Federal Tax Update for Industry

(FTUI)

KAPLAN

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KAPLAN

FEDERAL TAX UPDATE FOR INDUSTRY (FTUI)

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Unit

1

Corporate Transparency Act Reporting Regulations

LEARNING OBJECTIVES

- Explain to clients the reasons Congress used to justify the requirements to establish the beneficial ownership reporting requirements.
- Identify whether a particular corporation or LLC qualifies as an exempted large operating company
- List the information required to be provided in the initial and update reports on behalf of the entity, beneficial owners and company applicants.

On January 1st, 2021, a new law was born. Buried in the William M. (Mac) Thornberry National Defense Authorization Act for Fiscal Year 2021, this law - also known as the "Corporate Transparency Act" - requires corporations, LLCs, and other entities to report beneficial owner information to the Financial Crimes Enforcement Network (FinCEN). This data will be collected in a database for future reference.

Fast forward to September 2022, when FinCEN released the final regulations[1] for the law. Reporting will officially begin on January 1st, 2024. However, it's worth noting that there will be different rules for entities that existed before 2024 and those created in or after that year.

Though there are some exceptions to these requirements, many advisers will find that most of the small, closely held LLCs and corporations they work with will need to file these reports. And to top it off, any changes to the information provided must be updated within 30 days.

In short, this is a law that will impact many businesses across the country, so it's important to stay informed and up-to-date on its requirements.

[1] Federal Register, Vol. 87, No. 189, 87 FR 59498, September 30, 2023, https://www.federalregister.gov/d/2022-21020 (retrieved April 29, 2023)

WHY DID CONGRESS SEE THE NEED TO ENACT THESE RULES

Section 6402 of the Thornberry Act outlines the "Sense of Congress" regarding the justification for these provisions. That section notes, in part, that:

- More than 2,000,000 corporations and limited liability companies are being formed under the laws of the States each year;[2]
- Most or all States do not require information about the beneficial owners of the corporations, limited liability companies, or other similar entities formed under the laws of the State;[3]
- Malign actors seek to conceal their ownership of corporations, limited liability companies, or other similar entities in the United States to facilitate illicit activity, including money laundering, the financing of terrorism, proliferation financing, serious tax fraud, human and drug trafficking, counterfeiting, piracy, securities fraud, financial fraud, and acts of foreign corruption, harming the national security interests of the United States and allies of the United States;[4] and
- Money launderers and others involved in commercial activity intentionally conduct transactions through corporate structures in order to evade detection, and may layer such structures, much like Russian nesting ''Matryoshka'' dolls, across various secretive jurisdictions such that each time an investigator obtains ownership records for a domestic or foreign entity, the newly identified entity is yet another corporate entity, necessitating a repeat of the same process.[5]

The Section goes on to explain why this situation requires Federal intervention:

- Federal legislation providing for the collection of beneficial ownership information for corporations, limited liability companies, or other similar entities formed under the laws of the States is needed to—
  - set a clear, Federal standard for incorporation practices;
  - protect vital Unites States national security interests;
  - protect interstate and foreign commerce;
  - better enable critical national security, intelligence, and law enforcement efforts to counter money laundering, the financing of terrorism, and other illicit activity; and
  - bring the United States into compliance with international anti-money laundering and countering the financing of terrorism standards.6

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[2] Thornberry Act §6402(1)

[3] Thornberry Act §6402(2)

[4] Thornberry Act §6402(3)

[5] Thornberry Act §6402(4)

[6] Thornberry Act §6402(5)

Congress explains next how this information will be used:

- Beneficial ownership information collected under the amendments made by this title is sensitive information and will be directly available only to authorized government authorities, subject to effective safeguards and controls, to—
  - facilitate important national security, intelligence, and law enforcement activities; and
  - confirm beneficial ownership information provided to financial institutions to facilitate the compliance of the financial institutions with anti-money laundering, countering the financing of terrorism, and customer due diligence requirements under applicable law.[7]

The program is to be handled by the Treasury Department with Congress providing:

- Consistent with applicable law, the Secretary of the Treasury shall—
  - maintain the information obtained in a secure, nonpublic database, using information security methods and techniques that are appropriate to protect nonclassified information systems at the highest security level; and
  - take all steps, including regular auditing, to ensure that government authorities accessing beneficial ownership information do so only for authorized purposes consistent with this title; and
- in prescribing regulations to provide for the reporting of beneficial ownership information, the Secretary shall, to the greatest extent practicable consistent with the purposes of this title—
  - seek to minimize burdens on reporting companies associated with the collection of beneficial ownership information;
  - provide clarity to reporting companies concerning the identification of their beneficial owners; and
  - collect information in a form and manner that is reasonably designed to generate a database that is highly useful to national security, intelligence, and law enforcement agencies and Federal functional regulators.[8]

Note that while Treasury is required to "seek" to minimize the burden, that doesn't mean the burden will be minimal (the fact the agency seeks something doesn't mean they will find a way to do it). Contrast this with the final charge which doesn't have such a modifier, but rather requires the agency to create a "highly useful" database for the intended users of the information.

[7] Thornberry Act §6402(6)

[8] Thornberry Act §6402(7) and (8)

In an FAQ issued on March 24, 2023,[9] FinCEN summarized the reasons why this information must be reported to the Treasury Department:

> Very few U.S. states or territories require companies to disclose information about their beneficial owners—the individuals who own or control companies. This lack of transparency allows criminals, corrupt officials, and other bad actors to hide their identities and launder illicit funds through the United States using shell and front companies. This in turn hurts ordinary Americans because the lack of transparency results in an uneven playing field for honest and legitimate U.S. businesses. The inaccessibility of beneficial ownership information also makes it hard for law enforcement to track and prosecute criminal activity.
>
> In 2021, Congress, with bipartisan support, enacted the Corporate Transparency Act to address this problem. The Corporate Transparency Act requires certain types of U.S. and foreign entities to report information about their beneficial owners to the Treasury Department's Financial Crimes Enforcement Network, commonly known as FinCEN. FinCEN is responsible for safeguarding the U.S. financial system from illicit use. Subject to strict safeguards and controls, FinCEN will disclose the reported beneficial ownership information to certain authorized government authorities, financial institutions, and other authorized users.
>
> By collecting beneficial ownership information and sharing it with law enforcement, financial institutions, and other authorized users, FinCEN is making it harder for bad actors to hide or benefit from their ill-gotten gains. Companies that report beneficial ownership information will contribute to this important goal.[10]

We will look at the rules that were issued as part of the reporting regulations issued in September of 2022, as well as the additional guidance published by the agency in March of 2023 on the FinCEN website.

FILING REQUIREMENTS

The FAQ cited above is FinCEN's attempt to provide a plain English explanation of the law and how it will impact entities required to file. In addition to the FAQ, at the same time FinCEN published two other single page documents that provide summaries of key issues.

[9] "Beneficial Ownership Information Reporting Frequently Asked Questions," Financial Crimes Enforcement Network, United States Treasury, March 24, 2023, https://www.fincen.gov/sites/default/files/shared/BOI_FAQs_FINAL_508.pdf (retrieved April 28, 2023)

[10] "Beneficial Ownership Information Reporting Frequently Asked Questions," Financial Crimes Enforcement Network, United States Treasury, March 24, 2023, pp. 1-2

The first item is a one page PDF[11] showing the key reporting dates under this program:

BENEFICIAL OWNERSHIP INFORMATION REPORT FILING DATES

FinCEN will begin accepting beneficial ownership information reports from reporting companies[1] that are not exempt[2] on January 1, 2024, the effective date of the reporting requirement.

INITIAL REPORTS

Existing reporting companies

Created or registered to do business in the United States before January 1, 2024.

Reports due by **January 1, 2025**.

Created or registered to do business in the United States on or after January 1, 2024.

Reports due within **30 calendar days** of receiving actual or public notice that the creation or registration of the reporting company is effective.

UPDATED REPORTS

Required when there is a change to previously reported information about the reporting company itself or its beneficial owners.

Updated reports due within **30 calendar days** after a change occurs.

CORRECTED REPORTS

Required when previously reported information was inaccurate when filed.

Corrected reports due within **30 calendar days** days after the reporting company becomes aware or has reason to know of an inaccuracy.

More information can be found at www.fincen.gov/boi.

1 There are two types of reporting companies: domestic and foreign. A **domestic reporting company** is any entity that is a corporation, a limited liability company (LLC), or created by the filing of a document with a secretary of state or any similar office under the law of a U.S. state or Indian tribe. A **foreign reporting company** is any entity that is a corporation, LLC, or other entity that is formed under the law of a foreign country and registered to do business in any U.S. state or tribal jurisdiction by the filing of a document with a secretary of state or any similar office under the law of a U.S. state or Indian tribe.

2 There are 23 categories of entities that are exempt from the definition of reporting company. Please review FinCEN's final beneficial ownership information reporting rule, as well as FinCEN's reference materials published on www.fincen.gov/boi, for more details.

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The second one page document outlines a number of key questions[12] to be answered.

[11] "Beneficial Ownership Interest Report Filing Dates," Financial Crimes Enforcement Network, United States Treasury, March 24, 2023, https://www.fincen.gov/sites/default/files/shared/BOI_Reporting_Filing_Dates-Published03.24.23_508C.pdf (retrieved April 28, 2023)

[12] "Beneficial Ownership Reporting – Key Questions," Financial Crimes Enforcement Network, United States Treasury, March 24, 2023, https://www.fincen.gov/sites/default/files/shared/BOI_Reporting_Key_Questions_Published_508C.pdf (retrieved April 28, 2023)

BENEFICIAL OWNERSHIP REPORTING – KEY QUESTIONS

This document is explanatory only and does not supplement or modify any obligations imposed by statute or regulation. Please refer to the beneficial ownership information reporting final rule, available at www.fincen.gov/boi, for details on specific provisions.

1. Does my company have to report its beneficial owners?

While certain types of entities are exempt, if you are a small corporation or LLC, you will likely be required to report your beneficial ownership information to FinCEN. A key factor in determining whether your company will have to report is whether you had to file a document with your state's secretary of state or a similar office to create your company or, for foreign companies, register it to do business in the United States.

2. Who is a beneficial owner of my company?

A beneficial owner is any individual who exercises *substantial control* over your company, or who *owns or controls at least 25 percent* of your company.

3. Does my company have to report its company applicants?

There can be up to two individuals who qualify as company applicants — (1) the individual who directly files the document that creates, or first registers, the reporting company; and (2) the individual that is primarily responsible for directing or controlling the filing of the relevant document.

Your company is only required to report its company applicants if it is created or registered on or after January 1, 2024.

4. What specific information does my company need to report?

A reporting company will need to provide: (1) its legal name and any trade name or DBA; (2) its address; (3) the jurisdiction in which it was formed or first registered, depending on whether it's a U.S. or foreign company; and (4) its Taxpayer Identification Number (TIN).

For each of your company's beneficial owners and each company applicant (if required), your company will need to provide the individual's: (1) legal name; (2) birthdate; (3) address (in most cases, a home address); and (4) an identifying number from a driver's license, passport, or other approved document for each individual, as well as an image of the document that the number is from.

5. When and how should my company file its initial report?

If your company is created or registered before January 1, 2024, file by January 1, 2025. Otherwise, file within 30 calendar days of receiving actual or public notice from your state's secretary of state or similar office that your company was created or registered. FinCEN will accept reports electronically beginning January 1, 2024.

6. What if there are changes to or inaccuracies in reported information?

Your company will have 30 days to report any changes to reported information. For updates, the 30 days start from when the relevant change occurs. For corrections, the 30 days start after you become aware of, or have reason to know of, an inaccuracy in a prior report.

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We will look at the FAQ, which has more detailed information, below, along with citing back to the law and regulations underlying the FAQ's answers.

When Are Initial Reports to Be Filed?

A key issue to note is that no reports will need to be filed until 2024. FAQ Question 3 provides:

> **3. Should my company report beneficial ownership information now?**
>
> No. No one needs to report beneficial ownership information to FinCEN until January 1, 2024. FinCEN is currently not accepting any beneficial ownership information reports.[13]

While Reg. 31 CFR 1010.380(a)(1) provides the detail for initial reports, the FAQ provides a more simplified description of the initial filing dates:

> **4. When do I need to report my company's beneficial ownership information to FinCEN?**
>
> A reporting company created or registered to do business before January 1, 2024, will have until **January 1, 2025** to file its initial beneficial ownership information report.
>
> A reporting company created or registered on or after **January 1, 2024**, will have 30 days to file its initial beneficial ownership information report. This 30-day deadline runs from the time the company receives actual notice that its creation or registration is effective, or after a secretary of state or similar office first provides public notice of its creation or registration, whichever is earlier.[14]

This explanation omits what happens if an entity that is exempt from filing (classes that will be listed later) no longer meets the criteria for exemption, providing:

> Any entity that no longer meets the criteria for any exemption under paragraph (c)(2) of this section shall file a report within 30 calendar days after the date that it no longer meets the criteria for any exemption.[15]

It is important to note that while entities in existence before 2024 can file initial reports as late as January 1, 2025, entities formed in 2024 will not be able to wait until that date.

---

[13] "Beneficial Ownership Information Reporting Frequently Asked Questions," Financial Crimes Enforcement Network, United States Treasury, March 24, 2023, p. 2

[14] "Beneficial Ownership Information Reporting Frequently Asked Questions," Financial Crimes Enforcement Network, United States Treasury, March 24, 2023, p. 2

[15] 31 CFR 1010.380(a)(1)(iv)

EXAMPLE

Entity Created in 2024

ABC, LLC received actual notice of its creation from the appropriate state authority on December 31, 2023. ABC, LLC's deadline to file its initial report is January 1, 2025 as the entity was in existence before January 1, 2024.

XYZ, LLC received actual notice of its creation on January 2, 2024 from the appropriate state authority. While formed just two days later than ABC, LLC, this LLC's deadline is much earlier, needing to file within 30 days after the date of formation, or by February 1, 2024.

Reporting Company

The law requires certain entities to file these reports. Roughly reporting companies can be divided into two broad categories:

Type	Definition
Domestic reporting company	Any entity that is: (A) a corporation; (B) a limited liability company; or (C) created by the filing of a document with a secretary of state or any similar office under the law of a State or Indian tribe.[16]
Foreign reporting company	Any entity that is: (A) a corporation, limited liability company, or other entity; (B) formed under the law of a foreign country; and (C) registered to do business in any State or tribal jurisdiction by the filing of a document with a secretary of state or any similar office under the law of a State or Indian tribe.[17]

The FAQ provides the following details on reporting companies:

> **7. What companies will be required to report beneficial ownership information to FinCEN?**
>
> Certain companies — referred to as "reporting companies" — will be required to report their beneficial ownership information to FinCEN. There are two types of reporting companies — domestic reporting companies and foreign reporting companies.
>
> A domestic reporting company is defined as —
>
> - a corporation,
> - a limited liability company, or

[16] 31 CFR 1010.380(c)

[17] 31 CFR 1010.380(c)

- any other entity created by the filing of a document with a secretary of state or any similar office under the law of a state or Indian tribe.

A foreign reporting company is any entity that is —

- a corporation, limited liability company, or other entity formed under the law of a foreign country, AND
- registered to do business in any U.S. state or in any Tribal jurisdiction, by the filing of a document with a secretary of state or any similar office under the law of a U.S. state or Indian tribe.

If you had to file a document with a state or Indian Tribal-level office such as a secretary of state to create your company, or to register it to do business if it is a foreign company, then your company is a reporting company, unless an exemption applies.

For the definitions of both domestic and foreign reporting companies, a "state" means any state of the United States, the District of Columbia, the Commonwealth of Puerto Rico, the Commonwealth of the Northern Mariana Islands, American Samoa, Guam, the U.S. Virgin Islands, and any other commonwealth, territory, or possession of the United States.[18]

Several entities are exempt from filing this report, but only during the period the entity qualifies for the exemption. The FAQ provides the following detail:

8. Are there exemptions from the reporting requirement?

Yes. The Corporate Transparency Act exempts 23 types of entities from the beneficial ownership information reporting requirement. Below is a list of the types of entities that are exempt —

(i) Certain types of securities reporting issuers.

(ii) A U.S. governmental authority.

(iii) Certain types of banks.

(iv) Federal or state credit unions as defined in section 101 of the Federal Credit Union Act.

(v) Any bank holding company as defined in section 2 of the Bank Holding Company Act of 1956, or any savings and loan holding company as defined in section 10(a) of the Home Owners' Loan Act.

(vi) Certain types of money transmitting or money services businesses.

[18] "Beneficial Ownership Information Reporting Frequently Asked Questions," Financial Crimes Enforcement Network, United States Treasury, March 24, 2023, p. 3

(vii) Any broker or dealer, as defined in section 3 of the Securities Exchange Act of 1934, that is registered under section 15 of that Act (15 U.S.C. 78o).

(viii) Securities exchanges or clearing agencies as defined in section 3 of the Securities Exchange Act of 1934, and that is registered under sections 6 or 17A of that Act.

(ix) Certain other types of entities registered with the Securities and Exchange Commission under the Securities Exchange Act of 1934.

(x) Certain types of investment companies as defined in section 3 of the Investment Company Act of 1940, or investment advisers as defined in section 202 of the Investment Advisers Act of 1940.

(xi) Certain types of venture capital fund advisers.

(xii) Insurance companies defined in section 2 of the Investment Company Act of 1940.

(xiii) State-licensed insurance producers with an operating presence at a physical office within the United States, and authorized by a State, and subject to supervision by a State's insurance commissioner or a similar official or agency.

(xiv) Commodity Exchange Act registered entities.

(xv) Any public accounting firm registered in accordance with section 102 of the Sarbanes-Oxley Act of 2002.

(xvi) Certain types of regulated public utilities.

(xvii) Any financial market utility designated by the Financial Stability Oversight Council under section 804 of the Payment, Clearing, and Settlement Supervision Act of 2010.

(xviii) Certain pooled investment vehicles.

(xix) Certain types of tax-exempt entities.

(xx) Entities assisting a tax-exempt entity described in (xix) above.

(xxi) Large operating companies with at least 20 full-time employees, more than $5,000,000 in gross receipts or sales, and an operating presence at a physical office within the United States.

(xxii) The subsidiaries of certain exempt entities.

(xxiii) Certain types of inactive entities that were in existence on or before January 1, 2020, the date the Corporate Transparency Act was enacted.

> Many of these exempt entities are already regulated by federal and/or state government, and many already disclose their beneficial ownership information to a governmental authority.
>
> Additional information about the entities that are exempt can be found in the Beneficial Ownership Information Reporting Regulations at 31 CFR § 1010.380(c)(2).
>
> You should consult the text of the regulations, which include specific criteria for the exemptions, before concluding that an entity qualifies for an exemption.[19]

The last paragraph of the answer to question 8 is one to pay attention to, as there are specific requirements for each of the categories. We will look at some of the exceptions you are more likely to run into below.

Large Operating Company

The exception that will apply most often is the one that applies to *large operating companies*, found at 31 CFR §1010.380(c)(2)(xxi) and 31 USC §5336(a)(11)(B)(xxi). To qualify for this exemption, all of the following three criteria must be met:

- Employ more than 20 employees on a full time basis in the United States;[20]
- Filed federal income tax returns in the previous year that reported more than $5,000,000 in gross receipts or sales in the aggregate, including the receipts or sales of
  - other entities owned by the entity; and
  - other entities through which the entity operates;[21] and
- Has an operating presence at a physical office in the United States.[22]

The final rules provide more details on meeting the 20 full time employee test. The test borrows definitions found in the regulations for the applicable large employer (ALE) provisions of the Affordable Care Act (ACA) found at Treasury Reg. §§54.4980H-1(a) (which provides definitions of employees and full time employees) and 54.4980H–3 (which determines full time employees under the ACA for the ALE rules). Some key issues to note are:

- The definition of an *employer* under Reg. §54-4980H-1(a)(16) provides for treating all members of certain related party groups as employing all members of the related party group. Specifically, the regulation provides "For purposes of determining whether an employer is an applicable large employer, all persons treated as a single employer under section 414(b), (c), (m), or (o) are treated as a single employer. Thus, all employees of a controlled group of entities under section 414(b) or (c), an affiliated service group under section 414(m), or an entity in an arrangement described under section 414(o), are taken into account in

[19] "Beneficial Ownership Information Reporting Frequently Asked Questions," Financial Crimes Enforcement Network, United States Treasury, March 24, 2023, pp. 3-5

[20] 31 USC §5336(a)(11)(B)(xxi)(I)

[21] 31 USC §5336(a)(11)(B)(xxi)(II)

[22] 31 USC §5336(a)(11)(B)(xxi)(I)(III)

determining whether the members of the controlled group or affiliated service group together are an applicable large employer."

- A *full time employee* is defined generally as an employee who is employed an average of at least 30 hours a week in a calendar month,[23] with 130 hours per month being treated as equivalent of being employed on average at least 30 hours a week in a calendar month.[24]

One modification to the ACA rules that the definition of United States is changed to use the definition found at 31 USC §1010(hhh). That definition defines the United States as "[t]he States of the United States, the District of Columbia, the Indian lands (as that term is defined in the Indian Gaming Regulatory Act), and the Territories and Insular Possessions of the United States." Under the ACA the definition of United States is the one found at IRC §7701(a)(9)[25] which limits the definition to only the States of the United States and the District of Columbia.

The final rule also provides more details on the $5,000,000 test found in the statute. 31 CFR §1010.380(c)(2)(xxi)(C) provides:

> (C) Filed a Federal income tax or information return in the United States for the previous year demonstrating more than $5,000,000 in gross receipts or sales, as reported as gross receipts or sales (net of returns and allowances) on the entity's IRS Form 1120, consolidated IRS Form 1120, IRS Form 1120–S, IRS Form 1065, or other applicable IRS form, excluding gross receipts or sales from sources outside the United States, as determined under Federal income tax principles. For an entity that is part of an affiliated group of corporations within the meaning of 26 U.S.C. 1504 that filed a consolidated return, the applicable amount shall be the amount reported on the consolidated return for such group.

Subsidiary of Certain Exempt Entities

Another exempt category consists of any entity whose ownership interests are controlled or owned, directly or indirectly, by one of the following entities that qualify on their own for exemption under the law and regulations:[26]

- Securities reporting issuer;
- Governmental authority;
- Bank;
- Credit union;
- Depository institution holding company;
- Money services business;
- Broker or dealer in securities;

[23] Treasury Reg. §54-4980H-1(a)(21)(i)

[24] Treasury Reg. §54-4980H-1(a)(21)(ii)

[25] Treasury Reg. §54-4980H-1(a)(48)

[26] 31 USC §5336(a)(11)(B)(xxii)

- Securities exchange or clearing agency;
- Other Exchange Act registered entity;
- Investment company or investment adviser;
- Venture capital fund adviser;
- Insurance company;
- State-licensed insurance producer;
- Commodity Exchange Act registered entity;
- Accounting firm (registered under Section 102 of the Sarbanes-Oxley Act);
- Public utility;
- Financial market utility;
- Tax-exempt entity; or
- Large operating company.[27]

Note that each of those definitions have detailed technical requirements, so be sure to consult the final rule to determine whether the owning entity in fact is itself exempt.

Inactive Entity

A special category which exists solely to create a category of "grandfathered" exempt entities to avoid having long forgotten entities run afoul of these rules is the inactive entity category. Such an entity must meet *all* of the following criteria:

- Was in existence on or before January 1, 2020; (thus, no more entities of this type can be created)
- Is not engaged in active business;
- Is not owned by a foreign person, whether directly or indirectly, wholly or partially;
- Has not experienced any change in ownership in the preceding twelve month period;
- Has not sent or received any funds in an amount greater than $1,000, either directly or through any financial account in which the entity or any affiliate of the entity had an interest, in the preceding twelve month period; and

[27] 31 USC §5336(a)(11)(B)(xxii)

- Does not otherwise hold any kind or type of assets, whether in the United States or abroad, including any ownership interest in any corporation, limited liability company, or other similar entity.[28]

If an individual created or creates a new LLC or corporation on or after January 1, 2020, that entity will need to comply with the registration rules until the entity is dissolved unless it is otherwise exempt. The fact that it does nothing and never will do anything will not exempt such entities from facing potential consequences if they fail to comply with this law.

Beneficial Owner

Under the law, information about each "beneficial owner" of a non-exempt entity must be reported to FinCEN, with any changes in that information timely reported as well. So a key issue is the definition of a beneficial owner, found at 31 USC §5663(a)(3)(A). That law provides:

> (3) Beneficial owner.— The term " beneficial owner "—
>
> > (A) means, with respect to an entity, an individual who, directly or indirectly, through any contract, arrangement, understanding, relationship, or otherwise—
> >
> > > (i) exercises substantial control over the entity; or
> > >
> > > (ii) owns or controls not less than 25 percent of the ownership interests of the entity;

The final rule provides the following definition of what constitutes *substantial control*:

> (1) **Substantial control**—(i) Definition of substantial control. An individual exercises substantial control over a reporting company if the individual:
>
> > (A) Serves as a senior officer of the reporting company;
> >
> > (B) Has authority over the appointment or removal of any senior officer or a majority of the board of directors (or similar body);
> >
> > (C) Directs, determines, or has substantial influence over important decisions made by the reporting company, including decisions regarding:
> >
> > > (1) The nature, scope, and attributes of the business of the reporting company, including the sale, lease, mortgage, or other transfer of any principal assets of the reporting company;
> > >
> > > (2) The reorganization, dissolution, or merger of the reporting company;
> > >
> > > (3) Major expenditures or investments, issuances of any equity, incurrence of any significant debt, or approval of the operating budget of the reporting company;

[28] 31 USC §5336(a)(11)(B)(xxiii)

(4) The selection or termination of business lines or ventures, or geographic focus, of the reporting company;

(5) Compensation schemes and incentive programs for senior officers;

(6) The entry into or termination, or the fulfillment or non-fulfillment, of significant contracts;

(7) Amendments of any substantial governance documents of the reporting company, including the articles of incorporation or similar formation documents, bylaws, and significant policies or procedures; or

(D) Has any other form of substantial control over the reporting company.[29]

Per the final rule, such substantial control can be exercised in any of the following manners:

(ii) Direct or indirect exercise of substantial control. An individual may directly or indirectly, including as a trustee of a trust or similar arrangement, exercise substantial control over a reporting company through:

(A) Board representation;

(B) Ownership or control of a majority of the voting power or voting rights of the reporting company;

(C) Rights associated with any financing arrangement or interest in a company;

(D) Control over one or more intermediary entities that separately or collectively exercise substantial control over a reporting company;

(E) Arrangements or financial or business relationships, whether formal or informal, with other individuals or entities acting as nominees; or

(F) any other contract, arrangement, understanding, relationship, or otherwise.[30]

The final rule also provides detail about what constitutes ownership for purposes of determining if someone is a beneficial owner:

(2) Ownership Interests—(i) Definition of ownership interest. The term ''ownership interest'' means:

(A) Any equity, stock, or similar instrument; preorganization certificate or subscription; or transferable share of, or voting trust certificate or

[29] 31 CFR 1010.380(d)(1)(i)

[30] 31 CFR 1010.380(d)(1)(ii)

certificate of deposit for, an equity security, interest in a joint venture, or certificate of interest in a business trust; in each such case, without regard to whether any such instrument is transferable, is classified as stock or anything similar, or confers voting power or voting rights;

(B) Any capital or profit interest in an entity;

(C) Any instrument convertible, with or without consideration, into any share or instrument described in paragraph (d)(2)(i)(A), or (B) of this section, any future on any such instrument, or any warrant or right to purchase, sell, or subscribe to a share or interest described in paragraph (d)(2)(i)(A), or (B) of this section, regardless of whether characterized as debt;

(D) Any put, call, straddle, or other option or privilege of buying or selling any of the items described in paragraph (d)(2)(i)(A), (B), or (C) of this section without being bound to do so, except to the extent that such option or privilege is created and held by a third party or third parties without the knowledge or involvement of the reporting company; or

(E) Any other instrument, contract, arrangement, understanding, relationship, or mechanism used to establish ownership.[31]

A person's ownership or control of an interest can be established by any of the following:

(ii) Ownership or control of ownership interest. An individual may directly or indirectly own or control an ownership interest of a reporting company through any contract, arrangement, understanding, relationship, or otherwise, including:

(A) Joint ownership with one or more other persons of an undivided interest in such ownership interest;

(B) Through another individual acting as a nominee, intermediary, custodian, or agent on behalf of such individual;

(C) With regard to a trust or similar arrangement that holds such ownership interest:

(1) As a trustee of the trust or other individual (if any) with the authority to dispose of trust assets;

(2) As a beneficiary who:

(i) Is the sole permissible recipient of income and principal from the trust; or

(ii) Has the right to demand a distribution of or withdraw substantially all of the assets from the trust; or

[31] 31 CFR 1010.380(d)(2)(i)

(3) As a grantor or settlor who has the right to revoke the trust or otherwise withdraw the assets of the trust; or

(D) Through ownership or control of one or more intermediary entities, or ownership or control of the ownership interests of any such entities, that separately or collectively own or control ownership interests of the reporting company.[32]

The calculation of the percentage of such ownership interests is also provided for in the final rule:

(iii) Calculation of the total ownership interests of a reporting company. In determining whether an individual owns or controls at least 25 percent of the ownership interests of a reporting company, the total ownership interests that an individual owns or controls, directly or indirectly, shall be calculated as a percentage of the total outstanding ownership interests of the reporting company as follows:

(A) Ownership interests of the individual shall be calculated at the present time, and any options or similar interests of the individual shall be treated as exercised;

(B) For reporting companies that issue capital or profit interests (including entities treated as partnerships for federal income tax purposes), the individual's ownership interests are the individual's capital and profit interests in the entity, calculated as a percentage of the total outstanding capital and profit interests of the entity;

(C) For corporations, entities treated as corporations for federal income tax purposes, and other reporting companies that issue shares of stock, the applicable percentage shall be the greater of:

(1) the total combined voting power of all classes of ownership interests of the individual as a percentage of total outstanding voting power of all classes of ownership interests entitled to vote, or

(2) the total combined value of the ownership interests of the individual as a percentage of the total outstanding value of all classes of ownership interests; and

(D) If the facts and circumstances do not permit the calculations described in either paragraph (d)(2)(iii)(B) or (C) to be performed with reasonable certainty, any individual who owns or controls 25 percent or more of any class or type of ownership interest of a reporting company shall be deemed to own or control 25 percent or more of the ownership interests of the reporting company.[33]

[32] 31 CFR 1010.380(d)(2)(ii)

[33] 31 CFR 1010.380(d)(2)(iii)

EXAMPLE

Ownership Interest of a corporation

An individual currently owns 35% of the voting stock of the corporation. However, he also has an option to obtain another 10% interest that he can exercise at any time over the next five years but hasn't exercised yet.

To calculate the individual's total ownership interest in the reporting company, we need to consider the regulations issued by FinCEN for the Beneficial Owner Reporting rules found in the Corporate Transparency Act.

Since the corporation issues shares of stock, we need to apply 31 CFR §1010.380(d)(2)(iii)(C) to calculate the individual's ownership percentage. We need to determine whether the individual's total combined voting power of all classes of ownership interests or the total combined value of the ownership interests is greater.

As the individual currently owns 35% of the voting stock of the corporation, we can calculate his total combined voting power as:

Total combined voting power = 35%

If the individual exercises his option to obtain another 10% interest, his total combined voting power would be:

Total combined voting power = 35% + 10% = 45%

Thus, under 31 CFR §1010.380(d)(2)(iii)(C), the individual's ownership interest in the reporting company would be the greater of the total combined voting power or the total combined value of the ownership interests.

Therefore, if the corporation has only one class of stock outstanding and each share of stock has the same voting power and value, the individual's ownership interest in the reporting company would be 45%.

The FAQ provides the following information on beneficial interests:

> **9. Who is a beneficial owner of a reporting company?**
>
> In general, a beneficial owner is any individual (1) who directly or indirectly exercises "substantial control" over the reporting company, or (2) who directly or indirectly owns or controls 25 percent or more of the "ownership interests" of the reporting company.
>
> Whether an individual has "substantial control" over a reporting company depends on the power they may exercise over a reporting company. For example, an individual will have substantial control of a reporting company if they direct, determine, or exercise substantial influence over, important decisions the reporting company makes. In addition, any senior officer is deemed to have substantial control over a reporting company. Other rights or responsibilities may also constitute substantial control. Additional information about the definition of substantial control and who qualifies as exercising substantial control can be found in the Beneficial Ownership Information Reporting Regulations at 31 CFR §1010.380(d)(1).

> "Ownership interests" generally refer to arrangements that establish ownership rights in the reporting company, including simple shares of stock as well as more complex instruments. Additional information about ownership interests, including indirect ownership, can be found in the Beneficial Ownership Information Reporting Regulations at 31 CFR §1010.380(d)(2).[34]

The FAQ, in a footnote, clarifies the definition of a "senior officer":

> The term "senior officer" means any individual holding the position or exercising the authority of a president, chief financial officer, general counsel, chief executive officer, chief operating officer, or any other officer, regardless of official title, who performs a similar function. 31 CFR 1010.380(f)(8).[35]

FinCEN provides some examples in the FAQ of applying these rules:

EXAMPLE 1

FAQ Question 9

Example 1: The reporting company is a limited liability company (LLC). You are the sole owner and president of the company and make important decisions for the company. No one else owns or controls ownership interests in your company or exercises substantial control over your company.

You are a beneficial owner of the reporting company in two different ways, assuming no other facts. First, you exercise substantial control over the company because you are a senior officer of the company (the president) and because you make important decisions for the company. Second, you are also a beneficial owner because you own 25 percent or more of the reporting company's ownership interests.

Because no one else owns or controls ownership interests in your LLC or exercises substantial control over it, and assuming there are no other facts to consider, you are the only beneficial owner of this reporting company, and your information must be reported to FinCEN.

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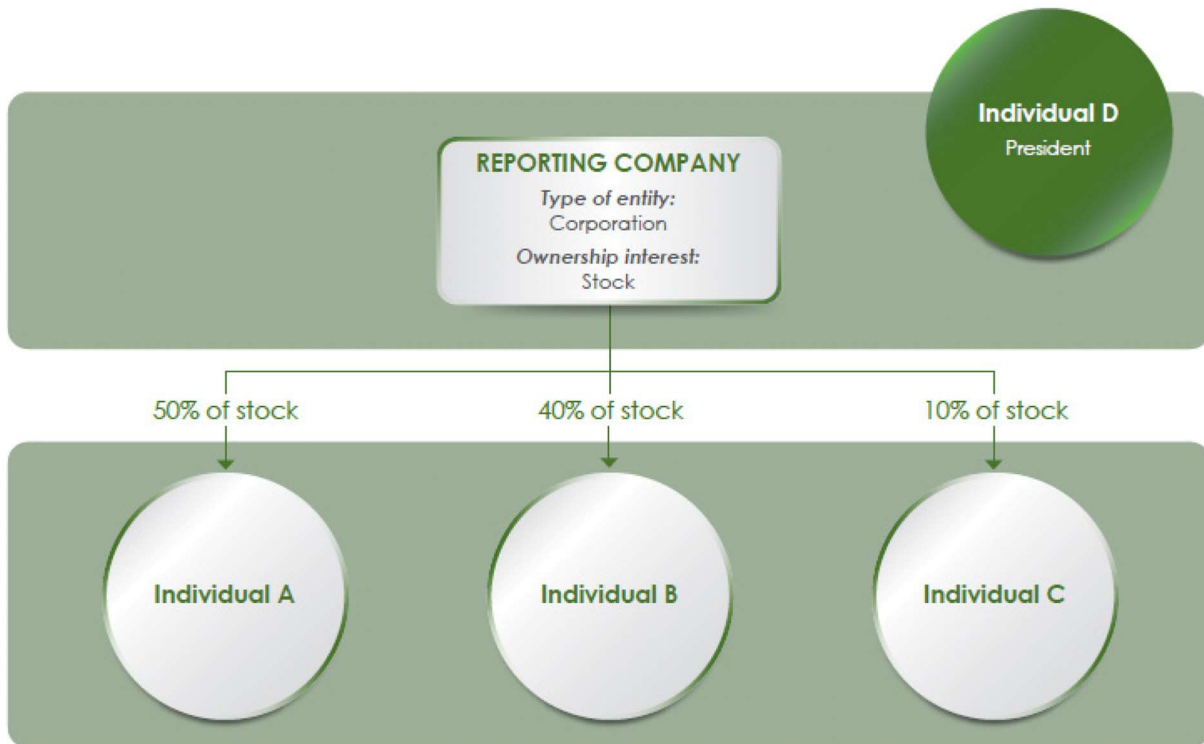
[34] "Beneficial Ownership Information Reporting Frequently Asked Questions," Financial Crimes Enforcement Network, United States Treasury, March 24, 2023, p. 5

[35] "Beneficial Ownership Information Reporting Frequently Asked Questions," Financial Crimes Enforcement Network, United States Treasury, March 24, 2023, p. 14

The second example uses the following illustration to help show the entity's structure:



EXAMPLE 2

FAQ Question 9

Example 2: The reporting company is a corporation. The company's total outstanding ownership interests are shares of stock. Three people (Individuals A, B, and C) own 50 percent, 40 percent, and 10 percent of the stock, respectively, and one other person (Individual D) acts as the President for the company, but does not own any stock.

Assuming there are no other facts, Individuals A, B, and D are all beneficial owners of the company and their information must be reported. Individual C is not a beneficial owner.

Individual A owns 50 percent of the company's stock and therefore is a beneficial owner because they own 25 percent or more of the company's ownership interests. Individual B owns 40 percent of the company's stock and therefore is a beneficial owner because they own 25 percent or more of the company's ownership interests.

Individual C is not a company officer and does not directly or in directly exercise any substantial control over the company. Individual C also owns 10 percent of your company's stock, which is less than the 25 percent or greater interest needed to qualify as a beneficial owner by virtue of ownership interests. Individual C is therefore not a beneficial owner of the company.

Individual D is president of the company and is therefore a beneficial owner. As a senior officer of the company, Individual D exercises substantial control, regardless of whether the individual owns or controls 25 percent or more of the company's ownership interests.

EXAMPLE 3

FAQ Question 9

Example 3: The reporting company is a corporation owned by four individuals who each own 25 percent of the company's ownership interests (e.g., shares of stock). Four other individuals serve as the reporting company's CEO, CFO, COO, and general counsel, respectively, none of whom hold any of the company's ownership interests.

In this example, there are eight beneficial owners. All four of the individuals who each own 25 percent of the company's ownership interests are beneficial owners of the company by virtue of their holdings in it, even if they exercise no substantial control over it. The CEO, CFO, COO, and general counsel are all senior officers and therefore exercise substantial control over the reporting company, making them beneficial owners as well.

Individuals Not Treated as Beneficial Owners

Even if an individual would qualify as a beneficial owner under the above rules, they may be in an excluded class found in 31 USC §5663(a)(3)(B). Those excluded are:

- A minor child, as defined in the State in which the entity is formed, if the information of the parent or guardian of the minor child is reported in accordance with this section;
- An individual acting as a nominee, intermediary, custodian, or agent on behalf of another individual;
- An individual acting solely as an employee of a corporation, limited liability company, or other similar entity and whose control over or economic benefits from such entity is derived solely from the employment status of the person;
- An individual whose only interest in a corporation, limited liability company, or other similar entity is through a right of inheritance; or
- A creditor of a corporation, limited liability company, or other similar entity, unless the creditor meets the requirements of ownership discussed earlier (that is, simply being a creditor won't make someone a beneficial owner).[36]

The final rules provides clarification on the application of these exclusions. First, the determination of whether an individual is a minor child is made under the law of the State or Indian tribe in which a domestic reporting company is created or a foreign reporting company is first registered.[37]

The employee exception will not apply if the individual is a senior officer as described in the FAQ footnote cited earlier and 31 CFR 1010.380(f)(8).[38]

[36] 31 USC §5663(a)(3)(B)

[37] 31 CFR 1010.380(d)(3)(i)

[38] 31 CFR 1010.380(d)(3)(iii)

The right of inheritance rule only applies to a *future* interest—it would not serve to exclude the person from being a beneficial owner once the interest has passed to the individual.[39]

The final rule also clarified that someone is considered a creditor "solely through rights or interests for the payment of a predetermined sum of money, such as a debt incurred by the reporting company, or a loan covenant or other similar right associated with such right to receive payment that is intended to secure the right to receive payment or enhance the likelihood of repayment."[40]

Company Applicants

Information on "company applicants" will need to be reported about its company applicants if the entity is created or registered on or after January 1, 2024, but such information is not required to be submitted for entities created before that date.[41]

A *company applicant* is defined as follows in the final rule:

> (e) **Company applicant**. For purposes of this section, the term ''company applicant'' means:
>
> > (1) For a domestic reporting company, the individual who directly files the document that creates the domestic reporting company as described in paragraph (c)(1)(i) of this section;
> >
> > (2) For a foreign reporting company, the individual who directly files the document that first registers the foreign reporting company as described in paragraph (c)(1)(ii) of this section; and
> >
> > (3) Whether for a domestic or a foreign reporting company, the individual who is primarily responsible for directing or controlling such filing if more than one individual is involved in the filing of the document.[42]

The FAQ provides:

> **10. Will a reporting company need to report any other information in addition to information about its beneficial owners?**
>
> Yes. The information that needs to be reported, however, depends on when the company was created or registered.
>
> - If a reporting company is created or registered on or after January 1, 2024, the reporting company will need to report information about itself, its beneficial owners, and its company applicants.

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[39] 31 CFR 1010.380(d)(3)(iv)

[40] 31 CFR 1010.380(d)(3)(v)

[41] 31 CFR 1010.380(b)(1)(ii) and (b)(2)(iv)

[42] 31 CFR 1010.380(e)

- If a reporting company was created or registered before January 1, 2024, the reporting company only needs to provide information about itself and its beneficial owners. The reporting company does not need to provide information about its company applicants.

11. Who is a company applicant of a reporting company?

There can be up to two individuals who qualify as company applicants —

- the individual who directly files the document that creates, or first registers, the reporting company; and
- the individual that is primarily responsible for directing or controlling the filing of the relevant document.

No reporting company will have more than two company applicants. If only one person was involved in filing the relevant document, then only that person should be reported as a company applicant.

Only reporting companies formed or registered on or after January 1, 2024, will have to report their company applicants. Companies created or registered before January 1, 2024, do not have to report their company applicants.[43]

FinCEN provided examples of applying these provisions in the FAQ.

EXAMPLE

FAQ Question 11

Example 1: Individual A is creating a new company. Individual A prepares the necessary documents to create the company and files them with the relevant state or Tribal office, either in person or using a self-service online portal. No one else is involved in preparing, directing, or making the filing.

Individual A is a company applicant because Individual A directly filed the document that created the company. Because Individual A is the only person involved in the filing, Individual A is the only company applicant. State or Tribal employees who receive and process the company creation or formation documents should not be reported as company applicants.

EXAMPLE

FAQ Question 11

Example 2: Individual A is creating a company. Individual A prepares the necessary documents to create the company and directs Individual B to file the documents with the relevant state or Tribal office. Individual B then directly files the documents that create the company.

Individuals A and B are both company applicants—Individual B directly filed the documents, and Individual A was primarily responsible for directing or controlling the filing. Individual B could, for example, be

[43] "Beneficial Ownership Information Reporting Frequently Asked Questions," Financial Crimes Enforcement Network, United States Treasury, March 24, 2023, pp. 7-8

Individual A's spouse, business partner, attorney, or accountant; in all cases, Individuals A and B are both company applicants in this scenario.

Information to Be Provided

Information will need to be provided and kept up to date about the entity itself, each beneficial owner and, if formed on or after January 1, 2024, each company applicant.

Information to Be Provided About the Entity

The initial report will contain the following information about the company:

- The full legal name of the reporting company;
- Any trade name or ''doing business as'' name of the reporting company;
- A complete current address consisting of:
  - In the case of a reporting company with a principal place of business in the United States, the street address of such principal place of business; and
  - In all other cases, the street address of the primary location in the United States where the reporting company conducts business;
- The State, Tribal, or foreign jurisdiction of formation of the reporting company;
- For a foreign reporting company, the State or Tribal jurisdiction where such company first registers; and
- The Internal Revenue Service (IRS) Taxpayer Identification Number (TIN) (including an Employer Identification Number (EIN)) of the reporting company, or where a foreign reporting company has not been issued a TIN, a tax identification number issued by a foreign jurisdiction and the name of such jurisdiction.[44]

The FAQ provides as well that "[a] reporting company will also have to indicate the type of filing it is making (that is, whether it is filing an initial report, a correction of a prior report, or an update to a prior report)."[45]

Information to Be Provided for Beneficial Owners and Company Applicants

Information will need to be provided on initial reports (and kept updated) for beneficial owners and, for entities formed on or after January 1, 2024, company applicants.

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[44] 31 CFR 1010.380(b)(1)(i)

[45] "Beneficial Ownership Information Reporting Frequently Asked Questions," Financial Crimes Enforcement Network, United States Treasury, March 24, 2023, p. 9

The information provided will consist of:

- The full legal name of the individual;
- The date of birth of the individual;
- A complete current address consisting of:
  - In the case of a company applicant who forms or registers an entity in the course of such company applicant's business, the street address of such business; or
  - In any other case, the individual's residential street address;
- A unique identifying number and the issuing jurisdiction from one of the following documents:
  - A non-expired passport issued to the individual by the United States government;
  - A non-expired identification document issued to the individual by a State, local government, or Indian tribe for the purpose of identifying the individual;
  - A non-expired driver's license issued to the individual by a State; or
  - A non-expired passport issued by a foreign government to the individual, if the individual does not possess any of the prior three documents
- An image of the document from which the unique identifying number was obtained.[46]

The FAQ contains the following specific information on the address supplied:

> *Address*: For a beneficial owner, the reporting company must report the residential street address.
>
> For a company applicant, the reporting company must report the individual's residential street address. However, if an individual engages in the business of corporate formation (e.g., as an attorney or corporate formation agent) and files the formation or registration document in the course of that business, then the reporting company must report the current street address of the company applicant's business. For example, if the company applicant is a paralegal who filed the document while working at a law firm, the reporting company must report the business address of the law firm where the paralegal worked when filing the document.[47]

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[46] 31 CFR 1010.380(b)(1)(ii)

[47] "Beneficial Ownership Information Reporting Frequently Asked Questions," Financial Crimes Enforcement Network, United States Treasury, March 24, 2023, p. 10

The FAQ goes on to provide more details about the identifying documents:

> *Identification Document*: The list below sets out the forms of acceptable identification documents:
>
> - A non-expired driver's license issued by a U.S. state. A "U.S. state" means any state of the United States, the District of Columbia, the Commonwealth of Puerto Rico, the Commonwealth of the Northern Mariana Islands, American Samoa, Guam, the U.S. Virgin Islands, and any other commonwealth, territory, or possession of the United States.
> - A non-expired identification document issued by a U.S. state or local government, or Indian Tribe that is issued for the purpose of identifying the individual. For example, a non-driver identification card issued by a state Department of Motor Vehicles would qualify because it is issued for identification purposes.
> - A non-expired passport issued by the U.S. government; or
> - If the individual does not have any of the three forms of identification document described above, the reporting company may provide the identifying number from a non-expired passport issued by a foreign government.[48]

[48] "Beneficial Ownership Information Reporting Frequently Asked Questions," Financial Crimes Enforcement Network, United States Treasury, March 24, 2023, p. 10

Updated Reports

An entity's responsibility to file reports goes beyond the initial filings. In various situations an updated report must be filed with FinCEN. The table below, created with the assistance of ChatGPT 3.5, provides a general summary of situations where an updated report must be filed:

Situation	When the time to file an updated report begins
Change in required information previously submitted to FinCEN concerning a reporting company or its beneficial owners (with more specific examples provided in the following rows)	The date on which such change occurs
Reporting company meets the criteria for any exemption subsequent to the filing of an initial report	When the event occurs that causes the entity to meet the criteria.
Death of a beneficial owner	When the estate of the deceased beneficial owner is settled, either through the operation of the intestacy laws of a jurisdiction within the United States or through a testamentary deposition. The updated report shall, to the extent appropriate, identify any new beneficial owners.
Minor child attains the age of majority	When the minor child attains the age of majority
Change in information on an identifying document	When the name, date of birth, address, or unique identifying number on such document changes

In all of these situations, the reporting company must file an updated report in the form and manner specified in the final rule within 30 calendar days after the date on which such change occurs.

The final rule provides details on updated reporting requirements. FinCEN has required updates to be made 30 days after information that is required to be provided on the report has changed. The rule provides:

> (i) If there is any change with respect to required information previously submitted to FinCEN concerning a reporting company or its beneficial owners, including any change with respect to who is a beneficial owner or information reported for any particular beneficial owner, the reporting company shall file an updated report in the form and manner specified in paragraph (b)(3) of this section within 30 calendar days after the date on which such change occurs.[49]

[49] 31 CFR 1010.380(a)(2)

The final rule provides detail as well on the information to be provided in such updated reports:

> (i) Updated reports—in general. An updated report required to be filed pursuant to paragraph (a)(2) of this section shall reflect any change with respect to required information previously submitted to FinCEN concerning a reporting company or its beneficial owners.[50]

One requirement found in the regulations that may surprise some professionals is the requirement to file a report to inform FinCEN that an organization now meets the requirements to be exempt from the filing requirements:

> (ii) Updated reports—newly exempt entities. An updated report required to be filed pursuant to paragraph (a)(2)(ii) of this section shall indicate that the filing entity is no longer a reporting company.[51]

And the requirement to file that information is found earlier in the final rule:

> (ii) If a reporting company meets the criteria for any exemption under paragraph (c)(2) of this section subsequent to the filing of an initial report, this change will be deemed a change with respect to information previously submitted to FinCEN, and the entity shall file an updated report.[52]

Similarly, if an entity that had been exempt now fails to meet the requirements, that entity will also need to file what will be an *initial* report within 30 days:

> (iv) Any entity that no longer meets the criteria for any exemption under paragraph (c)(2) of this section shall file a report within 30 calendar days after the date that it no longer meets the criteria for any exemption.[53]

The final rule contains special rules that will take effect if a beneficial owner dies and his/her interest is transferred:

> (iii) If an individual is a beneficial owner of a reporting company by virtue of property interests or other rights subject to transfer upon death, and such individual dies, a change with respect to required information will be deemed to occur when the estate of the deceased beneficial owner is settled, either through the operation of the intestacy laws of a jurisdiction within the United States or through a testamentary deposition. The updated report shall, to the extent appropriate, identify any new beneficial owners.[54]

Similarly, when a minor child reaches the age of majority, an updated report must be filed:

> (iv) If a reporting company has reported information with respect to a parent or legal guardian of a minor child pursuant to paragraphs (b)(2)(ii) and (d)(3)(i) of

[50] 31 CFR 1010.380(b)(3)(i)

[51] 31 CFR 1010.380(b)(3)(ii)

[52] 31 CFR 1010.380(a)(2)(ii)

[53] 31 CFR 1010.380(a)(1)(iv)

[54] 31 CFR 1010.380(a)(2)(iii)

> this section, a change with respect to required information will be deemed to occur when the minor child attains the age of majority.[55]

Finally, the regulation provides that if the identifying documents whose image was provided to FinCEN changes, that also will require an updated report:

> (v) With respect to an image of an identifying document required to be reported pursuant to paragraph (b)(1)(ii)(E) of this section, a change with respect to required information will be deemed to occur when the name, date of birth, address, or unique identifying number on such document changes.[56]

Corrected Reports

If an error is made in a filing, a corrected report must be filed within 30 days of when the reporting entity becomes aware of the error.

> If any report under this section was inaccurate when filed and remains inaccurate, the reporting company shall file a corrected report in the form and manner specified in paragraph (b) of this section within 30 calendar days after the date on which such reporting company becomes aware or has reason to know of the inaccuracy.[57]

The regulations also provide that the original filing won't be treated as a problem if the correction is made within 90 days of the original filing. This is a separate deadline from the 30 day requirement. Thus, if an error is discovered after 90 days, the correction must still be filed but FinCEN could take action to impose penalties:

> A corrected report filed under this paragraph (a)(3) within this 30-day period shall be deemed to satisfy 31 U.S.C. 5336(h)(3)(C)(i)(I)(bb) if filed within 90 calendar days after the date on which the inaccurate report was filed.[58]

FinCEN Identifier

Individuals and companies are offered the option of obtaining a FinCEN identifier which contains the information required for the report. Presumably this would allow the individual filing a single update for any changed information rather than having to make the same change on each company report.

The final rule provides the following information on the application process:

> (i) Application.
>
> > (A) An individual may obtain a FinCEN identifier by submitting to FinCEN an application containing the information about the individual described in paragraph (b)(1) of this section.

[55] 31 CFR 1010.380(a)(2)(iv)

[56] 31 CFR 1010.380(a)(2)(v)

[57] 31 CFR 1010.380(a)(3)

[58] 31 CFR 1010.380(a)(3)

(B) A reporting company may obtain a FinCEN identifier by submitting to FinCEN an application at or after the time that the entity submits an initial report required under paragraph (b)(1) of this section.

(C) Each FinCEN identifier shall be specific to each such individual or reporting company, and each such individual or reporting company (including any successor reporting company) may obtain only one FinCEN identifier.[59]

The final rule provides the following information on the use of the FinCEN identifier:

(ii) Use of the FinCEN identifier.

(A) If an individual has obtained a FinCEN identifier and provided such FinCEN identifier to a reporting company, the reporting company may include such FinCEN identifier in its report in lieu of the information required under paragraph (b)(1) of this section with respect to such individual.

(B) [Reserved][60]

The "reserved" section suggests that FinCEN has plans to add more information on the use of this identifier, perhaps to make it more attractive and powerful.

Update and correction rules for FinCEN identifiers are very similar to those for the entity filings:

(iii) Updates and corrections. (A) Any individual that has obtained a FinCEN identifier shall update or correct any information previously submitted to FinCEN in an application for such FinCEN identifier.

(1) If there is any change with respect to required information previously submitted to FinCEN in such application, the individual shall file an updated application reflecting such change within 30 calendar days after the date on which such change occurs.

(2) If any such application was inaccurate when filed and remains inaccurate, the individual shall file a corrected application correcting all inaccuracies within 30 calendar days after the date on which the individual becomes aware or has reason to know of the inaccuracy. A corrected application filed under this paragraph within this 30-day period will be deemed to satisfy 31 U.S.C. 5336(h)(3)(C)(i)(I)(bb) if filed within 90 calendar days after the date on which the inaccurate application was submitted.

(B) Any reporting company that has obtained a FinCEN identifier shall file an updated or corrected report to update or correct any information previously submitted to FinCEN. Such updated or corrected report shall be filed at the same

[59] 31 CFR 1010.380(b)(4)(i)

[60] 31 CFR 1010.380(b)(4)(ii)

time and in the same manner as updated or corrected reports filed under paragraph (a) of this section.[61]

Penalties for Reporting Violations

Reporting violations are found at 31 USC 5663(h)(1) which reads:

> (h) Penalties.—
>
> > (1) Reporting violations.— It shall be unlawful for any person to—
> >
> > > (A) willfully provide, or attempt to provide, false or fraudulent beneficial ownership information, including a false or fraudulent identifying photograph or document, to FinCEN in accordance with subsection (b); or
> > >
> > > (B) willfully fail to report complete or updated beneficial ownership information to FinCEN in accordance with subsection (b).

The final rule provides the following additional details regarding a reporting violation:

> (g) Reporting violations. It shall be unlawful for any person to willfully provide, or attempt to provide, false or fraudulent beneficial ownership information, including a false or fraudulent identifying photograph or document, to FinCEN in accordance with this section, or to willfully fail to report complete or updated beneficial ownership information to FinCEN in accordance with this section. For purposes of this paragraph (g):
>
> > (1) The term ''person'' includes any individual, reporting company, or other entity.
> >
> > (2) The term ''beneficial ownership information'' includes any information provided to FinCEN under this section.
> >
> > (3) A person provides or attempts to provide beneficial ownership information to FinCEN if such person does so directly or indirectly, including by providing such information to another person for purposes of a report or application under this section.
> >
> > (4) A person fails to report complete or updated beneficial ownership information to FinCEN if, with respect to an entity:
> >
> > > (i) such entity is required, pursuant to title 31, United States Code, section 5336, or its implementing regulations, to report information to FinCEN;
> > >
> > > (ii) the reporting company fails to report such information to FinCEN; and

[61] 31 CFR 1010.380(b)(4)(iii)

(iii) such person either causes the failure, or is a senior officer of the entity at the time of the failure.[62]

The penalties for a reporting violation are found at 31 USC §5663(h)(3)(A):

(3) Criminal and civil penalties.—

(A) Reporting violations.— Any person that violates subparagraph (A) or (B) of paragraph (1)—

(i) shall be liable to the United States for a civil penalty of not more than $500 for each day that the violation continues or has not been remedied; and

(ii) may be fined not more than $10,000, imprisoned for not more than 2 years, or both.

EXAMPLE

Under 31 USC §5663, a person may be subject to a civil penalty of up to $500 for each day the report is not filed, is filed with improper information or is not timely updated. The taxpayer may also be fined, up to a maximum of $10,000, and imprisoned for not more than 2 years or both. In this case, Joe willfully failed to file a beneficial ownership report for Joe's Store, LLC, and the report was due on June 30, 2025. Joe finally filed the report on December 12, 2025, which means that the report was overdue for a total of 165 days.

Since FinCEN has decided to impose the maximum per day financial penalty, the penalty imposed on Joe would be $500 for each day the report was overdue, multiplied by 165 days. Therefore, the total penalty amount would be $82,500.

The penalty amount was appropriate because Joe willfully failed to file the beneficial ownership report for Joe's Store, LLC, and the report was overdue for a significant period of time. Additionally, imposing the maximum per day financial penalty serves as a strong deterrent to others who may be tempted to willfully fail to file beneficial ownership reports in the future.

The $10,000 fine limit did not limit the civil penalty because it is only applicable to criminal penalties under the same section of law. In this case, FinCEN imposed a civil penalty, not a criminal penalty, for Joe's failure to file the beneficial ownership report.

How Reports Will Be Filed

The FAQ has information regarding how the reports will be filed. As is true of other FinCEN reports, such as the Foreign Bank Account Reporting (FBAR) filing, this report will be filed online:

14. How will I report my company's beneficial ownership information?

If you are required to report your company's beneficial ownership information to FinCEN, you will do so electronically through a secure filing system available

[62] 31 CFR 1010.380

via FinCEN's website. This system is currently being developed and will be available before your report must be filed.[63]

Entities with Access to Beneficial Ownership Information

Clients will likely ask who will have access to this information, much of which they may consider private and sensitive. The FAQ has information on the limited list of those who will be able to request access to the information in this database:

15. Who will be able to access reported beneficial ownership information and for what purposes?

The Corporate Transparency Act authorizes FinCEN to disclose beneficial ownership information in certain circumstances to six types of requesters:

- U.S. Federal agencies engaged in national security, intelligence, and law enforcement activities;
- State, local, and Tribal law enforcement agencies with court authorization;
- The U.S. Department of the Treasury;
- Financial institutions using beneficial ownership information to conduct legally required customer due diligence, provided the financial institutions have their customer consent to retrieve the information;
- Federal and state regulators assessing financial institutions for compliance with legally required customer due diligence obligations; and
- Foreign law enforcement agencies and certain other foreign authorities who submit qualifying requests for the information through a U.S. Federal agency.

The Corporate Transparency Act imposes stringent access requirements and safeguards on each group of requesters.[64]

FinCEN ends the FAQs with a discussion of the steps being taken to protect this data:

16. How will FinCEN protect beneficial ownership information reported to it?

Protecting the security and confidentiality of beneficial ownership information is a top priority for FinCEN. Federal law requires FinCEN to implement protocols to safeguard beneficial ownership information, to build a secure IT system to store the information, and to establish processes and procedures to ensure that

[63] "Beneficial Ownership Information Reporting Frequently Asked Questions," Financial Crimes Enforcement Network, United States Treasury, March 24, 2023, p. 10

[64] "Beneficial Ownership Information Reporting Frequently Asked Questions," Financial Crimes Enforcement Network, United States Treasury, March 24, 2023, p. 11

only authorized users can access beneficial ownership information for authorized purposes.

FinCEN is developing the policies and procedures that will govern access to and handling of beneficial ownership information. FinCEN is also building a secure and confidential IT system to store the information. Consistent with Federal law, the system will be cloud-based, and will meet the highest Federal Information Security Modernization Act (FISMA) level to keep beneficial ownership information secure.

FinCEN will work closely with those authorized to access beneficial ownership information to ensure that they understand their roles and responsibilities to ensure that the reported information is used only for authorized purposes and handled in a way that protects its security and confidentiality.[65]

CHECKLIST OF STEPS TO ASSIST CLIENTS WITH BENEFICIAL OWNER REPORTING

Below is a checklist of items for a CPA to consider when advising their client on the beneficial ownership reporting provisions of the Corporate Transparency Act (CTA). Note that this checklist is not exhaustive and should be tailored to each client's specific situation. It's essential to stay updated on the latest regulatory guidance and requirements.

- Determine if your malpractice insurance will cover this work or if the work will fall under the practice of law rules.
- Determine applicability:
  - Confirm if the client's entity is a "reporting company" under the CTA.
  - Identify any exemptions (e.g., publicly traded companies, banks, credit unions, investment companies, etc.).
- Identify beneficial owners:
  - Understand the CTA's definition of a beneficial owner (i.e., individuals who own 25% or more of the entity or exercise substantial control).
  - Assist the client in identifying all qualifying beneficial owners.
  - Advise on reporting requirements for indirect ownership interests or multi-layered ownership structures.
- Collect required information:
  - Obtain full legal names, dates of birth, current residential or business addresses, and a unique identifying number and document image for each beneficial owner.

[65] "Beneficial Ownership Information Reporting Frequently Asked Questions," Financial Crimes Enforcement Network, United States Treasury, March 24, 2023, p. 11

- Ensure the accuracy and completeness of the collected information.

- Initial reporting:
  - Determine if an initial report is required upon the formation or registration of a new entity.
  - Prepare and submit the initial report to the Financial Crimes Enforcement Network (FinCEN) within the required timeframe.
- Updates and changes:
  - Advise clients on the obligation to report changes in beneficial ownership within 30 days after becoming aware of the changed in information.
  - Establish procedures for monitoring and tracking beneficial ownership changes.
  - Assist with preparing and submitting reports to FinCEN for any changes.
- Recordkeeping requirements:
  - Help clients establish systems for maintaining accurate records of beneficial ownership information for at least five years after the entity's dissolution or termination.
- Compliance programs and training:
  - Assist clients in developing a compliance program tailored to their specific risk profile and industry.
  - Provide training on CTA requirements and reporting obligations.
- Penalties and enforcement:
  - Inform clients about the potential civil and criminal penalties for non-compliance, including fines and imprisonment.
  - Advise on the importance of timely reporting and accurate recordkeeping.
- Privacy and data security:
  - Educate clients on the privacy implications of reporting beneficial ownership information.
  - Assist in implementing data security measures to protect sensitive information.
- Monitor regulatory updates:
  - Stay informed about new guidance, regulations, or amendments to the CTA.
  - Update clients on any changes that may affect their reporting obligations.

Remember to consult with legal counsel and other experts as needed, as this checklist is for informational purposes only and does not constitute legal or professional advice.

Unit

2

Inflation Reduction Act of 2022

LEARNING OBJECTIVES

- Understand how the various clean energy tax provisions added in the Inflation Reduction Act of 2022 applies to your business

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

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

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

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

NON-ENERGY TAX PROVISIONS PRIMARILY IMPACTING INDIVIDUALS AND SMALL BUSINESSES

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

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

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

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

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

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

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

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

Household income percentage of Federal poverty line:	**Initial percentage**	**Final percentage**
Up to 150%	0%	0%
At least 150% but less than 200%	0%	2.0%
At least 200% but less than 250%	2.0%	4.0%
At least 250% but less than 300%	4.0%	6.0%
At least 300% but less than 400%	6.0%	8.5%

Household income percentage of Federal poverty line:	Initial percentage	Final percentage
400% and higher	8.5%	8.5%

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

That rule was suspended by ARPA for 2021 and 2022, so that so long as the SLCSP for a taxpayer exceeded 8.5% of the applicable household income, a taxpayer would continue to receive a tax credit.[66]

Extension of Limitation on Excess Business Losses of Noncorporate Taxpayers

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

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

The provision had already had its scheduled expiration pushed back one year previously as part of the American Rescue Plan Act of 2021 from the date set in 2017's Tax Cuts and Jobs Act and it seems unlikely the provision will be allowed to expire on its newly scheduled expiration date.[67]

Increase in Research Credit Against Payroll Taxes for Certain Small Businesses

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

IRA 2022 provides that a "qualified small business" may apply an addition $250,000 of qualifying research expenses against the employer share of Medicare taxes for tax years beginning after December 31, 2022, raising the maximum to $500,000 per year.[68]

[66] IRC §36B as amended by IRA 2022

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

[68] IRC §41(h) as amended by IRA 2022

ENERGY TAX CREDITS (OTHER THAN VEHICLES)

Extension, Increase, and Modifications of Nonbusiness Energy Property Credit

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

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

Old Law

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

The pre-IRA credit was equal to:

- 10 percent of the amount paid or incurred by the taxpayer for *qualified energy efficiency improvements* installed during such taxable year, and
- the amount of the *residential energy property expenditures* paid or incurred by the taxpayer during such taxable year.[69]

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

- An overall lifetime limit of $500 for all taxable years ending after December 31, 2005
- Within that overall $500 lifetime limit, specific items were limited to smaller amounts:
  - $200 for qualifying windows,
  - $50 for an advanced main air circulating fan,
  - $150 for any qualified natural gas, propane, or oil furnace or hot water boiler, and
  - $300 for any item of energy-efficient building property.[70]

[69] IRC §25C(a)

[70] IRC §25C(b)

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

- Such component is installed in or on a dwelling unit located in the United States and owned and used by the taxpayer as the taxpayer's principal residence,
- The original use of such component commences with the taxpayer, and
- Such component reasonably can be expected to remain in use for at least 5 years.[71]

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

- Applicable Energy Star program requirements, in the case of a roof or roof products,
- Version 6.0 Energy Star program requirements, in the case of an exterior window, a skylight, or an exterior door, and
- The prescriptive criteria for such component established by the 2009 International Energy Conservation Code, as such Code (including supplements) is in effect on the date of the enactment of the American Recovery and Reinvestment Tax Act of 2009, in the case of any other component.[72]

A *building envelope component* means—

- Any insulation material or system which is specifically and primarily designed to reduce the heat loss or gain of a dwelling unit when installed in or on such dwelling unit,
- Exterior windows (including skylights),
- Exterior doors, and
- Any metal roof or asphalt roof installed on a dwelling unit, but only if such roof has appropriate pigmented coatings or cooling granules which are specifically and primarily designed to reduce the heat gain of such dwelling unit.[73]

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

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

Such term includes expenditures for labor costs properly allocable to the onsite preparation, assembly, or original installation of the property.[74]

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

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

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

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

Qualified energy property means--

- Energy-efficient building property,
- A qualified natural gas, propane, or oil furnace or hot water boiler, or
- An advanced main air circulating fan (as defined at IRC §25C(d)(5)).[75]

Energy efficient building property means—

- An electric heat pump water heater which yields a Uniform Energy Factor of at least 2.2 in the standard Department of Energy test procedure,
- An electric heat pump which achieves the highest efficiency tier established by the Consortium for Energy Efficiency, as in effect on January 1, 2009,
- A central air conditioner which achieves the highest efficiency tier established by the Consortium for Energy Efficiency, as in effect on January 1, 2009, and
- A natural gas, propane, or oil water heater (as defined at IRC §25C(d)(4)) which has either a Uniform Energy Factor of at least 0.82 or a thermal efficiency of at least 90 percent.[76]

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

IRA 2022 Changes

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

Extension of 2021 Rules Into 2022

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

Renaming the Credit

IRC §25C's title is changed from "Nonbusiness Energy Property" to "Energy Efficient Home Improvement Credit."[77]

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

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

[77] IRA 2022 Act §13301(h)

30% Credit (IRC §25(a) as Revised)

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

- The amount paid or incurred by the taxpayer for qualified energy efficiency improvements installed during the taxable year,
- The amount of the residential energy property expenditures paid or incurred by the taxpayer during the taxable year, and
- The amount paid or incurred by the taxpayer during the taxable year for *home energy audits*.[78]

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

- Identifies the most significant and cost-effective energy efficiency improvements with respect to such dwelling unit, including an estimate of the energy and cost savings with respect to each such improvement and
- Is conducted and prepared by a home energy auditor that meets the certification or other requirements specified by the IRS in regulations or other guidance. Such guidance is to be issued within 365 days of August 16, 2022.[79]

For a credit to be claimed for expenditures related to a home energy audit, the taxpayer must include with the taxpayer's return such information or documents as the IRS may require.[80]

While the requirement that the property be a taxpayer's principal residence is removed for the old items that qualified for the credit comma note that a home energy audit only counts if it is performed on the taxpayers principal residence.

Revised Annual Rather Than Lifetime Limitations

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

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

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

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

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

[80] IRC §25C(b)(6)(B)

- Home energy audit - $150.

Notwithstanding the above rule, the maximum credit for heat pump and heat pump water heaters & biomass stoves and boilers is $2,000.[81]

Modifications Related to Qualified Energy Efficiency Improvements

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

- In the case of an exterior window or skylight, qualify for the Energy Star most efficient certification requirements,
- in the case of an exterior door, applicable Energy Star requirements, and
- in the case of any other component, the prescriptive criteria for such component established by the most recent International Energy Conservation Code standard in effect as of the beginning of the calendar year which is 2 years prior to the calendar year in which such component is placed in service.[82]

Roofs are no longer treated as building envelope components.[83] Added to the list of building envelope components are air sealing materials or systems.[84]

Revision of Definition of Residential Energy Property Expenditures

The Act revises the definition of residential energy property expenditures found at IRC §25C(d). Significantly, the requirement the property be used as the taxpayer's *principal* residence (as defined by IRC §121) is no longer required except for home energy audits. The new law only requires the home be used as a residence by the taxpayer.[85]

As was noted earlier, the definition of a home energy audit requires it take place on a taxpayer's principal residence and this law change will not change that definition.

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

Identification Number Requirement

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

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

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

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

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

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

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

- Such item is produced by a qualified manufacturer, and
- The taxpayer includes the qualified product identification number of such item on the return of tax for the taxable year.[86]

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

- Assign a qualified product identification number to each item of specified property produced by such manufacturer utilizing a methodology that will ensure that such number (including any alphanumeric) is unique to each such item (by utilizing numbers or letters which are unique to such manufacturer or by such other method as the IRS may provide),
- Label such item with such number in such manner as the IRS may provide, and
- Make periodic written reports to the IRS (at such times and in such manner as the IRS may provide) of the product identification numbers so assigned and including such information as the IRS may require with respect to the item of specified property to which such number was so assigned.[87]

Although a number of years will pass before the taxpayer is required to provide such a number, once the requirement goes into effect advisers can expect that in many cases obtaining this number will delay the preparation of the tax return.

Extension and Modification of Residential Clean Energy Credit

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

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

The Act renames §25D from "Residential energy efficient property" to "Residential clean energy credit."[88]

The Act moves the expiration date well into the future, with the credit applying to property placed in service before 2035.[89]

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

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

[88] IRA 2022 Act §13302(c)(2)

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

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

- 30% for property placed in service after December 31, 2021, and before January 1, 2033,
- 26% for property placed in service after December 31, 2032, and before January 1, 2034, and
- 22% for property placed in service after December 31, 2033, and before January 1, 2035.[90]

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

- Is installed in connection with a dwelling unit located in the United States and used as a residence by the taxpayer, and
- Has a capacity of not less than 3 kilowatt hours.[91]

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

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

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

Elective Payments for Applicable Entities

The first special rule exists to allow entities that are tax exempt to treat these credits as a payment of income taxes, as opposed to simply a tax credit, rendering the amount refundable to the extent the payment is in excess of the tax actually due for the year (which likely will be zero).[92]

Credits Eligible for Elective Payment Treatment

The credits that are eligible for this election are—

- The portion of the credit for alternative fuel vehicle refueling property allowed under IRC §30C which is treated as a credit under IRC §38(b) pursuant to IRC §30C(d)(1) (business property),
- The portion of the credit under IRC §45(a) (renewable electricity production credit) attributable to qualified facilities that are originally placed in service after December 31, 2022,
- The portion of the credit under IRC §45Q(a) (credit for carbon sequestration) attributable to qualified facilities that are originally placed in service after December 31, 2022,

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

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

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

- The §45U(a) zero-emission nuclear power production credit,
- The portion of the credit under IRC §45V(a) (credit for production of clean hydrogen) attributable to qualified clean hydrogen production facilities that are originally placed in service after December 31, 2012,
- For tax exempt entities that qualify for the §45W credit for qualified commercial vehicles under §45W(d)(3),
- The IRC §45X(a) credit for advanced manufacturing production,
- The IRC §45Y(a) credit for clean electricity production,
- The IRC §45Z(a) credit for clean fuel production,
- The IRC §48(a) clean energy credit,
- The IRC §48C credit for qualifying advanced energy projects, and
- The IRC §48E credit for clean electricity investment.[93]

Applicable Entities

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

- Any organization exempt from income tax,
- Any State or local government (or political subdivision thereof),
- The Tennessee Valley Authority,
- An Indian tribal government (as defined in IRC §30D(g)(9)),
- Any Alaska Native Corporation (as defined in 43 USC 1602(m)), or
- Any corporation operating on a cooperative basis that is engaged in furnishing electric energy to persons in rural areas.[94]

Transfer of Certain Credits

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

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

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

Credits Eligible to Be Transferred

The energy credits eligible to be transferred at:

- The amount of the alternative fuel vehicle refueling property credit allowed under IRC §30C which, pursuant to Code Sec. 30(C)(d)(1), is treated as a credit listed in Code Sec. 38(b) (business property subject to depreciation),
- The IRC §45(a) renewable electricity production credit,
- The IRC §45Q(a) carbon oxide sequestration credit,
- The IRC §45U(a) zero-emission nuclear power production credit,
- The IRC §45V(a) clean hydrogen production credit,
- The IRC §45X(a) advanced manufacturing production credit,
- The IRC §45Y(a) clean electricity production credit,
- The IRC §45Z(a) clean fuel production credit,
- The IRC §48 energy credit,
- The IRC §48C qualifying advanced energy project credit, and
- The IRC §48E clean electricity investment credit.[95]

The credits can be transferred by any taxpayer that is not an applicable entity eligible to elect to treat credits as a payment of income taxes under IRC §6417.[96]

Other Energy Provisions

The law contains many very focused energy incentive provisions. Due to the limited number of taxpayers likely to be impacted by these provisions compared to others discussed in the program, we are providing only a list here of the provisions. If you or clients are potentially impacted by these credits, you should follow up to see if they might be of use.

- §45 Electricity produced from certain renewable resources, etc. – extended and modified
- §48 Energy credit – extended and modified
- §45Q Credit for carbon oxide sequestration –extended and modified
- §45U Zero-emission nuclear power production credit—new credit added
- §40A Biodiesel and renewable diesel used as fuel—extended

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

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

- §40 Alcohol, etc., used as fuel—extension
- §40B Sustainable aviation fuel credit—new credit added
- §45V Credit for production of clean hydrogen—new credit added
- §179D Energy efficient commercial buildings deduction—modified
- §45L New energy efficient home credit—extended, increased and modified
- §48C Qualifying advanced energy project credit—revised
- §45X Advanced manufacturing production credit—new credit added
- §45Y Clean electricity production credit—new credit added
- §48E Clean electricity investment credit—new credit added
- §168(e)(3)(B) Green Energy Property Classified as 5-Year MACRS Property and
- §45Z Clean fuel production credit—new credit added

CREDITS ON CLEAN ENERGY VEHICLES

New Clean Vehicle Credit

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

IRA 2022 substantially revises the credit previously referred to as the new qualified plug-in electric drive motor vehicle credit (NQPEDMV), now being renamed to the new clean vehicle credit.[97]

Prior Law

The NQPEDMV credit had provided for a credit of up to $7,500 for a qualified vehicle placed in service during the year. The amount of the credit for the vehicle was computed as $2,500 plus in the case of a vehicle which draws propulsion energy from a battery with not less than 5 kilowatt hours of capacity, the amount determined under this paragraph is $417, plus $417 for each kilowatt hour of capacity in excess of 5 kilowatt hours (up to $5,000).[98]

The pre-IRA credit phases out over a *phaseout period* tied to each manufacturer. The phaseout period is the period beginning with the second calendar quarter following the calendar quarter which includes the first date on which the number of new qualified plug-in electric drive motor

[97] IRA 2022 Act §13401(i)(1)

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

vehicles manufactured by the manufacturer of the vehicle sold for use in the United States after December 31, 2009, is at least 200,000.[99]

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

- 50 percent for the first 2 calendar quarters of the phaseout period,
- 25 percent for the 3rd and 4th calendar quarters of the phaseout period, and
- 0 percent for each calendar quarter thereafter.[100]

Tesla and General Motors had both triggered phase out periods beginning in 2019.[101]

Although, as will be discussed later, the law immediately changes the credit to impose a requirement that final assembly of the vehicle take place in North America, the sales unit limitation is not repealed until after December 31, 2022. So, for the remainder of 2022, taxpayers will still not be able to qualify for this credit by purchasing vehicles manufactured by Tesla or General Motors.

Clients interested in vehicles manufactured by Tesla or General Motors will need to look into whether they and the specific vehicle they are interested in can qualify for the credit in 2023 or a later year.

IRA 2022 Provisions

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

Computation of the Credit for a Particular Vehicle

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

Now the credit is the total of—

- For an otherwise qualified vehicle that satisfies the *critical minerals* requirement, $3,750 and
- For an otherwise qualified vehicle that satisfies the *battery component* requirement, $3,750.[102]

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

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

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

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

For the vehicle to meet the *critical minerals requirement,* we test the battery from which the electric motor of such vehicle draws electricity. The percentage of the value of the *applicable critical minerals* contained in such battery that were—

- extracted or processed—
  - in the United States, or
  - in any country with which the United States has a free trade agreement in effect, or
- recycled in North America

must be equal to or greater than the *applicable percentage*.[103]

Critical minerals are defined by IRC §45X(c)(6) to include aluminum, antimony, barite, beryllium, cerium, cesium, chromium, cobalt, dysprosium, europium, fluorspar, gadolinium, germanium, graphite, indium, lithium, manganese, neodymium, nickel, niobium, tellurium, tin, tungsten, vanadium, yttrium, arsenic, bismuth, erbium, gallium, hafnium, holmium, iridium, lanthanum, lutetium, magnesium, palladium, platinum, praseodymium, rhodium, rubidium, ruthenium, samarium, scandium, tantalum, terbium, thulium, titanium, ytterbium, zinc, and zirconium.

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

- In the case of a vehicle placed in service after the date on which the proposed guidance is issued by the IRS and before January 1, 2024, 40%,
- in the case of a vehicle placed in service during calendar year 2024, 50%,
- in the case of a vehicle placed in service during calendar year 2025, 60%,
- in the case of a vehicle placed in service during calendar year 2026, 70%, and
- in the case of a vehicle placed in service after December 31, 2026, 80%.[104]

Any vehicle placed in service after December 31, 2024 is not a new clean vehicle if any of the critical minerals contained in the battery of such vehicle were extracted, processed, or recycled by a foreign entity of concern as defined in section 40207(a)(5) of the Infrastructure Investment and Jobs Act (42 U.S.C. 18741(a)(5)).[105]

The *battery component requirement* provides that, with respect to the battery from which the electric motor of such vehicle draws electricity, the percentage of the value of the components contained in such battery that were manufactured or assembled in North America is equal to or greater than the applicable percentage, as certified by the qualified manufacturer in the form and manner prescribed by the IRS.[106]

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

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

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

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

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

- In the case of a vehicle placed in service after the date on which the proposed guidance is issued by the IRS and before January 1, 2024, 50%,
- in the case of a vehicle placed in service during calendar year 2024 or 25, 60%,
- in the case of a vehicle placed in service during calendar year 2026, 70%,
- in the case of a vehicle placed in service during calendar year 2027, 80%,
- in the case of a vehicle placed in service during calendar year 2028, 90%, and
- in the case of a vehicle placed in service after December 31, 2028, 100%.[107]

The proposed guidance discussed for the two requirements is to be issued by the IRS no later than December 31, 2022.[108] On the IRS website for this credit, the IRS provides the following information with regard to the upcoming guidance:

> To reduce carbon emissions and invest in the energy security of the United States, the Inflation Reduction Act of 2022 significantly changes the eligibility rules for tax credits available for clean vehicles beginning in 2023. The Internal Revenue Service and the Department of the Treasury will post information and request comments from the public on various existing and new tax credit incentives in the coming weeks and months. Please look for updates on IRS.gov and other announcements from the Administration.[109]

Any vehicle placed in service after December 31, 2023, is not a new clean vehicle if any of the components contained in the battery of such vehicle were manufactured or assembled by a foreign entity of concern.[110]

Some concerns have been raised about the impact of requirements related to critical minerals or batteries on the supply of vehicles qualified for the credit, especially as the applicable percentages begin to increase each year.

Final Assembly Requirement

The *final assembly* of a vehicle must take place in North America for the vehicle to qualify for the credit. The term *final assembly* means the process by which a manufacturer produces a new clean vehicle at, or through the use of, a plant, factory, or other place from which the vehicle is delivered to a dealer or importer with all component parts necessary for the mechanical operation of the vehicle included with the vehicle, whether or not the component parts are permanently installed in or on the vehicle.[111]

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

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

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

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

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

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

This rule means taxpayers who had not made a binding commitment to purchase a qualified vehicle before August 16, 2022, will face a more limited selection of qualified vehicles to put in service by the end of 2022 than did taxpayers who made a binding commitment to purchase a qualified vehicle prior to that date.

The U.S. Department of Energy, following the enactment of the Act, has published a list of electric vehicles assembled in North America as of August 16, 2022.[112]

Model Year	Vehicle	Note
2022	Audi Q5	
2022	BMW 3-series Plug-In	
2022	BMW X5	
2022	Chevrolet Bolt EUV	Manufacturer sales cap met
2022	Chevrolet Bolt EV	Manufacturer sales cap met
2022	Chrysler Pacifica PHEV	
2022	Ford Escape PHEV	
2022	Ford F Series	
2022	Ford Mustang MACH E	
2022	Ford Transit Van	
2022	GMC Hummer Pickup	Manufacturer sales cap met
2022	GMC Hummer SUV	Manufacturer sales cap met
2022	Jeep Grand Cherokee PHEV	
2022	Jeep Wrangler PHEV	
2022	Lincoln Aviator PHEV	
2022	Lincoln Corsair Plug-in	
2022	Lucid Air	
2022	Nissan Leaf	
2022	Rivian EDV	
2022	Rivian R1S	
2022	Rivian R1T	
2022	Tesla Model 3	Manufacturer sales cap met
2022	Tesla Model S	Manufacturer sales cap met
2022	Tesla Model X	Manufacturer sales cap met
2022	Tesla Model Y	Manufacturer sales cap met
2022	Volvo S60	
2023	BMW 3-series Plug-In	
2023	Bolt EV	Manufacturer sales cap met

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

Model Year	Vehicle	Note
2023	Cadillac Lyriq	Manufacturer sales cap met
2023	Mercedes EQS	
2023	Nissan Leaf	

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

The article warns:

> Note that for some manufacturers, the build location may vary based on the specific vehicle, trim, or the date in the Model Year when it was produced because some models are produced in multiple locations. The build location of a particular vehicle should be confirmed by referring to its Vehicle Identification Number (VIN) using the VIN decoder described below or an information label affixed to the vehicle.[113].

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

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

Election to Apply Prior Rules During the Transition Period

If a taxpayer, after December 31, 2021, and before August 16, 2022, purchased, or entered into a written binding contract to purchase, a new qualified plug-in electric drive motor vehicle and that vehicle is placed in service on or after August 16, 2022, the taxpayer may elect to treat such vehicle as having been placed in service on August 15, 2022.[114] Thus, the taxpayer would optionally be able to use the pre-IRA 2022 rules, most likely to obtain a credit for a vehicle that would not meet the final assembly in North America provisions.

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

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

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

[114] IRA 2022 Act §13402(l)

> condition, as long as the condition is not within the control of either party. A contract will continue to be binding if the parties make insubstantial changes in its terms and conditions.[115]

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

> If you entered into a written binding contract to purchase a new qualifying electric vehicle before August 16, 2022, but do not take possession of the vehicle until on or after August 16, 2022 (for example, because the vehicle has not been delivered), you may claim the EV credit based on the rules that were in effect before August 16, 2022. The final assembly requirement does not apply before August 16, 2022.[116]

Definition of a New Clean Vehicle

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

- The minimum battery capacity is seven kilowatt hours (increased from four kilowatt hours)[117]
- Requires the seller to provide a report to the buyer and the IRS at such time and place where the IRS provides that contains:
  - the name and taxpayer identification number of the taxpayer,
  - the vehicle identification number of the vehicle, unless, in accordance with any applicable rules promulgated by the US Department of Transportation, the vehicle is not assigned such a number,
  - the battery capacity of the vehicle,
  - verification that original use of the vehicle commences with the taxpayer, and
  - the maximum credit under this section allowable to the taxpayer with respect to the vehicle.[118]
- The term "new clean vehicle" includes any new qualified fuel cell motor vehicle which meets the final assembly and report requirements in addition to the electric vehicles.[119]
- The vehicle must be made by a qualified manufacturer. A qualified manufacturer is a manufacturer who agrees to make periodic written reports to the IRS providing vehicle

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

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

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

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

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

identification numbers and such other information related to each vehicle manufactured by such manufacturer as the IRS may require.[120]

Only one new clean vehicle credit is allowed for each vehicle, determined by the vehicle identification number.[121] No credit will be allowed to the taxpayer unless the taxpayer includes the vehicle identification number of the automobile with the tax return.[122]

Limitation Based on Modified Adjusted Gross Income

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

No credit will be allowed for a taxable year if

- the lesser of—
  - the modified adjusted gross income of the taxpayer for such taxable year, or
  - the modified adjusted gross income of the taxpayer for the preceding taxable year, exceeds
- the *threshold amount*.[123]

The *threshold amount* shall be—

- in the case of a joint return or a surviving spouse, $300,000,
- in the case of a head of household, $225,000, and
- in the case of other taxpayers, $150,000.[124]

Modified adjusted gross income for this credit is the taxpayer's adjusted gross income increased by any amount excluded from gross income under IRC §§911 (foreign earned income and foreign housing exclusion), 931 (income from sources within Guam, American Samoa, or the Northern Mariana Islands), or 933 (income from sources within Puerto Rico).[125]

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

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

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

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

[123] IRC §30D(f)(10)(A)

[124] IRC §30D(f)(10)(B)

[125] IRC §30D(f)(10)(C)

While, as discussed later, a taxpayer can assign the credit to the dealer at the time of purchase, a taxpayer who fails to meet the modified adjusted gross income test in that year will have his/her/their tax increased by the amount of the credit transferred to the dealer.[126]

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

Manufacturer's Suggested Retail Price Limitation

In addition to restricting the credit to taxpayers with income below the threshold amounts, the law also denies the credit for vehicles whose manufacturer's suggested retail price exceeds certain levels. If the *manufacturer's suggested retail price* exceeds the *applicable limitation* no credit will be allowed.[127]

The applicable limitations are—

- Vans - $80,000,
- Sports utility vehicles - $80,000,
- Pickup trucks - $80,000, and
- Other vehicles - $55,000.[128]

The IRS is directed to issue regulations or other guidance necessary for determining vehicle classifications using criteria similar to that employed by the Environmental Protection Agency and the Department of Energy to determine size and class of vehicles.[129]

Credit Transferred to Dealer to Receive Reduced Purchase Price

Beginning in 2024, if the taxpayer acquires a new clean vehicle that qualifies for this credit, the taxpayer may elect to transfer the credit to the dealer (referred to as the *eligible entity*) as long as the dealer fulfills certain conditions. [130]

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

- Registered with the IRS (in such form and at such time as the IRS may prescribe) and that registration has not been revoked by the IRS for failure to comply with the requirements of the program,

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

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

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

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

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

- Prior to the election by the taxpayer and not later than at the time of such sale, disclosed to the taxpayer purchasing such vehicle—
  - The manufacturer's suggested retail price,
  - The value of the credit allowed and any other incentive available for the purchase of such vehicle, and
  - The amount provided by the dealer to such taxpayer as a condition of making this election.
- Not later than at the time of such sale, made payment to such taxpayer (whether in cash or in the form of a partial payment or down payment for the purchase of such vehicle) in an amount equal to the credit otherwise allowable to such taxpayer, and
- With respect to any incentive otherwise available for the purchase of a vehicle for which a credit is allowed under this section, including any incentive in the form of a rebate or discount provided by the dealer or manufacturer, ensured that—
  - The availability or use of such incentive shall not limit the ability of a taxpayer to make the election to transfer the credit to the dealer and
  - Such election shall not limit the value or use of such incentive.[131]

The election to transfer the credit to the dealer shall be made by the taxpayer purchasing the vehicle no later than the date on which the vehicle for which the credit is allowed is purchased.[132]

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

- Shall not be includible in the gross income of the taxpayer/buyer and
- Shall not be deductible by the dealer.[133]

Even though the credit is not claimed by the taxpayer, the taxpayer will still be required to reduce the basis of the vehicle acquired.[134]

If the taxpayer would not have been eligible to claim the credit in the year the vehicle was acquired due to failing to meet the modified adjusted gross income requirement, the taxpayer's tax for the year in question will be increased by the amount of the payment made to the dealer to the taxpayer.[135]

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

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

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

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

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

Termination of Credit

The credit will not apply to any vehicle placed in service after December 31, 2032.[136]

Credit for Previously-Owned Clean Vehicles

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

IRA 2022 adds a new credit for purchasers of *previously-owned clean vehicles*.[137] The credit is equal to the lesser of:

- $4,000, or
- 30 percent of the sales price of the vehicle.

The credit is available to a *qualified buyer* for the year in which the vehicle is placed in service.[138]

Previously-Owned Clean Vehicle Defined

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

- the model year of which is at least 2 years earlier than the calendar year in which the taxpayer acquires such vehicle,
- the original use of which commences with a person other than the taxpayer,
- which is acquired by the taxpayer in a *qualified sale*, and
- which—
  - Generally, meets the requirements to be eligible for the clean vehicle credit or
  - Is a clean fuel-cell vehicle which has a gross vehicle weight rating of less than 14,000 pounds[139]

Qualified Sale

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

- By a dealer,
- For a sales price that does not exceed $25,000, and

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

[137] IRC §25E added by IRA 2022

[138] IRC §25E(a) added by IRA 2022

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

- Which is the first transfer since the date of the enactment of IRA to a *qualified buyer* other than the person with whom the original use of such vehicle commenced.[140]

Qualified Buyer Defined

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

- Who is an individual,
- Who purchases such vehicle for use and not for resale,
- Who is not eligible to be claimed as a dependent by another taxpayer, and
- Who has not been allowed a credit under this section for any sale during the 3-year period ending on the date of the sale of such vehicle.[141]

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

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

No credit will be allowed unless the taxpayer provides the vehicle identification number for the vehicle on which the credit is being claimed on that year's tax return.[142]

Modified Adjusted Gross Income Limitation

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

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

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

exceeds the *threshold amount* for this credit.

The threshold amount is—

- Joint return or surviving spouse, $150,000

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

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

[142] IRC §25E(d)

- Head of household, $112,500 and
- Any other taxpayer, $75,000.

MAGI is computed in the same manner as it is for the new clean vehicle credit.[143]

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

Transfer of Credit

Again, like the new clean vehicle credit, beginning in 2024 this credit can be transferred to the dealer and used to help fund the purchase of the vehicle immediately rather than waiting for credit when a tax return is filed the following year. And, again, there is a recapture provision that could greatly surprise the unwary buyer.

IRC §25E simply references the transfer of credit provisions found in the new clean vehicle credit at IRC §30D(g).[144]

Termination of Credit

The credit will no longer be available for vehicles acquired after December 31, 2032.[145]

New Credit for Qualified Commercial Clean Vehicles

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

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

Amount of the Credit

The initial credit amount is the lesser of—

- 15 percent of the basis of such vehicle (30 percent in the case of a vehicle not powered by a gasoline or diesel internal combustion engine), or
- the *incremental cost* of such vehicle.[146]

[143] IRC §25E(b) as added by IRA 2022

[144] IRC §25E(f) as added by IRA 2022

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

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

The *incremental cost* of a qualified commercial clean vehicle is an amount equal to the excess of the purchase price for such vehicle over such price of a *comparable vehicle*.[147] A *comparable vehicle* means any vehicle which is powered solely by a gasoline or diesel internal combustion engine and which is comparable in size and use to such vehicle.

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

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

- In the case of a vehicle which has a gross vehicle weight rating of less than 14,000 pounds, $7,500, and
- In the case of a vehicle with a weight rating of 14,000 pounds or more, $40,000.[148]

Qualified Commercial Clean Vehicle Defined

A *qualified commercial clean vehicle* means any vehicle—

- That meets the definition of a new clean vehicle for purposes of the new clean vehicle credit found at IRC §30D(d)(1)(C) and is acquired for use or lease by the taxpayer and not for resale,
- Either—
  - Is treated as a motor vehicle for purposes of title II of the Clean Air Act and is manufactured primarily for use on public streets, roads, and highways (not including a vehicle operated exclusively on a rail or rails), or
  - Is mobile machinery, as defined in IRC §4053(8) (including vehicles that are not designed to perform a function of transporting a load over the public highways),
- Either—
  - Is propelled to a significant extent by an electric motor which draws electricity from a battery which has a capacity of not less than 15 kilowatt hours (or, in the case of a vehicle which has a gross vehicle weight rating of less than 14,000 pounds, 7 kilowatt hours) and is capable of being recharged from an external source of electricity, or
  - Is a motor vehicle which satisfies the following requirements:
    - Which is propelled by power derived from 1 or more cells which convert chemical energy directly into electricity by combining oxygen with hydrogen fuel which is stored on board the vehicle in any form and may or may not require reformation prior to use, and

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

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

    - Which, in the case of a passenger automobile or light truck, has received on or after the date of the enactment of this section a certificate that such vehicle meets or exceeds the Bin 5 Tier II emission level established in regulations prescribed by the Administrator of the Environmental Protection Agency under section 202(i) of the Clean Air Act for that make and model year vehicle, and

- Is of a character subject to the allowance for depreciation.[149]

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

- the United States, any State or political subdivision thereof, any possession of the United States, or any agency or instrumentality of any of the foregoing,

- an organization (other than a cooperative described in section 521) which is exempt from tax imposed by this chapter, or

- any Indian tribal government described in section 7701(a)(40).[150]

No Double Benefit Allowed

No credit will be allowed under this provision with respect to any vehicle to which a clean vehicle credit under IRC §30D was allowed.[151]

Vehicle Identification Number Must Be Provided

No credit will be allowed unless the taxpayer includes the vehicle identification number of such vehicle on the return of tax for the taxable year.[152]

Certain Clean Vehicle Credit Rules Apply

Rules like those found in the clean vehicle credit at IRC §30D(f), except for those found at (10) and (11), will apply to this credit.[153]

Termination

The credit will not apply to any vehicle acquired after December 31, 2032.[154]

[149] IRC §45W(c) as added by IRA 2022

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

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

[152] IRC §45W(e) as added by IRA 2022

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

[154] IRC §45W(g) as added by IRA 2022

Alternative Fuel Refueling Property Credit

Effective date: The delay in termination for credits under this section is effective for property placed in service after December 31, 2021. For all other provisions found in IRA 2022, the provisions are effective for property placed in service after December 31, 2022. Thus, the credit continues under the rules in place for 2021 for 2022, then is revised beginning in 2023.

IRA §13404 extends and revises the alternative fuel refueling property credit found at IRC §30C. The prior credit, which originally expired at the end of 2021, provided for a tax credit for any alternative fuel vehicle refueling property placed in service by a business or at the residence of a taxpayer equal to 30% of the cost of equipment placed in service at a particular location during the year subject to a maximum credit of:

- $30,000 for any property subject to an allowance for depreciation (business property) or
- $1,000 for property at the taxpayer's residence for personal use.[155]

Prior Law Version of Credit Extended Through 2022

The law first extends the version of the credit that had expired at the end of 2021 to now include property placed in service in 2022.[156] The other provisions added to IRC §30C will first apply to property placed in service in 2023.

Revised Basic Credit

The revised credit applies to the cost of any qualified alternative fuel vehicle refueling property placed in service by the taxpayer during the taxable year. The credit is equal to:

- 6% up to a maximum credit of $100,000 for qualified alternative fuel property subject to depreciation (business property) or
- 30% up to a maximum of $1,000 for any other qualified property.[157]

The credit for property subject to depreciation is increased to 30% if the wage and apprenticeship requirements of IRC §30C(g) are met. The increased percentage applies to all qualified property that is part of a *qualified alternative fuel vehicle refueling project*, which is a project consisting of one or more properties that are part of a single project.

The project meets the requirement to obtain the higher credit for qualifying property if it is either:

- A project the construction of which begins prior to the date that is 60 days after the IRS issues guidance on meeting the *prevailing wage* and *apprenticeship* requirements or
- A project that meets the *prevailing wage* and *apprenticeship* requirements.[158]

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155 IRC §30C prior to amendment by IRA 2022

156 IRA 2022 Act §13404(f)(2)

157

158 IRC §30C(g)(1)(C) as added by IRA 2022

The *prevailing wage requirement* to be met for a project involving depreciable property to qualify for the full 30% credit are met for a project if the taxpayer ensures that any laborers and mechanics employed by the taxpayer or any contractor or subcontractor in the construction of any qualified alternative fuel vehicle refueling property which is part of such project shall be paid wages at rates not less than the prevailing rates for construction, alteration, or repair of a similar character in the locality in which such project is located as most recently determined by the Department of Labor, in accordance with subchapter IV of chapter 31 of title 40, United States Code.[159]

A taxpayer that does not meet this requirement may still qualify for the increased credit by following the correction and penalty steps outlined in IRC §45(b)(7)(B). The taxpayer meets the correction step by paying each laborer or mechanic the difference between the compensation paid on the project and the amount required to be paid to meet the prevailing wage requirement plus interest at a rate 3 points higher than the rate at IRC §6621. As well, a penalty equal to $5,000 times each person paid less than the prevailing rate must be paid to the IRS.

A taxpayer would only make this payment to obtain the higher credit if the value of the increased credit exceeded the additional wage payment and the penalty, taking into account the fact that the penalty is likely not deductible for income tax purposes. That is, a taxpayer may simply elect to take the lower credit rather than paying the higher wages on the project.

The penalty makes it important to counsel clients on the trade-off between the reduced penalty and the higher wages before the project is undertaken.

The *apprenticeship requirements* are met if the taxpayer meets requirements similar to those at IRC §45(b)(8). The rules generally require that no less than the *applicable percentage* of the total labor hours of the construction, alteration, or repair work (including such work performed by any contractor or subcontractor) with respect to such facility shall, subject to the apprentice to journeyworker ratio rule described at IRC §45(b)(8)(B), be performed by qualified apprentices.[160]

The *qualified percentage* is determined based on the date construction begins. The *qualified percentage* will be:

- In the case of a project the construction of which begins before January 1, 2023, 10 percent,
- In the case of a project the construction of which begins after December 31, 2022, and before January 1, 2024, 12.5 percent, and
- In the case of a project the construction of which begins after December 31, 2023, 15 percent.[161]

Regardless of the percentage, each taxpayer, contractor, or subcontractor who employs 4 or more individuals to perform construction, alteration, or repair work with respect to the project construction shall employ 1 or more qualified apprentices to perform such work.[162]

[159] IRC §30C(g)(2)(A)

[160] IRC §45(b)(8)(A)

[161] IRC §45(b)(8)(A)(ii)

[162] IRC §45(b)(8)(C)

The taxpayer may be excused for failing to meet the apprenticeship requirement if it can meet the *good faith effort* exception. The rule provides:

> (ii) Good faith effort. For purposes of clause (i), a taxpayer shall be deemed to have satisfied the requirements under this paragraph with respect to a qualified facility if such taxpayer has requested qualified apprentices from a registered apprenticeship program, as defined in section 3131(e)(3)(B), and—
>
>> (I) such request has been denied, provided that such denial is not the result of a refusal by the taxpayer or any contractors or subcontractors engaged in the performance of construction, alteration, or repair work with respect to such qualified facility to comply with the established standards and requirements of the registered apprenticeship program, or
>>
>> (II) the registered apprenticeship program fails to respond to such request within 5 business days after the date on which such registered apprenticeship program received such request.[163]

IRC §3131(e)(3)(B) provides "[t]he term 'registered apprenticeship program' means an apprenticeship registered under the Act of August 16, 1937 (commonly known as the 'National Apprenticeship Act'; 50 Stat. 664, chapter 663; 29 U.S.C. 50 *et seq.*) that meets the standards of subpart A of part 29 and part 30 of title 29, Code of Federal Regulations."

As with the *prevailing wage* rule, a taxpayer who fails to meet this test can pay a penalty to the IRS to have the project treated as qualifying, though there is no additional amount to be paid to laborers. The penalty is equal to $50 times the total labor hours for which the requirement described in such subparagraph was not satisfied with respect to the construction, alteration, or repair work on the project.[164] However if the failure is due to intentional disregard of the requirements, the per hour penalty increases to $500 per hour.[165]

As with the prevailing wage issue, the taxpayer must consider the cost of this potentially nondeductible penalty with the reduction in the credit amount. The taxpayer may prefer to just accept the lower credit amount than incur the additional costs that may apply to comply with this rule or pay the penalty in lieu of compliance.

Additional Property Qualified

Qualified alternative fuel vehicle refueling property is expanded to include *bidirectional charging equipment* and electric charging stations for two- and three-wheeled vehicles that are intended for use on public roads.

The *bidirectional charging equipment* provision provides that property will not fail to be treated as qualified refueling property solely because the property—

- is capable of charging the battery of a motor vehicle propelled by electricity, and

[163] IRC §45(b)(8)(D)(ii)

[164] IRC §45(b)(8)(D)(i)(II)

[165] IRC §45(b)(8)(D)(iii)

- allows discharging electricity from such battery to an electric load external to such motor vehicle.[166]

The law provides that electronic charging stations qualify for this credit if

- The property otherwise meets the requirements to be qualified alternative fuel vehicle refueling property under IRC §30C,
- Is of a character subject to depreciation, and
- Is for recharging of a motor vehicle which—
  - Is manufactured primarily for use on public streets, roads, or highways (not including a vehicle operated exclusively on a rail or rails),
  - Has 2 or 3 wheels, and
  - Is propelled by electricity.[167]

Eligible Census Tract Requirement

The law also requires that the property be installed in an eligible census tract.[168] An eligible census tract is any population census tract which –

- Is a low-income community described in IRC §45D(e), or
- Is not an urban area.[169]

For these purposes, an *urban area* is "a census tract (as defined by the Bureau of the Census) which, according to the most recent decennial census, has been designated as an urban area by the Secretary of Commerce."[170]

Termination of Credit

The credit does not apply to property placed in service after December 31, 2032.[171]

PROVISIONS MAINLY APPLICABLE TO LARGE PUBLIC CORPORATIONS

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

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[166] IRC §30C(c)(2) as added by IRA 2022

[167] IRC §30C(f) as added by IRA 2022

[168] IRC §30C(c)(3)(A) as added by IRA 2022

[169] IRC §30C(c)(3)(B)(i) as added by IRA 2022

[170] IRC § 30C(c)(3)(B)(ii) as added by IRA 2022

[171] IRC §30C(i) as added by IRA 2022

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

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

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

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

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

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

- Prior to the current taxable year and
- End after December 31, 2021.[172]

A corporation meets the *average annual adjusted financial statement income test* for a taxable year if the average annual adjusted financial statement income of such corporation (determined without regard to section 56A(d)) for the 3-taxable-year period ending with such taxable year exceeds $1,000,000,000.[173]

The tentative minimum tax applies at a rate of 15% of the *adjusted financial statement income* as determined under IRC §56A over the corporate AMT tax credit for the tax year. The tax applies to the extent the tentative minimum tax exceeds the corporation's regular income tax for the year, including the base erosion and anti-abuse tax (BEAT) for the year.[174]

The *adjusted financial statement income* begins with the net income or loss found on the taxpayer's applicable financial statement per IRC §451(b)(3).[175] Various adjustments, including substituting MACRS depreciation for GAAP depreciation are made to this income.

