2024 Workbook

2024 University of Illinois Federal Tax Workbook

Authors & Editors

Kelly Golish
Assistant Director, Tax Materials
University of Illinois Tax School

John Richmann
Tax Materials Specialist
University of Illinois Tax School

Chris Korban
Tax Materials Specialist
University of Illinois Tax School

Production Supervision

Dan Harding
Publications Manager
University of Illinois Tax School

Diana Witt
Indexer
New Hampshire

Additional Content Contributors

Ashley Akin, New York
Rong Fu, Illinois
Deborah Held, Illinois
Michael Lathwell, Illinois
Roger McEowen, Iowa
Agnes Mung, Illinois
Peg Phillips, Illinois
Shane Smith, Colorado

Chapter Peer Review

Keith Baum, Illinois
Diane Beers, Illinois
Linda Beers, Illinois
Jeffrey Brend, Illinois
Jerard Brune, Illinois
Paul Bumgarner, North Carolina
Jeanne Campion, Illinois
Randy Carlson, Kansas
Fran Coet, Alabama
Curt Davis, Arkansas
Gabrielle Douglas, Illinois
Kyle Gateley, Illinois
Larry Gray, Missouri
Courtney Malcolm, Illinois
Gina Marsh, Illinois
Les Marti, Illinois
Mary Olsen, Illinois
Ronald Powell, North Carolina
Rheanon Rabideau, Illinois
Robert Rhea, Illinois
Catherine Riddick, Illinois
Greg Tissier, Illinois
Sue Voth, Illinois
Lori Walden, Illinois
Richard Walden, Illinois
Brenda Williams, Illinois
Kenneth Wright, Missouri

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2024 Federal Tax Workbook

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The IRS website is not considered substantial authority. Any citations thereto are for informational or contextual purposes only. It is up to the individual practitioner to perform due diligence with respect to any arguments before the IRS. See IRM 4.10.7 for more information at **uofi.tax/authority** [www.irs.gov/irm/part4/irm_04-010-007].

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Randall R. Carlson
Professional Tax Institutes, Inc.

Illinois

Gina Marsh
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University of Illinois at Urbana-Champaign

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Indiana University Conferences

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K-State Research and Extension
Department of Agricultural Economics
Kansas State University, Manhattan

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SCORE Maine's Tax Workshop Committee

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Missouri Society of CPAs

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Patricia Young
Office of Extended Learning,
University of North Dakota, Grand Forks

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For your convenience, in-text website links are also provided as short URLs. Anywhere you see **uofi.tax/xxx**, the link points to the address immediately following in brackets.

About the Author

Chris Korban, CPA, is a Tax Materials Specialist at the University of Illinois Tax School. He joined Tax School in 2023 with nine years of experience in public accounting. Chris earned both his Bachelor's Degree in Accounting and Master of Accounting Science from the University of Illinois.

Other chapter contributors and reviewers are listed at the front of this book.

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As a consequence of working with confidential and highly sensitive information, tax practitioners are responsible for conducting themselves and their practices in an ethical manner. Circular 230, a publication issued by the Department of the Treasury, lays the foundation of the governing rules for those practicing before the IRS. Among its contents, Circular 230 establishes ethical standards for tax practitioners. However, practitioners may find themselves in situations where an issue may not be as cut and dry as the scenarios and examples included in Circular 230. Often, a degree of judgement and consideration is involved in assessing such situations and navigating a path forward in how best to proceed and handle them.

Alicia Hutchinson is a fictional CPA with 15 years of experience working for an accounting firm of 50 employees, Hermann & Trout. While she prepares tax returns for individuals and small businesses, she also specializes in fiduciary taxation, preparing tax returns for estates and trusts. This chapter follows Alicia through a typical day in early March and examines several ethical situations she faces.

FEES

As Alicia arrives at her office, her phone is ringing. When she answers the phone, a client, Reed Barker, for whom she had prepared Form 1040, U.S. Individual Income Tax Return, begins angrily complaining about the invoice he received for Alicia's services for preparing his return. Specifically, Reed is surprised at the amount he is being billed for the tax preparation services, stating that the invoiced $500 is higher than the $400 he was expecting to pay. Alicia recalls that she spent additional time calculating Reed's basis in some shares of stock he sold during the tax year that was not reported on Form 1099-B, Proceeds from Broker and Barter Exchange Transactions, and that Reed did not know what the correct amount was at the time of the sale. Alicia calmly explains that the additional amount invoiced to Reed is for the time that she spent reviewing the historical pricing of the sold stock and calculating the basis after the stock-splits and reinvested dividends occurring after the date of acquisition.

While Reed understands and recalls Alicia's conversation with him during the preparation process when she explained she would need to spend time to calculate the basis for the sold stock, he is upset that Alicia did not explicitly tell him there would be an increase to the tax preparation fee and the amount of such an increase. Alicia points out that the engagement letter Reed signed contains a provision that additional work Alicia provides related to incomplete or unprovided information would result in higher fees. This explanation does not appease Reed.

UNCONSCIONABLE FEES

Circular 230, §10.27, provides ethical guidance pertaining to charging fees in connection to matters raised before the IRS, including tax return preparation. Section 10.27(a) states, generally, practitioners are prohibited from charging unconscionable fees. No additional guidance follows pertaining explicitly to unconscionable fees. Moreover, §10.27(c), which provides definitions for §10.27, does not include a definition or general characteristics of an unconscionable fee.

A definition is provided for **contingent fees,** and §10.27(b) provides rules practitioners must adhere to in regards to contingent fees. Notably, a contingent fee is a fee based wholly or in part on the outcome of a tax position. Generally, practitioners are prohibited from charging contingent fees. However, exceptions apply to fees for services pertaining to an IRS examination of original tax returns or certain amended returns, claims of credit related to IRS-assessed interest or penalties, and judicial proceedings arising from the Code.

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Within the context of the Circular 230 section, while contingent fees in general may be considered unconscionable fees, the publication does not state nor indicate that unconscionable fees are solely contingent fees. As Circular 230 does not define what is or what is not unconscionable, practitioners are left to best interpret what the IRS or the Department of the Treasury considers as such. In general, "unconscionable" is defined as shockingly unfair or unjust, excessive, unreasonable, and not guided by conscience.[1] From this definition, an interpreted guideline to adhere to the Circular 230 provisions pertaining to charging fees may include that a practitioner must charge a fee that is fair and reasonable. While what may constitute as fair or reasonable can vary from person to person, a practitioner could use documented reasoning, time spent on the return, and other contributing factors to defend and justify an invoiced fee.

According to the American Institute of Certified Tax Planners, a guiding factor to ensure practitioners are not charging unconscionable fees is that "the fee should represent a fair exchange of value."[2] A client could be upset over an invoiced fee due to a lack of perceived value. While that client may appreciate that their practitioner's time is valuable, perhaps they do not find the benefit received for that time to be of net benefit. For example, in the absence of supporting documentation or a reasonable method to calculate an asset's basis, the IRS will treat an asset's basis as zero.[3] If the basis a practitioner calculated resulted in a tax benefit that was less than the additional cost invoiced to their client for the practitioner's time in making the calculation as opposed to reporting the client's basis as zero, the client may understandably find the additional cost to them lacking in value.

CLEAR COMMUNICATION

Circular 230 identifies best practices relating to communication from practitioners to their clients. Section 10.33(a)(1) advocates clear communication between the parties pertaining to the terms of the engagement. A client should understand the type and scope of services to be rendered by the practitioner, as well as the fee structure for such services. Practitioners should communicate the engagement scope and terms in a written engagement letter and have clients sign the document to acknowledge they read, understood, and agree with the described terms.

Practitioner Planning Tip

Practitioners should consider the timing of communicating their fee structure to aid them in ensuring their expectations align with their client's. Ideally, such an understanding occurs before a practitioner begins preparing a client's tax return so the client can make an informed decision about proceeding with the engagement. This may present a challenge to practitioners who structure their fees based on the time it takes them to complete preparing a return. In addition to the written communication disclosed in an engagement letter, it may be beneficial for practitioners to verbally relay such fee structures to their clients, particularly in cases where a client is engaging with the practitioner for the first time. Practitioners should exercise caution if providing an estimate or range for their preparation time and resulting fee to avoid unrealistic expectations by the client.

1. *Unconscionable*. 2024. Merriam-Webster. [www.merriam-webster.com/dictionary/unconscionable] Accessed on Jan. 26, 2024.
2. *Ethical Considerations for Tax Professionals: Determining Fees*. Molina, Dominique. Sep. 13, 2022. American Institute of Certified Tax Planners. [certifiedtaxcoach.org/ethical-considerations-for-tax-professionals-determining-fees] Accessed on Jan. 30, 2024.
3. *Cost Basis Basics — Here's What You Need to Know*. 2024. FINRA. [www.finra.org/investors/insights/cost-basis-and-your-taxes] Accessed on Jan. 30, 2024.

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Written and verbal communication of the practitioner's fee structure alone may not alleviate a client's confusion about charges for additional work. While it may seem obvious to practitioners that additional time spent on work outside the scope of an engagement would result in additional charges, clients may not be aware of the existence or amount of additional time spent obtaining or calculating missing information. If practitioners explicitly tell a client there would be an increase in their tax preparation fee at the time they let the client know that additional work is necessary, the client is aware and can anticipate a higher fee. Additionally, such communication allows the client to weigh their options against the additional cost for their practitioner to incur additional work. For example, in the case of missing basis, such options may include the client reaching out to their broker to see if the broker could determine the basis, researching and calculating the basis themselves, or opting to report the basis for the asset sold as zero. Further explanation from practitioners may allow the client to make a more informed decision on how best to proceed when the issue is first raised by the practitioner.

DISCUSSION

What ethical considerations should be taken into account in this situation, and what actions, if any, should Alicia have taken to mitigate the misunderstanding and disappointment her client experienced? ____________________________

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Did Alicia charge Reed an unconscionable fee? Why or why not? ____

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How could Alicia more clearly communicate her fee structure? At what time during the engagement could this communication be more effective? ____

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What are some effective ways to disclose a practice's fee structure? What type of communication successfully conveys when additional work needed will result in additional charges for services rendered? ___________________

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DISCLOSING INFORMATION

Five minutes after ending her call with Reed, Alicia begins prepping for her meeting with a longtime client, Holly Lynn, a young professional with a high-earning position at a national consulting firm. Holly arrives at the meeting on time and brings her tax documents for Alicia to prepare her tax return. After they discuss the prior tax year, Holly explains that she is in the process of purchasing her first home and that her mortgage broker needs copies of her last two years' tax returns as part of the prequalification process. Holly asks Alicia if she could please send the copies of the returns directly to the mortgage broker.

PERMISSABLE DISCLOSURE

Practitioners are required to comply with strict provisions of the Code and law when disclosing sensitive data such as a taxpayer's tax return or tax return information. Section 10.51(a)(15) of Circular 230 identifies the willful disclosure or use of a taxpayer's tax return or tax return information not in accordance with provisions of the Code as a sanctionable act of incompetence and disreputable conduct. Therefore, before disclosing a tax return or tax return information to another party, practitioners must be familiar with the provisions of the Code and Treasury Regulations regarding disclosure of such information with and without the taxpayer's consent.

Disclosure with Taxpayer Consent

Treas. Reg. §301.7216-3 allows practitioners to disclose tax return information provided they obtain **written** consent from the taxpayer prior to the disclosure. Generally, such written consent must contain the following.

1. The name of the taxpayer and the name of the tax return preparer
2. The purpose and intended recipients of the disclosure
3. A description of the tax return information that the tax return preparer will disclose
4. The taxpayer's signature and date

Practitioners must obtain written consent from the taxpayer **before** they disclose tax return information. This means that practitioners are prohibited from receiving retroactive consent after disclosing tax return information. Retroactive consent fails to fulfill the permission timing requirements as specified by the regulations.[4] While the taxpayer may specify the duration of the consent, the default duration is one year from the date of the taxpayer's signature if the consent is silent on the matter of duration.[5] The following is an example of sufficient written consent that a practitioner may receive from their client who is requesting their preparer provide the prior two years tax returns to a mortgage broker to assist them with the prequalification process for approving a loan.[6]

4. Treas. Reg. §§301.7216-3(b)(1) and (2).

5. Treas. Reg. §301.7216-3(b)(5).

6. Example adapted from Rev. Proc. 2013-14, 2013-3 IRB 283.

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Consent to Disclose Tax Return Information

Federal law requires this consent form be provided to you. Unless authorized by law, we cannot disclose your tax return information to third parties for purposes other than the preparation and filing of your tax return without your consent. If you consent to the disclosure of your tax return information, Federal law may not protect your tax return information from further use or distribution.

You are not required to complete this form to engage our tax return preparation services. If we obtain your signature on this form by conditioning our tax return preparation services on your consent, your consent will not be valid. If you agree to the disclosure of your tax return information, your consent is valid for the amount of time that you specify. If you do not specify the duration of your consent, your consent is valid for one year from the date of signature.

You have indicated that you wish to have copies of your two most recent tax returns sent to [name of third party] to determine qualification for a mortgage loan. If you would like [name of practitioner] to disclose your tax return information to [name of third party], please check the corresponding box for the service in which you are interested, provide the information requested below, and sign and date your consent to the disclosure of your tax return information.

☐ I, [name of client], authorize [name of practitioner] to disclose to [name of third party] my tax return information for [applicable years] as part of the prequalification process to approve me for a mortgage loan.

Signature: ______________________________

Date: ________________

If you believe your tax return information has been disclosed or used improperly in a manner unauthorized by law or without your permission, you may contact the Treasury Inspector General for Tax Administration (TIGTA) by telephone at 1-800-366-4484, or by email at complaints@tigta.treas.gov.

Alternatively, if a practitioner maintains a policy of not providing tax return information to third parties (even if requested by the client), a practitioner may offer to prepare a copy of the requested returns for the client to then give to the third party. The practitioner could explain this approach to ensure that the client has complete ownership over the disclosure of her tax return information.

Practitioner Planning Tip

Practitioners should consider offering a secure client portal to avoid any disclosure issues and for the taxpayer to have ready access to their tax documents.

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Disclosure Without Taxpayer Consent

Treas. Reg. §301.7216-2 provides specific situations where a tax practitioner may release or may be required to disclose taxpayer information without the taxpayer's consent. These permitted disclosures do not result in sanctions (civil or criminal). The following are examples of permitted disclosures.

- **Disclosure** pursuant to any other Code section or Treasury regulation
- **Disclosure** to the IRS
- **Disclosure** pursuant to a court order
- **Use** of a client's tax return information when updating tax preparation/filing software
- **Use** of and **disclosure** to tax return preparers located within the same firm **inside** the United States for tax preparation or auxiliary services for that client
- **Use** of and **disclosure** to tax return preparers located within the same firm **outside** the United States for tax return preparation or auxiliary services for that client (with the client's written consent)
- **Use** of and **disclosure** between tax return preparers when both preparers are located within the same firm **outside** the United States if the information was originally provided to the firm by the taxpayer
- **Disclosure** to tax return preparation software/equipment contractors **only to the extent necessary** to provide contracted services
- **Disclosure** and **use** for certain related taxpayers
- **Disclosure** when securing legal advice, or during Treasury investigations or court proceedings concerning the preparer
- **Use** and **disclosure** to other members of the preparer firm for other tax, legal, or accounting services to the client

PENALTIES FOR IMPROPER DISCLOSURE

Under IRC §7216, a tax return preparer generally may not use or provide a taxpayer's **return information** to another party, unless:[7]

- The **use** or **disclosure** is specifically permitted by §7216 or Treas. Reg. §301.7216-2, or
- The tax return preparer obtains valid consent from the taxpayer.

IRC §6713 imposes civil penalties starting at $250 for each unauthorized or improper use or disclosure of tax return information. The penalties increase to $1,000 per event if the disclosure is made in connection with identity theft crime. The maximum annual fines imposed by these provisions are $10,000 and $50,000, respectively.

Disclosures made **knowingly or recklessly** are also subject to criminal penalties of up to $1,000 per event and up to one year in prison. Violations in connection with identity theft crimes are subject to fines of up to $100,000 each.[8]

7. IRC §7216(a)(1); Treas. Reg. §301.7216-3.

8. IRC §7216(a)(2).

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DISCUSSION

What allowable actions can Alicia take to address Holly's request? Is Alicia legally obligated to turn over Holly's return? ____

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Why might Hermann & Trout maintain a policy of not providing tax return information to third parties, even upon client request? What alternative actions could the firm's practitioners take to address such requests? ______________

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How do you handle requests for sending tax return information to third parties in your practice? What factors influence your approach in addressing such requests? ____

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COMPETENCE

Alicia receives an email from one of Hermann & Trout's tax associates who has been with the firm for just over two years, with this filing period being his third tax season. The associate, Ben, is assisting Alicia with the preparation of Form 1065, U.S. Return of Partnership Income, for one of Alicia's partnership clients. The email contains a list of questions, mostly pertaining to procedural applications of preparing the return instead of client-specific questions that Ben may not be privy to. Alicia is somewhat surprised at some of the questions she is receiving from Ben, as she would normally expect an associate at his level to know the information he is seeking. Ben works remotely, and only seldomly comes into the office. Alicia wonders whether Ben has the necessary competence to work on this partnership return, and whether Ben can obtain competence effectively considering his working environment.

Section 10.35 of Circular 230 requires practitioners to possess the "appropriate level of knowledge, skill, thoroughness, and preparation necessary" to engage in practice before the IRS. While it goes on to state that practitioners may obtain competence by consulting with experts or conducting research, Circular 230 does not provide specific criteria or examples of what would constitute an appropriate level of competence. As such, practitioners may need to look to other publications or sources in determining a framework to evaluate and assess competency, bearing in mind that such alternative resources **do not** necessarily provide protection or a defense against a challenge of competency by the IRS.

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Many professional organizations maintain a professional code of conduct to help define competency. For example, the code of professional conduct for the American Institute of Certified Public Accountants (AICPA) includes competency requirements and criteria for its members. The AICPA's code identifies competency as the level of knowledge required to provide services with an aptitude for the subject matter and exercise sound judgement in performing the necessary duties.[9] The code clarifies that competency is obtained through a combination of education and experience, with both aspects being a continuous process through the duration of a practitioner's career.[10] The following are provisions addressed specially to AICPA members who practice public accounting.[11]

1. Professional competency includes knowledge on standards of the profession, technical matter of the engagement, and exercising sound judgement in the application of such knowledge in practice.
2. Members accepting engagements do so with the implication they possess the ability to apply the necessary level of knowledge and skill **diligently and with reasonable care**. Such acceptance, however, does not imply infallibility of knowledge or judgement.
3. A member may obtain the necessary knowledge for performing an engagement through research and consultation during the performance of the engagement.
4. A member who does not have or is unable to obtain the level of competency necessary for an engagement should advise the client to engage with someone who possesses the necessary competence to perform the engagement.

Such criteria provide practitioners with more insight and guidance to possess and maintain competency in performing public accounting services, including practicing before the IRS, compared to the brief provision in Circular 230. Both Circular 230 and the AICPA code of professional conduct identify that practitioners are allowed to obtain competency during the performance of an engagement, and that not possessing such knowledge does not preclude them from accepting engagements. Therefore, obtaining knowledge or having access to resources such as research software or colleague expertise is an integral part of developing and maintaining competency. In developing new staff and fostering their growth in building skills and forming technical knowledge, firm management should be mindful of their staff's access to these critical resources. The working environment, whether it be in an office or a remote work arrangement, can therefore be a factor in fostering or hindering growing one's competency.

INCOMPETENCE AND DISREPUTABLE CONDUCT

Circular 230, §10.51, identifies actions deemed incompetent and exhibiting disreputable conduct. The consequences for such offenses can be severe, as the provision carries forward from §10.50, which addresses sanctions such as the ability of the Office of Professional Responsibility to censure, suspend, or disbar a practitioner. Circular 230, §10.51(a) illustrates a series of potentially actionable offenses that constitute incompetence and disreputable conduct.

- Criminal convictions
- Felony convictions resulting in the practitioner being unfit to represent taxpayers before the IRS
- Giving false or misleading testimony or helping others to give false or misleading testimony to IRS or Treasury employees
- False, misleading, or deceptive advertising practices
- Practitioners not filing their own returns or paying the tax they owe
- Assisting or suggesting ways a taxpayer may violate the law

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9. See §0.300.060 of *AICPA Code of Professional Conduct*. Jun. 2020. AICPA. [us.aicpa.org/content/dam/aicpa/research/standards/codeofconduct/downloadabledocuments/2014-december-15-content-asof-2020-June-20-code-of-conduct.pdf] Accessed on Feb. 12, 2024.

10. Ibid.

11. See §1.300.010 of *AICPA Code of Professional Conduct*. Jun. 2020. AICPA. [us.aicpa.org/content/dam/aicpa/research/standards/codeofconduct/downloadabledocuments/2014-december-15-content-asof-2020-June-20-code-of-conduct.pdf] Accessed on Feb. 12, 2024.

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- Taking funds from a taxpayer intended to pay tax obligations and using them personally
- Attempting to bribe Treasury officials
- Disbarment from practice by their state governing authority
- Assisting disbarred persons to practice before the IRS
- Rude, abusive, or threatening treatment of IRS employees
- Taking misleading positions known to be contrary to law
- Intentionally failing to sign returns prepared by the practitioner
- Unauthorized disclosure of taxpayer information
- Failing to maintain records of returns prepared
- Preparation of returns without a valid preparer tax identification number (PTIN)

DISCUSSION

In what ways could remote working limit Ben's ability to develop knowledge and skills? What are some ways Hermann & Trout can address deficiencies in competency in their newer staff or remote employees?______________

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Whose responsibility is it to ensure that Ben is competent: Alicia, the firm, or Ben? ____________________________

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How do you or your firm evaluate a practitioner's competency? Should firms develop evaluation criteria based on a practitioner's number of years of experience, or through some other metrics? __________________________________

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While a practitioner may obtain necessary competency after accepting an engagement, what factors should they consider when determining whether to accept or decline an engagement? _____________________________________

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PRACTICE OF LAW

Alicia meets with a long-time client, Barbara, to deliver her tax documents and discuss her current-year tax situation. Barbara explains how she and her neighbor, Maci, are planning on forming a limited liability company (LLC) to start a business together. The plan is for Maci to work 40 hours per week while Barbara contributes 75% of the start-up funds necessary to establish the business. Maci will contribute the remaining 25% of start-up funds from a previous business. Barbara asks if Alicia could form the LLC by drafting an operating agreement and filing the necessary papers with the secretary of state. Alicia would then prepare the LLC's income tax returns going forward. Barbara explains that she and Maci feel it is much more efficient if one person, such as Alicia, facilitates these tasks. Barbara further divulges that Maci is interested in Alicia preparing her individual tax return as well, making Alicia a one-stop shop for Barbara and Maci's accounting needs. As enticing as this proposed increase in business is to Alicia, she hesitates and wonders if she could or should accept the entirety of work that Barbara is requesting.

UNAUTHORIZED PRACTICE OF LAW[12]

Circular 230, §10.32, stipulates the duties and responsibilities of practicing before the IRS. Such duties and responsibilities **do not** give practitioners or any other persons who are not members of the bar the authority to practice law. Indeed, practitioners must be mindful regarding what activities constitute the practice of law to avoid unauthorized engagement in such practices. As a general principle, the interpretation of law constitutes the practice of law. However, practitioners are allowed to interpret tax law for engagements provided the interpretation does not extend beyond tax law. This distinction may be somewhat blurred when it comes to engagements involving the formation of business entities. A general rule for practitioners to follow in these situations is to advise clients on the tax ramifications of an entity selection rather than other legal implications, such as personal liability exposure, that would constitute practicing law. Additionally, the drafting of documents such as articles of incorporation are also practices of law.[13] When tax issues involve legal principles extending beyond tax law, practitioners must involve an attorney or rely on the counsel provided by members of the bar.

RELIANCE ON OUTSIDE ADVICE

Practitioners may find it necessary to rely on the advice of legal counsel. As discussed earlier in this chapter, a practitioner's lack of competence may also require the involvement and advice of another party who possesses such competence. Circular 230 provides provisions practitioners must adhere to when relying on the advice of others, allowing practitioners such reliance only when the advice is reasonable and in good faith with the surrounding facts and circumstances. Section §10.37(b) identities situations in which reliance does not meet the reasonableness standard.

1. Practitioner is either aware or should be aware that they should not rely on the opinion provided by the outside party.
2. Practitioner is either aware or should be aware the outside party lacks competence on the subject matter or does not have the qualifications to advise on the subject matter.
3. Practitioner is either aware or should be aware that the outside party has a conflict of interest (described later).

While practitioners are allowed to rely on the advice of outside parties, they must consider who is providing the advice. Practitioners must exercise due diligence in assessing the competence and qualifications of the person providing the advice and consider any potential conflicts of interest that exist or may arise before relying on outside advice.

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12. *Recognize and Avoid Unauthorized Practice of Law*. Ziss, Jonathan. Jun 1, 2011. Thomson Reuters. [casetext.com/analysis/recognize-and-avoid-unauthorized-practice-of-law] Accessed on Feb. 15, 2024.

13. *Model Definition Definition.* Sep. 18, 2002. American Bar Association. [americanbar.org/groups/professional_responsibility/task_force_model_definition_practice_law/model_definition_definition] Accessed on Feb. 15, 2024.

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DISCUSSION

What services do Barbara and Maci request from Alicia that constitute or could be considered a practice of law? ___

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If any of the services Barbara requests are practices of law, what options does Alicia have in proceeding with providing services to Barbara? ___

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What ethical practices other than the unauthorized practice of law must Alicia consider before determining what services she can provide to Barbara? ___

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CONFLICTS OF INTEREST

Terrance and Margo Smythe were new clients for Alicia last year. Alicia enjoyed working with the couple, and the tax preparation process went smoothly. In meeting with the Smythes to deliver and go over the current year tax filing season documents, Alicia notices a stark difference. Both Terrance and Margo are openly hostile with each other, even on matters of little importance. When Terrance excuses himself during the meeting to visit the restroom, Margo openly complains about him to Alicia. At one point, Margo comments that Terrance's financial decisions regarding his partnership interest were made haphazardly and with little to no consideration of future consequences. Alicia cannot help taking particular interest in this comment, as she prepares the partnership return as well as the other partners' individual income tax returns. As Margo leafs through her notebook to let Alicia know about certain questions she has regarding her Schedule C, Profit or Loss From Business, Margo accidentally drops a business card of a well-known divorce attorney in town. She hurriedly picks up the business card, offering no further comment or explanation. Terrance returns to the meeting shortly after. Alicia feels uncomfortable for the duration of the meeting.

When working with multiple people in a tax preparation and consulting context, issues involving conflicting interests are likely to occur. Building or maintaining relationships with others have the potential for a person or a firm to lack objectivity when dealing with one client versus another. A potential conflict of interest may arise when a practitioner fails to exercise impartiality to any and all engaged parties. Circular 230, §10.29, identifies the following situations as conflicts of interest.

1. The representation of one client is directly adverse to another client.
2. There is significant risk that the representation of one client will be limited by the practitioner's responsibilities to another client, a former client or a third person, or by the personal interest of the practitioner.

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If a conflict of interest exists, a tax professional does not necessarily have to terminate the engagement or refrain from engaging with a client. In fact, §10.29(b) states that a practitioner may still represent a client, even when a conflict exists, when the following conditions are all met.

1. The practitioner reasonably believes they will be able to **diligently represent** each affected client competently.
2. There is no law preventing the practitioner from representing the client.
3. Each client affected by a potential conflict of interest has been informed of the conflict and gives **written consent** to proceed, acknowledging the potential conflict of interest.

When situations occur where a conflict of interest exists or potentially exists, the practitioner must disclose such conflict to the impacted parties. The impacted parties must provide written consent to proceed no later than 30 days after the practitioner disclosed the conflict of interest.[14] Practitioners must retain the written consents for at least 36 months from the date the affected client's representation ended. Practitioners must provide the written representations to the IRS upon request.[15]

DISCUSSION

What potential conflict of interests arise from Alicia's meeting with Terrance and Margo? ______________________

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Is Alicia obligated or allowed to disclose Margo's comments regarding Terrance's business decisions to the other partners in the partnership who are Alicia's clients? Does this situation change if the comments are not hearsay from Margo and an observation made by Alicia?____

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What actions should or may Alicia take in response to her suspicions that Margo plans to divorce Terrance? Would there be a difference if Margo actually confirmed that she plans to divorce Terrance?___________________________

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If Margo and Terrance get divorced, is Alicia able to continue to serve both of them as their tax practitioner? What are some steps Alicia can take to ensure she can serve both Margo and Terrance? If she is unable to do so, should she serve one or neither of them? ____

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14. Circular 230, §10.29(b)(3).

15. Circular 230, §10.29(c).

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HANDLING TAX RETURNS AND DOCUMENTS

Next, Alicia meets with one of her S corporation clients, Hi-C Securities. Alicia discovers that an external company has secured an employee retention credit (ERC) for Hi-C. This is the first time that Alicia has heard of this matter, as Hi-C Securities did not inform her they amended their 2021 Forms 941, Employer's Quarterly Federal Tax Return, to claim the credit. Consequently, neither Alicia nor any other practitioner prepared an amended 2021 Form 1120-S, U.S. Income Tax Return for an S Corporation, to reflect the decrease in deductible wages resulting from the ERC. When broaching the subject, Alicia notices that the client appears reluctant to have an amended return prepared. Faced with this prickly situation, Alicia considers her obligations, and her options on how to proceed.

STANDARDS FOR TAX RETURNS AND DOCUMENTS

Circular 230, §10.34, covers standards regarding tax returns, documents, affidavits, and other papers. It emphasizes that practitioners may not sign tax returns or claims for refund nor advise clients when they are aware or should be aware of positions lacking reasonable basis or willful attempts to understate the tax liability under willful or reckless conduct. This concept stresses the importance of establishing and documenting a reasonable case for tax positions, especially those resulting in decreases to tax liabilities.

Regarding documents, affidavits, and other papers submitted to the IRS, practitioners may advise clients on positions contained therein only when those positions are not frivolous. While Circular 230 does not define what a frivolous position is, previously proposed rules have identified the term frivolous to mean clearly improper.[16] Within this context, similarly to tax returns, practitioners should refrain from advising on positions contained in other documents submitted to the IRS when such positions lack merit and are unreasonable.

Section 10.34(c) mandates that practitioners advise clients on potential penalties arising from positions taken on tax returns or documents, affidavits, or other papers submitted to the IRS that the practitioners either prepared or signed, or on which the practitioners provided advice. Furthermore, practitioners must also inform clients of the existence of and the means to avoid such penalties. This could include adequate disclosures to the IRS.

Caution. Practitioners maintain responsibility to inform clients of potential penalties even when the **practitioner** is not subject to a penalty with respect to a position. The focus of this responsibility is on the **taxpayer** being potentially subject to a penalty regarding a position.[17]

Section 10.34(d) states that while practitioners may generally rely on information and documents clients provide when taking a position on or signing a tax return without verification, they may not ignore implications of the information. In instances where the information appears incorrect, incomplete, or inconsistent with facts and expectations, practitioners must inquire about such information to either address or understand the implications in question.

Circular 230, §10.21, mandates practitioners who identify a client's omission or error in a return, affidavit, or other document furnished to the IRS to advise the client of such findings and relay the associated consequences in a timely manner. As such, the practitioner has a responsibility to the client in communicating discovered errors or omissions. Practitioners should also communicate possible actions to remedy such omissions or errors to mitigate the consequences of noncompliance, whether or not intended.

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16. *Regulations Governing Practice Before the Internal Revenue Service*. Sep. 26, 2007. Federal Register. [www.federalregister.gov/documents/2007/09/26/E7-18919/regulations-governing-practice-before-the-internal-revenue-service] Accessed on Feb. 20, 2024.

17. Circular 230, §10.34(c)(3).

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Practitioner Planning Tip

Circular 230 does not explicitly mandate that practitioners file amended returns to correct errors or noncompliant positions. Rather, the practitioner is responsible for communicating the error to the taxpayer and explaining the consequences of not addressing the error. While practitioners may recommend or relay the benefit of filing an amended return, the decision to do so is ultimately up to the client.[18]

Note. For more information on a practitioner's responsibility to amend ERC claims, see the 2023 *University of Illinois Federal Tax Workbook,* Chapter 11: New Developments.

DISCUSSION

What are Alicia's ethical responsibilities, if any, pertaining to Hi-C taking the ERC? ______________________

While Alicia was not aware of Hi-C considering and eventually taking the ERC when preparing the 2021 return, what are Alicia's responsibilities for amending the return? What options are available to Alicia in proceeding to engage with Hi-C? ______________________

If Hi-C is averse to amending their 2021 tax return, what courses of action can or should Alicia take? If Hi-C were your client, how would you approach the situation, and what factors would inform your decision? ______________________

18. See, for example, *Professional Responsibility and the Employee Retention Credit.* Mar. 7, 2023. IRS. [www.irs.gov/pub/irs-utl/2023-02-professional-responsibility-and-the-employee-retention-credit-R2-508-compliant.pdf] Accessed on Mar. 7, 2024.

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ACCURACY

Alicia meets with a new S corporation client, Aeronautical Innovations, to go over the current year filings. The company is five years old and previously used a small accounting firm to prepare its tax returns. However, due to the increased complexity of its tax return filings as its business grows, Aeronautical Innovations decides to hire Hermann & Trout for its current and future tax return preparation. When glancing through the company's previous two tax returns, Alicia notices that Schedule L, Balance Sheet per Books, was not completed. Alicia is used to completing the schedule for all Forms 1120-S she prepares, as is Hermann & Trout's standard protocol. When Alicia asks about the company's financial statements, they tell her the prior accountant used a summary statement of income and expenses when preparing their tax returns, as Aeronautical Innovations does not prepare a formal balance sheet or income statement. After hearing this, Alicia suspects this engagement is more involved than initially anticipated.

DUE DILIGENCE

Section 10.22 of Circular 230 calls upon practitioners to take reasonable steps to ensure the contents of any tax filings the practitioner preparers, approves, or files with the IRS are correct. Additionally, practitioners must exercise this same diligence in their written or oral representations to the Department of the Treasury. While practitioners may rely on the work of others and are deemed to exercise due diligence in such situations, practitioners must use reasonable care when engaging with, supervising, training, and evaluating the other party.

Practitioner Planning Tip

In cases where Schedule L is not presented, the practitioner or their client may want to reach out to the previous preparer for a balance sheet.

Practitioner Planning Tip

It may help to review client-provided documents under a similar approach to what the IRS utilizes when it reviews tax returns by identifying large or unusual items or high variances between tax years.[19] Reviewing financial record detail or questioning items or variances may help to uncover errors or misclassifications.

19. *Exercising Due Diligence*. Preusch, Nicholas. Jun. 1, 2015. Journal of Accountancy. [www.journalofaccountancy.com/issues/2015/jun/circular-230-due-diligence.html] Accessed on Feb. 25, 2024.

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ACCURACY CONSIDERATIONS CONCERNING SCHEDULE L

Schedule L comprises the book balance sheet of a filing organization. This schedule is included in Forms 1120, *U.S. Corporation Income Tax Return*, 1120-S, and 1065. Corporations and S corporations must complete Schedule L when receipts **or** total assets are $250,000 or more for the tax year.[20] For example, partnerships must complete Schedule L if any of the following apply.[21]

- Receipts for the tax year are $250,000 or more.
- Total assets at the end of the tax year were at least $1 million.
- Schedules K-1 (Form 1065), *Partner's Share of Income, Deductions, Credits, etc.*, are not filed with the return and furnished to the partners by the due date (including extensions).
- The partnership is required to file Schedule M-3 (Form 1065), *Net Income (Loss) Reconciliation for Certain Partnerships.*

A copy of Schedule L follows for reference.

Reconciliation	18	... subtract the sum of the amounts on lines 11 through 12d and 16f	18		

Schedule L Balance Sheets per Books	Beginning of tax year		End of tax year	
Assets	**(a)**	**(b)**	**(c)**	**(d)**
1 Cash				
2a Trade notes and accounts receivable				
b Less allowance for bad debts	( )		( )	
3 Inventories				
4 U.S. government obligations				
5 Tax-exempt securities (see instructions)				
6 Other current assets (attach statement)				
7 Loans to shareholders				
8 Mortgage and real estate loans				
9 Other investments (attach statement)				
10a Buildings and other depreciable assets				
b Less accumulated depreciation	( )		( )	
11a Depletable assets				
b Less accumulated depletion	( )		( )	
12 Land (net of any amortization)				
13a Intangible assets (amortizable only)				
b Less accumulated amortization	( )		( )	
14 Other assets (attach statement)				
15 Total assets				
Liabilities and Shareholders' Equity				
16 Accounts payable				
17 Mortgages, notes, bonds payable in less than 1 year				
18 Other current liabilities (attach statement)				
19 Loans from shareholders				
20 Mortgages, notes, bonds payable in 1 year or more				
21 Other liabilities (attach statement)				
22 Capital stock				
23 Additional paid-in capital				
24 Retained earnings				
25 Adjustments to shareholders' equity (attach statement)				
26 Less cost of treasury stock		( )		( )
27 Total liabilities and shareholders' equity				

Form **1120-S** (2023)

20. Instructions for Form 1120 and Form 1120-S.

21. Instructions for Form 1065.

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Practitioner Planning Tip

Even if not required, practitioners may consider completing Schedule L for business returns they prepare. An analysis of a balance sheet can lead to the discovery of additions to a client's fixed assets, which may result in depreciation expenses the client did not calculate or miscalculated. In analyzing the liabilities section, practitioners may notice liability balances remaining the same, which could potentially uncover liability payments recorded on the income statement instead of a portion reducing the liability on the balance sheet. Of significant importance is analyzing a client's retained earnings and ensuring that it rolls forward from the prior year's balance. In doing so, practitioners can identify prior period adjustments made by the client after the filing of a prior period tax return that should be incorporated into the current year tax return.

Tax practitioners should analyze the balance sheet in the preparation process to ensure accuracy of the reported income. Some tax preparation software incorporates the practitioner-entered income into the calculation of the current-year retained earnings on Schedule L. When the schedule does not balance, the software may provide diagnostic messages to alert the practitioner of a potential input error for income and expenses, or that retained earnings is not rolling forward. Catching such errors helps ensure the accuracy of the financial information disclosed in the return.

DISCUSSION

What concerns may Alicia have after discovering Aeronautical Innovations does not prepare and maintain a formal set of financial statements? ____________________

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What are the benefits of Alicia assisting Aeronautical Innovations in preparing a balance sheet? What are some hurdles she may experience in doing so, particularly during tax season? ____________________

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What are the benefits of Alicia completing Schedule L on Aeronautical Innovations' Form 1120-S as opposed to keeping workpapers showing the balance sheet in the practitioner's client folder? ____________________

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DIGITAL SECURITY BREACHES

Alicia likes to end her work day by catching up on emails. While looking through them, she finds a message that appears to be addressed from one of the partners, requesting an invoice to be paid in the amount of $1,200. There is an attachment to the email titled "Invoice No. 135-84." Alicia finds this message to be somewhat odd. She has never received an email from anyone within the firm requesting her to pay invoices, as these tasks are normally handled by the administration department. Furthermore, Alicia is confident that the partner knows that Alicia does not perform such administrative functions. As she takes pause, Alicia is strongly suspicious of the email she received. Unfortunately, the partner is already gone for the day, and she cannot ask them about it.

PERSONALLY IDENTIFIABLE INFORMATION[22]

Personally identifiable information (PII) consists of information where the identity of an individual can be known or inferred. PII may be non-sensitive, such as a person's name, business address, and occupation, while other PII may be sensitive, such as a social security number, medical information, tax return information, and other data elements that may result in harm if compromised. In the context of this chapter, the term PII refers to sensitive PII that practitioners are responsible for protecting when in their possession under Circular 230, §10.51, discussed later.

THREATS TO DIGITAL PII

The rise of digital communication and information storage and delivery has led to an increase in emerging cybersecurity threats. The accounting profession, which heavily involves sensitive information and PII, is a target for cybersecurity attacks. Identifying and containing cybersecurity breaches is both a timely and costly endeavor but is critical in mitigating potential harm inflicted on clients whose data is compromised. Consequently, practitioners should be aware of cybersecurity threats and develop practices and procedures to avoid and address them.[23]

Phishing Attacks[24]

Phishing attacks attempt to steal PII by enticing the recipient of an email into surrendering information. These attacks generally use email to initiate communication with an unsuspecting victim. One estimate holds that 3.4 billion phishing messages are sent **each day.**[25] The volume of emails is such that an individual message may not receive the scrutiny it needs for its recipient to discern it as fraudulent. In other cases, the fraudulent message may appear on social media or arrive by text or phone. Individuals with fraudulent intent may use phone calls in conjunction with phishing attacks to gain the confidence of unsuspecting employees, resulting in them providing passwords over the phone or surrendering other valuable information.

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22. *How To Safeguard Personally Identifiable Information*. May 2011. Department of Homeland Security. [www.dhs.gov/xlibrary/assets/privacy/privacy-safeguarding-pii-factsheet.pdf] Accessed on Feb. 24, 2024.

23. *Cybersecurity for Tax Professionals (Advanced Session)*. Jun. 29, 2023. IRS. [www.irs.gov/pub/taxpros/2023ntf-12-cybersecurity-for-tax-professionals.pdf] Accessed on Feb. 24, 2024.

24. *Report Phishing and Online Scams*. Jan. 20, 2023. IRS. [www.irs.gov/privacy-disclosure/report-phishing] Accessed on Feb. 22, 2024.

25. *How Many Phishing Emails Are Sent Daily in 2023? (New Stats).* Campbell, Stefan. Dec. 3, 2022. The Small Business Blog. [thesmallbusinessblog.net/how-many-phishing-emails-are-sent-daily] Accessed on Feb. 22, 2024.

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The objective of phishing attacks is not always the direct theft of PII. Phishing attacks can also attempt to install malware on computers, later subjecting them to a less detectable form of data theft.[26] The malware could be ransomware, which renders the computer inoperable. A barrage of email messages may attempt to contact as many individuals as possible at once in the hope that one recipient, who is not careful, triggers the mechanism that installs malware or releases PII. Another strategy is to closely emulate an expected email message so that even a relatively cautious recipient mistakes the fraud for a legitimate email message. Because the fraudulent sender of this type of message usually directs it at specific individuals, it has earned the dubious distinction of its own name, specifically "spear phishing."[27] Such tactics may include the impersonation of an individual known to the recipient, such as a boss or colleague, to feign legitimacy.

Practitioner Planning Tip

One method to potentially identify a phishing email is to scrutinize the email address of the sender. Commonly in phishing emails, the uniform resource locator (URL) of the email address differs from the official source. For example, an email from a governmental authority is likely sent from an email address ending in **.gov**, while the phishing email may use an address ending in **.com**. Identifying deviations (extra letters, characters, or other punctuation) from trusted emails can significantly help in detecting phishing emails that appear to be sent from a known source, such as a boss or colleague.

Tax practitioners who receive messages that they believe may be phishing attempts should follow these steps.[28]

- If the message claims to be from the IRS, tax practitioners should verify it actually originated at the IRS before replying to it.
- Emails requesting information from Forms W-2, *Wage and Tax Statement,* should be reported to the Internet Crime Complaint Center at **www.ic3.com.**
- If a tax practitioner falls victim to a request for PII, especially Form W-2 information, they should report this to **dataloss@irs.gov.**
- Tax practitioners should report unsolicited email messages referencing the IRS or tax matters to **phishing@irs.gov.**
- Tax practitioners should report unsolicited **fax** messages referencing the IRS both to the Treasury Inspector General for Tax Administration at **www.tigta.gov/hotline** and to the IRS at **phishing@irs.gov.**
- Suspicious phishing email messages that do not claim to be from the IRS can be reported by forwarding the messages to **reportphishing@antiphishing.org.**
- An individual may receive a suspicious email message which they suspect carries malware or other malicious code, but which does not claim to be from the IRS. If they have clicked on a link in the message or downloaded an attachment, they should visit **OnGuardOnline.gov,** where they can get up-to-date information from the Federal Trade Commission on action to be taken.

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26. *How to Recognize, Remove, and Avoid Malware*. May 2021. Federal Trade Commission. [consumer.ftc.gov/articles/how-recognize-remove-avoid-malware] Accessed on Feb. 22, 2024.

27. *Spear phishing targets tax pros and other businesses*. Jun. 30, 2022. IRS. [www.irs.gov/newsroom/spear-phishing-targets-tax-pros-and-other-businesses] Accessed on Feb. 22, 2024.

28. *Report Phishing and Online Scams.* Jan. 20, 2023. IRS. [www.irs.gov/privacy-disclosure/report-phishing] Accessed on Feb. 22, 2024.

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Smishing Attacks[29]

Some enterprising hackers have turned text messages into devices for pilfering PII, using the same strategy as phishing emails. The name smishing is a combination of "SMS" (short message service) and "phishing." Because text messages generally come from individuals the recipient already knows, they receive more credibility. The IRS requests that individuals report tax-related smishing attacks to the agency via email. Individuals should send the email to **phishing@irs.gov,** including the caller ID (number or email address) from the incoming message, the date and time of the message, and the recipient's phone number.

Keyloggers[30]

Keyloggers intercept messages or passwords as computer users enter them on a keyboard. Malicious keystroke software may get access to the system via:

- Downloads by the user from hostile emails or websites,
- USB devices innocuously plugged into the back of a computer,
- Software running on the low-level firmware of a computer or even on a nearby smartphone, or
- Sensors receiving electromagnetic emissions that are triggered when a typist presses specific keys on a keyboard.

Practitioner Planning Tip

Practitioners can put preventative measures in place to help mitigate against keyloggers, including:

- Using a virtual screen keyboard to enter login information such as user name and passwords, or
- Storing login information in a secured password manager.

Both of these methods eliminate the keystrokes sought by keyloggers. Efforts to combat keyloggers should be included in a practitioner's written information security plan (WISP).

Caution. All practitioners are now required to have a WISP. For more information on the WISP requirements and security concepts, see the 2023 *University of Illinois Federal Tax Workbook,* Chapter 1: Written Information Security Plans and Protecting Client Data.

29. *Dirty Dozen: IRS urges tax pros and other businesses to beware of spearphishing; offers tips to avoid dangerous common scams.* Mar. 29, 2023. IRS. [www.irs.gov/newsroom/dirty-dozen-irs-urges-tax-pros-and-other-businesses-to-beware-of-spearphishing-offers-tips-to-avoid-dangerous-common-scams] Accessed on Feb. 22, 2024.

30. *Tax Security 2.0 — A "Taxes-Security-Together" Checklist — Step 3.* Jan. 31, 2023. IRS. [www.irs.gov/newsroom/tax-security-2-0-a-taxes-security-together-checklist-step-3] Accessed on Mar. 24, 2023; *Keystroke Logging*. Oct. 13, 2022. Wikipedia. [en.wikipedia.org/wiki/Keystroke_logging] Accessed on Feb. 22, 2024.

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Ransomware[31]

Ransomware removes the ability to access a victim's data by covertly encrypting it and offering to decrypt it after the victim pays a ransom. Thus, users still have their proprietary data but cannot see it, interact with it, or use it because it is encrypted. This attack devastates a tax practice because it removes the practitioner's ability to prepare tax returns for their clients. The hackers do not have access to the practitioner's data but instead request untraceable funds transfers as ransom. The Treasury Department announced that the losses associated with 2021 ransomware attacks exceeded $1 billion.[32]

The federal Cybersecurity and Infrastructure Security Agency (CISA) publishes best practices for ransomware prevention, which may assist tax practitioners in preventing ransomware attacks on their businesses. It suggests the following actions.[33]

- Backup data, system images and configurations, keeping the backups offline
- Update and patch systems
- Ensure that security solutions are up to date
- Review and exercise (or practice) the business's incident response plan
- Pay attention to other ransomware events, applying lessons learned

Local Copy vs. Cloud Copy[34]

In the past, many small businesses used local backups, as slow Internet connection speeds did not make storing PII on the cloud practical. While this was useful, storing PII on a detachable storage device in a practitioner's possession did not protect data from a regional disaster.

The preference for Internet-based (cloud) backups changed when Internet connection speed increased. It became practical to store data on remote storage in another part of the country, far removed from the same threat of regional disaster as the tax practice might face. Thus, it is now common for small tax practices to store backups of their data securely on remote devices. However, there may be circumstances when **local** data is still preferred. If a tax practice receives a ransomware attack during tax season, it may be possible to restore data from the Internet without paying a ransom, but it potentially takes a long time. Data restoration from a local device may be a more practical means of restoring the data during tax season. Thus, tax practices may consider a network-attached storage device for local data backup. Fraudsters may encrypt PII possessed by the tax practice in a ransomware attack. In that case, restoration from a network-attached storage device stored in the server room may enable recovery from a ransomware attack within a few hours and without paying a ransom.

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31. IRS Pub. 4557, *Safeguarding Taxpayer Data; Ransomware Guide.* Sep. 2020. Cybersecurity & Infrastructure Security Agency. [www.cisa.gov/stopransomware/ransomware-guide] Accessed on Feb. 22, 2024.

32. *Reported Ransomware Incidents, Costs Soared in 2021, Treasury Says*. Rundle, James. Nov. 4, 2022. Wall Street Journal. [www.wsj.com/articles/reported-ransomware-incidents-costs-soared-in-2021-treasury-says-11667513649?mod=Searchresults_pos2&page=1] Accessed on Feb. 22, 2024.

33. *CISA INSIGHTS: Ransomware Outbreak.* Aug. 21, 2019. Cybersecurity & Infrastructure Security Agency. [www.cisa.gov/uscert/sites/default/files/2019-08/CISA_Insights-Ransomware_Outbreak_S508C.pdf] Accessed on Feb. 22, 2024.

34. *What is Cloud Backup? Cloud vs Local Backup Comparison*. Jan. 20, 2023. Acronis International GmbH. [acronis.com/en-us/blog/posts/cloud-vs-local-backup] Accessed on Mar. 26, 2023; See *Disaster Recovery*. Jan. 14, 2023. Wikipedia. [en.wikipedia.org/wiki/Disaster_recovery] Accessed on Feb. 22, 2024.

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CIRCULAR 230[35]

Circular 230 indirectly addresses practitioners' responsibilities for data security and client confidential information.

- **§10.35 — Competence.** A practitioner's overall competence includes technological competence.
- **§10.36 — Procedures to ensure compliance.** Practitioners who have or share the principal authority and responsibility for a firm's tax practice must have adequate procedures to ensure compliance by its members, associates, employees, and contractors.
- **§10.33 — Best practices for tax practitioners.** A practitioner should follow best practices when providing advice and preparing or assisting in the preparation of documents to the IRS, including compliance with the Circular 230 standards of practice and the obligation to maintain client confidences.

DISCUSSION

What red flags are present regarding the email Alicia received?______________________________

What are some ways Alicia can verify the legitimacy of the email? ______________________________

What action should Alicia take to address the email? What should Alicia specifically **not** do, to ensure that a breach of security does not occur? ______________________________

PHYSICAL SECURITY BREACHES

After a long day, Alicia is getting ready to go home and call it a night. Typical for an evening during filing season, Alicia is one of several employees to leave the office after 5:00 pm. As she is heading out, she notices that there are printed papers in the printing tray of the office copying machine, and some other documents left on the top of filing cabinets surrounding the copier. Some of these documents appear to be copies of a tax return. Alicia pauses because she recalls Hermann & Trout's policy of securing physical documents containing client PII. Someone must have been in a hurry to leave the office that evening and neglected to remove the documents from the open space and secure them. Hearing the sound of a vacuum cleaner just then, Alicia remembers that today is one of the two days per week a cleaning company comes to clean the office, which they typically do between 6:00 pm and 8:00 pm. With the presence of an outside party in the office, Alicia is feeling increasingly concerned about leaving the office with the exposed documents.

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35. *Careful WISP(er) — Professional Responsibility and Data Security: Practitioners' Obligation to Have a Written Information Security Plan.* Nov. 14, 2023. IRS. [www.irs.gov/pub/irs-utl/2023-10-careful-wisp%28er%29-professional-responsibility-and-data-security.pdf] Accessed on Mar. 7, 2024.

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SECURING PHYSICAL PII

While security threats to digital data and PII has been an increasingly prevalent area of concern to accounting firms, the protection of physical data and PII should not be overlooked. Potential break-ins of offices are not the sole concern. The presence of non-personnel in offices, such as clients and vendors, may result in the possibility of PII being stolen or compromised. For example, a client who is able to see another client's tax information on a practitioner's computer screen or lying on a desk is an unintended disclosure of such information. Best practices of protecting physical PII from the Department of Homeland Security include the following.[36]

1. PII should not be left on desks, printers, copiers, or other common areas unattended.
2. When not in use, PII should be secured in locked filing cabinets, desks, or other such secure storage options.
3. When in use, PII should be kept in controlled-access areas, limiting such space to people with a need-to-know basis.

Such best practices stress the importance of having security measures and practices in place to prevent unauthorized access to physical PII. Otherwise, disclosure of taxpayer information without client consent may constitute as an act of incompetence and disreputable conduct under Circular 230, §10.51(a)(15). Even in otherwise secure areas such as a practitioner's office, leaving documents containing PII on a desk could result in another client seeing the documents when attending their own meetings or cleaning personnel viewing the documents when cleaning the office during or after regular business hours. Consequently, even if such exposure may be brief, practitioners should be in the habit of securing such documents when other parties are present.

The consequences for practitioners failing to safeguard taxpayer data may be severe. IRC §7216 sanctions tax return preparers who knowingly or recklessly disclose client information. While the terms knowingly and recklessly are neither defined in the Code nor the associated Treasury Regulations, Treas. Reg. §301.7216-1(b)(5) states that "the term disclosure means the act of making tax return information known to any person in any manner whatever." Such violations may result in fines not exceeding $1,000 per misdemeanor, prosecution costs, and imprisonment not exceeding one year.[37]

The disposal of PII is another important consideration in preventing disclosure of taxpayer information without their consent. Practitioners should not throw away documents containing PII in the garbage or a recycling bin, as third parties could potentially retrieve such documents after they have been discarded. Instead, practitioners should either shred or burn paper records to ensure the PII may not be recovered. While the AICPA identifies burning documents as the most effective method of disposing PII, they identify that shredding documents is the most common practice.[38]

DISCUSSION

What is Alicia's responsibility for the documents she found lying on the copying machine? What actions, if any, should Alicia take before leaving the office? ____

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36. *How To Safeguard Personally Identifiable Information*. May 2011. Department of Homeland Security. [www.dhs.gov/xlibrary/assets/privacy/privacy-safeguarding-pii-factsheet.pdf] Accessed on Feb. 22, 2024.

37. IRC §7216(a)(2).

38. *Records Management: Integrating Privacy Using Generally Accepted Privacy Principles*. 2009. AICPA. [us.aicpa.org/content/dam/aicpa/interestareas/informationtechnology/resources/privacy/downloadabledocuments/10252-346-records-management-pro.pdf] Accessed on Feb. 22, 2024.

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How should Alicia handle reporting the violation of Hermann & Trout's document policy? What suggestions can she make to help ensure such violations are mitigated and do not reoccur? ______________________________

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What are the most common threats to physical PII in your practice? How do you address them? ______________

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AI CONSIDERATIONS

At home, Alicia logs in to her work email. She received an email from a client asking about filing thresholds for a nonresident state from which they received income. Desiring to quickly respond to the client to avoid having to spend time out of her busy schedule the next day researching the thresholds, Alicia uses an artificial intelligence (AI) program to draft an email to answer the client's question. In less than ten seconds, the program generates an email draft providing residency information and income thresholds for the state in question. Alicia quickly reads over the draft to see if she needs to correct any grammatical errors or linguistic abnormalities, copies the entirety of the text to send from her email, and sends the email to the client before logging off for the evening.

USE OF AI PROGRAMS

AI technology generally encompasses computer programs and applications that algorithmically process large amounts of data to recognize patterns to perform requested tasks. This simulated "learning" allows programs to perform functions for which they were not explicitly programmed.[39] The recent surge in AI program development and its subsequent use as a tool has permeated through a variety of businesses and industries, with the accounting profession being no exception. Accounting firms use AI programs for a multitude of tasks including drafting client communication, performing data analysis, and conducting tax research.[40] The use of these programs results from the effort of its users to perform such tasks quickly and reliably.

While AI programs' performance of requested tasks is quick, the reliability of the performance is inconsistent. **AI hallucinations** refer to a phenomenon where a program's perception of patterns yield an inaccurate or false response.[41] For example, a user prompting an AI program to provide a court case illustrating a specific concept or providing precedent on a certain topic could receive a list of court cases that, upon inspection, do not contain the information the user was searching. In some cases, the program could provide the name of a court case that does not exist. Additionally, some AI programs have access to data or receive training on data that is only as current as of a **cutoff date,** and therefore may not be able to perform functions that are accurate as of the time they are requested.[42] For example, a user attempting to do tax research may be using an AI program whose data cutoff date does not contain information on tax legislation Congress passed after the aforementioned cutoff date, potentially resulting in the program providing outdated information.

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39. *How Do Machines Learn? A Beginners Guide*. Wolfewixz, Arne. Nov. 16, 2022. Levity. [levity.ai/blog/how-do-machines-learn] Accessed on Apr. 15, 2024.

40. *How do different accounting firms use AI?* Feb. 21, 2024. Thomson Reuters. [tax.thomsonreuters.com/blog/how-do-different-accounting-firms-use-ai] Accessed on Apr. 15, 2024.

41. *What are AI hallucinations?* 2024. IBM. [www.ibm.com/topics/ai-hallucinations] Accessed on Apr. 15, 2024.

42. *Demystifying Knowledge Cutoff: Why it Matters for AI Models.* Jan. 8, 2024. Toolify.ai. [www.toolify.ai/ai-news/demystifying-knowledge-cutoff-why-it-matters-for-ai-models-396770] Accessed on Apr. 19, 2024.

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There are many ethical concerns regarding the use of AI programs, but the IRS and other professional organizations such as the AICPA have not yet provided any guidance.[43] While not explicitly stated in Circular 230, tax practitioners who use information from AI programs that may provide incorrect information could result in an accuracy issue if the user is not diligent in verifying the information the program outputs. This could be a violation of the §10.22 due diligence requirements. Additionally, reliance on such programs may result in deficiencies of competence under §10.35, where the appropriate level of knowledge and skill is relegated to the program instead of its user.

Furthermore, when AI programs are used to communicate advice to clients, Circular 230, §10.37 may come into play concerning ethical practices. Section 10.37 provides the following requirements practitioners must follow regarding written advice concerning tax matters.

- Base written advice on reasonable factual and legal assumptions.
- Consider relevant facts and circumstances the practitioner is, or should reasonably be, aware of.
- Reasonably attempt to identify and understand relevant facts regarding the subject matter.
- Provide applicable law and facts.
- Do **not** rely on representations, statements, or findings of others to an unreasonable extent.
- Do **not** assume a tax return or representation will not be audited when evaluating tax matters.

Based on the mandated practices required by §10.37, a practitioner bears responsibility for performing reasonable research and making sound considerations when providing written advice to clients. However, §10.37 does permit practitioners to rely on others when providing written advice as long as such reliance is **reasonable.** The section identifies the following as unreasonable reliance.[44]

- The practitioner is aware or should have been aware that the other person's opinion should not be relied on.
- The practitioner is aware or should have been aware that the other person lacks the necessary competence and qualifications.
- The practitioner is aware or should have been aware of potential conflicts of interest arising from reliance on the other person.

While §10.37 does not explicitly identify AI programs as an other individual or party, a takeaway is the practitioner must exercise due diligence when relying on opinions or statements of fact when providing written advice. Accordingly, a practitioner is prohibited from taking an opinion or statement of fact at face value. If under review, the IRS will assess the reasonableness of a practitioner's reliance on others by applying a reasonable practitioner standard.[45]

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43. *Employees 'unsure' of company ethics guidelines for AI.* Brown, Steph. Jan. 2, 2024. AICPA & CIMA. [fm-magazine.com/news/2024/jan/employees-unsure-of-company-ethics-guidelines-for-ai.html] Accessed on Apr. 16, 2024.

44. Circular 230, §10.37(b).

45. Circular 230, §10.37(c)(1).

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Practitioner Planning Tip

Considering the infancy of the technology and complexity of how such technology analyzes data in performing tasks, it is unlikely the IRS will determine a reasonable practitioner would rely on data output from an AI program without verifying its accuracy. As a best practice, practitioners should research and check that an AI program's output is accurate before including the advice in the practitioner's communication with their client. Documenting such practices and steps taken can help practitioners defend their reliance and positions if challenged by the IRS.

Note. In the absence of clear and authoritative guidance on the use of AI programs in the accounting profession, practitioners must ensure that the use of such programs does not result in the breach of provisions and requirements of compliance and regulatory standards. Practitioners should also be mindful of firm standards of conduct and culture when using AI technology to avoid breaches of firm practices and its mission statement.

Practitioner Planning Tip

To prevent an unauthorized disclosure, practitioners should avoid entering PII or client-specific data when using AI programs to compose email correspondence with clients. While there is significant uncertainty as to what data AI programs store and how it is used when generating content or performing requested tasks, practitioners should nevertheless exercise caution when writing prompts into the AI programs by avoiding the disclosure of details containing client PII. By using general language, the practitioner can use the AI program as a blueprint for client communication to be tailored specifically to the client when the practitioner drafts the communication outside of the AI program.

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DISCUSSION

What are some ethical considerations arising from Alicia's use of AI technology in responding to her client? ______

Did Alicia practice due diligence by checking the program's output for grammatical issues instead of technical accuracy? Should Alicia limit her use of AI technology to either administrative or technical tasks? Why or why not?

Is Alicia's reliance on the AI program's technical accuracy reasonable? What steps or processes should a reasonable practitioner follow when using AI programs in providing written advice to clients?

What are some arguments for or against Alicia having a responsibility to disclose her use of AI technology in preparing an email response to her client?

What should Hermann & Trout include in their firm policy regarding the use of AI technology and programs? How should the firm proceed in its use of AI programs in areas such as tax research, client communication, and data analysis?

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Paragraph 1. The authority citation for 31 CFR, part 10 continues to read as follows:
Authority: Sec. 3, 23 Stat. 258, secs. 2-12, 60 Stat. 237 et. seq.; 5 U.S.C. 301, 500, 551-559; 31 U.S.C. 321; 31 U.S.C. 330; Reorg. Plan No. 26 of 1950, 15 FR 4935, 64 Stat. 1280, 3 CFR, 1949-1953 Comp., p. 1017.

§ 10.0 Scope of part.

(a) This part contains rules governing the recognition of attorneys, certified public accountants, enrolled agents, enrolled retirement plan agents, registered tax return preparers, and other persons representing taxpayers before the Internal Revenue Service. Subpart A of this part sets forth rules relating to the authority to practice before the Internal Revenue Service; subpart B of this part prescribes the duties and restrictions relating to such practice; subpart C of this part prescribes the sanctions for violating the regulations; subpart D of this part contains the rules applicable to disciplinary proceedings; and subpart E of this part contains general provisions relating to the availability of official records.

(b) *Effective/applicability date.* This section is applicable beginning August 2, 2011.

Subpart A — Rules Governing Authority to Practice

§ 10.1 Offices.

(a) *Establishment of office(s).* The Commissioner shall establish the Office of Professional Responsibility and any other office(s) within the Internal Revenue Service necessary to administer and enforce this part. The Commissioner shall appoint the Director of the Office of Professional Responsibility and any other Internal Revenue official(s) to manage and direct any office(s) established to administer or enforce this part. Offices established under this part include, but are not limited to:

(1) The Office of Professional Responsibility, which shall generally have responsibility for matters related to practitioner conduct and shall have exclusive responsibility for discipline, including disciplinary proceedings and sanctions; and

(2) An office with responsibility for matters related to authority to practice before the Internal Revenue Service, including acting on applications for enrollment to practice before the Internal Revenue Service and administering competency testing and continuing education.

(b) Officers and employees within any office established under this part may perform acts necessary or appropriate to carry out the responsibilities of their office(s) under this part or as otherwise prescribed by the Commissioner.

(c) *Acting.* The Commissioner will designate an officer or employee of the Internal Revenue Service to perform the duties of an individual appointed under paragraph (a) of this section in the absence of that officer or employee or during a vacancy in that office.

(d) *Effective/applicability date.* This section is applicable beginning August 2, 2011, except that paragraph (a)(1) is applicable beginning June 12, 2014.

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§ 10.2 Definitions.

(a) As used in this part, except where the text provides otherwise —

(1) *Attorney* means any person who is a member in good standing of the bar of the highest court of any state, territory, or possession of the United States, including a Commonwealth, or the District of Columbia.

(2) *Certified public accountant* means any person who is duly qualified to practice as a certified public accountant in any state, territory, or possession of the United States, including a Commonwealth, or the District of Columbia.

(3) *Commissioner* refers to the Commissioner of Internal Revenue.

(4) *Practice before the Internal Revenue Service* comprehends all matters connected with a presentation to the Internal Revenue Service or any of its officers or employees relating to a taxpayer's rights, privileges, or liabilities under laws or regulations administered by the Internal Revenue Service. Such presentations include, but are not limited to, preparing documents; filing documents; corresponding and communicating with the Internal Revenue Service; rendering written advice with respect to any entity, transaction, plan or arrangement, or other plan or arrangement having a potential for tax avoidance or evasion; and representing a client at conferences, hearings, and meetings.

(5) *Practitioner* means any individual described in paragraphs (a), (b), (c), (d), (e), or (f) of §10.3.

(6) A *tax return* includes an amended tax return and a claim for refund.

(7) *Service* means the Internal Revenue Service.

(8) *Tax return preparer* means any individual within the meaning of section 7701(a)(36) and 26 CFR 301.7701-15.

(b) *Effective/applicability date.* This section is applicable on August 2, 2011.

§ 10.3 Who may practice.

(a) *Attorneys.* Any attorney who is not currently under suspension or disbarment from practice before the Internal Revenue Service may practice before the Internal Revenue Service by filing with the Internal Revenue Service a written declaration that the attorney is currently qualified as an attorney and is authorized to represent the party or parties. Notwithstanding the preceding sentence, attorneys who are not currently under suspension or disbarment from practice before the Internal Revenue Service are not required to file a written declaration with the IRS before rendering written advice covered under §10.37, but their rendering of this advice is practice before the Internal Revenue Service.

(b) *Certified public accountants.* Any certified public accountant who is not currently under suspension or disbarment from practice before the Internal Revenue Service may practice before the Internal Revenue Service by filing with the Internal Revenue Service a written declaration that the certified public accountant is currently qualified as a certified public accountant and is authorized to represent the party or parties. Notwithstanding the preceding sentence, certified public accountants who are not currently under suspension or disbarment from practice before the Internal Revenue Service are not required to file a written declaration with the IRS before rendering written advice covered under §10.37, but their rendering of this advice is practice before the Internal Revenue Service.

(c) *Enrolled agents.* Any individual enrolled as an agent pursuant to this part who is not currently under suspension or disbarment from practice before the Internal Revenue Service may practice before the Internal Revenue Service.

