well, if the non-key employees are also older, they will drive up the cost of a traditional defined benefit plan.

Adopting Both a Defined Benefit and Defined Contribution Plan

An employer can adopt both, though a special combined limitation may apply in such a case. For single employer plans, a defined contribution plan contribution only begins to count against the combined limit to the extent it exceeds 6% of compensation, meaning that an employer could maximum fund a defined benefit plan and continue to make a 6% contribution to defined benefit plan. [IRC §404(a)(7)(C)(iii)] As well, contributions to multiemployer plans are not subject to this combined contribution limitation. [IRC §404(a)(7)(C)(iv)]

If a single employer defined benefit plan is required to be covered under the PBGC insurance program, that plan's contribution will not enter into the combined contribution limitation at all. [IRC §404(a)(7)(C)(v)] This provision, along with a related provision that reduces the insurance charge levied on small plans, was designed to encourage small employers to adopt defined benefit plans that would be subject to PBGC coverage.

For small closely held companies, these provisions present opportunities for tax planning to increase contributions to qualified plans and should be considered by advisers with such plans that currently are "maxing out" their contributions.

Impact of Unsteady Profits History

A profit-sharing plan is the only type of plan that would afford a company ultimate flexibility with respect to the contributions made from year to year. Most profit sharing plans contain provisions that allow the company's contributions to be determined annually by its board of directors.

EXAMPLE

Selecting an Employer Sponsored Plan

Nancy owns 100% of the shares in a manufacturer's representative business. She has other employees who work for the organization. She knows that if she has a plan established, she will need to cover other employees who meet certain criteria and she is concerned about the cost.

> Nancy is age 52 and her employees are all significantly younger than her. Her earnings are also well in excess of any of the employees. You ask her for an employee census (list of employees, ages, date began work, hours worked and salary) to be provided to a plan consultant.
>
> The consultant notes that either a defined contribution plan or a new comparability plan would allow a large portion of the contribution to go to the benefit of Nancy, with the employee contributions being less than the overall tax savings each year.
>
> Nancy's business has not had a consistent history of profits and the idea of a plan that entails a long term commitment worries her—so you suggest that she might want to go with the defined benefit new comparability profit sharing plan design. While the illustration shows it won't give her nearly as much going into the plan for her benefit, it does preserve her flexibility.

Required Minimum Distribution Rules

In order to understand the issues when dealing with IRAs and retirement plans in an estate, the CPA must have a solid understanding of the basic retirement plan distribution and beneficiary designation rules.

In this section we'll begin with the basic rules and then expand out from there.

Required Minimum Distribution (RMD) Provisions Prior to the Death of the Beneficiary

Beginning at age 59½ a taxpayer may begin to take distributions from an IRA or an employer sponsored retirement plan without the risk of triggering the 10% additional tax on premature distributions. A special rule applies to participants in employer sponsored plans who separate from the employer's service after age 55, but it is important to note that rule does not apply to IRA accounts, nor if the employee has not separated from service.

Regardless of whether the individual has taken payments earlier, the RMD rules come into play generally when an individual attains age 72 (previously 70½). [IRC §409(a)(9), §408(a)(6), §408(b)(3)] As noted above, the SECURE Act generally raised this rule to age 72. A Roth IRA is not subject to the minimum distribution rules until after the death of the owner of the account (or the spouse of the owner if she elects to treat the Roth IRA as her own). [IRC §408A(c)(5)]

Minimum required distributions must begin no later than April 1 of the year following the year a taxpayer attains age 72, though they can be made before the end of the year the taxpayer turns age 72. If a taxpayer turns 72 under the new rule on January 1 or any day in such year, he or she must begin RMD no later than April 1 of the following year. While the first RMD will be as described, the taxpayer must take the next year's distribution before December 31 of the following year.

Failure to take the RMD allows the IRS to assess a penalty of 50% of the amount by which distributions fell short of the minimum required. The penalty can be abated for reasonable cause and provided that reasonable steps are taken to correct the problem.

Any excess withdrawn above the RMD does not count toward a subsequent year's RMD, but does reduce the capital balance on which the RMD will be computed.

The RMD must be calculated for each IRA separately, and then totaled. The total RMD may be taken from one or any combination of IRAs.

This rule becomes important because the options for RMDs are different depending on whether or not the retirement account or IRA is "pay" status (that is, RMDs have begun) when the original participant or account holder dies.

One key issue to note is that if the account is pay status and the minimum distribution for the year had not been taken (or not completely taken) by the time the participant dies, the remaining balance of that year's RMD will need to be taken before December 31.

Death Prior to Entering Pay Status

To understand the options, we'll look first at the issues involved when an IRA or retirement account holder dies before the required beginning date with a named beneficiary who is not the account holder's spouse.

As a general rule, the account holder's spouse can always accept the same result as if he was not the spouse—but being the spouse opens up additional alternatives that may serve to stretch out the IRA distributions over a longer period.

Because a Roth IRA does not have a required beginning date, it would always be in "pre-pay" status when the account owner dies.

A key fact to remember is that while these options are available, the actual plan document (for an employer plan) or the IRA custodial agreement (for an IRA) may set default options or limit the options for the participant.

As such, the documents related to the plan or IRA should be consulted in addition to the material noted below for use in planning actions related to the retirement accounts.

Life Expectancy (One Year) Rule

Under this rule, the required minimum distribution for the year following the year of death of the account owner will be based on the life expectancy of the designated beneficiary. If there are multiple beneficiaries, the life expectancy of the one with the shortest life expectancy will be used to compute the payout for the entire account. [Reg. §1.401(a)(9) 5, Q&A 7(a)(1)]

Only individuals may be designated beneficiaries under these rules. If even a single beneficiary is not an individual as of the September 30 measuring date described below (e.g., a charity or most trusts), the account is treated as having no designated beneficiary, even though there may be individual beneficiaries. Without a designated beneficiary, the life expectancy rule described in this section is not available for the account. [Reg. §1.409(a)(9) 4, Q&A 3]

The IRC provides that the life expectancy rule is the rule to be used if the plan does not specify (or allow the election to use) another rule and the participant has a designated beneficiary (measured as of September 30 of the year following the year of death). [Reg. §1.401(a)(9) 3, Q&A 4(a)]

The plan document may allow a choice of methods or may even require the use of the five-year rule even if the participant has a designated beneficiary. [Reg. §1.401(a)(9) 3, Q&A 4(c)] If such an election is allowed, it must be made no later than the earlier of:

- December 31 of the calendar year in which distributions would have to start to satisfy the requirements of the life expectancy distribution provision (normally the year after of death); or
- the end of the fifth calendar year following the year of the employee's death.

Because the election deadline date is most often the end of the year following the year of death of the participant, the life expectancy rule is sometimes referred to as the one-year rule (for the period during which an election must be made).

Let us consider an example of the use of this rule:

EXAMPLE

Inherited Retirement Plan

Joe dies on June 1, 2018, with an IRA account balance of $100,000. The account names Mary, his daughter, as his sole beneficiary. Joe had not yet passed his required beginning date at the time of his death. The IRA document is silent with regard to the distribution method.

On December 1, 2019, Mary comes to her CPA asking about how much has to be distributed out of the IRA. No distributions have been made at this point and the account retained its value of $100,000 as of December 31, 2018. Mary's life expectancy under the IRS tables is 20 years.

The RMD must be determined under the life expectancy rules. Thus, the distribution is equal to the following:

$100,000/(20 years) = $5,000

Mary must take this distribution by December 31, 2019.

Assume that the account also had named a charity as a 10% beneficiary. Mary pays out the $10,000 amount left to the charity in a distribution to the charity in June of 2019.

Because only eligible designated beneficiaries exist in the account at September 30, the life expectancy rules are used.

Assume all the same facts as in the first case except the IRA provides that the 5-year rule must be used and the funds are in this IRA on September 30, 2019. In that case there is no required distribution that must be made by December 31, 2019.

However, the entire balance will need to be distributed by the end of 2023.

One item to note, which applies for all cases discussed in this section except where the spouse treats the IRA as her own, is that the distribution now switches to a single life calculation of life expectancy and is not recalculated annually. So, if the life expectancy of the designated beneficiary turns out to be 20 years, the account will be fully distributed over that 20-year period even if only RMD distributions are taken.

In the following year, one will be subtracted from the factor instead of going back to the table to recompute the individual's life expectancy. So for the second year in this case, the factor would be 19 years.

One other caveat is that if the spouse is the beneficiary but does not elect to treat the account as his own, the single life is recalculated annually until the spouse dies.

Also, if the owner had not passed his required beginning date, the spouse can delay distributions until the date in which the now deceased participant would have attained age 70½.

Under the SECURE Act enacted in late 2019, distributions to non-spouse beneficiaries must generally be made within 10 years. There are exceptions to this rule for distributions to spouses, disabled persons, individuals not more than 10 years younger than the account owner, plus there is an exception until the age of majority for minor children. The SECURE Act also generally raised the 70½ age rule to 72.

Five-Year Rule

The five-year rule is required to be used in a case where the participant did not have a designated beneficiary as of the September 30 date (which would include cases with a non-individual beneficiary of the account that would eliminate the ability for the account to have a designated beneficiary) or if the plan document requires that the five-year method be used. [Reg. §1.401(a)(9) 3, Q&A 4]

Under the five-year rule, the entire balance in the account must be distributed by the end of the fifth calendar year following the employee's death. [Reg. §1.401(a)(9)-3, Q&A 2]

EXAMPLE

Use of the Five-Year Rule

In the previous example, Mary could hold the entire $100,000 along with any earnings in the account until 2023 and then withdraw the entire balance.

Furthermore, she could withdraw any or all of the account in the intervening years. But the entire balance will have to be paid out by end of 2023.

Inherited IRAs and Prohibition on Rollovers

Distributions made to anyone other than to an employee, an employee's surviving spouse, or an employee's former or current spouse under a qualified domestic relations order (QDRO) are not eligible for rollover treatment. [Reg. §1.402(c)-2, Q&A 12(b)] Specifically, balances in an inherited IRA are not eligible for this treatment. [IRC §408(d)(3)(C)(i)]

What can be done are transfers from one custodian to another—that is a trustee-to-trustee transfer or a direct rollover of the account balance. [Revenue Ruling 78-406; see also PLR 201927009, July 5, 2019]

EXAMPLE

Trustee-to-Trustee Transfer for Inherited IRAs

Joe is upset with the IRA custodian, XYZ Bank, that held his father's IRA, which Joe became the beneficiary of upon his father's passing. He has the bank issue him a check directly from his father's IRA in the belief he then has 60 days during which he will be able to deposit those funds into an IRA with another custodian.

Joe is mistaken in that belief. The funds, once having "escaped" the inherited IRA can no longer be deposited into an account with another custodian. Thus, the entire distribution is taxable to Joe.

> Instead of getting a check, Joe opens an account titled as an inherited IRA with ABC Brokerage and has the funds transferred directly from XYZ Bank to ABC Brokerage. This transfer meets the requirements of Revenue Ruling 78-406 and is not taxable to Joe.

Unfortunately, many taxpayers have read on the internet about the ability to borrow from an IRA if they return the funds within 60 days. Regardless of the general inadvisability of doing that on an account the taxpayer controls (if the money doesn't get back in, the IRS will almost certainly not grant a request for a late rollover, so the holder is playing a high stakes, no-mistakes-allowed game), the option is simply not available at all for an inherited IRA.

Death After Entering Pay Status

The rules change somewhat following a participant passing her required beginning date. Under these rules the 5-year rule goes away, replaced now by a choice of life expectancy payouts.

As a result, if the participant had not taken her required distribution for the year in which she died, that distribution will be taken under the calculation that is applicable prior to the participant's death, paid out by the required distribution date to the named beneficiary (or beneficiaries) of the account.

Generally, the RMD is made based upon the longer of

- the participant's remaining life expectancy at the date of death (as odd as that sounds); or
- the life expectancy of the designated beneficiary.

The participant's remaining life expectancy at death is based upon the single life (rather than the joint life with a presumed 10-year-younger beneficiary or, if a longer factor, a joint life expectancy with the participant's spouse), using the participant's age as of his birthday for the year of death. [Reg. §1.401(a)(9)-5, Q&A 5(c)]

The life expectancy of the designated beneficiary who is not the participant's spouse is determined using that person's age as of his birthday for the year following the year of death of the participant. [Reg. §1.401(a)(9)-5, Q&A 5(c) (1)]

If the designated beneficiary is the employee's spouse who does not elect to treat the account as her own, the factor is still a single life factor but it is recalculated each year through the spouse's death. [Reg. §1.401(a)(9)-5, Q&A 5(c)(2)]

If there is no designated beneficiary, then the participant's life expectancy must be used.

Keep in mind that the SECURE Act, with certain exceptions, requires that after 2019, distributions to non-spousal beneficiaries must generally be made within 10 years. These rules apply as to deaths after 2019.

> **EXAMPLE**
>
> Inherited IRA After Original Owner Entered Pay Status
>
> Harry dies in March 2018 after beginning minimum distributions. He has named a trust that does not qualify for look-through status as the sole beneficiary of his IRA. The minimum distribution for 2018 will be based on Harry's single life for his age on his 2018 birthday (even if that birthday was after the date of his death).
>
> For future years, the minimum distribution will be reduced by one each year.

> Harry names his brother Jack as the beneficiary of the IRA. Harry's life expectancy based on his 2018 birthday is 10, while Jack's life expectancy based on his age upon his birthday in 2019 is 14. The 14 will be used for 2019 as the factor to determine the minimum required distribution to Jack. The 14 will be reduced by one each year for future distributions. But if Harry had not taken his minimum distribution for 2018 before he died, that distribution (which will be taken by Jack) will be based on the 10-year factor tied to Harry's life before switching to Jack's life expectancy in the following year.

Spouse as a Beneficiary

Special rules exist for dealing with a spouse who is the beneficiary of the retirement account.

Treating an IRA as the Spouse's Own Account

If the sole beneficiary of the IRA is the owner's surviving spouse, the spouse can elect to treat the IRA as her own account. To do so, the spouse must have the right to take unlimited withdrawals from the IRA account. A spouse cannot make this election if a trust is the beneficiary of the IRA, even if the spouse is the sole beneficiary of the trust. [Reg. §1.408-8, Q&A 5(a)]

Once the election is made, the RMD rules are computed treating the spouse as the IRA owner for the year the election is made and for each subsequent year, unless the election is made in the year the owner dies. For that year, the RMD rules are governed by the rules applicable to the now deceased owner of the account. [preamble to TD 8987]

If the spouse receives a distribution from an inherited IRA from her deceased spouse that the surviving spouse had not yet elected to treat as her own, the spouse may nevertheless roll the balance over within 60 days. Also, if the amount is received prior to the date the owner of the account would have turned 70½, no amount of the distribution is treated as an RMD solely for purposes of the rollover rules. [preamble to TD 8987]

The spouse can make the election a number of ways:

- The spouse simply retitles the IRA in her name and not as an inherited IRA.
- The spouse fails to take a required RMD distribution under the inherited IRA rules.
- A contribution is made to the IRA.

A spouse who makes this election gains some advantages but may also face some disadvantages.

The primary advantage is that the spouse's RMDs are now governed by the owner's rules, which look not only to the single life expectancy of the surviving spouse but add on the assumed 10-year-younger beneficiary. Thus, distributions can be extended over a longer period.

A less significant advantage is that, as her IRA, the account may receive contributions and the spouse can combine this account with her own IRAs, simplifying the number of accounts to track.

Though not totally clear, it also seems likely that once the election is made the funds would again be retirement funds and subject to protection under the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA). It should be noted, though, that the Supreme Court did not directly address this in its decision in the *Clark v. Rameker* case (134 S.Ct. 2242

(2014)). It is possible that a creditor may try and argue that either the funds are available to it during the period immediately following death or that the funds cease to be retirement funds once an owner dies even if they are later treated by the tax law as the spouse's own IRA.

Rollover from Retirement Plan by Surviving Spouse

A surviving spouse receiving a distribution from a retirement plan is also eligible to roll the distribution into a retirement plan if the distribution would have been eligible had the surviving spouse been the plan participant. [IRC §409(c)(9)]

The rollover can be made to any eligible plan—thus, in addition to placing the funds in an IRA (the most often seen rollover), the surviving spouse, if an eligible participant in a plan, may also roll the balance over to employer-sponsored plans (plans under §§401(a), 403(a), 403(b) or 457).

Non-Spouse Trustee-to-Trustee Transfers from Employer Plans to IRAs

A non-spouse beneficiary, while not eligible to rollover funds distributed from an employer-sponsored retirement plan to the beneficiary's own IRA, may nevertheless transfer funds in a trustee-to-trustee transfer from the deceased participant's balance in an employer plan to a new inherited IRA account. [IRC §402(c)(11)(A)]

Normally, plans must offer non-spouse beneficiaries the option of a trustee-to-trustee transfer to an inherited IRA. [IRC §401(a)(31)] The law was clarified beginning in 2010 to make clear that a plan could not restrict this offering only to spouses of the deceased participant.

Remember, though, that these individuals must insure that there is a trustee- to-trustee transfer and not take a check from the plan. As was described earlier, once a non-spouse beneficiary takes a distribution, there's no way to put the funds back into a retirement account.

September 30 Rule

Selecting a beneficiary when RMDs begin is no longer critical. A taxpayer may now change beneficiaries at will because choosing a beneficiary will have no impact on how fast the retirement account must be paid out during his lifetime or after death. In fact, the actual beneficiary does not even have to be determined until September 30 of the year following death.

That little proviso allows a primary beneficiary (such as a spouse) to disclaim the account in favor of a younger contingent beneficiary (such as a child or grandchild). The newly named beneficiary could then take RMDs from what's left in the retirement account over her life expectancy in that year. [Reg. §1.409(a)-4, Q&A 4(a)] Result? A significantly delayed payment of income taxes on the amount in the IRA.

Even more importantly, that provision allows for getting rid of (as in paying out their share) "problem" beneficiaries who have no life expectancy, such as a charitable organization.

The fundamental rule is that we can generally subtract beneficiaries (by paying them out or transferring their share to a separate IRA account), but not add beneficiaries, between the day the owner dies and September 30 of the following year. In PLR 201021038, the IRS refused to respect a state court order, issued after the date the taxpayer died, that sought to retroactively modify a trust so that there would be designated beneficiaries. That order was not given retroactive effect when determining designated beneficiaries.

It is essential to make sure that these actions take place by September 30 of the year following the year of death—because the beneficiaries of the account at that date are those who will be the pool from which designated beneficiaries will be taken.

A special rule applies if a designated beneficiary dies before the September 30 testing date. If that interest is not disclaimed, the deceased individual will be treated as a beneficiary as of September 30 of the year following the year of death without regard to the successor beneficiary. That means the age of the original beneficiary, and not the age of his heir, will be used for the purposes of finding the beneficiary with the shortest life expectancy. [Regs. §1.409(a)-4, A-4(c)]

NON-QUALIFIED DEFERRED COMPENSATION (NQDC) PLAN

An NQDC plan allows a service provider such as an employee to earn compensation such as salaries, bonuses, and other compensation in a year then defer receiving that income until a later year. This also allows a deferment of the tax on that income. The deferral can result in a lower tax liability when the income is paid as oftentimes the payment is received when the employee leaves the workforce.

Conditions of a NQDC Plan

The non-qualified type of plan is created by an employer to enable employees to defer compensation that they have a legally binding right to receive. There are several varieties of NQDC plans (IRC §409 plans). NQDC plans include bonus plans, severance pay plans, and supplemental executive retirement plans (SERPs).

The focus is on deferring part of annual compensation.

IRC §409A states the following conditions:

- The plan must be in writing.
- The plan document(s) specifies, at the time an amount is deferred, the amount to be paid, the payment schedule, and the triggering event that will result in payment. Permissible triggering events include:
  - a fixed date,
  - separation from service (e.g., retirement), and
  - a change in ownership or control of the company, disability, death, or an unforeseen emergency.
- Other events, such as the need to pay tuition for a child, a change in the financial condition of the company, or a heavy tax bill, are not permissible triggering events.
- The employee makes an irrevocable election to defer compensation before the year in which the compensation is earned. However, a special deferral election rule applies to commission payments.

The NQDC plan may also impose conditions. These can include noncompete clauses or clauses which prevent the employee from providing advisory services after the employee has retired. The deferred amount can yield a return when invested. The compensation amount and the earnings are later paid to the employee.

These conditions, if violated, will result to immediate taxable income and additional penalties and interest.

Impact on the Employers

NQDC plans are more flexible than other plans that are qualified. The flexibility allows employers to offer these plans to specific employees such as executives and key employees since they are not governed by the Employee Retirement Income Security Act (ERISA). Therefore, there are no nondiscrimination rules.

These plans are also used as "golden handcuffs." Golden handcuffs are financial benefits used to encourage employees to remain with the company instead of moving to another company.

This amount is not deductible until paid, although it improves cash flow.

Impact on Employees

Unlimited savings and tax benefits are available. There is no limit to contributions as set forth in qualified deferred compensation plans. While the deferral of compensation under this plan also allows for withholding tax deferral, the deferred compensation is still subject to FICA and FUTA taxes in the year it is earned. Investment options are also available under this plan. As there is no restriction on the limitation, it allows for investment at a larger scale.

On the other hand, NQDC plans are not protected by ERISA. There are also strict distribution schedules that are put in place in which the employee can withdraw the funds only at the set date as stated in the plan.

> **EXAMPLE**
>
> Mendek, Inc. has an NQDC plan with his key employee, Jesse Mendek. The NQDC plan is for $12M and it states that Jesse Mendek will receive these funds and any growth related to the funds on June 30, 2020. Jesse is fine with this as he anticipates that he will retire by then. Jesse decided to retire a year earlier based on his doctor's advice. He put in his resignation effective June 30, 2019. He approached Mendek, Inc. and asked for his compensation on his resignation date. The NQDC plan does not allow this. He will have to wait until June 30, 2020.

QUALIFIED OPPORTUNITY ZONES

The qualified opportunity zone investments added by the Tax Cuts and Jobs Act actually combine deferral and conversion strategies. But when the CPA first raises the issue, the key advantage that is likely focused on is the ability to defer paying tax on capital gains until 2026 if they are reinvested in such funds.

In order to encourage investment in areas designed as disadvantaged by the various states, Congress added in special incentives for taxpayers to invest in qualified opportunity zone funds. Such funds consist almost entirely of investments in qualified opportunity zones, as recognized by the IRS upon application by the various states to have areas included in the list.

The IRS issued proposed regulations in 2018 and May 2019, then issued final regulations late in 2019. [IR-2019-212, December 19, 2019]

Qualified Opportunity Zones

Under IRC §1400Z-1, these zones must meet certain criteria and be designated for this status by the State in which the proposed zone is located. The IRS is charged with certifying that the zones nominated meet the requirements to be designated zones.[13]

The IRS has released the list of designated qualified opportunity zones under IRC §1400Z-1 in Notice 2018-48. The 383-page list defines areas for investment that can be used for qualified investments under IRC §1400Z-2 added by the Tax Cuts and Jobs Act.

Tax Benefits of Investing in a Qualified Opportunity Zone

The qualified opportunity zone fund provides several benefits to investors. These include:

- The ability to defer gains from the sale of property held by the taxpayer sold to a third party so long as the gain is invested in a qualified opportunity zone fund. Generally, such investment must be within 180 days beginning on the date of sale of the gain producing property. [IRC §1400Z-2(a)] Only gains recognized as capital gains for federal tax purposes qualify for this treatment. [Reg. §1.1400Z2(a)-1(a)(11)]
- The deferred gain is includable in income on the earlier of the date the investment in the fund is sold or December 31, 2026. However, this deferred gain is slowly transformed to some degree into tax-exempt gain over time. If the investment is held over 5 years, the basis in the deferred gain (which starts out at zero) is increased to 10% of the deferred gain. If the taxpayer holds the property more than 7 years, the excluded gain increases by an additional 5% of the deferred gain. [IRC §1400Z-2(a)(2)(B)] Investments made after 2019 would not qualify as having been held seven years by December 31, 2026.
- If the qualified opportunity fund investment is held for at least 10 years, the taxpayer may elect to have the basis of such property set as equal to the fair market value of the investment on the date the investment is sold or exchanged. [IRC §1400Z-2(c)]

If the taxpayer makes investments in the fund both of amounts to which the special deferral applies and other investments, the investment shall be treated as two separate investments and the special gain rules described above found in IRC §1400Z-2(a), (b), and (c) will apply only to the portion of the investment that came from the deferred gain investment.[14]45

EXAMPLE

Using a Qualified Opportunity Zone Investment

Janet sells publicly traded stock for a $390,000 capital gain in 2019. Ninety days later she pays $390,000 to acquire a qualified opportunity fund (QOF) on June 20, 2019. By doing this, she will not need to report the $390,000 capital gain on her 2019 return and won't need to pay tax on that gain.

If she holds the QOF until at least June 20, 2024, she will pick up $39,000 of basis in the investment (10% of the deferred gain). If she continues to hold it until at least June 20, 2026, her basis in the investment will rise to $58,500. At the end of 2026, Janet will pay tax on the deferred gain less the basis she has now established in the fund, or $331,500.

If Janet continues to hold the fund until at least June 20, 2029, when she sells the fund, she can elect to treat the basis as being equal to the selling price.

[13] IRC §1400Z-1(a)(1)

[14] IRC §1400Z-2(e)(1)

Thus, if she sells the QOF investment on May 12, 2030, for $1,000,000, she will pay no tax on that sale.

Considerations for Qualified Opportunity Funds

The tax benefits of the qualified opportunity funds are significant. But it is important to recognize that unless the taxpayer invests in a QOF that increases in value, he/she won't see much real benefit. One has to balance the potential tax benefits and appreciation potential for this investment while also weighing potential investment gains with other investments.

EXAMPLE

Investment Goes Sour

Assume Janet's example had not grown to $1,000,000, but rather became worthless after 9 years. Janet had continued to hold the fund, hoping to get that total tax-exempt growth.

In this case, had Janet simply paid the tax back in 2019, she would have potentially had to have paid in 23.8% of the $390,000 gain in 2019, or $92,820, leaving her with cash of $297,180. Of course, she would have paid 85% of that tax in 2026 ($78,897).

As well, by holding on to the investment to the bitter end, she now has $0. So despite having seen a significant tax savings in 2019, she would have been far better off financially had she not invested in the QOF.

§1031 EXCHANGES

Like-kind exchanges are also a pure deferral mechanism. By arranging for a like-kind exchange a taxpayer can move to a new investment without paying tax on the gain. But the trade-off is that taxpayers have to invest in like-kind property—so if a taxpayer believes that now is the time to get out of real estate, doing the like-kind exchange won't allow moving out of investing in real estate.

Congress in the TCJA decided to greatly limit the availability of like-kind exchanges, limiting them entirely to real property for tax years beginning on or after January 1, 2018. Taxpayers may still be concerned with transactions beginning before that date, so we still discuss exchanges of other types of property.

However, going forward, advisers must remember that only real property will now be covered by the like-kind exchange deferral provisions of IRC Section 1031.

IRC Section 1031 is meant to allow a taxpayer in certain circumstances to ignore the general rule that an exchange of one asset for another is treated as a taxable event (note that your tax references, as well as tax forms, constantly refer to a sale or exchange when discussing taxation of dispositions).

Conceptually, Congress determined that if a taxpayer exchanged certain property held for profit for "similar enough" property, it would not generate a tax event. Note that this section is not elective; if it applies, it must be used, and it can (and does) work to delay the recognition of losses as well as gains.

The Exchange of Property

To be a like-kind exchange, the property given up and the property received must be both of the following:

- Qualifying property
- Like-kind property

Additional requirements apply to exchanges in which the property received is not received immediately upon the transfer of the property given up.

If the exchange involves the receipt of money or unlike property or liabilities, gain may have to be recognized.

The like-kind exchange rules also apply to property exchanges that involve three- and four-party transactions. Any part of these multiple-party transactions can qualify as a like-kind exchange if it meets all the requirements.

A like-kind exchange can involve the receipt of property and title from a third party if it meets all the requirements.

The basis of the property acquired in a like-kind exchange is generally the same as the basis of the property given up.

EXAMPLE

Exchange of Real Estate

Alan exchanged real estate held for investment with an adjusted basis of $25,000 for other real estate held for investment. The FMV of both properties is $50,000. The basis in Alan's new property is the same as the basis in his old property ($25,000).

If money (boot) is paid in addition to giving up like-kind property, no gain or loss will be recognized. The basis of the property received is the basis of the property given up, increased by the money paid.

If property is sold and similar property is purchased in two mutually dependent transactions, the IRS may treat the sale and purchase as a single nontaxable step transaction.

Reporting

Report the exchange of like-kind property, even though no gain or loss is recognized, on Form 8824, Like-Kind Exchanges.

Form **8824**

Department of the Treasury
Internal Revenue Service

Like-Kind Exchanges

(and section 1043 conflict-of-interest sales)

Attach to your tax return.

Go to *www.irs.gov/Form8824* for instructions and the latest information.

OMB No. 1545-1190

2022

Attachment Sequence No. **109**

Name(s) shown on tax return | **Identifying number**

Part I Information on the Like-Kind Exchange

Note: Only real property should be described on lines 1 and 2. If the property described on line 1 or line 2 is real property located outside the United States, indicate the country.

1 Description of like-kind property given up:

2 Description of like-kind property received:

3 Date like-kind property given up was originally acquired (month, day, year) . . . . **3** MM/DD/YYYY

4 Date you actually transferred your property to the other party (month, day, year) . . . . **4** MM/DD/YYYY

5 Date like-kind property you received was identified by written notice to another party (month, day, year). See instructions for 45-day written identification requirement . . . . **5** MM/DD/YYYY

6 Date you actually received the like-kind property from other party (month, day, year). See instructions **6** MM/DD/YYYY

7 Was the exchange of the property given up or received made with a related party, either directly or indirectly (such as through an intermediary)? See instructions. If "Yes," complete Part II. If "No," go to Part III . . . ☐ **Yes** ☐ **No**

Note: Do not file this form if a related party sold property into the exchange, directly or indirectly (such as through an intermediary); that property became your replacement property; and none of the exceptions on line 11 applies to the exchange. Instead, report the disposition of the property as if the exchange had been a sale. If one of the exceptions on line 11 applies to the exchange, complete Part II.

Part II Related Party Exchange Information

8 Name of related party | Relationship to you | Related party's identifying number

Address (no., street, and apt., room, or suite no.; city or town; state; and ZIP code)

9 During this tax year (and before the date that is 2 years after the last transfer of property that was part of the exchange), did the related party sell or dispose of any part of the like-kind property received from you (or an intermediary) in the exchange? . . . . ☐ **Yes** ☐ **No**

10 During this tax year (and before the date that is 2 years after the last transfer of property that was part of the exchange), did you sell or dispose of any part of the like-kind property you received? . . . . ☐ **Yes** ☐ **No**

*If both lines 9 and 10 are "No" and this is the year of the exchange, go to Part III. If both lines 9 and 10 are "No" and this is **not** the year of the exchange, stop here. If either line 9 or line 10 is "Yes," complete Part III and report on this year's tax return the deferred gain or (loss) from line 24 **unless** one of the exceptions on line 11 applies.*

11 If one of the exceptions below applies to the disposition, check the applicable box.

a ☐ The disposition was after the death of either of the related parties.

b ☐ The disposition was an involuntary conversion, and the threat of conversion occurred after the exchange.

c ☐ You can establish to the satisfaction of the IRS that neither the exchange nor the disposition had tax avoidance as one of its principal purposes. If this box is checked, attach an explanation. See instructions.

For Paperwork Reduction Act Notice, see the instructions. Cat. No. 12311A Form **8824** (2022)

Form 8824 (2022) Page 2

Name(s) shown on tax return. Do not enter name and social security number if shown on other side. | Your social security number

Part III Realized Gain or (Loss), Recognized Gain, and Basis of Like-Kind Property Received

Caution: If you transferred **and** received (**a**) more than one group of like-kind properties, or (**b**) cash or other (not like-kind) property, see ***Reporting of multi-asset exchanges*** in the instructions.

Note: Complete lines 12 through 14 **only** if you gave up property that was not like-kind. Otherwise, go to line 15.

Line	Description			
12	Fair market value (FMV) of other property given up. See instructions	12		
13	Adjusted basis of other property given up	13		
14	Gain or (loss) recognized on other property given up. Subtract line 13 from line 12. Report the gain or (loss) in the same manner as if the exchange had been a sale		14	
	Caution: If the property given up was used previously or partly as a home, see ***Property used as home*** in the instructions.			
15	Cash received, FMV of other property received, plus net liabilities assumed by other party, reduced (but not below zero) by any exchange expenses you incurred. See instructions		15	
16	FMV of like-kind property you received		16	
17	Add lines 15 and 16		17	
18	Adjusted basis of like-kind property you gave up, net amounts paid to other party, plus any exchange expenses **not** used on line 15. See instructions		18	
19	**Realized gain or (loss).** Subtract line 18 from line 17		19	
20	Enter the smaller of line 15 or line 19, but not less than zero		20	
21	Ordinary income under recapture rules. Enter here and on Form 4797, line 16. See instructions		21	
22	Subtract line 21 from line 20. If zero or less, enter -0-. If more than zero, enter here and on Schedule D or Form 4797, unless the installment method applies. See instructions		22	
23	**Recognized gain.** Add lines 21 and 22		23	
24	Deferred gain or (loss). Subtract line 23 from line 19. If a related party exchange, see instructions		24	
25	**Basis of like-kind property received.** Subtract line 15 from the sum of lines 18 and 23. See instructions		25	

Part IV Deferral of Gain From Section 1043 Conflict-of-Interest Sales

Note: This part is to be used **only** by officers or employees of the executive branch of the federal government or judicial officers of the federal government (including certain spouses, minor or dependent children, and trustees as described in section 1043) for reporting nonrecognition of gain under section 1043 on the sale of property to comply with the conflict-of-interest requirements. This part can be used **only** if the cost of the replacement property is more than the basis of the divested property.

26 Enter the number from the upper right corner of your certificate of divestiture. (**Do not** attach a copy of your certificate. Keep the certificate with your records.) ____ – ____

27 Description of divested property ____________________

28 Description of replacement property ____________________

Line	Description			
29	Date divested property was sold (month, day, year)		29	MM/DD/YYYY
30	Sales price of divested property. See instructions	30		
31	Basis of divested property	31		
32	**Realized gain.** Subtract line 31 from line 30		32	
33	Cost of replacement property purchased within 60 days after date of sale	33		
34	Subtract line 33 from line 30. If zero or less, enter -0-		34	
35	Ordinary income under recapture rules. Enter here and on Form 4797, line 10. See instructions		35	
36	Subtract line 35 from line 34. If zero or less, enter -0-. If more than zero, enter here and on Schedule D or Form 4797. See instructions		36	
37	**Deferred gain.** Subtract the sum of lines 35 and 36 from line 32		37	
38	**Basis of replacement property.** Subtract line 37 from line 33		38	

Form **8824** (2022)

If gain is recognized because of the reception of money or unlike property, the gain is reported on Schedule D (Form 1040) or Form 4797, whichever applies. Ordinary income may have to be reported from depreciation recapture.

Exchange Expenses

Exchange expenses are generally the closing costs that are paid. They include such items as brokerage commissions, attorney fees, and deed preparation fees. Subtract these expenses from the consideration received to figure the amount realized on the exchange. Also, add them to the basis of the like-kind property received. If cash or unlike property is received in addition to the like-kind property, and gain is realized on the exchange, subtract the expenses from the cash or FMV of the unlike property. Then, use the net amount to figure the recognized gain.