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

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

[174] IRC §55(a) as added by IRA 2022

[175] IRC §56A as added by IRA 2022

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

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

The law also imposes on each *covered corporation* a tax equal to 1% of the fair market value of stock the corporation repurchases. A *covered corporation* is a U.S. corporation which is traded on an established securities market (as defined in IRC §7704(b)(1)), or basically a publicly traded security.[176]

The tax does not apply in various circumstances:

- To the extent that the repurchase is part of a reorganization (within the meaning of section 368(a)) and no gain or loss is recognized on such repurchase by the shareholder by reason of such reorganization,
- In any case in which the stock repurchased is, or an amount of stock equal to the value of the stock repurchased is, contributed to an employer-sponsored retirement plan, employee stock ownership plan, or similar plan,
- In any case in which the total value of the stock repurchased during the taxable year does not exceed $1,000,000,
- Under regulations prescribed by the Secretary, in cases in which the repurchase is by a dealer in securities in the ordinary course of business,
- To repurchases by a regulated investment company (as defined in section 851) or a real estate investment trust, or
- To the extent that the repurchase is treated as a dividend for income tax purposes.[177]

[176] IRC §4501(b)

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

NOTES

Unit

3

SECURE 2.0 Act of 2022

LEARNING OBJECTIVES

- Understand how the various revisions to fringe benefit rules added in the SECURE 2.0 Act of 2022 applies to your business

The SECURE 2.0 Act of 2022 was signed into law as part of the Consolidated Appropriations Act, 2023 (CAA 2023), on December 29, 2022. Division T of the CAA 2023 contains the SECURE 2.0 Act of 2022.

EXPANDING COVERAGE AND INCREASING RETIREMENT SAVINGS (TITLE I)

Expanding Automatic Enrollment in Retirement Plans (Section 101)

Effective Date: Plan years beginning after December 31, 2024.

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 101

One of the main reasons many Americans reach retirement age with little or no savings is that too few workers are offered an opportunity to save for retirement through their employers. However, even for those employees who are offered a retirement plan at work, many do not participate. But automatic enrollment in 401(k) plans – providing for people to participate in the plan unless they take the initiative to opt out – significantly increases participation. Since first defined and approved by the Treasury Department in 1998, automatic enrollment has boosted participation by eligible employees generally, and particularly for Black, Latinx, and lower-wage employees. An early study found that adoption of automatic enrollment increased participation in a 401(k) plan by short-tenure Latinx employees from 19 percent to 75 percent. An Ariel/Aon-Hewitt study found that, in plans using automatic enrollment, "[t]he most dramatic increases in enrollment rates are among younger, lower-paid employees, and the racial gap in participation rates is nearly eliminated among employees subject to auto-enrollment."

Section 101 requires 401(k) and 403(b) plans to automatically enroll participants in the respective plans upon becoming eligible (and the employees may opt out of coverage). The initial automatic enrollment amount is at least 3 percent but not more than 10 percent. Each year thereafter that amount is increased by 1 percent until it reaches at least 10 percent, but not more than 15 percent.

All current 401(k) and 403(b) plans are grandfathered. There is an exception for small businesses with 10 or fewer employees, new businesses (i.e., those that have been in business for less than 3 years), church plans, and governmental plans. Section 101 is effective for plan years beginning after December 31, 2024.

Analysis

New IRC §414A is added by the Act which details requirements for automatic enrollment for §401(k) and §403(b) salary reduction plans. The requirements apply (with exceptions) to:

- A qualified cash or deferred arrangement described in §401(k) and
- An annuity contract otherwise described in §403(b) which is purchased under a salary reduction agreement.[178]

The plan must meet the automatic enrollment requirements found in IRC §414(w)(3) which requires an arrangement:

- Under which a participant may elect to have the employer make payments as contributions under the plan on behalf of the participant, or to the participant directly in cash,
- Under which the participant is treated as having elected to have the employer make such contributions in an amount equal to a uniform percentage of compensation provided under the plan until the participant specifically elects not to have such contributions made (or specifically elects to have such contributions made at a different percentage), and
- Which meets the notice requirements found in IRC §414(w)(4).[179]

The notice shall be given within a reasonable period before plan year to each employee. Such notice must provide information about the rights and obligations under the arrangement which:

- Is sufficiently accurate and comprehensive to apprise the employee of such rights and obligations, and
- is written in a manner calculated to be understood by the average employee to whom the arrangement applies.[180]

The notice will not be treated as meeting these requirements unless:

- The notice includes an explanation of the employee's right under the arrangement to elect not to have elective contributions made on the employee's behalf (or to elect to have such contributions made at a different percentage),
- The employee has a reasonable period of time after receipt of the notice and before the first elective contribution is made to make such election, and

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[178] IRC §414A(a)

[179] IRC §414A(b)

[180] IRC §414(w)(4)(A)

- The notice explains how contributions made under the arrangement will be invested in the absence of any investment election by the employee.[181]

The program must allow for permissible withdrawals as defined in IRC §414(w)(2). Such a withdrawal:

- Is made pursuant to an election by an employee, and
- Consists of elective contributions under the program (and earnings attributable thereto).[182]

The election must be made no later than 90 days after the date of the first elective contribution with regard to the employee.[183] As well, the amount of any distribution by reason of the election is equal to the amount of elective contributions made with respect to the first payroll period to which the eligible automatic contribution arrangement applies to the employee and any succeeding payroll period beginning before the effective date of the election (and earnings attributable thereto).[184]

Minimum Contribution Percentage

The uniform percentage of compensation contributed by the participant under such arrangement during the first year of participation is not less than 3% and not more than 10% unless the participant specifically elects not to have such contributions made or to have such contributions made at a different percentage.[185] This percentage is then increased as of the first day of each subsequent year by 1% point to at least 10% but not more than 15% unless the participant specifically elects not to have such contributions made or to have such contributions made at a different percentage.[186]

The ceiling is reduced to 10% for plan years ending before January 1, 2025 except for an arrangement meeting the requirements of IRC §401(k)(12) or (13).[187]

Investment Requirements

The arrangement must provide that the amounts contributed pursuant to such arrangement, and for which no investment is elected by the participant, are invested in accordance with the requirements of section 2550.404c-5 of title 29, Code of Federal Regulations[188] (or any successor regulations).[189]

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[181] IRC §414(w)(4)(B)

[182] IRC §414(w)(2)(A)

[183] IRC §414(w)(2)(B)

[184] IRC §414(w)(2)(C)

[185] IRC §414W(b)(3)(A)(i)

[186] IRC §414W(b)(3)(A)(ii)

[187] IRC §414W(b)(3)(B)

[188] https://www.ecfr.gov/current/title-29/subtitle-B/chapter-XXV/subchapter-F/part-2550/section-2550.404c-5 (Retrieved December 26, 2022)

[189] IRC §414(b)(4)

Exceptions

There are a number of plans that are exempt from these requirements.

The automatic enrollment requirements do not apply to SIMPLE plans (as defined in IRC §401(k)(11)).[190]

Generally, the rules do not apply to preexisting plans and arrangements, specifically exempting:

- Any qualified cash or deferred arrangement established before the date of enactment of this section or
- Any annuity contract purchased under a plan established before the date of enactment of this section.[191]

However, the preexisting plan/arrangement exception does not apply in the case of an employer adopting after the date of enactment a plan maintained by more than one employer. In such a case, the automatic enrollment rules will apply with respect to that employer as if the plan were a single plan.[192]

The automatic enrollment provisions also do not apply to:

- Any governmental plan (within the meaning of IRC §414(d) or
- Any church plan (within the meaning of IRC §414(e).[193]

New businesses get an exemption from the automatic enrollment requirements. The law provides that the automatic enrollment provisions do not apply to any qualified cash or deferred arrangement, or any annuity contract purchased under a plan, while the employer maintaining such plan (and any predecessor employer) has been in existence for less than 3 years.[194]

A small employer exception to these rules is also found in the Act. The automatic enrollment rules shall not apply to any qualified cash or deferred arrangement, or any annuity contract purchased under a plan, earlier than the date that is 1 year after the close of the first taxable year with respect to which the employer maintaining the plan normally employed more than 10 employees.[195]

A multiple employer plan applies the new business and small business exception separately for each qualifying employers. Such a multiple employer plan shall treat all employer that do not qualify for either the new business or small employer exception applies as maintaining a single plan.[196]

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[190] IRC §414W(c)(1)

[191] IRC §414W(c)(2)(A)

[192] IRC §414W(c)(2)(B)

[193] IRC §414W(c)(3)

[194] IRC §414W(c)(4)(A)

[195] IRC §414W(c)(4)(B)

[196] IRC §414W(c)(4)(C)

Modification of Credit for Small Employer Pension Plan Startup Costs (Section 102)

Effective Date: Taxable years beginning after December 31, 2022.

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 102

The 3-year small business startup credit is currently 50 percent of administrative costs, up to an annual cap of $5,000. Section 102 makes changes to the credit by increasing the startup credit from 50 percent to 100 percent for employers with up to 50 employees. Except in the case of defined benefit plans, an additional credit is provided. The amount of the additional credit generally will be a percentage of the amount contributed by the employer on behalf of employees, up to a per-employee cap of $1,000. This full additional credit is limited to employers with 50 or fewer employees and phased out for employers with between 51 and 100 employees. The applicable percentage is 100 percent in the first and second years, 75 percent in the third year, 50 percent in the fourth year, 25 percent in the fifth year – and no credit for tax years thereafter. Section 102 is effective for taxable years beginning after December 31, 2022.

Analysis

Prior to the SECURE 2.0 Act changes, IRC §45E provided for a credit equal to 50% of *qualified startup costs* paid or incurred by an *eligible employer*. The credit, which only applies for three consecutive years, cannot exceed the greater of:

- $500 or
- The lesser of
  - $250 for each employee (other than highly compensated employees) of the employer who is eligible to participate in the plan or
  - $5,000.[197]

The plan must be a new plan, meaning the employer does not qualify if, during the 3-taxable year period immediately preceding the 1st taxable year for which the credit under this section is otherwise allowable for a qualified employer plan of the employer, the employer or any member of any controlled group including the employer (or any predecessor of either) established or maintained a qualified employer plan with respect to which contributions were made, or benefits were accrued, for substantially the same employees as are in the qualified employer plan.[198]

An *eligible employer* is an employer which had no more than 100 employees who received at least $5,000 of compensation from the employer for the preceding year.[199]

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[197] IRC §45E(b)

[198] IRC §45E(c)(2)

[199] IRC §45E(c)(2), IRC §408(p)(2)(C)(i)(

SECURE 2.0 Act Modifications

The SECURE Act 2.0 both double the base credit for those who employ 50 or fewer employees and creates an additional credit.

Increased Credit for Employers with 50 or Fewer Employees

The small business pension plan startup costs credit is modified for employers who have 50 or fewer employees who received at least $5,000 of compensation from the employer for the preceding year.[200] Such employers will qualify for a credit equal to 100% (up from 50%) of qualified plan startup costs paid or incurred by the taxpayer during the taxable year.[201]

Employer Contribution Credit

An additional credit is added to IRC §45E by the SECURE 2.0 Act, a credit based on employer contributions to the plan. The §45E credit is increased by an amount equal to the *applicable percentage* of employer contributions by the employer to an eligible employer plan. The credit does not apply, though, to employer contributions to defined benefit plans.[202]

This portion of the credit is subject to a $1,000 per employee limitation.[203]

The *applicable percentage* [204]is 100% for the taxable year in which the plan is established, with the percentage in following years determined under this table:

Taxable year following the year the plan is established	Applicable percentage
1st	100%
2nd	75%
3rd	50%
4th	25%
Any subsequent years	0%

Contributions made to employees who receives wages from the employer during the taxable year in excess of $100,000 are excluded in computing this additional credit.[205] For taxable years

[200] IRC §45E(e)(4), IRC §408(p)(2)(C)(i)

[201] IRC §45E(e)(4)

[202] IRC §45E(f)(1)

[203] IRC §45E(f)(2)(A)

[204] IRC §45E(f)(3)

[205] IRC §45E(f)(2)(C)(i)

beginning in a calendar year after 2023, the $100,000 value will be indexed for inflation in $5,000 increments.[206]

For employers with more than 50 employees, the credit is phased-out ratably up to 100 employees.[207]

For purposes of determining whether an employer is an eligible employer the requirement for a new qualified employer plan found at IRC §45E(c)(2) shall only apply to the taxable year during which the eligible employer plan to which this section applies is established with respect to the eligible employer.[208]

IRC §45E(e)(2) is amended to provide that deductions for employer contributions for a year are to be reduced by the amount of the additional credit allowed. IRC §45(e)(2) had already reduced the deduction for the applicable administrate costs by the amount of standard §45E(a) credit allowed for those costs.

Saver's Match (Section 103)

Effective Date: Taxable years beginning after December 31, 2026

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 103

Current law provides for a nonrefundable credit for certain individuals who make contributions to individual retirement accounts ("IRAs"), employer retirement plans (such as 401(k) plans), and ABLE accounts. Section 103 repeals and replaces the credit with respect to IRA and retirement plan contributions, changing it from a credit paid in cash as part of a tax refund into a federal matching contribution that must be deposited into a taxpayer's IRA or retirement plan. The match is 50 percent of IRA or retirement plan contributions up to $2,000 per individual. The match phases out between $41,000 and $71,000 in the case of taxpayers filing a joint return ($20,500 to $35,500 for single taxpayers and married filing separate; $30,750 to $53,250 for head of household filers). Section 103 is effective for taxable years beginning after December 31, 2026.

Promotion of Saver's Match (Section 104)

Effective Date: The Treasury Department must report on its anticipated promotional efforts no later than July 1, 2026

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 104

Section 104 directs the Treasury Department to increase public awareness of the Saver's Match to increase use of the match by low and moderate income taxpayers. The promotion will make clear that the Saver's Match cannot be withdrawn without incurring penalties, including repayment to the Treasury Department in some cases where the Saver's Match is withdrawn from an individual retirement account before retirement. Taxpayers will have an election to designate a retirement

[206] IRC §45E(f)(2)(C)(iii)

[207] IRC §45E(f)(2)(B)

[208] IRC §45E(f)(4)

account to receive the repaid Saver's Match. The Treasury Secretary must report to Congress on the Treasury Department's anticipated promotion efforts no later than July 1, 2026.

Pooled Employer Plan Modification (Section 105)

Effective Date: Plan years beginning after December 31, 2022

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 105

Section 105 clarifies that a pooled employer plan ("PEP") may designate a named fiduciary (other than an employer in the plan) to collect contributions to the plan. Such fiduciary would be required to implement written contribution collection procedures that are reasonable, diligent, and systematic. Section 105 is effective for plan years beginning after December 31, 2022.

Multiple Employer 403(b) Plans (Section 106)

Effective Date: Plan years beginning after December 31, 2022

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 106

Multiple employer plans ("MEPs") provide an opportunity for small employers to band together to obtain more favorable retirement plan investment results and more efficient and less expensive management services. The Setting Every Community Up for Retirement Enhancement Act of 2019 ("SECURE Act") made MEPs more attractive by eliminating outdated barriers to the use of MEPs and improving the quality of MEP service providers. Section 106 allows 403(b) plans, which are generally sponsored by charities, educational institutions, and non-profits, to participate in MEPs and PEPs, including relief from the one bad apple rule so that the violations of one employer do not affect the tax treatment of employees of compliant employers. Section 106 is effective for plan years beginning after December 31, 2022.

Increase in Age for Required Beginning Date for Mandatory Distributions (Section 107)

Effective Date: Distributions required to be made after December 31, 2022, with respect to individuals who attain age 72 after such date. But see the note below about a drafting error in the bill.

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 107

Under current law, participants are generally required to begin taking distributions from their retirement plans at age 72. The policy behind this rule is to ensure that individuals spend their retirement savings during their lifetime and not use their retirement plans for estate planning purposes to transfer wealth to beneficiaries. The SECURE Act of 2019 increased the required minimum distribution age to 72. Section 107 further increases the required minimum distribution age further to 73 starting on January 1, 2023 – and increases the age further to 75 starting on January 1, 2033.

Drafting Problem for Those Born in 1959

The legislation contains a drafting glitch that results in the "applicable age" for those born in 1959 being *both* age 73 and age 75. Revised IRC §401(a)(9)(C)(v) reads:

> (v) APPLICABLE AGE.—
>
> > (I) In the case of an individual who attains age 72 after December 31, 2022, and age 73 before January 1, 2033, the applicable age is 73.
> >
> > (II) In the case of an individual who attains age 74 after December 31, 2032, the applicable age is 75.

A person born in 1959 will attain age 73 after December 31, 2022 and before January 1, 2033 (that is, during 2032). Per §409(a)(9)(C)(v)(I) that would make the individual's applicable age 73. Therefore, the individual's first required minimum distribution would have to take place no later than April 1, 2033.

However, that person would also have attained age 74 after December 31, 2032 (since they would turn 74 in 2033), making their applicable age 75, which would set the required beginning date at April 1, 2035 (since this person would reach age 75 in 2034).

It would appear that the law should stated that age 75 with the required beginning date for those who attained age 73 after December 31, 2032 to properly reflect the intent of the law.

Indexing IRA Catch-Up Limit (Section 108)

Effective Date: Taxable years beginning after December 31, 2023

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 108

Under current law, the limit on IRA contributions is increased by $1,000 (not indexed) for individuals who have attained age 50. Section 108 indexes such limit and is effective for taxable years beginning after December 31, 2023.

Analysis

The indexing described above provided for in IRC §219(b)(5)(C)(iii) will take place in $100 increments.

Higher Catch-Up Limit to Apply at Age 60, 61, 62 and 63 (Section 109)

Effective Date: Taxable years beginning after December 31, 2024.

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 109

Under current law, employees who have attained age 50 are permitted to make catch-up contributions under a retirement plan in excess of the otherwise applicable limits. The limit on catch-up contributions for 2021 is $6,500, except in the case of SIMPLE plans for which the limit

is $3,000. Section 109 increases these limits to the greater of $10,000 or 50 percent more than the regular catch-up amount in 2025 for individuals who have attained ages 60, 61, 62 and 63. The increased amounts are indexed for inflation after 2025. Section 109 is effective for taxable years beginning after December 31, 2024.

Treatment of Student Loan Payments as Elective Deferrals for Purposes of Matching Contributions (Section 110)

Effective Date: Contributions for plan years beginning after December 31, 2023

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 110

Section 110 is intended to assist employees who may not be able to save for retirement because they are overwhelmed with student debt, and thus are missing out on available matching contributions for retirement plans. Section 110 allows such employees to receive those matching contributions by reason of repaying their student loans. Section 110 permits an employer to make matching contributions under a 401(k) plan, 403(b) plan, or SIMPLE IRA with respect to "qualified student loan payments." A qualified student loan payment is broadly defined as any indebtedness incurred by the employee solely to pay qualified higher education expenses of the employee. Governmental employers are also permitted to make matching contributions in a section 457(b) plan or another plan with respect to such repayments. For purposes of the nondiscrimination test applicable to elective contributions, Section 110 permits a plan to test separately the employees who receive matching contributions on student loan repayments. Section 110 is effective for contributions made for plan years beginning after December 31, 2023.

Application of Credit for Small Employer Pension Plan Startup Costs to Employers (Section 111)

Effective Date: Retroactively effective for taxable years beginning after December 31, 2019

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 111

Section 111 ensures the startup tax credit is available for 3 years for employers joining a MEP, regardless of how long the MEP has been in existence. Under both pre- and post-SECURE Act law, the startup tax credit only applies for the first 3 years that a plan is in existence. For example, if a small business joins a MEP that has already been in existence for 3 years, the startup credit is not available. If, for example, the MEP has been existence for 1 or 2 years when a small business joins, the small business may be able to claim the credit for 1 or 2 years, respectively. Section 111 fixes this issue so that employers joining a MEP (which includes PEPs) are eligible for the credit for all 3 years. Section 111 is effective retroactively for taxable years beginning after December 31, 2019.

Military Spouse Retirement Plan Eligibility Credit for Small Employers (Section 112)

Effective Date: Taxable years beginning after the date of enactment of this Act.

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 112

Military spouses often do not remain employed long enough to become eligible for their employer's retirement plan or to vest in employer contributions. Section 112 provides small employers a tax credit with respect to their defined contribution plans if they (1) make military spouses immediately eligible for plan participation within two months of hire, (2) upon plan eligibility, make the military spouse eligible for any matching or nonelective contribution that they would have been eligible for otherwise at 2 years of service, and (3) make the military spouse 100 percent immediately vested in all employer contributions. The tax credit equals the sum of (1) $200 per military spouse, and (2) 100 percent of all employer contributions (up to $300) made on behalf of the military spouse, for a maximum tax credit of $500. This credit applies for 3 years with respect to each military spouse – and does not apply to highly compensated employees. An employer may rely on an employee's certification that such employee's spouse is a member of the uniformed services. Section 112 is effective for taxable years beginning after the date of enactment of this Act.

Small Immediate Incentives for Contributing to a Plan (Section 113)

Effective Date: Plan years beginning after the date of enactment of this Act.

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 113

Under current law, employers may provide matching contributions as a long-term incentive for employees to contribute to a 401(k) plan. However, immediate financial incentives (like gift cards in small amounts) are prohibited even though individuals may be especially motivated by them to join their employers' retirement plans. Section 113 enables employers to offer de minimis financial incentives, not paid for with plan assets, such as low-dollar gift cards, to boost employee participation in workplace retirement plans by exempting de minimis financial incentives from section 401(k)(4)(A) and from the corresponding rule under section 403(b). Section 113 is effective for plan years beginning after the date of enactment of this Act.

Potential Unexpected Interaction with De Minimis Fringe Benefit Rules at IRC §132

While the Act allows for these de minimis incentives to be paid out by an employer to an employee without jeopardizing the qualification of the employee retirement plan, that does not mean such incentives might not end up being taxable income to the employee.

While IRC §132(a)(4) does provide for an exclusion from income for *de minimis* fringe benefits, §132 has its own, section specific definition of what is such a *de minimis* fringe benefit. IRC

§132(e)(1) contains this definition that must be met for the incentive to avoid inclusion in income:

> (e) **De minimis fringe defined**. For purposes of this section--
>
> > (1) **In general**. The term "de minimis fringe" means any property or service the value of which is (after taking into account the frequency with which similar fringes are provided by the employer to the employer's employees) so small as to make accounting for it unreasonable or administratively impracticable.

The key issue is that the benefit must be one for which it is unreasonable or administratively impracticable to account for.

The Senate Finance Committee explanation specifically offers up as an example of a *de minimis* incentive that would not put plan qualification at risk the provision of low dollar amount gift cards to an employee for participation in the retirement plan.

However, since such cards have a specific dollar amount stated, Reg. §1.132-6(c) takes the position that such gift certificate items are cash equivalents that must always be included in the employee's income:

> (c) **Administrability.** Unless excluded by a provision of chapter 1 of the Internal Revenue Code of 1986 other than section 132(a)(4), the value of any fringe benefit that would not be unreasonable or administratively impracticable to account for is includible in the employee's gross income. Thus, except as provided in paragraph (d)(2) of this section, the provision of any cash fringe benefit is never excludable under section 132(a) as a de minimis fringe benefit. Similarly except as otherwise provided in paragraph (d) of this section, a cash equivalent fringe benefit (such as a fringe benefit provided to an employee through the use of a gift certificate or charge or credit card) is generally not excludable under section 132(a) even if the same property or service acquired (if provided in kind) would be excludable as a de minimis fringe benefit.[209]

Thus, if the plan sponsor gave each employee participating in the retirement plan for the year a $10 gift card for Starbucks, that $10 would have to be included in the employee's W-2 as income subject to withholding for the year, as well as being subject to payroll taxes unless the IRS adopts changes to the regulations under IRC §132 to exclude items determined to be *de minimis* retirement plan incentives.

[209] Treasury Reg. §1.132-6(c)

Deferral of Tax for Certain Sales of Employer Stock to Employee Stock Ownership Plans (Section 114)

Effective Date: Sales after December 31, 2027.

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 114

Under section 1042 of the Internal Revenue Code ("Code"), an individual owner of stock in a non-publicly traded C corporation that sponsors an employee stock ownership plan ("ESOP") may elect to defer the recognition of gain from the sale of such stock to the ESOP if the seller reinvests the sales proceeds into qualified replacement property, such as stock or other securities issued by a U.S. operating corporation. After the sale, the ESOP must own at least 30 percent of the employer corporation's stock. Section 114 expands the gain deferral provisions of Code section 1042 with a 10 percent limit on the deferral to sales of employer stock to S corporation ESOPs. Section 114 is effective for sales made after December 31, 2027.

Withdrawals for Certain Emergency Expenses (Section 115)

Effective Date: Distributions made after December 31, 2023.

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 115

Generally, an additional 10 percent tax applies to early distributions from tax-preferred retirement accounts, such as 401(k) plans and IRAs, unless an exception applies. Section 115 provides an exception for certain distributions used for emergency expenses, which are unforeseeable or immediate financial needs relating to personal or family emergency expenses. Only one distribution is permissible per year of up to $1,000, and a taxpayer has the option to repay the distribution within 3 years. No further emergency distributions are permissible during the 3 year repayment period unless repayment occurs. Section 115 is effective for distributions made after December 31, 2023.

Allow Additional Nonelective Contributions to SIMPLE Plans (Section 116)

Effective Date: Taxable years beginning after December 31, 2023.

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 116

Current law requires employers with SIMPLE plans to make employer contributions to employees of either 2 percent of compensation or 3 percent of employee elective deferral contributions. Section 116 permits an employer to make additional contributions to each employee of the plan in a uniform manner, provided that the contribution may not exceed the lesser of up to 10 percent of compensation or $5,000 (indexed). Section 116 is effective for taxable years beginning after December 31, 2023.

Contribution Limit for SIMPLE Plans (Section 117)

Effective Date: Change to contribution limits applies for taxable years beginning after December 31, 2023. Treasury shall report to Congress on data related to SIMPLE-IRAs by December 31, 2024 and annually thereafter.

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 117

Under current law, the annual contribution limit for employee elective deferral contributions to a SIMPLE IRA plan is $14,000 (2022) and the catch-up contribution limit beginning at age 50 is $3,000. A SIMPLE IRA plan may only be sponsored by a small employer (100 or fewer employees), and the employer is required to either make matching contributions on the first 3 percent of compensation deferred or an employer contribution of 2 percent of compensation (regardless of whether the employee elects to make contributions). Section 117 increases the annual deferral limit and the catch-up contribution at age 50 by 10 percent, as compared to the limit that would otherwise apply in the first year this change is effective, in the case of an employer with no more than 25 employees. An employer with 26 to 100 employees would be permitted to provide higher deferral limits, but only if the employer either provides a 4 percent matching contribution or a 3 percent employer contribution. Section 117 makes similar changes to the contribution limits for SIMPLE 401(k) plans. Section 117 is effective for taxable years beginning after December 31, 2023. The Secretary of Treasury shall report to Congress on data related to SIMPLE IRAs by December 31, 2024, and annually thereafter.

Tax Treatment for Certain Non-Trade or Business SEP Contributions (Section 118)

Effective Date: Taxable years beginning after the date of enactment of this Act.

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 118

Section 118 permits employers of domestic employees (e.g., nannies) to provide retirement benefits for such employees under a Simplified Employee Pension ("SEP"). Section 118 is effective for taxable years beginning after date of enactment of this Act.

Application of §415 Limit for Certain Employees of Rural Electric Cooperatives (Section 119)

Effective Date: Effective for limitation years ending after date of enactment of this Act.

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 119

Under current law, section 415 generally limits the amount that may be paid by a pension plan in annual benefits to a participant to the lesser of $245,000 (2022) or 100 percent of the participant's average compensation. Section 119 eliminates the compensation-based limit for participants who are non-highly compensated employees and participate in a rural electric cooperative retirement plan. Section 119 is effective for limitation years ending after the date of enactment of this Act.

Exemption for Certain Automatic Portability Transactions (Section 120)

Effective Date: Transactions occurring on or after the date that is 12 months after the date of the enactment of the Act.

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 120

Under current law, an employer is permitted to distribute a participant's account balance without participant consent if the balance is under $5,000 and the balance is immediately distributable (e.g., after a termination of employment). Current law also requires an employer to roll over this distribution into a default IRA if the account balance is at least $1,000 and the participant does not affirmatively elect otherwise. Section 120 permits a retirement plan service provider to provide employer plans with automatic portability services. Such services involve the automatic transfer of a participant's default IRA (established in connection with a distribution from a former employer's plan) into the participant's new employer's retirement plan, unless the participant affirmatively elects otherwise. Section 120 is effective for transactions occurring on or after the date which is 12 months after the date of enactment of this Act.

Starter §401(k) Plans for Employers with No Retirement Plan (Section 121)

Effective Date: Plan years beginning on or after December 31, 2023.

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 121

Section 121 permits an employer that does not sponsor a retirement plan to offer a starter 401(k) plan (or safe harbor 403(b) plan). A starter 401(k) plan (or safe harbor 403(b) plan) would generally require that all employees be default enrolled in the plan at a 3 to 15 percent of compensation deferral rate. The limit on annual deferrals would be the same as the IRA contribution limit, which for 2022 is $6,000 with an additional $1,000 in catch-up contributions beginning at age 50. Section 121 is effective for plan years beginning after December 31, 2023.

Assisting States in Locating Owners of Applicable Savings Bonds (Section 122)

Effective Date: Effective on the date of enactment of this Act.

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 122

To facilitate efforts to locate the owners of matured and unredeemed savings bonds, Section 122 requires the Treasury Secretary to share certain relevant information with a state that relates to an applicable savings bond registered to an owner with a last known or registered address in that state. The state is permitted to use that information to locate the registered owner in accordance with the state's standards for recovery of abandoned property. Section 122 further requires the Treasury Secretary to develop guidance as may be necessary to carry out the proper disclosure and protection of such information. The Treasury Secretary also is required to submit to the Senate Appropriations and Finance Committees and House Appropriations and Ways and Means

Committees an annual report assessing its efforts to provide states with information on unclaimed savings bonds. Section 122 is effective on the date of enactment of this Act.

Certain Securities Treated as Publicly Traded in Case of Employee Stock Ownership Plans (Section 123)

Effective Date: Plan years beginning after December 31, 2027.

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 123

Section 123 updates certain ESOP rules related to whether a security is a "publicly traded employer security" and "readily tradeable on an established securities market." Section 123 allows certain non-exchange traded securities to qualify as "publicly traded employer securities" so long as the security is subject to priced quotations by at least four dealers on a Securities and Exchange Commission-regulated interdealer quotation system, is not a penny stock and is not issued by a shell company, and has a public float of at least 10 percent of outstanding shares. For securities issued by domestic corporations, the issuer must publish annual audited financial statements. Securities issued by foreign corporations are subject to additional depository and reporting requirements. The updated definitions in Section 123 will allow highly regulated companies with liquid securities that are quoted on non-exchange markets to treat their stock as "public" for ESOP purposes, thus making it easier for these companies to offer ESOPs to their U.S. employees. Section 123 is effective for plan years beginning after December 31, 2027.

Modification of Age Requirement for Qualified Able Programs (Section 124)

Effective Date: Taxable years beginning after December 31, 2025.

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 124

Current law allows states to create qualified ABLE programs, which are tax-advantaged savings programs for certain people with disabilities. Distributions from an ABLE account are tax-free if used for qualified disability expenses of the account's designated beneficiary. Section 124 increases the age by which blindness or disability must occur for an individual to be an eligible individual by reason of such blindness or disability for an ABLE program. Section 124 is effective for taxable years beginning after December 31, 2025.

Improving Coverage for Part-Time Workers (Section 125)

Effective Date: The reduction of the 3 year rule to 2 years is effective for plan years beginning after December 31, 2024. The provisions providing that pre-2021 service is disregarded for vesting purposes is retroactively effective as if included in the SECURE Act of 2019.

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 125

The SECURE Act requires employers to allow long-term, part-time workers to participate in the employers' 401(k) plans. The SECURE Act provision provides that – except in the case of collectively bargained plans – employers maintaining a 401(k) plan must have a dual eligibility

requirement under which an employee must complete either 1 year of service (with the 1,000-hour rule) or 3 consecutive years of service (where the employee completes at least 500 hours of service). Section 125 reduces the 3 year rule to 2 years, effective for plan years beginning after December 31, 2024. Section 125 also provides that pre-2021 service is disregarded for vesting purposes, just as such service is disregarded for eligibility purposes under current law, effective as if included in the SECURE Act to which the amendment relates. This provision also extends the long-term part-time coverage rules to 403(b) plans that are subject to ERISA.

Special Rules for Certain Distributions from Long-Term Qualified Tuition Programs to Roth IRAs (Section 126)

Effective Date: Distributions made after December 31, 2023.

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 126

Section 126 amends the Internal Revenue Code to allow for tax and penalty free rollovers from 529 accounts to Roth IRAs, under certain conditions. Beneficiaries of 529 college savings accounts would be permitted to rollover up to $35,000 over the course of their lifetime from any 529 account in their name to their Roth IRA. These rollovers are also subject to Roth IRA annual contribution limits, and the 529 account must have been open for more than 15 years.

Families and students have concerns about leftover funds being trapped in 529 accounts unless they take a non-qualified withdrawal and assume a penalty. This has led to hesitating, delaying, or declining to fund 529s to levels needed to pay for the rising costs of education. Section 126 eliminates this concern by providing families and students with the option to avoid the penalty, resulting in families putting more into their 529 account. Families who sacrifice and save in 529 accounts should not be punished with tax and penalty years later if the beneficiary has found an alternative way to pay for their education. They should be able to retain their savings and begin their retirement account on a positive note. Section 126 is effective with respect to distributions after December 31, 2023.

Emergency Savings Accounts Link to Individual Account Plans (Section 127)

Effective Date: Plan years beginning after 2023.

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 127

Though individuals can save on their own, far too many fail to do so. According to a report by the Federal Reserve, almost half of Americans would struggle to cover an unexpected $400 expense. Many are forced to tap into their retirement savings. A recent study found that, in the past year, almost 60 percent of retirement account participants who lack emergency savings tapped into their long- term retirement savings, compared to only 9 percent of those who had at least a month of emergency savings on hand. Separating emergency savings from one's retirement savings account will provide participants a better understanding that one account is for short-term emergency needs and the other is for long-term retirement savings, thus empowering employees to handle unexpected financial shocks without jeopardizing their long-term financial security in retirement through emergency hardship withdrawals.

Section 127 provides employers the option to offer to their non-highly compensated employees pension-linked emergency savings accounts. Employers may automatically opt employees into these accounts at no more than 3 percent of their salary, and the portion of an account attributable to the employee's contribution is capped at $2,500 (or lower as set by the employer). Once the cap is reached, the additional contributions can be directed to the employee's Roth defined contribution plan (if they have one) or stopped until the balance attributable to contributions falls below the cap. Contributions are made on a Roth-like basis and are treated as elective deferrals for purposes of retirement matching contributions with an annual matching cap set at the maximum account balance – i.e., $2,500 or lower as set by the plan sponsor. The first four withdrawals from the account each plan year may not be subject to any fees or charges solely on the basis of such withdrawals. At separation from service, employees may take their emergency savings accounts as cash or roll it into their Roth defined contribution plan (if they have one) or IRA.

Enhancement of §403(b) Plans (Section 128)

Effective Date: Amounts invested after the date of enactment of this Act.

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 128

Under current law, 403(b) plan investments are generally limited to annuity contracts and publicly traded mutual funds. This limitation cuts off 403(b) plan participants – generally, employees of charities and public schools, colleges, and universities– from access to collective investment trusts, which are often used by 401(a) plans to expand investment options for plan participants at a lower overall cost. Section 128 would permit 403(b) custodial accounts to participate in group trusts with other tax-preferred savings plans and IRAs, and would be effective after date of enactment.

PRESERVATION OF INCOME (TITLE II)

Remove Required Minimum Distribution Barriers for Life Annuities (Section 201)

Effective Date: Calendar years ending after the date of enactment of the Act.

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 201

Section 201 eliminates certain barriers to the availability of life annuities in qualified plans and IRAs that arise under current law due to an actuarial test in the required minimum distribution regulations. The test is intended to limit tax deferral by precluding commercial annuities from providing payments that start out small and increase excessively over time. In operation, however, the test commonly prohibits many important guarantees that provide only modest benefit increases under life annuities. For example, guaranteed annual increases of only 1 or 2 percent, return of premium death benefits, and period certain guarantees for participating annuities are commonly prohibited by this test. Without these types of guarantees, many individuals are unwilling to elect a life annuity under a defined contribution plan or IRA. Section 201 is effective for calendar years ending after the date of enactment of this Act.

Qualifying Longevity Annuity Contracts (Section 202)

Effective Date: Contracts purchased or received in an exchange on or after the date of enactment of this Act. Treasury must update the regulations within 18 months of the date of enactment of this Act.

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 202

In 2014, the Treasury Department published final regulations on qualifying longevity annuity contracts ("QLACs"). QLACs are generally deferred annuities that begin payment at the end of an individual's life expectancy. Because payments start so late, QLACs are an inexpensive way for retirees to hedge the risk of outliving their savings in defined contribution plans and IRAs. The minimum distribution rules were an impediment to the growth of QLACs in defined contribution plans and IRAs because those rules generally require payments to commence at age 72, before QLACs begin payments. The 2014 regulations generally exempted QLACs from the minimum distribution rules until payments commence. However, due to a lack of statutory authority to provide a full exemption, the regulations imposed certain limits on the exemption that have prevented QLACs from achieving their intended purpose in providing longevity protection. Section 202 addresses these limitations by repealing the 25 percent limit w *[sic]* and allowing up to $200,000 (indexed) to be used from an account balance to purchase a QLAC. Section 202 also facilitates the sales of QLACs with spousal survival rights – and clarifies that free-look periods are permitted up to 90 days with respect to contracts purchased or received in an exchange on or after July 2, 2014. Section 202 is effective for contracts purchased or received in an exchange on the date of enactment of this Act, and the Treasury Secretary must update the relevant regulations within 18 months of the date of enactment of this Act.

Insurance-Dedicated Exchange-Traded Funds (Section 203)

Effective Date: Applies to segregated asset account investments made on or after the date which is seven years after the date of enactment of this Act.

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 203

Exchange-traded funds ("ETFs") are pooled investment vehicles that are traded on stock exchanges. They are similar to mutual funds, except the shares can be traded throughout the day on the stock market, rather than having to be held until after the market closes. ETFs are widely available through retirement plans, IRAs, and taxable investment accounts. However, outdated Treasury Department regulations have prevented ETFs from being widely available through individual variable annuities. Simply because the regulations were written before ETFs existed, ETFs cannot satisfy the regulatory requirements to be "insurance-dedicated." Section 203 directs the Treasury Department to update the regulations to reflect the ETF structure to provide that ownership of an ETF's shares by certain types of institutions that are necessary to the ETF's structure would not preclude look-through treatment for the ETF, as long as it otherwise satisfies the current-law requirements for look-through treatment. This essentially would facilitate the creation of a new type of ETF that is "insurance-dedicated." Section 203 is effective for segregated asset account investments made on or after 7 years after the date of enactment of this Act, and directs the Treasury Secretary to update the relevant regulations by that time.

Eliminating a Penalty on Partial Annuitization (Section 204)

Effective Date: Date of enactment of this Act.

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 204

If a tax-preferred retirement account also holds an annuity, current law requires that the account be bifurcated between the portion of the account holding the annuity and the rest of the account for purposes of applying the required minimum distribution rules. This treatment may result in higher minimum distributions than would have been required if the account did not hold an annuity. Section 204 permits the account owner to elect to aggregate distributions from both portions of the account for purposes of determining minimum distributions and is effective on the date of enactment of this Act. The Treasury Secretary is to update the relevant regulations accordingly.

SIMPLIFICATION AND CLARIFICATION OF RETIREMENT PLAN RULES (TITLE III)

Recovery of Retirement Plan Overpayments (Section 301)

Effective Date: Date of enactment of this Act.

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 301

Sometimes retirees mistakenly receive more money than they are owed under their retirement plans. These mistakes cause problems when they occur over time, and plan fiduciaries later seek to recover the overpayments from unsuspecting retirees. When an overpayment has lasted for years, plans often compel retirees to repay the amount of the overpayment, plus interest, which can be substantial. Even small overpayment amounts can create a hardship for a retiree living on a fixed income. Section 301 allows retirement plan fiduciaries the latitude to decide not to recoup overpayments that were mistakenly made to retirees. If plan fiduciaries choose to recoup overpayments, limitations and protections apply to safeguard innocent retirees. This protects both the benefits of future retirees and the benefits of current retirees. Rollovers of the overpayments also remain valid. Section 301 is effective on the date of enactment of this Act, and further outlines how plan fiduciaries may proceed with respect to determinations made prior to the date of enactment of this Act to seek or not to seek recovery of overpayments.

Reduction of Excise Tax on Certain Accumulations in Retirement Plans (Section 302)

Effective Date: Taxable years beginning after the date of enactment of this Act.

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 302

Section 302 reduces the penalty for failure to take required minimum distributions from 50 to 25 percent. Further, if a failure to take a required minimum distribution from an IRA is corrected in a timely manner, as defined under this Act, the excise tax on the failure is further reduced from 25

percent to 10 percent. Section 302 is effective for taxable years beginning after the date of enactment of this Act.

Retirement Savings Lost and Found (Section 303)

Effective Date: Database to be created no later than 2 years after the date of enactment of this Act.

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 303

Every year, thousands of people approach retirement but are unable to find and receive the benefits that they earned often because the company they worked for moved, changed its name, or merged with a different company. Similarly, every year there are employers around the country ready to pay benefits to retirees, but they are unable to find the retirees because the former employees changed their names or addresses. Section 303 creates a national online searchable lost and found database for Americans' retirement plans at the Department of Labor ("DOL"). The database will enable retirement savers, who might have lost track of their pension or 401(k) plan, to search for the contact information of their plan administrator. Section 303 directs the creation of the database no later than 2 years after the date of enactment of this Act.

Updating Dollar Limit for Mandatory Distributions (Section 304)

Effective Date: Distributions made after December 31, 2023.

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 304

Under current law, employers may transfer former employees' retirement accounts from a workplace retirement plan into an IRA if their balances are between $1,000 and $5,000. Section 307 inc

Expansion of Employee Plans Compliance Resolution System (EPCRS) (Section 305)

Effective Date: Date of enactment of this Act.

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 305

Because of the ever growing complexity of retirement plan administration, Section 305 expands the Employee Plans Compliance Resolution System ("EPCRS") to (1) allow more types of errors to be corrected internally through self-correction, (2) apply to inadvertent IRA errors, and (3) exempt certain failures to make required minimum distributions from the otherwise applicable excise tax. For example, Section 305 allows for correction of many plan loan errors through self-correction, which are a frequent area of error and can be burdensome to correct a single loan error through the Internal Revenue Service. Section 305 is effective on the date of enactment of this Act. Any guidance or revision of guidance required by Section 305 shall be promulgated no later than 2 years after the date of enactment of this Act. Revenue Procedure 2021–30 (or any successor guidance) shall be updated to take into account the provisions of this section no later than 2 years after the date of enactment of this Act.

Eliminate the "First Day of the Month" Requirement for Governmental §457(b) Plans (Section 306)

Effective Date: Taxable years beginning after the date of enactment of this Act.

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 306

Under current law, participants in a governmental 457(b) plan must request changes in their deferral rate prior to the beginning of the month in which the deferral will be made. This rule does not exist for other defined contribution plans. Section 306 allows such elections to be made at any time prior to the date that the compensation being deferred is available. Section 306 is effective for taxable years beginning after the date of enactment of this Act.

One-Time Election for Qualified Charitable Distribution to Split-Interest Entity (Section 307)

Effective Date: Taxable years beginning after the date of enactment of this Act.

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 307

Section 307 expands the IRA charitable distribution provision to allow for a one-time, $50,000 distribution to charities through charitable gift annuities, charitable remainder unitrusts, and charitable remainder annuity trusts, effective for distributions made in taxable years beginning after the date of enactment of this Act. Section 307 also indexes for inflation the annual IRA charitable distribution limit of $100,000, effective for distributions made in taxable years ending after the date of enactment of this Act.

Distributions to Firefighters (Section 308)

Effective Date: Distributions made after the date of enactment of this Act.

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 308

Under current law, if an employee terminates employment after age 55 and takes a distribution from a retirement plan, the 10 percent early distribution tax does not apply. However, there is a special rule for "qualified public safety employees" in governmental plans, under which age 50 is substituted for age 55 for purposes of this exception from the 10 percent tax. This exemption applies to public sector firefighters, but not private sector firefighters. Section 308 extends the age 50 rule to private sector firefighters, who merit the same treatment for distributions. Section 308 is effective for distributions made after the date of enactment of this Act.

Exclusion of Certain Disability-Related First Responder Retirement Payments (Section 309)

Effective Date: Amounts received with respect to taxable years beginning after December 31, 2026.

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 309

Section 309 permits first responders to exclude service-connected disability pension payments from gross income after reaching retirement age. Section 309 is effective for amounts received in taxable years beginning after December 31, 2026.

Application of Top Heavy Rules to Defined Contribution Plans Covering Excludable Employees (Section 310)

Effective Date: Plan years beginning after December 31, 2023.

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 310

Under current law, qualified retirement plans must pass the top-heavy test, in addition to other nondiscrimination tests. Plans that are deemed top-heavy are required to provide employees with a minimum of a 3 percent of pay nonelective contribution, which is a significant cost to small businesses. Other nondiscrimination tests that apply to 401(k) plans allow an employer to test otherwise excludable employees (e.g., those who are under age 21 and have less than 1 year of service) separately. This was intended to encourage plan sponsors to permit employees to defer earlier than the minimum age and service conditions permitted under the law because it reduces the situations where plans would fail the nondiscrimination tests if these employees were included when performing the test. However, this separate testing is not allowed for the top-heavy test. Small business retirement plans often do not cover excludable employees because, if the plan is or becomes top heavy, the employer may be required to contribute a top-heavy employer contribution for all employees who are eligible to participate in the plan, straining the budget for these small businesses. Section 310 allows an employer to perform the top-heavy test separately on the non-excludable and excludable employees. This removes the financial incentive to exclude employees from the 401(k) plan and increase retirement plan coverage to more workers. Section 310 is effective for plan years beginning after December 31, 2023.

Repayment of Qualified Birth or Adoption Distributions Limited to 3 Years (Section 311)

Effective Date: Distributions made after the date of enactment of this Act and retroactively to the 3 year period beginning on the day after the date such distribution was received.

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 311

The SECURE Act included a provision that allows individuals to receive distributions from their retirement plan in the case of birth or adoption without paying the 10 percent additional tax under Code section 72(t) (known as a qualified birth or adoption distribution, or “QBAD”). The distributions can be recontributed to a retirement plan at any time and are treated as rollovers. The

problem with current law is the allowance of recontributions at any time. Code section 6511 prevents a refund from being provided to a taxpayer after the period of limitations for the return has closed, which is generally a 3 year period. Thus, there would not be a mechanism under the Code allowing someone who took a birth/adoption distribution to recontribute the distribution more than 3 years later and amend their return to receive a refund for the taxes that were paid in the year of the withdrawal. Section 311 amends the QBAD provision to restrict the recontribution period to 3 years. Section 311 is effective to distributions made after the date of the enactment of this Act and retroactively to the 3 year period beginning on the day after the date on which such distribution was received.

Employer May Rely on Employee Certifying That Deemed Hardship Distribution Conditions Met (Section 312)

Effective Date: Plan years beginning after the date of enactment of this Act.

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 312

Section 312 provides that, under certain circumstances, employees are permitted to self-certify that they have had an event that constitutes a hardship for purposes of taking a hardship withdrawal. This is a logical step in light of the success of the coronavirus-related distribution self-certification rules and the current hardship regulations that already permit employees to self-certify that they do not have other funds available to address a hardship. Section 312 is effective for plan years beginning after the date of enactment of this Act.

Individual Retirement Plan Statute of Limitations for Excise Tax on Excess Contributions and Certain Accumulations (Section 313)

Effective Date: Date of enactment of this Act.

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 313

Under current law, the statute of limitations for excise taxes imposed on excess contributions, or required minimum distribution failures start running as of the date that a specific excise tax return (Form 5329) is filed for the violation. Individuals often are not aware of the requirement to file Form 5329, and this can lead to an indefinite period of limitations that can cause hardship for taxpayers due to the accumulation of interest and penalties (see *Paschall v. C.I.R.*, 137 T.C. 8 (2011)). In order to provide finality for taxpayers in the administration of these excise taxes, Section 313 provides that a 3 year period of limitations begins when the taxpayer files an individual tax return (Form 1040) for the year of the violation, except in the case of excess contributions, in which case the period of limitations runs 6 years from the date Form 1040 is filed. There is a further exception from this 6 year rule for taxes that arise out of a bargain sale to the IRA. In general, these changes are intended to ensure that there is a reasonable period of limitations for violations of which taxpayers were not aware and thus did not file an excise tax return, while retaining existing law in fact scenarios that involve a bargain sale. Section 313 is effective on the date of enactment of this Act.

Penalty-Free Withdrawal from Retirement Plans for Individual in Case of Domestic Abuse (Section 314)

Effective Date: Distributions made after December 31, 2023

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 314

A domestic abuse survivor may need to access his or her money in their retirement account for various reasons, such as escaping an unsafe situation. Section 314 allows retirement plans to permit participants that self-certify that they experienced domestic abuse to withdraw a small amount of money (the lesser of $10,000, indexed for inflation, or 50 percent of the participant's account). A distribution made under Section 314 is not subject to the 10 percent tax on early distributions. Additionally, a participant has the opportunity to repay the withdrawn money from the retirement plan over 3 years and will be refunded for income taxes on money that is repaid. Section 318 is effective for distributions made after December 31, 2023.

Reform of Family Attribution Rule (Section 315)

Effective Date: Plan years beginning after December 31, 2023.

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 315

Under the Code, certain related businesses must be aggregated when performing the coverage and nondiscrimination tests. The aggregation rules are generally based on the degree of common ownership of the businesses. In determining the level of ownership in a business, the tax laws have certain attribution rules whereby an individual is deemed to own stock held by other individuals or entities. Section 315 updates two stock attribution rules. The first update addresses inequities where spouses with separate businesses reside in a community property state when compared to spouses who reside in separate property states. The second update modifies the attribution of stock between parents and minor children. Section 315 is effective for plan years beginning after December 31, 2023.

Amendments to Increase Benefit Accruals Under Plan for Previous Plan Year Allowed Until Employer Tax Return Due Date (Section 316)

Effective Date: Plan years beginning after December 31, 2023.

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 316

The SECURE Act permits an employer to adopt a new retirement plan by the due date of the employer's tax return for the fiscal year in which the plan is effective. Current law, however, provides that plan amendments to an existing plan must generally be adopted by the last day of the plan year in which the amendment is effective. This precludes an employer from adding plan provisions that may be beneficial to participants. Section 316 amends these provisions to allow discretionary amendments that increase participants' benefits to be adopted by the due date of the employer's tax return. Section 316 is effective for plan years beginning after December 31, 2023.

Retroactive Elective Deferrals for Sole Proprietors (Section 317)

Effective Date: Plan years beginning after December 31, 2023.

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 317

Under the SECURE Act, an employer may establish a new 401(k) plan after the end of the taxable year, but before the employer's tax filing date and treat the plan as having been established on the last day of the taxable year. Such plans may be funded by employer contributions up to the employer's tax filing date. Section 317 allows these plans, when they are sponsored by sole proprietors or single-member LLCs, to receive employee contributions up to the date of the employee's tax return filing date for the initial year. Section 317 is effective for plan years beginning after the date of enactment of this Act.

Performance Benchmarks for Asset Allocation Funds (Section 318)

Effective Date: The Department of Labor is to update its regulations no later than two years after the date of enactment of this Act.

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 318

The DOL's participant disclosure regulation requires that each designated investment alternative's historical performance be compared to an appropriate broad-based securities market index. However, the rule does not adequately address increasingly popular investments like target date funds that include a mix of asset classes. Section 318 directs the Labor Secretary to update the DOL's regulations so that an investment that uses a mix of asset classes can be benchmarked against a blend of broad-based securities market indices, provided (a) the index blend reasonably matches the fund's asset allocation over time, (b) the index blend is reset at least once a year, and (c) the underlying indices are appropriate for the investment's component asset classes and otherwise meet the rule's conditions for index benchmarks. This change in the disclosure rule allows better comparisons and aids participant decision-making. The DOL is to update its regulations no later than two years after enactment of this Act. Section 318 also requires DOL to report to Congress on the effectiveness of its benchmarking requirements no later than 3 years after the applicability date of the regulations.

Review and Report to Congress Relating to Reporting and Disclosure Requirements (Section 319)

Effective Date: Agency reports required to be delivered to Congress no later than three years after the date of enactment of this Act.

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 319

Section 319 directs the Treasury Department, DOL, and Pension Benefit Guaranty Corporation to review reporting and disclosure requirements for pension plans as soon as practicable after enactment of this Act. Section 319 further directs the agencies to make recommendations to Congress to consolidate, simplify, standardize, and improve such requirements no later than 3 years after the date of enactment of this Act.

Eliminating Unnecessary Plan Requirements Related to Unenrolled Participants (Section 320)

Effective Date: Plan years beginning after December 31, 2022.

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 320

Under current law, employees eligible to participate in a retirement plan are required to receive a broad array of notices that are intended to inform them of their various options and rights under the plan. In the case of eligible employees who have not elected to participate in the plan ("unenrolled participants"), these notices – such as notices regarding the different investment options available under the plan – are generally unnecessary, and can even have adverse effects on savings and coverage.

Section 320 no longer requires employers provide certain intermittent ERISA or Code notices to unenrolled participants who have not elected to participate in a workplace retirement plan. However, to further encourage participation of unenrolled participants, the plan is required to send (1) an annual reminder notice of the participant's eligibility to participate in the plan and any applicable election deadlines, and (2) any otherwise required document requested at any time by the participant. This rule applies only with respect to an unenrolled participant who received the summary plan description, in connection with initial eligibility under the plan, and any other notices related to eligibility under the plan required to be furnished. Section 320 is effective for plan years beginning after December 31, 2022.

Review of Pension Risk Transfer Interpretive Bulletin (Section 321)

Effective Date: Report due from Department of Labor no later than one year after the date of enactment of the Act.

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 321

Section 321 requires the DOL to review the current interpretive bulletin governing pension risk transfers to determine whether amendments are warranted and to report to Congress its finding, including an assessment of any risk to participant, no later than 1 year after enactment of this Act.

Tax Treatment of IRA Involved in a Prohibited Transaction (Section 322)

Effective Date: Taxable years beginning after the date of enactment of this Act.

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 322

When an individual engages in a prohibited transaction with respect to their IRA, the IRA is disqualified and treated as distributed to the individual, irrespective of the size of the prohibited transaction. Section 322 clarifies that if an individual has multiple IRAs, only the IRA with respect to which the prohibited transaction occurred will be disqualified. Section 322 is effective for taxable years beginning after the date of enactment of this Act.

Clarification of Substantially Equal Periodic Payment Rule (Section 323)

Effective Date: For transfers, rollovers, exchanges after December 31, 2023 and effective for annuity distributions on or after the date of enactment of this Act.

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 323

Current law imposes a 10 percent additional tax on early distributions from tax-preferred retirement accounts, but an exception applies to substantially equal periodic payments that are made over the account owner's life expectancy. Section 323 provides that the exception continues to apply in the case of a rollover of the account, an exchange of an annuity providing the payments, or an annuity that satisfies the required minimum distribution rules. Section 323 is effective for transfers, rollovers, exchanges after December 31, 2023 and effective for annuity distributions on or after the date of enactment of this Act.

Treasury Guidance on Rollovers (Section 324)

Effective Date: Development and release of the sample forms must be completed no later than January 1, 2025.

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 324

Section 324 requires the Treasury Secretary to simplify and standardize the rollover process by issuing sample forms for direct rollovers that may be used by both the incoming and outgoing retirement plan or IRA. Development and release of the sample forms must be completed no later than January 1, 2025.

Roth Plan Distribution Rules (Section 325)

Effective Date: Elimination of pre-death Roth plan distribution requirement is effective for taxable years beginning after December 31, 2023. The new law does not apply to distributions with respect to years beginning before January 1, 2024, but are permitted to be paid on or after such date.

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 325

Under current law, required minimum distributions are not required to begin prior to the death of the owner of a Roth IRA. However, pre-death distributions are required in the case of the owner of a Roth designated account in an employer retirement plan (e.g., 401(k) plan). Section 325 eliminates the pre-death distribution requirement for Roth accounts in employer plans, effective for taxable years beginning after December 31, 2023. Section 325 does not apply to distributions which are required with respect to years beginning before January 1, 2024, but are permitted to be paid on or after such date.

Exemption to Penalty on Early Distributions from Qualified Plans for Individuals with a Terminal Illness (Section 326)

Effective Date: Distributions made after the date of enactment of this Act.

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 326

Under current law, an additional 10 percent tax applies to early distributions from tax-preferred retirement accounts. Section 326 provides an exception to the tax in the case of a distribution to a terminally ill individual and would be effective for distributions made after the date of enactment of this Act.

Surviving Spouse Election to Be Treated as an Employee (Section 327)

Effective Date: Calendar years beginning after December 31, 2023.

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 327

Section 327 allows a surviving spouse to elect to be treated as the deceased employee for purposes of the required minimum distribution rules. Section 327 is effective for calendar years beginning after December 31, 2023.

Repeal of Direct Payment Requirement on Exclusion from Gross Income of Distributions from Governmental Plans for Health and Long-Term Care Insurance (Section 328)

Effective Date: Distributions made after the date of enactment of this Act.

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 328

Current law provides an exclusion from gross income ($3,000) for a distribution from a governmental retirement plan to a public safety officer to pay for their health insurance premiums. The exclusion requires that the plan directly pay the insurance premiums. Section 328 repeals the direct payment requirement and is effective for distributions made after the date of enactment of this Act.

Modification of Eligible Age for Exemption from Early Withdrawal Penalty (Section 329)

Effective Date: Distributions made after the date of enactment of this Act.

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 329

The 10 percent additional tax on early distributions from tax preferred retirement savings plans does not apply to a distribution from a governmental plan to a public safety officer who is at least

age 50. Section 329 extends the exception to public safety officers with at least 25 years of service with the employer sponsoring the plan and is effective for distributions made after the date of enactment of this Act.

Exemption from Early Withdrawal Penalty for Certain State and Local Government Corrections Employees (Section 330)

Effective Date: Distributions made after the date of enactment of this Act

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 330

Section 330 extends the public safety officer exception to the 10 percent early distribution tax to corrections officers who are employees of state and local governments, effective for distributions made after the date of enactment of this Act.

Special Rules for Use of Retirement Funds in Connection with Qualified Federally Declared Disasters (Section 331)

Effective Date: Disasters occurring after January 26, 2021.

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 331

Section 331 provides permanent rules relating to the use of retirement funds in the case of a federally declared disaster. The permanent rules allow up to $22,000 to be distributed from employer retirement plans or IRAs for affected individuals. Such distributions are not subject to the 10 percent additional tax and are taken into account as gross income over 3 years. Distributions can be repaid to a tax preferred retirement account. Additionally, amounts distributed prior to the disaster to purchase a home can be recontributed, and an employer is permitted to provide for a larger amount to be borrowed from a plan by affected individuals and for additional time for repayment of plan loans owed by affected individuals. Section 331 is effective for disasters occurring on or after January 26, 2021.

Employers Allowed to Replace SIMPLE Retirement Accounts with Safe Harbor §401(k) Plans During a Year (Section 332)

Effective Date: Plan years beginning after December 31, 2023.

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 332

Section 332 allows an employer to replace a SIMPLE IRA plan with a SIMPLE 401(k) plan or other 401(k) plan that requires mandatory employer contributions during a plan year, and is effective for plan years beginning after December 31, 2023.

Elimination of Additional Tax on Corrective Distributions of Excess Contributions (Section 333)

Effective Date: Applies to any determination of, or affecting, liability for taxes, interest, or penalties which is made on or after the date of the enactment of this Act, without regard to whether the act (or failure to act) upon which the determination is based occurred before such date of enactment.

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 333

Current law requires a distribution if too much is contributed to an IRA. The corrective distribution includes the excessive contribution and any earnings allocable to that contribution. Section 333 exempts the excess contribution and earnings allocable to the excess contribution from the 10 percent additional tax on early distributions, and is effective for any determination of, or affecting, liability for taxes, interest, or penalties which is made on or after the date of enactment of this Act, without regard to whether the act (or failure to act) upon which the determination is based occurred before such date of enactment.

Long-Term Care Contracts Purchased with Retirement Plan Distributions (Section 334)

Effective Date: Distributions made after the date which is three years after the date of enactment of the date of the Act.

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 334

Section 334 permits retirement plans to distribute up to $2,500 per year for the payment of premiums for certain specified long term care insurance contracts. Distributions from plans to pay such premiums are exempt from the additional 10 percent tax on early distributions. Only a policy that provides for high quality coverage is eligible for early distribution and waiver of the 10 percent tax. Section 334 is effective 3 years after date of enactment of this Act.

Corrections of Mortality Tables (Section 335)

Effective Date: Required amendments will be deemed to be made as of the date of enactment of the Act.

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 335

Section 335 generally requires that for purposes of the minimum funding rules, a pension plan is not required to assume beyond the plan’s valuation date future mortality improvements at any age greater than 0.78 percent. The Treasury Secretary shall amend the relevant regulation on the matter within 18 months, though Section 335 shall be deemed to take effect on the date of enactment of this Act.

Report to Congress on §402(f) Notices (Section 336)

Effective Date: Report due from Comptroller of the Currency no later than 18 months after the date of enactment of the Act.

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 336

Section 402(f) notices are given by employer retirement plans in the case of a distribution to a participant that is eligible for rollover to another tax preferred retirement account and describes distribution options and tax consequences. Section 336 requires the Government Accountability Office to issue a report to Congress on the effectiveness of section 402(f) notices within 18 months after the date of enactment of this Act.

Modification of Required Minimum Distribution Rules for Special Needs Trusts (Section 337)

Effective Date: Calendar years beginning after the date of enactment of the Act.

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 337

The SECURE Act placed limits on the ability of beneficiaries of defined contribution retirement plans and IRAs to receive lifetime distributions after the account owner's death. Special rules apply in the case of certain beneficiaries, such as those with a disability. Section 337 clarifies that, in the case of a special needs trust established for a beneficiary with a disability, the trust may provide for a charitable organization as the remainder beneficiary. Section 337 is effective for calendar years beginning after the date of enactment of this Act.

Requirement to Send Paper Statements in Certain Cases (Section 338)

Effective Date: Plan years beginning after December 31, 2025.

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 338

Section 338 amends ERISA to generally provide that, with respect to defined contribution plans, unless a participant elects otherwise, the plan is required to provide a paper benefit statement at least once annually. The other three quarterly statements required under ERISA are not subject to this rule (i.e., they can be provided electronically). For defined benefit plans, unless a participant elects otherwise, the statement that must be provided once every 3 years under ERISA must be a paper statement. The Labor Secretary must update the relevant sections of their regulations and corresponding guidance by December 31, 2024, and the annual paper statement is effective for plan years beginning after December 31, 2025.

Recognition of Tribal Government Domestic Relations Orders (Section 339)

Effective Date: Domestic relations orders received by plan administrators after December 31, 2022, including any such order which is submitted for reconsideration after such date.

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 339

Section 339 adds Tribal courts to the list of courts authorized under federal law to issue qualified domestic relations orders. Section 339 is effective to domestic relations orders received by plan administrators after December 31, 2022, including any such order which is submitted for reconsideration after such date.

Defined Contribution Plan Fee Disclosure Improvements (Section 340)

Effective Date: Actions by Department of Labor due three years after of enactment.

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 340

Section 340 builds on recommendations recently made to the DOL by the Government Accountability Office, and requires the agency to review its fiduciary disclosure requirements in participant-directed individual account plan regulations. A report must be submitted to Congress within 3 years on such findings, including recommendations for legislative changes.

Consolidation of Defined Contribution Plan Notices (Section 341)

Effective Date: Actions by Departments of Labor and Treasury not later than two years after date of enactment of this Act.

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 341

Current law requires certain retirement plan notices to be provided to participants as individual notices. Section 341 directs the Treasury and DOL Secretaries within 2 years to amend regulations to permit a plan to consolidate certain required plan notices.

Information Needed for Financial Options Risk Mitigation (Section 342)

Effective Date: Department of Labor must issue regulations not earlier than one year after date of enactment of this Act and they must be applicable not earlier than the issuance of a final rule and not later than one year after issuance of the final rule.

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 342

Section 342 requires pension plan administrators to provide plan participants and retirees with critical information that would allow people considering what is best for their financial futures to

compare between benefits offered under the plan and the lump sum, and would explain how the lump sum was calculated, the ramifications of accepting a lump sum, such as the loss of certain federal protections, details about the election period, where to follow up with questions, and other information. The DOL Secretary must issue regulations implementing this provision not earlier 1 year after enactment. Such regulations must be applicable not earlier than the issuance of a final rule and not later than 1 year after issuance of a final rule.

Defined Benefit Annual Funding Notices (Section 343)

Effective Date: Plan years beginning after December 31, 2023

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 343

Section 343 aims identify defined benefit pension plan funding issues more clearly on a plan's annual funding notice. Section 343 is effective for plan years beginning after December 31, 2023.

Report on Pooled Employer Plans (Section 344)

Effective Date: The Department of Labor study must be completed within five years.

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 344

Section 344 requires the DOL Secretary to conduct a study on the new and growing pooled employer plan industry. A report on the findings of the study must be completed within 5 years, with subsequent reports completed every 5 years thereafter.

Annual Audit for Group of Plans (Section 345)

Effective Date: Date of enactment of this Act.

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 345

Under current law, generally, a Form 5500 for a defined contribution plan must contain an opinion from an independent qualified public accountant as to whether the plan's financial statements and schedules are fairly presented. However, no such opinion is required with respect to a plan covering fewer than 100 participants. Section 345 clarifies that plans filing under a Group of Plans need only to submit an audit opinion if they have 100 participants or more. In other words, DOL and Treasury would continue to receive full audit information on at least the number of plans as under current law. Section 345 is effective on the date of enactment of this Act.

Worker Ownership, Readiness and Knowledge (Section 346)

Effective Date: Grants to be made in fiscal years 2025 to 2029

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 346

Section 346 boosts employee ownership programs through the DOL, which may make grants to promote employee ownership through existing and new programs. Funds are authorized to be appropriated for the purpose of making grants for fiscal years 2025 to 2029.

Report by the Secretary of Labor on the Impact of Inflation on Retirement Savings (Section 347)

Effective Date: Report to be submitted by Departments of Labor and Treasury within 90 days.

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 347

Section 347 directs the DOL Secretary, in consultation with the Treasury Secretary, to study the impact of inflation on retirement savings and submit a report to Congress within 90 days on the findings of the study.

Cash Balance (Section 348)

Effective Date: Plan years beginning after the date of enactment of this Act

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 348

Section 348 clarifies the application of the Code and ERISA's rules, prohibiting the backloading of benefit accruals, as they relate to hybrid plans that credit variable interest. Specifically, Section 348 clarifies that, for purposes of the applicable Code and ERISA rules, the interest crediting rate that is treated as in effect and as the projected interest crediting rate is a reasonable projection of such variable interest rate, subject to a maximum of 6 percent. This clarification will allow plan sponsors to provide larger pay credits for older longer service workers. Section 346 is effective for plan years beginning after the date of enactment of this Act.

Termination of Variable Rate Premium Indexing (Section 349)

Effective Date: Effective on date of enactment of this Act.

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 349

Section 349 removes the "applicable dollar amount" language in the rules for determining the premium fund target for purposes of unfunded vested benefits and replaces it with a flat $52 for each $1,000 of unfunded vested benefits. Section 349 is effective on the date of enactment of this Act.

Safe Harbor for Corrections of Employee Elective Deferral Failures (Section 350)

Effective Date: Errors after December 31, 2023.

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 350

Under current law, employers that adopt a retirement plan with automatic enrollment and automatic escalation features could be subject to significant penalties if even honest mistakes are made. The Internal Revenue Service has issued guidance on the correction of failures relating to default enrollment of employees into retirement plans. This guidance includes a safe harbor, which expires December 31, 2023, that permits correction if notice is given to the affected employee, correct deferrals commence within certain specified time periods, and the employer provides the employee with any matching contributions that would have been made if the failure had not occurred. Employers are concerned about the lapse of the safe harbor at the end of 2023. Section 350 eases these concerns by allowing for a grace period to correct, without penalty, reasonable errors in administering these automatic enrollment and automatic escalation features. Errors must be corrected prior to 9 ½ months after the end of the plan year in which the mistakes were made. Section 350 is effective to errors after December 31, 2023.

TECHNICAL AMENDMENTS (TITLE IV)

Amendments Related to Setting Every Community Up for Retirement Enhancement (SECURE) Act of 2019 (Section 401)

Effective Date: Effective as if included in the SECURE Act of 2019.

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 401

Section 401 includes three technical and five clerical amendments to the SECURE Act. These amendments are effective as if included in the section of the SECURE Act to which the amendment relates.

ADMINISTRATIVE PROVISIONS (TITLE V)

Provisions Related to Plan Amendments (Section 501)

Effective Date: Plan amendments may be made on or before the last day of the first plan year beginning on or after January 1, 2025 (2027 in the case of governmental plans).

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 501

Section 501 allows plan amendments made pursuant to this Act to be made on or before the last day of the first plan year beginning on or after January 1, 2025 (2027 in the case of governmental plans) as long as the plan operates in accordance with such amendments as of the effective date of a bill requirement or amendment. Section 501 also conforms the plan amendment dates under the

SECURE Act, the CARES Act, and the Taxpayer Certainty and Disaster Tax Relief Act of 2020 to these new dates (instead of 2022 and 2025).

REVENUE PROVISIONS (TITLE VI)

SIMPLE and SEP Roth IRAs (Section 601)

Effective Date: Taxable years beginning after December 31, 2022.

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 601

Generally, all plans that allow pre-tax employee contributions are permitted to accept Roth contributions with one exception – SIMPLE IRAs. 401(k), 403(b), and governmental 457(b) plans are allowed to accept Roth employee contributions. Section 601 allows SIMPLE IRAs to accept Roth contributions too. In addition, aside from grandfathered salaried reduction simplified employee pension plans, under current law, simplified employee pension plans ("SEPs") can only accept employer money and not on a Roth basis. Section 601 allows employers to offer employees the ability to treat employee and employer SEP contributions as Roth (in whole or in part). The provisions in Section 601 are effective for taxable years beginning after December 31, 2022.

Hardship Withdrawal Rules for §403(b) Plans (Section 602)

Effective Date: Plan years beginning after December 31, 2023.

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 602

Under current law, the distribution rules for 401(k) and 403(b) are different in certain ways that are historical anomalies for varied reasons. For example, for 401(k) plans, all amounts are available for a hardship distribution. For 403(b) plans, in some cases, only employee contributions (without earnings) are available for hardship distributions. Section 602 conforms the 403(b) rules to the 401(k) rules, effective for plan years beginning after December 31, 2023.

Elective Deferrals Generally Limited to Regular Contribution Limit (Section 603)

Effective Date: Taxable years beginning after December 31, 2023.

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 603

Under current law, catch-up contributions to a qualified retirement plan can be made on a pre-tax or Roth basis (if permitted by the plan sponsor). Section 603 provides all catch-up contributions to qualified retirement plans are subject to Roth tax treatment, effective for taxable years beginning after December 31, 2023. An exception is provided for employees with compensation of $145,000 or less (indexed).

Optional Treatment of Employer Matching or Nonelective Contributions as Roth Contributions (Section 604)

Effective Date: Date of enactment of this Act.

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 604

Under current law, plan sponsors are not permitted to provide employer matching contributions in their 401(k), 403(b), and governmental 457(b) plans on a Roth basis. Matching contributions must be on a pre-tax basis only. Section 604 allows defined contribution plans to provide participants with the option of receiving matching contributions on a Roth basis, effective on the date of enactment of this Act.

Charitable Conservation Easements (Section 605)

Effective Date: Contributions made after the date of enactment of this Act.

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 604

The tax deduction for charitable contributions of conservation easements has long played a crucial role in incentivizing the preservation of critical habitat, open spaces, and historically important areas and structures. However, since 2016 IRS has identified certain syndicated conservation easement transactions involving pass-through entities as "listed transactions" carrying a high potential for abusive tax avoidance. Section 605 disallows a charitable deduction for a qualified conservation contribution if the deduction claimed exceeds two and one half times the sum of each partner's relevant basis in the contributing partnership, unless the contribution meets a 3 year holding period test, substantially all of the contributing partnership is owned by members of a family, or the contribution relates to the preservation of a certified historic structure. In the case of a contribution for the preservation of a certified historic structure, a new reporting requirement applies. Section 605 also provides taxpayers the opportunity to correct certain defects in an easement deed (excluding easements involved in abusive transactions) and makes certain changes to statute of limitations and penalty provisions. Section 605 is generally effective for contributions made after the date of enactment of this Act.

Enhancing Retiree Health Benefits in Pension Plans (Section 606)

Effective Date: Transfer made on or after the date of enactment of this Act.

SENATE FINANCE COMMITTEE EXPLANATION OF SECTION 604

Under current law, an employer may use assets from an overfunded pension plan to pay retiree health and life insurance benefits. These rules sunset at the end of 2025. Section 606 extends the sunset date to the end of 2032 and would permit transfers to pay retiree health and life insurance benefits provided the transfer is no more than 1.75 percent of plan assets and the plan is at least 110 percent funded. Section 606 is effective for transfers made on or after the date of enactment of this Act.

Unit 4

Business Tax Update

LEARNING OBJECTIVES

- Apply recent developments over the past two years related to general business related matters to tax matters specific to your business

SECTION: 61

LEGAL MEMORANDUM CONCLUDES PROGRAM MARKETED TO LAW FIRMS DOES NOT RESULT IN PUSHING BACK RECOGNITION OF LEGAL FEE INCOME BY TEN YEARS

Citation: AM 2022-007, 12/16/22

The IRS addressed a structure the agency states is being marketed to law firms that claims to defer the taxation of legal fees in AM 2022-007.[210] The IRS found that the transaction, which purported to defer taxation of a fee from 2021 to August of 2031, did not result in the deferral of the income, outlining multiple theories that would cause immediate inclusion of the income.

The Facts of the Situation and Structure of the Arrangement

The memorandum poses the issue as follows:

> A law firm is a cash method taxpayer that represents a client on a contingency fee basis. Before formal settlement of the client's claim, the law firm enters into an arrangement with a third party that purports to defer receipt of the law firm's fee, payable out of the settlement amount negotiated by the law firm on behalf of its client. The opposing party's insurance company sends the portion of the settlement representing the law firm's fee to the third party, pursuant to the terms of the settlement agreement. When does income inclusion for the law firm occur with respect to the fee sent to the third party?[211]

[210] AM 2022-007, December 16, 2022, https://www.taxnotes.com/research/federal/irs-private-rulings/generic-legal-advice/irs-advises-on-inclusion-of-deferred-compensation-in-income/7fgzb (retrieved December 17, 2022)

[211] AM 2022-007, December 16, 2022

In the facts section of the memorandum, the IRS gives additional details about this transaction:

> Taxpayer represents a client (the Client) in connection with the Client's legal claim against a defendant (the Defendant) as a result of a personal physical injury suffered by the Client. On March 1, 2017, Taxpayer and the Client enter into an engagement letter (the Fee Agreement) pursuant to which Taxpayer will represent the Client in connection with all the Client's claims for damages against the Defendant. In exchange, the Client agrees to pay Taxpayer a 30% contingency fee out of any money paid by the Defendant or the Defendant's insurance company (the Insurer) to the Client, either as a result of a judgment or in settlement of the Client's claims. The Fee Agreement provides that the fee will be payable to Taxpayer upon any recovery through a judgement or a settlement.
>
> During pendency of the case but before trial, Taxpayer negotiates a settlement agreement (the Settlement Agreement) on behalf of the Client. The Settlement Agreement is between the Client, the Defendant, and the Insurer. Pursuant to the Settlement Agreement, the Client will release all legal claims against the Defendant in exchange for a cash settlement of $1,500,000. For purposes of applicable state law, the Settlement Agreement is binding and effective upon execution by the Client, the Defendant, and the Insurer. The Client accepts the settlement and asks to have it paid in full as soon as possible.
>
> On June 30, 2021, prior to the execution of the Settlement Agreement, Taxpayer enters into a deferral agreement (the Deferral Agreement) with a third party that was not involved in the litigation (the Third Party). The Third Party markets a deferred compensation product to law firms that features a purported income tax deferral and investment vehicles for the amounts deferred. Pursuant to the Deferral Agreement, Taxpayer agrees that 100% of any legal fees it earns arising out of the settlement of the Client's claim will be transferred directly from the Insurer to the Third Party. The Deferral Agreement purports to be irrevocable. In exchange, the Third Party agrees to pay a lump sum amount to Taxpayer on August 1, 2031, equal to the amount of the fee paid to the Third Party, adjusted for gains and losses based on the performance of a hypothetical investment portfolio selected by Taxpayer, less an annual administration fee (the Deferred Payment).[212]

The taxpayer argues that the arrangement will result in the deferral of recognition of the fee income until 2031, citing the 1994 Tax Court case of *Childs v. Commissioner*, 103 TC No. 36.[213] The memorandum describes the facts of that case as follows:

> In *Childs*, the taxpayers were attorneys who represented a client in a personal injury matter in exchange for a contingency fee. 103 T.C. at 637. The client's legal claims were settled in two separate cases (the Garrett litigation and the Jones litigation). *Id*. at 640, 645. Pursuant to the settlement agreement in the Garrett litigation, two insurance companies of the defendant, Georgia Casualty & Surety Co. (Georgia Casualty) and Stonewall Insurance Co. (Stonewall), agreed

[212] AM 2022-007, December 16, 2022

[213] *Childs v. Commissioner*, 103 TC No. 36, November 14, 1994, https://www.taxnotes.com/research/federal/court-documents/court-opinions-and-orders/fair-market-value-of-right-to-receive-payments-of-fees/1pv19?highlight=childs (retrieved December 17, 2022)

to pay the fees to the plaintiff's attorneys over a period of years. *Id*. at 640-42. The settlement agreement in the Garrett litigation provided for an assignment of this obligation to First Executive Corp. (First Executive), without releasing Georgia Casualty or Stonewall from the obligation to pay the fees. *Id*. First Executive purchased an annuity to pay the fees from its subsidiary, Executive Life Insurance Co. (Executive Life). *Id*. at 641. When Executive Life failed to make all the required payments, the shortfall was paid by Georgia Casualty and Stonewall. *Id*. at 644. Pursuant to the settlement agreement in the Jones litigation, the defendant's insurance company, Stonewall, was obligated to pay the fees, and it purchased an annuity from another insurance company, Manulife Service Corp., to pay the fees, though Stonewall again retained the obligation to pay the fees. *Id*. at 645-47. First Executive and Stonewall were the respective owners of the annuities and retained the power to change the beneficiaries, and the taxpayers' rights under the annuities were no greater than those of a general creditor. *Id*. at 643-47. The Tax Court determined that (1) the attorneys' rights to receive payments under the settlement agreements were not "property" for purposes of section 83, and (2) the doctrine of constructive receipt was not applicable to the arrangement. *Id*. at 653-55.[214]

In this case, matters moved forward as follows after the agreement was executed between the law firm and the third party:

> The Client, the Defendant, and the Insurer execute the Settlement Agreement on July 1, 2021. The Settlement Agreement provides that the entire amount of the settlement will be distributed by the Insurer on August 1, 2021, according to payment instructions to be provided by Taxpayer, acting on behalf of the Client.
>
> On July 15, 2021, Taxpayer provides written instructions to the Insurer regarding where to transfer the settlement funds. Taxpayer instructs the Insurer to split the lump sum into two separate wire transfers. One transfer for $1,050,000 is to be sent to Taxpayer's trust account. This amount represents the Client's net portion of the recovery ($1,500,000, less Taxpayer's 30% contingency fee of $450,000). The second transfer for $450,000 is to be sent to the Third Party. The second amount represents Taxpayer's fee.[215]

The payment was made in accordance with the agreement on August 1, 2021:

> On August 1, 2021, pursuant to the terms of the Settlement Agreement and wiring instructions noted above, the Insurer makes the two separate transfers totaling $1,500,000. Pursuant to the Settlement Agreement, the Defendant and Insurer are discharged of any obligation to pay additional amounts to the Client. Shortly thereafter, the case is dismissed by agreement of the parties. The entire value of the $1,500,000 settlement is excludible from the Client's gross income pursuant to section 104(a)(2).
>
> Upon receipt of the $450,000 from the Insurer on August 1, 2021, the Third Party places the funds in a grantor trust that conforms to the model trust language contained in Rev. Proc. 92-64, 1992-2 C.B. 422 (the Rabbi Trust). The Deferral

[214] AM 2022-007, December 16, 2022

[215] AM 2022-007, December 16, 2022

> Agreement provides that Taxpayer is a general unsecured creditor of the Third Party with respect to the Deferred Payment, Taxpayer has no right to assign, accelerate, defer, change the terms or time of, or transfer or sell the Deferred Payment, and the Third Party is the sole owner of the assets contained in the Rabbi Trust.[216]

But the law firm wasn't satisfied with waiting 10 years to get their hands on at least some of the cash, so they did the following:

> On September 1, 2021, Taxpayer obtains a $200,000 loan from the Third Party. For this loan, Taxpayer and the Third Party enter into a written promissory note (the Note). According to the Note, interest accrues on the loan at an annual rate of 6%, and the loan principal, plus accrued interest, are payable on September 1, 2025. In the event of Taxpayer's default on the loan due to non-payment, the Third Party is permitted, under the terms of the Note, to exercise a setoff right, such that the Third Party can reduce the Deferred Payment by the amount of the loan and accrued interest, to the extent of the default.[217]

The memorandum concludes by noting the value of this account at the end of 2021:

> Due to investment gains, net of fees, the value of the Deferred Payment increases from $450,000 to $470,000, as of December 31, 2021.[218]

Taxpayer Claims the Arrangement is an Unfunded Deferred Compensation Arrangement

The memorandum notes the general rules for inclusion of an item in income for a cash basis taxpayer:

> A cash method taxpayer must include amounts in gross income in the year in which they are actually or constructively received. Treas. Reg. §1.451-1(a). Broadly speaking, a compensation arrangement where a cash method taxpayer is owed compensation for the performance of services and the taxpayer arranges to have the compensation paid in cash in a year later than the year in which the compensation is earned can be categorized as either a funded or unfunded arrangement. See, e.g., Rev. Rul. 69-649, 1969-2 C.B. 106. If an arrangement is unfunded, the compensation is generally included in gross income in the year in which the taxpayer actually or constructively receives a cash payment of the compensation. On the other hand, if a compensation arrangement is funded, the compensation is generally included in the taxpayer's gross income in the year in which funding occurs, regardless of when the taxpayer actually or constructively receives a cash payment.[219]

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[217] AM 2022-007, December 16, 2022

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As is explained in a footnote:

> Stated another way, the three "funding" concepts discussed in this GLAM *(generic legal advice memorandum)* are exceptions to the general rule that a cash basis taxpayer is not required to include amounts in gross income until the year in which they are actually or constructively received in cash by the taxpayer. See e.g., *Helvering v. Horst*, 311 U.S. 112, 116 (1940) (anticipatory assignment of income doctrine); *Minor v. United States*, 772 F.2d 1472, 1473 (9th Cir. 1985) (economic benefit doctrine); *Childs*, 103 T.C. at 648 (section 83).[220]

The taxpayer's position is outlined as follows:

> Taxpayer's position is that the transaction described in this GLAM constitutes an unfunded deferred compensation arrangement, and, according to Childs, Taxpayer is not required to include the compensation in gross income until the year in which Taxpayer actually or constructively receives a cash payment, which is scheduled to occur in 2031.[221]

The memorandum states in the following sentence:

> This GLAM will explain why *Childs* does not apply to the transaction and Taxpayer cannot avoid income inclusion in the year that the funds representing its fee are transferred to the Third Party.[222]

And then immediately outlines the theories the memorandum will advance regarding why this income should be considered immediately taxable to the law firm:

> Historically, when compensation earned by a taxpayer has been paid to a third party, courts have taken various approaches to determine whether the taxpayer must include the compensation in gross income, even though the taxpayer did not actually or constructively receive a cash payment of the compensation. Three of these approaches are discussed in more detail in this GLAM, each of which can be applied to Taxpayer on these facts: the anticipatory assignment of income doctrine, the economic benefit doctrine, and section 83. Only one of these arguments, section 83, was directly addressed in *Childs*. While we believe that the arrangement is funded for the reasons discussed in this GLAM, if the arrangement is not funded, the arrangement must comply with section 409A, which was enacted in 2004, well after *Childs* was decided in 1994. As explained in more detail below, the arrangement fails to comply with section 409A, and the compensation is includible in Taxpayer's gross income in the year of the section 409A violation.[223]

[220] AM 2022-007, December 16, 2022

[221] AM 2022-007, December 16, 2022

[222] AM 2022-007, December 16, 2022

[223] AM 2022-007, December 16, 2022

Anticipatory Assignment of Income

The memorandum gives a broad explanation of why the author believes the anticipatory assignment of income doctrine requires current inclusion of the amount in the law firm's income:

> Taxpayer must recognize the fee income under the anticipatory assignment of income doctrine in 2021. When the funds were transferred to the Third Party from the Insurer, the funds represented compensation owed to Taxpayer from the Client under the Fee Agreement. Taxpayer diverted these amounts to the Third Party in anticipation of receiving the income and must include the amounts in taxable income as the party who earned the compensation.[224]

Banks Applies to Attorneys as Well as Clients

The analysis first begins by using the Supreme Court's ruling in *Commissioner v. Banks*, 543 U.S. 426 (2005) in a somewhat reverse fashion—just as an attorney's client is treated as being taxable on the portion of the legal award that he/she never receives but goes directly to counsel, the IRS argues that the attorney ends up in the same position when he/she assigns his/her fee to the third party in this case.

The memorandum notes that the fee is owed by the *client* to the attorney per their agreement:

> Taxpayer represented the Client pursuant to the Fee Agreement in which the Client agreed to pay Taxpayer a 30% contingency fee out of any money paid by the Defendant or the Insurer in settlement of the Client's claims. Taxpayer thus had a contractual right to compensation from the Client.[225]

Next, the analysis turns to look at the logic used by the Supreme Court to treat the assignment of an award due to an attorney's client as taxable to the client when it gets assigned to counsel to pay the client's legal fee to the attorney:

> In *Commissioner v. Banks*, 543 U.S. 426 (2005), the Supreme Court held that a client in a lawsuit recognizes income for the gross amount of the litigation recovery, even though a portion of the recovery is immediately payable to the attorney in the form of a contingency fee. In *Banks*, the Supreme Court reasoned that the client's cause of action is an asset owned by the client, and the client "retains dominion over this asset throughout the litigation." *Id*. at 435. The attorney and the client are in a principal-agent relationship. *Id*. at 436 (citing Restatement (Second) of Agency §1, Comment e (1957)). The "attorney, as an agent, is obligated to act solely on behalf of, and for the exclusive benefit of, the client-principal, rather than for the benefit of the attorney or any other party." *Id*. When a client relies on the efforts of their attorney to realize an economic gain (that is, the proceeds from settling the client's legal claims), the entire economic gain belongs to the client/principal, even if a portion is payable to the attorney/agent after the gain is realized. *Id*. at 437.[226]

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The memorandum argues that the same holdings should treat the transfer of the fee to the third party here as taxable to the law firm:

> Accordingly, consistent with *Banks*, the entire recovery in the settlement of a lawsuit (including the contingency fee) initially belongs to the Client. The resulting fee constitutes compensation from the Client, payable in exchange for Taxpayer's representation of, and services performed for, the Client. See *Kochansky v. Commissioner*, 92 F.3d 957, 959 (9th Cir. 1996) (contingency fee is "undisputed compensation for [an attorney's] personal services"). The Client owned an asset in the form of the cause of action against the Defendant. When the Client's legal claim was settled pursuant to the Settlement Agreement, the asset was converted into the Client's right to receive the $1,500,000 settlement, and the entire amount belonged to the Client. Pursuant to the terms of the Fee Agreement, the Client owed compensation to Taxpayer based on the Client's total recovery, payable at the time of the recovery. This is the case even though the funds representing the fee were paid by the Insurer directly to the Third Party. Because an attorney is "dutybound to act only in the interests of," and works for "exclusive benefit" of, their client, the fee represents compensation from the Client. See *Banks*, 543 U.S. at 436.[227]

More Straightforward Assignment of Income Analysis

The memo goes on to present an argument for anticipatory assignment of income beyond simply using the *Banks* case. The memo begins by noting IRC §61's broad definition of what constitutes income:

> The broad definition of "gross income" under section 61(a) includes all economic gains not otherwise exempted. *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 429-30 (1955). Under the anticipatory assignment of income doctrine, "[a] taxpayer cannot exclude an economic gain from gross income by assigning the gain in advance to another party." *Banks*, 543 U.S. at 433 (citing *Lucas v. Earl*, 281 U.S. 111 (1930); *Commissioner v. Sunnen*, 333 U.S. 591, 604 (1948); *Horst*, 311 U.S. at 116-17). The rationale for the anticipatory assignment of income doctrine is the principle that gains should be taxed "to those who earned them," Lucas, 281 U.S. at 114, a maxim the Supreme Court calls "the first principle of income taxation." *Commissioner v. Culbertson*, 337 U.S. 733, 739-40 (1949). As explained below, the anticipatory assignment of income doctrine can apply to a funded compensation arrangement where the compensation is earned by a taxpayer and paid to a third party.[228]

The analysis points out that prior case law looked at whether the taxpayer had retained control over the income generating asset:

> When a taxpayer attempts to assign income to another party, "the question becomes whether the assignor retains dominion over the income-generating asset, because the taxpayer 'who owns or controls the source of the income, also controls the disposition of that which he could have received himself and diverts the payment from himself to others as the means of procuring the satisfaction of

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> his wants.'" *Banks*, 543 U.S. at 434-35 (citing *Horst*). "The crucial question remains whether the assignor retains sufficient power and control over the . . . receipt of the income to make it reasonable to treat him as the recipient of the income for tax purposes." *Sunnen*, 333 U.S. at 604. Thus, the anticipatory assignment of income doctrine applies when a taxpayer retains control over the disposition of the income in question and diverts the payment of that income to another person or entity, thereby realizing a benefit by doing so. *Banks*, 543 U.S. at 435. See also *United States v. Basye*, 410 U.S. 441, 449 (1973) ("The entity earning the income . . . cannot avoid taxation by entering into a contractual arrangement whereby that income is diverted to some other person or entity."); *Wood Harmon Corp. v. United States*, 311 F.2d 918, 922 (2d Cir. 1963) ("[A] taxpayer who has performed services . . . cannot escape the tax on those earnings *merely by transferring the right to income to a third person.*") (emphasis added).[229]

The author of the memo argues that in this case the law firm maintained such control over the asset:

> The anticipatory assignment of income doctrine applies here because Taxpayer became entitled to receive income in the form of the fee, retained control over the disposition of the fee, and diverted payment of the fee to the Third Party, realizing a benefit by doing so.
>
> First, Taxpayer controlled the disposition of the fee. In the context of anticipatory assignments of compensation income, the taxpayer providing the services giving rise to the compensation has the power to dispose of the income, which is equivalent to the ownership of that income. *Duran v. Commissioner*, 123 F.2d 324, 326 (10th Cir. 1941) (citing *Horst* and *Helvering v. Eubank*, 311 U.S. 122 (1940)); see also *Kochansky*, 92 F.3d at 959 (for purposes of the anticipatory assignment of income doctrine, an attorney controls the services that produce a contingency fee). Because the fee arose out of services provided by Taxpayer, the fee represented compensation earned by Taxpayer, and Taxpayer controlled the disposition of that compensation income. *Duran*, 123 F.2d at 326; *Kochansky*, 92 F.3d at 959.
>
> Second, Taxpayer diverted the payment of the fee to another entity (the Third Party). *Banks*, 543 U.S. at 434; *Basye*, 410 U.S. at 451 ("[An] agreement . . . whereby a portion of the partnership compensation was deflected to" another entity "is certainly within the ambit of *Lucas v. Earl*."). Taxpayer realized a benefit when the cash representing the fee was received by the Third Party. A taxpayer enjoys the benefits of an item of income when the taxpayer exercises control of the income and causes an amount to be paid to his assignee to satisfy the taxpayer's wishes. See *Horst*, 311 U.S. at 116-17 ("[I]ncome is 'realized' by the assignor because he, who owns or controls the source of the income, also controls the disposition of that which he could have received himself and diverts the payment from himself to others as the means of procuring the satisfaction of his wants."); *Harrison v. Schaffner*, 312 U.S. 579, 582 (1941) ("[B]y the exercise of [the taxpayer's] power to command the income, [the taxpayer] enjoys the benefit of the income on which the tax is laid."); *Sunnen*, 333 U.S. at 606 ("[T]he

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> receipt of income by the assignee" is "the fruition of the assignor's economic gain."); *Raymond v. United States*, 355 F.3d 107, 114 (2d Cir. 2004) ("[E]xercising the right to 'control[ ] the disposition' of a fund is sufficient for the realization of taxable income.") (citing *Horst*); *Duran*, 123 F.2d at 326 ("[T]he exercise of [the] power in procuring payment to an assignee . . . is the equivalent of the enjoyment of the income.") (citing *Horst* and *Eubank*). Thus, Taxpayer controlled the disposition of the fee by providing the relevant services (to the Client), diverted the payment of the fee to another person or entity (the Third Party), and enjoyed a benefit when the cash was received by the Third Party. *Banks*, 543 U.S. at 435.[230]

However, in this case the taxpayer was not arguing that the income should ultimately be treated as the income of another party—rather, the taxpayer was simply arguing that the income should be recognized in a later year. The IRS, expecting the taxpayer to argue that this is a key difference, looks to deal with this issue as well, noting at first that there are cases that the taxpayer could cite for this position:

> Taxpayer may argue that the anticipatory assignment of income doctrine does not apply where income inclusion is merely deferred to a later year and there is no attempt by Taxpayer to avoid taxation entirely; in other words, that the doctrine relates to "who" should be taxed, not "when" that person should be taxed. For example, in *Oates v. Commissioner*, 18 T.C. 570, 585 (1952) (*Oates I*), the Tax Court rejected the government's argument that the assignment of income doctrine (specifically *Lucas*, *Eubank*, and *Horst*) was applicable where the taxpayers entered into binding agreements to defer compensation before it was payable to them. See also *Gann v. Commissioner*, 31 T.C. 211, 218 (1958) (anticipatory assignment of income doctrine did not apply where the taxpayer "did not sell, assign, or give up their right to receive" payment and "merely agreed to the postponement of the date of payment").[231]

The memo argues, though, that those cases did not involve the obligor sending the payment to a third party, and that is an important distinction:

> But the anticipatory assignment of income doctrine has not been so limited when income is diverted to a third party. In affirming *Oates I*, the Seventh Circuit Court of Appeals noted that each of *Lucas, Eubank*, and *Horst* involved an assignment of income to a third party. *Commissioner v. Oates*, 207 F.2d 711, 713 (7th Cir. 1953). This was not at issue in the case before them, as the taxpayers merely instructed their employer to make the payment at a later date, rather than causing the compensation to be paid immediately to a third party. *Id*. at 714. *Oates I* and Gann do not apply because Taxpayer did more than "merely agree[ ] to the postponement of the date of payment" of the fee from the Client. *Gann*, 31 T.C. at 218. Taxpayer gave up the right to receive the fee from the Client by diverting the payment to the Third Party.[232]

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[230] AM 2022-007, December 16, 2022

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[232] AM 2022-007, December 16, 2022

The memorandum argues that case law holds in a case like this, the taxpayer should pay tax when the payment is made to the assignee:

> Here, the anticipatory assignment of income doctrine is being applied to identify "who" should be taxed: Taxpayer, as the entity that performed the relevant services and earned the compensation. As for "when" Taxpayer should be taxed, the Supreme Court has repeatedly ruled that the assignor must recognize income when payments are made to the assignee. See *Lucas*, 281 U.S. 111 (assigned salary and fees taxable to the assignor in the years paid to the assignee); *Eubank*, 311 U.S. at 125 ("[W]e hold that the commissions were taxable as income of the assignor in the year *when paid*.") (emphasis added); *Horst*, 311 U.S. 112 (bond interest was taxable to the assignor in the years paid to the assignee); *Schaffner*, 312 U.S. 579 (attempted assignments of trust income executed in 1929 and 1930 taxable to the assignor in the years of payment, 1930 and 1931); *Sol C. Siegel Productions, Inc. v. Commissioner*, 46 T.C. 15, 23-24 (1966) ("Ordinarily . . . a cash basis assignor is accountable for his assigned income *in the year in which it is paid* rather than in the year in which he makes the assignment.") (emphasis added); Rev. Rul. 74-32, 1974-1 C.B. 22 ("[A] cash-method taxpayer who contracted to perform services under an arrangement whereby the remuneration for his services would be paid to a third party must include the compensation in his gross income [. . .] *at the time it is received by the third party*.") (emphasis added).[233]

The fact the taxpayer was not trying to avoid, but simply defer, recognition of the payment as income is deemed by the memo to be irrelevant:

> It is irrelevant whether Taxpayer's intent in entering into the Deferral Agreement was to defer, rather than to avoid completely, the inclusion of the fee in income, *Basye*, 410 U.S. at 452 ("[T]he tax laws permit no such easy road to tax avoidance or deferment.") (emphasis added). See also *Banks*, 543 U.S. at 434 (holding that a "discernible tax avoidance purpose" is not required for the doctrine to apply). It does not matter whether Taxpayer assigned its right to the fee before the Client's case had been settled and the fee had materialized. See *Banks*, 543 U.S. at 435 ("[T]he anticipatory assignment doctrine is not limited to instances when the precise dollar value of the assigned income is known in advance."); *Kochansky*, 92 F.3d at 959 ("That Kochanky's fee was contingent . . . does not change the fact that, when the fee materialized, it was undisputed compensation for Kochansky's personal services."). The doctrine applies equally to assignments entered into before the performance of services (as in *Lucas*) or after all the services have been performed (as in Eubank). Finally, while the Supreme Court has frequently applied the anticipatory assignment of income doctrine in the context of gratuitous transfers to family members (either directly or through a trust or partnership), for example, in *Lucas*, *Eubank*, *Horst*, and *Culbertson*, the doctrine is not limited to intra-family transfers, as illustrated by *Basye* and *Banks*.[234]

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Thus, the memo concludes, this means the taxpayer must recognize the income in 2021:

> In summary, Taxpayer must recognize the fee as income under the anticipatory assignment of income doctrine. Because the fee was compensation payable in exchange for services provided by Taxpayer to the Client, Taxpayer controlled the disposition of that compensation income. *Duran*, 123 F.2d at 326. Taxpayer diverted that income by having the fee paid to the Third Party. *Banks*, 543 U.S. at 434; *Basye*, 410 U.S. at 451. Taxpayer realized a benefit when the Third Party received the cash representing the fee at Taxpayer's direction. *Horst*, 311 U.S. at 116-17; *Schaffner*, 312 U.S. at 582; *Sunnen*, 333 U.S. at 606; *Raymond*, 355 F.3d at 114; *Duran*, 123 F.2d at 326. Taxpayer, as the earner and assignor of the income, "retain[ed] sufficient power and control over the . . . receipt of the income to make it reasonable to treat him as the recipient of the income for tax purposes," even though it was paid to the Third Party. *Sunnen*, 333 U.S. at 604.
>
> Taxpayer attempted to avoid taxation of the fee in 2021 by having it paid to the Third Party, but as the "entity earning the income," Taxpayer "cannot avoid taxation by entering into a contractual arrangement whereby that income is diverted to" the Third Party. *Basye*, 410 U.S. at 449. Taxpayer must recognize income in 2021 — the year that the assigned income was actually paid to the assignee. *Lucas*, 281 U.S. 111; *Eubank*, 311 U.S. at 125; *Horst*, 311 U.S. 112; *Schaffner*, 312 U.S. 579; *Sol C. Siegel Productions*, 46 T.C. at 23-24; Rev. Rul. 74-32.[235]

Childs Did Not Address the Assignment of Income Doctrine

The memorandum concludes the assignment of income analysis by pointing out the Tax Court only considered whether IRC §83 subjected the amount to taxation and never analyzed when the assignment of income doctrine would apply:

> *Childs* does not apply on these facts such that Taxpayer can avoid including the fee in gross income in 2021 under the anticipatory assignment of income doctrine. The Tax Court in *Childs* only addressed whether the taxpayers in that case had income under section 83 or the doctrine of constructive receipt. *Childs* did not address the application of the anticipatory assignment of income doctrine.[236]

Economic Benefit Doctrine

Separately, the memorandum argues the fee is taxable to the law firm in 2021 under the economic benefit doctrine:

> The purported deferral arrangement is also taxable in 2021 under the economic benefit doctrine when cash was transferred to the Third Party and the Third Party promised to pay amounts to Taxpayer that were owed to Taxpayer by the Client. Like the anticipatory assignment of income doctrine, courts have applied the

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economic benefit doctrine to funded compensation arrangements where the compensation in question has been paid to a third party.[237]

Transfer of Funds to a Third Party Beyond the Reach of the Client's Creditors is a Taxable Economic Benefit

A key issue in the view of the author of the memorandum is that the taxpayer no longer had to worry if the client would pay the fee in the later year, as the client transferred the fee to another party and the attorneys were no longer at risk of losing the fee to future creditors of the client:

> The Client had a contractual obligation to pay a fee of $450,000 to Taxpayer. Under the economic benefit doctrine, Taxpayer must recognize gross income upon the satisfaction of this obligation by means of the transfer of funds to the Third Party (a third party to the transaction) making them beyond the reach of the Client's creditors. Taxpayer's agreement with the Third Party is ineffective to stop recognition of income in the year that the funds representing the fee were transferred to the Third Party.[238]

The memorandum first cites the *Drescher* case in support of this position:

> In *United States v. Drescher*, 179 F.2d 863 (2d Cir. 1950), *cert. denied*, 340 U.S. 821 (1950), the Second Circuit Court of Appeals, applying the economic benefit doctrine, determined that the value of an annuity purchased by an employer for an employee in connection with the performance of services was includible in the employee's gross income at the time of the purchase. In *Drescher*, the taxpayer provided services as an officer and director of a corporation, and the corporation purchased nonforfeitable single-premium annuities from an insurance company, with the taxpayer named as the annuitant. *Id*. at 864. Under the annuity contracts, the taxpayer was entitled to fixed monthly payments for life commencing at age 65 and a death benefit payable to the taxpayer's beneficiary if the taxpayer died before age 65. *Id*.
>
> The court determined that the value of the annuities was includible in the taxpayer's gross income in the year of purchase rather than when payments were made, because the taxpayer "received as compensation for prior services something of economic benefit" in the form of "the obligation of the insurance company to pay money in the future to him or his designated beneficiaries on the terms stated in the policy." *Id*. at 865. Even though the employer retained ownership of the annuities, and the annuities could not be assigned by the executive, surrendered for cash, sold, or pledged for a loan, the court found that the "right to receive income payments" in the future "represented a present economic benefit" to the employee, and this benefit accrued and was taxable at the time the annuities were purchased. Id. (emphasis added). The result in *Drescher* is consistent with the "well-established principle that a cash basis taxpayer must include in gross income amounts paid to third parties exclusively for the benefit of the taxpayer that are not intended to be gifts." *Hyde v.*

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> *Commissioner*, 301 F.2d 279, 282-83 (2d Cir. 1962) (citing, inter alia, *Drescher*).[239]

The memorandum similarly cites the *Sproull* case to support this position:

> In *Sproull v. Commissioner*, 16 T.C. 244 (1951), *aff'd per curiam*, 194 F.2d 541 (6th Cir. 1952), an employer transferred $10,500 to a trust for the benefit of an employee (the taxpayer) in 1945, with payments to be made in 1946 and 1947. The taxpayer was the "sole beneficiary" of the trust, and "[n]o one else had any interest in or control over the monies." *Id*. at 247-48. The court determined that the entire amount was taxable income in 1945 (the year the money was placed in trust rather than the years when amounts were distributed from the trust) because the payment to the trust represented an "economic or financial benefit conferred on the employee as compensation." *Id*. at 247. When the money was placed in the trust, the "employer's part of the transaction terminated" and "the amount of the compensation was fixed at $10,500 and irrevocably paid out for [the taxpayer's] sole benefit." *Id*. The amount of compensation was not subject to any contingency, and there was no possibility that it could be returned or forfeited to the employer. *Id*.[240]

Next the analysis looks at two Revenue Rulings to support the position that the attorneys had received a taxable economic benefit in 2021:

> Rev. Ruls. 69-50, 1969-1 C.B. 140 and 77-420, 1977-2 C.B. 172, apply the result in Sproull and Drescher to the creation of an account payable with a third party for the benefit of the party providing services.
>
> In Rev. Rul. 69-50, a doctor provided medical services to a patient who was insured by a nonprofit corporation. The insurance company did not employ the doctor and was thus a third party to the transaction. The doctor entered into an agreement with the insurer to defer a portion of the fees for providing services to the patient. The payments would be deferred until the doctor's death, disability, or retirement. Citing *Drescher*, *Sproull*, and other economic benefit doctrine cases, the ruling concluded that the doctor had gross income once the medical services were performed and amounts were credited to the doctor's "account payable on the books of the" insurer. Once the doctor provided medical services to a patient, the doctor had a right to compensation from the patient, but instead of being paid directly by the patient, the doctor received a right to deferred compensation from the insurer, in the form of an account payable. The ruling concludes that the doctor's patients "funded their obligation" to the doctor, and "in doing so, they . . . conferred an economic or financial benefit" on the doctor.
>
> Rev. Rul. 77-420 amplifies Rev. Rul. 69-50 and provides that the tax result remains the same even if the doctor's right to deferred compensation from the insurer is subject to a substantial forfeiture provision in favor of the insurer, because there is no possibility that the deferred compensation could be forfeited to any patient (the recipient of the services).[241]

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The memorandum then looks to argue that the facts in this situation are effectively the same as those covered in the cited cases and rulings:

> These cases are applicable to the current facts. In *Drescher* and *Sproull*, a fixed amount of money was placed with a third party (a party other than the party receiving the services) for the benefit of the taxpayer (the party providing the services), the money was irrevocably placed with the third party because there was no possibility the money could be returned to the party receiving the services, and the money was not subject to the claims of creditors of the party receiving the services. That is, there was an "irrevocable set-aside of money . . . as compensation for services rendered . . . beyond the reach of the employer's creditors." Our *Country Home Enterprises*, 145 T.C. at 53.[242]

The memorandum continues:

> In Taxpayer's case, pursuant to the terms of the Settlement Agreement and the Deferral Agreement, a fixed amount of money ($450,000) was irrevocably placed with the Third Party (a third party that did not receive services from Taxpayer) for the benefit of Taxpayer (the party providing the services) as compensation for services performed by Taxpayer, there was no possibility that the money could be returned to the Client (the party receiving the services), and the money was not subject to claims of creditors of the Client. As in *Sproull*, the exact amount of compensation was known, that amount was not subject to any future contingency, and there was no possibility that the funds would be returned to the Client. 16 T.C. at 247. Taxpayer was the only beneficiary of the Third Party's promise to pay money in the future, and neither the Third Party nor any other party had any power to change the beneficiary. By the time the money was transferred to the Third Party, all the relevant services giving rise to the fee had been performed, and Taxpayer "had to do nothing further to earn it or establish his rights therein." *Id*. at 248. The only condition on Taxpayer's right to possess the funds was the passage of time, which is not a condition that prevents the application of the economic benefit doctrine. *Stiles v. Commissioner*, 69 T.C. 558, 569 (1978); *Thomas v. United States*, 213 F.3d 927, 932 (6th Cir. 2000).[243]

The fact that the funds might be subject to the claims of the third party's creditors isn't what is relevant—they were no longer subject to the claims of the creditors of the party for whom the services were performed.