(d) *Enrolled actuaries.*

(1) Any individual who is enrolled as an actuary by the Joint Board for the Enrollment of Actuaries pursuant to 29 U.S.C. 1242 who is not currently under suspension or disbarment from practice before the Internal Revenue Service may practice before the Internal Revenue Service by filing with the Internal Revenue Service a written declaration stating that he or she is currently qualified as an enrolled actuary and is authorized to represent the party or parties on whose behalf he or she acts.

(2) Practice as an enrolled actuary is limited

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to representation with respect to issues involving the following statutory provisions in title 26 of the United States Code: sections 401 (relating to qualification of employee plans), 403(a) (relating to whether an annuity plan meets the requirements of section 404(a) (2)), 404 (relating to deductibility of employer contributions), 405 (relating to qualification of bond purchase plans), 412 (relating to funding requirements for certain employee plans), 413 (relating to application of qualification requirements to collectively bargained plans and to plans maintained by more than one employer), 414 (relating to definitions and special rules with respect to the employee plan area), 419 (relating to treatment of funded welfare benefits), 419A (relating to qualified asset accounts), 420 (relating to transfers of excess pension assets to retiree health accounts), 4971 (relating to excise taxes payable as a result of an accumulated funding deficiency under section 412), 4972 (relating to tax on nondeductible contributions to qualified employer plans), 4976 (relating to taxes with respect to funded welfare benefit plans), 4980 (relating to tax on reversion of qualified plan assets to employer), 6057 (relating to annual registration of plans), 6058 (relating to information required in connection with certain plans of deferred compensation), 6059 (relating to periodic report of actuary), 6652(e) (relating to the failure to file annual registration and other notifications by pension plan), 6652(f) (relating to the failure to file information required in connection with certain plans of deferred compensation), 6692 (relating to the failure to file actuarial report), 7805(b) (relating to the extent to which an Internal Revenue Service ruling or determination letter coming under the statutory provisions listed here will be applied without retroactive effect); and 29 U.S.C. § 1083 (relating to the waiver of funding for nonqualified plans).

(3) An individual who practices before the Internal Revenue Service pursuant to paragraph (d)(1) of this section is subject to the provisions of this part in the same manner as attorneys, certified public accountants, enrolled agents, enrolled retirement plan agents, and registered tax return preparers.

(e) *Enrolled retirement plan agents* —

(1) Any individual enrolled as a retirement plan agent pursuant to this part who is not currently under suspension or disbarment from practice before the Internal Revenue Service may practice before the Internal Revenue Service.

(2) Practice as an enrolled retirement plan agent is limited to representation with respect to issues involving the following programs: Employee Plans Determination Letter program; Employee Plans Compliance Resolution System; and Employee Plans Master and Prototype and Volume Submitter program. In addition, enrolled retirement plan agents are generally permitted to represent taxpayers with respect to IRS forms under the 5300 and 5500 series which are filed by retirement plans and plan sponsors, but not with respect to actuarial forms or schedules.

(3) An individual who practices before the Internal Revenue Service pursuant to paragraph (e)(1) of this section is subject to the provisions of this part in the same manner as attorneys, certified public accountants, enrolled agents, enrolled actuaries, and registered tax return preparers.

(f) *Registered tax return preparers.*

(1) Any individual who is designated as a registered tax return preparer pursuant to §10.4(c) of this part who is not currently under suspension or disbarment from practice before the Internal Revenue Service may practice before the Internal Revenue Service.

(2) Practice as a registered tax return preparer is limited to preparing and signing tax returns and claims for refund, and other documents for submission to the Internal Revenue Service. A registered tax return preparer may prepare all or substantially all of a tax return or claim for refund of tax. The Internal Revenue Service will prescribe by forms, instructions, or other appropriate guidance the tax returns and claims for refund that a registered tax return preparer may prepare and sign.

(3) A registered tax return preparer may represent taxpayers before revenue agents, customer service representatives, or similar officers and employees of the Internal Revenue Service (including the Taxpayer Advocate Service) during an examination if the registered tax return preparer signed the tax return

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or claim for refund for the taxable year or period under examination. Unless otherwise prescribed by regulation or notice, this right does not permit such individual to represent the taxpayer, regardless of the circumstances requiring representation, before appeals officers, revenue officers, Counsel or similar officers or employees of the Internal Revenue Service or the Treasury Department. A registered tax return preparer's authorization to practice under this part also does not include the authority to provide tax advice to a client or another person except as necessary to prepare a tax return, claim for refund, or other document intended to be submitted to the Internal Revenue Service.

(4) An individual who practices before the Internal Revenue Service pursuant to paragraph (f)(1) of this section is subject to the provisions of this part in the same manner as attorneys, certified public accountants, enrolled agents, enrolled retirement plan agents, and enrolled actuaries.

(g) *Others.* Any individual qualifying under paragraph §10.5(e) or §10.7 is eligible to practice before the Internal Revenue Service to the extent provided in those sections.

(h) *Government officers and employees, and others.* An individual, who is an officer or employee of the executive, legislative, or judicial branch of the United States Government; an officer or employee of the District of Columbia; a Member of Congress; or a Resident Commissioner may not practice before the Internal Revenue Service if such practice violates 18 U.S.C. §§ 203 or 205.

(i) *State officers and employees.* No officer or employee of any State, or subdivision of any State, whose duties require him or her to pass upon, investigate, or deal with tax matters for such State or subdivision, may practice before the Internal Revenue Service, if such employment may disclose facts or information applicable to Federal tax matters.

(j) *Effective/applicability date.* Paragraphs (a), (b), and (g) of this section are applicable beginning June 12, 2014. Paragraphs (c) through (f), (h), and (i) of this section are applicable beginning August 2, 2011.

§ 10.4 Eligibility to become an enrolled agent, enrolled retirement plan agent, or registered tax return preparer.

(a) *Enrollment as an enrolled agent upon examination.* The Commissioner, or delegate, will grant enrollment as an enrolled agent to an applicant eighteen years of age or older who demonstrates special competence in tax matters by written examination administered by, or administered under the oversight of, the Internal Revenue Service, who possesses a current or otherwise valid preparer tax identification number or other prescribed identifying number, and who has not engaged in any conduct that would justify the suspension or disbarment of any practitioner under the provisions of this part.

(b) *Enrollment as a retirement plan agent upon examination.* The Commissioner, or delegate, will grant enrollment as an enrolled retirement plan agent to an applicant eighteen years of age or older who demonstrates special competence in qualified retirement plan matters by written examination administered by, or administered under the oversight of, the Internal Revenue Service, who possesses a current or otherwise valid preparer tax identification number or other prescribed identifying number, and who has not engaged in any conduct that would justify the suspension or disbarment of any practitioner under the provisions of this part.

(c) *Designation as a registered tax return preparer.* The Commissioner, or delegate, may designate an individual eighteen years of age or older as a registered tax return preparer provided an applicant demonstrates competence in Federal tax return preparation matters by written examination administered by, or administered under the oversight of, the Internal Revenue Service, or otherwise meets the requisite standards prescribed by the Internal Revenue Service, possesses a current or otherwise valid preparer tax identification number or other prescribed identifying number, and has not engaged in any conduct that would justify the suspension or disbarment of any practitioner under the provisions of this part.

(d) *Enrollment of former Internal Revenue Service employees.* The Commissioner, or delegate, may

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grant enrollment as an enrolled agent or enrolled retirement plan agent to an applicant who, by virtue of past service and technical experience in the Internal Revenue Service, has qualified for such enrollment and who has not engaged in any conduct that would justify the suspension or disbarment of any practitioner under the provisions of this part, under the following circumstances:

(1) The former employee applies for enrollment on an Internal Revenue Service form and supplies the information requested on the form and such other information regarding the experience and training of the applicant as may be relevant.

(2) The appropriate office of the Internal Revenue Service provides a detailed report of the nature and rating of the applicant's work while employed by the Internal Revenue Service and a recommendation whether such employment qualifies the applicant technically or otherwise for the desired authorization.

(3) Enrollment as an enrolled agent based on an applicant's former employment with the Internal Revenue Service may be of unlimited scope or it may be limited to permit the presentation of matters only of the particular specialty or only before the particular unit or division of the Internal Revenue Service for which the applicant's former employment has qualified the applicant. Enrollment as an enrolled retirement plan agent based on an applicant's former employment with the Internal Revenue Service will be limited to permit the presentation of matters only with respect to qualified retirement plan matters.

(4) Application for enrollment as an enrolled agent or enrolled retirement plan agent based on an applicant's former employment with the Internal Revenue Service must be made within three years from the date of separation from such employment.

(5) An applicant for enrollment as an enrolled agent who is requesting such enrollment based on former employment with the Internal Revenue Service must have had a minimum of five years continuous employment with the Internal Revenue Service during which the applicant must have been regularly engaged in applying and interpreting the provisions of the Internal Revenue Code and the regulations relating to income, estate, gift, employment, or excise taxes.

(6) An applicant for enrollment as an enrolled retirement plan agent who is requesting such enrollment based on former employment with the Internal Revenue Service must have had a minimum of five years continuous employment with the Internal Revenue Service during which the applicant must have been regularly engaged in applying and interpreting the provisions of the Internal Revenue Code and the regulations relating to qualified retirement plan matters.

(7) For the purposes of paragraphs (d)(5) and (6) of this section, an aggregate of 10 or more years of employment in positions involving the application and interpretation of the provisions of the Internal Revenue Code, at least three of which occurred within the five years preceding the date of application, is the equivalent of five years continuous employment.

(e) *Natural persons*. Enrollment to practice may be granted only to natural persons.

(f) *Effective/applicability date.* This section is applicable beginning August 2, 2011.

§ 10.5 Application to become an enrolled agent, enrolled retirement plan agent, or registered tax return preparer.

(a) *Form; address.* An applicant to become an enrolled agent, enrolled retirement plan agent, or registered tax return preparer must apply as required by forms or procedures established and published by the Internal Revenue Service, including proper execution of required forms under oath or affirmation. The address on the application will be the address under which a successful applicant is enrolled or registered and is the address to which all correspondence concerning enrollment or registration will be sent.

(b) *Fee.* A reasonable nonrefundable fee may be charged for each application to become an enrolled agent, enrolled retirement plan agent, or registered tax return preparer. See 26 CFR part 300.

(c) *Additional information; examination.* The Internal Revenue Service may require the applicant, as a condition to consideration of an application, to file

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additional information and to submit to any written or oral examination under oath or otherwise. Upon the applicant's written request, the Internal Revenue Service will afford the applicant the opportunity to be heard with respect to the application.

(d) *Compliance and suitability checks.*

(1) As a condition to consideration of an application, the Internal Revenue Service may conduct a Federal tax compliance check and suitability check. The tax compliance check will be limited to an inquiry regarding whether an applicant has filed all required individual or business tax returns and whether the applicant has failed to pay, or make proper arrangements with the Internal Revenue Service for payment of, any Federal tax debts. The suitability check will be limited to an inquiry regarding whether an applicant has engaged in any conduct that would justify suspension or disbarment of any practitioner under the provisions of this part on the date the application is submitted, including whether the applicant has engaged in disreputable conduct as defined in §10.51. The application will be denied only if the results of the compliance or suitability check are sufficient to establish that the practitioner engaged in conduct subject to sanctions under §§10.51 and 10.52.

(2) If the applicant does not pass the tax compliance or suitability check, the applicant will not be issued an enrollment or registration card or certificate pursuant to §10.6(b) of this part. An applicant who is initially denied enrollment or registration for failure to pass a tax compliance check may reapply after the initial denial if the applicant becomes current with respect to the applicant's tax liabilities.

(e) *Temporary recognition.* On receipt of a properly executed application, the Commissioner, or delegate, may grant the applicant temporary recognition to practice pending a determination as to whether status as an enrolled agent, enrolled retirement plan agent, or registered tax return preparer should be granted. Temporary recognition will be granted only in unusual circumstances and it will not be granted, in any circumstance, if the application is not regular on its face, if the information stated in the application, if true, is not sufficient to warrant granting the application to practice, or the Commissioner, or delegate, has information indicating that the statements in the application are untrue or that the applicant would not otherwise qualify to become an enrolled agent, enrolled retirement plan agent, or registered tax return preparer. Issuance of temporary recognition does not constitute either a designation or a finding of eligibility as an enrolled agent, enrolled retirement plan agent, or registered tax return preparer, and the temporary recognition may be withdrawn at any time.

(f) *Protest of application denial.* The applicant will be informed in writing as to the reason(s) for any denial of an application. The applicant may, within 30 days after receipt of the notice of denial of the application, file a written protest of the denial as prescribed by the Internal Revenue Service in forms, guidance, or other appropriate guidance. A protest under this section is not governed by subpart D of this part.

(f) *Effective/applicability date.* This section is applicable to applications received on or after August 2, 2011.

§ 10.6 Term and renewal of status as an enrolled agent, enrolled retirement plan agent, or registered tax return preparer.

(a) *Term.* Each individual authorized to practice before the Internal Revenue Service as an enrolled agent, enrolled retirement plan agent, or registered tax return preparer will be accorded active enrollment or registration status subject to renewal of enrollment or registration as provided in this part.

(b) *Enrollment or registration card or certificate.* The Internal Revenue Service will issue an enrollment or registration card or certificate to each individual whose application to practice before the Internal Revenue Service is approved. Each card or certificate will be valid for the period stated on the card or certificate. An enrolled agent, enrolled retirement plan agent, or registered tax return preparer may not practice before the Internal Revenue Service if the card or certificate is not current or otherwise

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valid. The card or certificate is in addition to any notification that may be provided to each individual who obtains a preparer tax identification number.

(c) *Change of address.* An enrolled agent, enrolled retirement plan agent, or registered tax return preparer must send notification of any change of address to the address specified by the Internal Revenue Service within 60 days of the change of address. This notification must include the enrolled agent's, enrolled retirement plan agent's, or registered tax return preparer's name, prior address, new address, tax identification number(s) (including preparer tax identification number), and the date the change of address is effective. Unless this notification is sent, the address for purposes of any correspondence from the appropriate Internal Revenue Service office responsible for administering this part shall be the address reflected on the practitioner's most recent application for enrollment or registration, or application for renewal of enrollment or registration. A practitioner's change of address notification under this part will not constitute a change of the practitioner's last known address for purposes of section 6212 of the Internal Revenue Code and regulations thereunder.

(d) *Renewal.*

(1) *In general*. Enrolled agents, enrolled retirement plan agents, and registered tax return preparers must renew their status with the Internal Revenue Service to maintain eligibility to practice before the Internal Revenue Service. Failure to receive notification from the Internal Revenue Service of the renewal requirement will not be justification for the individual's failure to satisfy this requirement.

(2) *Renewal period for enrolled agents.*

(i) All enrolled agents must renew their preparer tax identification number as prescribed by forms, instructions, or other appropriate guidance.

(ii) Enrolled agents who have a social security number or tax identification number that ends with the numbers 0, 1, 2, or 3, except for those individuals who received their initial enrollment after November 1, 2003, must apply for renewal between November 1, 2003, and January 31, 2004. The renewal will be effective April 1, 2004.

(iii) Enrolled agents who have a social security number or tax identification number that ends with the numbers 4, 5, or 6, except for those individuals who received their initial enrollment after November 1, 2004, must apply for renewal between November 1, 2004, and January 31, 2005. The renewal will be effective April 1, 2005.

(iv) Enrolled agents who have a social security number or tax identification number that ends with the numbers 7, 8, or 9, except for those individuals who received their initial enrollment after November 1, 2005, must apply for renewal between November 1, 2005, and January 31, 2006. The renewal will be effective April 1, 2006.

(v) Thereafter, applications for renewal as an enrolled agent will be required between November 1 and January 31 of every subsequent third year as specified in paragraph (d)(2)(i), (d)(2)(ii), or (d)(2)(iii) of this section according to the last number of the individual's social security number or tax identification number. Those individuals who receive initial enrollment as an enrolled agent after November 1 and before April 2 of the applicable renewal period will not be required to renew their enrollment before the first full renewal period following the receipt of their initial enrollment.

(3) *Renewal period for enrolled retirement plan agents.*

(i) All enrolled retirement plan agents must renew their preparer tax identification number as prescribed by the Internal Revenue Service in forms, instructions, or other appropriate guidance.

(ii) Enrolled retirement plan agents will be required to renew their status as enrolled retirement plan agents between April 1 and June 30 of every third year subsequent to their initial enrollment.

(4) *Renewal period for registered tax return preparers.* Registered tax return preparers must renew their preparer tax identification number and their status as a registered tax return preparer as prescribed by the Internal Revenue Service in forms, instructions, or other appropriate guidance.

(5) *Notification of renewal.* After review and approval, the Internal Revenue Service will notify

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the individual of the renewal and will issue the individual a card or certificate evidencing current status as an enrolled agent, enrolled retirement plan agent, or registered tax return preparer.

(6) *Fee*. A reasonable nonrefundable fee may be charged for each application for renewal filed. See 26 CFR part 300.

(7) *Forms*. Forms required for renewal may be obtained by sending a written request to the address specified by the Internal Revenue Service or from such other source as the Internal Revenue Service will publish in the Internal Revenue Bulletin (see 26 CFR 601.601(d)(2)(ii)(b)) and on the Internal Revenue Service webpage (www.irs.gov).

(e) *Condition for renewal*: continuing education. In order to qualify for renewal as an enrolled agent, enrolled retirement plan agent, or registered tax return preparer, an individual must certify, in the manner prescribed by the Internal Revenue Service, that the individual has satisfied the requisite number of continuing education hours.

(1) *Definitions*. For purposes of this section —

(i) *Enrollment year* means January 1 to December 31 of each year of an enrollment cycle.

(ii) *Enrollment cycle* means the three successive enrollment years preceding the effective date of renewal.

(iii) *Registration year* means each 12-month period the registered tax return preparer is authorized to practice before the Internal Revenue Service.

(iv) *The effective date of renewal* is the first day of the fourth month following the close of the period for renewal described in paragraph (d) of this section.

(2) *For renewed enrollment as an enrolled agent or enrolled retirement plan agent* —

(i) *Requirements for enrollment cycle*. A minimum of 72 hours of continuing education credit, including six hours of ethics or professional conduct, must be completed during each enrollment cycle.

(ii) *Requirements for enrollment year*. A minimum of 16 hours of continuing education credit, including two hours of ethics or professional conduct, must be completed during each enrollment year of an enrollment cycle.

(iii) *Enrollment during enrollment cycle* —

(A) *In general*. Subject to paragraph (e)(2)(iii)(B) of this section, an individual who receives initial enrollment during an enrollment cycle must complete two hours of qualifying continuing education credit for each month enrolled during the enrollment cycle. Enrollment for any part of a month is considered enrollment for the entire month.

(B) *Ethics*. An individual who receives initial enrollment during an enrollment cycle must complete two hours of ethics or professional conduct for each enrollment year during the enrollment cycle. Enrollment for any part of an enrollment year is considered enrollment for the entire year.

(3) *Requirements for renewal as a registered tax return preparer*. A minimum of 15 hours of continuing education credit, including two hours of ethics or professional conduct, three hours of Federal tax law updates, and 10 hours of Federal tax law topics, must be completed during each registration year.

(f) *Qualifying continuing education* —

(1) *General* —

(i) *Enrolled agents*. To qualify for continuing education credit for an enrolled agent, a course of learning must —

(A) Be a qualifying continuing education program designed to enhance professional knowledge in Federal taxation or Federal tax related matters (programs comprised of current subject matter in Federal taxation or Federal tax related matters, including accounting, tax return preparation software, taxation, or ethics); and

(B) Be a qualifying continuing education program consistent with the Internal Revenue Code and effective tax administration.

(ii) *Enrolled retirement plan agents*. To qualify for continuing education credit for an enrolled retirement plan agent, a course of learning must —

(A) Be a qualifying continuing education program designed to enhance professional knowledge in qualified retirement plan matters; and

(B) Be a qualifying continuing education program consistent with the Internal Revenue Code and effective tax administration.

(iii) *Registered tax return preparers*. To

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qualify for continuing education credit for a registered tax return preparer, a course of learning must —

(A) Be a qualifying continuing education program designed to enhance professional knowledge in Federal taxation or Federal tax related matters (programs comprised of current subject matter in Federal taxation or Federal tax related matters, including accounting, tax return preparation software, taxation, or ethics); and

(B) Be a qualifying continuing education program consistent with the Internal Revenue Code and effective tax administration.

(2) *Qualifying programs* —

(i) *Formal programs*. A formal program qualifies as a continuing education program if it —

(A) Requires attendance and provides each attendee with a certificate of attendance;

(B) Is conducted by a qualified instructor, discussion leader, or speaker (in other words, a person whose background, training, education, and experience is appropriate for instructing or leading a discussion on the subject matter of the particular program);

(C) Provides or requires a written outline, textbook, or suitable electronic educational materials; and

(D) Satisfies the requirements established for a qualified continuing education program pursuant to §10.9.

(ii) *Correspondence or individual study programs (including taped programs)*. Qualifying continuing education programs include correspondence or individual study programs that are conducted by continuing education providers and completed on an individual basis by the enrolled individual. The allowable credit hours for such programs will be measured on a basis comparable to the measurement of a seminar or course for credit in an accredited educational institution. Such programs qualify as continuing education programs only if they —

(A) Require registration of the participants by the continuing education provider;

(B) Provide a means for measuring successful completion by the participants (for example, a written examination), including the issuance of a certificate of completion by the continuing education provider;

(C) Provide a written outline, textbook, or suitable electronic educational materials; and

(D) Satisfy the requirements established for a qualified continuing education program pursuant to §10.9.

(iii) *Serving as an instructor, discussion leader or speaker*.

(A) One hour of continuing education credit will be awarded for each contact hour completed as an instructor, discussion leader, or speaker at an educational program that meets the continuing education requirements of paragraph (f) of this section.

(B) A maximum of two hours of continuing education credit will be awarded for actual subject preparation time for each contact hour completed as an instructor, discussion leader, or speaker at such programs. It is the responsibility of the individual claiming such credit to maintain records to verify preparation time.

(C) The maximum continuing education credit for instruction and preparation may not exceed four hours annually for registered tax return preparers and six hours annually for enrolled agents and enrolled retirement plan agents.

(D) An instructor, discussion leader, or speaker who makes more than one presentation on the same subject matter during an enrollment cycle or registration year will receive continuing education credit for only one such presentation for the enrollment cycle or registration year.

(3) *Periodic examination*. Enrolled Agents and Enrolled Retirement Plan Agents may establish eligibility for renewal of enrollment for any enrollment cycle by —

(i) Achieving a passing score on each part of the Special Enrollment Examination administered under this part during the three year period prior to renewal; and

(ii) Completing a minimum of 16 hours of qualifying continuing education during the last year of an enrollment cycle.

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(g) *Measurement of continuing education coursework*.

(1) All continuing education programs will be measured in terms of contact hours. The shortest recognized program will be one contact hour.

(2) A contact hour is 50 minutes of continuous participation in a program. Credit is granted only for a full contact hour, which is 50 minutes or multiples thereof. For example, a program lasting more than 50 minutes but less than 100 minutes will count as only one contact hour.

(3) Individual segments at continuous conferences, conventions and the like will be considered one total program. For example, two 90-minute segments (180 minutes) at a continuous conference will count as three contact hours.

(4) For university or college courses, each semester hour credit will equal 15 contact hours and a quarter hour credit will equal 10 contact hours.

(h) *Recordkeeping requirements*.

(1) Each individual applying for renewal must retain for a period of four years following the date of renewal the information required with regard to qualifying continuing education credit hours. Such information includes —

(i) The name of the sponsoring organization;

(ii) The location of the program;

(iii) The title of the program, qualified program number, and description of its content;

(iv) Written outlines, course syllibi, textbook, and/or electronic materials provided or required for the course;

(v) The dates attended;

(vi) The credit hours claimed;

(vii) The name(s) of the instructor(s), discussion leader(s), or speaker(s), if appropriate; and

(viii) The certificate of completion and/or signed statement of the hours of attendance obtained from the continuing education provider.

(2) To receive continuing education credit for service completed as an instructor, discussion leader, or speaker, the following information must be maintained for a period of four years following the date of renewal —

(i) The name of the sponsoring organization;

(ii) The location of the program;

(iii) The title of the program and copy of its content;

(iv) The dates of the program; and

(v) The credit hours claimed.

(i) *Waivers*.

(1) Waiver from the continuing education requirements for a given period may be granted for the following reasons —

(i) Health, which prevented compliance with the continuing education requirements;

(ii) Extended active military duty;

(iii) Absence from the United States for an extended period of time due to employment or other reasons, provided the individual does not practice before the Internal Revenue Service during such absence; and

(iv) Other compelling reasons, which will be considered on a case-by-case basis.

(2) A request for waiver must be accompanied by appropriate documentation. The individual is required to furnish any additional documentation or explanation deemed necessary. Examples of appropriate documentation could be a medical certificate or military orders.

(3) A request for waiver must be filed no later than the last day of the renewal application period.

(4) If a request for waiver is not approved, the individual will be placed in inactive status. The individual will be notified that the waiver was not approved and that the individual has been placed on a roster of inactive enrolled agents, enrolled retirement plan agents, or registered tax return preparers.

(5) If the request for waiver is not approved, the individual may file a protest as prescribed by the Internal Revenue Service in forms, instructions, or other appropriate guidance. A protest filed under this section is not governed by subpart D of this part.

(6) If a request for waiver is approved, the individual will be notified and issued a card or certificate evidencing renewal.

(7) Those who are granted waivers are required to file timely applications for renewal of enrollment or registration.

(j) *Failure to comply*.

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(1) Compliance by an individual with the requirements of this part is determined by the Internal Revenue Service. The Internal Revenue Service will provide notice to any individual who fails to meet the continuing education and fee requirements of eligibility for renewal. The notice will state the basis for the determination of noncompliance and will provide the individual an opportunity to furnish the requested information in writing relating to the matter within 60 days of the date of the notice. Such information will be considered in making a final determination as to eligibility for renewal. The individual must be informed of the reason(s) for any denial of a renewal. The individual may, within 30 days after receipt of the notice of denial of renewal, file a written protest of the denial as prescribed by the Internal Revenue Service in forms, instructions, or other appropriate guidance. A protest under this section is not governed by subpart D of this part.

(2) The continuing education records of an enrolled agent, enrolled retirement plan agent, or registered tax return preparer may be reviewed to determine compliance with the requirements and standards for renewal as provided in paragraph (f) of this section. As part of this review, the enrolled agent, enrolled retirement plan agent or registered tax return preparer may be required to provide the Internal Revenue Service with copies of any continuing education records required to be maintained under this part. If the enrolled agent, enrolled retirement plan agent or registered tax return preparer fails to comply with this requirement, any continuing education hours claimed may be disallowed.

(3) An individual who has not filed a timely application for renewal, who has not made a timely response to the notice of noncompliance with the renewal requirements, or who has not satisfied the requirements of eligibility for renewal will be placed on a roster of inactive enrolled individuals or inactive registered individuals. During this time, the individual will be ineligible to practice before the Internal Revenue Service.

(4) Individuals placed in inactive status and individuals ineligible to practice before the Internal Revenue Service may not state or imply that they are eligible to practice before the Internal Revenue Service, or use the terms enrolled agent, enrolled retirement plan agent, or registered tax return preparer, the designations “EA” or “ERPA” or other form of reference to eligibility to practice before the Internal Revenue Service.

(5) An individual placed in inactive status may be reinstated to an active status by filing an application for renewal and providing evidence of the completion of all required continuing education hours for the enrollment cycle or registration year. Continuing education credit under this paragraph (j)(5) may not be used to satisfy the requirements of the enrollment cycle or registration year in which the individual has been placed back on the active roster.

(6) An individual placed in inactive status must file an application for renewal and satisfy the requirements for renewal as set forth in this section within three years of being placed in inactive status. Otherwise, the name of such individual will be removed from the inactive status roster and the individual’s status as an enrolled agent, enrolled retirement plan agent, or registered tax return preparer will terminate. Future eligibility for active status must then be reestablished by the individual as provided in this section.

(7) Inactive status is not available to an individual who is the subject of a pending disciplinary matter before the Internal Revenue Service.

(k) *Inactive retirement status*. An individual who no longer practices before the Internal Revenue Service may request to be placed in an inactive retirement status at any time and such individual will be placed in an inactive retirement status. The individual will be ineligible to practice before the Internal Revenue Service. An individual who is placed in an inactive retirement status may be reinstated to an active status by filing an application for renewal and providing evidence of the completion of the required continuing education hours for the enrollment cycle or registration year. Inactive retirement status is not available to an individual who is ineligible to practice before the Internal Revenue Service or an individual who is the subject of a pending disciplinary matter under this part.

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(l) *Renewal while under suspension or disbarment.* An individual who is ineligible to practice before the Internal Revenue Service by virtue of disciplinary action under this part is required to conform to the requirements for renewal of enrollment or registration before the individual's eligibility is restored.

(m) *Enrolled actuaries.* The enrollment and renewal of enrollment of actuaries authorized to practice under paragraph (d) of §10.3 are governed by the regulations of the Joint Board for the Enrollment of Actuaries at 20 CFR 901.1 through 901.72.

(n) *Effective/applicability date.* This section is applicable to enrollment or registration effective beginning August 2, 2011.

§ 10.7 Representing oneself; participating in rulemaking; limited practice; and special appearances.

(a) *Representing oneself.* Individuals may appear on their own behalf before the Internal Revenue Service provided they present satisfactory identification.

(b) *Participating in rulemaking.* Individuals may participate in rulemaking as provided by the Administrative Procedure Act. See 5 U.S.C. § 553.

(c) *Limited practice* —

(1) *In general.* Subject to the limitations in paragraph (c)(2) of this section, an individual who is not a practitioner may represent a taxpayer before the Internal Revenue Service in the circumstances described in this paragraph (c)(1), even if the taxpayer is not present, provided the individual presents satisfactory identification and proof of his or her authority to represent the taxpayer. The circumstances described in this paragraph (c)(1) are as follows:

(i) An individual may represent a member of his or her immediate family.

(ii) A regular full-time employee of an individual employer may represent the employer.

(iii) A general partner or a regular full-time employee of a partnership may represent the partnership.

(iv) A bona fide officer or a regular full-time employee of a corporation (including a parent, subsidiary, or other affiliated corporation), association, or organized group may represent the corporation, association, or organized group.

(v) A regular full-time employee of a trust, receivership, guardianship, or estate may represent the trust, receivership, guardianship, or estate.

(vi) An officer or a regular employee of a governmental unit, agency, or authority may represent the governmental unit, agency, or authority in the course of his or her official duties.

(vii) An individual may represent any individual or entity, who is outside the United States, before personnel of the Internal Revenue Service when such representation takes place outside the United States.

(2) *Limitations*.

(i) An individual who is under suspension or disbarment from practice before the Internal Revenue Service may not engage in limited practice before the Internal Revenue Service under paragraph (c)(1) of this section.

(ii) The Commissioner, or delegate, may, after notice and opportunity for a conference, deny eligibility to engage in limited practice before the Internal Revenue Service under paragraph (c)(1) of this section to any individual who has engaged in conduct that would justify a sanction under §10.50.

(iii) An individual who represents a taxpayer under the authority of paragraph (c)(1) of this section is subject, to the extent of his or her authority, to such rules of general applicability regarding standards of conduct and other matters as prescribed by the Internal Revenue Service.

(d) *Special appearances*. The Commissioner, or delegate, may, subject to conditions deemed appropriate, authorize an individual who is not otherwise eligible to practice before the Internal Revenue Service to represent another person in a particular matter.

(e) *Fiduciaries*. For purposes of this part, a fiduciary (for example, a trustee, receiver, guardian, personal representative, administrator, or executor) is considered to be the taxpayer and not a representative of the taxpayer.

(f) *Effective/applicability date*. This section is applicable beginning August 2, 2011.

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§ 10.8 Return preparation and application of rules to other individuals.

(a) *Preparing all or substantially all of a tax return*. Any individual who for compensation prepares or assists with the preparation of all or substantially all of a tax return or claim for refund must have a preparer tax identification number. Except as otherwise prescribed in forms, instructions, or other appropriate guidance, an individual must be an attorney, certified public accountant, enrolled agent, or registered tax return preparer to obtain a preparer tax identification number. Any individual who for compensation prepares or assists with the preparation of all or substantially all of a tax return or claim for refund is subject to the duties and restrictions relating to practice in subpart B, as well as subject to the sanctions for violation of the regulations in subpart C.

(b) *Preparing a tax return and furnishing information*. Any individual may for compensation prepare or assist with the preparation of a tax return or claim for refund (provided the individual prepares less than substantially all of the tax return or claim for refund), appear as a witness for the taxpayer before the Internal Revenue Service, or furnish information at the request of the Internal Revenue Service or any of its officers or employees.

(c) *Application of rules to other individuals*. Any individual who for compensation prepares, or assists in the preparation of, all or a substantial portion of a document pertaining to any taxpayer's tax liability for submission to the Internal Revenue Service is subject to the duties and restrictions relating to practice in subpart B, as well as subject to the sanctions for violation of the regulations in subpart C. Unless otherwise a practitioner, however, an individual may not for compensation prepare, or assist in the preparation of, all or substantially all of a tax return or claim for refund, or sign tax returns and claims for refund. For purposes of this paragraph, an individual described in 26 CFR 301.7701-15(f) is not treated as having prepared all or a substantial portion of the document by reason of such assistance.

(d) *Effective/applicability date*. This section is applicable beginning August 2, 2011.

§ 10.9 Continuing education providers and continuing education programs.

(a) *Continuing education providers* —

(1) *In general*. Continuing education providers are those responsible for presenting continuing education programs. A continuing education provider must —

(i) Be an accredited educational institution;

(ii) Be recognized for continuing education purposes by the licensing body of any State, territory, or possession of the United States, including a Commonwealth, or the District of Columbia;

(iii) Be recognized and approved by a qualifying organization as a provider of continuing education on subject matters within §10.6(f) of this part. The Internal Revenue Service may, at its discretion, identify a professional organization, society or business entity that maintains minimum education standards comparable to those set forth in this part as a qualifying organization for purposes of this part in appropriate forms, instructions, and other appropriate guidance; or

(iv) Be recognized by the Internal Revenue Service as a professional organization, society, or business whose programs include offering continuing professional education opportunities in subject matters within §10.6(f) of this part. The Internal Revenue Service, at its discretion, may require such professional organizations, societies, or businesses to file an agreement and/or obtain Internal Revenue Service approval of each program as a qualified continuing education program in appropriate forms, instructions or other appropriate guidance.

(2) *Continuing education provider numbers* —

(i) *In general*. A continuing education provider is required to obtain a continuing education provider number and pay any applicable user fee.

(ii) *Renewal*. A continuing education provider maintains its status as a continuing education provider during the continuing education provider cycle by renewing its continuing education provider number as prescribed by forms, instructions or other appropriate guidance and paying any applicable user fee.

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(3) *Requirements for qualified continuing education programs*. A continuing education provider must ensure the qualified continuing education program complies with all the following requirements —

(i) Programs must be developed by individual(s) qualified in the subject matter;

(ii) Program subject matter must be current;

(iii) Instructors, discussion leaders, and speakers must be qualified with respect to program content;

(iv) Programs must include some means for evaluation of the technical content and presentation to be evaluated;

(v) Certificates of completion bearing a current qualified continuing education program number issued by the Internal Revenue Service must be provided to the participants who successfully complete the program; and

(vi) Records must be maintained by the continuing education provider to verify the participants who attended and completed the program for a period of four years following completion of the program. In the case of continuous conferences, conventions, and the like, records must be maintained to verify completion of the program and attendance by each participant at each segment of the program.

(4) *Program numbers* —

(i) *In general*. Every continuing education provider is required to obtain a continuing education provider program number and pay any applicable user fee for each program offered. Program numbers shall be obtained as prescribed by forms, instructions or other appropriate guidance. Although, at the discretion of the Internal Revenue Service, a continuing education provider may be required to demonstrate that the program is designed to enhance professional knowledge in Federal taxation or Federal tax related matters (programs comprised of current subject matter in Federal taxation or Federal tax related matters, including accounting, tax return preparation software, taxation, or ethics) and complies with the requirements in paragraph (a)(2)of this section before a program number is issued.

(ii) *Update programs*. Update programs may use the same number as the program subject to update. An update program is a program that instructs on a change of existing law occurring within one year of the update program offering. The qualifying education program subject to update must have been offered within the two year time period prior to the change in existing law.

(iii) *Change in existing law*. A change in existing law means the effective date of the statute or regulation, or date of entry of judicial decision, that is the subject of the update.

(b) *Failure to comply*. Compliance by a continuing education provider with the requirements of this part is determined by the Internal Revenue Service. A continuing education provider who fails to meet the requirements of this part will be notified by the Internal Revenue Service. The notice will state the basis for the determination of noncompliance and will provide the continuing education provider an opportunity to furnish the requested information in writing relating to the matter within 60 days of the date of the notice. The continuing education provider may, within 30 days after receipt of the notice of denial, file a written protest as prescribed by the Internal Revenue Service in forms, instructions, or other appropriate guidance. A protest under this section is not governed by subpart D of this part.

(c) *Effective/applicability date*. This section is applicable beginning August 2, 2011.

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Subpart B — Duties and Restrictions Relating to Practice Before the Internal Revenue Service

§ 10.20 Information to be furnished.

(a) *To the Internal Revenue Service.*

(1) A practitioner must, on a proper and lawful request by a duly authorized officer or employee of the Internal Revenue Service, promptly submit records or information in any matter before the Internal Revenue Service unless the practitioner believes in good faith and on reasonable grounds that the records or information are privileged.

(2) Where the requested records or information are not in the possession of, or subject to the control of, the practitioner or the practitioner's client, the practitioner must promptly notify the requesting Internal Revenue Service officer or employee and the practitioner must provide any information that the practitioner has regarding the identity of any person who the practitioner believes may have possession or control of the requested records or information. The practitioner must make reasonable inquiry of his or her client regarding the identity of any person who may have possession or control of the requested records or information, but the practitioner is not required to make inquiry of any other person or independently verify any information provided by the practitioner's client regarding the identity of such persons.

(3) When a proper and lawful request is made by a duly authorized officer or employee of the Internal Revenue Service, concerning an inquiry into an alleged violation of the regulations in this part, a practitioner must provide any information the practitioner has concerning the alleged violation and testify regarding this information in any proceeding instituted under this part, unless the practitioner believes in good faith and on reasonable grounds that the information is privileged.

(b) *Interference with a proper and lawful request for records or information.* A practitioner may not interfere, or attempt to interfere, with any proper and lawful effort by the Internal Revenue Service, its officers or employees, to obtain any record or information unless the practitioner believes in good faith and on reasonable grounds that the record or information is privileged.

(c) *Effective/applicability date.* This section is applicable beginning August 2, 2011.

§ 10.21 Knowledge of client's omission.

A practitioner who, having been retained by a client with respect to a matter administered by the Internal Revenue Service, knows that the client has not complied with the revenue laws of the United States or has made an error in or omission from any return, document, affidavit, or other paper which the client submitted or executed under the revenue laws of the United States, must advise the client promptly of the fact of such noncompliance, error, or omission. The practitioner must advise the client of the consequences as provided under the Code and regulations of such noncompliance, error, or omission.

§ 10.22 Diligence as to accuracy.

(a) *In general.* A practitioner must exercise due diligence —

(1) In preparing or assisting in the preparation of, approving, and filing tax returns, documents, affidavits, and other papers relating to Internal Revenue Service matters;

(2) In determining the correctness of oral or written representations made by the practitioner to the Department of the Treasury; and

(3) In determining the correctness of oral or written representations made by the practitioner to clients with reference to any matter administered by the Internal Revenue Service.

(b) *Reliance on others.* Except as modified by §§10.34 and 10.37, a practitioner will be presumed to have exercised due diligence for purposes of this section if the practitioner relies on the work product of another person and the practitioner used reasonable care in engaging, supervising, training, and evaluating the person, taking proper account of the nature of the relationship between the practitioner and the person.

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(c) *Effective/applicability date.* Paragraph (a) of this section is applicable on September 26, 2007. Paragraph (b) of this section is applicable beginning June 12, 2014.

§ 10.23 Prompt disposition of pending matters.

A practitioner may not unreasonably delay the prompt disposition of any matter before the Internal Revenue Service.

§ 10.24 Assistance from or to disbarred or suspended persons and former Internal Revenue Service employees.

A practitioner may not, knowingly and directly or indirectly:

(a) Accept assistance from or assist any person who is under disbarment or suspension from practice before the Internal Revenue Service if the assistance relates to a matter or matters constituting practice before the Internal Revenue Service.

(b) Accept assistance from any former government employee where the provisions of § 10.25 or any Federal law would be violated.

§ 10.25 Practice by former government employees, their partners and their associates.

(a) *Definitions.* For purposes of this section —

(1) *Assist* means to act in such a way as to advise, furnish information to, or otherwise aid another person, directly, or indirectly.

(2) *Government employee* is an officer or employee of the United States or any agency of the United States, including a special Government employee as defined in *18 U.S.C. 202(a)*, or of the District of Columbia, or of any State, or a member of Congress or of any State legislature.

(3) *Member of a firm* is a sole practitioner or an employee or associate thereof, or a partner, stockholder, associate, affiliate or employee of a partnership, joint venture, corporation, professional association or other affiliation of two or more practitioners who represent nongovernmental parties.

(4) *Particular matter involving specific parties* is defined at 5 CFR 2637.201(c), or superseding post-employment regulations issued by the U.S. Office of Government Ethics.

(5) *Rule* includes Treasury regulations, whether issued or under preparation for issuance as notices of proposed rulemaking or as Treasury decisions, revenue rulings, and revenue procedures published in the Internal Revenue Bulletin (see *26 CFR 601.601(d)(2)(ii)(b)*).

(b) *General rules* —

(1) No former Government employee may, subsequent to Government employment, represent anyone in any matter administered by the Internal Revenue Service if the representation would violate *18 U.S.C. 207* or any other laws of the United States.

(2) No former Government employee who personally and substantially participated in a particular matter involving specific parties may, subsequent to Government employment, represent or knowingly assist, in that particular matter, any person who is or was a specific party to that particular matter.

(3) A former Government employee who within a period of one year prior to the termination of Government employment had official responsibility for a particular matter involving specific parties may not, within two years after Government employment is ended, represent in that particular matter any person who is or was a specific party to that particular matter.

(4) No former Government employee may, within one year after Government employment is ended, communicate with or appear before, with the intent to influence, any employee of the Treasury Department in connection with the publication, withdrawal, amendment, modification, or interpretation of a rule the development of which the former Government employee participated in, or for which, within a period of one year prior to the termination of Government employment, the former government employee had official responsibility. This paragraph (b)(4) does not, however, preclude any former employee from appearing on one's own behalf or from representing a taxpayer before the Internal Revenue Service in connection with a particular matter involving specific

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parties involving the application or interpretation of a rule with respect to that particular matter, provided that the representation is otherwise consistent with the other provisions of this section and the former employee does not utilize or disclose any confidential information acquired by the former employee in the development of the rule.

(c) *Firm representation* —

(1) No member of a firm of which a former Government employee is a member may represent or knowingly assist a person who was or is a specific party in any particular matter with respect to which the restrictions of paragraph (b)(2) of this section apply to the former Government employee, in that particular matter, unless the firm isolates the former Government employee in such a way to ensure that the former Government employee cannot assist in the representation.

(2) When isolation of a former Government employee is required under paragraph (c)(1) of this section, a statement affirming the fact of such isolation must be executed under oath by the former Government employee and by another member of the firm acting on behalf of the firm. The statement must clearly identify the firm, the former Government employee, and the particular matter(s) requiring isolation. The statement must be retained by the firm and, upon request, provided to the office(s) of the Internal Revenue Service administering or enforcing this part.

(d) *Pending representation.* The provisions of this regulation will govern practice by former Government employees, their partners and associates with respect to representation in particular matters involving specific parties where actual representation commenced before the effective date of this regulation.

(e) *Effective/applicability date.* This section is applicable beginning August 2, 2011.

§ 10.26 Notaries.

A practitioner may not take acknowledgments, administer oaths, certify papers, or perform any official act as a notary public with respect to any matter administered by the Internal Revenue Service and for which he or she is employed as counsel, attorney, or agent, or in which he or she may be in any way interested.

§ 10.27 Fees.

(a) *In general.* A practitioner may not charge an unconscionable fee in connection with any matter before the Internal Revenue Service.

(b) *Contingent fees* —

(1) Except as provided in paragraphs (b)(2), (3), and (4) of this section, a practitioner may not charge a contingent fee for services rendered in connection with any matter before the Internal Revenue Service.

(2) A practitioner may charge a contingent fee for services rendered in connection with the Service's examination of, or challenge to —

(i) An original tax return; or

(ii) An amended return or claim for refund or credit where the amended return or claim for refund or credit was filed within 120 days of the taxpayer receiving a written notice of the examination of, or a written challenge to the original tax return.

(3) A practitioner may charge a contingent fee for services rendered in connection with a claim for credit or refund filed solely in connection with the determination of statutory interest or penalties assessed by the Internal Revenue Service.

(4) A practitioner may charge a contingent fee for services rendered in connection with any judicial proceeding arising under the Internal Revenue Code.

(c) *Definitions.* For purposes of this section —

(1) *Contingent fee* is any fee that is based, in whole or in part, on whether or not a position taken on a tax return or other filing avoids challenge by the Internal Revenue Service or is sustained either by the Internal Revenue Service or in litigation. A contingent fee includes a fee that is based on a percentage of the refund reported on a return, that is based on a percentage of the taxes saved, or that otherwise depends on the specific result attained. A contingent fee also includes any fee arrangement in which the practitioner will reimburse the client for all or a portion of the client's fee in the event

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that a position taken on a tax return or other filing is challenged by the Internal Revenue Service or is not sustained, whether pursuant to an indemnity agreement, a guarantee, rescission rights, or any other arrangement with a similar effect.

(2) *Matter before the Internal Revenue Service* includes tax planning and advice, preparing or filing or assisting in preparing or filing returns or claims for refund or credit, and all matters connected with a presentation to the Internal Revenue Service or any of its officers or employees relating to a taxpayer's rights, privileges, or liabilities under laws or regulations administered by the Internal Revenue Service. Such presentations include, but are not limited to, preparing and filing documents, corresponding and communicating with the Internal Revenue Service, rendering written advice with respect to any entity, transaction, plan or arrangement, and representing a client at conferences, hearings, and meetings.

(d) *Effective/applicability date.* This section is applicable for fee arrangements entered into after March 26, 2008.

§ 10.28 Return of client's records.

(a) In general, a practitioner must, at the request of a client, promptly return any and all records of the client that are necessary for the client to comply with his or her Federal tax obligations. The practitioner may retain copies of the records returned to a client. The existence of a dispute over fees generally does not relieve the practitioner of his or her responsibility under this section. Nevertheless, if applicable state law allows or permits the retention of a client's records by a practitioner in the case of a dispute over fees for services rendered, the practitioner need only return those records that must be attached to the taxpayer's return. The practitioner, however, must provide the client with reasonable access to review and copy any additional records of the client retained by the practitioner under state law that are necessary for the client to comply with his or her Federal tax obligations.

(b) For purposes of this section — Records of the client include all documents or written or electronic materials provided to the practitioner, or obtained by the practitioner in the course of the practitioner's representation of the client, that preexisted the retention of the practitioner by the client. The term also includes materials that were prepared by the client or a third party (not including an employee or agent of the practitioner) at any time and provided to the practitioner with respect to the subject matter of the representation. The term also includes any return, claim for refund, schedule, affidavit, appraisal or any other document prepared by the practitioner, or his or her employee or agent, that was presented to the client with respect to a prior representation if such document is necessary for the taxpayer to comply with his or her current Federal tax obligations. The term does not include any return, claim for refund, schedule, affidavit, appraisal or any other document prepared by the practitioner or the practitioner's firm, employees or agents if the practitioner is withholding such document pending the client's performance of its contractual obligation to pay fees with respect to such document.

§ 10.29 Conflicting interests.

(a) Except as provided by paragraph (b) of this section, a practitioner shall not represent a client before the Internal Revenue Service if the representation involves a conflict of interest. A conflict of interest exists if —

(1) The representation of one client will be directly adverse to another client; or

(2) There is a significant risk that the representation of one or more clients will be materially limited by the practitioner's responsibilities to another client, a former client or a third person, or by a personal interest of the practitioner.

(b) Notwithstanding the existence of a conflict of interest under paragraph (a) of this section, the practitioner may represent a client if —

(1) The practitioner reasonably believes that the practitioner will be able to provide competent and diligent representation to each affected client;

(2) The representation is not prohibited by law; and

(3) Each affected client waives the conflict of

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interest and gives informed consent, confirmed in writing by each affected client, at the time the existence of the conflict of interest is known by the practitioner. The confirmation may be made within a reasonable period of time after the informed consent, but in no event later than 30 days.

(c) Copies of the written consents must be retained by the practitioner for at least 36 months from the date of the conclusion of the representation of the affected clients, and the written consents must be provided to any officer or employee of the Internal Revenue Service on request.

(d) *Effective/applicability date.* This section is applicable on September 26, 2007.

§ 10.30 Solicitation.

(a) *Advertising and solicitation restrictions.*

(1) A practitioner may not, with respect to any Internal Revenue Service matter, in any way use or participate in the use of any form of public communication or private solicitation containing a false, fraudulent, or coercive statement or claim; or a misleading or deceptive statement or claim. Enrolled agents, enrolled retirement plan agents, or registered tax return preparers, in describing their professional designation, may not utilize the term "certified" or imply an employer/employee relationship with the Internal Revenue Service. Examples of acceptable descriptions for enrolled agents are "enrolled to represent taxpayers before the Internal Revenue Service," "enrolled to practice before the Internal Revenue Service," and "admitted to practice before the Internal Revenue Service." Similarly, examples of acceptable descriptions for enrolled retirement plan agents are "enrolled to represent taxpayers before the Internal Revenue Service as a retirement plan agent" and "enrolled to practice before the Internal Revenue Service as a retirement plan agent." An example of an acceptable description for registered tax return preparers is "designated as a registered tax return preparer by the Internal Revenue Service."

(2) A practitioner may not make, directly or indirectly, an uninvited written or oral solicitation of employment in matters related to the Internal Revenue Service if the solicitation violates Federal or State law or other applicable rule, e.g., attorneys are precluded from making a solicitation that is prohibited by conduct rules applicable to all attorneys in their State(s) of licensure. Any lawful solicitation made by or on behalf of a practitioner eligible to practice before the Internal Revenue Service must, nevertheless, clearly identify the solicitation as such and, if applicable, identify the source of the information used in choosing the recipient.

(b) *Fee information.*

(1)(i) A practitioner may publish the availability of a written schedule of fees and disseminate the following fee information —

(A) Fixed fees for specific routine services.

(B) Hourly rates.

(C) Range of fees for particular services.

(D) Fee charged for an initial consultation.

(ii) Any statement of fee information concerning matters in which costs may be incurred must include a statement disclosing whether clients will be responsible for such costs.

(2) A practitioner may charge no more than the rate(s) published under paragraph (b)(1) of this section for at least 30 calendar days after the last date on which the schedule of fees was published.

(c) *Communication of fee information.* Fee information may be communicated in professional lists, telephone directories, print media, mailings, and electronic mail, facsimile, hand delivered flyers, radio, television, and any other method. The method chosen, however, must not cause the communication to become untruthful, deceptive, or otherwise in violation of this part. A practitioner may not persist in attempting to contact a prospective client if the prospective client has made it known to the practitioner that he or she does not desire to be solicited. In the case of radio and television broadcasting, the broadcast must be recorded and the practitioner must retain a recording of the actual transmission. In the case of direct mail and e-commerce communications, the practitioner must retain a copy of the actual communication, along with a list or other description of persons to whom the

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communication was mailed or otherwise distributed. The copy must be retained by the practitioner for a period of at least 36 months from the date of the last transmission or use.

(d) *Improper associations.* A practitioner may not, in matters related to the Internal Revenue Service, assist, or accept assistance from, any person or entity who, to the knowledge of the practitioner, obtains clients or otherwise practices in a manner forbidden under this section.

(e) *Effective/applicability date.* This section is applicable beginning August 2, 2011.

(Approved by the Office of Management and Budget under Control No. 1545-1726)

§ 10.31 Negotiation of taxpayer checks.

(a) A practitioner may not endorse or otherwise negotiate any check (including directing or accepting payment by any means, electronic or otherwise, into an account owned or controlled by the practitioner or any firm or other entity with whom the practitioner is associated) issued to a client by the government in respect of a Federal tax liability.

(b) *Effective/applicability date.* This section is applicable beginning June 12, 2014.

§ 10.32 Practice of law.

Nothing in the regulations in this part may be construed as authorizing persons not members of the bar to practice law.

§ 10.33 Best practices for tax advisors.

(a) *Best practices.* Tax advisors should provide clients with the highest quality representation concerning Federal tax issues by adhering to best practices in providing advice and in preparing or assisting in the preparation of a submission to the Internal Revenue Service. In addition to compliance with the standards of practice provided elsewhere in this part, best practices include the following:

(1) Communicating clearly with the client regarding the terms of the engagement. For example, the advisor should determine the client's expected purpose for and use of the advice and should have a clear understanding with the client regarding the form and scope of the advice or assistance to be rendered.

(2) Establishing the facts, determining which facts are relevant, evaluating the reasonableness of any assumptions or representations, relating the applicable law (including potentially applicable judicial doctrines) to the relevant facts, and arriving at a conclusion supported by the law and the facts.

(3) Advising the client regarding the import of the conclusions reached, including, for example, whether a taxpayer may avoid accuracy-related penalties under the Internal Revenue Code if a taxpayer acts in reliance on the advice.

(4) Acting fairly and with integrity in practice before the Internal Revenue Service.

(b) *Procedures to ensure best practices for tax advisors.* Tax advisors with responsibility for overseeing a firm's practice of providing advice concerning Federal tax issues or of preparing or assisting in the preparation of submissions to the Internal Revenue Service should take reasonable steps to ensure that the firm's procedures for all members, associates, and employees are consistent with the best practices set forth in paragraph (a) of this section.

(c) *Applicability date.* This section is effective after June 20, 2005.

§ 10.34 Standards with respect to tax returns and documents, affidavits and other papers.

(a) *Tax returns*.

(1) A practitioner may not willfully, recklessly, or through gross incompetence —

(i) Sign a tax return or claim for refund that the practitioner knows or reasonably should know contains a position that —

(A) Lacks a reasonable basis;

(B) Is an unreasonable position as described in section 6694(a)(2) of the Internal Revenue Code (Code) (including the related regulations and other published guidance); or

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(C) Is a willful attempt by the practitioner to understate the liability for tax or a reckless or intentional disregard of rules or regulations by the practitioner as described in section 6694(b)(2) of the Code (including the related regulations and other published guidance).

(ii) Advise a client to take a position on a tax return or claim for refund, or prepare a portion of a tax return or claim for refund containing a position, that —

(A) Lacks a reasonable basis;

(B) Is an unreasonable position as described in section 6694(a)(2) of the Code (including the related regulations and other published guidance); or

(C) Is a willful attempt by the practitioner to understate the liability for tax or a reckless or intentional disregard of rules or regulations by the practitioner as described in section 6694(b)(2) of the Code (including the related regulations and other published guidance).

(2) A pattern of conduct is a factor that will be taken into account in determining whether a practitioner acted willfully, recklessly, or through gross incompetence.

(b) *Documents, affidavits and other papers* —

(1) A practitioner may not advise a client to take a position on a document, affidavit or other paper submitted to the Internal Revenue Service unless the position is not frivolous.

(2) A practitioner may not advise a client to submit a document, affidavit or other paper to the Internal Revenue Service —

(i) The purpose of which is to delay or impede the administration of the Federal tax laws;

(ii) That is frivolous; or

(iii) That contains or omits information in a manner that demonstrates an intentional disregard of a rule or regulation unless the practitioner also advises the client to submit a document that evidences a good faith challenge to the rule or regulation.

(c) *Advising clients on potential penalties* —

(1) A practitioner must inform a client of any penalties that are reasonably likely to apply to the client with respect to —

(i) A position taken on a tax return if —

(A) The practitioner advised the client with respect to the position; or

(B) The practitioner prepared or signed the tax return; and

(ii) Any document, affidavit or other paper submitted to the Internal Revenue Service.

(2) The practitioner also must inform the client of any opportunity to avoid any such penalties by disclosure, if relevant, and of the requirements for adequate disclosure.

(3) This paragraph (c) applies even if the practitioner is not subject to a penalty under the Internal Revenue Code with respect to the position or with respect to the document, affidavit or other paper submitted.

(d) *Relying on information furnished by clients.* A practitioner advising a client to take a position on a tax return, document, affidavit or other paper submitted to the Internal Revenue Service, or preparing or signing a tax return as a preparer, generally may rely in good faith without verification upon information furnished by the client. The practitioner may not, however, ignore the implications of information furnished to, or actually known by, the practitioner, and must make reasonable inquiries if the information as furnished appears to be incorrect, inconsistent with an important fact or another factual assumption, or incomplete.

(e) *Effective/applicability date.* Paragraph (a) of this section is applicable for returns or claims for refund filed, or advice provided, beginning August 2, 2011. Paragraphs (b) through (d) of this section are applicable to tax returns, documents, affidavits, and other papers filed on or after September 26, 2007.

§ 10.35 Competence.

(a) A practitioner must possess the necessary competence to engage in practice before the Internal Revenue Service. Competent practice requires the appropriate level of knowledge, skill, thoroughness, and preparation necessary for the matter for which the practitioner is engaged. A practitioner may become competent for the matter for which the practitioner has been engaged through various methods, such

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as consulting with experts in the relevant area or studying the relevant law.

(b) *Effective/applicability date.* This section is applicable beginning June 12, 2014.

§ 10.36 Procedures to ensure compliance.

(a) Any individual subject to the provisions of this part who has (or individuals who have or share) principal authority and responsibility for overseeing a firm's practice governed by this part, including the provision of advice concerning Federal tax matters and preparation of tax returns, claims for refund, or other documents for submission to the Internal Revenue Service, must take reasonable steps to ensure that the firm has adequate procedures in effect for all members, associates, and employees for purposes of complying with subparts A, B, and C of this part, as applicable. In the absence of a person or persons identified by the firm as having the principal authority and responsibility described in this paragraph, the Internal Revenue Service may identify one or more individuals subject to the provisions of this part responsible for compliance with the requirements of this section.

(b) Any such individual who has (or such individuals who have or share) principal authority as described in paragraph (a) of this section will be subject to discipline for failing to comply with the requirements of this section if—

(1) The individual through willfulness, recklessness, or gross incompetence does not take reasonable steps to ensure that the firm has adequate procedures to comply with this part, as applicable, and one or more individuals who are members of, associated with, or employed by, the firm are, or have, engaged in a pattern or practice, in connection with their practice with the firm, of failing to comply with this part, as applicable;

(2) The individual through willfulness, recklessness, or gross incompetence does not take reasonable steps to ensure that firm procedures in effect are properly followed, and one or more individuals who are members of, associated with, or employed by, the firm are, or have, engaged in a pattern or practice, in connection with their practice with the firm, of failing to comply with this part, as applicable; or

(3) The individual knows or should know that one or more individuals who are members of, associated with, or employed by, the firm are, or have, engaged in a pattern or practice, in connection with their practice with the firm, that does not comply with this part, as applicable, and the individual, through willfulness, recklessness, or gross incompetence fails to take prompt action to correct the noncompliance.

(c) *Effective/applicability date.* This section is applicable beginning June 12, 2014.

§ 10.37 Requirements for written advice.

(a) *Requirements.*

(1) A practitioner may give written advice (including by means of electronic communication) concerning one or more Federal tax matters subject to the requirements in paragraph (a)(2) of this section. Government submissions on matters of general policy are not considered written advice on a Federal tax matter for purposes of this section. Continuing education presentations provided to an audience solely for the purpose of enhancing practitioners' professional knowledge on Federal tax matters are not considered written advice on a Federal tax matter for purposes of this section. The preceding sentence does not apply to presentations marketing or promoting transactions.

(2) The practitioner must—

(i) Base the written advice on reasonable factual and legal assumptions (including assumptions as to future events);

(ii) Reasonably consider all relevant facts and circumstances that the practitioner knows or reasonably should know;

(iii) Use reasonable efforts to identify and ascertain the facts relevant to written advice on each Federal tax matter;

(iv) Not rely upon representations, statements, findings, or agreements (including projections, financial forecasts, or appraisals) of the taxpayer or any other person if reliance on them would be unreasonable;

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(v) Relate applicable law and authorities to facts; and

(vi) Not, in evaluating a Federal tax matter, take into account the possibility that a tax return will not be audited or that a matter will not be raised on audit.

(3) Reliance on representations, statements, findings, or agreements is unreasonable if the practitioner knows or reasonably should know that one or more representations or assumptions on which any representation is based are incorrect, incomplete, or inconsistent.

(b) *Reliance on advice of others.* A practitioner may only rely on the advice of another person if the advice was reasonable and the reliance is in good faith considering all the facts and circumstances. Reliance is not reasonable when—

(1) The practitioner knows or reasonably should know that the opinion of the other person should not be relied on;

(2) The practitioner knows or reasonably should know that the other person is not competent or lacks the necessary qualifications to provide the advice; or

(3) The practitioner knows or reasonably should know that the other person has a conflict of interest in violation of the rules described in this part.

(c) *Standard of review.*

(1) In evaluating whether a practitioner giving written advice concerning one or more Federal tax matters complied with the requirements of this section, the Commissioner, or delegate, will apply a reasonable practitioner standard, considering all facts and circumstances, including, but not limited to, the scope of the engagement and the type and specificity of the advice sought by the client.

(2) In the case of an opinion the practitioner knows or has reason to know will be used or referred to by a person other than the practitioner (or a person who is a member of, associated with, or employed by the practitioner's firm) in promoting, marketing, or recommending to one or more taxpayers a partnership or other entity, investment plan or arrangement a significant purpose of which is the avoidance or evasion of any tax imposed by the Internal Revenue Code, the Commissioner, or delegate, will apply a reasonable practitioner standard, considering all facts and circumstances, with emphasis given to the additional risk caused by the practitioner's lack of knowledge of the taxpayer's particular circumstances, when determining whether a practitioner has failed to comply with this section.

(d) *Federal tax matter.* A Federal tax matter, as used in this section, is any matter concerning the application or interpretation of---

(1) A revenue provision as defined in section 6110(i)(1)(B) of the Internal Revenue Code;

(2) Any provision of law impacting a person's obligations under the internal revenue laws and regulations, including but not limited to the person's liability to pay tax or obligation to file returns; or

(3) Any other law or regulation administered by the Internal Revenue Service.

(e) *Effective/applicability date.* This section is applicable to written advice rendered after June 12, 2014.

§ 10.38 Establishment of advisory committees.

(a) *Advisory committees.* To promote and maintain the public's confidence in tax advisors, the Internal Revenue Service is authorized to establish one or more advisory committees composed of at least six individuals authorized to practice before the Internal Revenue Service. Membership of an advisory committee must be balanced among those who practice as attorneys, accountants, enrolled agents, enrolled actuaries, enrolled retirement plan agents, and registered tax return preparers. Under procedures prescribed by the Internal Revenue Service, an advisory committee may review and make general recommendations regarding the practices, procedures, and policies of the offices described in §10.1.

(b) *Effective date.* This section is applicable beginning August 2, 2011.

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Subpart C — Sanctions for Violation of the Regulations

§ 10.50 Sanctions.

(a) *Authority to censure, suspend, or disbar.* The Secretary of the Treasury, or delegate, after notice and an opportunity for a proceeding, may censure, suspend, or disbar any practitioner from practice before the Internal Revenue Service if the practitioner is shown to be incompetent or disreputable (within the meaning of §10.51), fails to comply with any regulation in this part (under the prohibited conduct standards of §10.52), or with intent to defraud, willfully and knowingly misleads or threatens a client or prospective client. Censure is a public reprimand.

(b) *Authority to disqualify.* The Secretary of the Treasury, or delegate, after due notice and opportunity for hearing, may disqualify any appraiser for a violation of these rules as applicable to appraisers.

(1) If any appraiser is disqualified pursuant to this subpart C, the appraiser is barred from presenting evidence or testimony in any administrative proceeding before the Department of Treasury or the Internal Revenue Service, unless and until authorized to do so by the Internal Revenue Service pursuant to §10.81, regardless of whether the evidence or testimony would pertain to an appraisal made prior to or after the effective date of disqualification.

(2) Any appraisal made by a disqualified appraiser after the effective date of disqualification will not have any probative effect in any administrative proceeding before the Department of the Treasury or the Internal Revenue Service. An appraisal otherwise barred from admission into evidence pursuant to this section may be admitted into evidence solely for the purpose of determining the taxpayer's reliance in good faith on such appraisal.

(c) *Authority to impose monetary penalty —*

(1) *In general.*

(i) The Secretary of the Treasury, or delegate, after notice and an opportunity for a proceeding, may impose a monetary penalty on any practitioner who engages in conduct subject to sanction under paragraph (a) of this section.

(ii) If the practitioner described in paragraph (c)(1)(i) of this section was acting on behalf of an employer or any firm or other entity in connection with the conduct giving rise to the penalty, the Secretary of the Treasury, or delegate, may impose a monetary penalty on the employer, firm, or entity if it knew, or reasonably should have known of such conduct.

(2) *Amount of penalty.* The amount of the penalty shall not exceed the gross income derived (or to be derived) from the conduct giving rise to the penalty.

(3) *Coordination with other sanctions.* Subject to paragraph (c)(2) of this section —

(i) Any monetary penalty imposed on a practitioner under this paragraph (c) may be in addition to or in lieu of any suspension, disbarment or censure and may be in addition to a penalty imposed on an employer, firm or other entity under paragraph (c)(1)(ii) of this section.

(ii) Any monetary penalty imposed on an employer, firm or other entity may be in addition to or in lieu of penalties imposed under paragraph (c)(1)(i) of this section.

(d) *Authority to accept a practitioner's consent to sanction.* The Internal Revenue Service may accept a practitioner's offer of consent to be sanctioned under §10.50 in lieu of instituting or continuing a proceeding under §10.60(a).

(e) *Sanctions to be imposed.* The sanctions imposed by this section shall take into account all relevant facts and circumstances.

(f) *Effective/applicability date.* This section is applicable to conduct occurring on or after August 2, 2011, except that paragraphs (a), (b)(2), and (e) apply to conduct occurring on or after September 26, 2007, and paragraph (c) applies to prohibited conduct that occurs after October 22, 2004.

§ 10.51 Incompetence and disreputable conduct.

(a) *Incompetence and disreputable conduct.* Incompetence and disreputable conduct for which a practitioner may be sanctioned under §10.50 includes, but is not limited to —

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(1) Conviction of any criminal offense under the Federal tax laws.

(2) Conviction of any criminal offense involving dishonesty or breach of trust.

(3) Conviction of any felony under Federal or State law for which the conduct involved renders the practitioner unfit to practice before the Internal Revenue Service.

(4) Giving false or misleading information, or participating in any way in the giving of false or misleading information to the Department of the Treasury or any officer or employee thereof, or to any tribunal authorized to pass upon Federal tax matters, in connection with any matter pending or likely to be pending before them, knowing the information to be false or misleading. Facts or other matters contained in testimony, Federal tax returns, financial statements, applications for enrollment, affidavits, declarations, and any other document or statement, written or oral, are included in the term "information."