EXAMPLE

Exchange Expenses

Robert exchanges investment property with an FMV of $50,000 and a basis of $25,000 for like-kind property with an FMV of $45,000 and cash of $5,000. He incurs closing expenses of $4,000. He will recognize gain of $1,000 ($5,000 cash received less $4,000 of expenses).

His basis in the property will be:

Basis of property given up		$ 25,000
Gain realized-boot received	$ 5,000	
Less expenses	(4,000)	
Gain recognized		1,000
Basis in new property		26,000
Basis in cash received		(1,000)
Basis in investment property		$ 25,000

Qualifying Property

As part of the TCJA passed in December 2017, Congress limited like-kind exchanges under Section 1031 to solely real property. Thus, personal property, regardless of its use, does not qualify for like-kind exchange treatment under IRC Section 1031.

As amended, IRC Section 1031(a) now reads:

(1) In General

No gain or loss shall be recognized on the exchange of real property held for productive use in a trade or business or for investment if such real property is exchanged solely for real property of like kind which is to be held either for productive use in a trade or business or for investment.

The CPA must understand that Section 1031 rules apply differently to certain industries. While many forms of oil and gas interests qualify as real property for U.S. federal income tax purposes,[15] not all oil and gas interests are treated as real property for federal income tax purposes, even if the particular interest is treated as real property under applicable state law.[16] IRC Section 1031(a)(2) is simplified to read as follows:

(2) Exception for Real Property Held for Sale

This subsection shall not apply to any exchange of real property held primarily for sale.

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[15] See, e.g., *Palmer v. Bender*, 287 U.S. 551 (1933) (royalty interest); Rev. Rul. 73-428, 1973-2 C.B. 303 (royalty interest); Rev. Rul. 72-117, 1972-1 C.B. 226 (overriding royalty interest); Rev. Rul. 68-226, 1968-1 C.B. 362 (interest of a lessee in oil and gas in place).

[16] See, e.g., Rev. Rul. 68-226, 1968-1 C.B. 362 (stating that federal tax law is not subject to state law unless express language provides otherwise or the necessary implication of the section involved so requires).

Like-Kind Property

There must be an exchange of like-kind property. Like-kind properties are properties of the same nature or character, even if they differ in grade or quality. For example, the trade of land improved with an apartment house for land improved with a store building is a like-kind exchange.

Real Property Interests Like-Kind

The exchange of real estate for a real estate lease that runs 30 years or longer is a like-kind exchange. However, not all exchanges of interests in real property qualify. The exchange of a life estate expected to last less than 30 years for a remainder interest is not a like-kind exchange.

An exchange of a remainder interest in real estate for a remainder interest in other real estate is a like-kind exchange if the nature or character of the two property interests is the same.

Foreign Real Property

Real property located in the United States and real property located outside the United States are not considered like-kind property under the like-kind exchange rules. An exchange of foreign real property for property located in the United States will result in gain or loss on the exchange. Foreign real property is real property not located in a state or the District of Columbia.

This foreign real property exchange rule does not apply to the replacement of condemned real property. Foreign and U.S. real property can still be considered like-kind property under the rules for replacing condemned property, so as to postpone reporting gain on the condemnation.

Deferred Exchange

A *deferred exchange* is one in which property used in business or held for investment was transferred and, at a later date, like-kind property that will be used in business or hold for investment is received. The property received is replacement property. The transaction must be an exchange, property for property, rather than a transfer of property for money used to buy replacement property.

Actual or Constructive Receipt

If, before the replacement property was received, the taxpayer actually or constructively received money or unlike property in full payment for the property transferred, the transaction will be treated as a sale rather than a deferred exchange. In that case, realized gain or loss on the transaction will be recognized, even if the taxpayer later received the replacement property.

Money or unlike property is constructively received when it is credited to the taxpayer's account or made available to the taxpayer. The taxpayer also constructively receives money or unlike property when any limits or restrictions on it expire or are waived.

Whether the taxpayer actually or constructively receives money or unlike property is determined without regard to certain arrangements made to ensure that the other party carries out its obligation to transfer the replacement property to the taxpayer. For example,

if the taxpayer has the obligation secured by a mortgage or by cash or its equivalent held in a qualified escrow account or qualified trust, that arrangement will be disregarded in determining whether the taxpayer actually or constructively receive money or unlike property. [See Reg. §1.1031(k)-1(g)][17]

Identification Requirement

The taxpayer must identify the property to be received within 45 days after the date the original property transferred is given up in the exchange. This period is called the identification period. Any property received during the identification period is considered to have been identified.

If more than one property is transferred as part of the same transaction, and the properties are transferred on different dates, the identification period and the receipt period begin on the date of the earliest transfer.[18]

The taxpayer must identify the replacement property in a signed written document and deliver it to the other person involved in the exchange. The replacement property must be clearly identified in the written document. For example, use of the legal description or street address is required for real property, and the make, model, and year is required for a car. In the same manner, cancellation of an identified replacement property at any time before the end of the identification period is allowable.

Identifying Multiple Properties

A taxpayer can identify more than one replacement property. Regardless of the number of properties given up, the maximum number of replacement properties that can be identified is the greater of

- three; or
- any number of properties whose total fair market value (FMV) at the end of the identification period is not more than doubles the total FMV, on the date of transfer, of all properties given up.

If, as of the end of the identification period, the taxpayer has identified more properties than permitted under this rule, the only property that will be considered identified is

- any replacement property received before the end of the identification period; and
- any replacement property identified before the end of the identification period and received before the end of the receipt period, but only if the FMV of the property is at least 95% of the total FMV of all identified replacement properties. FMV is determined on the earlier of the date the property is received or the last day of the receipt period.[19]

[17] IRS Publication 544, 2018, p. 14

[18] IRS Publication 544, 2018, p. 13

[19] IRS Publication 544, 2018, p. 13

Deadline for Receipt of Like-Kind Property

The property must be received by the earlier of

- the 180th day after the date on which the taxpayer transfers the property given up in the exchange; or
- the due date, including extensions, for the taxpayer's tax return for the tax year in which the taxpayer gave up the property.

Where the replacement property is produced after the taxpayer identifies it, variations due to usual production changes are not taken into account to determine whether the property that was received was substantially the same as the property given up. Substantial changes in the property to be produced, however, will disqualify it.

If the replacement property is real property that had to be produced and is not completed by the date the taxpayer received it, it still may qualify as substantially the same property as identified. It will qualify only if—had it been completed on time—it would have been considered to be substantially the same property identified. It is considered to be substantially the same only to the extent it is considered real property under local law. However, any additional production on the replacement property after receipt does not qualify as like-kind property. To this extent, the transaction is treated as a taxable exchange of property for services.

Like-Kind Exchanges Using Qualified Intermediaries

If property is transferred through a qualified intermediary, the transfer of the property given up and receipt of like-kind property is treated as an exchange. This rule applies even if money or other property was received directly from a party to the transaction other than the qualified intermediary.

Definition of a Qualified Intermediary

A qualified intermediary is a person who enters into a written exchange agreement with the taxpayer to acquire and transfer the property the taxpayer gave up, and to acquire replacement property and transfer it to the taxpayer. This agreement must expressly limit the taxpayers' rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by the qualified intermediary.

A qualified intermediary cannot be either of the following:

- The taxpayers' agent at the time of the transaction. This includes a person who has been an employee, attorney, accountant, investment banker or broker, or real estate agent or broker within the two-year period before the transfer of property given up.
- A person who is related to the taxpayer or her agent is determined under the attribution rule, replacing 10% with 50%.

Transfer to Related Person

A taxpayer who transfers property given up to a qualified intermediary in exchange for replacement property formerly owned by a related person is not entitled to nonrecognition treatment if the related person receives cash or unlike property for the replacement property.

Requirements for QI Acquiring and Transferring Property

An intermediary is treated as acquiring and transferring property if all the following requirements are met:

- The intermediary acquires and transfers legal title to the property.
- The intermediary enters into an agreement with a person other than the original transferor for the transfer to that person of the property the original transferor gave up and that property is transferred to that person.
- The intermediary enters into an agreement with the owner of the replacement property for the transfer of that property and the replacement property is transferred to the original transferor.

An intermediary is treated as entering into an agreement if the rights of a party to the agreement are assigned to the intermediary and all parties to that agreement are notified in writing of the assignment by the date of the relevant transfer of property.

SECTION 351

Section 351 allows shareholders to transfer assets to a newly formed corporation tax free at the time of the transfer. The tax is deferred until the newly formed corporation disposes of the asset.

Section 351(a) provides that no gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control (as defined in § 368(c)) of the corporation.

Section 368(c) defines control to mean the ownership of stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock of the corporation.

Section 1.351-1(a)(1) of the Income Tax Regulations provides that the phrase “immediately after the exchange” does not necessarily require simultaneous exchanges by two or more persons, but comprehends a situation where the rights of the parties have been previously defined and the execution of the agreement proceeds with an expedition consistent with orderly procedure.

The CPA must ensure that the conditions are met to allow the client benefit from this tax-free setup. Many clients may want to move from sole proprietorship or a partnership to a Corporation. Oftentimes they are joined by others new shareholders.

The CPA must ensure that the client is receiving stock for property and that the client maintains control of the newly formed corporation as stated under Section 368(c).

Sec. 368(c) defines control as the ownership of stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock of the corporation.

EXAMPLE

M1 has three classes of stock. Classes R and S are voting common stock, and Class T is nonvoting common stock. The shares are owned by X1 and X2 shown in Exhibit A. X1 and X2 are unrelated parties. X1 transfers property (with unrealized gain) to M1 in exchange for 50 shares of Class R stock and 120 shares of Class S stock in

a value-for-value exchange. X2 does not transfer any property. The stock ownership of M1 after the exchange is shown in Exhibit B.

Exhibit A: Stock ownership in M1

	Class R(voting)	Class S(voting)	Class T(non-voting)
X1	70	40	20
X2	30	40	20
Total	100	80	40

Exhibit B: Stock ownership in M1 after the exchange

	Class R(voting)	Class S(voting)	Class T(non-voting)
X1	120	160	20
X2	30	40	20
Total	150	200	40

After the exchange, X1 now owns 80% of the total combined voting power of all classes of stock entitled to vote (Classes R and S) (280 ÷ 350) and 50% of all other classes of stock (Class T). Because the threshold requirement for control under Sec. 351 is not met (X1 owns only 50% of Class T instead of at least 80%), X1's transfer of property to M1 does not meet the requirements of Sec. 351 and is subject to federal income tax.

EXAMPLE

The facts are the same as in Example above, except that in addition to the Class R stock and Class S stock received, X1 receives 60 shares of Class I stock. The stock ownership after the exchange is shown in Exhibit C, below.

Exhibit C

	Class R(voting)	Class S(voting)	Class T(non-voting)
X1	120	160	80
X2	30	40	20
Total	150	200	100

In the scenario above, X1 meets the Sec. 351 control threshold after the transfer because it owns 80% of the total combined voting power of all classes of stock entitled to vote (Classes R and S) (280 ÷ 350) and 80% of the total number of shares for all other classes of stock (Class T) (80 ÷ 100). Because the control requirement is met, the transfer qualifies for tax-free treatment under Sec. 351.

Property

Section 351 property includes installment notes, plant and equipment, unrealized receivables of a cash basis taxpayer,[20] propriety processes and formulas including proprietary information in the general nature of a patentable invention.[21]

20 Hempt bros Inc v US74 1 ustc 9188 33 490 f2d 1172(CA-3,1974)

21 Rev. Rul. 64-56, 1964 -1 C.B, 133:Rev Rul.71-564,1971-2 C.B.179

Exchanging Stock for Compensation

It is important to note that the exchange must be of property. Oftentimes, a newly formed corporation provides stock in lieu of compensation, the value of the compensation is taxable to the recipient.

EXAMPLE

Manny, Eric, and Todd form a Corporation MET Designs. Manny transfers property with a basis of $200,000 and a FMV of $250,000 in exchange for 40% stock; Eric transfers property with a basis of $150,000 and a FMV of $175,000 in exchange for 25% stock; and Todd is given 35% stock in place of annual compensation of $400,000 for working as their lead designer. Since Todd is not transferring property and Manny and Eric's total shares is less than the 80%, this transaction does not qualify for the section 351 exchange.

The CPA may consider reducing Todd's stock ownership to ensure the shareholders benefit from the deferral.

Nominal Property Transfer

There are instances where property and compensation are transferred and the transactions still qualify as a section 351 transaction. Treasury Reg Section 1>351-1(a)(1)(ii) provides that any stock issued for property with a value that is relatively small in comparison with the value of the stock already owned (or to be received for services that are rendered) will not be treated as issued for the return of the property. The IRS states that a transferor can be included in the control group as long as the value of the property transferred is at least 10% of the value of the services provided.

EXAMPLE

Mikey and Steve form MS Corporation. Mikey transfers land worth $100,000 with a basis of $20,000. Steve transfers equipment worth $50,000 with an adjusted basis of $10,000 and provides services worth $50,000. Mikey and Steve each receive 50% of the MS stock. Because the value of the property transferred is not nominal related to the services, section 351 will apply.

If the property transferred was worth $1,000 then section 351 will not apply as the property transferred list of nominal value.[22]

Other ways to violate section 351.

- Having a binding commitment that violates the "control immediately after" requirement:

A transferor receiving stock in the exchange who is under a binding agreement to sell the stock received cannot include that stock for purposes of satisfying the "immediately after" control test. The contractual obligation to dispose of the stock, that stock is treated as if it was never held by the original transferor.[23] Thus, if, before the contribution, the transferors enter into a binding agreement to sell to a third party more than 20% of the shares they received in the exchange, section 351's control requirement will not have been satisfied.

22 Rev.Poc 77-37.977-2 C.B.56B

23 See, e.g., Intermountain Lumber Co., 65 T.C. 1025 (1976); Rev. Rul. 79-194, 1979-1 CB. See also Reg. §1.338-3(b)(3)(iii), Example 1; Reg. §1.197-2(k), Example 24.

- Using nonqualified preferred stock:

Nonqualified preferred stock (NQPS) is debt-like preferred stock that is treated as taxable consideration for purposes of section 351 exchange.[24] If a taxpayer contributes property in exchange for a mix of voting stock and NQPS, the NQPS will be treated as boot and potentially generate gain.

- Contribution of property in exchange for stock of the recipient corporation's parent:

If the transferor instead contributes property to a corporation in exchange for stock of the transferee corporation's parent, the contribution generally does not qualify under section 351.[25]

Tax Planning

There are certain times that a shareholder may want to opt out of the section 351, this may occur when the transferor decides to recognize gain in the transfer of property if the tax cost is low or if the transferor wants to recognize a loss, as section 351 does not allow recognition of any gain or loss on the transfer of property to the corporation.

In planning, the CPA must understand the client's objective before advising the client whether to go with section 351.

Section 6166 is another deferral section

Section 6166 in certain situations allows the executor of an estate to defer federal estate tax on a closely held business following an owner's death. The code's requirements apply where the decedent's ownership in the closely held business accounted for at least 20% of the company's value and more than 35% of the value of his or her adjusted gross estate at the time of death.

Section 6166 applies to any business structure but the number of shareholders are limited to 45 in the case of a corporation and limited to 45 partners in the case of a partnership or an LLC taxed as a partnership. The business must also be an Active Trade or Business.

Once these conditions are met, the executor is permitted to elect to defer and spread payment of the estate tax over a period of up to 14 years. In the early years of the deferral period, payments to the Treasury can be made as interest only. The estate tax deferral under this IRC section relates only to the business portion of the decedent's estate that represents the decedent's ownership in the company.

The advantage of this deferral is that it prevents the taxpayer's estate from coming up with a large payment within 9 months of the decedent's death, which is the due date of the tax return.

EXAMPLE

A successful car dealer has 15 locations. The spouse manages the dealership. The car dealer dies and leaves his ownership percentage to his spouse, the spouse now controls 100% of the business. Four years later, the widow dies and at the time of death the estate was valued at $60,000,000. At the time of death, the car dealership was worth $25,000,000. The estate qualifies for Section 6166 election. Assuming the widow has exhausted the unified lifetime exclusion.

24 Section 351(g)

25 See Rev. Rul. 84-44, 1984-1 CB 105

> Without the election the estate would have to pay taxes of $24,000,000 ($60,000,000 × 40%). If the estate does not have the amount in 9 months, the estate will have to pay interest and penalties on the outstanding taxes due.
>
> The election allows for up to 14 years deferral and the 1st principal payment is due after 5 years of death. Interest payment is due beginning from 9 months after the death. A special interest rate of 2% applies to a portion of the deferred tax. The portion of the tax to which the special 2% rate applies is the lesser of these:
>
> the full portion of the estate tax attributable to the closely held business, or the product of multiplying the 40% tax rate by the inflation-adjusted taxable value set by code section 6166. Originally $1 million, the amount has been indexed for inflation to $1.59 million for decedents dying in 2021.[26]

Tax Planning

The IRS may deny the valuation of the business. The CPA must ensure that the client appraises the business and the entire estate as soon as possible to ensure that the value of the business qualifies for the section 6166 deferral. The CPA should elect based on executors permission to defer the business interest, then pay the proper amount of taxes due for the nonbusiness estate assets, which are ineligible for the 6166 tax deferral.

26 Internal Revenue Procedure 2020-45 (Section 3. 2021 Adjusted Items, .51)

UNIT 4

Conversion Planning in Action

LEARNING OBJECTIVES

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

› Explain how rental real estate is used to convert taxable income to lower rates.
› Advise clients on the importance of after-tax returns for municipal bonds.
› Explain the use of §1202 stock and advise clients on when structuring a new business to qualify for §1202 status is appropriate.

In this chapter we plan to look at some practical tax strategies that make use of conversion of income to have it taxed at a lower rate. The strategy takes advantage that Congress uses the tax law to encourage certain activities by taxing income related to those activities at lower tax rates.

RENTAL REAL ESTATE—ORDINARY LOSSES, §1231 GAINS

One of the key strategies that many taxpayers use is the acquisition of rental real estate properties. Normally, the taxpayers get into rental real estate primarily attracted by a couple of features often found in the rental of real estate as an investment:

- Rents received are often enough to offset the out-of-pocket payments made each year, but due to the fact that in the early years, depreciation is most often greater than the principal being paid on the mortgage to acquire the property, there is no income taxes due on the annual rents.
- The property acquired is often expected to rise in value during the period the property is rented, with tax begin imposed on this increase in value only when the property is eventually sold by the taxpayer.

EXAMPLE

Rental Property as an Investment

Alexander purchases a residential rental property for $900,000 on January 1. He puts down 20% ($180,000) and finances the rest on a 30-year mortgage with a 5.25% interest rate. He expects to rent the property for $4,500.00 per month. His average cash expenses per month he expects to be $450 a month, which includes the real estate taxes he will owe plus expected repairs.

For simplicity, we will ignore the value of land that would exist in this purchase.

The monthly payment for the mortgage is $3,975.87. The first twelve payments will include $37,558.02 of interest (deductible on Schedule E) and $10,152.38 of principal (non-deductible cash outflow). More than offsetting the non-deductible principal paid on the mortgage is the first 12-month depreciation of $25,090.91.

Here is the cash flow for the first year:

Cash received	$ 54,000.00
Mortgage paid	(47,710.40)
Cash expense	(5,400.00)
Postive cash flow	$ 889.60

Although that is positive, here is the tax reporting for the year:

Rental income	$ 54,000.00
Depreciation	25,090.91
Interest	37,558.02
Other expenses	5,400.00
Total deductions	68,048.93
Loss	$ (14,048.93)

Note that the passive activity loss rules will most likely limit the taxpayer's ability to deduct that loss—but it still serves to accomplish two goals we'll look at:

- The lesser benefit is the fact that it keeps the positive cash flow from triggering any income taxes.
- When the passive loss rules do allow that deduction (either when the rental is sold, or once the principal payments are greater than the depreciation being paid, creating a reversal of the cash flow vs. taxable income issue), that deduction will be used against ordinary income.

EXAMPLE

Sale at the End of Year 2

Assume Alexander sells the property for $1,000,000 at the end of the second year. Again, he will have 11 ½ months of depreciation (half month convention for year of sale) and the interest for the year on the mortgage will be $37,012.00. All other items are the same as the prior year.

The Schedule E for the year will look like this:

Rental income	$ 54,000.00
Depreciation	25,090.91
Interest	37,012.00
Other expenses	5,400.00
Total deduction	67,502.91
Loss	$ (13,502.91)

Assume the entire passive loss carries into this year, so we have a total ordinary loss of $27,551.84. Assuming our client is in the maximum tax bracket, that will reduce the taxes for $10,194.18.

The gain on sale is computed as follows:

Sales Price	$ 1,000,000.00
Original Cost	900,000.00
Less depreciation	50,181.82
Adjusted Basis	849,818.18
Gain on sale	$ 150,181.82
Taxed at maximum 25%	$ 50,181.82
Taxed at maximum 20%	$ 100,000.00
25% Tax	$ 12,545.46
20% Tax	20,000.00
Total Tax	$ 32,545.46

Note that there is one additional tax we need to consider in our example—the net investment income (NII) tax. Generally, unless the taxpayer qualifies as a real estate professional and can show the rental is a §162 trade or business, the 3.8% net investment income tax will generally apply to the net taxable amount. In this case, that is the gain on sale ($150,181.82) less the passive loss ($27,551.84), for an NII taxable amount of $122,629.98 and an additional tax of $4,659.94.

EXAMPLE

Total Tax and Net Cash Flow

The overall net tax paid on the investment in the rental is shown below:

Tax on Sale	$ 32,545.46
Savings on losses	(27,551.84)
NII Tax	4,659.94
Total Tax	$ 9,653.55

The cash flow is summarized as follows:

Year 1/2 Cash Flow	$ 1,779.20
Sales price	1,000,000.00
Less mortgage	(699,149.22)
Down payment	(180,000.00)
Net cash flow	$ 122,629.98

Thus, the effective net tax rate is $9,653.55 divided by $122,629.98, or 7.87%.

Note that the rate is far less than the 23.8% rate that would have been imposed on a $122,629.98 gain on the sale of a capital gain asset. But that comparison is somewhat misleading—after all, the taxpayer is taking advantage of leverage when purchasing the rental.

So let's assume that the taxpayer had used $180,000 of his own cash and borrowed $720,000 to purchase stock. How would that change the situation?

EXAMPLE

Tax on Leveraged Stock Investment

In this case, the interest paid of $74,570.02 would be investment interest. As well, there is no incoming cash flow to give Alexander the cash to pay the interest.

The gain on sale is fairly straightforward—we have $1,000,000 sales price and a $900,000 basis, thus, a capital gain of $100,000. But don't multiply that by 23.8% just yet. Because that $74,570.02 is only deductible if a client has net investment income—but net investment income does not include long term capital gains or qualified dividends unless the taxpayer agrees to waive the special capital gain rates.

Assuming the client does not have large amounts of interest income to absorb the $74,570.02 of interest paid, it is likely that $74,570.02 of the capital gain will have to be taxed at regular rates. That means we have a gain taxable at 23.8% of $25,429.98 and a tax of $6,052.34.

While that is less than the tax on the rental, that doesn't mean the rate on net cash flow is lower—again, no money came in to pay the interest, so the interest is a pure cash drain.

Here is the net cash flow:

Sales price	$ 1,000,000.00
Less debt	(720,000.00)
Down payment	(180,000.00)
Interest paid	(74,570.02)
Net cash flow	$ 25,429.98

Note that the net cash flow is the taxable gain less the interest paid, so our effective rate on positive cash flow is 23.8%. And, as well, Alexander has significantly less cash after taxes.

This example helps illustrate why rental real estate is attractive to so many clients—the example shows a much better return than investing in pure growth stock in a similar setup.

This section looks at the various law provisions that create the tax benefits for real estate, giving us the ability to convert to a lower effective tax rate for this investment.

Depreciation Expense for Real Estate

One key advantage with residential real estate is that the taxpayer is allowed to recover the cost of the property over 27½ years on a straight-line basis. Traditionally, residential mortgages are amortized over 30 years, meaning the early payments are heavily weighted towards deductible interest expense and the actual cash used to pay principal down on the mortgage is far less than the non-cash depreciation expense allowed.

Buildings and structures are treated as either residential or nonresidential real estate. Residential real estate is assigned a MACRS life of 27½ years, while nonresidential real estate has a life of 39 years.[27]

Residential real estate is defined as follows by the law at §168(e)(2) as follows:

> (2) Residential rental or nonresidential real property
>
> (A) Residential rental property
>
> (i) Residential rental property
>
> The term "residential rental property" means any building or structure if 80 percent or more of the gross rental income from such building or structure for the taxable year is rental income from dwelling units.
>
> (ii) Definitions
>
> For purposes of clause (i)—
>
> (I) the term "dwelling unit" means a house or apartment used to provide living accommodations in a building or structure, but does not include a unit in a hotel, motel, or other establishment more than one-half of the units in which are used on a transient basis, and
>
> (II) if any portion of the building or structure is occupied by the taxpayer, the gross rental income from such building or structure shall include the rental value of the portion so occupied.

EXAMPLE

Residential Real Estate

Stephanie purchases a property that has 30 units that provides living units. She rents these units out on day-to-day agreements and units have an average rental period for each tenant of 2.5 days. The longest period of rental for a single unit during the year was 2 weeks.

Stephanie's property is used primarily on a transient basis. Thus, this property is nonresidential real estate and must be depreciated over 39 years.

Note that the transient use rule would also affect a property that was purchased to be used for Airbnb rentals, as those are going to be used for such transient use. That is true even though the property itself may be identical to one located next to it that will qualify as residential real

[27] IRC §168(c)

property as his neighbor rents the property on a standard annual lease to someone that makes the property his/her home.

EXAMPLE

Personal Use

Dennis buys a duplex. He rents out one of the units and makes the other unit his personal residence. The prior owner rented both units and obtained $45,000 a year for each unit in rent. Dennis is able to get the $45,000 in rent on the unit he does rent.

For purposes of the 80% test for residential real property, we deem that the unit Dennis has made his principal residence is rented at $45,000. When we add the $45,000 received from the tenant for the other unit, it indicated that 100% of the gross rental income is from dwelling units.

EXAMPLE

Business Use

Assume that the property had five units in it, one of which is designed to be a retail store. Dennis still uses one as his personal residence and the four other units (3 residential and 1 commercial) are all leased at annual rents of $45,000.

With the assumed $45,000 rental of Dennis' residence, the 80% test is met and the building is considered to be residential real estate.

Commercial real estate does not get the 27.5 year life, but rather faces a 39 year depreciable life. That reduces, but does not necessarily eliminate, the cash flow advantage.

Cash Flow and Rentals

As was noted in the discussion of depreciation, cash flow and taxable income or loss are most often quite different for rentals, with a key difference being how much is paid in down payment and principal payments on the mortgage vs. the depreciation expense allowed per year.

This relationship may not be clear to all clients, so it's useful to model the cash flow vs. tax effect for the years in question.

Care must be taken to understand that while financing a larger portion of the rental can serve to increase this cash flow vs. tax benefit, as always, such leveraging increases the taxpayer's risk with regard to the investment. When a taxpayer puts in less cash, the taxpayer is more exposed to the risk of having to pay in cash just to get out of the investment.

This leads to an important issue to consider in tax planning—the client needs to make a decision based on the overall effect of the transaction in question, taking into account such non-tax issues as the risk of the transaction. Advisers can find themselves on the wrong side of a civil claim if they fail to remind clients that the fact that a transaction "looks good" from a tax standpoint does not mean they should move forward with the transaction. Rather, it's just one input into the overall decision to move forward with the transaction.

§1231 Gains – Special Not Quite Capital Gain Class

Conversion takes place with rentals due to the effect of IRC §1231 when the rental property is sold. Normally, but not always, §1231 will give the taxpayer the benefit of a reduced tax

rate (either capital gain rates or the special 25% rate on unrecaptured §1250 gains discussed later) on the excess of the sales price over the adjusted basis of the property.

Dispositions in General

A little background on how gains on sale are taxed is required to see how §1250 fits into the rental equation—and why it is crucial to understanding the conversion options for rentals.

Gains or losses on the disposition of assets are initially governed by IRC §1001. That section provides that a taxpayer is deemed to have income under IRC §61 or a loss under IRC §165 based on the difference between the adjusted basis of the asset determined under IRC §1011 and the amount realized on the disposition.

The amount realized on the disposition is the sum of any money received plus the fair market value of any property received in exchange for the property.[28] One item that confuses some clients is that the amount realized on a sale includes any liabilities that the taxpayer has paid off as part of the sale.[29]

> **EXAMPLE**
>
> Debt Paid Off as Part of the Sale
>
> Kelsea has a rental property that she is going to sell. At the time of the sale the property is worth $750,000 and the unpaid balance of the mortgage on the property is $500,000 at the date of sale.
>
> While the buyer comes to the closing with $750,000, Kelsea will not receive $500,000 of those proceeds since that amount will have to be used to pay off the mortgage on the property so that the buyer can obtain clear title. Thus, at closing, Kelsea would only receive $250,000 (for simplicity we are ignoring other closing costs involved in the transaction).
>
> Despite only receiving $250,000 from the sale, Kelsea is treated as realizing $750,000 from the sale of the property. If Kelsea's adjusted basis in the property is less than $500,000, she will recognize gain that is greater than the $250,000 in cash she receives at closing.

Taxpayers will refer to gain in excess of cash received as "phantom gain" which is correct but somewhat misleading, as it actually will most often represent an amount that previously had been claimed as expenses (due to depreciation expense most often in a cash like this) on prior returns, or cash the taxpayer had received from a prior refinancing on which no tax is paid.

Advisers also need to be aware that if a taxpayer does not pay off the debt as part of the sale, but rather the lender discharges the balance of the debt, the taxpayer may face a taxable gain from the discharge of indebtedness if the debt is a recourse debt.[30] In the case of a foreclosure, the amount discharged by the transaction will generally be the fair mark value of the property at the date of foreclosure if the debt is a recourse debt.

If the debt in question is a nonrecourse debt, which is discharged as part of the transaction (such as when the lender forecloses on the property), the entire balance of the debt is treated

[28] IRC §1001(b)

[29] Reg. §1.1001-2(a)(1)

[30] IRC §61(a)(11), Reg. §1.1001-2(a)(2)

as an amount realized on the sale.[31] That is because, effectively, the lender has agreed by issuing a nonrecourse debt to accept the receipt of the property as full payment of the debt.

> **EXAMPLE**
>
> Foreclosure of Property—Recourse Debt
>
> Jillian has a rental property that is being foreclosed. The balance on the mortgage at the time of the foreclosure is $800,000 and the fair market value of the property securing the debt is $600,000. When the property is foreclosed upon by the lender, Jillian is treated as having disposed of the property in a taxable transaction with sales proceeds of $600,000.
>
> If the lender chooses not to pursue collection of the remaining $200,000 balance due on the debt, Jillian would have ordinary income from the discharge of indebtedness of $200,000. The $200,000 would not be part of the proceeds of the sale. Jillian may be able to exclude some or all of the $200,000 from income if she can meet one of the conditions found in IRC §108 that provides certain discharges of debt are treated as not currently taxable.

If the debt had been nonrecourse, the result would be quite different.

> **EXAMPLE**
>
> Foreclosure of Property—Nonrecourse Debt
>
> If the debt on Jillian's property was nonrecourse, the entire $800,000 would have been treated as an amount realized from the disposition and used to compute the gain or loss on sale under IRC §1001. The fact that the property was only worth $600,000 is not relevant since the debt was nonrecourse in nature.

Once we have a gain/loss computed we have to figure out the nature of that gain or loss. By default a gain or loss is treated as part of ordinary income. However, if the gain/loss is treated as a capital gain or loss, special tax treatments apply that are generally good news for a taxpayer if there is a gain, but bad news if there is a loss.

Capital gains and losses arise, generally, from gains or losses incurred on the sale or disposition of a capital asset.[32] What is a capital asset is defined at IRC §1221 which starts by broadly defining a capital asset as property held by a taxpayer,[33] but then has a series of eight types of property excluded from the classification of capital assets. The key one for our purposes is found at IRC §1222(a)(2) which excludes "property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business…"

Thus, if a rental is a trade or business of the taxpayer, any gain or loss from the sale of the asset is not a capital gain. Which, frankly, seems like bad news since we expect to have gain.

But, as it turns out, if we have held the rental for a year there is a generally even more favorable treatment to be found at IRC §1231.

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[31] Reg. §1.1001-2(a)(4)(i)

[32] IRC §1222

[33] IRC §1221(a)

§1231 Generally

While §1222 initially blocks the taxpayer from treating a rental that is part of a trade or business as a capital asset for sale purposes, a special rule for determining capital gains and losses found at §1231 serves to rescue most gains from disposing of trade or business rentals.

IRC §1231 deals with what the law refers to *§1231 gains and losses*. This term is defined at IRC §1231(a)(3) which reads:

> (3) Section 1231 gains and losses
>
> For purposes of this subsection—
>
> > (A) Section 1231 gain
> >
> > The term "*section 1231 gain*" means—
> >
> > > (i) any recognized gain on the sale or exchange of property used in the trade or business, and
> > >
> > > (ii) any recognized gain from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) into other property or money of—
> > >
> > > > (I) property used in the trade or business, or
> > > >
> > > > (II) any capital asset which is held for more than 1 year and is held in connection with a trade or business or a transaction entered into for profit.
> >
> > (B) Section 1231 loss
> >
> > The term "*section 1231 loss*" means any recognized loss from a sale or exchange or conversion described in subparagraph (A).

Note that while "property held in connection with … a transaction entered into for a profit" is subject to §1231 treatment in an involuntary conversion, that is not true if the property is sold. In the case of property sold, only property used in a trade or business qualifies for this treatment.[34]

Property used in a trade or business is, for purposes of rental property, defined in a similar but not identical manner as it is for the exclusion from capital asset treatment under §1221. For purposes of §1231, the property must be held for more one year.[35] Thus, if a rental is held for less than one year, a disposal is not subject to the §1231 rules, but is rather an ordinary gain or loss on disposition.

EXAMPLE

Holding Period

Lewis bought a rental that qualified as a trade or business on January 10, 20X1. On November 20, 20X1, he sold the property and generated a $40,000 gain. The gain is not a capital gain, as the property was excluded as trade or business property under IRC §1221(a)(2). The gain is also not a §1231 gain, since Lewis had not held the property

[34] IRC §1231(a)(3)(A)(i)

[35] IRC §1231(b)(1)

for more than one year, so it failed to meet the definition of §1231 property per IRC §1231(b)(1).

The gain on disposition is an ordinary gain.

Assuming we have met the trade or business requirement and have held the property for more than one year, the gain or loss from the sale or other disposition of a rental will be first part of the combined test to determine if we have a net §1231 gain or loss. The net §1231 gain or loss for the year is the total of all of the §1231 gains and losses incurred during the year by the taxpayer. If that number is positive, then there is a net §1231 gain—in which case all §1231 transactions are treated as long term capital gains or long-term capital losses as applicable.[36]

Conversely, if the number is negative then all §1231 transactions are as gains and losses from the sales of non-capital assets as applicable.[37]

EXAMPLE

Net §1231 Gains

Shawn has two rentals that qualify as trade or businesses. He sells both rentals during the year. For the first rental Shawn has a $250,000 gain on disposition while for the second rental Shawn has a net loss of $150,000. Shawn has no other §1231 gains or losses for the year.

Shawn's §1231 gains exceed his §1231 losses by $100,000 ($250,000 – $150,000). Since that results in a net gain, the transactions generate a long-term capital gain and a long-term capital loss.