> Taxpayer may argue that the economic benefit doctrine does not apply because Taxpayer's right to the Deferred Payment under the Deferral Agreement merely represents a non-negotiable, non-assignable, and non-transferable promise to pay money in the future that is subject to claims of creditors of the Third Party. The relevant inquiry, however, is whether the funds are subject to claims of creditors of the party receiving the services. *Our Country Home Enterprises*, 145 T.C. at 53 (economic benefit doctrine applies "where the money or property is beyond the reach of the employer's creditors") (emphasis added). Here, the Deferred Payment is subject to claims of creditors of the Third Party but not the Client (the party receiving the services). The facts of *Drescher*, *Sproull*, and Rev. Ruls. 69-

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50 and 77-420, illustrate that the doctrine applies even if funds are subject to claims of creditors of a third party:

- In *Drescher*, the insurance company's promise to pay money to the taxpayer under the annuities would have been subject to claims of creditors of the insurer, as an insurer and an annuitant generally have a debtor-creditor relationship. See *Hughes v. Sun Life Assur. Co. of Canada*, 159 F.2d 110, 113 (7th Cir. 1946). The annuities were not subject to claims of creditors of the employer, though, because the taxpayer was the beneficiary of the annuity, and only the taxpayer had the right to change the beneficiary. *Drescher*, 179 F.2d at 864.

- Because the trust in *Sproull* was irrevocably funded and the employer did not have "any interest in or control over the monies," assets in the trust would only have been subject to claims of creditors of the trust and not the employer. 16 T.C. at 247-48.

- In Rev. Rul. 69-50, the taxpayer was entitled to an "account payable on the books of the corporation," meaning it was subject to claims of creditors of the corporation (the third party) but not the patients (the recipients of the services). Rev. Rul. 77-420 notes that the taxpayer could not forfeit any amounts to any patient.[244]

The memorandum concludes on the issue as follows:

> In summary, the economic benefit doctrine applies because money was irrevocably set aside for the benefit of Taxpayer as compensation, beyond the reach of the Client's creditors. *Our Country Home Enterprises*, 145 T.C. at 53. The economic benefit is the obligation of the Third Party "to pay money in the future" to Taxpayer on the terms stated in the Deferral Agreement. *Drescher*, 179 F.2d at 865. The Client "confer[red] [the] economic or financial benefit" on Taxpayer when cash was transferred to the Third Party and Taxpayer received a right to receive the Deferred Payment from the Third Party, as Taxpayer's right to the Deferred Payment "emanate[d] from the . . . services that [were] rendered to" the Client by Taxpayer. Rev. Rul. 77-420 (citing Rev. Rul. 69-50). Once the fee was transferred to the Third Party, the Client's part of the transaction terminated and "the amount of the compensation was fixed," in our case at $450,000, and "irrevocably paid out for [the] sole benefit" of Taxpayer. *Sproull*, 16 T.C. at 247. As a cash method taxpayer, Taxpayer "must include in gross income amounts paid to third parties exclusively for the benefit of the taxpayer that are not intended to be gifts." *Hyde*, 301 F.2d at 282. Because the amounts paid to the Third Party arose from the services provided by Taxpayer to the Client, the amounts were not gifts.[245]

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Childs Did Not Look at the Economic Benefits Doctrine

The memorandum argues that, as was true of the anticipatory assignment of income doctrine, the *Childs* case did not look at the economic benefits doctrine either:

> *Childs* does not apply on these facts such that Taxpayer can avoid including the fee in gross income in 2021 under the economic benefit doctrine. The Tax Court in *Childs* only addressed whether the taxpayers in that case had income under section 83 or the doctrine of constructive receipt. *Childs* did not directly address the application of the economic benefit doctrine as a basis for income inclusion. While economic benefit doctrine case law is relevant to section 83, as courts (including the Tax Court in *Childs*) have looked to economic benefit doctrine case law to interpret section 83, the economic benefit doctrine remains an independent basis for income inclusion. Courts have continued to apply the economic benefit doctrine in the compensation context following the adoption of section 83 (see, e.g., *Wheeler v. United States*, 768 F.2d 1333 (Fed. Cir. 1985)).[246]

Section 83

While the memorandum has noted that *Childs* did not consider either the anticipatory assignment of income or economic benefit doctrine, the memorandum concedes *Childs* did rely on IRC §83 to exclude the amount from current income in that case. But the memorandum goes on to argue that, even under §83, this case is distinguishable from the facts in *Childs* and thus leads to a different result when applying that IRC provision.

The memorandum summarizes the relevant portions of IRC §83 as follows:

> Under section 83, "[i]f, in connection with the performance of services, property is transferred to any person other than the person for whom such services are performed," the party providing the services must include in gross income the fair market value of the property less the amount paid for the property.8 Section 83(a); Treas. Reg. §1.83-1(a)(1). "Property" includes (1) "real and personal property other than either money or an unfunded and unsecured promise to pay money or property in the future" and (2) "a beneficial interest in assets (including money) which are transferred or set aside from the claims of creditors of the transferor, for example, in a trust or escrow account." Treas. Reg. §1.83-3(e).
>
> If section 83 applies to a transfer of property, the party providing services must recognize income in the first year that the property is either transferable or not subject to a substantial risk of forfeiture. Section 83(a); Treas. Reg. §1.83-1(a)(1). Property is subject to a substantial risk of forfeiture if the taxpayer's rights to the property are conditioned upon (1) "the future performance [or refraining from the performance] of substantial services" or (2) "the occurrence of a condition related to a purpose of the transfer." Treas. Reg. §1.83-3(c)(1). The risk that the property may decline in value is not a substantial risk of forfeiture. *Id*.

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The memorandum argues that the client transferred property in the form of the right to receive a payment from the third party to the service provider (the law firm) in 2021, and that taxation took place immediately upon that transfer:

> All the requirements of section 83 were met in 2021 when cash was transferred to the Third Party in connection with the performance of services by Taxpayer for the Client. Taxpayer is subject to section 83, as the statute applies to any "person" that receives property in connection with the performance of services, and a partnership is a "person" for purposes of the Code. Section 7701(a)(1). Section 83 applies to employees and independent contractors. See Treas. Reg. §1.83-1(a)(1); *Cohn v. Commissioner*, 73 T.C. 443, 446 (1979). Taxpayer performed services for the Client by settling the Client's claims against the Defendant. In connection with the performance of those services, the Client transferred "property" to Taxpayer (as discussed in more detail below) in 2021.
>
> Under section 83, the value of the property is includible in Taxpayer's income in the year of transfer because the property was not subject to a substantial risk of forfeiture, as Taxpayer's right to receive the property was neither conditioned on the future performance of (or refraining from the performance of) substantial services nor any condition related to the purpose of the transfer. There was no possibility that the property could be forfeited to the Client, and the risk that the Deferred Payment could lose value due to investment losses is not a substantial risk of forfeiture for purposes of section 83.[247]

The Funded Promise to Pay Is Property for §83 Purposes

The memorandum discusses what is considered property under IRC §83:

> The term "property" is not defined in section 83. The section 83 regulations provide that the term "includes real and personal property other than either money or an unfunded and unsecured promise to pay money or property in the future." Treas. Reg. §1.83-3(e) (first sentence). The term "property" also includes "a beneficial interest in assets (including money) which are transferred or set aside from the claims of creditors of the transferor, for example, in a trust or escrow account." Id. (second sentence). Thus, under Treas. Reg. §1.83-3(e), there are three ways in which money or a promise to pay money can constitute "property": (1) a promise to pay money is funded, (2) a promise to pay money is secured, or (3) the receipt of a beneficial interest in money, when the money is transferred or set aside from the claims of creditors of the transferor.[248]

The memorandum goes on to argue that the transaction provided both a funded promise to pay and the receipt of a beneficial interest in money that was set aside from the claims of creditors of the client.

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Funded Promise to Pay

The memorandum notes that the Tax Court in *Childs* did analyze what would constitute a funded promise to pay under IRC §83:

> Based on a review of *Sproull*, *Minor*, and *Centre v. Commissioner*, 55 T.C. 16 (1970), the Tax Court in Childs determined that:
>
>> "funding occurs when no further action is required of the obligor for the trust or insurance proceeds to be distributed or distributable to the beneficiary. Only at the time when the beneficiary obtains a nonforfeitable economic or financial benefit in the trust or insurance policy is the provision for future payments secured or funded. However, if the trust or policy is subject to the rights of general creditors of the obligor, funding has not occurred."
>
> 103 T.C. at 651.
>
> In applying this test, the Tax Court treated the defendant's insurance companies as the "obligors" of the compensation without discussion. *Id*. at 651. As a result, the Tax Court determined that the promise to pay the fees in Childs was not "funded" for purposes of section 83 because the attorneys merely had a promise to pay from the insurers, and that promise to pay was subject to the rights of general creditors of the insurers. *Id*.10 Further, the purchase of the annuities by the insurance companies did not result in "funding" under section 83 because the insurers remained the owners of the annuities and reserved the right to change the beneficiaries, and the taxpayers did not have rights to payment greater than the rights of a general creditor of the insurers. *Id*.[249]

The memorandum treats as key the fact that the payment by the defendant's insurer (treating it as the *obligor* as did the court in *Childs)* to the third party was a key difference, as the insurer's obligation was terminated entirely upon making that payment:

> Under the current facts, pursuant to the Settlement Agreement, the Insurer agreed to pay the entire settlement of $1,500,000, inclusive of Taxpayer's fee. Treating the Insurer as the "obligor" of the fee, just as the Tax Court did with the insurers in *Childs*, the Deferred Payment became a "funded" promise to pay money for purposes of section 83 when the Third Party agreed to pay the fee on a deferred basis and the Insurer was released of the obligation to pay the fee under the Settlement Agreement. At that time, the Tax Court's conditions for "funding" under *Childs* were satisfied:
>
> - "[N]o further action [was] required of the obligor" (the Insurer) for the fee to be "distributed or distributable to the beneficiary" (Taxpayer). *Id*. at 651. Once the funds were transferred to the Third Party, the only condition on Taxpayer's right to receive the funds was the passage of time. No further action was required of the Insurer for the fee to be distributable to Taxpayer because the Insurer was released of any further obligations once the Insurer distributed the settlement funds. By contrast,

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in *Childs*, further action was required by the insurers, because the insurers at all times remained liable to make periodic payment to the taxpayers. Id. at 641, 645. The insurers' purchase of annuities in *Childs* to make payments to the taxpayers did not relieve the insurers of the ongoing obligation to pay the fees — when Executive Life failed to make payments under the annuities in the Garrett litigation, the shortfall was paid by Georgia Casualty and Stonewall. Id. at 644.

- Taxpayer "obtain[ed] a nonforfeitable economic or financial benefit" in the Deferred Payment. *Id*. at 651. The Third Party's "obligation . . . to pay money in the future to" Taxpayer on the terms stated in the Deferral Agreement represents an "economic benefit" to Taxpayer. *Drescher*, 179 F.2d at 865. This economic benefit was also nonforfeitable. At the time the funds were transferred to the Third Party, the funds were not "subject to the possibility of return to" the Client. *Sproull*, 16 T.C. at 247. Taxpayer had provided all the relevant services to the Client giving rise to the Deferred Payment and "had to do nothing further to earn it or establish [its] rights therein." *Id*. at 248.

- The Third Party's promise to pay Taxpayer under the Deferral Agreement was not "subject to the rights of general creditors of the obligor" (the Insurer). *Childs*, 103 T.C. at 651. When the settlement funds were transferred by the Insurer to the Third Party, the Insurer was released of any further obligation to pay the fee, and the Deferred Payment was only subject to rights of general creditors of the Third Party, not the Insurer.[250]

Assets Set Aside from the Creditors of the Transferor

The memorandum also points out that the *transferor* in this case would be the insurance company of the defendants or, potentially, the client of the law firm, but not the third party that received the payment from the insurance company. Once that payment was made, the funds were set aside from the creditors of either potential transferor, even if they might now be subject to the creditors of the transferee. The latter point, the memorandum argues, isn't relevant to the timing of the taxation of the amounts received.

The memorandum discusses the Code and Regulations in this area:

> Under Treas. Reg. §1.83-3(e) (second sentence), "a beneficial interest in assets (including money) which are transferred or set aside from the claims of creditors of the transferor" can also constitute "property" for purposes of section 83. While the court in *Childs* discussed the meaning of the phrase "unfunded and unsecured promise to pay money" under Treas. Reg. §1.83-3(e) (first sentence), it did not analyze whether the attorneys in that case received a beneficial interest in money that was set aside from the claims of creditors of the transferor.

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> The regulations do not define the term "transferor." The plain meaning of the term "transferor" in the context of Treas. Reg. §1.83-3(e) (second sentence) is the person who transfers the "assets (including money)."[251]

The memorandum then argues that only two parties could qualify as transferors, and neither is the third party that would make the final payment to the attorneys in 2031:

> Here, the "transferor" of the funds representing the fee for purposes of section 83 is either the Insurer or the Client. The Insurer is the "transferor" in the sense that the Insurer directly transferred $450,000 to the Third Party. Alternatively, the Client is the "transferor" in the sense that the settlement funds (including the fee) belonged to the Client before being transferred to the Third Party, because the settlement funds represented the total recovery that the Client received for disposition of the Client's legal claims against the Defendant, as discussed above under the heading "Client's Compensation Obligation to Taxpayer." In form, the funds representing the fee were transferred by the Insurer to the Third Party, but in substance, the funds were transferred by the Client, because only the Client had the legal authority to direct the funds to another party (that is, the Insurer facilitated the transfer of funds belonging to the Client to the Third Party for the benefit of Taxpayer).[252]

But it matters not whether the insurer or the attorney's client is the transferor for this analysis:

> For purposes of this GLAM, however, it is not necessary to resolve this issue, because the tax result is the same whether the Insurer or the Client is treated as the "transferor." See Treas. Reg. §1.83-1(a)(1) (section 83 can apply "even though the transferor is not the person for whom [the] services are performed"). In either case, the transfer of $450,000 to the Third Party constitutes a transfer of property for purposes of section 83, because "money" has been "transferred" to the Third Party for the benefit of Taxpayer, and the money has been "set aside from the claims of creditors of" both the Insurer and the Client. Treas. Reg. §1.83-3(e) (second sentence). After the Third Party received the money, the money was subject to claims of creditors of the Third Party, but it was no longer subject to claims of creditors of the Insurer or the Client, because neither the Insurer nor the Client had any right to the money after it was transferred to the Third Party.[253]

IRC §409A Would Apply if the Arrangement was a Deferred Compensation Arrangement

The memorandum concludes by issuing what amounts to a "be careful what you wish for" threat in this case, arguing that if, somehow, this arrangement was found to be a deferred payment arrangement it would be a deferred compensation arrangement that would violate §409A, triggering not only immediate taxation of the proceeds but a 20% penalty in addition.

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While noting that the author does not agree that this is unfunded deferred compensation, as the taxpayer argues, if it was to be treated that way IRC §409A, which did not exist when *Childs* was decided, would result in a tax disaster for the law firm:

> If the arrangement is viewed as an unfunded deferred compensation arrangement, the Third Party's promise to pay Taxpayer certain amounts in 2031 under the Deferral Agreement constitutes a "nonqualified deferred compensation plan" that is subject to the requirements of section 409A, and the plan is not exempt from section 409A under the independent contractor exception in Treas. Reg. §1.409A-1(f)(2). In 2021, the plan failed to comply with the initial deferral election requirements of section 409A(a)(4). Additionally, Taxpayer violated section 409A(a)(3) in 2021 when Taxpayer obtained a loan from the Third Party that, in the event of default, could be repaid through an offset or reduction of the Deferred Payment, because the loan was a substitute for an accelerated payment of deferred compensation. Treas. Reg. §1.409A-3(f). Because the arrangement violates section 409A, the entire value of the Deferred Payment as of December 31, 2021, is subject to income inclusion in 2021, plus an additional 20% tax. Section 409A(a)(1)(A)(i); Section 409A(a)(1)(B)(i)(II).[254]

When §409A Applies to an Arrangement

The memorandum outlines the definition of a deferred compensation arrangement to which IRC §409A would apply:

> Section 409A applies to any "nonqualified deferred compensation plan." Section 409A(a)(1)(A)(i). The term "nonqualified deferred compensation plan" means "any plan that provides for the deferral of compensation, other than (A) a qualified employer plan, and (B) any bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan." Section 409A(d)(1). The term "plan" includes any "agreement, method, program, or other arrangement, including an agreement, method, program, or other arrangement that applies to one person or individual." Treas. Reg. §1.409A-1(c)(1). Taxpayer, a cash method partnership, is subject to section 409A, as section 409A applies to "service providers," which includes individuals as well as corporations, partnerships, and other entities that "account[ ] for gross income from the performance of services under the cash receipts and disbursements method of accounting." Treas. Reg. §1.409A-1(f)(1).
>
> Unless an exception applies, a plan provides for a deferral of compensation subject to section 409A "if, under the terms of the plan and the relevant facts and circumstances, the service provider has a legally binding right during a taxable year to compensation that, pursuant to the terms of the plan, is or may be payable to (or on behalf of) the service provider in a later taxable year." Treas. Reg. §1.409A-1(b)(1).[255]

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The memorandum then explains how this arrangement meets this definition:

> On June 30, 2021, Taxpayer acquired a "legally binding right" to "compensation" payable by the Third Party when the parties entered into a "plan" (the Deferral Agreement), and compensation under that plan was payable to Taxpayer in a later taxable year (2031):
>
> - The Deferral Agreement constitutes a "plan," because the term "plan" includes an "agreement . . . that applies to one person or individual." Treas. Reg. §1.409A-1(c)(1). Taxpayer, a partnership, is a "person" for purposes of the Code. Section 7701(a)(1). As a cash method partnership, Taxpayer is a "service provider" subject to section 409A. Treas. Reg. §1.409A-1(f)(1).
> - Taxpayer had a "legally binding right" to a payment because Taxpayer had a contractual right in 2021 to a payment in 2031 under the Deferral Agreement. A "legally binding right includes a contractual right that is enforceable under the applicable law or laws governing the contract." Application of Section 409A to Nonqualified Deferred Compensation Plans, Explanation of Provisions and Summary of Comments, section III.B, 72 FR 19,234, 19,236.11
> - The amounts payable under the Deferral Agreement constitute "compensation." If the fee had been paid to Taxpayer directly by the Client, the payment would constitute "compensation for services" for purposes of section 61, because Taxpayer's right to the payment derived from the performance of legal services. Amounts retain their character as compensation for services even if the payor is a party other than the recipient of the services.in situations in which a right to a payment constituting compensation is substituted or exchanged for a new payment. See *United States v. Woolsey*, 326 F.2d 287, 291 (5th Cir. 1963); *Trantina v. United States*, 512 F.3d 567, 571-72 (9th Cir. 2008); *Turner v. Commissioner*, 38 T.C. 304, 308 (1962); *Flower v. Commissioner*, 61 T.C. 140, 149 (1973); *Henry v. Commissioner*, 62 T.C. 605, 606 (1974); *Seserman v. Commissioner*, 21 T.C.M. (CCH) 1042 (1962); *Ramella v. Commissioner*, 38 T.C.M. (CCH) 747 (1979).
> - The amounts payable under the Deferral Agreement were payable in a taxable year (2031) later than the year in which Taxpayer acquired the legally binding right to compensation from the Third Party (2021).
>
> Thus, the Deferral Agreement was a "nonqualified deferred compensation plan" subject to section 409A, because "the service provider," Taxpayer, had a "legally binding right during a taxable year [2021] to compensation that, pursuant to the terms of the plan [the Deferral Agreement], is or may be payable to (or on behalf of) the service provider in a later taxable year [2031]." Treas. Reg. §1.409A-1(b)(1).[256]

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Third Party Contractor Exception Does Not Apply

If you are familiar with IRC §409A you are probably thinking the IRS is forgetting one thing—the counselors were not employees of either the client or the insurer and you remember there is an independent contractor exception in the IRC §409A regulations. But the memorandum seeks to argue that this arrangement fails to meet the requirements of the independent contractor exception.

The memorandum summarizes what the author sees as the key issue that will create problems for applying the independent contractor exception in this case:

> Section 409A does not apply to "an amount deferred under a plan between a service provider and service recipient with respect to a particular trade or business in which the service provider participates," if certain conditions are met. Treas. Reg. §1.409A-1(f)(2)(i). This exception only applies to an amount "deferred under a plan ***between*** a service provider and ***service recipient***." *Id.* (emphasis added).[257]

The memorandum argues that the plan was between the service provider and a third party that did not receive the services in question:

> The fee was "deferred under a plan between" Taxpayer and the Third Party (rather than Taxpayer and the Client). The Client's obligation to pay the fee to Taxpayer was discharged when the Insurer transferred the funds representing the fee to the Third Party. Taxpayer acquired a legally binding right to compensation from the Third Party pursuant to the Deferral Agreement.[258]

The memorandum continues to point out exactly why the plan did not involve the service recipient, a requirement to meet the independent contractor exception:

> For purposes of section 409A, the term "service recipient" means "the person for whom the services are performed and with respect to whom the legally binding right to compensation arises." Treas. Reg. §1.409A-1(g). While Taxpayer had a legally binding right to compensation from the Third Party under the Deferral Agreement, Taxpayer did not provide any services to the Third Party (that is, all the relevant services were provided to the Client). Because the Third Party is not "the person for whom the services" giving rise to the fee were performed, the Third Party cannot qualify as a "service recipient" for purposes of the independent contractor exception to section 409A. Treas. Reg. §1.409A-1(f)–(g). Section 409A can apply to a plan "even if the payment of the compensation is not made by the person for whom services are performed." Treas. Reg. §1.409A-1(g). As such, the amounts payable to Taxpayer by the Third Party under the Deferral Agreement constitute "nonqualified deferred compensation" subject to section 409A, even though the Third Party is not a "service recipient."[259]

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[258] AM 2022-007, December 16, 2022

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The IRS argues this reading is consistent with the statute and regulations under IRC §409A, so if this truly does result in deferred compensation then compliance with IRC §409A is required or the service provider faces dire tax consequences:

> This reading of the independent contractor exception is consistent with the statute and regulations under section 409A. The statute broadly applies to "any plan that provides for the deferral of compensation." Section 409A(a)(1)(A)(i). The statute itself does not include any exception for independent contractors; instead, the independent contractor exception is a narrow regulatory exception to the broad reach of section 409A. The independent contractor exception is not intended to provide independent contractors with a categorical exclusion from section 409A.12 In other words, all deferred compensation arrangements of a service provider are not exempt from section 409A merely because that service provider can meet the requirements of Treas. Reg. §1.409A-1(f)(2)(i) with respect to one or more service recipients.
>
> Because the amounts payable under the Deferral Agreement represent deferred compensation subject to section 409A and the amounts cannot qualify for the independent contraction exception in the Final Regulations, Taxpayer must comply with the requirements of the statute, including the requirements of section 409A(a)(4) regarding election timing and section 409A(a)(3) regarding the accelerated payment of deferred compensation.[260]

The IRS sees two different issues that violated the requirements for a §409A deferred compensation arrangement, either one of which would trigger immediate taxation and the 20% penalty.

Failure to Meet the Initial Deferral Election Timing Requirements

IRC §409A and its related regulation provide for the timing of any initial election deferral. As the memorandum explains:

> A nonqualified deferred compensation plan subject to section 409A must provide, upon adoption of the plan or when otherwise permitted under the section 409A initial deferral election requirements, for a deferred amount to be paid at a time and in a form meeting the section 409A time and form of payment requirements. Treas. Reg. §1.409A-1(c)(3)(i).
>
> Under section 409A(a)(4), an irrevocable election as to the time and form of the payment of the deferred compensation must generally be made in the year before the taxable year in which the services giving rise to the compensation were performed. Section 409A(a)(4)(B)(i). However, a special timing rule applies in the first year in which a taxpayer becomes eligible to participate in a plan. In that case, the election can be made within 30 days after the date Taxpayer becomes eligible to participate in the plan, but only with respect to services to be performed after the election. Section 409A(a)(4)(B)(ii); Treas. Reg. §1.409A-2(a)(7)(i).[261]

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In this case, the deferral arrangement (and thus the election to defer) was entered into in 2021, after the services in question had been almost completely performed. And that turns out to be a big problem if the arrangement is covered by IRC §409A:

> The Deferral Agreement was entered into in 2021, which was the first year Taxpayer was eligible to participate in the plan. As a result, to comply with section 409A, Taxpayer had to make an irrevocable election regarding the timing of payment of the deferred compensation within 30 days after becoming eligible to participate in the plan, but only with respect to services to be performed after the election. By the time Taxpayer entered into the Deferral Agreement on June 30, 2021, and elected to be paid in 2031, all the services giving rise to the fee had already been performed. The legal engagement began on March 1, 2017, and was concluded on July 1, 2021, one day following the execution of the Deferral Agreement. As a result, Taxpayer's election to defer compensation was not timely for purposes of section 409A(a)(4) because it only became irrevocable after all the relevant services had been performed.[262]

Anti-Acceleration Rule and Substituted Payment

But even if the timing of the election to defer is found not to be a problem, the memorandum argues the arrangement runs afoul of provisions in IRC §409A that bar acceleration of the payment or use of a substituted payment. The memorandum notes:

> Under section 409A(a)(3), a nonqualified deferred compensation plan subject to section 409A cannot permit the acceleration of the time or schedule of any payment under the plan. Likewise, Treas. Reg. §1.409A-3(j)(1) provides as follows:
>
> > "Except as provided in paragraph (j)(4) of this section, a nonqualified deferred compensation plan may not permit the acceleration of the time or schedule of any payment or amount scheduled to be paid pursuant to the terms of the plan, and no such accelerated payment may be made whether or not provided for under the terms of such plan. For purposes of determining whether a payment of deferred compensation has been made, the rules of paragraph (f) of this section (substituted payments) apply."[263]

The memorandum argues that the loan taken out a month after the agreement was signed represented a violation of the anti-acceleration rule by providing for a substituted payment. The memorandum states:

> When amounts were initially deferred pursuant to the Deferral Agreement, Taxpayer elected to be paid in a lump sum in 2031. The anti-acceleration rule of section 409A(a)(3) was violated in 2021, when Taxpayer obtained a loan against amounts deferred with the Third Party. The loan was an accelerated payment of deferred compensation because of the substitution rule in Treas. Reg. §1.409A-3(f), which provides that "the payment of an amount as a substitute for a payment of deferred compensation will be treated as a payment of the deferred

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compensation." Whether one payment is a substitute for the payment of deferred compensation is based on the facts and circumstances. *Id*. If a "service provider receives a loan the repayment of which is secured by or may be accomplished through an offset of or a reduction in an amount deferred under a nonqualified deferred compensation plan, the payment or loan is a substitute for the deferred compensation." *Id*.

Taxpayer's loan constitutes a substitution under Treas. Reg. §1.409A-3(f). Under the terms of the Note, in the event of Taxpayer's default, the Third Party has a right to exercise a setoff right, such that the Third Party can reduce the Deferred Payment by the amount of loan and accrued interest, to the extent of the default. Under Treas. Reg. §1.409A-3(f), obtaining the loan represents a payment of deferred compensation because the repayment of the loan "*may be accomplished through an offset* of or a reduction in an amount deferred under a nonqualified deferred compensation plan" (emphasis added).[264]

Tax Impact of IRC §409A Violations

The memorandum concludes by outlining the impact of a violation of the requirements for a §409A plan.

> If at any time during a taxable year a nonqualified deferred compensation plan (1) fails to meet the requirements of section 409A(a), or (2) is not operated in accordance with such requirements, all compensation deferred under the plan for the taxable year and all preceding taxable years shall be includible in gross income for the taxable year to the extent not subject to a substantial risk of forfeiture and not previously included in gross income. Section 409A(a)(1)(A)(i). The income tax imposed is increased by an amount equal to (1) 20% of the compensation that is includible in income, plus (2) the amount of interest determined under section 409A(a)(1)(B)(ii). Section 409A(a)(1)(B). These amounts are an additional income tax, subject to the rules governing the assessment, collection, and payment of income tax, and are neither an excise tax nor a penalty.[265]

Thus, in the view of the author of the memorandum, if the taxpayer could establish that *Childs* requires that this arrangement be treated as a deferral arrangement, then the provisions of §409A, which was not part of the law till long after the year involved in *Childs*, would come crashing down on the attorneys.

> Because Taxpayer did not make a timely election to defer compensation under the plan, the plan failed to comply with the requirements of section 409A(a)(4) in 2021. The plan also failed to comply with the requirements of section 409A(a)(3) in 2021 when Taxpayer obtained a loan from the Third Party, the repayment of which may be accomplished through an offset of or a reduction in the Deferred Payment.
>
> As a result, the value of the Deferred Payment ($470,000) is includible in Taxpayer's gross income for 2021, to the extent not subject to a substantial risk

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of forfeiture and not previously included in income. Section 409A(a)(1)(A)(i). The Deferred Payment was not subject to a substantial risk of forfeiture, because Taxpayer's right to the Deferred Payment was not "conditioned upon the future performance of substantial services by any individual." Section 409A(d)(4). The amounts deferred under the plan have not previously been included in Taxpayer's income. As a result, the entire balance of the plan ($470,000) is includible in Taxpayer's gross income for 2021. This amount is also subject to an additional income tax of 20% under section 409A(a)(1)(B)(i)(II).[266]

SECTION: 61

TAXPAYER NOT QUALIFYING FOR PPP FORGIVENESS THAT APPLIES FOR AND RECEIVES IT MUST PAY TAX ON THE FORGIVEN AMOUNT

Citation: CCA 202237010, 9/16/22

In Chief Counsel Advice 202237010[267] the IRS indicated that if a taxpayer obtained forgiveness of a paycheck protection program (PPP) loan when he/she was not actually qualified to receive such forgiveness, the forgiveness would represent taxable income to the taxpayer even though the SBA would have the right to demand repayment of the loan balance.

The advice seeks to answer the following question:

> If a taxpayer makes one or more representations that he or she satisfies the conditions for forgiveness of a PPP loan under 15 U.S.C. §§ 636m and 636(a)(37)(J) ("qualifying forgiveness"), but does not factually satisfy the conditions for a qualifying forgiveness , and as a result, has the PPP loan forgiven improperly, may the taxpayer exclude the amount of the forgiven loan from gross income under 15 U.S.C. § 636m(i) or § 276(b)(1) of the COVID-related Tax Relief Act of 2020 (CTRA 2020)?[268]

The memorandum describes the situation that led to this question:

> Taxpayer X applied for and received a first draw PPP loan in 2020. Taxpayer X did not use the loan proceeds for eligible expenses and applied for forgiveness of the PPP loan in 2020 as if she were entitled to a qualifying forgiveness. In the loan forgiveness application submitted to the PPP lender, Taxpayer X failed to include all relevant facts that would indicate that she was not eligible for a qualifying forgiveness of the PPP loan. Based on the omissions and misrepresentations on that application, Taxpayer X received forgiveness of her PPP loan from the lender.[269]

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[266] AM 2022-007, December 16, 2022

[267] CCA 202237010, September 16, 2022, https://www.irs.gov/pub/irs-wd/202237010.pdf (retrieved September 16, 2022)

[268] CCA 202237010, September 16, 2022

[269] CCA 202237010, September 16, 2022

While this is the situation this memorandum addresses, a footnote indicates that the conclusion covers all situations that lead to an improper grant of forgiveness:

> A variety of fact patterns may establish that the taxpayer was not eligible for forgiveness under the statute and related regulatory guidance. For example, the taxpayer may have used the funds for personal expenditures. No implication is intended from the facts in the Situation presented below that it limits the reasons why a particular forgiveness is not a qualifying forgiveness.[270]

The analysis notes that although the taxpayer receives cash when the loan is granted, that is not a taxable accession to wealth at that time:

> There is no accession to wealth under section 61(a) upon receipt of PPP loan proceeds, as the PPP loan is issued by a bank, includes an interest rate and maturity date, and includes an obligation for the eligible recipient to repay. See *Commissioner v. Tufts*, 461 U.S. 300, 307 (1983); *Commissioner v. Indianapolis Power & Light Co.*, 493 U.S. 203, 207-8 (1990). Once a participating lender forgives a loan originated under the PPP, however, the recipient of the loan proceeds enjoys an accession to wealth in the amount of the loan that is forgiven. Under general principles of Federal income taxation, the amount forgiven must be included in the loan recipient's gross income. However, section 636m(i) of the United States Code, Title 15, and § 276(b)(1) of the CTRA 2020 provide express exceptions to the rule that forgiveness of a PPP loan constitutes gross income.[271]

While cancellation of indebtedness is generally an accession to wealth taxable under IRC §61, the memorandum notes a special provision added in the CARES Act provides that this income is not subject to tax so long as it is a *qualifying forgiveness*:

> Thus, a taxpayer who received a PPP loan that is forgiven may exclude the forgiven amount of the PPP loan from gross income if the forgiveness is described in section 636m(i) and § 276(b)(1) of the CTRA 2020. These exclusions apply only to a qualifying forgiveness of a PPP loan. Forgiveness of a PPP loan is a qualifying forgiveness only if the use of the loan proceeds satisfies the conditions relating to specified costs (as described in 15 U.S.C. § 636m(b), (d)). To receive a qualifying forgiveness, the loan recipient must apply for the forgiveness in accordance with the specific procedures set forth in the statute and associated regulations.[272]

The IRS position is that if forgiveness is obtained when a taxpayer does not meet the conditions found in the CARES Act and later laws, it is not *qualifying forgiveness* and thus does not get excluded from income:

> Failure to meet these conditions means that there is no qualifying forgiveness, and thus the exclusions would not apply to the forgiven PPP loan. As the Second

[270] CCA 202237010, September 16, 2022

[271] CCA 202237010, September 16, 2022

[272] CCA 202237010, September 16, 2022

Circuit concludes in discussing the forgiveness provision of the PPP (15 U.S.C. § 636m) in *Springfield Hosp., Inc*., 28 F.4th 403, 424 (2nd Cir. 2022):

> [F]orgiveness is neither automatic nor guaranteed. A borrower must apply for forgiveness, which will only be granted if specified criteria are met, see 15 U.S.C. § 636m(b)–(d), and the CARES Act places several additional conditions upon obtaining forgiveness [including that the funds are "used for statutorily authorized purposes"].[273]

The IRS then analyzes the situation in question and concludes the forgiveness in this case is not qualifying forgiveness:

> Turning to the Situation described above, because the forgiveness of Taxpayer X's PPP loan was based on omissions and misrepresentations, the loan that Taxpayer X received did not fall within the scope of loans that could be forgiven under 15 U.S.C. § 636m. The forgiveness of that loan accordingly did not constitute a qualifying forgiveness described in 15 U.S.C. § 636m, and may not be excluded from Taxpayer X's gross income under 15 U.S.C. § 636m(i). The exclusion provision applies only to a PPP loan that meets the conditions of a qualifying forgiveness. Similarly, the exclusion applies only if the loan recipient is an eligible recipient. Thus, even if the loan forgiveness is otherwise a qualifying forgiveness, the exclusion is inapplicable if the loan recipient is not an eligible recipient. [274]

The amounts must be included in income since IRC §61's broad definition of income would require including this in income:

> Because section 636m(i) does not apply to forgiveness of her PPP loan, Taxpayer X must include the forgiven amount in her gross income. This result follows from the application of the general principles of Federal income taxation to the amount forgiven in determining the proper tax treatment. [275]

Specifically, the IRS finds that this situation represents a *claim of right* as the taxpayer had complete dominion and control over the PPP loan proceeds:

> Section 61(a) generally provides that "gross income means all income from whatever source derived." This result applies to all payments that are "undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion" constitute taxable income. *Commissioner v. Glenshaw Glass Co*., 348 U.S. 426, 431 (1955). In 2020, the year of forgiveness and release from the obligation to repay, Taxpayer X had undeniable accessions to wealth, clearly realized, and over which she had complete dominion under the principles of *Glenshaw Glass.* Furthermore, notwithstanding the ability of the SBA to pursue repayment in the case of misuse of funds, Taxpayer X retained the PPP loan proceeds in 2020 under a claim of right.[276]

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[273] CCA 202237010, September 16, 2022

[274] CCA 202237010, September 16, 2022

[275] CCA 202237010, September 16, 2022

[276] CCA 202237010, September 16, 2022

The memorandum continues, applying the claim of right principles to these facts:

> The claim of right doctrine derives originally from the Supreme Court decision in *North American Oil Consolidated v. Burnet*, 286 U.S. 417 (1932). The court there stated that "[i]f a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent." Id. at 424. This doctrine applies regardless of whether the taxpayer acquires the proceeds lawfully; see *James v. United States*, 366 U.S. 213, 219 (1961) (applying the *North American Oil Consolidated* approach "[w]hen a taxpayer acquires earnings, lawfully or unlawfully, without the consensual recognition, express or implied, of an obligation to repay and without restriction as to their disposition").

The fact that the SBA may determine later that repayment is required does not change this result:

> The ability of the SBA to pursue repayment of the improperly forgiven PPP loan does not preclude the application of the claim of right doctrine to Taxpayer X in 2020. See *United States v. Lewis*, 340 U.S. 590 (1951) (taxpayer received a bonus in 1944 and was required to repay the bonus in 1946 after being informed the original payment was erroneous; the court found that the taxpayer held the bonus under a claim of right in 1944 and rejected his argument that he could amend his 1944 return to reflect the subsequent repayment).[277]

Thus, the memorandum comes to the following overall conclusion:

> If a taxpayer who does not factually satisfy the conditions for a qualifying forgiveness causes its lender to forgive the PPP loan by inaccurately representing that the taxpayer satisfies them, the taxpayer may not exclude the amount of the forgiven loan from gross income under 15 U.S.C. § 636m(i) or section 276(b)(1) of the CTRA 2020.[278]

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[277] CCA 202237010, September 16, 2022

[278] CCA 202237010, September 16, 2022

SECTION: 61

TAXPAYER HAD ENOUGH OF A GUARANTEE BUSINESS WOULD BE ABLE TO KEEP FUNDS RECEIVED THAT THE AMOUNTS IMMEDIATELY CONSTITUTED INCOME

Citation: United States v. VanDemark, CA6, Docket No. 21-3470, 6/30/22

We don't often write about criminal tax cases here on this site, but the case of *United States v. VanDemark*[279] discusses a taxpayer who, per the beginning of the Sixth Circuit opinion "tried to hoodwink the IRS."[280] Of interest outside the criminal tax controversy context, he attempted to argue in his defense that he did not have to report cash deposits he received as income due to lack of "some guarantee" the business would keep the funds, an argument the appellate panel did not find persuasive given the facts of his case.

The opinion continues with the following broad summary:

> Gregory VanDemark owns the Used Car Supermarket, which sells cars from two lots in Amelia, Ohio. In 2013 and 2014, VanDemark funneled away his customers' down payments and left them off his tax returns. He used this stashed-away cash to finance the mortgage on his mansion. The IRS caught wind soon enough. The government charged VanDemark with crimes related to his scheme, and a jury convicted him of six counts. VanDemark moved for an acquittal on three of these counts and a new trial on all six. The district court denied both motions.[281]

The opinion has more details on the structure of Mr. VanDemark's businesses:

> Gregory VanDemark made his fortune selling cars. He's built something of a mini-business empire in Amelia, Ohio. At the center of it all is the Used Car Supermarket, a C-corporation owned solely by VanDemark. Flanking the Supermarket are VanDemark's three S-corporations: the VanDemark Group, the VanDemark Corporation, and Gregory Properties. Each supports the Supermarket in its own way.1 And because these are S-corporations, VanDemark must report flow-through income and deductions on his personal returns.
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> The Supermarket's clientele is by and large low-income and low-credit. Customers typically finance their cars by entering into lease-to-buy agreements.

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[279] *United States v. VanDemark*, CA6, Docket No. 21-3470, June 30, 2022, https://www.taxnotes.com/research/federal/court-documents/court-opinions-and-orders/car-salesman%e2%80%99s-tax-fraud-conviction-upheld/7dm34 (retrieved July 1, 2022)

[280] *United States v. VanDemark*, CA6, Docket No. 21-3470, June 30, 2022

[281] *United States v. VanDemark*, CA6, Docket No. 21-3470, June 30, 2022

> The process kicks off with a large down payment. These down payments, and VanDemark's efforts to hide them, are at the heart of this appeal.[282]

The Court than outlines the actions that eventually led to the taxpayer's issues with the IRS:

> Before 2013, everything was above board at the Supermarket on the tax front. The Supermarket's protocols ensured all the down payments remained within the IRS's view. To begin with, VanDemark kept a handwritten ledger at each of the two lots. Every time a customer made a down payment, his employees recorded it in one of these ledger books. They made sure to deposit every payment into the Supermarket's bank account as well. Afterward, employees entered the bank receipts into an accounting software called QuickBooks. And as a final step, VanDemark's tax preparer used the QuickBooks files to complete the necessary tax returns.
>
> But in 2013, VanDemark began to short-circuit this process. He instructed an employee named Christopher McAfee to start stashing this cash in a safe at the main office. McAfee did as he was told. And, not surprisingly, the amount of cash deposited into the Supermarket's bank account plunged in 2013 and 2014. In 2012, VanDemark deposited $265,499.25 in cash into the account. But in 2013 and 2014, that number was much reduced to $12,194.63 and $71,150.86, respectively. Because the stashed-away cash never reached the bank account, it never made it into VanDemark's QuickBooks files. And because VanDemark's tax preparer relied on those QuickBooks files, he failed to report the cash on VanDemark's tax returns.[283]

Not surprisingly, Mr. VanDemark had a use in mind for this cash. The opinion notes that "VanDemark used most of this cash to pay the mortgage on his multimillion-dollar mansion."[284]

However, he was aware that the bank that held the mortgage faced requirements to report certain cash transactions, but he was unsure of the details. So, he decided to ask a bank employee about the issue:

> Wary of attracting the IRS's attention, VanDemark asked an employee at his bank to confirm the IRS reporting threshold. She told VanDemark that the bank had to report "[a]nything over 10,000 in cash" to the IRS. (R. 73, Trial Tr. (Luck), PageID 1086-87.) So with this information in hand, VanDemark began to make cash payments toward his mortgage several times a month, keeping each payment below $10,000.[285]

But his attempts to reduce his taxes did not stop with the cash from deposits being diverted to pay the mortgage. The opinion notes:

> But VanDemark's tax evasion didn't stop there. He overreported deductions on his personal returns as well. Aside from his Ohio mansion, VanDemark owned two other residences: a novelty house built in the shape of a paddleboat and an

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[282] *United States v. VanDemark*, CA6, Docket No. 21-3470, June 30, 2022

[283] *United States v. VanDemark*, CA6, Docket No. 21-3470, June 30, 2022

[284] *United States v. VanDemark*, CA6, Docket No. 21-3470, June 30, 2022

[285] *United States v. VanDemark*, CA6, Docket No. 21-3470, June 30, 2022

> oceanfront property in Florida. VanDemark claimed construction, maintenance, and insurance expenses on these properties as business expenses for his S-corporations. He pulled this off by telling the IRS that he was building the paddleboat house as a bed and breakfast, the Florida residence was his business headquarters, and his Ohio mansion was a rental property. Thanks to these efforts, VanDemark and the Supermarket paid no federal income tax in 2013 and 2014.[286]

However, it turned out that inquiring of the bank employee about how much he could pay in cash before the bank had to notify the IRS was going to lead to the exact type of IRS attention he appeared to be attempting to avoid. Apparently, he didn't realize that the employee might consider the very act of asking such a question and then making cash payments just below those levels would look suspicious to the bank employee:

> His enquiries at the bank had raised some eyebrows. The bank employee reported her conversation with VanDemark to her Bank Secrecy Act officer. This information made its way to the IRS, which deployed a special agent to investigate.[287]

An IRS special agent approached Mr. VanDemark posing as a businessman interested in buying his business. Not surprisingly, Mr. VanDemark felt he needed to tell the potential buyer that there was a bit of "off book" activity and this business was truly more profitable than it would appear from the tax returns and his *Quickbooks* ledger:

> In December 2014, an IRS special agent contacted VanDemark. Posing undercover as a businessman, he expressed an interest in buying VanDemark's businesses. The pair spoke over the phone several times. In one of these calls, VanDemark spilled the beans. He boasted that he had about "$16 million in assets" and his businesses "net over $1 million a year." (R. 90, Gov't Ex. 2, PageID 1524-25, 1546.) VanDemark all but admitted to tax evasion by explaining that he "pulled out . . . 25% of that big figure" "in the last couple of years [2013 and 2014]." (Id. at PageID 1549-50.) What's more, he kept track of the stashed-away 25% "just in case." (Id. at PageID 1551.) VanDemark let slip about his deductions as well. He admitted that he "shoved all expenses on the company" so that he wouldn't "end up paying a bunch of dang taxes." (Id. at PageID 1527.) And to top it all off, VanDemark confessed he was "kind of . . . giving [the agent] information [he] shouldn't even be talking about." (Id. at PageID 1550.)[288]

At this point, the IRS decided now was the time to obtain search warrants, seize records and begin questioning Mr. VanDemark. Apparently not realizing that his "buyer" was using his conversations to obtain incriminating information that the IRS agents now questioning him were aware of, Mr. VanDemark was, shall we say, not entirely truthful with the agents per the Court's description of the events.

> The IRS had heard enough. In July 2016, it executed search warrants at VanDemark's three residential properties and the two Supermarket lots. Agents

[286] *United States v. VanDemark*, CA6, Docket No. 21-3470, June 30, 2022

[287] *United States v. VanDemark*, CA6, Docket No. 21-3470, June 30, 2022

[288] *United States v. VanDemark*, CA6, Docket No. 21-3470, June 30, 2022

> recovered the handwritten ledgers from the two lots. They found VanDemark at his paddleboat-shaped house and interviewed him for over three hours. He told the agents that his QuickBooks files contained all of his business records. At no point did he mention the ledger books. Asked whether he had skimmed cash from his dealership, VanDemark claimed that his employees deposited everything into the Supermarket's bank account.[289]

As you have probably surmised, the IRS now had enough material to obtain an indictment against Mr. VanDemark:

> Fast forward a year and a half, and a grand jury indicted VanDemark on six counts. The first four charged VanDemark with helping prepare false tax returns, in violation of 26 U.S.C. § 7206(2). Counts One and Two dealt with the Supermarket's 2013 and 2014 corporate returns. Counts Three and Four concerned VanDemark's 2013 and 2014 personal returns. Count Five charged VanDemark with structuring payments, in violation of 31 U.S.C. § 5324(a)(3). And Count Six charged VanDemark with making false statements to federal agents, in violation of 18 U.S.C. § 1001.[290]

At his trial things did not go well for Mr. VanDemark:

> The trial began in March 2020. After the government rested, VanDemark made a Rule 29(a) motion for acquittal on Counts One, Two, and Three. The district court denied the motion. But VanDemark renewed it twice before the jury reached its verdict: once at the end of his case and again after the district court instructed the jury. The district court denied the motion twice more.
>
> The trial lasted six days. In the end, the jury found VanDemark guilty on all counts. VanDemark renewed his motion for acquittal under Rule 29(c). He also moved for a new trial on all six of his counts under Rule 33. In a 17-page written order, the district court denied both motions. In May 2021, the district court entered judgment. And now, VanDemark appeals.[291]

Mr. VanDemark appealed this result, arguing that the trial court improperly denied his motion to acquit. Key to this is his argument that, in fact, those deposits were properly not reported as income. As the opinion describes his argument:

> The first two counts charged VanDemark with assisting in the preparation of false corporate returns for 2013 and 2014. VanDemark's argument begins and ends with *Commissioner v. Indianapolis Power & Light Co*., which says that a deposit isn't taxable income unless "the taxpayer has *<u>some guarantee</u>* that he will be allowed to keep the money."3 493 U.S. 203, 210 (1990) (emphasis added). VanDemark claims that the lease agreements tied the Supermarket's hands. If a customer decides not to purchase the car at the lease's end, says VanDemark, the customer can demand a refund of the down payment under the contract. And so,

[289] *United States v. VanDemark*, CA6, Docket No. 21-3470, June 30, 2022

[290] *United States v. VanDemark*, CA6, Docket No. 21-3470, June 30, 2022

[291] *United States v. VanDemark*, CA6, Docket No. 21-3470, June 30, 2022

> the argument goes, the Supermarket lacked the necessary "guarantee," and the down payments were never taxable as a threshold matter.[292]

This issue is more in line with what we usually discuss in these articles. So, did the appeals court agree with Mr. VanDemark's argument that the deposits were not taxable and therefore he could not have been guilty of assisting in the preparation of false income tax returns?

Well, not quite. First, the panel did not agree Mr. VanDemark did not have some guarantee he would be allowed to keep the money:

> …[T]he Supermarket issued virtually no refunds across decades. The Supermarket found ways to keep these down payments at its discretion, the contract notwithstanding. And that means the down payments were taxable upon receipt consistent with Indianapolis Power.[293]

The panel noted a number of reasons why the corporation was virtually assured that it would keep the deposits it received:

> We begin with the Supermarket's track record on refunds. Christopher McAfee worked at the Supermarket for no fewer than 30 years. And he testified that, in those 30 years, he saw the down payment refunded "maybe, one, two, three" times total. (R. 72, Trial Tr. (McAfee), PageID 1470.) The record contains additional corroboration as well. A special agent reviewed VanDemark's ledger books from 2012 to 2014 and found only one refund. What's more, that single refund wasn't even issued at the end of the lease under the contract. Instead, VanDemark refunded the deposit the same day the customer paid it. Perhaps the customer changed his or her mind before finalizing the lease, and the Supermarket issued a refund at its discretion. In any event, that single refund had nothing to do with the contract. This means that the contract terms forced VanDemark's hand a grand total of zero times from 2012 to 2014 (and maybe "one, two, three" times in 30 years).
>
> Simply put, these numbers belie VanDemark's Indianapolis Power argument. One way or another, the Supermarket engineered for itself "some guarantee" of keeping the down payments — that much is clear enough. Certainly, this conclusion is within a rational jury's reach. VanDemark's control is shown in the contract itself and in how VanDemark applied that language. True, the contract requires the Supermarket to refund the down payment if the customer returns the car at the end of the lease. But that's only if the excess mileage fee and the cost of damages to the car do not exceed the down payment amount.
>
> And as the district court emphasized, these variables are couched in significant ambiguities. The Supermarket exploited them to maintain control over the down payments. On excessive mileage, the contract imposes a fee "equal to $.50 per mile for miles to be computed at the end of the lease and balance due." (R. 59, July, 17, 2020 Op. & Order, PageID 247.) But importantly, the contract fails to specify a base mileage. As a practical matter, this allows VanDemark to define the number of excess miles after the lease ends. This theme continues with the

[292] *United States v. VanDemark*, CA6, Docket No. 21-3470, June 30, 2022

[293] *United States v. VanDemark*, CA6, Docket No. 21-3470, June 30, 2022

> second variable. The contract says that damages beyond "ordinary wear and tear" come out of the deposit. (Id.) As for calculating those costs, however, the contract places everything in VanDemark's hands. It specifies that "a representative from VANDEMARK . . . shall be the sole judge and arbiter as to whether or not any disputed damage is due to ordinary wear and tear or due to some other cause." (Id. at PageID 247 (emphasis added).) These ambiguities enable the Supermarket to jack up both variables on the back end to prevent a refund if it wishes.[294]

But the panel notes that even if Mr. VanDemark was correct in his view under these facts that the deposits were not immediately taxable upon receipt, Mr. VanDemark failed to treat them as taxable once any potential risk of having to return the deposits went away:

> The plot thickens even more from here, and not in VanDemark's favor. VanDemark argues that everything rises and falls with the contract's refund language. He doesn't dispute that once a customer converts the lease into a purchase, the refund provision no longer applies. In other words, the down payment is taxable by that point. If only the refund language didn't tie his hands, no doubt VanDemark would have reported everything — that's the implication of his Indianapolis Power argument, anyway. This begs the question: When those 2013 and 2014 leases were eventually bought out — whether in 2013, 2014, or later — did VanDemark report the down payments?
>
> Not quite. It turns out that at least seven customers (1) began their leases in 2013 or 2014 and (2) bought out their cars within that same window. One of these leases ended in 2013, and the remaining six in 2014. And under VanDemark's own theory, the down payments for these leases should have appeared on the Supermarket's 2013 and 2014 returns. But they did not, which means that VanDemark fails his own test. And VanDemark says nothing about the 2013 and 2014 leases that were bought out after 2014. He could have pointed the IRS to those tax returns where he eventually reported the down payments for these leases. That way, his failure to report those payments in 2013 and 2014 becomes a timing issue that falls short of a criminal prosecution. But VanDemark did no such thing. All of this shows that he never intended to report any of the down payments, with or without Indianapolis Power. The district court properly denied VanDemark's acquittal motion as to Counts One and Two.[295]

The failure to *ever* include such deposits as income could reasonably be interpreted as evidence he acted to avoid paying tax on these funds.

[294] *United States v. VanDemark*, CA6, Docket No. 21-3470, June 30, 2022

[295] *United States v. VanDemark*, CA6, Docket No. 21-3470, June 30, 2022

SECTION: 105

WELLNESS INDEMNIFICATION PAYMENTS INCLUDIBLE IN EMPLOYEE'S TAXABLE INCOME

Citation: Chief Counsel Advice 202323006, 6/9/23

What are the tax implications of an employer-funded fixed-indemnity insurance policy that pays employees $1,000 per month through a wellness indemnification program? This payment is made for each month the employee participates in specific wellness activities, with the costs covered by a comprehensive medical plan offered by the employer.

In Chief Counsel Advice 202323006,[296] the IRS provided guidance on this matter, determining that the payments described above should be treated as taxable income, subject to payroll taxes, and cannot be excluded under Internal Revenue Code (IRC) §106.

The Question Posed

The memorandum looks at the following facts:

> An Employer provides comprehensive health coverage for its employees through a group health insurance policy. The comprehensive health coverage provides preventive care benefits, such as reimbursements for the cost of flu shots and other vaccinations, without any cost sharing for covered individuals. The coverage constitutes accident or health coverage for purposes of the exclusion for employer-provided accident or health coverage under §106(a).
>
> In addition to the health coverage, the Employer provides all employees, regardless of enrollment in other comprehensive health coverage, with the ability to enroll in coverage under a fixed-indemnity health insurance policy that would qualify as an accident and health plan under §106. Employees pay monthly $1,200 premiums for the fixed-indemnity health insurance policy by salary reduction through a §125 cafeteria plan. The only payments that the insurance company receives with respect to the insurance provided to the employees are the premium payments. In other words, the Employer has no liability for any costs incurred by the insurance company that may exceed the premiums paid by its employees.
>
> The Employer's fixed-indemnity health insurance policy is a voluntary program primarily intended to supplement its employees' other health coverage through the provision of wellness benefits. The first type of wellness benefit provided by the fixed-indemnity health insurance policy is a payment of $1,000 if an employee participates in certain health or wellness activities. This benefit is limited to one payment per month. Use of preventive care, such as vaccinations, under a comprehensive health plan in which an employee is enrolled, qualifies the employee for the payment for the month. The fixed-indemnity health insurance policy provides wellness counseling, nutrition counseling, and

[296] Chief Counsel Advice 202323006, June 9, 2023, https://www.irs.gov/pub/irs-wd/202323006.pdf (retrieved June 10, 2023)

> telehealth benefits at no additional cost. The employee is responsible for any costs associated with receiving any health-related activity, although in many cases all or part of the cost of the health-related activity will be provided at no cost or is covered by other insurance. The fixed-indemnity health insurance policy also provides a benefit for each day that the employee is hospitalized. Under the fixed-indemnity health insurance policy, the wellness benefits are paid from the insurance company to the Employer, which then pays out the wellness benefit to employees via the Employer's payroll system.[297]

The memorandum, based on those facts, seeks to answer the following questions:

> Whether wellness indemnity payments under an employer-funded, fixed-indemnity insurance policy (including where the premium for the coverage is paid by employee salary reduction through a cafeteria plan under section 125 of the Internal Revenue Code (Code)) are includible in the gross income of the employee if the employee has no unreimbursed medical expenses related to the payment.
>
> Whether the wellness indemnity benefits that are includible in gross income (taxable wellness indemnity benefits) are wages for purposes of Federal Insurance Contributions Act (FICA) taxes, Federal Unemployment Tax Act (FUTA) taxes, and federal income tax withholding (FITW) (collectively, "employment taxes") with respect to the payments of benefits in the situation described below.[298]

The Law – Inclusion in Income of the Employee

The memorandum commences by outlining the tax-exempt fringe benefit provisions under federal tax law, as stated in IRC §§105 and 106:

> In general, §106(a) provides that gross income of an employee does not include employer-provided coverage under an accident or health plan. Under §106(a), an employee may exclude from gross income premiums for accident or health insurance coverage that are paid by an employer.
>
> Section 105(a) provides that generally amounts received by an employee through accident and health insurance for personal injuries or sickness are included in gross income to the extent the amounts (1) are attributable to contributions by the employer which are not includable in the gross income of the employee or (2) are paid by the employer.
>
> Section 105(b) provides that gross income does not include amounts paid by an employer to reimburse an employee for expenses incurred by the employee for medical care as defined in §213(d). The exclusion under §105(b) is limited to amounts paid solely to reimburse expenses incurred for medical care and does

[297] Chief Counsel Advice 202323006, June 9, 2023

[298] Chief Counsel Advice 202323006, June 9, 2023

> not apply to amounts which the taxpayer would be entitled to receive irrespective of whether expenses for medical care are incurred.[299]

Next in the memorandum, the discussion shifts to the Regulations issued by the Treasury Department under IRC §105:

> Treasury Regulation §1.105-2 provides that section 105(b) does not apply to amounts which the taxpayer would be entitled to receive irrespective of whether the expenses are incurred for medical care. Section 1.105-2 also provides that if the amounts are paid to the taxpayer solely to reimburse expenses which were incurred for the prescribed medical care, section 105(b) is applicable even though such amounts are paid without proof of the amount of the actual expenses incurred by the taxpayer, but section 105(b) is not applicable to the extent that such amounts exceed the amount of the actual expenses for such medical care.[300]

The memorandum proceeds to analyze the IRC provision concerning cafeteria plans and its interaction with IRC §106.

> Generally, an employee choice between two or more benefits consisting of taxable benefits, such as cash, and nontaxable benefits, such as employer-provided health coverage, results in a cafeteria plan, the taxable benefits under which are included in income unless the choice is provided in accordance with the rules under §125 of the Code. Under §125, an employer may establish a cafeteria plan that permits an employee to choose among two or more benefits, consisting of cash (generally, salary) and qualified benefits, including accident or health coverage. Pursuant to §125, the amount of an employee's salary reduction through a cafeteria plan applied to purchase health coverage is not included in gross income, even though it was available to the employee and the employee could have chosen to receive cash instead. If an employee elects salary reduction pursuant to §125 to pay for health coverage, the coverage is excludable from gross income under §106 as employer-provided accident or health coverage.[301]

The memorandum continues, looking at the impact of IRC §104(a)(3) on the inclusion of benefits received under accident or health insurance.

> Section 104(a)(3) provides that gross income does not include amounts received through accident or health insurance (or through an arrangement having the effect of accident or health insurance) for personal injuries or sickness. This exclusion does not apply, however, if the amounts are either (1) attributable to contributions by the employer that were not includable in the gross income of the employee, or (2) paid by the employer. See Treas. Reg. §1.104-1(d). For this purpose, salary reduction under a §125 cafeteria plan is treated as an employer contribution, and not an employee contribution.[302]

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[299] Chief Counsel Advice 202323006, June 9, 2023

[300] Chief Counsel Advice 202323006, June 9, 2023

[301] Chief Counsel Advice 202323006, June 9, 2023

[302] Chief Counsel Advice 202323006, June 9, 2023

The analysis of the law for inclusion in income concludes with a discussion of how fixed-indemnity policy benefits are impacted by IRC §104(a)(3):

> A fixed-indemnity health insurance policy is an insurance policy that pays covered individuals a specified amount of cash for the occurrence of certain health-related events, such as office visits or days in the hospital. Similarly, a critical disease or specific disease policy pays a specific amount for the diagnosis of a particular disease. The amount paid is not related to the amount of any medical expense incurred or coordinated with other health coverage. The amount of the payment is not based on the employee's actual absence from work on account of the health-related event. The exclusion from gross income under §104(a)(3) applies to amounts received through accident or health insurance, or through an arrangement having the effect of accident or health insurance, for personal injuries or sickness. The exclusion under §104(a)(3), however, does not apply to the extent that amounts paid are attributable to contributions by the employer which were not includable in the gross income of the employee, or paid by the employer.[303]

The Law – Payroll Taxes

In addition to the standard considerations for inclusion in income, there is also a separate inquiry into how these benefits are taxed under various payroll tax programs, namely FICA and FUTA. The memorandum provides a detailed explanation of the definition of wages for these programs.

> Sections 3101 and 3111 impose FICA taxes (comprised of social security tax and Medicare tax) on "wages" as that term is defined in section 3121(a). Section 3121(a) defines wages as all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash, with certain specific exceptions.
>
> Section 3301 imposes federal unemployment (FUTA) tax on "wages" as that term is defined in §3306(b). Section 3306(b) defines wages as all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash, with certain specific exceptions.
>
> Treasury Regulation §31.3121(a)-1(b), relating to FICA tax, provides that the term "wages" means all remuneration for employment, unless specifically excepted under §3121(a) of the Code or the regulations thereunder. Treasury Regulation §31.3306(b)-1(b) contains a similar provision for purposes of FUTA.
>
> Section 3121(a)-1(c) of the Code and Treasury Regulation §31.3306(b)-1(c) provide that the name by which the remuneration is designated is immaterial. Salaries, fees, and bonuses, for example, are all wages if paid as compensation for employment.
>
> Sections 31.3121(a)-1(d) and 31.3306(b)-1(d) provide that, generally, the basis upon which the remuneration is paid is immaterial in determining whether the remuneration constitutes wages.[304]

[303] Chief Counsel Advice 202323006, June 9, 2023

[304] Chief Counsel Advice 202323006, June 9, 2023

In concluding its overview of the payroll tax law in this area, the memorandum examines the exclusions from FICA and FUTA wages for these benefits. It also discusses the requirements that must be met in order for these exclusions to apply.

> Section 3121(a)(5)(G) of the Code provides an exception from FICA wages for any payment to or on behalf of an employee under a cafeteria plan (within the meaning of §125) if such payment would not be treated as wages without regard to such plan and it is reasonable to believe that (if §125 applied for purposes of §3121) §125 would not treat any wages as constructively received. Section 3306(b)(5)(G) contains a similar exception from wages for purposes of FUTA tax.
>
> Section 3121(a)(2) provides an exception from FICA wages for:
>
>> the amount of any payment (including any amount paid by an employer for insurance or annuities, or into a fund, to provide for any such payment) made to, or on behalf of, an employee or any of . . . [the employee's] dependents under a plan or system established by an employer which makes provision for . . . [its] employees generally (or for . . . [its] employees generally and their dependents) or for a class or classes of . . . [its] employees (or for a class or classes of . . . [its] employees and their dependents) on account of
>>
>>> (A) sickness or accident disability (but, in the case of payments made to an employee or any of . . . [the employee's] dependents, this subparagraph shall exclude from the term "wages" only payments which are received under a [workers'] . . . compensation law);
>>>
>>> (B) medical or hospitalization expenses in connection with sickness or accident disability. . . .
>
> Section 3306(b)(2) contains an exception similar to §3121(a)(2) that applies for purposes of FUTA wages.
>
> Temporary Treasury Regulation §32.1(a), in effect, provides that payments to or on behalf of an employee on account of sickness or accident disability are not excluded from the term wages unless they are received under a workers' compensation law or qualify for the exception from wages provided under §3121(a)(4) of the Code, which provides an exception for any payment on account of sickness or accident disability made after the expiration of 6 calendar months following the last calendar month in which the employee worked.
>
> Temporary Treasury Regulation §32.1(d) provides that for purposes of determining the payments subject to FICA taxation under Temporary Treasury Regulation §32.1(a):
>
>> a payment made on account of sickness or accident disability includes any payment for personal injuries or sickness includible in gross income

under section 105(a) and the regulations thereunder and thus does not include —

(1) any amount which is expended for medical care as described in section 105(b) and section 1.105-2,

(2) any payment which is unrelated to absence from work as described in section 105(c) and section 1.105-3, or

(3) any payment or portion thereof which is attributable to a contribution by the employee as determined in paragraphs (d) and (e) of section 1.105-1.

A payment made on account of sickness or accident disability does not include any payment which is excludable from gross income under section 104(a)(2), (4), or (5).[305]

Inclusion in Employee's Income and Taxable for Payroll Tax Purposes

In its conclusion, the memorandum determines that under the program described within, employees are required to include the wellness indemnity payments in their income.

> Wellness indemnity payments under an employer-funded, fixed-indemnity insurance policy (including where the premium for the coverage is paid by employee salary reduction through a cafeteria plan under section 125 of the Internal Revenue Code (Code)) are includible in the gross income of the employee if the employee has no unreimbursed medical expenses related to the payment.
>
> The exclusion under §105(b) is limited to amounts paid solely to reimburse expenses incurred for medical care and does not apply to amounts which the taxpayer would be entitled to receive irrespective of whether expenses for medical care are incurred. The exclusion from income in §105(b) does not apply to payments when the employee has no unreimbursed medical expense either because the activity that triggers the payment does not cost the employee anything or because the cost of the activity is reimbursed by other coverage.
>
> The fixed indemnity health insurance policy pays $1,000 per month without regard to whether the employee has any unreimbursed health insurance expenses. Thus, the payment is included in the employee's gross income.[306]

Similarly, the memorandum arrives at a comparable conclusion regarding payroll taxes.

> Because the payment is provided in connection with the employee's employment, it is included in remuneration and treated as "wages" for employment tax purposes. The exclusions from "wages" for medical expenses would not apply because the payments are not for medical expenses.[307]

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[305] Chief Counsel Advice 202323006, June 9, 2023

[306] Chief Counsel Advice 202323006, June 9, 2023

[307] Chief Counsel Advice 202323006, June 9, 2023

The analysis behind the FICA and FUTA conclusion is provided as follows:

> The taxable wellness indemnity benefits are provided by employers to employees as remuneration for employment under benefit plans funded by employers and, thus, fit within the basic definition of wages under §3121(a). To the extent the taxable wellness indemnity benefits are not paid under a worker's compensation law, they do not qualify for the exception from wages provided by §3121(a)(2)(A). Although the payments are made on account of sickness or accident disability, the parenthetical in §3121(a)(2)(A) removes the payments from the exclusion because they are not received under a workers' compensation law. Moreover, the taxable wellness indemnity benefits cannot qualify for the §3121(a)(2)(B) exception because the payments are not made on account of medical or hospitalization expenses in connection with sickness or accident disability.
>
> Temporary Treasury Regulation §32.1(d) specifically bases inclusion in the definition of "payments on account of sickness or accident disability" subject to FICA tax on the payment being "includible in gross income under §105(a)." All the exceptions from treatment as payments on account of sickness or accident disability that are specifically mentioned in §32.1(d) support the conclusion that the payments subject to FICA taxes under the regulations are only those payments that are includible in gross income under §105(a) of the Code. The specifically listed numbered exceptions in Temporary Treasury Regulation §32.1(d) and the amounts excludable under §104(a)(2), (4), and (5) of the Code are all amounts that are excludable from gross income. It is, therefore, clear that Temporary Treasury Regulation §32.1(d) was not intended to provide an exception from FICA wages for payments that are includible in gross income. The taxable wellness indemnity benefits would be excludable under §32.1(d)(1) to the extent that they are expended for medical care as described in §105(b) of the Code and Treasury Regulation §1.105-2. However, because the taxable wellness indemnity benefits do not qualify for the Temporary Treasury Regulation §32.1(d)(1) exception, and no other exception applies, they are subject to FICA.
>
> A similar analysis applies for purposes of the similar exception under §3306(b)(2)(A) of the Code with respect to FUTA taxes. Thus, the taxable wellness indemnity benefits are also subject to FUTA taxation.[308]

The analysis of the inclusion of these wages for federal income tax withholding purposes reaches the same conclusion.

> Section 3402(a) of the Code, relating to U.S. Federal Income Tax Withholding (FITW), generally requires every employer making a payment of wages to deduct and withhold upon those wages a tax determined in accordance with prescribed tables or computational procedures. The term "wages" is defined in §3401(a) for FITW purposes as all remuneration for services performed by an employee for his employer, including the cash value of all remuneration (including benefits) paid in any medium other than cash with certain specific exceptions. Among the specific exceptions are several exceptions related to the provision of medical

[308] Chief Counsel Advice 202323006, June 9, 2023

> insurance and benefits. See §3401(a)(20), 3401(a)(21), and 3401(a)(22). No statutory exception applies to the taxable wellness indemnity benefits.
>
> The taxable wellness indemnity benefits are not sick pay (because they are not dependent upon an absence from work), and there is no exception from the definition of wages under §3401(a) that applies to the payments. Thus, as wages under §3401(a), the taxable wellness indemnity benefits are subject to FITW under the general FITW rules rather than the rules applicable to sick pay.[309]

The overall conclusion is summarized as follows:

> Thus, under the facts described above, when the insured plan pays $1,000 because the employee used a wellness benefit, the $1,000 is included in the employee's income and wages. Accordingly, taxable wellness indemnity benefits are wages for purposes of FICA, FUTA, and FITW with respect to the payments of benefits in the situation described above.[310]

SECTION: 119

TAXPAYER MUST INCLUDE VALUE OF EMPLOYER PROVIDED HOUSING IN HIS INCOME

Citation: Smith v. Commissioner, TC Memo 2023-6, 1/12/23

A government contractor could not exclude the value of employer provided housing from his income under IRC §119 per a Tax Court ruling in the case of *Smith v. Commissioner*, TC Memo 2023-6.[311]

Meals or Lodging for the Convenience of the Employer Exclusion

IRC §119 provides an exclusion from an employee's income for certain meals or lodging if provided, under the terms of the section, for the convenience of the employer.

IRC §119(a) reads:

> (a) Meals and lodging furnished to employee, his spouse, and his dependents pursuant to employment. There shall be excluded from gross income of an employee the value of any meals or lodging furnished to him, his spouse, or any of his dependents by or on behalf of his employer for the convenience of the employer, but only if--
>
>> (1) in the case of meals, the meals are furnished on the business premises of the employer, or

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[309] Chief Counsel Advice 202323006, June 9, 2023

[310] Chief Counsel Advice 202323006, June 9, 2023

[311] *Smith v. Commissioner*, TC Memo 2023-6, January 12, 2023, https://www.taxnotes.com/research/federal/court-documents/court-opinions-and-orders/air-force-contractor-can%27t-exclude-housing-benefit-from-income/7fvqb (retrieved January 13, 2023)

> (2) in the case of lodging, the employee is required to accept such lodging on the business premises of his employer as a condition of his employment.

The Facts of the Case

The opinion describes Mr. Smith's offer and acceptance of employment as follows:

> Mr. Smith is an Air Force veteran and engineer who, in September 2009, received an offer of employment from the Raytheon Company, a private defense contractor, to work as an engineer at the Joint Defense Facility at Pine Gap, Alice Springs, Northern Territory, Australia (Pine Gap). He ultimately accepted the offer.[312]

The options for housing provided to Mr. Smith are also outlined:

> All employees transferred to Alice Springs on the O&M Program are provided good quality [Pine Gap] housing. The employee is responsible for IRS taxable income on the local market rental value of furnished housing and the associated utilities. Additional information on the tax impact of [Pine Gap] housing can be found in the Taxes section elsewhere in this Handbook.
>
> The handbook further informed Mr. Smith of an alternative housing assistance option.
>
>> 5.3 HOUSING ASSISTANCE — ALTERNATE TO [PINE GAP] HOUSING
>>
>> Raytheon will provide a payment to an employee eligible for [Pine Gap] housing to compensate him or her for general costs associated with owning or renting non-[Pine Gap] housing. The actual amount of the allowance will be based upon the U.S. Department of State calculation of the Living Quarters Allowance (Group 3) for Alice Springs. Current Housing Assistance rates can be obtained from the Alice Springs Administration office.
>
> The handbook stated that "[a] current employee residing in [Pine Gap] housing" is eligible for alternate housing assistance "after first relinquishing their [Pine Gap] accommodation." Mr. Smith believed that this option was available to him only after moving to Australia and starting his employment with Raytheon.[313]

[312] *Smith v. Commissioner*, TC Memo 2023-6, January 12, 2023

[313] *Smith v. Commissioner*, TC Memo 2023-6, January 12, 2023

The handbook also provided details on the tax treatment Raytheon believed applied to the provision of this lodging.

> Regarding the income tax treatment of Mr. Smith's housing, the Raytheon handbook stated as follows:
>
> > 13.2 TAXABLE VALUE OF [PINE GAP] HOUSING
> >
> > An employee assigned overseas on this program is provided good quality furnished [Pine Gap] housing at no expense. Income tax on the value of [Pine Gap] housing and the associated utilities is the responsibility of the employee.
> >
> > The value for housing is based on the Northern Territory Housing Commission Rates and is adjusted annually. The taxable value of housing provided to the employee will be reported via a Form 1099 issued by the U.S. Air Force. . . . The employee should report the amount shown on the 1099 as income on his or her annual tax return.[314]

The housing that Mr. Smith was provided is discussed in the opinion:

> Mr. Smith learned that he was assigned housing in Alice Springs in August 2010. Mr. Smith's housing accommodation was U.S.-government housing at Shanahan Close, Alice Springs, Northern Territory (Housing Accommodation). The Housing Accommodation was [*4] in a cul-de-sac where other individuals who worked at Pine Gap lived, but on a public street with public access. Mr. Smith was not aware of any non-Pine Gap employees living in the cul-de-sac. The parties have stipulated that the Housing Accommodation "was not located on Raytheon's business premises" in the literal sense, nor was it a "camp" as defined by section 119(c).
>
> Mr. Smith began working for Raytheon and living at the Housing Accommodation in September 2010. All utilities other than telephone service were provided at no cost to Mr. Smith. In addition, Pine Gap provided or arranged for maintenance and trash removal services at no cost.[315]

The opinion also noted the location of Mr. Smith's housing vs. the location where he normally reported for work as well as work he did at home.

> Mr. Smith reported to work at a building on Hatt Road, Hugh, Northern Territory. Mr. Smith's Housing Accommodation was approximately 11 miles from his place of work. Mr. Smith also performed some work from home. For example, he completed training programs at home, maintained his time sheets, and completed employee evaluations. The training programs were in part voluntary and in part mandatory. Raytheon provided Mr. Smith with a key fob, also known as a hardware token, enabling him to remotely access its secured network from outside the workplace. If any U.S. or foreign visitors stayed with Mr. Smith, he was required to alert the Pine Gap Security Office.

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[314] *Smith v. Commissioner*, TC Memo 2023-6, January 12, 2023

[315] *Smith v. Commissioner*, TC Memo 2023-6, January 12, 2023

> After residing at the Housing Accommodation for nearly eight years, in September 2018, Mr. Smith had to move out and find housing on his own because Pine Gap ceased to provide housing.[316]

Mr. Smith Decides This Isn't Taxable

Originally Mr. Smith reported the value of this housing as taxable income:

> For each of the relevant years, Mr. Smith received from the Secretary of the Air Force a Form 1099-MISC, Miscellaneous Income, reporting as nonemployee compensation the value of his Housing Accommodation. The amounts reported to Mr. Smith for 2016, 2017, and 2018 were $15,889, $15,501, and $10,015, respectively.
>
> Mr. Smith prepared his own Forms 1040, U.S. Individual Income Tax Return, for the taxable years 2016 and 2017. He timely filed those [*5] returns reporting, in relevant part, gross receipts of $15,889 for 2016 and $15,501 for 2017 on Schedule C-EZ, Net Profit From Business. These amounts represented the value of Mr. Smith's Housing Accommodation as reported by the Secretary of the Air Force on Forms 1099-MISC.[317]

But Mr. Smith changed his mind about the tax treatment before it came time to file his 2018 tax returns:

> The Commissioner later received Forms 1040-X, Amended U.S. Individual Income Tax Return, for Mr. Smith's taxable years 2016 and 2017, accompanied by revised Forms 1040. The amended returns and revised Forms 1040 were filed by a preparer in the United States. In the returns, Mr. Smith again reported as gross receipts the value of the Housing Accommodation shown on the Forms 1099-MISC for 2016 and 2017 ($15,889 and $15,501, respectively). But Mr. Smith also claimed corresponding deductions for "employee benefit programs" in amounts equal to the value of the Housing Accommodation, which had the effect of excluding the value of the Housing Accommodation from his gross income.
>
> Mr. Smith's U.S. federal income tax return for the taxable year 2018 was timely filed by the preparer who filed his amended returns for 2016 and 2017. As in those returns, Mr. Smith reported in his 2018 return gross receipts equal to the value of his Housing Accommodation reflected on Form 1099-MISC ($10,015) and then claimed a corresponding deduction for employee benefit programs, which again had the effect of excluding the value of the Housing Accommodation from his gross income.[318]

The IRS examined the returns and did not agree with Mr. Smith's new position:

> After conducting an examination, the Commissioner issued Mr. Smith a notice of deficiency for the relevant years. In addition to other determinations no longer at

[316] *Smith v. Commissioner*, TC Memo 2023-6, January 12, 2023

[317] *Smith v. Commissioner*, TC Memo 2023-6, January 12, 2023

[318] *Smith v. Commissioner*, TC Memo 2023-6, January 12, 2023

issue, the Commissioner disallowed the deductions Mr. Smith claimed for employee benefit programs for each of the relevant years.[319]

Mr. Smith contested the IRS position, bringing his case before the United States Tax Court.

Analysis of §119 by the Tax Court

The Tax Court begins by summarizing the conditions that must exist for a taxpayer to exclude the value of employer provided lodging from income under IRC §119:

> Gross income generally includes all income from whatever source derived, including compensation for services. I.R.C. §61(a). An employee, however, may be able to exclude the value of lodging provided by the employer if certain conditions are met. I.R.C. §119(a). Namely, (1) the lodging must be "furnished on the business premises of the employer," (2) the lodging must be "furnished for the convenience of the employer," and (3) the employee must be "required to accept such lodging as a condition of his employment." Treas. Reg. § 1.119-1(b); see *Vanicek v. Commissioner*, 85 T.C. 731, 737–38 (1985).[320]

The Court notes that the IRS argues the taxpayer fails to meet *any* of these requirements while Mr. Smith disagrees:

> The Commissioner argues that Mr. Smith fails to meet all three conditions. Mr. Smith, on the other hand, argues that he satisfies all three and appears to suggest that the Commissioner should be precluded from addressing the second and third conditions because they were not challenged in the notice of deficiency or in the pleadings.[321]

The Court did not keep Mr. Smith in suspense for long regarding how this case was going to turn out, immediately noting:

> We are skeptical of Mr. Smith's preclusion argument; but, because we agree with the Commissioner that Mr. Smith fails to meet the first condition, we need not address the preclusion point further.5 See *Dole v. Commissioner*, 43 T.C. 697, 705 (1965) ("[The taxpayers'] failure . . . to meet any one of [the three requirements of section 119] will cause the value of the lodging to be includable in their gross income."), *aff'd per curiam*, 351 F.2d 308 (1st Cir. 1965).[322]

Business Premises of the Employer

The analysis of the business premises of the employer begins by outlining what the Court concludes is how this provision of the law has been applied:

> The phrase "'on the business premises' has been the subject of extensive judicial interpretation . . . [and] [a]lthough the application of these interpretations [has] at

[319] *Smith v. Commissioner*, TC Memo 2023-6, January 12, 2023

[320] *Smith v. Commissioner*, TC Memo 2023-6, January 12, 2023

[321] *Smith v. Commissioner*, TC Memo 2023-6, January 12, 2023

[322] *Smith v. Commissioner*, TC Memo 2023-6, January 12, 2023

times produced varying results, the principles laid down with respect to this issue have been fairly uniform." *Benninghoff v. Commissioner*, 71 T.C. 216, 219–20 (1978), *aff'd*, 614 F.2d 398 (5th Cir. 1980). The "business premises of the employer" generally means the employee's "place of employment." Treas. Reg. § 1.119-1(c)(1). And as our Court has explained before:

> Lodging is considered located "on the business premises of the employer" if such lodging is furnished at a place where the employee performs a significant portion of his duties or on the premises where the employer conducts a significant portion of his business. *McDonald v. Commissioner*, 66 T.C. 223, 230 (1976). We have also held that lodging is located on the business premises of the employer if (1) the living quarters constitute an integral part of the business property or (2) the company carries on some of its business activities there. *Dole v. Commissioner*, 43 T.C. 697, 707 (1965). . . . The extent or boundaries of the business premises in each case is a factual question whose resolution follows a consideration of the employee's duties as well as the nature of the employer's business. *Lindeman v. Commissioner*, 60 T.C. 609 (1973). "The touchstone of the business premises test is the lodging's relationship to the business activities of the employer." That is, "[t]he property must bear an integral relationship to the business activities of the employer." *Benninghoff v. Commissioner, supra* at 221.

Vanicek, 85 T.C. at 739–40.

The opinion notes that this was not the first time the Tax Court had looked at the issue of the off-base housing provided at the Pine Gap location:

> Our Court has previously applied these principles to determine whether off-base housing provided to contractors working at Pine Gap was "on the business premises of [the] employer" within the meaning of section 119.6 See *Middleton v. Commissioner*, T.C. Memo. 2008-150, 2008 WL 2369250; *Hargrove v. Commissioner*, T.C. Memo. 2006-159, 2006 WL 2280631. In each case, we decided it was not. In *Hargrove v. Commissioner*, 2006 WL 2280631, at *4, for example, we held that the housing provided to a contractor working at Pine Gap was not on the employer's business premises when (1) like the housing here, it was in Alice Springs miles away from the base on publicly accessible roads in an ungated area and (2) neither the employer nor the taxpayer performed work there. In *Middleton v. Commissioner*, 2008 WL 2369250, at *6, we considered nearly identical facts and reached the same conclusion.[323]

But Mr. Smith argued that, even though previous employees provided with housing at Pine Gap had lost on this issue, his case was different.

> The cases cited above would seem to be dispositive here. Nevertheless, Mr. Smith argues that his Housing Accommodation should be considered Raytheon's business premises because it bore "an integral relationship to the business activities of [Raytheon]." Pet'r's Mot. Summ. J. ¶ 63. More specifically, Mr.

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> Smith contends that this case should be decided differently from *Hargrove* and *Middleton* for four material reasons.
>
> First, Mr. Smith alleges that his Housing Accommodation allowed Raytheon to monitor his behavior and protect national security information. Second, he states that Raytheon, through Pine Gap, "maintained extensive control over [his] assigned hous[ing]" by, for example, providing all maintenance, repairs, and trash removal services, using the home to communicate information to him upon his initial arrival there, requiring him to report foreign visitors, and regulating who could live in his housing. Pet'r's Mot. Summ. J. ¶ 93. Third, he notes that, while located on public roads, his Housing Accommodation was in a cul-de-sac where other Pine Gap employees lived. And fourth, Mr. Smith points out that he completed some work from his Housing Accommodation, including completing training programs, time sheets, and employee evaluations, and was provided with a token that he could use to remotely access Raytheon's secure network.[324]

The Tax Court, noting that the Court found his arguments distinguishing his case unpersuasive, stated:

> Reviewing the facts in the light most favorable to Mr. Smith, we conclude that his activities at the Housing Accommodation were not significant enough to show that it was "integral" to Raytheon's business, see *Benninghoff*, 71 T.C. at 221, or "part and parcel" of Raytheon's workplace — Pine Gap, see *Lindeman*, 60 T.C. at 615. Compare *McDonald*, 66 T.C. at 230–31 (concluding that the value of lodging was not excludable when "the only business activities conducted by [the taxpayer] . . . in his residence were the occasional entertainment of business guests and the periodic use of the telephone to place or receive business calls"), with *Lindeman*, 60 T.C. at 615–16 (concluding that a hotel manager's residence was an integral part of the employer's business when the manager could observe the hotel from the residence, worked evenings from the residence and was connected to the hotel's switchboard there, and occasionally entertained hotel guests in the residence). Mr. Smith did not require immediate access to Pine Gap "at all hours" to perform his job, and his Housing Accommodation did not in fact provide immediate access. See *Lindeman*, 60 T.C. at 616. Nor do any facts show that Mr. Smith performed significant work from his Housing Accommodation, that the Housing Accommodation was in some way necessary for the performance of his duties, or that it served an important function on behalf of the business. Compare *Adams v. United States*, 218 Ct. Cl. 322, 333 (1978) (finding that a CEO's residence "was closely identified with [his employer's] business interests and was used to advance those interests"), with *McDonald*, 66 T.C. at 230–31 (reaching a contrary conclusion with respect to another executive's residence). Completing some trainings, time sheets, and evaluations from home "do[es] not constitute the requisite quantum or quality of activities to qualify as the 'significant portion' prescribed by both alternative constructions of 'on the business premises.'" *McDonald*, 66 T.C. at 231. And while (as we assume for purposes of ruling on the Commissioner's Motion) Mr. Smith was given a key fob to access Raytheon's secured network remotely, the

[324] *Smith v. Commissioner*, TC Memo 2023-6, January 12, 2023

> existence of the key fob does not convert otherwise insignificant work to significant.[325]

In a footnote, the Court also noted that even if the housing was viewed as effectively owned by his employer due to the control they had, that wouldn't change the result:

> To the extent Mr. Smith argues that Raytheon should be viewed as constructively owning the Housing Accommodation and that such constructive ownership makes the Housing Accommodation Raytheon's business premises, our Court has previously rejected that position. See *Benninghoff*, 71 T.C. at 221 ("To conclude that lodging is on the business premises of the employer merely because it is owned by the employer would make the [business premises] condition of section 119 meaningless. The property must bear an integral relationship to the business activities of the employer."). Mr. Smith appears to acknowledge this point in his Motion. See Pet'r's Mot. Summ. J. ¶¶ 51, 93.[326]

SECTION: 125

IRS ISSUES CHIEF COUNSEL ADVICE ON SUBSTANTIATION RULES FOR CAFETERIA PLANS AND DEPENDENT CARE ASSISTANCE PROGRAMS

Citation: Chief Counsel Advice 202317020, 4/28/2023

In Chief Counsel Advice (CCA) 202317020[327], the IRS examines the consequences of specific reimbursement policies adopted as part of an IRC §125 cafeteria plan's health flexible spending account (FSA) and/or dependent care account. Specifically, in some cases, the IRS determines that the policy leads to the inclusion of reimbursements in the employee's income.

The IRS Explanation of the Underlying Law

In the Law and Analysis section of the advice, the IRS discusses various IRC provisions and regulations that affect the administration of IRC §125 cafeteria plans. The analysis begins by examining the exclusion from an employee's income of various medical reimbursements paid by an employer under a qualified program that is not part of a cafeteria plan.

> In general, under section 105(b), an employee may exclude amounts received through employer-provided accident or health insurance if those amounts are paid to reimburse expenses incurred by the employee for medical care (of the employee, the employee's spouse, or the employee's dependents, as well as

[325] *Smith v. Commissioner*, TC Memo 2023-6, January 12, 2023

[326] *Smith v. Commissioner*, TC Memo 2023-6, January 12, 2023

[327] Chief Counsel Advice 202317020, April 28, 2023, https://www.taxnotes.com/research/federal/irs-private-rulings/legal-memorandums/fsa-medical-expense-reimbursements-are-includable-in-income/7gl6j (retrieved May 5, 2023)

> children of the employee who are not dependents but have not attained age 27 by the end of the taxable year) for personal injuries and sickness.
>
> …
>
> Amounts excluded from gross income under section 105(b) are also excluded from wages subject to income tax withholding under section 3401. In addition, amounts paid to reimburse expenses incurred by the employee for medical care (of the employee, the employee's spouse, or the employee's dependents, as well as children of the employee who are not dependents but have not attained age 27 by the end of the taxable year) for personal injuries or sickness are excepted from wages for FICA and FUTA tax purposes under sections 3121(a)(2) and 3306(b)(2), respectively.[328]

However, to qualify for this exclusion, the program must not apply to amounts a taxpayer could receive regardless of whether the employee incurs medical expenses:

> Treas. Reg. §1.105-2 provides that the exclusion under section 105(b) does not apply to amounts a taxpayer would be entitled to receive whether or not the taxpayer incurs expenses for medical care.[329]

A similar set of rules applies to dependent care benefits provided by an employer:

> In general, under section 129, an employee may exclude amounts received through a dependent care assistance program if those amounts are paid to reimburse dependent care assistance expenses incurred by the employee. Section 129(e)(9) generally requires identifying information of the dependent care service provider to be included in the employee's tax return for the amounts to be excluded under section 129.[330]

Cafeteria plans under IRC §125 are a special case that allows an employer to establish a program where the employee can choose to defer a portion of their compensation in exchange for certain fringe benefits specifically permitted by §125. Such deferrals are excluded from an employee's income if the deferral is made to a plan that complies with IRC §125:

> Section 125 allows an employer to establish a cafeteria plan that permits an employee to choose among two or more benefits, consisting of cash (generally, in the form of salary reduction) and qualified benefits, including accident or health coverage. Section 125 provides that the amount an employee contributes to the plan on a pre-tax basis through salary reduction that is applied to purchase the coverage is not included in gross income, even though it is available to the employees and the employee could have chosen to receive cash instead. If an employee elects to participate in a health FSA on a pre-tax basis through salary reduction under a section 125 cafeteria plan, the value of the coverage by the health FSA is excludable from gross income under section 106 as employer-provided accident or health coverage, and the amounts reimbursed for section 213(d) medical expenses are excludable from gross income under section 105(b)

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[328] Chief Counsel Advice 202317020, April 28, 2023

[329] Chief Counsel Advice 202317020, April 28, 2023

[330] Chief Counsel Advice 202317020, April 28, 2023

> as amounts reimbursed for section 213(d) medical expenses. If an employee elects to participate in a dependent care assistance program paid for through salary reduction under a section 125 cafeteria plan, the dependent care assistance program benefits are excludable from gross income under section 129.[331]

However, strict rules apply to the operation of the cafeteria plan in order to obtain the desired tax benefits for the employees. A key requirement for health FSAs and dependent care program relates to the requirement for the employee to provide adequate substantiation:

> Prop. Reg. §1.125-1(c)(7)(ii)(G) provides that a failure to comply with the substantiation requirements of Prop. Reg. §1.125-6 results in a failure of the cafeteria plan to operate in accordance with section 125 and the Proposed Treasury Regulations thereunder. In general, a cafeteria plan that fails to operate in accordance with these requirements is not a cafeteria plan and employees' elections between taxable and nontaxable benefits result in gross income to the employees.[332]

The plan must require all claims to be substantiated and cannot accept substantiation for only a percentage of claims:

> Prop. Reg. §1.125-6(b)(2) provides that all claims for reimbursement must be substantiated. Prop. Reg. §1.125-6(b)(2) provides that "[s]ubstantiating only a percentage of claims, or substantiating only claims above a certain dollar amount, fails to comply with the substantiation requirements of §1.125-1 and this section." See also Treas. Reg. §1.105-2; Rev. Rul. 2003-43, 2003-21 IRB 935 (holding that sampling techniques do not satisfy the substantiation requirements). Prop. Reg. §1.125-6(b)(3) provides that all claims for reimbursement must be substantiated by an independent third party and may not be self-substantiated.[333]

A failure to follow these rules will require all amounts paid under the FSA to be included in the employee's income, not just the amounts that are not substantiated:

> Specifically, Prop. Reg. §1.125-6(b)(3) provides that "[a]ll expenses must be substantiated by information from a third party that is independent of the employee and the employee's spouse and dependents." All amounts paid under a health FSA that permits self-substantiation are included in gross income, including amounts that are reimbursed for medical expenses, whether or not substantiated. See Notice 2006-69, 2006-31 IRB 107, 109 (holding that self-certification does not satisfy the substantiation requirements).[334]

Similar substantiation rules apply to dependent care assistance programs under cafeteria plans:

> Flexible spending arrangements for dependent care assistance must follow the substantiation rules applicable to health FSAs. Prop. Reg. §1.125-6(g) provides additional rules for reimbursing dependent care assistance through a debit card. If an employee submits the dependent care expenses to the employer through a

[331] Chief Counsel Advice 202317020, April 28, 2023

[332] Chief Counsel Advice 202317020, April 28, 2023

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> debit card, these expenses must be substantiated by providing a statement from the dependent care provider substantiating the dates and amounts for the dependent care services provided.[335]

In both programs, expenses cannot be reimbursed until the actual expenses have been incurred:

> Prop. Reg. §1.125-6(a)(4) provides that reimbursements of dependent care expenses may not be reimbursed before the expenses are incurred. Dependent care expenses are incurred when the care is provided and not when the employee is formally billed or charged for (or pays for) the dependent care.
>
> Prop. Reg. §1.125-6(b)(4) provides that reimbursing expenses before the expense has been incurred or before the expense is substantiated fails to satisfy the substantiation requirements of Treas. Reg. §1.105-2, Prop. Reg. §1.125-1 and Prop. Reg. §1.125-6(b)(4).[336]

Issues

The memorandum then examines two issues:

> (1) Are reimbursements of section 213(d) medical expenses to an employee from a health flexible spending arrangement (health FSA) provided in a section 125 cafeteria plan included in an employee's gross income under section 105(b) if any section 213(d) medical expenses of any employee are not substantiated in accordance with proposed regulation §1.125-6(b)?
>
> (2) Will expenses be considered properly substantiated if employees self-certify expenses, if the plan substantiates only some expenses "sampling", if only amounts over a certain level (i.e., de minimis amounts) are substantiated, if charges with favored providers are not required to be substantiated, or if dependent care expenses are reimbursed before the expenses are incurred?[337]

The IRS reaches the following conclusions:

> Reimbursements of section 213(d) medical expenses to an employee from a health FSA provided in a section 125 cafeteria plan are included in the gross income of such employee if any expense of any employee reimbursed by the health FSA is not fully substantiated including if any expenses below a certain threshold are not substantiated.
>
> If a section 125 cafeteria plan does not require an independent third party to fully substantiate reimbursements for medical expenses (for example, by permitting self-certification of expenses, "sampling" of expenses, or certification by favored providers), does not require substantiation for medical expenses below certain dollar amounts, or does not substantiate reimbursements for dependent care assistance expenses, then the plan fails to operate in accordance with the substantiation requirements of Prop. Reg. §1.125-6(b) and is not a cafeteria plan

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> within the meaning of section 125. Therefore, the amount of any benefits that any employee elects under the cafeteria plan must be included in gross income and is wages for Federal Insurance Contributions Act (FICA) and Federal Unemployment Tax Act (FUTA) purposes subject to withholding.
>
> In addition, an employer may not exclude reimbursements of dependent care expenses from an employee's gross income if any expenses of any employee under the dependent care assistance program are not substantiated after the expense has been incurred.[338]

The IRS then addresses six situations to apply these conclusions.

Situation 1 – Detailed Substantiation Required for All Expenses

The first situation is outlined as follows:

> *Situation 1.* An employer provides a section 125 cafeteria plan with a health FSA that reimburses section 213(d) medical expenses incurred by employees. The plan only reimburses section 213(d) medical expenses that are substantiated by information from a third party that is independent of the employee and the employee's spouse and dependents. In addition, the information from the third party describes the service or product, the date of service or sale, and the amount of the expense.
>
> In addition, the plan reimburses expenses based on information from an independent third party such as an "explanation of benefits" from an insurance company. The plan requires that information from the independent third party include (i) the date of the section 213(d) medical care, and (ii) the employee's share of the cost of the medical care (that is, coinsurance payments and amounts below the deductible). The plan also requires the employee to certify that any expense paid by the plan has not been reimbursed by insurance or otherwise and that the employee will not seek reimbursement from any other plan covering health benefits.2
>
> Lastly, the plan provides debit cards that can be used to reimburse section 213(d) medical expenses that meet the requirements of Prop. Reg. §1.125-6 (c), (d), (e), and (f).[339]

As expected, the IRS concludes that the requirements of this program, assuming they are enforced, will allow for the exclusion of reimbursements from the employees' income.

> In *Situation 1*, the substantiation of all claims complies with the requirements of section 105(b) and the proposed regulations under section 125 including the substantiation requirements under Prop. Reg. §1.125-6(b). Nothing in the way the plan substantiates the claims will prevent the employer from excluding the amounts reimbursed from the employee's income and wages for FICA and FUTA tax purposes.[340]

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Situation 2 – Self-Certification of Claims

Situation 2 is described as follows:

> *Situation 2.* Self-certification. Instead of only reimbursing expenses that are substantiated as described in Situation 1, the plan also reimburses employees for medical expenses for which an employee only submits information describing the service or product, the date of service or sale, and the amount of the expenses, but does not provide a statement from an independent third party (either automatically or after the transaction) to verify the expenses. Further, the plan does not substantiate debit card charges (including charges that are not auto-substantiated3 expenses for recurring medical expenses incurred at certain providers that match the amount, medical care provider, and time period of previously approved expenses) with a statement from an independent third party.[341]

The IRS does not find this self-certification program acceptable, meaning all amounts reimbursed will be included in the employees' income.:

> In *Situation 2*, the self-certification of claims that are not otherwise substantiated does not ensure that every claim be substantiated. Because the plan does not limit reimbursements or payments of claims to medical expenses that are substantiated, the plan does not satisfy the cafeteria plan substantiation requirements under section 125. See Prop. Reg. §1.125-6(b) requiring substantiation for all claims, regardless of the amount, and Prop. Reg. §1.125-6(b)(3) prohibiting self-substantiation of medical expenses. See also Notice 2006-69, 2006-31, IRB 107 providing that all amounts paid under a health FSA plan that allows self-substantiation of medical claims are included in gross income.[342]

Situation 3 – Substantiation by Sampling

In Situation 3, the IRS describes a program that uses a sampling technique to examine some otherwise unsubstantiated expenses:

> *Situation 3.* Sampling. In addition to reimbursing expenses that are substantiated as described in *Situation 1*, the plan reimburses all charges to the debit card and only requires substantiation of a random sample of otherwise unsubstantiated charges to the debit card (that is, charges that are not auto-substantiated) through third-party information describing the service or product and the date of the service or sale.[343]

The IRS does not approve of this technique either:

> In *Situation 3*, the sampling technique does not ensure that every claim is substantiated. Because the plan does not limit reimbursements or payments of

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> claims to medical expenses that are substantiated, the plan does not satisfy the cafeteria plan substantiation requirements under section 125. See Prop. Reg. §1.125-6(b) requiring substantiation for all claims, regardless of the amount and Rev. Rul. 2003-43 holding that sampling techniques do not satisfy the substantiation requirements.[344]

Situation 4 - De Minimis Amounts Not Substantiated

Situation 4 examines a case where the plan stipulates that charges below a certain amount do not need to be substantiated:

> *Situation 4.* De minimis. In addition to reimbursing expenses that are substantiated as described in Situation 1 or expenses that are auto-substantiated, if a charge to the debit card is less than a specified dollar amount, the plan does not require substantiation of the charge to the debit card through additional third-party information describing the service or product and the date of the service or sale.[345]

Once again, the IRS does not accept allowing no substantiation for small amounts:

> In *Situation 4*, the plan does not require employees to substantiate charges to the debit card for claims below a dollar threshold. Because the plan does not limit reimbursements or payments of claims to medical expenses that are substantiated (including expenses that are auto-substantiated), the plan does not satisfy the cafeteria plan requirements for substantiation under section 125. See Prop. Reg. §1.125-6(b) requiring substantiation for all claims, regardless of the amount.[346]

Situation 5 – No Substantiation Required for Amounts Paid to Favored Providers

In *Situation 5*, the plan specifies that if certain “favored providers” are paid, the employee is not required to submit substantiation.:

> *Situation 5*. Favored providers. In addition to reimbursing expenses that are substantiated as described in Situation 1 or expenses that are auto-substantiated, if a charge to the debit card is from certain dentists, doctors, hospitals or other health care providers, the plan does not require substantiation of the charge to the debit card through additional third-party information describing the service or product and the date of the service or sale.[347]

This provision is also deemed unsatisfactory by the IRS:

> In *Situation 5*, the plan does not require employees to substantiate charges to the debit card from certain dentists, doctors, hospitals, or other health care providers. Because the plan does not limit reimbursements or payments of claims to medical

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[346] Chief Counsel Advice 202317020, April 28, 2023

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expenses that are substantiated (including expenses that are auto-substantiated), the plan does not satisfy the cafeteria plan requirements for substantiation under section 125. See Prop. Reg. §1.125-6(b) requiring substantiation for all claims, regardless of the amount.[348]

Full Inclusion in Income Under Situation 2, 3, 4 and 5

The IRS highlights the consequences of using the flawed reimbursement schemes in Situations 2-5:

> In *Situation 2, Situation 3, Situation 4, and Situation 5*, the plan fails to satisfy the requirement to substantiate medical expenses. Reimbursements for unsubstantiated medical expenses under the cafeteria plan are not excludable from gross income under section 105(b). Therefore, in *Situation 2, Situation 3, Situation 4, and Situation 5* all reimbursements made during the year, including amounts paid to reimburse substantiated medical expenses, are included in the gross income of the employees.[349]

Situation 6 – Advance Substantiation for Dependent Care Assistance Program

The final situation examines a dependent care assistance program and the requirement of obtaining substantiation before the service is rendered:

> *Situation 6.* Advance Substantiation for Dependent Care Assistance Program. An employer provides a section 125 cafeteria plan with a dependent care assistance program under section 129 that reimburses dependent care expenses incurred by employees. The plan allows employees to submit a form in advance of receiving the dependent care, attesting to the amount of dependent care expenses they will incur in the upcoming year. The plan requires employees to notify the plan sponsor if their dependent care situation changes and they will not incur the amount of qualified dependent care expenses to which they attested for that year. The employee is automatically reimbursed every pay period a pro rata amount of the amount of dependent care assistance expenses to which the employee attested.[350]

The IRS points out that obtaining substantiation before the service is rendered is also a violation of the regulations.:

> In *Situation 6*, all claims for payment or reimbursement of the employee's dependent care assistance program are not substantiated because they are claimed in advance without additional verification. Because the plan does not limit reimbursements or payments of claims to dependent care assistance expenses that have been incurred or substantiated, the plan does not satisfy the requirements of section 129 and does not satisfy the cafeteria plan requirements of section 125. Therefore, the reimbursements for dependent care assistance expenses are not

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> excludable from gross income under section 129, and all payments made during the year under the dependent care assistance program are included in the gross income and wages of the employees for FICA and FUTA tax purposes.[351]

Situations 2-6 Are Also Plan Operational Issues

The IRS also observes that the last five situations could create potential plan qualification issues due to operational failures.:

> Further, in Situation 2, Situation 3, Situation 4, Situation 5, and Situation 6, failure to comply with the substantiation requirements of Prop. Reg. §1.125-6(b) results in the failure to operate in accordance with its written plan or the failure to operate in accordance with section 125 and Prop. Reg. §1.125-1(c)(7)(ii)(G).[352]

SECTION: 162

FOURTH CIRCUIT HOLDS THAT MORE THAN JUST HYPOTHETICAL RETURN OF INVESTORS NEEDS TO BE CONSIDERED FOR C CORPORATION REASONABLE COMPENSATION

Citation: Clay Hood, Inc. v. Commissioner, Case No. 22-1573, CA4, 5/31/23

Tax advisers who specialize in assisting small businesses might initially assume that a case involving "reasonable compensation" pertains to the IRS alleging that an S corporation owner did not declare a sufficient portion of their earnings as salary. In such instances, the agency typically aims to reclassify distributions as disguised salary.