(5) Solicitation of employment as prohibited under §10.30, the use of false or misleading representations with intent to deceive a client or prospective client in order to procure employment, or intimating that the practitioner is able improperly to obtain special consideration or action from the Internal Revenue Service or any officer or employee thereof.

(6) Willfully failing to make a Federal tax return in violation of the Federal tax laws, or willfully evading, attempting to evade, or participating in any way in evading or attempting to evade any assessment or payment of any Federal tax.

(7) Willfully assisting, counseling, encouraging a client or prospective client in violating, or suggesting to a client or prospective client to violate, any Federal tax law, or knowingly counseling or suggesting to a client or prospective client an illegal plan to evade Federal taxes or payment thereof.

(8) Misappropriation of, or failure properly or promptly to remit, funds received from a client for the purpose of payment of taxes or other obligations due the United States.

(9) Directly or indirectly attempting to influence, or offering or agreeing to attempt to influence, the official action of any officer or employee of the Internal Revenue Service by the use of threats, false accusations, duress or coercion, by the offer of any special inducement or promise of an advantage or by the bestowing of any gift, favor or thing of value.

(10) Disbarment or suspension from practice as an attorney, certified public accountant, public accountant, or actuary by any duly constituted authority of any State, territory, or possession of the United States, including a Commonwealth, or the District of Columbia, any Federal court of record or any Federal agency, body or board.

(11) Knowingly aiding and abetting another person to practice before the Internal Revenue Service during a period of suspension, disbarment or ineligibility of such other person.

(12) Contemptuous conduct in connection with practice before the Internal Revenue Service, including the use of abusive language, making false accusations or statements, knowing them to be false, or circulating or publishing malicious or libelous matter.

(13) Giving a false opinion, knowingly, recklessly, or through gross incompetence, including an opinion which is intentionally or recklessly misleading, or engaging in a pattern of providing incompetent opinions on questions arising under the Federal tax laws. False opinions described in this paragraph (a)(13) include those which reflect or result from a knowing misstatement of fact or law, from an assertion of a position known to be unwarranted under existing law, from counseling or assisting in conduct known to be illegal or fraudulent, from concealing matters required by law to be revealed, or from consciously disregarding information indicating that material facts expressed in the opinion or offering material are false or misleading. For purposes of this paragraph (a)(13), reckless conduct is a highly unreasonable omission or misrepresentation involving an extreme departure from the standards of ordinary care that a practitioner should observe under the circumstances. A pattern of conduct is a factor that will be taken into account in determining whether a practitioner acted knowingly, recklessly, or through gross incompetence. Gross incompetence

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includes conduct that reflects gross indifference, preparation which is grossly inadequate under the circumstances, and a consistent failure to perform obligations to the client.

(14) Willfully failing to sign a tax return prepared by the practitioner when the practitioner's signature is required by Federal tax laws unless the failure is due to reasonable cause and not due to willful neglect.

(15) Willfully disclosing or otherwise using a tax return or tax return information in a manner not authorized by the Internal Revenue Code, contrary to the order of a court of competent jurisdiction, or contrary to the order of an administrative law judge in a proceeding instituted under §10.60.

(16) Willfully failing to file on magnetic or other electronic media a tax return prepared by the practitioner when the practitioner is required to do so by the Federal tax laws unless the failure is due to reasonable cause and not due to willful neglect.

(17) Willfully preparing all or substantially all of, or signing, a tax return or claim for refund when the practitioner does not possess a current or otherwise valid preparer tax identification number or other prescribed identifying number.

(18) Willfully representing a taxpayer before an officer or employee of the Internal Revenue Service unless the practitioner is authorized to do so pursuant to this part.

(b) *Effective/applicability date.* This section is applicable beginning August 2, 2011.

§ 10.52 Violations subject to sanction.

(a) A practitioner may be sanctioned under §10.50 if the practitioner —

(1) Willfully violates any of the regulations (other than §10.33) contained in this part; or

(2) Recklessly or through gross incompetence (within the meaning of §10.51(a)(13)) violates §§ 10.34, 10.35, 10.36 or 10.37.

(b) *Effective/applicability date.* This section is applicable to conduct occurring on or after September 26, 2007.

§ 10.53 Receipt of information concerning practitioner.

(a) *Officer or employee of the Internal Revenue Service*. If an officer or employee of the Internal Revenue Service has reason to believe a practitioner has violated any provision of this part, the officer or employee will promptly make a written report of the suspected violation. The report will explain the facts and reasons upon which the officer's or employee's belief rests and must be submitted to the office(s) of the Internal Revenue Service responsible for administering or enforcing this part.

(b) *Other persons*. Any person other than an officer or employee of the Internal Revenue Service having information of a violation of any provision of this part may make an oral or written report of the alleged violation to the office(s) of the Internal Revenue Service responsible for administering or enforcing this part or any officer or employee of the Internal Revenue Service. If the report is made to an officer or employee of the Internal Revenue Service, the officer or employee will make a written report of the suspected violation and submit the report to the office(s) of the Internal Revenue Service responsible for administering or enforcing this part.

(c) *Destruction of report*. No report made under paragraph (a) or (b) of this section shall be maintained unless retention of the report is permissible under the applicable records control schedule as approved by the National Archives and Records Administration and designated in the Internal Revenue Manual. Reports must be destroyed as soon as permissible under the applicable records control schedule.

(d) *Effect on proceedings under subpart D*. The destruction of any report will not bar any proceeding under subpart D of this part, but will preclude the use of a copy of the report in a proceeding under subpart D of this part.

(e) *Effective/applicability date*. This section is applicable beginning August 2, 2011.

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Subpart D — Rules Applicable to Disciplinary Proceedings

§ 10.60 Institution of proceeding.

(a) Whenever it is determined that a practitioner (or employer, firm or other entity, if applicable) violated any provision of the laws governing practice before the Internal Revenue Service or the regulations in this part, the practitioner may be reprimanded or, in accordance with §10.62, subject to a proceeding for sanctions described in §10.50.

(b) Whenever a penalty has been assessed against an appraiser under the Internal Revenue Code and an appropriate officer or employee in an office established to enforce this part determines that the appraiser acted willfully, recklessly, or through gross incompetence with respect to the proscribed conduct, the appraiser may be reprimanded or, in accordance with §10.62, subject to a proceeding for disqualification. A proceeding for disqualification of an appraiser is instituted by the filing of a complaint, the contents of which are more fully described in §10.62.

(c) Except as provided in §10.82, a proceeding will not be instituted under this section unless the proposed respondent previously has been advised in writing of the law, facts and conduct warranting such action and has been accorded an opportunity to dispute facts, assert additional facts, and make arguments (including an explanation or description of mitigating circumstances).

(d) *Effective/applicability date.* This section is applicable beginning August 2, 2011.

§ 10.61 Conferences.

(a) *In general.* The Commissioner, or delegate, may confer with a practitioner, employer, firm or other entity, or an appraiser concerning allegations of misconduct irrespective of whether a proceeding has been instituted. If the conference results in a stipulation in connection with an ongoing proceeding in which the practitioner, employer, firm or other entity, or appraiser is the respondent, the stipulation may be entered in the record by either party to the proceeding.

(b) *Voluntary sanction* —

(1) *In general.* In lieu of a proceeding being instituted or continued under §10.60(a), a practitioner or appraiser (or employer, firm or other entity, if applicable) may offer a consent to be sanctioned under §10.50.

(2) *Discretion; acceptance or declination.* The Commissioner, or delegate, may accept or decline the offer described in paragraph (b)(1) of this section. When the decision is to decline the offer, the written notice of declination may state that the offer described in paragraph (b)(1) of this section would be accepted if it contained different terms. The Commissioner, or delegate, has the discretion to accept or reject a revised offer submitted in response to the declination or may counteroffer and act upon any accepted counteroffer.

(c) *Effective/applicability date.* This section is applicable beginning August 2, 2011.

§ 10.62 Contents of complaint.

(a) *Charges*. A complaint must name the respondent, provide a clear and concise description of the facts and law that constitute the basis for the proceeding, and be signed by an authorized representative of the Internal Revenue Service under §10.69(a)(1). A complaint is sufficient if it fairly informs the respondent of the charges brought so that the respondent is able to prepare a defense.

(b) *Specification of sanction*. The complaint must specify the sanction sought against the practitioner or appraiser. If the sanction sought is a suspension, the duration of the suspension sought must be specified.

(c) *Demand for answer*. The respondent must be notified in the complaint or in a separate paper attached to the complaint of the time for answering the complaint, which may not be less than 30 days from the date of service of the complaint, the name and address of the Administrative Law Judge with whom the answer must be filed, the name and address of the person representing the Internal Revenue Service to whom a copy of the answer must be served, and

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that a decision by default may be rendered against the respondent in the event an answer is not filed as required.

(d) *Effective/applicability date.* This section is applicable beginning August 2, 2011.

§ 10.63 Service of complaint; service of other papers; service of evidence in support of complaint; filing of papers.

(a) *Service of complaint.*

(1) *In general.* The complaint or a copy of the complaint must be served on the respondent by any manner described in paragraphs (a) (2) or (3) of this section.

(2) *Service by certified or first class mail.*

(i) Service of the complaint may be made on the respondent by mailing the complaint by certified mail to the last known address (as determined under section 6212 of the Internal Revenue Code and the regulations thereunder) of the respondent. Where service is by certified mail, the returned post office receipt duly signed by the respondent will be proof of service.

(ii) If the certified mail is not claimed or accepted by the respondent, or is returned undelivered, service may be made on the respondent, by mailing the complaint to the respondent by first class mail. Service by this method will be considered complete upon mailing, provided the complaint is addressed to the respondent at the respondent's last known address as determined under section 6212 of the Internal Revenue Code and the regulations thereunder.

(3) *Service by other than certified or first class mail.*

(i) Service of the complaint may be made on the respondent by delivery by a private delivery service designated pursuant to section 7502(f) of the Internal Revenue Code to the last known address (as determined under section 6212 of the Internal Revenue Code and the regulations there under) of the respondent. Service by this method will be considered complete, provided the complaint is addressed to the respondent at the respondent's last known address as determined under section 6212 of the Internal Revenue Code and the regulations thereunder.

(ii) Service of the complaint may be made in person on, or by leaving the complaint at the office or place of business of, the respondent. Service by this method will be considered complete and proof of service will be a written statement, sworn or affirmed by the person who served the complaint, identifying the manner of service, including the recipient, relationship of recipient to respondent, place, date and time of service.

(iii) Service may be made by any other means agreed to by the respondent. Proof of service will be a written statement, sworn or affirmed by the person who served the complaint, identifying the manner of service, including the recipient, relationship of recipient to respondent, place, date and time of service.

(4) For purposes of this section, *respondent* means the practitioner, employer, firm or other entity, or appraiser named in the complaint or any other person having the authority to accept mail on behalf of the practitioner, employer, firm or other entity or appraiser.

(b) *Service of papers other than complaint.* Any paper other than the complaint may be served on the respondent, or his or her authorized representative under §10.69(a)(2) by:

(1) mailing the paper by first class mail to the last known address (as determined under section 6212 of the Internal Revenue Code and the regulations thereunder) of the respondent or the respondent's authorized representative,

(2) delivery by a private delivery service designated pursuant to section 7502(f) of the Internal Revenue Code to the last known address (as determined under section 6212 of the Internal Revenue Code and the regulations thereunder) of the respondent or the respondent's authorized representative, or

(3) as provided in paragraphs (a)(3)(ii) and (a)(3)(iii) of this section.

(c) *Service of papers on the Internal Revenue Service.* Whenever a paper is required or permitted to be served on the Internal Revenue Service in

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connection with a proceeding under this part, the paper will be served on the Internal Revenue Service's authorized representative under §10.69(a)(1) at the address designated in the complaint, or at an address provided in a notice of appearance. If no address is designated in the complaint or provided in a notice of appearance, service will be made on the office(s) established to enforce this part under the authority of §10.1, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC 20224.

(d) *Service of evidence in support of complaint.* Within 10 days of serving the complaint, copies of the evidence in support of the complaint must be served on the respondent in any manner described in paragraphs (a)(2) and (3) of this section.

(e) *Filing of papers.* Whenever the filing of a paper is required or permitted in connection with a proceeding under this part, the original paper, plus one additional copy, must be filed with the Administrative Law Judge at the address specified in the complaint or at an address otherwise specified by the Administrative Law Judge. All papers filed in connection with a proceeding under this part must be served on the other party, unless the Administrative Law Judge directs otherwise. A certificate evidencing such must be attached to the original paper filed with the Administrative Law Judge.

(f) *Effective/applicability date.* This section is applicable beginning August 2, 2011.

§ 10.64 Answer; default.

(a) *Filing.* The respondent's answer must be filed with the Administrative Law Judge, and served on the Internal Revenue Service, within the time specified in the complaint unless, on request or application of the respondent, the time is extended by the Administrative Law Judge.

(b) *Contents.* The answer must be written and contain a statement of facts that constitute the respondent's grounds of defense. General denials are not permitted. The respondent must specifically admit or deny each allegation set forth in the complaint, except that the respondent may state that the respondent is without sufficient information to admit or deny a specific allegation. The respondent, nevertheless, may not deny a material allegation in the complaint that the respondent knows to be true, or state that the respondent is without sufficient information to form a belief, when the respondent possesses the required information. The respondent also must state affirmatively any special matters of defense on which he or she relies.

(c) *Failure to deny or answer allegations in the complaint.* Every allegation in the complaint that is not denied in the answer is deemed admitted and will be considered proved; no further evidence in respect of such allegation need be adduced at a hearing.

(d) *Default.* Failure to file an answer within the time prescribed (or within the time for answer as extended by the Administrative Law Judge), constitutes an admission of the allegations of the complaint and a waiver of hearing, and the Administrative Law Judge may make the decision by default without a hearing or further procedure. A decision by default constitutes a decision under §10.76.

(e) *Signature.* The answer must be signed by the respondent or the respondent's authorized representative under §10.69(a)(2) and must include a statement directly above the signature acknowledging that the statements made in the answer are true and correct and that knowing and willful false statements may be punishable under 18 U.S.C. §1001.

(f) Effective/applicability date. This section is applicable beginning August 2, 2011.

§ 10.65 Supplemental charges.

(a) *In general*. Supplemental charges may be filed against the respondent by amending the complaint with the permission of the Administrative Law Judge if, for example —

(1) It appears that the respondent, in the answer, falsely and in bad faith, denies a material allegation of fact in the complaint or states that the respondent has insufficient knowledge to form a belief, when the respondent possesses such information; or

(2) It appears that the respondent has knowingly

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introduced false testimony during the proceedings against the respondent.

(b) *Hearing.* The supplemental charges may be heard with other charges in the case, provided the respondent is given due notice of the charges and is afforded a reasonable opportunity to prepare a defense to the supplemental charges.

(c) *Effective/applicability date.* This section is applicable beginning August 2, 2011.

§ 10.66 Reply to answer.

(a) The Internal Revenue Service may file a reply to the respondent's answer, but unless otherwise ordered by the Administrative Law Judge, no reply to the respondent's answer is required. If a reply is not filed, new matter in the answer is deemed denied.

(b) *Effective/applicability date.* This section is applicable beginning August 2, 2011.

§ 10.67 Proof; variance; amendment of pleadings.

In the case of a variance between the allegations in pleadings and the evidence adduced in support of the pleadings, the Administrative Law Judge, at any time before decision, may order or authorize amendment of the pleadings to conform to the evidence. The party who would otherwise be prejudiced by the amendment must be given a reasonable opportunity to address the allegations of the pleadings as amended and the Administrative Law Judge must make findings on any issue presented by the pleadings as amended.

§ 10.68 Motions and requests.

(a) *Motions* —

(1) *In general.* At any time after the filing of the complaint, any party may file a motion with the Administrative Law Judge. Unless otherwise ordered by the Administrative Law Judge, motions must be in writing and must be served on the opposing party as provided in §10.63(b). A motion must concisely specify its grounds and the relief sought, and, if appropriate, must contain a memorandum of facts and law in support.

(2) *Summary adjudication.* Either party may move for a summary adjudication upon all or any part of the legal issues in controversy. If the non-moving party opposes summary adjudication in the moving party's favor, the non-moving party must file a written response within 30 days unless ordered otherwise by the Administrative Law Judge.

(3) *Good Faith.* A party filing a motion for extension of time, a motion for postponement of a hearing, or any other non-dispositive or procedural motion must first contact the other party to determine whether there is any objection to the motion, and must state in the motion whether the other party has an objection.

(b) *Response.* Unless otherwise ordered by the Administrative Law Judge, the nonmoving party is not required to file a response to a motion. If the Administrative Law Judge does not order the nonmoving party to file a response, and the nonmoving party files no response, the nonmoving party is deemed to oppose the motion. If a nonmoving party does not respond within 30 days of the filing of a motion for decision by default for failure to file a timely answer or for failure to prosecute, the nonmoving party is deemed not to oppose the motion.

(c) *Oral motions; oral argument* —

(1) The Administrative Law Judge may, for good cause and with notice to the parties, permit oral motions and oral opposition to motions.

(2) The Administrative Law Judge may, within his or her discretion, permit oral argument on any motion.

(d) *Orders.* The Administrative Law Judge should issue written orders disposing of any motion or request and any response thereto.

(e) *Effective/applicability date.* This section is applicable on September 26, 2007.

§ 10.69 Representation; ex parte communication.

(a) *Representation*.

(1) The Internal Revenue Service may be represented in proceedings under this part by an attorney or other employee of the Internal Revenue Service. An attorney or an employee of the Internal

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Revenue Service representing the Internal Revenue Service in a proceeding under this part may sign the complaint or any document required to be filed in the proceeding on behalf of the Internal Revenue Service.

(2) A respondent may appear in person, be represented by a practitioner, or be represented by an attorney who has not filed a declaration with the Internal Revenue Service pursuant to §10.3. A practitioner or an attorney representing a respondent or proposed respondent may sign the answer or any document required to be filed in the proceeding on behalf of the respondent.

(b) *Ex parte communication*. The Internal Revenue Service, the respondent, and any representatives of either party, may not attempt to initiate or participate in ex parte discussions concerning a proceeding or potential proceeding with the Administrative Law Judge (or any person who is likely to advise the Administrative Law Judge on a ruling or decision) in the proceeding before or during the pendency of the proceeding. Any memorandum, letter or other communication concerning the merits of the proceeding, addressed to the Administrative Law Judge, by or on behalf of any party shall be regarded as an argument in the proceeding and shall be served on the othe party.

(c) *Effective/applicability date*. This section is applicable beginning August 2, 2011.

§ 10.70 Administrative Law Judge.

(a) *Appointment.* Proceedings on complaints for the sanction (as described in §10.50) of a practitioner, employer, firm or other entity, or appraiser will be conducted by an Administrative Law Judge appointed as provided by *5 U.S.C. 3105*.

(b) *Powers of the Administrative Law Judge.* The Administrative Law Judge, among other powers, has the authority, in connection with any proceeding under §10.60 assigned or referred to him or her, to do the following:

(1) Administer oaths and affirmations;

(2) Make rulings on motions and requests, which rulings may not be appealed prior to the close of a hearing except in extraordinary circumstances and at the discretion of the Administrative Law Judge;

(3) Determine the time and place of hearing and regulate its course and conduct;

(4) Adopt rules of procedure and modify the same from time to time as needed for the orderly disposition of proceedings;

(5) Rule on offers of proof, receive relevant evidence, and examine witnesses;

(6) Take or authorize the taking of depositions or answers to requests for admission;

(7) Receive and consider oral or written argument on facts or law;

(8) Hold or provide for the holding of conferences for the settlement or simplification of the issues with the consent of the parties;

(9) Perform such acts and take such measures as are necessary or appropriate to the efficient conduct of any proceeding; and

(10) Make decisions.

(c) *Effective/applicability date.* This section is applicable on September 26, 2007.

§ 10.71 Discovery.

(a) *In general.* Discovery may be permitted, at the discretion of the Administrative Law Judge, only upon written motion demonstrating the relevance, materiality and reasonableness of the requested discovery and subject to the requirements of §10.72(d)(2) and (3). Within 10 days of receipt of the answer, the Administrative Law Judge will notify the parties of the right to request discovery and the timeframe for filing a request. A request for discovery, and objections, must be filed in accordance with §10.68. In response to a request for discovery, the Administrative Law Judge may order —

(1) Depositions upon oral examination; or

(2) Answers to requests for admission.

(b) *Depositions upon oral examination* —

(1) A deposition must be taken before an officer duly authorized to administer an oath for general purposes or before an officer or employee of the Internal Revenue Service who is authorized to administer an oath in Federal tax law matters.

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(2) In ordering a deposition, the Administrative Law Judge will require reasonable notice to the opposing party as to the time and place of the deposition. The opposing party, if attending, will be provided the opportunity for full examination and cross-examination of any witness.

(3) Expenses in the reporting of depositions shall be borne by the party at whose instance the deposition is taken. Travel expenses of the deponent shall be borne by the party requesting the deposition, unless otherwise authorized by Federal law or regulation.

(c) *Requests for admission.* Any party may serve on any other party a written request for admission of the truth of any matters which are not privileged and are relevant to the subject matter of this proceeding. Requests for admission shall not exceed a total of 30 (including any subparts within a specific request) without the approval from the Administrative Law Judge.

(d) *Limitations.* Discovery shall not be authorized if —

(1) The request fails to meet any requirement set forth in paragraph (a) of this section;

(2) It will unduly delay the proceeding;

(3) It will place an undue burden on the party required to produce the discovery sought;

(4) It is frivolous or abusive;

(5) It is cumulative or duplicative;

(6) The material sought is privileged or otherwise protected from disclosure by law;

(7) The material sought relates to mental impressions, conclusions, of legal theories of any party, attorney, or other representative, or a party prepared in the anticipation of a proceeding; or

(8) The material sought is available generally to the public, equally to the parties, or to the party seeking the discovery through another source.

(e) *Failure to comply.* Where a party fails to comply with an order of the Administrative Law Judge under this section, the Administrative Law Judge may, among other things, infer that the information would be adverse to the party failing to provide it, exclude the information from evidence or issue a decision by default.

(f) *Other discovery.* No discovery other than that specifically provided for in this section is permitted.

(g) *Effective/applicability date.* This section is applicable to proceedings initiated on or after September 26, 2007.

§ 10.72 Hearings.

(a) *In general* —

(1) *Presiding officer.* An Administrative Law Judge will preside at the hearing on a complaint filed under §10.60 for the sanction of a practitioner, employer, firm or other entity, or appraiser.

(2) *Time for hearing.* Absent a determination by the Administrative Law Judge that, in the interest of justice, a hearing must be held at a later time, the Administrative Law Judge should, on notice sufficient to allow proper preparation, schedule the hearing to occur no later than 180 days after the time for filing the answer.

(3) *Procedural requirements.*

(i) Hearings will be stenographically recorded and transcribed and the testimony of witnesses will be taken under oath or affirmation.

(ii) Hearings will be conducted pursuant to *5 U.S.C. 556*.

(iii) A hearing in a proceeding requested under §10.82(g) will be conducted de novo.

(iv) An evidentiary hearing must be held in all proceedings prior to the issuance of a decision by the Administrative Law Judge unless —

(A) The Internal Revenue Service withdraws the complaint;

(B) A decision is issued by default pursuant to §10.64(d);

(C) A decision is issued under §10.82 (e);

(D) The respondent requests a decision on the written record without a hearing; or

(E) The Administrative Law Judge issues a decision under §10.68(d) or rules on another motion that disposes of the case prior to the hearing.

(b) *Cross-examination.* A party is entitled to present his or her case or defense by oral or documentary evidence, to submit rebuttal evidence, and to conduct cross-examination, in the presence of the Administrative Law Judge, as may be required for a full and true disclosure of the facts. This

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paragraph (b) does not limit a party from presenting evidence contained within a deposition when the Administrative Law Judge determines that the deposition has been obtained in compliance with the rules of this subpart D.

(c) *Prehearing memorandum.* Unless otherwise ordered by the Administrative Law Judge, each party shall file, and serve on the opposing party or the opposing party's representative, prior to any hearing, a prehearing memorandum containing —

(1) A list (together with a copy) of all proposed exhibits to be used in the party's case in chief;

(2) A list of proposed witnesses, including a synopsis of their expected testimony, or a statement that no witnesses will be called;

(3) Identification of any proposed expert witnesses, including a synopsis of their expected testimony and a copy of any report prepared by the expert or at his or her direction; and

(4) A list of undisputed facts.

(d) *Publicity* —

(1) *In general.* All reports and decisions of the Secretary of the Treasury, or delegate, including any reports and decisions of the Administrative Law Judge, under this subpart D are, subject to the protective measures in paragraph (d)(4) of this section, public and open to inspection within 30 days after the agency's decision becomes final.

(2) *Request for additional publicity.* The Administrative Law Judge may grant a request by a practitioner or appraiser that all the pleadings and evidence of the disciplinary proceeding be made available for inspection where the parties stipulate in advance to adopt the protective measures in paragraph (d)(4) of this section.

(3) *Returns and return information* —

(i) *Disclosure to practitioner or appraiser.* Pursuant to *section 6103(l)(4) of the Internal Revenue Code,* the Secretary of the Treasury, or delegate, may disclose returns and return information to any practitioner or appraiser, or to the authorized representative of the practitioner or appraiser, whose rights are or may be affected by an administrative action or proceeding under this subpart D, but solely for use in the action or proceeding and only to the extent that the Secretary of the Treasury, or delegate, determines that the returns or return information are or may be relevant and material to the action or proceeding.

(ii) *Disclosure to officers and employees of the Department of the Treasury.* Pursuant to *section 6103(l)(4)(B) of the Internal Revenue Code* the Secretary of the Treasury, or delegate, may disclose returns and return information to officers and employees of the Department of the Treasury for use in any action or proceeding under this subpart D, to the extent necessary to advance or protect the interests of the United States.

(iii) *Use of returns and return information.* Recipients of returns and return information under this paragraph (d)(3) may use the returns or return information solely in the action or proceeding, or in preparation for the action or proceeding, with respect to which the disclosure was made.

(iv) *Procedures for disclosure of returns and return information.* When providing returns or return information to the practitioner or appraiser, or authorized representative, the Secretary of the Treasury, or delegate, will —

(A) Redact identifying information of any third party taxpayers and replace it with a code;

(B) Provide a key to the coded information; and

(C) Notify the practitioner or appraiser, or authorized representative, of the restrictions on the use and disclosure of the returns and return information, the applicable damages remedy under *section 7431 of the Internal Revenue Code*, and that unauthorized disclosure of information provided by the Internal Revenue Service under this paragraph (d)(3) is also a violation of this part.

(4) *Protective measures* —

(i) *Mandatory protection order.* If redaction of names, addresses, and other identifying information of third party taxpayers may still permit indirect identification of any third party taxpayer, the Administrative Law Judge will issue a protective order to ensure that the identifying information is available to the parties and the Administrative Law Judge for purposes of the proceeding, but is not

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disclosed to, or open to inspection by, the public.

(ii) *Authorized orders.*

(A) Upon motion by a party or any other affected person, and for good cause shown, the Administrative Law Judge may make any order which justice requires to protect any person in the event disclosure of information is prohibited by law, privileged, confidential, or sensitive in some other way, including, but not limited to, one or more of the following —

(1) That disclosure of information be made only on specified terms and conditions, including a designation of the time or place;

(2) That a trade secret or other information not be disclosed, or be disclosed only in a designated way.

(iii) *Denials.* If a motion for a protective order is denied in whole or in part, the Administrative Law Judge may, on such terms or conditions as the Administrative Law Judge deems just, order any party or person to comply with, or respond in accordance with, the procedure involved.

(iv) *Public inspection of documents.* The Secretary of the Treasury, or delegate, shall ensure that all names, addresses or other identifying details of third party taxpayers are redacted and replaced with the code assigned to the corresponding taxpayer in all documents prior to public inspection of such documents.

(e) *Location.* The location of the hearing will be determined by the agreement of the parties with the approval of the Administrative Law Judge, but, in the absence of such agreement and approval, the hearing will be held in Washington, D.C.

(f) *Failure to appear.* If either party to the proceeding fails to appear at the hearing, after notice of the proceeding has been sent to him or her, the party will be deemed to have waived the right to a hearing and the Administrative Law Judge may make his or her decision against the absent party by default.

(g) *Effective/applicability date.* This section is applicable beginning August 2, 2011.

§ 10.73 Evidence.

(a) *In general.* The rules of evidence prevailing in courts of law and equity are not controlling in hearings or proceedings conducted under this part. The Administrative Law Judge may, however, exclude evidence that is irrelevant, immaterial, or unduly repetitious.

(b) *Depositions.* The deposition of any witness taken pursuant to §10.71 may be admitted into evidence in any proceeding instituted under §10.60.

(c) *Requests for admission.* Any matter admitted in response to a request for admission under §10.71 is conclusively established unless the Administrative Law Judge on motion permits withdrawal or modification of the admission. Any admission made by a party is for the purposes of the pending action only and is not an admission by a party for any other purpose, nor may it be used against a party in any other proceeding.

(d) *Proof of documents.* Official documents, records, and papers of the Internal Revenue Service and the Office of Professional Responsibility are admissible in evidence without the production of an officer or employee to authenticate them. Any documents, records, and papers may be evidenced by a copy attested to or identified by an officer or employee of the Internal Revenue Service or the Treasury Department, as the case may be.

(e) *Withdrawal of exhibits.* If any document, record, or other paper is introduced in evidence as an exhibit, the Administrative Law Judge may authorize the withdrawal of the exhibit subject to any conditions that he or she deems proper.

(f) *Objections.* Objections to evidence are to be made in short form, stating the grounds for the objection. Except as ordered by the Administrative Law Judge, argument on objections will not be recorded or transcribed. Rulings on objections are to be a part of the record, but no exception to a ruling is necessary to preserve the rights of the parties.

(g) *Effective/applicability date.* This section is applicable on September 26, 2007.

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§ 10.74 Transcript.

In cases where the hearing is stenographically reported by a Government contract reporter, copies of the transcript may be obtained from the reporter at rates not to exceed the maximum rates fixed by contract between the Government and the reporter. Where the hearing is stenographically reported by a regular employee of the Internal Revenue Service, a copy will be supplied to the respondent either without charge or upon the payment of a reasonable fee. Copies of exhibits introduced at the hearing or at the taking of depositions will be supplied to the parties upon the payment of a reasonable fee (Sec. 501, Public Law 82-137) (65 Stat. 290) (31 U.S.C. § 483a).

§ 10.75 Proposed findings and conclusions.

Except in cases where the respondent has failed to answer the complaint or where a party has failed to appear at the hearing, the parties must be afforded a reasonable opportunity to submit proposed findings and conclusions and their supporting reasons to the Administrative Law Judge.

§ 10.76 Decision of Administrative Law Judge.

(a) *In general* —

(1) *Hearings.* Within 180 days after the conclusion of a hearing and the receipt of any proposed findings and conclusions timely submitted by the parties, the Administrative Law Judge should enter a decision in the case. The decision must include a statement of findings and conclusions, as well as the reasons or basis for making such findings and conclusions, and an order of censure, suspension, disbarment, monetary penalty, disqualification, or dismissal of the complaint.

(2) *Summary adjudication.* In the event that a motion for summary adjudication is filed, the Administrative Law Judge should rule on the motion for summary adjudication within 60 days after the party in opposition files a written response, or if no written response is filed, within 90 days after the motion for summary adjudication is filed. A decision shall thereafter be rendered if the pleadings, depositions, admissions, and any other admissible evidence show that there is no genuine issue of material fact and that a decision may be rendered as a matter of law. The decision must include a statement of conclusions, as well as the reasons or basis for making such conclusions, and an order of censure, suspension, disbarment, monetary penalty, disqualification, or dismissal of the complaint.

(3) *Returns and return information.* In the decision, the Administrative Law Judge should use the code assigned to third party taxpayers (described in §10.72(d)).

(b) *Standard of proof.* If the sanction is censure or a suspension of less than six months' duration, the Administrative Law Judge, in rendering findings and conclusions, will consider an allegation of fact to be proven if it is established by the party who is alleging the fact by a preponderance of the evidence in the record. If the sanction is a monetary penalty, disbarment or a suspension of six months or longer duration, an allegation of fact that is necessary for a finding against the practitioner must be proven by clear and convincing evidence in the record. An allegation of fact that is necessary for a finding of disqualification against an appraiser must be proved by clear and convincing evidence in the record.

(c) *Copy of decision.* The Administrative Law Judge will provide the decision to the Internal Revenue Service's authorized representative, and a copy of the decision to the respondent or the respondent's authorized representative.

(d) *When final.* In the absence of an appeal to the Secretary of the Treasury or delegate, the decision of the Administrative Law Judge will, without further proceedings, become the decision of the agency 30 days after the date of the Administrative Law Judge's decision.

(e) *Effective/applicability date.* This section is applicable beginning August 2, 2011.

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§ 10.77 Appeal of decision of Administrative Law Judge.

(a) *Appeal*. Any party to the proceeding under this subpart D may appeal the decision of the Administrative Law Judge by filing a notice of appeal with the Secretary of the Treasury, or delegate deciding appeals. The notice of appeal must include a brief that states exceptions to the decision of Administrative Law Judge and supporting reasons for such exceptions.

(b) *Time and place for filing of appeal*. The notice of appeal and brief must be filed, in duplicate, with the Secretary of the Treasury, or delegate deciding appeals, at an address for appeals that is identified to the parties with the decision of the Administrative Law Judge. The notice of appeal and brief must be filed within 30 days of the date that the decision of the Administrative Law Judge is served on the parties. The appealing party must serve a copy of the notice of appeal and the brief to any non appealing party or, if the party is represented, the non-appealing party's representative.

(c) *Response*. Within 30 days of receiving the copy of the appellant's brief, the other party may file a response brief with the Secretary of the Treasury, or delegate deciding appeals, using the address identified for appeals. A copy of the response brief must be served at the same time on the opposing party or, if the party is represented, the opposing party's representative.

(d) *No other briefs, responses or motions as of right*. Other than the appeal brief and response brief, the parties are not permitted to file any other briefs, responses or motions, except on a grant of leave to do so after a motion demonstrating sufficient cause, or unless otherwise ordered by the Secretary of the Treasury, or delegate deciding appeals.

(e) *Additional time for briefs and responses*. Notwithstanding the time for filing briefs and responses provided in paragraphs (b) and (c) of this section, the Secretary of the Treasury, or delegate deciding appeals, may, for good cause, authorize additional time for filing briefs and responses upon a motion of a party or upon the initiative of the Secretary of the Treasury, or delegate deciding appeals.

(f) *Effective/applicability date*. This section is applicable beginning August 2, 2011.

§ 10.78 Decision on review.

(a) *Decision on review.* On appeal from or review of the decision of the Administrative Law Judge, the Secretary of the Treasury, or delegate, will make the agency decision. The Secretary of the Treasury, or delegate, should make the agency decision within 180 days after receipt of the appeal

(b) *Standard of review.* The decision of the Administrative Law Judge will not be reversed unless the appellant establishes that the decision is clearly erroneous in light of the evidence in the record and applicable law. Issues that are exclusively matters of law will be reviewed de novo. In the event that the Secretary of the Treasury, or delegate, determines that there are unresolved issues raised by the record, the case may be remanded to the Administrative Law Judge to elicit additional testimony or evidence.

(c) *Copy of decision on review.* The Secretary of the Treasury, or delegate, will provide copies of the agency decision to the authorized representative of the Internal Revenue Service and the respondent or the respondent's authorized representative.

(d) *Effective/applicability date.* This section is applicable beginning August 2, 2011.

§ 10.79 Effect of disbarment, suspension, or censure.

(a) *Disbarment*. When the final decision in a case is against the respondent (or the respondent has offered his or her consent and such consent has been accepted by the Internal Revenue Service) and such decision is for disbarment, the respondent will not be permitted to practice before the Internal Revenue Service unless and until authorized to do so by the Internal Revenue Service pursuant to §10.81.

(b) *Suspension*. When the final decision in a case is against the respondent (or the respondent has offered his or her consent and such consent has been accepted by the Internal Revenue Service)

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and such decision is for suspension, the respondent will not be permitted to practice before the Internal Revenue Service during the period of suspension. For periods after the suspension, the practitioner's future representations may be subject to conditions as authorized by paragraph (d) of this section.

(c) *Censure*. When the final decision in the case is against the respondent (or the Internal Revenue Service has accepted the respondent's offer to consent, if such offer was made) and such decision is for censure, the respondent will be permitted to practice before the Internal Revenue Service, but the respondent's future representations may be subject to conditions as authorized by paragraph (d) of this section.

(d) *Conditions*. After being subject to the sanction of either suspension or censure, the future representations of a practitioner so sanctioned shall be subject to specified conditions designed to promote high standards of conduct. These conditions can be imposed for a reasonable period in light of the gravity of the practitioner's violations. For example, where a practitioner is censured because the practitioner failed to advise the practitioner's clients about a potential conflict of interest or failed to obtain the clients' written consents, the practitioner may be required to provide the Internal Revenue Service with a copy of all consents obtained by the practitioner for an appropriate period following censure, whether or not such consents are specifically requested.

(e) *Effective/applicability date*. This section is applicable beginning August 2, 2011.

§ 10.80 Notice of disbarment, suspension, censure, or disqualification.

(a) *In general*. On the issuance of a final order censuring, suspending, or disbarring a practitioner or a final order disqualifying an appraiser, notification of the censure, suspension, disbarment or disqualification will be given to appropriate officers and employees of the Internal Revenue Service and interested departments and agencies of the Federal government. The Internal Revenue Service may determine the manner of giving notice to the proper authorities of the State by which the censured, suspended, or disbarred person was licensed to practice.

(b) *Effective/applicability date*. This section is applicable beginning August 2, 2011.

§ 10.81 Petition for reinstatement.

(a) *In general*. A practitioner disbarred or suspended under §10.60, or suspended under §10.82, or a disqualified appraiser may petition for reinstatement before the Internal Revenue Service after the expiration of 5 years following such disbarment, suspension, or disqualification (or immediately following the expiration of the suspension or disqualification period, if shorter than 5 years). Reinstatement will not be granted unless the Internal Revenue Service is satisfied that the petitioner is not likely to engage thereafter in conduct contrary to the regulations in this part, and that granting such reinstatement would not be contrary to the public interest.

(b) *Effective/applicability date*. This section is applicable beginning June 12, 2014.

§ 10.82 Expedited suspension.

(a) *When applicable.* Whenever the Commissioner, or delegate, determines that a practitioner is described in paragraph (b) of this section, the expedited procedures described in this section may be used to suspend the practitioner from practice before the Internal Revenue Service.

(b) *To whom applicable.* This section applies to any practitioner who, within 5 years prior to the date that a show cause order under this section's expedited suspension procedures is served:

(1) Has had a license to practice as an attorney, certified public accountant, or actuary suspended or revoked for cause (not including a failure to pay a professional licensing fee) by any authority or court, agency, body, or board described in §10.51(a)(10).

(2) Has, irrespective of whether an appeal has been taken, been convicted of any crime under title

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26 of the United States Code, any crime involving dishonesty or breach of trust, or any felony for which the conduct involved renders the practitioner unfit to practice before the Internal Revenue Service.

(3) Has violated conditions imposed on the practitioner pursuant to §10.79(d).

(4) Has been sanctioned by a court of competent jurisdiction, whether in a civil or criminal proceeding (including suits for injunctive relief), relating to any taxpayer's tax liability or relating to the practitioner's own tax liability, for —

(i) Instituting or maintaining proceedings primarily for delay;

(ii) Advancing frivolous or groundless arguments; or

(iii) Failing to pursue available administrative remedies.

(5) Has demonstrated a pattern of willful disreputable conduct by—

(i) Failing to make an annual Federal tax return, in violation of the Federal tax laws, during 4 of the 5 tax years immediately preceding the institution of a proceeding under paragraph (c) of this section and remains noncompliant with any of the practitioner's Federal tax filing obligations at the time the notice of suspension is issued under paragraph (f) of this section; or

(ii) Failing to make a return required more frequently than annually, in violation of the Federal tax laws, during 5 of the 7 tax periods immediately preceding the institution of a proceeding under paragraph (c) of this section and remains noncompliant with any of the practitioner's Federal tax filing obligations at the time the notice of suspension is issued under paragraph (f) of this section.

(c) *Expedited suspension procedures.* A suspension under this section will be proposed by a show cause order that names the respondent, is signed by an authorized representative of the Internal Revenue Service under §10.69(a)(1), and served according to the rules set forth in §10.63(a). The show cause order must give a plain and concise description of the allegations that constitute the basis for the proposed suspension. The show cause order must notify the respondent —

(1) Of the place and due date for filing a response;

(2) That an expedited suspension decision by default may be rendered if the respondent fails to file a response as required;

(3) That the respondent may request a conference to address the merits of the show cause order and that any such request must be made in the response; and

(4) That the respondent may be suspended either immediately following the expiration of the period within which a response must be filed or, if a conference is requested, immediately following the conference.

(d) *Response*. The response to the show cause order described in this section must be filed no later than 30 calendar days following the date the show cause order is served, unless the time for filing is extended. The response must be filed in accordance with the rules set forth for answers to a complaint in §10.64, except as otherwise provided in this section. The response must include a request for a conference, if a conference is desired. The respondent is entitled to the conference only if the request is made in a timely filed response.

(e) *Conference*. An authorized representative of the Internal Revenue Service will preside at a conference described in this section. The conference will be held at a place and time selected by the Internal Revenue Service, but no sooner than 14 calendar days after the date by which the response must be filed with the Internal Revenue Service, unless the respondent agrees to an earlier date. An authorized representative may represent the respondent at the conference.

(f) *Suspension*—

(1) *In general.* The Commissioner, or delegate, may suspend the respondent from practice before the Internal Revenue Service by a written notice of expedited suspension immediately following:

(i) The expiration of the period within which a response to a show cause order must be filed if the respondent does not file a response as required by paragraph (d) of this section;

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(ii) The conference described in paragraph (e) of this section if the Internal Revenue Service finds that the respondent is described in paragraph (b) of this section; or

(iii) The respondent's failure to appear, either personally or through an authorized representative, at a conference scheduled by the Internal Revenue Service under paragraph (e) of this section.

(2) *Duration of suspension.* A suspension under this section will commence on the date that the written notice of expedited suspension is served on the practitioner, either personally or through an authorized representative. The suspension will remain effective until the earlier of:

(i) The date the Internal Revenue Service lifts the suspension after determining that the practitioner is no longer described in paragraph (b) of this section or for any other reason; or

(ii) The date the suspension is lifted or otherwise modified by an Administrative Law Judge or the Secretary of the Treasury, or delegate deciding appeals, in a proceeding referred to in paragraph (g) of this section and instituted under §10.60.

(g) *Practitioner demand for §10.60 proceeding.* If the Internal Revenue Service suspends a practitioner under the expedited suspension procedures described in this section, the practitioner may demand that the Internal Revenue Service institute a proceeding under §10.60 and issue the complaint described in §10.62. The demand must be in writing, specifically reference the suspension action under §10.82, and be made within 2 years from the date on which the practitioner's suspension commenced. The Internal Revenue Service must issue a complaint demanded under this paragraph (g) within 60 calendar days of receiving the demand. If the Internal Revenue Service does not issue such complaint within 60 days of receiving the demand, the suspension is lifted automatically. The preceding sentence does not, however, preclude the Commissioner, or delegate, from instituting a regular proceeding under §10.60 of this part.

(h) *Effective/applicability date*. This section is generally applicable beginning June 12, 2014, except that paragraphs (b)(1) through (4) of this section are applicable beginning August 2, 2011.

Subpart E — General Provisions

§ 10.90 Records.

(a) *Roster*. The Internal Revenue Service will maintain and make available for public inspection in the time and manner prescribed by the Secretary, or delegate, the following rosters —

(1) Individuals (and employers, firms, or other entities, if applicable) censured, suspended, or disbarred from practice before the Internal Revenue Service or upon whom a monetary penalty was imposed.

(2) Enrolled agents, including individuals —

(i) Granted active enrollment to practice;

(ii) Whose enrollment has been placed in inactive status for failure to meet the requirements for renewal of enrollment;

(iii) Whose enrollment has been placed in inactive retirement status; and

(iv) Whose offer of consent to resign from enrollment has been accepted by the Internal Revenue Service under §10.61.

(3) Enrolled retirement plan agents, including individuals —

(i) Granted active enrollment to practice;

(ii) Whose enrollment has been placed in inactive status for failure to meet the requirements for renewal of enrollment;

(iii) Whose enrollment has been placed in inactive retirement status; and

(iv) Whose offer of consent to resign from enrollment has been accepted under §10.61.

(4) Registered tax return preparers, including individuals —

(i) Authorized to prepare all or substantially all of a tax return or claim for refund;

(ii) Who have been placed in inactive status for failure to meet the requirements for renewal;

(iii) Who have been placed in inactive retirement status; and

(iv) Whose offer of consent to resign from their status as a registered tax return preparer has been accepted by the Internal Revenue Service under §10.61.

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(5) Disqualified appraisers.
(6) Qualified continuing education providers, including providers —
(i) Who have obtained a qualifying continuing education provider number; and
(ii) Whose qualifying continuing education number has been revoked for failure to comply with the requirements of this part.
(b) *Other records.* Other records of the Director of the Office of Professional Responsibility may be disclosed upon specific request, in accordance with the applicable law.
(c) *Effective/applicability date.* This section is applicable beginning August 2, 2011.

§ 10.91 Saving provision.

Any proceeding instituted under this part prior to June 12, 2014, for which a final decision has not been reached or for which judicial review is still available is not affected by these revisions. Any proceeding under this part based on conduct engaged in prior to June 12, 2014, which is instituted after that date, will apply subpart D and E of this part as revised, but the conduct engaged in prior to the effective date of these revisions will be judged by the regulations in effect at the time the conduct occurred.

§ 10.92 Special orders.

The Secretary of the Treasury reserves the power to issue such special orders as he or she deems proper in any cases within the purview of this part.

§ 10.93 Effective date.

Except as otherwise provided in each section and Subject to §10.91, Part 10 is applicable on July 26, 2002.

John Dalrymple,
Deputy Commissioner for Services and Enforcement

Approved: June 3, 2014
Christopher J. Meade,
General Counsel

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Chapter 2: Individual Taxpayer Issues

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Note. Corrections for all of the chapters are available at **TaxSchool.illinois.edu.** For clarification about terms used throughout this chapter, see the **Acronyms and Abbreviations** section following the index.

For your convenience, in-text website links are also provided as short URLs. Anywhere you see **uofi.tax/xxx**, the link points to the address immediately following in brackets.

About the Author

Chris Korban, CPA, is a Tax Materials Specialist at the University of Illinois Tax School. He joined Tax School in 2023 with nine years of experience in public accounting. Chris earned both his Bachelor's Degree in Accounting and Master of Accounting Science from the University of Illinois.

Other chapter contributors and reviewers are listed at the front of this book.

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RE-EVALUATING THE NET INVESTMENT INCOME TAX

Over the years since the inception of the net investment income tax (NIIT), the number of taxpayers subject to the additional tax has more than doubled. For instance, 7.1 million filers were subject to the NIIT in tax year 2021,[1] compared to the 3.1 million filers in tax year 2013.[2] As more taxpayers become subject to the NIIT, practitioners may expect the additional tax to impact more of their clients. This section reacquaints practitioners with the nuances and characteristics of the NIIT by exploring what triggers the tax, identifying what types of activities and income are subject to the tax, and providing considerations and potential planning tips on how to avoid the tax.

APPLICABILITY[3]

The NIIT was included as a revenue-raising component[4] of the Health Care and Education Reconciliation Act of 2010[5] as an amendment to the Patient Protection and Affordable Care Act of 2010 (ACA).[6] The tax is an additional 3.8% tax on net investment income (NII), which includes **passive** activity income from a trade or business and other income not derived from the ordinary course of a trade or business. The NIIT, calculated and reported on Form 8960, *Net Investment Income Tax — Individuals, Estates, and Trusts*, applies to individuals, estates, and trusts whose 2024 modified adjusted gross income (MAGI) or adjusted gross income (AGI) exceeds specified thresholds as follows.[7]

Filing Status	Threshold Amount
Married Filing Jointly	$250,000 MAGI
Qualifying Surviving Spouse	250,000 MAGI
Married Filing Separately	125,000 MAGI
Single or Head of Household	200,000 MAGI
Estates and Trusts	15,200 AGI

1. See *Table 3.3. All Returns: Tax Liability, Tax Credits, and Tax Payments, by Size of Adjusted Gross Income, Tax Year 2021 (Filing Year 2022)* available at *SOI Tax Stats — Individual Statistical Tables by Size of Adjusted Gross Income.* Jan. 31, 2024. IRS. [www.irs.gov/statistics/soi-tax-stats-individual-statistical-tables-by-size-of-adjusted-gross-income] Accessed on Mar. 28, 2024.
2. See *Table 3.3. All Returns: Tax Liability, Tax Credits, and Tax Payments, by Size of Adjusted Gross Income, Tax Year 2013* available at *SOI Tax Stats — Individual Statistical Tables by Size of Adjusted Gross Income.* Jan. 31, 2024. IRS. [www.irs.gov/statistics/soi-tax-stats-individual-statistical-tables-by-size-of-adjusted-gross-income] Accessed on Mar. 28, 2024.
3. IRC §1411.
4. *The 3.8% Net Investment Income Tax: Overview, Data, and Policy Options,* p. 1. Jun. 30, 2023. Congressional Research Service. [crsreports.congress.gov/product/pdf/IF/IF11820] Accessed on Dec. 21, 2023.
5. *Health Care and Education Reconciliation Act of 2010,* PL 111-152.
6. *Patient Protection and Affordable Care Act*, PL 111-148.
7. 2023 Instructions for Form 8960; Instructions for Form 1041-ES.

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However, the NIIT does not apply to the following.

- Nonresident aliens (NRAs)
- Dual-resident individuals claiming a benefit of a tax treaty between the United States and their country of residence[8]
- Dual-status individuals residing in the United States for only a part of the year[9]
- The following types of trusts[10]
  - Charitable trusts and qualified retirement plan trusts exempt from tax under IRC §501
  - Charitable remainder trusts exempt from tax under IRC §664
  - A trust for which all unexpired interests are devoted to one or more of the following purposes under IRC §170(c)(2)(B): religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition (providing none of the activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals
  - Grantor trusts under IRC §§671–679
  - Trusts not classified as trusts for federal income tax purposes, such as real estate investment trusts and common trust funds
  - Electing Alaska native settlement trusts described in IRC §646
  - Perpetual care (cemetery) trusts described in IRC §642(i)

IDENTIFICATION OF NII

In reporting and calculating NIIT, the first fundamental step is distinguishing what constitutes NII from what does not. This section describes the composition of NII, what is excluded from NII, and other considerations in characterizing NII.

Income Included in NII

Generally, NII comprises the following types of income.[11]

- Gross interest, dividends, annuities, royalties, rents, and substitute interest or dividends
- Other income derived from a passive activity or a trade or business trading in financial instruments or commodities
- Net capital gains attributable to the disposition of property that is not held in a trade or business

Example 1. Scott Eberly wants to start a petting zoo business but is unable to find resources to invest in the business. He asks his father, Doug Eberly, if he would either invest in his business or loan the money Scott needs to start the business. After careful consideration, Doug opts to invest in his son's business, resulting in the formation of an S corporation with Scott and Doug as equal shareholders. Scott manages the day-to-day operations of the business, while Doug has no involvement except for asking Scott how the business is going. Doug's participation in this activity is passive, and therefore, the income that Doug receives from the S corporation could be subject to NIIT.

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8. Treas. Regs. §§1.1411-2(a)(2)(i) and 301.7701(b)-7(a)(1).

9. Treas. Reg. §1.1411-2(a)(2)(ii).

10. Instructions for Form 8960.

11. IRC §1411(c)(1)(A).

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Income Excluded from NII

The following types of income are **not** considered NII for purposes of calculating NIIT.[12]

- Wages
- Unemployment compensation
- Operating income from a nonpassive business
- Social security benefits
- Alimony
- Tax-exempt interest
- Self-employment (SE) income
- Alaska permanent fund dividends
- Qualified IRC §§401(a), 403(a), 403(b), 408, 408A, and 457(b) plan distributions
- The gain on the sale of a personal residence excluded under IRC §121

Example 2. Use the same facts as **Example 1.** After several years of receiving Schedule K-1 (Form 1120-S), *Shareholder's Share of Income, Deductions, Credits, etc.*, showing relatively little income, Doug tells Scott he has ideas on how to financially improve the business and decides to take over the financial operation of the business. Due to his increased involvement and time devoted to the business, Doug's participation is no longer passive. Therefore, any net income from the business after this change is not subject to the NIIT.

Rental Income

The income that a taxpayer derives from an activity may be subject to the NIIT if their involvement in that activity is passive. Because distinguishing passive from nonpassive income is critical in determining the applicability of the NIIT, some activities require guidance to categorize the taxpayer's involvement as passive or nonpassive.

For instance, the categorization of rental income under IRC §469 determines whether the NII rules under IRC §1411 apply. Generally, rental income is considered passive under §469. However, if the taxpayer is a real estate professional, rental income is considered **nonpassive.**[13] A taxpayer is a real estate professional if they meet both of the following tests.[14]

1. More than half of the personal services the taxpayer performs during the year involve real estate trades or businesses in which the taxpayer materially participates.
2. The taxpayer spends more than 750 hours per year in real property trade or business activities in which they materially participate.

Note. See Treas. Reg. §1.469-9 for additional guidance on real estate professionals and the §469 rules for rental income.

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12. *Questions and Answers on the Net Investment Income Tax*. Oct. 23, 2023. IRS. [www.irs.gov/newsroom/questions-and-answers-on-the-net-investment-income-tax] Accessed on Dec. 21, 2023.

13. IRC §469(c)(7).

14. IRC §469(c)(7)(B); Treas. Reg. §1.469-9(c)(1).

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If the rental income is considered nonpassive under §469 and it is derived in an IRC §162 trade or business, that rental income is not part of the taxpayer's NII for the year because the business exception applies. The proposed regulation states that a real estate professional is **not necessarily** engaged in a trade or business with regard to rental real estate activities.[15] However, a safe harbor exists that allows gross rental income and gains or losses from the disposition of property used in such rental real estate activity to be deemed as derived from an ordinary course of a trade or business if the taxpayer meets **one** of the following two tests.[16]

1. The taxpayer participates in a rental real estate activity for over 500 hours during the tax year.
2. The taxpayer participated in a rental real estate activity for over 500 hours during any five tax years during the last ten tax years. The five years do not need to be consecutive.

Even if a taxpayer does not meet either test, their real estate income might still not be subject to the NIIT in certain situations. These tests are not the sole indication of their activity being a real estate trade or business.[17]

Example 3. Agatha works full-time as a mortician. Her filing status is single, and her MAGI is over the $200,000 threshold. She owns a second home, which she rents out to a tenant. In 2024, she receives $7,000 in net rental income. For the 2024 tax year, Agatha's rental income is considered passive income under the §469 rules because she is not a real estate professional. Therefore, Agatha's rental income is classified as NII for 2024 and is subject to the 3.8% NIIT. Agatha's NIIT liability is $266 (3.8% × $7,000).

Example 4. Use the same facts as **Example 3,** except that Agatha is a real estate professional who works more than 500 hours during 2024 in her job. Because Agatha satisfies the first safe harbor test, her rental income is nonpassive under the rules of §469. Under the NII rules, if the rental income is derived in the ordinary course of a business, then the rental income is not NII for 2024. Accordingly, the 3.8% NIIT does not apply to Agatha's $7,000 of rental income.

Grouping Activities under §469

Categorizing income as passive or nonpassive under §469 is necessary **before** applying the NII rules of §1411. Generally, only passive activities generate NIIT, as discussed previously. A taxpayer may want to reduce their NIIT by grouping profitable passive activities with nonpassive activities. However, these activities are still considered passive and constitute part of the taxpayer's NII.[18] This is the case if the income is from a §162 "trade or business" that is not in the business of trading financial instruments or commodities.[19]

A taxpayer may participate in multiple activities, none of which meet the material participation tests of Temp. Treas. Reg. §1.469-5T. If those activities collectively form an appropriate economic unit, they can be grouped together. When grouped, the activities are considered a **single activity** that may meet the material participation tests.[20]

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15. Preamble to REG-130507-11 (Dec. 5, 2012), p. 72,612.
16. Treas. Reg. §1.1411-4(g)(7)(i).
17. Treas. Reg. §1.1411-4(g)(7)(iii).
18. *Net Investment Income Tax Surprise: Significant Participation Rule Trumping Material Participation Tests*. Stamper, Dustin. Jan. 31, 2015. AICPA. [www.thetaxadviser.com/issues/2015/feb/tax-clinic-08.html] Accessed on Mar. 20, 2024.
19. As defined in IRC §475(e)(2).
20. See Treas. Reg. §1.469-4(c).

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Example 5. In addition to being the CEO of a financial consulting agency, Courtney has a public speaking business and owns a credit valuation business. The credit valuation business analyzes consumer asset portfolios and businesses and operates as a sole proprietorship. Courtney spends 520 hours in management in the credit valuation business in 2024. Her public speaking business runs as a joint venture. In 2024, she spends 85 hours in the public speaking business while her business associate spends 125 hours.

Because Courtney does not meet the material participation requirements for her speaking business, the net income from it is generally considered passive. She meets the material participation requirement for her valuation business.

Under the rules of §469, Courtney can group the two businesses to meet the material participation requirement for both if the activities constitute an appropriate economic unit. If she elects to group the two businesses as a single activity, the net profit from the speaking business is considered nonpassive under §469. Under the NII rules, if the speaking activity is a trade or business (under §162) and is not a covered business engaged in trading financial instruments or commodities, the income is not considered NII for Courtney for 2024. Consequently, it is not subject to the 3.8% NIIT.[21]

Passive Activity Loss Recharacterization Rules

Regulations under the passive activity loss rules of §469 have several "recharacterization rules" that serve to classify certain types of income as nonpassive that otherwise might be considered passive.[22] Income considered nonpassive under a recharacterization rule is not part of the taxpayer's NII if it is from a trade or business under §162 that is not a covered trade or business. This is because §469 is used within the definition of NII in determining whether income is passive and, therefore, part of the taxpayer's NII for the year.

One such recharacterization rule is the significant participation passive activity rule. A significant participation passive activity is one in which the taxpayer participates for more than 100 hours during the tax year but does not materially participate under any of the seven material participation tests found in Temp. Treas. Reg. §1.469-5T(a).[23]

Example 6. During 2024, Neil participates in three different trade or business activities. Each of these activities is a trade or business under §162. The following table provides a description of the type of interest, the type of activity, and other relevant data in connection with the 2024 tax year.

	S Corporation Interest (Event Coordinator)	Partnership Interest (Golf Club)	Sole Proprietorship (Apparel Retail)	Total
Hours of participation during the year	110	140	165	
Gross passive income	$7,000	$11,000	$6,000	$24,000
Passive activity deductions	(1,000)	(4,000)	(9,000)	(14,000)
Net passive income	$6,000	$7,000	($3,000)	$10,000

Neil's participation in each of the business activities is more than 100 hours and he does not meet any of the seven material participation tests in Temp. Treas. Reg. §1.469-5T. Therefore, each of the three activities constitutes a significant participation passive activity. Neil's gross income from significant participation passive activity exceeds his total significant participation passive deductions by $10,000 for the year.

Under Temp. Treas. Reg. §1.469-2T(f)(2)(i), the $10,000 of total net passive income is treated as income that is nonpassive. Accordingly, it is also considered nonpassive under NII rules because each business constitutes a trade or business under §162, and none of the businesses are in the business of trading financial instruments or commodities. Therefore, the $10,000 is excluded from Neil's 2024 NII.

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21. Treas. Regs. §§1.1411-5(a), (b), and (c).

22. Temp. Treas. Reg. §1.469-2T(f).

23. Temp. Treas. Reg. §1.469-2T(f)(2).

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Pass-Through Entity Stock and Interest Dispositions

S corporation shares and partnership interests are not considered property held in an active business.[24] Accordingly, any gain recognized on the taxpayer's sale of such an interest is subject to the NIIT.[25] However, an exception applies to active interests in S corporations and partnerships, where gains on the disposition of such interests are included in NII only to the extent of such a disposition's net gain being subject to the NIIT had the entity sold all its property immediately before the disposition of the ownership interest.[26] Taxpayers making adjustments for such an exception on Form 8960 must attach to their income tax return a statement including the following information.[27]

- The transferred partnership's or S corporation's name and tax identification number
- The transferor's gain or loss on the interest disposition for regular income tax purposes (included on Form 8960, line 5a)
- Information received by the transferor from the S corporation or partnership pertaining to the disposition, if applicable
- Any amount of the gain or loss adjustment resulting from basis adjustments for ownership in certain controlled foreign corporations (CFCs) or qualified electing funds (QEFs)

Example 7. Lenny is a passive investor in Gibson City Corp., an S corporation. Gibson City Corp. is not in the business of trading financial instruments or securities and there is no indebtedness owed to Lenny by the S corporation. Lenny sells his stock for a net gain of $2.8 million in 2023. Because he does not actively participate in Gibson City Corp., the entire $2.8 million is subject to NIIT. Lenny reports the investment income on the following Form 8960.

Form **8960** — Department of the Treasury, Internal Revenue Service

Net Investment Income Tax—Individuals, Estates, and Trusts
Attach to your tax return.
Go to *www.irs.gov/Form8960* for instructions and the latest information.

OMB No. 1545-2227 — 2023 — Attachment Sequence No. 72

Name(s) shown on your tax return: **Lenny King** — Your social security number or EIN: ***-**-5252

Part I Investment Income
☐ Section 6013(g) election (see instructions)
☐ Section 6013(h) election (see instructions)
☐ Regulations section 1.1411-10(g) election (see instructions)

Line	Description	Sub-line	Sub-amount	Line	Amount
1	Taxable interest (see instructions)			1	
2	Ordinary dividends (see instructions)			2	
3	Annuities (see instructions)			3	
4a	Rental real estate, royalties, partnerships, S corporations, trusts, trades or businesses, etc. (see instructions)	4a			
b	Adjustment for net income or loss derived in the ordinary course of a non-section 1411 trade or business (see instructions)	4b			
c	Combine lines 4a and 4b			4c	
5a	Net gain or loss from disposition of property (see instructions)	5a	2,800,000		
b	Net gain or loss from disposition of property that is not subject to net investment income tax (see instructions)	5b			
c	Adjustment from disposition of partnership interest or S corporation stock (see instructions)	5c			
d	Combine lines 5a through 5c			5d	2,800,000
6	Adjustments to investment income for certain CFCs and PFICs (see instructions)			6	
7	Other modifications to investment income (see instructions)			7	
8	Total investment income. Combine lines 1, 2, 3, 4c, 5d, 6, and 7			8	2,800,000

Investment Expenses Allocable to Investment Income and Modifications

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24. IRC §1411(c)(1)(A)(iii).

25. Preamble to REG 130507-11 (Dec. 5, 2012), p. 72,613.

26. IRC §1411(c)(4)(A).

27. Instructions for Form 8960.

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Example 8. Use the same facts as **Example 7,** except Lenny actively participates in Gibson City Corp. Lenny's sale of Gibson City stock of $2.8 million is not subject to NIIT. Accordingly, Lenny includes an adjustment of –$2.8 million on line 5c of Form 8960 to zero out the investment income subject to NIIT.

Form **8960** — Department of the Treasury, Internal Revenue Service

Net Investment Income Tax—Individuals, Estates, and Trusts
Attach to your tax return.
Go to *www.irs.gov/Form8960* for instructions and the latest information.

OMB No. 1545-2227 — 2023 — Attachment Sequence No. 72

Name(s) shown on your tax return: **Lenny King** — Your social security number or EIN: ***-**-5252

Part I Investment Income
☐ Section 6013(g) election (see instructions)
☐ Section 6013(h) election (see instructions)
☐ Regulations section 1.1411-10(g) election (see instructions)

Line	Description				
1	Taxable interest (see instructions)			1	
2	Ordinary dividends (see instructions)			2	
3	Annuities (see instructions)			3	
4a	Rental real estate, royalties, partnerships, S corporations, trusts, trades or businesses, etc. (see instructions)	4a			
b	Adjustment for net income or loss derived in the ordinary course of a non-section 1411 trade or business (see instructions)	4b			
c	Combine lines 4a and 4b			4c	
5a	Net gain or loss from disposition of property (see instructions)	5a	2,800,000		
b	Net gain or loss from disposition of property that is not subject to net investment income tax (see instructions)	5b			
c	Adjustment from disposition of partnership interest or S corporation stock (see instructions)	5c	(2,800,000)		
d	Combine lines 5a through 5c			5d	0
6	Adjustments to investment income for certain CFCs and PFICs (see instructions)			6	
7	Other modifications to investment income (see instructions)			7	
8	Total investment income. Combine lines 1, 2, 3, 4c, 5d, 6, and 7			8	0

Investment Expenses Allocable to Investment Income and Modifications

Lenny attaches the following statement to his income tax return explaining the adjustment he reported on Form 8960, line 5c.

Entity Name: Gibson City Corp.
Entity EIN: 12-3456789

Gain or loss from disposition: 2,800,000

Adjustments to gain or loss due to basis adjustments for certain CFCs and QEFs: 0

Taxpayer Lenny King sold equity interest in the S corporation in which he materially participated. The company is not in the business of trading financial instruments or securities. There is no indebtedness owed to the taxpayer by the business; therefore none of the gain is attributable to such indebtedness.

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SE Income

NII for the year does not include any net business income subject to SE tax.[28]

> **Note.** It is not possible for the taxpayer to receive income that is subject to both the SE tax and the NIIT.[29] Additionally, while a taxpayer may be subject to both the NIIT and additional Medicare tax of 0.9%, the same type of income is not taxed by both. The additional Medicare tax is assessed on wages, compensation, and SE income over specified thresholds. However, it does **not** apply to income included in NII.[30]

Other types of income that the Code specifically excludes from SE income may be part of the taxpayer's NII and subject to the NIIT. The Code specifically excludes the following types of income from SE income.

- Certain types of real estate net rental income, including rental income from personal property leased with real estate[31]
- Dividends and interest[32]
- A limited partner's distributive share (other than a guaranteed payment for services rendered)[33]
- Gains or losses from the sale or exchange of capital assets[34]

Although the Code excludes these types of income from SE income, they are subject to NIIT if they meet the definition of NII (discussed previously) and if the taxpayer's income exceeds the applicable NIIT threshold for the year.[35]

> **Note.** IRC §1402(a)(3)(A) states that gains or losses from the sale of capital assets are not included in SE net earnings and are therefore not subject to SE tax. IRC §1411(c)(6) states that NII does not include amounts that are subject to SE tax. When a self-employed taxpayer sells capital assets that could result in NII, these two provisions are important in determining what amounts are subject to NIIT rules.

Example 9. Shania is an engineer and a general partner in Evanescent Partners, LLP (EP). EP completes major construction projects worldwide. For 2024, Shania's distributive share from EP is $900,000. This amount includes her share of capital gain from the sale of land, $300,000. The remaining $600,000 of Shania's distributions constitutes SE income for the year and is subject to SE tax but not NIIT.