When a net gain exists, the taxpayer will obtain capital gain treatment (subject to the special rule on unrecaptured §1250 gains).

EXAMPLE

Net §1231 Losses

Assume that Shawn instead had only incurred a $50,000 gain on the sale of the first rental. In this case his §1231 losses would exceed his §1231 gains by $100,000. In this case, both transactions would be excluded from capital gain/loss treatment, resulting in an ordinary gain on the sale of the first rental and an ordinary loss on the sale of the second rental.

Non-Recaptured Net §1231 Losses

Another special rule can remove some or all of a taxpayer's net §1231 gains from capital gain treatment. An amount equal to the taxpayer's net §1231 gains is treated as ordinary income to the extent that it does not exceed a taxpayer's *non-recaptured section 1231 losses*.[38]

Non-recaptured section 1231 losses are a number that is calculated by taking

- the total amount of the taxpayer's net §1231 losses for the prior five years, over
- the portion of such losses that have already been used to convert net §1231 gains into ordinary gains over that same five-year period.

[36] IRC §1231(a)(1)

[37] IRC §1231(a)(2)

[38] IRC §1231(c)(1)

EXAMPLE

Non-Recaptured Section 1231 Losses

Kelly had the following net §1231 gains and losses over the past 5 years:

20X1	$25,000
20X2	–$20,000
20X3	$ 5,000
20X4	–$10,000
20X5	$15,000

In 20X6, Kelly incurs a net §1231 gain of $25,000. The non-recaptured §1231 gain for 20X6 is $10,000. That is computed by taking the $20,000 loss from 20X2 and the $10,000 loss from 20X4 and reducing the $30,000 total (but not below zero) by gains incurred in the years after the losses ($5,000 and $15,000) that were treated as ordinary gains under this rule.

The $25,000 gain in 20X1 does not enter into this calculation because it was incurred prior the first loss year.

Thus, $10,000 of Kelly's 20X6 §1231 gains will be treated as ordinary gains. The remaining §1231 gains will be treated as capital gains under the general rule of §1231 found at §1231(a)(1).

Whenever an adviser is planning for the tax impact of the sale of rental, the adviser must check to see if there exists non-recaptured §1231 losses and when the carryover period for those losses will expire. That is, one way to deal with this rule is to simply wait five years before selling assets for a §1231 gain after incurring net §1231 losses.

Again, if a taxpayer would need to wait a full five-year period, the taxpayer must consider the risk of holding the property for that extended period of time vs. the tax savings. But if it comes down to a question of closing on a sale on December 30 of the current year or January 2 of the following year, when the non-recaptured §1231 losses will expire at the end of the current year, it may be a lot easier to live with the risk of holding the property a few extra days.

Trade or Business and Rentals

Since §1231 only applies to rentals that are a trade or business, that raises the question of when is a rental a trade or business of the taxpayer. In that case, the gain or loss will be treated as gain or loss from a sale of a capital asset.

A rental could be either a trade or business or simply a transaction entered into for a profit. The Supreme Court recognized this distinction and gave us a "fact and circumstances" based test to determine the difference in the 1987 case of *Groetzinger v. Commissioner*, 480 US 23.

> Of course, not every income-producing and profit-making endeavor constitutes a trade or business. The income tax law, almost from the beginning, has distinguished between a business or trade, on the one hand, and "transactions entered into for profit but not connected with . . . business or trade," on the other. See Revenue Act of 1916, 5(a), Fifth, 39 Stat. 759. Congress "distinguished the broad range of income or profit producing activities from those satisfying the narrow category of trade or business." Whipple v. Commissioner, 373 U.S., at 197. We accept the

> fact that to be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity and that the taxpayer's primary purpose for engaging in the activity must be for income or profit. A sporadic activity, a hobby, or an amusement diversion does not qualify.

Thus, the tests are

- involvement with the undertaking with continuity and regularity and
- the primary purpose for engaging in the activity is income or profit.

Generally, year to year, the issues doesn't matter, since expenses related to the rental would be deductible in computing adjusted gross income in either case:

- Under IRC §62(a)(4) if the rental was "merely" an activity entered into for a profit, or
- Under IRC §62(a)(1) if the rental rose to the level of a trade or business.

In those cases where the issue has arisen, most often the courts have found the taxpayer's rental rose to the level of a trade or business. In the case of *Fackler v. Commissioner*, 133 F.2d 509 (1943) a taxpayer renting a single office building was found to have a trade or business activity. In the case of *Hazard v. Commissioner*, 7 TC 372 (1946) a single-family residence was held to be sufficient to constitute the conduct of a trade or business.

EXAMPLE

Rental Located Outside Second Circuit Jurisdiction

Adam owns a residential rental property. He has leased it on one-year leases to various tenants over the past five years. While most months Adam just has to collect the rent from tenants, he does take care of arranging for any repairs or maintenance that might be necessary on the property. When the property goes vacant, he also places ads for a new tenant and makes the decision on which tenant to lease the property to.

In the view of the Tax Court, found in the Hazard case, Adam has a sufficient level of activity to be in the trade or business of renting the property.

Note that, as well, it is just necessary that the taxpayer or his agent be involved with sufficient continuity and regularity.

EXAMPLE

Management Company

In 20X8, Adam engages the services of a management company to take over the tasks he had been handling for the rental. Although Adam does not directly meet the continuity and regularity tests, Adam's agent (the management company) does. Thus, the overall undertaking would still meet the test to be a trade or business under the *Hazard* test.

However, the Second Circuit Court of Appeals has contrary authority in the case of *Grier v. United States*, 120 F. Supp. 395 (1954), *affd*, CA2 218 F. 2d 603 (1955) where renting a single property was held by the trial court not to rise to a trade or business due to the following:

> In this case, the activities with relation to this single dwelling, although of long duration, were minimal in nature. Activity to rent and re-rent was not required. No employees were regularly engaged for maintenance or repair.

EXAMPLE

Rental Undertaking Where the Second Circuit Has Jurisdiction

Assume the same facts as the first example for a rental trade or business—Adam does not hire a management company. As well, Adam has had the same tenant for the seven years he has held the property. Adam lives in New York State (subject to the jurisdiction of the Second Circuit Court of Appeals) and the rental is also in New York.

In this case, there is a high likelihood Adam would be found not to be in the trade or business of renting property based on the Second Circuit's Grier precedent.

The fact that the result is inconsistent based on where the taxpayer is located is something the adviser must be aware of. Until and unless the U.S. Supreme resolves the difference of opinion among the Circuits, this situation will continue absent a reversal of position by one or more Circuit Courts of Appeal on this issue. Even though the U.S. Tax Court is a national court, it is bound by the precedent of the Circuit where the taxpayer's appeal would be heard per the *Golsen* rule.[39]

What has consistently not been found to be rentals rising to the level of a trade or business are triple-net lease rental—at least a single such rental. In Revenue Ruling 73-522, which looked at the very similar definition of a trade or business under IRC §871, the IRS held:

> In the instant case the taxpayer's only activity in the United States during the taxable year ended December 31, 1971, was the supervision of the negotiation of leases covering rental property that he owned during that year. No other activity was necessary on the part of the lessor in connection with the properties because of the provisions of the net leases. The taxpayer's supervision of the negotiation of new leases is not considered to be beyond the scope of mere ownership of real property or the mere receipt of income from real property since such activity was sporadic rather than continuous (that is a day-to-day activity), irregular rather than regular, and minimal rather than considerable.
>
> Accordingly, the taxpayer in the instant case is not considered to be engaged in trade or business within the United States during the taxable year ended December 31, 1971, within the meaning of section 871 of the Code.

The problem with a triple-net lease is that the taxpayer nor his/her agents do not have enough activity to be considered in a trade or business as opposed to merely being an investor.

EXAMPLE

Triple-Net Lease and Trade or Business Status

Ella owns a single office building that she leases to a local accounting firm. The lease is triple-net lease—that is, the accounting firm is required to pay for all repairs, maintenance and property taxes. Ella only pays the mortgage on the building and collects the monthly rent.

The activities related to the building are not sufficiently continuous and regular for the rental to be treated as a trade or business. Rather, this is simply an investment activity entered into for a profit.

39 Golsen v. Commissioner of Internal Revenue, 54 T.C. 742 (1970), aff'd on other grounds, 445 F.2d 985 (10th Cir. 1971), cert. denied, 404 U.S. 940 (1971),

However, in a case under ERISA dealing with a taxpayer with multiple triple-net leases, the Seventh Circuit found a trade or business existed. While it dealt with employee benefit plan issues under ERISA, the standard for a trade or business under ERISA is the §162 trade or business standard under the IRC—thus, the decision does appear on point for deciding if a rental is a trade or business.

Specifically, the Seventh Circuit in *Central States Pension Fund v. Personnel, Inc.,* 974 F.2d 789 (7th Cir. 1992) found a trade or business existed when the other activities related to the triple-net leases were significant (the court specifically used the IRC Section 162 test for what was a trade or business).[40]

EXAMPLE

Multiple Office Buildings

Assume Ella owns 30 high rise office complexes in 12 states, each of which have a large number of individual tenants. While the tenants are still responsible for their share of the property taxes on their building, as well as a share of common area repairs along with repairs to their own unit, Ella now must spend full time managing the operation of all of these buildings, including significant time handling the basic accounting to determine each tenant's share of common costs and constantly having to market empty units to new tenants and determine if a potential tenant is credit-worthy enough to allow to enter into a lease for an empty unit.

Under the logic found in the *Central States* case, Ella appears to have a trade or business even though each lease is technically a triple-net lease. This situation is markedly different from the situation of a taxpayer with a single triple-net lease.

Real Property and §1250

Although rental property is depreciable, the most significant items depreciated for a rental fall under the definition of §1250 property. Ever since the adoption of the MACRS depreciation system, assets that are §1250 property are not subjected to treatment of any portion of gain that is related to prior depreciation as ordinary income.

That is because recapture under IRC §1250 is limited to the excess of depreciation claimed over straight-line depreciation.[41] Since MACRS replaced ACRS decades ago, residential and commercial real property have only been eligible for straight-line depreciation.

EXAMPLE

Warning—ACRS Real Property from 1981–1986

While the adviser is not likely to run into the issue often, commercial real property placed in service during that time period for which the taxpayer did not elect the alternative straight-line depreciation is treated as §1245 property, with all depreciation subject to recapture as ordinary income upon sale based on IRC §1245(a)(5) as it in effect from 1981 until the effective date of the Tax Reform Act of 1986.

[40] Additional discussion of this case can be found on Kaplan Education's ***Current Federal Developments*** blog in the article "Can an LLC Operating a Shopping Center with Triple Net Leases for All Tenants Give Rise to Qualified Business Income?," February 29, 2019, https://www.currentfederaltaxdevelopments.com/blog/2019/2/23/can-an-llc-operating-a-shopping-center-with-triple-net-leases-for-all-tenants-give-rise-to-qualified-business-income?rq=triple%20net%20lease, retrieved June 30, 2019

[41] IRC §1250(a)(1)

> If you find yourself faced with commercial real property that was acquired during the ACRS time period (including property containing basis from such property that has been part of §1031 exchanges or §1033 transactions), an inquiry needs to be made to determine if depreciation, which now will almost certainly be the entire cost of the property, was taken by using the accelerated or straight-line method of depreciation.

Property acquired before ACRS was subject to §1250 ordinary income recapture only on the excess of accelerated depreciation claimed over straight-line depreciation that would have been allowable to date, but by now such property that is still being held by the original purchaser likely has been fully depreciated, so that no such excess exists.[42]

IRC §1250 property is defined as any real property (other than property defined as §1245 property at §1245(a)(3)) which is or has been of a type subject to depreciation for tax purposes.[43] That "special" §1245 real property includes property which has had basis adjustments or amortization under various IRC provisions, most significantly including IRC §179,[44] as well as certain other specialized use real property.

The §179 rule is important because Congress has expanded §179 to allow the use of that provision for certain types of commercial real property. If those special §179 rules are used on commercial property, the taxpayer must be aware that expensing is subject to ordinary income recapture on sale.

§1250 Unrecaptured Gain—Reducing the Benefit of Conversion (But Not Eliminating It)

A special rule applies to what the IRC refers to as *unrecaptured 1250 gain*. Such gains are subject to a maximum rate of 25%[45] as opposed to the standard maximum rate of 20% on long-term capital gains.

Unrecaptured 1250 gain represents the reduction in basis of real property that takes place due to depreciation.[46] However, the amount is limited to no more than the net §1231 gain for the tax year in question.[47]

Gains in excess of the unrecaptured 1250 gain amounts that are taxed as long-term capital gains are subject to the standard maximum long-term capital gain rate limits (20% for 2019).[48]

> **EXAMPLE**
>
> Computing Amount of Potential Unrecaptured §1250 Gain
>
> Mark has a commercial building he acquired a number of years ago. He purchased the building for $1,000,000 and has claimed $480,000 of depreciation to date on the building. The building is sold for $1,400,000.

[42] IRC §1250(a)
[43] IRC §1250(c)
[44] IRC §1245(a)(3)(C)
[45] IRC §1(h)(1)(E)
[46] IRC §1(h)(6)(A)
[47] IRC §1(h)(6)(B)
[48] IRC §1(h)

> Mark has an overall gain of $880,000 ($1,400,000 – ($1,000,000 – $480,000)). Of this gain, $480,000 potentially may be treated as unrecaptured 1250 gain since it represents the depreciation claimed on the building since inception. The remaining $400,000, assuming it is treated as capital gain after application of the rules of §1231, would be subject to the same maximum capital gain rates as regular long-term capital gains.

Since this special rate is still lower than individual rates above 25%, for those taxpayers with marginal rates above 25% there will still be a conversion benefit that arises from the depreciation expense which offset tax at rates above 25%, but which is now creating gain taxed at that lower 25% rate.

As well, the appreciation in the property is still taxed at the standard much lower capital gain rates. So while the addition of unrecaptured section 1250 gain rules reduced the benefit that used to exist for the rental depreciation, it did not remove all of the benefit of conversion from the law.

§199A and Rentals—It's Complicated

The Tax Cuts and Jobs Act of 2017 introduced the deduction for qualified business income under §199A that is available to be claimed for income from a trade or business by individuals, trusts and estates. And, as was discussed earlier, a rental may very well be a trade or business—but this is not necessarily good news under IRC §199A.

Why not? Well, if a taxpayer only incurs losses while operating a rental and then has a §1231 gain upon selling the rental, the final regulations under §199A will actually cause a taxpayer's §199A deductions on other pass-through income to go *down* in the year of sale.

Why you may ask? Well, the problem arises with the rules in the final §199A regulations regarding the tax treatment of any type of income, including §1231 gains, taxed at capital gain rates.

Income Related to a Trade or Business Taxed at Capital Gain Rates for §199A

The exclusion of §1231 gains that end up being taxed as capital gains from being part of QBI in the proposed regulations generated a number of comments that argued that §1231 gains should be part of QBI or pointing out complications of dealing with a category that might or might not be part of QBI.

In the preamble to the final regulations, the IRS recognizes that the determination of whether a §1231 gain or loss will be part of QBI can't be made at the RPE level, and will have to be made by the equity holder on his/her individual or fiduciary return. As the preamble states:

> The Treasury Department and the IRS acknowledge the added challenges in applying section 1231 in the context of calculating QBI under section 199A. Generally, under section 1231, a taxpayer nets all of its section 1231 gains and losses from multiple trades or businesses before determining their ultimate character. In other words, the section 1231 determination is not made until the taxpayer combines its section 1231 gain or loss from all sources. This does not change in the context of section 199A. Thus, the section 1231 rules remain the same in the context of section 199A. For purposes of calculating QBI, taxpayers should continue to net their section 1231 gains and losses from their multiple trades or businesses to determine whether they have excess gain (which characterizes all of the gain or loss as capital and so all are excluded from

> QBI) or excess loss (which characterizes all of the gain or loss as ordinary and so all are included in QBI). As would be the case outside the section 199A context, the character tracks back to the trade or business that disposed of the asset.[49]

The preamble also discusses the IRS's view on the proper treatment of §1231(c) loss recapture under the final regulations, although ultimately the agency declines to provide additional guidance in this area:

> Another potential complication noted by commenters is the section 1231(c) recapture rule. Under the rule, a taxpayer that has a section 1231 capital gain in the current year must look back to any section 1231 ordinary loss taken in the previous five years and convert a portion of the current year section 1231 capital gain to ordinary gain, based on the previous losses taken. One commenter asked for further guidance on how to allocate ordinary gains and losses that may result from the section 1231 calculation to multiple trades or businesses. While the Treasury Department and the IRS recognize the complexity in applying the section 1231(c) recapture rules and allocating gain to multiple trades or businesses, providing additional guidance with respect to section 1231(c) is beyond the scope of these regulations. For purposes of determining whether ordinary income is included in QBI, taxpayers should apply the section 1231(c) recapture rules in the same manner as they would otherwise. Notice 97-59, 1997-2 C.B. 309, provides guidance on netting capital gains and losses and how that netting incorporates the section 1231(c) recapture rule.[50]

The reference back to Notice 97-59 appears to direct readers to the following provision for ordering how §1231 gains are considered to be reclassified as ordinary income, with 25% "non-recapture recapture" being fully absorbed before any 20% capital gain §1231 gains are reclassified:

> COORDINATION WITH OTHER PROVISIONS…
>
> (2) RECHARACTERIZED SECTION 1231 GAINS. If a portion of the taxpayer's net section 1231 gain for the year is recharacterized as ordinary income under section 1231(c), the gain so recharacterized consists first of any net section 1231 gain in the 28-percent group, then any section 1231 gain in the 25-percent group, and finally any net section 1231 gain in the 20-percent group.[51]

Special Rental Safe Harbor Rule for Purposes of §199A

At the same time as final regulations were issued under §199A, the IRS issued a proposed revenue procedure that would provide for a safe harbor rule for treating a rental as a trade or business for §199A purposes in Notice 2019-07. Note that the rule only applies for the purposes of §199A—the question of whether the rental is a trade or business for other purposes (like §1231) must still be decided based on the facts and circumstances of the situation.

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[49] Final Regulations Under §199A, Preamble IV.A.10

[50] Final Regulations Under §199A, Preamble IV.A.10

[51] Notice 97-59

Although issued as a proposed revenue procedure, the IRS provided that taxpayer may rely on this safe harbor:

> The proposed revenue procedure is proposed to apply generally to taxpayers with taxable years ending after December 31, 2017.
>
> Until such time that the proposed revenue procedure is published in final form, taxpayers may use the safe harbor described in the proposed revenue procedure for purposes of determining when a rental real estate enterprise may be treated as a trade or business solely for purposes of section 199A.

Even if a taxpayer's rental does not meet the safe harbor tests, the taxpayer may still be able to treat the rental as a trade or business if it meets the definition of Reg. §1.199A-1(b)(14). As well, the safe harbor *only* applies for purposes of §199A.

The proposed revenue procedure offers the following justification for its issuance:

> The Treasury Department and the IRS are aware that whether a rental real estate enterprise is a trade or business for purposes of section 199A is the subject of uncertainty for some taxpayers. To help mitigate this uncertainty, this proposed revenue procedure provides a safe harbor for treating a rental real estate enterprise as a trade or business solely for purposes of the section 199A deduction.

Relevant pass-through entities (partnerships, S corporations, trusts and estates, referred to as RPEs) can use this test as well as individuals.

The proposed revenue procedure defines a *real estate enterprise* which is used for testing purposes under this proposed procedure. That definition provides:

> Solely for purposes of this safe harbor, a rental real estate enterprise is defined as an interest in real property held for the production of rents and may consist of an interest in multiple properties. The individual or RPE relying on this revenue procedure must hold the interest directly or through an entity disregarded as an entity separate from its owner under §301.7701-3. Taxpayers must either treat each property held for the production of rents as a separate enterprise or treat all similar properties held for the production of rents (with the exception of those described in paragraph .05 of this section) as a single enterprise. Commercial and residential real estate may not be part of the same enterprise. Taxpayers may not vary this treatment from year-to-year unless there has been a significant change in facts and circumstances.

Three requirements must be satisfied during a taxable year for a real estate enterprise to meet the safe harbor test to be treated as a trade or business. These requirements are as follows:

- Separate books and records are maintained to reflect income and expenses for each rental real estate enterprise.
- For taxable years beginning prior to January 1, 2023, 250 or more hours of rental services are performed (as described in this revenue procedure) per year with respect to the rental enterprise. For taxable years beginning after December 31, 2022, in any three of the five consecutive taxable years that end with the taxable year (or in each year for an enterprise held for less than five years), 250 or more hours of rental services are performed (as described in this revenue procedure) per year with respect to the rental real estate enterprise.
- The taxpayer maintains contemporaneous records, including time reports, logs, or similar documents, regarding the following: (i) hours of all services performed; (ii) description

of all services performed; (iii) dates on which such services were performed; and (iv) who performed the services. Such records are to be made available for inspection at the request of the IRS. The contemporaneous records requirement will not apply to taxable years beginning prior to January 1, 2019.

Rental services for purposes of the 250-hour test are defined as follows:

> Rental services for purpose of this revenue procedure include: (i) advertising to rent or lease the real estate; (ii) negotiating and executing leases; (iii) verifying information contained in prospective tenant applications; (iv) collection of rent; (v) daily operation, maintenance, and repair of the property; (vi) management of the real estate; (vii) purchase of materials; and (viii) supervision of employees and independent contractors.

These activities do not have to be performed by the taxpayer—rather they can be performed either by the taxpayer or his/her agents and independent contractors (such as handymen, landscapers, plumbers and the like).

> Rental services may be performed by owners or by employees, agents, and/or independent contractors of the owners.

While this expansion is helpful, it also means that beginning in 2019 taxpayers will have to inquire about the number of hours of work performed by those agents and contractors if the taxpayer him/herself cannot meet the 250-hour test simply using his/her own hours.

Certain activities, whether performed by the taxpayer or agents/contractors, do not count towards meeting the 250-hour test.

> The term rental services does not include financial or investment management activities, such as arranging financing; procuring property; studying and reviewing financial statements or reports on operations; planning, managing, or constructing long-term capital improvements; or hours spent traveling to and from the real estate.

Certain types of rentals will not qualify to use this safe harbor.

> Real estate used by the taxpayer (including an owner or beneficiary of an RPE relying on this safe harbor) as a residence for any part of the year under section 280A is not eligible for this safe harbor. Real estate rented or leased under a triple net lease is also not eligible for this safe harbor. For purposes of this revenue procedure, a triple net lease includes a lease agreement that requires the tenant or lessee to pay taxes, fees, and insurance, and to be responsible for maintenance activities for a property in addition to rent and utilities. This includes a lease agreement that requires the tenant or lessee to pay a portion of the taxes, fees, and insurance, and to be responsible for maintenance activities allocable to the portion of the property rented by the tenant.

The taxpayer must sign and include a statement attached to the tax return in order to make use of this safe harbor:

> A taxpayer or RPE must include a statement attached to the return on which it claims the section 199A deduction or passes through section 199A information that the requirements in Section 3.03 of this revenue procedure have been satisfied. The statement must be signed by the taxpayer, or an authorized representative of an eligible taxpayer or RPE, which states: "Under penalties of perjury, I (we) declare that I (we) have examined the statement, and, to the best of my (our) knowledge and belief, the statement contains all the relevant facts relating to the revenue procedure,

and such facts are true, correct, and complete." The individual or individuals who sign must have personal knowledge of the facts and circumstances related to the statement.

Impact of §199A Rental Trade or Business

The key problem arises when a taxpayer has net passive activity loss carryovers on a rental for a tax year that have arisen from 2018 and later years that are released upon the sale of the rental, either due to the passive income that arises from the gain on sale[52] or the release of passive losses that will occur upon a fully taxable disposition of the activity.[53]

Under Reg. §1.199A-2(b)(iv) these losses are held and taken into account in the year in which they finally impact taxable income for computing the §199A deduction for the year. Since they are negative, they will serve to offset qualified business income from other trades or businesses that appear on the taxpayer's return.

But, as was noted earlier, the §1231 gain that turned the rental into a profitable activity will not be treated as qualified business income for §199A purposes if, as we hope in order to obtain the benefit of conversion, there is a net §1231 gain for the year and no recapture of prior §1231 losses. In that case, the income will be taxed at capital gain rates. As was noted earlier in this section, those gains will be excluded from the computation of qualified business income.

EXAMPLE

Negative Impact of Rental as a Trade or Business

Bruce has rented a property for the past five years, generating $42,000 of passive activity loss carryover. All five years were after 2018. When he sells the rental, he generates a $100,000 gain. Overall, the rental generated a net $58,000 of taxable income over the period Bruce held it.

However, for purposes of §199A, only the $42,000 loss is taken into consideration in computing qualified business income under IRC §199A if the rental is a trade or business. Assuming Bruce has $100,000 of qualified business income from a separate activity, he will see a net reduction of his deduction under §199A from $20,000 to $11,600 (20% of $58,000 rather than 20% of $100,000). The $8,400 reduction is 20% of released passive loss on the rental.

Note that if a rental is profitable and is a trade or business, there will be some benefit from §199A. But the §1231 gain still will not obtain the 20% reduction, rather being taxed under the special capital gain rules discussed earlier.

But it actually gets worse if the property is sold at a loss—since a net §1231 loss is taxed as an ordinary loss, that would serve to reduce qualified business income.

EXAMPLE

Trade or Business Rental Sold at a Loss

Assume Bruce had sold the rental at a net loss of $10,000. In this case, he still would have released the $42,000 of passive loss carryover, all of which would reduce qualified business income. But if Bruce has a net §1231 loss (often the case, since most taxpayers

[52] IRC §469(d)(1)(B)

[53] IRC §469(g)

> don't have multiple significant §1231 gains and losses in the same year), then the $10,000 loss on the disposal of the rental will also reduce qualified business income.
>
> In this case, Bruce's negative qualified business income from the rental would rise to $52,000. His deduction under §199A, assuming the other qualified business income remains the same, would now drop to $9,600 (the $100,000 QBI from the other activity now reduced by the negative $52,000 QBI from the rental).

Of course, if there are unrecaptured §1231 losses then the §1231 gain will be ordinary income and part of QBI. But in that case, the taxpayer will have saved the §199A deduction, but lost the benefit of conversion in the transaction.

MUNICIPAL BONDS—AN ISSUE OF RETURNS

Converting income to tax exempt status is the ultimate tax conversion strategy—0% is clearly a preferable income tax rate to even the lowest rates imposed on taxable income. Under IRC §103, interest income on state and local bonds is exempt from the regular income tax.[54]

However, there are some caveats a taxpayer must consider before blindly pursuing municipal bonds as an investment based solely on the regular income tax advantage:

- The after-tax return of the bond for the taxpayer may be lower than the after-tax return of taxable bonds that carry the same level of risk.
- *Specified private activity bond* interest is a preference for computing alternative minimum taxable income.[55]
- Such tax-exempt is counted for certain tax rules tied to a taxpayer's overall income, such the taxable status of Social Security benefits[56] and the refundable credit under §36B for coverage under a qualified health plan.[57]

"Double Tax Free" Bonds—State Income Tax Consideration

One other benefit of tax-exempt bonds needs to be considered. If the taxpayer lives in a state with an income tax, the taxpayer will likely find that investing in municipal bonds issued by the state he/she resides in and localities within that state will not be subject to state income taxes either. In higher tax states that can be significant—for 2022 the maximum rate in California is 13.3%.[58]

Thus, a taxpayer in both the highest federal and California tax brackets is looking at 50.3% tax rate that is avoided by purchasing California municipal bonds vs. purchasing similar taxable bonds. Of course, this massive benefit is not lost on the governments in California—they can get away with paying even lower interest rates than those paid on other states' municipal bonds due to demand for such bonds from California residents. So, again, an after-tax calculation of rate of return for similar levels of risk needs to be carried out.

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[54] IRC §103(a)

[55] IRC §57(a)(5)

[56] IRC §86(b)(A)(ii)

[57] IRC §36B(d)(2)(B)(ii)

[58] https://www.caltax.org/caltax-resources/california-tax-facts/

Financial Planning Issue—Looking at After-Tax Return

Often advisers will run into clients who have continued to buy tax exempt bonds long after their individual marginal tax rates have been pushed far below the maximum rates. In many cases, such clients, while paying less tax, either have less after-tax funds than those who purchased taxable bonds with a similar level of risk or have taken on substantially more risk in order to obtain a similar after-tax rate of return than they would normally be comfortable with.

Although tax rate phase-outs and special rules can complicate the calculation, generally a taxpayer should be indifferent to purchasing taxable bonds that aren't double tax exempt based on the following formula for bonds of similar risk:

$$\text{taxable return} = \frac{\text{tax exempt return}}{(1 - \text{federal marginal tax rate})}$$

If double tax-exempt bonds are being considered, the state marginal rate is added to the federal marginal rate in the above equation.

EXAMPLE

Tax-Exempt Bonds Rate of Return Planning

Mark is looking at two investments in interest paying securities. One is a municipal bond that pays 3.6% while the other is a corporate bond paying 5%. Mark lives in a state without an income tax and Mark expects to be in the highest federal marginal tax bracket. The two bonds have similar levels of risk in Mark's view, so he's interested in the returns.

In this case, if Mark buys the taxable bond its higher initial yield must be reduced by the impact of the 37% tax Mark expects to pay on that interest. Thus, Mark can only keep 63% of the yield (1 – 0.37), or 3.15%. In this case, the municipal bond with a similar level of risk paying 3.6% give the better after-tax return to Mark.

EXAMPLE

Lower Marginal Rate

Mark retires and his income declines so that now he expects to be in the 25% marginal tax bracket for federal purposes. While the corporate bond pays the same 5%, the tax Mark expects to pay on the interest has gone down, so Mark expects to keep 75% of the yield (1 – 0.25). Thus, the after-tax yield of the taxable bond is now at 3.75% (75% of 5%), which is greater than the yield on the tax-free bond.

Now that Mark's marginal rate has declined, the corporate bonds provide the greater after- tax return.

A practical problem that many CPAs will run into involves clients who focus solely on lowering taxes. Such clients may end up with their entire portfolio moved into tax free municipal bonds, even though their marginal federal tax rates have now been reduced to 10%.

EXAMPLE

Excessive Tax Avoidance

Sara has complained for years about the money the government has stolen from her in taxes, so in her retirement she has invested her savings entirely in tax free municipal

bonds. She has the same facts as Mark, looking at choosing between the 3.6% municipal bond or the 5% corporate bond. Her investment portfolio is very significant, so she would generate over $100,000 in income from investing in either set of bonds.

Sara selects the municipal bond since she knows that will eliminate her taxes entirely. While this is correct, it also represents a far from optimal result in terms of rate of return, ignoring the additional risk she takes on by having such a highly non-diversified portfolio.

A much better option would be for Sara to invest in the taxable bonds up until her taxable income from those bonds push her to the beginning of a tax bracket where the after-tax return of the corporate bonds drops below that of the municipal bonds.

While the above is a very practical approach, it's important to understand two points:

- Most of our clients are not accountants, so may have difficulty understanding a discussion heavy on numbers (rates of returns, tax rates) and odd concepts (marginal tax brackets). This isn't because they aren't intelligent—but they have skills in other areas and don't work with these items every day (something we often find too easy to forget).
- The reaction against taxes is an emotional reaction and the explanation doesn't deal with the feelings that lead to the decision to go "all-in" on municipal bonds.

That doesn't mean you talk down to the client for being "too emotional" but rather consider approaching the issue from the client's perspective—for instance, pointing out they are effectively giving money to the government agency that they loaned the money to by allowing them to pay them such a low rate of interest.

As well, if you wish to demonstrate to a client the impact of this lower return, consider using charts to illustrate lower amounts of after-tax results over time. While CPAs tend to love endless tables of numbers to prove a point, most non-accountants immediately treat such presentations as too much trouble to try to bother to follow.

The solution is fairly easy—the tool most CPAs are using to prepare those pages of numbers (*Microsoft Excel*) also have the tools to turn those analyses into a "bottom line" chart that takes the key results (cumulative cash available after taxes) and create a chart from that data directly.

EXAMPLE

Analysis of Cost of Excessive Investment in Municipal Bonds

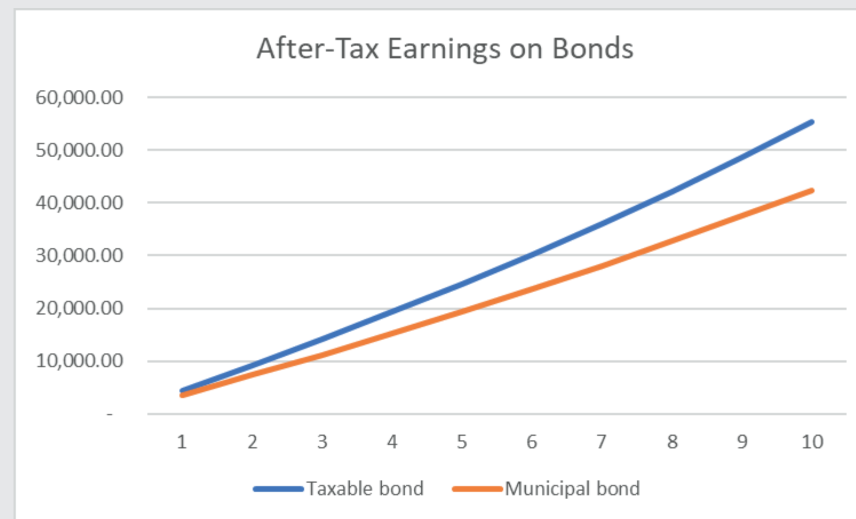
Let's take Sara, who has managed to push her marginal tax rate down to 10% with the bonds. What is the cost of doing this?

As accountants we would like a presentation like this:

Year	1	2	3	4	5	6	7	8	9	10
Taxable Bond										
Invested Cash	100,000.00	104,500.00	109,202.50	114,116.62	119,251.87	124,618.20	130,226.02	136,086.19	142,210.07	148,609.52
Interest paid	5,000.00	5,225.00	5,460.13	5,705.83	5,962.59	6,230.91	6,511.30	6,804.31	7,110.50	7,430.48
Tax	500.00	522.50	546.01	570.58	596.26	623.09	651.13	680.43	711.05	743.05
Net cash after tax	4,500.00	4,702.50	4,914.12	5,135.25	5,366.33	5,607.82	5,860.17	6,123.88	6,399.45	6,687.43
Cumulative cash	104,500.00	109,202.50	114,116.62	119,251.87	124,618.20	130,226.02	136,086.19	142,210.07	148,609.52	155,296.95
Tax Exempt Bond										
Invested Cash	100,000.00	103,600.00	107,329.60	111,193.47	115,196.43	119,343.50	123,639.87	128,090.91	132,702.18	137,479.46
Interest paid	3,600.00	3,729.60	3,863.87	4,002.96	4,147.07	4,296.37	4,451.04	4,611.27	4,777.28	4,949.26
Tax	-	-	-	-	-	-	-	-	-	-
Net cash after tax	3,600.00	3,729.60	3,863.87	4,002.96	4,147.07	4,296.37	4,451.04	4,611.27	4,777.28	4,949.26
Cumulative cash	103,600.00	107,329.60	111,193.47	115,196.43	119,343.50	123,639.87	128,090.91	132,702.18	137,479.46	142,428.72

However, Sara's eyes glaze over with comments asking how we can read that tiny print (we CPAs like getting it all on one sheet of paper as well).

But the chart below is a lot easier for Sara to grasp immediately, even if the CPA in you objects that it doesn't show the details you think are necessary to understand the issue.