However, those of us who have been in the tax profession for a longer period, predating the Tax Reform Act of 1986, recall a distinct other kind of unreasonable compensation case that is seen far less often today. This particular case arises with closely held C corporations, where the IRS contends that a portion of the owner's reported compensation should instead be treated as a dividend. It is precisely this type of case that the Fourth Circuit Court of Appeals addressed in *Clay Hood, Inc. v. Commissioner,* Case No. 22-1573, CA4.[353]

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[351] Chief Counsel Advice 202317020, April 28, 2023

[352] Chief Counsel Advice 202317020, April 28, 2023

[353] *Clay Hood, Inc. v. Commissioner,* Case No. 22-1573, CA4, May 31, 2023, https://www.taxnotes.com/research/federal/court-documents/court-opinions-and-orders/fourth-circuit-affirms-ceo-compensation-deduction%2c-vacates-penalty/7gtk2 (retrieved June 2, 2023)

Mr. Hood's C Corporation

As is customary, let us commence by examining the court's rendition of the facts in the case. The fundamental background of the case is elucidated as follows::

> Hood, Inc. was founded in 1980 as a subchapter C corporation, and during the period relevant to this appeal, Clary Hood and his wife, Gail Hood, each owned 50% of the company's stock. They were also the only members of its board of directors, and Mr. Hood served as the company's CEO. From 2000 to 2010, the company averaged approximately $21 million in revenue, earning an average of less than $1 million each year in net income before taxes. Seeking to increase revenue, Mr. Hood decided in 2011 to pivot the company away from retail-related projects to other commercial and industrial projects, and this decision proved to be especially astute. Revenues immediately increased, and by 2015, the company's revenue had grown to $44 million and by 2016, to $69 million. Net income before taxes also increased, as did cash and cash equivalents. The company also grew in size during this period, from approximately 80 employees in 2011 to approximately 150 employees in 2016.
>
> The Tax Court recognized the significance of Mr. Hood's various contributions, crediting mostly him with the success of Hood, Inc.[354]

The Court then proceeded to delve into a discussion regarding Mr. Hood's compensation in the years preceding the ones under scrutiny by the IRS in this case:

> For the years 2000 to 2010, Hood, Inc. paid Mr. Hood an annual salary of roughly $130,000. In some of those years Mr. Hood also received a bonus in addition to his salary, with the largest bonus amounting to $320,981. As the company's only board members, Mr. and Mrs. Hood set Mr. Hood's salary and bonuses. In 2013, Hood, Inc. began to increase Mr. Hood's salary and bonuses, and for 2013, it paid him a salary of $381,707 and a $1 million bonus, and for 2014 it paid him a salary of $181,538 and a $1.5 million bonus.[355]

At this juncture, the Company embarked on an assessment of Mr. Hood's previous compensation and arrived at the determination that he had been inadequately remunerated in the preceding years:

> During the company's fiscal year ending May 31, 2015, in which the company realized significant growth, Hood, Inc.'s Chief Financial Officer ("CFO") began an assessment of Mr. Hood's past compensation, and he concluded that in prior years, Mr. Hood had been undercompensated. To determine how much to compensate Mr. Hood for the 2015 fiscal year and the years thereafter, the CFO sought the advice of the company's accountants at Elliott Davis Decosimo, LLC ("Elliott Davis"). The record is not clear to what extent Mr. Hood participated in this assessment. But, as the Tax Court noted, Mr. Hood later acknowledged "that he was aware that he needed to start making necessary preparations from an 'income tax' perspective in 'getting money out of' the company in anticipation of 'a changing of the guard.'" After meeting with the company's accountants, Hood,

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> Inc.'s CFO determined that Mr. Hood had been undercompensated since 2000 and that the total amount that would both remedy that past undercompensation and recognize Mr. Hood's service for the 2015 year was $7.1 million.[356]

The question arises as to why Mr. Hood did not simply opt for taking distributions from the corporation as a means to extract funds before the business transitioned to its successor owners. Although such distributions would subject Mr. Hood to taxation on qualified dividends, which may attract more favorable long-term capital gain rates, it is worth noting that the corporation would not be eligible for any deduction on these payments. In contrast, if the amounts were disbursed to Mr. Hood as salary, the corporation would be able to claim a deduction.

This tax outcome elucidates why, particularly within the realm of closely held C corporations, the IRS frequently harbors skepticism when compensation paid to the owner exceeds what is deemed justifiable for their services. Conversely, the owner, especially in light of pre-Tax Cuts and Jobs Act corporate tax rates that would apply in the years before the Court, endeavors to extract a substantial portion of the funds they intend to withdraw as salary. This preference stems from the fact that the additional tax paid at the C corporation level surpasses the extra taxes the owner would incur by receiving salary instead of a qualified dividend.

Given the circumstances, it is unsurprising that the CFO relied on the findings of this assessment to substantiate the provision of substantial bonuses to Mr. Hood, without any dividends being distributed to the owner during the years in question:

> The CFO thus suggested that Hood, Inc. pay Mr. Hood a $5 million bonus in 2015, some portion of which was to remedy past undercompensation, with the balance of the undercompensation amount to be paid in "future years." The company's accountants gave their approval to this suggestion and concluded that the CFO's proposal was "reasonable." Accordingly, at the meeting of Hood, Inc.'s board of directors, Mr. and Mrs. Hood approved paying Mr. Hood a $5 million bonus, in addition to Mr. Hood's $168,559 salary. The minutes of that meeting explained that the bonus was approved in recognition of Mr. Hood's "many years of sacrificial work done on the Company's behalf."
>
> The following year, after Hood, Inc. went through the same process as it did for determining the bonus for the 2015 fiscal year, Mr. and Mrs. Hood as board members again approved a bonus to Mr. Hood of $5 million for the 2016 fiscal year, again in addition to Mr. Hood's salary, which in 2016 was $196,500.
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> Despite substantial retained earnings and cash, however, Hood, Inc. did not consider paying any dividends to its two shareholders, i.e., Mr. and Mrs. Hood. Indeed, the company had never paid any dividends.[357]

The IRS Exam, the Battle of the Experts and the IRS Victory in the Tax Court

Subsequently, the IRS initiated an examination of the corporation, with a particular emphasis on the substantial bonuses paid to Mr. Hood. Following its examination, the IRS reached the conclusion that a significant portion of these bonuses did not genuinely reflect compensation for

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services provided by Mr. Hood. As a result, the corporation was deemed ineligible to deduct this portion of the bonuses.

> Following an audit of Hood, Inc.'s federal income tax returns, the IRS issued a notice of deficiency to the company for its 2015 and 2016 tax years, finding that a substantial portion of Mr. Hood's compensation was excessive and therefore not deductible under 26 U.S.C. §162(a) as reasonable compensation for services rendered. It calculated tax deficiencies for 2015 and 2016 to be roughly $1.6 million for each year. Additionally, the IRS determined that the company was liable for a 20% penalty for each year because the company's understatements of income tax were "substantial."[358]

The taxpayer decided to pursue the matter with the Tax Court, seeking resolution. The appellate panel describes the proceedings before the Tax Court as follows

> During a six-day trial, the Tax Court heard from fact witnesses regarding the important role that Mr. Hood played in growing the company and increasing its revenues, as well as the process that Hood, Inc. followed in determining Mr. Hood's bonuses for the 2015 and 2016 fiscal years. And both the company and the IRS presented expert testimony.
>
> The IRS's expert, David Fuller, agreed that Mr. Hood was undercompensated for the period of 2000 to 2012 but found that Hood, Inc. had started to remedy this condition beginning with its payment of approximately $1.4 million in total compensation to Mr. Hood in 2013. Based on survey data of compensation paid to other similarly situated executives, the specific characteristics of Hood, Inc., and Mr. Hood's contributions, Fuller concluded in his report that Mr. Hood was undercompensated in total by approximately $2.3 million as of May 31, 2014. Taking this undercompensation amount into account, as well as interest on that amount, Fuller concluded that the total reasonable compensation amounts for Mr. Hood would be $3,681,269 for 2015 and $1,362,831 for 2016, and that any amounts above those figures constituted excess or "unreasonable" compensation.
>
> Hood, Inc. submitted two expert reports, but the Tax Court afforded them "little to no weight" based on the "dubious assumptions" underlying the reports and the lack of supporting calculations.[359]

The Tax Court's significant criticism of the taxpayer's experts' reports predictably lead to the outcome of the case resulting in a resounding victory for the IRS:

> In its thorough 64-page opinion, the Tax Court accepted Fuller's calculations and thus found that the amounts deductible as reasonable compensation to Mr. Hood for his services were $3,681,269 for 2015 and $1,362,831 for 2016. The court did not impose a "substantial underpayment" penalty under 26 U.S.C. §6662 for 2015, finding, pursuant to 26 U.S.C. §6664, that the company had established a reasonable-cause defense to any penalty for that year because it reasonably relied on professional tax advice in good faith. But the court found that the company

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had not established the same defense for 2016, and therefore it sustained the imposition of a penalty for that tax year.

The Tax Court entered its final decision on May 12, 2022, finding that Hood, Inc. was liable for a $550,866 income tax deficiency for 2015 and a $1,411,991 deficiency for 2016. It also imposed a penalty of $282,398 for 2016.[360]

The corporation opted to appeal the decision of the Tax Court to the Fourth Circuit Court of Appeals.

The Law for Reasonable Compensation per the Fourth Circuit Panel

Having examined the factual background of this case, let us now turn our attention to the legal framework that governs the application of these facts. We will begin by delving into the Fourth Circuit's analysis of the law regarding the reasonableness of compensation. The Court initiates its discussion by considering the application of this rule to taxpayers as a whole:

> The Internal Revenue Code allows a taxpayer to deduct "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including . . . a reasonable allowance for salaries or other compensation for personal services actually rendered." 26 U.S.C. §162(a)(1) (emphasis added). IRS regulations explain further that, in order to be deductible as an ordinary business expense, compensation "may not exceed what is reasonable under all the circumstances," taking into account "such amount as would ordinarily be paid for like services by like enterprises under like circumstances." 26 C.F.R. § 1.162-7(b)(3) (emphasis added). And any bonuses paid similarly must not exceed what is reasonable for the services rendered in order to be deductible as an ordinary business expense. 26 C.F.R. § 1.162-9.[361]

The panel highlights that when the same individual both provides the services and exercises control over the corporation, the Court exercises heightened scrutiny in assessing the reasonableness of such payments.

> In cases that involve "a closely held corporation whose controlling shareholders set their own level of compensation, the reasonableness of the compensation paid to the shareholder-employee is subject to close scrutiny." *Dexsil Corp. v. Comm'r*, 147 F.3d 96, 100 (2d Cir. 1998). This scrutiny is warranted because such corporations may more readily choose to pay out larger salaries and bonuses, which are deductible by the corporation under §162(a), rather than pay dividends from profits, which are not. *Id*. Thus, if some portion of the ostensible salary or bonus paid to a shareholder-employee is in fact a disguised dividend, rather than compensation for services rendered, it is not deductible. 26 C.F.R. § 1.162-7(b)(1). For these reasons, the close scrutiny to which closely held corporations are subject should focus on whether bonuses paid to shareholder-employees are compensation for only services actually rendered — which would make the payment deductible — or are the corporation's effort to transfer profits

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> to the shareholder-employees — which would not be deductible and therefore would have the effect of increasing the corporation's tax liability.[362]

Lastly, the panel delineates its approach to applying a reasonableness standard to the deduction claimed by the corporation for compensation.

> To make this determination, we apply a standard of reasonableness "under all the circumstances," taking into account practices and payments "by like enterprises under like circumstances." 26 C.F.R. § 1.162-7(b)(3). This, we conclude, calls for application of a multifactor approach that assesses the reasonableness of compensation under the totality of the circumstances. See, e.g., *Charles Schneider & Co. v. Comm'r,* 500 F.2d 148, 151-52 (8th Cir. 1974); *Kennedy v. Comm'r*, 671 F.2d 167, 173-74 (6th Cir. 1982); *Elliotts, Inc. v. Comm'r*, 716 F.2d 1241, 1245 (9th Cir. 1983); *B.B. Rider Corp. v. Comm'r*, 725 F.2d 945, 952 (3d Cir. 1984); *Owensby & Kritikos, Inc. v. Comm'r*, 819 F.2d 1315, 1323 (5th Cir. 1987); *Dexsil Corp.,* 147 F.3d at 100; *Eberl's Claim Serv., Inc. v. Comm'r*, 249 F.3d 994, 999 (10th Cir. 2001); *Haffner's Serv. Stations, Inc. v. Comm'r*, 326 F.3d 1, 3-5 (1st Cir. 2003). As we have previously explained, albeit in an unpublished opinion, under the multifactor approach, no single factor is decisive, but rather we consider numerous factors, such as
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> > the employee's qualifications; the nature, extent and scope of the employee's work; the size and complexities of the business; a comparison of salaries paid with gross income and net income; the prevailing general economic conditions; comparison of salaries with distributions to stockholders; the prevailing rates of compensation for comparable positions in comparable concerns; [and] the salary policy of the taxpayer as to all employees.
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> *Richlands Med. Ass'n v. Comm'r*, 953 F.2d 639, 1992 WL 14603, at *2 (4th Cir. 1992) (unpublished) (per curiam) (quoting *Owenseby & Kritikos, Inc*., 819 F.2d at 1323). And in the context of small corporations that have a limited number of officers, additional factors may be considered, such as the amount of compensation paid to the officer in previous years, see *Mayson Mfg. Co. v. Comm'r*, 178 F.2d 115, 119 (6th Cir. 1949), and whether the officer personally guaranteed debts or other obligations of the corporation, see *Owensby & Kritikos, Inc*., 819 F.2d at 1325 n.33. Moreover, we find appropriate the suggestion of some other courts of appeal that the various relevant factors may be reviewed through the "lens" of, *Dexsil Corp*., 147 F.3d at 101, or "from the perspective of," a hypothetical independent investor by asking "whether [such an] investor would be willing to compensate the employee as he was compensated," *Elliotts, Inc*., 716 F.2d at 1245.[363]

The taxpayer contends that the panel should adopt the independent investor test employed by the Seventh Circuit in the *Menard, Inc. case*, which this author previously discussed during the

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update courses I gave back in 2009. In that opinion, Judge Posner, writing for a unanimous Seventh Circuit panel, was rather scathingly skeptical of the use of a multi-factor test.

However, the panel, although acknowledging that considering a reasonable return to independent investors is a relevant factor, deems it inappropriate to rely solely on this factor.

> Hood, Inc. contends that because we have not formally adopted the multifactor test, the Tax Court erred in applying it here and that we should consider the adoption of a singular "independent investor" test, which establishes a rebuttable presumption that an executive's compensation is reasonable if the corporation's shareholders are receiving a sufficiently high rate of return on their equity investment. See *Menard, Inc. v. Comm'r*, 560 F.3d 620, 622-23 (7th Cir. 2009); *Exacto Spring Corp. v. Comm'r*, 196 F.3d 833, 839 (7th Cir. 1999). Hood, Inc. reasons that under that test we should approve Mr. Hood's bonuses because Hood, Inc. generated a 22% return on equity for its shareholders in 2015 and a 36% return in 2016 after accounting for Mr. Hood's total compensation.
>
> While it might be reasonable to consider the Seventh Circuit's independent investor test along with other factors relevant to the totality of the circumstances, we conclude that solely using that test to establish a presumption of reasonableness, as Hood, Inc. urges, would be too narrow in light of the regulatory demand that we consider "what is reasonable under all the circumstances." 26 C.F.R. § 1.162-7(b)(3). For instance, under the independent investor test, an executive's compensation could be presumed to be reasonable even if it exceeded the amount that was genuinely compensation "for personal services actually rendered," 26 U.S.C. §162(a)(1), and that "would ordinarily be paid for like services by like enterprises under like circumstances," 26 C.F.R. § 1.162-7(b)(3). By contrast, the multifactor test allows for consideration of the numerous other relevant factors. Accordingly, we conclude that it is the appropriate test to apply and that the Tax Court did not err in applying it here.[364]

Upon examining the Menard's case, it becomes apparent that, despite Judge Posner's disapproval of the multi-factor test, Menard, Inc. presented a more favorable set of circumstances compared to Hood, Inc. Menard had a history of paying dividends, had an established program for calculating and disbursing bonuses, and the bonus programs encompassed executives beyond John Menard himself. Additionally, Judge Posner highlighted that two years after John Menard received his bonus, the new CEO of Home Depot (one of the individuals whose salary was compared to Mr. Menard's) received a $124 million bonus.

As should become clear from the rest of the Fourth Circuit's opinion, it seems likely that the Fourth Circuit panel would have arrived at the same result as did the Seventh Circuit panel, accepting John Menard's compensation as reasonable, had they heard the appeal of that case.

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The Tax Court Properly Applied the Multi-Factor Analysis to Mr. Hood's Compensation

The panel goes on to look at the way the Tax Court applied the multi-factor analysis, first citing the taxpayer's complaints about how the Tax Court applied the analysis:

> Hood, Inc. contends that the Tax Court did not adequately account for the return on equity generated for the company's shareholders; that it did not appropriately credit Mr. Hood's extraordinary performance and recognize that such performance could justify compensation in excess of the norm; and that it placed too much emphasis on the comparison of Mr. Hood's compensation with that of similarly situated executives in the industry.[365]

But the panel rejected the taxpayer's complaints:

> These arguments, however, simply raise questions regarding the weight to assign the factors, as the Tax Court considered them among the many factors it addressed in its extensive opinion.[366]

The panel underscores that the Tax Court did indeed take into account Mr. Hood's exceptional contribution to the company's returns, which the hypothetical independent investor would have received even considering the compensation paid and deducted.

> As a starting point, the Tax Court recognized that Mr. Hood was "extraordinarily talented in his industry," served as the company's "key employee and driving force from its inception," and that the company's business of land excavation and grading was "more complex than that of a general construction company." The court also acknowledged that the trend of Hood, Inc.'s increasing revenue, culminating with an annual revenue of roughly $69 million in 2016, "[could] not be credited to economic conditions alone" and that Mr. Hood was instrumental in transitioning the business to more profitable projects. The court took account of these factors as well as others in its opinion, allowing reasonable compensation to Mr. Hood for his personal services in this regard.
>
> The Tax Court also recognized that it was permissible for Hood, Inc. to compensate Mr. Hood for undercompensation in prior years, as explained in *Alpha Medical, Inc. v. Commissioner*, 172 F.3d 942, 950 (6th Cir. 1999). In Alpha Medical, the court noted that "[a] taxpayer making such a claim must show: (1) the insufficiency of the officer's compensation in the previous year[s]; and (2) the amount of the current year's compensation that was intended as compensation for that underpayment." 172 F.3d at 950. Thus, the Tax Court agreed with Mr. Hood that he was entitled to some degree of additional compensation for the services rendered in prior years.[367]

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However, the panel acknowledges that this consideration alone does not conclude the analysis, as mandated by the regulations. Consequently, the panel agrees with the Tax Court's emphasis on three factors that indicate Mr. Hood's compensation was excessive.

The panel references the Tax Court's determination that the corporation's consistent failure to distribute dividends was a factor supporting the argument that a portion of Mr. Hood's compensation should be reevaluated. Additionally, the panel notes Mr. Hood's testimony that the compensation process was driven by an "income tax perspective" aimed at extracting funds from the corporation.

> First, the court noted that Hood, Inc. had never declared or paid a cash dividend to its shareholders, even after it began to accumulate significant capital during the period from 2013 to 2016. Although companies are not required to pay dividends, a court may nonetheless consider a profitable corporation's failure to do so in determining the reasonableness of compensation paid to its shareholder-employees. See *Miles-Conley Co*., 173 F.2d at 960; see also *Paul E. Kummer Realty Co. v. Comm'r,* 511 F.2d 313, 315 (8th Cir. 1975). In this case, the Tax Court agreed that Hood, Inc. had advanced persuasive reasons for not declaring dividends for many years, such as 2010, when business was slow and capital needs were high. It also recognized, as Hood, Inc. pointed out, that Hood, Inc.'s business was capital-intensive due to the cost of obtaining and maintaining heavy equipment. But the court noted that this rationale became less persuasive in later years given that Hood, Inc.'s year-end shareholder equity value had increased nearly sixfold, from approximately $5.5 million in 2010 to over $31 million in 2016. Yet the company opted to pay out large bonuses to Mr. Hood rather than paying any dividends. And the lack of dividends became especially suspect in light of Mr. Hood's testimony that in 2015, he was aware that he needed to start making preparations from an "income tax" perspective for "getting money out of [the] corporation" in preparation for "a changing of the guard." (Emphasis added).[368]

The panel agrees that the Tax Court rightly took into account the absence of a structured system to determine compensation. The fact that Mr. Hood and his wife made the determination each year was considered a factor indicating that the payments were more closely linked to his ownership stake rather than being tied directly to the services he provided.

> Second, the Tax Court noted that Hood, Inc. had "no structured system in place" for determining compensation and that Mr. Hood's compensation was set by himself and his wife. "Bonuses that have not been awarded under a structured, formal, consistently applied program generally are suspect. . . ." *Elliotts, Inc*., 716 F.2d at 1247. Moreover, "salaries paid to controlling shareholders are open to question if, when compared to salaries paid non-owner management, they indicate that the level of compensation is a function of ownership, not corporate management responsibility." *Id*. (emphasis added). Thus, the Tax Court's suspicion was enhanced by the fact that in 2015 and 2016, Mr. Hood's compensation represented almost 90% of the total compensation that Hood, Inc. paid to its officers, despite the fact that other non-shareholder officers worked similar hours and shared similar responsibilities. While some of that discrepancy could have been attributed to the need to remedy Mr. Hood's past under

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> compensation, it was nonetheless glaring that Hood, Inc.'s other officers each received a bonus of $100,000 or less for the 2015 and 2016 tax years, while Mr. Hood received a bonus of $5 million for each year.[369]

The panel also determined that the Tax Court appropriately placed emphasis on comparing Mr. Hood's compensation with that of similarly positioned executives in comparable companies.

> Finally, the Tax Court placed considerable weight on the comparison of Mr. Hood's compensation with that paid to similarly situated executives in comparable companies. While no single factor is decisive under the multifactor test, such comparisons have been described as "a most significant factor." *Aspro, Inc. v. Comm'r*, 32 F.4th 673, 680 (8th Cir. 2022) (quoting *Charles Schneider & Co*., 500 F.2d at 154); see also 26 C.F.R. § 1.162-7(b)(3) (requiring consideration of what "would ordinarily be paid for like services by like enterprises under like circumstances"). Relying on survey data included in Fuller's expert report about comparably sized site-preparation contractors and their compensation of employee-shareholders, the Tax Court noted that for the years 2013 through 2016, Fuller treated Mr. Hood as meriting compensation in the 99th percentile based on the company's success and still found that the compensation actually paid to Mr. Hood exceeded what was reasonable. Instead, relying on this comparative data, the Fuller report calculated that reasonable compensation for Mr. Hood would amount to $3,681,269 for 2015 and $1,362,831 for 2016. The Tax Court found these calculations to be "the most credible and complete source of data, analyses, and conclusions." At the same time, the court discounted the testimony of Hood, Inc.'s expert witnesses because they "did not provide satisfactory countervailing evidence . . . that would credibly support a greater allowable amount." It noted, for example, that one of Hood, Inc.'s expert reports based its analysis on survey data for CEO compensation from 2011 to 2016 for companies with a revenue of up to $500 million, which, the Tax Court concluded, was a poor match for both Hood, Inc.'s size and the relevant time period at issue.
>
> At bottom, the Tax Court held that a reasonable total compensation for Mr. Hood was $3,681,269 for 2015 and $1,362,831 for 2016, and that a $5 million bonus for each year — on top of his salary — was excessive.[370]

The panel ultimately concludes that the taxpayer did not demonstrate any clear error by the Tax Court, including its decision to rely on the expert report provided by the IRS rather than the one presented by the taxpayer.

> We find that Hood, Inc. has not demonstrated that the Tax Court's factual findings were clearly erroneous or that its reliance on Fuller's report was inappropriate. The court explained its reason for relying on Fuller and rejecting Hood, Inc.'s experts, and we see no basis to disturb that determination. See *United States v. Hall*, 664 F.3d 456, 462 (4th Cir. 2012) ("Evaluating the credibility of experts and the value of their opinions is . . . a function best committed to the district courts, and one to which appellate courts must defer,

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> and we should be especially reluctant to set aside a finding based on the trial court's evaluation of conflicting expert testimony" (cleaned up)).[371]

In summary, the panel expressed its view on the compensation issue as follows:

> Mr. Hood's business acumen and his contribution to Hood, Inc.'s prosperity were fully recognized by the Tax Court, and the Tax Court thus concluded that Hood, Inc. was entitled to compensate Mr. Hood well. And we agree.
>
> This case is not about such compensation but rather about whether the amount paid was entirely for Mr. Hood's personal services or whether it included profits distributable to him as a function of his ownership of the company. To make that determination, the Tax Court took a multifactor approach designed to measure the portion of compensation that was attributable only to Mr. Hood's personal services and concluded that not all his compensation was so attributable.[372]

However the Panel Did Not Agree with Tax Court's View That the Corporation Should be Assessed a Penalty for One Year

Although the IRS emerged victorious in its contention regarding the proper deductible compensation paid to Mr. Hood, the panel disagreed with the Tax Court's determination that the corporation should be penalized for the understatement in one of the years.

The corporation asserts that it had exercised reasonable care in ascertaining the appropriate amount of compensation deduction to report on its tax returns. It argues that it acted in good faith and relied on the advice of qualified experts to determine the claimed amount on both year's returns, so it should have escaped any penalty for both years.

> Finally, Hood, Inc. contends that the Tax Court clearly erred in imposing a penalty for the 2016 tax year. It emphasizes that the Tax Court found that Hood, Inc. had reasonably relied in good faith on its tax advisers when paying the 2015 bonus and that therefore no penalty should be imposed for that year, and based on this finding, it argues that because it relied on the same tax advice for paying the 2016 bonus, the Tax Court should also have found good faith in 2016 and therefore should not have imposed the penalty for that year.[373]

The panel engaged in a discussion regarding the relevant law pertaining to the penalty in question under IRC §6662(a), as well as the provision of a good faith exception to the penalty outlined in IRC §6664(c)(1):

> The Internal Revenue Code provides for the imposition of a 20% penalty on "any portion of an underpayment of tax" that is attributable to the taxpayer's "substantial understatement" of income tax liability on its tax return. 26 U.S.C. §6662(a), (b)(2). Generally, an understatement is substantial if it exceeds 10% of the tax required to be shown on the return. Id. §6662(d)(1)(B)(i). A defense to the imposition of the penalty is provided, however, "with respect to any portion of an

[371] *Clay Hood, Inc. v. Commissioner,* Case No. 22-1573, CA4, May 31, 2023

[372] *Clay Hood, Inc. v. Commissioner,* Case No. 22-1573, CA4, May 31, 2023

[373] *Clay Hood, Inc. v. Commissioner,* Case No. 22-1573, CA4, May 31, 2023

> underpayment if it is shown that there was a reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion." *Id.* §6664(c)(1) (emphasis added). In determining whether a taxpayer acted with reasonable cause and in good faith, "all pertinent facts and circumstances" must be considered, but "[g]enerally, the most important factor is the extent of the taxpayer's effort to assess the taxpayer's proper tax liability." 26 C.F.R. § 1.6664-4(b)(1). Whether a taxpayer acted with reasonable cause and in good faith is a question of fact that we review for clear error. *Est. of Kechijian v. Comm'r*, 962 F.3d 800, 810 (4th Cir. 2020).[374]

A crucial avenue for taxpayers to establish reasonable cause is by demonstrating that they relied in good faith upon the guidance of qualified tax advisers who possessed all the pertinent facts.

> Reliance on the advice of a professional tax adviser has been held to demonstrate reasonable cause and good faith if "(1) [t]he adviser was a competent professional who had sufficient expertise to justify reliance, (2) the taxpayer provided necessary and accurate information to the adviser, and (3) the taxpayer actually relied in good faith on the adviser's judgment." *Neonatology Assocs., P.A. v. Comm'r*, 115 T.C. 43, 99 (T.C. 2000), *aff'd*, 299 F.3d 221 (3d Cir. 2002); see also *United States v. Boyle*, 469 U.S. 241, 250 (1985) ("Courts have frequently held that 'reasonable cause' is established when a taxpayer shows that he reasonably relied on the advice of an accountant . . . even when such advice turned out to have been mistaken"); *Klamath Strategic Inv. Fund ex rel. St. Croix Ventures v. United States*, 568 F.3d 537, 548 (5th Cir. 2009) ("The validity of this reliance turns on the quality and objectivity of the professional advice which [the taxpayer] obtained" (cleaned up)).[375]

The panel discussed how the Tax Court found good faith reliance on a tax adviser for one year but not another—but was not impressed with the analysis and its conclusion.

> In this case, Hood, Inc. reported an income tax obligation for 2015 of $1,675,996, and the Tax Court found a deficiency of $550,866, which exceeded the 10% threshold for triggering a penalty. Similarly, Hood, Inc. reported an income tax obligation for 2016 of $4,040,956, while the Tax Court found a deficiency of $1,411,991, which again exceeded the 10% threshold for triggering a penalty. But with respect to the 2015 tax year, the court found that Hood, Inc. had established the reasonable-cause defense based on its reliance on the tax advice of two competent and experienced professional accountants at Elliott Davis. The company had provided Elliott Davis with accurate information regarding Mr. Hood's historic compensation and the proposed method of calculating his future compensation, and the two Elliott Davis accountants confirmed that they believed a $5 million bonus for Mr. Hood was reasonable. Yet with respect to the 2016 tax year, the Tax Court found that the evidence was lacking as to what advice the company may have received relating to Mr. Hood's 2016 compensation, observing that this absence of evidence was "particularly notable when considering that the record also does not show that, when awarding Mr. Hood the 2015 amount, [Hood, Inc.] felt Mr. Hood remained undercompensated or that additional backpay compensation might be warranted

[374] *Clay Hood, Inc. v. Commissioner,* Case No. 22-1573, CA4, May 31, 2023

[375] *Clay Hood, Inc. v. Commissioner,* Case No. 22-1573, CA4, May 31, 2023

> in the future for these prior services." We conclude, however, that the Tax Court overstated the discrepancy in evidence relating to the two years.[376]

The panel then provides its own analysis that finds that the corporation qualifies for relief from the penalty for both years.

> When Hood, Inc.'s CFO provided the backpay calculation to Elliott Davis in May 2015, he wrote, "Bonus due at 5/31/15 is $7,141,000. Pay $5,000,000 5/31/15 balance to future years." (Emphasis added). Thus, contrary to the Tax Court's observations, this evidence indicated that Hood, Inc. believed that Mr. Hood would still be undercompensated in 2016 following the payment of the $5 million bonus in 2015 and would therefore require additional backpay compensation in the future. Further, several of Hood, Inc.'s witnesses, including accountants at Elliott Davis, testified that they followed the same process to determine the bonus amount in 2016 as they did in 2015, and this fact went uncontroverted. Because the record indicates that Hood, Inc. anticipated remedying Mr. Hood's past undercompensation in installments over multiple years and discussed that plan with its tax advisors at Elliott Davis, who approved it as reasonable, we conclude that the Tax Court's finding regarding the reasonable-cause defense for the 2015 tax year should also have applied to the 2016 tax year.
>
> Accordingly, we vacate the portion of the Tax Court's decision imposing a $282,398 penalty for 2016.[377]

SECTION: 162

AMOUNTS PAID AS MANAGEMENT FEES BY C CORPORATION NOT DEDUCTIBLE

Citation: Aspro v. Commissioner, Case No. 21-1996, CA8, 4/26/22

In the case of *Aspro v. Commissioner*, Case No. 21-1996, CA8,[378] the Eighth Circuit Court of Appeals sustained the Tax Court's disallowance of a deduction of management fees paid to shareholders of a C corporation and the treatment of the payment as disguised distributions taxable as dividends.

There are various reasons why some closely held entities make payments to related parties that are labeled management fees. In this case we aren't told what the ultimate goal was of such fees, but we do know that they had continued for an extremely long period of time.

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[376] *Clay Hood, Inc. v. Commissioner,* Case No. 22-1573, CA4, May 31, 2023

[377] *Clay Hood, Inc. v. Commissioner,* Case No. 22-1573, CA4, May 31, 2023

[378] *Aspro v. Commissioner*, Case No. 21-1996, CA8, April 26, 2022, https://www.taxnotes.com/research/federal/court-documents/court-opinions-and-orders/eighth-circuit-affirms-manager-fees-were-disguised-distributions/7df6s (retrieved April 27, 2022)

The opinion summarizes the facts of the case as follows:

> Aspro, Inc. is an asphalt-paving company in Waterloo, Iowa. It is incorporated under Iowa law and treated as a subchapter C corporation for federal income-tax purposes. Between 2012 and 2014, the relevant years, Aspro stock was held by: Milton Dakovich, the president of Aspro; Jackson Enterprises Corp.; and Manatt's Enterprises, Ltd. Aspro has not paid dividends since the 1970s but, except for one year, has paid its shareholders "management fees" for at least twenty years. In addition to receiving management fees, Dakovich received a salary, director fees, and bonuses for each of the relevant years. There were no written agreements between Aspro and its three shareholders regarding fees paid for management services, nor was there an employment contract between Aspro and Dakovich. Aspro claimed deductions on its tax returns for management fees for tax years 2012 through 2014.[379]

The IRS examined the corporation's returns and denied the deduction for management fees, finding that the corporation had failed to establish that it had incurred or paid these fees for ordinary and necessary business purposes as required by IRC §162. Rather the IRS found that these payments represented disguised distributions being paid to the corporation's shareholders. The taxpayer filed a petition in the Tax Court challenging these findings of the IRS, but the Tax Court ruled in the IRS's favor. The taxpayers then appealed that decision to the Eighth Circuit Court of Appeals.

The Underlying Law for Deductibility of Such Management Fees

The panel's opinion begins by discussing the general rules for allowing a deduction for trade or business expenses of a corporation.

> …[W]e consider Aspro's challenge to the tax court's holding that none of the management fees paid by Aspro was deductible because they were instead disguised distributions of profits. See *United States v. Ellefsen*, 655 F.3d 769, 779 (8th Cir. 2011) (explaining that distributions of profits are not deductible). Whether payments made to shareholders are distributions of profits rather than compensation for services is a factual determination. *Heil Beauty Supplies, Inc. v. Comm'r*, 199 F.2d 193, 194-95 (8th Cir. 1952). We review the tax court's factual determinations for clear error and "must affirm unless left with a conviction that the tax court has committed a mistake." *Keating v. Comm'r*, 544 F.3d 900, 903 (8th Cir. 2008). We consider all the facts and circumstances when determining whether the compensation paid to a corporation's shareholders is actually a distribution of profits. See *Heil Beauty Supplies*, 199 F.2d at 195; *Charles Schneider & Co. v. Comm'r*, 500 F.2d 148, 151 (8th Cir. 1974). Aspro bore the burden of proving its entitlement to the deductions. See T.C.R. 142(a)(1).[380]

The panel discusses the differences between deductible business payments for a C corporation and amounts that represent distributions to the shareholders, including how to determine if an amount paid that claims to be for a business expense is actually a disguised distribution, structured in this manner to avoid the less favorable tax treatment of paying a distribution. That

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[379] *Aspro v. Commissioner*, Case No. 21-1996, CA8, April 26, 2022

[380] *Aspro v. Commissioner*, Case No. 21-1996, CA8, April 26, 2022

is, the negative tax consequence that the C corporation will get no deduction for this payment while it will still be taxable income to the shareholders:

> Corporations must pay federal income tax on their taxable income, 26 I.R.C. § 11(a), which is gross income less allowable deductions, § 63(a). Under § 162(a)(1), deductions are allowed for expenses that are "ordinary and necessary" in carrying on a trade or business, including "reasonable allowance for salaries or other compensation for personal services actually rendered." "Ordinary has the connotation of normal, usual, or customary," and describes expenses arising from transactions "of common or frequent occurrence in the type of business involved." *Deputy v. du Pont*, 308 U.S. 488, 495 (1940). Necessary means appropriate and helpful to the development of the business. See *Comm'r v. Heininger*, 320 U.S. 467, 471 (1943); *Welch v. Helvering*, 290 U.S. 111, 113 (1933).
>
> "As the language of § 162(a)(1) suggests, a deduction may be made if salary is both (1) 'reasonable' and (2) 'in fact payments purely for services.'" *David E. Watson, P.C. v. United States*, 668 F.3d 1008, 1018 (8th Cir. 2012) (quoting Treas. Reg. § 1.162–7(a)); see also *Wy'East Color Inc. v. Comm'r*, 71 T.C.M. (CCH) 2501, 1996 WL 119492, at *6 (1996) ("A taxpayer may deduct payments for management services under section 162 if the payments are for services actually rendered and are reasonable in amount."). "Usually, courts only need to examine the first prong," although "in the rare case where there is evidence that an otherwise reasonable compensation payment contains a disguised dividend, the inquiry may expand into compensatory intent apart from reasonableness." *David E. Watson*, 668 F.3d. at 1018 (brackets omitted). However, "[t]he inquiry into reasonableness is a broad one and will, in effect, subsume the inquiry into compensatory intent in most cases." Id. In general, reasonable compensation is limited to "such amount as would ordinarily be paid for like services by like enterprises under like circumstances." Treas. Reg. § 1.162-7(b)(3); see also *Home Interiors & Gifts, Inc. v. Comm'r*, 73 T.C. 1142, 1155-56 (1980).
>
> "[C]orporations are not allowed a deduction for dividends paid to the shareholders," *Ellefsen*, 655 F.3d at 779, including distributions that are disguised as compensation. Treas. Reg. § 1.162-7(b)(1); *Charles Schneider*, 500 F.2d at 152-53. Compensation paid by the corporation to shareholders is closely scrutinized to make sure the payments are not disguised distributions. *Heil Beauty Supplies*, 199 F.2d at 194 ("Any payment arrangement between a corporation and a stockholder . . . is always subject to close scrutiny for income tax purposes, so that deduction will not be made, as purported salary, rental or the like, of that which is in the realities of the situation an actual distribution of profits.").[381]

As well, the panel notes how the law is applied to determine if compensation (in whatever form) being paid to the shareholders is reasonable, as required under IRC §162:

> To determine whether compensation paid to a shareholder-employee is reasonable, courts consider factors enumerated in *Charles Schneider*, 500 F.2d at 151-52.6 No single factor is dispositive; rather, the court is to base its decision on

[381] *Aspro v. Commissioner*, Case No. 21-1996, CA8, April 26, 2022

a careful consideration of applicable factors in light of the relevant facts. See *Mayson Mfg. Co. v. Comm'r*, 178 F.2d 115, 119 (6th Cir. 1949). Because the factors in isolation offer insufficient guidance on their application, we view them in the context of the list as a whole.[382]

Why the Taxpayer Failed to Show These Were Deductible Business Expenses

The panel agreed with the Tax Court and the IRS that the taxpayer had failed to demonstrate these payments represented deductible business expenses under IRC §162. The panel pointed out a number of problems with these payments, problems that probably aren't all that unusual for many of the taxpayers that attempt to payout such management fees.

The panel begins by noting:

> Aspro did not present evidence showing what "like enterprises under like circumstances" would ordinarily pay for like management services. See Treas. Reg. § 1.162-7(b)(3). It also did not quantify the value of the management services provided, nor did it show that similar companies would pay that amount for similar services.[383]

The lack of any written agreement between the parties or any methodology being documented that was used to compute the amount of these management fees was also a major problem in the view of the panel:

> As the tax court noted, Aspro produced no written management-services agreement or other documentation of a service relationship between Aspro and either entity, no evidence of how Aspro determined the amount of the management fees, and no evidence that either entity billed Aspro or sent invoices for any services performed for Aspro. See *ASAT, Inc., v. Comm'r*, 108 T.C. 147 (1997) (holding that the taxpayer was not entitled to deduct consulting fees where there were no written agreements, no documentation providing how the management fees were calculated, and billing invoices containing almost no details); *Fuhrman v. Comm'r*, 102 T.C.M. (CCH) 347 2011-236, 2011 WL 4502290, at *2-3 (same).[384]

The nature of the actual payments appeared much more consistent with payments being made to the shareholders as a return based on their ownership interest in the corporation, something we'd normally refer to as a dividend payment:

> Further, we agree with the tax court that the management fees paid by Aspro to Jackson Enterprises Corp. and Manatt's Enterprises, Ltd. were not purely for services rendered and were instead disguised distributions of profits. See *David E. Watson*, 668 F.3d. at 1019. Aspro has made no dividend distributions since the 1970s but has paid management fees every year but one for twenty years. See *Paul E. Kummer Realty Co. v. Comm'r*, 511 F.2d 313, 315 (8th Cir. 1975) ("[T]he absence of dividends to stockholders out of available profits justifies an inference

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[382] *Aspro v. Commissioner*, Case No. 21-1996, CA8, April 26, 2022

[383] *Aspro v. Commissioner*, Case No. 21-1996, CA8, April 26, 2022

[384] *Aspro v. Commissioner*, Case No. 21-1996, CA8, April 26, 2022

> that some of the purported compensation really represented a distribution of profits as dividends."); *Charles Schneider*, 500 F.2d at 153 ("Perhaps most important [in identifying disguised distributions] is the fact that no dividends were ever paid by any of these companies during [this time], even though they enjoyed consistent profits and immense success in the industry.").[385]

In addition to the fact that dividends never had been paid, the court noted that the actual amount in management fees seemed to be roughly in line with the percentage of ownership interest of the various owners. Again, this is more like something we would expect to see in the payment of dividends then we would for payments based on the value of services actually rendered:

> And Aspro has also paid management fees in amounts roughly proportional to the ownership interests of the stockholders. Jackson Enterprises Corp. and Manatt's Enterprises, Ltd. each owned forty percent of Aspro's stock, and each received forty-three percent of the total management fees paid in 2012, forty-six percent in 2013, and forty-four percent in 2014. See *Paul E. Kummer*, 511 F.2d at 316 (suggesting that payments to shareholders that were "almost identical" to their ownership interest indicated disguised distributions); Treas. Reg. § 1.162-7(b)(1) (stating that a disguised distribution is likely where "excessive payments correspond or bear a close relationship" to ownership interests); *RTS Inv. Corp. v. Comm'r,* 53 T.C.M. (CCH) 171, aff'd, 877 F.2d 647 (8th Cir. 1989) (per curiam). The district court correctly found that Aspro had a "process of setting management fees [that] was unstructured and had little if any relation to the services performed" and "had relatively little taxable income after deducting the management fees," and Aspro does not dispute that it paid the management fees as lump sums at the end of the tax year even though many of the services that Aspro claims justified the management fees were performed throughout the year. See *Nor-Cal Adjusters v. Comm'r*, 503 F.2d 359, 362-63 (9th Cir. 1974) (affirming in a disguised-distribution context the tax court's reliance on factors including an unstructured process of setting shareholder compensation, consistently negligible taxable income, and lump-sum payments to shareholders). Therefore, the tax court did not clearly err in concluding that the management fees paid to Jackson Enterprises Corp. and Manatt's Enterprises, Ltd. were nondeductible because Aspro failed to carry its burden of showing that the fees were reasonable and purely for services.[386]

The corporation also failed to show that overall amounts paid to the shareholders for their salaries, bonuses, directors fees and management fees represented reasonable amounts of compensation to the shareholders for services actually rendered:

> We conclude that the district court did not clearly err in finding that Aspro failed to meet its burden to show that the management fees paid to Dakovich "would ordinarily be paid for like services by like enterprises under like circumstances." See Treas. Reg. § 1.162-7(b)(3); *Home Interiors*, 73 T.C. at 1155-56. Aspro did not present evidence showing what similar companies under like circumstances would pay as management fees (over and above salary and bonuses) to an employee like Dakovich for the same type of management services. It also did not quantify the value of the management services he provided, nor did it show

[385] *Aspro v. Commissioner*, Case No. 21-1996, CA8, April 26, 2022

[386] *Aspro v. Commissioner*, Case No. 21-1996, CA8, April 26, 2022

> that like enterprises would pay that amount for them. In fact, the Commissioner's expert said the exact opposite. Nunes, an expert in valuing compensation arrangements, reviewed deposition transcripts about the services Dakovich provided to Aspro and determined the amount of reasonable compensation that a comparable enterprise would have to pay in the marketplace for the services described in the depositions. He concluded that Dakovich's salary and bonus exceeded the industry average and median by a substantial margin and that management fees in addition to the salary and bonus were not reasonable. When Nunes added Dakovich's excess compensation per year to his management fees, his share of the total management fees over the three years at issue was twenty-two percent, closely aligning with his twenty-percent ownership interest in Aspro; the other two shareholders each received thirty-nine percent, which closely aligned with their approximately forty-percent-each ownership interest in Aspro.[387]

The panel also concluded, not surprisingly, that these payments did not constitute reasonable compensation to the shareholders:

> Factors discussed in *Charles Schneider* strengthen our conclusion that the district court did not clearly err, including "the absence of profits paid back to the shareholders as dividends"; "the nature, extent and scope of the employee's work"; and "a most significant factor," "the prevailing rates of compensation for comparable positions in comparable concerns." See *Charles Schneider*, 500 F.2d at 152-54.[388]

Rather the panel concludes the facts lead to the conclusion that these payments are far more likely to be distributions of corporate profits to the equity holders, something that is not deductible at the corporate level:

> Aspro has not paid any dividends to stockholders since the 1970s, but regularly pays management fees. This "justifies an inference that . . . the purported compensation really represents a distribution of profits." See id. at 153.[389]

The court also noted that these fees were always paid at the end of the year, and generally brought the corporation's taxable income down to a relatively small amount:

> As with Jackson Enterprises Corp. and Manatt's Enterprises, Ltd., Aspro paid the management fees as lump sums at the end of the tax year even though the purported services were performed throughout the year, had an unstructured process of setting the management fees that did not relate to the services performed, and had a relatively small amount of taxable income after deducting the management fees. See *Nor-Cal Adjusters*, 503 F.2d at 362-63. Therefore, the tax court did not clearly err in finding that Aspro failed to carry its burden of showing that the management fees were reasonable and purely for services actually performed.[390]

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[387] *Aspro v. Commissioner*, Case No. 21-1996, CA8, April 26, 2022

[388] *Aspro v. Commissioner*, Case No. 21-1996, CA8, April 26, 2022

[389] *Aspro v. Commissioner*, Case No. 21-1996, CA8, April 26, 2022

[390] *Aspro v. Commissioner*, Case No. 21-1996, CA8, April 26, 2022

Lessons from This Case

Advisors can take a number of lessons from studying this case. One of the key ones actually has little to do with the issue at hand, but rather to something that's often used to justify taking positions that the advisor should be aware would be unlikely to survive any sort of review by a taxing agency.

As the panel noted, the corporation had gotten away with making these disguised dividend payments for two decades before the IRS finally examined the corporation and raised the issues. The fact that the IRS had never challenged this before, or, as clients often love to tell their tax advisor, other taxpayers have been doing this for decades and never had an issue, is of no use once the challenge is brought forth. Note that the court never even vaguely considered allowing the taxpayer to claim this deduction merely because it had gone unchallenged for so long.

Second, it is important to carefully document anything dealing with a payment to a related party where the IRS may gain advantage by restructuring that payment under a different view. The lack of any sort of documentation regarding how these management fees had been computed allowed the IRS to easily persuade the court it was likely they were being paid to bail out earnings from the corporation to avoid having a double tax situation eventually, where amounts were going to be taxed at the corporate level and later taxed when distributed to the shareholders. Even worse, there wasn't even the very basic type of documentation regarding the nature of the agreement or what exactly the services were that were to be performed in order to earn these management fees.

The fact that payments were made solely in a lump sum at the end of the year also helped the IRS persuade the court that this was such a tool being used solely to reduce taxable income in the corporation, not an actual payment related to services being rendered to the corporation.

Again, it's important to note that the taxpayers had years of what they believed was IRS acceptance of this sort of a program. But reality is that the IRS doesn't look at most returns in any detail, even when claiming deductions for things like management fees that you might think could raise some issues. And it's also important to note that the fact you got away with it for 20 years is no defense whatsoever in a year in which the agency decides to ask about the item.

Advisors need to realize that even though this corporation got away with this for 20 years, advisors working with a large number of taxpayers are going to be far more exposed to the IRS running into the issue on one or more of their clients.

So the advisor is far more exposed than any individual client to potentially bad results arising from such sloppy and aggressive tax positions being taken. Such bad results can arise from the IRS taking action against the preparer, but more likely the advisor's client will suddenly be "shocked" to discover that this position was aggressive, regardless of how hard they may have pushed for it or how much they whined that all of their friends and business acquaintances were doing the same thing and they wondered why the advisor was being such a wimp about these matters. That may result in the client either filing a civil claim against the tax advisor or filing a complaint with a licensing agency.

SECTION: 174

AICPA LETTER GIVES RECOMMENDATION ON GUIDANCE ON UPCOMING TCJA REQUIREMENT TO AMORTIZE RATHER THAN EXPENSE R&D EXPENSES

Citation: "Comments on Research & Experimental Expenditures under section 174," Letter from AICPA Tax Executive Committee to Associate Chief Counsel Holly Porter, 5/26/22

The AICPA sent a letter[391] to IRS Associate Chief Counsel Holly Porter (Passthroughs and Special Industries) with comments regarding the need for guidance on research and experimental expenditures under IRC §174.

The Tax Cuts and Jobs Act revised IRC §174 so that, effective for tax years beginning after December 31, 2021, *specified research or experimental expenditures* are no longer currently deductible by a business, but rather must be amortized over 5 years for domestic research and 15 years for foreign research.

Stalled Attempt to Restore the Full Expensing of Such Costs

One of the regular budget games Congress has played over the years is to enact revenue raisers as part of major bills, but provide these likely unpopular revenue raising provisions won't take effect for many years. In the case of the Affordable Care Act, for example, the "Cadillac tax" on high cost medical plans was not scheduled to take effect until many years after the 2010 passage of the law.

An unstated assumption for such long delayed revenue raisers is that a later Congress will repeal the provision before it actually takes effect and begins to inflict pain. In the case of the Affordable Care Act, this implied agreement with future Congresses did eventually play out—that tax was never actually implemented.

This has the advantage of initially making the provisions in the original bill appear to have less of an overall impact on net federal spending. As the pain does not take place for years, there is less of a hue and cry about including this provision in lieu of making actual reductions in the cost of the package.

Then, years later, Congress can remove the provision once the only issue before the Congress is the pain this provision will create—a current pain that makes it easier to explain the need to incur the budget hit. Who knows, it might even help get those same Congressional members who voted for the first bill to now even get more credit for preventing these harms.

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[391] "Comments on Research & Experimental Expenditures under section 174," Letter from AICPA Tax Executive Committee to Associate Chief Counsel Holly Porter, May 26, 2022, https://us.aicpa.org/content/dam/aicpa/advocacy/tax/downloadabledocuments/56175896-aicpa-comment-letter-section-174-research-and-experimental-expenditures-final.pdf (retrieved June 3, 2022)

However, things aren't going so well for this provision that raised revenue by forcing companies to capitalize and amortize research or experimental expenditures in what seemed at the time the "distant" future. The expected repeal has been introduced, but it was part of the Build Back Better Act which has stalled in Congress. For now, backers of the repeal have not been able to attach the provisions to a "must pass" bill, nor have they succeeded in getting both chambers to consider a "clean" bill.

In the interim, C corporations looking to prepare GAAP financial statements have been forced to start trying to figure out how the law would impact their tax provisions. As well, while it seems more likely than not that Congress will eventually restore immediate expensing (albeit, potentially retroactively sometime in 2023), that cannot be guaranteed if Congress deadlocks—the repeal could become a victim of partisan battles in Congress even if clear majority on both sides of the aisle claim passing this provision is a high priority.

The Post-TCJA IRC §174

The new IRC §174 begins with the following general rule:

> (a) In general. In the case of a taxpayer's specified research or experimental expenditures for any taxable year —
>
> > (1) except as provided in paragraph (2), no deduction shall be allowed for such expenditures, and
> >
> > (2) the taxpayer shall —
> >
> > > (A) charge such expenditures to capital account, and
> > >
> > > (B) be allowed an amortization deduction of such expenditures ratably over the 5-year period (15-year period in the case of any specified research or experimental expenditures which are attributable to foreign research (within the meaning of section 41(d)(4)(F))) beginning with the midpoint of the taxable year in which such expenditures are paid or incurred.[392]

IRC §174(b) defines what are *specified research or experimental expenditures*, which is key to applying this provision:

> (b) Specified research or experimental expenditures. For purposes of this section, the term "specified research or experimental expenditures" means, with respect to any taxable year, research or experimental expenditures which are paid or incurred by the taxpayer during such taxable year in connection with the taxpayer's trade or business.[393]

[392] IRC §174(a)

[393] IRC §174(b)

Scope of the Guidance the AICPA is Requesting

The letter outlines those areas where the AICPA believes guidance is needed in the very near future. The letter reads:

> Specifically, the AICPA requests guidance and provides recommendations in the following areas.
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> 1. Identification of categories of section 174(a) expenditures.
>
>   – Treasury and IRS should issue regulations providing that section 174(a) expenditures include direct costs, including employee compensation, contract labor, and materials, and, at the taxpayer's election, allocable indirect and overhead costs.
>
>   – Additionally, Treasury and IRS should issue regulations that illustrate, using detailed examples, which costs are "incident to" the development or improvement of a product as per Reg. § 1.174-2.
>
> 2. Issues that have arisen with regard to Rev. Proc. 2000-50.
>
>   – IRS should modify the scope limitation under section 4 of Rev. Proc. 2000-50 to clarify that the limitation on costs that a taxpayer has treated as R&E expenditures under section 174 only applies to costs previously subject to an irrevocable election under section 174, including section 174(b) or charging the expenses to capital account.
>
>   – Additionally, IRS should make a corresponding modification to the scope limitation under section 9.01(2) of Rev. Proc. 2022-14.[394]

The AICPA describes the background that leads to the need for this updated guidance:

> Pre-TCJA, section 174 provided taxpayers with the option to immediately expense R&E expenditures under section 174(a) or elect to defer and amortize the expenditures over a period of not less than 60 months under section 174(b), or charge the expenditures to capital account under Reg. § 1.174-1. In addition, taxpayers could elect under section 59(e) to amortize over 10 years expenditures otherwise allowed as a deduction under section 174(a). Prior to the changes, taxpayers that paid or incurred costs for software development could rely on Rev. Proc. 2000-50, which allowed taxpayers to treat software development costs in the same manner as under section 174, including the same options (other than charging to capital account), whether the expenditures met the requirements of section 174 or not.

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[394] "Comments on Research & Experimental Expenditures under section 174," Letter from AICPA Tax Executive Committee to Associate Chief Counsel Holly Porter, May 26, 2022

> In addition to mandatory capitalization of R&E expenditures, the TCJA changed the language in section 174 from "research or experimental expenditures" to "specified research or experimental expenditures," and added a special rule under section 174(c)(3) that specifies that for purposes of section 174, any amount paid or incurred in connection with the development of any software is treated as a "specified research or experimental expenditure." As a result, the TCJA effectively eliminates taxpayers' ability to rely on Rev. Proc. 2000-50 to deduct software development expenditures in the year incurred.[395]

The AICPA breaks the letter down into two sections, the first looking for overall guidance on what constitutes various §174(a) expenditures and the second dealing with issues related to software expenditures arising due to Revenue Procedure 2000-50 and the post-TCJA IRC §174.

Identification of Categories of IRC §174(a) Expenditures

The AICPA begins by noting that a large number of taxpayers have no systems in place to identify research or experimental expenditures:

> Many taxpayers that pay or incur section 174 expenditures may not have an established methodology to identify the appropriate amounts of these expenditures that are now subject to mandatory amortization because, prior to the TCJA, the tax accounting treatment of current expensing generally would have been allowable whether the expenses were deductible as ordinary and necessary trade or business expenditures under section 162(a) or R&E expenditures under section 174(a).[396]

An initial reaction some might have is that, wait a minute, a lot has been written about the IRC §41 research credit and can't that serve to provide guidance. But the AICPA notes that while the §174 definitions are relevant to the research credit, more expenses are treated as §174 expenses than are those that can be used for IRC §41's research credit:

> Taxpayers with research activities conducted in the United States may claim a research credit under section 41 for increasing these activities. The amount of the section 41 research credit by statute is a function of several variables including the amount of expenditures paid or incurred by the taxpayer that meet the definition of section 174(a) expenses. Although meeting the definition of section 174 is generally considered a threshold requirement for the section 41 research credit, the pool of costs eligible for the credit has been clearly delineated to include only wages, supplies, rental or lease of computers, and contract research expenses.[397]

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[395] "Comments on Research & Experimental Expenditures under section 174," Letter from AICPA Tax Executive Committee to Associate Chief Counsel Holly Porter, May 26, 2022

[396] "Comments on Research & Experimental Expenditures under section 174," Letter from AICPA Tax Executive Committee to Associate Chief Counsel Holly Porter, May 26, 2022

[397] "Comments on Research & Experimental Expenditures under section 174," Letter from AICPA Tax Executive Committee to Associate Chief Counsel Holly Porter, May 26, 2022

The letter goes on to discuss the limitations of the regulations under IRC §174:

> In contrast to the requirements for the section 41 research credit, the regulations under Reg. § 1.174-2 do not clearly delineate the extent to which various categories of expenses, including direct and indirect costs, fall within the definition of research and experimental expenditures. Rather, the regulations focus on the nature of the activity to which the expenditures relate. The regulations further provide that the qualified activities must involve the elimination of uncertainty in the development or improvement of a product, including products to be used by the taxpayer in its trade or business, or held for sale, lease, or license. With respect to defining the categories of expenses that might fall within the scope of section 174, and thus the amortization requirement provided in the TCJA, the regulations provide a very general standard for identifying section 174 expenditures. Pursuant to the regulations, section 174 applies to all costs that are "incident to" the development or improvement of a product.
>
> While the regulations do not explicitly define which costs are "incident to" the development or improvement of a product, they do provide that costs paid or incurred in the production of a product after the elimination of uncertainty do not qualify as section 174 expenditures. The regulations exclude certain expenditures from section 174 eligibility including ordinary testing for quality control, management studies, and advertising and promotions, amongst others. Additionally, interpretive guidance suggests that allocable indirect costs and overhead may be section 174 eligible.[398]

The AICPA letter then notes that while previously there was little need for such specific §174 guidance since all expenses were immediately deductible, that is no longer the case:

> Up until the TCJA, due to the current expensing option and the explicit constraints on expenses eligible for the section 41 research credit, there has been far less of a need for detailed rules addressing which categories of costs must be allocated to R&E activities and the extent to which such costs are characterized as expenses subject to section 174 treatment. Indirect costs, including overhead and general and administrative costs are of particular concern for many taxpayers, as such costs may be properly allocable to many business activities. In light of the new mandatory amortization regime, there is a need for guidance that provides taxpayers with certainty and uniformity in the accounting for these costs, and that minimizes controversies over the categories of costs associated with R&E activities that are subject to amortization. Without such guidance, some taxpayers will interpret the rules to apply narrowly to direct costs, while others may apply a full-absorption costing method like the rules of section 263A.[399]

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[398] "Comments on Research & Experimental Expenditures under section 174," Letter from AICPA Tax Executive Committee to Associate Chief Counsel Holly Porter, May 26, 2022

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AICPA Recommendations on Section 174(a) Expenditures

The AICPA letter contains the following two recommendations to the IRS and Treasury:

- The AICPA recommends that Treasury and IRS issue regulations providing that section 174(a) expenditures include direct costs, including employee compensation, contract labor, and materials, and, at the taxpayer's election, allocable indirect and overhead costs.

- Additionally, the AICPA recommends that Treasury and IRS issue regulations that illustrate, using detailed examples, which costs are "incident to" the development or improvement of a product as per Reg. § 1.174-2.[400]

A key concern of the AICPA relates to how broadly the IRS might cast the net to bring in indirect expenses to be part of the amortization rules. For this reason, the AICPA argues Congress did not intend for §174 to include expenses broadly in the way that IRC §263A brings expenses into inventory:

> In contrast to section 174, the uniform capitalization rules of section 263A provide a requirement to capitalize all direct and indirect costs that directly benefit or are incurred by reason of the production or resale of specified categories of property. In enacting section 263A, Congress provided very detailed rules in the legislative history as to which categories of direct and indirect costs would be subject to capitalization under section 263A. Further, the regulations follow this mandate and provide very detailed rules with a high degree of specificity as to which categories of direct and indirect costs, including overhead and service costs, are required to be allocated to activities and capitalized to property subject to section 263A. The types of activities subject to section 263A are activities for which the capitalization of direct costs, and in some cases certain types of indirect costs, were required to be capitalized under pre-section 263A law. The enactment of section 263A represents a congressional intent to establish more uniform rules for the identification and treatment of indirect costs with respect to tangible property.
>
> Research and experimental expenses were considered a type of indirect cost associated with production of property, but by statute, preserving the current expensing option under section 174(a), this category of costs was explicitly excluded from the capitalization requirement of section 263A.[401]

The AICPA also points out that Treasury did not cast a broad §263A sized net in determining capitalization of intangible assets and benefits in response to the US Supreme Court's *INDOPCO*[402] decision:

> In 2003, in response to controversies that arose from the Supreme Court's 1992 decision in the *INDOPCO* case, the IRS and Treasury issued final regulations to provide certainty as to the capitalization of costs with respect to intangible assets

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[401] "Comments on Research & Experimental Expenditures under section 174," Letter from AICPA Tax Executive Committee to Associate Chief Counsel Holly Porter, May 26, 2022

[402] *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79 (1992)

> and benefits, including business acquisitions and restructurings. These regulations provide that taxpayers must capitalize amounts paid to acquire or create certain enumerated categories of intangible assets, and costs that facilitate the acquisition or creation of such intangible assets. In contrast to section 263A, these regulations explicitly provide that employee compensation, overhead, and certain de minimis costs are deemed not to facilitate the acquisition or creation of the enumerated intangibles and therefore are not required to be capitalized. Taxpayers may, however, elect to capitalize employee compensation, overhead, and de minimis costs with respect to such intangibles under the regulations.[403]

The letter argues that Congress has not looked to have expansive, full-absorption style costing rules apply to new IRC §174:

> Amended section 174 takes away the option of current expensing under section 174(a). Many, if not most, taxpayers have relied on and consistently used the current expensing method for decades where they have had little need to apply a full-absorption regime. In amending section 174 to eliminate the current expensing option, and mandate amortization for all section 174(a) expenses, including all software development activities, Congress gave no indication that a switch to mandatory amortization should be subjected to a full-absorption regime such as the uniform capitalization regime under section 263A. To the contrary, as evidenced by the need to add a Code section to mandate a full-absorption type regime, it can be inferred that such a regime should be the subject of congressional action rather than administrative mandate. Further, the new mandatory amortization regime mirrors the prior elective amortization option under section 59(e) whereby, to our knowledge and experience relying upon the available guidance, taxpayers availing themselves of that election have never applied a full-absorption regime to allocate additional overhead and general and administrative costs to the pool of costs subject to the election. Similarly, under the former alternative election to either defer and amortize the costs under section 174(b) or charge the expenses to capital account, and which applied to all costs allocable to specific projects, the IRS has never sought to require taxpayers to apply a full-absorption methodology to the project costs subject to these elections. These elections have been in place for almost 70 years without any indication in our practical experience of such a requirement.[404]

The letter then returns to comparing Congress' reasons for enacting IRC §263A as compared to the reasons for enacting IRC §174:

> The legislative history leading up to the enactment of the uniform capitalization rules indicates a perception that congressional action was necessary to mandate full-absorption costing with respect to the various categories of properties subjected to those rules. As evidenced by the statutory language, regulations, and legislative history, imposing such a regime requires detailed and specific rules defining the categories of costs subject to capitalization, the categories of costs not subject to capitalization and methods of allocating costs to the appropriate

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> property or cost objective. Congress gave no indication that in mandating that section 174 expenses be amortized rather than currently expensed, taxpayers would also be subject to a full-absorption costing regime like the one contained in section 263A. Further, given that section 263A treats section 174 expenses themselves as an indirect cost that are not required to be capitalized to property subject to section 263A, it would seem incongruous to then treat section 174 costs themselves as a direct cost that is burdened with indirect costs such as overhead and general and administrative costs. For these reasons, congressional action setting forth a specific requirement and detailed rules is necessary to require that taxpayers apply a full-absorption costing regime for purposes of defining the types and categories of costs that are classified as R&E costs under section 174(a).[405]

Thus, the AICPA concludes, the IRS and Treasury should provide guidance that limits the scope of costs mandated to be amortized under this rule:

> In the absence of such an explicit requirement referencing more detailed rules, guidance should clarify that taxpayers are required to allocate direct costs, including wages, contractor costs, other direct labor costs, and materials and supplies, to the particular costs objective and are not required to allocate indirect costs such as overhead and general and administrative costs to such activity for purposes of identifying the amount of costs required to be amortized under section 174. At the same time, it would also provide a clear reflection of income to permit taxpayers on an elective basis to allocate overhead expenses for this purpose. This election could be patterned after the election Treasury and IRS adopted in 2003 under the intangibles regulations.[406]

Revenue Procedure 2000-50 Issues Under New §174

The second part of the letter deals with Revenue Procedure 2000-50 which provided guidance for software costs under the prior law. The letter begins by summarizing the procedure, as well as the restriction that it only applied to costs not subject to amortization:

> Rev. Proc. 2000-50 provided guidance under prior law for the treatment of costs paid or incurred to develop, purchase, lease, or license computer software, and provides automatic consent for accounting method changes from one optional method to another. However, section 4 of Rev. Proc. 2000-50 explicitly states that this revenue procedure does not apply to any computer software that is subject to amortization as an "amortizable section 197 intangible" as defined in section 197(c) and the regulations thereunder, or to costs that a taxpayer has treated as a research and experimentation expenditure under section 174.[407]

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[405] "Comments on Research & Experimental Expenditures under section 174," Letter from AICPA Tax Executive Committee to Associate Chief Counsel Holly Porter, May 26, 2022

[406] "Comments on Research & Experimental Expenditures under section 174," Letter from AICPA Tax Executive Committee to Associate Chief Counsel Holly Porter, May 26, 2022

[407] "Comments on Research & Experimental Expenditures under section 174," Letter from AICPA Tax Executive Committee to Associate Chief Counsel Holly Porter, May 26, 2022

The letter summarizes the provisions of the Revenue Procedure as follows:

> Section 5 of Rev. Proc. 2000-50 provides that the costs of developing computer software (whether or not the particular computer software is patented or copyrighted) in many respects so closely resemble the kind of research and experimental expenditures that fall within the purview of section 174 as to warrant similar accounting treatment. Accordingly, the IRS will not disturb a taxpayer's treatment of costs paid or incurred in developing software for any particular project, either for the taxpayer's own use or to be held by the taxpayer for sale or lease to others, where:
>
> - All of the costs properly attributable to the development of software by the taxpayer are consistently treated as current expenses and deducted in full in accordance with rules similar to those applicable under section 174(a); or
>
> - All of the costs properly attributable to the development of software by the taxpayer are consistently treated as capital expenditures that are recoverable through deductions for ratable amortization, in accordance with rules similar to those provided by section 174(b) and the regulations thereunder, over a period of 60 months from the date of completion of the development or, in accordance with rules provided in section 167(f)(1) and the regulations thereunder, over 36 months from the date the software is placed in service.
>
> Section 9.01 of Rev. Proc. 2022-14 provides the latest automatic method change procedures for a taxpayer that wants to change its method of accounting for the costs of computer software to a method described in Rev. Proc. 2000-50, including a taxpayer that wants to change its treatment of the costs of developing computer software to one of the methods described above (but only for software development costs incurred in taxable years for which the mandatory amortization rules under section 174 are not in effect). However, section 9.01(2) of Rev. Proc. 2022-14 similarly states that this change does not apply to any computer software that is subject to amortization as an "amortizable section 197 intangible" as defined in section 197(c) and the regulations thereunder, or to costs that a taxpayer has treated as R&E expenditures under section 174.[408]

The letter goes on to describe issues arising regarding the accounting method provisions in this area:

> There has been longstanding uncertainty regarding whether taxpayers were deemed to have historically treated the costs of computer software as R&E expenditures under section 174 that would have precluded such taxpayers from changing their methods of accounting for the costs of computer software under the automatic change procedures of Rev. Proc. 2000-50 and Rev. Proc. 2022-14. In addition, while automatic change procedures are available for a change in the treatment of section 174 costs, a change in accounting method under section 174,

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> must be implemented on a cutoff basis rather than with a section 481(a) adjustment like a change in accounting method under Rev. Proc 2000-50.[409]

AICPA Requested Change to Scope

The letter requests the following modifications to guidance in this area:

> The AICPA recommends that the IRS modify the scope limitation under section 4 of Rev. Proc. 2000-50 to clarify that the limitation on costs that a taxpayer has treated as R&E expenditures under section 174 only applies to costs previously subject to an irrevocable election under section 174, including section 174(b) or charging the expenses to capital account.
>
> Additionally, the AICPA recommends that the IRS makes a corresponding modification to the scope limitation under section 9.01(2) of Rev. Proc. 2022-14.[410]

The AICPA begins its analysis by looking at the history of Revenue Procedure 2000-50:

> Section 162 allows a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business. Similarly, for tax years prior to 2022, section 174(a) allows for immediate expensing of R&E expenditures that are paid or incurred by a taxpayer during the taxable year in connection with its trade or business, although taxpayers may elect under section 174(b) to capitalize and amortize such costs ratably over a period of not less than 60 months. Regulation § 1.174-2(a)(1) defines R&E expenditures under section 174 as expenditures incurred in connection with the taxpayer's trade or business that represent research and development costs in the experimental or laboratory sense.
>
> The IRS published Rev. Proc. 2000-50 to update, modify, and restate the guidelines for the treatment of the costs of computer software. Rev. Proc. 2000-50 provides separate rules for the costs of developing computer software, costs of acquired computer software, and leased or licensed computer software. As mentioned above, the guidance provides three allowable methods of accounting for software development costs (two of which are based on rules similar to those provided by section 174). These options were provided to eliminate controversy and reduce disputes with taxpayers.[411]

The AICPA describes uncertainty created by this guidance in certain situations:

> The current guidance under Rev. Proc. 2000-50 does not apply to "costs that a taxpayer has treated as R&E expenditures under section 174." However, this specific wording has generated much uncertainty regarding whether certain

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taxpayers can apply the guidance under Rev. Proc. 2000-50, as illustrated by the following examples:

- Example 1: Taxpayer has historically treated various types of computer software costs (i.e., amounts paid or incurred to develop, purchase, lease, and/or license computer software) as immediate expenses. The taxpayer has now determined a method change is required under Rev. Proc. 2000-50 for the treatment of certain costs (e.g., the purchased software should be capitalized and amortized ratably over a period of 36 months in accordance with section 6.01(2) of Rev. Proc. 2000-50 and section 167(f)(1)).
- Example 2: Taxpayer previously changed its method of accounting for the costs of developing computer software under section 5.01(1) of Rev. Proc. 2000-50 to treat as current expenses *in accordance with rules similar to those applicable under section 174(a)*. The taxpayer has now decided to change its method of accounting for the costs of developing computer software to another method provided under section 5 of Rev. Proc. 2000-50 (e.g., capitalize and amortize ratably over a period of 36 months).[412]

The AICPA looks first at Example 1's facts and issues that arise:

> In example 1, the taxpayer historically treated the computer software costs as immediate expenses. However, has the taxpayer immediately expensed such costs as ordinary and necessary business expenses under section 162 or as R&E costs under section 174? If some of the costs actually meet the requirements of section 174 (e.g., resolving uncertainty) and others do not, would the statement only apply to the former or would it also apply if the taxpayer erroneously treated the expenses as section 174 costs? Based on this statement, could Rev. Proc. 2000-50 also be interpreted to apply only to software development expenses that do not in fact meet the requirements of section 174 (by virtue of the statement that the costs at issue "closely resemble" section 174 expenses, which creates an implication that the procedure might not apply to all software expenses but only the subset of software development expenses that do not in fact meet the requirements of section 174).
>
> It may be impossible to distinguish whether an expense was deducted as an ordinary and necessary business expense under section 162 or as R&E costs under section 174 based on how the costs were reflected on the taxpayer's federal income tax returns, and it would seem to defeat the purpose of Rev. Proc. 2000-50 to scope out of the method change any of the above situations. Furthermore, the guidance under Rev. Proc. 2000-50 was intended to simplify the accounting method treatment of computer software costs without burdening taxpayers from having to undertake an in-depth analysis to determine whether such costs are deductible as R&E expenditures under section 174. The results of such study would be highly subjective anyways given the lack of current guidance under section 174 with respect to computer software costs. In fact, the government

[412] "Comments on Research & Experimental Expenditures under section 174," Letter from AICPA Tax Executive Committee to Associate Chief Counsel Holly Porter, May 26, 2022

previously issued proposed regulations under section 174 in 1983 (47 FR 2790) and 1989 (54 FR 21224) attempting to clarify the treatment of software development costs under section 174 only to withdraw those amendments to the regulations in 1993 (58 FR 15819) and instead lean on the administrative guidance contained in Rev. Proc. 69-21. See below excerpt from the preamble to the 1993 proposed regulations under section 174:

> In Revenue Procedure 69-21, 1969-2 C.B. 303, the IRS announced that, as a matter of administrative practice, it would allow taxpayers to treat software development costs in a manner similar to the manner research or experimental expenditures are treated under section 174. The 1983 proposed regulation, however, would have provided additional conditions on the qualification of software development costs as research or experimental expenditures beyond those applicable to other products.
>
> In the preamble to the 1989 proposed regulation, the IRS announced that it is studying the continuing validity of Rev. Proc. 69-21. The IRS has no present intention of changing its administrative position contained in Rev. Proc. 69-21, but it continues to study its viability. Taxpayers may continue to rely on Rev. Proc. 69-21. The amendments proposed in this document do not provide additional conditions applicable to computer software development costs. The IRS again invites comments on the proper tax accounting treatment of software development costs that do not qualify as research or experimental expenditures.

The AICPA does not believe it was the IRS' intent to prohibit the taxpayer in example 1 from applying Rev. Proc. 2000-50 based on its present method of accounting. In fact, allowing this taxpayer to apply the guidance in Rev. Proc. 2000-50 would result in greater compliance with the Code. Therefore, the IRS should modify the scope limitations under section 4 of Rev. Proc. 2000-50 and section 9.01(2) of Rev. Proc. 2022-14 to clarify the limitation on costs that a taxpayer has treated as an R&E expenditure under section 174 only applies to costs that have been subject to an irrevocable election under section 174, including section 174(b) or charging the expenses to capital account.[413]

The letter concludes by giving the AICPA analysis of the second example:

> In example 2, the taxpayer's present method of accounting for software development costs is in accordance with section 5.01(1) of Rev. Proc. 2000-50, which is based on "rules similar to those applicable under section 174(a)." This language has led many taxpayers and practitioners to question whether the taxpayer's present method would render them ineligible to make a subsequent change in method of accounting for software development costs under Rev. Proc. 2000-50.
>
> As mentioned above, the guidance under section 5 of Rev. Proc. 2000-50 was provided to eliminate controversy and reduce disputes with taxpayers due to the uncertainty of the extent to which software development costs actually meet the

[413] "Comments on Research & Experimental Expenditures under section 174," Letter from AICPA Tax Executive Committee to Associate Chief Counsel Holly Porter, May 26, 2022

definition of R&E expenditures under section 174. In fact, section 5.01 of Rev. Proc. 2000-50 indicates that the costs of developing computer software "in many respects so closely resemble the kind of R&E expenditures that fall within the purview of section 174 as to warrant similar accounting treatment." Thus, the IRS seems to indicate that certain software development costs are not necessarily R&E costs under section 174 but should be afforded similar treatment. However, this guidance was intended to simplify the accounting method treatment of computer software costs without burdening taxpayers from having to undertake an in-depth analysis to determine which of their software development costs meet the classification criteria of section 174 requirements, and which do not.

The AICPA does not believe it was the IRS' intent to prohibit the taxpayer in example 2 from making a subsequent change in method of accounting for software development costs under Rev. Proc. 2000-50 merely because it presently treats such costs as current expenses.[414]

SECTION: 174

AUTOMATIC ACCOUNTING METHOD CHANGE ADDED FOR TCJA REQUIRED AMORTIZATION OF §174 RESEARCH AND EXPERIMENTAL EXPENDITURES

Citation: Revenue Procedure 2023-8, 12/12/22

The IRS has released guidance providing for automatic permission to change a taxpayers' method of accounting for IRC §174 research and experimental expenditures in Revenue Procedure 2023-8.[415] The guidance modifies Section 7 of Revenue Procedure 2022-14, which previously provided for an automatic change to the treatment of research and experimental expenditures under IRC §174.

TCJA Research & Experimental Expenditures Capitalization Requirement Takes Effect Beginning With Tax Years Beginning in 2022

As part of 2017's Tax Cuts and Jobs Act, Congress required taxpayers to begin amortizing research and experimental expenditures as defined in IRC §174 over five years if the research is conducted in the United States and fifteen years if conducted outside the United States for costs incurred in tax years beginning on or after January 1, 2022.[416] The amortization is to begin in the mid-point of the year the research is conducted.[417]

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[414] "Comments on Research & Experimental Expenditures under section 174," Letter from AICPA Tax Executive Committee to Associate Chief Counsel Holly Porter, May 26, 2022

[415] Revenue Procedure 2023-8, December 12, 2022, https://www.irs.gov/pub/irs-drop/rp-23-08.pdf (retrieved December 18, 2022)

[416] IRC §174(a)(2)(B)

[417] IRC §174(a)(2)(B)

This Revenue Procedure adds an automatic change in the method of accounting for research and experimental procedures to comply with the law change by creating a new Section 7.02 of Revenue Procedure 2022-14 (the general automatic change of accounting method revenue procedure).[418]

Change Made in the First Year Beginning After December 31, 2021

Changes made in the first year beginning after December 31, 2021 will not require the filing of a Form 3115, *Application for Change in Accounting Method.* Rather, the taxpayer will obtain permission by attaching a statement to the return.

The Procedure states:

> Except as otherwise provided in section 7.05 of this revenue procedure, the requirement of §1.446-1(e)(3)(i) to file a Form 3115, *Application for Change in Accounting Method*, is waived and a statement in lieu of a Form 3115 is authorized for the change in method of accounting under section 7.02 of this revenue procedure for which the year of change is the first taxable year beginning after December 31, 2021. Notwithstanding the definition of Form 3115 in section 3.07 of Rev. Proc. 2015-13, 2015-5 I.R.B. 419, the statement in lieu of a Form 3115 that is permitted under this section 7.02(4)(b) is considered a Form 3115 for purposes of the automatic consent procedures of Rev. Proc. 2015-13. The requirement to file the duplicate copy, under section 6.03(1)(a) of Rev. Proc. 2015-13, is waived.[419]

The statement is to contain the following information:

- The name and employer identification number or social security number, as applicable, of the applicant that has paid or incurred specified research and experimental expenditures after December 31, 2021;
- The beginning and ending dates of the first taxable year in which the change to the required §174 method takes effect for the applicant (year of change);
- The designated automatic accounting method change number for this change;
- A description of the type of expenditures included as specified research or experimental expenditures;
- The amount of specified research or experimental expenditures paid or incurred by the applicant during the year of change; and
- A declaration that the applicant is changing the method of accounting for specified research or experimental expenditures to capitalize such expenditures to a specified research or experimental capital account, and amortize such amount over either a 5-year period for domestic research or 15-year period for foreign research (as applicable) beginning with the mid-point of the taxable year in which such expenditures are paid or incurred in accordance

[418] Revenue Procedure 2023-8, December 12, 2022

[419] Revenue Procedure 2023-8, December 12, 2022

> with the method permitted under §174 for the year of change. Also, the declaration must state that the applicant is making the change on a cut-off basis.[420]

The change is to be made on the cut-off basis for expenditures paid or incurred in the first taxable year beginning after December 31, 2021.[421]

Changes in Later Years

While the change is required for the first year beginning after December 31, 2021, the ruling does provide for elections made in later years for taxpayers who fail to use the above change. This change will require filing Form 3115, *Application for Change in Accounting Method* with the tax return for the year of change.

In such a case, there will be a modified §481(a) adjustment required:

> The change under section 7.02 of this revenue procedure for a year of change later than the first taxable year beginning after December 31, 2021, is made with a modified §481(a) adjustment, and should take into account only specified research or experimental expenditures paid or incurred in taxable years beginning after December 31, 2021.[422]

A statement must be attached to the Form 3115 filed in this case, described as follows in the Revenue Procedure:

> In completing a Form 3115, Application for Change in Accounting Method, to make the change in method of accounting under section 7.02 of this revenue procedure with respect to any year of change later than the first taxable year beginning after December 31, 2021, a taxpayer must include on an attachment to Form 3115:
>
> > (A) a description of the type of expenditures included as specified research or experimental expenditures;
> >
> > (B) the taxable year(s) in which the specified research or experimental expenditures subject to the change were paid or incurred by the applicant; and (C) a declaration that the applicant is changing its method of accounting for specified research or experimental expenditures to capitalize such expenditures to a specified research or experimental capital account, and amortize such amount over either a 5-year period for domestic research or 15-year period for foreign research (as applicable) beginning with the mid-point of the taxable year in which such expenditures are paid or incurred in accordance with the method permitted under §174 for the year of change. Also, the declaration must state that the applicant is making the change with a modified §481(a) adjustment that takes into account only specified research or

[420] Revenue Procedure 2023-8, December 12, 2022

[421] Revenue Procedure 2023-8, December 12, 2022

[422] Revenue Procedure 2023-8, December 12, 2022

> experimental expenditures paid or incurred in taxable years beginning after December 31, 2021.[423]

Short Year Returns Filed Before January 9, 2023

Taxpayers who filed a return prior to January 9, 2023 (the date the procedure is to be published in the Internal Revenue Bulletin) are covered by a special transition rule where the taxpayer will be treated as complying with the procedure retroactively:

> A taxpayer who filed a Federal tax return on or before January 9, 2023, for a taxable year beginning after December 31, 2021, is deemed to have complied with the §446 method change procedures and section 7.02 of this revenue procedure to change its method of accounting for specified research or experimental expenditures paid or incurred in the first taxable year beginning after December 31, 2021, to the required §174 method to comply with §174 if the taxpayer:
>
> > (a) reported the amount of specified research or experimental expenditures paid or incurred for such taxable year on Part VI of Form 4562, Depreciation and Amortization, filed with the Federal tax return, and
> >
> > (b) properly capitalized and amortized such specified research or experimental expenditures in accordance with the required §174 method for such taxable year.[424]

Waiver of the Five Year Rule

The provision, found in Section 5.01(1)(f) of Revenue Procedure 2022-14 that bars a change unless the taxpayer has not made or requested a change for the same item during any of the five taxable years ending with the year of change does not apply to changes to the required §174 method for the taxpayer's first taxable year beginning after December 31, 2021.[425]

Lack of Audit Protection

A taxpayer does not receive audit protection under section 8.01 of Rev. Proc. 2015-13 for this change of accounting methods with respect to expenditures paid or incurred in taxable years beginning on or before December 31, 2021.[426]

Designated Change Number

The designated automatic accounting method change number for these changes is "265".[427]

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[423] Revenue Procedure 2023-8, December 12, 2022

[424] Revenue Procedure 2023-8, December 12, 2022

[425] Revenue Procedure 2023-8, December 12, 2022

[426] Revenue Procedure 2023-8, December 12, 2022

[427] Revenue Procedure 2023-8, December 12, 2022

SECTION: 223
IRS ANNOUNCES END OF COVID-19 EXPANSION OF DEFINITION OF PREVENTIVE CARE FOR HDHPS

Citation: Notice 2023-37, 6/23/23

The Internal Revenue Service (IRS) has issued Notice 2023-37, [428] declaring the cessation of unique provisions enabling high deductible health plans (HDHP) to extend certain benefits specifically for COVID-19 diagnosis and treatment before the participant had met his/her deductible for the plan year. These provisions were introduced during the COVID-19 public health emergency (PHE). The notice modifies the guidance found in Notice 2020-15 and provides clarification of Notice 2004-23.

The Notice provides a summary of its key points as follows:

> This notice also clarifies whether certain items and services are treated as preventive care under section 223(c)(2)(C). Specifically, this notice clarifies that the preventive care safe harbor, as described in Notice 2004-23, 2004-15 IRB 725, does not include screening (i.e., testing) for COVID-19, effective as of the date of publication of this notice. This notice also provides that items and services recommended with an "A" or "B" rating by the United States Preventive Services Task Force (USPSTF) on or after March 23, 2010, are treated as preventive care for purposes of section 223(c)(2)(C), regardless of whether these items and services must be covered, without cost sharing, under Public Health Service Act (PHS Act) section 2713.[429]

Summary of the Original Relief and End of the PHE

The Notice begins by describing the relief originally provided in Notice 2020-15:

> In March 2020, the Treasury Department and the IRS issued Notice 2020-15. The notice provides that due to the unprecedented public health emergency posed by COVID-19, and the need to eliminate potential administrative and financial barriers to testing for and treatment of COVID-19, a health plan that otherwise satisfies the requirements to be an HDHP under section 223(c)(2)(A) will not fail to be an HDHP merely because the health plan provides benefits for medical care services and items purchased related to testing for and treatment of COVID-19 prior to the satisfaction of the applicable minimum deductible. As a result, individuals covered by such a plan will not fail to be eligible individuals under section 223(c)(1) merely because of the provision of those health benefits prior to the satisfaction of the applicable minimum deductible.[430]

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[428] Notice 2023-37, June 23, 2023, https://www.taxnotes.com/research/federal/irs-guidance/notices/health-plan-guidance-modified-for-end-of-covid-19-emergency/7gx0k

[429] Notice 2023-37, June 23, 2023

[430] Notice 2023-37, June 23, 2023

Furthermore, the Notice details the chronology of the Public Health Emergency (PHE), its conclusion, and the earlier IRS guidance that permitted continued adherence to Notice 2020-15 until the issuance of a new directive. The present Notice thus serves as the anticipated updated guidance.

> On January 31, 2020, the Secretary of Health and Human Services (HHS) declared that a nationwide PHE existed as of January 27, 2020, as a result of COVID-19. This declaration was continually renewed by the HHS Secretary, most recently effective February 11, 2023. On January 30 and February 9, 2023, respectively, the President and the HHS Secretary announced their intent to end the COVID-19 National Emergency and the PHE on May 11, 2023. On February 10, 2023, the Federal Emergency Management Agency gave notice in the Federal Register that the national emergency under the Stafford Act would end on May 11, 2023. On April 10, 2023, the President signed H.J. Res. 7 ending the national emergency under the National Emergencies Act on April 10, 2023.
>
> On March 29, 2023, the Departments of Labor, HHS, and the Treasury (the Departments) issued Frequently Asked Questions (FAQs) under the heading, *FAQs About Families First Coronavirus Response Act, Coronavirus Aid, Relief, and Economic Security Act, and Health Insurance Portability and Accountability Act Implementation Part 58 (FAQs Part 58)*, which address changes in various rules as the result of the end of the COVID-19 National Emergency and the PHE. Question and Answer 8 of FAQs Part 58 states that, while Notice 2020-15 applies until further guidance is issued, the Treasury Department and the IRS are reviewing the appropriateness of continuing the relief in Notice 2020-15 given the anticipated end of the COVID-19 National Emergency and the PHE and anticipate issuing additional guidance in the near future.[431]

Benefits No Longer Allowed to Be Covered Prior to Satisfaction of Deductible

The Notice stipulates that, for plan years ending after December 31, 2024, high deductible health plans (HDHPs) will no longer be permitted to offer certain benefits to insured beneficiaries at no cost before the beneficiaries meet the yearly deductible:

> The Treasury Department and the IRS have determined that, with the end of the COVID-19 National Emergency and the PHE, the relief described in Notice 2020-15 is no longer needed. Accordingly, this notice modifies Notice 2020-15 to provide that the relief described in Notice 2020-15 applies only with respect to plan years ending on or before December 31, 2024. For subsequent plan years, an HDHP is not permitted to provide health benefits associated with testing for and treatment of COVID-19 without a deductible, or with a deductible below the minimum deductible (for self-only or family coverage) for an HDHP, except as otherwise provided in this notice.[432]

[431] Notice 2023-37, June 23, 2023

[432] Notice 2023-37, June 23, 2023

The Notice explains the IRS's stance on why COVID-19 screenings do not qualify as preventive care under Internal Revenue Code (IRC) §223(c)(2)(C).

> The Treasury Department and the IRS note that Notice 2004-23 provides that preventive care under section 223(c)(2)(C) includes, but is not limited to, screening services as specified in the Appendix to Notice 2004-23. However, preventive care does not generally include any service or benefit intended to treat an existing illness, injury, or condition. As part of the preventive care safe harbor, the Appendix to Notice 2004-23 includes Infectious Diseases Screening Services for the following infections: Bacteriuria, Chlamydial Infection, Gonorrhea, Hepatitis B Virus Infection, Hepatitis C, Human Immunodeficiency Virus (HIV) Infection, Syphilis, and Tuberculosis Infection. Screenings for common and episodic illnesses, such as the flu, are not included on the list. Accordingly, the Treasury Department and the IRS are of the view that COVID-19 differs from the types of infectious diseases included in the preventive care safe harbor as specified in Notice 2004-23, and this notice clarifies that the preventive care safe harbor as described in Notice 2004-23 does not include screening (i.e., testing) for COVID-19, effective as of the date of publication of this notice.[433]

Nevertheless, the Notice further stipulates that if the United States Preventive Services Task Force (USPSTF) were to endorse such tests with an "A" or "B" rating in the future, these tests would then be recognized as preventive care:

> In addition, the Treasury Department and the IRS note that on April 13, 2023, the Departments issued FAQs entitled, *FAQs About Affordable Care Act and Coronavirus Aid, Relief, and Economic Security Act Implementation Part 59 (FAQs Part 59)*, which provide initial guidance on how the decision in *Braidwood Management Inc. v. Becerra* affects the requirement to cover preventive services without cost sharing under PHS Act section 2713. Question and Answer 7 of FAQs Part 59 states that, until further guidance is issued, items and services recommended with an "A" or "B" rating by the USPSTF on or after March 23, 2010, will be treated as preventive care for purposes of section 223(c)(2)(C) of the Code, regardless of whether these items and services must be covered, without cost sharing, under PHS Act section 2713.
>
> Consistent with the position taken in Question and Answer 7 of FAQs Part 59, this notice provides that items and services recommended with an "A" or "B" rating by the USPSTF on or after March 23, 2010, are treated as preventive care for purposes of section 223(c)(2)(C) of the Code, regardless of whether these items and services must be covered, without cost sharing, under PHS Act section 2713. Accordingly, if COVID-19 testing were to be recommended with an "A" or "B" rating by the USPSTF, then that testing would be treated as preventive care under section 223(c)(2)(C) of the Code, regardless of whether it must be covered, without cost sharing, under PHS Act section 2713.[434]

[433] Notice 2023-37, June 23, 2023

[434] Notice 2023-37, June 23, 2023

SECTION: 223

IRS RELEASES 2024 INFLATION ADJUSTED NUMBERS FOR HSAS AND EXCEPTED BENEFIT HRAS

Citation: Revenue Procedure 2023-23, 5/16/23

In Revenue Procedure 2023-23, [435] the IRS disclosed the 2024 inflation-adjusted figures for both Health Savings Accounts (HSAs) and excepted-benefit Health Reimbursement Arrangements (HRAs). Notably, these figures have seen a more substantial increase than in previous years. This hike can largely be attributed to the heightened inflation rates observed over the past year.

In terms of Health Savings Accounts (HSAs), the annual contribution limit for an individual with self-only coverage under a high deductible health plan has increased from $3,850 in 2023 to $4,150 in 2024. This represents an increase of $300. For individuals with family coverage, the annual contribution limit has gone up from $7,750 in 2023 to $8,300 in 2024, an increase of $550.

The definition of a "high deductible health plan" has also seen changes. In 2023, such a plan was defined as a health plan with an annual deductible of not less than $1,500 for self-only coverage or $3,000 for family coverage. In 2024, these minimum deductibles have increased to $1,600 and $3,200 respectively. In terms of annual out-of-pocket expenses (excluding premiums), the limit for self-only coverage has increased from $7,500 in 2023 to $8,050 in 2024, and for family coverage, the limit has risen from $15,000 in 2023 to $16,100 in 2024.

For excepted benefit health reimbursement arrangements (HRAs), the maximum amount that can be newly made available for the plan year has increased from $1,950 in 2023 to $2,100 in 2024, a rise of $150.

In summary, for both HSAs and HRAs, all limits and thresholds have seen an increase from 2023 to 2024, a trend that's typically attributable to annual adjustments for inflation.

SECTION: 415

COST OF LIVING RETIREMENT AND FRINGE BENEFIT AMOUNTS FOR 2023 PUBLISHED BY THE IRS

Citation: Notice 2022-55, 10/21/22

The IRS issued inflation adjusted retirement plan and fringe benefit numbers for 2022 in Notice 2022-55.[436]

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[435] Revenue Procedure 2023-23, May 16, 2023, https://www.taxnotes.com/research/federal/irs-guidance/revenue-procedures/irs-announces-2024-inflation-adjusted-amounts-for-hsas/7gpf1 (retrieved May 20, 2023)

[436] Notice 2022-55, October 21, 2022, https://www.irs.gov/pub/irs-drop/n-22-55.pdf

Item	2023	2022
Annual Benefit Under a Defined Contribution Plan (IRC §415(b)(1)(A)	$ 265,000	$ 245,000
Limitation for Defined Contribution Plans (IRC §415(c)(1)(A)	66,000	61,000
Limitation on Exclusion for Elective Deferrals (IRC §402(g))	22,500	20,500
Annual Compensation Limit (IRC §§401(a)(17), 404(l), 408(k)(3)(C), and 408(k)(6)(D)(ii))	330,000	305,000
Key Employee in a Top Heavy Plan (IRC §416(i)(1)(A)(i)	215,000	200,000
Highly Compensated Employee (IRC §414(q)(1)(B))	150,000	135,000
Catch-up Contributions to Employer Plans Other than SIMPLEs (IRC §414(v)(2)(B)(i))	7,500	6,500
Catch-up Contributions to SIMPLE-IRAs and SIMPLE-401(k)s (IRC §414(v)(2)(B)(ii))	3,500	3,000
Annual Compensation Limitation for Certain Governmental Plans (IRC §401(a)(17))	490,000	450,000
Compensation Amount for Participation in a SEP (IRC §408(k)(2)(C))	750	650
Deferral Limitation for SIMPLE Retirement Accounts (IRC §408(p)(2)(E))	15,500	14,000
Limitation on Deferrals under IRC §457(e)(15) Governmental Plans and Tax-Exempt Organizations	22,500	20,500
Compensation Amount for an Officer Control Employee for Fringe Benefits (Reg. §1.61-21(f)(5)(i))	130,000	120,000
Compensation Amount for a Control Employee Based Solely on Compensation Reg. §1.61-21(f)(5)(iii))	265,000	245,000

Item	2023	2022
IRA Deductible Contribution Amounts (IRC §219(b)(5)(A))	6,500	6,000

The Notice defines the ranges over which deductible IRA contributions phase out for individuals who are active participants in a qualified retirement plan are provided as:

Item	2023	2022
Married participants filing a joint return or qualifying widow(er)	$116,000 to $129,000	$109,000 to $119,000
Other statuses except married filing separate	$73,000 to $83,000	$68,000 to $78,0000
Married filing separate	$0 to $10,000	$0 to $10,000
Married individual filing a joint who is not an active participant but whose spouse is an active participant	$218,000 to $228,000	$204,000 to $214,000

The adjusted gross income range over which the ability of a taxpayer to make a Roth IRA contribution phases out is as follows:

Item	2023	2022
Married participants filing a joint return or qualifying widow(er)	$218,000 to $228,000	$204,000 to $214,000
Single and head of household	$138,000 to $148,000	$129,000 to $144,000
Married filing separate	$0 to $10,000	$0 to $10,000

SECTION: 965

SUPREME COURT AGREES TO HEAR CASE REGARDING CONSTITUTIONALITY OF IRC §965 TRANSITION TAX

Citation: Moore v. United States, cert. granted, Case 22-800, 6/26/23

The US Supreme Court has granted an appeal to review the Ninth Circuit's ruling in the case of *Moore v. United States*.[437] Previously, the Ninth Circuit had declined a motion to reconsider the case en banc, despite four judges expressing dissent from the decision. The original panel had upheld the constitutionality of the IRC §965 transition tax, which was introduced as part of the Tax Cuts and Jobs Act.

The summary sheet posted on the Supreme Court's website provided the following summary of the question presented in the case:

> The Sixteenth Amendment authorizes Congress to lay "taxes on incomes ... without apportionment among the several States." Beginning with *Eisner v. Macomber*, 252 U.S. 189 (1920), this Court's decisions have uniformly held "income," for Sixteenth Amendment purposes, to require realization by the taxpayer. In the decision below, however, the Ninth Circuit approved taxation of a married couple on earnings that they undisputedly did not realize but were instead retained and reinvested by a corporation in which they are minority shareholders. It held that "realization of income is not a constitutional requirement" for Congress to lay an "income" tax exempt from apportionment. App.12. In so holding, the Ninth Circuit became "the first court in the country to state that an 'income tax' doesn't require that a 'taxpayer has realized income.'" App.38 (Bumatay, J., dissenting from denial of rehearing en banc).[438]

And the summary provides the following as the question presented by the case:

> Whether the Sixteenth Amendment authorizes Congress to tax unrealized sums without apportionment among the states.[439]

History of the Transition Tax

As a component of the Tax Cuts and Jobs Act, Congress introduced IRC §965 to the Internal Revenue Code. The Internal Revenue Service (IRS) provides a concise overview of IRC §965 on its webpage titled "Section 965 Transition Tax." The summary is as follows:

> Section 965 requires United States shareholders (as defined under section 951(b)) to pay a transition tax on the untaxed foreign earnings of certain specified foreign corporations as if those earnings had been repatriated to the United States. Very

[437] *Moore v. United States*, cert. granted, Case 22-800, June 26, 2023, https://www.supremecourt.gov/orders/23grantednotedlist.pdf (retrieved June 27, 2023)

[438] 22-800 MOORE V. UNITED STATES, June 26, 2023, https://www.supremecourt.gov/qp/22-00800qp.pdf (retrieved June 27, 2023)

[439] 22-800 MOORE V. UNITED STATES, June 26, 2023

generally, a specified foreign corporation means either a controlled foreign corporation, as defined under section 957 ("CFC"), or a foreign corporation (other than a passive foreign investment company, as defined under section 1297, that is not also a CFC) that has a United States shareholder that is a domestic corporation. Section 965 allows U.S. shareholders to reduce the amount of the income inclusion based on deficits in earnings and profits with respect to other specified foreign corporations. The effective tax rates applicable to income inclusions are adjusted by way of a participation deduction set out in section 965(c). A reduced foreign tax credit applies to the inclusion under section 965(g). Taxpayers may elect to pay the transition tax in installments over an eight-year period.[440]

In this article, our primary objective is to highlight the proactive steps taxpayers can take to safeguard their right to file a claim for a refund regarding a specific portion of the Section 965 tax. While it is worth noting that the statute of limitations for filing a refund claim may not have expired for certain amounts of the 965 tax paid, it is crucial to be aware of the potential risk of expiration before a final resolution is reached in the case.

Statute of Limitations for Filing a Claim for Refund

The primary regulation that governs the timeframe within which taxpayers must file a claim for refund is outlined in IRC §6511. Specifically, IRC §6511(a) establishes the general limitations period for filing such claims:

> **(a) Period of limitation on filing claim**. Claim for credit or refund of an overpayment of any tax imposed by this title in respect of which tax the taxpayer is required to file a return shall be filed by the taxpayer within 3 years from the time the return was filed or 2 years from the time the tax was paid, whichever of such periods expires the later, or if no return was filed by the taxpayer, within 2 years from the time the tax was paid. Claim for credit or refund of an overpayment of any tax imposed by this title which is required to be paid by means of a stamp shall be filed by the taxpayer within 3 years from the time the tax was paid.

The available amount of refund for the taxpayer is specified in IRC §6511(b):

> **(b) Limitation on allowance of credits and refunds**.
>
> > **(1) Filing of claim within prescribed period.** No credit or refund shall be allowed or made after the expiration of the period of limitation prescribed in subsection (a) for the filing of a claim for credit or refund, unless a claim for credit or refund is filed by the taxpayer within such period.
> >
> > **(2) Limit on amount of credit or refund.**

[440] "Section 965 Transition Tax," IRS website, Last Reviewed or Updated February 3, 2023, https://www.irs.gov/businesses/section-965-transition-tax#:~:text=What%20is%20section%20965%3F,repatriated%20to%20the%20United%20States. (retrieved June 27, 2023)

(A) Limit where claim filed within 3-year period. If the claim was filed by the taxpayer during the 3-year period prescribed in subsection (a), the amount of the credit or refund shall not exceed the portion of the tax paid within the period, immediately preceding the filing of the claim, equal to 3 years plus the period of any extension of time for filing the return. If the tax was required to be paid by means of a stamp, the amount of the credit or refund shall not exceed the portion of the tax paid within the 3 years immediately preceding the filing of the claim.

(B) Limit where claim not filed within 3-year period. If the claim was not filed within such 3-year period, the amount of the credit or refund shall not exceed the portion of the tax paid during the 2 years immediately preceding the filing of the claim.

While additional subsections present various special rules, the main focus for most taxpayers making installment payments for the §965 transition tax will primarily revolve around the aforementioned provisions.

The §965 Transition Tax and the Special Installment Payment Option

Under IRC §965(a) impacted taxpayers had to include the following amounts in their income:

(a) Treatment of deferred foreign income as subpart F income. In the case of the last taxable year of a deferred foreign income corporation which begins before January 1, 2018, the subpart F income of such foreign corporation (as otherwise determined for such taxable year under section 952) shall be increased by the greater of --

(1) the accumulated post-1986 deferred foreign income of such corporation determined as of November 2, 2017, or

(2) the accumulated post-1986 deferred foreign income of such corporation determined as of December 31, 2017.