IRC §1402(a)(3)(A) excludes the $300,000 capital gain from SE earnings and SE tax. However, for 2024, assuming all other requirements for the NII are satisfied, the $300,000 capital gain constitutes NII for Shania. If Shania's MAGI exceeds the applicable threshold for her filing status, she has NIIT liability on the $300,000 capital gain.

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28. IRC §1411(c)(6).
29. *Questions and Answers on the Net Investment Income Tax*. Oct. 23, 2023. IRS. [www.irs.gov/newsroom/questions-and-answers-on-the-net-investment-income-tax] Accessed on Dec. 21, 2023.
30. *Find out if Net Investment Income Tax applies to you.* Feb. 10, 2023. IRS. [www.irs.gov/individuals/net-investment-income-tax] Accessed on Dec. 21, 2023.
31. IRC §1402(a)(1).
32. IRC §1402(a)(2).
33. IRC §1402(a)(13).
34. IRC §1402(a)(3).
35. IRC §1411(a)(1)(B).

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EXPENSES REDUCING NII

NII is gross investment income less the following types of expenses to the extent that these expenses are allocable to gross investment income items.[36]

- Investment advisory fees
- Brokerage fees

Caution. Under the Tax Cuts and Jobs Act (TCJA), investment advisory fees and brokerage fees are not deductible as miscellaneous itemized expenses and therefore are not as allowed as a deduction against at NIIT.[37]

- Investment interest expense
- Rental expenses
- Royalty expenses
- State and local income taxes

Example 10. Adam and Amy are Illinois residents who file their Form 1040, *U.S. Individual Income Tax Return,* jointly for 2023. They itemize their deductions on Form 1040, Schedule A, *Itemized Deductions*. Both are age 70, retired, and have the following income in 2023.

Interest income	$ 28,500 [a]
Tax-exempt interest (nontaxable for federal tax purposes)	59,100
Ordinary dividends	12,700 [a]
Net capital gain from sales of securities (reported on line 7, Form 1040)	84,700 [a]
Individual retirement arrangement (IRA) distributions	48,500
Pension income	125,000
Net rental real estate income (farmland rental)	10,000 [a]
Taxable social security income	22,400
Total 2023 income	$390,900

[a] These items represent investment income for Form 8960 purposes. The other income items do not represent investment income and are omitted when completing Form 8960.

Adam and Amy's 2023 AGI shown on their Form 1040 is $331,800 ($390,900 – $59,100 of tax-exempt interest).

Their Illinois base income, as shown on their 2023 Form IL-1040, *Individual Income Tax Return*, is $195,000, which is calculated as follows.

Federal AGI reported on 2023 Form 1040	$331,800
Plus: tax-exempt interest	59,100
Less: IRA distributions	(48,500)
Less: pension income	(125,000)
Less: taxable social security income	(22,400)
2023 Form IL-1040 base income	$195,000

36. *Questions and Answers on the Net Investment Income Tax*. Oct. 23, 2023. IRS. [www.irs.gov/newsroom/questions-and-answers-on-the-net-investment-income-tax] Accessed on Jan. 8, 2024.

37. Instructions for Form 8960.

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Adam and Amy's 2023 Illinois state income tax deduction on Form 1040, Schedule A is $9,275, of which $6,464 is attributable to investment income reported in part 1 of their 2023 Form 8960. The amount of Adam and Amy's Illinois base income attributable to investment income is calculated as follows.

2023 Form IL-1040 base income	$195,000
Less: tax-exempt interest	(59,100)
Balance of 2023 Form IL-1040 base income	$135,900

The portion of the $9,275 total 2023 Illinois state income tax attributable to investment income reported on Adam and Amy's 2023 Form 8960 is expressed in the following fraction.

$$\textbf{State income tax attributable to investment income} = \frac{\$135{,}900}{\$195{,}000} \times \$9{,}275 = \$6{,}464$$

Adam and Amy's 2023 Form 8960 is prepared as shown on the following page.

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For Example 10

Form 8960 — Department of the Treasury, Internal Revenue Service

Net Investment Income Tax— Individuals, Estates, and Trusts

Attach to your tax return.
Go to *www.irs.gov/Form8960* for instructions and the latest information.

OMB No. 1545-2227 — 2023 — Attachment Sequence No. 72

Name(s) shown on your tax return: **Adam and Amy Andrews** — Your social security number or EIN: ***-**-6789

Part I Investment Income
☐ Section 6013(g) election (see instructions)
☐ Section 6013(h) election (see instructions)
☐ Regulations section 1.1411-10(g) election (see instructions)

Line	Description	Sub-line	Sub-amount	Line	Amount
1	Taxable interest (see instructions)			1	28,500
2	Ordinary dividends (see instructions)			2	12,700
3	Annuities (see instructions)			3	
4a	Rental real estate, royalties, partnerships, S corporations, trusts, trades or businesses, etc. (see instructions)	4a	10,000		
b	Adjustment for net income or loss derived in the ordinary course of a non-section 1411 trade or business (see instructions)	4b	0		
c	Combine lines 4a and 4b			4c	10,000
5a	Net gain or loss from disposition of property (see instructions)	5a	84,700		
b	Net gain or loss from disposition of property that is not subject to net investment income tax (see instructions)	5b	0		
c	Adjustment from disposition of partnership interest or S corporation stock (see instructions)	5c	0		
d	Combine lines 5a through 5c			5d	84,700
6	Adjustments to investment income for certain CFCs and PFICs (see instructions)			6	
7	Other modifications to investment income (see instructions)			7	
8	Total investment income. Combine lines 1, 2, 3, 4c, 5d, 6, and 7			8	135,900
Part II	**Investment Expenses Allocable to Investment Income and Modifications**				
9a	Investment interest expenses (see instructions)	9a			
b	State, local, and foreign income tax (see instructions)	9b	6,464		
c	Miscellaneous investment expenses (see instructions)	9c			
d	Add lines 9a, 9b, and 9c			9d	6,464
10	Additional modifications (see instructions)			10	
11	Total deductions and modifications. Add lines 9d and 10			11	6,464
Part III	**Tax Computation**				
12	Net investment income. Subtract Part II, line 11, from Part I, line 8. Individuals, complete lines 13–17. Estates and trusts, complete lines 18a–21. If zero or less, enter -0-			12	129,436
	Individuals:				
13	Modified adjusted gross income (see instructions)	13	331,800		
14	Threshold based on filing status (see instructions)	14	250,000		
15	Subtract line 14 from line 13. If zero or less, enter -0-	15	81,800		
16	Enter the smaller of line 12 or line 15			16	81,800
17	Net investment income tax for individuals. Multiply line 16 by 3.8% (0.038). **Enter here and include on your tax return** (see instructions)			17	3,108
	Estates and Trusts:				
18a	Net investment income (line 12 above)	18a			
b	Deductions for distributions of net investment income and charitable deductions (see instructions)	18b			
c	Undistributed net investment income. Subtract line 18b from line 18a (see instructions). If zero or less, enter -0-	18c			
19a	Adjusted gross income (see instructions)	19a			
b	Highest tax bracket for estates and trusts for the year (see instructions)	19b			
c	Subtract line 19b from line 19a. If zero or less, enter -0-	19c			
20	Enter the smaller of line 18c or line 19c			20	
21	Net investment income tax for estates and trusts. Multiply line 20 by 3.8% (0.038). **Enter here and include on your tax return** (see instructions)			21	

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 59474M Form **8960** (2023)

Adam and Amy's $59,100 of tax-exempt interest is not investment income and is therefore not subject to the 3.8% NIIT. Furthermore, their $6,464 of state income tax shown on line 9b of Form 8960 does not affect the computation of their $3,108 of NIIT. This is because their MAGI exceeds the threshold amount by only $81,800 (line 15), which is less than their NII of $129,436 (line 12).

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TAXATION OF LAWSUIT SETTLEMENTS

Lawsuit settlement payments represent an income tax consideration for taxpayers and practitioners, primarily in identifying whether the lawsuit settlement is taxable. Because the taxability of a lawsuit settlement generally depends on the nature of the underlying claim and the types of damages awarded, **taxpayers must assess the facts and circumstances surrounding such payments.** This section identifies when and what type of lawsuit settlements are taxable, what types of income the settlements may represent, and how to report such income on a tax return.

ORIGIN OF THE CLAIM

The taxability of settlement payments and the deductibility of expenses incurred in obtaining settlement payments or paying settlement claims are dependent on the **origin of the claim.**[38] This doctrine looks at the underlying reason for which compensation is sought, identifying the reason the taxpayer went to court as stated in their complaint. While the Code and IRS guidance identify specific causes for settlements as taxable and nontaxable, the origin of the claim must be used to determine into which category the settlement falls.

If the origin of the claim is not clearly specified or easily determined, the next area to assess is the payor's **intent.**[39] As opposed to examining the claimant, this test focuses on the **payor,** primarily concerning the reasoning behind making the payment. Evidence examined during the trial, the resulting judgment, the fact pattern leading to the payment agreement, and other facts may be used in assessing the character of the payment.[40] Settlement payments may include multiple elements, such as back pay, emotional distress, and attorney fees. The allocation of these multiple elements in a payment is made in an agreement between the parties that the IRS generally does not challenge if the allocation is consistent with the substance of the settled claims.[41]

Physical Sickness or Injury

Damages for **physical** sickness or injury are generally excluded from gross income.[42] The key consideration in identifying the origin of these claims is the "physical" requirement. While the IRS has not formally defined what constitutes a physical injury, the agency has provided examples of non-physical injuries, including emotional distress, defamation, and humiliation.[43] The resulting implication is that physical injuries constitute visible and observable bodily harm.[44]

While settlement payments for claims for physical sickness or injury are generally excluded from gross income, taxpayers must be mindful of allocations of the payment to medical expenses. If the taxpayer receives a settlement payment that includes a portion attributable to medical expenses that the taxpayer deducted on a prior year's tax return under IRC §213, that portion of the settlement must be included in gross income to the extent the deduction provided a tax benefit.[45] This should be reported on line 8z of Form 1040, Schedule 1, *Additional Income and Adjustments to Income.*

Note. For information about determining whether the recovery of previously deducted expenses provided a tax benefit, see Recoveries in IRS Pub. 525, *Taxable and Nontaxable Income*.

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38. *U.S. v. Gilmore*, 372 U.S. 39 (1963).

39. *Knuckles v. Comm'r*, 349 F.2d 610, 613 (10th Cir. 1965).

40. *Green v. Comm'r*, 507 F.3d 857, 868 (5th Cir. 2007).

41. IRS Pub. 4345, *Settlements — Taxability*.

42. IRC §104(a)(2) and Treas. Reg. §1.104-1(c).

43. *Tax Implications of Settlements and Judgments*. Oct. 16, 2023. IRS. [www.irs.gov/government-entities/tax-implications-of-settlements-and-judgments] Accessed on Jan. 9, 2024.

44. *Ten Rules Every Lawyer — and Client — Should Know about Taxes on Legal Settlements*. Wood, Robert W. Apr. 27, 2017. The American Bar Association. [americanbar.org/groups/business_law/resources/business-law-today/2017-april/ten-rules-every-lawyer-and-client-should-know-about-taxes-on-leg] Accessed on Jan. 9, 2024.

45. IRS Pub. 4345, *Settlements — Taxability*; IRC §104(a).

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Emotional Distress

The taxability of settlement payments for emotional distress depends on the reason for the emotional distress. If the taxpayer's emotional distress is attributable to physical sickness or injury, the payment is excluded from gross income.[46]

However, if the taxpayer's emotional distress is not attributable to physical sickness or injury, the payment is included in gross income. For example, emotional distress attributable to disparate treatment discrimination is taxable.[47] The amount of the payment that is included in gross income may be reduced by medical expenses that the taxpayer did not previously deduct on their income tax return or receive a tax benefit for.[48] This should be reported on line 8z of Form 1040, Schedule 1.

Lost Wages or Profits

The portion of settlement payments in employment-related lawsuits that are attributable to lost wages, including severance pay, back pay, and front pay, are taxable wages.[49] Such payments are subject to employment tax withholding by the payer, including social security and Medicare taxes. Ideally, the payer would also withhold the employee portion of the employment taxes from the payment. Recipients should report these amounts as wages on line 1a of Form 1040.[50]

The portion of settlement payments attributable to lost profits is subject to income tax as well as SE tax. Recipients should include the income on Schedule C, *Profit or Loss from Business,* which flows to Schedule 1 and then to Form 1040 as part of gross income. To report the portion of income subject to SE tax, recipients should include the income on Schedule SE, *Self-Employment Tax*.[51]

Damaged or Destroyed Property[52]

Settlement payments for damaged or destroyed property are generally treated as a return of capital.[53] If the award is less than the taxpayer's adjusted basis in the property, the payment is not taxable and excluded from income tax return reporting. The taxpayer's basis in the damaged property is reduced by the amount of the award. However, if the award exceeds the taxpayer's adjusted basis in the property, the basis is reduced to zero, and the excess amount is taxable income. If the damaged property was used in the taxpayer's trade or business, the taxpayer reports the gain on Form 4797, *Sale of Business Property*. For all other property, the taxpayer reports the capital gain on Form 1040, Schedule D, *Capital Gains and Losses*.

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46. Treas. Reg. §1.104-1(c)(1).
47. Rev. Rul. 96-65, 1996-2 CB 6.
48. IRS Pub. 4345, *Settlements — Taxability.*
49. Rev. Rul. 96-65, 1996-2 CB 6; TAM 200244004 (Nov. 1, 2002).
50. IRS Pub. 4345, *Settlements — Taxability.*
51. Ibid.
52. Ibid.
53. Rev. Rul. 81-277, 1981-2 CB 14.

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Punitive Damages

Courts assess punitive damages as a way of punishing defendants for harmful behavior. Punitive damages differ from compensatory damages, which are assessed to compensate a plaintiff for the harm they experienced from the defendant's actions. Punitive damages are included in gross income[54] unless awarded in civil wrongful death actions, where punitive damages are the only remedy under state law.[55] Taxpayers report punitive damages income on line 8z of Schedule 1 for Form 1040.[56]

> **Caution.** It is important to assess the multiple allocations of a settlement payment when assessing the taxable portion(s) of the awarded damages. Even in settlements for personal physical injuries or sickness, for which compensatory damages are excluded from gross income, the portion of the awarded damages attributed to punitive damages is included in gross income.[57] Thus, practitioners should not only identify the underlying cause for why the taxpayer sought damages but also identify all allocable components of the awarded damages when preparing tax returns for taxpayers who received lawsuit settlement payments.

Practitioner Planning Tip

A tax practitioner working with a client who received a settlement from a lawsuit should request a copy of the client's claims, as stated in their pleadings, as well as the court's final decision. Because of the time needed to thoroughly review these documents, receiving them well before tax season is preferable.

ATTORNEY FEES

As attorney fees are common expenses during litigation proceedings, the deductibility of attorney fees to offset settlement income is a key consideration. Before the enactment of the TCJA, attorney fees were deductible as miscellaneous itemized deductions subject to the 2% AGI limitation. As a result of the TCJA, attorney fees, along with all other itemized deductions subject to the 2% AGI limitation, are suspended for tax years 2018 through 2025.[58] Consequently, taxpayers who receive settlement payment income from lawsuits not involving their trade or business are unable to deduct attorney fees on their individual income tax returns.

> **Caution.** Because settlement payments are often net of expenses such as attorney fees, practitioners must exercise caution in reporting the correct amount of settlement income on a taxpayer's return. The practitioner must know the **gross income** from the settlement and cannot rely on the net amount provided on the check the taxpayer received.[59]

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54. IRC §104(a)(2).
55. IRC §104(c).
56. IRS Pub. 4345, *Settlements — Taxability.*
57. Ibid.
58. IRC §67(g).
59. *New Tax on Litigation Settlements, No Deduction for Legal Fees*. Wood, Robert W. Dec. 4, 2019. Marin County Bar Association. [marinbar.org/news/article/?type=news&id=500] Accessed on Jan. 10, 2024.

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If the taxpayer is engaged in a trade or business and receives awarded damages from a lawsuit **pertaining to that trade or business,** the taxpayer may deduct attorney fees for the portion of damages included in the taxpayer's income.[60] Consequently, an allocation may be needed to calculate the deductible portion of the attorney fees if the settlement payment includes multiple elements, particularly when some are included in income and others are not. The deductible portion of the expense is reported on Form 1040, Schedule C, which flows through to Form 1040, Schedule 1.

> **Caution.** Taxpayers should be mindful of Form 1099-MISC, *Miscellaneous Information*, filing requirements for payments made to attorneys. See the instructions to Form 1099-MISC for details on when a Form 1099-MISC should be issued.

Example 11. Rita acted on the advice of her tax professional, Derrick. The advice turned out to be erroneous, so Rita files a lawsuit against Derrick and is awarded $100,000 in damages. In 2024, she receives a check for $70,000 after a deduction for attorney fees totaling $30,000. The full $100,000 is included in Rita's gross income for 2024, and she is unable to deduct any attorney fees to offset the income.

GIFT TAX

Historically, transferring property from one individual to another was an attempt to avoid incurring estate tax. To prevent such avoidance, Congress unified the estate and gift taxes into one tax system in 1976.[61] This unified estate and gift tax system is effectively a wealth transfer tax rather than a tax on income. Estate taxes are calculated on the decedent's accumulated taxable gifts plus the decedent's taxable estate at death and then reduced by any gift taxes paid after 1976. Consequently, taxpayers must file gift tax returns for tax years in which they make taxable gifts.

Because the estate and gift tax is a more specialized and nuanced area of taxation, taxpayers may not be aware of the rules or requirements for gift tax returns. Consequently, practitioners may be unaware of their client's situations that require filing a gift tax return. This section explains the nuances and requirements for filing gift tax returns and identifies key issues of gift taxation.

TAXATION OF GIFTS

Understanding gift taxation is crucial for practitioners. They need to be familiar with what constitutes a taxable gift, how to value a gift, and what avenues may limit the taxability of a gift. Because gifting is a common practice among taxpayers who may not be aware of any associated tax implications, practitioners can play an important role in informing and advising their clients making gifts.

Identifying Taxable Gifts[62]

Taxable gifts consist of total gifts a taxpayer makes during a calendar year, excluding certain deductions and exclusions. However, taxpayers may not actually need to pay gift tax on taxable gifts due to the unified credit, discussed later.

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60. IRS Pub. 535, *Business Expenses*; IRS Pub. 529, *Miscellaneous Deductions*.

61. *Tax Reform Act of 1976*, PL 94-455, §2001.

62. IRC §2503.

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Deductions. Deductions are subtracted from total gifts to arrive at taxable gifts and include gifts made to the taxpayer's spouse.[63] Taxpayers do not report transfers made to charitable IRC §501(c)(3) organizations[64] and political organizations[65] as gifts made during a calendar year.

> **Caution.** There are certain gifts to a taxpayer's spouse that are subject to the gift tax. Gifts of a **terminable interest** (e.g., a life estate, one that terminates with the death of the beneficiary) where a non-spouse recipient receives interest in the gifted property following termination of the donee spouse's interest must be closely examined. Such gifts are excluded from taxable gifts only when the spouse is entitled for life to all income from the entire interest, such income is paid at least annually, the spouse may appoint the entire interest at their discretion, and none of the interest is subject to another person's power of appointment.[66] For more information on terminable interests, see the 2022 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 4: Tax Considerations in the Distribution of Estate Assets.

Exemptions from Taxable Gifts. In addition to deductions to arrive at taxable gifts, there are exemptions from gift tax for practitioners to keep in mind.

Annual Exclusion.[67] Taxpayers can exclude a dollar amount for each gift recipient per tax year to eliminate the need to report de minimis gifts. For 2024, the annual gift tax exclusion is $18,000 ($17,000 in 2023).[68] For the gift to qualify for the exclusion, it must be of a **present interest,** where the recipient has the immediate right to use the gift with no strings attached, rather than sometime in the future. However, when an adult is named as a guardian until the recipient reaches age 21, gifts to minors do not constitute a future interest that would disqualify the gift from the annual exclusion.

> **Note.** Taxpayers can get around the present interest requirement for gifts to be eligible for the annual exclusion by applying **Crummey powers** to a gift.[69] A Crummey power is named after a 1968 federal court opinion that allowed contributions to an irrevocable trust to qualify for the annual gift tax exclusion because the beneficiaries (typically the donor's grandchildren) are given an unrestricted right to withdraw the contributions for a specified period of time. The Crummey power has become a standard estate planning tool, the benefits of which increase through leveraging the annual exclusion to maximize the amount of gift-tax-free transfers to an irrevocable trust.

Married taxpayers can double their annual exclusion to a gift recipient by electing to **split their gifts** to that recipient, provided each spouse is a U.S. citizen or resident when making the gift.[70] To make the election, both spouses must each file a Form 709, *United States Gift (and Generation-Skipping Transfer) Tax Return,* on which they identify and report the gifts made by their spouses for gifts they are splitting under Schedule A, *Computation of Taxable Gifts (including transfers in trust)*.[71]

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63. IRC §2523.
64. IRC §2522(a)(2).
65. IRC §2501(a)(4).
66. IRC §2523(e).
67. IRC §§2503(b) and (c).
68. Rev. Proc. 2023-34, 2023-48 IRB 1287; Rev. Proc. 2022-38, 2022-45 IRB 445.
69. *Crummey v. Comm'r*, 397 F.2d 82 (9th Cir. 1968).
70. Treas. Reg. §25.2513-1(a).
71. Instructions for Form 709.

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Taxpayers who are divorced or widowed and do not remarry during the year can elect to split their gift if the gift was made before the date of death or divorce.

Part 1—General Information

Line		Yes	No
8	If the donor died during the year, check here ☐ and enter date of death ____________, ______.		
9	If you extended the time to file this Form 709, check here ☐		
10	Enter the total number of donees listed on Schedule A. Count each person only once		
11a	Have you (the donor) previously filed a Form 709 (or 709-A) for any other year? If "No," skip line 11b		
b	Has your address changed since you last filed Form 709 (or 709-A)?		
12	**Gifts by husband or wife to third parties.** Do you consent to have the gifts (including generation-skipping transfers) made by you and by your spouse to third parties during the calendar year considered as made one-half by each of you? See instructions. (If the answer is "Yes," the following information must be furnished and your spouse must sign the consent shown below. **If the answer is "No," skip lines 13–18.**)		
13	Name of consenting spouse — **14** SSN		
15	Were you married to one another during the entire calendar year? See instructions		
16	If line 15 is "No," check whether ☐ married ☐ divorced or ☐ widowed/deceased, and give date. See instructions		
17	Will a gift tax return for this year be filed by your spouse? If "Yes," mail both returns in the same envelope		
18	**Consent of Spouse.** I consent to have the gifts (and generation-skipping transfers) made by me and by my spouse to third parties during the calendar year considered as made one-half by each of us. We are both aware of the joint and several liability for tax created by the execution of this consent.		
	Consenting spouse's signature **Date**		

This election is also helpful to married taxpayers making gifts exceeding the annual exclusion, where the excess amount reduces each spouse's unified credit against the estate tax, discussed later, by half instead of reducing a given spouse's credit by the entire amount.

Example 12. Eduardo and Cecilia are a married couple. In 2024, Eduardo gifts $36,000 to his son Daniel. If Eduardo does not split his gift with Cecilia, Eduardo's taxable gift to Daniel for 2024 is $18,000 ($36,000 gift − $18,000 annual exclusion). However, if Eduardo splits the gift with Cecilia, each is considered to have gifted $18,000 to Daniel. Because Eduardo and Cecilia are each entitled to a $18,000 annual exclusion per gift recipient, the $36,000 gift to Daniel would not be a taxable gift.

Caution. Married taxpayers must file gift tax returns to split gifts with their spouses, **regardless** of the gift amount.[72]

Exclusion for Educational and Medical Expenses.[73] Payments made on behalf of an individual **directly** to an educational institution for tuition or **directly** to a doctor, hospital, or medical provider for medical services are not considered taxable gifts, even if such payments are over the annual gift tax exclusion.

Practitioner Planning Tip

Tax practitioners should caution their clients making such gifts that the payments must be made **directly** to the school or medical provider rather than the individual who incurred the expense. Even if the individual uses the gift proceeds for the intended education or medical purpose, the IRS will deem the gift a taxable gift to the extent it exceeds the applicable annual gift tax exclusion.

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72. Instructions for Form 709.

73. IRC §2503(e).

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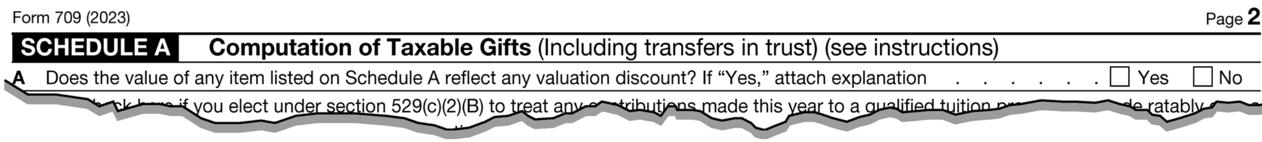
Valuing Gifts[74]

In calculating taxable gifts or assessing the applicability of the annual gift tax exclusion, the value of a gift is its fair market value (FMV) as of the date of the transfer. While this amount is easily determinable for cash gifts, other types of gifted property may not be as simple in calculating the FMV. FMV is the price at which a willing, knowledgeable buyer and seller agree to exchange. Depending on the type of gifted property, the application of this principle can vary. For example, when determining the FMV of a stock or bond, the taxpayer uses the average between the highest and lowest selling prices quoted on the date of the transfer. The FMV of real property, on the other hand, is best indicated by the sale of the property in an arm's-length transaction on the date of transfer. If no such transaction of real property occurred, the next best method to use would be a comparable sales method, factoring in necessary adjustments such as differences in size, scale, and location. For some gifts, it may be most practical to have an appraiser perform an appraisal. For any reported gifts where a taxpayer used an appraiser to determine the FMV of the gift, the taxpayer must either attach a copy of the appraisal to their filed gift tax return or provide a detailed explanation of how they determined the value of the gift on Form 709, Schedule A.

Valuation Discounts.[75] Often used in conjunction with family limited partnerships (FLP) as an estate planning tool to gift property to younger generations, valuation discounts can be used to factor in reductions to a gift's value when considering lack of marketability and minority interest. **Lack of marketability** reflects the fact that the sale or transfer of an ownership interest is restricted, resulting in no ready market for the interest. **Minority interest** provides a discount for gifts of non-majority ownership interests to reflect the limitation of control and decision-making power associated with minority ownership. This discount is available to FLPs with transfers between family members, even though control exists within the family unit after the transfer.[76] The percentage of these valuation discounts may be substantial depending on given facts and circumstances. Consequently, valuation discounts are under increased scrutiny by the IRS, requiring taxpayers to be diligent in maintaining documentation supporting their calculation of the discounts.[77] If a taxpayer applies any valuation discounts to the gifts they make in an applicable year, they must mark Box A "yes" and attach a written statement and support explaining such discounts.


Form 709 (2023) Page 2

SCHEDULE A **Computation of Taxable Gifts** (Including transfers in trust) (see instructions)

A Does the value of any item listed on Schedule A reflect any valuation discount? If "Yes," attach explanation . . . . ☐ Yes ☐ No

Note. For an in-depth analysis of the fundamentals of FLPs and valuation discounts, see the 2017 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 6: Beneficiary and Estate Issues. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

74. Instructions for Form 709.

75. *Discount for Lack of Marketability: Job Aid for IRS Valuation Professionals*. Sep. 25, 2009. IRS. [www.irs.gov/pub/irs-utl/dlom.pdf] Accessed on Oct. 11, 2023.

76. Rev. Rul. 93-12, 1993-1 CB 202.

77. *The FLP Valuation Discount Is Here to Stay…for Now*. Frazier, William H. Nov. 10, 2021. WealthManagement.com. [www.wealthmanagement.com/high-net-worth/flp-valuation-discount-here-stay-now] Accessed on Oct. 12, 2023.

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Generation-Skipping Transfer Tax

When making gifts to individuals, taxpayers should be aware of the possibility that intended recipients are **skip persons.** A skip person is an individual who is two or more generations below the transferor (if the recipient is not a relative, they are a skip person if they are more than 37½ years younger than the transferor[78]) or a trust that either comprises only beneficiaries who are skip persons or is prohibited from making distributions to non-skip persons.[79] Gifts made to skip persons are subject to the generation-skipping transfer tax (GSTT).[80] The GSTT is significant in distinguishing between regular estate tax, as the tax rate for the GSTT is the maximum federal estate tax rate, regardless of the dollar amount of the transfer (with some exclusions discussed later).[81] The GSTT was implemented to prevent gift and estate tax avoidance by skipping one or more generations.

However, each taxpayer has a lifetime GSTT exemption amount available to them to offset GSTT.[82] The exemption amount equals the unified credit amount against gift tax.[83] The GSTT exemption is automatically allocated to gifts made to direct skip persons. For gifts made in 2001 and later, the GSTT is automatically allocated to gifts to **indirect skips.**[84] Indirect skips are transfers where intermediate steps occur before the skip person receives the property.[85] An example of an indirect skip includes a trust that has or may eventually have a beneficiary who is a skip person to whom assets may be distributed. GSTT is calculated on Form 709, Schedule D, *Computation of Generation-Skipping Transfer Tax*.

Estate Tax Inclusion Period. The estate tax inclusion period (ETIP) is the period of time for which a transfer would be included in the taxpayer's gross estate should they die.[86] This is a concept that applies to transfers to trusts for which the grantor has a retained interest, and one or more of the beneficiaries of the trust is a skip person. While the taxpayer must report the gift portion of the transfer on Form 709, Schedule A at the time of the transfer, the taxpayer does not report the generation-skipping transfer (GST) portion on Schedule D to calculate the GSTT and applicable exemption until after the ETIP ends, which is the earlier of when the GST is complete, or the taxpayer dies.[87] Consequently, the GSTT exemption is calculated based on the value of the transferred assets at the end of the ETIP, thus subjecting any appreciation in the value of those assets to the GSTT.

Unified Credit Against Gift Tax[88]

The unification of the estate and gift tax in 1976 resulted in the two taxes being intrinsically related. Perhaps the most evident illustration of this concept is the unified credit against gift tax. Often referred to as a taxpayer's **lifetime exemption,** the credit represents the tax credit every decedent is entitled to use in offsetting both estate value and gift taxation.[89] A taxpayer's lifetime exemption is reduced by the amount of taxable gifts the taxpayer makes during their lifetime. This results in taxpayers who make taxable gifts that collectively do not exceed their lifetime exemption not owing or having to pay tax on the gifts when filing their gift tax return.

78. Instructions for Form 706-GS(T).
79. IRC §2613(a).
80. IRC §§2601 and 2611(a).
81. IRC §2641.
82. IRC §2631(a).
83. IRC §2631(c).
84. Treas. Reg. §26.2632-1(b).
85. IRC §2632(c)(3).
86. IRC §2642(f)(3).
87. Ibid.
88. IRC §§2505(a) and 2010(c).
89. IRC §2010(a).

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When a taxpayer makes **taxable** gifts, they report the taxable gifts on Form 709, which includes Schedule B, *Gifts From Prior Periods*, where the history of all taxable gifts the taxpayer made during their lifetime up until that tax year is reported. In the event a deceased taxpayer must file Form 706, *United States Estate (and Generation-Skipping Transfer) Tax Return*, the total taxable gifts of the decedent must be disclosed to calculate how much, if any, remaining lifetime exemption is available for the taxpayer to use in offsetting their federal estate tax.

The lifetime exemption changes annually. Normally, the lifetime exemption is set at a specified dollar amount and adjusted for inflation each year. However, with the passage of the TCJA, Congress changed the amount of the lifetime exemption, nearly doubling it from $5.6 million to $11.18 million.[90] For 2024, the lifetime exemption is $13.61 million.[91] If provisions of the TCJA are not extended, the lifetime exemption drops to its lower pre-TCJA amount beginning January 1, 2026.

Note. For further information regarding the impact of the potential expiration of the TCJA on the lifetime exemption, see the 2024 *University of Illinois Federal Tax Workbook*, Chapter 12: Planning for the Sunset of the TCJA.

Deceased Spousal Unused Exclusion. A decedent's lifetime exemption may more than cover the amount of estate tax for which they are subject. The **excess amount** of the exclusion may be transferred to the decedent's spouse through an election known as **portability.**[92] The decedent's executor can make this election by preparing and filing a Form 706, even if they are not otherwise required to file one.[93] The amount of excess exclusion that is transferred to the surviving spouse is known as the **deceased spousal unused exclusion (DSUE).** While the amount is calculated on the decedent's Form 706, the surviving spouse must also identify the amount of DSUE available to them for the year in which they make taxable gifts on Form 709, Schedule C, *Deceased Spousal Unused Exclusion (DSUE) Amount and Restored Exclusion*.[94] The amount of a taxpayer's DSUE is applied against any estate and gift tax **before** their own lifetime exemption.[95] Consequently, practitioners must be aware of any DSUE available to taxpayers for whom they are preparing a gift tax return.

Practitioner Planning Tip

A taxpayer's financial situation may change dramatically (e.g., winning the lottery) after their spouse dies. It may be advisable to offer to prepare a Form 706 electing portability any time a spouse dies, to capture the benefit of the DSUE. If the taxpayer declines, the practitioner should document the decision in the client's file.

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90. *Estate and Gift Tax FAQs*. Oct. 23, 2023. IRS. [www.irs.gov/newsroom/estate-and-gift-tax-faqs] Accessed on Oct. 23, 2023.
91. Rev. Proc. 2023-34, 2023-48 IRB 1287.
92. Treas. Reg. §20.2010-2.
93. Treas. Reg. §20.2010-2(a).
94. Instructions for Form 709.
95. Treas. Reg. §25.2505-2(b).

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Late Portability Election.[96] Relief for a late portability election is available for estates that are not required to and did not file an estate tax return for a decedent meeting the following criteria.

- Survived by a spouse
- Died after December 31, 2010
- Was a citizen or resident of the United States when they died

Such estates may qualify for relief for a late portability election by preparing and filing Form 706 by the fifth anniversary of the decedent's date of death. The top of Form 706 must include the language "filed pursuant to Rev. Proc. 2022-32 to elect portability under §2010(c)(5)(A)."

PREPARING FORM 709[97]

Taxpayers must file Form 709 for tax years in which they make one of the following types of gifts.

- Gifts to recipients in excess of the annual exclusion
- Gifts of future interests
- Gifts that were split with a spouse, regardless of the amount

As taxpayers are unable to file joint gift tax returns, spouses must file their own Form 709 for gifts that they made for the applicable year.

The form contains two parts and four accompanying schedules. Form 709, part 1, *General Information*, requires taxpayers to provide general information, such as their name, address, and social security number (SSN). This section is also where a taxpayer identifies whether they filed a previous gift tax return and whether they are electing to split gifts with their spouse, providing their spouse's name and SSN. Form 709, part 2, *Tax Computation*, discussed later, consists of calculating the gift tax.

Completing Form 709, Schedule A

A taxpayer reports gifts they made through the applicable tax year on Schedule A of Form 709. Schedule A is organized into four parts, with the first three parts identifying the following information.

- Donee's name and address
- Description of gift
- Donor's adjusted basis in the gift
- Date of the gift
- Gift's value at the time of the transfer
- Gifts made by the taxpayer's spouse if electing to split gifts with them

Information about the donee must include their name, address, and relationship, if any, to the donor. The information regarding the gift must include a description of the property gifted. If any securities were gifted, Form 709 must provide their identifying numbers as established by the Committee on Uniform Securities Identification Procedures (CUSIP).[98] If equity in a closely held entity is gifted, the donor must provide its employer identification number (EIN).

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96. Rev. Proc. 2022-32, 2022-30 IRB 101.

97. Instructions for Form 709.

98. These numbers are commonly referred to as "CUSIP numbers." See *CUSIP Number,* Apr. 27, 2015. U.S. Securities and Exchange Commission. [www.sec.gov/answers/cusip] Accessed on Mar. 14, 2024.

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In part 1, *Computation of Taxable Gifts (Including transfers in trust),* donors disclose gifts that are subject only to the gift tax and are not subject to the GSTT. These gifts are made to recipients who are neither direct nor indirect skip beneficiaries. Instead, taxpayers use part 2, *Direct Skips,* to disclose gifts made to direct skip persons and part 3, *Indirect Skips and Other Transfers in Trust,* to report gifts made to indirect skip persons and other transfers in trust. Such gifts are subject to both the gift tax and the GSTT. If the taxpayer elects to split gifts with their spouse, the bottom portion of each of the first three parts in Schedule A is where the taxpayer identifies gifts made by their spouse.

Schedule A, part 4, *Taxable Gift Reconciliation,* calculates the amount of taxable gifts made for the calendar year for which the taxpayer is filing. The taxpayer enters the total gifts they made from the preceding three parts of Schedule A on line 1. If the taxpayer elects to split gifts with their spouse, the taxpayer includes only the gifts they made on line 1 and excludes the portion of gifts made by their spouse. The taxpayer then reduces the total value of gifts reported on line 1 by the total annual exclusions for those gifts that the taxpayer may claim. Subsequently, the taxpayer subtracts any deductions, including charitable deductions, and adds the payable GSTT calculated in Schedule D, discussed later, to arrive at taxable gifts to report on line 1 of Form 709.

Example 13. Ted and his wife Karen jointly give $50,000 to each of their three adult children and $50,000 to their grandson, Edward, on June 30, 2023. Thus, Ted and Karen collectively gave these four recipients a total of $200,000 ($50,000 per gift × 4 recipients). They made gifts in the same amount in 2022 but no other taxable gifts in prior years. Ted and Karen elect to split their gifts in 2023, as they did the preceding year. In preparing their separate gift tax returns, Ted prepares Form 709, Schedule A, for his return as follows.

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For Example 13

Form 709 (2023) Page **2**

SCHEDULE A **Computation of Taxable Gifts** (Including transfers in trust) (see instructions)

A Does the value of any item listed on Schedule A reflect any valuation discount? If "Yes," attach explanation . . . . ☐ Yes ☒ No

B ☐ Check here if you elect under section 529(c)(2)(B) to treat any contributions made this year to a qualified tuition program as made ratably over a 5-year period beginning this year. See instructions. Attach explanation.

Part 1—Gifts Subject Only to Gift Tax. Gifts less political organization, medical, and educational exclusions. See instructions.

A Item number	B • Donee's name and address • Relationship to donor (if any) • Description of gift • If the gift was of securities, give CUSIP no. • If closely held entity, give EIN	C	D Donor's adjusted basis of gift	E Date of gift	F Value at date of gift	G For split gifts, enter 1/2 of column F	H Net transfer (subtract col. G from col. F)
1	**Nancy Harrington, daughter, cash**		**50,000**	**6/30/23**	**50,000**	**25,000**	**25,000**
2	**Michael Wheeler, son, cash**		**50,000**	**6/30/23**	**50,000**	**25,000**	**25,000**
3	**Holly Wheeler, daughter, cash**		**50,000**	**6/30/23**	**50,000**	**25,000**	**25,000**
Gifts made by spouse—*complete **only** if you are splitting gifts with your spouse and he/she also made gifts.*							
Total of Part 1. Add amounts from Part 1, column H							**75,000**

Part 2—Direct Skips. Gifts that are direct skips and are subject to both gift tax and generation-skipping transfer tax. You must list the gifts in chronological order.

A Item number	B • Donee's name and address • Relationship to donor (if any) • Description of gift • If the gift was of securities, give CUSIP no. • If closely held entity, give EIN	C 2632(b) election out	D Donor's adjusted basis of gift	E Date of gift	F Value at date of gift	G For split gifts, enter 1/2 of column F	H Net transfer (subtract col. G from col. F)
1	**Edward Harrington, grandson, cash**		**50,000**	**6/30/23**	**50,000**	**25,000**	**25,000**
Gifts made by spouse—*complete **only** if you are splitting gifts with your spouse and he/she also made gifts.*							
Total of Part 2. Add amounts from Part 2, column H							**25,000**

Part 3—Indirect Skips and Other Transfers in Trust. Gifts to trusts that are indirect skips as defined under section 2632(c) or to trusts that are currently subject to gift tax and may later be subject to generation-skipping transfer tax. You must list these gifts in chronological order.

A Item number	B • Donee's name and address • Relationship to donor (if any) • Description of gift • If the gift was of securities, give CUSIP no. • If closely held entity, give EIN	C 2632(c) election	D Donor's adjusted basis of gift	E Date of gift	F Value at date of gift	G For split gifts, enter 1/2 of column F	H Net transfer (subtract col. G from col. F)
1							
Gifts made by spouse—*complete **only** if you are splitting gifts with your spouse and he/she also made gifts.*							
Total of Part 3. Add amounts from Part 3, column H							

(If more space is needed, attach additional statements.) Form **709** (2023)

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Because Ted's grandson, Edward, is a skip beneficiary, Ted completes part 2 of Schedule A in addition to part 1. Karen's separate Form 709, Schedule A, follows.

Form 709 (2023) Page **2**

SCHEDULE A **Computation of Taxable Gifts** (Including transfers in trust) (see instructions)

A Does the value of any item listed on Schedule A reflect any valuation discount? If "Yes," attach explanation . . . . ☐ Yes ☒ No

B ☐ Check here if you elect under section 529(c)(2)(B) to treat any contributions made this year to a qualified tuition program as made ratably over a 5-year period beginning this year. See instructions. Attach explanation.

Part 1—Gifts Subject Only to Gift Tax. Gifts less political organization, medical, and educational exclusions. See instructions.

A Item number	B • Donee's name and address • Relationship to donor (if any) • Description of gift • If the gift was of securities, give CUSIP no. • If closely held entity, give EIN	C	D Donor's adjusted basis of gift	E Date of gift	F Value at date of gift	G For split gifts, enter 1/2 of column F	H Net transfer (subtract col. G from col. F)
1							
Gifts made by spouse—*complete **only** if you are splitting gifts with your spouse and he/she also made gifts.*							
1	**Nancy Harrington, daughter, cash**		**50,000**	**6/30/23**	**50,000**	**25,000**	**25,000**
2	**Michael Wheeler, son, cash**		**50,000**	**6/30/23**	**50,000**	**25,000**	**25,000**
3	**Holly Wheeler, daughter, cash**		**50,000**	**6/30/23**	**50,000**	**25,000**	**25,000**
Total of Part 1. Add amounts from Part 1, column H							**75,000**

Part 2—Direct Skips. Gifts that are direct skips and are subject to both gift tax and generation-skipping transfer tax. You must list the gifts in chronological order.

A Item number	B • Donee's name and address • Relationship to donor (if any) • Description of gift • If the gift was of securities, give CUSIP no. • If closely held entity, give EIN	C 2632(b) election out	D Donor's adjusted basis of gift	E Date of gift	F Value at date of gift	G For split gifts, enter 1/2 of column F	H Net transfer (subtract col. G from col. F)
1							
Gifts made by spouse—*complete **only** if you are splitting gifts with your spouse and he/she also made gifts.*							
1	**Edward Harrington, grandson, cash**		**50,000**	**6/30/23**	**50,000**	**25,000**	**25,000**
Total of Part 2. Add amounts from Part 2, column H							**25,000**

Part 3—Indirect Skips and Other Transfers in Trust. Gifts to trusts that are indirect skips as defined under section 2632(c) or to trusts that are currently subject to gift tax and may later be subject to generation-skipping transfer tax. You must list these gifts in chronological order.

A Item number	B • Donee's name and address • Relationship to donor (if any) • Description of gift • If the gift was of securities, give CUSIP no. • If closely held entity, give EIN	C 2632(c) election	D Donor's adjusted basis of gift	E Date of gift	F Value at date of gift	G For split gifts, enter 1/2 of column F	H Net transfer (subtract col. G from col. F)
1							
Gifts made by spouse—*complete **only** if you are splitting gifts with your spouse and he/she also made gifts.*							
Total of Part 3. Add amounts from Part 3, column H							

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Ted's part 4 of Schedule A is as follows.

Form 709 (2023) Page 3

Part 4—Taxable Gift Reconciliation

1	Total value of gifts of donor. Add totals from column H of Parts 1, 2, and 3			1	100,000
2	Total annual exclusions for gifts listed on line 1 (see instructions)			2	68,000
3	Total included amount of gifts. Subtract line 2 from line 1			3	32,000
Deductions (see instructions)					
4	Gifts of interests to spouse for which a marital deduction will be claimed, based on item numbers ________ of Schedule A	4	0		
5	Exclusions attributable to gifts on line 4	5	0		
6	Marital deduction. Subtract line 5 from line 4	6	0		
7	Charitable deduction, based on item numbers ________ less exclusions	7	0		
8	Total deductions. Add lines 6 and 7			8	0
9	Subtract line 8 from line 3			9	32,000
10	Generation-skipping transfer taxes payable with this Form 709 (from Schedule D, Part 3, col. G, total)			10	0
11	**Taxable gifts.** Add lines 9 and 10. Enter here and on page 1, Part 2—Tax Computation, line 1			11	32,000

The annual exclusion applied to the 2023 gifts that Ted made to his three children and grandchild totals \$68,000 (\$17,000 annual exclusion × 4 recipients). Because Ted has no other deductions, the amount of taxable gifts he made in 2023 is \$32,000 (\$100,000 gifts − \$68,000 annual exclusions).

Completing Form 709, Schedule B

A taxpayer identifies the amount of taxable gifts that they made in prior years and any amount of their lifetime exemption they used to offset the gift tax on those gifts on Schedule B, *Gifts From Prior Periods*. Taxpayers use the table at the beginning of the schedule to list and separately report each calendar year that the taxpayer made taxable gifts and prepared a Form 709. Column A of the table identifies the calendar year, and column B identifies the IRS office where the return for that year was filed. The taxpayer uses column C to report the amount of lifetime exemption they used against taxable gifts made after December 31, 1976, and column D to report the amount of exemption the taxpayer used against gifts made before January 1, 1977. Finally, the taxpayer reports the amount of taxable gifts for that prior reported year in column E.

Practitioner Planning Tip

To complete Schedule B, practitioners must obtain copies of the taxpayer's previously filed Forms 709. Ideally, those returns contain completed Schedules B, and the practitioner may roll forward the prior Schedule B filed. To include the prior return's applicable tax year information on Schedule B of the return that the practitioner is preparing, the practitioner completes the table in Schedule B using page 1 of the previously filed Form 709. In some circumstances, the practitioner must request transcripts of previously filed Forms 709 with Form 8821, *Tax Information Authorization*, or Form 2848, *Power of Attorney and Declaration of Representative.*

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After completing the table, the taxpayer reports the amount of calculated total taxable gifts from prior periods on line 2 of Form 709.

Example 14. Use the same facts as **Example 13.** Because Ted and Karen made taxable gifts in 2022, they each prepare a Schedule B to report the gifts' amounts and the applicable credit they used for tax year 2022. On Ted's Schedule B, he reported taxable gifts that he made in 2022 totaling $36,000, consisting of the $100,000 gifts he made to his three children and grandchild less the $64,000 annual exclusions he applied against it ($16,000 annual exclusion for 2022 × 4 recipients). The amount of applicable credit used against the 2022 taxable gifts was $7,320 (reported on line 12 of their 2022 Form 709). A copy of Ted's Schedule B is as follows.

SCHEDULE B Gifts From Prior Periods

If you answered "Yes" on line 11a of page 1, Part 1, see the instructions for completing Schedule B. If you answered "No," skip to the Tax Computation on page 1 (or Schedule C or D, if applicable). Complete Schedule A before beginning Schedule B. See instructions for recalculation of the column C amounts. Attach calculations.

A Calendar year or calendar quarter (see instructions)	B Internal Revenue office where prior return was filed	C Amount of applicable credit (unified credit) against gift tax for periods after December 31, 1976	D Amount of specific exemption for prior periods ending before January 1, 1977	E Amount of taxable gifts
2022	Kansas City, MO 64999	7,320	0	36,000
1 Totals for prior periods	**1**	7,320	0	36,000

2 Amount, if any, by which total specific exemption, line 1, column D, is more than $30,000	**2**	0
3 Total amount of taxable gifts for prior periods. Add amount on line 1, column E, and amount, if any, on line 2. Enter here and on page 1, Part 2—Tax Computation, line 2	**3**	36,000

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Completing Form 709, Schedule C

If a taxpayer is the surviving spouse of a decedent whose executor elected portability, a DSUE may be available to them to offset estate and gift tax. When making taxable gifts in years following their spouse's death, they must complete Schedule C of any Form 709 they file. Schedule C contains two parts, identifying the taxpayer's last deceased spouse and the applicable DSUE in part 1, *DSUE Received From Last Deceased Spouse,* and any spouses to whom the taxpayer was married prior to the last deceased spouse who elected portability, if any, in part 2, *DSUE Received From Predeceased Spouse(s)*. The amount of DSUE that a taxpayer may use to offset gift and estate tax is limited to the amount of DSUE of their last deceased spouse.[99] The amount of the taxpayer's DSUE is combined with their own lifetime exclusion amount to calculate the applicable credit to offset estate and gift tax reported on line 7 of Form 709.

Form 709 (2023) Page 4

SCHEDULE C Deceased Spousal Unused Exclusion (DSUE) Amount and Restored Exclusion

Provide the following information to determine the DSUE amount and applicable credit received from prior spouses. Complete Schedule A before beginning Schedule C.

A Name of deceased spouse (dates of death after December 31, 2010, only)	B Date of death	C Portability election made?		D If "Yes," DSUE amount received from spouse	E DSUE amount applied by donor to lifetime gifts (list current and prior gifts)	F Date of gift(s) (enter as mm/dd/yy for Part 1 and as yyyy for Part 2)
		Yes	No			
Part 1—DSUE RECEIVED FROM LAST DECEASED SPOUSE						
Part 2—DSUE RECEIVED FROM PREDECEASED SPOUSE(S)						
TOTAL (for all DSUE amounts applied from column E for Part 1 and Part 2)						

1	Donor's basic exclusion amount (see instructions)	1	
2	Total from column E, Parts 1 and 2	2	
3	Restored Exclusion Amount (see instructions)	3	
4	Add lines 1, 2, and 3	4	
5	Applicable credit on amount in line 4 (see *Table for Computing Gift Tax* in the instructions). Enter here and on line 7, Part 2—Tax Computation	5	

Computation of Generation-Skipping Transfer Tax

[99] Treas. Reg. §25.2502-2(a).

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Completing Form 709, Schedule D

Not only must taxpayers who made gifts to direct skip beneficiaries complete part 2 of Schedule A, but they must also complete Schedule D to calculate the GSTT and exemption to use against it. The taxpayer begins by completing the table in part 1, *Generation-Skipping Transfers,* where the taxpayer lists each gift from Schedule A, part 2. They must also include any gifted transfers for which the ETIP has ended and apply any applicable annual exclusion to them to calculate the net transfer of the gifts. The taxpayer calculates the GST exemption in part 2, *GST Exemption Reconciliation (Section 2631) and Section 2652(a)(3) Election,* and the GSTT in part 3, *Tax Computation,* of Schedule D. The taxpayer reports the calculated GSTT from Schedule D on page 1, line 16, of Form 709.

Example 15. Use the same facts as **Example 13.** Ted made a gift to his grandson, Edward, who is a direct skip beneficiary. Ted completes Schedule D accordingly, reporting the $50,000 gift made to Edward in 2023. Because he elects to split gifts with Karen, Ted identifies his portion of the split gift. Therefore, the net transfer for Ted in 2023 is the $25,000 gift ($50,000 total gift − $25,000 Karen's split) less the $17,000 annual exclusion to equal $8,000.

Part 2—Tax Computation 5

SCHEDULE D Computation of Generation-Skipping Transfer Tax

Note: Inter vivos direct skips that are completely excluded by the GST exemption must still be fully reported (including value and exemptions claimed) on Schedule D.

Part 1—Generation-Skipping Transfers. List items from Schedule A first, then items to be reported on Schedule D, including any transfers subject to an Estate Tax Inclusion Period (ETIP).

A Item number (from Schedule A, Part 2, col. A, then ETIP transfers, if any)	B Description (only for ETIP transfers)	C Value (from Schedule A, Part 2, col. H, or close of ETIP described in col. B)	D Nontaxable portion of transfer	E Net transfer (subtract col. D from col. C)
1		25,000	17,000	8,000
Gifts made by spouse (for gift splitting only)				

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When completing part 2, Ted identifies his allowable exemption to be used against the GSTT, which is $12,920,000 for 2023.[100] He also identifies the amount of the exclusion he used in prior periods, which solely consisted of the prior year's gift he made to Edward in 2022. This amount was $9,000 ($25,000 Ted's split − $16,000 annual exclusion for 2022), leaving Ted with $12,911,000 of exclusion to apply against 2023 gifts ($12,920,000 − $9,000). This is more than enough to cover the $8,000 of 2023 net transfer, resulting in zero GSTT payable for 2023.

[100]. Instructions for Form 709.

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For Example 15

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Part 2—GST Exemption Reconciliation (Section 2631) and Section 2652(a)(3) Election

Check here ☐ if you are making a section 2652(a)(3) (special QTIP) election. See instructions.
Enter the item numbers from Schedule A of the gifts for which you are making this election

		Line	Amount
1	Maximum allowable exemption (see instructions)	1	12,920,000
2	Total exemption used for periods before filing this return	2	9,000
3	Exemption available for this return. Subtract line 2 from line 1	3	12,911,000
4	Exemption claimed on this return from Part 3, column C, total below	4	8,000
5	Automatic allocation of exemption to transfers reported on Schedule A, Part 3. To opt out of the automatic allocation rules, you must attach an "**Election Out**" statement. See instructions	5	
6	Exemption allocated to transfers not shown on line 4 or line 5 above. **You must attach a "Notice of Allocation."** See instructions	6	
7	Add lines 4, 5, and 6	7	8,000
8	Exemption available for future transfers. Subtract line 7 from line 3	8	12,903,000

Part 3—Tax Computation

A Item number (from Schedule D, Part 1)	B Net transfer (from Schedule D, Part 1, col. E)	C GST exemption allocated	D Divide col. C by col. B	E Inclusion ratio (Subtract col. D from 1.000)	F Applicable rate (multiply col. E by 40% (0.40))	G Generation-skipping transfer tax (multiply col. B by col. F)
1	8,000	8,000	1.000	0.000	0.000	0
Gifts made by spouse (for gift splitting only)						
Total exemption claimed. Enter here and on Part 2, line 4, above. May not exceed Part 2, line 3, above		8,000	**Total generation-skipping transfer tax.** Enter here; on page 3, Schedule A, Part 4, line 10; and on page 1, Part 2—Tax Computation, line 16			0

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Completing Form 709, Part 2

With the applicable schedules completed, the taxpayer calculates the gift tax on Form 709, part 2. The taxpayer begins by calculating the estate tax for both current and prior-year taxable gifts. The gift tax is calculated using the following table.[101]

Column A Taxable Amount Over…	Column B Taxable Amount Not Over…	Column C Tax on Amount in Column A	Column D Rate of Tax on Excess Over Amount in Column A
$ 0	$ 10,000	$ 0	18%
10,000	20,000	1,800	20%
20,000	40,000	3,800	22%
40,000	60,000	8,200	24%
60,000	80,000	13,000	26%
80,000	100,000	18,200	28%
100,000	150,000	23,800	30%
150,000	250,000	38,800	32%
250,000	500,000	70,800	34%
500,000	750,000	155,800	37%
750,000	1,000,000	248,300	39%
1,000,000	—	345,800	40%

The taxpayer then calculates the applicable credit against the gift tax. The applicable credit consists of the credit on the lifetime exclusion amount and any DSUE available to the taxpayer. The applicable credit cannot exceed the amount of gift tax calculated on current and prior year gifts. The resulting balance is added to any GSTT calculated in Schedule D to calculate the total tax. After taking into account the total gift tax and GSTT the taxpayer paid during the lifetime, the remaining balance due is shown at the end of the form.

Example 16. Use the same facts as **Example 13.** Ted reports a total of $68,000 taxable gifts that he has made during his lifetime, which consists of $32,000 of taxable gifts he made in 2023 calculated in part 4 of Schedule A and $36,000 of taxable gifts he made in prior periods disclosed on Schedule B. The tax on these gifts totals $15,080 ($13,000 tax on threshold + (($68,000 taxable gifts − $60,000 threshold) × 26% excess rate)).[102] The amount of tax on Ted's prior gifts is $7,320 ($3,800 tax on threshold + (($36,000 taxable gift − $20,000 threshold) × 22% excess rate)), resulting in a tax of $7,760 on his 2023 gifts ($15,080 tax on lifetime gifts − $7,320 tax on prior period gifts).

The total applicable credit available to Ted in 2023 is $5,113,800.[103] Having already used $7,320 of his credit for gifts made in prior periods, Ted is left with $5,106,480 of credit to offset the tax on gifts he made in 2023 ($5,113,800 total credit − $7,320 credit applied to prior periods' gift tax). Therefore, Ted can use $7,760 of his credit to offset the gift tax of $7,760 on his 2023 gifts. Page 1 of Ted's Form 709 follows.

[101] Instructions for Form 709.

[102] Ibid.

[103] Ibid.

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For Example 16

Form 709 — Department of the Treasury, Internal Revenue Service

United States Gift (and Generation-Skipping Transfer) Tax Return

Go to *www.irs.gov/Form709* for instructions and the latest information.
(For gifts made during calendar year 2023)

OMB No. 1545-0020 — 2023

Part 1—General Information

1 Donor's first name and middle initial	2 Donor's last name	3 Donor's social security number
Ted	Wheeler	***-**-6789
4 Address (number, street, and apartment number)		5 Legal residence (domicile)
2530 Piney Wood		Indiana
6 City or town, state or province, country, and ZIP or foreign postal code		7 Citizenship (see instructions)
Hawkins, IN 46974		Citizen of the United States

Line	Question	Yes	No
8	If the donor died during the year, check here ☐ and enter date of death ______ , ______ .		
9	If you extended the time to file this Form 709, check here ☐		
10	Enter the total number of donees listed on Schedule A. Count each person only once **4**		
11a	Have you (the donor) previously filed a Form 709 (or 709-A) for any other year? If "No," skip line 11b	X	
b	Has your address changed since you last filed Form 709 (or 709-A)?		X
12	**Gifts by husband or wife to third parties.** Do you consent to have the gifts (including generation-skipping transfers) made by you and by your spouse to third parties during the calendar year considered as made one-half by each of you? See instructions. (If the answer is "Yes," the following information must be furnished and your spouse must sign the consent shown below. **If the answer is "No," skip lines 13–18.**)	X	
13	Name of consenting spouse **Karen Wheeler** — 14 SSN **xxx-xx-1234**		
15	Were you married to one another during the entire calendar year? See instructions	X	
16	If line 15 is "No," check whether ☐ married ☐ divorced or ☐ widowed/deceased, and give date. See instructions		
17	Will a gift tax return for this year be filed by your spouse? If "Yes," mail both returns in the same envelope	X	
18	**Consent of Spouse.** I consent to have the gifts (and generation-skipping transfers) made by me and by my spouse to third parties during the calendar year considered as made one-half by each of us. We are both aware of the joint and several liability for tax created by the execution of this consent.		
	Consenting spouse's signature — **Date**		
19	Have you applied a DSUE amount received from a predeceased spouse to a gift or gifts reported on this or a previous Form 709? If "Yes," complete Schedule C		X
20	Does any gift or other transfer reported on this Form 709 include a digital asset (or a financial interest in a digital asset)? See instructions		X

Part 2—Tax Computation

Line	Description		Amount
1	Enter the amount from Schedule A, Part 4, line 11	1	32,000
2	Enter the amount from Schedule B, line 3	2	36,000
3	Total taxable gifts. Add lines 1 and 2	3	68,000
4	Tax computed on amount on line 3 (see *Table for Computing Gift Tax* in instructions)	4	15,080
5	Tax computed on amount on line 2 (see *Table for Computing Gift Tax* in instructions)	5	7,320
6	Balance. Subtract line 5 from line 4	6	7,760
7	Applicable credit amount. If donor has DSUE amount from predeceased spouse(s) or Restored Exclusion Amount, enter amount from Schedule C, line 5; otherwise, see instructions	7	5,113,800
8	Enter the applicable credit against tax allowable for all prior periods (from Sch. B, line 1, col. C)	8	7,320
9	Balance. Subtract line 8 from line 7. Do not enter less than zero	9	5,106,480
10	Enter 20% (0.20) of the amount allowed as a specific exemption for gifts made after September 8, 1976, and before January 1, 1977. See instructions	10	0
11	Balance. Subtract line 10 from line 9. Do not enter less than zero	11	5,106,480
12	Applicable credit. Enter the smaller of line 6 or line 11	12	7,760
13	Credit for foreign gift taxes (see instructions)	13	0
14	Total credits. Add lines 12 and 13	14	7,760
15	Balance. Subtract line 14 from line 6. Do not enter less than zero	15	0
16	Generation-skipping transfer taxes (from Schedule D, Part 3, col. G, total)	16	0
17	Total tax. Add lines 15 and 16	17	0
18	Gift and generation-skipping transfer taxes prepaid with extension of time to file	18	
19	If line 18 is less than line 17, enter **balance due**. See instructions	19	
20	If line 18 is greater than line 17, enter **amount to be refunded**	20	

Attach check or money order here.

Sign Here

Under penalties of perjury, I declare that I have examined this return, including any accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than donor) is based on all information of which preparer has any knowledge.

May the IRS discuss this return with the preparer shown below? See instructions. ☐ Yes ☐ No

Signature of donor — Date

Paid Preparer Use Only

Print/Type preparer's name	Preparer's signature	Date	Check ☐ if self-employed	PTIN

Firm's name — Firm's EIN

Firm's address — Phone no.

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When to File Form 709[104]

Form 709 is a calendar-year, annual return. Filers must submit Form 709 no later than **April 15** or the next business day following the Saturday, Sunday, or legal holiday on which April 15 falls. The return may be extended for six months by filing an income tax return extension or filing Form 8892, *Application for Automatic Extension of Time To File Form 709 and/or Payment of Gift/Generation-Skipping Transfer Tax*. **Form 709 is not available for electronic filing** and must be mailed to the following address.

Department of the Treasury
Internal Revenue Service Center
Kansas City, MO 64999

For donors that die during the tax year in which they made a taxable gift, the due date for Form 709 is the earlier of the following.

- The due date (including extensions) of the donor's Form 706
- April 15 of the following tax year, or the extended due date

The due date of a decedent's Form 706 is nine months from the date of death.[105]

Late filing and payment penalties apply for Form 709 under IRC §6651. The late filing penalty is 5% of the unpaid tax for each month the return is late, not to exceed 25%.[106] The late payment penalty is 0.5% of the unpaid tax for each month the payment is late, not to exceed 25%.[107] The IRS may abate the penalties for reasonable cause provided by the taxpayer in a statement attached to the submitted Form 709.

Practitioner Planning Tip

Because the late filing and payment penalties are assessed on unpaid tax, and the higher exclusion amount provided by the TCJA has generally resulted in fewer instances of gift tax being due with a filed Form 709, it may be tempting to not prioritize preparing and filing the gift tax return. However, it is important to disclose gifts and transfers in a timely manner to begin running the statute of limitations of three years.[108]

RECIPIENT CONSIDERATIONS

While reporting requirements are generally the responsibility of the donor regarding gift and estate taxation, there are taxable considerations for the recipients of gifts. This section covers the basis implications of gifted assets as well as reporting requirements for the receipt of foreign gifts from the recipient's perspective.

104. Ibid.

105. Instructions for Form 706.

106. Instructions for Form 8892.

107. Ibid.

108. IRM 4.25.1.2.1.2 (2020); IRC §6501.

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Basis of Gifted Property

In determining the recipient's basis in property received as a gift, the donor's adjusted basis in the property at the time of the gift, the FMV of the property at the time of the gift, and any gift tax paid on the gift must be known.

Donor's Adjusted Basis is Less Than or Equal to FMV. If the donor's adjusted basis in the gifted property is **less than or equal to the FMV** of the property at the time of the gift, the recipient's basis in the gifted property is equal to the donor's adjusted basis.[109] If the donor paid gift tax on the transfer of the property, the recipient's basis is increased by the amount of gift tax paid to the extent that such an adjustment does not result in the basis exceeding the FMV of the property at the time the gift was made.[110] The recipient's basis in the property subsequent to its receipt is increased or decreased for adjustments appropriately as any other held asset, such as the basis increasing for any improvements.[111]

Example 17. Teresa gifted Mark a parcel of land on June 30, 2024. At the time of the gift, Teresa's adjusted basis in the land was $50,000, and its FMV was $75,000. Teresa did not pay any gift tax on the transfer when filing her Form 709 for the tax year. Mark's basis in the land is equal to Teresa's adjusted basis of $50,000.

Donor's Adjusted Basis Exceeds FMV.[112] If the donor's adjusted basis in the gifted property **exceeds** the FMV of the property at the time of the gift, the recipient's basis in the gift depends on whether they have a gain or a loss when disposing of the property. If the donor's adjusted basis exceeds the property's FMV, the following two rules guide the computation of gain or loss.

1. The recipient's **gain** on the disposal of the gifted property is calculated using the **donor's adjusted basis** when they made the gift. This basis is adjusted for any increases or decreases while the recipient owned the property.
2. The recipient's **loss** on the gifted property is calculated using the **property's FMV** as the initial basis when the donor made the gift. This basis is also adjusted for any increases or decreases while the recipient owned the property.

Note. If using the donor's adjusted basis for the recipient basis results in a loss and using the gifted property's FMV for the recipient's basis results in a gain, then the recipient's basis is equal to the proceeds received from the disposal of the property so that neither a gain nor loss is recognized.

Example 18. Use the same facts as **Example 17,** except that Teresa's basis in the land was $80,000. If Mark sells the land on October 1, 2025, for $100,000, Mark's basis in the land sold is equal to Teresa's adjusted basis of $80,000, resulting in a $20,000 gain ($100,000 proceeds − $80,000 basis).

Example 19. Use the same facts as **Example 18,** except that Mark sells the land for $70,000. Mark's basis in the land sold is equal to the FMV of the land at the time Teresa gifted it to Mark of $75,000, resulting in a $5,000 loss ($70,000 proceeds − $75,000 basis).

Example 20. Use the same facts as **Example 18,** except that Mark sells the land for $77,000. If calculating for a gain and using Teresa's adjusted basis in the land of $80,000, Mark would have a loss of $3,000 ($77,000 proceeds − $80,000 Teresa's adjusted basis). If calculating for a loss and using the land's FMV of $75,000, Mark would have a gain of $2,000 ($77,000 proceeds − $75,000 FMV). Therefore, Mark's basis in the property sold must equal the selling proceeds of $77,000 so that he would not recognize a gain or loss on the disposal ($77,000 proceeds − $77,000 basis).

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109. IRC §1015(a).

110. IRC §1015(d)(1)(A).

111. *Property (Basis, Sale of Home, etc.).* Jun. 15, 2023. IRS. [www.irs.gov/faqs/capital-gains-losses-and-sale-of-home/property-basis-sale-of-home-etc] Accessed on Jan. 12, 2024.