Even with this, Sara may cling to her refusal to pay taxes—and since what she is doing is perfectly legal, even if clearly not the most advantageous thing to do, we accept the client's decision. It is always important to remember that our job is to advise, and the client's job is to decide. So long as the taxpayer stays in compliance with the law, we should follow the client's instruction—after we point out what they may not have fully considered.

Note that the above has taken the simple approach of applying a single marginal tax rate in the analysis. While this analysis may be correct, as we'll discuss next, that may be overly simplistic due to various provisions that may cause the exempt interest to impact taxes for the year(s) in question. Similarly, if a taxpayer is sitting near the level of income where the taxpayer's marginal rate will change that also has to be taken into account.

As always in tax planning, this means that for a situation of any complexity serious consideration has to be given to the use of tax planning software to model the impact of different tax strategies over multiple years and under various different assumptions regarding actions of the taxpayer and others, as well as other taxable income.

Back Door Taxation Due to Other Tax Provisions

While municipal bonds may be tax free, that doesn't mean that Congress has not given them other tax effects. As Congress has added means tested tax benefits to the law that are meant to limit benefits to either taxpayers that are lower income or, perhaps, just ones not deemed to be rich, they have turned to using various forms of *modified adjusted gross income* to perform such tests.

Modified adjusted gross income (MAGI) does not have a single definition—rather, the modifications change from IRC section to IRC section. But what it means at the very least is that some types of income that are not included initially in the computation of adjusted gross income will be included in MAGI for determining if a taxpayer is able to benefit from a specific tax provision.

As well, other times the exempt interest is included in other calculation that can have a detrimental tax effect.

Whenever an adviser is working with a client who is considering municipal bonds, the adviser should point out the potential impact of that income on various tax benefits. These additional tax impacts should be taken into account when modeling the tax impact of the investments.

Some of the items affected by including municipal interest in determining taxability or a tax benefit include the following:

- The portion of a taxpayer's Social Security benefits subject to tax[59]
- A taxpayer's qualification for the refundable credit for coverage under a qualified health plan[60]
- To determine if a taxpayer has excessive investment income for purposes of qualifying for the earned income tax credit[61]
- Inclusion of income from *private activity bonds* in the calculation of alternative minimum taxable income as an item of tax preference[62]
- Interest on out of state bonds will generally be taxed by the taxpayer's state of residence if that state imposes an income tax

Again, the best way to deal with these complications is with a comprehensive tax projection program that can control for these items. Such programs often are sold by vendors of tax software as either part of the tax package or as an add-on module available[63] or can be acquired as a stand-alone program.[64]

§1202 STOCK—NOW A GENERAL UTILITIES EQUIVALENT?

Prior to the Tax Reform Act of 1986 far more closely held businesses operated as C corporations than do now. The major reason why advisers moved closely held businesses away from C corporation status was the repeal in the Tax Reform Act of 1986 of what was known as the *General Utilities* doctrine.

Generally, what was left of the doctrine just before its final repeal in 1986 allowed a corporation that was planning on liquidating because, for instance, it had been approached by a party interested in buying the assets of the corporation, would recognize no gain on the sale of assets that were part of the plan of liquidation if the liquidation as completed within one year.

While a shareholder would still pay tax on the gain realized on disposing of his/her shares which would only amount to a single tax on the appreciated assets of the corporation. Most often those appreciated assets would be the goodwill, customer lists, and other intangible assets, which had no basis but were the real value of buying the operating business.

EXAMPLE

Application of General Utilities Doctrine

From 1970–1979 Kelly owned 100% of the stock of Ascot Widgets. Over those 10 years Kelly took out salary and the company had income left in that just happened to be taxed

[59] IRC §86(b)(2)(B)

[60] IRC §36B(d)(2)(B)(ii)

[61] IRC §32(i)(2)(B)

[62] IRC §57(a)(5)

[63] Such as Lacerte 1040 Planner, CCH ProsystemFX Tax Planning, Thomson Reuter's Planner CS, etc.

[64] The best known stand-alone program is the Bloomberg Tax (formerly BNA) Income Tax Planner.

at the lowest corporate rates. Thus, Ascot Widget's income before taxes and taxes for those years looked like this.

Here is the net after-tax earnings for Kelly with the C corporation, along with comparison with what after tax income would have looked like had the entity been set up as an S corporation and either paid out the $25,000 as salary or let it show up on Kelly's K-1.

Year	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979
Income before taxes	25,000	25,000	25,000	25,000	25,000	25,000	25,000	25,000	25,000	25,000
Tax on first $25,000	22%	22%	22%	22%	22%	20%	20%	20%	20%	17%
Federal income tax	5,500	5,500	5,500	5,500	5,500	5,000	5,000	5,000	5,000	4,250
Net after taxes	19,500	19,500	19,500	19,500	19,500	20,000	20,000	20,000	20,000	20,750
Individual tax rate										
Paid as salary	70%	70%	50%	50%	50%	50%	50%	50%	50%	50%
Passed through S corporation	70%	70%	70%	70%	70%	70%	70%	70%	70%	70%
Available at individual level										
Paid as salary	7,500	7,500	12,500	12,500	12,500	12,500	12,500	12,500	12,500	12,500
Passed through S corporation	7,500	7,500	7,500	7,500	7,500	7,500	7,500	7,500	7,500	7,500

In those years the top individual income tax rate was 70%. Beginning in 1972 Congress created a special 50% maximum tax bracket that applied to earned income.

As should be clear, operating her company as a C corporation saved Kelly a lot of taxes over the 10 years, assuming the corporation had a use for $25,000 of capital each year (as most do).

That looks all well and good, but if a buyer shows up to acquire Kelly's business that buyer is going to want to buy assets. And, at that point, for the shareholder to be able to claim the money a second tax would have to be paid.

But, was noted earlier, that wasn't the case in 1980. Then IRC §336 codified the result the Supreme Court had arrived at in the *General Utilities* case.[65] Under the then existing IRC §336, a corporation that had adopted a plan of liquidation would recognize no gain on the sale of its assets. The shareholders rather recognized a capital gain upon the redemption of the stock.

EXAMPLE

Sale of Ascot Widgets Under Old §366

A buyer offered Kelly $5,000,000 for the assets of Ascot Widgets on January 1, 1980, an offer she accepted. Let us assume, for simplicity, that Kelly has no basis in her stock. Ascot Widgets immediately adopts a formal plan of liquidation and then sells its asset (the amounts paid were entirely for the valuable goodwill, customer lists and other intangibles that Ascot held) for $5,000,000. The company, not having any liabilities, then redeems Kelly's shares for $5,000,000. In fact, Kelly had a $5,000,000 capital gain on the redemption of her shares. In 1980 Kelly would have excluded 60% of the gain under the law that existed prior to the Tax Reform Act of 1986. Thus, she would have paid tax on 40% of the gain at a maximum rate of 70% or a 28% tax rate on long term capital gains.

[65] *General Utilities. & Operating Co. v. Helvering*, 29 B.T.A. 934, (1934), *aff'd*, 74 F.2d 972, 975 (4th Circ, 1935), *aff'd* 296 US 203 (1935)

Below we compare the total taxes paid by Kelly and Ascot Widgets as a C corporation vs. the tax that would have been paid had she operated the corporation as an S corporation an either passed out the $25,000 as flow through income or additional salary.

		S Corporation	
	C Corporation	K-1 Income	Salary
Total taxes 1970-1979	51,750	175,000	135,000
1980 tax on sale (28% rate)	1,400,000	1,400,000	1,400,000
Total taxes 1970-1980	1,451,750	1,575,000	1,535,000

While the tax paid was identical on the sale of the assets, a substantial tax savings was generated in the years the business operated.

But we also have to account for the tax Kelly would pay on the assets (all cash we'll assume for simplicity) remained trapped in the corporation each year. Over the 10 years Kelly had after-tax earnings of $198,250, assuming that was also sent out to Kelly in the sale, it would have been taxed as additional gain on sale, triggering a tax of $55,010. But even adding that to the $51,170 only results in tax on the operational year earnings of $107,260, still less than either of the results from the C corporation—and over half of that tax didn't have to be paid until the end of the 10 years.

As a practical matter, the C corporation more likely was able to use those retained funds to build up even more value in the corporation or, in the S structure, Kelly would have been forced to borrow additional funds to continue to grow at the same rate as the C corporation would have allowed her to grow.

However, the Tax Reform Act of 1986 changed that math dramatically and the tax on sale of the business now argued strongly in favor of a pass-through structure.

EXAMPLE

Sale of Assets After General Utilities Repeal

Let's assume that the sale of the company took place after the repeal of General Utilities. Now if the corporation's assets were sold, the gain on sale of intangibles inside the corporation would have been subject to a 34% maximum corporate tax rate, for a total tax of $1,700,000 paid by the corporation.

The cash available to redeem Kelly's shares would have been reduced by the tax paid, resulting in a gain on disposition of her shares of $3,300,000 which would now be subject to personal tax.

Note the change in results this time in the table below:

		S Corporation	
	C Corporation	K-1 Income	Salary
Total taxes operating years	-	115,000	115,000
Inside tax	1,700,000	-	-
1980 tax on sale (28% rate)	924,000	1,400,000	1,400,000
Total taxes paid	2,624,000	1,515,000	1,515,000

The advantage the C corporation previously had is now dwarfed by the massive impact of the double tax in the year of sale. Thus, following the repeal of the *General Utilities* doctrine in the Tax Reform Act of 1986 C corporations converted to S status in large numbers and few closely held C corporation would be formed in the succeeding decades.

Seven years after the repeal of the General Utilities doctrine in 1993, Congress enacted a new provision that provided a similar type of relief on the sale of certain businesses that were operated as a C corporation. Originally, this provision simply provided for reduced level of tax if the stock were sold or disposed of after a minimum holding period, as well as a tax-free rollover option into another qualified entity's stock. Beginning in 2010, the provision was modified to allow for a total exclusion of the gain (up to $10,000,000) on the sale of stock acquired after September 27, 2010.

Tax Cuts and Jobs Act's Impact

While the Tax Cut and Jobs Act did not change §1202 directly, it did make other changes that now make an understanding of that provision crucial for any CPA advising taxpayers on the type of entity he/she should be using for a new business. Corporate rates are now set at 21%, significantly below individual rates even after taking into account the deduction under IRC §199A for qualified business income that would be available if a pass-through entity was used.

As that is a 20% deduction, that only reduces the maximum 37% individual rate to 29.6% on such income. Thus, if a taxpayer is in the maximum individual tax bracket there will be a significantly higher rate of federal tax imposed on the income earned.

While a double tax would still apply if the income was paid out as a dividend, prior to the 1986 Act this rarely proved to be a major problem. If the corporation has a use for the funds, they can be retained to grow the business without having to turn to borrowing—a fact that may be particularly important if the business could run into the business interest limitations added by the Tax Cuts and Jobs Act at IRC §163(j).

For a qualifying business, while the corporation would still pay tax on a sale of its assets to a buyer, the subsequent redemption of a shareholder holding qualified §1202 stock would be tax free up to $10 million of gain if the requirements are met.

This does not mean that all potentially qualified entities should be a C corporation. There are a number of issues, especially if the business does not plan to grow and/or the owner is going to drain all earnings out of the enterprise each year for person spending.

But it does mean that the CPA who was advising the taxpayer when the entity was formed may have to show that the §1202 option was considered and why it was ultimately rejected at a time when the stockholder is facing a capital gains tax on a $10 million gain that would not exist had the C corporation option been considered.

Exclusion of Gain Rules

IRC §1202(a) provides for an exclusion of varying amounts of gain from the sale of qualified small business stock held more than 5 years.

Definition of Qualified Small Business Stock

Qualified small business stock (QSBS) is defined at IRC §1202(c). The basic requirements for such stock are:

- As of the date of issuance, the corporation must be a "qualified small business" as defined at IRC §1202(d).

- Except for stock acquired by conversion of other stock (as defined at IRC §1202(f)) or via certain tax-free transfers detailed at IRC §1202(h), the stock must be acquired by the taxpayer at its original issue (directly or via an underwriter)
  - in exchange for money or other property (but not stock), or
  - as compensation for services provided to the corporation (other than services as an underwriter of the stock). [IRC §1202(c)(1)]

Anti-Evasion Rules

Stock will not be treated as QSBS if certain purchases are made by the corporation of its own stock surrounding the date the shareholder acquired his/her own stock. This is meant to prevent evasion of the rules by having a shareholder sell his/her shares back to the corporation and then have the corporation sell shares to a new shareholder as a method of allowing the new shareholder to acquire the shares of the old shareholder and still have QSBS.

The anti-evasion rules will treat stock acquired as not QSBS stock if

- at any time during the 4-year period beginning two years before the new shareholder acquired his/her shares, the corporation purchased more than a *de minimis* amount of its stock from the taxpayer or a person related to the taxpayer [IRC §1202(c)(3)(A)], *or*
- during the 2-year period beginning one year before the acquisition of the stock from the corporation, the corporation made with one or more purchases of its stock with an aggregate value at the time of purchase exceeding 5% of the value of all of its stock at the beginning of the 2-year period. [IRC §1202(c)(3)(B)]

For purposes of the 4-year rule, purchases are more than *de minimis* if the total shares purchased exceed 5% of the aggregate value of the corporation's stock as of the beginning of the 4-year period. [Reg. §1.1202-2(a)(2)]

The IRS has created four exceptions to the above rules by regulation found at Reg. §1.1202-1(d). The regulations provide that a stock purchase will be disregarded if the stock is being acquired in any of the following circumstances:

- The stock was acquired by the seller in connection with the performance of services as an employee or director and the stock is purchased from the seller incident to the seller's retirement or other bona fide termination of such services.
- Prior to a decedent's death, the stock (or an option to acquire the stock) was held by the decedent or the decedent's spouse (or by both), by the decedent and joint tenant, or by a trust revocable by the decedent or the decedent's spouse (or by both), and
  - the stock is purchased from the decedent's estate, beneficiary (whether by bequest or lifetime gift), heir, surviving joint tenant, or surviving spouse, or from a trust established by the decedent or decedent's spouse; and
  - the stock is purchased within 3 years and 9 months from the date of the decedent's death.
- The stock is purchased incident to the disability or mental incompetency of the selling shareholder.
- The stock is purchased incident to the divorce (within the meaning of section 1041(c)) of the selling shareholder.

Active Business Requirement

To retain its status as qualified small business stock, the corporation must also meet an active business requirement as defined at IRC §1202(e).

Under the general active business rules, the corporation must meet two tests:

- At least 80% (by value) of the assets of such corporation are used by such corporation in the active conduct of 1 or more qualified trades or businesses.
- The corporation is an eligible corporation.

A special set of rules found at IRC §1202(e)(2) expand the active conduct test to cover activities, generally of a start-up company, that generally qualify as active conduct of a business to qualify as such for this rule. Assets used in an activity shall be considered used in connection with the active conduct of a trade or business if, in connection with any future qualified trade or business, the corporation is engaged in

- start-up activities described in section 195(c)(1)(A),
- activities resulting in the payment or incurring of expenditures which may be treated as research and experimental expenditures under section 174, or
- activities with respect to in-house research expenses described in section 41(b)(4).

Not all businesses qualify for stock issued to be treated as QSBS. Rather the business in question must **not** be

- 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;
- 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;
- any banking, insurance, financing, leasing, investing, or similar business;
- any farming business (including the business of raising or harvesting trees);
- 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 (percentage depletion); and
- any business of operating a hotel, motel, restaurant, or similar business. [IRC §1202(e)(3)]

Similarly, the law also blocks certain corporations from issuing QSBS. QSBS may not be issued by

- a DISC or former DISC;
- a corporation that is eligible for the §936 possessions tax credit or which has a direct or indirect subsidiary eligible for that credit;
- a regulated investment company (mutual fund), real estate investment trust (REIT) or REMIC; or
- a cooperative. [IRC §1202(c)(4)]

For purposes of the 80% of assets test, stock and debt of a subsidiary corporation will be disregarded, with the parent deemed to own its ratable share of the subsidiary's assets and

to conduct a ratable share of the subsidiary's activities. [IRC §1202(c)(5)(A)] A corporation will be deemed a subsidiary for these purposes if the parent owns more than 50% of the combined voting power of all classes of stock entitled to vote *or* more than 50% in value of all outstanding stock of the subsidiary. [IRC §1202(c)(5)(C)]

Conversely, if a corporation holds a portfolio of stock and securities in other corporations that are not its subsidiary, it will not be able to issue QSBS for any period where the value of that portfolio exceeds 10% of the value of its assets in excess of liabilities. Or, to put it more simply, its equity, not its total assets. [IRC §1202(c)(5)(B)]

The same equity-based test will disqualify the corporation from issuing QSBS for any period where it holds real property not used in the active conduct of a trade or business whose value exceeds the same 10% of equity threshold. [IRC §1202(c)(7)]

A special test applies to determine if working capital will be deemed to be an asset that can be counted in meeting the 80% test described above. Subject to the limitation described below, assets will be considered used in the active conduct of a trade or business if

- the assets are held as a part of the reasonably required working capital needs of a qualified trade or business of the corporation, or
- the assets held for investment and are reasonably expected to be used within 2 years to finance research and experimentation in a qualified trade or business or increases in working capital needs of a qualified trade or business.

However, if the business has been in existence more than 2 years, no more than 50% of the assets of the corporation qualify as used in the active conduct of a qualified trade or business for these working capital reasons. [IRC §1202(e)(6)]

Rights to software held by the corporation will count as an asset used in the active conduct of a business where the software produces active business software royalties. For this purpose "active business software royalties" will have the same meaning it has under the provisions found at IRC §543(d)(1) in determining whether such royalties can be excluded from the definition of personal holding company income. [IRC §1202(e)(7)]

Qualified Small Business

The corporation also needs to be a qualified small business at the time the stock is issued. To be a qualified small business, the corporation must meet all three of the following criteria:

- The corporation must be a domestic corporation which is taxed as a C corporation (thus this provision is not open to an S corporation).
- The aggregate gross assets of such corporation (or any predecessor thereof) at all times on or after the date of the enactment of the Revenue Reconciliation Act of 1993 and before the issuance did not exceed $50,000,000.
- The aggregate gross assets of such corporation immediately after the issuance (determined by taking into account amounts received in the issuance) do not exceed $50,000,000.
- Such corporation agrees to submit such reports to the IRS and to shareholders as the IRS may require to carry out the purposes of this section. Note that, to date, no such reporting requirements have been published by the IRS. [IRC §1202(d)(1)]

For purposes of the gross assets test, the gross assets shall be the total of the cash and aggregate adjusted basis of other property held by the corporation. However, in computing the adjusted

basis of other property, the adjusted basis of any property contributed to the corporation shall be computed as if the basis of such property were equal to its fair value at the time of the contribution. [IRC §1202(d)(2)]

For purposes of these tests, all corporations which are members of the same parent-subsidiary controlled group are treated as a single corporation. However, the test for a parent-subsidiary relationship shall be based on a "more than 50%" rather than "more than 80%" test for such control and insurance companies subject to tax under §801 will not be treated as a controlled group separate from the controlled group they otherwise would be part of. [IRC §1202(d)(3)]

Exclusion Amounts

Generally the taxpayer qualifies for an exclusion of some (or all) of the gain on disposition if the stock is held for at least five years. The amount to be excluded is as follows:

- 100% of the gain for stock acquired after September 27, 2010
- 75% of the gain for stock acquired after February 17, 2009, and before September 28, 2010
- Stock issued before Aug. 11, 1993, is not eligible for the QSBS gain exclusion.
- For stock acquired between August 11,1993 and February 18, 2009,
  - Generally 50% of the gain
  - However, 60% of the gain from the sale of stock of that was a "qualified business entity" as defined at IRC §1397C(b) during substantially all of the taxpayer's holding period attributable to periods before January 1, 2019.

A qualified business entity for purposes of the 60% exclusion is an entity that meets all of the following requirements:

- Every trade or business of such entity is the active conduct of a qualified business within an empowerment zone.
- At least 50% of the total gross income of such entity is derived from the active conduct of such business.
- A substantial portion of the use of the tangible property of such entity (whether owned or leased) is within an empowerment zone.
- A substantial portion of the intangible property of such entity is used in the active conduct of any such business.
- A substantial portion of the services performed for such entity by its employees are performed in an empowerment zone.
- At least 35% of its employees are residents of an empowerment zone.
- Less than 5% of the average of the aggregate unadjusted bases of the property of such entity is attributable to collectibles (as defined in section 408(m)(2)) other than collectibles that are held primarily for sale to customers in the ordinary course of such business.
- Less than 5% of the average of the aggregate unadjusted bases of the property of such entity is attributable to nonqualified financial property.

Let's revisit our example.

EXAMPLE

Ascot Widgets and §1202 Gains

Let's have Kelly begin Ascot Widgets in 2011. At the time Kelly acquires her shares for full control of the brand new Ascot has nowhere near $50,000,000 of total assets (remember we assume she has no basis when she sells).

Here is our table of the operating years from 2011-2020 using maximum rates in place at the time:

Year	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Income before taxes	25,000	25,000	25,000	25,000	25,000	25,000	25,000	25,000	25,000	25,000
Tax on first $25,000	15%	15%	15%	15%	15%	15%	15%	21%	21%	21%
Federal income tax	3,750	3,750	3,750	3,750	3,750	3,750	3,750	5,250	5,250	5,250
Net after taxes	21,250	21,250	21,250	21,250	21,250	21,250	21,250	19,750	19,750	19,750
Individual tax rate										
Paid as salary	43.4%	43.4%	43.4%	43.4%	43.4%	43.4%	43.4%	41.2%	41.2%	41.2%
Passed through S corporation	39.6%	39.6%	39.6%	39.6%	39.6%	39.6%	39.6%	29.6%	29.6%	29.6%
Available at individual level										
Paid as salary	14,150	14,150	14,150	14,150	14,150	14,150	14,150	14,700	14,700	14,700
Passed through S corporation	15,100	15,100	15,100	15,100	15,100	15,100	15,100	17,600	17,600	17,600

The salary rate from 2011-2020 includes an additional 3.8% to account for the Medicare tax and additional Medicare tax on such salary. The pass-through rate for 2018-2020 assumes that Kelly gets a 20% deduction under §199A for the flow through income reported on her personal return.

As with the earlier example, the C corporation still looks better each year if the funds are retained in the corporation. And, note, that didn't really change in 1986 either—the problem in 1986 and later arose when the assets were sold.

So, assuming that Ascot Widgets stock is qualified §1202 stock in Kelly's hands, how does the situation play out now?

EXAMPLE

Sale of Ascot Widgets under 100% Exclusion of §1202 Stock Gain

Again, we have a sale of the assets for $5,000,000 by the corporation, followed by a redemption of Kelly's stock. In this case the situation has now swung back in favor of the C corporation if a 100% §1202 exclusion applies when the stock is disposed of.

		S Corporation	
	C Corporation	K-1 Income	Salary
Total taxes operating years	42,000	106,850	158,500
Inside tax (at 21%)	1,050,000	-	-
2021 tax on sale (20%)	-	1,000,000	1,000,000
Total taxes paid	1,092,000	1,106,850	1,158,500

Note that this time we don't even have to worry about the trapped assets—when they come out to Kelly, they increase her gain on sale, which is fully excludable.

Another item to note—if there had been pure "money" investors who did not materially participate in Ascot, their gain on sale on their personal returns would potentially be subject to the 3.8% net investment income tax, which would end up with the year of sale tax being higher than what would have existed in the C corporation.

What Does This Mean?

We are back again to a case where the C corporation can no longer be dismissed out of hand for an entity that qualifies as a §1202 entity. Even though the tax benefit on an absolute level in the example was modest, note that the C corporation allowed for quite a delay in paying that tax.

Clearly, a difference in state tax treatment could upset the analysis. And, as 1986 showed, Congress may decide to yet again radically change the relative advantages of pass-through entities vs. C corporations.

Advisers talking to clients about forming a new entity are doing their clients a disservice to reject the C corporation structure out of hand. In 1987, that rejection made lots of sense—the year of sale tax disaster was simply too big of a difference to easily overcome with the lower year to year tax rate on reinvested earnings unless the sale could be pushed very far into the future (preferably, after the shareholder died and the stock got a step-up in basis).

The original §1202 did not fully solve the problem, so even in 1993 the C corporation looked like a not terribly appetizing choice. With the 2010 change to make the §1202 gain fully excludable from income up to $10,000,000 and the lowering of the maximum corporate rate in 2018, the math now often tips in favor of C corporation even assuming an ultimate sale of the assets of the corporation.

Needless to say, if the buyer will actually agree to buy stock (and that does happen from time to time, as the author can attest) then the situation tilts in favor of the §1202 C corporation, since the inside gain tax is avoided entirely.

Elective Rollover Exclusion Provision

Rather than make use of the exclusion provisions above, a taxpayer may elect to take advantage of the rollover rules found at IRC §1045 to exclude gain from the disposition of QSBS stock.

The rollover rules can be advantageous if

- the taxpayer has held the stock for more than 6 months, but not more than 5 years (and thus does not qualify for exclusion on sale rules described above), or
- the stock was acquired before the date when the 100% exclusion applies.

If the provision is elected, gain on the disposition of the QSBS is recognized only to the extent that the amount realized on sale exceeds

- the cost of any qualified small business stock purchased by the taxpayer during the 60-day period beginning on the date of such sale, reduced by
- any portion of such cost previously taken into account under this provision.

The second condition would apply if a taxpayer had multiple sales of QSBS shares for which an election was made during the period a beginning 59 days before the date of purchase. [IRC §1045(a)]

Any gain not recognized pursuant to this provision, the basis of the QSBS acquired is reduced by that unrecognized gain. [IRC §1045(b)(3)]

The election must be made on or before the due date (including extensions) of the taxpayer's tax return for the year in which the stock was sold. [Revenue Procedure 98-48]

The election is made by

- reporting the entire gain from the sale of QSB stock on Schedule D, Capital Gains and Losses, of the return in accordance with the instructions for Schedule D;
- writing "section 1045 rollover" directly below the line on which the gain is reported; and
- entering the amount of the gain deferred under section 1045 on the same line as the rollover notation, as a loss, in accordance with the instructions for Schedule D. [Revenue Procedure 98-48]

NOTES

UNIT 5

Combination Planning in Action

LEARNING OBJECTIVES

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

- Describe how to balance brackets by using year-end control of deductions and/or income.
- Identify opportunities to handle both types of planning.
- Identify tax planning techniques post Tax Cuts and Jobs Act of 2017.

In this unit we'll look at some combination planning options, where we look at techniques that take advantage of more than one type of planning option.

We will also look at the option of both delaying the recognition of income and also trying to move income into lower tax brackets, either by changing the taxpayer or by balancing income over multiple years to offset the effect of progressive tax brackets.

> **EXAMPLE**
>
> Uneven vs. Balance Income in Progressive Brackets
>
> Wilma is a single individual. Between 2022 and 2023 she will have $400,000 in taxable income- $200,000 of the income will definitely come in 2022, $100,000 in 2023, and the final $100,000 may end up being received in either 2022 or 2023.
>
> Wilma would like to have the money as soon as possible, so she wonders if this whole "higher tax bracket" talk she's been hearing really means that much. For purposes of this example we will use 2022 single tax brackets for both years (that is, ignore any inflation adjustment in 2023).

If Wilma gets the $100,000 in 2022 (her preference), here is the expected taxes due between the two years:

Uneven Income	2022	2023	Total
Taxable Income	300,000	100,000	400,000
Tax	80,194	18,175	98,369

However, if Wilma doesn't receive that floating $100,000 until 2020, the following taxes are expected to be paid.

Balanced Income	2022	2023	Total
Taxable Income	200,000	200,000	400,000
Tax	45,317	45,317	90,634

If the income is moved into 2020, Wilma both pays less taxes in the aggregate (nearly $8,000 less), but she also doesn't end up having to come up with the vast majority of the tax payment on the 2019 return.

The big reason for the difference is that Wilma ends up with the following results if she gets the income bunched into 2022:

- A portion of her income is taxed at 35% in the uneven income example, while none of her income is taxed at 35% in the balanced income scenario.
- She leaves unused a portion of the 22% bracket unused in 2023 and, between the two years, uses up less of the 24% bracket.

In this unit, we look at trying to combine options to give the client a better result.

YEAR END PLANNING AND BALANCING BRACKETS

The year tax planning routine is a normal part of any tax CPA's life, dominating the month of December. It's important to remember that while the client may be happy with simply paying less tax this year, ultimately, we need to be concerned with the impact over a series of years, not forgetting to take present value concepts into account.

For instance, let's go back to our example.

EXAMPLE

Reducing Tax in First Year, Tax Disaster the Second

In the example with Wilma, the out of balance year was the first year in the bad scenario. But, in our push to lower the current year's tax we do need to take care that we don't shove so much income into the following year, that we create a tax disaster that is only slightly offset by time value of money concepts.

This time Wilma has $100,000 she is going to get in 2022, $200,000 in 2023 and then $100,000 she could get before the end of December if pushes her customer hard to pay, but likely won't come to her until 2023 if she follows her normal billing and collection practices. Figuring it's always best to delay the payment of tax, Wilma does not push to get paid by the end of the year.

Here is the tax result:

Delayed income disaster	2022	2023	Total
Taxable Income	100,000	300,000	400,000
Tax	18,175	80,194	98,369

Wilma initially feels good about the situation when she picks up her 2022 return—look how little she paid. But she has real sticker shock when she picks up her 2023 return.

Even using present value calculation to take into account the payment of the tax later. Assuming a 5% discount rate and, for simplicity, that the taxes are paid at the end of each year this scenario has taxes with a net present value of $87,030.53 at the beginning of 2022, vs. $81,933.96 if the income is split evenly.

The rate of return that Wilma would need to obtain to have the delay pay for the extra tax is not one she is realistically likely to see—or, if she does have a way to obtain that return, she likely would be best off ignoring tax planning entirely and spending more time doing what she did to obtain those extraordinary returns.

So, year-end planning is not just simply about getting taxes down for the return to be filed in April—rather, it needs to be looked at as part of a long-term overall plan. Again, the use of tax planning software to watch for spillover effects in later years is an important part of this planning to avoid accidentally bunching income, and running up against a bad side effect of progressive rates, when with a little foresight the issue could have been avoided entirely.

Initial Year Benefit and Holding Pattern Planning

One situation that often comes up in tax planning is a situation where an action (say accruing a significant contribution to a profit sharing plan) creates a tax benefit in one year, but then must be replicated each year to avoid giving back the initial benefit right away.

EXAMPLE

Pay on Time, Expense Immediately

AM Trucking, Inc. was excited about the ability to immediately write off their equipment under the new bonus depreciation regime at the end of 2017. It was even better, since they could finance the purchase with little cash down and get an immediate write-off against their taxes. They were able to buy $3,000,000 of tractors late in the year, putting down $300,000.

However, during the following few years they found they hit a problem—they were paying back principal on the loans they had taken out and their accountant informed they could not take a deduction for these large payments. The only way to avoid paying tax on income in excess of the cash flow or, even better, not pay more tax than last year, is to buy another $3,000,000 worth of equipment, again borrowing $2,700,000.

They continue this, but when the economy slows down and it no longer makes sense to buy new equipment because they have no need for it, credit has become more difficult to obtain, and their cash flow has been extremely tight, they don't acquire equipment.

Although they paid a significant on loan payments, much of it now represented non-deductible principal.

Now they feel they have not been properly advised, since they now owe tax with no cash available to pay the tax and when the business is deep in a down cycle.

The fact that plan may require the taxpayer to continue to take the same action is something that should be communicated to the client. That's especially true when the taxpayer gets a deduction before actually expending cash to receive it.

It also cautions against a purely mathematical test for tax planning—a full communication of all consequences (including things like this potential reversal of the tax savings at an inopportune moment) need to be communicated to the client.

Balancing Income

One of the key issue noted earlier is the idea of balancing income between years to avoid bunching of income even if that bunching would result in pushing tax to a later tax year. But if the balancing will not result in a bracket shift, then moving income to the later year may still be a better strategy to gain some advantage from the time value of money.

An area where this often comes into play is helping a client decide about minimum required distributions.

EXAMPLE

First Year Minimum Required Distribution

Robert hit his required beginning date this year. He will be required to take an initial distribution of $25,000 from his IRA by April 1 of the following year, but if he does so he will need to take his second distribution (which we will assume will also be $25,000) by the end of the following year. Assume Robert has no basis in his IRA account.

Robert is single and has taxable income of $95,000 before taking any IRA distributions. We will use 2022 tax brackets for these computations. Robert has a single filing status.

In 2022, $95,000 of taxable income places Robert in the 24% marginal tax bracket. The 32% bracket begins at taxable income of $170,050.

If Robert takes the first distribution by the end of 2022, his tax for the two years is projected to look like this:

First Distribution by 12/31	2022	2023	Total
Taxable Income	120,000	120,000	240,000
Tax	22,636	22,636	45,272

If, instead, Robert delays the distribution until after the first of the year, his tax for the tax year is projected to look like this:

First Distribution after 12/31	2022	2023	Total
Taxable Income	95,000	145,000	240,000
Tax	16,636	28,636	45,272

While the tax is identical, the majority of the tax is not paid until the following year. Thus, present value concepts would lead us to recommend that Robert save up the $6,000 he saves in 2022 and pay it over with his 2023 return.

As was discussed previously, the adviser will need to warn Robert about the significant tax increase he'll see in 2023, but note that since he's paying the same amount of tax there's no harm in delaying the distribution as long as he keeps the funds liquid so that the extra tax can be paid come April of 2024.

However, if Robert's taxable income is higher, things are a bit different.

EXAMPLE

Taxable Income of $135,000 Before IRA Distribution

Assume Robert's taxable income before the IRA distribution is $135,000 for each year. Now there is a bump in tax if Robert allows the first distribution to spill into 2023.

Here are the tax computations when Bob takes his first distribution by the end of 2022:

First Distribution by 12/31	2022	2023	Total
Taxable Income	160,000	160,000	320,000
Tax	32,236	32,236	64,472

Compare this to the computation when Robert pushes the entire distribution into 2023:

First Distribution after 12/31	2022	2023	Total
Taxable Income	135,000	185,000	320,000
Tax	26,236	39,432	65,668

Note that Robert pays $1,196 of additional tax if he delays the distribution. Robert would need to earn over 20% from holding the $6,000 for an extra year to pay for that increase in tax. Given that rate of return is rather high, the time value of money benefit may not be enough to justify paying the extra tax.

In cases like this, the adviser may want to run calculations on the effect of moving just enough income into the first year to minimize the amount of income subject to the higher rate bracket in the second year.

While the first RMD distribution issue may be the textbook case of such an option, the issues come up in other scenarios where the taxpayer may be able to appropriately delay the receipt of income.

Prepayment of Expenses

One planning option that has to be undertaken with care is the use of prepaying for items to claim a deduction for taxpayers on the cash of accounting. The prepayment option is used to defer taxation (by reducing the first year's net income by paying the expense early, which is offset in the following year by the lack of the deduction) as well as part of a balancing strategy (moving expenses into an earlier year to get income below a change in tax brackets when it's expected income will be lower in the following year).

But the tax law does not allow for unfettered use of prepaying expenses. While the cash method of accounting under IRC §446(c)(1) is defined as follows in Reg. §1.446-1(c)(1)(i):

> Generally, under the cash receipts and disbursements method in the computation of taxable income, all items which constitute gross income (whether in the form of cash, property, or services) are to be included for the taxable year in which actually or constructively received. Expenditures are to be deducted for the taxable year in which actually made.