In the case where both the corporation and the individual follow a calendar year for tax purposes, the taxpayer would have reported the relevant amounts in their income on their 2017 calendar year tax return.

Congress, recognizing that the amount of tax due could be substantial, provided an election for taxpayers to pay the tax due over eight annual installments under IRC §965(h):

(h) Election to pay liability in installments.

(1) In general. In the case of a United States shareholder of a deferred foreign income corporation, such United States shareholder may elect to pay the net tax liability under this section in 8 installments of the following amounts:

(A) 8 percent of the net tax liability in the case of each of the first 5 of such installments,

(B) 15 percent of the net tax liability in the case of the 6th such installment,

(C) 20 percent of the net tax liability in the case of the 7th such installment, and

(D) 25 percent of the net tax liability in the case of the 8th such installment.

(2) Date for payment of installments. If an election is made under paragraph (1), the first installment shall be paid on the due date (determined without regard to any extension of time for filing the return) for the return of tax for the taxable year described in subsection (a) and each succeeding installment shall be paid on the due date (as so determined) for the return of tax for the taxable year following the taxable year with respect to which the preceding installment was made.

The special installment payment election allows taxpayers who choose to take advantage of the installment payment option to make payments over a span of eight years, despite the fact that the tax amount was calculated and reported on the 2017 tax return.

Based on the given circumstances, it appears that for a calendar year taxpayer with an affected calendar year corporation, the tax return referenced in IRC §6511(a) would be the individual's 2017 return. The due date for that return, assuming no extension was requested, would have been April 15, 2018. The three-year period mentioned in §6511(a) would have expired on April 15, 2021. In the event an extension was requested, the latest possible expiration date would have been October 15, 2021.

It is important to note that taxpayers making installment payments for the §965 transition tax only made a single installment payment with that first return. Assuming the taxpayer did not choose to accelerate the payment of the tax, either voluntarily or due to actions that would trigger immediate acceleration under IRC §965(h), they would have continued making such payments annually up to the present year.

Although the statute of limitations for claiming a refund based on the date of filing the tax return may have expired (unless certain events occurred to keep the statute open), it is worth noting that a refund claim could still be eligible for payment concerning any installment payments made within the two-year period before the claim is filed. Additionally, potential refunds could also cover future payments if the IRS approves the taxpayer's claim for a refund.

However, a significant challenge persists. The Moores' case has not been resolved yet, and at best, a decision will not be reached until sometime in 2024, likely after the expiration of the statute for obtaining a refund on April 15 on payments made in 2022. Furthermore, even if the Supreme Court rules in favor of the Moores, there is a possibility that the case could be remanded back to the trial court for further findings, which would block the availability of refunds for additional years' payments if the taxpayer waits for the Moores' result.

A viable solution to address this challenge lies in the concept of a protective refund claim.

Protective Refund Claims

A protective claim refers to a refund claim that a taxpayer files with the IRS, requesting the agency to withhold processing until a specific contingency is resolved. In the case of a pending Supreme Court decision that would determine the constitutionality of a tax, such as the question at hand, a protective claim can be utilized to await the outcome before the IRS determines whether to approve or deny the claim. This allows taxpayers to safeguard their refund rights while awaiting a definitive resolution on the constitutional issue.

The Internal Revenue Manual provides guidelines and procedures concerning the handling of a protective claim for refund. While it is conceivable that a court may deem a protective claim valid even if the IRS procedures are not strictly followed, it is advisable to adhere to the prescribed procedures to ensure a smooth process and minimize the risk of the IRS rejecting the claim, with a potential agreement from the court. Following the established procedures enhances the chances of a favorable outcome and strengthens the validity of the claim in the eyes of both the IRS and the court.

IRM 4.10.11.2.1.3(4) (09-04-200) provides the following description of the reason that protective claims for refund are filed:

> (4) In some instances, a claim may be filed by the taxpayer in anticipation of an expected change in the tax law, other legislation, regulations, case law, or other contingency. A "protective claim" is a claim for credit or refund filed by the taxpayer to preserve the right to pursue a refund based on the resolution of an issue contingent on future events that may not be determinable until after the refund statute has expired. Taxpayers file protective claims to ensure they meet the timeliness requirement.

The Internal Revenue Manual (IRM) provides guidance on the various types of contingencies for which a taxpayer may file a protective claim.

> (1) Protective Claims may be informal claims, formal claims, or amended returns for credit or refund normally based on expected changes in a:
>
> - Current Regulation
> - Pending legislation or
> - Current litigation[441]

Of particular relevance to this matter is the provision outlined in IRM 21.5.3.4.7.3.1 (09-10-2013):

> 1) Any claim identifying a pending court case or decision should be considered a Protective Claim.

[441] IRM 21.5.3.4.7.3(1) (10-01-2018)

What must be in such a protective claim? The IRM continues to describe what should be found in a valid protective claim for refund:

> With regard to the requirements of form and content, a protective claim must be in writing, include the taxpayer's name, address, TIN and signature, identify the contingency affecting the claim, be sufficiently clear and definite to alert the IRS as to the essential nature of the claim, and identify the specific year(s) for which the refund is sought. The exact amount of refund requested may not be known at the time the claim is filed. See IRM 25.6.1.10.2.6.5, Protective Claims, for additional information.[442]

IRM 21.5.3.4.7.3.2(3) and (4) (10-21-2009) provides that all claims will be checked for the following items before sending them on to Examination:

> (3) Protective Claims must be processible before sending to Examination Classification. Screen all Protective Claims for:
>
> - Statute timeliness
> - Completeness
> - Signatures
>
> (4) If the claim is not processible, call or correspond with the taxpayer for all missing information. Refer to IRM 21.3.3.5.1.1, Suspense Time Frames, for information on suspense periods. Follow normal adjustment procedures for rejecting the claim if no reply is received.

According to IRM 25.6.1.10.2.6.5(3), the Internal Revenue Service (IRS) has discretion in determining how to process a protective claim for refund. While the IRS is not obligated to hold the claim pending the resolution of the contingency, it is generally considered to be in the best interest of all parties involved to put the claim on hold and await the outcome of the contingency. This approach ensures a more coherent and efficient handling of the claim, aligning with the interests of both the taxpayer and the IRS.

> (3) The Service has discretion in deciding how to process protective claims. In general, it is in the best interests of the Service and taxpayers to delay action on protective claims until the pending litigation or other contingency is resolved. Once the contingency is resolved, the Service may obtain additional information necessary to process the claim and then allow or disallow the claim.

Mechanical Issues

The process of filing a protective claim for a unique scenario like the Section 965 transition tax installment payments may present some complexities. While the IRS instructions typically require using Form 1040-X for any income tax-related claims, the specific nature of these installment payments may not align well with reporting on Form 1040-X. However, it's important to note that the actual tax computation, which would be zero if the taxpayers prevail in Moore, exists only on the 2017 or 2018 Form 1040.

[442] IRM 4.10.11.2.1.3(4) (09-04-2020)

Reg. §301.6402-2(c) provides that "[i]f a particular form is prescribed on which the claim must be made, then the claim must be made on the form so prescribed." The same provision goes on to note that "[a]ll claims by taxpayers for the refund of taxes, interest, penalties, and additions to tax that are not otherwise provided for must be made on Form 843, 'Claim for Refund and Request for Abatement.'"

The most recent version of the instruction for Form 843 provides:

Do not use Form 843 when you must use a different tax form.

> - Use Form 1040-X, Amended U.S. Individual Income Tax Return, to change any amounts reported on Form 1040, 1040-SR, 1040A, 1040EZ, 1040-NR, or 1040-NR-EZ, to change amounts previously adjusted by the IRS, or to make certain elections after the prescribed deadline (see Regulations sections 301.9100-1 through -3).

Based on the available guidance as of late June 2023, it is indeed indicated that filing a Form 1040-X to revise the 2017 tax return would be the appropriate approach for claiming the refund. As previously mentioned, the protective claim must be in writing and include

- The taxpayer's name,
- Address,
- Tax identification number, and
- Signature.[443]

Additionally, the claim must:

- Clearly identify the contingency affecting the claim, which in this case would be the US Supreme Court's decision in the Moore case and any subsequent court actions directed by the Supreme Court to lower courts.
- Be sufficiently clear and specific to inform the IRS about the essential nature of the claim, namely the potential reduction of the Section 965 transition tax reported on the 2017 or 2018 tax return.
- Identify the specific year(s) for which the refund is sought. It is crucial to provide a careful explanation that refunds are being sought for installment payments previously made, for which the statute of limitations remains open at the date the claim is filed. Additionally, any payments made during the period when the dispute's resolution is under consideration by the courts should be included as part of the claim as each payment is made.[444]

Although the three-year statute of limitations for refund claims based on the date of filing of the 2017 or 2018 return will have expired, the deferred tax payment installment structure allows for two payments to be made within the two-year statute for claiming a refund (i.e., within two years

[443] IRM 4.10.11.2.1.3(4) (09-04-2020)

[444] IRM 4.10.11.2.1.3(4) (09-04-2020)

after the date the tax is paid) for taxpayers who have been making payments according to the schedule.

Certainly, in situations where the taxpayer is not facing an imminent expiration of a potential statute, it may be advisable for an advisor to consider delaying the filing of the protective claim. This approach allows for the possibility of the IRS releasing specific guidance to address the unique nature of the Form 965 installment payment regime and provide clearer instructions on the appropriate format for such protective claims.

By staying informed and monitoring any updates or guidance from the IRS, taxpayers and their advisors can ensure that the protective claim is filed in accordance with the most up-to-date instructions and requirements. This approach helps to mitigate any potential uncertainties and increases the chances of a smooth and successful claims process.

SECTION: 1202
RETAIL SALE OF DRUGS FOUND TO BE A QUALIFIED TRADE OR BUSINESS FOR §1202 PURPOSES

Citation: PLR 202221006, 5/27/22

In PLR 202221006[445] a corporation whose shareholders were negotiating a sale of their stock to an unrelated third party asked the IRS to rule that the business is a *qualified trade or business* under IRC §1202(e)(3).

§1202 Status and Benefits

IRC §1202 provides for a full or partial exclusion of gain from the disposal of *qualified small business stock* held for more than five years. The amount of the exclusion varies depending on when the stock was acquired, with stock acquired after September 27, 2010 being eligible for a 100% exclusion of gain on the sale[446] of up to the greater of $10 million or 10 times the aggregate adjusted bases of qualified small business stock issued by such corporation and disposed of by the taxpayer during the taxable year.[447]

Only certain types of businesses can qualify as a *qualified trade or business*, something necessary for gain on the sale of the stock to qualify for a §1202 exclusion. IRC §1202(e)(3) contains the definition of a *qualified trade or business* and reads:

> (3) Qualified trade or business
>
> For purposes of this subsection, the term "qualified trade or business" means any trade or business other than--
>
>> (A) any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial

[445] PLR 202221006, May 27, 2022, https://www.irs.gov/pub/irs-wd/202221006.pdf (retrieved May 27, 2022)

[446] IRC §1202(a)(4)

[447] IRC §1202(b)(1)(A)

science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees,

(B) any banking, insurance, financing, leasing, investing, or similar business,

(C) any farming business (including the business of raising or harvesting trees),

(D) any business involving the production or extraction of products of a character with respect to which a deduction is allowable under section 613 or 613A, and

(E) any business of operating a hotel, motel, restaurant, or similar business.[448]

In this case the question was whether the business of the corporation was performance of services in the field of health or the principal asset of the business was the skill or reputation of one or more employees.[449]

Facts as Represented in the Ruling Request

The taxpayer in this case is involved in the sale of certain drugs:

> Taxpayer is only involved in the retail sale of a limited number of drugs and does not manufacture them. The manufacturers of these drugs prefer entering into exclusive distribution arrangements with companies such as Taxpayer.[450]

The employees involved in the business are both pharmacists and various other employees:

> Employees of Taxpayer include several pharmacists who fill prescriptions received from physicians. Other employees coordinate the insurance coverage with respect to such prescription orders. Once the insurance process is complete and the prescription is filled by the pharmacist, Taxpayer mails the prescription to the patient's home. The non-pharmacist employees will also occasionally contact individuals receiving prescriptions to inquire as to any side effects of the prescriptions and to schedule refills. Such non-pharmacist employees are not subject to state licensing requirements or classified as healthcare professionals by any applicable state, Federal or regulatory authority.[451]

The nature of the employees' interactions with the patients and physicians is outlined as follows:

> Pharmacists and other employees of Taxpayer have no contact or interaction with physicians, other than to receive prescriptions from them. With respect to

[448] IRC §1202(e)(3)

[449] IRC §1202(e)(3)(A)

[450] PLR 202221006, May 27, 2022

[451] PLR 202221006, May 27, 2022

> patients, pharmacists interact with patients only if a patient has a question about a particular prescription. Employees are never involved in diagnosing any medical issues or recommending any treatment or drug to individuals. Their interaction with patients is limited to the filling and maintenance of prescriptions as ordered by a physician. Therefore, none of Taxpayer's employees diagnose, treat or manage any aspect of any patient's care. Taxpayer's revenues are strictly related to the sale of such drugs, and Taxpayer earns no revenues in connection with the medical care of patients.[452]

Analysis and Ruling

The analysis section of the ruling begins with a discussion of the two categories that the taxpayer was concerned the IRS might on exam argue their business falls into that would bar treatment as a *qualified trade or business*, making their gain on sale fully taxable:

> Section 1202(e)(3) excludes businesses from being a qualified trade or business if they offer value to customers primarily in the form of certain specified services, or in the form of individual expertise. A question arises as to whether Taxpayer is (i) involved in the performance of services in the field of health or (ii) where the principal asset of the trade or business is the reputation or skill of one or more of its employees.[453]

The ruling concludes that this business is not a health business as contemplated by IRC §1202(e)(3)(A) since the employees actions don't rise to the level of diagnostic services or medical care provided to either patients or physicians:

> Taxpayer's employees are not engaged in the provision of medical services. Other than the pharmacists, such employees are not certified healthcare providers and are not otherwise regulated under state or Federal law. Taxpayer's pharmacists fill prescriptions provided by health care professionals, and other employees help manage the insurance process and occasionally communicate with patients regarding prescription issues and timely refill requests. Any interaction with patients regarding their prescriptions is merely incidental to ensuring receipt of their required prescriptions or answering a patient's question about them. Taxpayer's employees do not provide any diagnostic services or medical care to either patients or physicians, and all revenues are generated by the sale of the drugs.[454]

The IRS also found that the principal asset of the business was not the employees' reputation or skill:

> Also, Taxpayer's principal asset is not the reputation or skill of one or more employees, but its exclusive pharmaceutical distribution rights.[455]

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[452] PLR 202221006, May 27, 2022

[453] PLR 202221006, May 27, 2022

[454] PLR 202221006, May 27, 2022

[455] PLR 202221006, May 27, 2022

SECTION: 2702
VALUATION SHOULD HAVE INCLUDED CONSIDERATION OF LIKELY SALE OF BUSINESS

Citation: CCA 202152018, 12/30/21

Determining the fair market value for a closely-held business for various tax purposes depends upon valuations assuming a willing buyer and willing seller aware of all relevant facts. In CCA 202152018[456] the IRS finds that the valuation used by a taxpayer in attempting to set up a grantor retained annuity trust (GRAT) did not consider the fact that there was a high likelihood the entity being valued would be likely involved in a lucrative merger in the near future.

IRC §2702 governs the values of certain interests transferred in trust:

> Solely for purposes of determining whether a transfer of an interest in trust to (or for the benefit of) a member of the transferor's family is a gift (and the value of such transfer), the value of any interest in such trust retained by the transferor or any applicable family member (as defined in section 2701(e)(2)) shall be determined as provided in paragraph (2).[457]

Under IRC §2702(a)(2)(A), the value of any interest retained by the donor in a trust is set at zero. Thus, the entire value will be deemed as being transferred to the remainder interest holders, so if $1,000,000 of assets are put in trust for a member of the donor's family as the remainder beneficiary and the donor retains an interest that would normally be valued at $500,000, the value of the beneficiary's interest would be the full $1,000,000 for gift tax purposes and not the $500,000 that represents the economic value of that interest.

The law does provide an option where the donor's interest will not be considered to have a zero value, found at IRC §2702(a)(2)(B), where a *qualified interest* will be valued under IRC §7520 (the IRS valuation tables). This is a GRAT. To be a *qualified interest*, the following three conditions must be met:

- Any interest which consists of the right to receive fixed amounts payable not less frequently than annually,
- Any interest which consists of the right to receive amounts which are payable not less frequently than annually and are a fixed percentage of the fair market value of the property in the trust (determined annually), and
- Any noncontingent remainder interest if all of the other interests in the trust consist of interests described in the prior two bullets.[458]

[456] CCA 202152018, December 30, 2021, https://www.taxnotes.com/research/federal/irs-private-rulings/legal-memorandums/anticipated-merger-affects-grat-appraisal-valuation/7cr6d (retrieved December 31, 2021)

[457] IRC §2702(a)

[458] IRC §2702(b)

If an interest does not strictly meet the requirements above, then its value will be set to zero under the default treatment of IRC §2702(a)(2)(A). In this case the question will be whether the annuity payment was actually being determined based on the fair market value of the property in the trust.

The memorandum begins by discussing the donor's commencement of an attempt to find an outside buyer for his very successful company:

> Donor is the founder of a very successful company, Company. At the end of Year 1, Donor contacted two Investment Advisors to explore the possibility of finding an outside buyer. The facts indicate that, "[T]he Company was marketed through outreach by investment bankers to potential strategic buyers, some of which had previously expressed an interest in partnering with [Company]. Meetings were then scheduled to introduce [Company] and determine if there was additional interest." Potential buyers were expected to purchase a minority stake of Company with a call option after several years to acquire the remainder of Company at a formula valuation.
>
> In Year 2, approximately six months later and within a two-week period concluding on Date 1, the Investment Advisors presented Donor with an offer from each of Corporation A, Corporation B, Corporation C, Corporation D, and Corporation E (collectively, the Corporations).[459]

At this point, the Donor made a transfer to a trust that was intended to qualify as a GRAT under IRC §2702:

> Three days later, on Date 2, Donor created Trust, a two-year grantor retained annuity trust (GRAT), the terms of which appeared to satisfy the requirements for a qualified interest under § 2702 and the corresponding regulations. Under the terms of Trust, the trustee was to base the amount of the annuity payment on a fixed percentage of the initial fair market value of the trust property. Donor funded Trust with a shares of Company. The value of the shares of Company was determined based on an appraisal of Company on December 31, Year 1, a date approximately seven months prior to the transfer to Trust. The appraisal, which was obtained in order to satisfy the reporting requirements for nonqualified deferred compensation plans under § 409A of the Code, valued the shares of Company at $w per share.[460]

Note the use here of a valuation that was performed just after the Donor began having advisers contact third parties to determine interest in the Company, but well before the Donor had five offers to buy on the table. As well, the purpose of that valuation was for reporting for the IRC §409A plans.

The process of completing a merger then moved forward.

> Additional time was granted to the Corporations to submit final offers. The last offer was received on Date 3, almost three months after the initial offers.

[459] CCA 202152018, December 30, 2021

[460] CCA 202152018, December 30, 2021

> Corporations A through D raised their offers, while Corporation E withdrew from the bidding, expressing no further interest.[461]

Now the Donor establishes and funds a charitable remainder trust (CRT), this time obtaining a new valuation for this purpose:

> On Date 4, Donor gifted Company shares to a separate charitable remainder trust and valued those shares at $x per share pursuant to a qualified appraisal. This per share value was equal to the tender offer value described below.[462]

Following the formation of the CRT, the sale process continued and concluded:

> Three months after the new offers were received and several weeks after the transfer to his charitable remainder trust, Donor accepted Corporation A's offer, which represented a 10 percent increase over its initial offer. Per the final offer, an initial cash tender offer was made of $x per share, an amount that was nearly three times greater than $w (the value determined as of December 31, Year 1). During the tender period, Donor tendered b shares, while Donor's charitable remainder trust also took advantage of the tender offer.
>
> On December 31, Year 2, Donor again had Company appraised for purposes of § 409A and the new appraised value was $y per share, which was almost twice the previous year's value of $w per share.2 These steps were repeated for a December 31, Year 3 appraisal with similar results. The December 31, Year 2 and Year 3 appraisals both included the following language: "[a]ccording to management, there have been no other recent offers or closed transactions in Company shares as of the Valuation Date." There was no such declaration in the December 31, Year 1 appraisal.
>
> In Year 4, approximately six months after the end of Trust's two-year GRAT term, Corporation A purchased the balance of the Company shares for $z per share, a price almost double the value of $y.[463]

The CCA notes that while, generally, events occurring after the date of a donation are not considered as of the valuation date, what was known about such events, including how likely the events are to take place, do have an impact:

> Generally, a valuation of property for Federal transfer tax purposes is made as of the valuation date without regard to events happening after that date. *Ithaca Trust Co. v. United States,* 279 U.S. 151 (1929). Subsequent events may be considered, however, if they are relevant to the question of value. *Estate of Noble v. Commissioner*, T.C. Memo. 2005-2 n.3. Federal law favors the admission of probative evidence, and the test of relevancy under the Federal Rules of Evidence is designed to achieve that end. *Id*. Thus, a post-valuation date event may be considered if the event was reasonably foreseeable as of the valuation date. *Trust*

[461] CCA 202152018, December 30, 2021

[462] CCA 202152018, December 30, 2021

[463] CCA 202152018, December 30, 2021

Services of America, Inc. v. U.S., 885 F.2d 561, 569 (9th Cir. 1989); *Bank One Corp.*, 120 T.C. 174, 306. [464]

But even if the event is not reasonably foreseeable, a sale shortly after the event in a sale where we have truly willing buyers and sellers does provide evidence of value.

> Furthermore, a post-valuation date event, even if unforeseeable as of the valuation date, also may be probative of the earlier valuation to the extent that it is relevant to establishing the amount that a hypothetical willing buyer would have paid a hypothetical willing seller for the subject property as of the valuation date. See *Estate of Gilford v. Commissioner*, 88 T.C. 38, 52-55 (1987).[465]

If a taxpayer or the IRS wants to ignore that sale, generally the party pushing to ignore that value will want to explain what changed that renders this later arms-length sale not representative of the value at the date the value is important from a tax perspective.

The key issue is what information would have been available to the willing buyer and willing seller at the date in question, as the memorandum discusses:

> The principle that the hypothetical willing buyer and willing seller are presumed to have "reasonable knowledge of relevant facts" affecting the value of property at issue applies even if the relevant facts at issue were unknown to the actual owner of the property. *Estate of Kollsman v. Commissioner*, T.C. Memo. 2017-40, *aff'd*, 777 Fed. Appx. 870 (9th Cir. 2019). In addition, both parties are presumed to have made a reasonable investigation of the relevant facts. *Id*. Thus, in addition to facts that are publicly available, reasonable knowledge includes those facts that a reasonable buyer or seller would uncover during negotiations over the purchase price of the property. *Id*. Moreover, a hypothetical willing buyer is presumed to be "reasonably informed" and "prudent" and to have asked the hypothetical willing seller for information that is not publicly available. *Id*.[466]

The CCA outlines the taxpayers' explanation for the use of the seven month old valuation for the GRAT contribution and annuity amount and the use of a new valuation for the CRT funding shortly thereafter:

> When asked to explain the use of the outdated appraisal (as of December 31, Year 1) to value the transfer to the GRAT, as well as the use of a new appraisal to value the transfers to charity, the company that conducted the appraisal stated only that "[t]he appraisal used for the GRAT transfer was only six months old, and business operations had not materially changed during the 6-month period . . . For the charitable gifts, under the rules for Form 8283, in order to substantiate a charitable deduction greater than $5,000, a qualified appraisal must be completed. Because of this requirement an appraisal was completed for the donations of [Company] stock to various charities on [Date 4]."[467]

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[464] CCA 202152018, December 30, 2021

[465] CCA 202152018, December 30, 2021

[466] CCA 202152018, December 30, 2021

[467] CCA 202152018, December 30, 2021

In analyzing this situation, the CCA finds one court case especially helpful. The CCA discusses the facts and rulings in the *Ferguson* case:

> In *Ferguson v. Commissioner*, 174 F.3d 997 (9th Cir. 1999), *aff'g* 108 T.C. 244 (1997), the appellate court considered the issue of whether the Tax Court correctly held that taxpayers were liable for gain in appreciated stock under the anticipatory assignment of income doctrine. In *Ferguson*, taxpayers owned 18 percent of AHC and served as officers and on the board of directors. In late 1987 and early 1988, the AHC board of directors contacted and eventually authorized Goldman, Sachs & Co. to find a purchaser of AHC and to assist in the negotiations. By July 1988, Goldman, Sachs had found four prospective purchasers. Shortly thereafter, AHC entered into a merger agreement with DCI Holdings, Inc. With the taxpayers abstaining from the vote, the AHC board unanimously approved the merger agreement. On August 3, 1988, the tender offer was started. On August 15, the taxpayers, with the help of their broker, executed a donation-in-kind record with respect to their intention to donate stock to a charity and two foundations. On September 9, 1988, the charity and the foundations tendered their stock. On September 12, 1988, the final shares were tendered and on or about October 14, 1988, the merger was completed.
>
> The Court of Appeals affirmed the Tax Court's conclusion that the transfers to charity and the foundations occurred after the shares in AHC had ripened from an interest in a viable corporation into a fixed right to receive cash and the merger was "practically certain" to go through. In particular, the 9th Circuit noted that "[t]he Tax Court really only needed to ascertain that as of [the valuation] date, the surrounding circumstances were sufficient to indicate that the tender offer and the merger were practically certain to proceed by the time of their actual deadlines — several days in the future." *Ferguson*, 174 F.3d at 1004. Consequently, the assignment of income doctrine applied and the taxpayers realized gain when the shares were disposed of by the charity and foundations.[468]

The memorandum finds that this situation was very similar to the *Ferguson* situation:

> The current case shares many factual similarities with *Ferguson, supra*, for example, the targeted search by Donor to find merger candidates, the exclusive negotiations with Corporation A immediately before the final agreement, the generous terms of the merger, and an agreement that was "practically certain" to go through. While the Ferguson opinion deals exclusively with the assignment of income doctrine, it also relies upon the proposition that the facts and circumstances surrounding a transaction are relevant to the determination that a merger is likely to go through. See *Bank One* and *Kollsman*, *supra*.
>
> Further, the current case presents an analogous issue, that is, whether the fair market value of the stock should take into consideration the likelihood of the merger as of the date of the transfer of the shares to Trust. The *Ferguson* and *Silverman* opinions, as considered by the Tax Court and the Ninth Circuit and Second Courts of Appeal, respectively, support the conclusion that the value of the stock in Company must take into consideration the pending merger. Accordingly, the value determined in the December 31, Year 1 appraisal does not

[468] CCA 202152018, December 30, 2021

> represent the fair market value of the shares as of the valuation date. Under the fair market value standard as articulated in § 25.2512-1, the hypothetical willing buyer and willing seller, as of Date 2, would be reasonably informed during the course of negotiations over the purchase and sale of the shares and would have knowledge of all relevant facts, including the pending merger. Indeed, to ignore the facts and circumstances of the pending merger undermines the basic tenets of fair market value and yields a baseless valuation, and thereby casts more than just doubt upon the bona fides of the transfer to the GRAT.[469]

The memorandum goes on to find that this dooms the entire GRAT structure:

> In addition, although the governing instrument of Trust appears to meet the requirements in § 2702 and the corresponding regulations, intentionally basing the fixed amount required by § 2702(b)(1) and § 25.2702-3(b)(1)(i) on an undervalued appraisal causes the retained interest to fail to function exclusively as a qualified interest from the creation of the trust. The trustee's failure to satisfy the "fixed amount" requirement under § 2702 and § 25.2702-3(b)(1)(ii)(B) is an operational failure because the trustee paid an amount that had no relation to the initial fair market value of the property transferred to the trust; instead, the amount was based on an outdated and misleading appraisal of Company, at a time when Company had received offers in the multi-billion dollar range. When asked about the use of the outdated appraisal, the company that conducted the appraisal stated only that business operations had not materially changed during the 6-month period. In contrast, in valuing the transfer to the charitable trust, the company that conducted the appraisal focused only on the tender offer, and accordingly gave little weight to the business operations for valuation purposes.
>
> The operational effect of deliberately using an undervalued appraisal is to artificially depress the required annual annuity. Thus, in the present case, the artificial annuity to be paid was less than 34 cents on the dollar instead of the required amount, allowing the trustee to hold back tens of millions of dollars. The cascading effect produced a windfall to the remaindermen. Accordingly, because of this operational failure, Donor did not retain a qualified annuity interest under § 2702. See *Atkinson*.[470]

Of course, this document is merely a memorandum from the IRS Chief Counsel's office, and there's no guarantee that a court would agree with the entirety of this analysis or find any shortcomings are totally fatal to the GRAT.

But certainly, it appears the facts of this case present the IRS with opportunities it would have been better had the taxpayer avoided. While it's very likely the IRS would have complained about using the valuation from the prior December for the GRAT regardless, the creation of the CRT triggered a significantly higher valuation that was much closer in time to the funding of the GRAT. The higher valuation conceded that, at least by the date of the CRT funding, the taxpayer's position was that the merger negotiations greatly increased the fair market value of the operation.

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[469] CCA 202152018, December 30, 2021

[470] CCA 202152018, December 30, 2021

Certainly, the taxpayer and advisers should have recognized that using the appraisal prepared months earlier to value the contribution to the GRAT was going to lead to questions in the event of an IRS challenge due to events related to the eventual sale that took place between the date of the valuation and the date the GRAT was funded. A preparation of a valuation at the GRAT funding date and basing the annuity payments on that amount would have greatly reduced this risk.

Similarly, when it was decided to fund a charitable remainder trust, the fact that a new, much higher appraisal would be prepared should have raised concerns about both the risk and potential for success of an IRS attack against the GRAT which relied upon a much older valuation before the merger talks got serious.

Obviously, we are not privy to how the taxpayer and advisers addressed these issues, or what facts they may believe would serve to blunt the impact of the IRS's arguments since this is purely an IRS document. But the memorandum should serve to remind advisers of the need to consider issues that arise when the taxpayer decides against getting an updated valuation prepared before any major gift tax or income tax transaction.

At the very least, a valuation prepared as of the date of the transaction allows the appraiser to outline the facts being relied upon as well as a justification at the time regarding any arguments to limit the impact of such negotiations in process. While clients may balk at paying for "yet another" valuation, a valuation prepared right at the time of a gift transaction before the final results of negotiations to sell the business are known will be a lot easier to defend than an attempt to argue, after all parties know what ultimately happened, that that result was not easy to spot at the valuation date.

SECTION: 280F
IRS ANNOUNCES DEPRECIATION AND LEASE INCLUSION AMOUNTS ON VEHICLES FOR 2023

Citation: Revenue Procedure 2023-14, 1/18/23

In Revenue Procedure 2023-14[471] the IRS has released the depreciation limits on automobiles under IRC §280F for 2023.

Table 1[472] applies to passenger automobiles acquired by the taxpayer after September 27, 2017, and placed in service by the taxpayer during calendar year 2023, for which the §168(k) additional

[471] Revenue Procedure 2013-14, January 18, 2023, https://www.irs.gov/pub/irs-drop/rp-23-14.pdf (retrieved January 20, 2023)

[472] Revenue Procedure 2013-14, January 18, 2023

first year depreciation deduction applies. The maximum depreciation deduction allowed for each year is as follows:

Tax Year	Amount
1st Tax Year	$20,200
2nd Tax Year	$19,500
3rd Tax Year	$11,700
Each Succeeding Year	$6,960

Table 2[473] applies to passenger automobiles placed in service by the taxpayer during calendar year 2023 for which no §168(k) additional first year depreciation deduction applies. The maximum depreciation deduction allowed for each year is as follows:

Tax Year	Amount
1st Tax Year	$12,200
2nd Tax Year	$19,500
3rd Tax Year	$11,700
Each Succeeding Year	$6,960

The Revenue Procedure also provides Table 3, which provides the dollar amount used by lessees of passenger automobiles with a lease term beginning in 2023 to determine the income inclusion amount for those passenger automobiles.[474]

[473] Revenue Procedure 2013-14, January 18, 2023

[474] Revenue Procedure 2013-14, January 18, 2023

SECTION: 3134

IRS POINTS OUT WARNING SIGNS FOR MISLEADING ERC SCAMS

Citation: "IRS alerts businesses, tax-exempt groups of warning signs for misleading Employee Retention scams; simple steps can avoid improperly filing claims," IRS News Release IR-2023-105, 5/25/23

The IRS has recently issued a news release[475] to inform businesses about the growing concern of overly aggressive employee retention tax credit (ERC) promoters. Within this statement, the IRS highlights key indicators that employers should be mindful of in order to identify potential promoters engaging in questionable practices. Furthermore, the statement sheds light on the tactics employed by these promoters to attract employers and offers valuable suggestions on how businesses can safeguard themselves against potentially costly errors that may arise from claiming an ERC credit without meeting the eligibility criteria.

Current Problem in the View of the IRS

The news release commences by addressing the ongoing challenges observed by the IRS in relation to consultants who employ aggressive tactics to persuade employers into submitting refund claims associated with the ERC:

> The IRS and tax professionals continue to see a barrage of aggressive broadcast advertising, direct mail solicitations and online promotions involving the Employee Retention Credit. While the credit is real, aggressive promoters are wildly misrepresenting and exaggerating who can qualify for the credits.
>
> …
>
> "The aggressive marketing of the Employee Retention Credit continues preying on innocent businesses and others," said IRS Commissioner Danny Werfel. "Aggressive promoters present wildly misleading claims about this credit. They can pocket handsome fees while leaving those claiming the credit at risk of having the claims denied or facing scenarios where they need to repay the credit."[476]

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[475] "IRS alerts businesses, tax-exempt groups of warning signs for misleading Employee Retention scams; simple steps can avoid improperly filing claims," IRS News Release IR-2023-105, May 25, 2023, https://www.irs.gov/newsroom/irs-alerts-businesses-tax-exempt-groups-of-warning-signs-for-misleading-employee-retention-scams-simple-steps-can-avoid-improperly-filing-claims (retrieved May 28, 2023)

[476] "IRS alerts businesses, tax-exempt groups of warning signs for misleading Employee Retention scams; simple steps can avoid improperly filing claims," IRS News Release IR-2023-105, May 25, 2023

The IRS has announced its proactive measures to initiate audits and criminal investigations into claims that exhibit a questionable foundation:

> The IRS has stepped up audit and criminal investigation work involving these claims. Businesses, tax-exempt organizations and others considering applying for this credit need to carefully review the official requirements for this limited program before applying. Those who improperly claim the credit face follow-up action from the IRS.[477]

The IRS cautions employers against adopting the notion that requesting the credit "just in case" would be inconsequential. They emphasize that it is unwise to assume that claiming the credit without meeting the eligibility requirements would have no negative repercussions.

> The IRS reminds anyone who improperly claims the ERC that they must pay it back, possibly with penalties and interest. A business or tax-exempt group could find itself in a much worse cash position if it has to pay back the credit than if the credit was never claimed in the first place. So, it's important to avoid getting scammed.[478]

IRS Warning Signs of Aggressive ERC Marketing

The IRS presents a comprehensive list of aggressive marketing techniques that employers should be cautious of when considering the use of such services. The outlined methods serve as warning signs and aim to raise awareness among employers to exercise vigilance in their decision-making process.

- Unsolicited calls or advertisements mentioning an "easy application process."
- Statements that the promoter or company can determine ERC eligibility within minutes.
- Large upfront fees to claim the credit.
- Fees based on a percentage of the refund amount of Employee Retention Credit claimed. This is a similar warning sign for average taxpayers, who should always avoid a tax preparer basing their fee on the size of the refund.
- Aggressive claims from the promoter that the business receiving the solicitation qualifies before any discussion of the group's tax situation. In reality, the Employee Retention Credit is a complex credit that requires careful review before applying.
- The IRS also sees wildly aggressive suggestions from marketers urging businesses to submit the claim because there is nothing to lose. In reality, those improperly receiving the credit could have to repay the credit – along with substantial interest and penalties.[479]

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[477] "IRS alerts businesses, tax-exempt groups of warning signs for misleading Employee Retention scams; simple steps can avoid improperly filing claims," IRS News Release IR-2023-105, May 25, 2023

[478] "IRS alerts businesses, tax-exempt groups of warning signs for misleading Employee Retention scams; simple steps can avoid improperly filing claims," IRS News Release IR-2023-105, May 25, 2023

[479] "IRS alerts businesses, tax-exempt groups of warning signs for misleading Employee Retention scams; simple steps can avoid improperly filing claims," IRS News Release IR-2023-105, May 25, 2023

The IRS concludes this section by warning:

> These promoters may lie about eligibility requirements. In addition, those using these companies could be at risk of someone using the credit as a ploy to steal the taxpayer's identity or take a cut of the taxpayer's improperly claimed credit.[480]

IRS Outlines Ways Unscrupulous Promoters Lure Their Victims

The IRS next provides a list of methods used by the unscrupulous to convince their victims to use their services:

- **Aggressive marketing**. This can be seen in countless places, including radio, television and online as well as phone calls and text messages.
- **Direct mailing**. Some ERC mills are sending out fake letters to taxpayers from the non-existent groups like the "Department of Employee Retention Credit." These letters can be made to look like official IRS correspondence or an official government mailing with language urging immediate action.
- **Leaving out key details**. Third-party promoters of the ERC often don't accurately explain eligibility requirements or how the credit is computed. They may make broad arguments suggesting that all employers are eligible without evaluating an employer's individual circumstances.
  - For example, only recovery startup businesses are eligible for the ERC in the fourth quarter of 2021, but promoters fail to explain this limit.
  - Again, the promoters may not inform taxpayers that they need to reduce wage deductions claimed on their business' federal income tax return by the amount of the Employee Retention Credit. This causes a domino effect of tax problems for the business.
- **Payroll Protection Program participation**. In addition, many of these promoters don't tell employers that they can't claim the ERC on wages that were reported as payroll costs if they obtained Paycheck Protection Program loan forgiveness.[481]

IRS Recommendation on How Businesses Can Protect Themselves

The IRS concludes by providing a set of recommended steps that employers should take in order to safeguard themselves:

- **Work with a trusted tax professional**. Eligible employers who need help claiming the credit should work with a trusted tax professional; the IRS urges people not to rely on the advice of those soliciting these credits. Promoters who are marketing this ultimately have a vested interest in making money; in many cases they are not looking out for the best interests of those applying.

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[480] "IRS alerts businesses, tax-exempt groups of warning signs for misleading Employee Retention scams; simple steps can avoid improperly filing claims," IRS News Release IR-2023-105, May 25, 2023

[481] "IRS alerts businesses, tax-exempt groups of warning signs for misleading Employee Retention scams; simple steps can avoid improperly filing claims," IRS News Release IR-2023-105, May 25, 2023

- **Don't apply unless you believe you are legitimately qualified for this credit**. Details about the credit are available on IRS.gov, and again a trusted tax professional – not someone promoting the credit – can provide critical professional advice on the ERC.

- **To report ERC abuse, submit Form 14242, Report Suspected Abusive Tax Promotions or Preparers**. People should mail or fax a completed Form 14242, Report Suspected Abusive Tax Promotions or Preparers, and any supporting materials to the IRS Lead Development Center in the Office of Promoter Investigations.[482]

SECTION: 45W

INCREMENTAL COST SAFE HARBORS PROVIDED FOR QUALIFIED COMMERCIAL CLEAN VEHICLE CREDIT

Citation: Notice 2023-9, 12/29/22

The qualified commercial clean vehicle credit at IRC §45W added by the Inflation Reduction Act of 2022 that takes effect beginning in 2023 requires taxpayers to reference the incremental cost of their qualified vehicle as one of the factors that can limit the credit. However, in no case can the credit exceed $7,500 for a vehicle with a gross vehicle weight of less than 14,000 pounds, so if the incremental cost is more than $7,500 then it would not serve to limit the amount of the credit.

In Notice 2023-9,[483] the IRS has issued guidance for determining the incremental cost of vehicles for purposes of the credit under IRC §45W, providing for safe harbor values taxpayers may use based on the Department of Energy's (DOE) *2022 Incremental Purchase Cost Methodology and Results for Clean Vehicles*.[484]

DOE Results

The Notice summarizes the results of the DOE's analysis:

> The Department of the Treasury (Treasury Department) has reviewed an incremental cost analysis of current costs by the Department of Energy (DOE) across classes of street vehicles (DOE Analysis). The DOE Analysis modeled the costs of representative commercial clean vehicles and comparable internal combustion engine vehicles. Results of the DOE Analysis show that the modeled incremental cost of all street vehicles, other than compact car PHEVs, that have a gross vehicle weight rating of less than 14,000 pounds will be greater than $7,500 in calendar year 2023.[485]

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[482] "IRS alerts businesses, tax-exempt groups of warning signs for misleading Employee Retention scams; simple steps can avoid improperly filing claims," IRS News Release IR-2023-105, May 25, 2023

[483] Notice 2023-9, December 29, 2022, https://www.irs.gov/pub/irs-drop/n-23-09.pdf (retrieved December 29, 2022)

[484] *2022 Incremental Purchase Cost Methodology and Results for Clean Vehicles*, Department of Energy, December 23, 2022, https://www.energy.gov/sites/default/files/2022-12/2022.12.23%202022%20Incremental%20Purchase%20Cost%20Methodology%20and%20Results%20for%20Clean%20Vehicles.pdf (Retrieved December 29, 2022)

[485] Notice 2023-9, December 29, 2022, Section 2

A compact car PHEV is defined as follows:

> Compact cars are defined as those with an interior volume index of less than 110 cubic feet, and for the purpose of the DOE analysis also include minicompact cars, subcompact cars, and compact cars as described in 40 CFR 600.315-08(a)(1)(ii), (iii), and (iv). PHEVs are defined as commercial clean vehicles that use a gasoline or diesel internal combustion engine and are propelled to a significant extent by an electric motor that draws electricity from a battery that has a capacity of not less than 7 kilowatt hours (15 kilowatt hours in the case of a vehicle with a gross vehicle weight rating of 14,000 pounds or more) and are capable of being recharged from an external source of electricity. See § 45W(b)(1) and (c).[486]

Safe Harbor for Vehicles with a Gross Vehicle Weight of Less than 14,000 Pounds Other Than Compact PHEVs

For cars other than compact car PHEVs, the IRS will accept the taxpayer's use of an incremental cost of $7,500 for the vehicle:

> For all street vehicles (other than compact car PHEVs) with a gross vehicle weight rating of less than 14,000 pounds, the DOE Analysis provides that incremental cost will not limit the available § 45W credit amount for vehicles placed in service in calendar year 2023. Accordingly, the Treasury Department and IRS will accept a taxpayer's use of $7,500 as the incremental cost for all street vehicles (other than compact car PHEVs) with a gross vehicle weight rating of less than 14,000 pounds to calculate the § 45W credit amount for vehicles placed in service during calendar year 2023.[487]

Safe Harbor for Compact PHEVs

For compact car PHEVs the Notice provides the following safe harbor for computing the vehicle's incremental cost:

> The DOE Analysis calculated the incremental cost for compact car PHEVs, which include minicompact and subcompact cars, to be less than $7,500. The Treasury Department and the Internal Revenue Service (IRS) will accept a taxpayer's use of the incremental cost published in the DOE Analysis to calculate the § 45W credit amount for compact car PHEVs placed in service during calendar year 2023.[488]

[486] Notice 2023-9, December 29, 2022, Section 2, Footnote 3

[487] Notice 2023-9, December 29, 2022, Section 3

[488] Notice 2023-9, December 29, 2022, Section 3

Safe Harbor for Vehicles with a Gross Vehicle Weight of More than 14,000 Pounds

The Notice also provides a safe harbor to use for qualified street vehicles with a gross vehicle weight of more than 14,000 pounds.

> In addition, the DOE Analysis provides an incremental cost analysis of current costs for several representative classes of street vehicles with a gross vehicle weight rating of 14,000 pounds or more in calendar year 2023. The Treasury Department and the IRS will accept a taxpayer's use of the incremental cost published in the DOE Analysis for the appropriate class of street vehicle to calculate the § 45W credit amount for vehicles placed in service during calendar year 2023.[489]

Table of Incremental Costs

The Department's table of incremental costs[490] is provided below:

Table 5: Resulting Incremental Cost, Representative Vehicle Classes, 2022.

Representative Vehicle Modeled	BEV	PHEV	FCEV
Compact Car	$7,500	$7,000	$11,000
Midsize Car	$8,500	$8,000	$15,000
Midsize SUV	$14,000	$9,500	$19,000
Pickup Truck	$19,500	$14,000	$35,500
Class 4-6 Box	$34,500	$28,000	$41,000
Class 7 Daycab	$93,500	$66,000	$80,500
Class 8 Longhaul	$297,500	$164,000	$105,500

BEV stands for "battery electric vehicle," PHEV stands for "plug-in hybrid electric vehicle" and FCEV stands for "fuel cell electric vehicle."

[489] Notice 2023-9, December 29, 2022, Section 3

[490] *2022 Incremental Purchase Cost Methodology and Results for Clean Vehicles*, Department of Energy, December 23, 2022, Table 5

The gross vehicle weight rating for the various classes of vehicles are found in Table 1[491] of the Department of Energy's document:

Table 1: Mapping of Modeled Vehicle to Broader Represented Classes of Vehicles[7]

Representative Vehicle Modeled	Representative of Vehicle Class	Gross Vehicle Weight Rating of Representative Vehicle Classes
Compact Car	Minicompact, Subcompact and Compact Cars	<14,000 lbs.
Midsize Car	Midsize and Large Car, All Station Wagons	<14,000 lbs.
Midsize SUV	Standard SUV, Small SUVs, Minivans	<14,000 lbs.
Pickup Truck	Pickup Trucks, including Classes 2/3	<14,000 lbs.
Class 4-6 Box	Classes 4 - 6	14,001 – 26,000 lbs.
Class 7 Daycab	Class 7	26,001 – 33,000 lbs.
Class 8 Longhaul	Class 8	>33,000 lbs.

SECTION: 6402

IMPLICATIONS FOR REFUNDS IN PROFESSIONAL EMPLOYER ORGANIZATIONS (PEOS) AND THEIR CLIENTS

Citation: ECC 202319015, 5/12/23

In an email response (ECC 201319015[492]), the Internal Revenue Service (IRS) conducted an examination of the scenario where a Professional Employer Organization (PEO) submits a claim for refund on behalf of one of its clients regarding the Employee Retention Credit (ERC). This examination specifically explored the implications when the PEO possesses outstanding tax liabilities. The conclusion reached in the response asserts that the IRS holds the authority to allocate the refund towards the PEO's outstanding tax obligations.

The email articulated the precise question as follows:

> You asked whether the IRS is authorized to offset certain COVID-19 employment tax credits (e.g., employee retention credit (ERC)) to any existing tax liabilities of a Professional Employer Organization (PEO) that pays wages to individuals as part of the services provided to a client employer pursuant to a service agreement, although the credits being claimed on the Form 941 Schedule R are attributable to wages paid to a client employer's employees.[493]

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[491] *2022 Incremental Purchase Cost Methodology and Results for Clean Vehicles*, Department of Energy, December 23, 2022, Table 1

[492] ECC 202319015, May 12, 2023, https://www.taxnotes.com/research/federal/irs-private-rulings/e-mail-chief-counsel-advice/irs-may-offset-peo-employment-credits-for-client-employees/7gp15 (retrieved May 13, 2023)

[493] ECC 202319015, May 12, 2023

The discussion begins by looking at the IRS's authority to apply a taxpayer's overpayments of tax against other outstanding liabilities of that taxpayer under IRC §6402(a):

> IRC §6402(a) grants the IRS discretion to credit any overpayment against "any liability in respect of an internal revenue tax on the part of the person who made the overpayment." With respect to the COVID-19 employment tax credits, the IRS made the business decision to offset excess refundable COVID-19 employment tax credits to any existing tax liabilities on the employer's account (see COVID-19-Related Employee Retention Credits: General Information FAQs, FAQ #12 and COVID-19-Related Tax Credits: Basic FAQs, FAQ #14). This decision applies to all types of refundable COVID-19 employment tax credits including the ERC, the credit for paid sick and family leave wages, and the COBRA credit.[494]

IRC §6402(a) states the following:

> **(a) General rule.** In the case of any overpayment, the Secretary, within the applicable period of limitations, may credit the amount of such overpayment, including any interest allowed thereon, against any liability in respect of an internal revenue tax on the part of the person who made the overpayment and shall, subject to subsections (c), (d), (e), and (f), refund any balance to such person.

However, the determination of who the "person" refers to in this particular scenario requires clarification. While it may be assumed that the overpayment, pertaining to the PEO's client, would mean the client should be considered the person in this context, the IRS takes the position that the PEO itself should be regarded as the person in this case. The IRS commences by providing an explanation of the relationship between the parties involved in a PEO arrangement concerning payroll taxes:

> For taxpayers who use third-party payors (TPPs), the process for claiming credits against employment tax liabilities and liability for erroneously claimed credits differs depending on the type of TPP used. For taxpayers who use a section 3504 agent, Certified Professional Employer Organization (CPEO) or PEO that pays wages to individuals as part of the services provided to a client pursuant to a service agreement, although the credits being claimed on the Form 941 Schedule R are attributable to wages paid to a client's employees, the 3504 agent, the CPEO or **PEO is the taxpayer** who is actually claiming the employment tax in an aggregate amount on a single line on a Form 941 filed under its own EIN. If a refund is ultimately issued to the TPP aggregate filer, it is then between the TPP aggregate filer and the client to ensure the TPP remits any portion of the refund it received to the client in the appropriate amount.[495]

Therefore, according to the IRS, the "person" referred to in this particular case is the PEO itself, rather than the client on whose behalf the overpayment is made.

[494] ECC 202319015, May 12, 2023

[495] ECC 202319015, May 12, 2023

Continuing from the previous explanation, the email further elaborates on the IRS's interaction with PEOs regarding payroll tax filings and tax refunds, emphasizing that the IRS does not engage directly with the PEO's clients. The email states:

> The IRS is not a party to those agreements and has no legal obligation to refund any portion of the TPP filer's refund to a client identified on Schedule R. In addition, when the IRS conducts an audit of a Form 941 filed by these types of TPPs, the IRS is examining the aggregate total amount of the line item credit claimed by the TPP on the Form 941, using the client by client allocation information provided on Schedule R as part of the examination. The IRS does not issue refunds or make credit adjustments to the client entities themselves, but rather any credits/refunds are paid to TPP. Any credits claimed against the employment taxes reported on the Form 941, reduce the reported liability of the TPP. Moreover, any adjustment to a credit claimed by a TPP on the Form 941 will affect the total employment tax liability on the TPP aggregate filer's employment tax return. Schedule R only provides a portion of the information (the allocable share of wages and credits on a client-by-client basis) which was used by the TPP, in part, to determine its own total tax liability on the return. Since the Schedule R information is not itself determinative of the TPP's ultimate tax liability, the IRS would not be able to determine the appropriate refund to issue to the TPP based solely on the Schedule R information on a client-by-client basis for any particular employment tax credit. Rather, until the IRS determines entitlement to the entire line item amount claimed on the Form 941, no refunds or credits are paid out to the TPP. Please note that offsetting a TPP's outstanding tax liability is, in fact, providing the credit to the TPP by way of a reduction in the TPP's liability.[496]

By providing this explanation, the IRS clarifies that its role in the PEO arrangement is limited to examining the aggregate amount of credits claimed by the TPP and adjusting the overall employment tax liability accordingly. The IRS does not directly issue refunds or credits to the PEO's clients, and any offsetting of the PEO's outstanding tax liability effectively functions as a credit provided to the TPP by reducing its overall liability.

In conclusion, the email acknowledges that customers of PEOs may face challenges in receiving payment for the refundable tax credits they are eligible for if the chosen PEO has outstanding federal tax liabilities. The email states:

> Although employers who utilize TPPs (such as PEOs in the fact pattern examples provided by TAS) may encounter difficulties receiving payment of the refundable tax credits they may be entitled to if the TPP they have chosen has outstanding federal tax liabilities, this is a civil matter strictly between the TPP/PEO and the client employer.[497]

The email concludes the IRS's role is limited to the application of tax laws and regulations, and it does not intervene in the payment disputes or obligations between the PEO and its client employer.

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[496] ECC 202319015, May 12, 2023

[497] ECC 202319015, May 12, 2023

SECTION: 6651

TAX COURT FINDS ELDERLY ATTORNEY QUALIFIED FOR REASONABLE CAUSE EXCEPTION FOR LATE FILING AND LATE PAYMENT

Citation: Tracy v. Commissioner, T.C. Summ. Op. 2023-20, 5/30/23

Tracy v. Commissioner, T.C. Summ. Op. 2023-20[498], presented the Tax Court with the question of whether a disabled and elderly attorney should be eligible for relief from penalties due to late payment and late filing concerning payroll taxes associated with the winding down of his law practice.

The Law for Failure to Pay and Failure to File – IRC §6651

IRC §6651(a)(1) establishes a penalty for taxpayers who fail to timely file their tax returns, encompassing the payroll tax returns discussed in this particular case. Nevertheless, the penalty can be exempted if the taxpayer can establish that the failure to file was attributable to reasonable cause rather than willful neglect.

The provision reads as follows:

> (a) **Addition to the tax**. In case of failure—
>
> > (1) to file any return required under authority of subchapter A of chapter 61 (other than part III thereof), subchapter A of chapter 51 (relating to distilled spirits, wines, and beer), or of subchapter A of chapter 52 (relating to tobacco, cigars, cigarettes, and cigarette papers and tubes), or of subchapter A of chapter 53 (relating to machine guns and certain other firearms), on the date prescribed therefor (determined with regard to any extension of time for filing), unless it is shown that such failure is due to reasonable cause and not due to willful neglect, there shall be added to the amount required to be shown as tax on such return 5 percent of the amount of such tax if the failure is for not more than 1 month, with an additional 5 percent for each additional month or fraction thereof during which such failure continues, not exceeding 25 percent in the aggregate;

Another penalty associated with these circumstances is specified in IRC §6651(a)(2), which addresses the failure to make timely payments of taxes when they are due. As with the aforementioned penalty, this penalty can be waived if the taxpayer can establish that the failure to pay was a result of reasonable cause rather than willful neglect.

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[498] *Tracy v. Commissioner*, T.C. Summ. Op. 2023-20, May 30, 2023, https://www.taxnotes.com/research/federal/court-documents/court-opinions-and-orders/court-finds-reasonable-cause-for-ailing-attorney%e2%80%99s-failure-to-pay/7gtf0 (retrieved June 3, 2023)

IRC §6651(a)(2) reads as follows:

> (a) **Addition to the tax**. In case of failure—
>
> …
>
> (2) to pay the amount shown as tax on any return specified in paragraph (1) on or before the date prescribed for payment of such tax (determined with regard to any extension of time for payment), unless it is shown that such failure is due to reasonable cause and not due to willful neglect, there shall be added to the amount shown as tax on such return 0.5 percent of the amount of such tax if the failure is for not more than 1 month, with an additional 0.5 percent for each additional month or fraction thereof during which such failure continues, not exceeding 25 percent in the aggregate;

Within this particular case, it is evident that the taxpayer failed to meet the deadlines for paying the payroll tax liabilities and filing the corresponding tax returns. Hence, the pivotal question revolves around whether the taxpayer can provide evidence to establish that these failures were due to reasonable cause and not the outcome of willful neglect.

Facts of this Case

The opinion commences by providing an overview of the factual background of this case.

> Petitioner, 92 years old at the time of this Opinion, was a sole proprietor who operated a law practice during the periods in issue and had done so for approximately 60 years. He did not timely file returns or timely pay his employment tax liabilities for the periods ending September 30, 2017, through June 30, 2019. During this time petitioner was 87 to 88 years old and was closing his solo law practice because of his declining health and advanced age.[499]

During the period of these failures, the taxpayer was grappling with a wide array of substantial challenges and difficulties in his personal life:

> A Navy veteran, petitioner had long been determined disabled because of hearing loss and a back injury that had worsened with time. He was nearly deaf and had significant balance difficulties. Petitioner also suffered from joint disease in his knees and hips (which were in poor condition and needed replacing), atrial fibrillation, hypertension, and cardiopulmonary disease. As he took the steps necessary to close his law practice, petitioner's assistant of more than 25 years helped him in his daily business operations while another attorney substantially worked petitioner's cases. In addition, he relied on a part-time aide for his daily living activities, including grocery shopping, errands, laundry, cooking, and cleaning. During this time, petitioner also cared for his dying wife of 55 years.[500]

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[499] *Tracy v. Commissioner*, T.C. Summ. Op. 2023-20, May 30, 2023

[500] *Tracy v. Commissioner*, T.C. Summ. Op. 2023-20, May 30, 2023

The closure of a law practice presents a distinct set of responsibilities and challenges that exceed those encountered when shutting down other types of businesses. It is crucial to recognize that these responsibilities cannot be disregarded solely due to the challenges confronting the taxpayer.

> An attorney, petitioner had an ethical obligation to his remaining clients. He could not simply close his practice and walk away. Although petitioner's law practice continued to operate, it was not he who did the bulk of the work. Petitioner's assistant and another attorney kept the law practice operating until it closed.
>
> Petitioner's assistant handled his bookkeeping and payroll. Another of petitioner's assistant's duties was to communicate with petitioner's tax preparer and handle petitioner's employment taxes on petitioner's behalf.[501]

However, it is important to recognize that the assistant was keenly aware of the circumstances where the income of the law firm was declining while substantial bills still awaited payment:

> However, the assistant, privy to the law practice's declining income and fearful of losing her job, did not perform the duties assigned to her in relation to petitioner's employment taxes.
>
> Petitioner was not aware that his assistant had shirked her duties. Upon learning of the unfiled returns and unpaid taxes, petitioner promptly filed the returns and paid the taxes. He did not pay the additions to tax but requested that the IRS abate them. The IRS granted petitioner partial abatement of section 6651(a)(2) failure to pay penalties.[502]

Following a Collection Due Process (CDP) hearing, the taxpayer was unable to secure the abatement of other penalties.

> Respondent issued petitioner a levy notice dated August 16, 2021, proposing to collect the unpaid penalties. Petitioner timely requested a collection due process (CDP) hearing, challenging his liability for the penalties. The IRS Independent Office of Appeals (Appeals) assigned the case to a settlement officer (SO). The SO determined that petitioner did not meet the criteria for penalty abatement for reasonable cause under Internal Revenue Manual 20.1.1.3.2.2.1 (Nov. 25, 2011). The SO further found that the IRS had already granted petitioner a partial abatement of the failure to pay penalties. Accordingly, Appeals issued a notice of determination dated April 14, 2022, sustaining the penalties.[503]

The Internal Revenue Manual section referred to by the settlement officer reads as follows:

[501] *Tracy v. Commissioner*, T.C. Summ. Op. 2023-20, May 30, 2023

[502] *Tracy v. Commissioner*, T.C. Summ. Op. 2023-20, May 30, 2023

[503] *Tracy v. Commissioner*, T.C. Summ. Op. 2023-20, May 30, 2023

20.1.1.3.2.2.1 (11-25-2011)

Death, Serious Illness, or Unavoidable Absence

1. Death, serious illness, or unavoidable absence of the taxpayer, or a death or serious illness in the taxpayer's immediate family, may establish reasonable cause for filing, paying, or depositing late for the following:

    a. **Individual:** If there was a death, serious illness, or unavoidable absence of the taxpayer or a death or serious illness in the taxpayer's immediate family (i.e., spouse, sibling, parents, grandparents, children).

    b. **Corporation, estate, trust, etc.:** If there was a death, serious illness, or other unavoidable absence of the taxpayer (person responsible), or a member of such taxpayer's immediate family, and that taxpayer had sole authority to execute the return, make the deposit, or pay the tax.

2. If someone other than the taxpayer, or the person responsible, is authorized to meet the obligation, consider the reasons why that person did not meet the obligation when evaluating the request for relief. In the case of a business, if only one person was authorized, determine whether this was in keeping with ordinary business care and prudence.

3. Information to consider when evaluating a request for penalty relief based on reasonable cause due to death, serious illness, or unavoidable absence includes, but is not limited to, the following:

    a. The relationship of the taxpayer to the other parties involved.

    b. The date of death.

    c. The dates, duration, and severity of illness.

    d. The dates and reasons for absence.

    e. How the event prevented compliance.

    f. If other business obligations were impaired.

    g. If tax duties were attended to promptly when the illness passed, or within a reasonable period of time after a death or return from an unavoidable absence.

The Tax Court Finds Taxpayer Qualifies for Relief

The Tax Court initiates its analysis by providing an overview of the applicable law and the criteria by which a taxpayer can demonstrate reasonable cause and establish the absence of willful neglect.

> Whether a taxpayer had "reasonable cause" and lacked "willful neglect" are questions of fact, and the burden of establishing these facts is on the taxpayer. *United States v. Boyle*, 469 U.S. 241, 245 (1985). To prove reasonable cause for failure to timely file a return, the taxpayer must show that he exercised ordinary business care and prudence and was nevertheless unable to file the return within the prescribed time. *Crocker v. Commissioner*, 92 T.C. 899, 913 (1989); Treas. Reg. § 301.6651-1(c)(1). A taxpayer can show that he did not act with "willful neglect" if he can "prove that the late filing did not result from a 'conscious, intentional failure or reckless indifference.'" *Niedringhaus v. Commissioner*, 99 T.C. 202, 221 (1992) (quoting *Boyle*, 469 U.S. at 245-46).[504]

In particular, the Court discusses how a taxpayer may qualify for relief based on illness or incapacity.

> A taxpayer may have reasonable cause for failure to timely file a return where he experiences an illness or incapacity that prevents him from filing the return. *Boyle*, 469 U.S. at 248 n.6; *Jordan v. Commissioner*, T.C. Memo. 2005-266; *Paradiso v. Commissioner*, T.C. Memo. 2005-187. "Where a taxpayer's disability is raised as part of a reasonable cause defense, we have looked to the severity of the disability and the impact it had on the taxpayer's life. . . ." *Jones v. Commissioner*, T.C. Memo. 2006-176, 2006 WL 2423425, at *6.
>
> Illness or incapacity generally does not prevent a taxpayer from filing returns where the taxpayer is able to continue his business affairs despite the illness or incapacity. See *Hazel v. Commissioner*, T.C. Memo. 2008-134, 2008 WL 2095614, at *3-4; see also *Watts v. Commissioner*, T.C. Memo. 1999-416, 1999 WL 1247548, at *2 ("[A] taxpayer's selective inability to perform his or her tax obligations, while performing their regular business, does not excuse failure to file."). Further, failure to timely file is not excused by a taxpayer's reliance on an agent, and such reliance is not reasonable cause for a late filing under section 6651(a)(1). *McNair Eye Ctr., Inc. v. Commissioner*, T.C. Memo. 2010-81, 2010 WL 1558164, at *2 (citing *Boyle*, 469 U.S. at 252).[505]

Through an examination of the taxpayer's actions in navigating the difficulties he confronted, the Tax Court concludes that there existed reasonable cause for the failure to timely file the returns in question.

> Notwithstanding petitioner's many difficulties due to his failing health and advanced age, petitioner was diligent in exercising ordinary business care and prudence. He had systems in place to ensure tax compliance. Petitioner's systems had not previously failed him in his approximately 60 years of solo law practice. It was reasonable, and not willfully neglectful, for petitioner to trust his systems'

[504] *Tracy v. Commissioner*, T.C. Summ. Op. 2023-20, May 30, 2023

[505] *Tracy v. Commissioner*, T.C. Summ. Op. 2023-20, May 30, 2023

> continued reliability. Further, it was not petitioner's reliance on his assistant but his inability to adequately supervise her (due to his failing health and advanced age) that caused his failure to file. Petitioner acted quickly to file the outstanding returns upon discovering he was out of compliance. Had he been able to supervise his assistant properly, petitioner would have ensured that the returns were filed.[506]

Recognizing the similarity in criteria for demonstrating reasonable cause between failing to timely pay the tax and failing to timely file, the Court determines that reasonable cause indeed exists for the taxpayer's failure to timely pay the tax in question.:

> Given all the facts and circumstances, petitioner was diligent in exercising ordinary business care and prudence in providing for payment of his tax liabilities but was nevertheless unable to pay timely because of his poor health and advanced age. As previously discussed, petitioner had effective systems in place that failed him in his final years of law practice only because he was unable to supervise his assistant properly.[507]

Unique Facts Lead to a Unique Result

The unique set of circumstances in this case results in a outcome that deviates from the potential consequences your client may face when confronted with a failure to file and failure to pay penalty, particularly if an employee entrusted with these responsibilities fails to ensure prompt adherence to the required obligations.

Typically, a taxpayer will not be deemed to have exercised ordinary business care and prudence if they merely delegate actions to a third party but fail to adequately oversee and supervise the actions of that party to ensure the fulfillment of the obligation.

Similarly, if a taxpayer can maintain the continuity of their business operations despite encountering illness or other adversities, it is improbable that the IRS and courts will excuse a failure to meet tax obligations.

In this case, the taxpayer's reliance on the assistant was deemed justified due to multiple factors. Firstly, the assistant had been implementing procedures that had proven successful for the taxpayer throughout his extensive 60-year practice. Additionally, the taxpayer's illness and the responsibility of caring for his terminally ill spouse contributed to the unique circumstances. The Court determined that it was the rare combination of the assistant's procedures failing precisely when the taxpayer encountered numerous challenges that excused his failure to identify the issues earlier.

In a similar vein, despite the law practice's ability to remain functional during this period, it was primarily individuals other than the taxpayer who assumed the responsibility of carrying out the essential business activities required to meet the attorney's obligations towards clients. The practice operated in a manner that deviated significantly from its regular operations during the majority of its existence.

[506] *Tracy v. Commissioner*, T.C. Summ. Op. 2023-20, May 30, 2023

[507] *Tracy v. Commissioner*, T.C. Summ. Op. 2023-20, May 30, 2023

SECTION: ERC

AICPA ISSUES DOCUMENT OUTLINING FACT AND FICTION WHEN DEALING WITH EMPLOYEE RETENTION CREDIT

Citation: "Employee retention credit: Fact or fiction?," AICPA & CIMA, 10/3/22

The AICPA Tax Division has released a three page summary[508] of some key issues with the Employee Retention Credit that is available for download to AICPA Tax Section members.

The document does provide specific statements regarding some claims often heard from organizations involved in heavily marketed ERC study programs where businesses are tempted to pay for such a study with promises of large ERC payments that are claimed to be available to the business. It also provides a short summary document that can be useful to provide to clients confused by what they have been hearing.

A couple of key items found in the document are noted below.

The ERC Applies to Most Small Businesses

Many of the ads promoting these studies at the very least strongly imply that most small businesses will qualify for a significant ERC payment. The document begins by labeling as fiction the claim that "[g]iven GOVID-19's wide-reaching effects, many small businesses will qualify for an employee retention credit (ERG)."

The document notes that the determination of whether a business qualifies for the credit is a complex undertaking:

> Determining whether a business is eligible for the ERG can be pretty complex. Your business must meet the gross receipts test (50% or more reduction for 2020 or a 20% or more decline for 2021 qualifying quarters when compared to 2019 quarters) or experience a full or partial suspension of operations because of a government order. Whether a business experienced a partial suspension is a facts ·and circumstances determination and will vary depending on the location of the business and the government orders.[509]

However, the document notes that a business without a significant decline in revenues can qualify for the credit is a fact—but notes that "there must have been a full or partial suspension of operations BECAUSE OF A GOVERNMENT ORDER that limited commerce, travel or group meetings due to COVID-19." As well, that order "would need to have a more. than a nominal impact on the business to qualify for the ERC."[510]

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[508] "Employee retention credit: Fact or fiction?," AICPA & CIMA, October 3, 2022, https://www.aicpa.org/resources/download/employee-retention-credit-erc-fact-or-fiction (membership required)

[509] "Employee retention credit: Fact or fiction?," AICPA & CIMA, October 3, 2022

[510] "Employee retention credit: Fact or fiction?," AICPA & CIMA, October 3, 2022

Nature of Restrictions

The documents labels as fiction many blanket claims regarding full or partial suspension some clients have reported being told by parties marketing studies to them.

These include:

- *All safety recommendations or guidelines a government agency issues should be considered government orders to suspend operation requirements.* The document notes there are requirements beyond simply recommendations to qualify as an order for these purposes, as well as noting "[n]o federal order during 2020 or 2021 would qualify businesses for the ERC…"[511]

- *My business experienced supply chain disruption, which means it qualifies for the ERC.* The document notes that merely experiencing a supply chain disruption, even if related to the pandemic in some form, wouldn't be sufficient to qualify unless all of the following are met:

  - The business's supplier cannot made deliveries of critical goods due to a qualifying government order (which, based on the previous discussion, would need to be a state or local order),

  - The business cannot purchase these critical goods from an alternative supplier, and

  - The business must experience a more than nominal effect from this issue.[512]

- *My business qualifies for the ERC because employees and clients had to wear masks*.[513] This requirement alone would not qualify as a full or partial suspension of business operations that had a more than nominal effect on the business.

- *My business was in a location where them was a stay-at-home order, and I adjusted operations based on this. This automatically means I can claim the ERC*. Voluntary changes made a business, even if in response to pandemic conditions, related to service demand do not qualify as a full or partial suspension.[514] If the issue is reduction in demand, the business would have to show it met the reduction in gross revenue test.

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[511] "Employee retention credit: Fact or fiction?," AICPA & CIMA, October 3, 2022

[512] "Employee retention credit: Fact or fiction?," AICPA & CIMA, October 3, 2022

[513] "Employee retention credit: Fact or fiction?," AICPA & CIMA, October 3, 2022

[514] "Employee retention credit: Fact or fiction?," AICPA & CIMA, October 3, 2022

SECTION: ERISA
DEPARTMENT OF LABOR WARNS 401(K) PLAN FIDUCIARIES REGARDING OFFERING CRYPTO INVESTMENT OPTION

Citation: "401(k) Plan Investments in 'Cryptocurrencies'", Compliance Assistance Release No. 2022-01, 3/10/22

The US Department of Labor issued a Compliance Assistance Release that contains warnings to 401(k) plans that are offering or are considering offering investments in cryptocurrencies as part of the investment options for 401(k) plan participants.[515]

The Department notes in a footnote that their concerns involve all types of digital assets, not just cryptocurrencies, despite the release only referencing cryptocurrencies:

> Although this release specifically references "cryptocurrencies," the same reasoning and principles also apply to a wide range of "digital assets" including those marketed as "tokens," "coins," "crypto assets," and any derivatives thereof.[516]

The release begins by cautioning plan fiduciaries about needing to exercise extreme care before offering such an option:

> In recent months, the Department of Labor has become aware of firms marketing investments in cryptocurrencies to 401(k) plans as potential investment options for plan participants. The Department cautions plan fiduciaries to exercise extreme care before they consider adding a cryptocurrency option to a 401(k) plan's investment menu for plan participants.[517]

The release points out the duty of plan fiduciaries to act solely in the financial interests of the plan participants:

> Under ERISA, fiduciaries must act solely in the financial interests of plan participants and adhere to an exacting standard of professional care. Courts have commonly referred to these prudence and loyalty obligations as the "highest known to the law." Fiduciaries who breach those duties are personally liable for any losses to the plan resulting from that breach. A fiduciary's consideration of whether to include an option for participants to invest in cryptocurrencies is subject to these exacting responsibilities.[518]

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[515] "401(k) Plan Investments in 'Cryptocurrencies'", Compliance Assistance Release No. 2022-01, March 10, 2022, https://www.dol.gov/agencies/ebsa/employers-and-advisers/plan-administration-and-compliance/compliance-assistance-releases/2022-01 (retrieved March 10, 2021)

[516] "401(k) Plan Investments in 'Cryptocurrencies'", Compliance Assistance Release No. 2022-01, Footnote 1, March 10, 2022

[517] "401(k) Plan Investments in 'Cryptocurrencies'", Compliance Assistance Release No. 2022-01, March 10, 2022

[518] "401(k) Plan Investments in 'Cryptocurrencies'", Compliance Assistance Release No. 2022-01, March 10, 2022

The Department goes on to warn fiduciaries that they cannot shift this responsibility to the participants regarding the prudence of this investment option:

> In a defined contribution plan, such as a 401(k) plan, the value of a participant's retirement account depends on the investment performance of the employee's and employer's contributions. When defined contribution plans offer a menu of investment options to plan participants, the responsible fiduciaries have an obligation to ensure the prudence of the options on an ongoing basis. Fiduciaries may not shift responsibility to plan participants to identify and avoid imprudent investment options, but rather must evaluate the designated investment alternatives made available to participants and take appropriate measures to ensure that they are prudent. As the Supreme Court recently explained, "even in a defined-contribution plan where participants choose their investments, plan fiduciaries are required to conduct their own independent evaluation to determine which investments may be prudently included in the plan's menu of options."[519]

Specifically, the Department states:

> The failure to remove imprudent investment options is a breach of duty.[520]

As you may surmise from that warning, the Department believes it is very likely such options are an imprudent option in most cases. The Department warns that these investments in virtual assets present significant risks and challenges to participants' retirement accounts, including significant risks of fraud, theft and loss, for the following reasons:

- **Speculative and Volatile Investments**: The Securities and Exchange Commission (SEC) staff has cautioned that investment in a cryptocurrency is highly speculative. At this stage in their development, cryptocurrencies have been subject to extreme price volatility, which may be due to the many uncertainties associated with valuing these assets, speculative conduct, the amount of fictitious trading reported, widely published incidents of theft and fraud, and other factors. Extreme volatility can have a devastating impact on participants, especially those approaching retirement and those with substantial allocations to cryptocurrency.

- **The Challenge for Plan Participants to Make Informed Investment Decisions:** Cryptocurrencies are often promoted as innovative investments that offer investors unique potential for outsized profits. These investments can all too easily attract investments from inexpert plan participants with great expectations of high returns and little appreciation of the risks the investments pose to their retirement investments. Cryptocurrencies are very different from typical retirement plan investments, and it can be extraordinarily difficult, even for expert investors, to evaluate these assets and separate the facts from the hype. Participants are less likely to have sufficient knowledge about these investments, as compared to traditional investments, or to have the technical expertise necessary to make informed decisions about investing in them. When plan fiduciaries, charged with the duties of prudence and loyalty, choose to include a cryptocurrency option on a 401(k) plan's menu, they effectively tell the plan's participants that knowledgeable investment experts have approved the cryptocurrency option as a prudent option for plan participants. This can easily lead plan participants astray and cause losses.

[519] "401(k) Plan Investments in 'Cryptocurrencies'", Compliance Assistance Release No. 2022-01, March 10, 2022

[520] "401(k) Plan Investments in 'Cryptocurrencies'", Compliance Assistance Release No. 2022-01, March 10, 2022

- **Custodial and Recordkeeping Concerns**: Cryptocurrencies are not held like traditional plan assets in trust or custodial accounts, readily valued and available to pay benefits and plan expenses. Instead, they generally exist as lines of computer code in a digital wallet. With some cryptocurrencies, simply losing or forgetting a password can result in the loss of the asset forever. Other methods of holding cryptocurrencies can be vulnerable to hackers and theft. These are just a few examples of the custodial and recordkeeping issues that may present additional difficulties for fiduciaries of retirement plans.

- **Valuation Concerns**: The Department is concerned about the reliability and accuracy of cryptocurrency valuations. Experts have described the question of how to appropriately value cryptocurrencies as complex and challenging. Experts have fundamental disagreements about important aspects of the cryptocurrency market, noting that none of the proposed models for valuing cryptocurrencies are as sound or academically defensible as traditional discounted cash flow analysis for equities or interest and credit models for debt. Compounding these concerns, cryptocurrency market intermediaries may not adopt consistent accounting treatment and may not be subject to the same reporting and data integrity requirements with respect to pricing as other intermediaries working with more traditional investment products.

- **Evolving Regulatory Environment:** Rules and regulations governing the cryptocurrency markets may be evolving, and some market participants may be operating outside of existing regulatory frameworks or not complying with them. Fiduciaries who are considering whether to include a cryptocurrency investment option will have to include in their analysis how regulatory requirements may apply to issuance, investments, trading, or other activities and how those regulatory requirements might affect investments by participants in 401(k) plans. For example, the sale of some cryptocurrencies could constitute the unlawful sale of securities in unregistered transactions. Plan fiduciaries must take care to avoid participating in unlawful transactions, exposing themselves to liability and plan participants to the risks of inadequate disclosures and the loss of investor protections that are guaranteed under the securities laws. In addition, as the Financial Industry Regulatory Authority (FINRA) has cautioned, Bitcoin and impliedly other cryptocurrencies have "… been used in illegal activity, including drug dealing, money laundering, and other forms of illegal commerce. Abuses could impact consumers and speculators; for instance, law enforcement agencies could shut down or restrict the use of platforms and exchanges, limiting or shutting off the ability to use or trade bitcoins."[521]

And, just in case the above language didn't dissuade the fiduciary yet, the DOL concludes by announcing an investigative program aimed at plans that offer these options:

> Based on these and other concerns, EBSA expects to conduct an investigative program aimed at plans that offer participant investments in cryptocurrencies and related products, and to take appropriate action to protect the interests of plan participants and beneficiaries with respect to these investments. The plan fiduciaries responsible for overseeing such investment options or allowing such investments through brokerage windows should expect to be questioned about how they can square their actions with their duties of prudence and loyalty in light of the risks described above.[522]

[521] "401(k) Plan Investments in 'Cryptocurrencies'", Compliance Assistance Release No. 2022-01, March 10, 2022

[522] "401(k) Plan Investments in 'Cryptocurrencies'", Compliance Assistance Release No. 2022-01, March 10, 2022

SECTION: FBAR REPORTING
IGNORANCE WAS NOT BLISS: CPA FOUND LIABLE FOR OVER $663,000 OF FBAR PENALTIES FOR ACCOUNTS HE FAILED TO REPORT

Citation: United States v. Kronowitz, USDC SD Fla., Case No. 19-cv-62648-BLOOM/Valle, 6/3/21

A CPA with 60 years of experience in preparing tax returns found that the Court wasn't very sympathetic regarding his failure to file FBAR reports, even though income had been (kind of) reported in the case of *United States v. Kronowitz*.[523]

Taxpayer's Background as a CPA

The taxpayer in this case was a CPA who had a small practice that consisted mainly of individuals and small local businesses.[524] His practice was described as follows:

> Kronowitz was a professional tax preparer and has been preparing tax returns since 1961 or 1962. For the majority of his career, he prepared between thirty (30) and forty (40) tax returns per year. He began to wind down his practice in 2008 because of his declining health. Nevertheless, as recently as 2020, he was preparing tax returns for others for money. Indeed, for tax years 2019 and 2020, he prepared approximately ten (10) to fifteen (15) federal income tax returns each year. In his tax preparation practice, he prepared 1040s (personal returns) and 1120s (corporate returns) for subchapter S corporations. He also prepared his own tax returns.[525]

The Court noted that Mr. Kronowitz had been required to regularly attend continuing professional education courses:

> In order to maintain his CPA certification, he was required to participate every two years in eighty (80) hours of continuing professional education ("CPE"). During the course of his career, he took CPE courses such as Tax Shelter Seminar, Foreign Taxation, Offshore Trusts, and Asset Protection/Est[ate] Pl[an]ning. He does not recall the FBAR being specifically mentioned in any CPE class.[526]

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[523] *United States v. Kronowitz*, USDC SD Fla., Case No. 19-cv-62648-BLOOM/Valle, June 3, 2021, https://www.taxnotes.com/research/federal/court-documents/court-opinions-and-orders/longtime-cpa-is-liable-for-willful-fbar-penalties/76khr (retrieved June 4, 2021)

[524] *United States v. Kronowitz*, USDC SD Fla., Case No. 19-cv-62648-BLOOM/Valle, June 3, 2021

[525] *United States v. Kronowitz*, USDC SD Fla., Case No. 19-cv-62648-BLOOM/Valle, June 3, 2021

[526] *United States v. Kronowitz*, USDC SD Fla., Case No. 19-cv-62648-BLOOM/Valle, June 3, 2021

Offshore Accounts

Mr. Kronowitz's offshore adventures began when a client allowed the CPA to invest in a portion of certain projects in different countries:

> Eli Levy, a real estate developer, was a client of Kronowitz's beginning in the 1970s. Kronowitz did Levy's Florida business returns but did not handle his personal returns or anything in other countries. However, Levy did give Kronowitz the opportunity to buy one or two percent of a couple of projects in different countries as a reward for good service. Kronowitz knew he was investing in properties in different countries.[527]

Mr. Kronowitz did not ask a lot of questions about the investments he made with Mr. Levy:

> Kronowitz invested with Levy mostly in the 1970s. He would meet with Levy in person and give him a check for the investment. In return, Levy did not give him any statement or confirmation of the investment because the documents were in foreign languages. In addition, according to Kronowitz, Levy told him that if he thought Levy was trying to "screw" him, then he should not invest with Levy. Nevertheless, Kronowitz invested with Levy because he had a good feeling about Levy. Kronowitz never signed anything for Levy (other than the checks he gave Levy). Kronowitz's only record of his investments with Levy was a yellow legal pad on which he kept notes on the basis of the investments. Kronowitz does not have the yellow legal pad anymore.[528]

As well, in 1999 Mr. Kronowitz became involved with a number of foreign entities which he believes may have been established via information he had given to Mr. Levy:

> In 1999, Kronowitz's signature and former office address appeared on a document titled "Management and Administration Agreement," (the "Agreement"), ECF No. [48-8], regarding the management of an entity called Cramo Stiftung/Foundation ("Cramo"). The Agreement is between Kronowitz and an entity named Consista Treuunternehmen ("Consista"), a company in Liechtenstein, and empowers Consista to manage Cramo on behalf of Kronowitz. The Agreement is also signed by an individual named Beat Kranz, on behalf of Consista, and as director of Cramo. Kronowitz is designated as the beneficial owner of Cramo's assets, and if he is deceased, his wife is the secondary beneficiary. Kronowitz testified that he does not know what Cramo Stiftung or Cramo Foundation is, and he never met Beat Kranz. Kronowitz testified that he may have spoken to Kranz once or twice on a phone call. Kronowitz gave his personal information to Levy, including his wife and children's names and birth dates, and believes that Levy must have given that information to Consista. Although Kronowitz does not remember signing any documents for Levy or for Consista, his signature appears on the Agreement. ECF No. [48-8] at 3.
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> On October 10, 2005, Cramo opened an account at United Bank of Switzerland ("UBS"), for which Kronowitz was listed as the beneficial owner on the account

[527] *United States v. Kronowitz*, USDC SD Fla., Case No. 19-cv-62648-BLOOM/Valle, June 3, 2021

[528] *United States v. Kronowitz*, USDC SD Fla., Case No. 19-cv-62648-BLOOM/Valle, June 3, 2021

> opening paperwork. Kronowitz was the beneficiary of the account held at UBS by Cramo from 2005 to 2009.[529]

Asset Protection and Offshore Accounts and Trusts

In addition to these investments, Mr. Kronowitz looked to utilize offshore accounts and trust for asset protection. As the opinion noted, one of the things he did remember being discussed at CPE courses was asset protection and the advantages of having assets offshore:

> He does recall attending a course given by a University of Miami lecturer during which the movement of assets offshore for protection of those assets was discussed. …
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> Based upon Kronowitz's attendance at the CPE course in which he remembers being advised that professionals should move assets offshore for protection, and a rumor that a former client, Irwin Mogerman, was going to sue him for fraud related to his work for Mogerman's company Grand Prix Race-o-Rama, Kronowitz opened two bank accounts in the Cayman Islands in 2001 ("Cayman Accounts"). Kronowitz had signature authority and was the financial beneficiary of the Cayman Accounts. His purpose in opening the Cayman Accounts was to keep funds out of reach from potential creditors[530]

Dealing with the Gains from the Levy Investments

Mr. Kronowitz had significant gains from the Levy investments, so he also established a trust and reported gain on the trust tax returns:

> By 2008, Kronowitz's investments with Levy had generated significant gains. In order to protect and manage the gains, Kronowitz created the 1210 Trust ("Trust"). In 2008, someone associated with Levy contacted Kronowitz and told him to contact Consista to direct where Kronowitz wanted the proceeds from his investments with Levy sent. In response, Kronowitz contacted Consista and instructed them to send the proceeds to one of his Cayman Accounts. He called the Caymans bank to verify that the wire transfers from Consista were completed. The Trust's assets in its bank account were comprised solely of transfers from Kronowitz's Cayman Accounts. Nevertheless, the Trust did not own the Cayman Accounts. Kronowitz used the information on the yellow legal pad to report the gains from his investments with Levy on his Trust's tax returns.
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> On March 27, 2009, the funds held by Cramo at UBS were transferred to an account at Basler Kantonalbank ("BKB"), which was opened for Kronowitz's benefit. Kronowitz was identified as the beneficial owner of the account. All correspondence from the BKB account were directed to Consista.
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> On August 11, 2009, Kronowitz sent correspondence to an individual with initials "R.Z." and directed R.Z. to transfer $300,000.00 "to my account. You have the information on file." ECF No. [41] at 14, ¶ 56; see also ECF No. [48-9].

[529] *United States v. Kronowitz*, USDC SD Fla., Case No. 19-cv-62648-BLOOM/Valle, June 3, 2021

[530] *United States v. Kronowitz*, USDC SD Fla., Case No. 19-cv-62648-BLOOM/Valle, June 3, 2021

> Finally, on December 6, 2010, Kronowitz e-mailed Consista and instructed them to "liquidate my account and forward all moneys as you did before to my account in the [C]aymans." Id. ¶ 57. On December 29, 2010, Cramo wired $318,067.53 to the Cayman Accounts.[531]

Dealing With Those Pesky FBAR Questions on Tax Returns

Mr. Kronowitz did report various items of income from the offshore investments on various tax returns—but answered any questions regarding the existence of offshore accounts with a "No."

> Kronowitz prepared his own tax returns for tax years 2005, 2006, 2007, 2008, 2009, and 2010. Schedule B is an attachment to the individual federal income tax return (Form 1040) that is used for reporting interest and dividend income, as well as any financial interest in, or signature authority over, financial accounts located in foreign countries. See ECF No. [41] at 9, ¶ 17. Kronowitz was required to file a Schedule B in conjunction with his 2005 through 2010 individual income tax returns; however, Kronowitz did not disclose his financial interest in foreign accounts in a Schedule B or in an FBAR for his 2005 through 2010 individual tax returns. In fact, on the Schedule B form filed with his 2008 tax return, in response to the question asking "[a]t any time during 2008, did you have an interest in or signature or other authority over a financial account in a foreign country, such as a bank account, securities account or other financial account?" Kronowitz marked "no." Id. at 10, ¶ 21. Furthermore, there were no Schedule B forms attached to the 2005, 2006, 2009, or 2010 individual tax returns.
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> …
>
> Kronowitz also prepared the tax returns for the Trust for tax years 2008, 2009, and 2010. He marked "no" in response to the question asking, "[a]t any time during [the] calendar year [ ], did the estate or trust have an interest in or a signature or other authority over a bank, securities, or other financial account in a foreign country?" On the 2008 Trust tax return, Kronowitz disclosed $370,700.00 in gains from investments from Brazil, Panama, and Israel. On the 2009 Trust tax return, Kronowitz disclosed $281,725.00 in gains from investments in the Cayman Islands and Brazil. On the 2010 Trust tax return, Kronowitz disclosed $296,218.00 in gains from investments in foreign countries. However, beyond writing the names of certain of the Levy investments on the 2008, 2009, and 2010 Trust tax returns, Kronowitz did not otherwise disclose his interest in any foreign accounts or assets. See ECF No. [48-6].[532]

Obviously, there are some issues here with how the tax returns in question were prepared. But Mr. Kronowitz testified that he had not read the instructions for Schedule B—and that reading such instructions wasn't really a concern of his:

> Kronowitz testified that he has probably seen hundreds of Schedule Bs over the course of his career, but admitted that he probably did not read the instructions to Schedule B because he is an accountant and not an attorney. In addition, he stated

[531] *United States v. Kronowitz*, USDC SD Fla., Case No. 19-cv-62648-BLOOM/Valle, June 3, 2021

[532] *United States v. Kronowitz*, USDC SD Fla., Case No. 19-cv-62648-BLOOM/Valle, June 3, 2021

> that he was more concerned with taking care of his clients and providing for his family.[533]

Failure to File FBAR Returns

As was noted, Mr. Kronowitz failed to file FBAR returns, even for years where he presumably had read the question regarding offshore accounts (since he answered the questions no). The Court provided Mr. Kronowitz's explanation:

> Although required to do so, Kronowitz admits that he did not timely file FBARs for tax years 2005 through 2010. In preparing tax returns, Kronowitz was aware of the question asking about interests in foreign accounts, but he did not do any research, nor did he look up form number TDF90-22.1 (the FBAR) referenced in the returns. He testified that he had not heard of the FBAR and that he had no knowledge that he was a beneficiary of the UBS and BKB accounts, until he hired an attorney to represent him before the IRS during an audit in 2011. Kronowitz believed that if he reported the income from a foreign source on the Trust tax returns, he had complied with his tax obligations. He never asked anybody about this assumption—he thinks he heard it at a seminar or read it somewhere. He did not see a difference in reporting the income on the Trust return or on his individual return as long as the amounts were reported and the taxes paid.[534]

The IRS examined Mr. Kronowitz and, unfortunately for Mr. Kronowitz, the IRS agent *did* know about the FBAR requirements. In November 2017 the IRS assessed penalties for failing to file FBAR forms for 2005-2010 in the amount of $663,771.[535]

The IRS position was that Mr. Kronowitz's failure to file the FBAR returns was willful, which triggered these rather massive penalties.

Willful Failure to File the Return and Recklessness

Obviously, Mr. Kronowitz claims that his failure to file these forms was not willful—he was just ignorant of his filing responsibilities, so how could his failure be willful?

However, the Court notes that to be willful under these rules, the violation does not have to be a knowing violation if the taxpayer behaves recklessly in failing to attempt to become properly aware of the responsibility.

> The statutes and regulations at issue in this case do not define the term willful; however, the BSA identifies the applicable penalty as a "civil money penalty." 31 U.S.C. § 5321(a)(5)(A). "[W]here willfulness is a statutory condition of civil liability, we have generally taken it to cover not only knowing violations of a standard, but reckless ones as well." *Safeco Ins. Co. of Am. v. Burr*, 551 U.S. 47, 57 (2007). "While the term recklessness is not self-defining, the common law has generally understood it in the sphere of civil liability as conduct violating an

[533] *United States v. Kronowitz*, USDC SD Fla., Case No. 19-cv-62648-BLOOM/Valle, June 3, 2021

[534] *United States v. Kronowitz*, USDC SD Fla., Case No. 19-cv-62648-BLOOM/Valle, June 3, 2021

[535] *United States v. Kronowitz*, USDC SD Fla., Case No. 19-cv-62648-BLOOM/Valle, June 3, 2021

> objective standard: action entailing an unjustifiably high risk of harm that is either known or so obvious that it should be known." *Id*. at 68 (quoting *Farmer v. Brennan*, 511 U.S. 825, 836, 114 S. Ct. 1970, 128 L. Ed 2d 811 (1994)) (internal quotations omitted). In the FBAR context, the United States Court of Appeals for the Eleventh Circuit recently held that "willfulness in the § 5321 includes reckless disregard of a known or obvious risk." *United States v. Rum*, --- F.3d ----, 2021 WL 1589153, at *6 (11th Cir. Apr. 23, 2021).[536]

Citing *United States v. Horowitz*, 978 F.3d 80, 89 (4th Cir. 2020) the opinion finds in this case willfulness based on recklessness is established if the taxpayer:

- Clearly ought to have known that
- There was a grave risk that an accurate FBAR was not being filed *and*
- He was in a position to find out for certain very easily.[537]

The Court found a number of factors supported the view that Mr. Kronowitz's actions were reckless with regard to his FBAR filings.

First, the fact that he had been involved in tax practice for 60 years meant that he was not someone unaware of the tax in general—dealing with tax issues had been his primary business for his life.

The Court was also not impressed with his failure to even consult the instructions for the Schedules that he was preparing:

> He admitted to seeing hundreds of Schedule Bs, and being familiar with the purpose of Schedule B and its requirements, but testified that he probably did not read the instructions because he was more concerned with providing for his family and taking care of his clients. Indeed, he testified that "my purpose in life at the time was to get clients, bill them, and collect the money, not spending the whole year reading[.]"[538]

This author is somewhat amazed the taxpayer expected the Court to believe that someone made it through 60 years of tax practice believing that actually spending time understanding the law he was supposedly following in serving his clients was unnecessary, as well as not realizing such understanding might help in keeping his family safe from the consequences of a failure to properly apply the law (in this case, an amount that has now grown to $753,680.37 by the time the Government filed its complaint).

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[536] *United States v. Kronowitz*, USDC SD Fla., Case No. 19-cv-62648-BLOOM/Valle, June 3, 2021

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[538] *United States v. Kronowitz*, USDC SD Fla., Case No. 19-cv-62648-BLOOM/Valle, June 3, 2021

As well, even what he did read (the questions asking if he had such foreign accounts) he either failed entirely to understand or just intentionally decided to answer in error:

> Furthermore, Kronowitz affirmatively answered "no" to questions regarding interests in foreign accounts on both his individual tax returns and on the Trust tax returns he prepared.[539]

Not wanting to read to find out the proper treatment of items, he claims to have developed his reporting positions by "assuming" none of the details mattered:

> He simply and incorrectly assumed that reporting the gains from his Levy investments would be sufficient to satisfy tax reporting obligations. When asked why he chose to report the gains on the Trust return as opposed to reporting the gains on his personal return, he responded that
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> > …that's where the money went, that's where the money came out to pay the taxes. Okay. From the 1210 Trust. I didn't see any big difference one way or the other. As long as they were reported and the taxes were paid.[540]

Unfortunately for the taxpayer, it turns out this did make a big difference.

Actions Aren't Consistent with a Simple Mistake

The Court also makes clear it doesn't really accept this is just the simple, innocent mistakes of someone who might not have been the most skilled tax researcher among CPAs. Rather, his actions suggest he remained willfully ignorant of key details (which I suspect the Court also believes explains his failure to want to spend time reading up on tax law):

> Beginning with his investments with Levy, Kronowitz displayed a surprisingly laissez-faire attitude—he simply gave Levy his money and did not ask any questions, even when he was given no receipt or acknowledgment for the funds he invested. He also failed to ask any questions about how his funds would be held for him, or how he might access them if needed. Therefore, the Court does not assign much weight to the fact that Kronowitz did not know that he was the beneficiary of two Swiss bank accounts containing the proceeds from his Levy investments. He did not know because he never asked how Levy would handle his investments or the proceeds they might potentially generate. Moreover, even when he learned that his investments had generated significant gains, he still asked no questions and simply directed the transfer of funds to his Cayman Accounts. Similarly, in reporting the gains on those investments, he simply assumed that putting them on the Trust tax return would be sufficient—he neither did any research, nor did he ask anyone with more expertise if his assumption was correct. In addition, despite preparing hundreds of tax returns and his familiarity with the forms, which contain instructions and questions pertaining

[539] *United States v. Kronowitz*, USDC SD Fla., Case No. 19-cv-62648-BLOOM/Valle, June 3, 2021

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> specifically to interests in foreign accounts, he never inquired whether his foreign accounts might trigger any additional obligations on his part.[541]

The circuitous route funds took to get into the Trust accounts additionally caught the attention of the Court.

> Moreover, the manner in which Kronowitz handled the gains from his Levy investments does not support a finding that he was simply mistaken, as opposed to reckless under the circumstances. Once Kronowitz learned that his investments with Levy had generated significant gains, he gave instructions for the funds to be transferred first to the Caymans, and then to the Trust, rather than directly to the Trust's bank account in the United States. In addition, he admittedly opened the Cayman Accounts to keep assets out of reach of potential creditors, like Mogerman, based upon advice he heard during a CPE course; but without conducting any follow- up to determine the potential tax effects of maintaining offshore accounts. See ECF No. [41] at 11, ¶ 27 ("The purpose of opening these [Cayman Accounts] was that if Kronowitz was to be sued for malpractice, such funds could not be reached by the potential creditor."). Kronowitz testified at trial that in connection with the advice he heard regarding moving assets offshore, "[t]hat's when I opened the account in the Caymans and put some money over there. I didn't have a lot, but I put some." And while Kronowitz insists that there was no intent to defraud the IRS, no fraudulent intent is required for a finding of willfulness in the FBAR context.[542]

Finally, the Court rejected the claim that his declining health had compromised his cognitive abilities:

> In support of the defense that his failure to file FBARs was not willful or reckless, Kronowitz introduced evidence at trial. That evidence consisted of the testimony of his daughter, Tracy Falkowitz, and his wife, Sybil Kronowitz, that he has experienced significant declines in his health and memory in recent years. However, the evidence does not establish that Kronowitz's declining health affected his behavior during the relevant time period, such that it would support a finding that his violations were not reckless. Although the Court is sympathetic to Kronowitz's recent lapses in memory and additional health complications, there was no medical evidence presented at trial to establish that Kronowitz's cognitive abilities were compromised during the relevant tax years. Rather, the evidence demonstrates that his actions related to the handling of his accounts and the gains from his investments with Levy were purposeful and deliberate.[543]

Court's Summary – The CPA Should Have Known

The Court concludes the opinion as follows:

> Based upon Kronowitz's background and experiences as a CPA and tax preparer, and the totality of his actions in this case, the Court finds that he clearly ought to

[541] *United States v. Kronowitz*, USDC SD Fla., Case No. 19-cv-62648-BLOOM/Valle, June 3, 2021

[542] *United States v. Kronowitz*, USDC SD Fla., Case No. 19-cv-62648-BLOOM/Valle, June 3, 2021

[543] *United States v. Kronowitz*, USDC SD Fla., Case No. 19-cv-62648-BLOOM/Valle, June 3, 2021

> have known that there was a grave risk that he was failing to comply with the FBAR requirements with respect to his foreign accounts. Furthermore, he was in a position to find out for certain very easily, had he taken the time to either conduct independent research, or consult with another person more knowledgeable on tax law as to whether any additional reporting requirements might apply to him.[544]

SECTION: LEGISLATION
THREE PROPOSED BILLS INTRODUCED BY CHAIR OF WAYS & MEANS COMMITTEE

Citation: H.R. 3936, "Tax Cuts for Working Families Act", H.R. 3937, "Small Business Jobs Act" and H.R. 3938, "Build It In America Act", 6/9/23

The Chair of the House Ways and Means Committee has recently introduced three tax bills. These bills are slated for consideration by the Committee during the week commencing June 12. These bills are anticipated to serve as the initial framework for negotiations in crafting a tax bill or bills that could potentially be enacted in 2023.

The bills introduced on Friday, June 9, 2023 are:

- H.R. 3936, "Tax Cuts for Working Families Act"[545]
- H.R. 3937, "Small Business Jobs Act"[546] and
- H.R. 3938, "Build It In America Act"[547]

H.R. 3936, "Tax Cuts for Working Families Act"

The initial bill renames the standard deduction as the *guaranteed deduction* and proposes a temporary increase in its amount. In the report on the bill, the Joint Committee on Taxation describes the increase as follows:

> The proposal adds a new bonus guaranteed deduction for taxable years beginning after December 31, 2023, and before January 1, 2026. The bonus guaranteed deduction is allowed in addition to the basic guaranteed deduction and additional guaranteed deduction (i.e., the guaranteed deduction is the sum of the basic guaranteed deduction, the additional guaranteed deduction, and, if applicable, the bonus guaranteed deduction).

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[544] *United States v. Kronowitz*, USDC SD Fla., Case No. 19-cv-62648-BLOOM/Valle, June 3, 2021

[545] HR 3936, "Tax Cuts for Working Families Act, June 9, 2023, https://www.congress.gov/118/bills/hr3936/BILLS-118hr3936ih.pdf (retrieved June 10, 2023)

[546] HR 3937, "Small Business Jobs Act", June 9, 2023, https://www.congress.gov/bill/118th-congress/house-bill/3937?q=%7B%22search%22%3A%5B%22HR+3937%22%5D%7D&s=2&r=1 (retrieved June 10, 2023)

[547] HR 3938, "Build It In America Act", June 9, 2023, https://www.congress.gov/118/bills/hr3938/BILLS-118hr3938ih.pdf (retrieved June 10, 2023)

> For taxable years beginning in 2024, the amount of the bonus guaranteed deduction is $2,000 for an unmarried individual (other than a head of household or a surviving spouse) and a married individual filing a separate return, $3,000 for a head of household, and $4,000 for married individuals filing a joint return and a surviving spouse. For taxable years beginning in 2025, these amounts are indexed for inflation. The bonus guaranteed deduction does not apply to taxable years beginning after December 31, 2025.[548]

The credit also phases out at higher income levels:

> The bonus guaranteed deduction is phased out at a five-percent rate for taxpayers with modified AGI above certain thresholds. This threshold is $200,000 for an unmarried individual (other than a head of household or a surviving spouse) and a married individual filing a separate return, $300,000 for a head of household, and $400,000 for married individuals filing a joint return and a surviving spouse. Modified AGI means AGI increased by any amount excluded from gross income under sections 911 (foreign earned income exclusion), 931 (exclusion of income for a bona fide resident of American Samoa), or 933 (exclusion of income for a bona fide resident of Puerto Rico). In 2024, after application of the five-percent phaseout the bonus guaranteed deduction is fully eliminated at $240,000 of modified AGI for an unmarried individual (other than a head of household or a surviving spouse) and a married individual filing a separate return, at $360,000 for a head of household, and at $480,000 for married individuals filing a joint return and a surviving spouse.11 Figure 1 below, illustrates the amount of the guaranteed deduction under the proposal in comparison with the amount of the standard deduction under present law allowed to different categories of taxpayers by modified AGI for 2024.[549]

This particular provision constitutes the sole provision within this bill, making it notably shorter compared to the other two bills by a significant margin.

H.R. 3937, "Small Business Jobs Act"

The second bill is the "Small Business Jobs Act" and, per its table of contents, contains the following provisions:

- Increase in threshold for requiring information reporting with respect to certain payees.
- Restoration of reporting rule for third party network transactions.
- Modifications to exclusion for gain from qualified small business stock.
- Increase in limitations on expensing of depreciable business assets.
- Establishment of special rules for capital gains invested in rural opportunity zones.
- Reporting on qualified opportunity funds and qualified rural opportunity funds.

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548 Joint Committee on Taxation, *Description of H.R. 3936, the "Tax Cuts for Working Families Act"* (JCX-25-23), June 9, 2023, https://www.jct.gov/publications/2023/jcx-25-23/ (retrieved June 10, 2023)

549 Joint Committee on Taxation, *Description of H.R. 3936, the "Tax Cuts for Working Families Act"* (JCX-25-23), June 9, 2023

Among the provisions within this bill, the changes to the information reporting rules are anticipated to have the most extensive impact across various sectors and stakeholders.

The first change significantly increases the threshold for filing most information reporting returns for payments made after December 31, 2023. The Joint Committee's report on this bill describes the changes as follows:

> The proposal increases the information reporting threshold under sections 6041 and 6041A to $5,000 in a calendar year, with the threshold amount (including the threshold for reporting of direct sales) to be indexed annually for inflation in calendar years after 2024.
>
> The proposal also makes a conforming change to the dollar threshold in section 3406 with respect to information reporting required under sections 6041 and 6041A to align with the new $5,000 reporting threshold. Under the proposal, both the information reporting thresholds and the backup withholding thresholds are for transactions that equal or exceed $5,000 (indexed for inflation for calendar years after 2024).[550]

The second information reporting change in the bill seeks to retroactively reverse the modifications made to reporting third-party network transactions, which were initially scheduled to take effect for payments in 2022 but were deferred by the IRS for one year.

> The proposal reverts to the previous de minimis reporting exception for third party settlement organizations. A third party settlement organization is not required to report unless the aggregate value of third party network transactions with respect to a participating payee for the year exceeds $20,000 and the aggregate number of such transactions with respect to a participating payee exceeds 200.
>
> The obligations of a merchant acquiring entity are unchanged. For example, if a business that provides a web-based rental platform for short-term travelers is considered a third party settlement organization, it does not have to provide a Form 1099-K to property owners participating on its web-based platform who have received payments of $20,000 or less. Alternatively, if a company is considered a merchant acquiring entity, it must issue a Form 1099-K to all participating payees who have received payments of any amount starting with the first dollar.[551]

The other provisions descriptions are found in the Joint Committee Reports.