112. Ibid.

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Receiving Foreign Gifts

While the responsibility of reporting domestic gifts falls on the donor, recipients of gifts from a non-U.S. source may be subject to a reporting requirement. A recipient subject to this reporting requirement is a U.S. citizen or resident who in the current tax year:[113]

- Received more than $100,000 of gifts from a foreign individual or estate;
- Received more than the IRC §6039F threshold amount ($19,570 in 2024),[114] adjusted for inflation, of gifts from foreign corporations or partnerships;
- Received distributions from a foreign trust;
- Received a loan of cash or marketable securities from a foreign trust;
- Received the uncompensated use of foreign trust property; or
- Is an owner or beneficiary of a foreign trust holding an outstanding qualified obligation to the owner or beneficiary, or a related party to the owner or beneficiary.

Such recipients are required to file Form 3520, *Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts.*[115] Unlike Form 709, Form 3520 is an informational form for which no tax is assessed. Form 3520 must be mailed to the following address.

Internal Revenue Service Center
P.O. Box 409101
Ogden, UT 84409

Form 3520 is required to be filed by the 15th day of the fourth month following the recipient's tax year or the next business day following the Saturday, Sunday, or legal holiday on which the 15th day of the fourth month falls.[116] **If the recipient fails to file the form on time, a penalty is assessed equaling 5% of the foreign gift for each month the return is late, not to exceed 25%.[117]** The IRS may abate the penalties for reasonable cause provided by the taxpayer if they can prove their noncompliance did not result from willful neglect.[118]

Form 3520 includes multiple sections used for the following purposes.

- Report the recipient's general information
- Identify foreign trusts held by the recipient
- Disclose transfers to and from those foreign trusts
- Disclose gifts received from foreign persons in excess of $10,000

The recipient uses Form 3520, part IV, *U.S. Recipients of Gifts or Bequests Received During the Current Tax Year From Foreign Persons*, to disclose the gifts they received from foreign persons. Page 1 of Form 3520 and part IV follow.

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113. Instructions for Form 3520.
114. Rev. Proc. 2023-34, 2023-48 IRB 1287.
115. IRC §6039F(a).
116. Instructions for Form 3520.
117. IRC §6039F(c).
118. Ibid.

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Form **3520** (Rev. December 2023) Department of the Treasury Internal Revenue Service

Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts

Go to *www.irs.gov/Form3520* for instructions and the latest information.

OMB No. 1545-0159

Note: All information must be in English. Show all amounts in U.S. dollars. File a **separate** Form 3520 for **each** foreign trust.

For calendar year 20 , or tax year beginning , 20 , ending , 20

A Check appropriate boxes: ☐ Initial return ☐ Final return ☐ Amended return

B Check box that applies to person filing return: ☐ Individual ☐ Partnership ☐ Corporation ☐ Trust ☐ Executor

C Check if any excepted specified foreign financial assets are reported on this form. See instructions . . . ☐

Check all applicable boxes. See applicable instructions.

☐ You are **(a)** a U.S. transferor who, directly or indirectly, transferred money or other property during the current tax year to a foreign trust; **(b)** a U.S. person who (1) during the current tax year, transferred property (including cash) to a related foreign trust (or a person related to the trust) in exchange for an obligation, or (2) holds a qualified obligation from the trust that is currently outstanding; or **(c)** the executor of the estate of a U.S. decedent and (1) the decedent made a transfer to a foreign trust by reason of death, (2) the decedent was treated as the owner of any portion of a foreign trust immediately prior to death, or (3) the decedent's estate included any portion of the assets of a foreign trust. **Complete all applicable identifying information requested below and Part I of the form.**

☐ You are a U.S. owner of all or any portion of a foreign trust at any time during the tax year. **Complete all applicable identifying information requested below and Part II of the form.**

☐ You are **(a)** a U.S. person (including a U.S. owner) or an executor of the estate of a U.S. person who, during the current tax year, received, directly or indirectly, a distribution from a foreign trust; **(b)** a U.S. person who is a U.S. owner or beneficiary of a foreign trust and in the current tax year, you or a U.S. person related to you received (1) a loan of cash or marketable securities, directly or indirectly, from such foreign trust, or (2) the uncompensated use of trust property; or **(c)** a U.S. person who is a U.S. owner or beneficiary of a foreign trust and in the current tax year such foreign trust holds an outstanding qualified obligation of yours or a U.S. person related to you. **Complete all applicable identifying information requested below and Part III of the form.**

☐ You are a U.S. person who, during the current tax year, received certain gifts or bequests from a foreign person. **Complete all applicable identifying information requested below and Part IV of the form.**

1a Name of U.S. person(s) with respect to whom this Form 3520 is being filed (see instructions)				**b** Taxpayer identification number (TIN)
c Number, street, and room or suite no. If a P.O. box, see instructions.				**d** Spouse's TIN
e City or town	**f** State or province		**g** ZIP or foreign postal code	**h** Country

i If you are filing with your spouse a current-year joint income tax return and a joint Form 3520, check this box . . . ☐

j If an automatic 2-month extension applies for the U.S. person's tax return, check this box and attach statement. See instructions . . . ☐

k If an extension was requested for the tax return, check this box ☐ and enter the form number of the tax return to be filed:

2a Name of foreign trust (if applicable)				**b** Employer identification number (EIN), if any
c Number, street, and room or suite no. If a P.O. box, see instructions.				**d** Date foreign trust was created
e City or town	**f** State or province		**g** ZIP or foreign postal code	**h** Country

3 Did the foreign trust appoint a U.S. agent (defined in the instructions) who can provide the IRS with all relevant trust information? ☐ **Yes** ☐ **No**
If "Yes," complete lines 3a through 3g. If "No," and you are required to complete Part I, complete lines 15 through 18.

3a Name of U.S. agent				**b** TIN, if any
c Number, street, and room or suite no. If a P.O. box, see instructions.				
d City or town	**e** State or province		**f** ZIP or postal code	**g** Country
4a Name of U.S. decedent (see instructions)		**b** Address		**c** TIN of decedent
d Date of death				**e** EIN of estate

f Check applicable box.

☐ U.S. decedent made transfer to a foreign trust by reason of death.

☐ U.S. decedent treated as owner of foreign trust immediately prior to death.

☐ Assets of foreign trust were included in estate of U.S. decedent.

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 56398R Form **3520** (Rev. 12-2023)

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Part IV U.S. Recipients of Gifts or Bequests Received During the Current Tax Year From Foreign Persons (see instructions)

54 During your current tax year, did you receive more than $100,000 that you treated as gifts or bequests from a nonresident alien (including a distribution received from a domestic trust treated as owned by a foreign person) or a foreign estate? See instructions for special rules regarding related donors . . . . . ☐ **Yes** ☐ **No**

If "Yes," complete columns (a) through (c) with respect to each such gift or bequest in excess of $5,000. If more space is needed, attach a statement.

(a) Date of gift or bequest	(b) Description of property received	(c) FMV of property received
Total		$

55 During your current tax year, did you receive amounts from a foreign corporation or a foreign partnership that you treated as gifts in excess of the amount provided in the instructions? See instructions regarding related donors . . . . . ☐ **Yes** ☐ **No**

If "Yes," complete columns (a) through (g) with respect to each such gift. If more space is needed, attach a statement.

(a) Date of gift	(b) Name of foreign donor	(c) Address of foreign donor	(d) TIN, if any

(e) Check the box that applies to the foreign donor		(f) Description of property received	(g) FMV of property received
Corporation	**Partnership**		

56 Do you have any reason to believe that the foreign donor, in making any gift or bequest described in lines 54 and 55, was acting as a nominee or intermediary for any other person? If "Yes," see instructions . . . . . ☐ **Yes** ☐ **No**

Sign Here

Under penalties of perjury, I declare that I have examined this return, including any accompanying reports, schedules, or statements, and to the best of my knowledge and belief, it is true, correct, and complete.

Signature	Title	Date

Paid Preparer Use Only

Print/Type preparer's name	Preparer's signature	Date	Check ☐ if self-employed	PTIN
Firm's name			Firm's EIN	
Firm's address			Phone no.	

Form **3520** (Rev. 12-2023)

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APPLYING FOR AN INDIVIDUAL TAXPAYER IDENTIFICATION NUMBER

An individual taxpayer identification number (ITIN) enables individuals to file tax returns if they are ineligible to obtain SSNs. This section identifies what an ITIN is, which individuals or situations necessitate applying for an ITIN, and the procedures for obtaining an ITIN.

PURPOSE OF AN ITIN

First introduced in 1996,[119] ITINs are 9-digit numbers used for federal tax reporting purposes only. The IRS issues them to individuals who are required to have a U.S. taxpayer identification number but are ineligible to obtain an SSN. Those who must apply for an ITIN include individuals who are required to furnish a federal tax identification number or file a federal tax return and are in one of the following categories.[120]

- An NRA who is required to file a U.S. tax return or is filing a U.S. tax return to claim a refund
- A U.S. resident alien who files a U.S. tax return based on the number of days they were present in the United States
- A dependent or spouse of a U.S. citizen, resident alien, or visa-holding NRA
- An NRA student, professor, or researcher who files a U.S. tax return or claims an exception to the U.S. tax return filing requirement
- An NRA who claims a tax treaty benefit requiring an ITIN

Note. For more information on who is required to file an individual federal income tax return, see IRS Pub. 17, *Your Federal Income Tax*.

Certain parties, such as banks or financial institutions, may request an ITIN from an individual for those parties to comply with information reporting requirements, even if those individuals are not filing or are not required to file an income tax return. Such individuals may apply for an ITIN if they qualify for one of the following exceptions to the return filing requirement.[121]

1. The individual receives passive income subject to third-party withholding or covered by tax treaty benefits.
2. The individual does not claim benefits of an income tax treaty and receives taxable scholarship, fellowship, or grant income or claims the benefits of a U.S. tax treaty with a foreign country and receives any of the following.
   a. Wages, salary, compensation, and honoraria payments
   b. Scholarships, fellowships, and grants
   c. Gambling income
3. The individual has a home mortgage loan on real property in the United States that is subject to third-party reporting of mortgage interest.
4. The individual is a party to the disposition of a U.S. real property interest by a foreign person, which is generally subject to withholding by the transferee or buyer.
5. The individual has an IRS reporting requirement under TD 9363[122] and is submitting Form W-7, *Application for IRS Individual Taxpayer Identification Number*, with Form 13350, *Registration for e-services*.

---

119. *The Facts About the Individual Taxpayer Identification Number (ITIN)*. Mar. 14, 2022. The American Immigration Council. [www.americanimmigrationcouncil.org/research/facts-about-individual-taxpayer-identification-number-itin] Accessed on Dec. 6, 2023.

120. *Individual Taxpayer Identification Number*. Nov. 7, 2023. IRS. [www.irs.gov/individuals/individual-taxpayer-identification-number] Accessed on Dec. 6, 2023.

121. Instructions for Form W-7.

122. TD 9363, 2007-49 IRB 1084.

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A benefit of obtaining an ITIN includes the ability for taxpayers to e-file income tax returns, such as Form 1040-NR, *U.S. Nonresident Alien Income Tax Return.* However, taxpayers may only e-file the returns beginning with the calendar year following the year in which they applied for the ITIN.[123]

> **Note.** TD 9363 concerns the requirements for filing corporate income tax returns and returns for certain exempt organizations on magnetic media.

APPLICATION PROCESS

Applicants use Form W-7 to apply for and obtain an ITIN. The form, along with supporting documentation, may be submitted with the original tax return for which the filer is attempting to obtain the ITIN, provided they reside in the United States.[124] Alternatively, filers may furnish Form W-7 and supporting documentation to the IRS by mail, in person to an IRS employee, or to a certified acceptance agent (CAA).[125] For filers who reside outside of the United States, they must furnish Form W-7 and supporting documentation by mail or in person to an IRS employee, a Secretary-approved community-based CAA, or a designee of the Secretary at a United States diplomatic mission or consular post.[126]

> **Note.** In order to determine whether a particular tax center reviews and accepts ITIN applications, see **uofi.tax/24x2x1** [www.irs.gov/help/irs-taxpayer-assistance-centers-providing-in-person-itin-document-review].

Form W-7

Form W-7 is an informational form identifying the applicant's name, mailing address, birth information, and the type of identification documents accompanying the application. The form, along with the supporting documentation, may be mailed to the following address.[127]

Internal Revenue Service
ITIN Operation
P.O. Box 149342
Austin, TX 78714-9342

The IRS suggests allowing up to seven weeks for the agency to notify filers of their ITIN application status, although this process may take an additional two to four weeks if applicants filed their applications during the peak processing period of January 15 through April 30.[128]

Example 21. Elsa is a Norwegian student studying atmospheric sciences at the University of Illinois. She is an NRA and earns income from part-time work. Elsa applied for an ITIN in February 2023 when she prepared her 2022 Form 1040-NR. Elsa submitted the following Form W-7, along with her Form 1040-NR and supporting documents on paper. In 2024, Elsa can e-file her 2023 Form 1040-NR with the ITIN the IRS issued her in 2023.

---

123. IRS Pub. 1915, *Understanding Your IRS Individual Taxpayer Identification Number ITIN.*
124. IRC §6109(i)(1).
125. IRC §6109(i)(1)(A).
126. IRC §6109(i)(1)(B).
127. Instructions for Form W-7.
128. Ibid.

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For Example 21

Form **W-7** (Rev. August 2019) Department of the Treasury Internal Revenue Service

Application for IRS Individual Taxpayer Identification Number

► For use by individuals who are not U.S. citizens or permanent residents.
► See separate instructions.

OMB No. 1545-0074

An IRS individual taxpayer identification number (ITIN) is for U.S. federal tax purposes only.

Before you begin:
• ***Don't submit*** *this form if you have, or are eligible to get, a U.S. social security number (SSN).*

Application type (check one box):
☒ Apply for a new ITIN
☐ Renew an existing ITIN

Reason you're submitting Form W-7. Read the instructions for the box you check. **Caution:** If you check box **b, c, d, e, f,** or **g, you must file a U.S. federal tax return with Form W-7 unless you meet one of the exceptions** (see instructions).

- **a** ☐ Nonresident alien required to get an ITIN to claim tax treaty benefit
- **b** ☐ Nonresident alien filing a U.S. federal tax return
- **c** ☐ U.S. resident alien **(based on days present in the United States)** filing a U.S. federal tax return
- **d** ☐ Dependent of U.S. citizen/resident alien — If **d,** enter relationship to U.S. citizen/resident alien (see instructions) ►
- **e** ☐ Spouse of U.S. citizen/resident alien — If **d** or **e,** enter name and SSN/ITIN of U.S. citizen/resident alien (see instructions) ►
- **f** ☒ Nonresident alien student, professor, or researcher filing a U.S. federal tax return or claiming an exception
- **g** ☐ Dependent/spouse of a nonresident alien holding a U.S. visa
- **h** ☐ Other (see instructions) ►

Additional information for **a** and **f**: Enter treaty country ► and treaty article number ►

Name (see instructions)
1a First name: **Elsa** | Middle name: | Last name: **Frost**

Name at birth if different ►
1b First name: | Middle name: | Last name:

Applicant's Mailing Address
2 Street address, apartment number, or rural route number. **If you have a P.O. box, see separate instructions.**
1301 W Green St
City or town, state or province, and country. Include ZIP code or postal code where appropriate.
Urbana, IL 61801

Foreign (non-U.S.) Address (see instructions)
3 Street address, apartment number, or rural route number. **Don't use a P.O. box number.**
2013 Olaf Ln
City or town, state or province, and country. Include postal code where appropriate.
Oslo, Norway 0160

Birth Information
4 Date of birth (month / day / year): **11/22/2003** | Country of birth: **Norway** | City and state or province (optional): | 5 ☐ Male ☒ Female

Other Information
6a Country(ies) of citizenship: **Norway** | 6b Foreign tax I.D. number (if any): | 6c Type of U.S. visa (if any), number, and expiration date:

6d Identification document(s) submitted (see instructions) ☒ Passport ☐ Driver's license/State I.D. ☐ USCIS documentation ☐ Other

Issued by: **Norway** No.: **456789** Exp. date: **12/31/26** Date of entry into the United States (MM/DD/YYYY): **08/15/2022**

6e Have you previously received an ITIN or an Internal Revenue Service Number (IRSN)?
☒ **No/Don't know.** Skip line 6f.
☐ **Yes.** Complete line 6f. If more than one, list on a sheet and attach to this form (see instructions).

6f Enter ITIN and/or IRSN ► ITIN ___-__-____ IRSN ___-__-____ and name under which it was issued ► First name Middle name Last name

6g Name of college/university or company (see instructions) ► **University of Illinois**
City and state ► **Urbana, IL** Length of stay ► **4 years**

Sign Here

Under penalties of perjury, I (applicant/delegate/acceptance agent) declare that I have examined this application, including accompanying documentation and statements, and to the best of my knowledge and belief, it is true, correct, and complete. I authorize the IRS to share information with my acceptance agent in order to perfect this Form W-7, Application for IRS Individual Taxpayer Identification Number.

Keep a copy for your records.

► Signature of applicant (if delegate, see instructions) | Date (month / day / year) / / | Phone number

► Name of delegate, if applicable (type or print) | Delegate's relationship to applicant ► ☐ Parent ☐ Court-appointed guardian ☐ Power of attorney

Acceptance Agent's Use ONLY

► Signature | Date (month / day / year) / / | Phone | Fax

► Name and title (type or print) | Name of company | EIN | PTIN | Office code

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 10229L Form **W-7** (Rev. 8-2019)

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Supporting Documentation

Applicants must provide supporting documentation accompanying Form W-7 that meets all the following requirements.[129]

1. The documentation establishes the applicant's identity and connection to a foreign country (foreign status).
2. The documents supporting the information disclosed on Form W-7 must be original documents or copies provided and certified by the issuing agency.
3. The documents must be current and unexpired.

Note. Applicants who are dependents of U.S. military personnel are allowed to submit notarized copies of identification documents, which a public notary bears witness to the signing of an official document and affixes a seal asserting the document is legitimate.[130] All other applicants are not able to use this form of documentation to satisfy the document requirements for the ITIN application.

Unless an individual provides an original valid passport or a **certified copy from the issuing agency,** an applicant must submit at least two documents from the following list to verify their identity (i.e., the document contains the applicant's name) and support their claim of foreign status. At least one of the documents must contain the applicant's photo unless the application is submitted for a dependent who is under age 14 (under age 18 if a student).[131]

Documentation	Establishes Foreign Status	Establishes Identity
Passport	X	X
U.S. Citizenship and Immigration Services (USCIS) photo identification	X	X
Visa issued by the U.S. Department of State	X	X
U.S. driver's license		X
U.S. military identification card		X
Foreign driver's license		X
Foreign military identification card	X	X
National identification card (containing name, photograph, address, date of birth, and expiration date)	X	X
U.S. state identification card		X
Foreign voter's registration card	X	X
Civil birth certificate (required if an applicant is under age 18 and did not provide a valid passport)	X (if foreign)	X
Medical records (valid only for dependents under age 6)	X (if foreign)	X
School records (valid only for a dependent under age 18, if a student; period must be for a term ending no more than 12 months from date of application)	X (if foreign)	X

129. Ibid.

130. *ITIN Documentation Frequently Asked Questions (FAQs)*. Oct. 20, 2023. IRS. [www.irs.gov/individuals/international-taxpayers/itin-documentation-frequently-asked-questions-faqs] Accessed on Dec. 8, 2023.

131. Instructions for Form W-7.

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CAA Program

An alternative to mailing supporting documentation with Form W-7 available to applicants is working with a CAA to assist in the application for an ITIN. A CAA is a person or entity authorized by the IRS to review the necessary documents, authenticate the applicant's identity when able, and forward the completed forms to the IRS.[132]

A CAA may use Form W-7 (COA), *Certificate of Accuracy for IRS Individual Taxpayer Identification Number*, to certify that they reviewed and verified original documentation or certified copies from issuing agencies of documents.[133] The IRS requires the CAA to retain copies of the supporting documentation used to fulfill the verification requirements, along with copies of the signed Forms W-7 they submitted to the IRS on behalf of the applicant.[134]

Acceptance Agents (AAs) are another resource that applicants may use for assistance. AAs assist applicants with the preparation and filing of Form W-7, but they do not certify the validity of the supporting documentation accompanying the application. Consequently, original documents or certified copies are submitted with the Form W-7 and later returned to the applicant after processing.[135]

> **Note.** A directory of CAAs and AAs may be found online at **uofi.tax/24x2x2** [www.irs.gov/individuals/international-taxpayers/acceptance-agent-program]. The IRS updates the directory quarterly.[136]

Taxpayer Assistance Centers[137]

Applicants may also apply for an ITIN in person at designated IRS Taxpayer Assistance Centers (TACs). Agents may assist applicants with the preparation and filing of Form W-7 and verification of supporting documentation. Consequently, the IRS agent immediately returns supporting documentation to the applicant. Applicants may utilize this resource only by scheduling an appointment.

RENEWING AN ITIN

An ITIN generally remains valid until the taxpayer does not file an income tax return or is claimed as a dependent on the return of another taxpayer for three consecutive taxable years after the ITIN's issuance.[138] For ITINs that were issued before January 1, 2013, they are valid until the earlier of the applicable date or until the taxpayer does not file an income tax return or is **not** claimed as a dependent on the return of another taxpayer for three consecutive taxable years after the ITIN's issuance.[139] The applicable date for such ITINs is as follows.[140]

- January 1, 2017, for ITINs issued before January 1, 2008
- January 1, 2018, for ITINs issued during 2008
- January 1, 2019, for ITINs issued in 2009 or 2010
- January 1, 2020, for ITINs issued in 2011 or 2012

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132. Ibid.

133. Instructions for Form W-7 (COA).

134. Form W-7 (COA).

135. Instructions for Form W-7.

136. *Acceptance Agent Program*. Dec. 7, 2023. IRS. [www.irs.gov/individuals/international-taxpayers/acceptance-agent-program] Accessed on Dec. 12, 2023.

137. Instructions for Form W-7.

138. IRC §6109(i)(3)(A).

139. IRC §6109(i)(3)(B).

140. IRC §6109(i)(3)(C).

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When an ITIN expires, the taxpayer must renew their ITIN unless they will not be filing a tax return or claiming a refund.[141] If individuals only use an ITIN for information returns, such as Forms 1099, they do not need to renew their ITIN and may use it for those reporting purposes.[142] Taxpayers renew existing ITINs by completing Form W-7, checking the "Renew an existing ITIN" box at the top of the form, including the original tax return filing with the ITIN listed, and providing supporting documentation confirming the taxpayer's identity and foreign status.[143] Upon renewal, the taxpayer should receive a CP565 Notice, *Confirmation of your Individual Taxpayer Identification Number*, from the IRS.[144]

ACCESS TO ONLINE IRS ACCOUNT[145]

Taxpayers with ITINs can register for an IRS online account to check balances due, view their payment history, and access their tax records. The registration utilizes a video chat process through ID.me,[146] where applicants must provide a valid email address, proof of having an ITIN, one primary document, and one secondary document. Either the primary or secondary document must provide proof of address. Primary documents include passports, U.S. state- or territory-issued driver's licenses and state IDs, and U.S. permanent resident cards.[147] Secondary documents may include U.S. health insurance cards, Forms W-2, *Wage and Tax Statement,* pay stubs, electric bills, and bank, loan, or financial institution statements.[148]

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141. *ITIN Expiration Frequently Asked Questions*. Oct. 20, 2023. IRS. [www.irs.gov/individuals/itin-expiration-faqs] Accessed on Dec. 15, 2023.

142. Ibid.

143. Instructions for Form W-7.

144. *Understanding Your CP565 Notice*. Jan. 30, 2023. IRS. [www.irs.gov/individuals/understanding-your-cp565-notice] Accessed on Dec. 19, 2023.

145. *Individual Taxpayer Identification Number.* Nov. 7, 2023. IRS. [www.irs.gov/individuals/individual-taxpayer-identification-number] Accessed on Dec. 19, 2023.

146. *A digital passport to streamline your life.* ID.me. [www.id.me] Accessed on Mar. 14, 2023.

147. *Primary and secondary identification documents*. 2022. ID.me. [help.id.me/hc/en-us/articles/360017833054-Primary-and-secondary-identification-documents] Accessed on Dec. 19, 2023.

148. Ibid.

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Chapter 3: Form 1099 Issues for Various Taxpayers

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Note. Corrections for all of the chapters are available at **TaxSchool.illinois.edu.** For clarification about terms used throughout this chapter, see the **Acronyms and Abbreviations** section following the index.

For your convenience, in-text website links are also provided as short URLs. Anywhere you see **uofi.tax/xxx**, the link points to the address immediately following in brackets.

About the Authors

Kelly Golish, CPA, is the Assistant Director, Tax Materials, at the University of Illinois Tax School. She was previously a manager at Crowder, CPAs in Danville, IL and worked for both public and private accounting firms in Decatur, IL, Cleveland, OH, and San Jose, CA. Kelly earned a Masters in Accounting with an emphasis in Taxation and a Bachelors in Accounting at the University of Notre Dame.

Chris Korban, CPA, is a Tax Materials Specialist at the University of Illinois Tax School. He joined Tax School in 2023 with nine years of experience in public accounting. Chris earned both his Bachelor's Degree in Accounting and Master of Accounting Science from the University of Illinois.

Peg Phillips, CPA, is a writer and editor for the University of Illinois Tax School. She has been with the program since 2003. Peg graduated from the University of Illinois with high honors in accounting and passed the CPA exam in 1989. She currently owns and operates Phillips Tax Service in Pekin, IL.

Other chapter contributors and reviewers are listed at the front of this book.

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The IRS has increased their emphasis on income reporting on Forms 1099 to counteract underreporting by taxpayers. Taxpayers may be surprised to receive a Form 1099, which could be Form 1099-K, *Payment Card and Third Party Network Transactions,* Form 1099-MISC, *Miscellaneous Information,* or Form 1099-NEC, *Nonemployee Compensation.*

The IRS anticipated 44 million Forms 1099-K to be distributed in 2023,[1] and many of those recipients may not have expected a Form 1099-K or known how to comply with reporting regulations. Consequently, more taxpayers may have questions or issues regarding the disclosure of Form 1099-K income reporting on their tax returns. Particularly, taxpayers engaged in activities such as crowdfunding, gambling, reselling tickets, student athletics, and research participation may receive a Form 1099.

GENERAL FORM 1099-K ISSUES

Form 1099-K was first used in 2012 to report certain payments received through a credit card, payment app, or online marketplace, totaling more than **$20,000** and if the total number of such transactions exceeded 200 in 2011.[2] Third party settlement organizations (TPSO) and payment settlement entities (PSE) are subject to the reporting requirements for transactions they process.[3] TPSOs are organizations contractually obligated to remit payment to payees in third party network transactions (e.g., Paypal and Venmo) and include online marketplace services (e.g., eBay and Airbnb).[4] Third party network transactions are agreements or arrangements where an unrelated central organization settles transactions for the provision of goods and services for payment.[5] PSEs include banks and credit card processing companies such as Bank of America and American Express.

Note. Healthcare networks, in-house accounts payable departments, and automated clearing houses are not considered TPSOs and are not subject to the reporting requirements under IRC §6050W.[6]

Congress intended to lower the dollar threshold of the reporting requirement to $600 effective for payments made in 2022.[7] The 200 transactions threshold would remain the same. However, the IRS has been delaying implementation and is **retaining the $20,000 and 200 transactions thresholds for 1099-Ks through 2023.** As of this publication, the plan is to reduce the threshold to **$5,000 for 2024** as part of a phase-in process.[8]

As the threshold is lowered, many taxpayers who receive a Form 1099-K may not expect one and may not have a tax obligation on the reported income. The IRS is working on updating Form 1040, *U.S. Individual Income Tax Return,* and the related schedules to make it easier for taxpayers to properly report income included on Forms 1099-K.[9]

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1. *IRS announces delay in Form 1099-K reporting threshold for third party platform payments in 2023; plans for a threshold of $5,000 for 2024 to phase in implementation.* Jan. 8, 2024. IRS. [www.irs.gov/newsroom/irs-announces-delay-in-form-1099-k-reporting-threshold-for-third-party-platform-payments-in-2023-plans-for-a-threshold-of-5000-for-2024-to-phase-in-implementation] Accessed on Sep. 5, 2024.
2. *Housing and Economic Recovery Act of 2008,* PL 110-289, §3091; Instructions for Form 1099-K (2011).
3. Instructions for Form 1099-K.
4. Ibid.
5. IRC §§6050W(c)(3) and (d)(3).
6. Instructions for Form 1099-K.
7. *American Rescue Plan Act of 2021,* PL 117-2, §9674.
8. *IRS announces delay in Form 1099-K reporting threshold for third party platform payments in 2023; plans for a threshold of $5,000 for 2024 to phase in implementation.* Jan. 8, 2024. IRS. [www.irs.gov/newsroom/irs-announces-delay-in-form-1099-k-reporting-threshold-for-third-party-platform-payments-in-2023-plans-for-a-threshold-of-5000-for-2024-to-phase-in-implementation] Accessed on Sep. 5, 2024.
9. Ibid.

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Nearly every participating payee who accepts credit or debit cards or receives payments through online marketplaces is subject to reporting requirements under §6050W. A **participating payee** is any person, including any governmental unit that accepts a payment card, or any account number or other data associated with a payment card, as payment or accepts payment from a TPSO in settlement of a third-party network transaction.[10] While the IRS claims that personal payments from family and friends should **not** be included on Form 1099-K,[11] the ability to designate such payments as excludable is dependent upon the software and the user capabilities.

Taxpayers who receive a Form 1099-K should review the form, determine if the amount is correct, and calculate any deductible expenses associated with the income. The form or schedule on which the income is reported depends upon the nature of the transactions. For tax purposes, income may be classified as any of the following.[12]

1. Personal transactions such as gifts and reimbursements for which a Form 1099-K should not be issued.
2. Payments in exchange for goods or services. Depending on the circumstances, such transactions might be reportable as the following.
   a. Self-employment (SE) income
   b. Hobby or other non-business income
   c. Capital gains/losses, subject to applicable limitations
3. Passive income, such as rental income.

Note. A taxpayer may receive more than one type of income from the same reporting entity reported in the total income on the issued Form 1099-K. Taxpayers should use proper accounting methods to classify the types of income they receive. Additionally, they should maintain proper documentation supporting the nature of the income and expenses they report.

BEST PRACTICES FOR REPORTING FORM 1099-K INCOME[13]

The following are best practices for taxpayers to accurately report Form 1099-K income.

Review Form 1099-K

In addition to the number of transactions and amount of payments received, Form 1099-K discloses additional information provided by the issuing merchant. One such piece of information is a merchant category code (MCC) that is reported in box 2. Containing 4-digit numbers, MCCs serve as a classification code for the types of goods or services sold by the recipient of Form 1099-K. Taxpayers should check the accuracy and appropriateness of the reported MCC, as an incorrect code could potentially impact the comparative analysis performed by the IRS leading to a notice or examination. To avoid this potential outcome, taxpayers should notify the issuing PSE or TPSO of any incorrect MCC reported on their Forms 1099-K and request the issuance of corrected forms.

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10. Instructions for Form 1099-K.

11. *Understanding your Form 1099-K*. Dec 22, 2023. IRS. [www.irs.gov/businesses/understanding-your-form-1099-k] Accessed on Dec. 30, 2023.

12. *What to do with Form 1099-K*. Mar. 4, 2024. IRS. [www.irs.gov/businesses/what-to-do-with-form-1099-k] Accessed on Apr. 22, 2024.

13. *How to Reconcile the Difference between Gross Receipts and Receipt Reported on Form 1099-K*. Sep. 11, 2017. Legacy Tax & Resolution Services. [www.legacytaxresolutionservices.com/blog/how-to-reconcile-the-difference-between-gross-receipts-and-receipt-reported-on-form-1099-k/255877] Accessed on Apr. 22, 2024.

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There may be situations where the taxpayer receives a Form 1099-K that includes income reporting of multiple entities. Known as **aggregated payees,** these taxpayers receive the payment of funds on behalf of other entities and then distribute the payment to the other entities. The aggregated payees should **receive** a Form 1099-K reporting the payments they received and also **issue** a Form 1099-K or Form 1099-MISC, as appropriate, to the entities to which they distributed the funds.[14] Additionally, a taxpayer may have multiple sources of business income but receives only a single Form 1099-K from a PSE. In such cases, the IRS instructs taxpayers to report the income on the appropriate lines or schedules.[15]

Reporting Considerations

Box 1a of Form 1099-K reports the amount of gross payment received through payment card and third party network transactions. This amount is not adjusted for any fees, credits, refunds, shipping, or discounts. The reported gross payment generally includes processing and transaction fees even though they were deducted from the recipient's net payment. Additionally, the gross payment may also include non-income items such as sales tax receipts or tips. The IRS advises taxpayers to report the gross income as shown in box 1a and to report any adjustments and non-income items as deductions.[16] This best practice is an attempt to prevent a mismatch notice from the IRS.

If Form 1099-K includes receipts for the sale of personal items, the reporting of such income depends on whether the items were sold at a gain or a loss. If sold at a **gain,** such transactions are taxable (to the extent the proceeds exceeds the taxpayer's adjusted basis) and reported on Form 8949, *Sales and other Dispositions of Capital Assets*, and Schedule D, *Capital Gains and Losses*. If sold at a **loss,** such transactions are not taxable, but also do not receive benefit from a loss deduction. The IRS recommends reporting the proceeds from such losses in part I, line 8z of Form 1040, Schedule 1, *Additional Income and Adjustments to Income*, and reporting the offsetting adjustment in the same amount in part II, line 24z of Form 1040, Schedule 1. Alternatively, taxpayers may report personal item losses on Form 8949 and Schedule D.[17]

Reconciliation

To ensure the accuracy of income reporting to the IRS, it may be valuable for taxpayers to reconcile their income with the reported receipts on issued Forms 1099-K. Such a process can help taxpayers identify any errors and non-taxable receipts. For example, box 1a of Form 1099-K may include cash back payments for customers if the taxpayer accepts payment methods offering such rewards. This portion of the received payment should not be included in gross receipts on a taxpayer's tax return. The IRS provides guidance that states such items are not claimed as income or backed out as a business expense.[18] Therefore, it important for the taxpayer to identify such items that may be included on Form 1099-K to prevent reporting non-taxable receipts on their income tax returns.

When reconciling business income to Forms 1099-K, taxpayers should also consider any income that may have also been reported on a Form 1099-MISC to prevent double-reporting income. While in most situations a payment falling under both Form 1099-K reporting requirements under §6050W and Form 1099-MISC filing requirements under IRC §6041 should only be reported on Form 1099-K,[19] errors may occur, and a reconciliation can help identify such errors.

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14. Treas. Reg. §1.6050W-1(d)(1); *What to do with Form 1099-K*. Mar. 4, 2024. IRS. [www.irs.gov/businesses/what-to-do-with-form-1099-k] Accessed on Apr. 22, 2024.
15. *What to do with Form 1099-K*. Mar. 4, 2024. IRS. [www.irs.gov/businesses/what-to-do-with-form-1099-k] Accessed on Apr. 22, 2024.
16. *Comingled 1099-K*. Jun. 21, 2023. IRS. [www.irs.gov/pub/taxpros/2023ntf-11-comingled-1099-k.pdf] Accessed on Apr. 23, 2024.
17. *What to do with Form 1099-K*. Mar. 4, 2024. IRS. [www.irs.gov/businesses/what-to-do-with-form-1099-k] Accessed on Apr. 22, 2024.
18. Ibid.
19. *IRC Section 6050W Frequently Asked Questions*. Jul. 31, 2012. IRS. [www.irs.gov/pub/irs-utl/irdm_section_6050w_faqs_7_23_11.pdf] Accessed on Apr. 23, 2024.

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There may be challenges taxpayers face when attempting to reconcile Forms 1099-K. For example, a TPSO's or PSE's cutoff date for reporting transactions may differ from the taxpayer's (generally the taxpayer's yearend). In such cases, performing a reconciliation and attaching it to the return may help prevent IRS notices if reconciling differences exist between the Form 1099-K and a taxpayer's income tax return.

RECIPIENTS OF A NOMINEE FORM 1099[20]

A person who receives a Form 1099-K for amounts actually belonging to another person is considered a **nominee recipient.**[21] This is different from a Form 1099-K that is issued in error.

> **Note**. The IRS advises taxpayers to include **incorrect** amounts reported on a Form 1099-K as additions in part I of Form 1040, Schedule 1. Taxpayers should enter the appropriate subtraction in part II to arrive at the correct amount of income to report on their income tax return.

If a taxpayer's information and the transactions amount are correct, but the money was actually received on behalf of another, **the nominee, not the original payer,** is responsible for filing a Form 1099-K for the true recipient. Spouses are not required to file a nominee return to show amounts owned by the other spouse.[22]

Practitioner Planning Tip

In situations regarding nominee recipients where the spouses do not file jointly, the nominee would be well advised to put a disclosure with their return regarding the nominated income.

The required Forms 1099-K are filed with Form 1096, *Annual Summary and Transmittal of U.S. Information Returns*, at the IRS Submission Processing Center for the nominee's area. On the forms, the nominee is listed as the "filer" and the true recipient as the "payee."

Example 1. In 2019, Penelope's friend, Derek, asked her to help him find a way to accept electronic payments when he started his new business. She created the account with the payment processer and used her own information when the registration form asked for "Your" name and tax identification number. She subsequently forgot all about it.

In 2024, Derek processed more than 200 payments totaling more than $20,000. Penelope received a Form 1099-K from the processor reporting the income under her name and identification number. Penelope used the information on the Form 1099-K she received to send Derek the following Form 1099-K. She sent the Form 1099-K's Copy A, *For Internal Revenue Service,* to the IRS address shown in the instructions with a signed fileable copy of Form 1096. A portion of her copy of the Form 1096 is shown next.

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20. *What to do with Form 1099-K.* Mar. 4, 2024. IRS. [www.irs.gov/businesses/what-to-do-with-form-1099-k] Accessed on Apr. 22, 2024.

21. General Instructions for Certain Information Returns (2024).

22. Ibid.

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For Example 1

☐ CORRECTED (if checked)

FILER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no.	FILER'S TIN	OMB No. 1545-2205	Payment Card and Third Party Network Transactions
Penelope Garcia, Nominee 1234 Range Rd Quantico, VA 22134 555-005-2024	37-1334247 PAYEE'S TIN 85-1334247 1a Gross amount of payment card/third party network transactions $ 240000.00	Form 1099-K (Rev. March 2024) For calendar year 2024	
Check to indicate if FILER is a (an): Payment settlement entity (PSE) ☐ Electronic Payment Facilitator (EPF)/Other third party ☐ Check to indicate transactions reported are: Payment card ☐ Third party network ☐	1b Card Not Present transactions $ 240000.00	2 Merchant category code 1799	Copy B For Payee
	3 Number of payment transactions 240	4 Federal income tax withheld $	This is important tax information and is being furnished to the IRS. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if taxable income results from this transaction and the IRS determines that it has not been reported.
PAYEE'S name Derek Morgan	5a January $ 20000.00	5b February $ 20000.00	
Street address (including apt. no.)	5c March $ 20000.00	5d April $ 20000.00	
1236 Range Rd	5e May $ 20000.00	5f June $ 20000.00	
City or town, state or province, country, and ZIP or foreign postal code	5g July $ 20000.00	5h August $ 20000.00	
Quantico, VA 22134	5i September $ 20000.00	5j October $ 20000.00	
PSE'S name and telephone number	5k November $ 20000.00	5l December $ 20000.00	
Account number (see instructions)	6 State	7 State identification no.	8 State income tax withheld $ $

Form 1099-K (Rev. 3-2024) (Keep for your records) www.irs.gov/Form1099K Department of the Treasury - Internal Revenue Service

Do Not Staple 6969

Form 1096 Department of the Treasury Internal Revenue Service	Annual Summary and Transmittal of U.S. Information Returns	OMB No. 1545-0108 2024

FILER'S name

Penelope Garcia, Nominee

Street address (including room or suite number)

1234 Range Rd

City or town, state or province, country, and ZIP or foreign postal code

Quantico, VA 22134

Name of person to contact	Telephone number	For Official Use Only
Penelope Garcia	555-005-2024	
Email address	Fax number	
nominee20231099k@gmail.com	555-346-2137	

1 Employer identification number	2 Social security number	3 Total number of forms	4 Federal income tax withheld	5 Total amount reported with this Form 1096
37-1334247		1	$	$ 240000.00

6 Enter an "X" in only one box below to indicate the type of form being filed.

W-2G 32	1097-BTC 50	1098 81	1098-C 78	1098-E 84	1098-F 03	1098-Q 74	1098-T 83	1099-A 80	1099-B 79	1099-C 85	1099-CAP 73		1099-DIV 91	1099-G 86	1099-INT 92	1099-K 10
☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐		☐	☐	☐	X
1099-LS 16	1099-LTC 93	1099-MISC 95	1099-NEC 71	1099-OID 96	1099-PATR 97	1099-Q 31	1099-QA 1A	1099-R 98	1099-S 75	1099-SA 94	1099-SB 43	3921 25	3922 26	5498 28	5498-ESA 72	5498-QA 2A
☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐
5498-SA 27																
☐																

Return this entire page to the Internal Revenue Service. Photocopies are not acceptable.
Send this form, with the copies of the form checked in box 6, to the IRS in a flat mailer (not folded).

Under penalties of perjury, I declare that I have examined this return and accompanying documents and, to the best of my knowledge and belief, they are true, correct, and complete.

Signature Title FILER Date

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CROWDFUNDING[23]

Crowdfunding is a method of soliciting funds from a large group of people through websites. The contributions may fund businesses, be charitable donations, or be gifts. The money raised may be solicited by crowdfunding organizers on behalf of other people or businesses. Alternatively, crowdfunders or social fundraisers may establish crowdfunding campaigns to raise money for themselves or their businesses.

INCOME RECOGNITION

A person receiving property as a **gift** through a crowdfunding campaign or through any event does not include the amount of the gift in their gross income. A crowdfunding organizer who **solicits donations** on behalf of others does not include monetary distributions in their gross income if the organizer distributes the money raised to the subject of the campaign.

> **Note.** It can be inferred that an organizer who does not distribute the money raised to the subject of the campaign must include the donations in their income. Because the income is acquired through fraud, the organizer could be subject to criminal prosecution.

A **donor** who contributes to a crowdfunding campaign with "detached and disinterested generosity" and who does not receive or expect to receive anything in return may be able to treat the amounts as gifts which may be excluded from the gross income for the person or business for which the campaign is organized. However, contributions made by donors without detached and disinterested generosity may not be gifts.

An **employer** that contributes to, or for the benefit of, an employee, generally includes the contributions in the gross income of the employee.

CHARITABLE DEDUCTION[24]

To be deductible, charitable gifts must meet the following two criteria.

1. Made to **qualified charitable organizations**[25]
2. Do not benefit any particular individual or organization

Example 2. Kara's house burns down in a cooking accident. She sets up a crowdfunding campaign to raise funds to find alternative living arrangements and to replace her clothes and other personal items. Her friend Drew donates $500 to Kara's campaign. Drew cannot claim a charitable deduction on his return because Kara is not a qualified charitable organization.

Example 3. Ronnie's children attend Main Town Elementary School. The school's parent-teacher organization (PTO), an IRC §501(c)(3) qualified charitable organization, sets up a crowdfunding campaign to raise money for students to attend space camp during the summer. Ronnie donates $50. Because the PTO is a qualified charitable organization, Ronnie can deduct his contribution, subject to his itemized deduction limitations.

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23. *Money received through "crowdfunding" may be taxable; taxpayers should understand their obligations and the benefits of good recordkeeping.* Jan. 31, 2023. IRS. [www.irs.gov/newsroom/money-received-through-crowdfunding-may-be-taxable-taxpayers-should-understand-their-obligations-and-the-benefits-of-good-recordkeeping] Accessed on Dec. 31, 2023.

24. IRC §170(c).

25. Generally defined in IRC §501(c)(3).

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FORM 1099-K REPORTING

A recipient of more than $600 from certain crowdfunding campaigns, regardless of the number of transactions, may receive a Form 1099-K related to the fundraiser. If the crowdfunding website uses a third-party processor, the company issuing the Form 1099-K may not be the same company as the website.

Only campaigns which reward contributors with goods or services in exchange for their donations are subject to reporting. All others are exempt.

Example 4. Shelly's friend Howard travels out of state for medical care and needs help paying for the trip. Shelly starts an online fundraising campaign on his behalf. Contributors do not receive anything in return for their donations. Shelly receives the money from the processor and uses it to fund Howard's travel.

The processor is not required to issue her a Form 1099-K. Shelly does not include the donations she collects in her income.

Example 5. Use the same facts as **Example 4,** except that Howard raises funds for his medical care by starting a fundraiser on his favorite social networking site. He promises everyone who contributes a personalized gift. Because the contributors are promised a future benefit, the payment processor is required to issue him a Form 1099-K.

Example 6. Use the same facts as **Example 4.** Howard's employer, BBT, Inc., donates $1,000 to Shelly's crowdfunding campaign. BBT includes the $1,000 contribution in Howard's gross income reported on his Form W-2, *Wage and Tax Statement*.

If BBT donated the $1,000 to Howard's crowdfunding fundraiser in **Example 5,** the contribution would still be included in Howard's gross income. Because Howard is not a qualified charitable organization, BBT may not deduct the donation as a charitable contribution.

GAMBLING ACTIVITIES

In 2018, the Supreme Court's decision in *Murphy v. National Collegiate Athletic Association* opened the door for legalized sports gambling across the country.[26] In 2022, commercial gaming revenue in the United States reached $60.4 billion, which includes $7.2 billion in sports betting, an increase of 73% from 2021, and $5 billion in online gambling, an increase of 35% from 2021.[27] Gambling income is considered taxable income and includes winnings from the following.[28]

- Lotteries
- Raffles
- Horse races
- Casinos
- Fantasy sports
- Online sports betting sites (e.g., DraftKings and FanDuel)

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26. *Murphy v. National Collegiate Athletic Association*, No. 16-476, 584 U.S. 453 (2018).

27. *Commercial Gaming Revenue Tops $60B, Breaking Annual Record For Second Consecutive Year.* Feb. 15, 2023. American Gaming Association. [www.americangaming.org/new/2022-commercial-gaming-revenue-tops-60b-breaking-annual-record-for-second-consecutive-year] Accessed on Feb. 13, 2024.

28. IRS Pub. 525, *Taxable and Nontaxable Income; Topic no. 419, Gambling income and losses.* Jan. 30, 2024. IRS. [www.irs.gov/taxtopics/tc419] Accessed on Feb. 14, 2024; Ltr. Rul. 202042015 (Oct. 16, 2020).

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Gambling winnings are required to be reported to the IRS in the following circumstances.[29]

1. Bingo or slot machine winnings (not reduced by the wager) of $1,200 or more
2. Keno game winnings (reduced by the wager) of $1,500 or more
3. Poker winnings (reduced by the wager or buy-in) of more than $5,000
4. Other winnings that are $600 or more and at least 300 times the amount of the wager (the payor may opt to reduce the reported winnings by the wager)
5. The winnings are subject to federal income tax withholding (either regular gambling withholding or backup withholding)

Gambling activities are generally treated as either recreational[30] or a business venture.[31] Regardless of this differentiation of nature, all types of betting and wagering can generate taxable income. **Gambling** winnings are reported by the payor to the IRS on Form W-2G, *Certain Gambling Winnings.* Winnings from **games of skill** are reported on Form 1099-MISC.[32] Taxpayers must report income from any gambling activities even if they do not receive a report from the source of the winnings (i.e., casinos or betting sites).

Note. Winnings from sweepstakes are reported on either Form 1099-MISC or Form W-2G depending on whether the contest contains a gambling component. Winnings from sweepstakes not involving a wager are reported on Form 1099-MISC, while winnings from sweepstakes involving a wager are reported on Form W-2G.[33]

If taxpayers receive the payment for their winnings from a TPSO or a PSE such as Venmo and PayPal, the taxpayer may receive a Form 1099-K reporting the amount of the payment. Therefore, it is possible for a taxpayer to receive Form 1099-K in addition to Form W-2G or Form 1099-MISC for the same winnings. Taxpayers and their practitioners should be mindful of such instances to avoid reporting duplicate items of income on a tax return.

Practitioner Planning Tip

Practitioners should include a question about client gambling activity on their organizer. Additionally, the existence of one type of tax document reporting wagering income should prompt a practitioner to inquire if the taxpayer received any additional winnings via other means. Note that winnings include both legal and illegal gambling. Such discussions, inquiries, and the taxpayer's responses should be well documented.

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29. Instructions for Form W-2G.
30. *Topic no. 419, Gambling income and losses.* Jan. 30, 2024. IRS. [www.irs.gov/taxtopics/tc419] Accessed on Mar. 26, 2024.
31. *Comm'r v. Groetzinger,* 480 U.S. 23 (1987).
32. Ltr. Rul. 200532025 (May 3, 2005); Instructions for Form 1099-MISC.
33. Instructions for Forms 1099-MISC and 1099-NEC.

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Example 7. Kyle enjoys betting on his favorite football team through GamblingGizmo, an app on his phone. He links his GamblingGizmo account with his PayPal account to fund his bets and to receive his winnings. At the end of the year, Kyle has total winnings of $1,000 and total losses of $3,000.

As a TPSO, PayPal sends Kyle a Form 1099-K reporting the $1,000 of winnings.

Example 8. Kyle, from **Example 7,** also places a longshot bet on his football team at a casino while on vacation in Las Vegas. Miraculously, he wins the bet, and the casino sends Kyle a Form W2-G reporting the winnings.

WITHHOLDING

Generally, gambling organizations will withhold federal income taxes for winnings totaling $5,000 or more.[34] Some exceptions apply to this treatment. For example, gambling winnings from bingo games or slot machines generally are not subject to income tax withholding.[35] However, in instances where the winner does not provide the payor with their social security number (SSN), the payor may have to withhold a flat 24% of the winnings for federal income tax.[36] This rule also applies to general gambling winnings in addition to bingo game and slot machine winnings.[37]

Practitioner Planning Tip

Practitioners should consider quarterly check-ins with taxpayers who traditionally have gambling income to calculate appropriate estimated payments to avoid underpayment penalties. For more information on estimates, see the 2023 *University of Illinois Federal Tax Workbook,* Chapter 9: Individual Taxpayer Issues.

REPORTING INCOME AND EXPENSES

Properly reporting gambling winnings and any related deductible expenses starts with determining if the wagering activity rises to the level of being a trade or business. The distinction between recreational winnings and business winnings is important because it determines how the income is taxed and if any related expenses are deductible.

The classification is based on the facts and circumstances of each situation. While there is no bright line test, the Supreme Court established the following standard for what constitutes a trade or business with respect to gambling activities.[38]

1. The taxpayer must be involved in the activity with continuity and regularity, **and**
2. The taxpayer's primary purpose for the activity must be for income or profit.

Because all gamblers intend to make a profit, the classification of their gambling winnings depends upon the continuity and regularity of their activities. The Court ruled that when gambling is pursued full-time, in good faith, and with regularity to produce income for a livelihood, it is considered a trade or business. Gamblers who make large-scale efforts to earn income that requires skill are likely not merely engaged in gambling as a hobby.

34. Treas. Reg. §31.3402(q)-1(b).
35. Treas. Reg. §31.3402(q)-1(a)(2).
36. IRS Pub. 505, *Tax Withholding and Estimated Tax.*
37. Ibid.
38. *Comm'r v. Groetzinger,* 480 U.S. 23 (1987).

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In determining whether a gambler is a professional engaged in a trade or business, courts hold taxpayers to a much higher standard than for nongambling trades or businesses. The following are some principles derived from cases that have dealt with the issue.

- To rise to the level of professional gambling, the gambling activity should be the taxpayer's full-time occupation. If the taxpayer has another occupation, gambling is generally not seen as being full-time unless the other occupation is part-time, and the amount of time devoted to gambling is significantly more than the time devoted to the other occupation.[39]
- If the taxpayer has significant income from sources other than gambling, courts view the taxpayer as not earning a livelihood from gambling. Because most gambling cases involve losses in excess of winnings, it is difficult for a taxpayer to win on this point. Therefore, nongambling sources of income should be minimal for the taxpayer to be considered a professional gambler.[40]
- Frequency and regularity of gambling activities are important. Taxpayers who gamble occasionally, even if they do so frequently, are not engaged in the activity with the requisite regularity to be considered professional gamblers.[41]
- Courts often apply hobby loss factors under IRC §183 in determining whether a taxpayer is in the trade or business of gambling. The court's analysis includes such factors as adequacy of recordkeeping, whether the taxpayer has conducted proper research into the gambling activity, and whether the taxpayer sought professional advice, among others.[42]

If a taxpayer is in the **business of gambling,** the income is reported on Schedule C, *Profit or Loss From Business.* Any allowable losses and expenses are deductible on the schedule up to the amount of income received.[43] Because professional gamblers report gambling activities on Schedule C, all expenses related to the activity are deductible in determining adjusted gross income (AGI), not just their wagers. This can actually create a loss from the gambling activity because only the wager portion is subject to the winnings limitation. However, for tax years 2018 through 2025, expenses **in excess** of gambling winnings are not deductible even if the activity is operated as a business.[44] Furthermore, net profits from a wagering business are subject to SE taxes.[45]

Note. For more information on qualifying gambling activities as businesses, see page 112 of the 2017 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 2: Individual Taxpayer Issues. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

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39. See, e.g., *Moore v. Comm'r,* TC Memo 2011-173 (Jul. 18, 2011).
40. Ibid.
41. See, e.g., *Free-Pacheco v. U.S.*, 117 Fed. Cl. 228 (2014).
42. See Treas. Reg. §1.183-2(b); see also *Merkin v. Comm'r,* TC Memo 2008-146 (Jun. 5, 2008).
43. See, e.g., *Boyd v. U.S.,* 762 F.2d 1369 (9th Cir. 1985).
44. IRC §165(d).
45. *Topic Number 554, Self-employment tax*. Feb. 12, 2024. IRS. [www.irs.gov/taxtopics/tc554] Accessed on Mar. 28, 2024; *Comm'r v. Groetzinger,* 480 U.S. 23 (1987).

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The income from **nonbusiness gambling** is reported on Form 1040, Schedule 1, as other income on line 8b. Losses are reported on Schedule A, *Itemized Deductions*, as other itemized deductions and are not subject to the 2%-of-AGI limitation and are not preferences in determining alternative minimum tax income (AMTI). Deductible gambling losses and expenses are limited to gambling income for federal income tax purposes.[46] Some states, such as Illinois, do not allow state income tax deductions for gambling losses even to the extent of winnings.[47]

Caution. The treatment of itemized deductions is one of the issues that could be impacted by the expiration of the Tax Cuts and Jobs Act (TCJA) at the end of 2025. For additional information, see the 2024 *University of Illinois Federal Tax Workbook,* Chapter 12: Planning for the Sunset of the TCJA.

Note. Participation in such Internet activities as daily fantasy sports may qualify as gambling, which permits taxpayers to deduct costs against earnings if the taxpayer itemizes. However, if the winnings from such activities are considered **prizes** for games of skill, the losses and expenses are treated as miscellaneous itemized deductions subject to the 2% floor, which are suspended until tax year 2026.[48]

To determine the amount of winnings and losses incurred each year, taxpayers must keep appropriate records. Such records include the following information.[49]

- Date and type of specific wager or wagering activity
- Name and address of gambling establishment
- Names of other persons (if any) present with taxpayer at gambling establishment
- Amount(s) won or lost

Note. IRS Notice 2015-21 provides a safe harbor for determining winnings and losses from slot machine play.[50] This safe harbor applies only to slot machines and does not permit gains or losses from separate sessions to be netted against each other. Thus, a taxpayer who participates in both slot machine play and table games at a casino cannot net the two activities into a single session of play.

Gamblers often do not keep complete records of their gaming wins and losses. In some circumstances, the court estimates the amount allowable when a taxpayer establishes that they paid or incurred a deductible expense but does not establish the exact amount.[51] Courts may recognize evidence of losses, such as bank and brokerage records showing the taxpayer's casino-related activities,[52] but proper documentation of gambling activities prevent taxpayers from having to present their evidence in court.

46. IRC §165(d).
47. *Tax issues for professional gamblers*. Nevius, Alistair M. Oct. 1, 2016. Journal of Accountancy. [www.journalofaccountancy.com/issues/2016/oct/taxes-for-gamblers.html] Accessed on Mar. 26, 2024.
48. IRC §§67(b) and (g).
49. IRS Pub. 529, *Miscellaneous Deductions.*
50. IRS Notice 2015-21, 2015-12 IRB 765.
51. See *Cohan v. Comm'r,* 39 F.2d 540 (2d Cir. 1930).
52. *John M. Coleman v. Comm'r,* TC Memo 2020-146 (Oct. 22, 2020).

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TICKET RESELLERS

People who sell or resell tickets to events may receive a Form 1099-K for sales paid through TPSOs and PSEs, such as StubHub or Ticketmaster. Proper reporting of such receipts and the deductibility of associated expenses on a tax return depends upon the facts and circumstances surrounding the seller's profit motive and the nature of the activity.

A purchaser who later sells tickets may be considered to be in the trade or business of ticket reselling. An activity may rise to the level of a trade or business when an individual conducts the activity continually and with regularity to earn income or realize a profit.[53] Instead of straight line tests or quantified criteria, regulations state that facts and circumstances surrounding a taxpayer's situation drives the determination of a profit motive.[54] Such factors indicating a taxpayer's profit objective include the following.[55]

- The manner in which a taxpayer engages in the activity, including whether they maintain books or records, or conduct the activity in a similar nature to other profitable activities
- The taxpayer's reliance on their own specialized knowledge or a third party's expertise in conducting the activity
- The amount of time and effort the taxpayer exerts in their involvement in the activity
- The taxpayer's intention of earning a profit, whether it be during the regular course of participating in the activity or at the conclusion or termination of the activity
- The taxpayer's historical involvement in similar activities and the profitability of such activities
- The taxpayer's historical profitability or incursion of losses in the activity
- The taxpayer's financial health
- The presence of a personal or recreational component in the activity

Depending on the facts and circumstances, selling several tickets at a profit over a period of months may meet the attributes of conducting a trade or business. In those situations, the taxpayer should report the activity on Schedule C.[56]

If the facts and circumstances surrounding the taxpayer's ticket reselling activities do not indicate the taxpayer is doing so in the capacity of conducting a trade or business, the tickets are capital assets under IRC §1221. If sold at a gain, the profit from the ticket sale is taxable as short-term or long-term capital gain, based on the holding period. The taxpayer uses Form 8949 to report such gains. Sellers should mark box C to indicate the transaction was not reported to the taxpayer on Form 1099-B, *Proceeds From Broker and Barter Exchange Transactions.* Details of the transaction are reported in the list box of line 1 in each part. Sellers then must report the total of the transactions on Schedule D. However, if the taxpayer sells the ticket at a loss, it is not deductible.[57]

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53. *Comm'r v. Groetzinger,* 480 U.S. 23 (1987).
54. Treas. Reg. §1.183-2(a).
55. Treas. Reg. §1.183-2(b).
56. Instructions for Schedule C.
57. IRC §165.

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Example 9. Glen believes that his favorite sportsball team is going to make it to the Grand Super World Finals this year. Every year, he purchases 10 tickets for the potential championship event before the game season starts.

In 2023, his foresight paid off. Glen paid $200 per ticket and told his family to save the dates. His family made other plans, however, and he was holding nine extra tickets to the biggest game of the year. He sold the extra tickets for $1,000 each just before the final game of the year. Glen reported the sale on his 2023 Form 8949 and Schedule D as shown next.

Form **8949**

Department of the Treasury
Internal Revenue Service

Sales and Other Dispositions of Capital Assets

File with your Schedule D to list your transactions for lines 1b, 2, 3, 8b, 9, and 10 of Schedule D.

Go to *www.irs.gov/Form8949* for instructions and the latest information.

OMB No. 1545-0074

2023

Attachment Sequence No. **12A**

Name(s) shown on return: **Glen Fan**

Social security number or taxpayer identification number: *****-**-9293**

Before you check Box A, B, or C below, see whether you received any Form(s) 1099-B or substitute statement(s) from your broker. A substitute statement will have the same information as Form 1099-B. Either will show whether your basis (usually your cost) was reported to the IRS by your broker and may even tell you which box to check.

Part I **Short-Term.** Transactions involving capital assets you held 1 year or less are generally short-term (see instructions). For long-term transactions, see page 2.

Note: You may aggregate all short-term transactions reported on Form(s) 1099-B showing basis was reported to the IRS and for which no adjustments or codes are required. Enter the totals directly on Schedule D, line 1a; you aren't required to report these transactions on Form 8949 (see instructions).

You *must* check Box A, B, *or* C below. Check only one box. If more than one box applies for your short-term transactions, complete a separate Form 8949, page 1, for each applicable box. If you have more short-term transactions than will fit on this page for one or more of the boxes, complete as many forms with the same box checked as you need.

☐ **(A)** Short-term transactions reported on Form(s) 1099-B showing basis was reported to the IRS (see **Note** above)
☐ **(B)** Short-term transactions reported on Form(s) 1099-B showing basis **wasn't** reported to the IRS
☒ **(C)** Short-term transactions not reported to you on Form 1099-B

1 (a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold or disposed of (Mo., day, yr.)	(d) Proceeds (sales price) (see instructions)	(e) Cost or other basis See the **Note** below and see *Column (e)* in the separate instructions.	Adjustment, if any, to gain or loss. If you enter an amount in column (g), enter a code in column (f). **See the separate instructions.** (f) Code(s) from instructions	(g) Amount of adjustment	(h) Gain or (loss) Subtract column (e) from column (d) and combine the result with column (g).
9 Sports Event Tickets	02/24/23	11/11/23	9,000	1,800			7,200

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For Example 9

SCHEDULE D (Form 1040) Department of the Treasury Internal Revenue Service	**Capital Gains and Losses** Attach to Form 1040, 1040-SR, or 1040-NR. Use Form 8949 to list your transactions for lines 1b, 2, 3, 8b, 9, and 10. Go to *www.irs.gov/ScheduleD* for instructions and the latest information.	OMB No. 1545-0074 2023 Attachment Sequence No. 12
Name(s) shown on return: Glen Fan		Your social security number: ***-**-9293

Did you dispose of any investment(s) in a qualified opportunity fund during the tax year? ☐ Yes ☒ No
If "Yes," attach Form 8949 and see its instructions for additional requirements for reporting your gain or loss.

Part I Short-Term Capital Gains and Losses—Generally Assets Held One Year or Less (see instructions)

See instructions for how to figure the amounts to enter on the lines below. This form may be easier to complete if you round off cents to whole dollars.	(d) Proceeds (sales price)	(e) Cost (or other basis)	(g) Adjustments to gain or loss from Form(s) 8949, Part I, line 2, column (g)	(h) Gain or (loss) Subtract column (e) from column (d) and combine the result with column (g)
1a Totals for all short-term transactions reported on Form 1099-B for which basis was reported to the IRS and for which you have no adjustments (see instructions). However, if you choose to report all these transactions on Form 8949, leave this line blank and go to line 1b				
1b Totals for all transactions reported on Form(s) 8949 with **Box A** checked				
2 Totals for all transactions reported on Form(s) 8949 with **Box B** checked				
3 Totals for all transactions reported on Form(s) 8949 with **Box C** checked	9,000	1,800		7,200
4 Short-term gain from Form 6252 and short-term gain or (loss) from Forms 4684, 6781, and 8824			4	
5 Net short-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1			5	
6 Short-term capital loss carryover. Enter the amount, if any, from line 8 of your **Capital Loss Carryover Worksheet** in the instructions			6	( )
7 **Net short-term capital gain or (loss).** Combine lines 1a through 6 in column (h). If you have any long-term capital gains or losses, go to Part II below. Otherwise, go to Part III on the back			7	7,200

The IRS provides taxpayers with two methods to report sales that result in non-deductible losses.

1. Using Form 8949 and adjusting the loss[58]
2. Using Schedule 1, part I, to report the income and part II to deduct the cost[59]

Example 10. Dyanne, the eternal optimist, believes her team will do better each and every year. Early in 2023, she purchased 10 tickets to her team's possible big game for $1,000 each. Later in the year (before all hope was lost), she sold nine of the tickets for $500 each on a social media platform's marketplace.

Dyanne lives in a state with lower mandatory reporting thresholds than the federal thresholds, and the $4,500 total exceeds that threshold. The social media platform sends Dyanne a Form 1099-K reporting the income. She reports the transactions on her 2023 return as follows.

> **Note.** Code L in column 1(f) reflects that the adjustment in column 1(g) is for nondeductible losses.

58. Instructions for Form 8949.

59. *Frequently Asked Questions about Form 1099-K*. Dec. 2022. IRS. [www.irs.gov/pub/taxpros/fs-2022-41.pdf] Accessed on Feb. 7, 2024.

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For Example 10

Form **8949** — Department of the Treasury, Internal Revenue Service

Sales and Other Dispositions of Capital Assets

File with your Schedule D to list your transactions for lines 1b, 2, 3, 8b, 9, and 10 of Schedule D.
Go to *www.irs.gov/Form8949* for instructions and the latest information.

OMB No. 1545-0074 — 2023 — Attachment Sequence No. **12A**

Name(s) shown on return	Social security number or taxpayer identification number
Dyanne DeVries	***-**-0234

Before you check Box A, B, or C below, see whether you received any Form(s) 1099-B or substitute statement(s) from your broker. A substitute statement will have the same information as Form 1099-B. Either will show whether your basis (usually your cost) was reported to the IRS by your broker and may even tell you which box to check.

Part I **Short-Term.** Transactions involving capital assets you held 1 year or less are generally short-term (see instructions). For long-term transactions, see page 2.

Note: You may aggregate all short-term transactions reported on Form(s) 1099-B showing basis was reported to the IRS and for which no adjustments or codes are required. Enter the totals directly on Schedule D, line 1a; you aren't required to report these transactions on Form 8949 (see instructions).

You *must* check Box A, B, *or* C below. Check only one box. If more than one box applies for your short-term transactions, complete a separate Form 8949, page 1, for each applicable box. If you have more short-term transactions than will fit on this page for one or more of the boxes, complete as many forms with the same box checked as you need.

☐ **(A)** Short-term transactions reported on Form(s) 1099-B showing basis was reported to the IRS (see **Note** above)
☐ **(B)** Short-term transactions reported on Form(s) 1099-B showing basis **wasn't** reported to the IRS
☒ **(C)** Short-term transactions not reported to you on Form 1099-B

1 (a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold or disposed of (Mo., day, yr.)	(d) Proceeds (sales price) (see instructions)	(e) Cost or other basis See the **Note** below and see *Column (e)* in the separate instructions.	Adjustment, if any, to gain or loss If you enter an amount in column (g), enter a code in column (f). **See the separate instructions.** (f) Code(s) from instructions	(g) Amount of adjustment	(h) **Gain or (loss)** Subtract column (e) from column (d) and combine the result with column (g).
9 Sports Event Tickets	02/24/23	12/01/23	4,500	9,000	L	4,500	0

Example 11. Taylor and Tyler are best friends who want to attend the sure-to-be sold-out concert of the year together. Tyler purchases the tickets for the both of them and Taylor swiftly uses Venmo to pay Tyler for her ticket. Neither Taylor nor Tyler is issued a Form 1099-K.