However, if the payment results in an intangible asset containing a benefit that is applicable to a later year, generally, the taxpayer must capitalize the payment into an asset and claim the deduction over the period to which it applies.[66] That includes prepaid expenses.[67]

EXAMPLES

Prepaid Insurance Capitalization (Example 1 from Reg 1 §1.263(a)-4(d)(3(ii))

N corporation, an accrual method taxpayer, pays $10,000 to an insurer to obtain three years of coverage under a property and casualty insurance policy. The $10,000 is a prepaid expense and must be capitalized.

EXAMPLE

Prepaid Rent Capitalization (Example 2 from Reg. §1.263(a)-4(d)(3(ii))

X corporation, a cash method taxpayer, enters into a 24-month lease of office space. At the time of the lease signing, X prepays $240,000. No other amounts are due under the lease. The $240,000 is a prepaid expense and must be capitalized.

Thus, the following proposed strategy would fail:

EXAMPLE

Improper Strategy for Paying Cash Basis Expenses

Natasha has an accounting firm which is having an exceptionally good year due to being paid substantial fees to assist a long-time client in the sale of her business. While those fees were good news, Natasha knows that they won't recur in the future and, in fact, her revenues are likely to be substantially lower in the near future until she is able to replace the work she used to perform for the business that was sold.

Natasha decides to contact her tax research provider and comes to an agreement where she will pay the vendor a fee equal to five times the amount of her upcoming one-year renewal payment in November. That payment will give her five years' worth of access to the online research materials. She plans to claim the full deduction on her tax return in the current year to offset those extra high fees.

Natasha's plan will not work—under Reg. §1.263(a)-4(d)(3)(i) Natasha must capitalize the entire amount she paid for the five years of access and amortize the amount paid over the 60 months she has access to the materials.

Does that mean the cash basis of accounting doesn't work for expenses? After all, many bills are paid before the service is performed. If each of those payments are deemed to create an intangible asset that cannot be written until the service is delivered or over the period the service is received, then the cash basis of accounting would become an administrative nightmare.

[66] Reg. §1.263(a)-4(d)

[67] Reg. §1.263(a)-4(d)(3)

Reg. §1.263(a)-4(f) provides relief from that administrative nightmare and, as well, a tax planning opportunity—just one that is limited.

The regulation provides an exception to the capitalization rules noted above if the conditions of the exception are met. Under this provision, a taxpayer will not be required to capitalize an amount paid to create or facilitate the creation of any right or benefit (such as the right to use the office the CPA firm is leasing) if the right or benefit does not extend beyond the earlier of

- 12 months after the first date the taxpayer realizes the right or benefit (such as the first day the CPA firm is allowed to access the research service under the agreement), or
- the end of the taxpayer's taxable year immediately following the tax year in which the payment is made.[68]

If the agreement can be renewed by the taxpayer, then the renewal period may have to be tacked in computing the 12-month period or determining if the agreement extends beyond the end of the following tax year if there is a reasonable expectation of renewal.[69] The following factors are listed as significant items in determining if there is a reasonable expectation of renewal:

- *Renewal history*—If similar rights are regularly renewed, it is evidence of a reasonable expectation of renewal. Similarly, if they most often have not been renewed, that's evidence there is no such reasonable expectation.
- *Economics of the transaction*—If renewal is necessary for the taxpayer to earn back his/her investment in the right, that's evidence of a reasonable expectation of renewal.
- *Likelihood of renewal by the other party*—The regulation provides that "evidence that indicates a likelihood of renewal by the other party to a right, such as a bargain renewal option or similar arrangement, is evidence of a reasonable expectancy of renewal. However, the mere fact that the other party will have the opportunity to renew on the same terms as are available to others is not evidence of a reasonable expectancy of renewal."
- *Terms of renewal*—If significant terms are subject to renegotiation at the end of them, that's evidence that there is no reasonable expectation of renewal.
- *Terminations*—If similar rights are generally terminated prior to renewal, that also suggests there is no reasonable expectation of renewal.[70]

Note that this is a purely mechanical test where you look at the earlier of the two dates—so you have to take care with paying for rights/services for a period that begins after the end of the taxpayer's tax year.

EXAMPLE

Prepaid for One-Year Term Beginning After Year End

Lauren pays for the liability insurance for her unincorporated business on November 1. She files on the calendar year for tax purposes. The policy covers a one-year period beginning on February 1 of the following year.

Although the policy covers no more than 12 months, because the coverage does not begin until February of the following year, the benefit that Lauren receives from the payment extends past the end of the tax year following the year she paid the premium.

[68] Reg. §1.263(a)-4(f)(1)

[69] Reg. §1.263(a)-4(f)(5)(i)

[70] Reg. §1.263(1)-4(f)(5)(ii)

> Thus, Lauren does not qualify for the 12-month rule allowing immediate expensing of the payment under Reg. §1.263(a)-4(f). She will not be able to claim any deduction for the year of payment, and will only be able to deduct 10/12 of the premium on her return for the following year.

Another misunderstanding of this rules arises when taxpayers believe because less than 12 months will remain on the contract at the end of the year that no accrual is required at year end.

> **EXAMPLE**
>
> Contract for 13 Months when Benefit First Received
>
> Assume Lauren's insurance coverage had expired on November 1. She decided to convert to a calendar year policy and paid for 14 months of coverage on November 1. Although only 12 months remains on the contract at year end, so the benefits do not extend beyond the end of the following tax year, 12/14 of the amount paid must be capitalized at year end and deducted in the following year.
>
> In this case, Lauren violated the requirement that there be no more than 12 months covered by the contract based on the first day she received benefits. In this case, she received benefits over 14 months, so the majority of the payment must be capitalized.

Note that Lauren could not get around this with two contracts that she paid on November 1, most likely as the IRS would be able to successfully argue based on substance over form that there was only a single transaction. Similarly, if she only paid for two months on November 1, but had an absolute right to the same policy coverage for the following year if she paid the premium for the following year by December 31, the IRS would likely look to the renewal rule described above to treat both transactions as one.

ROTH CONVERSIONS

One way to help assure that the taxpayer doesn't leave unused low brackets form year to and to increase flexibility in retirement is to look at Roth IRA conversions. While the ability to contribute to a Roth IRA is limited based on income, no such limit occurs for a taxpayer converting from a traditional IRA to a Roth IRA.

Note that this planning option can be a tough sell to a large percentage of your clients, since it often involves voluntarily paying taxes today to get the funds from the traditional IRA to the Roth IRA. However, the math often still works out surprisingly well in that case on a present value basis, with the Roth coming out ahead in cases where the client does not expect rates to be lower in retirement and is willing to delay withdrawals from the IRA, so that the funds come out slower than they would under the standard IRA's required minimum distribution formula.

Roth IRA Conversion

The way any taxpayer can get funds into a Roth IRA is to convert regular IRA funds into Roth IRA funds via one of the following options:

- Taking an eligible rollover distribution from a regular IRA and placing it into a Roth IRA.
- Transferring funds from an IRA account held by one custodian directly to a different custodian who places the funds in a Roth IRA account.
- Having the same custodian place regular IRA funds into a Roth IRA. [IRC §408A(d)(3)(A)(i)]

The above can also be done with funds from a SIMPLE-IRA account, but only after the mandatory initial two-year period related to SIMPLE-IRAs has been satisfied. You should recall that during the first two years a taxpayer has a SIMPLE-IRA the funds may only be rolled into another SIMPLE-IRA, and there is no Roth variant of a SIMPLE-IRA.

When a taxpayer makes a conversion under one of the above methods, the taxpayer pays tax just as if the IRA funds had been distributed to him/her. However, if the taxpayer is under age 59 ½ the premature distribution 10% tax under IRC §72(t) is tentatively waived. [IRC §408A(d)(3)(A)]

The "tentative" modifier refers to the fact that if the taxpayer who escaped the 10% tax under §72(t) takes a distribution within five years that is properly traced back to the rollover contribution the tax will retroactively apply to the amount taken out. [IRC §408A(d)(3)(F)]

For the first year of the conversion there was an option to split the income inclusion over two years, but that only applied to the initial conversion. Taxpayers converting since then have to include the full amount in the year of the conversion. [IRC §408A(d)(3)(E)]

Taxpayers report conversions on Part II of Form 8606.

Form 8606 (2022) Page 2

Part II **2022 Conversions From Traditional, SEP, or SIMPLE IRAs to Roth IRAs**
Complete this part if you converted part or all of your traditional, SEP, and SIMPLE IRAs to a Roth IRA in 2022.

16	If you completed Part I, enter the amount from line 8. Otherwise, enter the net amount you converted from traditional, SEP, and SIMPLE IRAs to Roth IRAs in 2022	16	
17	If you completed Part I, enter the amount from line 11. Otherwise, enter your basis in the amount on line 16 (see instructions)	17	
18	**Taxable amount.** Subtract line 17 from line 16. If more than zero, also include this amount on 2022 Form 1040, 1040-SR, or 1040-NR, line 4b	18	

Note that if a taxpayer has basis in the IRA account in question, then Part I of page 1 of the Form 8606 would also need to be completed.

Math of the Roth IRA

A key factor to understand how Roth IRAs can work in tax planning is to understand the basic financial math of the Roth IRA. Doing so will enable the adviser to spot situations where the numbers will work in favor of the client taking advantage of a Roth.

Perfectly Balanced Usage

To start the analysis, you need to look at an "indifference" analysis- that is, a scenario where, on a present value basis, the taxpayer ends up in exactly the same position using either a Roth IRA or a deductible IRA.

We'll look at this with an individual who has $6,500 available and is eligible to make either a deductible IRA contribution or a Roth contribution. However, that $6,500 can only go fully in the account if he obtains the tax benefit. If not, he will be taking the increased tax from choosing the Roth IRA and reducing his contribution.

So, assuming a 30% tax rate and a 51-year-old taxpayer with over $6,500 in earnings for a regular IRA he would fund the entire $6,500. However, for the Roth IRA he would reduce the contribution as shown:

Available Funds	6,500
Tax "cost"	1,950
Total to Account	4,550

The regular IRA starts out with $6,500 in the account while the Roth IRA starts out with $4,550.

He leaves the funds in the account for 20 years in both cases and it grows at a 7% annual rate. Thus, we compute the balance in each account as follows:

Traditional IRA:

$$\$6,500 \times (1 + 0.07)^{20} = \$25,153$$

Roth IRA:

$$\$4,550 \times (1 + 0.07)^{20} = \$17,607$$

The taxpayer plans to draw on the funds over 10 years, spending the account to zero. He is interested in what amount of available cash he will have each of the 10 years to plan for his retirement, since his psychic has informed him of the specific date he will die and he doesn't want to leave anything to his kids who "will just blow it." Thus, he has a goal of spending his last dime on the day he dies.

So we now start withdrawing the balance over 10 years, taking 1/10 the first year, 1/9 the second, etc. so that the balance will be exhausted over 10 years. We will also continue the same marginal tax rate on the distributed funds.

The distributions from the regular IRA look like this. The final column shows the spendable withdrawal each year, being the withdrawal after paying tax on the distribution:

Year	**Beginning Balance**	**Earnings**	**Distribute 1/10**	**Ending Balance**	**Tax**	**After Tax**
1	25,153	1,585	(2,515)	24,223	755	1,760
2	24,223	1,507	(2,691)	23,039	807	1,884
3	23,039	1,411	(2,880)	21,570	864	2,016
4	21,570	1,294	(3,081)	19,783	924	2,157
5	19,783	1,154	(3,297)	17,640	989	2,308
6	17,640	988	(3,528)	15,100	1,058	2,470
7	15,100	793	(3,775)	12,118	1,133	2,642
8	12,118	566	(4,039)	8,645	1,212	2,827
9	8,645	303	(4,323)	4,625	1,297	3,026
10	4,625	0	(4,625)	0	1,388	3,237

Over the 10-year period, the beneficiary ends up with total spendable distributions of $24,327 after paying the tax due.

What happens if the taxpayer had chosen the Roth path, but still took the funds out beginning at the same date and using the same 10-year payout?

The Roth IRA results are summarized as follows:

Year	Beginning Balance	Earnings	Distribute 1/10	Ending Balance	Tax	After Tax
1	17,607	1,109	(1,761)	16,955	0	1,761
2	16,955	1,055	(1,884)	16,126	0	1,884
3	16,126	988	(2,016)	15,098	0	2,016
4	15,098	906	(2,157)	13,847	0	2,157
5	13,847	808	(2,308)	12,347	0	2,308
6	12,347	691	(2,469)	10,569	0	2,469
7	10,569	555	(2,642)	8,482	0	2,642
8	8,482	396	(2,827)	6,051	0	2,827
9	6,051	212	(3,026)	3,237	0	3,026
10	3,237	0	(3,237)	0	0	3,237

Aside from minor rounding issues in the computation, you'll note that the two tables produce identical final columns.

Why? Simple algebra. If we simplify the matter to simply withdraw the funds all in one year, you can view the regular IRA as producing the following result:

> After tax balance = Available Front End Funds × $(1 + \text{Annual Return})^{\text{Years}}$ × (1-Tax Rate)

Basic algebra tells us that the order in which we multiply the same factors will not change the final result. And that's what happening with the equivalence.

It is important to note the conditions required to obtain the equivalent result:

- The true (more on that idea later) marginal tax rate is the same when funds go into and come out of the IRA.
- The taxpayer withdraws funds at the same rate from each account.
- Withdrawals begin at the same time.
- The Roth contribution is reduced by the tax benefits not received in the first year.

By understanding these issues, the adviser can recognize when the Roth IRA will present a financial advantage to the client and in what cases it will not.

Economically Larger Maximum Contribution (Subject to AGI Limits)

One of the first key observations an adviser should note is that, in the equivalent payout example, we achieved the same result with the Roth IRA making a less than maximum contribution that we achieved the same payout as we achieved with a deductible IRA funding the IRA at the maximum amount.

The obvious consequence of this is that a Roth IRA effectively gives the taxpayer the right to create larger after tax retirement pools.

In the real world, a client that is able to make a maximum contribution to a retirement account most likely is actually able to make a contribution in excess of that amount and most likely would be likely to do so if the law allowed a greater contribution. Assuming the client can look at financial issues involving tax matters unemotionally (something you need to be aware most clients cannot do), making a Roth IRA contribution allows more significant retirement funding.

For instance, let's continue the example above, but now modify the case so that the taxpayer has available the $1,950 in other funds to pay the "extra" tax. Investing the full $6,500 in the Roth IRA it will grow over 20 years to the same $25,153 balance as the deductible IRA did above. But its distributions will not be subject to tax.

In that case, his Roth IRA analysis now looks like this:

Year	Beginning Balance	Earnings	Distribute 1/10	Ending Balance	Tax	After Tax
1	25,153	1,585	(2,515)	24,223	0	2,515
2	24,223	1,507	(2,691)	23,039	0	2,691
3	23,039	1,411	(2,880)	21,570	0	2,880
4	21,570	1,294	(3,081)	19,783	0	3,081
5	19,783	1,154	(3,297)	17,640	0	3,297
6	17,640	988	(3,528)	15,100	0	3,528
7	15,100	793	(3,775)	12,118	0	3,775
8	12,118	566	(4,039)	8,645	0	4,039
9	8,645	303	(4,323)	4,625	0	4,323
10	4,625	0	(4,625)	0	0	4,625

But, you will note, the deductible IRA investor will have that $1,950 available to invest. To take that into account we'll put that $1,950 into a taxable account and draw from the fund over the 10 years to supplement the regular IRA.

Over the 20 years that fund will also grow at 7%, but it will need to also pay the 30% income tax on that return. So its return will be:

$$\$1{,}950 \times (1 + (1 + 0.30)^{20}) = \$5{,}076$$

The Roth investor received $34,754 after tax, while the regular IRA and invest the difference in a taxable account investor ended up with $29,403.

Clients don't think rationally when it comes to taxes, and this analysis will be one that, in the author's experience, a large number of clients will simply refuse to accept. The client will focus on "saving" the $1,950 today, not realizing that the tax will be paid back and more, with the "pay me later" part of the equation more than offsetting the temporary reduction in tax.

Distributions and the Roth IRA

One of the biggest differences between a Roth IRA and a traditional IRA is the elimination of the minimum required distribution provisions for Roth IRAs until funds pass to someone other than a spouse of a beneficiary. Coupled with planning that leaves the asset to the youngest heir, this, theoretically, can allow a Roth IRA to provide significant additional wealth to the family over time vs. traditional retirement programs.

Coupled with the fact that Roth funds are truly tax free rather than merely tax deferred, significant benefits can be achieved.

For instance, let's assume that the taxpayer hits RMDs with $500,000 in a traditional IRA. Looking only at what's in the IRA itself, again assuming an annual 7% rate of return, we find the following results:

Age	Beginning Balance	Earnings	RMD Factor	Distribute RMD	Ending Balance
72	500,000	33,723	27.4	(18,248)	515,502
73	515,502	34,723	26.5	(19,453)	530,799
74	530,799	35,705	25.6	(20,734)	545,796
75	545,796	36,659	24.7	(22,097)	560,382
76	560,382	37,579	23.8	(23,545)	574,440
77	574,440	38,455	22.9	(25,085)	587,833
78	587,833	39,278	22.0	(26,720)	600,413
79	600,413	40,046	21.2	(28,321)	612,159
80	612,159	40,740	20.3	(30,156)	622,763
81	622,763	41,358	19.5	(31,937)	632,204
82	632,204	41,888	18.7	(33,808)	640,303
83	640,303	42,317	17.9	(35,771)	646,867
84	646,867	42,633	17.1	(37,828)	651,689
85	651,689	42,820	16.3	(39,981)	654,544
86	654,544	42,862	15.5	(42,229)	655,192
87	655,192	42,765	14.8	(44,270)	653,702
88	653,702	42,514	14.1	(46,362)	649,868
89	649,868	42,096	13.4	(48,498)	643,480
90	643,480	41,497	12.7	(50,668)	634,321
91	634,321	40,702	12.0	(52,860)	622,175
92	622,175	39,732	11.4	(54,577)	607,342

In this case, the taxpayer passes $607,342 to the heir(s) in a traditional IRA account. That doesn't look too bad, since the account has grown by $107,342 over the 20 years.

But note what happens if we substitute a Roth IRA for the traditional IRA in this example.

Age	Beginning Balance	Earnings	RMD Factor	Distribute RMD	Ending Balance
72	500,000	35,000	None	0	535,000
73	535,000	37,450	None	0	572,450
74	572,450	40,072	None	0	612,522
75	612,522	42,877	None	0	655,399
76	655,399	45,878	None	0	701,277
77	701,277	49,089	None	0	750,366

Age	Beginning Balance	Earnings	RMD Factor	Distribute RMD	Ending Balance
78	750,366	52,526	None	0	802,892
79	802,892	56,202	None	0	859,094
80	859,094	60,137	None	0	919,231
81	919,231	64,346	None	0	983,577
82	983,577	68,850	None	0	1,052,427
83	1,052,427	73,670	None	0	1,126,097
84	1,126,097	78,827	None	0	1,204,924
85	1,204,924	84,345	None	0	1,289,269
86	1,289,269	90,249	None	0	1,379,518
87	1,379,518	96,566	None	0	1,476,084
88	1,476,084	103,326	None	0	1,579,410
89	1,579,410	110,559	None	0	1,689,969
90	1,689,969	118,298	None	0	1,808,267
91	1,808,267	126,579	None	0	1,934,846
92	1,934,846	135,439	None	0	2,070,285

Not facing the burden of minimum distributions draining the account each year, the account has more than quadrupled over that time period.

As well, even if the beneficiary simply banks the funds coming out of the traditional IRA, they will first face a 30% haircut due to income taxes, and then the return on the investment will also become taxable.

However, remember that the taxpayer received a tax benefit for contributing to the traditional IRA. What if the taxpayer had reduced his contributions to the Roth to account for that difference?

Following the logic outlined above for the "equivalent" IRAs, we would expect the Roth to have a balance equal to 70% of the traditional IRA if we factor in a 30% tax rate--so rather than $500,000 in the account we would expect it to start with $350,000. Using that number, here's how the Roth fares:

Age	Beginning Balance	Earnings	RMD Factor	Distribute RMD	Ending Balance
72	350,000	24,500	None	0	374,500
73	374,500	26,215	None	0	400,715
74	400,715	28,050	None	0	428,765
75	428,765	30,014	None	0	458,779
76	458,779	32,115	None	0	490,894
77	490,894	34,363	None	0	525,257
78	525,257	36,768	None	0	562,025
79	562,025	39,342	None	0	601,367
80	601,367	42,096	None	0	643,463

Age	Beginning Balance	Earnings	RMD Factor	Distribute RMD	Ending Balance
81	643,463	45,042	None	0	688,505
82	688,505	48,195	None	0	736,700
83	736,700	51,569	None	0	788,269
84	788,269	55,179	None	0	843,448
85	843,448	59,041	None	0	902,489
86	902,489	63,174	None	0	965,663
87	965,663	67,596	None	0	1,033,259
88	1,033,259	72,328	None	0	1,105,587
89	1,105,587	77,391	None	0	1,182,978
90	1,182,978	82,808	None	0	1,265,786
91	1,265,786	88,605	None	0	1,354,391
92	1,354,391	94,807	None	0	1,449,198

The Roth still catches up and surges ahead even if we “burden” it with having to absorb the lack of tax savings.

Conversion of Traditional IRAs to Roth IRA

The equivalency calculation earlier has an impact on the Roth conversion decision. Taken in its simplest form, assuming the same tax rates on conversion and during distributions, the rule would tell us that a conversion is arguably a “nonevent” if the taxpayer uses the funds in the IRA to pay the tax.

But it may not be so simple. If the taxpayer is under age 59½, IRC §408A(d)(3)(A)(ii) provides relief from the IRC §72(t) excise tax on a premature distribution. But that is only for amounts that actually are rolled. If the taxpayer has an IRA with $1,000,000 in it and converts, but holds back $300,000 to pay the tax on the rollover, that $300,000 won’t qualify for the exception under IRC §72(t). So our taxpayer would be $30,000 “short” of funds to pay the tax.

That can be solved by increasing the amount held back, taking into account that when the holdback increases the IRC §72(t) penalty increases as well. But, now the assumption of the “same rate” won’t hold. The taxpayer needs his marginal tax rate (aside from the §72(t) rate which would not have applied had he held the funds in the IRA until after age 59½) to increase in future years.

However, the situation changes if the taxpayer takes funds currently held in taxable accounts outside the IRA and uses those funds to pay the tax.

- The IRA account, while having the same balance as before, is now more valuable because there is no tax cost to take the funds out of the IRA.
- Effectively, by using taxable funds to pay the tax on the conversion, the taxpayer has indirectly “moved” the taxable funds into a fully tax exempt fund.

Of course, the simple analysis still assumes that rates stay the same or move upward for the taxpayer. This benefit is significant enough that the advantage can survive a certain level of decline in rates and still work.

Back Door Roth Conversion—IRS Unofficial Blessing?

Many CPAs are aware of the "backdoor" Roth IRA technique. Many have also wondered about whether the IRS might challenge this technique given that it, first, has gained a name that sounds like a "cheat" and, second, it is clearly trying to work around the contribution limits Congress has left in the law even after removing the income limits on converting a regular IRA to a Roth IRA. But now we have at least an unofficial blessing of the technique from an IRS employee on an IRS sponsored broadcast.

Tax analysts reported in the July 11, 2018, edition of *Tax Notes Today* that Donald Kieffer Jr., tax law specialist (employee plans rulings and agreements), IRS Tax-Exempt and Government Entities Division made favorable comments about the technique in a *Tax Talk Today* webcast broadcast on June 10, 2018.[71]

Per IRC §408A(c)(3), the ability of a taxpayer to make a Roth IRA contribution is limited based on adjusted gross income. For 2022, the taxpayer's ability to make a Roth IRA contribution phases out over the following adjusted gross income phase out ranges:

- Married filing a joint return: $204,000 – $214,000
- Single and head of household: $129,000 – $144,000
- Married filing a separate return: $0 – $10,000[72]

However, under IRC §408A(d)(3) a taxpayer may rollover funds to a Roth IRA from a traditional IRA regardless of the taxpayer's adjusted gross income level. In that case, the taxpayer will be treated as taking a taxable distribution from the IRA, with the taxable amount determined by reducing the distribution by the basis in the IRA allocated to that distribution.

The "backdoor" contribution works best when a taxpayer has no traditional IRA accounts prior to beginning the process of making the backdoor contribution. The taxpayer opens a traditional IRA and makes a *non-deductible* contribution to the account. So long as there is sufficient earned income a non-deductible contribution is always available to the taxpayer regardless of income.

Later, the taxpayer then rolls the balance of that IRA into a Roth IRA under IRC §408(d)(3). Since the taxpayer had no other traditional IRAs, the entire contribution becomes basis in the IRA. The taxpayer would then only pay tax on the earnings from the time the funds entered the traditional IRA until the account was rolled into the Roth IRA.

If the taxpayer already has a traditional IRA the backdoor rollover does not work as well, since the basis is spread over the entire balance of the account. That creates, effectively, the taxpayer paying tax twice on virtually all of the rollover in many cases—one for the earned income allowing for the contribution and a second time on the rollover. Thus, the technique is rarely used in such cases.

Let's go back to when the math does make sense—can we really get around the deduction limits of IRC §408A(c)(3) via this trivial workaround for a taxpayer who does not currently have a traditional IRA?

[71] Stephanie Cummings, "IRS Won't Target 'Backdoor' Roth IRA Contributions", *Tax Notes Today*, July 11, 2018, 2018 TNT 133-2

[72] https://www.irs.gov/newsroom/irs-announces-changes-to-retirement-plans-for-2022#:~:text=Roth%20IRA%20contributions%20income%20phase,to%20%2410%2C000%20%2D%20Married%2C%20filing%20separately

Mr. Kieffer indicated the answer is yes, based on a footnote in the conference report to the Tax Cuts and Jobs Act that stated:

> Although an individual with [adjusted gross income] exceeding certain limits is not permitted to make a contribution directly to a Roth IRA, the individual can make a contribution to a traditional IRA and convert the traditional IRA to a Roth IRA.

The Tax Analysts article quotes Mr. Kieffer on the subject as follows:

> "I think the IRS's only caution would be whenever we see words like 'back door' or 'workaround' or other step transactions that are putatively enabling a way to get around limits — especially statutory contribution limits — you generally find the IRS is not happy and prepared to challenge those," Kieffer said. "But in this one that we're talking about, it's allowed under the law."

While this is not binding guidance issued by the IRS, it seems unlikely Mr. Kieffer would have felt comfortable making such a statement blessing the technique unless, in fact, the IRS has determined the agency is not planning to challenge such arrangements.

EXAMPLE

Back Door Roth IRA Contribution

Troy and Tory are married and have adjusted gross income of $380,000. They are both covered by qualified retirement plans. Neither currently has a traditional IRA. Both are currently age 40. They are interested in making additional retirement contributions, but their research on the internet has indicated they can only make a non-deductible traditional IRA contribution.

You advise them that this is true, but can get rid of the tax on the earnings which would normally apply to a traditional IRA with basis if we do a "back door" Roth conversion. After Troy and Tory make a contribution of $6,000 each to their traditional IRAs, the balance is then converted to a Roth IRA after waiting few days.

Assuming the IRA have not had earnings over that time period, the conversion will take place without tax. They will have converted 100% of their traditional IRAs and, as such, will be able to use 100% of that basis in computing the taxable portion of the conversion. Since basis = cash out balance at this point, no tax is due. Thus, they will have moved $12,000 into Roth IRAs by using the back door technique.

GENERATIONAL SHIFTING OF INCOME (AND AVOIDING THE KIDDIE TAX)

Another way to change tax rates is to push income to an individual with a lower tax rate, especially if there other reasons (such as paying for higher education in the future for a child) to want to transfer funds to that person. As well, the assets can be given to the child without triggering a recognition of gain at the time of the transfer by the transferee.

Before the estate tax exemption was increased to over $5 million (and now temporarily above $12 million) such planning also was used by a large number of clients to achieve hoped for estate tax savings. Today, a much smaller portion of the population faces the prospect of estate taxes even if the exemption reverts to the 2010 inflation adjusted limit.

Congress took action against this planning opportunity when it enacted what is referred to as the *kiddie tax*.[73] The idea Congress had was to force unearned income of children (and,

[73] IRC §1(g)

eventually, even some adult children in college) to be taxed at the parent's rates once it exceeded certain limits.

> **EXAMPLE**
>
> Law Change Note
>
> Congress changed the kiddie tax in the Tax Cuts and Jobs Act to have it based on trust and estate income tax rates rather than the parents' rates, arguably to simplify the calculation. However, a number of cases of children of Gold Star soldiers (those killed in action) who received benefits are being stuck with significantly higher tax bill than in the past, since their surviving parent most often was not a high-income earner.
>
> The SECURE Act repealed this change to the kiddie tax effective in 2020 and thereafter. The taxpayer can also apply the rules to 2019 and amend 2018.

The following individuals are covered by the kiddie tax:

- A child who has not attained the age of 18 by the end of the tax year; or
- who is age 18 at the end of the tax year; or
- who has attained age 19 and is a student.

For 2018, a person covered by the kiddie tax (who, remember, doesn't have to be a minor any longer) can have up to $2,100 in *net unearned income*[74] without triggering the kiddie tax under IRC §1(g). This figure is $2,200 for 2019 and 2020.

Unearned income is defined by what it is not. Basically, it's any income of the taxpayer that is not treated as earned income. In this case, the Code borrows the definition of earned income found at IRC §911(d)(2). That definition of earned income includes

- wages,
- salaries,
- professional fees, and
- other amounts received as compensation for personal services actually rendered.[75]

It is important to remember that, for these purposes, unearned income does not equate to investment income. For instance, taxable benefits paid to the child of a deceased U.S. service member would not be earned income, since the child did not perform services to receive the compensation.[76]

Law Change Note

See the above law change note as to the changes enacted with the SECURE Act.

While the kiddie tax makes such planning more difficult than in the past, it's still possible to move income to a certain extent, or by taking actions to move income recognition to a year when the kiddie tax no longer applies to the individual.

This can include the following options, among others:

- Paying the child reasonable compensation for work actually performed in a business operated by the party looking to benefit the child and move the tax burden. Such income, *so*

[74] IRC §1(g)(1)

[75] IRC §911(d)(2)

[76] Reg. §1.911-3(c)(2) specifically provides that pensions and annuities are not considered earned income under §911(d)(2)

long as it represents reasonable compensation for services actually rendered (a very, very important point to remember), is earned income and both exempt from the kiddie tax *and* it will serve to increase the child's standard deduction, potentially increasing it to the same level as the one generally available to those not eligible to be claimed as a dependent of another.

- Having the child hold the funds in growth stocks until the child ages out of the kiddie tax. Given that capital gains for a party with low income starts with a capital gain tax rate of zero percent, this option can work out well *if the parties can accept the additional risk of constraining investment decisions that are tax driven (again, not a minor issue).*
- Investing in tax-deferred investments (such as annuities) where the investment income is insulated from tax, with a view towards finally taking funds out of the product after the child escapes the kiddie tax. Again, *the adviser must warn the client about the dangers of constraining investment options to meet tax goals.* While, in this case, the taxpayer can switch annuities tax free via §1035 exchanges, the insurance carrier will charge fees and expenses to have the funds in the insurance product that almost certainly will be greater than those that would have been incurred had the investments been held outside the insurance product.
- Making sure the child has sufficient investment assets to use up his/her $2,300 (rising in the future for inflation) that they can realize each year without triggering the kiddie tax.

OPPORTUNITIES TO TAKE ADVANTAGE OF BOTH TYPES OF PLANNING

The CPA should be on the lookout for opportunities to take advantage of either or both of the major planning techniques. These opportunities arise in a number of situations including:

- *Sale of a business*—Allocation of values of assets for Section 1060 statement (Form 8954) in the sale of a business offers opportunities for getting better tax rates and the treatment of installment sales may offer up the option to defer the payment of tax on the gain.
- *Divorce*—Divorce provides a number of tax planning opportunities, but it brings along with it a large risk of the CPA facing a claim of violating his/her duty to either a current or former client, so caution is advised. As a practical matter, only a CPA who has not been involved with the couple during their marriage can serve as a full adviser to a party in the divorce regarding structuring of the arrangement.
- *Employment contract*—If a client is negotiating the terms of employment with a new employer, the CPA can assist in designing a compensation package that may provide certain advantages such as negotiating for a larger expense reimbursement account vs. current compensation to deal with the repeal of the deduction for employee business expenses. The CPA can also help the client evaluate the value of various potential types of retirement programs that might be offered by employers competing for the employee's services.
- *Business formation*—A number of issues arise with regard to entity selection type for a new business, and the CPA can help in the planning. That includes the relative benefit that may be possible with reasonable compensation in an S corporation reducing payroll tax expenses vs. the loss of flexibility in allocation of income among the owners that electing S naturally requires. The new tax law makes this a very crucial planning aspect of businesses. Questions arise on whether to switch from one entity or the other based on Section 199A for passthrough entities and the reduced tax rate for corporations. This is further explained below.

TAX PLANNING POST-TCJA

The TCJA brought about specific changes in the tax law. Below are specific changes with the associated tax planning techniques.

Individuals

Capital Gains

For 2018 through 2025, tax brackets on long-term capital gains and qualified dividends are separate and no longer tied to ordinary-income tax brackets. Although the tax rates on long-term capital gains and qualified dividends remain the same under the TCJA as under prior law: 0%, 15%, and 20%, these rates are stand-alone. The 3.8% net investment income tax (NIIT) also still applies to people in higher brackets. Capital gain tax rates for 2022 follow:

	0% Tax Rate	15% Tax Rate	20% Tax Rate
Single Filers	$0 – $41,675	$41,676 – $459,750	$459,751 and up
Married Filing Jointly	$0 – $83,350	$83,351 – $517,200	$517,201 and up
Head of Household	$0 – $55,800	$55,801 – $488,500	$488,501 and up
Trusts and Estates	$0 – $2,800	$2,801 – $13,700	$13,701 and up

Tax Planning

Short-term capital gains are taxed at an extremely high rate. The rates can exceed 37% for those in the high tax bracket, not including state and local taxes in states that have these taxes. It is important that taxpayers ensure they minimize the tax impact on their portfolio.

Charitable Donations

TCJA increased the standard deduction to the following amounts:

	Standard Deduction 2022 / 2021
Single Filers/Married Filing Separately	$12,950 / $12,550
Head of Household	$19,400 / $18,800
Married Filing Jointly	$25,900 / $25,100

This increase made it less likely for individuals who contribute to charity to take the deduction in the year contributed.

Bunch Donations

Taxpayers should bunch donations to charities in specific years while limiting donations in other years. When individual taxpayers bunch donations, they combine multiple years of qualified annual charitable contributions into a single year. In these years where they bunch the donations, the large charitable contributions, in combination with other itemized deductions such as mortgage interest and state and local taxes (SALT) that cannot be deferred or bunched, will increase the likelihood of exceeding the standard deduction providing the taxpayers with additional tax savings.

Donate Appreciated Property

When a taxpayer donates appreciated long-term capital gain property, the charitable deduction is the fair market value (FMV) of the property, not the cost basis. The taxpayer will not have a capital gain or loss on the donations. The taxpayer must ensure that he or she

receives a written acknowledgement from the recipient charity specifying the amount and date of contribution. The donation of capital assets, whether held long-term or short-term, generally does not trigger gain because the asset was gifted, not sold.

Businesses

Section 199A QBI Deduction

Taxpayers other than corporations may be entitled to a deduction of up to 20% of their qualified business income (QBI).