H.R. 3938, "Build It In America Act"

The largest bill in the package is the Build It In America Act, which combines the temporary deferral of three revenue-raising business provisions from the Tax Cuts and Jobs Act with the repeal of certain key items from the Inflation Reduction Act of 2022.

[550] Joint Committee on Taxation, *Description of H.R. 3937, the "Small Business Jobs Act"* (JCX-26-23), June 9, 2023, https://www.jct.gov/publications/2023/jcx-26-23/ (retrieved June 10, 2023)

[551] Joint Committee on Taxation, *Description of H.R. 3937, the "Small Business Jobs Act"* (JCX-26-23), June 9, 2023

However, the inclusion of the repeal of provisions enacted last year has led most observers to believe that a bill containing those provisions is unlikely to pass the Senate. Likewise, in the previous year, Democrats had emphasized the requirement of adding an extension of an enhanced Child Tax Credit as part of a bill that would defer the effective date of those business provisions to gain their support. This further contributes to the perception that significant modifications would be necessary for this bill to gain passage in the Senate.

Nevertheless, if anything from this bill does become law, the most likely would be the three business tax revenue raiser deferral provisions.

The proposal in question provides for a temporary suspension of the application of section 174, specifically for research or experimental expenditures paid or incurred in taxable years commencing after December 31, 2021, and before January 1, 2026. During the period of the suspension, the proposal introduces rules (under new section 174A) that closely resemble the rules outlined in the previous law's section 174, governing such expenditures.

The Joint Committee Report on this bill outlines the temporary suspension of IRC §174 as follows:

> The proposal temporarily suspends the application of section 174 for research or experimental expenditures paid or incurred in taxable years beginning after December 31, 2021, and before January 1, 2026. For expenditures to which the suspension of the application of section 174 applies, the proposal provides rules (in new section 174A) similar to the rules of prior law section 174.[552]

The description continues describing provisions added in new IRC §174A:

> The proposal provides that research or experimental expenditures paid or incurred by a taxpayer during the taxable year in connection with the taxpayer's trade or business are deductible. Alternatively, a taxpayer may elect to either (1) capitalize part or all of its research or experimental expenditures and recover them ratably over the useful life of the research (but in no case over a period of less than 60 months), or (2) capitalize part or all of its research or experimental expenditures to a capital account.
>
> Similar to present law section 174, research or experimental expenditures include software development costs.
>
> The proposal requires a taxpayer to reduce the amount taken into account as research or experimental expenditures (whether expensed or capitalized) by the amount of the research credit allowable under section 41. Taxpayers instead may elect to claim a reduced research credit amount under section 41.[553]

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[552] Joint Committee on Taxation, *Description of H.R.3938, the "Build It in America Act"* (JCX-28-23), June 9, 2023, https://www.jct.gov/publications/2023/jcx-28-23/ (retrieved June 10, 2023)

[553] Joint Committee on Taxation, *Description of H.R.3938, the "Build It in America Act"* (JCX-28-23), June 9, 2023

Special rules for taxpayers using the percentage of completion method under IRC §460 are described nest:

> For purposes of recognizing taxable income under the percentage of completion method of section 460, a taxpayer that pays or incurs a research or experimental expenditure under a long-term contract must include the amount paid or incurred as a cost allocated to the contract for the taxable year. For example, a taxpayer that pays or incurs $100 of research or experimental expenditures under a long-term contract must include that $100 as a cost allocated to the contract in that year for purposes determining the percentage of completion under section 460, regardless of whether it deducts the full $100 or instead claims a smaller amortization deduction in that year.[554]

The act provides a provision that clarifies the treatment of the change to amortization of such expenses beginning in 2026:

> The proposal treats the requirement to capitalize and amortize research or experimental expenditures paid or incurred in taxable years beginning after December 31, 2025 as a change in the taxpayer's method of accounting for purposes of section 481. This change is treated as initiated by the taxpayer, is treated as made with the consent of the Secretary, and is applied prospectively on a cut-off basis with no corresponding catch-up adjustment to taxable income under section 481(a).[555]

The Committee Report describes proposed modifications to treatment of these expenses for alternative minimum tax purposes:

> For research or experimental expenditures paid or incurred in taxable years beginning after December 31, 2025, the proposal coordinates the applicable rules (that is, the present law section 174 rules that the proposal temporarily suspends) with the application of the alternative minimum tax rules for individuals, including the optional election under section 59(e), and the rules for making certain basis adjustments. Under these coordination rules, neither the adjustment to an individual's alternative minimum taxable income under section 56(b)(2) nor the election under section 59(e)(2)(B) to capitalize and amortize research and experimental expenditures over 10 years apply to specified research or experimental expenditures. In addition, the proposal clarifies that the basis of property is reduced by amortization deductions allowed under section 174(a). For purposes of recognizing taxable income under the percentage of completion method of section 460, a taxpayer that pays or incurs a specified research or experimental expenditure under a long-term contract in a taxable year must include the amortization deduction under section 174(a) as a cost allocated to the contract in that year.[556]

[554] Joint Committee on Taxation, *Description of H.R.3938, the "Build It in America Act"* (JCX-28-23), June 9, 2023

[555] Joint Committee on Taxation, *Description of H.R.3938, the "Build It in America Act"* (JCX-28-23), June 9, 2023

[556] Joint Committee on Taxation, *Description of H.R.3938, the "Build It in America Act"* (JCX-28-23), June 9, 2023

The description of the research and experimental expenditures changes concludes by describing two elective transition rules:

> The proposal provides two elective transition rules. The first election allows a taxpayer that adopts a method of accounting under section 174 before the date of the proposal's enactment for the taxpayer's first taxable year beginning after December 31, 2021, to treat the application of the temporary rules as a change in method of accounting initiated by the taxpayer for the taxpayer's immediately succeeding taxable year with a catch-up adjustment to taxable income under section 481(a) made on a modified cut-off basis.32
>
> The second transition rule allows an eligible taxpayer to make a late election under section 59(e)(2)(B) to capitalize and amortize research or experimental expenditures over 10 years by filing an amended income tax return within one year of the date of enactment.33 An eligible taxpayer is any taxpayer that does not elect the application of the first transition rule, and that filed an income tax return for the taxpayer's first taxable year beginning after December 31, 2021, before the earlier of the due date for that return and the date of enactment.[557]

The change to the computation of adjusted taxable income, extending the period for which the limitation is based on earnings before interest, taxes, depreciation and amortization (EBITA limitation) is described as follows:

> The proposal temporarily extends the EBITDA limitation under section 163(j) to apply to taxable years beginning before January 1, 2026. Thus, under the proposal, adjusted taxable income is computed without regard to the deduction for depreciation, amortization, or depletion for taxable years beginning before January 1, 2026.[558]

While this proposal is effective for taxable years beginning after December 31, 2022, the Joint Committee Report describes an elective transition rule to apply the EBITA limitation to 2022:

> The proposal provides an elective transition rule that allows a taxpayer to elect to apply the extension of the EBITDA limitation under section 163(j) to taxable years beginning after December 31, 2021.[559]

The report also describes the extension of the 100% bonus depreciation rules for 2023-2025:

> The proposal extends the allowance of a 100-percent bonus depreciation deduction for property placed in service after December 31, 2022, and before January 1, 2026 (January 1, 2027, for longer production period property and certain aircraft), as well as for specified plants planted or grafted after December 31, 2022, and before January 1, 2026. The proposal retains the present law 20-percent bonus depreciation deduction that is allowed for property placed in service after December 31, 2025, and before January 1, 2027 (after December 31, 2026, and before January 1, 2028, for longer production period property and

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[557] Joint Committee on Taxation, *Description of H.R.3938, the "Build It in America Act"* (JCX-28-23), June 9, 2023

[558] Joint Committee on Taxation, *Description of H.R.3938, the "Build It in America Act"* (JCX-28-23), June 9, 2023

[559] Joint Committee on Taxation, *Description of H.R.3938, the "Build It in America Act"* (JCX-28-23), June 9, 2023

certain aircraft), as well as for specified plants planted or grafted after December 31, 2025, and before January 1, 2027.[560]

The proposal does have some bad news once this extension of the 100% amount ends. Previously the amount of bonus depreciation decreased by 20% per year once the 100% rate no longer applied. However, now the rate generally drops to 20% for 2026 and 2027. Under the prior law, the rate for 2026 would have been 40%, not 20%.

All other provisions are described in the Joint Committee Report.

[560] Joint Committee on Taxation, *Description of H.R.3938, the "Build It in America Act"* (JCX-28-23), June 9, 2023

Unit 5

Tax Practice Update

LEARNING OBJECTIVES

- Apply recent developments over the past two years related to passthrough entities to matters involving your business

SECTION: 164
AICPA MAKES ADDITIONAL RECOMMENDATIONS TO IRS ON PASSTHROUGH ENTITY TAX GUIDANCE

Citation: AICPA Tax Executive Committee Letter, "RE: Additional Guidance Needed on Section 461 Accrual Basis Taxpayers and Notice 2020-75, Forthcoming Regulations Regarding the Deductibility of Payments by Partnerships and S Corporations for Certain State and Local Taxes, October 4, 2022

The AICPA Tax Executive Committee has released another letter[561] to the IRS regarding additional guidance needed for the state passthrough entity taxes beyond what was provided in Notice 2020-75.[562]

[561] AICPA Tax Executive Committee Letter, "RE: Additional Guidance Needed on Section 461 Accrual Basis Taxpayers and Notice 2020-75, Forthcoming Regulations Regarding the Deductibility of Payments by Partnerships and S Corporations for Certain State and Local Income Taxes," October 4, 2022

[562] Notice 2020-75, November 9, 2020, https://www.irs.gov/pub/irs-drop/n-20-75.pdf (retrieved October 7, 2022)

The AICPA summarizes their requests in this letter as follows:

> We recommend:
>
> > 1. The SITP liability is deductible in accordance with the partnership or S corporation's method of accounting.
> >
> > 2. The SITP liability is a specifically identified tax and accordingly, a taxpayer should be entitled to adopt the recurring item exception method of accounting with respect to the liability.
> >
> > 3. An entity that is unable to make an entity level election until a year subsequent to the taxable year of imposition should be allowed to make a Federal election to deduct the tax in the taxable year of imposition or the following year (similar to the treatment of plan contributions made on account of a tax year but after the year they relate to under section 404(a)(6)).[563]

Deduction and Taxpayer's Method of Accounting

The AICPA first deals with the issue created by the implication in Notice 2020-75 that the passthrough tax must be paid by the taxpayer's year end to obtain a deduction.

> The language in Section 3.02(3) of the Notice causes confusion amongst taxpayers and tax practitioners as the Notice indicates a SITP is deductible for the taxable year in which the payment is made. In response to a previously issued Treasury Regulation intended to address state and local government programs intended as workarounds to the Federal $10,000 state and local deduction cap, taxpayers and advisors are closely hewing to following the four corners of the Notice.
>
> The Notice does not make mention of an entity's method of accounting controlling the timing of the deduction and only references payment, leading many to question whether the deduction is to be taken on a cash basis method of accounting. However, to be a SITP the tax must be an income tax and must be directly imposed by the state (or other domestic jurisdiction) on the partnership or S corporation.[564]

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[563] AICPA Tax Executive Committee Letter, "RE: Additional Guidance Needed on Section 461 Accrual Basis Taxpayers and Notice 2020-75, Forthcoming Regulations Regarding the Deductibility of Payments by Partnerships and S Corporations for Certain State and Local Income Taxes," October 4, 2022

[564] AICPA Tax Executive Committee Letter, "RE: Additional Guidance Needed on Section 461 Accrual Basis Taxpayers and Notice 2020-75, Forthcoming Regulations Regarding the Deductibility of Payments by Partnerships and S Corporations for Certain State and Local Income Taxes," October 4, 2022

The AICPA recommends:

> The AICPA recommends that Treasury and the IRS issue guidance that the deduction for a SITP is deductible in accordance with the passthrough entity's established method of accounting.[565]

After discussing the overall rules for accrual methods, the AICPA concludes:

> All told, the basis for the deduction to be claimed in accordance with the taxpayer's method of accounting and that the PTET liability is an eligible recurring item exception item is sound. Taxpayers though, in an abundance of caution, would appreciate guidance from the IRS affirmatively stating so.[566]

Recurring Item Exception

The AICPA also makes a case that taxpayers should be allowed to use the recurring item exception for state passthrough entity taxes:

> The recurring item exception must be consistently applied to a type of item, or for all items, from one taxable year to the next to clearly reflect income. In other words, the recurring item exception is a method of accounting and as such, if a taxpayer is not on a recurring item exception method for a type of item, it must request consent of the IRS to change its method of accounting.
>
> A passthrough entity may have an established method of accounting for other taxes, such as state income, franchise, or real property taxes. However, as 29 states now have entity level tax regimes, the state income tax liability may take on more significance. In the interest of administrative benefit for both taxpayers and the IRS, the IRS should state that a SITP liability is a separate item for purposes of the ability to adopt the recurring item exception method of accounting.[567]

The AICPA recommends:

> The SITP liability is a specifically identified separate tax and, accordingly, a taxpayer should be entitled to adopt the recurring item exception method of accounting with respect to the liability.
>
> Alternatively, if the IRS disagrees that the SITP is a separate item from state income taxes, the IRS should plainly state this determination and provide an eligibility restriction waiver for a prior five-year change for the timing of

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[565] AICPA Tax Executive Committee Letter, "RE: Additional Guidance Needed on Section 461 Accrual Basis Taxpayers and Notice 2020-75, Forthcoming Regulations Regarding the Deductibility of Payments by Partnerships and S Corporations for Certain State and Local Income Taxes," October 4, 2022

[566] AICPA Tax Executive Committee Letter, "RE: Additional Guidance Needed on Section 461 Accrual Basis Taxpayers and Notice 2020-75, Forthcoming Regulations Regarding the Deductibility of Payments by Partnerships and S Corporations for Certain State and Local Income Taxes," October 4, 2022

[567] AICPA Tax Executive Committee Letter, "RE: Additional Guidance Needed on Section 461 Accrual Basis Taxpayers and Notice 2020-75, Forthcoming Regulations Regarding the Deductibility of Payments by Partnerships and S Corporations for Certain State and Local Income Taxes," October 4, 2022

> incurring liabilities for state income taxes to allow taxpayers to adjust any methods of accounting for these liabilities.[568]

The AICPA provides the following analysis in support of this recommendation:

> Treasury Reg. § 1.461-5(d)(1) provides that a taxpayer is permitted to adopt the recurring item exception as part of its method of accounting for any type of item for the first taxable year in which that type of item is incurred. In addition, the recurring item exception must be consistently applied with respect to a type of item, or for all items, from one taxable year to the next in order to clearly reflect income.
>
> As the Treasury and IRS are aware, the SITP is for a tax directly imposed upon an entity without regard to whether the imposition of and liability for the income tax is the result of an election by the entity. While the item is a state income tax, the separate definition of a SITP by the IRS recognizes this tax as a separate item from a general state income tax.[569]

Ability to Choose Year When Election Made After Year End

The AICPA notes that the fact that many states don't allow an election to be made until after year end creates concerns about the year of deduction:

> As noted, section 3.02(2) of the Notice states SITPs are deductible when paid. However, section 3.02(1) of the Notice defines SITPs as amounts paid to satisfy a liability for income taxes. There is confusion among practitioners about whether a taxpayer would have a liability for income taxes in the current taxable year for an elective PTE tax where the election is made after the end of the current taxable year, especially in states where the statute does not permit an election to be made any earlier than the following taxable year. Some practitioners have been advising taxpayers to enter into a binding agreement directing the passthrough entity to make an election to pay PTE tax in order to claim a deduction in the current taxable year. In the interest of administrative benefit, the IRS should allow taxpayers to make a binding election on its timely filed tax return to claim a current year deduction for SITP arising from any PTE tax imposed on current year taxable income.[570]

The AICPA recommendation is:

> The AICPA recommends that with respect to elective SITP regimes, the IRS allow taxpayers to treat the SITP as a liability for the year in which the tax is

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[568] AICPA Tax Executive Committee Letter, "RE: Additional Guidance Needed on Section 461 Accrual Basis Taxpayers and Notice 2020-75, Forthcoming Regulations Regarding the Deductibility of Payments by Partnerships and S Corporations for Certain State and Local Income Taxes," October 4, 2022

[569] AICPA Tax Executive Committee Letter, "RE: Additional Guidance Needed on Section 461 Accrual Basis Taxpayers and Notice 2020-75, Forthcoming Regulations Regarding the Deductibility of Payments by Partnerships and S Corporations for Certain State and Local Income Taxes," October 4, 2022

[570] AICPA Tax Executive Committee Letter, "RE: Additional Guidance Needed on Section 461 Accrual Basis Taxpayers and Notice 2020-75, Forthcoming Regulations Regarding the Deductibility of Payments by Partnerships and S Corporations for Certain State and Local Income Taxes," October 4, 2022

> imposed (meaning a fixed liability in the case of an accrual method taxpayer and an otherwise deductible liability in the case of a cash basis taxpayer) in situations where the state does not provide a mechanism or procedure for taxpayers to elect into the PTET prior to the end of the tax year for which the tax is imposed.[571]

The AICPA describes the problem as follows:

> In situations where a state revenue authority lacks a formal procedure for a taxpayer to make an election to pay PTE tax on current year taxable income until the following year, there is uncertainty whether the all events test is met during the current taxable year. Generally, practitioners have interpreted the all events tests as denying a SITP deduction of an elective PTE tax where an affirmative election to pay PTE tax is not made on or before the end of the taxable year. However, other practitioners have suggested the fact of the liability is fixed as of the end of the year since by statute income tax is assessed on any taxable income earned by a passthrough entity as of the end of the taxable year. A PTE tax election only acts to shift the liability from the individual owners or partners to the entity itself rather than establish that a liability exists.
>
> As a work around when an election to pay PTE tax is unavailable on or before the end of the taxable year, some practitioners have been advising taxpayers to put in place binding agreements before the end of the taxable year mandating the passthrough entity make the election in the following taxable year. However, even with such an agreement in place, there is still uncertainty for taxpayers whether the IRS will respect the substance of such an agreement or what specific information would have to be included in such an agreement to avoid a challenge by the IRS. This process also places an administrative burden on taxpayers to draft such agreements, especially for smaller taxpayers who may be lacking counsel, and on the IRS to review such agreements upon examination for completeness.[572]

The letter goes on to justify the recommendation:

> PTE taxes are put in place by states to change the state tax treatment of individual owners and partners in certain passthrough entities. By issuing the Notice and treating PTE taxes as a deductible expense for Federal income tax purposes, Treasury has signaled its apparent agreement that changes to state tax laws that shift the state tax liability from the individual to the passthrough entity removes such tax from the limitation on individual SALT deductions. From a policy perspective, there seems little reason to deny similar treatment to individuals who are owners or partners in passthrough entities which conduct business in states where the taxpayer is certain of paying PTET but is only prevented from making an affirmative election to pay PTE tax during the taxable year by state statute.

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[571] AICPA Tax Executive Committee Letter, "RE: Additional Guidance Needed on Section 461 Accrual Basis Taxpayers and Notice 2020-75, Forthcoming Regulations Regarding the Deductibility of Payments by Partnerships and S Corporations for Certain State and Local Income Taxes," October 4, 2022

[572] AICPA Tax Executive Committee Letter, "RE: Additional Guidance Needed on Section 461 Accrual Basis Taxpayers and Notice 2020-75, Forthcoming Regulations Regarding the Deductibility of Payments by Partnerships and S Corporations for Certain State and Local Income Taxes," October 4, 2022

> Therefore, for the sake of eliminating uncertainty and reducing administrative burden on both taxpayers and the IRS, the IRS should allow a passthrough entity to make a binding election on its timely filed tax return to treat any PTE tax imposed on current year taxable income as fixing a liability to pay PTE tax as of the end of the that taxable year regardless of when an actual election is allowed by the state revenue authority, and any payment of such PTE tax to be treated as a deductible SITP in the year paid.[573]

SECTION: 168
PERMISSION GRANTED TO MAKE LATE ELECTION TO NOT CLAIM BONUS DEPRECIATION DUE TO FAILURE TO CONSIDER STATE LAW ISSUES

Citation: PLR 202323001, 6/9/23

Sometimes, as tax advisers, we and our clients tend to concentrate so intensely on federal income tax matters that we inadvertently overlook the potential impact of state income tax issues. However, it is crucial to recognize that these state-level considerations can be significant enough to warrant a reevaluation of the optimal choice for a federal return election.

In the case of PLR 202323001,[574] it came to light that the taxpayer, a partnership, was unaware of the substantial adverse consequences on the partners' state income tax returns resulting from the utilization of bonus depreciation on their federal income tax return. Neither the partnership nor its tax adviser identified this matter until after the tax return had already been prepared and filed.

In this ruling, the taxpayer approached the IRS seeking permission to retroactively make a late election to forego the deduction of additional first-year depreciation. The objective was to rectify the unintended consequences arising from the utilization of such depreciation on their federal income tax return, which had a detrimental impact on the partners' state income tax returns.

What Could Be the State Issue?

Although the details regarding the state income tax return are not explicitly provided in the PLR, it is plausible that the issue at hand stemmed from the state's disallowance of the additional first-year depreciation. Consequently, it may be the case that the state tax law requires the inclusion of the excess of bonus depreciation over the depreciation not claiming bonus depreciation in federal taxable income in all cases.

This inclusion of the excess bonus depreciation becomes problematic when the state tax regulations fail to consider that a portion or all of the bonus depreciation was not deducted on the current year's federal return due to the application of the passive activity loss rules outlined in IRC §469. If the state does not account for this distinction, it can lead to unexpected and arguably unfair consequences for taxpayers.

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[573] AICPA Tax Executive Committee Letter, "RE: Additional Guidance Needed on Section 461 Accrual Basis Taxpayers and Notice 2020-75, Forthcoming Regulations Regarding the Deductibility of Payments by Partnerships and S Corporations for Certain State and Local Income Taxes," October 4, 2022

[574] PLR 202323001, June 9, 2023, https://www.irs.gov/pub/irs-wd/202323001.pdf (retrieved June 9, 2023)

This author's home state of Arizona, prior to conforming to federal bonus depreciation rules, had exactly this sort of method of dealing with a depreciation difference in a passive activity—so I've seen this exact situation arise.

The Facts of the Ruling

The letter describes the facts of the situation as follows:

> Taxpayer is treated as a partnership for federal income tax purposes and files a Form 1065, U.S. Income Tax Return for Partnership Income, on a calendar year basis. Taxpayer's overall method of accounting is the accrual method.
>
> During the Taxable Year, Taxpayer placed in service property that is classified as 5-year property or 7-year property and is qualified property under § 168(k)(2) of the Code (collectively, classes of property). On its timely filed federal tax return for the Taxable Year, Taxpayer deducted the additional first year depreciation for the classes of property.
>
> Taxpayer engaged Firm to prepare its federal income tax return for the Taxable Year. Taxpayer reviewed this federal income tax return prior to its filing, but was not aware at that time of certain unfavorable state tax implications to one or more partners of Taxpayer stemming from Taxpayer's deduction of the additional first year depreciation on its federal income tax return for its Taxable Year. These implications were discovered after the Taxpayer filed its federal income tax return on Date1, in connection with a partner's State income tax return.
>
> Firm was also not aware that Taxpayer's claiming the additional first year depreciation deduction on its federal income tax return for the Taxable Year would result in unfavorable State tax implications that impacted one or more partners of Taxpayer. As a result, Firm did not advise Taxpayer to make the election not to deduct the additional first year depreciation for the classes of property placed in service during the Taxable Year.[575]

The taxpayer submitted a request to the IRS, seeking the following ruling to be granted.

> Accordingly, Taxpayer requests an extension of time pursuant to §§301.9100-1 and 301.9100-3 of the Procedure and Administration Regulations to make the election under §168(k)(7) not to deduct the additional first year depreciation deduction for all classes of property that are qualified property under §168(k) and placed in service by Taxpayer during the Taxable Year.[576]

[575] PLR 202323001, June 9, 2023

[576] PLR 202323001, June 9, 2023

The Law Governing Electing to Not Claim Bonus Depreciation

The private letter ruling commences by providing an overview of the relevant provisions within the Internal Revenue Code that govern bonus depreciation and the election to forgo deducting such depreciation.

> Sections 168(k)(1) and (6) allow, in the taxable year that qualified property is placed in service, a 100-percent additional first year depreciation deduction for qualified property acquired by the taxpayer after September 27, 2017, and placed in service by the taxpayer after September 27, 2017, and before January 1, 2023 (or before January 1, 2024 for qualified property described in §168(k)(2)(B) or (C)).
>
> Section 168(k)(7) provides that a taxpayer may make an election not to deduct the additional first year depreciation for any class of property that is qualified property placed in service during the taxable year (the §168(k)(7) election).[577]

The ruling next delves into a discussion of the Treasury regulations pertaining to the election to waive the claim of bonus depreciation under IRC §168(k).

> Section 1.168(k)-2(f)(1)(i) provides that the §168(k)(7) election applies to all qualified property that is in the same class of property and placed in service in the same taxable year. Section 1.168(k)-2(f)(1)(ii) defines "class of property" for purposes of the §168(k)(7) election as meaning each class of property described in §1.168(k)-2(f)(1)(ii)(A)-(G).
>
> Section 1.168(k)-2(f)(1)(iii)(A) provides that the §168(k)(7) election not to deduct additional first year depreciation must be made by the due date (including extensions) of the Federal tax return for the taxable year in which the property is placed in service by the taxpayer.
>
> Section 1.168(k)-2(f)(1)(iii)(B) provides that the §168(k)(7) election not to deduct additional first year depreciation must be made in the manner prescribed on Form 4562, "Depreciation and Amortization," and its instructions. The instructions to Form 4562 for the Taxable Year provide that the election not to deduct the additional first year depreciation is made by attaching a statement to the taxpayer's timely filed tax return indicating that the taxpayer is electing not to deduct the additional first year depreciation and the class of property for which the taxpayer is making the election.[578]

It is worth noting that the deadline for making the election is determined by Treasury regulations rather than the statute. Although the IRS maintains the position that it cannot waive election due dates prescribed by the statute, it does offer an alternative for cases where the deadline is established in regulations issued by the Treasury Department. In such instances, the IRS has

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[577] PLR 202323001, June 9, 2023

[578] PLR 202323001, June 9, 2023

provided an option for taxpayers to request consideration of a late election. The ruling describes this specific option, which the taxpayer intends to pursue to their advantage.

> Under §301.9100-1, the Commissioner has discretion to grant a reasonable extension of time under the rules set forth in §§301.9100-2 and 301.9100-3 to make a regulatory election.
>
> Sections 301.9100-1 through 301.9100-3 provide the standards the Commissioner will use to determine whether to grant an extension of time to make an election. Section 301.9100-2 provides automatic extensions of time for making certain elections. Section 301.9100-3 provides extensions of time for making elections that do not meet the requirements of §301.9100-2.
>
> Section 301.9100-3(a) provides that requests for relief under §301.9100-3 will be granted when the taxpayer provides evidence to establish to the satisfaction of the Commissioner that the taxpayer acted reasonably and in good faith, and that granting relief will not prejudice the interests of the Government.[579]

Although this option necessitates submitting a formal private letter ruling request and paying the relevant user fee, it provides an avenue to rectify the issues stemming from the adviser's lack of awareness regarding the state tax consequences resulting from the failure to make the aforementioned election. Consequently, the taxpayer proceeded to file the formal request that ultimately resulted in the issuance of this private letter ruling.

The IRS Decision

The IRS decided to grant the taxpayer's request in this case, stating:

> Based solely on the facts and representations submitted, we conclude that the requirements of §§301.9100-1 and 301.9100-3 have been satisfied. Accordingly, Taxpayer is granted an extension of 60 calendar days from the date of this letter ruling to make the election not to deduct the additional first year depreciation under §168(k) for all classes of qualified property placed in service by Taxpayer during the Taxable Year.[580]

The ruling provides instructions to the taxpayer regarding the actions they must undertake within the given 60-day timeframe to effectively utilize the granted permission to make the late election.:

> This election must be made by Taxpayer filing an amended Form 1065 for the Taxable Year, with a statement indicating that Taxpayer is electing not to deduct the additional first year depreciation for all classes of qualified property placed in service by Taxpayer during the Taxable Year.[581]

As previously discussed, it is important to acknowledge that this option is not without costs. In numerous situations, the expenses associated with obtaining a favorable ruling may exceed the tax cost of accepting the consequences resulting from the failure to make the election.

[579] PLR 202323001, June 9, 2023

[580] PLR 202323001, June 9, 2023

[581] PLR 202323001, June 9, 2023

Additionally, it is imperative to emphasize that making the change without obtaining a private letter ruling is prohibited by law. However, when the ramifications are substantial, pursuing the letter ruling becomes a viable course of action.

This case serves as an important reminder that when an adviser is engaged for tax matters concerning a partnership, it is crucial for the adviser to recognize that the ultimate tax implications will materialize at the individual partner return level, which may not involve the adviser in any capacity. Furthermore, as evident in this case, these partners may reside in states with income tax provisions that could significantly influence decisions such as electing or not electing certain options on the partnership return.

Advisers should carefully consider the *possibility* of state or other individual partner-level impacts resulting from available elections. It is advisable to inform partnership management that they may want to consider reaching out to individual partners and consulting their respective tax advisers to assess any potential impacts on their tax situations arising from such elections. Subsequently, partnership management would need to determine how to strike a balance between the interests of the various partners when making these decisions.

SECTION: 469
TAXPAYERS DENIED DEDUCTIONS FOR PARTNERSHIP LOSSES FOR A MULTITUDE OF REASONS

Citation: Dunn v. Commissioner, TC Memo 2022-112, 11/29/22

In the case of *Dunn v. Commissioner*, TC Memo 2022-112,[582] the taxpayers lost deductions for claimed depreciation on an automobile and losses from a partnership they wholly owned that held real estate.

Facts of the Case

The opinion begins by describing the LLC taxed as a partnership held by Heather and Edison Dunn:

> Petitioners formed Magnet Development, LLC (Magnet), in February 2007 to manage investments in real estate. On March 14, 2008, Magnet purchased a 21-unit apartment building in Hephzibah, Georgia (Hephzibah building). Petitioners lived approximately 150 miles from the Hephzibah building. To assist in managing the Hephzibah building Magnet employed Ebony Calhoun from January 5 to July 27, 2013, to collect rents, show apartments, and clean vacant apartments. In addition Magnet hired Augusta Partners Property Management, LLC (Augusta Partners), to rent, lease, operate, and manage the Hephzibah building pursuant to a contract with an effective date of January 2, 2014. Petitioners owned additional properties in Athens and Snellville, Georgia, in their individual names and which they managed on their own.

[582] *Dunn v. Commissioner*, TC Memo 2022-112, November 29, 2022, https://www.taxnotes.com/research/federal/court-documents/court-opinions-and-orders/couple-liable-for-penalties%3b-deductions-disallowed/7ff38 (retrieved December 3, 2022)

…

> Petitioners each owned 50% of Magnet, which was treated as a non-TEFRA partnership for federal income tax purposes. Magnet timely filed Forms 1065, U.S. Return of Partnership Income, for the years in issue. Magnet reported income and claimed expense deductions for the Athens and Snellville properties on its Forms 8825, Rental Real Estate Income and Expenses of a Partnership or an S Corporation. It [*3] also claimed depreciation deductions at 100% business use of a 2013 Ford Explorer that petitioner wife purchased in May 2013. It reported net losses for both years in issue.[583]

The Court noted that the taxpayers, despite each having full-time employment, were arguing they were real estate professionals:

> During the years in issue petitioner husband was employed as a full-time technology support specialist with Gwinnett County Public Schools, and petitioner wife was employed as a full-time computer specialist with Huron Consulting Services, LLC. In addition they attempted to work as full-time real estate professionals. In order to substantiate their real estate activities, petitioners kept two separate logs with respect to the hours they claim to have spent working on the Hephzibah building, the Athens property, and the Snellville property in 2013 and 2014. One log relates to activity conducted at the Hephzibah building in 2014. This log provides the date along with a two- or three-word description of the job completed; it does not list the hours spent working. The second log relates to activity conducted at all three properties in 2013 and 2014. This log provides the date, name of the property, hours worked, and a vague description of the work performed; it does not specify the tasks each petitioner individually performed.[584]

The couple claimed the entire amount of losses reported by the partnership on their individual income tax returns:

> Petitioners filed a joint individual income tax return for each year in issue; however, they did not make an election to group their rental real estate activities as one activity for purposes of section 469(c)(7)(A) for either year. They claimed flowthrough losses from Magnet of $85,260 and $48,740 for taxable years 2013 and 2014, respectively. Petitioners also claimed a loss deduction of $7,028 on their Schedule E, Supplemental Income and Loss, for 2014.[585]

The IRS examined the taxpayers' return and, as you might expect given these facts, asserted the taxpayers had claimed losses they were not entitled to:

> On June 8, 2016, the examiner's group manager signed a Civil Penalty Approval Form with respect to the examination of Magnet approving accuracy-related penalties pursuant to section 6662(a) on the individual shareholders' returns for 2013 and 2014. On September 19, 2016, the group manager signed a second Civil Penalty Approval Form approving accuracy-related penalties against

[583] *Dunn v. Commissioner*, TC Memo 2022-112, November 29, 2022

[584] *Dunn v. Commissioner*, TC Memo 2022-112, November 29, 2022

[585] *Dunn v. Commissioner*, TC Memo 2022-112, November 29, 2022

> petitioners for the same period. On February 1, 2017, respondent issued petitioners a notice of deficiency for the years in issue.[586]

Automobile Expenses Had a Number of Problems

The Court first deals with the automobile depreciation deduction claimed on the partnership return. The Court notes:

> For property used in a trade or business or held for the production of income, a depreciation deduction is allowed for reasonable exhaustion or wear and tear. § 167(a). Magnet claimed depreciation deductions for petitioner wife's Ford Explorer for the years in issue.[587]

The opinion immediately comments on the fact that the partnership did not actually own the vehicle in question:

> Petitioners failed to explain why Magnet should be entitled to deductions for property it did not own.[588]

The Court notes that detailed documentation requirements apply to any claimed deduction for vehicles:

> To substantiate entitlement to a depreciation deduction, a taxpayer must establish the property's depreciable basis by showing the cost of the property, its useful life, and the previously allowed depreciation. *Cluck v. Commissioner*, 105 T.C. 324, 337 (1995). To be entitled to a deduction for an automobile, a taxpayer must establish that the automobile was used at least partially for business, and the deductions will be allowed only to the extent of its business use. In addition, a claimed deduction with respect to any "listed property" — a category including "any passenger automobile" — is subject to the heightened substantiation requirements under section 274(d). See § 280F(d)(4) (defining "listed property").[589]

The Court concludes that the taxpayers didn't come close to substantiating the claimed depreciation:

> Petitioners failed to substantiate the cost of the Ford Explorer, when it was placed in service, the business percentage use of the vehicle, and the previously allowed depreciation. Accordingly, we sustain the disallowance of a deduction for depreciation for both 2013 and 2014.[590]

[586] *Dunn v. Commissioner*, TC Memo 2022-112, November 29, 2022

[587] *Dunn v. Commissioner*, TC Memo 2022-112, November 29, 2022

[588] *Dunn v. Commissioner*, TC Memo 2022-112, November 29, 2022

[589] *Dunn v. Commissioner*, TC Memo 2022-112, November 29, 2022

[590] *Dunn v. Commissioner*, TC Memo 2022-112, November 29, 2022

Partnership Didn't Own Two Properties

The Ford Explorer wasn't the only item that the couple attempted to report on the partnership return that wasn't owned by the partnership. As the Court noted:

> For 2013 and 2014 Magnet reported income, expenses, and resulting losses of $3,662 and $5,100 for 2013 and 2014, respectively, for the properties in Athens and Snellville. However, petitioners owned these properties in their individual capacities, not Magnet. Petitioners did not provide any evidence to show that Magnet was entitled to deduct these losses. Accordingly, petitioners are not entitled to deduct them as flowthrough losses.[591]

In a footnote the Court noted the taxpayers failed to argue that, if the properties weren't partnership property, they should be able to report the loss on their own return—and why it wouldn't have mattered if they had made that argument:

> Nor have petitioners claimed that they should be allowed to deduct Schedule E losses in those amounts; and even if they had, for the reasons set forth below they would not be entitled to them.[592]

Lack of Documentation of Basis for Partnership Interests

Things don't get better for the taxpayers when the Court turns to the partnership losses. The Court begins by noting that no losses could have been allowed, regardless of other issues the Court will discuss, because the taxpayers provided no evidence of their basis in their partnership interests:

> Pursuant to section 704(d) "[a] partner's distributive share of partnership loss (including capital loss) shall be allowed only to the extent of the adjusted basis of such partner's interest in the partnership at the end of the partnership year in which such loss occurred." Petitioners formed Magnet on February 8, 2007, and they provided no evidence showing their basis for 2013 or 2014. Because there is no evidence of petitioners' adjusted bases, they are not entitled to deduct losses from Magnet for 2013 and 2014.[593]

Also Missing Documentation of At Risk Amount

The Court continued pointing out the many ways the taxpayers were going to be unable to claim any losses, this time pointing out that they did not show they had enough at risk to claim any losses from the partnership.

> Pursuant to section 465(a) taxpayers are entitled to losses from rental real estate only to the extent of the aggregate amount with respect to which the taxpayer is at risk for such activity at the close of the year. Amounts considered at risk include (1) the amount of money and the adjusted basis of other property contributed by the taxpayer to the activity and (2) borrowed funds that the taxpayer is personally liable for or has pledged property for the borrowed

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[591] *Dunn v. Commissioner*, TC Memo 2022-112, November 29, 2022

[592] *Dunn v. Commissioner*, TC Memo 2022-112, November 29, 2022

[593] *Dunn v. Commissioner*, TC Memo 2022-112, November 29, 2022

> amount. § 465(b). Petitioners failed to show that any amounts in respect of their rental real estate activities were at risk.[594]

Passive Activity Loss Problem

The final area the Tax Court decision looks at that would also deny any deduction relates to the passive loss rules of IRC §469.

The opinion first provides the basic rules applicable to passive activities:

> Taxpayers may deduct costs for certain business and investment expenses under section 162. If the taxpayer is an individual, section 469 generally disallows any passive activity loss deduction for the taxable year and treats it as a deduction or credit for the next taxable year. § 469(a) and (b). A passive activity loss is defined as the excess of the aggregate losses from all passive activities for the taxable year over the aggregate income from all passive activities for that year. § 469(d)(1).
>
> A passive activity is any trade or business in which the taxpayer does not materially participate. § 469(c)(1). A taxpayer is treated as materially participating in an activity only if his or her involvement in the operations of the activity is regular, continuous, and substantial. § 469(h)(1).[595]

The opinion then notes that, under the law, a rental activity generally is considered a passive activity:

> Rental activity is generally treated as a per se passive activity regardless of whether the taxpayer materially participates. § 469(c)(2). A taxpayer who actively participates in a rental real estate activity can deduct a maximum loss of up to $25,000 per year (subject to phaseout limitations) related to the activity. § 469(i)(1)–(3).[596]

However, a provision enacted after the Tax Reform Act of 1986 brought the passive activity rules into the law carved out an exception to this default passive treatment for a taxpayer who qualifies as a real estate professional:

> Section 469(c)(7) provides an exception to the general rule that a rental activity is per se passive. The rental activities of a taxpayer in a real property trade or business (a real estate professional) are not subject to the per se rule of section 469(c)(2). § 469(c)(7); see *Kosonen v. Commissioner*, T.C. Memo. 2000-107, slip op. at 9; Treas. Reg. § 1.469-9(b)(6), (c)(1).[597]

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[594] *Dunn v. Commissioner*, TC Memo 2022-112, November 29, 2022

[595] *Dunn v. Commissioner*, TC Memo 2022-112, November 29, 2022

[596] *Dunn v. Commissioner*, TC Memo 2022-112, November 29, 2022

[597] *Dunn v. Commissioner*, TC Memo 2022-112, November 29, 2022

To be a real estate professional, the taxpayer must satisfy two tests for the tax year:

> A taxpayer qualifies as a real estate professional if: (1) more than one-half of the personal services performed in trades and businesses by the taxpayer during the taxable year are performed in real property trades or businesses in which the taxpayer materially participates and (2) the taxpayer performs more than 750 hours of services during the taxable year in real property trades or businesses in which the taxpayer materially participates. § 469(c)(7)(B). Section 469(c)(7)(C) provides that "the term 'real property trade or business' means any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business." In the case of a joint return the above requirements are satisfied if either spouse separately satisfied these requirements. § 469(c)(7)(B)[598]

But being a real estate professional by itself does not make a taxpayers' rental real estate activities nonpassive. Rather, the taxpayer now is permitted to show material participation and only then will the activity or activities be treated as non-passive:

> Rather, the rental activities of a real estate professional are subject to the material participation requirements of section 469(c)(1). See Treas. Reg. § 1.469-9(e)(1).[599]

A taxpayer thus must meet the requirements to show material participation in the activity or activities to be able to treat the losses as not subject to the §469 limits:

> A taxpayer is considered to have materially participated in an activity if one of the seven tests listed in the regulations is satisfied. Temp. Treas. Reg. § 1.469-5T(a). A taxpayer may establish hours of participation by any reasonable means. *Id.* para. (f)(4). Contemporaneous daily reports are not required if the taxpayer can establish participation by other reasonable means. *Id*. Reasonable means include "appointment books, calendars, or narrative summaries" that identify the services performed and "the approximate number of hours spent performing such services." Id. We have noted previously that we are not required to accept a postevent "ballpark guesstimate" or the unverified, undocumented testimony of taxpayers. See, e.g., *Moss v. Commissioner*, 135 T.C. 365, 369 (2010).[600]

For a married couple filing a joint return, the hours tests are different for qualifying as materially participating in the activity vs. qualifying as a real estate professional:

> If a taxpayer is married, activity by the taxpayer's spouse counts in determining "material participation" by the taxpayer. See § 469(h)(5); Temp. Treas. Reg. § 1.469-5T(f)(3). Spousal attribution may not be used for the purpose of satisfying the 750-hour annual service requirement. See *Oderio v. Commissioner*, T.C. Memo. 2014-39, at *6.[601]

[598] *Dunn v. Commissioner*, TC Memo 2022-112, November 29, 2022

[599] *Dunn v. Commissioner*, TC Memo 2022-112, November 29, 2022

[600] *Dunn v. Commissioner*, TC Memo 2022-112, November 29, 2022

[601] *Dunn v. Commissioner*, TC Memo 2022-112, November 29, 2022

The Court then takes note of the records the taxpayers did present to document the hours they had been involved in the rentals:

> In 2013 and 2014 both petitioners worked full-time jobs unrelated to real estate. They provided logs that purported to show their collective rental real estate activities during that time. The logs show 767 hours worked in 2013 and 407 hours worked in 2014; however, the logs do not specify which petitioner worked these hours. Moreover, the hours recorded in the logs are inflated because petitioners included not only hours spent performing activities related to rental real estate, but also the hours they spent physically present at the properties.[602]

The Court first points out that the taxpayers had failed to show either of them had met the requirements to be a real estate professional for either year:

> Petitioners contend that they both spent more than one-half of the personal services they performed in a trade or business in a real property trades or business. We disagree. Both petitioners had full-time jobs unrelated to real estate. The evidence does not support the conclusion that half of their time was spent performing services in real property trades or businesses.
>
> Petitioners further contend that they met the 750-hour requirement. To meet this requirement only one spouse needs to have reached the 750-hour mark. See § 469(c)(7)(B). Petitioners have not shown that either of them met the material participation requirements; therefore, neither petitioner qualifies as a real estate professional.[603]

The Court also notes that the taxpayers did not show material participation in their rental activities. By failing to make the election to treat all rentals as a single activity, the taxpayers were faced with showing material participation separately for each rental:

> A taxpayer's material participation in a rental real estate activity is considered separately with respect to each rental property unless the taxpayer makes an election to treat all interests in rental real estate as a single rental real estate activity. § 469(c)(7)(A); Treas. Reg. § 1.469-9(e)(1). A taxpayer makes the election by "filing a statement with the taxpayer's original income tax return for the taxable year." Treas. Reg. § 1.469-9(g)(3). There is no evidence that petitioners made an election for either 2013 or 2014 to treat all their rental real estate activities as one activity.[604]

The Court then points out that the taxpayers had not met the requirements that would have been necessary to show material participation in their rental activities:

> Nor have they shown that they met one of the seven requirements of Temporary Treasury Regulation § 1.469-5T(a). The logs provide vague and misleading estimates of time spent on the rental properties. We cannot conclude from the logs that either petitioner performed more than 500 hours during the taxable year and that their participation in the activities was not less than the participation of

[602] *Dunn v. Commissioner*, TC Memo 2022-112, November 29, 2022

[603] *Dunn v. Commissioner*, TC Memo 2022-112, November 29, 2022

[604] *Dunn v. Commissioner*, TC Memo 2022-112, November 29, 2022

any other individual (including individuals who are not owners of interests in the activities) for such year. See *id*. subpara. (1). Even if we were to find that petitioners met the 100-hour requirement described in Temporary Treasury Regulation § 1.469-5T(a)(3), they have not shown that either Ms. Calhoun or Augusta Partners worked less than 100 hours.[605]

SECTION: 704
LB&I DIVISION ANNOUNCES NEW CAMPAIGN FOCUSING ON LIMITS ON DEDUCTION DUE TO PARTNER'S BASIS UNDER §704(D)

Citation: Partnership Losses in Excess of Partner's Basis Campaign, Large Business and International Active Campaigns, IRS webpage, 2/8/22

The IRS has announced a new Large Business and International Division Active Campaign on partnership losses in excess of partner's basis.[606]

The limited summary on the IRS webpage states:

> Partners that report flow-through losses from partnerships must have adequate outside basis as determined pursuant to IRC § 705 to deduct the losses or else the losses are suspended per § 704(d) to the extent they exceed the partner's basis in the partnership interest.[607]

Tax Notes Today Federal described the program in an article discussing the release as follows:

> The campaign focuses on section 704(d), which states that a partner's distributive share of partnership loss will be allowed only to the extent of the partner's adjusted basis in his partnership interest — that is, his outside basis — at the end of the partnership year in which the loss occurred.
>
> The campaign notes that if the partner's share of losses exceeds his outside basis, the excess amount is suspended and may be carried over for use in another tax year in which the partner has outside basis available.[608]

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[605] *Dunn v. Commissioner*, TC Memo 2022-112, November 29, 2022

[606] Partnership Losses in Excess of Partner's Basis Campaign, Large Business and International Active Campaigns, IRS webpage, February 8, 2022 update, https://www.irs.gov/businesses/corporations/lbi-active-campaigns (retrieved February 12, 2022)

[607] Partnership Losses in Excess of Partner's Basis Campaign, Large Business and International Active Campaigns, IRS webpage, February 8, 2022 update

[608] Kristen A. Parillo, "New LB&I Campaign Focuses on Partnership Loss Limitation Rules," *Tax Notes Today Federal*, February 9, 2022, https://www.taxnotes.com/tax-notes-today-federal/basis/new-lbi-campaign-focuses-partnership-loss-limitation-rules/2022/02/09/7d5p3 (subscription required, retrieved February 12, 2022)

SECTION: 754
FINAL REGULATIONS ISSUED REMOVING REQUIREMENT FOR SIGNING AN ELECTION UNDER §754

Citation: TD 9963, 8/4/22

The IRS issued final regulations[609] that adopt proposed regulations originally issued in October 2017[610] without making any changes eliminating the requirement that the election under IRC §754 included with a partnership income tax return be signed by a partner of the partnership.

An election under IRC §754, once made, requires that the basis of partnership property be adjusted:

- For distributions, as provided in IRC §734 and
- For transfers of a partnership interest, as provided in IRC §743.

This election cannot be revoked except as provided for in regulations issued by the IRS.[611]

Prior Regulations

Before this change, Reg §1.754-1(b)(1) provided, in its fourth sentence, the following requirements for the content and form of the election under IRC §754:

> The statement required by this subparagraph shall (i) set forth the name and address of the partnership making the election, *(ii) be signed by any one of the partners, (emphasis added)* and (iii) contain a declaration that the partnership elects under section 754 to apply the provisions of section 734(b) and section 743(b).[612]

The signature requirement generally meant that the partnership needed to scan a copy of the election signed by a partner as a PDF to attach to an electronically filed partnership tax return.

Revised Regulations

The only change found in the new regulations is to replace the fourth sentence of Reg. §1.754-1(b)(1) with the following:

> The statement required by this paragraph (b)(1) must set forth the name and address of the partnership making the election and contain a declaration that the

[609] TD 9963, August 5, 2022 *Federal Register* publication date, announced August 4, 2022, https://public-inspection.federalregister.gov/2022-16271.pdf (retrieved August 4, 2022)

[610] REG-116256-17, 82 FR 47408, October 12, 2017

[611] IRC §754

[612] Reg. §1.754-1(b)(1) before being revised by TD 9963

partnership elects under section 754 to apply the provisions of section 734(b) and section 743(b).[613]

The clause that required the partners' signature has been removed from this version.

Effective Date

The new fourth sentence will apply to taxable years ending on or after August 5, 2022. However, taxpayers may apply the fourth sentence (that is, not having to have a partner sign the election to the return) for taxable years ending before that date, duplicating what had been temporary relief granted when the proposed regulations were issued back in 2017.

SECTION: 1361
TRUSTEES FORGET TO PUT S SHARES INTO QSST TRUST, HAVE TO ASK FOR IRS PLR TO SAVE S STATUS

Citation: PLR 202218004,, 5/6/22

S Corporations may be a popular form of doing business, but they are very fragile structures. The status can be lost in various ways, leading to the corporation becoming a C corporation, quite often a much less favorable tax structure for the entity. While a taxpayer can ask the IRS for relief with a finding that the termination of the status was inadvertent, this comes with a significant user fee and a significant amount of professional time to obtain the private letter ruling.

This situation confronted an S corporation that sought and obtained relief in PLR 202218004.[614]

Trusts Eligible to Be S Corporation Shareholders

S corporations must qualify at all times to be treated as a small business corporation under IRC §1361(b). A violation of any of the requirements results in a termination of S status[615] regardless of whether such a violation was intentional or wasn't done with "bad intent" to attempt to gain some tax advantage.

One of the key problems is having an S corporation end up with an ineligible shareholder. Quite often problems arise when a shareholder dies and the decedents' assets move to various trusts under their estate plan. Only certain trusts are eligible to hold S shares. IRC §1362(c)(2)(A) provides the list of trusts that are eligible S corporation shareholders:

- A trust all of which is treated (under subpart E of part I of subchapter J of this chapter) as owned by an individual who is a citizen or resident of the United States—that is, a *grantor trust*.

[613] Reg. §1.754-1(b)(1) after being revised by TD 9963

[614] PLR 202218004, May 6, 2022, https://www.taxnotes.com/research/federal/irs-private-rulings/letter-rulings-%26-technical-advice/termination-of-s-corp-election-inadvertent/7dgjj (retrieved May 7, 2022)

[615] IRC §1362(d)(2)

- A trust which was a grantor trust under the prior bullet immediately before the death of the deemed owner and which continues in existence after such death, *but only for the 2-year period beginning on the day of the deemed owner's death*.

- A trust with respect to stock transferred to it pursuant to the terms of a will, *but only for the 2-year period beginning on the day on which such stock is transferred to it*.

- A trust created primarily to exercise the voting power of stock transferred to it.

- An electing small business trust (ESBT) where the *trustee* timely elects to have the ESBT rules apply or

- A qualifying subchapter S trust when the *beneficiary* timely elects to have the QSST rules apply.

An estate plan may be drafted to provide that the shares will be held in trust for various reasons (almost all of which have nothing to do with income tax benefits), but most often this will require the shares be moved into a qualifying trust before two years elapse (note the two year limit on holding shares in formerly grantor trusts on the grantor's death or in trusts established by the decedent's will). If the qualifying trust is meant to be an ESBT or QSST, a timely election must be made once the shares are transferred to the trust.

All too often these requirements are overlooked until, at some later date (perhaps when a potential buyer of the S corporation is having a due diligence review performed) the problem is noted and action must be taken—action that will require the private letter ruling request and resulting expense.

The Facts in This Case

In this PLR, the facts were as follows:

> The information submitted states that X was incorporated under the laws of State 1 on Date 1 and elected to be an S corporation effective Date 2. On Date 3, A, a shareholder of X, died. On Date 4, A's shares of X were transferred to Trust 1 pursuant to the terms of A's will. Trust 1 qualified as a permissible S corporation shareholder under § 1361(c)(2)(A)(iii) for a 2-year period beginning on Date 4, the day on which X stock was transferred to it.[616]

Up to this point all is well, but the 2-year clock has begun to run for action to be taken to get the shares out of this trust and into the hands of a qualifying shareholder. And that's where the problems arose.

> Pursuant to A's will, the trustees of Trust 1 were supposed to have transferred X stock to a separate trust (Trust 2) that was intended to be a qualified subchapter S trust (QSST) for the benefit of B because the governing provisions of Trust 1 did not satisfy the QSST requirements under § 1361(d)(3). However, the trustees of Trust 1 failed to transfer X stock to Trust 2 and B, the income beneficiary of Trust 2, failed to file a QSST election under § 1361(d)(2) for Trust 2.

[616] PLR 202218004, May 6, 2022

> Consequently, on Date 5, Trust 1 became an ineligible shareholder of X and X's S corporation election terminated.[617]

The stock ending up being inadvertently left in the original trust is not all of that unusual a situation, especially if the advisers originally involved in the estate plan aren't involved at the point the shareholder dies. But the result becomes a conversion of the S corporation to a C corporation.

Fixing the Problem and Obtaining the Letter Ruling

In this case, the problem was eventually noticed. To get relief the problem is going to have to be solved which requires that a private letter ruling be obtained. The PLR continues:

> In late Date 6, X learned that its S corporation election terminated on Date 5 and that Trust 1 was an ineligible shareholder. Subsequently, trustees of Trust 1 petitioned a State 2 court to modify the terms of Trust 1 to ensure it qualified as a QSST effective Date 4. On Date 7, the State 2 court approved the requested modification.[618]

At this point the proper structures are in place to solve the problem, but we have another issue:

> After Trust 1 was modified and before X stock was transferred to Trust 2 to effectuate the State 2 court-approved modification, X ceased to exist as a corporation following a reorganization on Date 8. [619]

In the best situation the reorganization would have been delayed until after the S status was restored (or at least until after the stock was moved to Trust 2), but likely in this case the transaction that would lead to the end of corporate status was already underway and other parties were unwilling or unable to delay the transaction.

The taxpayers provided a representation that the corporation and its shareholders, in their ignorance, continued to treat this as if it had continued to be an S corporation:

> X represents that at all relevant times, X and its shareholders have filed federal tax returns consistent with X being an S corporation. X represents that the termination of its S corporation election was inadvertent and was not motivated by tax avoidance or retroactive tax planning. X and its shareholders agree to make any adjustments consistent with the treatment of X as an S corporation as may be required by the Secretary.[620]

Note that this problem did not just affect the trust and its beneficiaries. The termination of the S election would have impacted *all* of the shareholders, even if they were not aware that shares had been transferred to a trust at all, let alone that the trustees had failed to move shares to a qualified trust and timely obtain a QSST election from the beneficiary.

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[617] PLR 202218004, May 6, 2022

[618] PLR 202218004, May 6, 2022

[619] PLR 202218004, May 6, 2022

[620] PLR 202218004, May 6, 2022

Note that even though the IRS may not have been harmed by this issue (the tax got paid as if the elections were made and stocks moved to the proper trusts), the taxpayer can't argue a "no harm, no foul" position on exam under the law. IRC §1362(f) and Reg. §1.1362-4 requires obtaining the consent of the IRS to be able to treat the termination as inadvertent.

As well, Revenue Ruling 93-79 provides specifically that a reformation of a trust will only be considered prospectively:

> Accordingly, the reformation of the Trust will not be recognized retroactively to cure the defective S corporation election filed by X. Because an ineligible trust held shares of X stock at the time X's S corporation election was filed, X was not a small business corporation on that date (as required by section 1362(a) of the Code) and on each day of 1992 before that date (as required by section 1362(b)(2)(B)(i)). Therefore, X never became an S corporation because the S corporation election filed by X on March 15, 1992, was ineffective. Furthermore, the provision of section 1362(b)(2) permitting certain otherwise ineffective elections to be effective for the following taxable year does not permit the election filed by X to be valid for the following taxable year, 1993, because X was not a small business corporation when the election was filed.[621]

Since the trust itself needed reformation, that is another issue that requires the IRS to grant relief, as the controlling ruling will not allow the taxpayer to consider the changes retroactively.

IRS Ruling

In this case, as is most often the case, the IRS has granted the request for retroactive relief.

> Based solely on the facts submitted and the representations made, we conclude that X's S corporation election terminated on Date 5 when Trust 1 became an ineligible shareholder. We further conclude that the termination of X's S corporation election on Date 5 was inadvertent within the meaning of § 1362(f). Pursuant to the provisions of § 1362(f), X will be treated as continuing to be an S corporation from Date 5 until it ceased to exist as a corporation following the reorganization on Date 8, provided that X's S corporation election was valid and has not otherwise terminated under § 1362(d).[622]

SECTION: 1361 OPERATING AGREEMENT REVISION THAT CONTAINED §704(B) LANGUAGE TERMINATED LLC S CORPORATION STATUS

Citation: PLR 202247004, 11/25/22

Some taxpayers may prefer to use a limited liability company (LLC) as the underlying legal entity in which to form what is intended to be, for tax purposes, an S corporation. It may be due to quirks in state law (as is true in my home state of Arizona) or some other reason. But what is

[621] Revenue Ruling 93-79, November 13, 1993

[622] Revenue Ruling 93-79, November 13, 1993

too often overlooked is that the LLC's operating agreement must not create a situation where there is deemed to be multiple classes of "stock" outstanding, or the LLC will not qualify as an S corporation.

This very issue forced taxpayers to pay for and seek an IRS ruling that the termination of their S corporation status was inadvertent in the ruling found at PLR 202247004.[623]

IRC §1361(b)(1) provides the following requirements for a corporation to be able to elect S status:

> (b) **Small business corporation.**
>
> > (1) **In general.** For purposes of this subchapter, the term "small business corporation" means a domestic corporation which is not an ineligible corporation and which does not--
> >
> > > (A) have more than 100 shareholders,
> > >
> > > (B) have as a shareholder a person (other than an estate, a trust described in subsection (c)(2), or an organization described in subsection (c)(6)) who is not an individual,
> > >
> > > (C) have a nonresident alien as a shareholder, and
> > >
> > > (D) have more than 1 class of stock.

Treasury Reg. §1.1361-1(l)(1) provides the following description of what constitutes one class of stock, looking to *rights* to distribution and liquidation proceeds:

> (l) **Classes of stock.**
>
> > (1) **General rule.** A corporation that has more than one class of stock does not qualify as a small business corporation. Except as provided in paragraph (l)(4) of this section (relating to instruments, obligations, or arrangements treated as a second class of stock), a corporation is treated as having only one class of stock if all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds.

However, such ownership classes can have different voting rights, as the regulation goes on to note:

> > Differences in voting rights among shares of stock of a corporation are disregarded in determining whether a corporation has more than one class of stock. Thus, if all shares of stock of an S corporation have identical rights to distribution and liquidation proceeds, the corporation may have voting and nonvoting common stock, a class of stock that may vote only on certain issues, irrevocable proxy agreements, or groups of

[623] PLR 202247004, 11/25/22, https://www.irs.gov/pub/irs-wd/202247004.pdf (retrieved November 26, 2022)

> shares that differ with respect to rights to elect members of the board of directors.[624]

Treasury Reg. §1.1361-1(l)(2)(i) makes it clear that the rights provided in the governing documents are the items to consider in making this determination.

> (i) **In general.** The determination of whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds is made based on the corporate charter, articles of incorporation, bylaws, applicable state law, and binding agreements relating to distribution and liquidation proceeds (collectively, the governing provisions).

Advisers must realize that since it is rights that are considered, the question is not *if* a differing distribution for different ownership classes has been or is likely ever to be made. Rather, the question is whether the governing documents allow for such a distribution to take place, even if it is only true if certain conditions are met.

The problem we encounter with limited liability companies is that they don't issue corporate stock, so we must treat the membership interests as if they are stock. That's not an insurmountable problem—it is possible to draft an operating agreement that provides for "units" for ownership interests and provide the necessary identical rights for each unit.

But here we run into another problem. LLCs with more than one owner are most often treated by the owners as partnerships under tax law and, in such cases, the operating agreements are drafted most often to comply with the regulations under IRC §704(b) so that allocations under the agreement can be treated as having economic effect and thus respected by the courts when the LLC is taxed as a partnership. Quite often the §704(b) regulations are incorporated by reference into the operating agreement.

However, those §704(b) regulations require that distributions in liquidation of an interest must be governed by the capital accounts determined under these regulations. That liquidation can very easily lead to differing amounts per unit, thus creating differing classes of "stock" being held by each equity holder under the S corporation regulations.

The §704(b) language will be found quite often in standard LLC operating agreement boilerplate text, which leads to it often being found in the operating agreements for LLCs that wish to be treated as S corporations unless the party drafting the agreement is both aware the entity plans to elect S status and is aware of the need to modify their standard agreement to contain the proper S corporation distribution language.

If the LLC has only one member the §704(b) language really isn't a problem—that owner's "units" all have identical rights in liquidation.

But once a second member is admitted to the LLC the second class of stock is now treated as issued—and the S status is terminated, with the entity reverting to being taxed as a C corporation. While the status of the LLC as a corporation isn't impacted by having more than one class of stock, it simply can no longer be an S corporation.

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[624] Treasury Reg. §1.1361-1(l)(1)

One unusual aspect of this letter ruling request is that it appears the entity did not have this problem initially. The ruling notes:

> The information submitted states that X was formed on Date 1 under the laws of State and elected to be treated as an S corporation effective Date 2. A and B were the sole shareholders of X as of Date 3.[625]

We can't tell from these facts if the entity was originally formed as a state law corporation, or if it was an LLC that had an agreement that properly took care of the one class of stock issue. But we do know that when the entity adopted a new operating agreement, the problematical §704(b) language made its first appearance:

> On Date 3, A and B entered into an Amended and Restated Operating Agreement that included provisions regarding partnerships. Section 5.1 of this agreement provides, in part, that X would maintain capital accounts for each member. Section 10.4 of this agreement provides, in part, that upon liquidation of X, members would distributions to the extent of their capital account balances followed by their interests in X.[626]

The LLC later adopted a second revision to the operating agreement that also contained the problem text. However, eventually the issue was discovered, and the LLC adopted a third revised operating agreement that removed the §704(b) text and now complied with the one class of stock requirement:

> Upon discover [sic] of the effect of the partnership provisions, A and B entered into a Third Amended and Restated Operating Agreement on Date 5 to remove the requirement for the members to maintain capital accounts and to provide identical distribution and liquidation rights to the members.[627]

The problem at this point is that while the entity now qualifies to be an S corporation, its S status terminated when the first revised operating agreement was adopted. Good news is that the IRS can grant relief from inadvertent terminations under IRC §1362(f), but bad news is that obtaining that relief requires requesting and paying for a private letter ruling.

The LLC went ahead and asked for the private letter ruling. In doing so, the LLC made the following representations:

> X represents that the termination of X's S corporation election was inadvertent and not motivated by tax avoidance. X further represents that since Date 3, X and its members have filed all returns consistent with X's status as an S corporation. X also represents that since Date 3, all distributions were made to the members based on their pro rata shares of ownership of X. X and its members have agreed to make such adjustments consistent with the treatment of X as an S corporation as may be required by the Secretary.[628]

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[625] PLR 202247004, 11/25/22

[626] PLR 202247004, 11/25/22

[627] PLR 202247004, 11/25/22

[628] PLR 202247004, 11/25/22

The requested relief was obtained, as the IRS ruled:

> Based solely on the facts submitted and representations made, we conclude that X's S corporation election terminated on Date 3 due to the provisions in the Amended and Restated Operating Agreement. We further conclude this termination was inadvertent under the provisions of § 1362(f). We also conclude that if X's status had not terminated on Date 3 it would have terminated on Date 4 due to the provisions in the Second Amended and Restated Operating Agreement. We conclude that X's termination on Date 4 would also have been inadvertent under the provisions of § 1362(f). Therefore, pursuant to § 1362(f), X will be treated as an S corporation effective Date 3, and thereafter, provided that X is otherwise eligible to be an S corporation and provided that the election was not otherwise terminated.[629]

SECTION: 1362
IRS PROVIDES RELIEF PROCEDURES FOR S ELECTIONS, ALSO PROVIDES WILL NOT ISSUE PRIVATE LETTERING RULINGS GENERALLY IN AREAS COVERED BY THE RELIEF

Citation: Revenue Procedure 2022-19, 10/11/22

In Revenue Procedure 2022-19[630] the IRS has issued a series of "taxpayer assistance procedures" to resolve certain issues involving S corporations and their shareholders without requiring the issuance of a private letter ruling (PLR).

The areas covered by this guidance are:

- Agreements and Arrangements with No Principal Purpose to Circumvent One Class of Stock Requirement
- Governing Provisions That Provide for Identical Distribution and Liquidation Rights
- Procedures for Addressing Missing Shareholder Consents, Errors with Regard to a Permitted Year, Missing Officer's Signature, and Other Inadvertent Errors and Omissions
- Procedures for Verifying S Elections or QSub Elections
- Procedures for Addressing a Federal Income Tax Return Filing Inconsistent with an S Election or a QSub Election
- Procedures for Retroactively Correcting One or More Non-Identical Governing Provisions[631]

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[629] PLR 202247004, 11/25/22

[630] Revenue Procedure 2022-19, October 11, 2022, https://www.taxnotes.com/research/federal/irs-guidance/revenue-procedures/letter-rulings-not-needed-for-some-s-corp-election-requests/7f7bl (retrieved October 8, 2022)

[631] Revenue Procedure 2022-19, October 11, 2022

Details of the Six Areas

The procedure provides:

> Sections 2.03(1) through 2.03(6) of this revenue procedure describe the six areas for which issues are resolvable without a PLR, and for which this revenue procedure provides taxpayer assistance procedures. With regard to the sixth area described in 2.03(6) of this revenue procedure (addressing potential retroactive correction of non-identical governing provisions), the validity or continuation of a corporation's S election is not affected in certain circumstances only if the corporation and its applicable shareholders (as defined in section 3.06(1)(a) of this revenue procedure) meet the requirements of section 3.06 of this revenue procedure.[632]

Agreements and Arrangements with No Principal Purpose to Circumvent One Class of Stock Requirement.

The Procedure describes the background for the first area of relief as follows:

> **(1) One class of stock requirement and governing provisions, including "principal purpose" conditions.**
>
> **(a) Overview.** Pursuant to § 1361(b) (1)(D) and § 1.1361-1(l)(1), a corporation that has more than one class of stock does not qualify as a small business corporation. Section 1.1361-1(l)(1) provides generally that a corporation is treated as having only one class of stock if all outstanding shares of stock confer identical rights to distribution and liquidation proceeds.
>
> **(b) Governing provisions.** Section 1.1361-1(l)(2)(i) provides that the determination of whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds is made based on the corporate charter, articles of incorporation, bylaws, applicable State law, and binding agreements relating to distribution and liquidation proceeds (collectively, governing provisions). A commercial contractual agreement is not a binding agreement relating to distribution and liquidation proceeds, and therefore is not a governing provision, unless a principal purpose of the agreement is to circumvent the one class of stock requirement. See § 1.1361-1(l)(2)(i).
>
> **(c) Other agreements and arrangements**. The Income Tax Regulations identify a number of other agreements and arrangements between or among an S corporation and its shareholders that may or may not be treated as second classes of stock depending in part on whether a principal purpose of the agreement or arrangement was to circumvent the one class of stock requirement or otherwise alter shareholders' rights to distribution and liquidation proceeds. See § 1.1361-1(l)(2)(iii)(A) (buy-sell agreements among shareholders, agreements restricting the transferability of stock, and redemption agreements), § 1.1361-1(l)(4)(ii)(A) (special rules for instruments, obligations, or arrangements treated as equity under general principles of Federal tax law), § 1.1361-1(l)(4)(ii)(B)(1) (short-

[632] Revenue Procedure 2022-19, SECTION 2.03, October 11, 2022

> term unwritten advances that fail the safe harbor described in § 1.1361-1(l)(4)(ii)(B)(1)), and § 1.1361-1(l)(4)(ii)(B)(2) (obligations of the same class that are considered equity under general principles of Federal tax law but fail the safe harbor described in § 1.1361-1(l)(4)(ii)(B)(2)). See section 3.01 of this revenue procedure (providing that the IRS will not treat taxpayers who have entered into the agreements or arrangements described in this section 2.03(1)(c) as violating the one class of stock requirement of § 1361(b)(1)(D) so long as there was no principal purpose to use the agreement or arrangement as a means to circumvent the one class of stock requirement).[633]

The procedure provides the following relief regarding agreements and arrangements that had no principal purpose of circumventing the one class of stock requirement:

> **.01 Agreements and Arrangements with No Principal Purpose to Circumvent One Class of Stock Requirement.** Certain agreements and arrangements described in section 2.03(1)(c) of this revenue procedure are not governing provisions and are not treated as second classes of stock so long as there was no principal purpose to use the agreement as a means to circumvent the one class of stock requirement. Accordingly, the IRS will not treat an S corporation as violating the one class of stock requirement of § 1361(b)(1)(D) as a result of an agreement or arrangement identified in section 2.03(1)(c) of this revenue procedure that does not have a principal purpose to circumvent the one class of stock requirement. Because entering into these specific agreements in these circumstances will not result in termination of S corporation status, taxpayers do not need to seek relief from the IRS. For this reason, and because the existence of a principal purpose is inherently factual in nature, the IRS will not rule in these situations. See section 4.01(1) of this revenue procedure.[634]

Essentially, the IRS has indicated that the agency will not issue a PLR with regard to such an arrangement if the principal purpose of the arrangement is not to evade the one class of stock rules *and* the procedure specifically provides the IRS will not issue a PLR on whether an arrangement has such a principal purpose:

> **(1) Principal purpose determinations regarding the one class of stock requirement**. The IRS will not issue a PLR under § 1362(f) addressing the validity or continuation of an S election in situations regarding the one class of stock requirement that require a determination of the existence of a principal purpose because such a determination is inherently factual in nature. See section 6.02 of Rev. Proc. 2022-1 (or any successor revenue procedure). Accordingly, the IRS will not issue a PLR under § 1362(f) addressing:
>
>> (a) For purposes of determining whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds under § 1.1361-1(l)(2), whether a principal purpose of a commercial contractual agreement, buy-sell agreement, an agreement restricting the transferability of stock, or a redemption agreement is to circumvent the one class of stock requirement of § 1361(b)(1)(D) and § 1.1361-1(l) (see § 1.1361-1(l)(2)(i) and (iii)(A)(1)); or

[633] Revenue Procedure 2022-19, SECTION 2.03(1), October 11, 2022

[634] Revenue Procedure 2022-19, SECTION 3.01, October 11, 2022

(b) For purposes of determining whether an instrument, obligation, or arrangement is treated as a second class of stock, whether:

> (i) A principal purpose of issuing or entering into an instrument, obligation, or arrangement is to circumvent the rights to distribution or liquidation proceeds conferred by the outstanding shares of stock or to circumvent the limitation on eligible shareholders contained in § 1.1361-1(b)(1) (see § 1.1361-1(l)(4)(ii)(A)(2)); or
>
> (ii) A principal purpose of an unwritten advance or proportionately held obligation is to circumvent the rights of the outstanding shares of stock or the limitation on eligible shareholders under § 1.1361-1(l)(4)(ii)(A)(2) (see § 1.1361-1(l)(4)(ii)(B)).[635]

Governing Provisions That Provide for Identical Distribution and Liquidation Rights

The second area deemed resolvable without obtaining a private letter ruling relates to disproportionate distributions:

> **(2) Disproportionate distributions.** A "disproportionate distribution" is any distribution (including an actual distribution, a constructive distribution, or a deemed distribution) of property by a corporation with respect to shares of its stock that differs in timing or amount from the distribution with respect to any other shares of its stock. See § 1.1361-1(l)(1) and (2). Section 1.1361-1(l)(2)(i) provides that, "[a]lthough a corporation is not treated as having more than one class of stock so long as the governing provisions provide for identical distribution and liquidation rights, any distributions (including actual, constructive, or deemed distributions) that differ in timing or amount are to be given appropriate tax effect in accordance with the facts and circumstances." Despite this regulation providing that "a corporation is not treated as having more than one class of stock so long as the governing provisions provide for identical distribution and liquidation rights," taxpayers and practitioners have indicated concern with the language of § 1.1361-1(l)(2)(i). The articulated concern is that the word "although" in combination with the subsequent language requiring that certain disproportionate distributions "be given appropriate tax effect" creates uncertainty as to whether an S corporation has created a second class of stock — even though the governing provisions provide identical distribution and liquidation rights with respect to each share. Practitioners suggest that the language in § 1.1361-1(l)(2)(i) could be clarified by removing the word "[a]lthough" and point to inconsistency in PLRs in the treatment of disproportionate distributions. See section 3.02 of this revenue procedure (providing that the IRS will not treat any disproportionate distributions by a corporation as violating the one class of stock requirement of § 1361(b)(1)(D) so

[635] Revenue Procedure 2022-19, SECTION 4.01(1), October 11, 2022

> long as the corporation's governing provisions provide for identical distribution and liquidation rights).[636]

In this case the IRS provides for the following relief and also adds this item as one on which the agency will not issue a private letter ruling:

> **.02 Governing Provisions That Provide for Identical Distribution and Liquidation Rights.** As outlined in section 2.03(2) of this revenue procedure, § 1.1361-1(l)(2)(i) provides that a corporation is not treated as having more than one class of stock so long as the governing provisions provide for identical distribution and liquidation rights. Accordingly, the IRS will not treat any disproportionate distributions made by a corporation as violating the one class of stock requirement of § 1361(b)(1)(D) so long as the governing provisions of the corporation provide for identical distribution and liquidation rights. Because disproportionate distributions made in these circumstances will not result in the termination of S corporation status, taxpayers do not need to seek relief from the IRS and the IRS will not rule in these situations. See section 4.01(2)(a) of this revenue procedure.[637]

Procedures for Addressing Missing Shareholder Consents, Errors with Regard to a Permitted Year, Missing Officer's Signature, and Other Inadvertent Errors and Omissions

The next section governs inadvertent errors or omissions on the Form 2553 or Form 8869:

> **(3) Certain inadvertent errors or omissions on Form 2553 or Form 8869**. An inadvertent error or omission on Form 2553 or Form 8869 does not invalidate an S election or a QSub election, unless the error or omission is with respect to a shareholder consent, a selection of a permitted year (as defined in § 1378(b) and § 1.1378-1(b)), or an officer's signature. See generally § 1362(a)(2) (an S election is valid "only if all persons who are shareholders in such corporation on the day on which such election is made consent to such election"), § 1.1378-1 (requiring that the taxable year of an S corporation must be a permitted year, which is defined to include a calendar year or any other taxable year for which the corporation establishes a business purpose to the satisfaction of the Commissioner), and § 1.1361-3(a)(2) (a QSub election form must be signed by a person authorized to sign the S corporation's return). See section 3.03 of this revenue procedure (providing procedures for a taxpayer to correct, without the receipt of a PLR, an error, an omission, or a missing required consent on a Form 2553 or Form 8869).[638]

The Procedure provides the following procedures for specific omissions and errors.

[636] Revenue Procedure 2022-19, SECTION 2.03(2), October 11, 2022

[637] Revenue Procedure 2022-19, SECTION 3.02, October 11, 2022

[638] Revenue Procedure 2022-19, SECTION 2.03(3), October 11, 2022

Missing Shareholder Consent

The Procedure provides a set of potential methods to correct the situation where a shareholder consent is missing, only providing for a PLR if none of the others apply:

> An S election that fails to include the consent of a shareholder may be corrected pursuant to the following:
>
> > (a) Section 1.1362-6(b)(3)(iii) (providing an extension of time for filing a shareholder consent to an S election);
> >
> > (b) Rev. Proc. 2013-30 (providing a simplified method for taxpayers to request relief for late S elections);
> >
> > (c) Rev. Proc. 2004-35, 2004-1 C.B. 1029 (providing automatic relief for certain taxpayers requesting relief for late shareholder consents for S elections in community property States); or
> >
> > (d) If the remedies listed in section 3.03(1)(a) through (c) of this revenue procedure do not apply, a taxpayer or the taxpayer's authorized representative may request relief by submitting a request for a PLR under § 1362(f) to the Associate Chief Counsel (Passthroughs and Special Industries).[639]

Correction of an Error With Regard to a Permitted Year

For an error related to a permitted year, the IRS again reminds taxpayers of automatic relief options before allowing for a PLR to be issued:

> A Form 2553 that contains an inadvertent error with regard to a permitted year may be corrected pursuant to Rev. Proc. 2013-30 (providing a simplified method for taxpayers to request relief for late S elections). If a taxpayer is not eligible for relief under Rev. Proc. 2013-30, a correction may be obtained through the receipt of a PLR under § 1362(f) from the Associate Chief Counsel (Passthroughs and Special Industries).[640]

Correction of Missing Officer's Signature

In the case of a missing officer's signature, the Procedure first directs taxpayers to the existing standard late S election relief:

> A Form 2553 or Form 8869 that is missing the signature of an authorized officer of the S corporation that affects the validity of the S election or QSub election may be corrected pursuant to Rev. Proc. 2013-30 (providing a simplified method for taxpayers to request relief for late S elections and QSub elections). If a taxpayer is not eligible for relief under Rev. Proc. 2013-30, a correction may be

[639] Revenue Procedure 2022-19, SECTION 3.03(1), October 11, 2022

[640] Revenue Procedure 2022-19, SECTION 3.03(2), October 11, 2022

> obtained through the receipt of a PLR under § 1362(f) from the Associate Chief Counsel (Passthroughs and Special Industries).[641]

Correction of Other Inadvertent Errors or Omissions

The Procedure concludes with a simplified process to deal with other inadvertent errors or omissions not covered by the previous sections:

> Errors and omissions on Form 2553 or Form 8869, other than those addressed in section 3.03(1) through (3) of this revenue procedure, may be corrected by explaining in writing the error(s) or omission(s) and the necessary correction(s) and submitting the written explanation to one of the following addresses (depending on the Internal Revenue Submission Processing Center with which the S corporation files its Form 1120-S) or any successor address the IRS may provide:
>
> > (a) Internal Revenue Service, MS 6055, 333 W. Pershing Rd., Kansas City, MO 64108.
> >
> > (b) Internal Revenue Service, MS 6273, 1973 N. Rulon White Blvd., Ogden, UT 84404.[642]

No PLRs Issued for Certain Inadvertent Errors, Omissions, or Missing Required Consents

Again the Procedure provides that the IRS will not generally issue rulings for any such issues other than those where the Procedure specifically provides that a PLR should be requested:

> The IRS will not issue a PLR under § 1362(f) regarding any error or omission described in section 3.03(4) of this revenue procedure. Such inadvertent errors or omissions do not impact a corporation's S election or QSub election. See section 2.03(3) of this revenue procedure. The IRS will also not issue a PLR under § 1362(f) for a missing required consent, errors with regard to a permitted year, or a missing officer's signature where the taxpayer qualifies for relief under any of the means of relief identified in section 3.03(1) through (3) of this revenue procedure. The Associate Chief Counsel (Passthroughs and Special Industries) will consider the issuance of a PLR only if the error or omission concerns a shareholder consent, the selection of a permitted year, or a missing officer's signature, and the taxpayer has no other means of requesting relief. See section 4.02(2) of this revenue procedure.[643]

[641] Revenue Procedure 2022-19, SECTION 3.03(3), October 11, 2022

[642] Revenue Procedure 2022-19, SECTION 3.03(4), October 11, 2022

[643] Revenue Procedure 2022-19, SECTION 3.03(5), October 11, 2022

Procedures for Verifying S Elections or QSub Elections

The Procedure discusses issues where the corporation is unable to locate the letter from the IRS accepting the S election or QSub election:

> Generally, within 90 days after the IRS receives a corporation's Form 2553, the IRS mails a CP261 Notice as an acknowledgment to the corporation that the IRS has accepted the corporation's filing. For QSub elections filed on Form 8869, the IRS mails a CP279 Notice to the filer and a CP279A Notice to the subsidiary, generally within 60 days after the IRS accepts the QSub election. A lack of written acknowledgement that the IRS has accepted the corporation's S election or its subsidiary's QSub election (for example, because it was lost or never received) creates uncertainty for some taxpayers about the validity of the election. However, neither subchapter S of the Code nor the Income Tax Regulations thereunder provide that a lack of possession of a CP261 Notice, CP279 Notice, or CP279A Notice affects the validity of an S election or a QSub election, respectively. Rather, such notices are merely administrative acknowledgments of an effective election that can be reproduced upon the taxpayer's request. See section 3.04 of this revenue procedure (providing procedures to replace a missing CP261 Notice, CP279 Notice, or CP279A Notice).[644]

The Procedure adds an exclusive method for requesting an additional copy of these letters:

> **(1) Availability of replacement letters**. With regard to a missing administrative acceptance letter for an S election or an administrative acceptance letter for a QSub election, as appropriate, a replacement letter may be requested:
>
> > (a) For an S corporation and shareholders of an S corporation, by contacting the IRS Business and Specialty Tax Line at 800-829-4933; and
> >
> > (b) For practitioners, by contacting the IRS Practitioner Priority Service at 866-860-4259.[645]

Not surprisingly, what cannot be done is request a PLR on the issue:

> **(2) Unavailability of a PLR.** The IRS will not issue a PLR under § 1362(f) with regard to any missing administrative acceptance letter described in section 3.04(1) of this revenue procedure. See section 4.01(2) of this revenue procedure. A missing administrative acceptance letter does not impact an S election or a QSub election. See section 2.03(4) of this revenue procedure.[646]

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[644] Revenue Procedure 2022-19, SECTION 3.03(5), October 11, 2022

[645] Revenue Procedure 2022-19, SECTION 3.04, October 11, 2022

[646] Revenue Procedure 2022-19, SECTION 3.04, October 11, 2022

Procedures for Addressing a Federal Income Tax Return Filing Inconsistent with an S Election or a QSub Election

The Procedure describes the following problem that sometimes arises with S corporations:

> Occasionally, a corporation files a Federal income tax return that is inconsistent with the corporation's status as an S corporation or a QSub (for example, an S corporation files a Form 1065, U.S. Return of Partnership Income, or Form 1120, U.S. Corporation Income Tax Return, instead of Form 1120-S, U.S. Income Tax Return for an S Corporation). Although an inconsistent Federal income tax return filing can create several complications for the filer, nothing in the Code or Income Tax Regulations thereunder provides that such a filing affects the validity of a corporation's S election or QSub election. For example, neither § 1362(d) nor § 1.1361-5(a) lists an inconsistent Federal income tax return filing as an event that gives rise to a termination of an S election or a QSub election. See section 3.05 of this revenue procedure (providing procedures for taxpayers to address, without the receipt of a PLR, a Federal income tax return filing inconsistent with an S election or a QSub election, as appropriate).[647]

The Procedure provides the following method to resolve this issue:

> **(1) Filing a corrected original return or an amended return.** An S corporation, or a parent S corporation of a QSub, that files a Federal income tax return for a taxable year that is inconsistent with the status of the corporation as an S corporation, or inconsistent with the status of a subsidiary of the parent S corporation as a QSub, must file a Federal income tax return for open taxable years consistent with its status, as appropriate —
>
> > (a) to reflect the status of the corporation as an S corporation or parent of a QSub; or
> >
> > (b) to reflect the status of the subsidiary as a QSub.[648]

The Procedure provides the following guidance regarding the federal income tax effect of a corporation's prior transactions in this case:

> Because a corporation is not treated as having terminated its S election or QSub election, as appropriate, merely due to the filing of one or more Federal income tax returns inconsistent with its S election or QSub election, the corporation's distributions and other transactions will be treated consistent with its status as an S corporation or a QSub, as appropriate. Thus, a QSub's income or deductions will be treated as income or deductions of the parent S corporation and distributions between the QSub and its parent will be disregarded.[649]

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[647] Revenue Procedure 2022-19, SECTION 2.03(5), October 11, 2022

[648] Revenue Procedure 2022-19, SECTION 3.05(1), October 11, 2022

[649] Revenue Procedure 2022-19, SECTION 3.05(3), October 11, 2022

As with prior issues, the IRS provides no private letter rulings will be issued in this area:

> The IRS will not issue a PLR under § 1362(f) with regard to any inconsistent return filing described in section 3.05(1) of this revenue procedure. See section 4.01(2) of this revenue procedure. Such an inconsistent return filing does not impact an S election or a QSub election. See section 2.03(5) of this revenue procedure.[650]

Procedures for Retroactively Correcting One or More Non-Identical Governing Provisions

The most complex taxpayer assistance procedure involves a case where the governing provisions create non-identical rights to regular or liquidating distributions, triggering a second class of stock. This can happen when standard boilerplate language is added to corporate documents when having both voting and non-voting stock that can provide for separate declarations of distributions to each type of stock. This creates a problem even if no disproportionate distribution ever takes place.

A similar problem can arise with LLC operating agreements when the "check the box" corporation takes on more than one member and the language of the operating agreement provides for any possibility of differing distribution rights.

The Procedure describes the problem as follows:

> **(6) Non-identical governing provisions.**
>
> **(a) Overview.** Section 1361(b)(1)(D) requires an S corporation to have only one class of stock. Section 1.1361-1(l) provides that a corporation is treated as having only one class of stock if all outstanding shares of the corporation's stock confer identical rights to distribution and liquidation proceeds and if the corporation has not issued any instrument or obligation, or entered into any arrangement, that is treated as a second class of stock. An S corporation in compliance with § 1.1361-1(l) is commonly referred to as having "identical governing provisions." The term "non-identical governing provision" means a governing provision, as defined by § 1.1361-1(l)(2)(i), on its own or as part of another governing provision, that for Federal income tax purposes results in the S corporation having more than one class of stock under § 1.1361-1(l)(1) (even if the S corporation never made a non-pro rata distribution or liquidating distribution).
>
> **(b) Consequences of non-identical governing provisions**. If an entity files an S election when it has more than a single class of stock, the entity does not meet the requirements to be an S corporation and its attempted election is invalid. See § 1361(a)(1). If a valid S corporation later provides for more than a single class of stock, its S election automatically terminates on the day the disqualifying event occurs. See § 1362(d)(2). See section 3.06 of this revenue procedure (providing procedures for correcting, without the receipt of a PLR, the validity or

[650] Revenue Procedure 2022-19, SECTION 3.05(2), October 11, 2022

> continuation of an S election with regard to one or more non-identical governing provisions, as defined in section 2.03(6)(a) of this revenue procedure).[651]

The relief provisions for this problem are much longer than those for the other areas.

Definitions

The Procedure provides the following definitions for this relief procedures:

- *Applicable shareholder.* The term "applicable shareholder" means a current or former shareholder of a corporation who owns or owned stock of the corporation at any time during the period:
  - (i) Beginning on the date on which the non-identical governing provision was adopted (on its own or as part of another governing provision); and
  - (ii) Ending on the date on which the nonidentical governing provision was removed or modified in a manner such that the governing provision complies with the one class of stock requirement.
- *Discovered by the IRS.* The term "discovered by the IRS" has the meaning given the term in § 301.9100-3(b)(1)(i) of the Procedure and Administration Regulations (26 CFR part 301).
- *Disproportionate distribution.* The term "disproportionate distribution" is defined in section 2.03(2) of this revenue procedure.
- *Non-identical governing provision.* The term "non-identical governing provision" is defined in section 2.03(6)(a) of this revenue procedure.[652]

Retroactive Corrective Relief Procedures

The Procedure provides a series of steps at Section 3.06(2) that must be followed to obtain retroactive relief. The section provides:

> **(a) Retroactive continuing validity of S election**. If an S corporation and its applicable shareholders meet the requirements of this section 3.06, an S election that is invalid or terminated solely as the result of one or more non-identical governing provisions will be treated for Federal income tax purposes as continuing from the date on which the first non-identical governing provision that invalidated or terminated the corporation's S election was adopted.[653]

[651] Revenue Procedure 2022-19, SECTION 2.03(6), October 11, 2022

[652] Revenue Procedure 2022-19, SECTION 3.06(1), October 11, 2022

[653] Revenue Procedure 2022-19, SECTION 3.06(2)(a), October 11, 2022

To be eligible for retroactive relief, the corporation must meet the following requirements:

> **(b) Eligibility**. A small business corporation and each applicable shareholder of the corporation are eligible for corrective relief under this section 3.06 if the following requirements are satisfied:
>
> > (i) The corporation has or had one or more non-identical governing provisions;
> >
> > (ii) The corporation has not made, and for Federal income tax purposes is not deemed to have made, a disproportionate distribution to an applicable shareholder;
> >
> > (iii) The corporation timely filed a return on Form 1120-S (as required under § 6037 of the Code and § 1.6037-1 of the Income Tax Regulations) for each taxable year of the corporation beginning with the taxable year in which the first non-identical governing provision was adopted and through the taxable year immediately preceding the taxable year in which the corporation made a request for corrective relief under this section 3.06 (a corporation is treated as having timely filed a required Form 1120-S under this section 3.06(2)(b)(iii) if the Form 1120-S is filed within six months after its original due date, excluding extensions); and
> >
> > (iv) Before any non-identical governing provision is discovered by the IRS, all of the requirements described in section 3.06(2)(c) of this revenue procedure are satisfied.[654]

The following corrective relief statements are also required to obtain retroactive relief:

> **(c) Corrective relief statements.**
>
> > **(i) Corporate governing provision and shareholder statements.** The corporation must complete a Corporate Governing Provision Statement in accordance with section 3.06(2)(c)(ii) of this revenue procedure and a Shareholder Statement signed by each applicable shareholder in accordance with section 3.06(2)(c)(iii) of this revenue procedure.
> >
> > **(ii) Corporate Governing Provision Statement**. The Corporate Governing Provision Statement, a sample of which is provided in Appendix A, must be completed in accordance with this section 3.06(2)(c)(ii).
> >
> > > (A) Designation. The Corporate Governing Provision Statement must state at the top of the document: "CORPORATE GOVERNING PROVISION STATEMENT PURSUANT TO REV. PROC. 2022-19, SECTION 3.06(2)(c)(ii)".
> > >
> > > **(B) Information.** The Corporate Governing Provision Statement must provide the following information:

[654] Revenue Procedure 2022-19, SECTION 3.06(2)(b), October 11, 2022

(1) The date of the Corporate Governing Provision Statement, the corporation's name, employment identification number (EIN), address, date of formation or incorporation, and State of formation or incorporation;

(2) The actual or intended effective date of the corporation's S election filed on Form 2553 (see Form 2553, Part I, line E) that is the subject of the request for corrective relief under this section 3.06;

(3) The name, address, and social security number or taxpayer identification number of each applicable shareholder; and

(4) To establish an inadvertent termination or invalidation of the S election of the corporation, a description of all relevant facts regarding why each non-identical governing provision was adopted, how each non-identical governing provision was discovered, and each action taken to correct or remove each non-identical governing provision before any non-identical governing provision is discovered by the IRS. This description must include each action taken by the corporation and each applicable shareholder to establish that the corporation and each applicable shareholder acted reasonably and in good faith in correcting or removing each non-identical governing provision upon discovery to demonstrate reasonable cause for relief.

(C) Representations. Except as provided in section 3.06(2)(c)(ii)(D), the corporation must provide the following four representations:

(1) "The corporation's S election was inadvertently invalid or terminated solely because of the adoption of one or more non-identical governing provisions.";

(2) "The corporation and each applicable shareholder satisfy all of the requirements set forth in section 3.06 of Rev. Proc. 2022-19.";

(3) "The corporation responds in the negative to each requested statement set forth in section 7.01(4) or (5) of Rev. Proc. 2022-1, or any successor revenue procedure (statements regarding whether the same or a similar issue was previously ruled on or whether a request involving the same or a similar issue was submitted or is currently pending)."; and

> (4) "The corporation and each applicable shareholder acted reasonably and in good faith in correcting or removing each non-identical governing provision upon discovery.".

(D) Explanation regarding previously ruled on, submitted, or pending PLRs. If the corporation cannot respond in the negative to any requested statement set forth in section 7.01(4) or (5) of Rev. Proc. 2022-1, or any successor revenue procedure (and therefore cannot make the representation described in section 3.06(2)(c)(ii)(C)(3) of this revenue procedure), the corporation must provide an explanation for each such response as part of the description of all relevant facts required by section 3.06(2)(c)(ii)(B)(4) of this revenue procedure.

(E) Statements. The corporation must provide the statements set forth in section 3.06(2)(c)(ii)(E)(1) through (3) of this revenue procedure:

> (1) "The corporation acknowledges that the relief provided by section 3.06 of Rev. Proc. 2022-19 is limited solely to each non-identical governing provision described in this Corporate Governing Provision Statement.";
>
> (2) "The corporation acknowledges that the relief provided by section 3.06 of Rev. Proc. 2022-19 is based solely on the information, representations, and other statements provided by the corporation pursuant to section 3.06 of Rev. Proc. 2022-19, each of which is subject to verification during IRS examination."; and
>
> (3) "During the period between the date on which the non-identical governing provision became effective and the date on which all of the procedures described in section 3.06 of Rev. Proc. 2022-19 are completed, each applicable shareholder has reported their income on all affected returns consistent with the S corporation election for the taxable year the non-identical governing provision became effective and for all subsequent years for which each applicable shareholder owned shares of the corporation.".

(F) Signature. The Corporate Governing Provision Statement must be signed under penalties of perjury by a person authorized to sign the corporation's Federal income tax return under § 6062 of the Code. The penalties of perjury statement must be provided in the following format: "Under penalties of perjury, I declare that I have examined this Corporate Governing Provision Statement for corrective relief for one or more non-identical governing provisions, as provided by Rev. Proc. 2022-19,

section 3.06, including accompanying documents, and, to the best of my knowledge and belief, the request contains all the relevant facts, and such facts are true, correct, and complete.”.

(iii) Shareholder Statement. The Shareholder Statement, a sample of which is provided in Appendix B, must be completed in accordance with this section 3.06(2)(c)(iii).

(A) Designation. The Shareholder Statement must state at the top of the document: “SHAREHOLDER STATEMENT PURSUANT TO REV. PROC. 2022-19, SECTION 3.06(2)(c)(iii)”.

(B) Information. The Shareholder Statement must provide:

(1) The date of the Shareholder Statement, the corporation's name, EIN, address, date of formation or incorporation, and State of formation or incorporation;

(2) The name and address of each applicable shareholder;

(3) The social security number or taxpayer identification number of each applicable shareholder;

(4) The number of shares of stock or, in the case of a limited liability company, percentage of ownership each applicable shareholder owns or owned and the date(s) the stock was acquired and, if applicable, transferred; and

(5) The date that each applicable shareholder provided their signature, as required by section 3.06(2)(c)(iii)(D) of this revenue procedure.

(C) Statement of consent. Each applicable shareholder must provide the following statement of consent: “Under penalties of perjury, I declare that I consent to the election of [insert corporation's name], referred to herein as “the Corporation,” located at [insert the Corporation's address], whose employment identification number (EIN) is [insert the Corporation's EIN], to be an S corporation under § 1362(a)(1) of the Code. I have examined this consent statement, including accompanying documents, and, to the best of my knowledge and belief, the request for corrective relief contains all the relevant facts, and such facts are true, correct, and complete. I understand that my consent is binding and may not be withdrawn after the Corporation receives relief pursuant to Rev. Proc. 2022-19, section 3.06. I also declare under penalties of perjury that I have reported my income on all affected returns consistent with the Corporation's election to be an S corporation for the taxable year

for which the election would have been in effect but for the non-identical governing provision(s) described in the Corporate Governing Provision Statement for corrective relief and for all subsequent years I have owned shares of the Corporation.".

(D) Signature. The Shareholder Statement must be signed under penalties of perjury by each applicable shareholder.[655]

Finally, there is a record retention requirement for this relief:

(d) Record retention requirement. The corporation is required to retain the Corporate Governing Provision Statement, the Shareholder Statement(s), and the revised governing provisions in accordance with § 6001 of the Code and the Income Tax Regulations thereunder. The Corporate Governing Provision Statement, the Shareholder Statement(s), and the revised governing provisions must be retained by the corporation for inspection by authorized Internal Revenue officers or employees, and must be retained so long as the contents thereof may become material in the administration of any provision of the Code or the Income Tax Regulations. See § 1.6001-1(e).[656]

If the taxpayer does not qualify for the above retroactive relief, then the following procedures must be used to request a private letter ruling:

(e) Alternative relief.

(i) General rule. An S corporation or applicable shareholder that does not qualify for corrective relief under this section 3.06 may seek corrective relief through a request submitted by the S corporation, applicable shareholder, or authorized representative (as appropriate) to the Associate Chief Counsel (Passthroughs and Special Industries) for a PLR. The request must provide the required explanation described in section 3.06(2)(e)(ii) of this revenue procedure. See generally Rev. Proc. 2022-1 (or any successor revenue procedure).

(ii) Required explanation. A request for a PLR by an S corporation or applicable shareholder, or authorized representative, under section 3.06(2)(e)(i) of this revenue procedure must include an explanation regarding each reason why the requirements for corrective relief under this section 3.06 could not be satisfied.[657]

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[655] Revenue Procedure 2022-19, SECTION 3.06(2)(c), October 11, 2022

[656] Revenue Procedure 2022-19, SECTION 3.06(2)(d), October 11, 2022

[657] Revenue Procedure 2022-19, SECTION 3.06(2)(e), October 11, 2022

SECTION: 1367
DEALING WITH MISSING S CORPORATION BASIS FOR NEW CLIENTS

Citation: Kristen A. Parillo, "New Basis Reporting Form Spotlights Role of Proper Documentation," Tax Notes Today Federal, 6/1/22

This week Kristen Parillo published an article in *Tax Notes Today Federal* looking at how the requirement to prepare and attach Form 7203 impacted this tax season that this author was quoted in.[658]

One of the key issues raised in the article was how to deal with new clients who lack basis information on their S corporation investments, either because they had been preparing their own return and had ignored basis rules (perhaps because they had no idea there were such rules) or their prior preparer had ignored the issue.

This article looks at the options that might exist to deal with these situations.

Why the IRS Created Form 7203

The IRS had been requiring S basis computations to be attached to tax returns for many years. The 1997 Schedule E instructions, the oldest version found on the IRS website, had this instruction that was to be used in preparing 1997 returns:

> If you are claiming a deduction for your share of an aggregate loss, attach to your return a computation of the adjusted basis of your corporate stock and of any debt the corporation owes you.[659]

The IRS made the requirement more explicit in 2018, adding a specific box that must be checked indicating if a basis calculation was required to be attached. Presumably the IRS added this because the agency noticed that such basis calculations were often not being attached.

Part II **Income or Loss From Partnerships and S Corporations** — **Note:** If you report a loss, receive a distribution, dispose of stock, or receive a loan repayment from an S corporation, you **must** check the box in column **(e)** on line 28 and attach the required basis computation. If you report a loss from an at-risk activity for which **any** amount is **not** at risk, you **must** check the box in column **(f)** on line 28 and attach **Form 6198** (see instructions).

27 Are you reporting any loss not allowed in a prior year due to the at-risk, excess farm loss, or basis limitations, a prior year unallowed loss from a passive activity (if that loss was not reported on Form 8582), or unreimbursed partnership expenses? If you answered "Yes," see instructions before completing this section . . . . ☐ **Yes** ☐ **No**

28	**(a)** Name	**(b)** Enter **P** for partnership; **S** for S corporation	**(c)** Check if foreign partnership	**(d)** Employer identification number	**(e)** Check if basis computation is required	**(f)** Check if any amount is not at risk
A			☐		☐	☐
B			☐		☐	☐
C			☐		☐	☐
D			☐		☐	☐

[658] Kristen A. Parillo, "New Basis Reporting Form Spotlights Role of Proper Documentation," *Tax Notes Today Federal,* June 1, 2022, https://www.taxnotes.com/tax-notes-today-federal/basis/new-basis-reporting-form-spotlights-role-proper-documentation/2022/06/01/7djjp (retrieved June 4, 2022)

[659] 1997 Instructions for Schedule E, Supplemental Income and Loss, p. 5, https://www.irs.gov/pub/irs-prior/i1040se--1997.pdf (retrieved June 4, 2022)

Now it appears the IRS has decided that even the check box had not gotten the attention of those filing returns, so the agency created Form 7203 that must be attached to Form 1040 if the taxpayer:

- Is claiming a deduction for their share of an aggregate loss from an S corporation (including an aggregate loss not allowed last year because of basis limitations),
- Received a non-dividend distribution from an S corporation,
- Disposed of stock in an S corporation (whether or not gain is recognized), or
- Received a loan repayment from an S corporation.[660]

[660] Instructions for Form 7203 (12/2021), January 19, 2022, https://www.irs.gov/instructions/i7203#en_US_202112_publink100045402 (retrieved June 4, 2022)

The first page of Form 7203 is reproduced below:

Form **7203**
(December 2021)
Department of the Treasury
Internal Revenue Service

S Corporation Shareholder Stock and Debt Basis Limitations

▶ Attach to your tax return.
▶ Go to *www.irs.gov/Form7203* for instructions and the latest information.

OMB No. 1545-2302
Attachment Sequence No. **203**

Name(s) shown on return	**Identifying number**
Name of S corporation	**Employer identification number**

Stock block (see instructions) ▶

Part I — Shareholder Stock Basis

1	Stock basis at the beginning of the corporation's tax year			**1**	
2	Basis from any capital contributions made or additional stock acquired during the tax year			**2**	
3a	Ordinary business income (enter losses in Part III)	**3a**			
b	Net rental real estate income (enter losses in Part III)	**3b**			
c	Other net rental income (enter losses in Part III)	**3c**			
d	Interest income	**3d**			
e	Ordinary dividends	**3e**			
f	Royalties	**3f**			
g	Net capital gains (enter losses in Part III)	**3g**			
h	Net section 1231 gain (enter losses in Part III)	**3h**			
i	Other income (enter losses in Part III)	**3i**			
j	Excess depletion adjustment	**3j**			
k	Tax-exempt income	**3k**			
l	Recapture of business credits	**3l**			
m	Other items that increase stock basis	**3m**			
4	Add lines 3a through 3m			**4**	
5	Stock basis before distributions. Add lines 1, 2, and 4			**5**	
6	Distributions (excluding dividend distributions)			**6**	
	Note: If line 6 is larger than line 5, subtract line 5 from line 6 and report the result as a capital gain on Form 8949 and Schedule D. See instructions.				
7	Stock basis after distributions. Subtract line 6 from line 5. If the result is zero or less, enter -0-, skip lines 8 through 14, and enter -0- on line 15			**7**	
8a	Nondeductible expenses	**8a**			
b	Depletion for oil and gas	**8b**			
c	Business credits (sections 50(c)(1) and (5))	**8c**			
9	Add lines 8a through 8c			**9**	
10	Stock basis before loss and deduction items. Subtract line 9 from line 7. If the result is zero or less, enter -0-, skip lines 11 through 14, and enter -0- on line 15			**10**	
11	Allowable loss and deduction items. Enter the amount from line 47, column (c)			**11**	
12	Debt basis restoration (see net increase in instructions for line 23)			**12**	
13	Other items that decrease stock basis			**13**	
14	Add lines 11, 12, and 13			**14**	
15	**Stock basis at the end of the corporation's tax year.** Subtract line 14 from line 10. If the result is zero or less, enter -0-			**15**	

Part II — Shareholder Debt Basis

Section A—Amount of Debt (If more than three debts, see instructions.)

Description	**Debt 1** ☐ Formal note ☐ Open account debt	**Debt 2** ☐ Formal note ☐ Open account debt	**Debt 3** ☐ Formal note ☐ Open account debt	**Total**
16 Loan balance at the beginning of the corporation's tax year				
17 Additional loans (see instructions)				
18 Loan balance before repayment. Combine lines 16 and 17				
19 Principal portion of debt repayment (this line doesn't include interest)	( )	( )	( )	( )
20 Loan balance at the end of the corporation's tax year. Combine lines 18 and 19				

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 56396V Form **7203** (12-2021)

The page contains the full computation of stock basis in Part I and the beginning of the shareholder's basis in debt in Section A of Part II.