> **Note.** As a result of the Form 1099-K filing requirements, ticket sellers may request additional information from purchasers. For example, Ticketmaster requires individuals and entities that are considered U.S. persons who sell tickets on the Ticketmaster marketplace to provide their legal name, address, phone number, and tax identification number.[60]

60. *2024 U.S. Tax Law Updates You Need to Know.* Jan. 18, 2024. Ticketmaster. [business.ticketmaster.com/business-solutions/2024-u-s-tax-law-updates-you-need-to-know] Accessed on Feb. 7, 2024.

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STUDENT-ATHLETES[61]

In 2021, the National Collegiate Athletic Association (NCAA) approved a name, image, and likeness (NIL) policy that permits student-athletes to make a profit off their NIL without impacting their NCAA eligibility.[62] Such profit, depending on what the payment was for and how the payment was made, is reported to the IRS on various 1099 forms. A student-athlete who earns $600 or more in **royalties** from selling their NIL may receive a Form 1099-MISC.[63] A student-athlete who earns $600 or more by providing a **service** associated with their NIL may receive Form 1099-NEC.[64] Student-athletes who **receive payment from a TPSO** from selling their NIL may receive a Form 1099-K. Consequently, a student-athlete who receives more than $600 paid by a TPSO from selling their NIL may receive both a Form 1099-NEC or Form 1099-MISC and a Form 1099-K. In rare circumstances, a student-athlete receives a Form W-2 if they are considered an employee.

All income from NIL activities is reportable income, including non-monetary items like virtual currencies, nonfungible tokens (NFT), paid vacations, etc. Income from NIL activities is reported on Schedule C and is subject to SE tax. NIL activities include the following.

- Guest appearances
- Autograph signings
- Sponsorships
- Endorsements
- Apparel sales
- Corporate partnerships
- Charitable appearances
- Product or service promotions

Note. Income from **licensing one's image** when the services provided are immaterial to the agreement is passive income, not self-employment.[65] Accordingly, such income is likely reported as royalties on Schedule E, *Supplemental Income and Loss*.

Student-athletes are permitted to offset their NIL income with any ordinary, necessary, and reasonable expenses related to their NIL income. This could include mileage, travel, office expenses, cell phone expenses, professional fees such as legal, accounting, marketing, or agency fees.

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61. *Name, Image, and Likeness.* Jan. 4, 2024. Taxpayer Advocate Service. [www.taxpayeradvocate.irs.gov/get-help/general/nil] Accessed on Jan. 9, 2024; Messina, Marena and Messina, Frank. (2022, Jul.) A Primer on the Income Tax Consequences of the NCAA's Name, Image and Likeness (NIL) Earnings for College Athletes. *Journal of Athlete Development and Experience.* Vol. 4: Iss. 2, Article 5.

62. AM 2023-004 (Jun. 9, 2023).

63. *Student Athletes Need to Know the Potential Tax Implications of the Name, Image, Likeness Rules in College Football.* Hornbrook, Carlos J. Jun. 11, 2023. American Bar Association. [www.americanbar.org/groups/taxation/publications/abataxtimes_home/23spr/23spr-prp-hornbrook-nil-rules] Accessed on Apr. 3, 2024.

64. Ibid.

65. *Goosen v. Comm'r*, 136 TC 547 (2011).

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Practitioner Planning Tip

Athletics are specified service trades or businesses for purposes of the qualified business income deduction per IRC §199A. However, the potential expiration of the TCJA at the end of 2025 may impact the qualified business income adjustment for years beginning in 2026. Tax practitioners should keep this possibility in mind when engaging in tax planning for their student-athlete clients. For more information, see the 2024 *University of Illinois Federal Tax Workbook,* Chapter 12: Planning for the Sunset of the TCJA.

Net NIL income of $400 or more is subject to SE tax, calculated on Schedule SE, *Self-Employment Tax.*[66] Consequently, student-athletes who receive income totaling less than the tax year's applicable standard deduction but receive more than $400 of NIL income do not have an income tax liability but are still responsible for payment of the SE tax.

Example 12. Blaire, 22, is a soccer player at College State University (CSU). Water Break, a local beverage establishment that serves CSU students, pays Blaire to enjoy some beverages on a Friday night. Water Break pays Blaire $100 per appearance, plus the cost of any beverages she consumes. During 2023, Blaire earns $1,200 in cash and products. Water Break pays Blaire through CashMo, a TPSO. As such, Blaire receives a Form 1099-K in January 2024.

The $1,200 of earned income is below Blaire's standard deduction, so she does not have an income tax liability. However, she is responsible for SE tax.

66. See Schedule SE, *Self-Employment Tax.*

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DEPENDENCY ISSUES

Tax preparers must determine whether a student-athlete with NIL income is going to claim themselves or whether their parent can claim the student-athlete as a dependent. Student-athletes with gross income of $4,700 or more usually cannot be claimed as a dependent unless they are a **qualifying child.**[67] IRS Pub. 501, *Dependents, Standard Deduction, and Filing Information,* summarizes the rules for claiming a dependent.

This table is only an overview of the rules. For details, see the rest of this publication.

- You can't claim any dependents if you, or your spouse if filing jointly, could be claimed as a dependent by another taxpayer, unless that taxpayer files a return only to claim a refund of withheld income tax or estimated tax paid.
- You can't claim a married person who files a joint return as a dependent unless that joint return is filed only to claim a refund of withheld income tax or estimated tax paid.
- You can't claim a person as a dependent unless that person is a U.S. citizen, a U.S. resident alien, a U.S. national, or a resident of Canada or Mexico.[1]
- You can't claim a person as a dependent unless that person is your **qualifying child** or **qualifying relative.**

Tests To Be a Qualifying Child	Tests To Be a Qualifying Relative
1. The child must be your son, daughter, stepchild, foster child, brother, sister, half brother, half sister, stepbrother, or stepsister, or a descendant of any of them.	1. The person can't be your qualifying child or the qualifying child of any other taxpayer.
2. The child must be (a) under age 19 at the end of the year and younger than you (or your spouse if filing jointly); (b) under age 24 at the end of the year, a student, and younger than you (or your spouse if filing jointly); or (c) any age if permanently and totally disabled.	2. The person either (a) must be related to you in one of the ways listed under *Relatives who don't have to live with you*, or (b) must live with you all year as a member of your household[2] (and your relationship must not violate local law).
3. The child must have lived with you for more than half of the year.[2]	3. The person's gross income for the year must be less than $4,700.[3]
4. The child must not have provided more than half of the child's own support for the year.	4. You must provide more than half of the person's total support for the year.[4]
5. The child must not be filing a joint return for the year (unless that joint return is filed only to claim a refund of withheld income tax or estimated tax paid).	
If the child meets the rules to be a qualifying child of more than one person, generally only one person can actually treat the child as a qualifying child. See *Qualifying Child of More Than One Person*, later, to find out which person is the person entitled to claim the child as a qualifying child.	

[1] There is an exception for certain adopted children.

[2] There are exceptions for temporary absences, children who were born or died during the year, children who were adopted or lawfully placed for adoption during the year, children who are eligible foster children placed during the year, children of divorced or separated parents (or parents who live apart), and kidnapped children.

[3] There is an exception if the person is disabled and has income from a sheltered workshop.

[4] There are exceptions for multiple support agreements, children of divorced or separated parents (or parents who live apart), and kidnapped children.

Parents cannot claim their student-athlete child as a dependent if the student-athlete provides more than half of their own total support for the year. Additionally, parents and student-athletes should be aware of the age requirements for dependency as shown in the preceding table when determining dependency status.

[67] See IRS Pub. 501, *Dependents, Standard Deduction, and Filing Information.*

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If the parents cannot claim the student-athlete as a dependent, the student-athlete is able to receive the entire standard deduction to offset their NIL income, which would lower their potential tax obligation. Regardless, the student-athlete may need to file a tax return even if they do not owe income tax because they may owe SE taxes, as discussed previously.

Note. There are other considerations parents and their children should consider when determining whether the parents should claim the student-athlete as a dependent. This includes whether the parents' income is too high to be eligible for education credits or recovery rebates. Additionally, because NIL income is taxable, student-athletes must report the income on their Free Application for Federal Student Aid (FAFSA) which may impact any financial aid they receive. For more information on federal student aid tax strategies, see the 2023 *University of Illinois Federal Tax Workbook,* Chapter 9: Individual Taxpayer Issues.

COLLECTIVES[68]

Student-athletes may receive assistance from **collectives,** i.e., groups formed to support NIL opportunities for student-athletes. Payments and other forms of compensation from such entities are income to the student-athlete.

Caution. Some of these groups are operating as putative non-profit NIL collectives. The IRS Chief Counsel has concluded that such organizations are more likely to be serving the private interests of student-athletes than operating for a purpose that qualifies for non-profit status under §501(c)(3).[69]

OTHER TAX CONSIDERATIONS

Parents and student-athletes should also consider the impact NIL income has on the kiddie tax.[70] Unearned income during 2024 in excess of $2,600[71] may be subject to the tax on unearned income of certain children (i.e., kiddie tax). The kiddie tax applies to children under age 18 at the end of the tax year or **fulltime students under age 24 at the end of the tax year who did not have earned income that exceeded half of their own support.** Therefore, a student-athlete with **royalty income** from licensing their NIL has **unearned income** that could subject them to the kiddie tax.[72]

Note. Income from nonemployee contract work (e.g., appearances, autograph signings, etc.) is earned income and not subject to the kiddie tax calculation.

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68. See *Name, Image, and Likeness*. Mar. 7, 2023. Taxpayer Advocate Service. [www.taxpayeradvocate.irs.gov/get-help/general/nil] Accessed on Feb. 9, 2024; AM 2023-004 (Jun. 9, 2023); *The Long Read: Tax Implications of College Collectives, NIL Deals.* Shaw, Tim. Oct. 6, 2022. Thomson Reuters. [tax.thomsonreuters.com/news/the-long-read-tax-implications-of-college-collectives-nil-deals] Accessed on Mar. 29, 2024.

69. AM 2023-004 (Jun. 9, 2023).

70. *Topic no. 553, Tax on a child's investment and other unearned income (Kiddie tax).* Jan. 12, 2024. IRS. [www.irs.gov/taxtopics/tc553] Accessed on Feb. 9, 2024.

71. Rev. Proc. 2023-24, 2023-48 IRB 1287.

72. *Student Athletes Need to Know the Potential Tax Implications of the Name, Image, Likeness Rules in College Football.* Hornbrook, Carlos. Jan. 11, 2023. American Bar Association. [www.americanbar.org/groups/taxation/publications/abataxtimes_home/23spr/23spr-prp-hornbrook-nil-rules] Accessed on Feb. 9, 2024.

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If the student-athlete's only income is from interest and dividends (including capital gain distributions) and totals less than $13,000 (2024), the parents can elect to include the income on their return.[73]

> **Caution.** Student-athletes with NIL income may be surprised to owe taxes on NIL income and should consider if they are required to pay estimated payments. Additionally, student-athletes paid in noncash compensation may find they do not have the cash required to pay their tax liability.

Student-athletes may also have complex state income tax issues. Their resident state is normally where their parents live even when the student leaves that state to play for a university in another state.[74] However, the rules applicable to each state need to be considered when determining where they legally reside. In addition, the student-athlete needs to consider the laws of every state in which they earn income to determine if they have to file returns with those states.

RESEARCH STUDY PARTICIPANTS

Participants in a research study are often paid for their participation and may also be reimbursed for travel expenses including gas, lodging, and food. Consequently, participants may be issued a Form 1099 for their compensation. The treatment and reporting of income from research study participation for income tax purposes depends on the type of payment the participant received.

REMUNERATION

Research study participants may receive payment for their participation in the form of remuneration. **Remuneration** is compensation for services rendered and is taxable income to the recipient.[75] Such payment may be issued in the form of cash and cash equivalents including gift cards and bank checks. If a research participant earns $600 or more from a research provider or company, they will be issued a Form 1099.[76] The participant's facts and circumstances will determine whether they should be issued a Form 1099-MISC or a Form 1099-NEC.

If the research participant's involvement in the research study rises to the level of a trade or business, discussed earlier, the research participant should be issued a Form 1099-NEC if they receive $600 or more.[77] The research participant reports this income on Schedule C of their Form 1040 and is subject to SE tax. The research participant can deduct expenses they incur in participating in research studies from the income they earn, reporting these expenses on Schedule C.[78]

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73. See Form 8814, *Parents' Election to Report Child's Interest and Dividends;* Rev. Proc. 2023-34, 2023-48 IRB 1287.

74. *Am I an Illinois resident if I live in Illinois while attending school?* Apr. 27, 2023. IDOR. [tax.illinois.gov/questionsandanswers/answer.708.html] Accessed on Apr. 3, 2024; *First-Time Filer Residency Information: Am I a resident?* Sep. 11, 2022. IDOR. [tax.illinois.gov/individuals/studentdefinitions.html] Accessed on Apr. 3, 2024.

75. IRC §61(a)(1).

76. Instructions for Forms 1099-MISC and 1099-NEC.

77. Ibid.

78. IRC §162(a).

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If the research participant's involvement **does not** rise to the level of a trade or business, the research participant receiving $600 or more in compensation from a research provider should be issued a Form 1099-MISC.[79] The research participant reports this income on part 1, line 8z of Schedule 1 of their Form 1040. This compensation is not subject to SE tax. The expenses the research participant incurs in participating in research studies constitutes a miscellaneous itemized deduction subject to a 2% of AGI floor.[80] Such itemized deductions are disallowed under the TCJA.[81]

Caution. Regardless of whether the research participant was issued a Form 1099, research participants are nonetheless required to report compensation they received from their participation as income on their income tax returns. The appropriate reporting of this income depends on whether their involvement in participating in research activities rises to a trade or business, as discussed previously.[82]

REIMBURSEMENT

Research study participants may receive reimbursement of out-of-pocket expenses they incur while participating in the study. Such expenses may include travel, transportation, and parking. Research providers should not report the reimbursement of incurred expenses on either Forms 1099-MISC or 1099-NEC[83] and research study participants should not report such payments as income on their income tax returns.[84]

If research providers make payments to research study participants for **estimated payments** of out-of-pocket expenses that the participants have not yet incurred, the treatment of such payments may differ from reimbursements of incurred expenses. Some research providers adopt the same principles of reimbursements and expense allowance arrangements for employees to research study participants.[85] Under these principles, the treatment of advance payments of reimbursed expenses depends on whether the payor makes such payments under an accountable plan.[86] **Accountable plans** require the following.[87]

1. The reimbursed expense must have a business connection.
2. The reimbursed party must substantiate the expenses to the payor within a reasonable period of time.
3. The reimbursed party must return any excess amount of payment exceeding the actual expense to the payor within a reasonable time.

Note. For more information on accountable plans, see the 2021 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 6: Small Business Issues. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

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79. Instructions for Forms 1099-MISC and 1099-NEC.

80. Treas. Reg. §1.212-1(a).

81. IRC §67(g).

82. *If You Don't Get Form 1099, Is It Taxable, Will IRS Know? (Hint: 'If A Tree Falls In The Forest...').* Wood, Robert W. Nov. 22, 2021. Forbes. [www.forbes.com/sites/robertwood/2021/11/22/if-you-dont-get-form-1099-is-it-taxable-will-irs-know-hint-if-a-tree-falls-in-the-forest] Accessed on May 2, 2024.

83. Instructions for Forms 1099-MISC and 1099-NEC.

84. IRS Pub. 463, *Travel, Gift, and Car Expenses*.

85. *Payments to Human Subjects for Participation in Research*. Sep. 10, 2010. Partners Healthcare. [www.partners.org/Assets/Documents/Medical-Research/Clinical-Research/Payments-to-Human-Subjects-for-Participatio-in-Research.pdf] Accessed on May 2, 2024.

86. Treas. Reg. §1.62-2.

87. IRS Pub. 463, *Travel, Gift, and Car Expenses*.

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If the advance payment is made under an accountable plan, the research provider does not report the reimbursement on Forms 1099-MISC or 1099-NEC and research study participants should not report such payments as income on their income tax returns. Conversely, if the advance payments are not made under an accountable plan, the research provider will report such payments on either Form 1099-MISC or Form 1099-NEC and the research study participant must report the payment as income on their income tax returns.[88]

Note. Instead of reimbursing the participant directly, a research provider may instead pay the expense incurred by the participant directly to the vendor. This payment should not reflect compensation or reimbursement to the participant.[89]

Example 13. In 2024, Elizabeth participated in a research study for Emerald Goliaths Research, a company specializing in anger management research. Elizabeth incurred and paid $100 in travel expenses to the testing center where the study was conducted and $250 for lodging. Emerald Goliaths Research paid Elizabeth $650 for participating in the study and fully reimbursed her for her travel and lodging expenses after she furnished her receipts, resulting in a total payment of $1,000 ($100 travel expense reimbursement + $250 lodging reimbursement + $650 remuneration). Elizabeth does not participate in research studies on a continual basis and such activities do not rise to the level of a trade or business for her.

Emerald Goliaths Research issued Elizabeth a Form 1099-MISC for $650 of remuneration for her participation in the research study in 2024. Because Elizabeth incurred and paid her travel and lodging expenses before receiving reimbursement of those expenses, Emerald Goliaths Research correctly excluded the reimbursement portion of the $1,000 payment to Elizabeth from the Form 1099-MISC. Elizabeth reported $650 of income on part 1, line 8z of Schedule 1 for her 2024 Form 1040.

Example 14. Use the same facts as **Example 13,** except Emerald Goliaths Research paid Elizabeth advance reimbursement payments of $150 for travel expenses and $300 for lodging expenses. Elizabeth did not submit her receipts to Emerald Goliaths Research and she did not pay back the $100 excess of payment she received ($150 travel expense advance reimbursement + $300 lodging advance reimbursement − $100 travel expense incurred − $250 lodging expense incurred). Emerald Goliaths Research issued Elizabeth a Form 1099-MISC for $1,100 ($150 travel expense advance reimbursement + $300 lodging advance reimbursement + $650 remuneration). Elizabeth reports the full $1,100 as income on part 1, line 8z of Schedule 1 for her 2024 Form 1040.

GIFTS

Research providers may give gifts to research study participants as an acknowledgement of appreciation. If such gifts are noncash items of nominal value, research providers should not include the gift in reported compensation on Form 1099-MISC or Form 1099-NEC and research study participants should not include the gift as income on their tax returns.[90] However, cash or cash equivalent gifts must be reported on Form 1099-MISC or Form 1099-NEC as compensation and is taxable income to the research study participant.[91]

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88. *Payments to Human Subjects for Participation in Research*. Sep. 10, 2010. Partners Healthcare. [www.partners.org/Assets/Documents/Medical-Research/Clinical-Research/Payments-to-Human-Subjects-for-Participatio-in-Research.pdf] Accessed on May 2, 2024.

89. Ibid.

90. IRS Pub. 525, *Taxable and Nontaxable Income.*

91. Ibid.

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Chapter 4: Partnership Terminations

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Note. Corrections for all of the chapters are available at **TaxSchool.illinois.edu.** For clarification about terms used throughout this chapter, see the **Acronyms and Abbreviations** section following the index.

For your convenience, in-text website links are also provided as short URLs. Anywhere you see **uofi.tax/xxx**, the link points to the address immediately following in brackets.

About the Author

John W. Richmann, EA, is a Tax Materials Specialist at the University of Illinois Tax School. Prior to joining Tax School in 2021, he owned a tax practice in St. Charles, Illinois, and held positions in private industry and consulting firms. John earned a Masters Degree in Business Administration from the University of Texas and an electrical engineering degree from the Massachusetts Institute of Technology.

Other chapter contributors and reviewers are listed at the front of this book.

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This chapter builds upon the "Select Topics for Partnership Operations" chapter in the 2023 *University of Illinois Federal Tax Workbook*, and the "Partnership Basics" chapter in the 2022 *University of Illinois Federal Tax Workbook*.

> **Note.** For the purposes of this chapter, assume a limited liability company (LLC) is a multi-member LLC (MMLLC) being taxed as a partnership. An MMLLC may elect to be taxed as a C corporation or an S corporation. For more information on these "check the box" rules, see the 2022 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 3: Partnership Basics. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

In the partnership taxation realm, there are three types of capital accounts.

1. Tax basis, which reflects the partners' adjusted inside tax basis in the entity
2. Book basis (IRC §704(b)), which reflects the fair market value (FMV) of assets and related adjustments
3. Generally accepted accounting principles (GAAP) or other financial reporting basis, which reflects the partnership's activity as reported in its financial statements

For the purposes of this chapter, references to capital accounts represent book basis. Tax basis is distinguished from "tax capital accounts," which generally reflects an adjusted basis. Unless explicitly identified, GAAP or other financial reporting basis is not discussed in this chapter.

BASIC CONCEPTS OF PARTNERSHIP TERMINATION

Partnerships may terminate for a variety of reasons, some voluntary and some involuntary. A partnership may terminate voluntarily by ceasing operations, agreement of the partners, merging, incorporating into a C or S corporation, partners withdrawing, or entering a qualified joint venture (QJV). Additionally, a partnership could terminate involuntarily through bankruptcy or a judicial dissolution.

Regardless of the reason for their termination, partnerships nearing the end of their existence create numerous tax issues. Most of these issues pass through to the partners on their Schedules K-1 (Form 1065), *Partner's Share of Income, Deductions, Credits, etc.* This is because partnerships do not pay federal income tax, except in unusual situations.[1]

Sometimes, federal tax law is guided by **partnership agreements** or state law. For example, the Code allows the partnership agreement to define a partner's distributive share of income, gain, loss, deduction, or credit.[2] The Code looks to partnership agreements to govern whether a retiring or deceased partner can receive payments for goodwill.[3] Similarly, treasury regulations contain many references to partnership agreements.[4]

State law may play an important role in governing the termination of partnerships. State law generally controls when partnership agreements do not exist or are silent on an issue.[5] However, partnership agreements are limited in some ways, as they generally cannot alter statutory provisions that concern judicial dissolutions, as discussed later. State law may also affect the distribution of assets, the satisfaction of liabilities, or the resolution of disputes among the partners arising during termination.

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1. IRC §701. The *Bipartisan Budget Act of 2015*, PL 114-74, established a centralized partnership audit regime, under which tax associated with an adjustment to a partnership item must be paid by the partnership unless an election can be and is made.
2. IRC §704(b)(1).
3. IRC §736(b)(2).
4. For example, Treas. Reg. §1.702-1(a)(8)(i) provides for partners calculating their distributive shares to take into account various items of income, gain, loss, etc. that may differ from the allocation of partnership taxable income.
5. For an Illinois example, see the *Illinois Uniform Partnership Act*, 805 ILCS 206 §103(a), which provides generally for the governance of a partnership agreement unless it is silent on an issue addressed by state's Uniform Partnership Act.

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DETERMINING IF AND WHEN A PARTNERSHIP HAS TERMINATED

A partnership terminates when its partners and officers wind up its affairs.[6] This criterion is satisfied when neither the partnership, acting as an entity, nor any of its partners, engages in any of the following.[7]

- Any business of the partnership
- Any financial operation of the partnership
- Any venture of the partnership

Under IRC §708, when these activities have all ended, the partnership has terminated.

Liquidation of All Partnership Assets[8]

A partnership is terminated when it discontinues its operations, and no partner carries on any part of its business. **The liquidation of all partnership assets by itself does not terminate a partnership.**

Example 1. Rare Earth Partners, LP, is a partnership formed in 2020 under Texas law to own royalty-producing real estate. The partnership's manager, Todd, is particularly interested in financing the development of real estate that produces rare earth minerals in west Texas. Its two properties are ranchland in central Texas, and oil-producing land in west Texas. Todd accepts an offer to purchase both properties in 2024. The proceeds of the sale are enough to pay off the debt and the attorneys, but the sale produces no additional cash.

Thus, with no land and no cash, Rare Earth has no assets. Nevertheless, its partners still believe in the prospect of producing rare earth minerals, and all want to continue the venture. Todd and one other partner actively seek new properties in which to invest. For this reason, Rare Earth continues as a partnership because one requirement for partnership termination, that no partner carries on operations, is **not satisfied.**

SELECTED TERMINATION RULINGS AND CASES

Although the Code and associated regulations define the rule of when a partnership is considered terminated, there is ambiguity in the practical application of the winding up process. Additionally, the courts have not applied a standard approach, which leads to litigation to determine when a partnership is truly terminated.[9] Many of these cases concern whether the complete distribution of partnership assets is necessary before a partnership can be considered terminated.

- In a 2004 case, the Tax Court required all partnership assets to be liquidated before considering the partnership as having terminated.[10] However, the managing partner of the partnership attempted to establish that the partnership was terminated in the year before the liquidating distributions.
- In a 2008 memorandum decision, the Tax Court found the presence of dormant foreign currency in a bank account was enough to delay the termination of the partnership.[11]

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6. IRS Pub. 541, *Partnerships*.
7. Treas. Reg. §1.708-1(b)(1); IRC §708.
8. IRC §708(b)(1); Treas. Reg. §1.708-1(b)(1).
9. *When does a partnership terminate under Sec. 708?* Steitz, Timothy. Jul. 1, 2021. The Tax Adviser. [www.thetaxadviser.com/issues/2021/jul/partnership-terminate-sec-708.html] Accessed on Dec. 8, 2023.
10. *Harbor Cove Marina Partners Partnership v. Comm'r,* 123 TC 64 (2004).
11. *7050, Ltd. v. Comm'r*, TC Memo 2008-112 (Apr. 23, 2008).

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- A 2012 letter ruling suggests a more flexible approach in the winding up period for a terminating partnership.[12] This opinion allowed the partnership to terminate before contingent liabilities were fully resolved. This ruling cited *Goulder v. U.S.*, which permitted a partnership to terminate before contingent security deposit obligations were fully settled.[13]

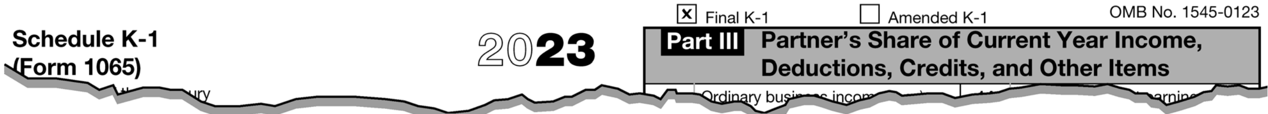
  The 2012 letter ruling[14] used *Goulder* to conclude that a limited partnership would be terminated when it had distributed its assets to its partners and a liquidating trust, and dissolved the limited partnership under state law. Although the letter's text cites cases in which a partnership was deemed to have continued despite the fact that it was in the process of winding up,[15] it advised the letter's requester that its limited partnership would terminate when it no longer conducted business and it had distributed assets to its partners and to the liquidating trust.

> **Caution.** Legal issues like these point to the critical role attorneys skilled in partnership law provide. Attorneys with experience interpreting legal precedents play an invaluable role. In some circumstances, the tax practitioner may also wish to involve an accountant skilled in applying partnership accounting rules in light of the wording of partnership agreements. Additionally, the partnership may have payroll issues that warrant the involvement of a payroll specialist.

TYPES OF PARTNERSHIP TERMINATION

Partnerships can terminate in various ways, but this text divides them into two broad categories. A tax practitioner should already understand when advising their client whether the client is terminating their partnership voluntarily or if a judicial act or bankruptcy is forcing them to involuntarily end the partnership's existence.

Regardless of how the partnership is terminated, the termination is reported to the partner on Schedule K-1 (Form 1065) by marking the box identified as Final K-1, as shown next.



VOLUNTARY TERMINATION

If a client's reason for the termination is one of their own choosing or that of the partners collectively, they are opting for a voluntary termination. Even if market forces have made the partnership unprofitable and impaired its viability, the decision to terminate it is still one that the partners make.

Ceasing Operations

Partners may decide to close the business. This occurs if the partnership no longer meets the partners' business goals or if they want to scale back their commitments.

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12. Ltr. Rul. 201244004 (Jun. 29, 2012).

13. *Goulder v. U.S.*, 64 F.3d 663 (6th Cir. 1995).

14. Ltr. Rul. 201244004 (Jun. 29, 2012).

15. *Harbor Cove Marina Partners Partnership v. Comm'r*, 123 TC 64 (2004); *Baker Commodities, Inc. v. Comm'r*, 415 F.2d 519 (9th Cir. 1969), *aff'g* 48 TC 374 (1967); *Estate of Aaron Levine v, Comm'r*, 72 TC 780 (1979), *aff'd* 634 F.2d 12 (2nd Cir. 1980).

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Practitioner Planning Tip

Because the criterion for a business termination is the cessation of business and financial operations, it is likely that this event does not coincide with the end of the entity's tax year.[16] Therefore, extensions of the filing date (usually the 15th day of the third month following the termination)[17] may be particularly useful for terminating partnerships. No cost is associated with them, and they provide additional time to gather needed information regarding the disposition of assets, distributions, and other components of Schedule K-1 (Form 1065). They also extend the time that a superseding Form 1065, *U.S. Return of Partnership Income,* can be filed if the original filing must be corrected.[18]

Example 2. At a New Year's Day party in 2024, Bob and Lewis announced their retirement plans, both having reached age 70 in the previous months. Their produce distributorship, B&L Produce, LP (B&L), is organized as a partnership. Because it has numerous customers who must find alternate sources for the produce they buy from B&L, Bob and Lewis estimate they cannot cease operations until sometime in March. Fortunately, their tax practitioner, Julienne, also learns of their plans.

The plans become the main point of their previously scheduled January meeting, where Julienne tells them they should meet with their attorney to discuss the legal aspects of winding up their business. She informs them that the business's final tax return is due the 15th day of the third month following the winding up of the business, so they should advise her promptly when this occurs.

Julienne explains to Bob that the partnership is terminated when all partners cease to carry on any part of the business. She adds that if they are not in regular communication, it can easily cause their final tax return to be filed late. Consequently, Julienne asks Bob to send her a weekly sales report every Friday with a sales forecast for the following week. She asks Bob if this approach is a workable approach to define the cessation of B&L's business operations. Bob confirms that this is a valid approach because their produce cannot be sold if it is older than a week. In addition, he has already told his produce providers that he expects to stop purchases in early March.

On March 11, Bob visits Julienne's office to sign off on the 2023 tax return and to advise her that the partnership has ceased operations as of March 4. Although the business no longer distributes produce and has cleared out its warehouse, it still has financial assets that have not been distributed or liquidated.

On March 31, Bob calls Julienne to inform her that both partners have received final distributions as of the previous day. She schedules a meeting with them on April 22 to review the partnership's books for 2024 and to discuss the preparation of the final short period tax return. As the phone conversation ends, Julienne reminds Bob that the final tax return is due on June 15. Nevertheless, she receives approval from Bob to file an extension, and does so as soon as the phone conversation ends, allowing them to file the tax return as late as December 16, 2024.

16. IRS Pub. 541, *Partnerships*.

17. IRC §6072(b).

18. Rev. Proc. 2019-32, 2019-33 IRB 659.

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Practitioner Planning Tip

Partners should be advised of any delay in the partnership return filing for their tax planning and estimated payment purposes.

Agreement of the Partners

Partners may agree to dissolve the partnership. Partnership agreements may have language to govern the entity's dissolution, but if not, state partnership law provides some guidelines. Forty-five states and territories[19] have adopted a form of the Uniform Partnership Act (1997), which has a section titled "Dissolution and Winding Up."[20]

The partnership agreement of a partnership likely contains language that guides the dissolution of a partnership. When a partnership terminates, the agreement may contain language guiding the distribution of assets, satisfaction of liabilities, and resolution of disputes to which the partners have already agreed.

Example 3. XYZ, LP, is a real estate venture authorized by its Secretary of State. XYZ's partnership agreement provides for a dissolution of the partnership when all partners vote to do so. The partners vote unanimously on March 31, 2024, to wind up the partnership.

In May, a buyer offers to purchase XYZ's remaining asset, a rented building. The sale of the building closes on June 3, 2024, at which time the mortgage is paid off, and XYZ receives $90,000. By June 10, this amount is distributed to the partners in accordance with the partnership agreement and each partner's percentage ownership of the entity's capital and profits. The partnership's business and financial affairs are wound up by this act and the partnership is voluntarily terminated.

Merger with Another Partnership[21]

A partnership may terminate if it merges with another partnership. Generally, the partnership having partners who own more than 50% of the interest in the resulting (merged) partnership is considered the **surviving partnership.** If more than one partnership meets this threshold, the surviving partnership is the one that contributes assets having the greatest FMV **net of liabilities** to the merged partnership. Any partnerships other than the surviving partnership are terminated with a tax year closing on the date of the merger.

In some circumstances, a merger of partnerships takes place that results in no partnership having partners who represent more than 50% of the consolidated partnership's capital. In such circumstances, none of the merging partnerships survives the merger. Instead, a new partnership is established, and each of the prior partnerships is terminated.

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19. *Partnership Act*. 2024. Uniform Law Commission. [www.uniformlaws.org/committees/community-home?communitykey=52456941-7883-47a5-91b6-d2f086d0bb44] Accessed on Nov. 9, 2023.

20. *Uniform Partnership Act (1997),* Article 8.

21. IRC §708(b)(1); Treas. Reg §1.708-1(c).

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Example 4. Peter and Sarah are equal members of the PS partnership, which has total capital of $100,000. Quinn and Sue are equal members of the QS partnership, which also has total capital of $100,000. Robert and Sophia are equal members of the RS partnership, also with total capital of $100,000. The six partners jointly decide to merge their three partnerships, with the resulting entity having partnership capital of $300,000 ($100,000 PS capital + $100,000 QS capital + $100,000 RS capital) and named the PQRS partnership. Each of the initial partnerships has contributed one-third of the capital in the PQRS partnership ($100,000 capital contributed ÷ $300,000 total capital in the new organization). Because the partners of **none** of the predecessor partnerships contributed more than 50% to PQRS's capital, PQRS is a new partnership, and all three of its predecessors are terminated.

Example 5. The JK Limited Partnership (JK) and LMN, LLC execute a merger on July 5, 2024. JK was formed by Joe and Kim, who are still partners. The entity owns real estate free of debt; the real estate has a value of $400,000, as appraised shortly before a merger. JK owns no other assets apart from $1,000 operating cash. Joe owns 60% of the capital interest in the partnership, with Kim owning the remaining 40%. Thus, the value of its assets net of liabilities contributed to the surviving partnership is $401,000 ($400,000 real estate FMV + $1,000 cash).

LMN owns real estate appraised at $600,000, but it is subject to a $400,000 mortgage. It also has $1,000 in operating cash. Thus, the value of its assets net of liabilities is $201,000 ($600,000 real estate FMV − $400,000 mortgage + $1,000 cash).

JK is the surviving partnership because its assets net of liabilities is $401,000, which is more than 50% of the FMV of the assets net of liabilities of the merged partnership's assets (66.61% = $401,000 JK assets ÷ ($401,000 JK assets + $201,000 LMN assets net of liabilities)). Thus, even though JK's assets have an FMV less than LMN's assets, it is the surviving entity. LMN, LLC terminates as a partnership on July 5, 2024.

The terminated partnership(s) may treat the merger of the entity's assets and liabilities using either of two forms. The **assets-over form** occurs when the terminated partnership is treated as contributing the **assets and liabilities** in exchange for an ownership interest in the surviving partnership. It then distributes the ownership interests to its partners in the liquidation of the terminated partnership.

The **assets-up form** accomplishes the same result in the opposite order. In this case, the terminated partnership is considered to have distributed all of its **assets** to the partners in the termination of the partnership. The partners are then treated as having contributed the same assets to the surviving partnership immediately after receiving them in distribution.

Incorporation

A partnership's incorporation results in the termination of that partnership.[22] Rev. Rul. 84-111 provides that a transfer of assets to a corporation under IRC §351 terminates the partnership.[23] This treatment assumes that all the stock of the receiving corporation is distributed to the partners. In addition, it assumes that all the liabilities of the partnership become the corporation's liabilities. This form of conversion is accomplished as assets are retitled in the name of the corporation.[24]

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22. IRC §708(b)(1).
23. Rev. Rul. 84-111, 1984-2 CB 88.
24. Metrejean, Cheryl and Nash, Claire (2005, Feb.) Tax Consequences of a Formless Conversion Following Rev. Rul. 2004-59. *TAXES*, 83, 43–48.

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Rev. Rul. 84-111 looks at three situations that accomplish the conversion from a partnership to a corporation.[25]

1. With the **assets-over** approach to incorporation, the partnership transfers assets to the corporation, which assumes the partnership's liabilities. All the corporation's stock is transferred to the partnership, which then distributes it to the partners proportionately. The partnership is then terminated, as it no longer has assets or a continuing business.
2. With the **interests-over** approach, the partnership distributes assets and liabilities to its partners, who then transfer them to the corporation in exchange for all of its stock.
3. With the **assets-up-and-over** approach, the partners transfer their partnership interests to the new corporation, which issues them stock.

With each of these approaches, the entity does not retain ownership of its assets but instead transfers ownership to a new entity.

Withdrawal of All Partners Except One[26]

A partnership is terminated if all partners except one withdraw from the partnership. Generally, this results in a partnership becoming a sole proprietorship. Its remaining partner is now a sole proprietor or property owner who reports income on their Form 1040, *U.S. Individual Income Tax Return,* Schedule C, *Profit or Loss from Business*, Schedule E, *Supplemental Income and Loss*, or Schedule F, *Profit or Loss From Farming*.

By definition, a partnership is "a business entity… that is not a corporation and that has at least two members."[27] Thus, a partnership cannot exist if only one person owns its equity. If the entity was organized as an LLC, with only one member, it becomes a single-member LLC (SMLLC), thereby establishing a disregarded entity.[28] The remaining member of an LLC can file Form 8832, *Entity Classification Election*, to elect treatment as a corporation.[29]

Example 6. Allen and Betty have operated the AB partnership since 2010. On February 1, 2023, Betty purchases Allen's interest in the entity for $10,000, making her the only partner. The AB partnership terminates on this day. AB has a taxable year ending on that date and must file a final Form 1065 showing February 1, 2023, as its yearend. It must also provide final Schedules K-1 to Allen and Betty. The final Form 1065 is due by May 15, 2023, unless AB files an extension.

As AB was a partnership, it is now Betty's sole proprietorship, and she reports its income on her Schedule C. If AB had been an LLC, it would be a disregarded SMLLC unless Betty files Form 8832 to elect to be treated as a corporation.

The termination of a partnership is reported on Form 1065 by marking box G (2), *final return*, as shown next.

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25. *Incorporating a Partnership or LLC: Does Rev. Rul. 84-111 Need Updating?* Gruidl, Nick. Apr. 1, 2007. The Tax Advisor. [www.thetaxadviser.com/issues/2007/apr/incorporatingapartnershiporllcdoesrevrul84-111needupdating.html] Accessed on May 21, 2024.

26. Rev. Rul. 99-6, 1999-6 IRB 6.

27. Treas. Reg. §301.7701-2(c)(1).

28. Treas. Reg. §301.7701-3(f)(2).

29. Treas. Reg. §301.7701-3(c)(1)(i).

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For Example 6

Form 1065 Department of the Treasury Internal Revenue Service	U.S. Return of Partnership Income For calendar year 2023, or tax year beginning Jan. 1, 2023, ending Feb. 1, 20 23. Go to www.irs.gov/Form1065 for instructions and the latest information.		OMB No. 1545-0123 2023
A Principal business activity Retail Trade	Type or Print	Name of partnership AB	D Employer identification number 78-9999999
B Principal product or service Men's Clothing		Number, street, and room or suite no. If a P.O. box, see instructions. 1000 N Main St	E Date business started 1/2/2010
C Business code number 458110		City or town, state or province, country, and ZIP or foreign postal code Galena, IL 61036	F Total assets (see instructions) $ 0

G Check applicable boxes: (1) ☐ Initial return (2) ☒ Final return (3) ☐ Name change (4) ☐ Address change (5) ☐ Amended return

H Check accounting method: (1) ☒ Cash (2) ☐ Accrual (3) ☐ Other (specify):

I Number of Schedules K-1. Attach one for each person who was a partner at any time during the tax year: 2

J Check if Schedules C and M-3 are attached ☐

K Check if partnership: (1) ☐ Aggregated activities for section 465 at-risk purposes (2) ☐ Grouped activities for section 469 passive activity purposes

Caution: Include **only** trade or business income and expenses on lines 1a through 23 below. See instructions for more information.

Death. If one partner of a 2-member partnership dies, the partnership does not terminate if it continues operating, provided that the deceased partner's estate continues to receive the deceased partner's profits or losses.[30] However, the partnership terminates if the deceased partner's estate or any successor does not succeed to the deceased partner's interest.

Qualified Joint Venture

When a married couple shares a business enterprise but has not yet elected QJV status, they must treat their business as a partnership, requiring the preparation and filing of Form 1065.[31] The spouses can terminate their partnership by electing to be treated as a QJV.[32] Making an election under IRC §761(f), their partnership terminates on the last day of the calendar year.

> **Note.** For more information about QJVs, see the 2020 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 6: Schedule E. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

INVOLUNTARY TERMINATION

Under unfavorable circumstances, the application of law may force a partnership to dissolve involuntarily. The provisions for technical terminations of partnerships before the Tax Cuts and Jobs Act (TCJA) became law were the usual cause of involuntary terminations, such as when the retirement of partners representing more than 50% of the total capital and profits interests could trigger these provisions.[33] The TCJA eliminated the technical termination provisions.[34] Bankruptcy and a court order dissolving a partnership are common methods of involuntary terminations.

30. Treas. Reg. §1.708-1(b)(1)(i).
31. IRC §761(f).
32. IRC §761(f)(2)(C).
33. *Questions and Answers about Technical Terminations, Internal Revenue Code (IRC) Sec. 708*. May 1, 2023. IRS. [www.irs.gov/newsroom/questions-and-answers-about-technical-terminations-internal-revenue-code-irc-sec-708] Accessed on Nov. 10, 2023.
34. *TCJA*, PL 115-97, §13504.

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Bankruptcy

Some states may require partnerships to terminate when they file for bankruptcy protection under Title 11.[35] However, a bankruptcy filing does not terminate their existence under the Code. In fact, IRC §1399 specifically states that a bankruptcy filing does not create a separate taxable entity, as it would for an individual.

Thus, although the bankruptcy of a partnership may eventually result in a partnership termination, the bankruptcy itself does not cause the termination of a partnership under federal tax law. However, it may lead to the eventual termination of a partnership because bankruptcy may force it to cease operations.

Judicial Dissolution

A court may order the dissolution of a partnership based on its interpretation of the partnership agreement or state partnership law or for another legal reason. The Code does not specifically cite judicial decisions as a reason for dissolving a partnership.[36] However, a court order for a partnership to cease operation necessarily triggers the general rule for termination.[37]

CAPITAL ACCOUNT ISSUES

Partnerships use **§704(b)** capital accounts to track the partners' economic and financial interests within the partnerships, as distinguished from the partners' tax investments. Partnership capital accounts are commonly referred to as **"book"** accounts. When a partner contributes a noncash asset to a partnership, the partner's book capital account is generally increased by the asset's FMV.[38] Book capital accounts are essential for allocating profits, losses, distributions, and credits among partners based on their contributions to the partnership and the provisions of partnership agreements. When a partnership terminates, these accounts usually determine the final allocations due to a partner.

In contrast, partnerships use **tax-basis** capital accounts for tax reporting purposes.[39] Beginning with 2020 tax returns, partnerships are required to report capital accounts under tax basis, "using the transactional approach for the tax basis method."[40] When a partner contributes a noncash asset to the partnership, their tax-basis capital account is generally increased by the asset's basis in the partner's hands. Thus, these accounts reflect the partners' tax positions and help to determine the tax consequences, such as their share of taxable income, tax deductions, or taxable amount of any distribution. When a partnership terminates, tax-basis capital accounts and qualifying debt determine a partner's **tax** gain or loss on the disposal of partnership assets and the winding down of its affairs.

> **Note.** For more information about book capital accounts and tax-basis capital accounts, see the 2023 *University of Illinois Federal Tax Workbook*, Chapter 4: Select Topics for Partnership Operations.

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35. *Tax Geek Tuesday: When Does a Partnership Terminate for Tax Purposes?* Nitti, Tony. Apr. 12, 2016. Forbes Magazine. [www.forbes.com/sites/anthonynitti/2016/04/12/tax-geek-tuesday-when-does-a-partnership-terminate-for-tax-purposes/] Accessed on Nov. 13, 2023.
36. IRC §708.
37. IRC §708(b)(1).
38. See Treas. Regs. §§1.704-1(b)(2)(iv)(b) and (g).
39. IRS Notice 2019-66, 2019-52 IRB 1509.
40. IRS Notice 2021-13, 2021-06 IRB 832.

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DISTINCTIONS BETWEEN PROFITS AND CAPITAL INTERESTS

Proper bookkeeping for partnership capital accounts depends on whether partners have profits interests or capital interests. The type of interest that a partner holds governs how their investment in the partnership is maintained.

A **profits interest** entitles the partner to share only in the future profits of the partnership.[41] The profits interest provides the partner with a distributive share of the partnership's net income for a particular tax year. This depends on how the partnership agreement or operating agreement establishes this interest, but it likely includes a proportionate share of separately disclosed items and possibly special allocations. The partnership may allocate to a partner owning a profits interest a portion of special items under IRC §§704(b), (c), and (e), 736, and 743. A profits interest is a partnership interest that is not a capital interest.[42]

A **capital interest** entitles the partner to share in a distribution of partnership assets upon the partnership's termination or when they withdraw from the partnership.[43] Assuming the partnership maintains capital accounts in line with Treas. Reg. §1.704-1(b)(2)(iv), the partnership can assume that a particular partner's proportionate capital interest is their capital account divided by the capital accounts of all partners. In a particular tax year, this is measured on the first day of that tax year.[44]

Aligning Book Capital Accounts with Tax Basis Capital Accounts

With §704(c), Congress created rules to prevent partnerships from shifting tax benefits from one partner to another when the only reason for the transfer was tax avoidance. This can readily happen when a partnership allocates income or expenses disproportionately to the partners' relative interests. It can also happen when one partner contributes property with a built-in gain, but the property is then distributed to another partner. The incentive for these allocations is particularly strong when partnerships terminate.

Substantial Economic Effect.[45] Properly maintaining partners' capital accounts is not just good practice; it is required by the regulations. Their importance is paramount during partnership termination, but special allocations can complicate the maintenance of capital accounts throughout the partnership's existence. By ensuring the allocations meet the substantial economic effect test, the Code aligns tax benefits with actual economic effects rather than minimizing one partner's tax liability.

Special allocations arise from the disproportionate allocation of partnership items of income, deduction, or credits, not based on partners' capital contributions or the ratio established for sharing partnership items. The purpose of the regulations is to ensure that the **income tax consequences** of an allocation follow the **economic consequences.** For a special allocation to be considered to have substantial economic effect, three requirements must be met.[46]

1. The partners' capital accounts must be properly maintained, following rules in Treas. Reg. §1.704-1(b)(2)(iv).
2. A liquidating distribution must be made from a **positive** capital account. This applies to either a complete partnership liquidation or the liquidation of a partner's interest. The alternative, a distribution from a negative capital account, infers that a partner receives a distribution despite having no investment in the partnership.
3. The partnership agreement or LLC operating agreement must contain a **deficit restoration obligation (DRO).** This provision obligates a partner to restore their capital account to at least a $0 value by the end of the partnership's tax year or within 90 days after its liquidation. The partner may give the partnership a promissory note to satisfy this obligation, provided that the maker of the promissory note is the partner or a person related to them under Treas. Reg. §1.752-4(b).

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41. Treas. Reg. §1.706-1(b)(4)(ii)(A).
42. Rev. Proc. 93-27, 1993-2 CB 343; Rev. Proc. 2001-43, 2001-2 CB 191.
43. Treas. Reg. §1.706-1(b)(4)(iii).
44. Ibid.
45. Treas. Reg. §1.704-1(b)(2).
46. Treas. Reg. §1.704(b)(2)(ii)(b).

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Instead of a DRO, the partnership agreement can provide for a qualified income offset (QIO). This is a provision in the partnership agreement that satisfies the following requirements.[47]

- No allocation can be made to a partner with a QIO that causes or increases a deficit balance in that partner's capital account as of the end of the partnership tax year to which the allocation relates.
- The partnership agreement must provide that a partner who unexpectedly receives allocations or distributions resulting in a deficit capital account is allocated pro rata items of partnership income and gain in an amount and manner sufficient to eliminate the deficit balance as quickly as possible.

In determining the capital account of a partner with a QIO at the end of a tax year for allocation purposes, the regulations require the capital account to be reduced first to reflect the following adjustments that are **reasonably expected** at the end of the year to be made in subsequent years.[48]

- Oil and gas depletion
- Losses and deductions allocated to the partner under the family partnership rules, the rules governing retroactive allocations, and the rules governing disproportionate distributions of unrealized receivables and substantially appreciated inventory
- Distributions the partner will receive that exceed reasonably expected increases in the partner's capital account in the same year as the subsequent distribution

Note. For more information about the substantial economic effect rules, see the 2023 *University of Illinois Federal Tax Workbook*, Chapter 4: Select Topics for Partnership Operations.

Property Contributions on Book Capital Accounts at Termination[49]

IRC §704(c) allocations generally concern **continuing** partnerships. However, they can affect partnership termination when a partner receives a distribution of property that has been contributed to the partnership with a built-in gain. Even though the difference between the book value of the contributed property and its basis is reduced over time,[50] the partnership may terminate before these values become equal. In this event, a partner (other than the contributing partner) may receive as a distribution the property with the remaining portion of the built-in gain.[51]

Note. Only the traditional method for making allocations is discussed here. For more information about §704(c) allocations, see the 2023 *University of Illinois Federal Tax Workbook,* Chapter 4: Select Topics for Partnership Operations.

47. Ibid.
48. Ibid.
49. Treas. Reg. §1.704-1(b)(2)(iv)(d)(3).
50. Treas. Reg. §1.704-3(a)(3)(ii).
51. Treas. Reg. §1.704-3(a)(8)(i).

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Schedule K-1 (Form 1065) provides sections to report information for capital accounts, built-in gain, and unrecognized §704(c) items, as shown next.

L Partner's Capital Account Analysis	**23** ☐ More than one activity for passive activity purposes*
Beginning capital account . . . $	*See attached statement for additional information.
Capital contributed during the year . . $	For IRS Use Only
Current year net income (loss) . . . $	
Other increase (decrease) (attach explanation) $	
Withdrawals and distributions . . . $ ( )	
Ending capital account . . . . $	
M Did the partner contribute property with a built-in gain (loss)? ☐ **Yes** ☐ **No** If "Yes," attach statement. See instructions.	
N Partner's Share of Net Unrecognized Section 704(c) Gain or (Loss)	
Beginning . . . . $	
Ending . . . . $	

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Traditional Method of Making §704(c) Allocations.[52] If a partnership has received contributions of §704(c) property, the associated depreciation is generally incurred over several years. However, the total income, gain, loss, or deduction allocated to the partners for a tax year with respect to a property cannot exceed the total partnership income, gain, loss, or deduction for that property for the tax year. Referred to as the "ceiling rule," this causes adjustments over a number of years if the allocation is sufficiently large.

Cost Recovery with Built-In Gain at Termination. When a partner contributes property having an FMV greater than their basis in the asset, the asset's built-in gain could affect the partnership's termination for years into the future; this makes it §704(c) property. The asset's built-in gain is reduced every year by the decrease in the difference between the two following amounts.

- Property's §704(b) or book value (FMV)
- Property's adjusted tax basis (carryover basis)

If straight-line deprecation is used for tax purposes, the difference between the two becomes smaller because the depreciation associated with the book value is greater than the tax depreciation. The same percentage is used to depreciate both amounts, but the book value of the property having a built-in gain is greater.

However, when the modified accelerated cost recovery system (MACRS) is used, this may not be the case. This is because, for tax purposes, the percentage of an asset's value that is recovered through depreciation declines yearly. It is further complicated because the recovery period started when the asset was still the contributing partner's property.

Eventually, the asset's built-in gain should be zero because the depreciation has reduced the noncontributing partner's capital account associated **with the asset** to the contributing partner's tax basis.

The period for reducing the asset's built-in gain generally lasts for the balance of the asset's cost recovery period. This is because the asset's depreciation is preferentially allocated to the **noncontributing** partner during the asset's recovery period.

When the partnership dissolves, the price realized for the asset may still include some built-in gain. In that event, the contributing partner recognizes a taxable **gain** equal to the portion of the built-in gain that has not depreciated at the time of disposition.

52. Treas. Reg. §1.704-3.

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When the terminating partnership sells an asset with a built-in gain, the first amount of gain must be allocated to the contributing partner. If the taxable gain at disposition exceeds the built-in gain at the time of contribution, the excess is allocated among the partners in proportion to their ownership interests.

Note. It is imperative that a practitioner construct both a book and tax balance sheet to assist with this process of accounting for adjustments in the partnership's basis in its assets.

Example 7. On January 1, 2022, Chuck and Diane formed the CD, LP, partnership. Its partnership agreement states that Chuck and Diane are both 50% partners and that the partnership must make allocations under §704(c) using the traditional method when permitted by the Code and regulations.

Upon the partnership's formation, Chuck contributes a machine to the partnership, which has an FMV of $20,000, an adjusted tax basis of $8,000, and has 10 years of its recovery period remaining. The rules for §704(c) property require that Chuck's contribution results in a $20,000 credit to his partnership book capital account. The partnership also elects to use straight-line depreciation. However, because his basis in the machine is only $8,000, the partnership's tax records must show a book-tax disparity of $12,000 ($20,000 machine's FMV – $8,000 Chuck's tax basis), equal to Chuck's built-in gain on the machine. Diane contributes $20,000 of cash, which has no §704(c) consequences.

The machine that was contributed has the following financial characteristics.

	Book Value	Adjusted Tax Basis	Adjusted Built-In Gain
Jan. 1, 2022	$20,000	$8,000	$12,000
2022 Depreciation	(2,000)	(800)	
Dec. 31, 2022	$18,000	$7,200	10,800
2023 Depreciation	(2,000)	(800)	
Dec. 31, 2023	$16,000	$6,400	9,600

The partners have tax basis capital accounts and book capital accounts as follows.

	Chuck		Diane	
	§704(b) or Book Capital Account	Tax Basis Capital	§704(b) or Book Capital Account	Tax Basis Capital
Jan. 1, 2022 capital	$20,000	$8,000	$20,000	$20,000
2022 Depreciation	(1,000)	(0)	(1,000)	(800)
2023 Depreciation	(1,000)	(0)	(1,000)	(800)
Dec. 31, 2023 capital	$18,000	$8,000	$18,000	$18,400

If the CD partnership owns the machine until the end of 2032, the 10 years of depreciation will have reduced Diane's tax basis capital to $12,000 ($20,000 on January 1, 2022 – (10 years × $800 per year)), while Chuck's remains at $8,000.

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The traditional method of making §704(c) allocation is to regain parity of book capital and tax capital accounts. In this example, having been allocated no tax depreciation during the 10-year period, Chuck's tax basis capital equals $8,000, as expected among 50-50 partners. Both partners have book capital accounts equal to $10,000 ($20,000 on January 1, 2022 – (10 years × $1,000 depreciation per year)). At this point, the total book capital in the partnership is $20,000 ($10,000 Chuck's book capital + $10,000 Diane's book capital). The CD partnership's total tax basis capital is also $20,000 but is divided among the partners differently (Chuck's $8,000 tax basis capital in contrast with Diane's $12,000 tax basis capital). Thus, the book-tax disparity has been eliminated, but this parity has required the contributed asset's entire cost recovery period (10 years in this example) to accomplish this.

Consequently, if Chuck and Diane decide to terminate the CD partnership at the end of 2023, Chuck has a December 31, 2023, tax basis capital of $8,000, but Diane's tax basis capital is $18,400. The partnership has a total tax basis capital of $26,400 ($8,000 Chuck + $18,400 Diane). However, it has a total book capital of $36,000 ($18,000 Chuck + $18,000 Diane). Thus, at the end of two years, a book-tax disparity of $9,600 ($36,000 book capital – $26,400 tax basis capital) still exists.

The termination of the CD partnership after two years must take this disparity into account. If the machine is sold for $18,000 in the liquidation of the partnership, it will **have realized** a tax gain of $11,600 on its disposition ($18,000 value allocated to machine at liquidation – (8,000 Chuck's basis in the machine – (2 years × $800 per year tax depreciation))). Although Chuck and Diane are 50-50 partners in the CD partnership, Chuck must be allocated more gain than Diane in the entity's termination.

In this instance, the entire amount of gain is allocated to Chuck to account for the built-in gain on the machine when he contributed it. None of the loss on the sale of the machine is allocated to Diane because she has already received depreciation deductions for the machine.

TAX CONSIDERATIONS

Taxpayers must consider the characteristics of the assets disposed when determining the tax considerations of a terminating partnership.[53] Terminating partnerships must consider adjusted basis issues, the "mixing bowl" transaction requirements,[54] holding periods, and the special considerations that accompany the distributions of marketable securities.[55]

A partnership distributing assets in liquidation that readily generate ordinary income, such as inventory and unrealized receivables, have unique treatments in a partnership termination. These assets are not treated as capital assets but instead continue to be treated as assets potentially generating ordinary income. There are specific rules covering liquidating distributions of IRC §751 hot assets.

Another consideration at termination is for partnerships that use **debt** as a source of capital.[56] The way a partnership satisfies a debt affects the partners' tax consequences, particularly basis, when the partnership terminates. A partnership's financial operations have not ceased until its debt is either discharged by payment or until it is irrevocably assumed by another party, such as a partner.[57]

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53. IRC §§731–733, 735.

54. IRC §704(c).

55. IRC §731(c) and supporting regulations.

56. *Equity Financing vs. Debt Financing: What's the Difference?* Maverick, J.B. Oct. 10, 2023. Investopedia. [www.investopedia.com/ask/answers/042215/what-are-benefits-company-using-equity-financing-vs-debt-financing.asp] Accessed on Nov. 27, 2023.

57. See *In re Samoset Associates, Debtor*. 14 B.R. 408 (Bankr. D. Me. 1981).

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CHARACTERISTICS OF PARTNERSHIP ASSETS

The characteristics of a partnership's assets rise in significance when the entity disposes of them. The partners share a gain or loss when an asset is sold to an unrelated party. Although a partner does not necessarily recognize a gain or loss on an asset when the partnership distributes an asset to a partner,[58] a gain or loss would be recognized when the asset is sold to an unrelated party. In determining the tax effects of a distributed asset, the partnership must consider the following characteristics of the asset.

- Basis
- Source
- Holding periods
- Whether marketable securities are distributed

Basis

A partner has an **outside basis** in a partnership that is established when they make an initial contribution to the partnership's capital, adjusted by additional contributions and partnership income, gains, losses, and distributions.[59] The partnership itself has a basis in each of its assets. Because each partner has an interest in the partnership as a pass-through entity, they also have a basis in each of the partnership's assets as seen from inside the entity. This is termed the partnership's **inside basis.**[60]

Inside and outside basis has an immediate effect on a partner's tax position at **liquidation.** In a termination of a partnership, all partner's interests are liquidated. IRC §732(b) provides that the basis of property (other than money) distributed by a partnership to a partner is equal to the adjusted basis of the partner's interest in the partnership but reduced by money the partner receives.

In contrast, if the partner's interest in the partnership is **not** being liquidated, the property's basis is generally equal to the property's adjusted basis to the partnership immediately before the distribution.[61]

Source and Mixing Bowl Transactions

The contribution of nonmonetary property from a partner generally does not result in gain or loss at the time of contribution.[62] Appreciated property contributed by one partner may be either distributed to other partners or sold outright as a result of the partnership termination. A partnership termination may accelerate the application of the so-called "mixing bowl" transaction provisions of §704(c)(1)(B) or IRC §737. Because the ownership of an appreciated asset transfers to another partner, these distributions are referred to as "mixing bowl transactions."[63] Such distributions within seven years of the contributing partner contributing the property to the partnership result in the following consequences.[64]

1. The property is deemed to have been sold by the partnership for its FMV on the day it is distributed to another partner or otherwise disposed of.
2. The gain or loss resulting from the deemed sale is allocated to the contributing partner.
3. The outside basis of the contributing partner is adjusted to reflect the gain or loss.
4. The basis of the asset in the partnership is adjusted for the gain or loss effective immediately before the distribution. As a result, the receiving partner receives the property with its basis also adjusted for the gain or loss.

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58. IRC §731.
59. Treas. Reg. §1.705-2(a).
60. Ibid.
61. IRC §732(a)(2).
62. IRC §721.
63. *A practical guide to partnership division planning.* Dalton, Corey. Jul. 1, 2022. The Tax Adviser. [www.thetaxadviser.com/issues/2022/jul/partnership-division-planning.html] Accessed on May 7, 2024.
64. IRC §704(c)(1)(B).

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Assets having built-in losses cannot be aggregated with other assets having built-in gains.[65] Thus, if a partner contributes two assets, one with a gain and the other with a loss, upon termination (or other disposition), the gain and the loss are considered separately in determining the contributing partner's gain or loss.

Holding Periods

When a terminating partnership distributes an asset to a partner, the partner's holding period includes the time the partnership owned the asset.[66] Also, when a partner contributes an asset to the partnership, the partnership's holding period includes the partner's holding period. However, if the asset is inventory in the hands of a contributing partner, it is not eligible for capital gain treatment in the partnership.[67]

A gain or loss from an asset's sale can be treated as a long-term gain or loss on the day after the anniversary of its acquisition.[68] Because the partnership can include the time an asset was held by a contributing partner, this longer holding period requirement is more easily met.

Example 8. Jerome purchased a 2-acre parcel of land on February 28, 2023, for $20,000 with the hope of using it for his farming operations. In September 2023, the QRT partnership expresses an interest in acquiring the parcel even though it is not in the real estate business. It offers Jerome a partnership interest in exchange for the parcel. He accepts this offer, becoming a partner of QRT on September 30, 2023, and contributes the land to the partnership on the same day. Because the land's value has not changed since Jerome purchased it, his tax basis capital account and book capital accounts are both $20,000.

In March 2024, QRT's partners decide to terminate the partnership, and offer the land for sale. Within a month, Boone County Developers, Inc. purchases the land from QRT for $40,000. With no other assets, QRT terminates in June 2024. Although QRT owned the land for less than one year, the land's sale is eligible for treatment as a long-term capital gain. This result comes from Jerome's ownership of it during the 7-month period prior to contributing it to QRT. Thus, its holding period satisfies the holding period for long-term capital gains.

Inventory

If the property distributed is considered inventory to the partnership, it is not a capital asset.[69] A partner selling an inventory item that has been distributed to them must include its sale as ordinary income, regardless of how long they have owned the asset.[70]

Disguised Sales[71]

If a contributing partner subsequently receives another asset as a distribution,[72] even if the partnership is in the process of terminating, the disguised sales provisions in IRC §§707, 704, and 737 apply.

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65. Treas. Reg. §1.704-3(a)(2).

66. IRS Pub. 541, *Partnerships*; IRC §735(b).

67. IRS Pub. 544, *Sales and Other Dispositions of Assets*, p. 20 (2022).

68. *Topic No. 409, Capital Gains and Losses*. Oct. 17, 2023. IRS. [www.irs.gov/taxtopics/tc409] Accessed on Nov. 29, 2023.

69. IRC §1221(a)(1).

70. IRC §735(c)(1).

71. IRC§707(a)(2)(B).

72. *Basic Partnership Tax II: Sales, Disguised Sales & Terminations*, p. 3. Jan. 22, 2016. Wagner, Kirkman, Blaine, Klomparens & Youmans, LLP. [www.wkblaw.com/wp-content/uploads/Basic-Partnership-Tax-II-Sales-Disguised-Sales-Termination.pdf] Accessed on Nov. 29, 2023.

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IRC §707 provides the general rules for disguised sales of assets. If a partner contributes property to a partnership and receives a distribution of money or other property within a specified period, the transaction will be recharacterized as a sale or exchange. If the transfer of an asset takes place within two years, the transaction is **presumed to be a disguised sale.**[73] Furthermore, the transaction must be disclosed to the IRS following the provisions of Treas. Reg. §1.707-8. If the distribution is made within two years of the original contribution, it is presumed to be a disguised sale of the property contributed to the partnership, although facts and circumstances may indicate otherwise.[74]

IRC §704(c)(1)(B) provides guidance on disguised sales that are also part of the mixing bowl transaction provisions discussed previously.

IRC §737 identifies complications that arise from distributions of property that were previously contributed with precontribution gain. Although contributions of property generally do not cause gain or loss to the partner,[75] §737 requires the contributing partner to recognize some gain. This amount is the lesser of the following two amounts.[76]

1. Any excess distribution, which is the amount by which the FMV of the property distributed to the partner exceeds their adjusted tax basis in their partnership interest
2. Any net contribution gain, which is the amount of net gain that the partner would have realized if all the property they had contributed within the previous five years and held by the partnership immediately before the distribution had been distributed to another partner who does not hold a controlling interest in the partnership

In this manner, §737 coordinates with §704(c)(1)(B) to tax at least some of the built-in gain that a partner may have contributed within the past seven years.

Example 9. On January 1, 2021, Nancy, Oscar, and Peter form the NOP partnership, each with a one-third interest. Nancy contributes depreciable real estate in Adams County with an FMV of $300,000 and an adjusted tax basis of $200,000. Oscar contributes land in Boone County, having an FMV and an adjusted basis of $300,000. Peter contributes $300,000 of cash to the partnership.

The real estate Nancy contributed has another 10 years remaining on its depreciation schedule and is depreciated using the straight-line method. The partnership uses the traditional method for allocating items for the Adams County property. NOP has $30,000 of annual **book** depreciation on this property ($300,000 book basis × 10%). The partnership has **tax** depreciation of $20,000 per year ($200,000 adjusted tax basis × 10%), which is evenly split between Oscar and Peter, the noncontributing partners.

At the end of 2023, the book value of the Adams County real estate is $210,000 ($300,000 initial book value – (3 years × $30,000 annual book depreciation)). This property's adjusted tax basis is $140,000 ($200,000 initial adjusted basis at time of contribution – (3 years × $20,000 annual tax depreciation)).

On December 31, 2023, the partners terminate the NOP partnership. Nancy receives the land in Boone County as a liquidating distribution. Her adjusted tax basis in NOP is still $200,000 because she was not allocated any of the depreciation on the Adams real estate. The $300,000 cash is distributed equally to Oscar and Peter, and each receives an undivided interest in the depreciable real estate in Adams County. The distributions of real estate are presumed not to be disguised sales because more than two years have passed since the real estate was contributed.

Nancy's excess distribution is $100,000 ($300,000 FMV of the land – $200,000 adjusted basis in NOP).

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73. Treas. Reg. §1.707-3(c).

74. See Treas. Reg. §1.707-3(c)(2) for three broad conditions requiring disclosure.

75. IRC §721(a).

76. Treas. Regs. §§1.737-1(a)–(c).

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Nancy's net precontribution gain is $70,000 ($210,000 book value of the Adams County real estate she contributed in 2021 – $140,000 adjusted tax basis when she received it as a distribution). Nancy must recognize the gain on receipt of the distribution of $70,000 (lesser of the excess distribution ($100,000) and the net precontribution gain ($70,000)).