IRC section 199A allows passthrough entity taxpayers to deduct 20% of the income earned in a qualified trade or business. Specifically, the deduction amount is the lesser of 1) 20% of total QBI, plus 20% of qualified REIT dividends, plus 20% of qualified publicly traded partnership (PTP) income; or 2) 20% of a taxpayer's taxable income computed before the QBI deduction, minus net capital gains. [Treasury Regulations section 1.199A-1(a)(2)]

The exception is specified service trades or businesses (SSTBs) as defined in Sec. 199A(d)(2). SSTBs include trades or businesses involving the performance of services in the fields of health, law, accounting, actuarial services, performing arts, consulting, athletics, financial services, brokerage services, or any other trade or business that relies on the reputation or skill of one or more of its employees. SSTBs also include trades or businesses involving the performance of investing and investment management services, trading, or dealing in securities, partnership interests, or commodities.

Taxpayers with taxable incomes below a threshold amount with trades or businesses that are SSTBs are not subject to this exception. Taxpayers with taxable incomes above the upper threshold amount are subject to the exception in full. The taxable income threshold amounts begin at $340,100 and $329,800 (for 2022 and 2021 respectively), for taxpayers filing joint returns, $170,050 and $164,900 (for 2022 and 2021 respectively) for single and head-of-household returns, $170,050 and $164,925 (2022 and 2021 respectively) for married filing separate returns. The range of phaseout for 2022 is $440,100 for married couples filing jointly, $220,050 for married individuals filing separately, and $220,050 for all others.

Tax Planning

Aggregation may result in a higher section 199A deduction. Aggregation results in trades or businesses that would be treated as separate and will be combined into one trade or business for purposes of calculating the QBI deduction. To aggregate certain conditions, the following five conditions must be met:

1. The same person or group of persons, directly or by attribution under Sec. 267(b) or 707(b), owns 50% or more of each trade or business to be aggregated. Under Regs. Sec. 1.199A-4(b)(1)(i), 50% or more of each trade or business means, in the case of such trades or businesses owned by an S corporation, 50% or more of the issued and outstanding shares of the corporation, or, in the case of such trades or businesses owned by a partnership, 50% or more of the capital or profits in the partnership;
2. The ownership described above exists for a majority of the tax year, including the last day of the tax year, in which the items attributable to each trade or business to be aggregated are included in income;
3. All of the items attributable to each trade or business to be aggregated are reported on returns with the same tax year, not taking into account short tax years;

4. None of the trades or businesses to be aggregated is a specified service trade or business (SSTB); and
5. The trades or businesses to be aggregated satisfy at least two of the following factors (based on all of the facts and circumstances):
   – The trades or businesses provide products, property, or services that are the same or customarily offered together;
   – The trades or businesses share facilities or share significant centralized business elements, such as personnel, accounting, legal, manufacturing, purchasing, human resources, or information technology; or
   – The trades or businesses are operated in coordination with, or reliance upon, one or more of the businesses in the aggregated group (for example, supply chain interdependencies).

EXAMPLE

A taxpayer has exceeded the threshold limit of QBI of $200 each from two trades or businesses *A* and *B*. *A* has $100 of W-2 wages, and *B* has $40 of W-2 wages. Neither *A* nor *B* owns any qualified property. If the QBI deduction is calculated separately for *A* and *B*, *A* would have a QBI deduction of $40, since 50% of W-2 wages, $50, exceeds 20% of QBI, $40. *B* would receive a QBI deduction of $20, since 50% of W-2 wages, $20, is less than 20% of QBI, $40. Thus, the total QBI deduction for both *A* and *B* is $60 ($40 for *A* + $20 for *B*). If *A* and *B* were aggregated, the total QBI of the combined trade or business would be $400, and the total W-2 wages would be $140. The QBI deduction for the aggregated group would be $70, since 50% of the W-2 wages, $70, is lower than 20% of the QBI of the combined group, $80. Aggregation of *A* and *B* results in a net increase to the QBI deduction of $20 over not aggregating the businesses.

Reduction of Corporate Tax Rate

The TCJA reduced the corporate tax rate to a flat 21% rate.

Tax Planning

Consider choice of entity. The CPA should weigh all facts and goals of clients before considering changing its entity structure from a passthrough entity to a C corporation. One issue among others is to see if the client constantly takes distributions from the entity. If this is the case, a C corporation may not be a better option due to double taxation that applies when the C corporation pays out dividends. The CPA should also look at whether the Section 199A deduction for the passthrough entity results in a better tax position for the client as opposed to when changing to a C corporation. Also, consider shifting income to a C corporation when its 21% tax rate is less than the marginal tax rate that would apply in an individual return.

Bonus Depreciation

The new law increases the bonus depreciation percentage from 50% to 100% for qualified property acquired and placed in service after September 27, 2017, and before January 1, 2023. The bonus depreciation percentage for qualified property that a taxpayer acquired before September 28, 2017, and placed in service before January 1, 2018, remains at 50%. Special rules apply for longer production period property and certain aircraft.

The definition of property eligible for 100% bonus depreciation was expanded to include used qualified property acquired and placed in service after September 27, 2017, if all of the following factors apply:

- The taxpayer or its predecessor didn't use the property at any time before acquiring it.
- The taxpayer didn't acquire the property from a related party.
- The taxpayer didn't acquire the property from a component member of a controlled group of corporations.
- The taxpayer's basis of the used property is not figured in whole or in part by reference to the adjusted basis of the property in the hands of the seller or transferor.
- The taxpayer's basis of the used property is not figured under the provision for deciding basis of property acquired from a decedent.
- Also, the cost of the used property eligible for bonus depreciation doesn't include the basis of property determined by reference to the basis of other property held at any time by the taxpayer (for example, in a like-kind exchange or involuntary conversion). As noted above, like-kind exchanges are limited to real property for tax years beginning on or after January 1, 2018.

The new law added qualified film, television, and live theatrical productions as types of qualified property that may be eligible for 100% bonus depreciation. This provision applies to property acquired and placed in service after September 27, 2017.

Under the new law, certain types of property are not eligible for bonus depreciation in any taxable year beginning after December 31, 2017. One such exclusion from qualified property is for property primarily used in the trade or business of the furnishing or sale of

- electrical energy, water, or sewage disposal services,
- gas or steam through a local distribution system, or
- transportation of gas or steam by pipeline.

This exclusion applies if the rates for the furnishing or sale have to be approved by a federal, state, or local government agency, a public service or public utility commission, or an electric cooperative.

The new law also adds an exclusion for any property used in a trade or business that has had floor-plan financing indebtedness if the floor-plan financing interest was taken into account under Section 163(j)(1)(C). Floor-plan financing indebtedness is secured by motor vehicle inventory in a business that sells or leases motor vehicles to retail customers.

The new law eliminated qualified improvement property acquired and placed in service after December 31, 2017, as a specific category of qualified property.

Section 179 Deduction Increase

Section 179 allows taxpayers to deduct the cost of certain property as an expense when the property is placed in service. For tax years beginning after 2017, the TCJA increased the maximum Section 179 expense deduction from $500,000 to $1 million. The phase-out limit increased from $2 million to $2.5 million. These amounts are indexed for inflation for tax years beginning after 2018.

The Section 179 deduction applies to tangible personal property such as machinery and equipment purchased for use in a trade or business, and if the taxpayer elects, qualified real property. The TCJA amended the definition of qualified real property to include qualified

improvement property and some improvements to nonresidential real property, such as roofs, heating, ventilation, and air-conditioning property, fire protection and alarm systems, and security systems. Revenue Procedure 2019-08 explains how taxpayers can elect to treat qualified real property as Section 179 property.

Tax Planning

- Both Section 179 and bonus depreciation reduce taxpayers' taxable income. In choosing to apply the bonus depreciation, the taxpayer must apply the bonus depreciation to ALL capital expenditures that qualify in the current year. Section 179 deduction on the other hand allows taxpayers to expense only purchases they want to expense as long as the deduction does not exceed the Section 179 threshold and does not create a loss.
- CPAs must understand their clients' specific needs. Certain times clients expect more profits in the upcoming years and using bonus depreciation may not be the best option in the current year. Clients have the option to elect out of bonus depreciation.

UNIT 6

Tax Planning Based on the SECURE Act of 2019, CARES Act of 2020, and CAA of 2021

LEARNING OBJECTIVES

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

- Describe additional tax planning strategies related to the SECURE Act.
- Explain tax planning strategies related to the CARES Act.
- Explain tax planning strategies related to the CAA.

In the last three years, Congress has passed legislation to enhance retirement and provide relief to individuals and businesses during the COVID-19 pandemic. They include the Setting Every Community Up for Retirement Enhancement Act (SECURE Act) of 2019, the Coronavirus Aid, Relief, and Economic Security Act (CARES Act) of 2020, and the Consolidated Appropriations Act (CAA) of 2021. An earlier chapter explained the features of the SECURE Act. This chapter provides additional tax planning strategies related to the SECURE Act of 2019, integrated with the CARES Act and the CAA. Certain modifications enacted with the American Rescue Plan Act, signed into law March 11, 2021, are also noted.

The importance of tax planning is to ensure the CPA keeps up to date with changes in all legislation and its impact. Some of the provisions are sunset provisions, which means they can disappear at any point in time. It is important that the CPA ensure that his/her client benefits from these provisions.

RETIREMENT PLANNING

The threshold for the retirement plans has increased. This increase has been reflected in an earlier chapter.

The conversion of a traditional IRA to a Roth IRA was in existence before the SECURE Act. Additional provisions provide for tax planning opportunities for IRA Roth conversions.

The SECURE Act now ensures that most non-spouse beneficiaries of inherited IRAs and qualified plans must distribute the account balance within 10 years. In the case of a traditional IRA, most distributions will occur perhaps in the prime of life, thus piling up more taxes.

Tax Planning

Tax planning in converting a traditional to a Roth IRA may be a great tax planning strategy:

1. The client may have lower gross income because of the pandemic.
2. The marginal tax rate is currently very low, the lowest since 1913. The client can take advantage of this lower tax rate to pay fewer taxes.
3. An inherited IRA will not have a negative tax impact on the recipient who could be burdened with tax liability due to the shortage of time of withdrawal to the 10 years.

HEALTH SAVINGS ACCOUNTS (HSA/FLEXIBLE SPENDING ACCOUNTS [FSA])

HSAs/FSAs are pretax deductions. The annual deduction for the family in 2022 is $7,300 (single $3,650). There is a catch-up of $1,000 for individuals age 55 and above. The CARES Act expanded on various items that qualify as medical deductions. It permanently reinstates over-the-counter medical products as eligible expenses for FSAs, certain Health Reimbursement Accounts (HRAs), and HSAs without a prescription.

HSAs were “use it or lose it” accounts, meaning that the taxpayer could not carry unused funds to the next year. The CAA allows the entire balance of unused funds to be carried from 2020 to 2021 and 2021 to 2022. The carryover flexibility applies to health and dependent care FSAs.

Tax Planning

The CPA should encourage the client to take advantage of FSAs, including HSAs. This is relevant, as many employees may not have used the FSA and HSA in 2020 due to the pandemic. The main reason for using an FSA or an HSA is tax savings, not to forfeit the funds in lieu of tax savings.

CHARITABLE DONATIONS

In 2020, the CARES Act increased the threshold of cash donations from 60% to 100% of AGI. Even though there is an increase in the threshold, the client may not benefit from this CARES Act provision because of the increase in the standard deduction amount from the TCJA. The standard deduction is indexed for inflation.

Tax Planning

If a client itemizes, the client should consider setting up a donor-advised fund as a tax planning strategy. The donor-advised fund allows the client to bunch their donations in one year and take a standard deduction in another year.

REQUIRED MINIMUM DISTRIBUTION

Required minimum distribution (RMD) was waived in 2020 as part of the CARES Act. In the year 2021, the waiver has been lifted, but in year 2022, there are changes in the amount that constitutes RMD based on life expectancy.

Tax Planning

Due to the waiver of 2020 RMD, the funds that were not withdrawn in 2020 can therefore remain vested up to December 2021 when the next RMD is required for withdrawal.

It is also important that the client should not use 2022 RMD rates for 2021 because the distributions are smaller, leading to a shortage. The deficit shortage is currently subject to a 50% penalty.

This is another reason why the CPA should always keep up to date with changes in the tax law.

CORONAVIRUS-RELATED DISTRIBUTION

There are special rules for distributions made to an individual

- who is diagnosed with COVID-19,
- whose spouse is diagnosed with COVID-19,
- whose dependent is diagnosed with COVID-19, or
- who experienced changes in financial circumstances as a result of COVID-19, such as
  - reduction in hours,
  - layoff,
  - furlough, or
  - losing childcare.

Distributions made up to 100% are not subject to the 10% early withdrawal nor 20% withholding.

If the qualifying individual took advantage of this provision, the qualifying individual can either include the entire income in the year of receipt or spread it over the period of three years from the year of receipt. Recontributing is allowed but not required. The recontributing must be made within a period of three years from the date of distribution.

> **EXAMPLE**
>
> S is a qualifying individual. S received $60,000 in qualifying distributions. S can choose to report the entire $60,000 in the year of receipt (2020) or report $20,000 each year (2020, 2021, and 2022).

NET OPERATING LOSS

Under the CARES Act, an NOL from a tax year beginning in 2018, 2019, or 2020 can be carried back five years. Taxpayers don't have to carry back their 2018, 2019, and 2020 NOLs. They can elect to waive the carryback period and only carry these NOLs forward to future years.

Under the CARES Act, taxpayers that carry back their NOLs must use the entire five-year carryback period. This provision expires for tax years beginning in 2021.

NOLs generated in 2018, 2019, and 2020 are subject to the TCJA 80%-of-income limitation if carried forward to a year in which the limitation applies (such as tax years beginning after 2020).

NOLs generated in 2018, 2019, and 2020 are not subject to the 80%-of-income limitation if claimed completely during the five-year carryback period during 2018, 2019, or 2020.

EXAMPLE

M, Inc., is an accrual-method C corporation; it expects to have $3 million of taxable income in 2019 and $0 taxable income in 2020. M's projections assume it will defer recognizing income associated with a one-time prepayment of $1 million received in 2019 for services to be performed in 2020 under the deferral method based on Section 451(c). If M, based on Rev. Proc. 2004-34, uses the full inclusion method instead, M will have $4 million of taxable income in 2019 (subject to tax at a 21% rate) and a $1 million NOL in 2020 that can be carried back to offset income in 2015 (subject to tax at a 35% rate).

The tax shifting, which will result in additional tax savings because the tax rate in 2019 is 21% and that in 2015 is 35%, will result in the following:

tax savings = $1,000,000 × 35% = $350,000, less $1,000,000 × 21% = $140,000

Tax Planning

The CPA should work with the client to understand the tax implication of carrying back the NOL to the five years to ensure the client has the maximum benefit of the NOL carryback. The NOL carryback provisions are not a requirement but an incentive. Thus, the CPA would need to see if this provision is beneficial to the client.

EXCESS BUSINESS LOSS LIMITATION DELAYED

Section 461(l) placed a limitation on the amount of trade or business losses that can be deducted by a taxpayer to $250,000 for a single taxpayer ($500,000 for a joint return) based on the TCJA 2017. The CARES Act delayed the effective date of the business loss limitation to the years after December 31, 2020. The American Rescue Plan Act of 2021 extended this provision for one year, through 2026.

Tax Planning

The CPA can file an amended return to create a tax refund for 2018 and 2019. If an NOL is created as a result of this amendment, the NOL rules apply under the CARES Act and the taxpayer can therefore carry back the NOL over a period of five years.

C CORPORATION ALTERNATIVE MINIMUM TAX (AMT) CREDITS

When AMT was repealed under the TCJA, C corporations were allowed to claim the refundable credits over a period of four tax years beginning in 2018, 2019, 2020, and 2021. The CARES Act provides that the C corporations can claim the credits fully in tax years beginning in 2018 and 2019 or choose to claim 50% in 2018 and the balance in 2019. To claim the full credit in 2018, the taxpayer must either file an amended return for 2018 or file for a tentative refund on Form 1139.

Form **1139** (Rev. October 2018) Department of the Treasury Internal Revenue Service

Corporation Application for Tentative Refund

► Go to *www.irs.gov/Form1139* for instructions and the latest information.
► Do not file with the corporation's income tax return—file separately.
► Keep a copy of this application for your records.

OMB No. 1545-0123

Name	**Employer identification number**
Number, street, and room or suite no. If a P.O. box, see instructions.	Date of incorporation
City or town, state, and ZIP code	Daytime phone number

1 Reason(s) for filing. See instructions—attach computation
- **a** Net operating loss (NOL) . . ► $
- **b** Net capital loss . . . . ► $
- **c** Unused general business credit ► $
- **d** Other . . ► $

2 Return for year of loss, unused credit, or overpayment under section 1341(b)(1) ► **a** Tax year ended **b** Date tax return filed **c** Service center where filed

3 If this application is for an unused credit created by another carryback, enter ending date for the tax year of the first carryback ►

4 Did a loss result in the release of a foreign tax credit, or is the corporation carrying back a general business credit that was released because of the release of a foreign tax credit (see instructions)? If "Yes," the corporation must file an amended return to carry back the released credits . . . ☐ Yes ☐ No

5a Was a consolidated return filed for any carryback year or did the corporation join a consolidated group (see instructions)? ☐ Yes ☐ No

b If "Yes," enter the tax year ending date and the name of the common parent and its EIN, if different from above (see instructions) ►

6a If Form 1138 has been filed, was an extension of time granted for filing the return for the tax year of the NOL? . . ☐ Yes ☐ No

b If "Yes," enter the date to which extension was granted ► **c** Enter the date Form 1138 was filed . ►

d Unpaid tax for which Form 1138 is in effect . . . ► $

7 If the corporation changed its accounting period, enter the date permission to change was granted . . . ►

8 If this is an application for a dissolved corporation, enter date of dissolution . . . ►

9 Has the corporation filed a petition in Tax Court for the year or years to which the carryback is to be applied? . . ☐ Yes ☐ No

10 Is any part of the decrease in tax due to a loss or credit resulting from a reportable transaction required to be disclosed? If "Yes," attach Form 8886 . . . ☐ Yes ☐ No

Computation of Decrease in Tax See instructions.	____ preceding tax year ended ►		____ preceding tax year ended ►		____ preceding tax year ended ►	
Note: If only filing for an unused general business credit (line 1c), skip lines 11 through 15.	**(a)** Before carryback	**(b)** After carryback	**(c)** Before carryback	**(d)** After carryback	**(e)** Before carryback	**(f)** After carryback
11 Taxable income from tax return						
12 **Capital loss carryback** (see instructions)						
13 Subtract line 12 from line 11						
14 **NOL deduction** (see instructions) . . .						
15 Taxable income. Subtract line 14 from line 13						
16 **Income tax**						
17 Alternative minimum tax						
18 Base erosion minimum tax (Attach Form 8991)						
19 Add lines 16 through 18						
20 General business credit (see instructions)						
21 Other credits (see instructions)						
22 Total credits. Add lines 20 and 21 . . .						
23 Subtract line 22 from line 19						
24 Personal holding company tax (Sch. PH (Form 1120))						
25 Other taxes (see instructions)						
26 Total tax liability. Add lines 23 through 25						
27 Enter amount from "After carryback" column on line 26 for each year						
28 **Decrease in tax.** Subtract line 27 from line 26						
29 Overpayment of tax due to a claim of right adjustment under section 1341(b)(1) (attach computation)						

Sign Here

Under penalties of perjury, I declare that I have examined this application and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete.

Signature of officer | Date | Title

Paid Preparer Use Only

Print/Type preparer's name	Preparer's signature	Date	Check ☐ if self-employed	PTIN
Firm's name ►			Firm's EIN ►	
Firm's address ►			Phone no.	

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11170F Form **1139** (Rev. 10-2018)

Tax Planning

The provisions for the AMT under the CARES Act allow business owners to claim the credit for the current tax year, which can help to provide a refund to the client, which could provide some relief to the client if the client's business has experienced a drop in revenues due to the pandemic. The CPA should confirm if claiming the credit will work best for the client at 50% for 2018 or 100% for 2018 by assessing income levels and the client's objective.

EXCLUSION OF STUDENT LOAN REPAYMENT

The CARES Act allows employers to pay up to $5,250 between March 27, 2020, and December 31, 2020, for each employee as student loan repayment. The payment is not taxable to the employee and is deductible to the employer under IRC 127.

The CAA amended IRC 127 and expanded eligible expenses to include loan repayment assistance. The earlier phase under this section only included employee's tuition, fees, and books without raising the employee's gross taxable income. The threshold still remains at $5,250. The CAA extends the payment to 2025.

The American Rescue Plan Act of 2021, signed March 11, 2021, amended Section 108(f) to provide that gross income does not include income from the discharge of a student loan after December 31, 2020, and before January 1, 2026.

The loans do not need to be related to the employee's employment with the employer and may have been incurred prior to the employment relationship.

Employers desiring to offer this benefit to employees need to develop an educational assistance program. Certain requirements as stated under Section 127 of the IRS Code are that the program must

1. not discriminate in favor of highly compensated employees (in 2022, a highly compensated employee is one receiving compensation in excess of $135,000) (i.e., it must be available to most employees in your company);
2. give no more than 5% of amounts paid by the employer to individuals who are shareholders or owners;
3. have a written plan document describing the group of eligible employees, the types of benefits offered, and a statement that employees cannot choose between the benefit and cash compensation;
4. provide notice to employees that the benefit exists;
5. obtain expense substantiation for amounts to be paid under the plan; and
6. perform nondiscrimination testing.

Tax Planning

Many employers are business owners; this option is in addition to the deductible amount of student loan interest on personal tax returns. This provision helps to retain staff. The cost of employing new staff cannot be overemphasized. Looking for ways to retain staff is an additional way to reduce costs.

BONUS DEPRECIATION ON QUALIFIED IMPROVEMENT PROPERTY

The CARES Act includes a provision for qualified improvement property (QIP), which was left out in the TCJA. The CARES Act now allows QIP to qualify for 15-year depreciation and therefore also be eligible for 100% first-year bonus depreciation. This change is retroactive to QIP placed in service on or after January 1, 2018.

QIP is defined as a Section 1250 property relating to an internal structural improvement to nonresidential realty.

Tax Planning

The CPA can advise the client to file an amended return to take advantage of the increased depreciation expense or can file a Form 3115 to change the accounting method. An increased depreciation deduction reduces the client's tax liability and can lead to a refund.

Form **3115**
(Rev. December 2018)
Department of the Treasury
Internal Revenue Service

Application for Change in Accounting Method

► **Go to *www.irs.gov/Form3115* for instructions and the latest information.**

OMB No. 1545-2070

Name of filer (name of parent corporation if a consolidated group) (see instructions)	**Identification number** (see instructions)
	Principal business activity code number (see instructions)
Number, street, and room or suite no. If a P.O. box, see the instructions.	Tax year of change begins (MM/DD/YYYY) Tax year of change ends (MM/DD/YYYY)
City or town, state, and ZIP code	Name of contact person (see instructions)
Name of applicant(s) (if different than filer) and identification number(s) (see instructions)	Contact person's telephone number

If the applicant is a member of a consolidated group, check this box . . . . ► ☐

If **Form 2848,** Power of Attorney and Declaration of Representative, is attached (see instructions for when Form 2848 is required), check this box . . . . ► ☐

Check the box to indicate the type of applicant.

- ☐ Individual
- ☐ Corporation
- ☐ Controlled foreign corporation (Sec. 957)
- ☐ 10/50 corporation (Sec. 904(d)(2)(E))
- ☐ Qualified personal service corporation (Sec. 448(d)(2))
- ☐ Exempt organization. Enter Code section ►
- ☐ Cooperative (Sec. 1381)
- ☐ Partnership
- ☐ S corporation
- ☐ Insurance co. (Sec. 816(a))
- ☐ Insurance co. (Sec. 831)
- ☐ Other (specify) ►

Check the appropriate box to indicate the type of accounting method change being requested. See instructions.

- ☐ Depreciation or Amortization
- ☐ Financial Products and/or Financial Activities of Financial Institutions
- ☐ Other (specify) ►

Caution: To be eligible for approval of the requested change in method of accounting, the taxpayer must provide all information that is relevant to the taxpayer or to the taxpayer's requested change in method of accounting. This includes **(1)** all relevant information requested on this Form 3115 (including its instructions), and **(2)** any other relevant information, even if not specifically requested on Form 3115.
The taxpayer must attach all applicable statements requested throughout this form.

Part I Information for Automatic Change Request

		Yes	No
1	Enter the applicable designated automatic accounting method change number ("DCN") for the requested automatic change. Enter only one DCN, except as provided for in guidance published by the IRS. If the requested change has no DCN, check "Other," and provide both a description of the change and a citation of the IRS guidance providing the automatic change. See instructions.		
a	(1) DCN: ____ (2) DCN: ____ (3) DCN: ____ (4) DCN: ____ (5) DCN: ____ (6) DCN: ____ (7) DCN: ____ (8) DCN: ____ (9) DCN: ____ (10) DCN: ____ (11) DCN: ____ (12) DCN: ____		
b	Other ☐ Description ►		
2	Do any of the eligibility rules restrict the applicant from filing the requested change using the automatic change procedures (see instructions)? If "Yes," attach an explanation.		
3	Has the filer provided all the information and statements required **(a)** on this form and **(b)** by the List of Automatic Changes under which the applicant is requesting a change? See instructions. . . . . **Note:** Complete Part II and Part IV of this form, and, Schedules A through E, if applicable.		

Part II Information for All Requests

		Yes	No
4	During the tax year of change, did or will the applicant **(a)** cease to engage in the trade or business to which the requested change relates, or **(b)** terminate its existence? See instructions.		
5	Is the applicant requesting to change to the principal method in the tax year of change under Regulations section 1.381(c)(4)-1(d)(1) or 1.381(c)(5)-1(d)(1)? . . . . If "No," go to line 6a. If "Yes," the applicant cannot file a Form 3115 for this change. See instructions.		

Sign Here

Under penalties of perjury, I declare that I have examined this application, including accompanying schedules and statements, and to the best of my knowledge and belief, the application contains all the relevant facts relating to the application, and it is true, correct, and complete. Declaration of preparer (other than applicant) is based on all information of which preparer has any knowledge.

Signature of filer (and spouse, if joint return)	Date	Name and title (print or type)

Preparer (other than filer/applicant)

Print/Type preparer's name	Preparer's signature	Date
Firm's name ►		

For Privacy Act and Paperwork Reduction Act Notice, see the instructions. Cat. No. 19280E Form **3115** (Rev. 12-2018)

UNIT 7

Other Tax Planning Opportunities

LEARNING OBJECTIVES

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

- Identify additional tax planning opportunities beyond deferral and conversion.
- Recall various CPA's responsibility regarding these tax planning opportunities.

In addition to deferral and conversion in tax planning, other tax planning opportunities exist. These include choice of entity, Section 1244 gift splitting, alternative valuation election, and deceased spouse unused exclusion. This unit explains these options.

SECTION 1244[77]

Not all businesses succeed. The tax code recognizes this and has used section 1244 to alleviate the burden of businesses that fail. Section 1244 also encourages angel investments. Section 1244 allows investors to take all small business losses as a tax 1244.

A section 1244 stock is a stock market loss that allows stock owners to claim losses from the sales of shares in small companies as regular losses rather than capital losses. Individual stock owners can claim losses of up to $50,000, and couples may claim up to $100,000. (This is unlike capital losses, which are subject to an annual deduction limit of only $3,000.)

Claiming the 1244 losses as ordinary losses does not prohibit the stock owner from enjoying capital gain rates (if the stock owner has capital gains in the same year), and they offset other income taxed at ordinary rates. Section 1244 stock loss is claimed on line 10 of Form 4797. Any loss in excess of the limit should be reported on Schedule D, Form 1040.

77 I.R.C §1244

To qualify as a small business stock the following conditions must be met:

- The corporation must be a domestic corporation (including an S corporation) and is a small business corporation if, when the stock is issued, the total amount of money and property received by the corporation for stock (or as a contribution to capital or as paid in surplus) does not exceed $1 million (Secs. 1244(c)(1)(A) and (3)(A)). In its transitional year (the first taxable year in which the $1 million mark is exceeded), the corporation must designate which shares are 1244 for that year.
- The stock must be issued in exchange for cash or other property (other than stock and securities) (Sec. 1244(c) (1)(B)). Therefore, stock issued in exchange for services does not qualify (Regs. Sec. 1.1244(c)-1(d)(1)).

Tax Planning

The CPA should allow the corporation to pay cash for services rendered and then the shareholder can use the cash to purchase the stock.

Stock issued in exchange for stock or securities, including stock of the issuing corporation, normally does not qualify for Sec. 1244 treatment. Stock received the qualify include:

1. certain stock dividend transactions,
2. an E reorganization (a recapitalization) under Sec. 368(a)(1)(E), or
3. an F reorganization (a change in identity, form, or place of organization) under Sec. 368(a) (1)(F) can qualify.
4. Cancellation of a bona fide debt in exchange for stock qualifies for Sec. 1244 treatment, unless the debt is evidenced by a security or arises out of the performance of personal services (Regs. Sec. 1.1244(c)-1(d)(1)).

Note that stock exchanged for debt that is worthless when exchanged will not generate a Sec. 1244 loss because the basis of the stock will be zero.

To avoid this, debt should be converted into stock as early in the corporation's life as possible. Waiting to convert until the company reaches a hardship stage (i.e., insolvency) increases the odds that a Sec. 1244 loss will be disallowed.

- Shareholders must have bought and paid for the stocks themselves and not received them as bonuses or incentives from the company, the stock must be issued directly to the original owner, who is the only one entitled to claim a Sec. 1244 loss (Regs. Sec. 1.1244(a)-1(b)). In addition, the owner must be an individual or a partnership (Sec. 1244(a)).
- Taxpayers who purchase existing corporation's stock do not get section 1244 treatment as they are not the original owners. To have section 1244 apply, they can purchase the corporation's assets and transfer them to a new corporation.
- The stock can be either common or preferred, provided the preferred stock was issued after July 18, 1984 (H.R. Rep't No. 98-432, 98th Cong., 2d Sess. 1581 (1984)). Common stock does not include securities convertible into common stock or common stock convertible into other securities (Regs. Sec. 1.1244(c)-1(b)). For common stock issued before November 7, 1978, other requirements must be met. (See Regs. Sec. 1.1244(c)-1(f))

The corporation must meet the gross receipts test (Sec. 1244(c)(1)(C)). Under this test, during the five most recent tax years ending before the date the loss was sustained by the shareholder (or the life of the corporation, if less than 5 years), the corporation must have derived more than 50% of its aggregate gross receipts from sources other than royalties, rents, dividends, interest, annuities, and sales or exchanges of stocks or securities. Note that the gross receipts test does not apply if the corporation's cumulative deductions (excluding the NOL carryover and carryback deduction and the special dividends-received deductions) exceed its cumulative gross income during the 5-year testing period (Sec. 1244(c)(2)(C)).

Even if the gross receipts test is passed (or the corporation qualifies for the exception noted in the previous paragraph), the stock will qualify as Sec. 1244 stock only if the corporation is an operating company for the 5-year testing period (Regs. Sec. 1.1244(c)-1(e)(2)). The corporation cannot be a holding or investment company.

To benefit from the section 1244 stock treatment, the CPA should ensure that any stock purchased falls within the requirements of section 1244 stock.

Choice of Entity

Another way to plan from inception is the ability for the CPA to decide on which entity choice would work best for the client to reduce their tax liability.

The various common entity types are sole proprietorships, partnerships, limited liability companies, S Corporations, and C Corporations.

Sole Proprietorship

Many clients may want to start their business as a sole proprietorship. Although the sole proprietorship is easy to form as it does not require any formalities, it has a high tax. The taxes include self-employment taxes. Thus even if the business makes a loss, the client still has to pay self-employment taxes. It is important to note that a sole proprietor cannot pay themselves.

The Partnership

The partnership is made of two or more owners. The partnership usually has an operating agreement, the partners like the sole proprietorship has a high tax liability. Partners do not receive salaries. Partners can be paid guarantee payments. Partners income and guarantee payments are subject to self-employment taxes in addition to income taxes.

The limited liability company (LLC) is a legal structure. The limited liability company that has one owner is a disregarded entity and is taxed as a sole proprietorship and the LLC that has two or more owners is taxed as a partnership.

The S Corporation is a tax structure; an LLC can elect to be taxed as an S Corporation, or a C Corporation can elect to be taxed as an S Corporation. The S corporation in addition to having protection is shareholders form legal liability, it is also a flow through entity. The S Corporation allows the shareholders to pay themselves a reasonable salary, the salary and related taxes are deductible by the corporation. The S Corporation offers very many tax advantages but is restrictive.

An S Corporation based on IRC §1361(b) must:

- Be a domestic corporation
- Have only allowable shareholders
  - May be individuals, certain trusts, and estates and
  - May not be partnerships, corporations, or nonresident alien shareholders
- Have no more than 100 shareholders
- Have only one class of stock
- Not be an ineligible corporation (i.e., certain financial institutions, insurance companies, and domestic international sales corporations)

The entity can elect to be an S Corporation by filing a form 2553. The election is due by the 15th day of the 3rd month of the calendar year. Late election provisions exist.

Form **2553**
(Rev. December 2017)
Department of the Treasury
Internal Revenue Service

Election by a Small Business Corporation

(Under section 1362 of the Internal Revenue Code)
(Including a late election filed pursuant to Rev. Proc. 2013-30)
▶ You can fax this form to the IRS. See separate instructions.
▶ Go to *www.irs.gov/Form2553* for instructions and the latest information.

OMB No. 1545-0123

Note: This election to be an S corporation can be accepted only if all the tests are met under *Who May Elect* in the instructions, all shareholders have signed the consent statement, an officer has signed below, and the exact name and address of the corporation (entity) and other required form information have been provided.

Part I Election Information

Type or Print	Name (see instructions)	**A** Employer identification number
	Number, street, and room or suite no. If a P.O. box, see instructions.	**B** Date incorporated
	City or town, state or province, country, and ZIP or foreign postal code	**C** State of incorporation

D Check the applicable box(es) if the corporation (entity), after applying for the EIN shown in **A** above, changed its ☐ name or ☐ address

E Election is to be effective for tax year beginning (month, day, year) (see instructions) . . . . ▶

Caution: A corporation (entity) making the election for its first tax year in existence will usually enter the beginning date of a short tax year that begins on a date other than January 1.

F Selected tax year:
(1) ☐ Calendar year
(2) ☐ Fiscal year ending (month and day) ▶
(3) ☐ 52-53-week year ending with reference to the month of December
(4) ☐ 52-53-week year ending with reference to the month of ▶
If box (2) or (4) is checked, complete Part II.

G If more than 100 shareholders are listed for item J (see page 2), check this box if treating members of a family as one shareholder results in no more than 100 shareholders (see test 2 under *Who May Elect* in the instructions) ▶ ☐

H Name and title of officer or legal representative whom the IRS may call for more information	Telephone number of officer or legal representative

I If this S corporation election is being filed late, I declare I had reasonable cause for not filing Form 2553 timely. If this late election is being made by an entity eligible to elect to be treated as a corporation, I declare I also had reasonable cause for not filing an entity classification election timely and the representations listed in Part IV are true. See below for my explanation of the reasons the election or elections were not made on time and a description of my diligent actions to correct the mistake upon its discovery. See instructions.

Sign Here

Under penalties of perjury, I declare that I have examined this election, including accompanying documents, and, to the best of my knowledge and belief, the election contains all the relevant facts relating to the election, and such facts are true, correct, and complete.