The second page of Form 7203 contains the following:

Form 7203 (12-2021) Page 2

Part II **Shareholder Debt Basis** *(continued)*

Section B—Adjustments to Debt Basis

	Description	Debt 1	Debt 2	Debt 3	Total
21	Debt basis at the beginning of the corporation's tax year				
22	Enter the amount, if any, from line 17				
23	Debt basis restoration (see instructions)				
24	Debt basis before repayment. Combine lines 21, 22, and 23				
25	Divide line 24 by line 18				
26	Nontaxable debt repayment. Multiply line 25 by line 19				
27	Debt basis before nondeductible expenses and losses. Subtract line 26 from line 24				
28	Nondeductible expenses and oil and gas depletion deductions in excess of stock basis				
29	Debt basis before losses and deductions. Subtract line 28 from line 27. If the result is zero or less, enter -0-				
30	Allowable losses in excess of stock basis. Enter the amount from line 47, column (d)				
31	**Debt basis at the end of the corporation's tax year.** Subtract line 30 from line 29. If the result is zero or less, enter -0-				

Section C—Gain on Loan Repayment

	Description	Debt 1	Debt 2	Debt 3	Total
32	Repayment. Enter the amount from line 19				
33	Nontaxable repayments. Enter the amount from line 26				
34	**Reportable gain.** Subtract line 33 from line 32				

Part III **Shareholder Allowable Loss and Deduction Items**

	Description	**(a)** Current year losses and deductions	**(b)** Carryover amounts (column (e)) from the previous year	**(c)** Allowable loss from stock basis	**(d)** Allowable loss from debt basis	**(e)** Carryover amounts
35	Ordinary business loss					
36	Net rental real estate loss					
37	Other net rental loss					
38	Net capital loss					
39	Net section 1231 loss					
40	Other loss					
41	Section 179 deductions					
42	Charitable contributions					
43	Investment interest expense					
44	Section 59(e)(2) expenditures					
45	Other deductions					
46	Foreign taxes paid or accrued					
47	**Total loss.** Combine lines 35 through 46 for each column. Enter the total loss in column (c) on line 11 and enter the total loss in column (d) on line 30					

Form **7203** (12-2021)

Big Deal or Not So Much?

The *Tax Notes Today Federal* article looked at the impact of this form on the past tax season. As the article notes:

> Whether preparing Form 7203 for the first time was a straightforward task or a nightmare for tax professionals seems to depend on the basis tracking history and recordkeeping skills of whoever handled the shareholder's previous tax returns.[661]

The article quotes a number of tax professionals who have found issues with both returns previously prepared by taxpayers and even those prepared by other tax professionals when taking on a new client.

[661] Kristen A. Parillo, "New Basis Reporting Form Spotlights Role of Proper Documentation," *Tax Notes Today Federal,* June 1, 2022

Taxpayers are ultimately responsible for tracking the basis in their investments. For partnerships and S corporations this requires tracking much more than simply how much the taxpayer paid for his/her interest.

For stock in an S corporation that basis is tracked under rules found at IRC §1367 after the initial basis of the interest is determined at acquisition. This basis number is used for the following purposes:

- Limiting the amount of net losses that may be deducted by the shareholder on their Form 1040
- Determining if any non-dividend distributions received from the S corporation are considered a return of capital or taxable as a capital gain and
- Computing gain or loss on the sale or exchange of the S corporation shares.

S corporation shareholders also have to track basis in any amounts they have loaned to the S corporation. Such debt basis is important as

- A source of basis for deducting losses from the S corporation should stock basis be exhausted or
- Determining the proportion of any principal repayment that is considered taxable gain vs. a return of the debt basis in the loan.

Debt basis cannot be used to convert taxable distributions in excess of stock basis to a nontaxable status. As well, if debt basis is not restored by year end (before taking into account current year losses), *any* repayment of the debt will lead to taxable income based on the ratio of the basis remaining in the debt to the outstanding principal of the debt.

Thus, basis in stock and debt must be referred to in preparing a shareholder's Form 1040 in the following cases:

- The K-1 shows a net loss being passed out to the shareholder for the tax year;
- Prior year losses suspended due to a lack of basis flow into the current year return;
- Distributions (other than tax dividends) are paid to the shareholder during the tax year;
- Any debt from the shareholder to the S corporation is fully or partially repaid during the year; or
- The S corporation interest is sold or exchanged during the year.

Not coincidentally, this list corresponds to the situations where the IRS demands that Form 7203 be attached to the tax return in order to document any of the following positions on the return:

- The losses claimed on the individual return are allowed to be claimed in the year in question;
- Some or all distributions are not taxable to the shareholder as a gain;
- Any amount of the repayment of shareholder loans is not taxable to the shareholder; and

- The gain or loss on disposition of the S corporation shares has been properly computed, which includes the disposition of the shares in a year the S corporation is liquidated.

When the New Client Hasn't Tracked Basis

If the taxpayer begins tracking basis with the first return the S corporation investment appears on, Form 7203 presents no real challenge in most cases. The *Tax Notes Today Federal* article quoted Nathan Smith of CBIZ Inc. on how difficult the Form 7203 processing was:

> "We saw a few questions come up from time to time, but by and large it was pretty much smooth sailing," said Nathan Smith of CBIZ Inc. "Unlike the Schedule K-2 and K-3 disaster, the new standardized reporting on Form 7203 was fairly seamless."[662]

But the article notes that things become a lot more difficult if the professional takes on a new client who has not been tracking the information:

> While the form wasn't a struggle for those who were already tracking basis, it highlighted the problem that tax professionals face when taking on new clients who weren't tracking it themselves and whose preparers weren't doing it either.[663]

A client who comes to the practitioner with no prior records related to basis has always required the practitioner to deal with obtaining information to determine what is beginning basis and if the taxpayer may have reported losses in the past or avoided reporting gain on distributions that means prior returns contain errors.

There are various ways a professional may obtain basis information. For now, we'll consider three options that the practitioner should consider.

Recalculate Basis from Day One

Clearly the best option to deal with obtaining basis information for a taxpayer who has not tracked basis in the past is to obtain the information for each prior year to properly compute stock and debt basis. The Form 7203 itself serves as an excellent set of worksheets to prepare for each year to obtain a comprehensive and easily defendable calculation of basis up through the beginning of the year the practitioner is first looking to prepare.

One key fact to keep in mind is the absolute rule that basis can *never* go below zero. Generally, if events occur that would push basis below zero, the "excess" reduction is taken care of either by limiting deductions to the amount that takes basis to zero (and carrying such disallowed losses to the next taxable year) or by recognizing a gain on distributions.

Later we'll discuss options to deal with this situation in closed years based on IRS documents. While these documents are not binding authority, they contain analyses that do cite to binding

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[662] Kristen A. Parillo, "New Basis Reporting Form Spotlights Role of Proper Documentation," *Tax Notes Today Federal,* June 1, 2022

[663] Kristen A. Parillo, "New Basis Reporting Form Spotlights Role of Proper Documentation," *Tax Notes Today Federal,* June 1, 2022

authority and aren't likely to be challenged by IRS examiners if the taxpayer conforms to the methods described.

But, for now, when computing basis we simply note that such "problematical" events occurred in a year but still treat ending basis as zero.

While this option is by far the best, in many cases it is not possible to obtain all data necessary to do the full calculation using the schedules for each year. We'll discuss some options to deal with this situation, realizing that it's very possible the IRS will challenge any such calculation on exam—and may very well succeed in pushing down the basis.

Even if it is possible to obtain the data, clients may balk at the effort and cost involved in obtaining the data. The adviser should strongly suggest the client take the steps necessary to obtain the information and have fully supported basis calculations should the IRS examine his/her return. Remember that the problem exists because the taxpayer failed to take the steps *required* of the taxpayer to prepare the prior year's returns.

While that may have been due to inadequate work done by a paid preparer, it's not due to inadequate work done by the preparer taking on the return—but if the preparer simply acquiesces in the client's whining about not wanting to have the work done to properly calculate basis, the preparer may find that he/she now will be deemed by the client to have "blessed" the less desirable method—and the client may look for compensation should the IRS successfully challenge the return later.

IRS LB&I Process Unit Methods

The *IRS Large Business & Industry Process Unit Knowledge Base – S Corporations*[664] describes a number of issues IRS examiners may encounter in examining S corporations and their shareholders. The recommendations for steps for examining agents to take when faced with imperfect information on basis are found in this document.

In the section entitled "Losses Claimed in Excess of Basis" the document suggests the following steps be taken when historical information is not available:

> When historical records are not available to substantiate the shareholder's initial stock basis or the adjustments to basis since making the S election, estimate initial stock basis by taking the earliest S corporation return available and adding:
>
> - beginning capital stock,
> - beginning additional paid-in capital,
> - beginning accumulated adjustments account, and
> - beginning other adjustments account.

[664] *IRS Large Business & Industry Process Unit Knowledge Base – S Corporations*, Document Control Number SCO/P/53_05_01_03-06(2016), Revised April 9, 2018, https://www.irs.gov/pub/irs-utl/sco_p_53_05_01_03_06.pdf (retrieved June 5, 2022)

Multiply the total by the shareholder's ownership percentage to arrive at each individual's estimated initial stock basis[665]

The document provides two examples of performing such a calculation:

Example 1 – Estimating Initial Stock Basis Using the Return Resulting in Positive Basis

The balance sheet and Schedule M-1 show the following information:

*Accumulated Adjustments Account (AAA)

**Other Adjustments Account (OAA)

	Beginning	Ending
Capital Stock (Line 22)	45,000	60,000
Additional Paid in Capital (Line 23)	0	0
Retained Earnings (Line 24)	(22,000)	(86,000)

	AAA*	OAA**
1. Balance at beginning of the Year	(21,000)	1,000
2. Ordinary Income from page 1, line 21	0	
3. Other additions	0	0
4. Loss from page 1, line 21	(64,000)	
5. Other reductions	0	0
6. Combined lines 1 through 5	(85,000)	1,000
7. Distributions other than dividends	0	0
8. Balance at end of year	(85,000)	1,000

Based on this information, the estimated beginning stock basis is computed as follows:

Beginning Capital Stock	45,000
Plus: Beginning Additional Paid in Capital	0
Equals: Beginning Stock Cost	45,000
Plus: Beginning AAA and OAA	(20,000)
Equals: Estimated Beginning Stock Basis	25,000

If there is more than one shareholder, multiply the $25,000 by each shareholder's ownership percentage to determine each shareholder's estimated initial stock basis. For example, if there are two equal shareholders, then take the estimated beginning stock basis of $25,000 times 50-percent ownership, which equals $12,500 of estimated beginning stock basis for each shareholder.[666]

[665] *IRS Large Business & Industry Process Unit Knowledge Base – S Corporations*, Document Control Number SCO/P/53_05_01_03-06(2016), Revised April 9, 2018

[666] *IRS Large Business & Industry Process Unit Knowledge Base – S Corporations*, Document Control Number SCO/P/53_05_01_03-06(2016), Revised April 9, 2018

Example 2 – Estimating Initial Stock Basis Using the Return Results in Negative Basis[667]

The corporation made its S election in 2000, but the earliest S corporation return available is 2012. Therefore, the 2012 return is used to estimate initial stock basis. The balance sheet and Schedule M-1 show the following information:

	Beginning
Capital Stock (Line 22)	45,000
Additional Paid in Capital (Line 23)	0
Retained Earnings (Line 24)	(22,000)

	AAA	OAA
1. Balance at beginning of the Year	(98,000)	0
2. Ordinary Income from page 1, line 21	0	
3. Other additions	0	
4. Loss from page 1, line 21	(64,000)	
5. Other reductions	0	
6. Combined lines 1 through 5	(162,000)	0
7. Distributions other than dividends	0	
8. Balance at end of year	(162,000)	0

Based on this information, the estimated beginning stock basis is computed as follows:

Beginning Capital Stock	45,000
Plus: Beginning Additional Paid in Capital	0
Equals: Beginning Stock Cost	45,000
Plus: Beginning AAA and OAA	(98,000)
Equals: Estimated Beginning Stock Basis	(53,000)

However, IRC 1367(a)(2) states that basis cannot be decreased below zero. A negative estimated initial stock basis indicates the S corporation generated losses or paid distributions greater than the income it earned in years prior to 2012. Assuming the shareholder’s 2012 return and basis computation do not report $53,000 in suspended losses, a suspense account must be established to track the ($53,000). TAM 200619021, FSA 200230030 and TAM 9304004.

This example assumes debt basis is zero. If there is debt basis of at least $53,000, then the beginning debt basis amount would be reduced by the $53,000 loss instead of establishing a suspense account. Also, if the shareholder has a NOL carryforward of at least $53,000 from an open statute year, then the NOL is decreased instead establishing a suspense account.

As in Example 1, if there is more than one shareholder, multiply the ($53,000) by the shareholder’s ownership percentage to determine each shareholder’s suspense account.

[667] *IRS Large Business & Industry Process Unit Knowledge Base – S Corporations*, Document Control Number SCO/P/53_05_01_03-06(2016), Revised April 9, 2018

The suspense account is entered on the Stock Basis Worksheet and the Stock & Debt Basis Workbook as follows:

For more information on the suspense account see the Audit Tool – S Corporation Shareholder Loss Limitations Issue Guide.

Name of Corporation
Shareholder's Name – Stock Basis Computation Worksheet
2012

	STOCK BASIS					
1	**Stock Basis at Beginning of Year** (cannot be negative)					$ -
2	**Increase for Capital Contribution or Additional Stock Purchase**					
	Capital Contribution				$ -	
	Stock Purchase				-	-
3	**Increase for Income & Gain Items**	***2012 Sch. K-1***				
	Ordinary Business Income	*Line 1*	$ -			
	Separately Stated Income:					
	Net Rental Real Estate Income	*Line 2*	-			
	Other Net Rental Income	*Line 3*	-			
	Interest Income	*Line 4*	-			
	Ordinary Dividends & Royalties	*Lines 5a & 6*	-			
	Net Short and Long Term Capital Gain	*Lines 7 & 8a*	-			
	Net Section 1231 Gain	*Line 9*	-			
	Other Income	*Line 10 (A-E)*	-			
	Total Income and Gain Items				-	
	Increase for Tax-Exempt Income	*Line 16 (A-B)*			-	
	Increase for Excess Depletion Adjustment	*Line 17 (R)*			-	
	Increase From Recapture of Business Credits	(see IRC §49(a), 50(a), 50(c)(2), & 1371(d))			-	
4	**Stock Basis After Increases**					-
5	**Reduced by: "Suspense Account"** (Relying on the logic of TAM 200619021)		Beg. of Year	Used in Current Yr	Balance	
	Suspended Basis Losses Previously Claimed in Error (Closed by Statute)		(53,000)	-	(53,000)	-
6	**Stock Basis Before Distributions** (cannot be negative)					-
7	**Reduction for Non-Dividend Distributions**	*Line 16 (D)*				-
	*Note: * Non-Taxable Distributions cannot exceed Ln. 6. If the total distributions exceed Ln. 6, the excess is treated as a deemed sale of S Corporation stock (i.e. LTCG). * If the S Corporation has C Corporation Accumulated Earning & Profits, distributions in excess of the AAA will be taxed as dividend income & will not reduce stock basis).*				Gain -	
8	**Stock Basis Before Non-Deductible Expenses & Depletion** (cannot be negative)					-
9	**Decrease for Non-Deductible Exp, Depletion & Business Credits**		Current Year	Applied to Stock Basis	In Excess of Stock Basis	

Computation of Shareholder Basis

Shareholder Name	0	Initials	0
Taxpayer ID Number	0	Date	1/0/1900
Income Year	Prior Years		

Schedule 1

	Total Distributive Shares			Basis and Suspended Losses					Debt
	1 Prior Year Suspended Losses	2 Current Distributive Shares	3 Total [1+2]	4 Stock Basis	5 Debt Basis Schedule 1a	6 Current Losses Allowed [4+5]	7 Losses Claimed tha Can't be Adjusted	8 Current Suspended Losses [3-6-7]	9 Face Amount of Debt Schedule 1a
A. Beginning Balance				0	0				0
B. Additions				0	0				0
C. Subtotal [A+B]				0	0				0
D. Additions:									
-Ordinary Business Income		0	0						
-Net Rental Real Estate Income		0	0						
-Other Net Rental Income		0	0						
- Interest Income		0	0						
-Ordinary Dividends & Royalties		0	0						
-Net ST & LT Gain		0	0						
-Net Section 1231 Gain		0	0						
-Other Income		0	0						
-Tax Exempt Income		0	0						
-Excess Depletion Adjustment		0	0						
-Recapture of Business Credits		0	0						
E. Total Additions			0	0	0				
F. Subtotal [C+E]				0	0				
G. Suspense Account	53,000			0	0		53,000		
H. Decrease Basis for Income not reported in closed year									

Instructions / Input_Sheet / Tab 1 / Tab 2 / Tab 3 / Tab 4 / Tab 5 / Tab 6 / Tab 7 / Tab 8 / Tab 9 / Tab 10 / 1a

The document also notes that it's important to understand how the S corporation shareholder acquired his/her shares when using these estimation methods:

Note: It is important to establish how and when each shareholder acquired basis in the S corporation as the above estimate may need to be modified as a result of

> ownership changes. If the estimate appears to be unreasonable based on the facts and circumstances, then consider using zero as the initial stock basis.[668]

Other Methods – <u>Cohan</u> Case

The basic authority for the estimation methods the IRS discussed comes from the case of *Cohan v. Commissioner*.[669] That case established that if the evidence makes it clear that the taxpayer should qualify for some deduction but does not have sufficient records to document the amount, the taxpayer will still be allowed some deduction to the extent the amount he/she should be allowed can reasonably be estimated, taking into account the taxpayer's level of responsibility for a lack of adequate records.

While the IRS clearly is relying on this case to justify the proposed methods, an adviser might find some other reasonable methodology to compute basis and then be ready to defend that method if necessary.

Losses Previously Claimed in Excess of Basis

The IRS document goes on to advise examining agents regarding what to do when they discover losses in excess of basis have been claimed in prior years. Advisers may discover the same issue when looking to determine basis for new clients.

Step 2 of the process of dealing with losses claimed in excess of basis discussed first the absolute rule, noted earlier, that basis can never drop below zero, so basis becomes zero for the year following the year when excess losses are claimed:

> Stock basis can never be reduced below zero. Therefore, even if a loss is claimed in excess of basis, the stock basis at the beginning of the following year is zero.[670]

If these losses were claimed in years closed to IRS assessments by statute, you might think this reset to zero means the taxpayer "wins" in this case, but the document goes on to provide a methodology that could very well allow the IRS to recover that excess tax benefit by using a suspense account:

> National Office's position is that if a shareholder claims losses in excess of basis in a year closed by statute, then the shareholder must suspend all future tax-free distributions and losses from the S corporation until the excess losses claimed, but not allowed, are recaptured. FSA 200230030; TAM 200619021 and PLR 9304004.[671]

As is noted, the IRS has brought this concept up in documents dating back to 1993.

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[668] *IRS Large Business & Industry Process Unit Knowledge Base – S Corporations*, Document Control Number SCO/P/53_05_01_03-06(2016), Revised April 9, 2018

[669] *Cohan v. Commissioner*, 39 F.2d 540 (2d Cir. 1930)

[670] *IRS Large Business & Industry Process Unit Knowledge Base – S Corporations*, Document Control Number SCO/P/53_05_01_03-06(2016), Revised April 9, 2018

[671] *IRS Large Business & Industry Process Unit Knowledge Base – S Corporations*, Document Control Number SCO/P/53_05_01_03-06(2016), Revised April 9, 2018

The guide also provides the agent with citations to use against an attempt by the taxpayer to argue the agent has no right to look at "closed" years:

> IRC 7602(a)(1) authorizes the examiner to examine any books, papers, records, or other data which may be relevant or material to determine the correctness of any return, including information from prior years not under examination or closed by statute. IRC 6214(b) allows the Tax Court to determine the correct tax liability for the open year(s) by referring, as necessary, to facts from other years. *Lone Manor Farms, Inc. v. Commissioner* - 61 T.C. 436, 440-441 (1974); *Goldsmith v. Commissioner* - T.C. Memo. 2017-20.[672]

The document outlines how the suspense account is absorbed in open years:

> If a taxpayer claims a loss in excess of basis in a closed statue year, then a suspense account is created, pursuant to IRC 1366(d)(2), to track the excess losses. The balance in the suspense account must be reduced to zero before the taxpayer is allowed to take tax-free non-dividend distributions or report pass-through losses. TAM 200619021 explains that the "suspended basis losses claimed in error" should reduce stock basis before current year distributions, non-deductibles and losses and deductions are taken into account.[673]

The steps the LB&I document outlines for agents to take are:

- Review the basis computation schedule and identify any years for which the losses and deductions exceed the shareholder's basis.
- Compare the basis computation to the shareholder's return to determine if the losses claimed in closed statute years exceed basis.
- Establish or increase the suspense account for any losses and deductions claimed in excess of basis in closed statute years.[674]

The document provides the following example of applying these procedures:

Example 3 – Suspense Account[675]

Mary, the sole owner of an S corporation, reported the following income and deduction items on Form 1040 for 2013 (a closed statute year), as reported on Schedule K-1:

Ordinary Income	5,000
Section 1231 Loss	(8,000)
Charitable Contributions	(1,000)

[672] *IRS Large Business & Industry Process Unit Knowledge Base – S Corporations*, Document Control Number SCO/P/53_05_01_03-06(2016), Revised April 9, 2018

[673] *IRS Large Business & Industry Process Unit Knowledge Base – S Corporations*, Document Control Number SCO/P/53_05_01_03-06(2016), Revised April 9, 2018

[674] *IRS Large Business & Industry Process Unit Knowledge Base – S Corporations*, Document Control Number SCO/P/53_05_01_03-06(2016), Revised April 9, 2018

[675] *IRS Large Business & Industry Process Unit Knowledge Base – S Corporations*, Document Control Number SCO/P/53_05_01_03-06(2016), Revised April 9, 2018

The shareholder's beginning stock and debt basis was zero. As 2013 is a closed statute year, the suspense account is computed as follows:

Beginning Basis	0
Ordinary Income	5,000
Section 1231 Loss	(8,000)
Charitable Contributions	(1,000)
Suspense Account	(4,000)

The suspense account is entered on the Stock Basis Worksheet and the Stock & Debt Basis Workbook as follows:

For more information on the suspense account see the Audit Tool – S Corporation Shareholder Loss Limitations Issue Guide.

S Corporation
Mary – Stock Basis Computation Worksheet
2013

STOCK BASIS

1 **Stock Basis at Beginning of Year** (cannot be negative)							$ -
2 **Increase for Capital Contribution or Additional Stock Purchase**							
Capital Contribution						$ -	
Stock Purchase						-	-
3 **Increase for Income & Gain Items**	*2012 Sch. K-1*						
Ordinary Business Income	*Line 1*			$ 5,000			
Separately Stated Income:							
Net Rental Real Estate Income	*Line 2*			-			
Other Net Rental Income	*Line 3*						
Decrease for Depletion	*Line 17 (R)*						
Decrease for Business Credits (see IRC §50(c)(1) & (5))				-	-	-	-
Note: If the above exceed stock basis, the excess is applied to the S/H's debt basis. The amount in excess of debt basis is not carried over.							
10 **Stock Basis Before Allowable Losses & Deductions** (cannot be negative)							5,000
11 **Decrease for Loss & Deduction Items**	*2012 Sch. K-1*	Current Year Distributive Share	Carryover Amount #	Allowable Loss & Deductions	Losses Claimed That Can't be Adjusted @	Suspended Basis C/O	
Ordinary Business Loss	*Line 1*	-	-	-	-	-	
Separately Stated Loss & Deductions:							
Net Rental Real Estate Loss	*Line 2*		-	-	-	-	
Other Net Rental Loss	*Line 3*	-	-	-	-	-	
Net ST & LT Capital Loss	*Lines 7 & 8a*	-	-	-		-	
Net Section 1231 Loss	*Line 9*	(8,000)	-	(4,444)	(3,556)	0	
Other Loss	*Line 10 (A-E)*	-	-	-	-	-	
Section 179 Deduction	*Line 11*	-	-	-	-	-	
Charitable Contributions	*Line 12 (A-G)*	(1,000)	-	(556)	(444)	(0)	
Investment Interest Expense	*Line 12 (H)*	-	-	-	-	-	
Deductions - Royalty Income	*Line 12 (I)*	-	-	-	-	-	
Section 59(e)(2) Expenditures	*Line 12 (J)*	-	-	-	-	-	
Portfolio Income Expenses	*Line 12 (K-L)*	-	-	-	-	-	
Other Deductions	*Line 12 (M-O & S)*	-	-	-	-	-	
Foreign Taxes Paid/Accrued	*Line 14 (L-M)*	-	-	-	-	-	
					(4,000)	(0)	
Total Allocated Loss & Deductions		(9,000)					
Total Allowable Loss & Deductions							(5,000)
12 **Stock Basis at End of Year** (cannot be negative)							$ -

	Total Distributive Shares			Basis and Suspended Losses					Debt
	1 Prior Year Suspended Losses	2 Current Distributive Shares	3 Total [1+2]	4 Stock Basis	5 Debt Basis Schedule 2a	6 Current Losses Allowed [4+5]	7 Losses Claimed that Can't be Adjusted	8 Current Suspended Losses [3-6-7]	9 Face Amount of Debt Schedule 2a
A. Beginning Balance				0	0				0
B. Additions				0	0				0
C. Subtotal [A+B]				0	0				0
D. Additions:									
-Ordinary Business Income		5,000	5,000						
-Net Rental Real Estate Income		0	0						
-Other Net Rental Income	0	0					0		
-Net ST & LT Capital Loss	0	0	0	0	0		0	0	
-Net Section 1231 Loss	0	8,000	8,000	4,444	0	4,44	3,556	0	
-Other Loss	0	0	0	0	0		0	0	
-Section 179 Deduction	0	0	0	0	0		0	0	
-Charitable Contributions	0	1,000	1,000	556	0	55	444	0	
-Investment Interest Expense	0	0	0	0	0		0	0	
-Deductions - Royalty Income	0	0	0	0	0		0	0	
-Section 59(e)(2) Expenditures	0	0	0	0	0		0	0	
-Portfolio Income Expense	0	0	0	0	0		0	0	
-Other Deductions	0	0	0	0	0		0	0	
-Foreign Taxes Paid/Accrued	0	0	0	0	0		0	0	
O. Total Subtractions			9,000	5,000	0		4,000		
P. Subtotal [M-O]				0	0				
Q. Net Increase (Decrease) [E-J-L-O]			-4,000						
R. Other Stock Reductions and Debt Repayments				0	0				0
S. Ending Balance (Not Below Zero)				0	0				0

The IRS document discusses the general rules for handling losses in excess of basis

> The amount of losses and deductions taken by a shareholder for any taxable year cannot exceed the sum of the shareholder's stock basis and the adjusted basis of any S corporation indebtedness owed to the shareholder (debt basis).
>
> When stock and debt basis is insufficient, and there is more than one type of loss or deduction item that reduces basis, the amounts allowed as losses or deductions are allocated on a pro rata basis. The pro rata allocation is computed dividing the loss or deduction item by the total loss and deduction items and multiplying the resulting percentage by the available basis.
>
> Any losses or deductions disallowed for any taxable year are suspended and carried forward indefinitely until the shareholder has adequate stock or debt basis. The suspended losses retain their character and are carried forward and treated as incurred in the first succeeding year.

If the stock is sold or otherwise disposed of, then the suspended losses are no longer carried forward and are lost forever.[676]

The IRS outlines the following steps to absorb suspense accounts:

- If the shareholder has a suspense account, then reduce the shareholder's basis by the lesser of
  - the absolute value of the suspense account, or
  - the basis after the current-year increases.
- Review the basis computation schedule and identify open statute years for which the losses and deductions exceed the shareholder's basis.
- Compare the basis computation to the shareholder's return to determine if the losses claimed in open statute years exceed basis.
- Disallow any losses or deductions in excess of basis, verifying that each loss or deduction item is properly limited on a pro-rata basis.[677]

The IRS provides two examples of applying the rules:

Example 4 – Allocation of Losses and Deductions[678]

The sole owner of an S corporation has stock basis of $9,000 at the beginning of the year. During the year, the S corporation generated the following:

Item	Amount
Ordinary Loss	(20,000)
Section 1231 Gain	4,000
Cash Charitable Contributions	5,000
Non-Deductible Travel & Entertainment	1,000

Since the items that reduce basis exceed the shareholder's stock basis, the loss is limited to the amount of stock basis. First, the stock basis ordering rules are applied to arrive at stock basis before losses and deductions. Since there is more than one type of loss and deduction item which reduces basis, the amounts allowed as a loss or deduction must be prorated as follows:

Item	Amount	Computation
Beginning Stock Basis	9,000	
IRC 1231 Gain	4,000	
Stock Basis Before Non-Deductible Exp.	13,000	
Non-Deductible Travel & Entertainment	(1,000)	
Stock Basis Before Losses & Deductions	12,000	
Ordinary Loss	(9,600)	((20,000 / (20,000 + 5,000)) x 12,000
Cash Charitable Contribution	(2,400)	((5,000 / (20,000 + 5,000)) x 12,000
Ending Stock Basis	0	

[676] *IRS Large Business & Industry Process Unit Knowledge Base – S Corporations*, Document Control Number SCO/P/53_05_01_03-06(2016), Revised April 9, 2018

[677] *IRS Large Business & Industry Process Unit Knowledge Base – S Corporations*, Document Control Number SCO/P/53_05_01_03-06(2016), Revised April 9, 2018

[678] *IRS Large Business & Industry Process Unit Knowledge Base – S Corporations*, Document Control Number SCO/P/53_05_01_03-06(2016), Revised April 9, 2018

The carry over to the next taxable year is:

Ordinary Loss	(10,400)	(20,000) – (9,600)
Cash Charitable Contribution	(2,600)	(5,000) – (2,400)
Total Carryover	(13,000)	(25,000) – (12,000)

Note: Even though this example uses a 100% shareholder, the allocation applies to all shareholders. If a shareholder owns 25% of the S corporation stock, the ordinary income and separately stated items are first allocated 25% to that shareholder. That shareholder then looks to his basis to see if the allocated amount is fully deductible.

Example 5 – Treatment of Suspended Loss Items[679]

Continued from Example 4, during Year 2, the S corporation generated the following:

Ordinary Income	35,000
Section 1231 Loss	(10,000)
Cash Charitable Contributions	1,000
Non-Deductible Travel & Entertainment	5,000

The shareholder's stock basis at the beginning of the year is $0. Losses suspended in a previous year are treated as being incurred in the next tax year and can only be deducted when basis is increased.

Beginning Stock Basis Year 2	0
Ordinary Income	35,000
Stock Basis Before Non-Deductible Exp.	35,000
Non-Deductible Travel & Entertainment	(5,000)
Stock Basis Before Losses & Deductions	30,000

Ordinary Loss	(10,400)	(0 + (10,400))
IRC 1231 Loss	(10,000)	
Cash Charitable Contribution	(3,600)	((1,000) + (2,600))
Ending Stock Basis Year 2	6,000	

Although the Schedule K-1 only shows the current year income items, the shareholder is allowed to take the previously suspended losses. Suspended losses may not be combined with current income amounts, but must be listed on a separate line on the Form 1040, Schedule E, Supplemental Income and Loss, or the appropriate schedule when possible. Suspended ordinary loss carryover is not netted with the current year ordinary income when applying the stock basis ordering rules. Treas. Reg. 1.1366-2(a)(3) & (4).

[679] *IRS Large Business & Industry Process Unit Knowledge Base – S Corporations*, Document Control Number SCO/P/53_05_01_03-06(2016), Revised April 9, 2018

SECTION: 6011
FINAL S CORPORATION SCHEDULES K-2 AND K-3 INSTRUCTIONS ISSUED FOR 2022 RETURNS

Citation: 2022 S Corporation Instructions for Schedules K-2 and K-3 (Form 1120-S), 12/20/22

The IRS issued the final 2022 instructions for Schedules K-2 and K-3 for Form 1120-S on December 20, 2022.[680] The document contains the final instructions for a corporation to meet the domestic filing exception to preparing Schedules K-2 and K-3 for 2022. These rules are virtually the same as were found in the draft instructions released on December 5, 2022.

Domestic Filing Exception

The instructions begin by describing the domestic filing exception broadly:

> An S corporation does not need to (i) complete and file with the IRS the Schedules K-2 and K-3, or (ii) furnish to a shareholder the Schedule K-3 (except where requested by a shareholder after the 1-month date (defined in criterion 3)) if each of the following are met with respect to the S corporation's tax year 2022.[681]

The initial hurdle an S corporation must clear to be eligible to use the domestic filing exception is the "No or limited foreign activity" test. The test is defined as follows:

> **1. No or limited foreign activity**. During an S corporation's tax year 2022, the S corporation either has no foreign activity (as defined later), or if it does have foreign activity, such foreign activity is limited to:
>
> - Passive category foreign income (determined without regard to the high-taxed income exception under section 904(d)(2)(B) (iii)),
> - Upon which not more than $300 of foreign income taxes allowable as a credit under section 901 are treated as paid or accrued by the S corporation, and
> - Such income and taxes are shown on a payee statement (as defined in section 6724(d)(2)) that is furnished or treated as furnished to the S corporation.[682]

For these purposes, *foreign activity* is defined as follows:

> **Foreign activity**. For purposes of the Domestic Filing Exception, foreign activity means any of the following.

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[680] 2022 S Corporation Instructions for Schedules K-2 and K-3 (Form 1120-S), December 20, 2022, https://www.irs.gov/pub/irs-pdf/i1120s23.pdf (retrieved December 21, 2022)

[681] 2022 S Corporation Instructions for Schedules K-2 and K-3 (Form 1120-S), December 20, 2022, p. 3

[682] 2022 S Corporation Instructions for Schedules K-2 and K-3 (Form 1120-S), December 20, 2022, p. 3

- Foreign income taxes paid or accrued (as defined in section 901 and the regulations thereunder).
- Foreign source income or loss (as determined in sections 861 through 865, and section 904(h), and the regulations thereunder).
- Ownership interest in a foreign partnership (as defined in sections 7701(a)(2) and (5)).
- Ownership interest in a foreign corporation (as defined in sections 7701(a)(3) and (5)).
- Ownership of a foreign branch (as defined in Regulations section 1.904-4(f)(3)(vii)).
- Ownership interest in a foreign entity that is treated as disregarded as an entity separate from its owner (as defined in Regulations section 301.7701-3).[683]

An entity that passes the foreign activity test must provide notifications to its shareholders that the corporation does not plan to provide the shareholders with Schedule K-3:

> **2. Shareholder notification**. With respect to an S corporation that satisfies criterion 1, shareholders receive a notification from the S corporation at the latest when the S corporation furnishes the Schedule K-1 to the shareholder. The notice can be provided as an attachment to the Schedule K-1. The notification must state that shareholders will not receive Schedule K-3 from the S corporation unless the shareholders request the schedule.[684]

The final instructions retain the provision that allows the corporation to provide this notice with the K-1s sent to the shareholders at the time the return is filed.

The final hurdle to clear for the corporation to not be required to provide Schedules K-2 and K-3 with its 2022 Form 1120-S filing with the IRS requires that the entity not receive any Schedule K-3 requests by a date one month before the date the entity files its Form 1120-S for 2022:

> **3. No 2022 Schedule K-3 requests by the 1-month date**. The S corporation does not receive a request from any shareholder for Schedule K-3 information on or before the 1-month date. The "1-month date" is 1 month before the date the S corporation files the Form 1120-S. For tax year 2022 calendar year S corporations, the latest 1-month date is August 15, 2023, if the S corporation files an extension.[685]

A key item to note here is that, unlike the original draft instructions issued in October, there is no provision requiring the notice to the shareholders to be issued prior to the 1-month date. In fact, given that the instructions specifically point out that the notice can be sent as part of the Schedule

[683] 2022 S Corporation Instructions for Schedules K-2 and K-3 (Form 1120-S), December 20, 2022, p. 3

[684] 2022 S Corporation Instructions for Schedules K-2 and K-3 (Form 1120-S), December 20, 2022, p.3

[685] 2022 S Corporation Instructions for Schedules K-2 and K-3 (Form 1120-S), December 20, 2022, p.3

K-1 package to shareholders, the IRS has authorized providing the notice well after the 1-month date will have passed.

Although there will be no filing of this information with the IRS if there is no request by the 1-month date, if a shareholder sends in a request for Schedule K-3 after the 1-month date the corporation still must take action to provide the shareholder that information:

> **Note.** If an S corporation receives a request from a shareholder for the Schedule K-3 information after the 1-month date and has not received a request from any other shareholder for Schedule K-3 information on or before the 1-month date, the Domestic Filing Exception is met and the S corporation is not required to file the tax year 2022 Schedules K-2 and K-3 with the IRS or furnish the tax year 2022 Schedule K-3 to the non-requesting shareholders.
>
> However, the S corporation is required to provide the tax year 2022 Schedule K-3, completed with the requested information, to the requesting shareholder on the later of the date on which the S corporation files the Form 1120-S or 1 month from the date on which the S corporation receives the request from the shareholder.[686]

Note that receiving this request related to the 2022 return will require the corporation to prepare Schedules K-2 and K-3 for the information requested by this shareholder for the 2023 Form 1120-S filing with the IRS:

> The S corporation must complete and file tax year 2023 Schedules K-2 and K-3 with respect to the requesting shareholder by the tax year 2023 Form 1120-S filing deadline.[687]

Rule for Corporations That Receive at Least One Request for Schedule K-3 by the 1-Month Date

The instructions provide guidance for an S corporation that meets the first two requirements, but receives a request for a Schedule K-1 from at least one shareholder by the 1-month date that will limit the information required to be provided to the IRS by the corporation:

> If the S corporation received a request from a shareholder for Schedule K-3 information on or before the 1-month date and therefore the S corporation does not satisfy criterion 3, the S corporation is required to file the Schedules K-2 and K-3 with the IRS and furnish the Schedule K-3 to the requesting shareholder.
>
> The Schedules K-2 and K-3 are required to be completed only with respect to the parts and sections relevant to the requesting shareholder. For example, if a shareholder requests the information reported in Part III, Section 2 (Interest Expense Apportionment Factors), the S corporation is required to complete and file Schedule K-2, Part III, Section 2, with respect to the S corporation's total assets and Schedule K-3, Part III, Section 2, with respect to the requesting shareholder's pro rata share of the assets.

[686] 2022 S Corporation Instructions for Schedules K-2 and K-3 (Form 1120-S), December 20, 2022, p. 3

[687] 2022 S Corporation Instructions for Schedules K-2 and K-3 (Form 1120-S), December 20, 2022, p. 3

> On the date that the S corporation files Schedules K-2 and K-3 with the IRS, the S corporation must provide a copy of the filed Schedule K-3 to the requesting shareholder.
>
> The S corporation does not need to complete, attach, file, or furnish any other parts or sections of the Schedules K-2 and K-3 to the IRS, the requesting shareholder, or any other shareholder. The S corporation should keep records of the information requested by the shareholder.[688]

Guidance is also provided for the case where shareholder requests for a Schedule K-3 are received both before and after the 1-month date:

> If an S corporation receives requests from shareholders for Schedule K-3 information both on or before the 1-month date and after the 1-month date, the S corporation is required to file Schedules K-2 and K-3 as described in the prior paragraph only with respect to the shareholder requests received on or before the 1-month date. With respect to requests received after the 1-month date, the S corporation is required to provide the Schedule K-3, completed with that shareholder's requested information, on the later of the date on which the S corporation files the Form 1120-S or 1 month from the date on which the S corporation receives the request from the shareholder.[689]

Form 1116 Exception

The final instructions also continue to provide a separate Form 1116 exemption that may be available to corporations that are unable to meet the Domestic Filing Exception:

> **Note.** If an S corporation does not meet the Domestic Filing Exception, it may meet the Form 1116 Exemption to filing the Schedules K-2 and K-3. See Form 1116 Exemption, later.[690]

In this case, the corporation looks to obtain statements from the shareholders that they are not required to file Form 1116 to claim a foreign tax credit:

> Under section 904(j), certain shareholders are not required to file a Form 1116 ("Form 1116 Exemption"). Also see Foreign Tax Credit - How to Figure the Credit on IRS.gov. An S corporation is not required to complete Schedules K-2 and K-3 if all shareholders are eligible for the Form 1116 Exemption and the S corporation receives notification of the shareholders' eligibility for such exemption by the 1-month date (as defined earlier).[691]

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[688] 2022 S Corporation Instructions for Schedules K-2 and K-3 (Form 1120-S), December 20, 2022, p. 3

[689] 2022 S Corporation Instructions for Schedules K-2 and K-3 (Form 1120-S), December 20, 2022, p. 3

[690] 2022 S Corporation Instructions for Schedules K-2 and K-3 (Form 1120-S), December 20, 2022, p. 4

[691] 2022 S Corporation Instructions for Schedules K-2 and K-3 (Form 1120-S), December 20, 2022, p. 9

If the corporation obtains this notification from some, but not all shareholders, the instructions provide that Schedules K-3 only need to be provided to those shareholders who failed to provide the notification:

> If an S corporation receives notification from only some of the shareholders that they are eligible for the Form 1116 Exemption, the S corporation need not complete the Schedule K-3 for those exempt shareholders but must complete the Schedules K-2 and K-3 with respect to the other shareholders to the extent that the S corporation does not qualify for the Domestic Filing Exception.[692]

Consider the Option to Just Prepare the Forms

Advisers may wish to consider the other alternative to qualifying the S corporation to meet either the Domestic Filing Exception or the Form 1116 Exemption Exception—just preparing the Schedules K-2 and K-3 for an S corporation with only domestic activities.

Several professional tax software publishers have added the option to check a box that tells the software that the entity has only United States operations. When the box is checked the software uses the information entered on the forms to complete the rest of the Form 1120-S to populate Parts II and III of Schedules K-2 and K-3 based on the normal allocation information for profits and losses for the return, as well as the average book value for assets reported on the corporation's depreciation schedule.

For many simple S corporations, this procedure will produce either a correct Schedule K-2 and K-3, or a starting point for quickly creating proper Schedules K-2 and K-3 for the corporation. In that case, taking the additional steps to meet the requirements to meet either exceptions may consume far more professional time than simply preparing these forms for filing with the Form 1120-S and providing the appropriate Schedule K-3 to each shareholder.

SECTION: 6011
FINAL PARTNERSHIP SCHEDULES K-2 AND K-3 INSTRUCTIONS ISSUED FOR 2022 RETURNS

Citation: 2022 Partnership Instructions for Schedules K-2 and K-3 (Form 1065), 12/28/22

The IRS posted the final version of the 2022 partnership Schedule K-2 and K-3 instructions to their 2022 forms site on December 28, 2022.[693] No changes appear to have been made to the Domestic Filing Exception when compared to the second draft version of the instructions that were issued in early December.

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[692] 2022 S Corporation Instructions for Schedules K-2 and K-3 (Form 1120-S), December 20, 2022, p. 9

[693] 2022 Partnership Instructions for Schedules K-2 and K-3 (Form 1065), IRS website, December 28, 2022, https://www.irs.gov/pub/irs-pdf/i1065s23.pdf (retrieved December 29, 2022)

Domestic Filing Exception

The domestic filing exception is explained beginning on page 3 of the 2022 instructions.

> **Domestic filing exception (exception to filing Schedules K-2 and K-3).** A domestic partnership (as defined under section 7701(a)(2) and (4)) does not need to (a) complete and file with the IRS the Schedules K-2 and K-3, or (b) furnish to a partner the Schedule K-3 (except where requested by a partner after the 1-month date (defined in criteria number 4, below)) if each of the following four criteria are met with respect to the partnership's tax year 2022.[694]

No or Limited Foreign Activity

The first criteria that must be met is that the partnership must have no or limited foreign activity. For these purposes, foreign activity is defined as:

- Foreign income taxes paid or accrued (as defined in section 901 and the regulations thereunder);
- Foreign source income or loss (as determined in sections 861 through 865, and section 904(h), and the regulations thereunder);
- Ownership interest in a foreign partnership (as defined in sections 7701(a)(2) and (5));
- Ownership interest in a foreign corporation (as defined in sections 7701(a)(3) and (5));
- Ownership of a foreign branch (as defined in Regulations section 1.904-4(f)(3)(vii));
- Ownership interest in a foreign entity that is treated as disregarded as an entity separate from its owner (as defined in Regulations section 301.7701-3).[695]

The instructions provide the following information about meeting this criterion:

> **1. No or limited foreign activity.** During a domestic partnership's tax year 2022, the domestic partnership either has no foreign activity (as defined below), or, if it does have foreign activity, such foreign activity is limited to
>
> - Passive category foreign income (determined without regard to the high-taxed income exception under section 904(d)(2)(B)(iii));
> - Upon which not more than $300 of foreign income taxes allowable as a credit under section 901 are treated as paid or accrued by the partnership; and
> - Such income and taxes are shown on a payee statement (as defined in section 6724(d)(2)) that is furnished or treated as furnished to the partnership.[696]

[694] 2022 Partnership Instructions for Schedules K-2 and K-3 (Form 1065), IRS website, December 28, 2022

[695] 2022 Partnership Instructions for Schedules K-2 and K-3 (Form 1065), IRS website, December 28, 2022

[696] 2022 Partnership Instructions for Schedules K-2 and K-3 (Form 1065), IRS website, December 28, 2022

US Citizen/Resident Alien Partners

Assuming the partnership met the first criteria, the next test looks at the partners of the partnership. All direct partners of the partnership must be contained on the list found in the instructions.

> **2. U.S. citizen/resident alien partners.** During tax year 2022, all the direct partners in the domestic partnership are:
>
> (a) individuals that are U.S. citizens;
>
> (b) individuals that are resident aliens (as defined in section 7701(b)(1)(A) and the regulations thereunder);
>
> (c) domestic decedent's estates (that is, decedent's estates that are not foreign estates as defined in section 7701(a)(31)(A)), with solely U.S. citizen and/or resident alien individual beneficiaries;
>
> (d) domestic grantor trusts (that is, trusts described under sections 671 through 678) that are not foreign trusts as defined in section 7701(a)(31)(B)) and that have solely U.S. citizen and / or resident alien individual grantors and solely U.S. citizen and / or resident alien individual beneficiaries;
>
> (e) domestic non-grantor trusts (that is, trusts subject to tax under section 641 that are not foreign trusts as defined in section 7701(a)(31)(B)) with solely U.S. citizen and/or resident alien individual beneficiaries;
>
> (f) S corporations with a sole shareholder; or
>
> (g) single-member LLCs, where the LLC's sole member is one of the persons in subparagraphs (a) through (f), and the LLC is disregarded as an entity separate from its owner (as defined in Regulations section 301.7701-3).[697]

When these instructions were not issued at the same time as the final instructions for S Corporation Form K-2 and K-3 instructions, it seemed possible that the IRS might be working on a revision of this list to allow at least some additional entities. However, the final list is the same list found on the early December draft version of these instructions.

Partner Notification

A partnership that meets the first two criteria must next issue notices to the partners advising each that the partnership does not plan to issue a Schedule K-3 to the partner unless the partner specifically requests that schedule. Like the early December instructions, the final instructions allow this notice to be issued to the partners as late as the Schedules K-1 are issued to the

[697] 2022 Partnership Instructions for Schedules K-2 and K-3 (Form 1065), IRS website, December 28, 2022

partners. The instructions also explicitly allow this notice to be sent as an attachment to the Schedules K-1.

> **3. Partner notification.** With respect to a partnership that satisfies criteria 1 and 2, partners receive a notification from the partnership at the latest when the partnership furnishes the Schedule K-1 to the partner. The notice can be provided as an attachment to the Schedule K-1. The notification must state that partners will not receive Schedule K-3 from the partnership unless the partners request the schedule.[698]

Note that this means that if a partnership files for an extension of time to file its return and does not file the return until the last date allowed per the extension, the partners would not need to receive their K-1s (and thus the notice) until September 15, 2023.

No 2022 Schedule K-3 Requests by the 1-Month Date

Assuming the first three criteria have been met, the last criteria provides that the partnership will not need to file a Schedule K-2 or the partners' Schedules K-3 with its return, nor provide such Schedules K-3 to the partners at the time they receive their K-1s, unless the partnership receives a request from a partner to receive a Schedule K-3 by the date that is one month before the date the partnership files its tax return (the *1-month date*).

> **4. No 2022 Schedule K-3 requests by the 1-month date.** The partnership does not receive a request from any partner for Schedule K-3 information on or before the 1-month date. The "1-month date" is 1 month before the date the partnership files the Form 1065. For tax year 2022 calendar year partnerships, the latest 1-month date is August 15, 2023, if the partnership files an extension.[699]

K-3 Requests Received After the 1-Month Date

While meeting the four criteria relieves the partnership from having to file the Schedule K-2 and partners Schedules K-3 with its tax return, the partnership may still need to prepare Schedules K-3 for individual partners. The forms will need to be prepared (though not sent to the IRS, either via an amendment to the return or an administrative adjustment request) if any partner makes such a request for the form after the 1-month date.

The instructions provide:

> **Note**. If a partnership receives a request from a partner for the Schedule K-3 information after the 1-month date and has not received a request from any other partner for Schedule K-3 information on or before the 1-month date, the domestic filing exception is met and the partnership is not required to file the tax year 2022 Schedules K-2 and K-3 with the IRS or furnish the tax year 2022 Schedule K-3 to the non-requesting partners.
>
> However, the partnership is required to provide the tax year 2022 Schedule K-3, completed with the requested information, to the requesting partner on the later

[698] 2022 Partnership Instructions for Schedules K-2 and K-3 (Form 1065), IRS website, December 28, 2022

[699] 2022 Partnership Instructions for Schedules K-2 and K-3 (Form 1065), IRS website, December 28, 2022

> of the date on which the partnership files the Form 1065 or 1 month from the date on which the partnership receives the request from the partner[700]

It's not clear how a partnership could be filing its Form 1065 more than 1 month after the partner requests the Schedule K-3, but the partner still have failed to make the request before the 1-month date. So, for practical purposes the Schedule K-3 will need to be provided to the partner within one month of the date of his/her late request.

However, this late request will have an impact on the 2023 filings, as the partnership will need to prepare a Schedule K-3 for this partner in 2023 and send that form to the IRS along with the partnership wide Schedule K-2 form. The instructions state:

> The partnership must complete and file tax year 2023 Schedules K-2 and K-3 with respect to the requesting partner by the tax year 2023 Form 1065 filing deadline.[701]

When Only Some Partners Request a Schedule K-3 by the 1-Month Date

The instructions provide additional directions for what happens when some, but not all, partners request a Schedule K-3 by the 1-month date and all other criteria for the Domestic Filing Exception have been met. In this case, the partnership will obtain some relief as noted below:

> If the partnership received a request from a partner for Schedule K-3 information on or before the 1-month date and therefore the partnership does not satisfy criterion 4, the partnership is required to file the Schedules K-2 and K-3 with the IRS and furnish the Schedule K-3 to the requesting partner.
>
> The Schedules K-2 and K-3 are required to be completed only with respect to the parts and sections relevant to the requesting partner.
>
> For example, if a partner requests the information reported on Part III, Section 2 (Interest Expense Apportionment Factors), the partnership is required to complete and file Schedule K-2, Part III, Section 2 with respect to the partnership's total assets and Schedule K-3, Part III, Section 2 with respect to the requesting partner's distributive share of the assets. On the date that the partnership files Schedules K-2 and K-3 with the IRS, the partnership must provide a copy of the filed Schedule K-3 to the requesting partner.
>
> The partnership does not need to complete, attach, file, or furnish any other parts or sections of the Schedules K-2 and K-3 to the IRS, the requesting partner, or any other partner. The partnership should keep records of the information requested by the partner.[702]

Again, if the partnership now receives additional requests from other partners after the 1-month date, while it still provides these Schedules K-3 to the requesting partners, it does not provide

[700] 2022 Partnership Instructions for Schedules K-2 and K-3 (Form 1065), IRS website, December 28, 2022

[701] 2022 Partnership Instructions for Schedules K-2 and K-3 (Form 1065), IRS website, December 28, 2022

[702] 2022 Partnership Instructions for Schedules K-2 and K-3 (Form 1065), IRS website, December 28, 2022

them to the IRS nor file any sort of revised partnership return to add this information to the return filed with the agency:

> If a partnership receives requests from partners for Schedule K-3 information both on or before the 1-month date and after the 1-month date, the partnership is required to file Schedules K-2 and K-3 as described in the prior paragraph only with respect to the partner requests received on or before the 1-month date.
>
> With respect to requests received after the 1-month date, the partnership is required to provide the Schedule K-3, completed with that partner's requested information, on the later of the date on which partnership files the Form 1065 or 1 month from the date on which the partnership receives the request from the partner.[703]

No Requirement the Notice Must Be Given Before the 1-Month Date

I have noted some commentators have suggested that the rules outlined above still require that the notice to partners be sent out prior to the 1-month date. However, nothing in the instructions either requires or even implies that the notice must be given before that date. As well, some have stated that any request received prior to August 15, 2023, would require filing Schedules K-2 and K-3 with the return filed with the IRS.

Nothing in the instructions themselves contain any requirement that the notice be given before the 1-month date. In fact, as noted earlier, the instructions would allow providing the notice with a K-1 issued to the partner on September 15, 2023, with a return filed on that date. September 15, 2023 would be, per the instructions themselves, after the final possible 1-month date for a 2022 calendar year return.

What seems to cause some confusion for those who believe that any request before August 15, 2023, requires filing the forms with the return sent to the IRS is the statement in the instructions that "For tax year 2022 calendar year partnerships, the latest 1-month date is August 15, 2023, if the partnership files an extension." But notice this merely says the *latest* 1-month date for a calendar year partnership is August 15, 2023 (and then only for a partnership that obtains an extension of time to file its return), not that this *is* the 1-month date for all partnerships.

As well, it seems unlikely that anyone who had not read the October draft instructions would conclude that there is any "advance notice" requirement at all. Those instructions mechanically required a notice to be issued by January 15 and set the 1-month date at February 15—but the second draft and the final instructions eliminated those specific dates.

Based on the instructions themselves, the following example appears to be a perfectly acceptable way for a partnership to move forward

[703] 2022 Partnership Instructions for Schedules K-2 and K-3 (Form 1065), IRS website, December 28, 2022

EXAMPLE

ABC partnership has two partners, Jeffrey and Renee, both U.S. citizens. The partnership has a single rental property located in Gila Bend, Arizona. The partnership has no foreign activities of any sort.

On March 1, 2023, the partnership files its 2022 Form 1065 and provides Schedules K-1 to each partner. As of February 1, 2023 (one month before the return was filed) neither partner had requested a Schedule K-3 from the partnership. If the partnership attaches a statement that the partnership will not be providing a Schedule K-3 unless the partner requests it to each partner's K-1, the partnership will have fulfilled all requirements to make use of the Domestic Filing Exception for 2022. Thus, the Form 1065 submitted to the IRS will not contain a Schedule K-2, nor will it have a Schedule K-3 included for either partner with that return sent to the IRS.

On April 1, Jeffrey notifies the partnership that he will need a Schedule K-3 from the partnership to complete his return. The partnership must provide Jeffrey with a Schedule K-3 by May 1, 2023. However, the partnership does not submit that Schedule K-3 to the IRS, does not prepare a Schedule K-2 and does not file an amended return or administrative adjustment request with the IRS to provide the agency with this information.

For 2023 the partnership will be required to prepare a Schedule K-3 for Jeffery with its original return due to his late request for that information for 2022.

SECTION: 6031
IRS RELEASES VARIOUS DRAFT 2023 PARTNERSHIP TAX RETURNS

Citation: Draft Forms 1065, K-1 and K-3, 6/23/23

As we transition into the second half of 2023, the Internal Revenue Service (IRS) has commenced the release of draft tax forms for the current year. We will be focusing on the draft versions of the 2023 partnership tax forms that have been recently disseminated by the IRS. The pertinent forms under consideration are:

- Form 1065[704]
- Schedule K-1 (Form 1065)[705] and
- Schedule K-3 (Form 1065).[706]

While the practical application of these draft forms may be somewhat restricted due to the absence of corresponding draft instructions for 2023, they nonetheless provide valuable insights.

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[704] 2023 Form 1065 (June 23, 2023 Draft), June 23, 2023, https://www.irs.gov/pub/irs-dft/f1065--dft.pdf (retrieved June 29, 2023).

[705] 2023 Schedule K-1 (June 14, 2023 Draft), June 14, 2023, https://www.irs.gov/pub/irs-dft/f1065sk1--dft.pdf (retrieved June 29, 2023)

[706] 2023 Schedule K-3 (June 21, 2023 Draft), June 21, 2023, https://www.irs.gov/pub/irs-dft/f1065sk3--dft.pdf (retrieved June 29, 2023)

Even in their draft state, these forms can offer preliminary indications regarding potential modifications to the reporting requirements set by the IRS for partnerships in 2023.

Form 1065, "U.S. Return of Partnership Income"

Although the majority of the 2023 draft Form 1065 mirrors its 2022 counterpart, an alteration can be found in Schedule B's "Other Information" section. This change pertains to queries about elections under Internal Revenue Code (IRC) Section 754 and the related adjustments under IRC Sections 734(b) and 743(b).

The questions pertaining to these provisions continue to be housed in Question 10, but the 2022 version required an attachment of statements if a current year basis adjustment under IRC Sections 734(b) and/or 743(b) was necessitated.

10a Is the partnership making, or had it previously made (and not revoked), a section 754 election? . . . .
See instructions for details regarding a section 754 election.

b Did the partnership make for this tax year an optional basis adjustment under section 743(b) or 734(b)? If "Yes," attach a statement showing the computation and allocation of the basis adjustment. See instructions . . . .

c Is the partnership required to adjust the basis of partnership assets under section 743(b) or 734(b) because of a substantial built-in loss (as defined under section 743(d)) or substantial basis reduction (as defined under section 734(d))? If "Yes," attach a statement showing the computation and allocation of the basis adjustment. See instructions

The 2023 draft provides that the precise amounts of these adjustments will need to be disclosed directly on lines within the Question 10 segment of Schedule B. The first two sections relating to this can be found on page 2 of the draft Form 1065:

10a Is the partnership making, or had it previously made (and not revoked), a section 754 election? If "Yes," enter the effective date of the election . . . . ____________
See instructions for details regarding a section 754 election.

b For this tax year, did the partnership make an optional basis adjustment under section 743(b)? If "Yes," enter the total aggregate net positive amount $ ____________ and the total aggregate net negative amount $ (____________) of such section 743(b) adjustments for all partners made in the tax year. The partnership must also attach a statement showing the computation and allocation of each basis adjustment. See instructions . . . .

The remaining two portions of Question 10 found on page 4.

c For this tax year, did the partnership make an optional basis adjustment under section 734(b)? If "Yes," enter the total aggregate net positive amount $ ____________ and the total aggregate net negative amount $ (____________) of such section 734(b) adjustments for all partnership property made in the tax year. The partnership must also attach a statement showing the computation and allocation of each basis adjustment. See instructions . . . .

d For this tax year, is the partnership required to adjust the basis of partnership property under section 743(b) or 734(b) because of a substantial built-in loss (as defined under section 743(d)) or substantial basis reduction (as defined under section 734(d))? If "Yes," enter the total aggregate amount of such section 743(b) adjustments and/or section 734(b) adjustments for all partners and/or partnership property made in the tax year $ ____________. The partnership must also attach a statement showing the computation and allocation of the basis adjustment. See instructions . . . .

TREASURY/IRS

Even though the attachment of statements for these adjustments is still necessary, the total adjustments are now required to be disclosed directly on Form 1065. This new inclusion on the form itself should facilitate the IRS's ability to use these numbers during return analyses, enabling a more efficient identification of potential issues that might warrant further inquiry during an examination.

In addition, the IRS has introduced two new questions to occupy the space previously designated for Question 29's "Reserved for future use" line on the 2022 Form 1065. The first of these new questions seeks information regarding whether the partnership is obliged to file the newly

introduced Form 7208, titled "Excise Tax on Repurchase of Corporate Stock." This form was initially released in its draft version on June 8, 2023.[707]

The first two sections of the question are found on page 3 of the draft Form 1065:

29	Is the partnership required to file Form 7208 relating to the excise tax on repurchase of corporate stock (see instructions):		
a	Under the applicable foreign corporation rules?		

With the next two sections on page 4:

b	Under the covered surrogate foreign corporation rules?		
	If "Yes" to either (a) or (b), complete Form 7208, Excise Tax on Repurchase of Corporate Stock. See the Instructions for Form 7208.		

The second new question may already be familiar to seasoned tax professionals. The digital asset question, previously found on the 2022 Form 1040, will now make an appearance on Form 1065 as well, albeit not on the first page.

30	At any time during this tax year, did the partnership (a) receive (as a reward, award, or payment for property or services); or (b) sell, exchange, or otherwise dispose of a digital asset (or financial interest in a digital asset)? See instructions		

Schedule K-1, "Partner's Share of Income, Deductions, Credits, etc."

Alterations in the 2023 draft Schedule K-1 are identifiable in Part II, specifically in Sections J and K. In the 2022 form, Section J asked whether a decrease in a partner's share of profit, loss, or capital was attributable to a sale or an exchange of partnership interest. However, it did not inquire which of the two events had transpired.

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

	Beginning	Ending
Profit	%	%
Loss	%	%
Capital	%	%

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

The 2023 draft of Schedule K-1 now requires the partnership to specify whether the decrease was the result of a sale or an exchange.

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

	Beginning	Ending
Profit	%	%
Loss	%	%
Capital	%	%

Check if decrease is due to:

☐ Sale or ☐ Exchange of partnership interest. See instructions.

[707] Form 7208 (Draft as of June 8, 2023), June 8, 2023, https://www.irs.gov/pub/irs-dft/f7208--dft.pdf (retrieved June 29, 2023)

In May 2023, we posted an article[708] about Kristen Parillo's article in *Tax Notes Today*[709] in which Adrienne Mikolashek, the IRS Deputy Associate Chief Counsel for Passthroughs and Special Industries, revealed at the American Bar Association Section of Taxation meeting that the 2023 Schedule K-1 (Form 1065) would undergo revisions. Specifically, it was stated that the form would separately report a partner's share of recourse liabilities, including debt restoration obligations and partner debt guarantees.

However, the draft K-1 does not mandate the disclosure of specific amounts related to debt restoration obligations or partner debt guarantees. Instead, it introduces a checkbox to indicate if any portion of the partners' reported share of liabilities is subject to a guarantee or other payment obligation by the partner.

K1 Partner's share of liabilities:

	Beginning	Ending
Nonrecourse . .	$	$
Qualified nonrecourse financing . . .	$	$
Recourse . . .	$	$

K2 Check this box if item K1 includes liability amounts from lower-tier partnerships ☐

K3 Check if any of the above liability is subject to guarantees or other payment obligations by the partner. See instructions . . . . . ☐

The draft does include a note stating "See instructions." This suggests that additional guidelines may require a schedule detailing the precise amounts of such items to be attached to Schedule K-1. However, until the instructions for the 2023 form are released, this remains speculative.

Schedule K-3 (Form 1065), "Partner's Share of Income, Deductions,Credits, etc.—International"

The initial modification in the 2023 draft Schedule K-3 is the elimination of a checkbox that was utilized in the 2022 version for the provision of additional information to the partner. Specifically, in the 2022 Schedule K-3, checkbox 7 signified that attachments related to Form 8858, "Information Return of U.S. Persons With Respect to Foreign Disregarded Entities (FDEs) and Foreign Branches (FBs)," would accompany Schedule K-3.

Part I **Partner's Share of Partnership's Other Current Year International Information**

Check box(es) for additional specified attachments. See instructions.

☐ 1. Gain on personal property sale	☐ 5. High-taxed income	☐ 8. Form 5471 information	☐ 11. Dual consolidated loss
☐ 2. Foreign oil and gas taxes	☐ 6. Section 267A disallowed deduction	☐ 9. Other forms	☐ 12. Form 8865 information
☐ 3. Splitter arrangements	☐ 7. Form 8858 information	☐ 10. Partner loan transactions	☐ 13. Other international items (attach description and statement)
☐ 4. Foreign tax translation			

[708] Ed Zollars, CPA, "Imminent IRS Changes to Schedule K-1 Seek to Refine Debt Reporting and Partner Obligations," *Current Federal Tax Developments*, May 13, 2023, https://www.currentfederaltaxdevelopments.com/blog/2023/5/13/imminent-irs-changes-to-schedule-k-1-seek-to-refine-debt-reporting-and-partner-obligations (retrieved June 29, 2023)

[709] Kristen A. Parillo, "ABA Section of Taxation Meeting: IRS to Tweak Schedule K-1 Reporting of Recourse Debt," Tax Notes Today Federal, May 9 2023, https://www.taxnotes.com/tax-notes-today-federal/information-reporting/aba-section-taxation-meeting-irs-tweak-schedule-k-1-reporting-recourse-debt/2023/05/09/7gnl0 (subscription required, retrieved June 20, 2023)

In the 2023 draft of Schedule K-3 (Form 1065), this previously utilized checkbox is grayed out, indicating the attachment's removal from the form's list of requirements.

Part I **Partner's Share of Partnership's Other Current Year International Information**

Check box(es) for additional specified attachments. See instructions.

☐ 1. Gain on personal property sale	☐ 5. High-taxed income	☐ 8. Form 5471 information	☐ 11. Dual consolidated loss
☐ 2. Foreign oil and gas taxes	☐ 6. Section 267A disallowed deduction	☐ 9. Other forms	☐ 12. Form 8865 information
☐ 3. Splitter arrangements	☐ 7. Reserved for future use	☐ 10. Partner loan transactions	☐ 13. Other international items (attach description and statement)
☐ 4. Foreign tax translation			

AND OMB USE

The subsequent modification is observed in Part II (Foreign Tax Credit Limitation), specifically Section 2 (Deductions) concerning interest. In the 2022 version of Schedule K-3, the columns for U.S. source, foreign branch category income, passive category income, general category income, and Other were grayed out, indicating they were not applicable.

Section 2—Deductions

Description	(a) U.S. source	Foreign Source				(f) Sourced by partner	(g) Total
		(b) Foreign branch category income	(c) Passive category income	(d) General category income	(e) Other (category code_____)		
25 Expenses allocable to sales income							
26 Expenses allocable to gross income from performances of services							
27 Net short-term capital loss							
28 Net long-term capital loss							
29 Collectibles loss							
30 Net section 1231 loss							
31 Other losses							
32 Research & experimental (R&E) expenses							
A SIC code:							
B SIC code:							
C SIC code:							
33 Allocable rental expenses—depreciation, depletion, and amortization							
34 Allocable rental expenses—other than depreciation, depletion, and amortization							
35 Allocable royalty and licensing expenses—depreciation, depletion, and amortization							
36 Allocable royalty and licensing expenses—other than depreciation, depletion, and amortization							
37 Depreciation not included on line 33 or 35							
38 Charitable contributions							
39 Interest expense specifically allocable under Regulations section 1.861-10(e)							
40 Other interest expense specifically allocable under Regulations section 1.861-10T							
41 Other interest expense—business							
42 Other interest expense—investment							
43 Other interest expense—passive activity							

In the 2023 draft of Schedule K-3, these columns are no longer grayed out but are instead open to accept entries on each line.

Section 2—Deductions

AND OMB USE ONLY DRAFT June 21, 2023 DO NOT FILE

Description	(a) U.S. source	Foreign Source				(f) Sourced by partner	(g) Total
		(b) Foreign branch category income	(c) Passive category income	(d) General category income	(e) Other (category code ____)		
25 Expenses allocable to sales income							
26 Expenses allocable to gross income from performance of services							
27 Net short-term capital loss							
28 Net long-term capital loss							
29 Collectibles loss							
30 Net section 1231 loss							
31 Other losses							
32 Research & experimental (R&E) expenses							
A SIC code:							
B SIC code:							
C SIC code:							
33 Allocable rental expenses—depreciation, depletion, and amortization							
34 Allocable rental expenses—other than depreciation, depletion, and amortization							
35 Allocable royalty and licensing expenses—depreciation, depletion, and amortization							
36 Allocable royalty and licensing expenses—other than depreciation, depletion, and amortization							
37 Depreciation not included on line 33 or line 35							
38 Charitable contributions							
39 Interest expense specifically allocable under Regulations section 1.861-10(e)							
40 Other interest expense specifically allocable under Regulations section 1.861-10T							
41 Other interest expense—business							
42 Other interest expense—investment							
43 Other interest expense—passive activity							

The final revisions are located in Part XIII, titled "Foreign Partner’s Distributive Share of Deemed Sale Items on Transfer of Partnership Interest." The 2022 Schedule K-3 included the following information:

Part XIII Foreign Partner’s Distributive Share of Deemed Sale Items on Transfer of Partnership Interest

A Date of transfer of the partnership interest	B1 Percentage interest in the partnership transferred	B2 Number of units in the partnership transferred	B3 Reserved for future use

C Check if: 1 ☐ Capital 2 ☐ Preferred 3 ☐ Profits 4 ☐ Other

			Partner’s Distributive Share
1	Total ordinary gain (loss) that would be recognized on the deemed sale of section 751 property	1	
2	Aggregate effectively connected ordinary gain (loss) that would be recognized on the deemed sale of section 751 property	2	
3	Aggregate effectively connected capital gain (loss) that would be recognized on the deemed sale of non-section 751 property	3	
4	Gain (loss) that would be recognized under section 897(g) on the deemed sale of U.S. real property interests	4	
5	Check this box if the amount provided on line 2 or 3 is determined (in whole or in part) under Regulations section 1.864(c)(8)-1(c)(2)(ii)(E) (material change in circumstances rule for a deemed sale of the partnership’s inventory property or intangibles) ☐		
6	Reserved for future use	6	
7	Reserved for future use	7	
8	Reserved for future use	8	

In the 2023 draft, three additional lines have been introduced, effectively replacing the previously designated "Reserved for future use" lines.

Part XIII Foreign Partner’s Distributive Share of Deemed Sale Items on Transfer of Partnership Interest

June 21, 2023 DO NOT FILE

A Date of transfer of the partnership interest	B1 Percentage interest in the partnership transferred	B2 Number of units in the partnership transferred	B3 Reserved for future use

C Check if: 1 ☐ Capital 2 ☐ Preferred 3 ☐ Profits 4 ☐ Other

			Partner’s Distributive Share
1	Total ordinary gain (loss) that would be recognized on the deemed sale of section 751 property	1	
2	Aggregate effectively connected ordinary gain (loss) that would be recognized on the deemed sale of section 751 property	2	
3	Aggregate effectively connected capital gain (loss) that would be recognized on the deemed sale of non-section 751 property	3	
4	Aggregate effectively connected gain (loss) that would be recognized on the deemed sale of section 1(h)(5) collectible assets	4	
5	Aggregate effectively connected gain that would be recognized on the deemed sale of section 1(h)(6) unrecaptured section 1250 gain assets	5	
6	Check this box if any amount on lines 2 through 5 is determined (in whole or in part) under Regulations section 1.864(c)(8)-1(c)(2)(ii)(E) (material change in circumstances rule for a deemed sale of the partnership’s inventory property or intangibles) ☐		
7	Capital gain (loss) that would be recognized under section 897(g) on the deemed sale of U.S. real property interests	7	
8	Gain that would be recognized under section 897(g) on the deemed sale of section 1(h)(6) unrecaptured section 1250 gain assets	8	

SECTION: 6221
UNDERLYING ENTITY TYPE, NOT EXEMPT VS. TAXABLE STATUS, DETERMINES IF AN ORGANIZATION IS AN ELIGIBLE PARTNER FOR PARTNERSHIP ELECTION OUT OF BBA AUDIT REGIME

Citation: IRS Emailed Counsel Advice 202147012, 11/26/21

The IRS clarified, in emailed counsel advice,[710] that it does not matter if a partner is a for profit or exempt organization to determine if that partner will bar the partnership from electing out of the regime under IRC §6221(b).

The email is written in response to a question that is not disclosed in the document. However, it's fairly certain the question that was asked was whether a partnership that had a tax exempt partner could opt out of the BBA partnership audit regime when filing its return using the procedures found at IRC §6221(b)(1).

IRC §6221(b)(1) provides:

> (b) Election out for certain partnerships with 100 or fewer, etc.
>
> (1) In general
>
> This subchapter shall not apply with respect to any partnership for any taxable year if—
>
> > (A) the partnership elects the application of this subsection for such taxable year,
> >
> > (B) for such taxable year the partnership is required to furnish 100 or fewer statements under section 6031(b) with respect to its partners,
> >
> > (C) each of the partners of such partnership is an individual, a C corporation, any foreign entity that would be treated as a C corporation were it domestic, an S corporation, or an estate of a deceased partner,
> >
> > (D) the election—
> >
> > > (i) is made with a timely filed return for such taxable year, and
> > >
> > > (ii) includes (in the manner prescribed by the Secretary) a disclosure of the name and taxpayer identification number of each partner of such partnership, and
> >
> > (E) the partnership notifies each such partner of such election in the manner prescribed by the Secretary.

[710] IRS Emailed Counsel Advice 202147012, November 26, 2021, https://www.irs.gov/pub/irs-wd/202147012.pdf (retrieved November 29, 2021)

The email provides the following answer in response to the inquiry:

> Whether an entity is tax-exempt/not-for-profit or not has nothing to do with whether an entity is an eligible partner for purposes of election out under BBA. It solely depends on what type of entity the partner is. A tax-exempt/not-for-profit entity still has an entity type (e.g., C corp, etc).[711]

[711] IRS Emailed Counsel Advice 202147012, November 26, 2021

NOTES

Unit

6

Tax Practice Update

LEARNING OBJECTIVES

- Apply recent developments over the past two years related to tax practice matters to your business' tax issues

SECTION: 6011
IRS EXTENDS THROUGH OCTOBER 2023 PROGRAM ALLOWING E-SIGNATURES FOR A SPECIFIC LIST OF FORMS

Citation: "Details on using e-signatures for certain forms," FS-2021-12, September 1, 2021

After initially beginning a temporary acceptance of certain e-signatures during 2020 as a response to the COVID-19 pandemic, then extending that program twice, dropping the "temporary" designation in the most recent extension, the IRS now appears to have made the program permanent in IRS Fact Sheet 2021-12.[712]

The IRS justifies allowing e-signatures on certain forms as follows:

> To help reduce burden for the tax community, the IRS allows taxpayers to use electronic or digital signatures on certain paper forms they cannot file electronically. The agency is balancing the e-signature option with critical security and protection needed against identity theft and fraud. Understanding the importance of electronic signatures to the tax community, the IRS offers an overview about using them on certain forms.[713]

The Fact Sheet provides that it will accept a "wide range of electronic signatures." The notice goes on to list the following specific methods that are deemed acceptable:

- A typed name typed on a signature block

[712] "Details on using e-signatures for certain forms," FS-2021-12, September 1, 2021, https://www.irs.gov/newsroom/details-on-using-e-signatures-for-certain-forms

[713] "Details on using e-signatures for certain forms," FS-2021-12, September 1, 2021

- A scanned or digitized image of a handwritten signature that's attached to an electronic record
- A handwritten signature input onto an electronic signature pad
- A handwritten signature, mark or command input on a display screen with a stylus device
- A signature created by a third-party software.[714]

While the Fact Sheet does not bar the use of other forms of e-signatures, professionals likely will want to use one of the specifically approved methods, if possible, to eliminate the risk of the IRS claiming the specific method used is not appropriate.

The Fact Sheet notes that various methods can be used to capture the e-signature:

> The IRS doesn't specify what technology a taxpayer must use to capture an electronic signature. The IRS will accept images of signatures (scanned or photographed) including common file types supported by Microsoft 365 such as tiff, jpg, jpeg, pdf, Microsoft Office suite or Zip.[715]

One missing format on that list is the HEIC (High-Efficiency Image Format) image format used by default by iPhones and other Apple products running recent versions of the company's operating systems (such as iOS 11 and later versions), so most likely they should be converted to JPEG or PDF for permanent storage if a professional receives files in that format.

Apple switched to that format as it is more space efficient, but support outside of Apple products is more limited, specifically causing issues for Windows users who don't resort to third party software. The lack of native Windows support likely explains why the IRS does not list this format in its list of clearly acceptable formats.

The IRS added more forms to those for which e-signatures will be accepted as the program was extended. The list of forms for which the IRS will deem electronic signatures acceptable are, as of September 1, 2021:

- Form 11-C, Occupational Tax and Registration Return for Wagering;
- Form 637, Application for Registration (For Certain Excise Tax Activities);
- Form 706, U.S. Estate (and Generation-Skipping Transfer) Tax Return;
- Form 706-A, U.S. Additional Estate Tax Return;
- Form 706-GS(D), Generation-Skipping Transfer Tax Return for Distributions;
- Form 706-GS(D-1), Notification of Distribution from a Generation-Skipping Trust;
- Form 706-GS(T), Generation-Skipping Transfer Tax Return for Terminations;

[714] "Details on using e-signatures for certain forms," FS-2021-12, September 1, 2021

[715] "Details on using e-signatures for certain forms," FS-2021-12, September 1, 2021

- Form 706-QDT, U.S. Estate Tax Return for Qualified Domestic Trusts;
- Form 706 Schedule R-1, Generation Skipping Transfer Tax;
- Form 706-NA, U.S. Estate (and Generation-Skipping Transfer) Tax Return;
- Form 709, U.S. Gift (and Generation-Skipping Transfer) Tax Return;
- Form 730, Monthly Tax Return for Wagers;
- Form 1066, U.S. Income Tax Return for Real Estate Mortgage Investment Conduit;
- Form 1120-C, U.S. Income Tax Return for Cooperative Associations;
- Form 1120-FSC, U.S. Income Tax Return of a Foreign Sales Corporation;
- Form 1120-H, U.S. Income Tax Return for Homeowners Associations;
- Form 1120-IC DISC, Interest Charge Domestic International Sales – Corporation Return;
- Form 1120-L, U.S. Life Insurance Company Income Tax Return;
- Form 1120-ND, Return for Nuclear Decommissioning Funds and Certain Related Persons;
- Form 1120-PC, U.S. Property and Casualty Insurance Company Income Tax Return;
- Form 1120-REIT, U.S. Income Tax Return for Real Estate Investment Trusts;
- Form 1120-RIC, U.S. Income Tax Return for Regulated Investment Companies;
- Form 1120-SF, U.S. Income Tax Return for Settlement Funds (Under Section 468B);
- Form 1127, Application for Extension of Time for Payment of Tax Due to Undue Hardship;
- Form 1128, Application to Adopt, Change or Retain a Tax Year;
- Form 2678, Employer/Payer Appointment of Agent;
- Form 3115, Application for Change in Accounting Method;
- Form 3520, Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts;
- Form 3520-A, Annual Information Return of Foreign Trust With a U.S. Owner;
- Form 4421, Declaration – Executor's Commissions and Attorney's Fees;
- Form 4768, Application for Extension of Time to File a Return and/or Pay U.S. Estate (and Generation-Skipping Transfer) Taxes;
- Form 8038, Information Return for Tax-Exempt Private Activity Bond Issues;

- Form 8038-G, Information Return for Tax-Exempt Governmental Bonds;
- Form 8038-GC; Information Return for Small Tax-Exempt Governmental Bond Issues, Leases, and Installment Sales;
- Form 8283, Noncash Charitable Contributions;
- Form 8453 series, Form 8878 series, and Form 8879 series regarding IRS e-file Signature Authorization Forms;
- Form 8802, Application for U.S. Residency Certification;
- Form 8832, Entity Classification Election;
- Form 8971, Information Regarding Beneficiaries Acquiring Property from a Decedent;
- Form 8973, Certified Professional Employer Organization/Customer Reporting Agreement; and
- Elections made per Internal Revenue Code Section 83(b).[716]

The IRS Fact Sheet indicates that these are forms that cannot be filed using IRS e-file.[717] Thus, it seems unlikely that the IRS will allow e-signatures to be used for forms that can be electronically filed with the IRS and that any form on this list that is later added to IRS e-file may be removed from the list.

Advisers must take care not to use this option for any forms not on the list. As we reported in July, the use of an unapproved signature method can cause the filing to be rejected as lacking a signature.[718]

SECTION: 6051
IRS OPENS UP WEBSITE TO ALLOW FOR ELECTRONIC SIGNING AND SUBMISSION OF POWERS OF ATTORNEY

Citation: "Use Tax Pro Account," IRS website, 7/18/21

The IRS has opened up a website by which Circular 230 practitioners (CPAs, EAs and attorneys) can submit a Power of Attorney request.[719] The page contains information on using the service as well as the link to access the system. The IRS has also published an addition to the Internal

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[716] "Details on using e-signatures for certain forms," FS-2021-12, September 1, 2021

[717] "Details on using e-signatures for certain forms," FS-2021-12, September 1, 2021

[718] See Ed Zollars, CPA, "Digital Signature on 2014 and 2015 Amended Returns Was Not a Valid Signature," *Current Federal Tax Developments* website, July 15, 2021, https://www.currentfederaltaxdevelopments.com/blog/2021/7/15/digital-signature-on-2014-and-2015-amended-returns-was-not-a-valid-signature

[719] "Use Tax Pro Account," IRS website, https://www.irs.gov/tax-professionals/use-tax-pro-account (retrieved July 18, 2021)

Revenue Manual at 21.2.1.63[720] that describes the program and noted it would become available on July 18, 2021. The program is described as follows:

> Tax Pro Account is an online system, available to the public on July 18, 2021, that allows individual tax professionals to securely request third party authorizations for an individual taxpayer as power of attorney (POA) or tax information authorization (TIA), in lieu of filing a paper Form 2848, *Power of Attorney and Declaration of Representative*, or Form 8821, *Tax Information Authorization*.[721]

However, the IRM notes that "[t]he Tax Pro Account application does not have the [specific capabilities] that the forms allow, as detailed below."[722] That is, only a very limited set of authorizations can be handled via this system. In fact, advisers will note that the system, at least at the beginning, is very limited in the situations in which it can be used, and it will require the adviser's client to access the system as well as this system has both the professional and the client electronically sign the form.

To use the system the tax professional must verify their identity and pass an authorization process using the IRS Secure Access eAuthentication.[723] The professional must already have a Centralized Authorization File (CAF) number, be in good standing and not have been suspended or disbarred from practice before the IRS.[724]

The system's hours are provided as follows:

> The system will be available Monday 6:00 a.m. to Saturday 9:00 p.m. Eastern Time, and Sunday 10:00 a.m. to midnight Eastern Time.[725]

There are restrictions on the years available under this program:

> Authorizations for POA and TIA may be requested from tax year 2000 through the current year, plus three additional years. For 2021 authorizations may be requested for 2000-2024. If the tax professional requires authorization for tax year 1999 and prior, they must submit their request to the CAF unit on a Form 2848 or Form 8821.[726]

Filing a Form 2848 or Form 8821 will replace any existing authorization of the same type for the same year(s) on the taxpayer's account.[727] The IRS gives the following example of this replacement:

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[720] IRM Procedural Update, "Tax Pro Account - New Online System Interface," July 6, 2021, https://www.irs.gov/pub/foia/ig/wi/wi-21-0721-0914.pdf (retrieved July 18, 2021)

[721] IRM 21.2.1.63.1

[722] IRM 21.2.1.63.1

[723] IRM 21.2.1.63.2

[724] IRM 21.2.1.63.4

[725] IRM 21.2.1.63.3

[726] IRM 21.2.1.63.6

[727] IRM 21.2.1.63.7

EXAMPLE

(IRM 21.2.1.63.7)

Enrolled agent Grayson Smith has authority on taxpayer Mary Johnson's account for tax years 2000 – 2018. A new request for authority is made for 2017 – 2024 by Michael Williams on Mary Johnson's account. Once the request is processed, Grayson Smith will only have authority for 2000 – 2016, as Michael William's request via Tax Pro Account will invalidate Grayson's authorization on 2017 and 2018. In order to preserve Grayson Smith's authority on 2017 – 2018, Mary Johnson will have to file a Form 2848 or Form 8821, check the box to maintain a prior authorization and include a copy of Grayson Smith's authorization.

The professional will need to have the following information in order to complete an online request for authorization:

- Their CAF number.
- The name and address, as currently on file with their CAF number per IRS records. Address must be located in one of the 50 US States or the District of Columbia.
- The taxpayer's Taxpayer Identification Number (TIN).
- The taxpayer's name and address, as currently on file per the IRS records. Address must be (in) the 50 US States and District of Columbia.
- The Tax Matters and Tax Years for which they are requesting authority.[728]

The following items are not supported for representation requests submitted under this system and will require filing a paper form instead:

- Specific Use Not Recorded on CAF (line 4 of Form 2848 and Form 8821)
- Additional Acts Authorized (line 5a on Form 2848)
- Specific Acts Not Authorized (line 5b on Form 2848)
- Retention/Revocation of Prior Power(s) of Attorney (line 6 on Form 2848), Retention/Revocation of Prior Tax Information Authorizations (line 5 on Form 8821)[729]

In Step 1 the IRS will have the tax professional enter their own information which the agency will verify. If the information does not match IRS records, the professional will need to correct the information to proceed.[730]

In Step 2 the professional will enter the taxpayer's information. To prevent the abuse of the system to be used by parties looking to obtain information that could be used for frauds against

[728] IRM 21.2.1.63.8

[729] IRM 21.2.1.63.9

[730] IRM 21.2.1.63.11

taxpayers, the system will not inform the tax professional if the information does not match the IRS records. However, only if the information does match the information for the taxpayer will the request be forwarded to the taxpayer's own online account for their approval. The taxpayer will need to have or setup an online account with the IRS to use this system, going through a similar verification and authentication process as the tax professional went through to establish an account.[731]

In Step 3, the tax professional will enter the tax periods and tax matters to be covered by the authorization. The tax matters supported by the online system currently are:

- Form 1040 Income Tax
- Split Spousal Assessment or Form 8857 Innocent Spouse Relief
- Shared Responsibility Payment
- Shared Responsibility Payment – Split Spousal Assessment
- Civil Penalty (limited to periods of March, June, September, and December)[732]

Again, if the adviser wishes to obtain authorization for tax matters not listed, the tax adviser will need to file a paper authorization form.[733]

In Step 4 the tax professional will be able to review, edit and submit the request.[734] In Step 5, the professional will receive a confirmation of submission if the request is successfully submitted. Until the taxpayer takes action on the request, the tax professional can cancel the request, but once the taxpayer approves or rejects the request the professional will no longer be able to cancel the request.[735]

The tax professional is advised at this point to contact the taxpayer to advise them they need to log into their IRS online account and act on the request.[736] If the taxpayer approves the request, the authorization will show in the tax professional's authorization list as approved, while if the taxpayer rejects the request it will be removed from the authorization list and the professional will not be able to review the status.[737]

However, the IRM notes that an approved request may not be immediately added to the tax professional's approved list:

> If the taxpayer approves the request and it goes into a "processing" status, meaning it will attempt to be processed in the next 48 hours, it will be removed from the tax professional's list. The item will be removed from their list because the tax professional can no longer cancel it and it is not written to CAF. If this

[731] IRM 21.2.1.63.12

[732] IRM 21.2.1.63.13, 14

[733] IRM 21.2.1.63.14

[734] IRM 21.2.1.63.15

[735] IRM 21.2.1.63.16

[736] IRM 21.2.1.63.16

[737] IRM 21.2.1.63.17, 18

> authorization is later processed to the CAF database, it will show in the tax professional's Authorizations table as Approved. The tax professional should contact the taxpayer regarding any questions or concerns as they apply to the status of a request that they can't view.[738]

A withdrawal of representation cannot be processed on this system:

> Tax Pro Account does not allow for withdraw or revoke, at this time. Cancel is not the same as withdraw. Cancel is the functionality used for the tax professional to delete or remove a request they have initiated for the taxpayer to sign. Once signed and processed, the request must follow the same revoke or withdraw guidelines as a paper Form 2848 or Form 8821. The person wanting to revoke or withdraw must print a copy of the authorization and submit it following the Form 2848 or Form 8821 instructions for revoke or withdraw.[739]

Special limits apply to multiple requests by a professional on the same day:

> Tax Pro Account has the ability for the tax professional to cancel any requests that they don't want the taxpayer to approve. However, if the taxpayer approves a request today and is then presented with another request, for the same tax professional, with at least one of the same tax periods and tax matters that they have already approved today, the request will fail to write to CAF. The new request for the same tax professional will be able to be signed and processed on a future date.[740]

If multiple representatives are to be appointed via this system, the following special rules apply:

- Each third-party must complete their own authorization request and submit it to the taxpayer's IRS online account, following the guidance above.
- The taxpayer must sign all of the online authorization requests <u>on the same day</u>
- Only two third parties can receive copies of IRS notices and communications for each authorization type. If the taxpayer attempts to approve more than two to receive notices, any request, after the second one, will fail to write to the CAF.[741]

[738] IRM 21.2.1.63.19

[739] IRM 21.2.1.63.21

[740] IRM 21.2.1.63.22

[741] IRM 21.2.1.63.23

SECTION: 6061
DIGITAL SIGNATURE ON 2014 AND 2015 AMENDED RETURNS WAS NOT A VALID SIGNATURE

Citation: Mills v. United States, United States Court of Federal Claims, 7/14/21

During the COVID-19 pandemic, many people turned to digital signatures to avoid meeting face to face. And, as we've noted in prior posts, the IRS also authorized the use of electronic signatures for many purposes.[742] If you search Google for "digital signatures legally binding" you are likely to get links to articles from many digital signature providers with headlines stating that such signatures are legally binding.

But if you read behind the headlines you will find caveats and exceptions. In the case of *Mills v. United States*,[743] the taxpayer discovered that signatures on tax documents are subject to specific requirements and his use of a digital signature did not count, costing him the chance to pursue his claim for refund.

The taxpayer in question was a U.S. citizen living in Australia working for a defense contractor. His path to this case dealing with electronic signatures began when he had a tax consulting firm look at his tax returns.

> In 2018, the plaintiff hired a tax-consulting firm, Castro & Co., LLC, to review his tax returns and to prepare amended returns. (Id. ¶ 45.) Castro & Co. determined that the plaintiff was entitled both to an FEIE[744] and to a tax exclusion for employer-provided lodging. (Id. ¶ 46.) The plaintiff had not claimed either exclusion on his original 2015 and 2016 tax returns. (Id.) Based on this assessment, the plaintiff sought to amend his returns.[745]

Mr. Mills initially tried to file amended returns by having an associate of the tax consulting firm sign the amended returns on his behalf:

> On November 29, 2018, the plaintiff filed Form 1040X, U.S. Amended Income Tax Returns, for both tax years 2015 and 2016 ("first amended returns"), claiming a refund of $10,950.00 and $1,764.00, respectively. (Id. ¶ 47; see also ECF 24-2, Ex. 5; ECF 24-3, Ex. 7.) Because he was living in Australia when he filed his first amended returns, the plaintiff did not sign them. (Mills Decl. ¶ 5; see also ECF 24-2, Ex. 5 at A-083; ECF 24-3, Ex. 7 at A-179.) Instead, Tiffany Michelle Hunt, an associate of Castro & Co., signed her name on both the 2015

[742] See Edward Zollars, "IRS Extends and Expands Temporary Deviation Allowing Some Forms to Be Signed Electronically or Digitally," *Current Federal Tax Developments* website, April 23, 2021, https://www.currentfederaltaxdevelopments.com/blog/2021/4/23/irs-extends-and-expands-temporary-deviation-allowing-some-forms-to-be-signed-electronically-or-digitally (retrieved July 15, 2021)

[743] *Mills v. United States*, United States Court of Federal Claims, July 14, 2021, https://www.taxnotes.com/research/federal/court-documents/court-opinions-and-orders/%27digital-marks%27-on-amended-returns-spell-end-of-refund-suit/76vwb (retrieved July 15, 2021)

[744] Foreign Earned Income Exclusion

[745] *Mills v. United States*, United States Court of Federal Claims, July 14, 2021

> and 2016 amended returns on each return's line designated for the taxpayer's sworn signature in the jurat. (See ECF 24-2, Ex. 5 at A-083; ECF 24-3, Ex. 7 at A-179.) The name "John Anthony Castro," of Castro & Co., was typed on the line designated for the preparer's signature. (See ECF 24-2, Ex. 5 at A-083; ECF 24-3, Ex. 7 at A-179.) The plaintiff did not include a power of attorney with these first amended returns. (See ECF 24-2, Ex. 5; ECF 24-3, Ex. 7.)
>
> Several months after filing the first amended returns, the plaintiff filed a Form 2848, Power of Attorney and Declaration of Representative, that he signed on January 31, 2019. (Mills Decl. ¶ 6; see also ECF 24-3, Ex. 9.) On his Form 2848, the plaintiff indicated his authorization for John Anthony Castro, Tiffany Michelle Hunt, and Kasondra Kay Humphreys to represent him before the IRS. (Mills Decl. ¶ 6; see also ECF 24-3, Ex. 9.) Although the plaintiff gave these three representatives authority to act on his behalf for income-tax matters, he did not check the box in Part 5a of Form 2848 providing them with the authority to "[s]ign a return." (ECF 24-3, Ex. 9 at A-276.) The plaintiff signed the power of attorney form with his handwritten signature. (See id. at A-277.)[746]

Eventually the IRS noticed that the taxpayer had not himself signed the returns in question:

> In a letter dated August 20, 2019, the IRS advised the plaintiff that the first amended returns did "not appear to have your signatures" and that it did "not appear that you have authorized a representative to sign a return on your behalf." (ECF 24-3, Ex. 11 at A-280.) The IRS requested the plaintiff submit 1040X forms bearing original signatures. (Id.)

By this time, the taxpayer was now on assignment in Afghanistan, facing the request that he hand sign the forms:

> In response to the IRS's request, on August 27, 2019, the plaintiff again filed Form 1040X, U.S. Amended Income Tax Returns, for tax years 2015 and 2016 ("second amended returns"). (ECF 1, ¶ 47; see also ECF 24-3, Exs. 6 & 8.) At the time of filing, the plaintiff was deployed by his employer to Afghanistan without an easily accessible unclassified printer to print, sign by hand, and scan the documents. (Mills Decl. ¶¶ 9-11.) Instead of signing the forms by hand, the plaintiff attests that he electronically "signed" each Form 1040X with his initials, "KJM." (Id. ¶ 11; see also ECF 24-3, Ex. 6 at A-176, Ex. 8 at A-275.) He attests that he intended the digital markings to be his signature and to bind him to the second amended returns. (Mills Decl. ¶ 11.)[747]

Mr. Mills filed suit in the Court of Federal Claims attempting to get the refunds he claimed were due to him on the amended returns. But the IRS argued that Mr. Mills had failed to take the steps necessary to bring this matter before the United States Court of Federal Claims:

IRC §7422(a) provides:

> No suit or proceeding shall be maintained in any court for the recovery of any internal revenue tax alleged to have been erroneously or illegally assessed or

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[746] *Mills v. United States*, United States Court of Federal Claims, July 14, 2021

[747] *Mills v. United States*, United States Court of Federal Claims, July 14, 2021

> collected, or of any penalty claimed to have been collected without authority, or of any sum alleged to have been excessive or in any manner wrongfully collected, until a claim for refund or credit has been duly filed with the Secretary, according to the provisions of law in that regard, and the regulations of the Secretary established in pursuance thereof.[748]

The IRS pointed out that the regulations required written verification under penalty of perjury, and that such a claim must be signed properly.[749] The IRS position was that such a digital signature was not an authorized method of signing this return at the time it was filed in August of 2019.

The Court noted that the IRS has provided little guidance on what is necessary for a signature, not defining the words *sign* or *signature*.[750]

Congress did direct the IRS to develop measures to accept electronic signatures in 1998, adding IRC §6061(b)(1) which provides:

> (b) Electronic signatures. —
>
> > (1) In general. — The Secretary shall develop procedures for the acceptance of signatures in digital or other electronic form. Until such time as such procedures are in place, the Secretary may —
> >
> > > (A) waive the requirement of a signature for; or
> > >
> > > (B) provide for alternative methods of signing or subscribing,
> >
> > a particular type or class of return, declaration, statement, or other document required or permitted to be made or written under internal revenue laws and regulations.[751]

The Court noted that over those more than twenty years the IRS had not, until recently, developed any procedures to accept electronic signatures on amended returns. The Court also notes that while the IRS instructions for the original Forms 1040 for the years in question provide for accepting electronic signatures with a personal identification number, the instructions for amended returns had no comments on accepting electronic signatures.[752]

The taxpayer argued that his electronic signature should count as a signing of the amended return:

> The plaintiff argues that he did sign the second amended returns under penalty of perjury, as required by Treasury Regulation § 301.6402-2(b). He relies on the definition of "signature" found at 1 U.S.C. § 1: "'signature' or 'subscription' includes a mark when the person making the same intended it as such." 1 U.S.C. § 1.9 At the time that he filed his second amended returns, the plaintiff was working in Afghanistan. (Mills Decl. ¶ 9.) Without an easily accessible

[748] *Mills v. United States*, United States Court of Federal Claims, July 14, 2021

[749] Treasury Reg. §301-6402-2

[750] *Mills v. United States*, United States Court of Federal Claims, July 14, 2021

[751] IRC §6061(b)(1)

[752] *Mills v. United States*, United States Court of Federal Claims, July 14, 2021

> unclassified printer to print, sign by hand, and scan the documents, the plaintiff attests that he electronically signed the form with his initials, "KJM," and intended those digital markings to be his signature and to bind him to the second amended returns. (Id. ¶¶ 9-11; see also ECF 24-3, Ex. 6 at A-176, Ex. 8 at A-275.) Although the plaintiff argues that, as a matter of policy, he should be allowed to submit an electronic signature in his unique situation, he cannot point to any source of law authorizing him to do so.
>
> The plaintiff also relies on the definition of electronic signature in the Government Paperwork Elimination Act ("GPEA"), Pub. L. No. 105-277, §§ 1701-10, 112 Stat. 2681 (1998). The GPEA provides that "[t]he term 'electronic signature' means a method of signing an electronic message that — (A) identifies and authenticates a particular person as the source of the electronic message; and (B) indicates such person's approval of the information contained in the electronic message." GPEA § 1710. The plaintiff cites a 2016 IRS Chief Counsel Advisory that provided that digital signatures are legally sufficient under the GPEA and I.R.C. § 6061(b)(1), the provision directing the Secretary to develop procedures for accepting signatures in digital or other electronic form. Electronic Signatures & Form 2678, IRS CCA 201650019 (Dec. 9, 2016).

But the Court did not accept either justification. First, it notes that the law, by itself, did not allow for the taxpayer's digital signature.

> The Court, however, finds that I.R.C. § 6061(b)(1) does not, on its own, authorize the plaintiff's digital markings as a signature. Until the Secretary establishes procedures for digital or electronic signing, the Secretary ***may***, but is not required to, waive the signature requirement or provide alternative methods of signing. I.R.C. § 6061(b)(1). The plaintiff has not pointed to any waiver or alternative method authorizing him to sign his second amended returns with digital markings as a signature. Similarly, 1 U.S.C. § 1 does not determine the meaning of signature in I.R.C. § 6061. The definition of "signature" in 1 U.S.C. § 1 applies "unless the context indicates otherwise." 1 U.S.C. § 1. Context indicates otherwise here; in fact, I.R.C. § 6061(b)(1) expressly governs electronic signatures on tax returns. See *First Nationwide Bank v. United States*, 431 F.3d 1342, 1348 (Fed. Cir. 2005) ("As a principle of statutory interpretation, a specific provision prevails against broader or more general provisions, absent clear contrary intent."). Under I.R.C. § 6061(b)(1), the plaintiff cannot digitally mark a tax return as a signature without a waiver or prescribed alternative method of signing.[753]

The Court also rejected the taxpayer's attempt to rely on the GPEA and a Chief Counsel Advisory, noting:

> The plaintiff's reliance on the GPEA and the Chief Counsel Advisory is likewise misplaced. As the plaintiff admits, the GPEA does not apply to the IRS. See GPEA § 1709 (providing explicitly that the GPEA does not apply to the Department of the Treasury or the IRS). As for the Chief Counsel Advisory, it "may not be used or cited as precedent." IRS CCA 201650019; see I.R.C. §

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[753] *Mills v. United States*, United States Court of Federal Claims, July 14, 2021

6110(k)(3) ("Unless the Secretary otherwise establishes by regulations, a written determination may not be used or cited as precedent.").

Not only may the Chief Counsel Advisory not be relied on as precedent, but it also did not consider the question of electronic signatures on tax returns. *See generally* IRS CCA 201650019. The Advisory examined "whether the Service may accept a Form 2678, *Employer/Payer Appointment of Agent*, that displays an electronic signature." Id. (italics in original). Its conclusion cuts against the plaintiff's argument. The Advisory concluded that the IRS should not accept electronic signatures without published guidance:

> It is our view that an electronic signature should only be accepted by the Service when there are published guidance or [Internal Revenue Manual ("IRM")] provisions that specifically authorize use of an electronic signature for the specific form involved. Since there is no guidance or IRM provisions authorizing the use of an electronic signature on Forms 2678, we recommend that the Service not accept Forms 2678 signed electronically until the Service authorizes its use for Forms 2678 either in published guidance or in the IRM.
>
> Id.[754]

The opinion notes that the taxpayer has not provided any example of a provision providing for such authorization to use the digital signature in the amended return situation:

> The plaintiff here has not cited any provision, in the IRM or otherwise, that authorized the use of an electronic signature on Form 1040X amended returns at the time he filed his second amended returns. That the plaintiff is unable to do so is not surprising. Electronic signatures are required for documents that may be submitted in electronic format; forms that have traditionally been filed in paper format must always have a handwritten signature.[755]

Thus, the Court finds the taxpayer has not submitted a signature with his amended return and therefore the return is not treated as filed:

> The IRS had not established procedures for accepting electronic signatures on hard-copy amended returns, had not waived the signature requirement, and had not prescribed an alternative method of signing at the time the plaintiff filed his amended returns. Accordingly, the plaintiff's digital markings on his second amended returns do not meet the requirement that his returns "be signed" and, as a refund claim, "be verified by a written declaration that it is made under the penalties of perjury." I.R.C. § 6061(a); Treas. Reg. § 301.6402-2(b).[756]

[754] *Mills v. United States*, United States Court of Federal Claims, July 14, 2021

[755] *Mills v. United States*, United States Court of Federal Claims, July 14, 2021

[756] *Mills v. United States*, United States Court of Federal Claims, July 14, 2021

SECTION: 6213
TAXPAYER'S ISSUES WITH ELECTRONIC FILING OF TAX COURT PETITION NOT SUFFICIENT CAUSE TO EXCUSE FILING MADE 11 SECONDS LATE

Citation: Sanders v. Commissioner, 160 TC No. 16, 6/20/23

Most likely, everyone has encountered a situation where a phone, computer, website, or app did not function as expected or required. A similar circumstance arose for the taxpayer in the case of *Sanders v. Commissioner*, 160 TC No. 16.[757] However, Mr. Sanders discovered that the Tax Court did not recognize his technological difficulties as a valid reason to accept his Tax Court petition, which was ultimately filed electronically just eleven seconds past midnight.

Mr. Sanders' Struggles

Mr. Sanders had a dispute with the IRS, prompting the agency to issue a notice of deficiency. Consequently, he decided to initiate a petition with the Tax Court:

> The Commissioner mailed a notice of deficiency to Mr. Sanders on September 8, 2022. Notwithstanding the actual mailing date, the notice was dated September 12, 2022, and stated that the last day to file a petition with this Court was December 12, 2022.[758]

At this juncture, Mr. Sanders made what turned out to be a consequential decision to attempt to file his petition late in the evening on the final due date using his smartphone.

> Mr. Sanders prepared to file his Petition electronically. Before December 12, 2022, Mr. Sanders set up an account to electronically file a petition through DAWSON, the Court's electronic filing system. On the evening of December 12, 2022, Mr. Sanders began the process of electronically filing his Petition. At 9:59 p.m. EDT, he downloaded the necessary PDF forms to his Android mobile phone, but he was unable to fill out the forms on his phone.
>
> Shortly after 11 p.m. on December 12, 2022, Mr. Sanders tried to file his Petition from his phone. At 23:03:07.442 (11:03 p.m.), he logged into DAWSON. At 23:42:53.728 (11:42 p.m.), he logged in again. Between 11:03 p.m., when Mr. Sanders first logged in, and 11:44 p.m., when he was logged out from his Android device for the rest of the evening, he states that he attempted to upload documents, but DAWSON "would not even allow [him] to click the button to upload the documents from [his] android device even after several times of login in and logging out."[759]

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[757] *Sanders v. Commissioner*, 160 TC No. 16, June 20, 2023, https://www.taxnotes.com/research/federal/court-documents/court-opinions-and-orders/tax-court-lacks-jurisdiction-over-petition-filed-seconds-too-late/7gwq3

[758] *Sanders v. Commissioner*, 160 TC No. 16, June 20, 2023

[759] *Sanders v. Commissioner*, 160 TC No. 16, June 20, 2023

As the deadline to submit his petition loomed, Mr. Sanders pivoted to using a computer. Despite ultimately succeeding, this alternative approach was not without its share of complications.