Caution. A liquidating distribution can trigger a disclosure requirement under the disguised sale requirements.[77] If a partnership distributes property to a partner who has contributed noncash property within the past two years, and the partnership within two years makes a distribution to the partner, both are required to disclose the event to the IRS. The partnership and the partner must each file a Form 8275, *Disclosure Statement*, containing the following information.[78]

- A caption that identifies the statement as a disclosure under §707
- A description of the property or money transferred to the partner, including its value
- A description of facts that are potentially useful to determine if the transfer of property is a disguised sale

Distributions of Marketable Securities[79]

When a partnership owning marketable securities terminates, it may distribute the securities, rather than sell them, to generate cash that it could distribute instead. Generally, marketable securities, such as publicly traded stocks, are treated as **money** when distributed to partners. This treatment reflects the ability of a partner who receives the security to sell it and thereby convert it to cash. To the extent that the distribution of the marketable security is treated as a distribution of money, a partner's interest in the partnership as well as their outside basis in the partnership may be reduced.

Example 10. Jack, Ian, and Kathy have jointly owned a partnership, JIK, LP, for 10 years, and each owns a one-third interest in the entity. JIK is not an investment partnership. In December 2024, they wish to terminate the partnership, whose sole assets are 30 bonds of Corporation Z, each bond having an FMV of $1,000. These bonds are widely traded and are considered marketable securities.

On December 19, JIK terminates and transfers 10 of the Corporation Z bonds into the personal accounts of each partner. Each partner's interest in JIK is reduced by $10,000 (10 bonds distributed × $1,000 FMV per bond).

Note. An investment partnership is any partnership that has never been engaged in a trade or business and substantially all of its assets have always consisted of money, stock in a corporation, notes, bonds, debentures, or other evidences of indebtedness, etc.[80] Discussion of these partnerships is beyond the scope of this chapter.

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77. IRS Pub. 541, *Partnerships,* p. 8 (2022); Treas. Reg. §1.707-3(c)(2).

78. Treas. Reg. §1.707-8(b).

79. Treas. Reg. §1.731-2.

80. IRC §731(c)(3)(C).

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Marketable Securities Defined. Marketable securities are traded on a national securities exchange when they are distributed. The marketable securities themselves include the following.[81]

- A financial instrument that can be exchanged for money or other marketable securities
- Common trust fund
- Regulated investment company
- Any interest in a precious metal, unless the partnership uses precious metals in its business
- The partnership's interest in any other entity whose assets are primarily marketable securities, money, or both

For these purposes, a financial instrument is one of the following.[82]

- Stock
- Evidence of indebtedness, such as a bond or note
- Options
- Forward contracts
- Futures contracts
- Derivatives
- Notional principal contracts

Exceptions. The Code and the supporting regulations provide three exceptions to treating the distribution of marketable securities as money.

1. A partner may contribute a marketable security to a partnership. In this event, the distribution of the same security back to the same partner does not result in any change in basis. The distribution itself is not treated as the distribution of money.[83]
2. If the security was not considered marketable when the partnership accepted its contribution, it is not considered money if:[84]
   - At the time the partnership acquired the security, the issuing entity had no outstanding marketable securities,
   - The partner held the security for at least six months before the security became marketable, and
   - The partnership distributed the security within five years of when the security became marketable.
3. A partnership may be considered an investment partnership under IRC §731(c)(3)(C).

If any of these exceptions is met, the partnership's distribution of marketable securities to its partners is not considered a distribution of money. However, this exception only applies to distributions made to eligible partners, who are defined as those who have contributed only marketable securities to the partnership and are not involved in a transfer of an interest in the partnership that results in a transfer of a partnership interest having no taxable income recognized.[85]

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81. IRC §731(c)(2)(B).
82. IRC §731(c)(2)(C).
83. IRC §731(c)(3)(A)(i).
84. Treas. Reg. §1.731-2(d)(1)(iii).
85. IRC §731(c)(3)(C)(iii).

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Reduction of Amount Treated As Money.[86] When a partner receives a distribution of marketable securities, they can reduce a fraction of the securities' FMVs that they treat as money. This reduction permits the receiving partner to treat the remaining portion as distributed property. This results in the partner receiving some of the securities with their carryover basis from the partnership.

The calculation considers the receiving partner's share of **net gain** on all the marketable securities. The net gain is the gain the partnership would recognize if it sold all of the marketable securities in its possession at their FMVs. Thus, this necessarily considers the partnership's basis in the securities. The partnership must apply the §743(b) adjustments to the securities' bases. However, it should exclude securities that the receiving partner contributed.[87]

The fraction of the distributed securities' FMVs considered as money is the difference between the following two amounts.

1. The receiving partner's distributive share of net gain is what they would recognize if the partnership sold all its marketable securities held immediately **before** distributing the securities to the partner.
2. The receiving partner's distributive share of the marketable securities held by the partnership immediately **after** distributing the securities to the receiving partner.

The difference cannot be less than zero, so this provision is not applicable if the FMV of the securities after the distribution is greater than the FMV of the securities before the distribution.

Example 11. Sarah and Ted are equal partners in the ST Partnership, which is not an investment partnership but generates significant cash flow.[88] To prudently invest excess cash, they purchase the following widely traded stocks in the name of the partnership.

	FMV on December 28, 2023	Basis	Gain/(Loss)
A common stock	$10,000	$ 7,000	$3,000
B common stock	10,000	8,000	2,000
C common stock	10,000	11,000	(1,000)

On December 29, 2023, ST distributes the A stock to Sarah.

If ST had sold the securities at FMV immediately before distributing them to Sarah, the partnership would have realized $4,000 of net gain ($3,000 on A stock + $2,000 gain on B stock – $1,000 loss on C stock). Sarah's distributive gain would have been $2,000 (50% × $4,000 net gain).

If ST had sold the balance of the securities on the open market immediately **after** distributing only A stock to Sarah, the partnership would have $1,000 of net gain ($2,000 of unrealized gain on B stock – $1,000 unrealized gain on C stock). Sarah's share of the distributive gain on just B and C stock would have been $500 ($1,000 of net gain on B stock and C stock × 50%).

As a result, the distribution of only A stock to Sarah caused a decrease of $1,500 in Sarah's share of the net gain in the ST Partnership's securities ($2,000 net gain before distribution – $500 net gain after distribution).

The amount of the distribution of A stock that is treated as a distribution of money is reduced by $1,500. Thus, the distribution of A stock is treated as a distribution of $8,500 to Sarah ($10,000 FMV – $1,500 reduction)

86. Treas. Reg. §1.731-2(b).

87. Treas. Reg. §1.731-2(d)(1).

88. Based on Treas. Reg. §1.731-2(j), example 2.

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Practitioner Planning Tip

Just because cryptocurrencies are not explicitly listed in §731(c)(2)(C), tax practitioners should not assume they are not included. In fact, by their very nature, cryptocurrencies are currencies that are traded on a financial market. The appearance on the 2023 Form 1065 of questions relating to virtual currency underscores the importance of asking partnership clients these questions.

LIQUIDATING DISTRIBUTIONS OF ASSETS

The tax treatment of a distribution of an asset depends on whether it entirely liquidates a partner's interest in the partnership.[89] If a distribution does not liquidate a partner's interest, it is considered a current distribution, and the partnership may not be terminated, as discussed previously.[90] IRC §732(a) provides that the basis of property other than money distributed as part of a **current distribution** is its adjusted basis to the partnership immediately prior to the distribution. However, this inside basis may not exceed the distributee-partner's outside basis in the partnership immediately prior to the distribution and after the reduction for any money distributed.[91]

However, if a partnership distributes property to liquidate a partner's **entire** interest, the partner's basis in the assets distributed is calculated differently.[92] The basis of the distributed property is the partner's outside basis **reduced** by any money the partnership distributes.

Liquidating Distributions of Assets Not Subject to IRC §751

Although constrained by the disguised sale regulations, partnerships can generally transfer assets to partners, who can subsequently sell them as assets subject to capital gains rates. However, the Code provides for an exception for "hot" assets, which are subject to §751.

Liquidating Distributions of Assets Subject to IRC §751(b)[93]

The purpose of §751(b) is to ensure that each partner reports their share of the partnership's ordinary income for distributions. For example, when a partner sells their interest in the partnership, IRC §741 treats it as a sale of a capital asset resulting in either capital gain or loss to the partner. In effect, the partner is selling their indirect ownership percentage in each asset the partnership holds. Instead of using capital gains rates on any recognized gain, the partner must recharacterize this gain as being subject to other possible income tax rates (e.g., 25% for unrecaptured IRC §1250 gain, 28% for collectibles,[94] or up to 39.6% for certain ordinary income assets). Assets subject to ordinary income recharacterization under §751(b) are unrealized receivables, substantially appreciated inventory, and depreciation recapture. These are commonly referred to as **hot assets.** The sale of a partnership interest that includes hot assets requires the partnership to file Form 8308, *Report of a Sale or Exchange of Certain Partnership Interests,* as discussed later.

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89. IRC §§732(a)–(b).
90. Treas. Reg. §1.761-1(d).
91. Treas. Reg. §1.732-1(a).
92. IRC §732(b).
93. IRC §751.
94. IRC §§1(h)(1)(E) and (F).

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Even distributions that rearrange the partners' indirect interest in certain ordinary income assets (unrealized receivables and appreciated inventory items) are taxed as a sale or exchange between the distributee-partner and the partnership.[95] Consequently, either the partner or the partnership may recognize gain or loss on the recharacterized transaction.

The §751(b) hot asset rules can apply with both **nonliquidating and liquidating distributions**. However, this is true only to the extent that a partner receives:

- Hot assets in exchange for any part of their interest in other property,
- Other property, or
- Non-hot assets in exchange for any part of their interest in hot assets.[96]

IRC §751 **does not apply** to the following situations.[97]

- Distributions of property that the distributee-partner originally contributed to the partnership
- Payments to a retiring partner or a deceased partner's successor interest made under §736(a)
- Draws or advances against a partner's distributive share
- Distributions treated as gifts
- Payments for services
- Payments for the use of capital

Unrealized Receivables. Unrealized receivables are **not exclusively** limited to cash basis receivables in a service-type partnership. The Code uses a broad definition of the term to mean the right to payment for goods or services that have been delivered or rendered, or that will be.[98] The term also extends to the rights of a cash method partnership to a payment that results from a contract or agreement that is in existence at the time a partnership interest is sold or a distribution of partnership property is made.

Within the broad scope of unrealized receivables, the partnership can still have unaccrued contract rights for services to be performed and goods to be delivered in the future. Any ordinary income depreciation recapture is also included.[99] However, any unrecaptured §1250 is separately accounted for, as it is taxed at its own rate.[100]

The total gain must be computed first to determine the portion of gain associated with unrealized receivables. Next, the portion of the gain associated with the partnership's hot assets must be computed. This total amount to be allocated among all partners is the ordinary gain or loss associated with §751 assets immediately prior to the termination of the partnership.[101]

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95. IRC §751(b).
96. Treas. Reg. §1.751-1(b)(1)(i).
97. Treas. Reg. §1.751-1(b)(1)(ii).
98. IRC §751(c).
99. Generally, IRC §§1245 or 1250, but also includes several other ordinary income items under IRC §§1252, 1253, and 1254.
100. IRC §1(h)(6).
101. Treas. Reg. §1.751-1(a)(2).

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Substantially Appreciated Inventory.[102] Substantially appreciated inventory is treated as a hot asset and receives ordinary income treatment when distributed by any partnership, including terminating partnerships.[103] Inventory includes any partnership assets held for sale to customers in the normal course of its trade or business. It also includes all partnership property that, if sold or exchanged, is considered a noncapital asset or property not used in the partnership's trade or business.

To be "substantially appreciated," the total FMV of all the partnership's inventory items must exceed 120% of the aggregate adjusted bases of those items. The "unrealized receivables" as well as "realized receivables" (most likely in an accrual partnership) are both included in the definition of "inventory" when ascertaining whether the 120% mark was passed.

Observation. If an accrual basis partnership has significant realized receivables, it is less likely that the substantially appreciated test will be met because receivables are included in the aggregate adjusted bases for all inventory items.

Note. IRC §751(**a**) pertains to sales or exchanges of partnership interests and includes **all** inventory in the calculations involving hot assets. IRC §751(**b**), in contrast, applies to **distributions** that must be treated as sales or exchanges; the calculation of hot assets under this subsection of the Code is only concerned with **substantially appreciated** inventory.

Calculating Ordinary Gain on Hot Assets.[104] This critical calculation is made by first computing the **total** gain on a distribution, separately determining the amount of gain on each hot asset, classifying those hot assets, and assigning gain to each classification. Any difference between the total gain reduced for the gain associated with hot assets is attributable to capital gain on the transaction. This sometimes has the counterintuitive result of producing a capital **loss** when a partner experiences an overall total gain.

Identify and Classify Hot Assets. Hot assets must be classified according to the tax rate applied to each type. For example, recaptured depreciation is generally taxed at ordinary rates when it is recovered. Some assets, such as §1250 real estate, are taxed at a maximum rate of 25%, so they must be categorized differently.

In addition, the partnership should distinguish §751 gain from the sale or exchange of partnership interests from the §751 gain arising from the **distribution** of partnership assets. A partnership must report any gain or loss generated by the distribution of partnership property as other income on Form 1065, Schedule K, *Partner's Distributive Share Items,* line 11.[105] In contrast, the gain generated by the **sale or exchange** of partnership interests should be reported on Form 1065, line 6, because it originates on Form 4797, *Sales of Business Property,* line 10, and is included in the total on line 17.

When a partnership terminates, if one partner acquires the partnership interests of all others, both scenarios may occur on the same Form 1065. Only the §751(a) gain that arises from the sale or exchange of partnership interests is reported on Schedule K-1 (Form 1065), part III, box 20 with code AB.[106]

Note. Any gains taxed at ordinary rates also increase the qualified business income deduction (QBID). For more information on how hot assets generate QBID, see the 2024 *University of Illinois Federal Tax Workbook*, Chapter 5: Partners Terminating Their Interest in a Partnership.

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102. IRC §751(d)(2); Treas. Reg. §1.751-1(d).

103. Treas. Reg. §1.751-1(a)(1).

104. Treas. Reg. §1.751-1(a)(2).

105. 2023 Instructions for Form 1065, page 38.

106. 2023 Instructions for Schedule K-1 (Form 1065), page 29.

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Determine the Total Gain. Taxpayers determine total gain by adding the total sales proceeds from the transaction for the partner. This sum must consider marketable securities distributed and the relief from any responsibility for indebtedness that the taxpayer has received. The taxpayer subtracts their basis in the partnership interest from this amount to determine their total gain.

> **Example 12.** Alethia Printing, LP, purchased a printing press for $300,000 in 2021, and since then has claimed $80,000 of ordinary depreciation. Alethia's four equal partners have each voted to terminate the partnership, with Vera, the only general partner, purchasing the other partners' interests in the partnership for $85,000 each. Vera receives the press as a distribution. An appraiser estimated the press's FMV at $360,000. Each partner has an outside basis in the partnership equal to $58,000.
>
> Prior to the press's distribution, Alethia had a hot asset, the accumulated depreciation, with an FMV of $80,000. This asset has a $0 basis. Of the $85,000 that each exiting partner receives from Vera, $20,000 ($80,000 accumulated depreciation ÷ 4 partners) is considered an unrealized receivable under **§751(a).**
>
> Each exiting partner realizes a total gain of $27,000 ($85,000 realized price – $58,000 basis in the partnership). Of this amount, $20,000 is treated as **§751(a)** ordinary gain. The remaining $7,000 ($27,000 total gain – $20,000 ordinary gain) is treated as a capital gain. Vera receives a liquidating distribution under **§751(b).** The §751 gain may result in a QBID deduction for the partners.

4

Determine the Gain or Loss on Each Hot Asset by Category.[107] After determining the total gain, that gain is partitioned into different categories based on asset class. Hot assets that generate **ordinary income** must be reviewed for the gain they produce. For example, if the disposal of depreciable assets triggers ordinary income following the rules of IRC §1245, a portion of the total gain is set aside for the recapture of this gain. Generally, the amount of recapture is a gain because the partnership's basis in it is $0. However, the disposal of inventory generally involves computing the partnership's basis in that inventory.

A portion of the total gain is set aside for the remaining asset classes, including collectibles gain, §1250 capital gain, and residual long-term capital gain or loss. The most likely source of this is §1250 property, which is taxed at a maximum rate of 25%.

These amounts are subtracted from the total gain to determine the capital gain or loss on the total disposition of all partners. If this amount is positive, the former partner can report a capital gain, which is taxed at lower rates than the other asset classes mentioned. If this amount is negative, the former partner can report a capital loss. Unless there are other capital gains that the capital loss can offset, an individual partner can deduct only $3,000 of capital loss each year ($1,500 if the partner is married filing a separate return).[108]

Allocate a Portion of the Gain or Loss on Each Hot Asset to the Partners Involved. The allocation of each asset class for each partner can then be determined. In many partnerships, the partnership agreements allocate the same percentage of all assets to partners. Partnerships with more complex partnership agreements may allocate gain associated with certain assets differently. Because hot assets are subject to higher tax rates, there may be an incentive to allocate gain from these assets differently. However, §751(b) provides for the deemed sale of non-§751 assets to counteract this incentive.

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107. Treas. Reg. §1.1(h)-1(a).

108. IRC §1211.

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Example 13. Carl and Barb formed the Salmon Partnership many years ago. On November 1, 2023, Carl told Barb that he wanted to retire. Barb told Carl she would purchase his 40% interest in the partnership for $240,000 with a closing on December 31. On that date, Carl's outside basis in Salmon is $360,000.

The partnership's balance sheet follows.

		Inside Basis	FMV
Cash		$ 5,000	$ 5,000
Accounts receivable		41,000	25,000
Inventory		40,000	50,000
Equipment (IRC §1245 asset)	$ 50,000		
Accumulated depreciation	(26,000)		
	$ 24,000	24,000	35,000
Building	$780,000		
Accumulated Depreciation	(40,000)		
	$740,000	740,000	830,000
Land		50,000	55,000
Total assets		$900,000	$1,000,000
Debt		$400,000	$400,000
Partner capital (Barb)		300,000	360,000
Partner capital (Carl)		200,000	240,000
Total liabilities and capital		$900,000	$1,000,000

The $240,000 that Carl receives on December 31 indicates that the FMV of the partnership is $600,000 ($240,000 ÷ 40%). Combined with the $400,000 debt, this means that the partnership's total assets are $1,000,000 ($600,000 partnership FMV + $400,000 debt).

Because every partnership must have at least two partners, Salmon terminates on December 31 when Carl ceases to be a partner. Because he is relieved of his obligation for his share of Salmon's $400,000 of debt, Carl receives a total consideration of $400,000 for the sale of his interest in the partnership ($240,000 + 40% × $400,000).

Carl's outside basis is approximately $360,000, the inside basis of his partner capital account plus his share of the liabilities ($200,000 + $160,000). Thus, Carl's projected total gain on the entire sale is $40,000 ($400,000 consideration received – $360,000).

To determine the gain associated with partnership §751 assets, the following spreadsheet is constructed to calculate the partnership's gain from §751 assets.

Asset	Inside Basis	FMV	Difference	Carl's Share	Carl's Share of §751 Gain/(Loss)	Carl's Share of Unrecaptured §1250 Gain/(Loss)	Carl's Share of Capital Gain
Accounts receivable	$ 41,000	$ 25,000	($16,000)	($ 6,400)	($6,400)	$ 0	$ 0
Inventory	40,000	50,000	10,000	4,000	4,000	0	0
Equipment	24,000	35,000	11,000	4,400	4,400	0	0
Building	740,000	830,000	90,000	36,000	0	16,000	20,000
Land	50,000	55,000	5,000	2,000	0	0	2,000
Total					$2,000	$16,000	$22,000

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The breakdown of the gain for the building requires additional explanation. Because the building was purchased for $780,000, the partnership has already taken $40,000 of depreciation on it. Unlike the equipment, however, the partnership termination does not trigger ordinary income for the building but rather unrecaptured §1250 gain. Carl's share is $16,000 ($40,000 partnership unrecaptured §1250 gain × 40%). The appreciation of the building means that the rest of Carl's gain is $20,000 capital gain ($36,000 total gain on building – $16,000 uncaptured §1250 gain).

Thus, Carl must recognize $2,000 of ordinary income as his share of §751 gain. IRC §751 converts what would have been a capital gain or unrecaptured §1250 gain into ordinary income with its higher tax rate.

Example 14. The Trout Partnership has the following assets.

Asset	FMV	Adjusted Tax Basis	Gain
Cash	$50,000	$50,000	$ 0
Receivables	80,000	0	80,000
Inventory	20,000	10,000	10,000
Land	50,000	30,000	20,000
Total			$110,000

The total FMV of all inventory items, which includes receivables, is $100,000 ($80,000 + $20,000), and the adjusted basis of all inventory items is $10,000. Because the total FMV of all inventory items ($100,000) is more than 120% of the adjusted basis of all inventory items ($10,000), the partnership's inventory is considered substantially appreciated. As a result, both Trout's inventory and receivables are treated as hot assets. When Trout terminates, the partnership will allocate a portion of the total gain to the deemed disposition of hot assets.

Observation. This increases their effective tax rate on the termination because hot assets are taxed at a higher rate than capital assets.

Disproportionate Distributions of §751 Assets. IRC §751(b) applies when a non pro rata distribution of a partnership's hot assets is made to a partner which has the effect of "rearranging" the partners' shares of §751(b) property. In making this determination for a continuing partnership, the distributee-partners' predistribution interest in hot assets versus non-hot assets is compared with their respective postdistribution interests in such property. If such a shift in the partners' interests in the partnership's hot assets occurs, then the distribution is treated as a sale or exchange of property under §751(b). The purpose of this Code section is:

> *[t]o prevent the conversion of potential ordinary income into capital gain by virtue of transfers of partnership interests.*[109]

When a partnership terminates, it may dispose of its hot assets in several ways.

Distributions of Hot Assets Proportionately.[110] Hot assets may be distributed to partners in proportion to their interests in the partnership's capital. Generally, the partnership does not incur reportable income before final distributions because it has distributed the assets, not sold them. Each partner has received a hot asset that reflects their proportionate interest in the partnership, so §751 does not apply.

109. *Roth v. Comm'r*, 321 F.2d 607 (9th Cir. Aug. 5, 1963), quoting S. Rep. No. 1622, 83rd Cong., 2d Sess. (1954).

110. Treas. Reg. §1.751-1(b)(2)(ii).

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Example 15. Larry and Curly form the LAC Law Group, LLC, each owning 50%. After several successful years of working together, they are both interested in retiring. They decide that the easiest way to do this is to divide everything 50-50 and terminate the LLC. First, they use the available cash to pay off all outstanding liabilities. The remaining balance sheet is as follows.

	FMV	Adjusted Tax Basis
Cash	$ 50,000	$50,000
Accounts receivable	50,000	0
Furniture	1,000	0
Computers	500	0
Total	$101,500	$50,000
Partner's capital	$101,500	$50,000

Each partner receives the following in liquidation.

Cash	$25,000
Accounts receivable	25,000
Furniture	500
Computers	250

The furniture and the computers were purchased by the LLC several years ago and have been fully depreciated. They are §1245 property. In addition, the accounts receivable have a zero-tax basis and, therefore, are subject to ordinary income treatment. However, because the assets are divided pro rata, neither Larry nor Curly recognizes any income on the termination. Rather, the basis of their partnership interest is first reduced by the cash distributed. Any remaining balance is allocated to other assets received. However, the accounts receivable, the furniture, and the computers continue to carry the "taint" of ordinary income. As the receivables are collected, the former partners realize ordinary income.

Deemed Sales with Disproportionate Distributions.[111] When a partnership terminates, if one or more of the partners receives a distribution of non-§751(b) property that is greater than their proportionate share of hot assets, they are deemed to have sold their share of the hot assets to the partnership for their FMV. This can result in a series of transactions with cascading effects. Because the partner is deemed to have sold their share of the hot assets, they generally must recognize a taxable gain, although a tax loss may also result.

If a disproportionate distribution of hot assets is made and it results in a deemed sale or exchange under §751(b), both the partnership and the distributee-partner are required to include a statement with their respective returns for the year of the distribution which explains the computation of any resulting income, gain, or loss.[112]

The distributee-partner's statement is also required to include the following information.[113]

1. Date of the distribution
2. Adjusted tax basis of their partnership interest
3. Amount of any money or value of any non-§751(b) property received
4. Election and computation of their adjusted tax basis in §751(b) property under §732(d) (if otherwise applicable)
5. Allocation and computation of special basis adjustments to partnership properties under §743(b) (if otherwise applicable)

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111. Treas. Reg. §1.751-1(b)(3).

112. Treas. Reg. §1.751-1(b)(5).

113. Treas. Regs. §§1.751-1(a)(3) and 1.751-1(b)(5).

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Example 16. Scott, Don, and Albert each own a one-third interest in the Eagle Partnership. The partnership has the following assets.

Asset	Basis	FMV
Cash	$ 6,000	$ 6,000
Inventory	6,000	12,000
Land	9,000	18,000
	$21,000	$36,000

Scott's partnership interest has a basis of $7,000 ($21,000 ÷ 3). All inventory is distributed to Scott in the liquidation of his partnership interest. Don and Albert each are distributed $3,000 cash and half the land. This liquidates the partnership's assets.

Scott is treated as having exchanged a one-third interest in the cash and the land for a two-thirds increased interest in the inventory. Scott has a gain of $3,000 because he received $8,000 (⅔ × $12,000) of inventory in exchange for assets with a basis to him of $5,000 (⅓ × ($6,000 cash + $9,000 land)). The $3,000 gain ($8,000 realized – $5,000 basis) would be capital gain if the land was a capital asset. Don and Albert are also each allocated $3,000 of gain.

The partnership is treated as having received $8,000 (FMV of Scott's ⅓ share of cash and land) in exchange for inventory with a basis of $4,000 (basis of inventory distributed in excess of Scott's ⅓ share). Thus, the partnership recognizes ordinary income of $4,000, one-third of which is allocated to each of the three partners.

PARTNERSHIP DEBT ISSUES AT TERMINATION

The distribution of assets becomes more complicated when debts encumber the assets. A terminating partnership may decide to repay its debts and obligations prior to winding up, but it is common for assets to be distributed to partners with debt attached to them. General considerations affect nonrecourse liabilities, recourse liabilities, and debt relief in general.

Debt relief is generally treated as the receipt of cash for income tax purposes. For partnership purposes, **the partner is treated as receiving a cash distribution** to the extent the partner is relieved of or has decreased their share of partnership debt. If this constructive distribution exceeds the partner's outside basis in the partnership, the excess is taxable as a sale or exchange of the partnership interest,[114] resulting in long- or short-term capital gain based on the partner's holding period in the interest.[115]

Nonrecourse and Recourse Liabilities

The general rules applying debt relief to nonrecourse and recourse debt follow. Generally, debt affects basis but not the capital account.

Nonrecourse Liabilities. When a partnership terminates, a partner may receive an asset with the **nonrecourse** debt still attached, as part of the distribution. That partner assumes the portion of the debt for which they were not already accountable.[116] However, nonrecourse liabilities do not provide **at-risk** basis, unless an exception applies.[117] The exception arises from **qualified** nonrecourse debt, which is treated as an amount at risk.[118] A lender may prefer to foreclose on a piece of real estate if they have made a nonrecourse loan to a partnership.

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114. IRC §731(a).

115. Treas. Reg. §1.1223-3.

116. IRC §752(a).

117. IRC §465(b)(4).

118. IRC §465(b)(6).

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If the lender forecloses on the property secured by nonrecourse debt, partners may realize a taxable **gain** if the amount of recourse debt that is discharged exceeds the adjusted basis of the property secured.[119] Because nonrecourse debt does not provide an at-risk basis, a partner is unlikely to have a taxable loss that they can recognize.

Recourse Liabilities. When a partnership terminates, it is possible for a partner to receive the underlying asset in distribution with the **recourse** liability still attached. The terms of the loan agreement likely control the transfer of the liability, and they may not permit it at all. The lender may not wish the liability to be transferred, particularly if an individual would be liable for the payment of principal, interest, and fees, as they may not have the needed credit capacity. In this event, the creditor may decide its financial position is stronger if it forecloses on the property and either sells it or operates it as a rental.[120]

If the lender forecloses on the property secured by recourse debt, partners may realize a taxable **gain** if the amount of recourse debt that is discharged exceeds the adjusted basis of the property secured.[121] If the adjusted basis of the property securing the recourse debt is greater than the amount of debt extinguished, the possibility exists for the former partner to recognize a loss on the foreclosure of the property.

Basis Issues: Debt Encumbering Assets Distributed at Termination

When a partnership distributes assets to a partner, the distribution of property subject to debt may be treated as a taxable transaction despite the nonrecognition provisions of §731(a).

Disappearing Basis.[122] The adjusted tax basis of the distributed property in the hands of a partner may be less than its tax basis in the hands of the partnership. For example, the partner's outside basis in the partnership immediately before distribution may be less than the partnership's basis in the asset adjusted downward for the debt attached to the asset, assuming this is a liquidating distribution. Therefore, the distribution can cause the taxable gain on a subsequent sale by the partner to be greater or the taxable loss to lessen.

However, the distributed asset may displace some of the partner's gain when their partnership is terminated. Instead of being associated with the partnership interest, making it taxable when the partnership is terminated, the asset is taxed when the taxpayer to whom it is distributed disposes of it. Thus, the asset may be taxed at a later time. In some cases, if the partnership acquired the asset shortly before the partnership termination, a partner waiting a year to sell it may be able to change the character of its gain from a short-term to a long-term capital gain, assuming that the asset was a capital asset.

Deemed Distributions.[123] If the partnership liabilities for which a partner is responsible decrease, the partner is considered to have received a distribution of money, even though they have received no cash. When a partnership distributes assets encumbered with debt for which partners not receiving the property had been responsible, they have received a deemed distribution. This reduces their outside basis in the partnership. If the value of remaining liabilities exceeds the partner's outside basis, they are subject to gain to the extent that the value of the distributed assets exceeds their basis.[124]

Reductions of Partners' Shares of Recourse Liabilities.[125] Assuming that the debt associated with distributed assets continues to encumber those assets, other partners are responsible for a reduced amount of debt.

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119. IRS Pub. 4681, *Canceled Debts, Foreclosures, Repossessions, and Abandonments for Individuals*.

120. *Recourse vs. Nonrecourse Debt and Why It Matters for Taxes.* Yoder, Tim and Smith, Liz. Mar. 19, 2024. Fit Small Business. [fitsmallbusiness.com/recourse-vs-nonrecourse-debt/] Accessed on May 3, 2024.

121. IRS Pub. 4681, *Canceled Debts, Foreclosures, Repossessions, and Abandonments for Individuals*.

122. IRC §732(b).

123. IRC §752(b).

124. IRC §731(a)(1).

125. IRC §752(b).

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Netting Liabilities.[126] If the distribution is made by a terminating partnership, the partner must determine whether their net change in liabilities is positive or negative. This evaluation must compare the partner's share of liabilities when the partnership is subject to them with the partner's obligation for the liabilities once the property is distributed. If the net change in liabilities is negative, the decrease is treated by both the partnership and the partner as a distribution of cash. Sometimes, the net change may be greater than the partner's outside basis in their partnership interest. In this event, the partner must recognize gain equal to the amount by which the deemed distribution exceeds their basis. The deemed distribution includes the amount of money and a net decrease in liabilities to the extent that the decrease exceeds their outside basis in the partnership.

Example 17. Vicky and Alvin are 50-50 partners in the Falcon Partnership. Vicky's outside basis in the partnership is $12,000, as is Alvin's. The entity owns a piece of undeveloped Alabama land clear of debt with an FMV of $14,000, as well as another parcel of land in Virginia worth $14,000. The partnership also has $4,000 cash. Falcon purchased the Alabama land in 2021 for $6,000, which is still its basis.

Vicky and Alvin terminate their partnership on June 1, 2024. Falcon distributes $2,000 cash to Alvin along with the Alabama land. Vicky also receives a $2,000 cash distribution, as well as the Virginia land. Alvin's basis in the land is limited to $10,000, which is his $12,000 outside basis reduced by the $2,000 he received as a distribution. Thus, by distributing the land to Alvin, its basis increased from $6,000 to $10,000, and his recognition of the gain for tax purposes is deferred until he sells it.

Example 18. Abby and Brandon formed the ABV partnership five years ago, each contributing $5,000 cash. The partnership agreement provides for partners to participate equally in gains, losses, and contributions. It also requires any distributions to be made proportionately to the partner's capital account, but these distributions are only permitted if their capital account is positive.

A year later, ABV purchases undeveloped land for $20,000, incurring $20,000 in nonrecourse debt secured by the land. The partnership makes no cash distributions for five years, and all revenues are exactly offset by expenses. In early January 2024, Abby and Brandon have the land appraised and learn that its FMV is $30,000.

When they originally formed ABV and made their cash contributions, both Abby and Brandon had capital accounts of $5,000. Acquiring the undeveloped land did not change Abby's or Brandon's partnership capital. The property is acquired with nonrecourse debt for which neither Abby nor Brandon is responsible or has an economic risk of loss. Thus, before the appraisal, Abby and Brandon each had a partnership capital account of $5,000.

Example 19. Use the same facts as **Example 18.** Brandon and Abby terminate the partnership. The partnership had not spent the $10,000 in total initial contributions that it had received from the partners when ABV was formed. The entity distributes the land with the debt to Abby, and Brandon receives $10,000 in cash.

Because the land is distributed in a terminating distribution, the partners' capital accounts must be adjusted to reflect the unrealized gain. Subject to the provisions of the partnership agreement that gains and losses be equally shared, Abby's partnership capital account is increased by $5,000 (($30,000 appraised value – $20,000 purchase price) × 50%) to $10,000 ($5,000 initial contribution + $5,000 increase due to appreciation of the land).

For the same reasons, Brandon's capital account has also increased to $10,000. Because the land is distributed to a partner, the asset is transferred to the partner with the same basis as its hands in the partnership.

[126] Treas. Reg. §1.752-1(f).

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Basis Issues: Lender Acquires Assets and Forgives Debt

When a loan goes into default, and a lender must seize the collateral, the tax consequences of this transaction depend on whether the debt is considered nonrecourse or recourse.

Nonrecourse Debt Forgiven. When a partnership's assets are acquired by a nonrecourse lender in foreclosure, the lender's acquisition of the property is considered a deemed sale by the partnership to the lender.[127] If the asset so conveyed was the principal asset of the partnership, the partnership may terminate. The amount realized in the deemed sale is the principal amount of the nonrecourse debt plus unpaid associated interest and other expenses potentially paid by the lender.[128]

The partnership likely realizes income on this transaction, as the income realized through the deemed sale may exceed the inside basis of the encumbered asset.[129] No cancelation of debt income (CODI) arises from this scenario, however.[130]

Recourse Debt Forgiven.[131] If the lender forecloses on a partnership asset securing recourse debt, at least one partner has liability for the loan, even if the lender acquires the asset. The deemed sale amount arising from the forgiveness of recourse debt is the lesser of the following two amounts.[132]

- FMV of the property foreclosed and acquired by the lender
- Amount of the secured debt

Depending on the remaining basis of the property, the terminating partnership may realize a **gain or loss** on the acquisition by the lender.[133] If the lender forgives the outstanding loan, partners for whom the debt was recourse may have CODI.[134] This occurs to the extent the outstanding balance of the forgiven loan exceeds the property's FMV.[135] However, if the lender continues to pursue repayment from a recourse partner, no cancelation of debt has occurred, although the partnership will still be treated as having a deemed sale of the property.

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127. *Comm'r v. Tufts*, 461 US 300 (1983).

128. *Allan v. Comm'r*, 856 F.2d 1169 (8th Cir. 1988).

129. *Commercial real estate: Debt restructuring and planning*. Broze, Ryan. Aug. 1, 2021. The Tax Adviser. [www.thetaxadviser.com/issues/2021/aug/commercial-real-estate-debt-restructuring-planning.html] Accessed on Dec. 8, 2023.

130. IRC §108(i)(6). Nonrecourse debt would not decrease a partner's share of liabilities.

131. *Commercial real estate: Debt restructuring and planning*. Broze, Ryan. Aug. 1, 2021. The Tax Adviser. [www.thetaxadviser.com/issues/2021/aug/commercial-real-estate-debt-restructuring-planning.html] Accessed on Dec. 8, 2023.

132. Treas. Reg. §1.1001-2(a).

133. These provisions are not specific to terminating partnerships, but the loss of a key asset to foreclosure likely results in a partnership termination.

134. IRC §108(d)(6).

135. See Treas. Reg. §1.1001-2(c), example 8.

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Partnership Debt Paid by Partner

It is not uncommon for lenders to request personal guarantees from the principals of a business. A guarantee may eventually become a personal liability of a partner if the partnership is unable to satisfy the liability. In this circumstance, the partner may be required to make good on a guarantee. Generally, the partner increases their basis to the extent that they personally cover the liabilities of the partnership they actually pay. The contingent obligation associated with the guarantee by itself has no effect on the partner's basis or their capital account.[136]

Observation. Partnerships treat CODI differently from S corporations. Partnerships report CODI on partners' Schedules K-1 (Form 1065), passing the income to them as a separately stated item.[137] However, S corporations apply certain exclusions at the entity level, specifically the following.[138]

- Any cancelation of debt excluded from income under IRC §108(a)
- Any reduction of tax attributes under §108(b)
- Any qualified real property business indebtedness under §108(c)
- Any discharge of qualified farm indebtedness under §108(g)

Other CODI is passed to the S corporation's shareholders.[139]

Debt Paid by Partner to Former Creditor. Occasionally, a partner may voluntarily settle a debt of a terminating partnership in return for an increased interest in the partnership. Thus, the former creditor is paid by a partner, not the partnership that was obligated to repay the debt. With a partnership in financial distress, a partner's payment of third-party debt is likely to be considered a capital contribution. Although it may be more advantageous for the partner to extend a personal loan that replaces the third-party loan, the financial distress makes the repayment of the loan questionable. If the debt payment is treated as a capital contribution, the partner's interest is increased by the amount of the payment made to the creditor.[140] The partnership does not recognize gain or loss in this event.[141]

If the partnership does not provide the partner who pays the debt with an increased partnership interest, the partner may be able to treat the payment of principal or interest as a worthless debt, although the questions about the nature of the partner's advance, capital or debt, may arise.[142] The loan documents should identify the partner as the loan's guarantor, endorser, or indemnitor. In addition, the taxpayer must have received some form of "reasonable consideration" for having undertaken the guarantee.[143]

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136. IRC §752(a), which restricts a partner's increase in basis to their "share of the liabilities of a partnership" or the assumption by the partner of the entity's liabilities.

137. IRC §108(d)(6).

138. IRC §108(d)(7)(A).

139. Ibid.; See *Debt Discharge Under Sec. 108: Partnerships vs. S Corps.* Boos, Robert, Nov. 30, 2012. The Tax Adviser. [www.thetaxadviser.com/issues/2012/dec/clinic-story-05.html] Accessed on Feb. 8, 2024.

140. IRS Pub. 541, *Partnerships*, p. 10 (2022).

141. Ibid., p. 8 (2022).

142. Treas. Reg. §1.166-9(a).

143. Treas. Reg. §1.166-9(e)(1).

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Debt Assumed by Purchaser that Acquires Assets

If a terminating partnership sells property subject to indebtedness, the treatment depends on whether the indebtedness was recourse or nonrecourse. If the debt is nonrecourse, the partnership must treat the assumption of the debt by the property's purchaser as an increase in the amount realized for the sale of the property.[144] In contrast, the sale of property securing a recourse liability generates CODI unless another taxpayer agrees to pay the debt.

Forfeiture or Abandonment

At some time in the life of a partnership, one or more partners may want to leave the partnership. In some cases, the partner is willing to abandon their partnership interest just for the purpose of getting away from the potential liabilities.

If the abandonment of a partnership interest results in a loss, an **identifiable event** must occur to claim the deduction.[145] Typically, a letter to the creditors indicates that the partner is no longer liable for debts. While the lender might not release the partner from existing debts, the exiting partner is not liable for any future loans. This letter and a letter to the remaining partners are enough to demonstrate that an identifiable event occurred.

If the abandonment of a partnership interest results in the partner being relieved of debt, the debt relief is treated as a deemed sale.[146] If the partner does not have basis in excess of the deemed sale, they must recognize a gain. This gain is reported on the partner's Form 1040, Schedule D, *Capital Gains and Losses*, as a capital gain. It is reported as a long-term gain if the partnership interest has been held for more than one year. The gain is also reported on Form 8949, *Sales and Other Dispositions of Capital Assets.*

Note. For more information on forfeiture or abandonment of partnership interest, see the 2024 *University of Illinois Federal Tax Workbook*, Chapter 5: Partners Terminating Their Interest in a Partnership.

PREPARING THE FINAL PARTNERSHIP TAX RETURN

Many issues confront the managers of a terminating partnership as they approach the preparation of its final tax return. Unlike corporations, which must file Form 966, *Corporate Dissolution or Liquidation*, when they terminate, partnerships do not have a special IRS form to file when they decide to dissolve the entity or liquidate partnership interests.

The partnership is required to file a final income tax return by the 15th day of the third month following the termination,[147] although this can be extended by six months.[148] Because a partnership's tax year ends on the date the partnership terminates, it must file a short-period return unless the termination date occurs in the last month of its tax year.[149] Details on preparing the final return are covered at the end of this chapter.

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144. Treas. Reg. §1.1001-2(a)(4)(i).
145. Treas. Reg. §1.165-1(b).
146. Rev. Rul. 93-80, 1993-2 CB 239.
147. IRC §6072(b).
148. IRC §6081(a).
149. IRC §6072(b).

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Example 20. Dirk, Edna, and Fran formed a service business, DEF, LLP, in 2017.[150] On April 30, 2024, they all vote to end the partnership. They stop providing services to their customers on July 31, 2024. After that date, the only partnership assets are $3,000 in cash. On September 30, 2024, each of the three partners receives their share of the partnership's assets, and they close the partnership's bank account.

DEF, LLP, continues its financial operations until September 30, 2024, which marks the termination of the partnership. DEF's final Form 1065 is due December 16, 2024, although it can file an extension that would make the return due June 16, 2025. Because DEF was a calendar-year partnership, the Form 1065 is a short-period return.

REPORTING THE PARTNERSHIP TERMINATION

In the absence of a special form, the partnership's final Form 1065 return should be marked as final, as should any associated Schedules K-1 or K-3, *Partner's Share of Income, Deductions, Credits, etc. — International*. The 2023 Schedule K-2, *Partners' Distributive Share Items — International*, does not contain a checkbox to indicate that the schedule is the last one the partnership will generate.

Because a partnership's **final return triggers special processing** at the IRS,[151] it is important for tax practitioners to establish the proper termination date. A partnership terminates when neither the entity nor any of its partners engages in any business, financial operation, or venture of the partnership, as discussed previously. The breadth of this requirement may make it difficult for tax practitioners to determine this date. However, the Internal Revenue Manual states this simply in the following manner.[152]

A "Final" Short Period return ends on the date the partnership went out of business.

The Internal Revenue Manual provides for the IRS to indicate other means of indicating a partnership return is final.[153] If the return is a final short-period return, it may also use the following words written on it to indicate it is final: "FINAL," "OUT OF BUSINESS," or "NO LONGER LIABLE."[154] A partnership may also signal that it plans to file no further Form 1065 with one of the following notations.[155]

- Deceased
- Liquidation
- Exempt under IRC §501(c)(3)
- Dissolved
- Filed in accordance with Rev. Proc. 2003-84
- Return is a "nominee" return
- IRC §"761(a) election" notated and is accepted by examination

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150. Treas. Reg. §1.708-1(b)(1).

151. IRM 3.11.15.12 (2020), 3.11.15.15.4 (2022), 3.11.15.16 (2023), 3.11.15.26 (2024), 3.11.15.50.2 (2017).

152. IRC 3.11.15.8.4 (2020).

153. Ibid.

154. Ibid.

155. IRM 3.11.15.15.4 (2022).

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REPORTING POINTS

Although it is always important to ensure the underlying bookkeeping is correct before undertaking a business tax return, it is especially important with a partnership termination. **Both the §704(b) book and tax basis capital accounts are critical.** For example, if §704(b) book capital accounts are incorrect, partners may receive incorrect distributions of assets. If the tax basis capital account should be reported as negative, but is not, a partner may incorrectly conclude that a distribution is not taxable, when to the contrary, it would be subject to tax. Other reports of partners' economic interests may also be distorted.

Reporting Sales of Partnership Property

Taxpayers use Form 4797 to report sales of business property. If a partnership sells property in the process of winding down, it may have to report the sale of these assets on this form. However, if the assets are distributed to partners, they are reported instead on Schedule K-1 (Form 1065), box 19, *Distributions*, either with code B if they consist of property contributed by another partner within the previous seven years or code C if the distributed assets were so contributed.[156]

Reporting Sales or Distributions of Partnership Goodwill[157]

If a terminating partnership sold assets that constitute a trade or business while winding down, it may be required to file Form 8594, *Asset Acquisition Statement Under Section 1060*. In general, the requirement to file is imposed if the assets constitute a trade or a business and goodwill is attached to the disposition. The requirement to file is also imposed if the person taking possession of the assets uses the price they paid to determine their basis in the assets.

Practitioner Planning Tip

Because both the seller of a business and the purchaser must file Form 8594, it is wise for the two to exchange copies of this form.[158]

Form 8594 may also be used to report the distribution of a partnership interest and the basis of the interest.[159] The associated regulations require both the recipient and the transferor to report the transfer of the partnership interest. Such a transaction is outside the scope of this discussion. Partnerships file Form 8594 with their Forms 1065 for the year that includes the sales of business assets. If the allocation to a specific asset changes in a subsequent year, parts I, *General Information*, and III, *Supplemental Statement*, must be filed in another Form 8594.

Note. For more information on Form 8594 and the sale of a business, see the 2022 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 2: Terminating a Business Interest. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

156. Partner's Instructions for Schedule K-1 (Form 1065).

157. Instructions for Form 8594.

158. Treas. Reg. §301.6721-1(h)(3)(xvii).

159. Treas. Regs. §§1.743-1(k)(1) and (2).

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Reporting the Sale or Exchange of Partnership Interests[160]

If a partner sells their interest in a partnership and a part of the sale is attributable to §751(a) assets, such as accounts receivable or inventory, the partnership must report the transaction on Form 8308. This form reports the two parties in the sale, the sale date, the type of partnership interest transferred, and the partner's share of gain or loss. Generally, the partnership must include one Form 8308 for each partnership interest sold or exchanged.

Example 21. Isaac, Julie, and Kevin have been the only members of the IJK, LLC, since they formed it in 2009. IJK is a calendar-year entity taxed as a partnership that has sold lamps from a retail store throughout its existence. IJK was successful because it built a steady repeat business with interior decorators who consistently referred business to it. Although the partners worked in the business, each received guaranteed payments for their services, which were consistently reported on their Schedules K-1 (Form 1065).

In early 2024, the three partners voted to sell the business by selling its goodwill and going concern value, store fixtures, receivables, and inventory to another store, Lamps and Lights (L&L). IJK also owns a fully depreciated delivery truck that it purchased in 2013. IJK is distributing this truck to Isaac, who plans to use it in an unrelated business.

Julie, the partnership representative, discussed this plan with IJK's tax practitioner, Sam, in March 2024. Sam advises her that they should plan on filing Form 4797 to report the sale of store fixtures and Form 8594 to report the sale of inventory and goodwill to L&L. Because IJK is selling assets covered by §751(a) to L&L, Sam tells Julie that their Form 1065 must also include the following Form 8308 to report the sale of her interest to L&L. The LLC must file similar Forms 8308 to report Isaac's and Kevin's sales of their interests.

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160. Form 8308, *Report of a Sale or Exchange of Certain Partnership Interests.*

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For Example 21

Form **8308** (Rev. October 2023) Department of the Treasury Internal Revenue Service

Report of a Sale or Exchange of Certain Partnership Interests

Go to *www.irs.gov/Form8308* for the latest information.

OMB No. 1545-0123

Name of partnership	Phone number	Employer identification number
IJK, LLC	217-555-6666	27-1234567

Number, street, and room or suite no. If a P.O. box, see instructions.
123 Main St

City or town, state or province, country, and ZIP or foreign postal code
Northwoods, IL 60185

Part I Transferor Information
Record holder of the partnership interest immediately before transferring that interest:

Name	Identifying number
Julie Smith	***-**-6789

Number and street (including apt. no.)
123 Red St

City or town, state or province, country, and ZIP or foreign postal code
Elgin, IL 60123

Check if the transferor is foreign: ☐

Beneficial owner of the partnership interest immediately before transferring that interest:

Name	Identifying number
Julie Smith	***-**-6789

Number and street (including apt. no.)
123 Red St

City or town, state or province, country, and ZIP or foreign postal code
Elgin, IL 60123

Notice to Transferors: The information on this form has been supplied to the IRS. The transferor in a section 751(a) exchange is required to treat a portion of the gain realized from the exchange as ordinary income. For more details, see Pub. 541, Partnerships.

Statement by Transferor: The transferor in a section 751(a) exchange is required under Regulations section 1.751-1(a)(3) to attach a statement relating to the sale or exchange to their return. See *Instructions to Transferors* on page 3 for more details.

Part II Transferee Information
Record holder of the partnership interest immediately after the transfer of that interest:

Name	Identifying number
Lamps and Lights	27-8912345

Number and street (including apt. no.)
123 Brown St

City or town, state or province, country, and ZIP or foreign postal code
Geneva, IL 60134

Beneficial owner of the partnership interest immediately after the transfer of that interest:

Name	Identifying number
Lamps and Lights	27-8912345

Number and street (including apt. no.)
123 Brown St

City or town, state or province, country, and ZIP or foreign postal code
Geneva, IL 60134

Part III Transfer of Partnership Interest

1 Date of sale or exchange of partnership interest: **09 / 04 / 2024**

2 Type of partnership interest transferred:

A Capital ☒

B Preferred ☐

C Profits ☐

D Other ☐

For Paperwork Reduction Act Notice, see instructions. Cat. No. 62503I Form **8308** (Rev. 10-2023)

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For Example 21

Form 8308 (Rev. 10-2023) Page 2

Part IV Partner's Share of Gain (Loss) Required by Sections 751(a) and 1(h)(5) and (6)
The amounts in column (c) should be reported to the selling partner on their Schedule K-1 in box 20 using the relevant code.

		(a) Partnership-level deemed sale gain (loss)	(b1) Percentage interest in the partnership transferred	(b2) Number of units in the partnership transferred	(c) Partner-level deemed sale gain (loss)	K-1 box 20 code
1	Section 751(a) gain (loss)	12,000	33.3333		4,000	AB
2	Section 1(h)(5) gain					AC
3	Deemed section 1250 unrecaptured gain					AD

Sign here only if you are filing this form by itself and not with Form 1065.
Under penalties of perjury, I declare that I have examined this return, including accompanying attachments, and to the best of my knowledge and belief, it is true, correct, and complete.

Julie Smith — Signature of partnership representative or partner or limited liability company member
11 / 15 / 2024 — Date

Short-Period Tax Return Considerations

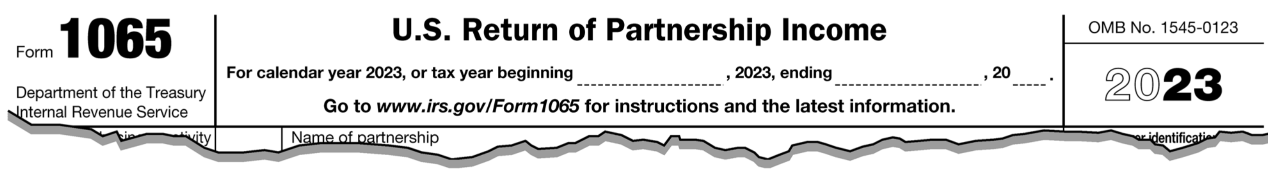
Unless a partnership terminates during the last month of its tax year, it must file a short period return by the 15th day of the third month following the partnership's termination.[161] The short-period return reports the partnership's income and expenses during the portion of its final year before it terminates. In most cases, the partnership return can be filed up to six months later under the automatic extension rules.[162]

Practitioner Planning Tip

Unless the termination occurs so late in the year that the appropriately dated tax returns become available, the return may need to be filed using the previous year's tax software. Regardless, dates indicating the beginning and the end of the partnership's final tax year should be entered at the top of Form 1065. The Internal Revenue Manual requires both dates to be maintained in the IRS's systems, identifying the return as a "Final Short Period" return.[163]

Example 22. Use the same facts as in **Example 21.** On August 21, 2024, Julie calls Sam to inform him the partnership is closing on September 4, just two weeks later. He informs her that their short-period Form 1065 is due December 16, 2024, although its filing can be extended.

When a partnership terminates prior to its normal year end, the short year is identified at the top of Form 1065 with the appropriate date of the year end.


Form 1065
Department of the Treasury
Internal Revenue Service
U.S. Return of Partnership Income
For calendar year 2023, or tax year beginning ____________, 2023, ending ____________, 20____.
Go to *www.irs.gov/Form1065* for instructions and the latest information.
OMB No. 1545-0123
2023
Name of partnership

161. IRC §6072(b).

162. IRC §6081(a).

163. IRM 3.11.15.8.1 (2020); IRM 3.11.15.8.4 (2020).

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Other Matters

A miscellany of other issues can warrant a tax practitioner's attention as a partnership terminates.

Reporting Rental Income and Expenses. A partnership normally reports all real estate rental activity on Form 8825, *Rental Real Estate Income and Expenses of a Partnership or an S Corporation*. This information should coincide with the information on the partnership's Form 1065, Schedule K, line 2.

> **Note.** Form 8825 is not required when a partnership files a final tax return.[164] However, if a terminating partnership has any rental or royalty activity, completing this form may assist the tax practitioner in ensuring that the tax basis capital accounts are properly reported.

Employment Tax Returns.[165] If the partnership had employees, it should file final payroll tax returns when it terminates.[166] This return should be marked "Final," and it should also provide a statement with the form indicating the address where the partnership plans to maintain its payroll records. This statement is required with both Forms 941, *Employer's QUARTERLY Federal Tax Return,* and 940, *Employer's Annual Federal Unemployment (FUTA) Tax Return*.

Additionally, Forms W-2, *Wage and Tax Statement*, and Forms 1099 must be sent to employees and recipients. Filing these forms can be easily overlooked among the myriad of tasks surrounding the termination of a partnership.

Record Retention. A terminating partnership may have many years of records to maintain. The partnership must maintain records for at least several more years to be able to answer an IRS inquiry.[167] Treas. Reg. §1.6001-1(e) states that taxpayers, and potentially their agents, should maintain them "at all times available for inspection" by authorized IRS personnel. This regulation requires their retention "so long as the contents thereof may become material" for the enforcement of tax law.

However, this requirement does not just apply to partnerships. A reasonable reading suggests that the partnership maintain records as long as they may be useful to any partner's tax matter. Under some circumstances, the partners may need the records longer than the partnership.

Unamortized Expenses.[168] If a partnership has not fully amortized any deferred expenses when it terminates, the unamortized balance can be deducted on the entity's final return. IRC §709 specifically permits deductions for organization and syndication fees. For example, if a partnership incurred start-up or organizational expenses when it started,[169] but they have not been fully amortized, they can be deducted on the final return. They are subject to the requirement that they must be deductible under IRC §165, which pertains to losses. As a consequence, goodwill acquired through an acquisition can be deducted because it is a business expense deductible under IRC §197(c)(1). However, the self-created goodwill of a terminating partnership cannot be deducted because the Code does not permit taxpayers to amortize intangibles they have created.[170]

Winding Up Expenses. There may be expenses associated with the ending of the partnership that are paid or incurred after the final tax return has been prepared. For example, if the tax preparer fails to bill and collect the final return preparation fee, that expense will be incurred after the final return has been filed. Additionally, the final return may reflect a refund of state income taxes that may be received after all accounts have been closed. As discussed previously, the IRS may claim that the partnership has not terminated until after all of these winding-up activities have been completed.

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164. IRM 3.11.15.25.1 (2021).
165. Treas. Regs. §§31.6011(a)-1(a)(1) and 31.6011(a)-6.
166. Treas. Reg. §31.6011(a)-1(a)(1).
167. IRC §6001.
168. IRC §195(b)(2); IRS Pub. 535, *Business Expenses*, p. 30 (2022).
169. IRC §195(b)(1).
170. IRC §197(c)(2).

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Chapter 5: Partners Terminating Their Interest in a Partnership

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Note. Corrections for all of the chapters are available at **TaxSchool.illinois.edu.** For clarification about terms used throughout this chapter, see the **Acronyms and Abbreviations** section following the index.

For your convenience, in-text website links are also provided as short URLs. Anywhere you see **uofi.tax/xxx**, the link points to the address immediately following in brackets.

About the Author

John W. Richmann, EA, is a Tax Materials Specialist at the University of Illinois Tax School. Prior to joining Tax School in 2021, he owned a tax practice in St. Charles, Illinois, and held positions in private industry and consulting firms. John earned a Masters Degree in Business Administration from the University of Texas and an electrical engineering degree from the Massachusetts Institute of Technology.

Other chapter contributors and reviewers are listed at the front of this book.

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Partners often form a partnership venture with the goal of making a profit. However, various reasons might lead them to exit this venture and the exit process can become complicated. This chapter provides an introduction to various tax matters that arise when terminating a partnership interest. The method of termination influences the divestment of a partnership interest and is the first topic of discussion.

Building on this foundation, the chapter explores three ways that the termination of a partnership interest can result in unexpected costs that could further affect the profitability of a partnership interest: negative IRC §704(b) capital accounts; basis issues; and hot assets. Tax practitioners must then help clients navigate reporting information from their final Schedule K-1 (Form 1065), *Partner's Share of Income, Deductions, Credits, etc.*

> **Note.** This chapter uses the following terms throughout.
>
> - **Retiring partner** — a partner who leaves a partnership by ceasing to be a partner under local law, generally when the partnership redeems the retiring partner's interest.
> - **Selling partner** — a partner withdrawing from the partnership who sells their interest to another party. The buyer may have no connection to the partnership, or they may already be a partner.
> - **Withdrawing partner** — an individual leaving a partnership generally, without specifying whether they are retiring from the partnership or selling their interest.

METHODS OF TERMINATING A PARTNER'S INTEREST

A partner may relinquish their interest in a partnership in a number of ways. The most common ways follow.

- Sale
- Liquidation or proportionate sale to all other partners
- Retirement and death
- Gift
- Abandonment or forfeiture
- Worthlessness

Alternatively, the partnership itself may terminate, thereby terminating all partners' interests.[1] Although a partnership may approve a plan of liquidation, its partners continue to have an interest in the entity until their interests are completely liquidated. If the plan of liquidation calls for the partner's interest to be liquidated through a single distribution or a series of distributions, only upon the final distribution is the partner's interest terminated.

> **Note.** For more information about the termination of partnerships, see the 2024 *University of Illinois Federal Tax Workbook*, Chapter 4: Partnership Terminations.

1. IRC §708(b).

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SALE

One of the more common methods of terminating a partner's interest is the partner selling their interest in the partnership. This includes sales to a third party, sales to other partners that are not proportionate, or a proportionate sale to all the other partners. The selling partner has a responsibility to advise the partnership that they have sold their interest.[2]

Sale to a Third Party

One of the ways an individual partner may sell their interest in a partnership is to an unrelated third party. The sale of their partnership interest is generally considered the sale of a capital asset, although IRC §751(a) requires that the partner characterize gain associated with certain types of assets as generating ordinary income. This recharacterization is discussed later.[3]

The original partner ends their relationship with the partnership, and the new partner figuratively steps into the shoes of the original partner, acquiring their **inside** basis in the partnership's asset, as well as other attributes of those assets. The new partner's **outside** basis in the partnership is the consideration they paid for the partnership interest plus any indebtedness they assumed in connection with the partnership.[4]

> **Note.** For more information on the distinction between inside and outside basis, see the 2023 *University of Illinois Federal Tax Workbook*, Chapter 4: Select Topics for Partnership Operations.

Sale to Other Partners[5]

A partner may sell their interest to other partners, with tax treatment similar to the sale of a partnership interest to a third party.[6] The acquiring partners acquire a share of the selling partner's interest in the partnership.[7]

With a sale to other partners, the selling partner is required to recognize gain or loss.[8] If the partnership has only two partners, and one sells their entire interest to the other, this also terminates the partnership's status as an entity distinct from its owners.[9]

Example 1. Tom, Mike, and Nathan are equal partners in the TMN, LLC. Tom and Nathan want to buy Mike's interest in the limited liability company (LLC). The fair market value (FMV) of TMN is $270,000, and Mike's share is 1/3 or $90,000. Each partner has a basis in their partnership interest of $10,000. Tom and Nathan each pay Mike $45,000 for 1/2 of Mike's interest. Mike realizes a gain of $80,000 ($90,000 payment – $10,000 basis) on the sale of his interest. Tom and Nathan now have additional basis in their partnership interest having paid $45,000 for the additional 16.67% interest acquired from Mike. After the transaction, Tom and Nathan each own 1/2 of TMN LLC, and each has a basis of $55,000 ($45,000 from Mike's interest + $10,000 original 1/3 interest).

Example 2. Use the same facts as **Example 1,** except TMN, LLC only had two partners, Tom and Mike. Tom buys Mike's interest, making Tom the only remaining member of TMN, LLC. Because a partnership requires at least two partners, TMN, LLC is now a single-member LLC and no longer qualifies as a partnership.

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2. Treas. Reg. §1.6050K-1(d)(1).
3. IRC §741; Treas. Regs. §§1.741-1(a) and (b).
4. IRC §752(a).
5. Treas. Reg. §1.736-1(b)(1) and IRC §741.
6. IRC §741; Treas. Reg. §1.741-1(b).
7. Ibid.
8. IRC §741.
9. Treas. Reg. §1.708-1(b)(1)(ii).

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LIQUIDATION OR PROPORTIONATE SALE TO ALL OTHER PARTNERS

If a partner retires from the partnership or dies, that partner's interest may be proportionately sold to the remaining partners.[10] This transaction constitutes a sale, and the remaining partners may retain the same proportional interest in the entity after acquiring the retiring or deceased partner's interest.

If the partners handle the transaction as a **redemption** instead of a sale, payments to the departing partner should be made directly from the partnership rather than as proportionate payments that the remaining partners make themselves.[11] By definition, liquidations of a partnership interest can result only from distributions that terminate a partner's complete interest.[12] This is considered a redemption of their interest. Because the withdrawing partner's interest is redeemed, they have received a distribution that does not alter the organization's ownership structure. This is because the remaining partners proportionately increase their ownership of the partnership when the withdrawing partner's interest is redeemed.

When their interest is redeemed, the withdrawing partner **does not recognize capital gain,** provided their adjusted basis after the transaction is not negative.[13]

CONTRASTING SALES AND LIQUIDATIONS

As discussed previously, a partner treats the sale of a partnership interest as the sale of a capital asset.[14] This results in capital gain except to the extent the gain is recharacterized as ordinary income under §751. **Liquidation** of the interest of a **deceased or retiring partner** is treated as a distribution and is governed by IRC §736. If the partnership interest is liquidated for cash, it is generally only a matter of distinguishing between payments under §§736(a) and 736(b). The tax treatment of the two can differ significantly.

A **selling partner** is required to recharacterize gain as ordinary income to the extent of the partner's share of unrealized receivables.[15] The remaining partners receive no benefit from such recharacterization unless an IRC §754 election is in effect, and then only the purchasing partner or partners receive a benefit. In a liquidation, a partner's interest in unrealized receivables may be treated as a §736(a) payment for partnership property, thereby reducing ordinary income to the remaining partners because the payments reduce the distributive shares of the remaining partners or are deductible by the partnership as a guaranteed payment.[16]

Example 3. Use the same facts as **Example 1,** except that the partners agree to terminate Mike's interest in the partnership. The three partners agree that Mike is entitled to a $90,000 distribution from the partnership in termination of his interest. After Mike's interest is liquidated, Tom and Nathan each own 50% of TMN, LLC and Mike receives the $90,000 distribution. However, Tom and Nathan do not receive any additional basis in their ownership interest because neither of them paid Nathan for his interest.

Mike may have ordinary income rather than capital gain income. If any of the $90,000 distribution is a guaranteed payment under §736, Tom and Nathan share in the deduction for the guaranteed payment, and Mike has ordinary income treatment.

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10. Treas. Reg. §1.741-1(b).
11. *Termination of a Partnership Interest*. Dulworth, Cynthia. Oct. 1, 2008. AICPA. [www.thetaxadviser.com/issues/2008/oct/terminationofapartnershipinterest.html] Accessed on Apr. 18, 2024.
12. Treas. Reg. §1.761-1(d).
13. IRC §733; Treas. Reg. §1.731-1(a)(1)(i).
14. IRC §741.
15. Ibid.
16. IRC §736(a).

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In summary, the sale of a partnership interest typically results in capital gain income or loss. In contrast, the liquidation of a partnership leads to various types of payments: ordinary partnership income, guaranteed payments, payments for unrealized receivables, payments for goodwill, and potentially some distributions that are not taxed. Because of the differing tax consequences, it is important to distinguish a sale from a liquidation of the interest. The general rule is that the partners are free to determine the form in which to cast the transaction. Courts generally accept an unambiguous agreement characterizing the transaction. If it is not clear, the transaction is examined for its substance under a facts-and-circumstances determination.[17]

RETIREMENT AND DEATH[18]

A retired partner is no longer considered a partner under the state or local law under which the partnership was formed. Nevertheless, they are still partners for federal income tax purposes until their interest in the partnership has been liquidated. For partnership tax law, the term "retirement" does not mean that the partner has stopped working in general, only that they no longer have a relationship to a **continuing** partnership. Like the proportionate sale to all other partners, this also involves the provisions of §736.

The payments made to a retiring partner may consist of some combination of the following.[19]

- The partner's distributive share of partnership income
- Guaranteed payments
- Payment for unrealized receivables
- Goodwill of the partnership

Guaranteed Payments (Liquidation Only) or Distributive Shares[20]

Payments under §736(a) are taxable to the withdrawing partner as a distributive share of partnership income if they are payable with regard to partnership profit. They are treated as **guaranteed payments** under IRC §707(c) if payable without regard to partnership profit. In either event, §736(a) payments are taxable income to the withdrawing partner and either reduce the distributive share of the remaining partners (if distributions) or are deductible by the partnership (if guaranteed payments).[21]

> **Note.** For more information about guaranteed payments, see the 2023 *University of Illinois Federal Tax Workbook,* Chapter 4: Select Topics for Partnership Operations.

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17. See, e.g., *Foxman, et al. v. Comm'r*, 41 TC 535 (1964), *aff'd* 352 F.2d 466 (3rd Cir. 1965), *acq*. 1966-2 CB 4.
18. Treas. Reg. §1.736-1.
19. IRC §736.
20. Ibid.
21. IRC §736(a)(2).