▶ Signature of officer | Title | Date

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 18629R Form **2553** (Rev. 12-2017)

To request relief for a late election, a corporation that meets the following requirements must explain the reasonable cause for failure to timely file the election and its diligent actions to correct the mistake upon discovery. This information can be provided on line I of Form 2553 or on an attached statement.

1. The corporation intended to be classified as an S corporation as of the date entered in line E of Form 2553;
2. The corporation fails to qualify as an S corporation (see Who May Elect, earlier) on the effective date entered in line E of Form 2553 solely because Form 2553 wasn't filed by the due date (see When To Make the Election, earlier);
3. The corporation has reasonable cause for its failure to timely file Form 2553 and has acted diligently to correct the mistake upon discovery of its failure to timely file Form 2553;
4. Form 2553 will be filed within 3 years and 75 days of the date entered in line E of Form 2553; and
5. A corporation that meets requirements (1) through (4) must also be able to provide statements from all shareholders who were shareholders during the period between the date entered in line E of Form 2553 and the date the completed Form 2553 is filed stating that they have reported their income on all affected returns consistent with the S corporation election for the year the election should have been made and all subsequent years. Completion of Form 2553, Part I, column K, Shareholder's Consent Statement (or similar document attached to Form 2553), will meet this requirement; or
6. A corporation that meets requirements (1) through (3) but not requirement (4) can still request relief for a late election on Form 2553 if the following statements are true.
    a. The corporation and all its shareholders reported their income consistent with S corporation status for the year the S corporation election should have been made, and for every subsequent tax year (if any);
    b. At least 6 months have elapsed since the date on which the corporation filed its tax return for the first year the corporation intended to be an S corporation; and
    c. Neither the corporation nor any of its shareholders was notified by the IRS of any problem regarding the S corporation status within 6 months of the date on which the Form 1120-S for the first year was timely filed.

To request relief for a late election when the above requirements aren't met, the corporation generally must request a private letter ruling and pay a user fee in accordance with Rev. Proc. 2021-1, 2021-1 I.R.B. 1 (or its successor).

C Corporation

The C Corporation also offers legal liability protection to its shareholders. The C Corporation allows the shareholders to receive a salary and the salary and the related taxes are deductible. The issue with the C Corporation is double taxation. The C Corporation is taxed at the level of the corporation and it is also taxed when dividends are distributed.

As much as possible, the CPA should assist the client in choosing their business structure. In doing so, the CPA should listen to the objective of the client.

EXAMPLE

If Jason is a U.S. citizen and he plans to start a clothing business, JY Clothing, that he wants to get into the global market, perhaps Australia. To encourage entry into the Australian market, he decides to include an Australian as a shareholder. Although an S Corporation has many tax advantages, JY Clothing will not qualify as an S Corporation because it has a nonresident alien as its shareholder.

Another planning opportunity for Choice of Entity is the availability of passive activity limitations. IRC section 469 states that passive activity losses can only be deducted against passive activity gains. This applies when the taxpayer has a business that is a flow through entity. If the business has a high level of passive activity the better option for the taxpayer is a C Corporation. The passive activity limitation rules do not apply to C Corporation.

Gift Splitting

The gift tax annual exemption for 2022 is $16,000 per person. The unified lifetime exclusion for 2022 is $12,060,000. Any amount given that is above that threshold is taxable. IRC Section 2513(a)(1), if elected, states that a gift made by one spouse to a person other than that donor's spouse is considered, for gift tax purposes, as made one-half by the donor and one-half by the donor's spouse. The spouse must give their consent. Thus, if a client wants to give an amount that exceeds the exclusion amount, the client can split the gift with the client's spouse.

EXAMPLE

Mark and Lizzy are married, both U.S. citizens, and live in Iowa. In 2022, Mark decides that he wants to gift $28,000 to their son, Trent. If Lizzy consents to split this gift with Mark, the gift is recognized as $16,000 being transferred from Mark and $12,000 transferred from Lizzy. By splitting this gift, Mark and Lizzy are individually maximizing the use of their $16,000 annual gift exclusions.

To consent to this split gifts, Mark who is the donor must complete and file a federal gift tax return (Form 706), Lizzy who is the nondonor spouse must also sign, providing consent to split gifts for the calendar year applicable to the gift tax return. A married couple typically has up until the tax filing deadline for the prior year to elect to split gifts made in the prior year.[78] If the couple already filed a federal gift tax return consenting to split gifts and wish to revoke their consent, they must do this before the tax filing deadline; otherwise, the consent to split gifts that was previously provided becomes irrevocable.[79]

The CPA should ensure the client is aware of the availability of the gift-splitting provision, and the CPA should file the Form 709 on a timely basis. The CPA must also note that if the client and the spouse divorce prior to filing their taxes for the year the gift took place, neither spouse can be remarried for gift splitting to qualify.[80]

The CPA must also carefully analyze the constant changes in the tax law. Currently, the unified tax credit threshold is $11,700,000 and is set to expire in 2025. After 2025, the threshold will be set at $6,700,000 per person. In advising on gift tax splitting, the CPA should use the more favorable position for the client and understand the clients financial

78 IRC §2513 (b)

79 Treas. Reg. §25-2513-3

80 Internal Revenue Service. "Instructions for Form 709 (2021) | Internal Revenue Service (irs.gov) Accessed December 15, 2021.

position to provide the relevant advice. The CPA must consider the clients present income and projected estate estimate when advising on gift splitting.

EXAMPLE

Mark and Lizzy are married, both U.S. citizens, and live in Iowa. In 2021, Mark decides that he wants to gift $10,600,000 to their son, Trent. If Lizzy consents to splitting the gift with Mark, the gift is recognized as $5,300,000 being transferred from Mark and $5,300,000 transferred from Lizzy. By splitting this gift, both will have a lifetime exclusion remaining of $6,400,000 ($11,700,000 – $5,300,000). If the lifetime exclusion reduces to the proposed $6.7 M, this would leave Mark and Lizzy with $2,800,000. If there is no gift splitting, then in 2026, Mark will have no additional exemption but Lizzy will have her full $6,700,000 exemption.

The CPA should consider projected value of an estate when advising clients.

Form **706**

(Rev. August 2019)

Department of the Treasury
Internal Revenue Service

United States Estate (and Generation-Skipping Transfer) Tax Return

▶ Estate of a citizen or resident of the United States (see instructions). To be filed for decedents dying after December 31, 2018.

▶ Go to *www.irs.gov/Form706* for instructions and the latest information.

OMB No. 1545-0015

Part 1—Decedent and Executor

1a Decedent's first name and middle initial (and maiden name, if any)	**1b** Decedent's last name		**2** Decedent's social security no.
3a City, town, or post office; county; state or province; country; and ZIP or foreign postal code	**3b** Year domicile established	**4** Date of birth	**5** Date of death
6a Name of executor (see instructions)	**6b** Executor's address (number and street including apartment or suite no.; city, town, or post office; state or province; country; and ZIP or foreign postal code) and phone no.		
6c Executor's social security number (see instructions)	Phone no.		

6d If there are multiple executors, check here ☐ and attach a list showing the names, addresses, telephone numbers, and SSNs of the additional executors.

7a Name and location of court where will was probated or estate administered | **7b** Case number

8 If decedent died testate, check here ▶ ☐ and attach a certified copy of the will. **9** If you extended the time to file this Form 706, check here ▶ ☐

10 If Schedule R-1 is attached, check here ▶ ☐ **11** If you are estimating the value of assets included in the gross estate on line 1 pursuant to the special rule of Reg. section 20.2010-2(a)(7)(ii), check here ▶ ☐

Part 2—Tax Computation

Line	Description		Line	Amount
1	Total gross estate less exclusion (from Part 5—Recapitulation, item 13)		1	
2	Tentative total allowable deductions (from Part 5—Recapitulation, item 24)		2	
3a	Tentative taxable estate (subtract line 2 from line 1)		3a	
b	State death tax deduction		3b	
c	Taxable estate (subtract line 3b from line 3a)		3c	
4	Adjusted taxable gifts (see instructions)		4	
5	Add lines 3c and 4		5	
6	Tentative tax on the amount on line 5 from Table A in the instructions		6	
7	Total gift tax paid or payable (see instructions)		7	
8	Gross estate tax (subtract line 7 from line 6)		8	
9a	Basic exclusion amount	9a		
b	Deceased spousal unused exclusion (DSUE) amount from predeceased spouse(s), if any (from Section D, Part 6—Portability of Deceased Spousal Unused Exclusion)	9b		
c	Restored exclusion amount (see instructions)	9c		
d	Applicable exclusion amount (add lines 9a, 9b, and 9c)	9d		
e	Applicable credit amount (tentative tax on the amount in line 9d from Table A in the instructions)	9e		
10	Adjustment to applicable credit amount (May not exceed $6,000. See instructions.)	10		
11	Allowable applicable credit amount (subtract line 10 from line 9e)		11	
12	Subtract line 11 from line 8 (but do not enter less than zero)		12	
13	Credit for foreign death taxes (from Schedule P). (Attach Form(s) 706-CE.)	13		
14	Credit for tax on prior transfers (from Schedule Q)	14		
15	Total credits (add lines 13 and 14)		15	
16	Net estate tax (subtract line 15 from line 12)		16	
17	Generation-skipping transfer (GST) taxes payable (from Schedule R, Part 2, line 10)		17	
18	Total transfer taxes (add lines 16 and 17)		18	
19	Prior payments (explain in an attached statement)		19	
20	Balance due (or overpayment) (subtract line 19 from line 18)		20	

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

Sign Here

▶ Signature of executor ▶ Date

▶ Signature of executor ▶ Date

Paid Preparer Use Only

Print/Type preparer's name	Preparer's signature	Date	Check ☐ if self-employed	PTIN
Firm's name ▶			Firm's EIN ▶	
Firm's address ▶			Phone no.	

For Privacy Act and Paperwork Reduction Act Notice, see instructions. Cat. No. 20548R Form **706** (Rev. 8-2019)

Alternative Valuation Date Election

In estate taxes, the value of property on the date of transfer (after death) is usually the value used to determine the estate tax, the federal gift tax, or the generation skipping tax. Thus, the fair market value is used. The provisions of IRC Section 2032 allow the executor to elect to value the estate at an alternative valuation date. The election is made by the executor of the estate, and the election is irrevocable. The election does not apply to gift taxes.

The election gives relief to estates where the asset value declines from the date of death of the taxpayer to the date of payment of the tax liability. If the executor makes this election, the election will apply to all assets of the estate. If the election is made, all assets are valued, either 6 months after death or on the date of disposition, whichever is earlier.

To qualify for this election, the election must decrease the value of the estate and the estate tax liability.

EXAMPLE

	Value at Death	Value After 6 Months
Land	$15,000,000	15,050,000
Building	1,500,000	1,250,000
Stock in JJTM	500,000	250,000
Total	$17,000,000	$16,550,000

The example shows that even though the land appreciated, the total value of the estate decreased from $17,000,000 to $16,550,000. Assuming the decedent has exceeded the lifetime exemption and the tax rate is at 40%, the tax savings will be $180,000 ($6,800,000 – 6,620,000).

The CPA should assess the value of the decedent's estate to determine if the estate will be in a better position when the alternative valuation election was made. If the estate is in a better position, the CPA can reduce the tax liability.

Deceased Spouse Unused Exemption

Prior to 2010, spouses that had an unused unified exemption lost the excess when that spouse died.

EXAMPLE

Tanner and Kylie were married for 50 years. Their total estate was worth $22,000,000 of which Kylie's estate was worth $8,000,000 of the $22,000,000. If Kylie dies in 2022, she would lose the exemption amount of $4,060,000 ($12,060,000 – $8,000,000) that was unused. When Tanner dies, his estate will be taxed on the amount of $1,940,000 ($14,000,000 – $12,060,000 [the exemption amount]).

IRC section 2010 allows for portability. Portability allows the deceased spouse's unused exemption (DSUE) to pass to the surviving spouse, thus increasing the surviving spouses' unified exemption amount. In the above example, Kylie's DSUE of $4,060,000 would pass onto Tanner, increasing the exemption to $16,120,000 ($12,060,000 + $4,060,000), and thus the total amount of $14,000,000 would be exempt as it is less than Tanner's unified exemption threshold, which is now $16,120,000.

Portability of the DSUE is not automatic. The CPA should ensure that the estate tax return is timely and properly filed when the first spouse passes away. If the election is not made, the estate loses the DSUE when the surviving spouse dies.

The IRS has imposed the last deceased spouse rule. The rule specifies that if a taxpayer had a DSUE and then subsequently remarries, they lose the first DSUE in the event their second spouse passes away.[81]

The taxpayer can also use the DSUE to shield from gift taxes, and the CPA can guide the taxpayer in this area, as any annual gift within the unified exclusion amount can be given tax free. Although the current unified exemption amount is $12,060,000, this amount is set to reduce to $5.6 million in 2026. The CPA should continue to keep up to date with changes that will impact their clients that have high valued estates.

81 Treasury Reg 25.2505-2(a)(1))

NOTES

UNIT
8

Tax Practice and Professional Standards

LEARNING OBJECTIVES

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

- Describe the relevant professional standards that apply to tax advice and signing returns.
- Identify and explain penalties that may apply to clients when the IRS challenges a strategy.

SUMMARY OF STANDARDS FOR A CPA IN TAX PRACTICE

There are numerous standards that CPAs must comply with. Generally, if all standards can be complied with, the CPA must comply with all applicable standards. That is, the fact that one standard may not require a certain action will not excuse the CPA from not performing that action if it is required by another standard *and* the performance of that action isn't *prohibited* by the first standard.

A summary of the standards is provided in the table below:

	Internal Revenue Code			
	§6662 (Taxpayer)	**§6694 (Preparer)**	**Circular 230**	**AICPA SSTS**
More Likely Than Not	Tax Shelter	Tax Shelter	Tax Shelter	Tax Shelter (See Note)**
Substantial Authority	No Disclosure	No Disclosure	No Disclosure	See Note**
Realistic Possibility				No Disclosure*
Reasonable Basis	Disclosed	Disclosed	Disclosed	Disclosed
Not Frivolous	No longer available under any applicable standard			

* Only if no higher taxing authority standard

** Effective federal income tax return standard. "SSTS" stands for Statements on Standards for Tax Services.

RETURN POSITION STANDARDS

The levels of authority discussed above are taken from regulations that were written to apply the accuracy related penalty to taxpayers under IRC §6662. These standards are discussed below.

Substantial Authority

An understatement penalty is imposed if the understatement is caused by a position that the tax return preparer knew (or reasonably should have known) that there did not exist substantial authority for the position taken on the return.

Regulation §1.6662-4(d)(2) provides this general outline of the "substantial authority" standard:

> (2) Substantial authority standard
>
> The substantial authority standard is an objective standard involving an analysis of the law and application of the law to relevant facts. The substantial authority standard is less stringent than the more likely than not standard (the standard that is met when there is a greater than 50-percent likelihood of the position being upheld), but more stringent than the reasonable basis standard as defined in section 1.6662-3(b)(3). The possibility that a return will not be audited or, if audited, that an item will not be raised on audit, is not relevant in determining whether the substantial authority standard (or the reasonable basis standard) is satisfied.

This paragraph puts substantial authority into context for us, positioning it between "reasonable basis" and "more likely than not" (at least the absolute version of the latter). It also emphasizes that we cannot consider "audit lottery" considerations. As well, the IRS announces it is an objective standard—that implies that the question of a preparer's experience or expertise would not enter into whether or not substantial authority exists.

The exclusive list of the types of authority we can consider are outlined at Reg. §1.6662-4(d)(3)(iii), which lists the following as authorities we can consider:

1. Applicable provisions of the Internal Revenue Code and other statutory provisions
2. Proposed, temporary and final regulations construing such statutes
3. Revenue rulings and revenue procedures
4. Tax treaties and regulations thereunder, and Treasury Department and other official explanations of such treaties
5. Court cases
6. Congressional intent as reflected in committee reports, joint explanatory statements of managers included in conference committee reports, and floor statements made prior to enactment by one of a bill's managers
7. General Explanations of tax legislation prepared by the Joint Committee on Taxation (the Blue Book)
8. Private letter rulings and technical advice memoranda issued after October 31, 1976
9. Actions on decisions and general counsel memoranda issued after March 12, 1981 (as well as general counsel memoranda published in pre-1955 volumes of the Cumulative Bulletin)
10. Internal Revenue Service information or press releases
11. Notices, announcements, and other administrative pronouncements published by the Service in the Internal Revenue Bulletin

The regulation notes one thing that doesn't count that many practitioners rely on in practice—editorial content. Reg. §1.6662-4(d)(3)(iii) goes on, following the above list of authorities, to note:

> Conclusions reached in treatises, legal periodicals, legal opinions or opinions rendered by tax professionals are not authority. The authorities underlying such expressions of opinion where applicable to the facts of a particular case, however, may give rise to substantial authority for the tax treatment of an item.

Put simply, a citation from *CCH's Standard Federal Tax Reporter, RIA's Federal Tax Coordinator 2d, a BNA Portfolio*, or other such documents may not be used, standing alone, to provide support.

The need to determine if the item we are relying on has been overruled is also noted, as the regulation continues:

> Notwithstanding the preceding list of authorities, an authority does not continue to be an authority to the extent it is overruled or modified, implicitly or explicitly, by a body with the power to overrule or modify the earlier authority. In the case of court decisions, for example, a district court opinion on an issue is not an authority if overruled or reversed by the United States Court of Appeals for such district.

However, the regulation goes on to note a "special" rule for Tax Court decisions:

> However, a Tax Court opinion is not considered to be overruled or modified by a court of appeals to which a taxpayer does not have a right of appeal, unless the Tax Court adopts the holding of the court of appeals.

For instance, the Tax Court might rule in a published opinion in a certain manner, a ruling that is overruled in that case by the Court of Appeals to which that particular taxpayer would appeal. Nevertheless, unless the Tax Court adopts the holding of that Court of Appeals in general (that is, it ceases to treat its own original holding as precedential), the original holding would still constitute authority outside of the particular Court of Appeals.

Private letter rulings are also given special limitations:

> Similarly, a private letter ruling is not authority if revoked or if inconsistent with a subsequent proposed regulation, revenue ruling or other administrative pronouncement published in the Internal Revenue Bulletin.

However, the taxpayer's own private letter ruling is generally a slam dunk substantial authority support, as noted in Reg. §1.6662-4(d)(iv)(A):

> (A) Written determinations.
>
> There is substantial authority for the tax treatment of an item by a taxpayer if the treatment is supported by the conclusion of a ruling or a determination letter (as defined in section 301.6110-2(d) and (e)) issued to the taxpayer, by the conclusion of a technical advice memorandum in which the taxpayer is named, or by an affirmative statement in a revenue agent's report with respect to a prior taxable year of the taxpayer ("written determinations"). The preceding sentence does not apply, however, if –
>
> (1) There was a misstatement or omission of a material fact or the facts that subsequently develop are materially different from the facts on which the written determination was based, or

> (2) The written determination was modified or revoked after the date of issuance by–
>
> (i) A notice to the taxpayer to whom the written determination was issued,
>
> (ii) The enactment of legislation or ratification of a tax treaty,
>
> (iii) A decision of the United States Supreme Court,
>
> (iv) The issuance of temporary or final regulations, or
>
> (v) The issuance of a revenue ruling, revenue procedure, or other statement published in the Internal Revenue Bulletin.
>
> Except in the case of a written determination that is modified or revoked on account of section 1.6662-4(d)(3)(iv)(A)(l), a written determination that is modified or revoked as described in section 1.6662-4(d)(3)(iv)(A)(2) ceases to be authority on the date, and to the extent, it is so modified or revoked. See section 6404(f) for rules which require the Secretary to abate a penalty that is attributable to erroneous written advice furnished to a taxpayer by an officer or employee of the Internal Revenue Service.

The analysis itself is outlined in Reg. §1.6662-4(d)(3)(ii). It starts out by holding:

> The weight accorded an authority depends on its relevance and persuasiveness, and the type of document providing the authority. For example, a case or revenue ruling having some facts in common with the tax treatment at issue is not particularly relevant if the authority is materially distinguishable on its facts, or is otherwise inapplicable to the tax treatment at issue.

The mere fact that a case or ruling shares some facts with a taxpayer's situation isn't enough—you have to evaluate if the item can otherwise be distinguished from your taxpayer's case by looking at what is different, and then evaluating whether those differences will impact the result.

The regulation also notes, indirectly, that some authorities really aren't going to give enough information to enable them to be very useful.

> An authority that merely states a conclusion ordinarily is less persuasive than one that reaches its conclusion by cogently relating the applicable law to pertinent facts. The weight of an authority from which information has been deleted, such as a private letter ruling, is diminished to the extent that the deleted information may have affected the authority's conclusions.

We have to consider the type and age of a document as well:

> The type of document also must be considered. For example, a revenue ruling is accorded greater weight than a private letter ruling addressing the same issue. An older private letter ruling, technical advice memorandum, general counsel memorandum or action on decision generally must be accorded less weight than a more recent one. Any document described in the preceding sentence that is more than 10 years old is generally accorded very little weight. However, the persuasiveness and relevance of a document, viewed in light of subsequent developments, should be taken into account along with the age of the document.

Note the general presumption that a private letter ruling, technical advice memorandum, general counsel memorandum, or action on decision that is more than 10 years old is

immediately considered suspect by the regulation. From a practical standpoint, right now that means we want any such rulings to be dated after 2010.

But, as well, the fact that the only authority existing is the underlying Code (often the case with new law) doesn't preclude getting to substantial authority:

> There may be substantial authority for the tax treatment of an item despite the absence of certain types of authority. Thus, a taxpayer may have substantial authority for a position that is supported only by a well-reasoned construction of the applicable statutory provision.

A taxpayer's jurisdiction generally does not apply—except when considering the Court of Appeals:

> (B) Taxpayer's jurisdiction.
>
> The applicability of court cases to the taxpayer by reason of the taxpayer's residence in a particular jurisdiction is not taken into account in determining whether there is substantial authority for the tax treatment of an item. Notwithstanding the preceding sentence, there is substantial authority for the tax treatment of an item if the treatment is supported by controlling precedent of a United States Court of Appeals to which the taxpayer has a right of appeal with respect to the item.

Finally, since new rulings and cases are issued continuously, we have to worry about the point in time when the level of authority will be determined. Reg. §1.6662-4(d)(3)(iv)(C) gives us a choice of two dates. We have to establish the existence of substantial authority either on

1. the date the taxpayer files the return containing the item, or
2. the last day of the taxable year to which the return relates.

More Likely Than Not

The toughest standard in general use is the "more likely than not" and the standard means pretty much what we would expect. Under the regulations, it is virtually defined in passing, telling us how substantial authority differs from it. At Reg. §1.6662-4(d)(2), a parenthetical reference informs us that the more likely than not standard is "met when there is a greater than 50-percent likelihood of the position being upheld."

Additional guidance is found in Reg. §1.6694-2(b) on how to apply the rule. The regulation specifically directs the practitioner to undertake the analysis described to ascertain substantial authority, but to evaluate the results based not on whether there is substantial authority, but rather if there is a greater than 50 percent chance of the position being sustained on its merits. [Reg. §1.6694-2(b)(1)]

Reg. §1.6694-2(b)(2) goes on to direct the practitioner to consider the same list of the eleven accepted authorities found at Reg. §1.6662-4(d)(3)(iii) noted earlier in this unit.

One quirk is that, for purposes of the preparer penalty standard, the test for "more likely than not" status (and presumably the "substantial authority" and "reasonable basis" status) is as of the date the return is prepared. [Reg. §1.6694-2(b)(5)] Thus, the status of the position at the end of the tax year, while available to the taxpayer for substantial authority testing, is not available to the preparer for "more likely than not" positions.

This standard is generally applicable to positions relating to tax shelters (as defined at IRC §6662(d)(2)(C)(ii)) and, in a modified form, for analysis of the status of a tax benefit for

GAAP purposes. [ASC 740-10-25-5, based on a modified definition beginning at ASC 740-10-25-7 that allows for consideration of "administrative precedent"].

Realistic Possibility of Success

This standard, which currently exists only in various state taxing arenas and in the AICPA Statements on Standards for Tax Services, has a straight 1 in 3 chance of prevailing threshold.

Prior to law changes in 2007 to §6694 this standard used to be the standard used for undisclosed positions for apply preparer penalties. For that reason, some state penalty provisions retain this standard. As well, the AICPA SSTSs use this standard as the minimum for a nondisclosed position if the taxing agency in question either has no minimum standard or has a lower minimum standard.

An interesting quirk in the AICPA rules is that while the AICPA refers to the same basic authorities as the regulation defining substantial authority does, the AICPA also allows a realistic possibility of success position to be based on well-reasoned editorial materials. However, given the requirement generally to satisfy all applicable standards, in most cases this opening to make use solely of editorial materials won't be of much practical benefit if the position comes into question.

Reasonable Basis

Beginning with the revisions to §6694 in 2007 and continuing with revisions to the AICPA Statements on Standards for Tax Services and Circular 230, the reasonable basis standard has become the minimum standard under which a practitioner can recommend a position or sign a return, even with disclosure. Thus, every position taken on the return must, at a minimum, meet this standard. And even if that is true, if the position does not meet the substantial authority standard, full disclosure of the position is required when preparing the tax return or must be recommended to the taxpayer, client, or other preparer who relies on an individual preparer's work.

The definition of reasonable basis is found at Reg. §1.6662-3(b)(3), which outlines the following features of a "reasonable basis":

- The standard is significantly higher than *not frivolous* or *not patently improper*.
- The standard is not satisfied if a position is merely arguable or was merely a "colorable claim."

The regulation goes on to give what may be viewed as a "safe harbor" position, noting that a return position reasonably based on one or more of the eleven authorities found in the substantial authority definition regulation at Reg. §1.6662-4(d)(3)(iii), taking into account the relevance and persuasiveness of the authority along with any effect of subsequent developments, would generally satisfy the reasonable basis standard. [Reg. §1.6662-3(b)(3)]

Not Frivolous

Prior to the 2007 changes to §6694 and subsequent changes to Circular 230 and the AICPA Statements on Standards for Tax Practice, "not frivolous" used to be the lowest available standard for positions with disclosure. Generally, a frivolous position was one that was "patently improper" so the bar was rather low to achieve a position where a return could be signed or a position advocated with disclosure.

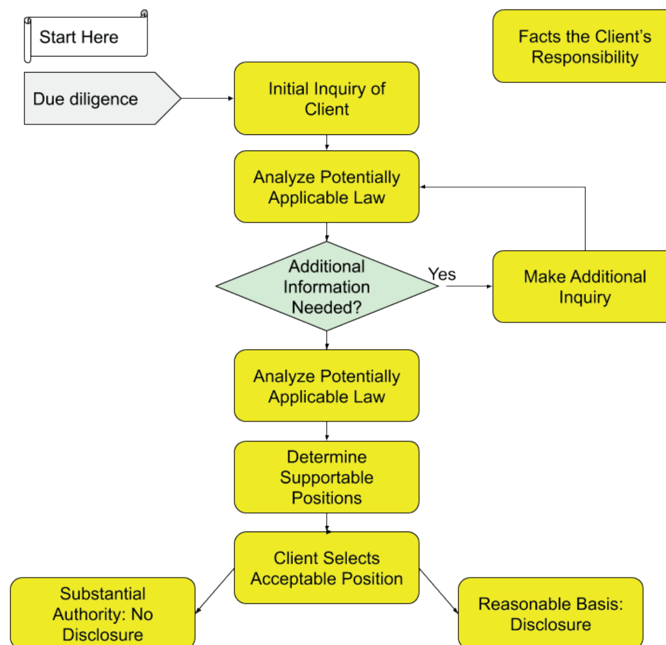
However, with adoption of the revisions to Circular 230 in August of 2011, this standard no longer exists as a supportable level of authority, even with disclosure. An important fact to note is this change means that positions that may have been acceptable to take on returns, with disclosure, in earlier years would no longer be acceptable for a CPA to either include in a return he/she prepares, nor to recommend to a client.

Some commentators believe that, in fact, this change in the rules, while given much less press than the change for nondisclosed positions, is in fact the far more significant change we've had in recent years.

Summary of CPA's Responsibilities

There's a division of responsibilities between the CPA and client for any positions that are advised to be taken on the tax return. But while the client is responsible for the facts, the CPA is responsible for letting the client know what key facts the CPA needs to know, or which will need to exist, for the planning to work as expected.

The following flowchart outlines these responsibilities for preparation. In the area of planning, the CPA does help the client understand the key facts and their impact on the results, but the CPA still needs to understand the various positions that might be possible and communicate those issues to the client.



AICPA STATEMENTS ON STANDARDS FOR TAX SERVICES

For purposes of tax planning and providing tax advice, two AICPA *Statements on Standards for Tax Services* are directly related to the matter at hand—SSTS No. 1, *Tax Return Positions* and SSTS No. 7, *Form and Content of Advice to Taxpayers*.

Standard Number 1—Tax Return Positions

The first Standard was the most significantly modified standard under the standards that became effective in January 2010. The purpose of the modification was to take into

account the standards Congress imposed on preparers for positions taken on returns in its revision of §6694, discussed later.

The new standard requires that a preparer comply with either the minimum standard outlined in SSTS No. 1 or the standards (if any) imposed by the taxing authority with which the return is to be filed, whichever is the higher standard.

The minimum AICPA standard states that a member should not recommend a tax return position or sign a tax return taking a position unless the member has a good-faith belief the position has at least a realistic possibility of being sustained on its merits if challenged.

The only way you can recommend a position or sign a return that does not meet this standard is if there is a reasonable basis for the position (as that term is defined for §6694 purposes). To have a reasonable basis, there must exist some valid authority that has not been overturned or rendered obsolete for the position in question.

Note that new SSTS No. 1 imposes a higher standard for signing a return with disclosure than did the prior version of SSTS No. 1. Previously, if a position was not frivolous a CPA could sign the return with disclosure. Now if the position does not have a reasonable basis but is not frivolous, the CPA cannot sign the return even with disclosure.

When preparing or signing a tax return or recommending a tax return position, you should advise the taxpayer of any penalty consequences of the tax return position and, if disclosure is an option, how to avoid the penalty through adequate disclosure. Disclosure requirements should be based upon authorities in the jurisdiction appropriate to the particular circumstances and facts in the taxpayer's case.

When you recommend a tax return position but do not prepare or sign the return you will be in compliance with the Standard if you "advise the taxpayer concerning appropriate disclosure of the position." Penalty avoidance through disclosure is the taxpayer's responsibility. However, the same disclosure that protects the taxpayer protects the preparer from the preparer's penalty. Therefore, if your advice on disclosure is not heeded by the taxpayer you should consider withdrawing.

You should not prepare or sign a return or recommend a return position that you know will be used as a "mere arguing position solely in order to obtain leverage" with a taxing authority during the settlement negotiation bargaining process. You also should not recommend a position, sign, or prepare a return that includes a position that would exploit the taxing authority's audit selection process.

The realistic possibility standard is based on your judgment as to the extent of the needed research "with respect to all the facts and circumstances known to the member." Where research is necessary you may use authorities that are not permitted in evaluating whether substantial authority exists under Section 6662 regulations. For purposes of Standard Number 1, acceptable authorities include sources of tax analysis and reference tools used by tax preparers and advisors, as well as articles in recognized professional publications and well-reasoned treatises. Note, however, that such authorities are not recognized under §6694 for purposes of establishing substantial authority and would therefore also not appear to be sufficient for meeting SSTS No. 1's requirements for positions on returns where §6694 applies to the preparer.

You should also consider the type of authority; whether the taxpayer's particular facts and circumstances can be distinguished from those covered by the court case, regulation, or other authority; and whether the authority critically analyzes the issue or merely states a conclusion.

If more than one tax return position could meet the standard, you should discuss with the taxpayer the likelihood that each position might or might not cause the taxpayer's return to be examined and whether the position would be challenged in an examination. This discussion does not violate the requirement that you not recommend a position based solely on "audit lottery" considerations, as that rules serves only to determine which positions simply could not be considered regardless of their audit exposure.

The standard, in paragraph 8, emphasizes that the CPA has both the right and the responsibility to be an advocate for the taxpayer for any position that meets the standards. While the advocacy role does not allow a CPA to recommend or sign a return with a position that does not comply with the minimum standards, among the universe of positions that do comply with the standard the CPA can apply that advocacy role.

However, remember that an advocate serves the client's interests as the client views those interests after being informed of the consequences. A client quite often will not wish to take the most tax advantaged position that a CPA could accept when signing a return, since the client determines his/her interests not merely by looking at the quantitative issue of the amount of tax, but also at other factors. These factors include the client's tolerance for an uncertain result on examination or the potential expense and inconvenience of the process of the exam that might result from the position.

The operating rule, then, can be summarized this way. First, if there exist standards applied by the taxing authority and those standards are stricter than the standards below, the CPA should apply those standards. If the taxing agency has no applicable standards or the standards are less stringent than those listed below, the CPA should follow the following standards:

- You should not advise a position, or sign a return taking a position, that does not have a realistic possibility of prevailing on its merits.
- You may, however, advise or sign so long as the position has a reasonable basis of support and is properly disclosed in the return. That allows for the ethical presentation of positions that may not meet the realistic possibility standard but do have a reasonable basis.

The decision to disclose and how to do so is the taxpayer's. Whether you remain associated with the return is your decision, after considering the consequences under the potentially applicable standards (Circular 230, §6694 and SSTS No. 1).

Interpretation 1-1—"Realistic Possibility Standard"

Old Interpretation 1-1 provided additional definitions, interpretations, and fifteen illustrations to help you comply with the Standard. However, the changes made to SSTS No. 1 rendered the old interpretation obsolete. The AICPA has released an exposure draft of the proposed new standard. While not yet in effect, it does provide some insight that may prove useful in attempting to comply with requirements of SSTS No. 1.

The preface to the new interpretations contains description of the various reporting standards applicable to CPAs. Of special interest is that the interpretation notes specific percentages to the likelihood of success to normally be practically achieved for each standard. The preface notes that for "more likely than not" a greater than 50% likelihood of success must exist.

The preface continues to note that a "substantial authority" position is generally interpreted to require approximately a 40 percent likelihood of success on the merits if the position is challenged. For "realistic possibility of success" that level drops to 33 percent, and down to 20 percent for a "reasonable basis" position.

The preface also points out that what constitutes an authority can vary depending upon whether the CPA is attempting to meet SSTS No. 1's general "realistic possibility of success" test or a taxing agency's standards. Specifically, federal regulations do not recognize editorial commentary from respected individuals and publications as constituting authority, though SSTS No. 1 does. Therefore, the preface implies, if the measuring standard under SSTS No. 1 becomes the federal regulations, those documents cannot be used. Interpretation No. 1 makes clear that, however, if the SSTS "realistic possibility of success" rule is the applicable rule, those sources can be used.

Interpretation No. 1 begins by noting that since the substantial authority and more likely than not standard are higher standards than the realistic possibility standard, if the taxing agency laws and regulations require meeting those standards the CPA must comply with those higher standards for undisclosed positions to comply with SSTS No. 1. However, if the taxing agency has a lower standard than realistic possibility of success (or no standard), the CPA must meet the realistic possibility of success standard for nondisclosed positions.

The interpretation requires the CPA to advise the client if a penalty could be asserted to discuss with the client the possibility of avoiding a penalty with disclosure. However, the decision of whether and how to disclose is the taxpayer's responsibility. Note, though, that if SSTS No. 1 requires disclosure in order for the CPA to sign the return the CPA may be unable to complete the engagement if the client refuses to authorize the disclosure.