> After trying to file the Petition from his phone, Mr. Sanders was "finally able to switch" to his Windows computer shortly before midnight. He was slowed down by "having to send the filled out forms" from his phone to his email to be downloaded to his computer. At 23:56:15.888 (11:56 p.m.), Mr. Sanders unsuccessfully attempted to log in to DAWSON on his computer. However, within one second, another Windows user successfully logged into DAWSON. Likewise at 23:57:21.379 (11:57 p.m.), Mr. Sanders successfully logged in as well. After he logged in and started the filing process, Mr. Sanders was slowed down by having "to do other steps" before he could actually file his Petition. Additionally, he had to refer to the instructions several times. Throughout this process and at all relevant times, DAWSON remained fully operational.[760]

Regrettably, the submission process did not finalize until just after midnight, causing the system to assign a date received that fell one day after the final permissible filing date for his petition:

> While residing in North Carolina, Mr. Sanders filed the Petition from his computer after midnight on December 13, 2022. At 00:00:09.493, he began the upload of the Petition, and at 00:00:11.693 (i.e., 11 seconds after midnight), it was filed. At the time of filing, DAWSON automatically applied a cover sheet to the Petition that states that the Petition was electronically filed and received at "12/13/22 12:00 am."[761]

As expected, the IRS filed a Motion to Dismiss for lack of jurisdiction, arguing that Mr. Sanders' petition was not filed within the required timeframe. Mr. Sanders contended that his petition should not be considered as having been filed on December 13.

> Mr. Sanders filed an Objection to the Commissioner's Motion to Dismiss for Lack of Jurisdiction on February 21, 2023. He states as follows:
>
>> I object to this motion due to the fact that I logged in and uploaded documents on time. On December 12, 2022 I attempted several times to upload documents well before midnight. Finally I was able to get it uploaded and it literally did not finish the upload until exactly 12a.
>>
>> I am sure it can be proven that the system had errors and that my upload was loading before cut off time.[762]

The Tax Court invited briefs from *amici curiae* and received one:

> The Center for Taxpayer Rights, represented by the Tax Clinic at the Legal Services Center of Harvard Law School, submitted an amicus brief. The amicus principally offers two arguments. First, the amicus argues that Mr. Sanders's Petition should be treated as filed at the time that he relinquished control of it. In making this argument, the amicus urges the Court to adopt a position akin to the

[760] *Sanders v. Commissioner*, 160 TC No. 16, June 20, 2023

[761] *Sanders v. Commissioner*, 160 TC No. 16, June 20, 2023

[762] *Sanders v. Commissioner*, 160 TC No. 16, June 20, 2023

> timely mailing rule of section 7502. Although the amicus does not ask the Court to apply equitable tolling, it urges the Court to view the timeliness of an electronically filed petition "through the lens of equitable tolling."[763]

General Rule – The Petition is Filed When Received

The opinion highlights the standard rules concerning the determination of when an electronically submitted petition is deemed filed:

> A petition is ordinarily considered to have been filed when it is received by the Tax Court. See, e.g., *Leventis v. Commissioner*, 49 T.C. 353, 354 (1968). Under Rule 22(d), an electronically filed petition "will be considered timely filed if it is electronically filed at or before 11:59 p.m., eastern time, on the last day of the applicable period for filing." Because electronic filing is not limited to the Court's business hours, electronic filing systems may extend the number of hours available for filing, but not the number of days. *State Bank of S. Utah v. Beal (In re Beal)*, No. 21-4124, 2022 WL 17661140, at *2 (10th Cir. Dec. 14, 2022), *aff'g State Bank of S. Utah v. Beal*, 633 B.R. 398 (D. Utah 2021), *aff'g State Bank of S. Utah v. Beal (In re Beal)*, 616 B.R. 140 (Bankr. D. Utah 2020); *Justice v. Town of Cicero*, Ill., 682 F.3d 662, 664 (7th Cir. 2012); *Nutt v. Commissioner*, No. 15959-22, 160 T.C., slip op. at 4-5 (May 2, 2023); see Rule 22(a).[764]

The Tax Court promptly dismissed the notion that initiating (or attempting to initiate) the electronic filing process should be regarded as the timestamp of the filing:

> Electronic filing is not accomplished merely by logging into the system or beginning the filing process. See *In re Sands*, 328 B.R. 614, 619 (Bankr. N.D.N.Y. 2005). In *In re Sands*, 328 B.R. at 617-18, the bankruptcy court addressed the issue of precisely when an electronic filing occurs. In that case, a debtor's attorney began the process of electronically filing a petition shortly before it was due but did not upload the petition until minutes after the deadline. *Id*. at 615-16. The debtor contended that commencing the electronic filing process is equivalent to "physically handing" the clerk a petition. *Id*. at 616. The court disagreed, holding that an electronic petition is placed in the clerk's possession, and is thus "filed," when the "server receives the transmission." *Id*. at 619. Likewise in *Nutt*, 160 T.C., slip op. at 3, we held that an electronically filed petition is filed with this Court at the time it is received.[765]

Therefore, by default, Mr. Sanders' petition is considered as having been filed a day late.

> Mr. Sanders's Petition was not received within the time prescribed by section 6213(a). Notwithstanding that the notice of deficiency was mailed on September 8, 2022, Mr. Sanders's last day to file his petition was Monday, December 12, 2022, because section 6213(a) allows him to rely on the last day for filing that was specified in the notice. Although he logged into DAWSON on December 12, 2022, Mr. Sanders did not file his Petition until the next day. He initiated the

[763] *Sanders v. Commissioner*, 160 TC No. 16, June 20, 2023

[764] *Sanders v. Commissioner*, 160 TC No. 16, June 20, 2023

[765] *Sanders v. Commissioner*, 160 TC No. 16, June 20, 2023

> upload of the Petition 9 seconds after midnight on December 13, 2022, and his Petition was received and filed at 11 seconds after midnight. Because the Petition was not received by the Court until 11 seconds after midnight, it was not timely under section 6213(a).[766]

The Court Rejects the Equivalent of a Timely Mailing Rule in This Case

The opinion indicates that the Tax Court had recently dismissed an attempt to apply a timely mailing equivalent rule for the electronic submission of a petition:

> The timely mailing rule is an exception to the general rule that documents are filed when received. Under that rule, a document that is properly mailed before the due date but received after the due date is deemed to have been filed on the date it was postmarked. I.R.C. §7502(a). The amicus urges that we find Mr. Sanders's Petition timely because he relinquished control over his Petition before the filing deadline, a position that is analogous to the timely mailing rule of section 7502. But we have previously held that the timely mailing rule does not apply to an electronically filed petition. *Nutt*, 160 T.C., slip op. at 4.[767]

The opinion clarifies that while IRC §7502 does permit the IRS to issue regulations applying such rules to electronic submissions, the issued regulations do not extend to the electronic filing of Tax Court petitions.

> Although section 7502 also contains a provision relating to electronic filing, that provision does not apply to the electronic filing of Tax Court petitions. When applicable, section 7502 relies on a postmark or similar recorded date as evidence of mailing. I.R.C. §7502(a)(1), (f)(2)(C). Section 7502(c)(2) authorizes the Secretary to provide regulations to apply this postmark rule to electronic filing. The Secretary adopted regulations providing that an electronically filed document is considered filed when the recipient "receives the transmission of a taxpayer's electronically filed document on its host system." Treas. Reg. § 301.7502-1(d)(3)(ii).
>
> But the regulations are inapplicable to the filing of a Tax Court petition. The Secretary's regulations require the use of an authorized electronic return transmitter. *Id*. subdiv. (i). None is involved in the filing of a Tax Court petition.[768]

However, the Court also notes that even if such rules were applied to this submission, Mr. Sanders' filing would still be deemed late.

> Mr. Sanders's Petition would be untimely even if we applied these regulations or the amicus's "relinquished control" argument. The regulations would deem an electronically filed document to be filed when the electronic record shows it was received. The electronic record shows that Mr. Sanders's Petition was received 11 seconds after midnight; thus it would be untimely under the regulations that

[766] *Sanders v. Commissioner*, 160 TC No. 16, June 20, 2023

[767] *Sanders v. Commissioner*, 160 TC No. 16, June 20, 2023

[768] *Sanders v. Commissioner*, 160 TC No. 16, June 20, 2023

> apply in the case of an electronic return transmitter. And the Petition is untimely under the amicus's relinquished control argument. Mr. Sanders did not relinquish control of his Petition until he initiated the upload 9 seconds after midnight. In short, the narrow exceptions that might deem a petition to be filed before the Court receives it are both legally and factually inapplicable to this case.[769]

Was the System Inaccessible and, If So, Does That Make His Filing Timely?

However, recall that the taxpayer encountered difficulties accessing the DAWSON system. Could these difficulties be classified as those rendering the system unavailable?

The opinion points out that circumstances that make the filing location inaccessible to the general public could permit additional time for petition filing:

> In circumstances where the Clerk's office or a filing location is inaccessible or otherwise unavailable to the general public, a taxpayer may have additional time to file a petition. See I.R.C. §7451(b); *Guralnik*, 146 T.C. at 247. Mr. Sanders alleges that DAWSON system errors prevented him from filing his Petition at or before 11:59 p.m. on December 12, 2022.[770]

The Tax Court provides a summary of the *Guralnik* decision, which allowed for this extension in the petition filing deadline.

> In *Guralnik*, we held that if the Tax Court Clerk's office is inaccessible on the last day for filing a petition, then the time for filing is extended to the first accessible day that is not a Saturday, Sunday, or legal holiday. *Guralnik*, 146 T.C. at 232-33 (applying Fed. R. Civ. P. 6(a)). In that case, the Tax Court was closed because of a winter storm on the taxpayer's last day to file a petition. *Id*. The taxpayer mailed his petition, but the closure prevented the petition from being delivered on the due date. It was delivered the following day when the Court reopened. *Id*. at 233-34. We found that although Mr. Guralnik mailed his petition to the Court, he could not take advantage of section 7502 (the "timely mailing rule") because he did not use the U.S. Postal Service or a designated delivery service. *Guralnik*, 146 T.C. at 242; see I.R.C. §7502. But by applying the principles of Rule 6(a) of the Federal Rules of Civil Procedure (Fed. R. Civ. P.), we concluded that the Clerk's office was inaccessible because of the snow day closure and held that the petition was timely. *Guralnik*, 146 T.C. at 232-33.[771]

For electronic submissions, Congress stipulated a similar extension of time in IRC §7451(b). The provision reads as follows:

> **(b) Tolling of time in certain cases.**
>
> > **(1) In general**. Notwithstanding any other provision of this title, in any case (including by reason of a lapse in appropriations) in which a filing location is inaccessible or otherwise unavailable to the general public on

[769] *Sanders v. Commissioner*, 160 TC No. 16, June 20, 2023

[770] *Sanders v. Commissioner*, 160 TC No. 16, June 20, 2023

[771] *Sanders v. Commissioner*, 160 TC No. 16, June 20, 2023

> the date a petition is due, the relevant time period for filing such petition shall be tolled for the number of days within the period of inaccessibility plus an additional 14 days.
>
> **(2) Filing location**. For purposes of this subsection, the term “filing location” means—
>
> > (A) the office of the clerk of the Tax Court, or
> >
> > (B) any on-line portal made available by the Tax Court for electronic filing of petitions.

The Tax Court looks at how other decisions and court rules have defined inaccessible:

> The parties disagree about whether DAWSON was inaccessible or otherwise unavailable to the general public on the last day for Mr. Sanders to file a petition. The statute does not define “inaccessible or otherwise unavailable to the general public,” but we can look to other courts and court rules to help us define that phrase. In the context of Fed. R. Civ. P. 6(a)(3) and Rule 9006(a)(3) of the Federal Rules of Bankruptcy Procedure (Fed. R. Bankr. P.), “inaccessibility” traditionally refers to physical inaccessibility — that is, a courthouse closure caused by “weather or other conditions.” *In re Beal*, 616 B.R. at 153; see *Guralnik*, 146 T.C. at 245, 249. “The definition of inaccessibility broadened with the advent of electronic filing.” *In re Beal*, 616 B.R. at 153. Thus, in the 2009 amendments to Fed. R. Civ. P. 6(a)(3) and Fed. R. Bankr. P. 9006(a)(3), “[t]he reference to ‘weather’ was deleted from the text to underscore that inaccessibility can occur for reasons unrelated to weather, such as an outage of the electronic filing system.” Fed. R. Bankr. P. 9006 advisory committee’s note to 2009 amendment; Fed. R. Civ. P. 6 advisory committee’s note to 2009 amendment; see In re Beal, 616 B.R. at 154.
>
> Although inaccessibility can include an outage of an electronic filing system, federal courts have consistently held that inaccessibility does not include user error or technical difficulties on the user’s side. See, e.g., *In re Beal*, 616 B.R. 140. In *In re Beal*, 616 B.R. at 143, 147, a bank’s attorney logged onto the electronic filing system at 11:40 p.m. on the last day to file a complaint and filed the complaint 16 minutes after midnight (i.e., the following day). The bank, relying on the attorney’s testimony about perceived malfunctions with the electronic filing system, argued that the complaint would have been timely but for those malfunctions. *Id*. at 142, 150. But the attorney’s testimony was inconsistent and sometimes unsupported, and court records showed that the filing system was operational. *Id*. at 150-51, 155. For example, the attorney logged in, experienced no technical difficulties until multiple steps into the process, received error messages the system was designed to produce, and filed a complaint about 36 minutes after logging into the system. *Id*. at 143-44, 147, 151, 155. The district court explained that the bankruptcy court found it “very unlikely for the system to be rapidly toggling between short periods of functionality and error” and concluded that any errors that occurred were on the user’s side. Beal, 633 B.R. at 405. The bankruptcy court held that the electronic filing system was accessible, and the district court and the U.S. Court of Appeals for the Tenth

Circuit affirmed. *In re Beal*, 616 B.R. at 155; *Beal*, 633 B.R. at 409-10; *In re Beal*, 2022 WL 17661140, at *5.

To determine whether section 7451 applies, we must distinguish between the availability of the Court's system and user-specific issues. This approach is consistent whether looking to electronic or physical inaccessibility. For example, in *In re Sizemore*, 341 B.R. 658, 660 (Bankr. N.D. Ind. 2006), an attorney who filed an untimely petition on behalf of a debtor asked the bankruptcy court to deem the petition to have been timely filed. The attorney was unable to timely file because of problems with his own software. *Id*. at 659. Looking to Fed. R. Civ. P. 6(a) and Fed. R. Bankr. P. 9006(a), the court acknowledged that filing deadlines may be suspended if a weather-related court closure or other local conditions render the clerk's office physically inaccessible. *In re Sizemore*, 341 B.R. at 660. But the court found no authority that would deem the clerk's office to be inaccessible to an individual filer who was unable to timely file for reasons that were unique to that individual filer. *Id*.; see also *In re Bicoastal Corp*., 136 B.R. 288, 289 (Bankr. M.D. Fla. 1990) (finding inclement weather in another part of the country that caused a delay in the delivery of documents did not render the clerk's office, which was open, inaccessible). The bankruptcy court analogized problems that are unique to a user to a situation where a person gets stuck in traffic on the way to filing a document with the court. *In re Sizemore*, 341 B.R. at 660.[772]

The opinion clarifies that issues encountered by the user do not qualify as circumstances that render the electronic filing site unavailable.

In the context of electronic filing, user problems, such as entering an incorrect password, a Wi-Fi outage, or problems with the user's device, are analogous to traffic jams or car problems that occur on the way to an open courthouse; they do not render the system inaccessible or otherwise unavailable to the general public. Although traffic jams and Wi-Fi outages involve different complications, the underlying principle is the same: inaccessibility does not encompass problems that are unique to an individual. Id. Similarly, for purposes of section 7451, a DAWSON outage that affects the public's ability to file petitions renders DAWSON inaccessible or otherwise unavailable to the general public, whereas problems that an individual filer experiences while DAWSON is operational do not.[773]

Mr. Sanders' issues were unique to him, and thus, are classified as user problems:

The difficulties Mr. Sanders experienced confirm that DAWSON was accessible and available to the general public. His inability to fill out PDF forms on his phone is irrelevant because the forms are completed separately and are not part of DAWSON's filing portal. See United States Tax Court, How to e-File a Petition, https://ustaxcourt.gov/resources/dawson/how_to_efile_a_petition.pdf (last visited Apr. 19, 2023). And although a taxpayer must complete multiple steps to file a petition, these are realities of filing whether filing electronically, by mail, or in person. See also *In re Beal*, 616 B.R. at 154 n.74, 155 (finding that inaccessibility

[772] *Sanders v. Commissioner*, 160 TC No. 16, June 20, 2023

[773] *Sanders v. Commissioner*, 160 TC No. 16, June 20, 2023

> does not include "a lack of familiarity with [the electronic filing system] that causes a filer to make missteps in the filing process or simply to progress through it more slowly than anticipated"); *In re Sands*, 328 B.R. at 619.10 Finally, Mr. Sanders's failed login at 11:56 p.m., which occurred between successful logins, does not show a problem with DAWSON. It shows a failed attempt by the user to log into an operational system.
>
> The Court's own records show the system was operational at all relevant times. The Court's website allows users to view DAWSON's system status. See United States Tax Court, https://status.ustaxcourt.gov/. The system recorded no downtime on December 12, 2022. See *id*. And DAWSON logs show that Mr. Sanders logged in multiple times in the final hour of the day. The logs also show that his failed login at 11:56:15 p.m. was followed by successful logins by another Windows user within one second of his failed attempt and by Mr. Sanders himself within one minute of his failed attempt. These successful logins show that DAWSON was working properly.[774]

The Court highlights that Mr. Sanders, by procrastinating until the eleventh hour, must accept the repercussions of the issues that hindered him from completing the filing process in time for the petition to be received by the system before midnight.

> Mr. Sanders's case exemplifies the risk in last-minute electronic filing. Filing close to the deadline leaves "little margin for error." *Beal*, 633 B.R. at 410. As the U.S. Court of Appeals for the Seventh Circuit has noted:
>
> > Courts used to say that a single day's delay can cost a litigant valuable rights. . . . With e-filing, one hour's or even a minute's delay can cost a litigant valuable rights. A prudent litigant or lawyer must allow time for difficulties on the filer's end. A crash of the lawyer's computer, or a power outage at 11:50 PM, does not extend the deadline, even though unavailability of the court's computer can do so. . . .
>
> *Justice*, 682 F.3d at 665[775].

For those who are not typically engaged in filing court petitions but do partake in electronically filing tax returns, a similar risk exists—and there's no reason to anticipate that the Tax Court would demonstrate greater leniency in such situations.

But It's Not Fair – Shouldn't the Tax Court Take That Into Account?

Many might argue that it is evident Mr. Sanders intended to file on time. His confusion could be easily empathized with by anyone who has grappled with technology. Moreover, it's not as if anyone at the Tax Court would actually notice the filing a moment earlier had it been submitted eleven seconds before. Therefore, shouldn't the Court offer some leniency to the unfortunate taxpayer and allow his case to proceed? However, the Tax Court's stance is that Congress explicitly prohibits the Court from granting such equitable relief, irrespective of how much the Court might empathize with Mr. Sanders' situation.

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[774] *Sanders v. Commissioner*, 160 TC No. 16, June 20, 2023

[775] *Sanders v. Commissioner*, 160 TC No. 16, June 20, 2023

> We are unable to apply the doctrine of equitable tolling to the deadline to file a petition in a deficiency case. The deadline to file a petition in a deficiency case is jurisdictional. I.R.C. §6213(a); *Hallmark Rsch. Collective*, 159 T.C., slip op. at 42. Equitable tolling has the effect of extending a limitations period set by Congress when a litigant has diligently pursued his rights "but some extraordinary circumstance" nevertheless prevents him from meeting a deadline. *Lozano v. Montoya Alvarez*, 572 U.S. 1, 10 (2014). But if a federal court's subject-matter jurisdiction depends on a timely pleading, the filing deadline cannot be equitably tolled. *United States v. Wong*, 575 U.S. 402, 408-09 (2015); *Hallmark Rsch. Collective*, 159 T.C., slip op. at 7. Where Congress "clearly states" that a deadline is jurisdictional, we must enforce it regardless of equitable considerations. *Wong*, 575 U.S. at 409; *Arbaugh v. Y&H Corp*., 546 U.S. 500, 515-16 (2006); *Hallmark Rsch. Collective*, 159 T.C., slip op. at 8.[776]

SECTION: 6662
IRS ISSUES STATEMENT ON TAXPAYERS' RELIANCE ON IRS FAQS

Citation: "General Overview of Taxpayer Reliance on Guidance Published in the Internal Revenue Bulletin and FAQs," IRS website, 10/15/21

One of the tools the IRS has used with increasing frequency to provide guidance has been the use of Frequently Asked Questions (FAQs) posted on the IRS website. The IRS began using the tool heavily to provide guidance for various Tax Cut and Jobs Act provisions, and that use continued with guidance for various items found in the COVID relief bills.

However, tax professionals have expressed major concerns with the IRS reliance on such guidance. First, it's not clear what happens if the IRS discovers that an FAQ no longer agrees with what the agency and courts find to be the proper interpretation of the law. Can the IRS assert a position contrary to a published FAQ against a taxpayer and if they succeed in doing so, do taxpayers face potential penalties for taking positions on a tax return relying upon the FAQ?

Second, the IRS has in the past often changed FAQs without making any public statement regarding the changes aside from updating the "Page Last Reviewed or Updated:" footer on the various pages. Advisers may not realize an FAQ was changed just before a taxpayer files a return based on the prior version of the FAQ unless the adviser goes to each of the multitude of IRS FAQs each day to see if any have changed.

The IRS has released a reliance web page[777] that addresses these issues along with a News Release[778] issued simultaneously.

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[776] *Sanders v. Commissioner*, 160 TC No. 16, June 20, 2023

[777] "General Overview of Taxpayer Reliance on Guidance Published in the Internal Revenue Bulletin and FAQs," IRS website, October 15, 2021 (last updated), https://www.irs.gov/newsroom/general-overview-of-taxpayer-reliance-on-guidance-published-in-the-internal-revenue-bulletin-and-faqs (retrieved October 15, 2021)

[778] "IRS updates process for frequently asked questions on new tax legislation and addresses reliance concerns," IRS News Release IR-2021-202, October 15, 2021, https://www.irs.gov/newsroom/irs-updates-process-for-frequently-asked-questions-on-new-tax-legislation-and-addresses-reliance-concerns (retrieved October 15, 2021)

News Release

The News Release begins by announcing:

> Today, the Internal Revenue Service is updating its process for certain frequently asked questions (FAQs) on newly enacted tax legislation. The IRS is updating this process to address concerns regarding transparency and the potential impact on taxpayers when these FAQs are updated or revised. At the same time, the IRS is also addressing concerns regarding the potential application of penalties to taxpayers who rely on FAQs by providing clarity to taxpayers as to their ability to rely on FAQs for penalty protection.[779]

The IRS release provides that the IRS will now take the following actions for "significant FAQs" on newly enacted legislation:

> Significant FAQs on newly enacted tax legislation, as well as any later updates or revisions to these FAQs, will now be announced in a news release and posted on IRS.gov in a separate Fact Sheet. These Fact Sheet FAQs will be dated to enable taxpayers to confirm the date on which any changes to the FAQs were made. Additionally, prior versions of Fact Sheet FAQs will be maintained on IRS.gov to ensure that, if a Fact Sheet FAQ is later changed, taxpayers can locate the version they relied on if they later need to do so. In addition to significant FAQs on new legislation, the IRS may apply this updated process in other contexts, such as when FAQs address emerging issues.[780]

While this seems to be an improvement, advisers should be concerned that this rule only covers "significant FAQs" without giving any guidance on what makes an FAQ significant. Similarly, FAQs that aren't related to new legislation are not covered by this policy and it's not clear if even the American Recovery Program Act (ARPA) would still be treated as "new legislation" at this point based on the language of the news release.

The news release also describes the statement it is releasing on taxpayer reliance on the Internal Revenue Bulletin and FAQs:

> To address concerns about the potential application of penalties to taxpayers who rely on an FAQ, the IRS is today releasing a statement clarifying that if a taxpayer relies on any FAQ (including FAQs released before today) in good faith and that reliance is reasonable, the taxpayer will have a "reasonable cause" defense against any negligence penalty or other accuracy-related penalty if it turns out the FAQ is not a correct statement of the law as applied to the taxpayer's particular facts. For more information on taxpayer reliance, see the *General Overview of Taxpayer Reliance on Guidance Published in the Internal Revenue Bulletin and FAQs*.

Finally, the News Release provides that the following statement will be added to Fact Sheet FAQs:

[779] "IRS updates process for frequently asked questions on new tax legislation and addresses reliance concerns," IRS News Release IR-2021-202, October 15, 2021

[780] "IRS updates process for frequently asked questions on new tax legislation and addresses reliance concerns," IRS News Release IR-2021-202, October 15, 2021

> These FAQs are being issued to provide general information to taxpayers and tax professionals as expeditiously as possible. Accordingly, these FAQs may not address any particular taxpayer's specific facts and circumstances, and they may be updated or modified upon further review. Because these FAQs have not been published in the Internal Revenue Bulletin, they will not be relied on or used by the IRS to resolve a case. Similarly, if an FAQ turns out to be an inaccurate statement of the law as applied to a particular taxpayer's case, the law will control the taxpayer's tax liability. Nonetheless, a taxpayer who reasonably and in good faith relies on these FAQs will not be subject to a penalty that provides a reasonable cause standard for relief, including a negligence penalty or other accuracy-related penalty, to the extent that reliance results in an underpayment of tax. Any later updates or modifications to these FAQs will be dated to enable taxpayers to confirm the date on which any changes to the FAQs were made. Additionally, prior versions of these FAQs will be maintained on IRS.gov to ensure that taxpayers, who may have relied on a prior version, can locate that version if they later need to do so.[781]

IRS Statement on Reliance on the Internal Revenue Bulletin and FAQs

Included in the news release, as well as on its own page on irs.gov, is the promised statement, entitled “General Overview of Taxpayer Reliance on Guidance Published in the Internal Revenue Bulletin and FAQs.”

The guidance begins with a section outlining the status of items published in the Internal Revenue Bulletin (IRB). The guidance first states that the IRB is where items with various levels of authority will be published

> The Internal Revenue Bulletin (Bulletin) is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest.[782]

The statement then outlines the IRS’s policy of what items it will publish in the IRB:

> It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.[783]

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[781] “IRS updates process for frequently asked questions on new tax legislation and addresses reliance concerns,” IRS News Release IR-2021-202, October 15, 2021

[782] “General Overview of Taxpayer Reliance on Guidance Published in the Internal Revenue Bulletin and FAQs,” IRS website, October 15, 2021 (last updated)

[783] “General Overview of Taxpayer Reliance on Guidance Published in the Internal Revenue Bulletin and FAQs,” IRS website, October 15, 2021 (last updated)

The statement describes the class of items published in the IRB that are treated as Revenue Rulings:

> Revenue rulings represent the conclusions of the Service on the application of the law to the pivotal facts stated in the revenue ruling. In those based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and information of a confidential nature are deleted to prevent unwarranted invasions of privacy and to comply with statutory requirements.[784]

The level of authority represented by items in the IRB is described in the final paragraph of the first section.

> Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Rulings not published in the Bulletin will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases.[785]

The statement points out that those looking to rely on such items published in the IRB do have to consider events occurring after publication of the item in the IRB—that is, the IRS has no obligation to update items published in the IRB for such changes or developments.

> In applying published rulings and procedures, the effect of subsequent legislation, regulations, court decisions, rulings and procedures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.[786]

This portion of the statement is in line with what advisers have generally understood to be the level of reliance that can be placed on items found in the IRB and the due diligence to be performed to assure that the item has not been rendered void by later developments.

The relatively new material is found in the second portion of this document that informs taxpayers of how much reliance the taxpayer can place on items published not in the Internal Revenue Bulletin, but rather in FAQs.

The section begins by offering a justification for the IRS use of FAQs to provide guidance:

> FAQs are a valuable alternative to guidance published in the Bulletin because they allow the IRS to more quickly communicate information to the public on topics of frequent inquiry and general applicability. FAQs typically provide responses to general inquiries rather than applying the law to taxpayer-specific

[784] "General Overview of Taxpayer Reliance on Guidance Published in the Internal Revenue Bulletin and FAQs," IRS website, October 15, 2021 (last updated)

[785] "General Overview of Taxpayer Reliance on Guidance Published in the Internal Revenue Bulletin and FAQs," IRS website, October 15, 2021 (last updated)

[786] "General Overview of Taxpayer Reliance on Guidance Published in the Internal Revenue Bulletin and FAQs," IRS website, October 15, 2021 (last updated)

> facts and may not reflect various special rules or exceptions that could apply in any particular case.[787]

But this statement is immediately followed by a description of the severe limitations on any reliance on an FAQ:

> FAQs that have not been published in the Bulletin will not be relied on, used, or cited as precedents by Service personnel in the disposition of cases. Similarly, if an FAQ turns out to be an inaccurate statement of the law as applied to a particular taxpayer's case, the law will control the taxpayer's tax liability. Only guidance that is published in the Bulletin has precedential value.[788]

Interestingly, in this case the guidance talks about FAQs that *have not been published in the Internal Revenue Bulletin.* It's not clear if that is just a reminder that FAQs to date have not been published there, or if the IRS is considering publishing some types of FAQs in the IRB.

But for those FAQs not published in the IRB, the statement makes clear that a taxpayer will not be able to hold the IRS to a position found in the FAQ if it is determined to be at odds with the law, even if the position stated in the FAQ is more favorable to the taxpayer than the one the IRS is now asserting is required by the law.

Despite this statement, taxpayers may find that the IRS faces a practical problem going against such informal, but widely disseminated, guidance if it affects a large number of taxpayers. In 2014, the IRS prevailed in the case of *Bobrow v. Commissioner* (TC Memo 2014-21) with the Tax Court agreeing that a taxpayer could only have one rollover per year for all of his/her IRAs. The taxpayer argued that the limit applied on a per IRA account basis. However, the Tax Court did not accept that view, effectively treating all IRAs of the taxpayer as one for the rollover rule.

But advisers reading the decision quickly pointed out that IRS Publication 590, *Individual Retirement Arrangements (IRAs)* at the time specifically allowed applying the rule on a per account basis, as Mr. Bobrow had done.

In reaction to this situation, the IRS released Announcement 2014-15 where the agency agreed to allow an account by account test for rollovers through the end of 2014, and that the agency would not challenge any such rollovers taking place before the deadline in 2014 or prior years. But taxpayers should note that if their issue is more obscure, there may not be the hue and cry that led the IRS to back off on applying the law rather than their non-binding guidance to transactions for a number of months.

The statement continues noting that while taxpayers will not be saved from the consequences of law that is contrary to the FAQ for the taxes and interest due on the understatement, the agency will consider reliance on such FAQs in determining if the taxpayers had a reasonable basis for taking the position:

> Taxpayers who show that they relied in good faith on an FAQ and that their reliance was reasonable based on all the facts and circumstances will not be

[787] "General Overview of Taxpayer Reliance on Guidance Published in the Internal Revenue Bulletin and FAQs," IRS website, October 15, 2021 (last updated)

[788] "General Overview of Taxpayer Reliance on Guidance Published in the Internal Revenue Bulletin and FAQs," IRS website, October 15, 2021 (last updated)

> subject to a penalty that provides a reasonable cause standard for relief, including a negligence penalty or other accuracy-related penalty, to the extent that reliance results in an underpayment of tax. See Treas. Reg. § 1.6664-4(b) for more information. In addition, FAQs that are published in a Fact Sheet that is linked to an IRS news release are considered authority for purposes of the exception to accuracy-related penalties that applies when there is substantial authority for the treatment of an item on a return. See Treas. Reg. § 1.6662-4(d) for more information.[789]

Essentially, the IRS is stating that they will not require a taxpayer to demonstrate that the position outlined in the FAQ they relied upon was disclosed on a Form 8275 and had a reasonable basis under the law to avoid an accuracy related penalty under IRC §6662. Rather, the position will be deemed to have substantial authority even though it was not found to be the ultimately correct answer.

As you may realize, as a practical matter the IRS is treating positions based on an FAQ similarly to positions based on an IRS Publication that is later held to be at odds with the law.

SECTION: 6707A
IRS ANNOUNCES PLAN TO RELEASE PROPOSED REGULATIONS TO ADD LISTED TRANSACTIONS WHOSE STATUS HAS BEEN BROUGHT INTO QUESTION BY RECENT COURT DECISIONS

Citation: Announcement 2022-28, 12/6/22

The IRS in Announcement 2022-28[790] explained the reasons why it issued proposed regulations[791] involving certain syndicated conservation easement cases.

Administrative Procedures Act

The IRS took this action due to two recent losses in Court cases regarding the method the IRS used to add listed transactions under §6707A(c)(2) that would incur the penalties found in IRC §6707A(b) if such transactions were not properly disclosed on a taxpayer's tax return. IRC §6707A(c)(2) provides the following:

> **(2) Listed transaction.** The term "listed transaction" means a reportable transaction which is the same as, or substantially similar to, a transaction specifically identified by the Secretary as a tax avoidance transaction for purposes of section 6011.

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[789] "General Overview of Taxpayer Reliance on Guidance Published in the Internal Revenue Bulletin and FAQs," IRS website, October 15, 2021 (last updated)

[790] Announcement 2022-28, December 6, 2022, https://www.taxnotes.com/research/federal/irs-guidance/announcements/irs-explains-need-for-proposed-regs-listing-easement-transactions/7ffp7 (retrieved December 7, 2022)

[791] REG-106134-22, Proposed Reg. §1.6011-9, December 6, 2022, https://www.taxnotes.com/research/federal/proposed-regulations/proposed-regs-require-reporting-of-conservation-easement-deals/7ffp5 (retrieved December 7, 2022)

The penalty in this case, 75% of the reduction in tax claimed due to the transaction, subject to a maximum penalty of $200,000 (or $100,000 for a natural person) per return, is strictly based on the failure to disclose such a transaction properly, Thus, even if the taxpayer later prevails in an IRS challenge to obtain the tax benefit, the penalty would still need to be paid.

In the cases of *Mann Construction Inc. v. United States*, 27 F.4th 1138 (6th Cir. 2022)[792] and *Green Valley Investors LLC v. Commissioner*, 159 T.C. No. 5 (2022)[793] the courts ruled that the IRS had not properly added two transactions to the list of listed transactions, thus holding that the penalty under §6707A(c) did not apply in those two cases even though the taxpayers had failed to disclose the transactions.

The Courts each found that the IRS had violated 5 USC §553, part of the Administrative Procedures Act. That provision provides:

> **5 USC §553 Rule making**
>
> (a) This section applies, according to the provisions thereof, except to the extent that there is involved—
>
> > (1) a military or foreign affairs function of the United States; or
> >
> > (2) a matter relating to agency management or personnel or to public property, loans, grants, benefits, or contracts.
>
> (b) General notice of proposed rule making shall be published in the Federal Register, unless persons subject thereto are named and either personally served or otherwise have actual notice thereof in accordance with law. The notice shall include—
>
> > (1) a statement of the time, place, and nature of public rule making proceedings;
> >
> > (2) reference to the legal authority under which the rule is proposed; and
> >
> > (3) either the terms or substance of the proposed rule or a description of the subjects and issues involved.
>
> Except when notice or hearing is required by statute, this subsection does not apply—
>
> > (A) to interpretative rules, general statements of policy, or rules of agency organization, procedure, or practice; or
> >
> > (B) when the agency for good cause finds (and incorporates the finding and a brief statement of reasons therefor in the rules issued) that notice

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[792] *Mann Construction Inc. v. United States,* 27 F.4th 1138 (6th Cir. 2022), March 3, 2022, https://www.taxnotes.com/research/federal/court-documents/court-opinions-and-orders/sixth-circuit-holds-irs-didn%e2%80%99t-comply-with-apa-in-issuing/7d7r1 (retrieved December 7, 2022)

[793] *Green Valley Investors LLC v. Commissioner*, 159 T.C. No. 5 (2022), November 9, 2022, https://www.taxnotes.com/research/federal/court-documents/court-opinions-and-orders/tax-court-holds-notice-in-conservation-easement-cases-is-invalid/7fcg2 (retrieved December 7, 2022)

and public procedure thereon are impracticable, unnecessary, or contrary to the public interest.

(c) After notice required by this section, the agency shall give interested persons an opportunity to participate in the rule making through submission of written data, views, or arguments with or without opportunity for oral presentation. After consideration of the relevant matter presented, the agency shall incorporate in the rules adopted a concise general statement of their basis and purpose. When rules are required by statute to be made on the record after opportunity for an agency hearing, sections 556 and 557 of this title apply instead of this subsection.

(d) The required publication or service of a substantive rule shall be made not less than 30 days before its effective date, except—

(1) a substantive rule which grants or recognizes an exemption or relieves a restriction;

(2) interpretative rules and statements of policy; or

(3) as otherwise provided by the agency for good cause found and published with the rule.

(e) Each agency shall give an interested person the right to petition for the issuance, amendment, or repeal of a rule.

In both cases the courts found that identifying a transaction as a listed transaction was a rule covered by this section, rejecting the IRS's view that either Congress had specifically exempted IRC §6707A(c)(2) actions from the APA by the language of the statute or this was a mere interpretative rule.

Notice 2017-10, dealing with syndicated conservation easements, was the topic of the Tax Court's *Green Valley Investors* decision. The IRS, despite still disputing the holdings of both courts, made the decision to go through a formal notice and comment process to add back the syndicated conservation easement transactions to the listed transaction list even if IRS in unable to convince other courts that Notice 2017-10 did add properly these transactions to the listed transaction list.

IRS Notice Procedures for Listed Transactions

The Announcement begins by noting that more than 30 listed transactions have been added since 2000 under Reg. §1.6011-4.

> Since 2000, the Internal Revenue Service (IRS) has identified over 30 "listed transactions" — transactions that the IRS has determined to be abusive tax avoidance transactions within the meaning of § 1.6011-4(b)(2) of the Income Tax Regulations — by publishing a notice or other subregulatory guidance as provided in § 1.6011-4.[794]

[794] Announcement 2022-28, December 6, 2022

The Announcement makes clear that the IRS disagrees with the courts' rulings:

> The Department of the Treasury (Treasury Department) and the IRS disagree with the Tax Court's decision in *Green Valley* and the Sixth Circuit's decision in *Mann Construction*, and are continuing to defend the validity of existing listing notices in circuits other than the Sixth Circuit.[795]

But the IRS has decided, while still contesting the view that the APA must be followed in this case, to start adding the listed transactions back into the law via the formal regulatory path:

> At the same time, however, to eliminate any confusion and to ensure that these decisions do not disrupt the IRS's ongoing efforts to combat abusive tax shelters throughout the nation, the Treasury Department and the IRS are today issuing proposed regulations to identify certain syndicated conservation easement transactions as listed transactions. The Treasury Department and the IRS intend to finalize these regulations, after due consideration of public comments, in 2023 and intend to issue proposed regulations identifying additional listed transactions in the near future.[796]

Congress Enacted IRC §6707A After Reg. §1.6011-4 Had Been Adopted

The Announcement notes that after the IRS had adopted Reg. §1.6011-4, Congress added IRC §6707A to the Code via the *American Jobs Creation Act*:

> Following the promulgation of § 1.6011-4, Congress passed the American Jobs Creation Act (AJCA), which included section 6707A of the Code. Section 6707A imposes penalties on any person who fails to disclose participation in a reportable transaction, including a listed transaction. Consistent with the regulation, that statute defines a "reportable transaction" as "any transaction with respect to which information is required to be included with a return or statement because, as determined under regulations prescribed under section 6011, such transaction is of a type which the Secretary determines as having a potential for tax avoidance or evasion;" and a "listed transaction" as "a reportable transaction which is the same as, or substantially similar to, a transaction specifically identified by the Secretary as a tax avoidance transaction for purposes of section 6011."[797]

IRS Position: These Remain Listed Transactions

The Announcement notes that while the IRS still takes the position that their actions were proper (and thus these remain listed transactions), they note that the Sixth Circuit decision can't be ignored by the IRS for taxpayers subject to that Circuit's jurisdiction:

> The Treasury Department and the IRS continue to take the position that listed transactions can be identified by notice or other subregulatory guidance and that the APA's notice-and-comment procedure does not apply to identification of

795 Announcement 2022-28, December 6, 2022

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> such transactions. The Treasury Department and the IRS disagree with the Tax Court's decision in *Green Valley* and the Sixth Circuit's decision in *Mann Construction* and continue to defend the validity of existing listing notices in litigation. The Treasury Department and the IRS recognize, however, that Mann Construction is controlling law in the Sixth Circuit, and the IRS has ceased enforcing disclosure and list maintenance requirements with respect to Notice 2017-10 in the Sixth Circuit.[798]

Not stated, but implied by the paragraph, is that the IRS is likely going to continue to assert the penalties outside the Sixth Circuit. While the published Tax Court decision means the IRS will not prevail should the taxpayer take the case to that venue (which seems likely to happen), the IRS likely will be looking to find a case to take to another Court of Appeals to look to create a split in the decisions of the Circuits.

Thus, those who reside outside the Sixth Circuit are taking more than zero level of risk by failing to report these transactions should the IRS prevail in their Circuit. For this particular penalty there's additional jeopardy, since the law provides that a listed transaction penalty is not subject to being rescinded by the IRS[799] and would not be subject to judicial appeal.[800] Thus, should the IRS ultimately prevail (not likely given two rulings against them, but still possible), the agency may argue it's required to collect the penalty from any taxpayers outside the Sixth Circuit who failed to file disclosures following these cases.

The current cases succeeded because the taxpayers were able to persuade the Court that these weren't listed transactions, thus working around the bar on judicial appeal of a penalty imposed on an actual listed transaction.

Problems Even in the Sixth Circuit if Valid Regulation Makes This a Listed Transaction

The IRS decided to add some saber rattling language to the announcement, noting that even if the Notice procedure is found to be an improper way to add a listed transaction, if the transaction is validly added after a notice and comment period the law will require reporting of the transaction within 90 days of it becoming listed with regard to any return for which the statute is open at the date it becomes listed:

> Taxpayers should take note that, if a transaction becomes a listed transaction after a taxpayer files a return reflecting the tax effects of the transaction, § 1.6011-4(e)(2)(i) requires the participant to file a disclosure statement with OTSA within 90 days of the transaction becoming a listed transaction if the assessment limitations period remains open for any taxable year in which the taxpayer participated in the listed transaction. Accordingly, any taxpayer, including taxpayers who reside in the Sixth Circuit, who has participated in a transaction in any year for which the assessment limitation period remains open when the regulation identifying the transaction as a listed transaction is finalized will have an obligation to disclose the transaction. Failure to disclose will subject the taxpayer to the penalty under section 6707A. Participants required to disclose

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[799] IRC §6707A(d)(1)(A)

[800] IRC §6707A(d)(2)

> listed transactions who fail to do so are also subject to an extended period of limitations under section 6501(c)(10). That section provides that the time for assessment of any tax with respect to the transaction will not expire before the date that is one year after the earlier of the date the participant discloses the transaction or the date a material advisor discloses the participation pursuant to a written request under section 6112(b)(1)(A).[801]

There will also be impacts on material advisers of the finalization of the regulation:

> Likewise, if a regulation identifying a transaction as a listed transaction is finalized after the occurrence of the events described in § 301.6111-3(b)(4)(i) of the Procedure and Administration Regulations, a material advisor will be treated as becoming a material advisor on the date the regulation is finalized pursuant to § 301.6111-3(b)(4)(iii) (if not deemed a material advisor earlier pursuant to a valid listing notice). A material advisor is required to file a Form 8918 by the last day of the month following the quarter in which the advisor became a material advisor with respect to the listed transaction. See § 301.6111-3(d) and (e).
>
> In addition, a material advisor must maintain a list identifying each person with respect to whom the advisor acted as a material advisor with respect to a listed transaction, if the person advised by the material advisor entered into the listed transaction within six years before the transaction was identified as a listed transaction. See § 301.6112-1(b)(2).[802]

Quirky Nature of IRC §6707A and Impact of the Rulings

Advisers should note that the rulings only find that the transactions were not ones that had to be reported under IRC §6707A because the IRS had not properly adopted these rules per the requirements of the Administrative Procedure Act.

It is important to note what was not decided:

- Neither Court ruled that these transactions are not ones of a type that could be added to the listed transaction list. Only after the IRS went through a proper notice and comment period and adopted the same rule would there be consideration of whether that resulting regulation is or isn't valid. The IRS clearly is betting that even if the court opinions are not overturned, the regulatory process will eventually put the list right back where it was before *Mann Construction* and *Green Valley*.

- Neither Court dealt with the merits (or lack of merits) of the underlying transactions, as that issue is not relevant with regard to the disclosure penalty under IRC §6707A. An absolutely meritless transaction would nevertheless fail to be a listed transaction under the rulings in question should they have been added to the list by the use of subregulatory Notices.

Both are important to note, since there is existing caselaw on the merits of similar transactions that advisers will need to consider before advising a client that such a transaction is one for which the adviser would be able to sign the tax return.

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As well, some advisers are using these losses to bring into question every piece of IRS guidance issued via a subregulatory process, implying that such tax positions at odds with such guidance would gain the tax advantage claimed by the taxpayer. That likely is overreaching for a couple of reasons.

First, the APA clearly allows the IRS to skip the comment period if the guidance is merely interpretative. The decisions in these cases take care to show why selecting specific transactions to add to the list goes beyond mere interpretation.

Second, this particular statute is one that gives each transaction a binary state—it either is on the list or it isn't. In other cases, even if the IRS guidance was found to be invalid, the taxpayer would still need to show that the tax benefits weren't denied by the language of the statute. In this case, an invalid addition to the list would automatically mean the penalty would not apply.

Few statutes only apply to situations that the IRS has added to something like the listed transaction list. Rather, most often the IRS is looking to outline the positions that are and aren't acceptable based on statute that does not itself require any such IRS action before it could be applied against taxpayers.

It is true that the courts have become more likely to look at compliance with the Administrative Procedures Act and that it's very possible more IRS guidance will be struck down for failure to comply with it. But it does not flow from such a result that a court would have to find a transaction at odds with that not validly issued guidance would automatically gain the claimed tax benefits—at that point the taxpayer must be able to justify the result based on the law enacted by Congress.

SECTION: 7502
TAXPAYERS NOT ALLOWED TO PROVIDE OTHER PROOF OF TIMELY MAILING WHEN USPS FAILED TO PLACE A POSTMARK ON THEIR CLAIM FOR REFUND

Citation: McCaffery v. United States, Case No. 1:19-CV-01112, US Court of Federal Claims, 8/9/21

In holding that the taxpayers in the case of *McCaffery v. United States*[803] had failed to prove their claim for refund was filed timely, the US Court of Federal Claims decision took the position that the US Tax Court had developed a method of showing timely filing for an envelope lacking a postmark that is at odds with the Internal Revenue Code.

The Court described the facts of this case as follows:

> Plaintiffs filed their federal income tax return for the 2013 tax year on April 15, 2014 with a total tax liability of $70,977. Compl. ¶¶ 6-7; Def.'s App. B at B-1-B-2 (ECF 11-1). In 2017, Plaintiffs filed an amended tax return claiming an

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[803] *McCaffery v. United States*, Case No. 1:19-CV-01112, US Court of Federal Claims, August 9, 2021, https://www.taxnotes.com/research/federal/court-documents/court-opinions-and-orders/court-holds-return-wasn%25e2%2580%2599t-timely-filed%253b-refund-suit-dismissed/7754m (retrieved August 10, 2021)

> overpayment of $69,080 for the 2013 tax year and requesting a refund in that amount. Compl. ¶ 8; Def.'s Mot. to Dismiss at 3; Def.'s App. B at B-15, B-17. The parties agree (and it appears to the Court) that the deadline for claiming an overpayment was April 18, 2017. Def.'s Mot. to Dismiss at 5; Pls.' Opp. at 1, 3.4 But the IRS noted the receipt date of Plaintiffs' amended return as April 24, 2017 — six days later.[804]

The IRS did not keep a copy of the envelope in which the return was mailed, but the agency did have a scanned image of the envelope. The opinion describes the image as follows:

> The image has Plaintiffs' surname and address handwritten on the top left, the IRS's address centered, and four postage stamps in the top right corner. Each stamp bears the same two lines of text: "US POSTAGE $0.49" and "SOLD APR [ ] FIRST CLASS."). Id. The bottom-right stamp appears to read "SOLD APR 17, 2017 FIRST CLASS," but the exact dates on the others are illegible. Id. The envelope bears the partly legible date "04/24/201[ ]" near the bottom right, and an alphanumerical sequence — "09B 030" — across the stamps along the right edge. Several dots and lines appear near the middle of the top edge of the envelope, but they do not form any distinct characters, shapes, or images, and there is no way to tell how they were made.[805]

The IRS disallowed the claim as not timely filed, noting:

> "The received date on your return is Apr. 24, 2017. The last day to file a timely claim or return for tax year 2013 was Apr. 15, 2017 [sic]. We can't allow your claim or return because the received date isn't on or before the deadline." Pls.' Ex. B (ECF 1-1).[806]

As a taxpayer must first file a timely claim for refund before being able to bring suit for a refund in the US Court of Federal Claims, the IRS argued when the taxpayers filed suit in the case that the Court had to dismiss the case for lack of subject matter jurisdiction. As the parties agreed, the only issue was whether the taxpayers could show timeliness under the rules for mailing a document to the IRS:

> The parties do not dispute that Plaintiffs' refund application was delivered to the IRS after the April 18, 2017 actual-delivery deadline. Given that this Court lacks jurisdiction over tax refund claims that are not timely presented to the IRS, see *Dalm*, 494 U.S. at 602, the issue is whether Plaintiffs have established timeliness under the deemed delivery rule.[807]

The Court found that the envelope clearly lacked a postmark and the taxpayers had not used certified or registered mail (where the date stamped on the receipt by a USPS employee would establish a postmark date). Thus, the issue was if there was a way to show timely filing of an envelope that lacked the postmark.

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[804] *McCaffery v. United States*, Case No. 1:19-CV-01112, US Court of Federal Claims, August 9, 2021

[805] *McCaffery v. United States*, Case No. 1:19-CV-01112, US Court of Federal Claims, August 9, 2021

[806] *McCaffery v. United States*, Case No. 1:19-CV-01112, US Court of Federal Claims, August 9, 2021

[807] *McCaffery v. United States*, Case No. 1:19-CV-01112, US Court of Federal Claims, August 9, 2021

The taxpayers provided evidence other than a postmark or certified or registered mail receipt to show the document was mailed on April 17, 2021. But the Court found it could not consider such evidence:

> But on the plain text of section 7502, the deemed delivery rule only applies if a postmark or equivalent marking was made: The date of the postmark is what matters, not the date of the mailing. I.R.C. § 7502(a) ("[T]he date of the United States postmark stamped on the cover in which such return, claim, statement, or other document, or payment, is mailed shall be deemed to be the date of delivery[.]"). Similarly, the regulations provide for extrinsic evidence only to prove the contents of an illegible postmark, not to prove time of mailing when there was no postmark. 26 C.F.R. § 301.7502-1 ("If the postmark on the envelope is made by the U.S. Postal Service *but is not legible*, the person who is required to file the document or make the payment has the burden of proving the date that the postmark *was made*.") (emphasis added). As noted above, exceptions to a statutory requirement should generally be treated as exclusive. Without even an illegible postmark, the deemed delivery rule does not apply, and extrinsic evidence about the date of mailing is beside the point. That leaves only the dispositive fact that the amended return was delivered to the IRS after the delivery deadline.[808]

But the taxpayers point to a series of cases from the United States Tax Court where such extrinsic evidence was deemed to show timely mailing in the absence of a postmark. The opinion lists those various cases the taxpayer was relying upon:

> They cite a line of cases from the Tax Court holding that extrinsic evidence as to timely mailing must be considered when an envelope contains no postmark at all. Pls.' Opp. at 5 (citing to *Sylvan v. Comm'r*, 65 T.C. 548 (1975); *Seely v. Comm'r*, 119 T.C.M. (CCH) 1031, 2020 WL 201751 (2020); *Williams v. Comm'r*, 117 T.C.M. (CCH) 1328, 2019 WL 2373552 (2019); *Blake v. Comm'r*, 94 T.C.M. (CCH) 51, 2007 WL 2011294 (2007); *Menard, Inc. v. Comm'r*, 41 T.C.M. (CCH) 1279, 1981 WL 10531 (1981); *Monasmith v. Comm'r*, 38 T.C.M. (CCH) 60, 1979 WL 3117 (1979); *Ruegsegger v. Comm'r*, 68 T.C. 463 (1977)).[809]

But in this decision, the Court argues that these cases are based on what the judge finds to be a significant error in the *Sylvan* decision:

> In that case, much like this one, the Tax Court confronted an envelope with no postmark that was delivered after a deadline. The court found a gap in the statute: "There is nothing at all in the statute or legislative history indicating what Congress intended where the postmark is illegible; where there is no postmark because the petition was inserted in a new postal cover when the original cover was damaged; or where no postmark is affixed due to oversight or malfunction of a machine." *Sylvan*, 65 T.C. at 552. "[I]n these circumstances," the court reasoned, its "task . . . is to ask what Congress would have intended on a point not presented to its mind, if the point had been present." *Id*. (quotes omitted). The court concluded, over a dissent, that extrinsic evidence should be admitted to

[808] *McCaffery v. United States*, Case No. 1:19-CV-01112, US Court of Federal Claims, August 9, 2021

[809] *McCaffery v. United States*, Case No. 1:19-CV-01112, US Court of Federal Claims, August 9, 2021

> prove the date of mailing for purposes of the deemed delivery rule not only when a postmark is illegible, but where it is absent.[810]

The opinion begins an extended discussion about the issues it finds with the *Sylvan* decision. The first is to object to the claim that the law did not provide for a result if there was no postmark applied:

> That was erroneous for several reasons. To begin with, the Tax Court was mistaken that the Internal Revenue Code contains "nothing at all . . . indicating what Congress intended" in cases of absent postmarks. Id. Section 6511(a) contains a deadline, and section 7502 contains a deemed-delivery exception that is textually inapplicable when a postmark is missing. There is thus no gap to be filled; a late-received envelope lacking a postmark is simply untimely, whatever the extrinsic evidence might be. When a court treats circumstances covered by a general rule as falling into a gap, the court is not really "ask[ing] what Congress would have intended," *Sylvan*, 65 T.C. at 552, but presuming that the statute should say something different. See also Antonin Scalia & Bryan Garner, *Reading Law: The Interpretation of Legal Texts* 94 (2012) ("As Justice Louis Brandeis put the point: 'A casus omissus does not justify judicial legislation.' And Brandeis again: 'To supply omissions transcends the judicial function.'") (citing *Ebert v. Poston*, 266 U.S. 548, 554 (1925), and *Iselin v. United States*, 270 U.S. 245, 251 (1926)).[811]

In the Court's view, the law simply provided this document was not timely filed regardless of what evidence might otherwise be advanced to show the document was mailed on April 17.

The opinion also complained that the Tax Court was, effectively, creating additional provisions beyond those contained in the Treasury Regulations governing this provision:

> Besides, when *Sylvan* was decided, the Treasury had already promulgated the regulation providing for extrinsic evidence of the contents of illegible postmarks, but not absent ones. See *Republication*, 32 Fed. Reg. 15241, 15355 (Nov. 3, 1967); see also *Sylvan*, 65 T.C. at 560 (Drennen, J., dissenting) (noting that the regulations then in effect "provide[ ] that if the postmark on the envelope is not legible, the petitioner has the burden of proving the time when the postmark was made"). By sanctioning proof by extrinsic evidence in other circumstances, the Tax Court merely created a new exception that neither Congress nor the administering agency authorized. That, too, is inappropriate: A judge should not "elaborate unprovided-for exceptions to a text, as Justice Blackmun noted while a circuit judge: 'If the Congress had intended to provide additional exceptions, it would have done so in clear language.'" Scalia & Garner, supra, at 93 (citing *Petteys v. Butler*, 367 F.2d 528, 538 (8th Cir. 1966) (Blackmun, J., dissenting)). Nor should a court assume that because a legislature provided relief from a general rule in one circumstance, similar relief should be applied in other circumstances. See *Easterbrook*, supra, at 541 ("Legislators seeking only to further the public interest may conclude that the provision of public rules should reach so far and no farther[.]")[812]

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[810] *McCaffery v. United States*, Case No. 1:19-CV-01112, US Court of Federal Claims, August 9, 2021

[811] *McCaffery v. United States*, Case No. 1:19-CV-01112, US Court of Federal Claims, August 9, 2021

[812] *McCaffery v. United States*, Case No. 1:19-CV-01112, US Court of Federal Claims, August 9, 2021

Thus, the Court of Federal Claims concludes that the missing postmark means automatically that the filing was late when it was not received by the IRS by the last date in the statute. Despite the fact that the result may seem harsh, the opinion concludes that it must follow the text of the statute:

> Yet the text controls. The Supreme Court recently addressed a strikingly similar situation in *Pereida v. Wilkinson*, which held that noncitizens challenging removal orders under the Immigration and Nationality Act have the burden of proving "all aspects of their eligibility" for relief. 141 S. Ct. 754, 758 (2021). Much like the McCafferys, the noncitizen facing removal in *Pereida* argued that under the Court's interpretation, some individuals entitled to relief might be unable to prove it "through no fault of [their] own," perhaps because of "poor state court record-keeping practices." *Id*. at 766. The Court answered that it was bound to the policy choice reflected in the statute: "It is hardly this Court's place to pick and choose among competing policy arguments like these along the way to selecting whatever outcome seems to us most congenial, efficient, or fair. Our license to interpret statutes does not include the power to engage in such freewheeling judicial policymaking." *Id*. at 766-67; see also *BP P.L.C. v. Mayor & City Council of Baltimore*, 141 S. Ct. 1532, 1542 (2021) (observing that a court's task "is to discern and apply the law's plain meaning as faithfully as we can, not 'to assess the consequences of each approach and adopt the one that produces the least mischief'") (quoting *Lewis v. Chicago*, 560 U.S. 205, 217 (2010)). The same is true here.[813]

SECTION: 7502
SIXTH CIRCUIT HOLDS COMMON LAW MAILBOX RULE DOES NOT APPLY TO PROVE DELIVERY, BUT TAXPAYER IS ALLOWED TO ATTEMPT TO PROVE ACTUAL DELIVERY

Citation: Pond v. United States, Docket No. 22-1537, CA4, 5/26/23

An issue that has been a recurrent subject for discussion among tax professionals is the applicability of the timely mailing rule outlined in IRC §7502. Specifically, the case we will look at it addresses the consequences when a taxpayer submits a document without utilizing certified mail, registered mail, or an approved private delivery service. Although this scenario typically arises when a taxpayer asserts having mailed their return on the final day for filing, the present case entails the taxpayer's assertion that the document in question was mailed three months prior to the document's deadline for submission.

Proof of Timely Filing

IRC §7502 was enacted with the purpose of offering taxpayers a sense of assurance and certainty when utilizing the U.S. Postal Service to file their tax returns and other essential tax documents. It establishes specific methods that enable taxpayers to ensure that their documents have been filed within the designated time frame.

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[813] *McCaffery v. United States*, Case No. 1:19-CV-01112, US Court of Federal Claims, August 9, 2021

The general rule is found at IRC §7502(a)(1) and reads:

> (a) **General rule**.
>
> > (1) **Date of delivery**. If any return, claim, statement, or other document required to be filed, or any payment required to be made, within a prescribed period or on or before a prescribed date under authority of any provision of the internal revenue laws is, after such period or such date, delivered by United States mail to the agency, officer, or office with which such return, claim, statement, or other document is required to be filed, or to which such payment is required to be made, the date of the United States postmark stamped on the cover in which such return, claim, statement, or other document, or payment, is mailed shall be deemed to be the date of delivery or the date of payment, as the case may be.

While the timely mailing rule under IRC §7502 does offer a level of protection to taxpayers who choose to file using standard first-class mail, it is important to note its significant limitations. Firstly, the rule applies solely if the return is effectively delivered to the IRS, and the taxpayer is able to substantiate such delivery, typically by having the IRS locate the filed return. Secondly, it necessitates a postmark bearing a date no later than the final deadline for filing the document.

For taxpayers seeking both documentation of the postmark date and the presumption of actual delivery, IRC §7502(c) provides a viable solution. The statute outlines one option explicitly (registered mail) and presents two additional options that the IRS has the authority to implement through regulations (certified mail and the use of electronic filing). The IRS has issued comprehensive regulations outlining the specific requirements and procedures to qualify for the protection afforded by each of these methods.

IRC §7502(c) provides:

> (c) **Registered and certain mailing; electronic filing**.
>
> > (1) **Registered mail**. For purposes of this section, if any return, claim, statement, or other document, or payment, is sent by United States registered mail--
> >
> > > (A) such registration shall be prima facie evidence that the return, claim, statement, or other document was delivered to the agency, officer, or office to which addressed; and
> > >
> > > (B) the date of registration shall be deemed the postmark date.
> >
> > (2) **Certified mail; electronic filing**. The Secretary is authorized to provide by regulations the extent to which the provisions of paragraph (1) with respect to prima facie evidence of delivery and the postmark date shall apply to certified mail and electronic filing.

Additionally, IRC §7502(f) introduced an alternative option (for which the IRS has developed regulations) that allows taxpayers to utilize an approved private delivery service.

Before delving further into the specifics of the current case, it is crucial to acknowledge a vital practical consideration. Had the taxpayer availed themselves of the methods stipulated in IRC §7502(c) or (f), along with the corresponding regulations, the matter would have been resolved in favor of the taxpayer. In light of this, tax advisers should strongly emphasize and encourage clients to adopt these measures as a best practice.

Facts of this Case

The Fourth Circuit Court of Appeals recently weighed in on this matter through the case of *Pond v. United States*.[814] The case revolves around an incident where the IRS made an error, leading to a taxpayer paying the requested tax amount. Subsequently, the taxpayer's CPA received the IRS's explanation of the tax obligation and accurately determined that the tax in question (which had already been paid by the taxpayer) was not actually owed.

The Court summarized the issue as follows:

> The IRS audited Pond's business and revealed an alleged overpayment. But the IRS misinterpreted its own audit, concluding that Pond had underpaid. So the IRS told Pond that he owed more taxes. He paid up, including interest. Only later did Pond's accountant discover the IRS's mistake. Properly understood, the audit revealed that Pond had *overpaid*.[815]

Consequently, the taxpayer pursued a course of action to reclaim the amount rightfully owed to them.

> Pond thus requested a refund (1) on his 2012 taxes, (2) on his 2013 taxes, and (3) of the interest he had paid on the 2012 back payments. To request the refund on the taxes for both years, Pond says that he sent separate forms in a single envelope via first-class mail to an IRS center in Holtsville, New York in July 2017. Around the same time, to request the refund of the interest, Pond sent a form to an IRS center in Covington, Kentucky, which forwarded the request to an IRS center in Andover, Massachusetts.[816]

The opinion notes that Mr. Pond eventually received a refund of 2012 taxes but no refund of 2013 taxes:

> What followed was a series of communications with the IRS that resulted in Pond getting a refund on his 2012 taxes and of the interest he paid, but not on his 2013 taxes.[817]

The Court then outlined the next developments:

> Pond first heard back from IRS Andover in September about his interest-refund request: They had received his request but wanted a copy of his refund claim for

[814] *Pond v. United States*, Docket No. 22-1537, CA4, May 26, 2023, https://www.taxnotes.com/research/federal/court-documents/court-opinions-and-orders/fourth-circuit-finds-tax-refund-suit-was-improperly-dismissed/7gs17 (retrieved May 28, 2023).

[815] *Pond v. United States*, Docket No. 22-1537, CA4, May 26, 2023

[816] *Pond v. United States*, Docket No. 22-1537, CA4, May 26, 2023

[817] *Pond v. United States*, Docket No. 22-1537, CA4, May 26, 2023

> the 2012 taxes to confirm that he was entitled to the interest refund. Pond responded on October 3 that he had sent his original request for a tax refund to IRS Holtsville. But to be helpful — and "out of an abundance of caution" — he forwarded a duplicate copy of his 2012 tax-refund request to IRS Andover. J.A. 9. Three weeks later, on October 26, 2017, the statutory period to claim a refund ended.
>
> After another few weeks, Pond heard from IRS Andover again. They claimed to have shared Pond's 2012 tax-refund claim with IRS Holtsville and that someone from Holtsville would contact Pond about his claim. Several months passed and Pond heard nothing. Then, in March 2018 — without further contact from IRS Holtsville — Pond received a refund for the 2012 tax year, including interest.[818]

But 2013 proved to be more of a problem for Mr. Pond:

> Sometime later, having heard nothing about his 2013 claim, he again contacted the IRS about it. At that time, agents at the IRS "attempting to locate the 2013 Form 1040X were unable to find it anywhere on the IRS's system." J.A. 10. So Pond sent a duplicate copy of his 2013 claim to IRS Holtsville. Time passed. Again, Pond heard nothing. So Pond contacted IRS Holtsville and learned that his claim had been "processed . . . and assigned to an agent." J.A. 10. They "promised" Pond would hear something from the agent. J.A. 10.
>
> More months went by, and Pond still heard nothing. When he once again contacted IRS Holtsville, Pond learned that his 2013 claim had been closed with no refund issued. Although the claim had been closed, the agent at IRS Holtsville could not locate a copy of the claim on the IRS's system, so Pond faxed a third copy directly to the agent.
>
> A couple of weeks later, Pond received a Notice of Denial informing him that his 2013 refund claim was denied because the statute of limitations had run. The denial letter listed the "[d]ate of claims received" as July 17, 2017. J.A. 84.[819]

This date of claims received would eventually become an issue in the Court's decision. But now the taxpayer faced an IRS holding that this claim had been filed too late, which meant the IRS was not going to issue him a refund.

So now the taxpayer attempted to get this determination reversed:

> Pond filed a formal protest of the denial with IRS Holtsville. He got no response, so he contacted the office and learned that his protest had not been processed. So he tried to go to the higher-ups. He filed a protest with the IRS's Office of Appeals. But the Office of Appeals returned his protest and told Pond that he did not "have a case pending in the Office of Appeals," effectively sending him back to IRS Holtsville. J.A. 12.

[818] *Pond v. United States*, Docket No. 22-1537, CA4, May 26, 2023

[819] *Pond v. United States*, Docket No. 22-1537, CA4, May 26, 2023

> Having had enough, Pond filed an action in federal court for a tax refund. The government moved to dismiss under Rule 12(b)(1), arguing they were entitled to sovereign immunity because the refund claim was not timely filed.[820]

Taxpayer's First Option for Timely Filing – Attempting to Use the Common Law Mailbox Rule

The Court now summarizes the deadlines that applied in this case for the 2013 refund:

> During the relevant period, a refund claim was timely if filed "within 6 months after the day on which the Secretary mails the notice of computational adjustment to the partner." See 26 U.S.C. §6230(c)(2)(A) (2016). The IRS sent Pond a Notice of Computation Adjustment on April 26, 2017. He was therefore required to file his claim by October 26, 2017, to benefit from the sovereign-immunity waiver. Pond says that he complied with this requirement, and that he sent his refund claim via first-class mail postmarked July 18, 2017. But the IRS says that they have no record of that claim. So Pond must — at this stage — either show that he (1) can rely on a presumption of delivery or (2) plausibly alleged physical delivery.[821]

The taxpayer first claims that he should be able to use the common law mailbox rule to establish timely filing of his claim. The Court summarizes the rule as follows:

> …[W]hen courts refer to the "mailbox rule," they are often talking about one of two distinct — but related — presumptions. The narrower presumption is merely of timeliness, not delivery. In other words, if a filer can show that the document was actually delivered, but can't pinpoint precisely when that happened, then this narrower version of the mailbox rule would allow a court to presume that "physical delivery occurred in the ordinary time after mailing." *Philadelphia Marine Trade Ass'n-Int'l Longshoremen's Ass'n Pension Fund v. Comm'r*, 523 F.3d 140, 147 (3d Cir. 2008); see also id. ("[T]he mailbox rule is merely a method for determining the date of physical delivery under the 'physical delivery' rule. It does not ignore the physical delivery requirement."); *Me. Med. Center v. United States*, 675 F.3d 110, 114 (1st Cir. 2012).
>
> The broader presumption is of physical delivery. Courts adopting this version of the mailbox rule say that "proof of proper mailing — including by testimonial or circumstantial evidence — gives rise to a rebuttable presumption that the document was physically delivered to the addressee in the time such a mailing would ordinarily take to arrive." *Baldwin*, 921 F.3d at 840; see also *Detroit Auto. Prod. Corp. v. Comm'r*, 203 F.2d 785, 785 (6th Cir. 1953) ("[W]hen mail matter is properly addressed and deposited in the United States mails, with postage thereon duly prepared, there is a rebuttable presumption of fact that it was received by the addressee in the ordinary course of mail.").[822]

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[820] *Pond v. United States*, Docket No. 22-1537, CA4, May 26, 2023

[821] *Pond v. United States*, Docket No. 22-1537, CA4, May 26, 2023

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A crucial question arises regarding the continued applicability of this common law principle in light of the enactment of IRC §7502. The Court acknowledges this matter and highlights the absence of consensus among other Circuit Courts of Appeal regarding the correct interpretation and resolution of the issue:

> May a taxpayer invoke the preexisting common-law mailbox rule now that Congress enacted the new statutory mailbox rule in §7502? The answer depends on whether the statute merely supplements the common-law mailbox rule or else supplants it altogether. And the courts of appeals have split on the question. The Second and Sixth Circuits both say that the statute supplanted the common-law rule. See *Miller v. United States*, 784 F.2d 728, 731 (6th Cir. 1986); *Deutsch v. Comm'r*, 599 F.2d 44, 46 (2d Cir. 1979). The Eighth and Tenth Circuits, however, both say the statute merely supplemented the common-law rule. See *Sorrentino v. IRS*, 383 F.3d 1187, 1193–94 (10th Cir. 2004); *Est. of Wood v. Comm'r*, 909 F.2d 1155, 1160–61 (8th Cir. 1990).[823]

The Fourth Circuit panel announces that, in its view, IRC §7502 completely replaces, rather than supplements, the common-law mailbox rule concerning the matters encompassed by IRC §7502:

> We agree with the Second and Sixth Circuits that the statute has supplanted the common-law rule.[824]

The panel outlines the concepts it deems appropriate to apply in making this determination:

> When a federal statute invades an area occupied by federal common law, we generally presume the statute does not change the established common law. *United States v. Texas*, 507 U.S. 529, 534 (1993). This presumption favors "the retention of long-established and familiar principles." *Isbrandtsen Co. v. Johnson*, 343 U.S. 779, 783 (1952). But the presumption in favor of background principles may be overcome — and the common law supplanted — when "the language of a statute be clear and explicit for this purpose." *Fairfax's Devisee v. Hunter's Lessee*, 11 U.S. (7 Cranch) 603, 623 (1812); see also *Texas*, 507 U.S. at 534; *Isbrandtsen*, 343 U.S. at 783.11
>
> Does this amount to a clear statement rule? No, Congress need not attach an express disclaimer to a statute that "this statute hereby abrogates the common law." See *Astoria Fed. Sav. & Loan Ass'n v. Solimino*, 501 U.S. 104, 108 (1991) ("This interpretative presumption is not [] one that entails a requirement of clear statement, to the effect that Congress must state precisely any intention to overcome the presumption's application to a given statutory scheme."); see also Antonin Scalia & Bryan A. Garner, *Reading Law: The Interpretation of Legal Texts* §52 (2012) (a change in common law "need not be express"). Instead, evidence that the statute supplants the common law can be implied when the statute "'speaks directly' to the question addressed by the common law." *Texas*, 507 U.S. at 534 (quoting *Mobil Oil Corp. v. Higginbotham*, 436 U.S. 618, 625 (1978)).[825]

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The Court then explains why §7502 meets these tests:

> …§7502 abrogates the common-law mailbox rule because the Act "speaks directly" to the same question as the common-law rule. *Texas*, 507 U.S. at 534. Section 7502 mirrors the two presumptions that the common-law rule afforded: the presumption of timeliness and the presumption of delivery. See §7502(a), (c). In doing so it directly addresses the common-law rule's question. For taxpayers, §7502 provides a complete, if slightly narrower, set of mailbox presumptions. And that supplants the common law without the need for an express statement or unavoidable conflict. See *Milwaukee*, 451 U.S. at 319–20 (noting that when a statute thoroughly addresses an issue, "there is no basis for a federal court to impose more stringent limitations . . . by reference to federal common law"); *Gardner v. Collins*, 27 U.S. 58, 93 (1829) (explaining that a court cannot "resort to the common law" when the statute does not contain "a causus omissus; but a complete scheme").[826]

Hence, the Court concluded that the taxpayer cannot rely on the presumption of delivery provided by the common law mailbox rule. Instead, the Court emphasized that the taxpayer should have followed the procedures stipulated in IRC §7502 to obtain the presumption of delivery, as the statute supersedes the mailbox rule for this particular purpose.:

> In short, Pond cannot resort to the common-law presumption of delivery. He must proceed under the statute. And §7502 makes clear when the presumption of delivery can apply to a taxpayer filing: certified and registered mailings. See §7502(c). Because Pond did not send his 2013 refund claim by certified or registered mail, he does not satisfy the statute's requirements. Thus, he is not entitled to a presumption of delivery.[827]

But the Taxpayer is Allowed to Attempt to Demonstrate Actual Physical Delivery to the IRS

In contrast to the District Court's ruling, the panel, upon reviewing the alleged facts presented by the taxpayer, determined that there is a possibility for the taxpayer to demonstrate the actual physical delivery of the claim for refund to the IRS. It is worth noting that both IRC §7502 and the common law mailbox rule are only relevant if the taxpayer is unable to establish the actual timely physical delivery of the claim.

> Is Pond out of luck just because he cannot rely on a presumption of delivery? No. He can still proceed if he has plausibly alleged that his claim was physically delivered to the IRS. The district court held that Pond "is unable to show" physical delivery and that his allegations of physical delivery are "implausible." *Pond v. United States*, No. 1:21CV83, 2022 WL 1105031, at *6–7 (M.D.N.C. Apr. 13, 2022). We disagree. Affording the complaint all reasonable inferences, Pond adequately alleged physical delivery. So his claim survives the government's motion to dismiss.

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> The complaint directly alleges the 2013 claim was "physically delivered to the IRS service center in Holtsville, New York, in accordance with standard postal delivery practices and in accordance with IRS guidelines." J.A. 7. The government argues that this is a "mere conclusory and speculative allegation[]." Government Br. at 20–21 (citing *Painter's Mill Grille, LLC v. Brown*, 716 F.3d 342, 350 (4th Cir. 2013)). Perhaps, but Pond elsewhere supported this conclusion with three factual allegations. These well-pled factual allegations — and their resulting inferences — make physical delivery plausible.[828]

The first allegation is that the document was postmarked on July 18, 2017:

> First, Pond alleged that the envelope containing the 2013 claim "was postmarked with a date of July 18, 2017[.]" J.A. 7. The fact that the document was postmarked for delivery — which we accept as true — suggests that the document made it to its destination. This is the very idea underlying the presumptions of delivery: we can expect the U.S. Postal Service to do its job with some reliability. But if we allowed an allegation of a postmark alone to suffice for showing physical delivery, then that would effectively afford a "backdoor" presumption of delivery. So Pond must show more.[829]

Additionally, the taxpayer provided testimony stating that they had filed both the 2012 and 2013 claims within the same envelope. It is evident that the IRS processed the 2012 claim, which initially supports the taxpayer's argument:

> Second, Pond alleged that his 2012 and 2013 claims were sent in a single envelope. The 2012 claim was paid. A reasonable inference from the fact that the IRS paid Pond's 2012 claim is that they timely received it at IRS Holtsville. If both the 2012 claim and the 2013 claim were in the same envelope, then another reasonable inference is that IRS Holtsville received Pond's 2013 claim at the same time.[830]

However, the Court acknowledges the possibility that the IRS may have acquired the 2012 claim through an alternative method or recognized the initial error made by the agency in presuming additional tax was owed for the 2012 return.

> True, there are other possibilities. The IRS might have refunded Pond his 2012 overpayment without a filed claim. See §6230(d)(5). Or the IRS may have paid Pond's 2012 claim based on a duplicate copy of the claim that he sent to IRS Andover in connection with his requested interest refund. These other possible scenarios show that Pond's preferred inference — that IRS Holtsville received the envelope with Pond's 2012 and 2013 claims — is far from certain. But the plausibility standard is not a "probability requirement." *Ashcroft v. Iqbal*, 556 U.S. 662, 678 (2009). We are required to draw all factual inferences in Pond's favor, so long as they are "reasonable." See *Nemet Chevrolet*, 591 F.3d at 253. Notwithstanding other possibilities, one reasonable inference is that IRS

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> Holtsville received Pond's envelope. And that inference would support a plausible claim.[831]

Lastly, it is important to recall that the IRS issued a notice indicating the "date of claims received" as July 17, 2017. This statement, accepted as written by the IRS itself, serves as evidence that the IRS did indeed receive the claim well before the deadline for filing the claim.

> Third, Pond alleged that the letter he received from the IRS denying his 2013 claim listed the "date of claims received" as July 17, 2017. J.A. 11. We cannot ignore — in deciding whether Pond plausibly alleged timely filing — that the IRS itself prepared a document listing a timely date as the "[d]ate of claims received." J.A. 84.[832]

The Court acknowledges the argument put forth by the IRS, which contends that the IRS statement must be incorrect since the taxpayer testified to mailing the claims on July 18th.

> The government responds to this last point with a great deal of hand-waving. It says that, under Pond's own narrative, the claims could not have been delivered by July 17, 2017. After all, Pond alleged that, while he signed the refund claims on July 17, 2017, he did not place them in the mail until a day later, July 18, 2017. A letter cannot arrive a day before it was sent. But cf. Stephen W. Hawking, *A Briefer History of Time* (2008) (explaining when it might be possible to arrive at your destination before departing). So, the government claims, the IRS obviously put the wrong date on the letter. It was a simple mistake. The government even offers an explanation: The agent who authored the denial letter was surely referencing a later copy of the 2013 claim that Pond faxed over, well after the deadline.[833]

However, the panel also highlights that this mistake made by the IRS does not necessarily establish that the IRS never received the claim.

> But just because the IRS used the wrong date does not mean that they never received a timely copy of Pond's 2013 claim. Perhaps the denial letter's author got the date from a subsequent fax. But it is also plausible that the letter's author got the date from the original — and timely — copy of the 2013 claim. And if that is the case, then the claim may well have been received before the deadline. As Pond notes, "given the comedy of errors by the Holtsville service center, using the date Pond signed his 2013 Amended Return as the date his claim was received would be the least egregious error committed by the IRS in this refund saga." Appellant's Br. at 18. In any event, at this stage we need not conduct a searching inquiry into why the IRS listed a timely "date of claims received." It just matters that they did so. Again, the plausibility standard is not a "probability requirement." *Iqbal*, 556 U.S. at 678.[834]

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The panel concludes that the District Court had erred by granting summary judgement to the IRS based on the judge's conclusion that proving timely filing wasn't possible for Mr. Pond.

> This shows the error in dismissing his complaint at this stage. The district court reasoned that Pond "cannot show actual physical delivery or receipt by the IRS, since, according to the Complaint, the IRS has no record of receiving the return." *Pond*, 2022 WL 1105031, at *7. But this misreads Pond's complaint. It alleges that: "After inquiring again through counsel about the status of the 2013 refund, Plaintiff learned that the agents attempting to locate the 2013 Form 1040X were unable to find it anywhere in the system." J.A. 10 (emphasis added). That some IRS agents could not locate Pond's claim on the system does not mean the IRS never received it, nor does it mean that the IRS actually has no records of its delivery. A more exhaustive effort during discovery could reveal something that the initial search missed. So this allegation is compatible with the IRS having record of timely filing. A denial letter listing a timely "date of claims received," is itself some evidence that his claim was timely filed. On remand, the government may produce evidence supporting their argument that the date they listed as "date of claims received" must have been a mistake. Or, to the contrary, discovery might unearth additional evidence that the 2013 claim was timely filed.
>
> A court should grant a Rule 12(b)(1) motion to dismiss "only if the material jurisdictional facts are not in dispute and the moving party is entitled to prevail as a matter of law." *Richmond, Fredericksburg & Potomac R.R. Co. v. United States*, 945 F.2d 765, 768 (4th Cir. 1991). Here, the jurisdictional facts are in dispute. Pond plausibly alleges that he sent his 2012 and 2013 claims in a single envelope postmarked July 18, 2017. The IRS paid the 2012 claim, so there is a reasonable inference the envelope was physically delivered. True, there are other scenarios explaining why the 2012 — and not the 2013 — claim was paid. And while one scenario gives the court jurisdiction, others don't. But we shouldn't be picking among them at this stage. See *Adams*, 697 F.2d at 1219.
>
> Instead, we must draw all reasonable inferences in the light most favorable to Pond. After doing so, we find that Pond plausibly alleged in his complaint that his 2013 claim was physically delivered to the IRS before the statutory deadline. That is enough to show that the district court has jurisdiction within the United States's sovereign-immunity waiver under §1364(a) to hear his claim. So Pond's complaint should not have been dismissed under Rule 12(b)(1).[835]

Summary – The Task in Front of Mr. Pond is Difficult, but He Is Allowed to Attempt to Show Timely Delivery

Note that the panel did not determine that the claim had ever been delivered or that, if it was delivered, that it could meet the timeliness requirement. Rather, Mr. Pond can attempt to prove that actual delivery:

> Pond plausibly alleges that his claim for a refund on his 2013 taxes was physically delivered to the IRS before the statutory deadline. If true, then Pond's suit falls within the United States's sovereign-immunity waiver, and the district

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> court has jurisdiction. The district court's order holding otherwise is thus vacated.[836]

Returning to the crucial practical lesson to be learned from this case, it is evident that Mr. Pond has encountered this arduous challenge due to the failure to utilize the provisions outlined in IRC §7502 to secure prima facie evidence of the timely filing of the 2013 claim. As the opinion concludes:

> But Pond cannot rely on a presumption of delivery. Section 7502 is clear: only registered and certified mail are presumed delivered. And because the statute "speaks directly" to that presumption, it displaces the common-law presumption that might otherwise help Pond. Pond could have mailed his 2013 claim by registered or certified mail and been protected by the statutory presumption. He chose not to, so he must show physical delivery on remand.[837]

It is essential to emphasize the significance of the final sentence when advising clients on the seemingly routine task of filing documents with the IRS. This case serves as a reminder to clients about the importance of following the prescribed procedures and utilizing the available provisions found in IRC §7502 to establish compelling evidence of timely filing.

SECTION: 7701
IRS INFORMATION LETTER ADDRESSES CASES WHERE A CONTROLLER IS AND IS NOT A PAID PREPARER OF RETURNS

Citation: INFO 2021-0029, 12/30/21

In IRS Information Letter 2021-0029[838] the agency addresses an issue that CPAs employed as a controller in small, closely held businesses with various related businesses run into. If they are asked to prepare a number of returns for individuals and other related entities that aren't their employer, at what point does the controller become a paid preparer with regard to some or all of those returns.

The letter addresses this specific concern of the party to whom the letter is addressed:

> As we understand the facts provided, you prepare a number of income tax returns for your employer, an S-Corporation, for whom you have been employed for over seven years. The entities you prepare returns for include partnerships and individuals. You state that these partnerships are Limited Liability Companies related to your employer, and that these individuals are employed by the taxpayer. You ask whether you are required to sign these returns as a tax preparer.[839]

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[836] *Pond v. United States*, Docket No. 22-1537, CA4, May 26, 2023

[837] *Pond v. United States*, Docket No. 22-1537, CA4, May 26, 2023

[838] INFO 2021-0029, December 30, 2021, https://www.irs.gov/pub/irs-wd/21-0029.pdf (retrieved January 7, 2022)

[839] INFO 2021-0029, December 30, 2021

The letter first addresses the general rule governing such situations:

> The definition of "tax return preparer" found in section 7701(a)(36)(A) of the Internal Revenue Code (Code) includes any person who prepares a return for compensation. Section 7701(a)(36)(B) of the Code states that a person is not a preparer merely because they prepare returns for an employer for whom they are continuously employed. This exception includes persons who prepare returns for officers and other employees of the employer.[840]

The letter then provides detailed information on how the party to whom the letter is addressed can resolve his/her situation:

> Treasury Regulation § 301.7701-15(f)(1)(ix) states that individuals preparing returns for an employer, including returns prepared for an officer, general partner, member, shareholder, or employee, are not considered tax return preparers.

Thus, if the individuals for whom the controller is preparing a return fits one of those categories, the controller is not a paid preparer for that return. But if an individual does not fit into one of those categories, then the controller would be a paid preparer for that return.

The letter continues to look at related *corporations* where an employee of one will be considered an employee of the other:

> Treasury Regulation § 301.7701-15(f)(4) further states that the employee of a corporation owning more than 50 percent of the voting power of another corporation, or the employee of a corporation more than 50 percent of the voting power of which is owned by another corporation, is considered the employee of the other corporation as well. Treasury Regulation § 301.7701-15(f)(1)(ix) therefore applies to an employee preparing a return for an entity described in Treasury Regulation § 301.7701-15(f)(4) as well.[841]

As noted above, Treasury Regulation § 301.7701-15(f)(1)(ix) would allow preparing returns for an officer, general partner, member, shareholder, or employee of those organizations as well. But note that the regulation only refers to related corporations. This would appear to make the limited liability companies taxed as partnerships entities not covered by this exception, making the controller a paid preparer with regard to returns for those entities under the general rule found at Treasury Regulation § 301.7701-15(a) which states:

> A tax return preparer is any person who prepares for compensation, or who employs one or more persons to prepare for compensation, all or a substantial portion of any return of tax or any claim for refund of tax under the Internal Revenue Code (Code).[842]

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840 INFO 2021-0029, December 30, 2021

841 INFO 2021-0029, December 30, 2021

842 Treasury Regulation §301.7701-15(a)

SECTION: AICPA
AICPA ISSUES PROPOSED REVISIONS TO STATEMENTS ON STANDARDS FOR TAX SERVICES

Citation: Revised Statements on Standards for Tax Services: An Exposure Draft and Invitation to Comment, American Institute of Certified Public Accountants, 8/29/22

The AICPA has released an exposure draft of significant proposed changes to the Statements on Standards for Tax Services.[843] The AICPA states it will consider all comments received by December 31, 2022. These proposed standards would be effective no earlier than January 1, 2024.

The document also contains an invitation to comment on potential later revisions to the Statements that could create quality control guidance for tax practices.

Proposed Changes

The exposure draft would both reorganize the *Statements on Standards for Tax Services* and create three new standards. As the Introduction in the Explanatory Memorandum section of the document states:

> As part of those efforts, the task force:
>
> - Developed a new structure to organize the SSTSs by type of tax work performed,
> - Updated the existing standards to better reflect the current and possible future state of the tax profession and
> - Drafted three new standards surrounding data protection, reliance on tools and the representation of clients before taxing authorities.[844]

Proposed Reorganization of the Statements

As the AICPA did with the *Code of Professional Conduct*, the Institute is looking to reorganize the standards, this time using a practice-based organizational structure for these standards. The AICPA in the "Explanation of proposed revisions to the SSTSs" listed the four broad standard areas as follows:

- Standard 1 includes general tax guidance with broad applicability (includes new standards on data protection and reliance on tools)

[843] *Revised Statements on Standards for Tax Services: An Exposure Draft and Invitation to Comment*, American Institute of Certified Public Accountants, August 29, 2022, https://www.aicpa.org/resources/download/tax-standards-ssts-exposure-draft-and-invitation-to-comment (retrieved September 4, 2022)

[844] *Revised Statements on Standards for Tax Services: An Exposure Draft and Invitation to Comment*, American Institute of Certified Public Accountants, August 29, 2022

- Standard 2 includes tax return preparation guidance
- Standard 3 includes guidance specific to providing tax advice
- Standard 4 includes guidance for members providing tax representation services (new standard)[845]

Much of the reorganization simply takes the existing set of standards and distributes them among the renumbered practice-based standards. The explanation explains the proposed restructuring as follows:

> This revision project has reorganized the standards so that most of the existing standards have been incorporated into either general standards (Standard 1) or compliance standards (Standard 2). Because the proposed new standards around data protection and reliance on tools are applicable to different types of tax services, they were also included with the general standards. The existing standard as related to tax advisory services (Standard 3) and the new standard related to representation services (Standard 4) were determined to be unique and have been separately stated. This alignment is intended to assist members in applying standards to specific tax practice situations and to help them understand the scope and expectations of these standards.[846]

The document contains a section providing a mapping of the current standards to the location where they will be found under the new standards, as well as changes that may be made to the current standards.

Proposed Data Protection Standard (Proposed Section 1.3)

In the explanation the AICPA gives the justification for proposing to add these provisions to the standards:

> The subject of the protection of taxpayer data has exponentially grown over time and has gained global importance as technology now allows for the transfer and storage of large amounts of confidential financial information with the simple press of a button. In many cases, this data is never seen in a hard copy format. The task force believed it was important to implement a standard which ensures members adopt reasonable safeguards to protect taxpayer data, both in electronic format and otherwise.
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> The task force also recognized that constant advances in technology make it challenging to identify any one set of standards with broad applicability across all tax practices. The purpose of the new standard is to expressly state a member's responsibility to make a reasonable effort to safeguard confidential client

[845] *Revised Statements on Standards for Tax Services: An Exposure Draft and Invitation to Comment*, American Institute of Certified Public Accountants, August 29, 2022

[846] *Revised Statements on Standards for Tax Services: An Exposure Draft and Invitation to Comment*, American Institute of Certified Public Accountants, August 29, 2022

information. It was broadly written to consider the variability among member practices as well as continuingly changing privacy laws and technology.[847]

The statement provides the following proposed standard at 1.3.4 and 1.3.5:

> **1.3.4.** A member should make reasonable efforts to safeguard taxpayer data, including data transmitted or stored electronically.
>
> **1.3.5.** A member should consider applicable privacy laws when collecting and storing taxpayer data.[848]

The proposed explanation section, running from 1.3.6 to 1.3.13 gives more details on how a CPA in tax practice is expected to fulfill the proposed standards.

The explanation begins by emphasizing the term *reasonable* is being used in the standard to recognize that there is no "one size fits all" methodology that will be appropriate for all firms or for all time:

> **1.3.6.** The statement uses the term "reasonable," knowing that actions or behaviors considered "reasonable" may differ over time, among members and from firm to firm based on size and resources. The absence of any bright-line rules was purposeful, allowing for changing technology, laws, guidance and practice.[849]

A more detailed discussion of appropriate safeguards to be considered is found at 1.3.7:

> **1.3.7.** Appropriate safeguards should be implemented to protect both member and taxpayer data stored within the member's information systems platform. Appropriate safeguards should be based on current recommended practices, and may, for example, include the installation and use of commercial security software to prevent unwanted or unauthorized access to information, encryption of data that is sent between multiple parties over the internet, the use of secure networks, strong password policies, use of firewalls and use of secure data sharing/collaboration platforms.
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>> a. A member should consider other industry standards, such as the AICPA's Privacy Management Framework and Trust Services Criteria when developing a privacy program.[850]

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[847] *Revised Statements on Standards for Tax Services: An Exposure Draft and Invitation to Comment*, American Institute of Certified Public Accountants, August 29, 2022

[848] *Revised Statements on Standards for Tax Services: An Exposure Draft and Invitation to Comment*, American Institute of Certified Public Accountants, August 29, 2022

[849] *Revised Statements on Standards for Tax Services: An Exposure Draft and Invitation to Comment*, American Institute of Certified Public Accountants, August 29, 2022

[850] *Revised Statements on Standards for Tax Services: An Exposure Draft and Invitation to Comment*, American Institute of Certified Public Accountants, August 29, 2022

The explanation next goes on at 1.3.8 to explain that CPAs have responsibilities to consider data risks that might exist at third parties the CPA uses for its tax service, such as the tax return software provider who handles electronic filing for the firm:

> **1.3.8.** Members may use electronic tools owned and hosted by others, such as tax return preparation software, or may outsource certain tasks, such as converting paper documents to electronic information. Members should take reasonable efforts to confirm that taxpayer information properly shared with others in the course of providing a service is appropriately protected.[851]

The explanation also suggests that CPAs consider limiting the amount of data the firm retains since, obviously, data that does not exist on the firm's servers can't be at risk of unauthorized access:

> **1.3.9.** A member should take reasonable steps to limit the amount of taxpayer confidential information in the member's files. For example, the member should collect only the information necessary to perform the services for which the member is being engaged or otherwise approved to perform by the taxpayer, returning or redacting any confidential taxpayer information unnecessary to complete the services. This may also include insisting that any personally identifiable information (PII) or personal health information (PHI) be masked/anonymized prior to receipt by the member. Additionally, adherence to appropriate document retention and destruction policies can help to ensure that taxpayer data is properly removed from a member's information systems once it is no longer needed under the respective statute of limitations or the member's document retention policies.[852]

The explanation also discusses the requirement for CPAs to have developed plans for how the firm would react in the case of a data breach at 1.3.10:

> **1.3.10.** In developing safeguards, members should also consider steps to be taken in the event of a data breach, including compliance with notification obligations. For example, the Federal Trade Commission (FTC) provides recommendations that include securing systems and fixing issues that are attributed to the breach. Consider forming a plan to quickly respond to those affected by the breach. Notify appropriate authorities of the breach as required by law.[853]

The need to understand and comply with privacy laws is discussed at 1.3.11:

> **1.3.11.** Members should consider applicable privacy laws. For example, the Financial Services Modernization Act of 1999 (also referred to as the Gramm-Leach-Bliley Act (GLBA)), requires professional tax return preparers to ensure the security and confidentiality of customer (i.e., taxpayer) financial information. As part of the implementation of the GLBA, the FTC issued the Safeguards Rule,

[851] *Revised Statements on Standards for Tax Services: An Exposure Draft and Invitation to Comment*, American Institute of Certified Public Accountants, August 29, 2022

[852] *Revised Statements on Standards for Tax Services: An Exposure Draft and Invitation to Comment*, American Institute of Certified Public Accountants, August 29, 2022

[853] *Revised Statements on Standards for Tax Services: An Exposure Draft and Invitation to Comment*, American Institute of Certified Public Accountants, August 29, 2022

requiring the development of a written information security plan that describes the program put in place to protect taxpayer information commensurate with relative firm size of the member and complexity of services provided. Additionally, under these rules, return preparers are responsible for taking steps to ensure that their affiliates and service providers safeguard taxpayer information in their care. As with many privacy laws, the FTC has subsequently updated the rule to keep pace with technology and members should periodically review applicable privacy laws to keep abreast of applicable rules.[854]

Taxing agencies, such as the IRS, also impose requirements on those involved in tax practice that the CPA must comply with, as discussed in 1.3.12:

> **1.3.12.** A member should have general knowledge of the current security expectations of taxing authorities and taxpayers. Data security is a topic addressed in the tax press and by taxing authorities. For example, at the time of this writing, the IRS has a webpage with links to various publications and other information related to data protection. Members are not expected to become experts in this area, but it is reasonable that a member avail himself or herself of the information made generally available to tax professionals on the subject, including those referenced in section 1.3.7.1.[855]

Finally, the discussion concludes with responsibilities the CPA has to train employees regarding data security issues at 1.3.13:

> **1.3.13.** Training is a vital component of any data protection plan. A member should make reasonable efforts to ensure all non-member personnel who the member supervises should be trained and informed about data protection. For example, staff should be informed how to recognize phishing emails and the dangers of opening or downloading attachments from unknown senders.[856]

Proposed Standard on the Use of Tools By the CPA

The standard discusses the use of various practice aids and research sources by the CPA, broadly describing such items as *tools* under the proposed standard. Proposed standard section 1.4.2 defines *tools* as follows:

> **1.4.2.** For purposes of this section, a tool is a resource used in the provision of tax services. Tools include, but are not limited to, tax preparation software, tax research publications (paper or electronic), tax-related calculation aides, tax planning software, state and local tax aids, online data search engines, data analytics, statistical models, artificial intelligence and relevant professional publications and resources.[857]

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[854] *Revised Statements on Standards for Tax Services: An Exposure Draft and Invitation to Comment*, American Institute of Certified Public Accountants, August 29, 2022

[855] *Revised Statements on Standards for Tax Services: An Exposure Draft and Invitation to Comment*, American Institute of Certified Public Accountants, August 29, 2022

[856] *Revised Statements on Standards for Tax Services: An Exposure Draft and Invitation to Comment*, American Institute of Certified Public Accountants, August 29, 2022

[857] *Revised Statements on Standards for Tax Services: An Exposure Draft and Invitation to Comment*, American Institute of Certified Public Accountants, August 29, 2022

The standard discusses the care a CPA must use when selecting and using a tool, as well as the requirement that the CPA must accept the ultimate responsibility for complying with professional standards. The standard, found at 1.4.3 and 1.4.4 provides:

> **1.4.3** A member should exercise appropriate professional judgement and professional care when relying on a tool.
>
> **1.4.4.** A member may reasonably rely on tools used in providing tax services to a taxpayer. Use of the tool does not absolve the member of his or her professional obligations under AICPA or other applicable ethical standards.[858]

The explanations portion of 1.4 provides additional discussion to clarify the application of this standard in practice.

The use of tools is noted as being a best practice generally for CPA firms, to help insure delivery of quality services:

> **1.4.5.** Tools developed for use in the provision of tax services provide significant benefits to members. It is generally a best practice of a member to rely on such tools to a certain extent to improve efficiency and client service.[859]

CPAs should consider the source of the tool when determining the level of reliance on the tool:

> **1.4.6.** The source of the tools must be considered when determining the appropriate level of reliance on that tool. For example, subscription-based tax research tools and resources may have more weight than opinion articles from independent internet sources.[860]

While understanding the point that the task force is attempting to make here, readers should not shorten this to simply deciding all subscription-based services should be given more weight than any independent internet sources. The world isn't quite that simple and every editorial source will eventually publish erroneous guidance (including CPE manuals from major providers of paid CPE).

For example, some subscription-based services are only updated annually. It is incumbent upon the CPA to understand when any material was last updated and note that, for instance, a paperback tax handbook published in January (such as the *CCH Master Tax Guide*, *RIA Federal Tax Handbook*, *Quickfinder*, or *The Tax Book*) will not contain information on laws passed during the year in question, even those that might have retroactive impact. Often such sources will have some source of updated information, but the CPA must remember to check those update sources rather than merely relying on the printed book.

Similarly, many binding authorities are first published by courts and taxing agencies on the internet, representing the ultimate authority even if they aren't provided by a publisher to which

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the CPA is paying a subscription fee. That is, the full opinion of a published Tax Court opinion posted by the United States Tax Court carries more weight than a summary of that case published by a major tax publisher in their daily news service.

At 1.4.7 the explanation points out that the CPA is ultimately responsible for ensuring accurate results are obtained by the tool, and that includes insuring that tax preparation software properly computes the returns:

> **1.4.7.** A member who employs tools in providing tax services remains responsible for the completed work product in accordance with the various other standards contained in the statements. Accordingly, members should take reasonable steps to satisfy themselves that the results presented by the use of various tools are reliable. For example, a member should confirm that the calculation of taxable income and tax liability for an income tax return that is completed using professional tax return preparation software is accurate and meets the standards for tax return positions established in 2.1, Tax Return Positions.[861]

Finally, at 1.4.8 the explanation again emphasizes that the CPA cannot transfer responsibility to the tool:

> **1.4.8.** Tools should be used to enhance or improve the member's understanding of a tax issue, not to supplant the member's professional judgement. For example, when preparing a Federal Form 1040, U.S. Individual Income Tax Return, a member must still attest under penalties of perjury that, to the best of the preparer's knowledge and belief, the return and accompanying schedules are true, correct and complete. That responsibility cannot be transferred entirely to reliance on a tool.[862]

Proposed Statement on Standards for Tax Services No. 4, Standards for Members Providing Tax Representation Services

The final new provision is placed in its own standard, *Proposed Statement on Standards for Tax Services No. 4, Standards for Members Providing Tax Representation Services*.

The Introduction explains what this proposed standard would cover:

> **4.1.1.** This statement sets forth the applicable standards for a member representing a taxpayer with a power of attorney before an applicable taxing authority. Representing a taxpayer in various tax matters could involve application of other standards. The focus of this statement is on the representation relationship itself.

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> **4.1.2.** In addition to the AICPA, applicable taxing authorities may impose specific guidance related to the representation of taxpayers, such as Circular 230. These standards can vary between taxing authorities and by type of tax.[863]

In this case, the statement has six distinct subsections:

> **4.1.3.** The member, and any individuals working with or for the member, should have or take steps to obtain technical competence in the subject matter involved. This includes competence in the technical tax area involved as well as the tax practice and procedures of the taxing authority. For this purpose, competence follows the definition established in Section 10.35 of Circular 230.
>
> **4.1.4.** The member should take appropriate steps to ensure compliance with all relevant professional and regulatory obligations when representing a taxpayer.
>
> **4.1.5.** The member should act with integrity and professionalism in all dealings with the taxing authority. This includes not unduly delaying or impeding the taxing authority.
>
> **4.1.6.** Information requested by the taxing authority should, with taxpayer approval, be provided by the member on a timely basis unless there is a good-faith belief that the information is privileged.
>
> **4.1.7.** The member should consider if the taxpayer's conduct may be fraudulent or criminal in nature. If so, the member should advise the taxpayer to retain legal counsel and refrain from further representation.
>
> **4.1.8.** Upon completion of the examination by the taxing authority, the member should review any documents or computations detailing the results of the examination for correctness and discuss with the taxpayer the consequences of agreeing to these conclusions.[864]

The explanation begins by noting that competence for a representation engagement requires more than just technical tax competence in the area under examination. The CPA must also have competence in dealing with tax practice issues as well, something not generally covered in continuing education courses that aren't ones specifically related to tax practice:

> **4.1.9.** Competency is an important issue for professionals who provide tax representation services. While continuing professional education tends to focus on tax law updates or more complex technical tax issues, members often overlook the complicated rules of tax practice and procedure that go hand in hand with representation of taxpayers. Members dealing with tax agencies should be knowledgeable about the procedural issues they may encounter while representing taxpayers.[865]

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The explanation goes on to point out specific areas that could impact representation:

> **4.1.10.** Members should consider multiple areas which could impact a taxpayer representation engagement. Among other items, this may include:
>
> a. Consulting with a local law firm to determine whether the representation would constitute the unauthorized practice of law;
>
> b. Determining whether CPA licensure in another jurisdiction may be required;
>
> c. Executing any taxpayer authorizations required by the taxing authority such as powers of attorney;
>
> d. Determining whether the member may be facing a conflict of interest such as representing other taxpayers who are taking a contrary position;
>
> e. Establishing and documenting in writing an understanding with the taxpayer regarding objectives of the engagement, services to be performed, taxpayer's acceptance of its responsibilities, member's responsibilities and any limitations of the engagement.[866]

Finally, the explanation points out potential conflict of interest issues that must be considered:

> **4.1.11.** When representing taxpayers, members are required to comply with all conflict-of-interest standards, such as Section 1.000.020, *Ethical Conflicts of the Code of Professional Conduct*.[867]

Invitation to Comment on Tax Practice Quality Issues

Not part of the proposed standard is an invitation to comment on tax practice quality control issues and whether they should be part of the *Statements on Standards for Tax Services* in the future. If this was to become part of the SSTSs, there would need to be a new proposed revision to the Statements issued, with an appropriate comment period.

The AICPA specifically asks those commenting on this area to answer four questions:

> **ITC1 .** How do you define quality management in tax? Please be as specific as possible.
>
> **ITC2.** What role do you think the AICPA should undertake regarding quality management in tax? Please explain your rationale.
>
> **ITC3.** To preserve the ability to self-regulate, do you believe the AICPA should consider quality management in tax for potential inclusion in future SSTSs? If

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"no," how should quality management in tax be addressed? Please provide your reasoning.

ITC4. How do you currently approach and ensure adherence to quality management within your tax function?

- What challenges do you experience?
- What type of application material would be helpful from the AICPA?[868]

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