The proposed interpretation outlines the following steps that are to be followed to determine if the reporting and disclosure standards have been satisfied:

- Establish the relevant background facts.
- Consider the reasonableness of the assumptions and representations.
- Consider applicable regulations and standards regarding reliance on information and advice received from a third party.
- Apply the pertinent authorities to the relevant facts.
- Consider the business purpose and economic substance of the transaction, if relevant to the tax consequences of the transaction. (Mere reliance on a representation that there is a business purpose or economic substance generally is insufficient.)
- Consider whether the issue involves a listed transaction or a reportable transaction (or their equivalents) as defined by the applicable taxing authority.
- Arrive at a conclusion supported by the authorities.

More than one position may be found by the CPA to satisfy the various standards. As well, the mere fact that certain types of authority do not exist does not prevent the CPA from determining the relevant level of authority has been achieved. That can include situations when the only authority that exists is the statute itself—quite often the case shortly after a new provision is enacted into law.

The proposed interpretation includes 16 illustrations. Two of the illustrations are new, outlining both when a higher taxing agency standard exists and when the taxing agency has no specific standards. Two old illustrations outlining frivolous positions are deleted from this interpretation, likely because no longer is frivolous the "cut-off" level where the CPA cannot sign the return or advise a position even with disclosure. Now that level has risen to the level of "reasonable basis."

Interpretation 1-2—Tax Planning

As with Interpretation 1-1, this interpretation was withdrawn with the issuance of the new SSTS No. 1. Again, while the new interpretation is still (at the time this manual was last revised) issued only in the form of an exposure draft, it still gives some helpful guidance on applying the revised SSTS No. 1 to tax planning engagements.

In addition to return preparation, most tax practices involve assisting clients in tax planning. Taxing authorities, courts, the AICPA, and other professional organizations are struggling to define and regulate such transactions. Sometimes it is difficult to clearly delineate what is considered a tax shelter in a way that will discourage abuse, while allowing tax professionals to help taxpayers arrange their affairs so as to pay no more than their fair share of taxes. The proposed interpretation makes clear that a position can be aggressive but still be a legitimate position.

For purposes of this interpretation, tax planning includes, both with respect to prospective and completed transactions, recommending or expressing an opinion on

- a tax return position, or
- a specific tax plan developed by the CPA, the taxpayer, or a third party.

The service may include both proposed transactions and transactions that have already been completed. The proposed interpretation cautions the CPA that if a transaction has been completed, the preparer may be treated as a non-signing preparer under federal law on the issue even if the CPA does not prepare the related return.

When issuing an opinion to reflect the results of the tax planning service, a CPA should do all of the following:

- Establish the relevant background facts.
- Consider the reasonableness of the assumptions and representations.
- Consider applicable regulations and standards regarding reliance on information and advice received from a third party.
- Apply the pertinent authorities to the relevant facts.
- Consider whether there is business purpose/economic substance for the transaction (the revision notes that it is generally not sufficient to solely rely on a representation there is a business purpose).
- Consider whether the issue involves a listed transaction or a reportable transaction (or their equivalents) as defined by the applicable taxing authority.
- Consider other regulations and standards applicable to written tax advice promulgated by the applicable taxing authority.
- Arrive at a conclusion supported by the authorities.

When a third party has issued an opinion and the CPA is retained to evaluate that opinion, the CPA should establish that the third party followed those same steps.

Here are some of the questions the CPA should ask her/himself in connection with any tax planning engagement that are suggested by the Interpretation:

- Is it appropriate to rely on any assumption concerning facts instead of employing other procedures to support the advice or obtaining a representation from the taxpayer or another person?

- If the answer is "Yes," then you must consider the likelihood that they will receive independent advice or that they have sufficient tax knowledge to understand the transaction.
- Are all assumptions and representations reasonable and consistent with my client's circumstances?
- Does the transaction have both a business purpose and economic substance relevant to my client's tax consequences? The revision again cautions that the CPA cannot merely accept a statement there is economic substance, but must specify the basis for making that determination and evaluate the reasonableness of that basis.
- Have I done enough work to understand and evaluate the entire transaction?

The interpretation adds the strong suggestion (the word used is "should consider the necessity") that the CPA obtain an engagement letter for the engagement.

Like interpretation 1-1, this interpretation updates the examples that were in the old version for the changes in SSTS No. 2. The proposed standard also adds a new example that clarifies if a CPA is engaged to advise a taxpayer on a transaction in a planning engagement where penalties could apply to the adviser if the transaction fails to meet certain standards, the conclusions found at the advice engagement must be updated to insure the level of assurance is still met if the CPA later prepares the tax return. Law develops and changes over time, and it is possible a position that met the "more likely than not" standard earlier in the year when the transaction was being planned may no longer meet that standard at the time the return is prepared.

The Interpretation puts significant responsibility for determining the reasonableness of tax planning ideas on the CPA tax advisor. We cannot hide behind the skirts of a promoter or a law firm. Instead, if we are engaged to offer advice about a tax planning transaction, we must take responsibility for it.

Standard Number 7—Form and Content of Advice to Taxpayers

While there is no standard form for how tax advice should be communicated, you have an ethical responsibility to do so in a form that "appropriately serves the taxpayer's needs." You should assume, when giving requested advice, that it will affect the reporting of the matter in your client's return.

The Standard recognizes that advice may be requested on a wide range of topics, from simple to complex, and acknowledges the utility of oral advice for routine matters, or on well-defined issues. Written communications are clearly recommended for matters that are

- important,
- unusual, or
- complicated.

In determining the form in which to provide advice, the Standard suggests you consider the following:

- The importance of the transaction and amounts involved
- The specific or general nature of the taxpayer's inquiry
- The time available for development and submission of the advice
- The technical complexity involved
- The existence of authorities and precedents

- The tax sophistication of the taxpayer
- The need to seek other professional advice
- The type of transaction and whether it is subject to heightened reporting or disclosure requirements
- The potential penalty consequences of the tax return position for which the advice is rendered
- Whether any potential applicable penalties can be avoided through disclosure

While we are generally not obligated to update advice unless that was part of the engagement, when we are engaged to implement the advice, the Standard suggests that we should monitor new developments and update the advice as necessary.

Any CPA who provides advice to clients must exercise care, because either the content or the clarity of the advice could serve as the basis for a malpractice claim. Even advice in routine matters should be given in writing, delineating your responsibilities, and indicating whether you will continue to monitor the matter on the client's behalf on an ongoing basis.

The revisions effective in January 2010 made clear that a CPA must comply with the standards of the taxing authorities that may be applicable to written advice (such as Circular 230 ¶10.37).

ACCURACY RELATED PENALTY IMPOSED ON THE TAXPAYER

IRC Sec. 6662 imposes a 20% penalty on the following:

- Substantial understatements of income tax
- Underpayments attributable to negligence or disregard of the rules or regulations

Both failure to file and accuracy related penalties can apply to late-filed returns; however, the accuracy related penalty applies only if a return is filed. Components of the penalty cannot be stacked, i.e., if both the substantial understatement and negligence parts of the accuracy related penalty apply to the same item, the total accuracy related penalty will be 20% of the underpayment caused by the item.

Substantial Understatement

A substantial understatement of income tax must exceed the greater of

- 10% of the tax required to be shown on the return; or
- the applicable minimum penalty which is
  - $5,000 (except for corporations); or
  - $10,000 for corporations that are not S corporations or personal holding companies.

There are no other requirements. If the tax deficiency exceeds the limits, the penalty will be assessed and the IRS will be deemed to meet its initial burden of proof. However, there is a reasonable cause exception to the penalty, discussed later.

The shift of the burden is the key difference between the substantial understatement penalty and the negligence penalty. If the amount of the tax deficiency is not high enough to trigger the substantial underpayment penalty the burden is on the IRS to show the taxpayer either acted with negligence or with disregard of the rules or regulations.

Because a partnership or S corporation is a pass-through entity, the substantial understatement penalty is determined at the partner or shareholder level.

The understatement is reduced by amounts attributable to items that are

- supported by substantial authority, or
- have a reasonable basis and are adequately disclosed.

Reasonable basis will generally require the taxpayer to show that he/she took reasonable steps to properly determine his/her tax liability but nevertheless failed to do so. One of the best defenses for the taxpayer is to show that he/she appropriately relied on the advice of a tax professional. That generally requires the taxpayer to show the following:

- He/she selected a professional that the taxpayer believed was competent to render advice on the transaction in question and whom the taxpayer believed had no interests in the transaction that would bring into question the professional's objectivity.
- The taxpayer provided the professional with all information
  - the taxpayer reasonably believed was important to enable the professional to give advice on the matter, and
  - responded fully and honestly to inquiries of the professional regarding the transaction.
- The taxpayer relied upon that advice in the preparation of the tax return that led to the deficiency.

Note that if all of the above are true, if the adviser was also the preparer, that person may be at risk for a preparer penalty. As well, generally a taxpayer will be successful with the above defense only if the adviser will provide evidence to support the taxpayer's assertion of reliance and having provided all necessary information. This creates a conflict of interest issue if the adviser in question is also representing the taxpayer in the exam and the adviser needs to consider the requirements of Circular 230 §10.29 and the AICPA *Code of Professional Conduct* with regard to conflicts and representation.

Opinion Shopping Does Not Give Reasonable Basis for Substantial Understatement

The tax laws are complicated and, at times, the results are not what a taxpayer might like. The combination of these two facts causes some taxpayers to start "opinion shopping" when they receive an answer they don't like. In the case of *Mallory v. Commissioner*, TC Memo 2016-110, the taxpayers ended up casting about for someone who would tell them what they wanted to hear.

The family had purchased a single premium variable life insurance policy on Mr. Mallory for $87,500 in 1987. The policy provided that Mr. Mallory could borrow from the carrier and the loan would be secured by the policy, with any unpaid interest on the loan being added to the loan amount. Beginning in 1991, Mr. Mallory took advantage of this "tax free" source of funds, eventually taking out cash of over $133,000 by the end of 2001.

While Mr. Mallory ceased taking money from the policy in 2001, he did not make any interest payments. On October 17, 2011, the carrier wrote Mr. Mallory indicating that the cash value of the policy was now less than the outstanding balance of the loan and that unless he paid $26,061.67 by December 17, 2011 the policy would be terminated. The letter also warned Mr. Mallory that such a termination would create taxable income in the amount of $155,119.16 for Mr. Mallory.

Mr. Mallory did not pay the amount necessary to keep the policy in force and thus a 1099R showing a revised taxable amount of $150,397.25 was issued for 2011.

The taxpayer consulted with their tax preparer on this matter—and he didn't have much good news:

> Before filing their 2011 income-tax return, Larita Mallory spoke with Steve Miller of Liberty Tax Services about the income that Monarch Life had reported on the Form 1099-R. Miller told Larita Mallory that she "was going to owe a bunch of money". Miller prepared the Mallorys' 2011 Form 1040, "U.S. Individual Income Tax Return." The Mallorys did not file their 2011 Form 1040 until around March 8, 2013.

However, when they finally filed the return, it did not contain this income. Rather the Mallorys attached a handwritten note to the return:

> Paid hundreds of $. No one knows how to compute this using the 1099R from Monarch—IRS could not help when called—Pls send me a corrected 1040 explanation + how much is owed. Thank you.

At trial the taxpayers clarified what that note meant:

> Larita Mallory's testimony clarifies the meaning of the note attached to the return. She testified that before the Mallorys filed their return, she telephoned several [7] persons other than Miller to ascertain whether the Form 1099-R was correct. The persons she telephoned consisted of two groups: (1) people who advertised themselves in the telephone directory as tax professionals (and whom she did not pay, unlike Miller) and (2) various IRS personnel. None of the persons she contacted was willing to confirm whether the Form 1099-R was correct.

Not surprisingly, the Tax Court found that the amount was taxable to the taxpayer—and that included the portion of the gain that represented the accrued interest since, as the Court pointed out, personal interest (which is the default treatment for interest unless the taxpayer can trace the proceeds elsewhere) is generally not deductible under IRC §163(a)- and the taxpayer's testimony clearly indicated the money was taken to cover short-term needs and no evidence was presented that these were other than living expenses. Even though not deductible, the liability for the interest was real and the policy value was used to pay off that liability, thus triggering taxable gain.

The real question, though, was whether the taxpayers had reasonable cause for their failure to properly report the income. In the case of substantial understatement of tax (that is, an understatement of the greater of $5,000 or 10% of the tax properly due with the return), the penalty is automatically presumed to apply. [IRC §6662]

A taxpayer can only escape that penalty if the position of the taxpayer had substantial authority (not an argument the taxpayer made in this case—and not one they would have succeeded with anyway), was disclosed and had a reasonable basis (the Court noted the rather odd disclosure but found the position had no reasonable basis under the law) or if the taxpayer had reasonable cause for the understatement and acted in good faith.

For the last exception the taxpayers pointed out that they had asked numerous preparers and called the IRS and, in each case, the person on the other end of the line was unable to tell them the taxable portion of what they had received.

But it was incorrect that no one gave the taxpayers an answer (which was also the correct answer) to the question. Rather, as the Court pointed out:

> The Mallorys received the letter from Monarch Life informing them that the policy debt on Kenneth Mallory's variable life insurance policy had exceeded its cash value, that the termination of the policy would result in a taxable event, and that any taxable gain in the policy would be reported to Kenneth Mallory and the IRS on a Form 1099-R. The Mallorys received the Form 1099-R from Monarch Life before the April 15, 2012 filing deadline. The only tax adviser that they paid, Miller, suggested there would be a tax liability. Although various IRS employees and unpaid tax professionals declined to confirm whether the Monarch Life Form 1099-R was correct, it was unreasonable for the Mallorys to conclude from this unwillingness that they had no income from Monarch Life.

Thus, the Court sustained the penalties in this case.

Reliance on Adviser to File an Extension is Not Reasonable Cause for Late Filing of Return

In the case of the *Specht v. United States* (115 AFTR 2d ¶ 2015-315, USDC SD Ohio, Case No. 1:13-cv-00705, 2015 TNT 5-12, affirmed, CA6, 118 AFTR 2d ¶ 2016-5243) the issue involved whether a taxpayer should be found to have reasonable cause for the late filing of a tax return if the client's attorney misled the estate into believing the attorney had filed an extension for filing the return.

The numbers in question are not small—the estate had been hit with penalties and interest of $1,198,261.38 due to the late filing of the estate tax return.

When Virginia Escher died her estate was worth over $12 million. Her cousin was appointed executor of the estate. Her cousin had never previously served as an executor, did not own any stock (Virginia's estate consisted principally of stock in UPS) and had never actually been in an attorney's office. She therefore decided to select Virginia's attorney to assist her due to her lack of experience in financial and probate matters.

The attorney appeared more than qualified to handle the matter. She had over 50 years of experience in estate planning and had handled Virginia's planning. However, she was privately battling brain cancer, a fact she did not disclose to the executor. Very likely due to issues related to that illness, the quality of the attorney's representation of the estate was well below the quality she had previously evidenced in her practice.

The attorney indicated to the executor that she had filed for an extension of time to file the estate tax return though, in fact, no extension had been filed. The opinion notes that it's not clear whether she intentionally misled the estate on this issue or not, but eventually the attorney voluntarily relinquished her law licensed following malpractice claims. As well, she has since been incompetent and is subject to a guardianship over her person and estate.

The attorney had informed the executor that the estate tax return was due on September 30, 2009. She also informed the executor that the estate would owe approximately $6 million in estate tax. In order to pay the tax, the estate would need to sell UPS stock, the asset that made up the bulk of the estate.

The executor testified that she was aware that the filing deadline was important and that negative consequences would take place if the deadline was missed. Prior to the September 30

date the executor had received multiple notices from the probate court warning that counsel for the estate was failing to perform her duties and the estate had missed various deadlines.

When she asked the attorney about the missed estate tax return filing deadline, the attorney assured the executor that an extension had been filed and that the attorney was handling the matters related to the estate. The executor accepted this statement, though she never asked to see the extension in question.

However, notices continued to come from the probate court about missed deadlines. As well another family that had hired this attorney to handle an estate contacted the executor to warn her that they were seeking to have this attorney removed from handling their estate because she was incompetent. The attorney again assured the executor that all was going well and there were no issues.

However, now the executor began to get notices from the state warning that the estate's state tax return had not been filed and was late, and alerted her that the state had not received any responses in letters to the attorney for the estate regarding this matter. The letter also informed her that additional amounts might be due because of the tardiness of the filing.

As well, she received additional warnings from the other family regarding the attorney's lack of competence. Eventually, she did consult with another attorney to consider if the estate's counsel's performance was a problem. This attorney advised her that she needed to hire an attorney other than the one she had retained to handle the estate. However, she still did not terminate the services of the attorney.

Finally, she received another letter from the state regarding the delinquent filings. At this point she contacted UPS and discovered that, despite having given the attorney documents many months earlier to arrange for a sale of the UPS stock (a sale that had to take place in order to pay the tax), UPS had never received a request to sell the stock.

A few days later she terminated the services of the original attorney, hiring the attorney she had consulted (and who had advised her, it appears very correctly, to terminate the original attorney) to handle estate matters. Within a month the UPS stock was sold and on January 26, 2011 the estate filed its now very delinquent estate tax return.

The estate now sought relief from the penalties imposed due to the late filing, arguing that the failure to file met the requirements for relief found at IRC §6651(a)(1). Those requirements are to show that the failure was

- due to reasonable cause, and
- not due to willful neglect.

Unfortunately, the court found that the estate could not meet either criteria.

Generally, the requirement to timely file a tax return cannot be delegated. As the court noted:

> Treasury Regulations require the estate to demonstrate that it "exercised 'ordinary business care and prudence' but nevertheless was 'unable to file the return within the prescribed time.'" Boyle, 469 U.S. at 246 (quoting 26 C.F.R. §301.6651(c)(1)). In *Boyle*, the Supreme Court held that "[t]he failure to make a timely filing of a tax return is not excused by the taxpayer's reliance on an agent, and such reliance is not 'reasonable cause' for a late filing under Section 6651(a)(1)." 469 U.S. at 248. In *Boyle*, the Supreme Court recognized a distinction between a taxpayer who "has relied on the erroneous advice of counsel concerning a question of law," and a taxpayer who has retained an attorney to attend to "an unambiguous, precisely defined duty to file" a return by a certain time. *Id.* at 250. Although a taxpayer may

> reasonably rely on advice received from an attorney "on a matter of tax law . . . one does not have to be a tax expert to know that tax returns have fixed filing dates and that taxes must be paid when they are due." *Id*. at 251.

The opinion concludes:

> Accordingly, even though Plaintiff hired counsel to handle the estate, reliance on counsel cannot constitute reasonable cause for the late filing and payment of taxes. Even if Backsman's [*the attorney*] medical condition led her to malpractice in the course of representing the Estate, this did not render Mrs. Specht [*the executor*] "disabled."

Rather, to put it simply, the executor had a duty to confirm that filing deadlines had been met rather than simply accepting the word of her attorney.

The court also found that there was evidence of willful neglect. The court notes that mere carelessness is enough to deny relief under this standard.

And, unfortunately, there are plenty of items that came to the executor's attention that suggested there might be major problems with the adviser she had hired. As the opinion summarized:

> Mrs. Specht was aware that the Estate's federal tax return needed to be filed and paid nine months after Ms. Escher's death on September 30, 2009; that the tax liability was approximately $6,000,000; and that the Estate would need to sell its UPS stock to cover the tax liability. Mrs. Specht further understood that the September 30, 2009 deadline was important, and that missing the deadline would result in consequences. In the months prior to the estate tax deadline, Mrs. Specht received at least four notices from the probate court informing her that the estate was missing probate deadlines. After the deadline, Mrs. Specht received at least two additional noticed from the probate court warning that Backsman had failed to file a first accounting of the Estate's assets; numerous calls from the Rotterman family informing Specht that Backsman was incompetent; two letters from the Ohio Department of Taxation informing Specht that the state tax return was delinquent; and a warning from another attorney- whom she eventually hired to replace Backsman- informing her that she needed to hire another attorney.

The court did close by noting that the result certainly seems harsh and unfair. But as the opinion notes:

> Serving as the executor of a probate estate is clearly not an easy task, which is why Mrs. Specht trusted an attorney to guide her through the process. While this Court finds it difficult to hold that Plaintiffs are ultimately responsible for Ms. Backsman's malpractice, that is what binding precedent requires. Notably, in light of Ms. Backman's malpractice, the State of Ohio refunded the late filing and payment penalties for Ohio estate taxes without the Estate filing a refund suit. (Doc. 16, Ex. 2 at ¶14). It is truly unfortunate that the United States did not follow the State of Ohio's lead.

Given the amounts involved, not surprisingly the estate appealed this decision to the Sixth Circuit Court of Appeals—but the appellate panel found that executor has not shown reasonable cause for her failure to insure the return was timely filed. The medical condition of the attorney, and its effect on her ability to competently conduct her practice weren't relevant as the opinion notes "the relevant question is whether the executor, not the attorney, was reasonable in missing the deadline."

Had the attorney been the executor, it's very possible the court would have found reasonable cause for the late filing—but timely filing cannot be delegated by a taxpayer to a third party. The taxpayer may have reasonable cause relief for cases where the taxpayer received erroneous advice on a matter of law (such as being told no return was required when, in fact, it was) but not for what the courts see as the simple matter of seeing if a document was actually filed on a specific date.

PREPARER PENALTIES—IRC SEC. 6694

Originally, the new penalty imposed a more-likely-than-not standard on preparers. However, as controversy built over the practicality of two different standards for preparers and taxpayers, Congress, in the Emergency Economic Stabilization Act of 2008 modified the preparer penalty to match the taxpayer penalty with respect to the substantial authority standard. However, Congress kept other provisions of the preparer penalty changes intact. Final regulations covering many of the provisions were issued on December 15, 2008. These final regulations replaced proposed regulations issued earlier in the year.

Penalty on Preparer of Return

A new enhanced penalty is imposed on any preparer who prepares a return or refund claim with a tax understatement arising from an unreasonable position (IRC Sec. 6694(a)(1) and (2)).

A return position is unreasonable if

- the preparer knew or reasonably should have known of the position; and
- there was not substantial authority for the position; or
- the position was not disclosed as provided in IRC Sec. 6662, provided there was a reasonable basis for the position. If there was not reasonable basis for the position, disclosure will not protect the return preparer from penalty.

If the position involves a tax shelter (as defined in IRC Sec. 6662(d)(2)(C)(ii) or is a reportable transaction to which the penalty in IRC Sec. 6662A applies, there must be a reasonable belief that the position would more likely than not be sustained on its merits.

There is a reasonable cause exception for the penalty, provided the preparer acted in good faith.

Amount of Penalty

The penalty is the greater of

- $1,000, or
- 50% of the income derived or to be derived from the return preparation.

Willful or Reckless Conduct

A penalty is also imposed on any preparer who prepares a return or refund claim with a tax understatement due to willful or reckless conduct (IRC Sec. 6694(b)).

Willful or reckless conduct is conduct which is

- a willful attempt to understate the tax liability on the return or claim, or
- a reckless or intentional disregard of the rules or regulations. This essentially means that the practitioner made little or no effort to determine what the tax law was for this issue.

This penalty will be reduced by the penalty paid by the preparer due to an unreasonable position.

Where a return position is contrary to a rule or regulation if the position isn't frivolous, is adequately disclosed (see below) and is a good faith challenge to the rule or regulation, the penalty won't apply (Reg. 1.6694-3(c)).

Where the position is contrary to a Revenue Ruling or Notice published by the IRS, there is no reckless or willful disregard if the position has a realistic possibility of success.

Amount of Penalty

The penalty is the greater of

- $5,000, or
- 50% of the income derived or to be derived from the return preparation.

Returns Covered by Penalty

The preparer penalties cover all return preparers– those preparing income, estate, gift, unemployment, excise tax, and exempt organization tax returns.

This expansion of preparer liability means that much more attention has to be paid to any return prepared. Claims for refund are covered as well.

Each position in each return must be considered prior to filing the return. This can lead to some very interesting problems:

- A not-for-profit conducts political activity. Can it still be an exempt entity?
- An executor wants to take the position that a family limited partnership is a valid entity. However, the practitioner, in reviewing the estate documents sees that it fails many of the tests set forth by the Tax Court.
- A parent is filing a gift tax return and claiming an 83% discount for lack of marketability. There is a valuation, but it has questionable assumptions and arguments.

ADDITIONAL PREPARER PENALTIES

IRC §6700 – Promoting Abusive Tax Shelters

The penalty is for a promoter of an abusive tax shelter and is generally equal to $1,000 for each organization or sale of an abusive plan or arrangement (or, if lesser, 100% of the income derived from the activity).

IRC §6701 – Penalties for Aiding and Abetting Understatement of Tax Liability

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

IRC §7206 – Fraud and False Statements

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

IRC §7207 – Fraudulent Returns, Statements, or Other Documents

Guilty of a misdemeanor and, upon conviction, a fine of not more than $10,000 ($50,000 in the case of a corporation), imprisonment of not more than one year, or both.

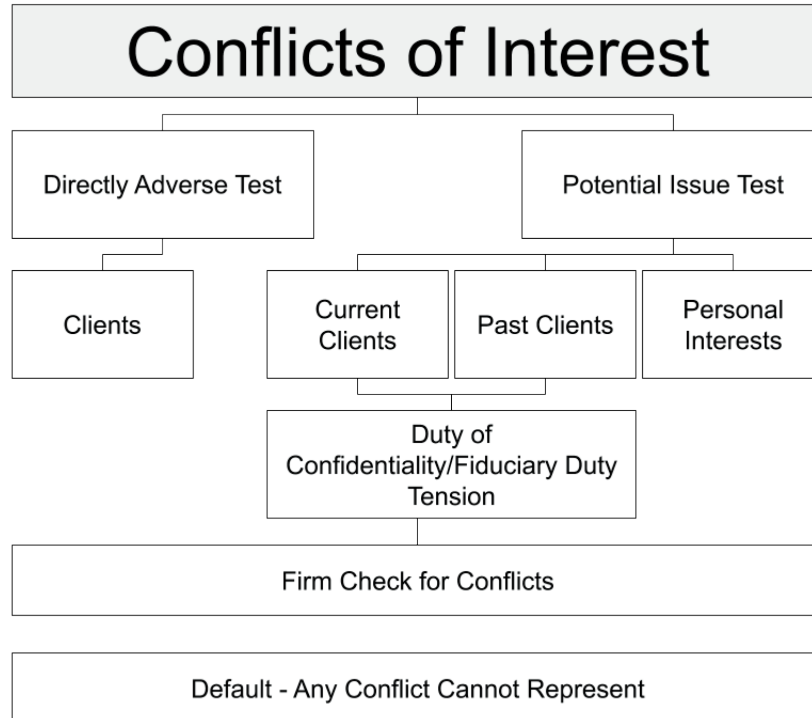
These penalties can apply when CPAs do not take the time to assess the client's position. In providing tax planning that will benefit the client, CPAs may tend to "overreach" which can put the CPA in a dire situation. Therefore, care must be taken to ensure CPAs understand their responsibilities when performing tax planning services for the client.

There are cases where the tax preparer may want to claim that the acts of fraud and false statements fall under IRC Section 7207 instead of IRC Section 7206. Section 7206 is a felony, while IRC Section 7207 is a misdemeanor. In the case *United States v. Bishop*, 412 U.S. 346 (1973), the court held that the word "willfully" has the same meaning in §§7206(1) and 7207, connoting the voluntary, intentional violation of a known legal duty, and the distinction between the statutes is based on the additional misconduct, which is essential to the violation of the felony provision; based on this fact, the district court properly refused the lesser charge.

CPAs must ensure they are not exposed to any legal action for their negligence and that they are not involved in any fraudulent activity.

CONFLICTING INTERESTS [SECTION 10.29]

Except as provided in the exception explained below, a practitioner may not represent a client before the IRS if that representation would be a conflict of interest. A conflict of interest exists if the representation of one client will be directly adverse to another client; or there is a significant risk that the representation of one or more clients will be materially limited by the practitioner's responsibilities to another client, a former client or a third person or by a personal interest of the practitioner.



The practitioner may represent a client, even if there is a conflict of interest, only if

- the practitioner reasonably believes that the practitioner will be able to provide competent and diligent representation to each affected client,
- the representation is not prohibited by law, and
- each affected client gives informed consent, confirmed in writing, at the time the conflict is known to the preparer. The confirmation may be made within a reasonable time after the informed consent, *but in no event more than 30 days after that event*. The consents must be retained for 36 months following the conclusion of the representation of the affected clients.

Note that the CPA first must make the determination under the first bullet point that he/she can provide both competent and diligent representation, taking into account the conflict. If the CPA concludes that the conflict will preclude this (the CPA would feel bound to withhold advice from the client due to the fact it might have an adverse effect on another party, including another client or the CPA him/herself), then the CPA cannot undertake the representation.

This is true even if the client, fully aware of the matter, wants to consent to the representation.

EXAMPLE

Conflict of Interest Example

Joe and Mary are getting divorced. Harry has been the couple's tax adviser for many years, but he primarily worked with Joe. When he would ask Mary about issues, she would respond that she really didn't like to deal with this sort of thing and that Harry would need to ask Joe.

Both Joe and Mary want Harry to continue to be their individual tax advisers, but Joe demands that Harry not talk with Mary about tax matters related to taxation of alimony

> and the impact of any property settlement, including who will receive their burned out tax shelters that are about to fail. However, Joe does want Harry to tell him how to arrange such items to reduce his tax.
>
> Mary is aware of this restriction and Joe's demands, but she tells Harry she is fine with this limitation. Despite Mary's claim that she is fine with the arrangement, Harry cannot provide the services. In reality, he likely cannot work with either party because even if he has Mary go elsewhere, his prior year responsibilities to her will likely run afoul of Joe's view of what his tax adviser should do in the divorce.

If the CPA decides he can clear the hurdle of being able to offer competent and diligent representation and that representation is not barred by law, the affected client(s) still must provide informed consent to the representation.

The client(s) must sign the consent. The preamble to the final regulations makes it clear that oral consent from the client along with a notation in the CPA's files that the client gave such consent is not sufficient to comply with these requirements. Neither does a "negative consent" work, where the CPA sends a client a letter outlining the issues and then requires the client to take action only if they do not wish to consent.

An example of a consent form is presented below:

> **EXAMPLE**
>
> Consent Form
>
> I,____(*client name*)__________, hereby acknowledge that I have been advised by _____(CPA name)______ that a conflict of interest exists in representing me before the Internal Revenue Service in a matter that involves ____(*other party or parties' name*)__.
>
> That matter is appropriately described as ____
>
> __________(*brief description of the matter in which the current or potential conflict exists such as trust fund penalty assessment, request for innocent spouse relief, examination of tax returns, etc..*)_________________.
>
> I understand the possibility of such conflict of interest and, having been given the opportunity to discuss this matter with my personal attorney, I hereby release ____(*CPA name*)________ and discharge (*her/him*) from any and all liability whatsoever that may result from any conflict of interest arising in this matter. This consent is intended to satisfy the requirements of section 10.29 of Treasury Circular 230, September 2007 revision.
>
> In witness whereof, and intending to be bound by it, I have signed this consent this ____ day of ______ 20__.
>
> ________ (Client Signature) ____________
>
> (Client Name – printed)
>
> ______ (Witness Signature) ____________
>
> (Witness Name – printed)
>
> *[This example is not provided nor intended to replace legal advice. You should consult with your legal counsel regarding the appropriate form for a consent to conflict of interest in your jurisdiction.]*

As well, the consent must be informed. Generally, this means the client must be fully aware of the risks and issues that arise due to the existence of the conflict and, specifically, why it might not be a good idea to allow the representation to go forward.

One key area that must be addressed relates to disclosure of confidential information related to the conflict. Generally, as is noted elsewhere in this manual, a CPA must have the consent of a client to disclose any confidential information. This can lead to a "Catch-22" situation for the CPA.

- In order to give informed consent, the client must be made aware of the nature of the client which requires disclosure of confidential information related to the other affected client.
- However, in order to ask for a consent to disclose from the other client, the CPA might be required to disclose confidential information related to the first client so the client can decide if he/she wishes to consent to the disclosure. Of course, that requires consent from the first client who can't be asked until the second client consents.

In this situation, there's no way to begin the process of asking for consents.

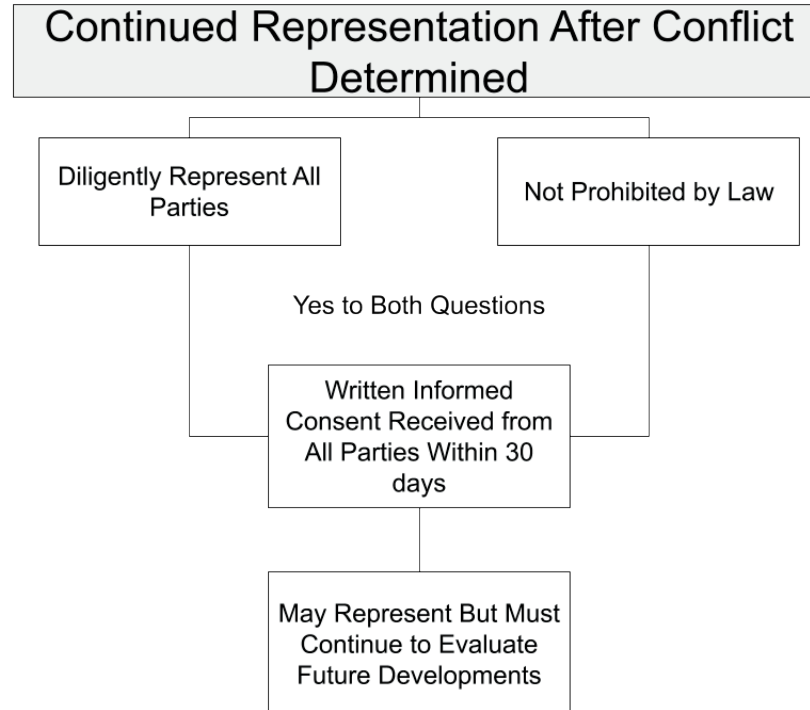
Even if that problem is overcome and the clients consent, the CPA has another confidentiality problem that needs to be understood by the affected clients before they give consent. In order to give competent and diligent representation, the CPA must be able to make full use of all information the CPA is aware of. However, if that information is obtained while performing services for the other party, the CPA will need to obtain that party's consent to disclose.

If the consent to disclose is not granted, the CPA now fails the first prong of the requirements to provide services in the face of a conflict. This will force the CPA to resign abruptly and, since no consent has been given to disclose, to be unable to explain the reason. Of course, the very act of resigning will likely alert the party that "something is up" and the CPA's inability to say what it is will often allow the affected party to figure out what is up or, perhaps worse, decide whatever it is must be much worse than it is.

A CPA needs to be sure that all parties affected under this "no secrets" issue and the fact that if a party refuses consent to disclose the CPA will be forced to resign, very possibly effectively allowing the other party to figure out what is being kept from them or significantly complicating relations between the parties.

Understanding this issue is key to any client truly giving "informed" consent.

Also, OPR Director Hawkins has remarked in public that advisers should understand this consent is really just for continued representation while there are no material changes to the nature of the conflict. The CPA must continue to evaluate in a conflict situation whether the nature of the conflict remains similar enough to what it was when the signed consents were obtained.



If that is not the case, the CPA must start over by determining if continued representation is possible and, if it is, obtain new informed consents due to the revised situation.

CPAs must also consult the requirements under Ethics Interpretation 102-2 in determining under those rules if a conflict exists, and needs to comply with both Ethics Interpretation 102-2 and Circular 230 §10.29 in such a situation.

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