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Payment for Unrealized Receivables[22]

Liquidating distributions to a retiring partner for the partner's interest in partnership property are subject to §736(b). Although distributions are generally not taxable to the retiring partner, §736(b) payments can result in **capital gain or loss.** An exception is provided if there are unrealized receivables or inventory items. In that case, the partner is required under §751 to treat as ordinary income an amount equal to what the partner's share of gain would have been if the partnership disposed of all of its receivables and inventory in a taxable sale at FMV.[23] The partner, therefore, has ordinary income to the extent of that amount.[24] The remainder of the §736(b) liquidating distribution is governed by the provisions of IRC §731.[25] The constructive sale treatment is not required for distributions of §751 property contributed to the partnership by the distributee-partner or for distributions treated as distributive shares of partnership income or guaranteed payments under §736(a).[26]

Note. Liquidating distributions result in the termination of a partner's interest in a partnership.[27] It does not matter whether the partnership continues. When receiving a **current distribution,** the partner's interest continues to exist. Even if the distribution is made subject to a plan for the distribution of all partnership assets, the distribution is still considered a current distribution.

Under §736(b), **liquidating** distributions to a partner are treated in the same manner as current distributions under §731. This means they are generally tax-free except to the extent the liquidated partner receives cash in excess of basis. Because a liquidating distribution is a termination of a partner's interest, the distributee-partner is required to substitute the distributee's outside basis in the partnership immediately before the distribution as the partner's basis in the property distributed by the partnership.[28] In contrast, a current distribution requires the distributee to take the carryover basis of the partnership.[29]

Although liquidating distributions use a **substituted** basis rather than a carryover basis, the actual basis allocation rules are the same for both liquidating and current distributions. In addition, unlike current distributions, a partner may be permitted to recognize a **loss** on a liquidating distribution if the distribution:[30]

- Consists solely of money (for this purpose, not including marketable securities), unrealized receivables, and inventory; and
- The partner's basis immediately before the distribution exceeds the money and the basis of the receivables and inventory distributed.

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22. IRC §736(b).
23. Treas. Reg. §1.751-1(a)(2).
24. Treas. Reg. §1.751-1(a)(1).
25. Treas. Reg. §1.736-1(b)(1).
26. IRC §751(b)(2).
27. Treas. Reg. §1.761-1(d).
28. IRC §732(b).
29. IRC §732(a).
30. IRC §731(a)(2).

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Example 4. David receives a **liquidating distribution** from a partnership when his outside basis in the partnership is $10,000. The distribution consists of $7,000 of cash and IRC §1231 property (property used in a trade or business and held for more than one year) with an adjusted basis of $5,000 and an FMV of $9,000. David recognizes no gain because the cash he received does not exceed his outside basis. His partnership basis is reduced from $10,000 to $3,000 by the distribution of $7,000 cash. The $3,000 of the remaining partnership basis is substituted as his outside basis in the §1231 property.

If David then sells the property for its $9,000 FMV, he would recognize $6,000 of gain. This is because David originally received a distribution with a total value of $16,000 ($7,000 cash distributed + $9,000 FMV of §1231 property distributed) against only $10,000 of basis but was not taxed at that time.

Unrealized receivables and partnership goodwill are specifically excluded from the scope of §736(b) unless an exception for goodwill applies (discussed later).[31] Therefore, they are treated as a distributive share of partnership income if the amount paid depends on the partnership's income. They are treated as a guaranteed payment if the amount is determined without regard to the partnership's income.[32]

If a partner receives deferred payments taxable under both §§736(a) and (b) (discussed later), any payment must be allocated proportionately between the two as described in the regulations or in such other manner as the partnership and retired partner or successors of a deceased partner may agree in writing.[33]

Goodwill

The **sale** of a partnership interest to a third party under IRC §741 may include an amount for the selling partner's share of the partnership's goodwill. This is treated as capital gain to the selling partner.[34] If a §754 election is in place, the purchaser may be treated as having a basis in partnership goodwill amortizable under IRC §197 to the extent that basis is allocable to goodwill pursuant to that election.[35]

In a **liquidation,** goodwill may be treated under §736(a) as a distributive share of partnership income or as a guaranteed payment except to the extent the partners have agreed in the partnership agreement that it will be treated as a §736(b) payment for an interest in partnership property.[36] The withdrawing partner can treat goodwill in this manner only if capital is a material income-producing factor in the partnership and the partner is considered a general partner.[37] Thus, in a liquidation, the partners have the ability, if capital is a material income-producing factor, to make amounts received for goodwill, either capital gain to the withdrawing partner and nondeductible by the partnership or distributive shares or guaranteed payments that reduce the distributive shares of the remaining partners or are deductible by the partnership.[38]

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31. IRC §736(b)(2).
32. IRC §736(a).
33. Treas. Reg. §1.736-1(b)(5)(iii).
34. IRC §741.
35. Treas. Reg. §1.755-1(a)(5).
36. IRC §736(b)(2)(B).
37. IRC §736(b)(3).
38. IRC §736(b)(2)(B).

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Example 5. ABC is a personal service partnership in which capital is not a material income-producing factor. ABC's balance sheet follows.

	Adjusted Basis	FMV
Assets:		
Cash	$13,000	$13,000
Unrealized receivables	0	30,000
Capital assets and §1231 assets	20,000	23,000
Total	$33,000	$66,000
Capital:		
Alton	11,000	22,000
Brad	11,000	22,000
Carla	11,000	22,000
Total	$33,000	$66,000

Alton retires from the partnership and in accordance with an agreement with his partners, he receives $10,000 per year for three years, for a total of $30,000. His basis in his partnership interest is $11,000.

Under the agreement terminating Alton's interest, the value of his interest in §736(b) partnership property is $12,000 (1/3 × ($13,000 cash + $23,000 FMV of capital assets and §1231 assets)). Alton's share in unrealized receivables is not included in the interest in partnership property described in §736(b). Because the basis of Alton's interest is $11,000, he realizes a capital gain of $1,000 ($12,000 – $11,000) from the disposition of his interest in partnership property.

The remaining $18,000 ($30,000 total Alton receives – $12,000 for §736(b) property) constitutes payments under §736(a) that are taxable to Alton as guaranteed payments under §707(c) because they are fixed in amount and not dependent on partnership profit. Thus, unless the partners agree to allocate annual payments otherwise, each annual payment of $10,000 is allocated as follows.

- $6,000 (($18,000 payment under §736(a) ÷ $30,000 total payments) × $10,000) is a §736(a) ordinary income payment.
- $4,000 (($12,000 payments under §736(b) ÷ $30,000 total payments) × $10,000) is a payment for an interest in §736(b) partnership property.

The gain on the payments for partnership property is determined under §731 in the same manner as for any distribution. Therefore, Alton treats only $4,000 of each payment as a distribution in a series of liquidation of his entire interest. Under §731, Alton has a capital gain of $1,000 (($23,000 FMV of capital and §1231 assets – $20,000 adjusted basis) × 1/3) when the last payment is made. However, if Alton elects, he may treat each $4,000 payment as follows.

- $333 as capital gain (1/3 of the total capital gain of $1,000)
- $3,667 as a return of capital

Example 6. Use the same facts as **Example 5,** except the agreement between the partners provides that payments to Alton for three years are a percentage of annual income instead of a fixed amount. All payments received by Alton up to $12,000 (his share of §736(b) property) are treated under §736(b) as payments for his interest in partnership property. Alton's gain of $1,000 is taxed only after he receives his full basis under §731. Because the payments are not fixed in amount, the election to recover basis proportionately is not available. Any payments in excess of $12,000 are treated as a distributive share of partnership income to Alton under §736(a).

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Example 7. Use the same facts as **Example 5,** except capital is an income-producing factor, Alton is considered a general partner, and the partnership agreement provides that the payment for his interest in partnership property includes payment for his interest in partnership goodwill.

At the time of Alton's retirement, the partners determine the value of partnership goodwill is $9,000. Therefore, the value of Alton's interest in partnership property under §736(b) is $15,000 (⅓ × ($13,000 cash + $23,000 capital assets and §1231 assets + $9,000 goodwill)). From the disposition of Alton's interest in partnership property, he realizes a capital gain of $4,000 ($15,000 value – $11,000 basis). The remaining payments of $15,000 ($30,000 total payments – $15,000 value) constitute ordinary income under §736(a), which are taxable to Alton as guaranteed payments under §707(c).

If a §754 election is in place, however, the partnership can adjust its inside bases to reflect certain tax consequences to the liquidated partner (discussed earlier). To the extent gain is recognized by that partner on partnership goodwill, the partnership may be able to allocate this to partnership goodwill as a §197 amortizable intangible. This is not the case in a partnership in which capital is not a material income-producing factor. Such partnerships are not eligible to treat goodwill as partnership property under §736(b) and must, therefore, always treat it as a §736(a) payment.

Note. For more information about §754 elections, see the 2023 *University of Illinois Federal Tax Workbook,* Chapter 4: Select Topics for Partnership Operations.

The IRS has not defined circumstances in which capital is not a material income-producing factor. However, the Conference Committee Report to the Revenue Reconciliation Act of 1993, which enacted §736(b)(3), states the following.[39]

For purposes of this provision, capital is not a material income-producing factor where substantially all the gross income of the business consists of fees, commissions, or other compensation for personal services performed by an individual. The practice of his or her profession by a doctor, dentist, lawyer, architect, or accountant will not, as such, be treated as a trade or business in which capital is a material income-producing factor even though the practitioner may have a substantial capital investment in professional equipment or in the physical plant constituting the office from which such individual conducts his or her practice so long as such capital investment is merely incidental to such professional practice.

Special Considerations for Death

Although the death of a partner may cause the dissolution of a general partnership under state law,[40] death does not trigger a partnership's termination for federal tax purposes.[41] This is true even in the case of the death of one partner in a 2-partner partnership, as long as any successor-in-interest of the deceased partner continues to receive payments from the partnership before a complete liquidation of the decedent's interest.[42] Payments for a deceased partner's interest in the partnership are considered payments under §736 and are taxed accordingly.

A partner's death closes the partnership's tax year for the deceased partner.[43] The decedent's final return should include any distributive share of income to that point. Any distributive share after death is reported on the successor's return.[44]

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39. HR Rep. No. 103-213 at 698 (1993) (Conf. Rep.).

40. See *New York Partnership Law Section 109 — Effect of retirement, death or insanity of a general partner*. Feb. 3, 2019. Onecle Inc. [law.onecle.com.new-york/partnership/PTR0109_109.html] Accessed on Jan. 9, 2024.

41. IRC §706(c)(1).

42. Treas. Reg. §1.708-1(b)(1)(i).

43. IRC §706(c)(2)(A).

44. Treas. Regs. §§1.706-1(c)(2)(i) and (ii).

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The tax year for a partner ends on the date of their death,[45] even though the partnership continues in existence.[46] Also, on that date, their outside basis in the partnership steps up to its FMV[47] unless the partner's executor elects an alternate valuation date.[48] However, the outside basis must take into account the decedent's share of the partnership's liabilities.[49]

If a partner was already receiving liquidating distributions at the time of death, these payments are generally considered income in respect of a decedent (IRD).[50] IRD is income that would have been recognized by the recipient if they had not died. This income may be included in the estate of the deceased partner, particularly if the estate assumes the partner's role in the partnership.[51] Consequently, IRD is excluded from the stepped-up outside basis in the partnership.[52]

Note. In reviewing a partner's final tax return, tax practitioners should expect to see some portion of a liquidating payment treated as an unrecognized receivable under §751(c).

Note. For more information about IRD, see the 2021 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 1: Select Trust Topics. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

GIFT

If a partner transfers their interest through a gift, the donee uses the carryover basis from the donor. If the donor pays gift tax associated with the transfer of the partnership interest, this amount is added to the donee's basis as of the date of the gift.[53] The holding period for the donor carries over to the donee.[54] The partnership year of the donor ends on the date of the gift, while that of the donee begins on the next day.[55]

In addition, the donee may increase their basis in the partnership by any suspended **passive** losses associated with the donor's interest at the time of the transfer,[56] as they can never be deducted. However, any of the donor's losses that have been suspended because of their lack of basis or the at-risk limitations do not flow over to the recipient.[57]

45. IRC §706(c)(2)(A).
46. IRC §706(c)(1).
47. IRC §1014(a)(1).
48. IRC §2032(a).
49. Treas. Reg. §1.741-1(a).
50. IRC §691(c).
51. IRC §753.
52. Treas. Reg. §1.753-1(b).
53. IRC §1015(d)(1).
54. IRC §1223(2).
55. Treas. Reg. §1.706-1(c)(5).
56. IRC §469(j)(6)(A).
57. IRC §704(d)(1).

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Practitioner Planning Tip

Tax practitioners may need to advise their clients about their outside basis in the partnership when they receive gifts of partnership interests. These recipients may not be aware that suspended losses affect their outside basis in the partnership. Additionally, practitioners should advise clients to ask the donor for a copy of Form 8582, *Passive Activity Loss Limitations*, showing any suspended losses.

Example 8. In January 2022, Austin gifted his niece, Mallory, his entire interest in the Circle P Partnership. The entity's only asset is 640 acres of Oklahoma land. Because of cumulative losses, Austin's outside basis in the partnership is $0. He has no gift tax liability associated with this gift but has $10,000 of suspended losses related to the partnership, as he is a passive investor. Thus, Mallory's outside basis in the Circle P Partnership is $10,000 on the day she receives it.

Mallory is a passive investor in Circle P, just like her uncle. For each of 2022 and 2023, Mallory's share of the partnership's losses was $1,000. Thus, she had $2,000 of suspended losses as of December 31, 2023.

In January **2024**, Mallory sells her entire interest in Circle P to an oil company for $16,000. Her adjusted basis in the partnership is still $10,000 because she is a passive investor. Mallory's 2024 tax return reports a capital gain on the sale of her interest of $6,000 ($16,000 sale proceeds − $10,000 adjusted basis). Additionally, she deducts $2,000 of suspended losses on her 2024 Schedule E, *Supplemental Income and Loss,* because she sold her entire interest.

Family Gift of a Partnership Interest[58]

Family partnerships are subject to special rules to prevent income-shifting from high-income family partners to low-income family partners. The IRS may reallocate the income between the partners without regard to their respective capital interests if the partnership **does not meet certain tests.** The applicable tests depend on whether capital is a material income-producing factor in the business.

The determination that capital is the source of a material portion of the partnership's income is made based on the facts and circumstances related to the business. In general, capital is usually a **material income-producing factor** if the operation of the business requires substantial inventories or a substantial investment in land, plant, machinery, or other equipment. Farming is a business in which capital is a material income-producing factor.[59] Capital is **not** a significant factor if the income of the business consists principally of fees, commissions, or other compensation for services.

If **capital is a material income-producing factor,** the facts and circumstances must support the following.

1. The partners acquired their capital interests in a bona fide transaction (which includes gifts).
2. The partners actually own their purported interests.
3. The partners have dominion and control over their respective interests.

58. IRC §704(e). See also Treas. Reg. §1.704-1(e).

59. *Leo A. Woodbury et al. v. Comm'r*, 49 TC 180 (1967).

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Additional rules apply when the partnership interest is gifted or sold to a family partner. Under these rules, the following restrictions affect the partner's distributive share of partnership income.

- The distributable income must be reduced by reasonable compensation for services that the donor renders to the partnership.
- The distributive share of income allocated to the recipient of the gifted interest must not be proportionately greater than the donor's distributive share attributable to the donor's capital.

Note. The presence or absence of a tax-avoidance motive is one of the many factors to be considered in determining the ownership in a partnership interest acquired by gift.

If capital is not a material income-producing factor, the facts and circumstances must support the conclusion that the partners joined together in good faith to conduct a business. It is extremely important that any family partners performing significant services for the partnership receive adequate guaranteed payments in return.

ABANDONMENT OR FORFEITURE

Abandonments may result in ordinary losses in limited situations if both of the following requirements are satisfied.[60]

- The transaction is not a sale or exchange.
- The partnership has not made a distribution to the partner, either actual or deemed. Under IRC §752(b), if a partner is relieved of their share of liabilities, they are deemed to have received a distribution of money from the partnership.[61]

Although abandonment of a partnership interest can result in a loss, a higher standard exists for ordinary losses. In general, the taxpayer must be able to show the following.[62]

- They have evidence of their intent to abandon the partnership interest.
- They have "overtly act[ed] to abandon the asset."
- They have received nothing in distribution that is not classified as money, unrealized receivables, or inventory.

The requirement to establish a clear intent to abandon a partnership interest generally results in a partner providing a signed document that clearly expresses their intent to the partnership.[63] The taxpayer should furthermore undertake an act that affirms their desire to abandon their interests in the partnership.

Taxpayers handle the forfeiture of a partnership interest in the same way as an abandonment.[64]

Reporting Abandonments

In certain circumstances, an abandoning partner may conclude that their best option is to abandon their interest in a partnership. Under these circumstances, it is unlikely that the partnership has the assets to make a liquidating distribution.

At first glance, it might appear that the amount the partner realizes upon abandonment is zero because they receive no cash distributions in most cases. However, the concepts previously discussed in association with partnership termination come into play and affect this plan in two ways.

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60. IRS Pub. 541, *Partnerships*.

61. See *Thomas E. and Mary Watts v. Comm'r*, TC Memo 2017-114 (Jun. 14, 2017).

62. Rev. Rul. 93-80, 1993-2 CB 239.

63. *Taxation of Worthless and Abandoned Partnership Interests*. Schnee, Edward, and Seago, W. Eugene. Feb. 1, 2016. AICPA. [www.thetaxadviser.com/issues/2016/feb/taxation-of-worthless-and-abandoned-partnership-interests.html] Accessed on Mar. 19, 2024. See the appellate court's opinion regarding the 2-part test in *A. J. Industries, Inc. v. U.S.*, 503 F.2d 660 (9th Cir. 1974).

64. *Echols v. Comm'r*, 950 F.2d 209 (1991), *aff'g* 935 F.2d 703, *rev'g* 93 TC 553.

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First, the abandoning partner has likely received an allocation of the partnership's liabilities, and the allocation may exceed their outside partnership basis. Their basis may have been adjusted downward because of sustained losses.[65] The resulting disposition is a deemed sale that could provide the partner with a **taxable gain or loss** to report on Schedule D (Form 1040), *Capital Gains and Losses*.[66] Any reduction of the partner's share of liabilities is considered a distribution of money.[67] However, if the partner retains the liability for the debts, the reduction in debt is not considered to be income.[68]

Second, the abandoning partner may have unexpected ordinary income arising from how the Code requires that they treat hot assets.[69] Assuming they have appropriately notified the partnership of their abandonment, Rev. Rul 93-80 may cause a reduction to any losses because of §751(b). Because it is considered a distribution of only money, the reduction of any liabilities triggers a **disproportionate distribution of hot assets,** as discussed previously. In this case, §751 attributes a portion of this money to the partner's share of the entity's hot assets. These assets are then sold for their FMV. The net result is that the partner has another potential source of ordinary income, even though they abandon their partnership interests with no compensation.

Example 9. Joe has been a 1% partner in the XOP Partnership, having invested $100,000 for his interest in 2010 when the partnership was started. The partnership invests in rental real estate, which secures the mortgages used to finance it. Due to a downturn in the rental market, the properties have lost value, and the partnership has consistently reported losses over the last few years.

On his 2023 Schedule K-1 (Form 1065), Joe's tax basis capital account is reported as negative $10,000, which corresponds to Joe's records, which also show Joe's outside tax basis in XOP is $10,000. Joe is concerned that there is no future for him in this investment vehicle and decides to abandon his interest. The Schedule K-1 shows that Joe has been allocated $20,000 of partnership debt. Furthermore, the partnership has maintenance equipment that it depreciates under IRC §1245. The equipment had a basis of $80,000 with accumulated depreciation of $30,000. This is an unrealized receivable under §751(b).

Joe sends a letter to the general partner of XOP stating his desire to abandon his interest. Joe states that he will contribute no more funds to the partnership, and he specifically asks that no distributions, earnings, or allocations be made on his behalf, aside from those required by law. Joe includes a letter that he requests the general partner sign and return. This letter acknowledges Joe's intent to abandon his interest as of March 31, 2024, and accepts it as of that date. This letter confirms that Joe will receive no further distributions or allocations of earnings, expenses, or credits after December 31, 2023, aside from those required by law through March 31, 2024. Joe's letter further requests that he be excused from any obligation for the partnership's debt. The general partner dates the letter March 15, 2024, mails it the following day, and Joe receives it on March 20, 2024.

In February 2025, Joe receives a Schedule K-1 (Form 1065) that is marked final with a final date of March 31, 2024, just as Joe expected. It shows $2,000 as Joe's allocation of rental income for the first three months of the year. It also shows ordinary income of $300 ($30,000 accumulated depreciation × 1%), which is Joe's share of the §1245 property that is subject to depreciation and an unrealized receivable.

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65. IRC §705; Treas. Reg. §1.1001-2(a); *Gifts of Partnership Interests.* Ellentuck, Albert. Apr. 1, 2016. AICPA. [www.thetaxadviser.com/issues/2016/apr/gifts-of-partnership-interests.html] Accessed on Mar. 28, 2024.

66. IRC §741.

67. Treas. Reg. §1.752-1(c).

68. IRC §752(b).

69. *Taxation of Worthless and Abandoned Partnership Interests*. Schnee, Edward and Seago, W. Eugene. Feb. 1, 2016. AICPA. [www.thetaxadviser.com/issues/2016/feb/taxation-of-worthless-and-abandoned-partnership-interests.html] Accessed on Mar. 28, 2024.

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Joe must recognize income of $10,000 on the abandonment of the partnership, which comes from losses he was able to deduct using the debt as basis. To his surprise, Joe has the following sources of income for 2024.

- $9,700 capital gain on the abandonment of the partnership interest ($20,000 money received from debt cancelation – $300 unrealized receivable – $10,000 outside tax basis)
- $300 ordinary income from the equipment depreciation recapture, which is a §751(b) asset
- $2,000 rental income from rental operations January 1 – March 31, 2024

Practitioner Planning Tip

Tax practitioners may consider advising their clients not to disavow their share of any partnership debts. By retaining the liabilities, they may prevent §751 from converting a portion of a capital loss from the abandonment into ordinary income.

WORTHLESSNESS[70]

The IRS defines the worthlessness of a partnership interest as a consequence of "hopeless insolvency." The IRS used this term in the context of the *Echols* case,[71] in which the Echols contended that their interest in a partnership was being abandoned and was also worthless. The Tax Court found that the Echols had not properly abandoned their partnership interest, consequently sustaining the IRS's denial of an ordinary deduction. However, the appellate court found that the court should have considered the claim of worthlessness under IRC §165(a).

While abandonment of a partnership interest has objective criteria, worthlessness of a partnership interest has elements of objective and subjective judgment. Owning a 75% capital interest in the partnership, the Echols clearly indicated their perception of the worthlessness of their partnership interest at a 1976 annual partnership meeting when they conveyed their partnership interest to anyone who wanted it without compensation. Within a year, the only property the partnership owned was sold at foreclosure. The appellate court concluded that the requirements for worthlessness had been satisfied and, therefore, the Tax Court had "clearly erred," enabling it to overturn the Tax Court's findings.

As a result, the appellate court found that a taxpayer who conclusively demonstrates their perception that their partnership interest is worthless is entitled to an ordinary loss deduction under §165(a), independent of whether they had abandoned it.

Reporting Worthlessness

A partner's interest in a partnership is worthless to the extent that it has no current or potential value.[72] IRC §165(a) enables a partner to take a deduction for a loss they sustain during a year under certain circumstances, as noted in *MCM Investment Management, LLC v. Comm'r*.[73]

> *[A] loss must be evidenced by closed and completed transactions, fixed by identifiable events, and actually sustained during the tax year.*

70. *Echols v. Comm'r*, 950 F.2d 209 (1991), *aff'g* 935 F.2d 703, *rev'g* 93 TC 553.

71. Ibid.

72. Rev. Rul. 77-17, 1977-1 CB 44, cited in *Gifts of Partnership Interests.* Ellentuck, Albert. Apr. 1, 2016. AICPA. [www.thetaxadviser.com/issues/2016/apr/gifts-of-partnership-interests.html] Accessed on Mar. 28, 2024.

73. *MCM Investment Management, LLC v. Comm'r*, TC Memo 2019-158 (Dec. 10, 2019).

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To claim a worthless partnership interest, the partner must carefully determine the year in which the partnership interest became worthless. For a partner to determine the worthlessness of their partnership interest, they generally must meet both subjective and objective criteria.

The actual belief that their partnership interest is worthless constitutes the subjective criterion. The MCM Investment Management, LLC filed its tax returns consistent with this belief. Its 2009 Form 1065, *Partner's Share of Income, Deductions, Credits, etc.,* reported a loss of over $41 million with the notation "Worthless Ptrship Interest — McMillan Companies" on its Form 4797, *Sales of Business Property*. Because this LLC had elected to be taxed as a partnership, each member received a Schedule K-1 (Form 1065) consistent with this form. This filing and the severe impact that the 2009 financial debacle had on MCM's industry persuaded the court that it had met the subjective criterion for worthlessness.

The court's decision in the *MCM Investment Management* case illustrates how a partner can satisfy the objective criterion for the worthlessness of a partnership interest.

- No current or liquidating value
- Lack of potential future value
- Identifiable events
- Hopeless insolvency

NEGATIVE IRC §704(b) PARTNERSHIP CAPITAL ACCOUNTS[74]

Capital accounts track a partner's equity in the partnership. They track the partner's share of capital contributions, distributions, profits, and losses. A positive capital account indicates the partner has positive equity, while a negative value indicates a deficit of equity value. A series of losses may result in a negative capital account, or the negative capital account may be the result of overgenerous distributions, including distributions that are funded by the partnership's assumption of debt.

Regardless of how a partner terminates their interest, the partner has an obligation to restore their capital account to at least zero. Before a partner can consider the impact that terminating their partnership interest has on their outside basis, they must consider the impact of a negative capital account, if they have one. A partner with a negative capital account may take one of the following actions.[75]

- Pay the deficit in the capital account to the partnership
- Undertake a deficit restoration obligation (DRO), which requires them to restore the deficit in their capital account within 90 days after the liquidation of the partnership
- Execute a promissory note or other unconditional obligation
- Report the deficit capital account as income, such as cancelation of debt income[76]

Any of these actions would affect their outside basis in the partnership.

Note. For more information about DROs, see the 2023 *University of Illinois Federal Tax Workbook*, Chapter 4: Select Topics for Partnership Operations.

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74. IRC §§704(a) and (b).

75. Treas. Reg. §1.704-1(b)(2)(ii).

76. *Monahan v. Comm'r*, TC Memo 1994-201 (May 5, 1994).

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Practitioner Planning Tip

It is essential for a tax practitioner to review a current version of the partnership agreement to understand their client's obligations to correct negative capital accounts. If they must correct negative capital accounts, the resulting payments or changes in the allocation of income and expenses under Treas. Reg. §1.704-1 likely affect the client's outside basis in the partnership. If the partnership agreement does not address negative capital accounts, the tax practitioner should advise their client to seek legal counsel.

BASIS CONSIDERATIONS

When a partnership distributes assets to a partner when their interest is being terminated, the tax basis of those assets influences the partner's economic outcome from the partnership. This outcome is the result of many transactions that affect the partner's outside basis during their ownership, including those that terminate their interest. When their tax return for the year is prepared, gain or loss is computed relative to their outside basis.

To help clients who are terminating their interests in partnerships, tax practitioners should help them understand the different rules for basis calculations when the partnership terminates. A current distribution from a continuing partnership reduces their capital account and outside tax basis.[77] In contrast, the termination of a partner's interest subjects the distributed assets to a different set of rules if those assets are not considered money.[78]

CASH DISTRIBUTIONS

IRC §731(a) provides that distributions of money to partners (including liability relief) are tax-free to the extent of the partner's outside basis in the partnership. For this purpose, the FMV of marketable securities distributed to the partner may be treated as money.[79] The partner's basis is reduced to the extent of the money distributed. Distributions of money in excess of basis are treated as gain from a constructive sale of the partnership interest. This results in short- or long-term capital gain, except to the extent such distributions are governed by IRC §§736, 737, and 751.

If both money and property are distributed, the partner's outside basis is always reduced first to the extent of money distributed.[80] With liquidating distributions, the partner can recognize a loss, even though a **current** distribution cannot result in recognition of a loss.[81] The partnership itself recognizes neither gain nor loss on a distribution.[82]

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77. IRC §733.
78. IRC §731(a)(2).
79. IRC §731(c)(1). Certain exceptions are provided for securities distributed to the contributing partner and for investment partnerships.
80. IRC §732(a)(2).
81. IRC §731(a)(2).
82. IRC §731(b).

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When a partner's interest terminates, their gain or loss is determined by the difference between the partner's outside basis and the money received. The amount of any relieved liabilities is added to the money received to determine the amount they realize.[83] For this purpose, a partner treats the reduction of a liability as though it were the receipt of cash. The release of liabilities is treated as a distribution of money to the partner.[84] Accordingly, the tax consequences are determined under the rules applicable to the distribution.

Example 10. Travis is a general partner of Travis and Sons, LLP. He owns 3/4 of the partnership interests. He made the initial capital contribution to start the partnership, but his sons perform all the work. The partnership has shown years of losses, eroding Travis's entire basis. In addition, the partnership has a $10,000 liability as a result of a bank loan.

After a competitor on the other side of town expresses interest in the business, Travis sells his interest in Travis and Sons, LLP, to that individual for $20,000, to be paid in cash. This new partner agrees to be liable for Travis's share of the bank loan, to which the bank also agrees. Therefore, Travis must report $27,500 income ($20,000 cash received + ($10,000 bank liability relieved × 3/4 partnership interest)) on the sale of his partnership interest.

Travis's 3/4 share of the $10,000 liability had increased his basis, which was $0 prior to the sale. Because he previously received a tax benefit from claiming the losses, he must reclaim those losses due to the relief of the liability.[85]

Example 11. Use the same facts as **Example 10,** except that Travis and Sons, LLP redeems Travis's interest with a payment of $20,000, as there is no outside investor willing to acquire Travis's interest.

Travis's sons assume responsibility for Travis's share of the bank loan, and this is acceptable to the bank. With the same calculation used in **Example 10,** Travis must still report $27,500 income on the disposition of his partnership interest. Travis may have a capital gain or loss, depending on his outside basis immediately before his interest was redeemed.

PROPERTY DISTRIBUTIONS

IRC §732(a) provides that the basis of property other than money distributed as part of a **current** distribution is its adjusted basis to the partnership immediately before the distribution. However, this basis may not exceed the distributee-partner's outside basis in the partnership immediately prior to the distribution and after the reduction for any money distributed.

In contrast, if the property is distributed in a **liquidating** distribution, the property distributed acquires a basis equal to the partner's outside basis minus the FMV of money received.[86] If the distributee-partner's outside basis in the partnership is less than the bases in properties distributed (after reduction for money distributed), the partner's basis is first allocated to hot assets. Any remaining basis is allocated among other distributed property in proportion to the partnership's bases in the properties. Thus, the retiring partner is then left with a zero basis in the partnership.

The point of the property distribution rules is to defer the taxation of any gain or loss on the distributed property until the distributee-partner disposes of it.[87]

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83. Treas. Reg. §1.752-1(h).

84. IRC §752(b).

85. See, e.g., *Comm'r v. Tufts*, 461 U.S. 300 (1983).

86. Treas. Reg. §1.732-1(b).

87. Treas. Reg. §1.731-1(a)(1)(i).

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Example 12. Renee has an outside basis of $15,000 in the Electron Partnership and is retiring from the partnership on December 31, 2024. She receives a liquidating distribution on that date consisting of $5,000 cash and a parcel of land the partnership purchased for $14,000. Renee's basis in Electron is first reduced by the cash received, reducing it from $15,000 to $10,000 ($15,000 original outside basis – $5,000 cash distributed). Because Renee's status as a partner is ending, her remaining basis, $10,000, is assigned to the real estate distributed to her.

In contrast, if Renee had retained her partnership interest, perhaps by not receiving the cash distribution, her basis in the land distributed to her would be $14,000, as the partnership's basis would carry over to her.

Cash and Property Distributed[88]

When a partner receives cash and property in liquidation of their interest, the amount of cash is first subtracted from their outside basis. Any remaining basis is then apportioned to the property distributed. If multiple assets exist, the basis is next assigned to hot assets, valued at their adjusted basis in the partnership's hands. To the extent that any portion of the partner's outside basis remains, it is allocated among remaining assets.

Special allocation rules apply under §732(c) in situations in which the distributee-partner's partnership basis required to be allocated among the distributed assets is greater (in the case of a liquidating distribution) or less (in the case of current or liquidating distributions) than the partnership's aggregate bases in those assets.

Step 1. These rules allocate a distributee-partner's basis adjustment among distributed assets first to unrealized receivables and inventory items in an amount equal to the partnership's basis in each such property, as under the usual rules.

Step 2. To the extent of any basis not allocated in accordance with step 1, basis is allocated first to the extent of each distributed property's adjusted basis to the partnership. Any remaining basis adjustment, if an increase, is allocated among properties with unrealized appreciation in proportion to their respective amounts of unrealized appreciation (to the extent of each property's appreciation), and then in proportion to their respective FMVs.

Example 13. The XYZ partnership has two assets, A and B, which are both distributed in liquidation to Yolanda, whose basis in the partnership interest is $55. Neither asset consists of inventory or unrealized receivables. Asset A has a basis to the partnership of $5 and an FMV of $40. Asset B has a basis to the partnership of $10 and an FMV of $10. Yolanda's basis in the partnership is first allocated $5 to asset A and $10 to asset B (their respective adjusted bases to the partnership).

Yolanda's remaining basis in the partnership is $40 ($55 original basis − $15 partnership's total basis in distributed assets). This basis is then allocated to asset A in the amount of its unrealized appreciation of $35 ($5 partnership basis – $40 FMV). No allocation is attributable to asset B for unrealized appreciation because its FMV equals the partnership's adjusted basis in it. The remaining basis adjustment of $5 is then allocated in the ratio of the assets' FMVs. Therefore, the remaining basis is allocated $4 to asset A ($5 basis adjustment × ($40 FMV for asset A ÷ $50 FMV for both assets)) and $1 to asset B ($5 basis adjustment × ($10 FMV for asset B ÷ $50 FMV for both assets)). After these allocations, asset A has a total basis of $44 ($5 + $35 + $4), and asset B has a total basis of $11 ($10 + $1).

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88. Treas. Regs. §§1.732-1(b) and (c)(1).

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Step 3. Any remaining basis adjustment that is a decrease arises when the partnership's total adjusted basis in the distributed properties exceeds the amount of the partner's basis in its partnership interest, and the latter amount is the basis to be allocated among the distributed properties (nonliquidating distributions). If the partner's basis to be allocated is less than the sum of the adjusted bases of the properties in the hands of the partnership, then, to the extent a decrease is required to make the total adjusted bases of the properties equal to the basis to be allocated, the decrease is allocated in the following order.

- Among properties with unrealized depreciation in proportion to their respective amounts of unrealized depreciation (to the extent of each property's depreciation)
- In proportion to their respective adjusted bases (taking into account the adjustments already made)

Example 14. Andy is a partner in a partnership, and his outside basis in it is $10,000.[89] The partnership is terminating and it distributes two depreciable machines to Andy: a copier and a drill press. In the hands of the partnership, the copier's adjusted basis is $7,500, and its FMV is also $7,500. The drill press has a $2,500 FMV and an adjusted basis of $7,500.

Because of this difference, Andy must allocate his basis in the machines in two steps. In step 1, Andy allocates a provisional basis to each machine based on its adjusted basis. Thus, the copier has a provisional basis of $7,500, and the drill press has a provisional basis of the same amount. Because the total basis of the two machines exceeds Andy's outside basis in his partnership interest by $5,000 ($7,500 copier basis + $7,500 provisional drill press basis – $10,000 outside basis), he must reduce the basis in the drill press by the lesser of its unrealized depreciation ($5,000, which is $2,500 FMV – $7,500 adjusted basis) and his outside basis in the partnership ($10,000).

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Although a partner increases their basis when they accept a distribution of an asset encumbered with recourse debt they are liable to repay, the increase in basis is permitted "to the extent of the" FMV of the asset.[90] This has no effect if an asset's FMV exceeds its basis. However, the basis associated with an asset declining in value may be limited by its FMV rather than the basis itself.[91]

Example 15. Use the same facts as **Example 14,** except that the drill press is subject to recourse debt with a principal amount of $5,000, which Andy accepts with the distribution. Generally, Andy's outside basis in the partnership would increase by the amount of the liability secured by the drill press, or $5,000. However, because the drill press has an FMV less than the amount of the liability, his outside basis increases only by $2,500, the FMV of the drill press. In this instance, Andy's basis becomes $12,500 ($10,000 outside basis before distribution + $2,500 increase in outside basis limited by the FMV of the drill press).

Holding Period and Character of Distributed Assets.[92] In general, a partner's holding period for an asset distributed to them includes the period that the partnership owned the asset. However, if **inventory** has been distributed to a partner, its disposition results in ordinary gain or loss if the partner disposes of it within five years from the time it is distributed to them. If **unrecognized receivables** are distributed to a partner, they always result in ordinary income or loss, regardless of when the partner disposes of them.

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89. This example is a modified version of the example appearing on page 6 of Pub. 541, *Partnerships* (2022).

90. IRC §752(c).

91. Treas. Reg. §1.752-1(e). Although this principle is illustrated for terminating partnerships, it also applies to continuing partnerships.

92. IRC §735.

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Precontribution Gain on Contributed Assets. The Code provides special rules that may alter the tax impact of distributions to partners who have contributed property to the partnership with a built-in gain or loss. This type of property is commonly referred to as §704(c) property. Under §737, if a partner who contributed property with a built-in gain receives other property in a distribution in the seven years following the contribution, then that partner will have a gain recognition event.[93] IRC §737 does not differentiate between liquidating and continuing distributions. Thus, §704(c) gain can be triggered in a liquidating distribution. The contributing partner must recognize gain equal to the lesser of the remaining unrecognized §704(c) gain or the excess of the current FMV of the distributed property over the adjusted basis of the partner's interest.

Thus, §704(c) requires recognition of precontribution gain associated with contributed property to be specially allocated to the partner who contributed it. If the contributing partner is no longer a partner when the underlying property is sold, this cannot be accomplished. However, §737 ensures that the contributing partner recognizes the gain on property that the partner has effectively converted to another form, either through cash distributions from the partnership or through receiving other property. The gain is not necessarily equal to the partner's excess distribution, which is the amount by which the distributed property's FMV exceeds the partner's adjusted basis in the partnership.[94]

The gain recognized by the partner is limited to the lesser of the following amounts.[95]

- Excess distribution
- Partner's net precontribution gain

The partner's excess distribution is the amount by which the distributed property's FMV exceeds the partner's adjusted basis in the partnership.[96] The partner's net precontribution gain is the difference between the partner's adjusted book value in the distributed property and their adjusted tax basis at the time of the distribution.[97]

The partner who contributed the property has then paid tax on the precontribution gain from the original property. IRC §737(c)(2) provides the partnership with a step-up in basis equal to the gain recognized by the departing partner.

Example 16. In December, 2022, John, George, and Ringo form Cicada, LLC as equal members. The partners contribute the following assets.

- John contributes a specialty sound recording machine with an FMV of $30,000 and an adjusted tax basis of $20,000.
- George contributes a piece of artwork with an FMV and adjusted tax basis of $30,000.
- Ringo contributes $30,000 of cash.

The sound recording machine has a remaining useful life of 10 years and is depreciated using the straight-line method. The **book** depreciation in 2023 is $3,000 ($30,000 FMV ÷ 10 years) allocated equally among the partners. The **tax** depreciation for 2023 is $2,000 ($20,000 adjusted tax basis ÷ 10 years) and this is allocated 50% each to George and Ringo.

In 2024, John decides that he no longer wants to be a partner of Cicada, LLC. His outside basis in his partnership interest remains unchanged at $20,000 because he was not allocated any tax depreciation. The book value of the sound recording machine is $27,000 ($30,000 FMV – $3,000 book depreciation), and the tax basis of the sound recording machine is $18,000 ($20,000 adjusted tax basis – $2,000 tax depreciation).

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93. IRC §737(c).
94. Treas. Reg. §1.737-1(b)(1).
95. Treas. Reg. §1.737-1(a)(1).
96. Treas. Reg. §1.737-1(b)(1).
97. Treas. Reg. §1.737-1(c).

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John receives a liquidating distribution of the artwork. The book value of the artwork at the end of 2023 is $30,000. John's tax basis in his partnership interest at the time of the distribution is $20,000 because he was not allocated any tax depreciation. The excess distribution, if any, is the difference between the FMV of the artwork ($30,000) and John's basis in his partnership interest ($20,000), or $10,000. John's net precontribution gain is the difference between the book value of the sound recording machine ($27,000) and its adjusted tax basis at the time of the distribution ($18,000) or $9,000.

John must recognize gain on the distribution that is equal to the lesser of the excess distribution of $10,000 and the net precontribution gain of $9,000.

Note. IRC §737 applies only to built-in **gains.** A partner may also contribute property with a built-in loss. There are special allocations with respect to loss property only to the contributing partner.[98] For the remaining partners, the contributed property is deemed to have a basis equal to its FMV at the time of contribution. The recognition of any built-in loss triggered by a distribution of property may be limited by other provisions.[99]

EFFECT OF LIABILITIES

A partner's outside basis is adjusted for increases and decreases in their share of any debt owed by the partnership. Additional liabilities increase basis while reductions in liabilities reduce basis.

If the partner has sold their interest, they may be relieved of certain partnership liabilities.[100]

Relief from Liabilities

When a partner **sells** their interest to a third party, the selling partner generally transfers a share of the partnership's liabilities to the third party. The selling partner's overall share of the partnership's liabilities is zero if they have sold their entire interest. They treat the reduced amount of liabilities as consideration for their partnership interest.[101] The reduced amount of liabilities is the total of liabilities outstanding before the sale minus the total liabilities after the partner has sold their partnership interest.[102]

The amount of gain or loss a withdrawing partner realizes is equal to the difference between the amount realized and the withdrawing partner's adjusted basis in the partnership interest.[103] The amount realized on the sale or exchange of a partnership interest is calculated as follows.

	Money received
+	FMV of property received
+	Reduction in the partner's share of partnership liabilities
	Amount realized on sale or exchange

Example 17. Mona has a basis in her partnership interest of $30,000, which includes her $20,000 share of partnership liabilities. She sells her entire partnership interest to Luann, an unrelated taxpayer, for $15,000. The amount Mona realizes from the sale is calculated as follows.

Money received	$15,000
Liabilities assumed by purchaser	20,000
Amount realized from the sale	$35,000

98. IRC §704(c)(1)(C).

99. See, e.g., IRC §707(b).

100. See Treas. Reg. §1.707-6(d), example 2, for an example of a partner's receipt of a distributed asset that is encumbered with a nonrecourse liability.

101. Treas. Reg. §1.752-1(h), citing IRC §1001.

102. Ibid.

103. IRC §1001; Rev. Rul. 84-53, 1984-1 CB 159.

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If a **gift** of the partnership interest releases the donor from partnership liabilities, the donor must treat the gift as a disposition.[104] The amount realized from the disposition includes the liabilities from which the donor was released.[105] If the amount realized is greater than the partner's basis, the result is a taxable gain.[106] However, the loss is not deductible if the amount realized is less than the partner's basis.[107]

If only a portion of the partnership interest is transferred by gift, the reduction in the partner's share of partnership liabilities is treated as a cash distribution rather than as an amount received from a sale.[108] Therefore, the transferred liability reduces the donor's basis immediately **before** the gift.

Gifts of partnership interests potentially have the following three implications.[109]

1. The gift's value is the FMV of the property transferred to the recipient minus liabilities transferred.[110] If any gift tax is paid, it is added to the recipient's basis in the property.[111]
2. If the donor recognizes gain because their liability relief exceeds their basis, they must treat the transfer as a deemed sale transaction under Treas. Reg. §1.1001-2(a).
3. If the general partner has unrestricted authority to make or withhold distributions, the gift is of a **future interest** and, therefore, does **not** qualify for the annual exclusion under IRC §2503(b)(1).[112]

Practitioner Planning Tip

Tax practitioners may wish to warn clients that the capital gains they realize from the redemption or sale of a partnership interest are likely going to be greater than they expect because not all of the amount realized assumes the form of cash. The relief of liabilities is treated as money when a partnership interest is redeemed, even though it never touches the retiring partner's hands.

Assumption of Liabilities

When a partner assumes the liabilities of the partnership, they, in effect, are contributing money to the partnership.[113] If the liabilities they assume are attached to property that is also distributed to the partner, they also increase their investment in the partnership, but only to the extent that the amount of debt does not exceed the FMV of the property that is encumbered to the debt. This is not an issue if the property has increased in value since the partnership acquired it. However, if the property has declined in value since the partnership acquired it, the partner's basis is increased only to the extent of the property's FMV on the day it was distributed to the partner.

104. Treas. Reg. §1.1001-2(a)(4)(iii).
105. Treas. Reg. §1.1001-2(a)(1).
106. See Treas. Reg. §1.1001-2(c), example 4.
107. Ibid.
108. Treas. Reg. §1.1001-1(c); IRC §752(b).
109. *Gifts of Partnership Interests*. Ellentuck, Albert. Apr. 1, 2016. AICPA. [www.thetaxadviser.com/issues/2016/apr/gifts-of-partnership-interests.html] Accessed on Mar. 22, 2024.
110. IRC §2512.
111. IRC §1015(a).
112. TAM 9751003 (Aug. 28, 1997).
113. IRC §752(a).

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In other cases, a partnership may terminate by distributing all property with debt still attached to it. In this case, the partner acquiring the property from the terminating partnership treats the debt as though it were not associated with the partnership.[114] When there are both increases and decreases associated with the partner's share of partnership liabilities, the two are netted against each other.[115]

Debt Assumed by Partners Upon Distribution of Assets. A partner in a partnership may receive an asset encumbered with debt that has been distributed by the partnership. In a current distribution of non-cash property from a partnership to a partner, the partnership's basis in the property carries over to the partner. However, if the partner's interest has terminated, the partner's basis in all assets is limited to the partner's **outside** basis in their partnership interest after reduction for any money received by the partner.[116] Their basis is also limited by the assets' FMVs and any associated debt.[117] If the amount of debt attached to an asset exceeds the FMV of the asset, the partner's increase in outside basis is limited to the FMV of the asset.[118]

- If the basis of distributed assets exceeds the partner's outside basis, the bases of any assets distributed is reduced.
- If the basis of distributed assets is less than the partner's outside basis, then their bases are adjusted **up** to the partner's outside basis.

If distributed property is subject to any liabilities assumed by the partner, their basis in the partnership is changed in the following manner.[119]

- Increased by the liabilities assumed in connection with the distribution
- Decreased by the partner's resulting reduction in partnership liabilities
- Decreased by the basis of the distributed property[120]

Example 18. Ryan has a partnership basis of $3,000 and a capital account balance of $2,600 when he decides to retire from the partnership. He receives a liquidating distribution of property with an FMV of $12,000. The property has an adjusted basis to the partnership of $3,000 and is subject to a liability of $10,000. At the time of distribution, $6,000 of the liability was included in Ryan's $30,000 basis. Ryan's information is summarized in the following table.

FMV of property	$12,000
Basis of property	(3,000)
Net unrealized gain on property	9,000
Liability attached to property	10,000

Effective immediately before the distribution, two transactions are deemed to have occurred. First, the partnership recognizes the gain on the property it is about to distribute. For Ryan, this results in a $5,400 gain to his capital account ($9,000 net unrealized gain × 60%).

114. IRC §752(d).
115. Treas Reg. §1.752-1(f).
116. IRC §732(b).
117. Treas. Reg. §1.732-1(b).
118. Treas. Reg. §1.752-1(e).
119. IRC §752. See Treas. Regs. §§1.752-1, 1.752-2, and 1.752-3.
120. IRC §733.

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Second, Ryan's capital account is increased by the incremental liability he is about to assume. In this example, he is increasing his responsibility for the liability associated with the asset by $4,000 ($10,000 total liability – $6,000 already allocated to him). With these two adjustments, Ryan's capital account increases to $12,000 immediately before the distribution of the property, as shown in the following table.

	Ryan	Other Partners	Total
Partnership ownership	60%	40%	100%
Opening capital account	$ 2,600	$1,733	$4,333
Book gain on property	5,400	3,600	9,000
Net increase in capital account from assumption of partnership liability	4,000		
Capital account prior to distribution	$12,000		
Distribution	(12,000)		
Closing capital account	$ 0		

Upon receiving the distribution, Ryan's capital account is reduced to $0 ($2,600 opening capital balance + $5,400 gain on property + $4,000 Ryan's net increase in liability – $12,000 FMV of property distributed), and he has retired from the partnership. Ryan's adjusted basis in the property distributed to him is $12,000 ($3,000 opening outisde basis + $9,000 unrealized gain).

HOT ASSETS

The general rule that a partner's sale or exchange of their partnership interest triggers capital gain does not apply to the extent the gain realized on the transaction is attributable to **hot assets.** Hot assets (as defined under §751) include the following.

- Unrealized receivables
- Inventory items of the partnership

When the withdrawing partner transfers their interest, the partnership has either not recognized income that the hot assets generate (in the case of unrealized receivables) or the value of the assets may change, even though the partnership has recognized income from them (in the case of substantially appreciated inventory). In either case, the partner would eventually recognize **ordinary** income from them. The partner must receive an allocation of ordinary income, which is taxed at ordinary income tax rates.

The partner's sale or exchange of their interest merely accelerates the recognition of the ordinary income (such as with depreciation recapture). Thus, the income on the transaction is recharacterized from capital to ordinary.[121] The rationale for the recharacterization is that, if the partnership were to sell such hot assets, ordinary income or loss would be recognized on the sale. Thus, when a partner sells or exchanges a partnership interest, the partner should recognize ordinary income on the portion of the income from the sale of the partnership interest that is attributable to the hot assets.

Observation. If this recharacterization rule did not apply, a partner would be able to transform what would have been ordinary income into capital gain by selling or exchanging their partnership interest.

However, a **proportionate** distribution of hot assets does not trigger the provisions of §751.[122] For example, if a 20% partner withdraws from a partnership and receives a 20% distribution of the entity's hot assets, §751 does not require the partner to recognize ordinary income. However, if a partner receives a disproportionate distribution, the provisions are triggered.

121. IRC §751(a).

122. IRC §751(b)(1).

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When a partnership distributes property to a partner in exchange for the partner's interest in the hot assets of the partnership, the transaction may be treated as a sale or exchange of the hot assets between the partner and the partnership, generating ordinary income.

As defined by §751, a liquidating distribution of cash may require the former partner to recognize ordinary gain on the distribution of hot assets. The withdrawing partner's outside basis in the partnership is allocated among distributed items in the following sequence.

1. Money, including cash, marketable securities, and any net decrease in the partner's share of partnership liabilities[123]
2. Hot assets, valued at the partnership's inside basis in them[124]
3. Other assets[125]

5

In the following circumstances, the rules for hot assets do not apply.[126]

- A withdrawing partner receives a distribution of property they previously contributed to the partnership.
- The property received by the retiring partner is their distributive share of the partnership's income or a guaranteed payment.

TYPES OF §751 HOT ASSETS

IRC §751 defines two broad classes of assets for which a partner must recognize ordinary income upon receiving a distribution of them: unrealized receivables and substantially appreciated inventory.

Unrealized Receivables

According to §751(c) and Treas. Regs. §§1.751-1(c)(4)(iii) and (v), there are three categories of unrealized receivables.

1. Goods
2. Services
3. Recapture items

The term unrealized receivables includes money owed to a taxpayer using the **cash receipts and disbursements method** for work already performed or goods already provided.[127] However, the accounts receivable of an **accrual method** taxpayer are considered inventory items, not unrealized receivables,[128] as the income for an accrual basis taxpayer would have been realized. The scope of unrealized receivables reaches far beyond trade receivables. Anything receivable that could generate ordinary income upon receipt of payment is also treated as an unrealized receivable for purposes of §751(c), including the following.[129]

- Property subject to recapture of depreciation under IRC §§1245 and 1250
- Market discount bonds and short-term obligations
- Stock of certain controlled foreign corporations

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123. IRC §§732(b), 731(c), and 752(b).
124. Treas. Reg. §1.732-1(c)(1)(i).
125. Treas. Reg. §1.732-1(c)(1)(ii).
126. IRC §751(b)(2); IRS Pub. 541, *Partnerships*.
127. IRC §446(c)(1); Treas. Reg. §1.751-1(c).
128. IRC §446(c)(2); Treas. Reg. §1.751-1(d)(2)(ii).
129. IRS Pub. 541, *Partnerships*, p. 12 (2022).

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- Oil, gas, or geothermal property for which intangible drilling costs were deducted
- Franchises, trademarks, or trade names
- Certain farmland for which expenses for soil and water conservation or land clearing were deducted
- Stock in a domestic international sales corporation (DISC)
- Mining property for which exploration expenses were deducted

If a partner's interest in a partnership is being sold on an installment basis under IRC §453, they must recognize §1245 recapture as ordinary income in the year of the sale, thus making the recapture ineligible for installment sale treatment.[130] The recapture may take one of the following two forms.

- §1245 recapture income to the extent that it is included in unrealized receivables under §751
- §1250 **recapture** income to the extent that it is included in unrealized receivables

In both cases, the recapture income is limited to the amount that would be considered an unrealized receivable under §751.[131] Because §1250 recapture income is associated with a tax provision that ended with the Tax Reform Act of 1986, this type of income is rarely seen.

Note. Although part of a liquidating distribution is associated with §751 assets and results in ordinary income, this does **not** also convert it to self-employment (SE) income to the selling partner. For example, the sale of inventory by a partnership may result in SE income for certain partners of a continuing partnership. However, Treas. Reg. §1.1402(a)-6(a) expressly prevents the ordinary income from depreciation recapture under §1231 being considered SE income.

Example 19. The Callisto Partnership is terminating on December 31, 2024, making its two partners, Ned and Lydia, retiring partners. The partnership has $10,000 cash and two identical pieces of machinery, each having an original cost of $4,000, an FMV of $3,000, and a remaining basis of $2,500. The machinery qualifies as §1245 property, and each unit potentially has $1,500 of depreciation recapture ($4,000 original cost – $2,500 remaining basis).

That morning, Lydia and Ned receive checks for $5,000, which they promptly deposit at their respective banks. One piece of machinery is distributed to Lydia and the other to Ned. Because the distribution of the machinery is proportionate, Lydia and Ned do not need to recognize $1,500 of ordinary income when they receive the distribution of the machinery. They can defer recognizing this income because each receives a proportionate distribution of the machinery. The depreciation associated with each piece of machinery would be an unrealized receivable, but the proportionate distribution of the partnership's assets does not fall under §751.

Even if a portion of the income associated with terminating their interests is ordinary income, Lydia and Ned do not need to report any SE income on their tax returns associated with it.

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130. IRC §453(i).

131. IRC §453(i)(2).

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Substantially Appreciated Inventory

Inventory is also included among hot assets. This is always the case when partnership interests are sold or exchanged, as provided by §751(a), but only to the extent that it is considered to have appreciated substantially when §751(b) requires that a distribution be treated as a sale or exchange. This threshold of substantial appreciation is met if the inventory's FMV exceeds 120% of the partnership's adjusted basis in the property. The definition of inventory is broadened to include the following.[132]

- Property that the partnership would properly include in inventory if on hand at the end of the tax year or that the entity offers for sale to customers in the normal course of business.
- Property that, if the partnership sold or exchanged it, would not be a capital asset or §1231 property (real or depreciable business property held for more than one year). For example, accounts receivable acquired for services or from the sale of inventory and unrealized receivables are inventory items.
- Property held by the partnership that would be considered inventory if held by the partner selling their interest or receiving the distribution.

An accrual method taxpayer establishes basis in its trade accounts receivable when it recognizes revenue.[133] Because customers of a taxpayer are typically unwilling to pay more for services or goods than have been contracted for and have already been invoiced, the FMV of an accrual basis taxpayer accounts receivable generally do not increase.

Example 20. Isaac and Owen formed the Io Partnership many years ago and have always used accrual method accounting. They terminate Io on December 31, 2024, when its only two assets are $10,000 cash and accounts receivable of $10,000. Because the accounts receivable has already been recognized as income, it is considered inventory for purposes of §751. However, its FMV has not changed since the sale was finalized, and the revenue was recognized on December 10. Because it uses the accrual method of accounting, Io established its $10,000 basis in the accounts receivable on that day. The value of accounts receivable does not generally increase if the receivables are collectible. Io's accounts receivable would have had to increase to $12,000 ($10,000 basis × 120%) by December 31, 2024, to have substantially appreciated, which they did not. Because they have not substantially appreciated, Io's accounts receivable are not considered a hot asset when the partnership terminates at the end of December.

EFFECT ON DISTRIBUTIONS

Hot assets complicate the withdrawing partner's tax return. Even if the sales agreement states that only the partnership interest is being sold, §751 pulls the sale of hot assets onto the partner's tax return. The simplest scenario is discussed first and occurs when the agreement clearly communicates that a **proportionate transfer** of all partnership assets is being sold. The transfer may be accomplished by sale, redemption, gift, or bequest.

Another scenario involves the **disproportionate transfer** of assets, either by sale or liquidating distribution. This can happen when the partner sells their partnership interest for cash, omitting explicit mention of the hot assets in the sales agreement. A variation involves the sale of some hot assets disproportionately to the partner's interest.

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132. IRS Pub. 541, *Partnerships*, p. 12 (2022).

133. Treas. Reg. §1.451-1(a), which provides for income to be included in gross income when all events have occurred that fix the right to receive the income, thereby establishing basis in the accounts receivable.

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Proportionate Distributions of Hot Assets

If a withdrawing partner receives a proportionate distribution of the partnership's hot assets, they do not need to make any special adjustments. With a proportionate distribution, the partner recognizes their proportion of the income that the asset eventually generates. When the asset is §1245 property, its eventual sale generates ordinary income, for example.[134]

Gain or Loss Recognized by the Withdrawing Partner. As long as the withdrawing partner does not receive more or less than their proportionate share of the partnership's hot assets, they recognize gain only if the FMV of money received and relief of liabilities exceeds their outside basis in the partnership prior to the distribution.[135]

The withdrawing partner can recognize a loss if their distribution consists of nothing other than cash, marketable securities, and hot assets. If they receive a capital asset as part of a liquidating distribution, they do not recognize a loss.[136] A capital loss can only be recognized if the retiring partner has outside basis remaining after a reduction for money received, hot assets received, and relief of liabilities and no other property is distributed. Otherwise, this remaining basis would be assigned to any capital asset distributed to the retiring partner.

Disproportionate Transfers of Hot Assets

If a partnership has hot assets and a partner withdraws from it, §751 requires the partner to recognize a distribution of hot assets. For example, if the withdrawing partner receives only cash, they have received a disproportionate distribution of hot assets, regardless of their intent.

Gain or Loss Recognized by the Withdrawing Partner. The withdrawing partner must use a series of three transactions to reflect the disproportionate distribution of hot assets. Collectively, these transactions have no cash effect but apply §751 requirements to the disproportionate transfer of hot assets.

For the **first transaction,** the partner who has received a cash or disproportionate distribution associated with their withdrawal from the partnership is deemed to have received their share of the partnership's hot assets as a distribution. Their proportionate share is based on their interest in partnership capital, not their profits interest, at the time of redemption.[137]

The **second transaction** that is deemed to occur is the sale of the same hot assets. If the partner is selling their interest, they transfer the hot assets to the buyer for a portion of the price. If the partner is liquidating their interest, they are selling their interest back to the partnership. In either case, the amount realized for this portion of the disposition is their proportionate share of the FMV of the hot assets. The withdrawing partner recognizes gain on the sale of the hot assets based on their bases.

The **third transaction** is the conveyance of the actual partnership interest. The partnership interest is transferred to its buyer in a sales transaction. Alternatively, it is surrendered to the partnership if the partner is retiring and the partnership is redeeming the partner's interest.

With this series of deemed transactions, the withdrawing partner has reconstituted their transaction so that the partnership has distributed a proportionate share of hot assets to the withdrawing partner. The rules for recognition of gain or loss and basis in assets for proportionate distributions apply, as stated previously.

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134. Treas. Reg. §1.751-1(c)(4)(iii).

135. IRC §751(a); Treas. Reg. §1.751-1(b)(1)(ii).

136. Ibid.

137. Treas. Reg. §1.751-1(g), examples 1–6 each contain references to determining proportionate interest in the partnership's assets based on their proportionate share of partnership capital, as cited in *Determining a Partner's Share of Unrealized Receivables At the Liquidation of the Partner's Interest*. Utz, Stephen. Oct. 2000. Taxes: The Tax Magazine. [papers.ssrn.com/sol3/papers.cfm?abstract_id=248150] Accessed on Feb. 26, 2024. The required use of the partner's interest in the partnership's capital is inferred from these examples, rather than by its explicit reference in the regulations they exemplify.

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Example 21. Use the same facts as **Example 19,** except that Lydia and Ned receive disproportionate distributions of cash and the machinery. Lydia receives $8,000 cash, and Ned receives $2,000 cash and both machines.

The termination of their partnership interests starts with the first transaction. For Lydia, she is deemed to have received a distribution of a 1/2 interest in both pieces of machinery. For her second transaction, she is deemed to have sold her interest in the two machines to the partnership, recognizing ordinary income of $1,500 as she recaptures the depreciation on the machinery. For the final transaction, she receives a distribution of cash for her partnership interest.

Ned is deemed to have a $3,000 gain ($6,000 FMV for both machines – ($8,000 total cash provided to Lydia – $5,000 her 50% share of partnership cash)). Of this amount, $1,500 is ordinary income and $1,500 is capital gain income ($3,000 gain – $1,500 ordinary gain).

Example 22. Aaron and Becca are equal partners in the Neptune partnership.[138] On March 1, 2024, Becca sells her interest in Neptune to Tim, for which he pays her $30,000. Neptune's February 29, 2024, balance sheet follows, showing both adjusted basis and FMV. Becca's outside basis is $18,000, the same as her inside basis.

	Adjusted Basis per Books	FMV
Assets		
Cash	$ 6,000	$ 6,000
Loans receivable	20,000	20,000
Land	14,000	10,000
Unrealized receivables	0	28,000
Total assets	$40,000	$64,000
Liabilities and Capital		
Liabilities	$ 4,000	$ 4,000
Capital		
Aaron	18,000	30,000
Becca	18,000	30,000
Total liabilities and capital	$40,000	$64,000

Becca realizes $32,000 on the sale of her interest to Tim ($30,000 cash + $2,000 assumption of Neptune's liabilities ($4,000 × 1/2)). If it were not for §751, Becca would recognize a capital gain on her interest in the Neptune partnership of $12,000 ($32,000 realized on sale – $20,000 basis).

However, Neptune has unrealized receivables and §751 applies. Becca is deemed to have received her share of them as a distribution, which she passes to Tim. She recognizes **ordinary** income on the sale of the unrealized receivables in the amount of $14,000 (1/2 × ($28,000 FMV of unrealized receivables – $0 basis)). This amount is subtracted from the total gain she would otherwise receive of $12,000.

Consequently, Becca recognizes ordinary income of $14,000 and a capital loss of $2,000 ($12,000 total gain – $14,000 considered ordinary gain). In this case, Becca has a less favorable result as a consequence of the §751 regulations, as they convert capital gain income into ordinary income.

138. Based on Treas. Reg. §1.751-1(g), example 1.

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Basis Adjustments Due to a Terminating Interest.[139] **Example 22** assumes that the partner's outside basis equals their inside basis and that the hot assets have no basis. When these assumptions are removed, the calculations change. If a partnership has hot assets with bases greater than $0, the assets' bases may be reduced by the basis limit imposed by a terminating distribution. Because the partner receiving a liquidating distribution must have zero basis after receiving the liquidating distribution, the hot assets' bases may be reduced if the partner's outside basis in the partnership is less than their inside basis.

Example 23. Use the same facts as **Example 22,** except that Becca's **outside** basis in the Neptune partnership is $10,000, including her share of its liabilities, and the basis of the unrealized receivables is $10,000. Neptune's February 29, 2024, balance sheet follows.

	Adjusted Basis per Books	FMV
Assets		
Cash	$ 6,000	$ 6,000
Loans receivable	20,000	20,000
Land	14,000	10,000
Unrealized receivables	10,000	28,000
Total assets	$50,000	$64,000
Liabilities and Capital		
Liabilities	$ 4,000	$ 4,000
Capital		
Aaron	23,000	30,000
Becca	23,000	30,000
Total liabilities and capital	$50,000	$64,000

Becca still realizes $32,000 on the sale of her interest to Tim because she receives $30,000 and is still relieved of $2,000 of partnership liabilities. However, her total gain, is now increased to $22,000 ($32,000 consideration received – $10,000 outside basis).

Caution. Many factors complicate the determination of whether a particular distribution is disproportionate. For more information on this topic, see the 2006 *University of Illinois Federal Tax Workbook*, Chapter 5: Partnerships. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

In addition, §732 may require the adjustment of the withdrawing partner's basis in §751(b) property. For more information, see §732(c) and Treas. Reg. §1.732-1(c).

The situation in **Example 23** does not materially change once the partnership terminates. The regulations do not establish separate rules to govern the deemed sales of hot assets by terminating partnerships. However, it is more likely that the partnership will have liquidated all §751 assets prior to making final liquidating distributions to its partners, thus removing the need for allocating some portion of any capital gain to the hot assets' ordinary income. It is possible, however, for a terminating partnership to distribute §751 assets to its partners, who may subsequently sell them or otherwise recognize ordinary income.[140]

139. Treas. Reg. §1.732-1(b).

140. Treas. Reg. §1.751-1.

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QBID[141]

Qualified business income (QBI) includes the net amount of qualified items of income, gain, deduction, and loss for any qualified trade or business conducted within the United States. Ordinary income generated by hot assets is taken into consideration when computing QBI.

If available, the qualified business income deduction (QBID) is generally 20% of the taxpayer's QBI, less its net capital gain. Thus, any hot asset transaction potentially generates QBI, and possibly provides an exiting partner with QBID.

> **Note.** For more information about QBID, see the 2018 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 2: Small Business Issues and the 2019 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 1: QBID Update. These can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

Depreciation Recapture[142]

The potential recapture of accumulated depreciation of §1245 property is considered an unrealized receivable or a hot asset. The calculation of ordinary income from accumulated depreciation considers the proceeds generated by the potential sale of §1245 assets for their FMV. Because the depreciation recapture generated by §1245 property is a hot asset, the recapture can generate QBI.

Example 24. On January 5, 2022, Peter, Pat, Penny, and Patsy formed the Pluto partnership as equal partners. Pluto manufactures gyroscopes and is not a specified service trade or business. Pluto operates entirely within the United States. Each partner purchased their interest with a $100,000 cash capital contribution, used to purchase manufacturing assets for the business.

On October 31, 2024, Penny announces she wishes to leave Pluto. Because the seasonal demand for gyroscopes is depressed, Pluto has no inventory or accounts receivable. The assets that Pluto purchased with its starting capital have been 50% depreciated. The FMV of the assets has declined to $360,000. Thus, Pluto has unrealized receivables of $160,000 ($360,000 FMV − ($400,000 original basis of equipment purchased × 50% depreciation)) associated with the depreciation that Pluto would recapture if it sold the equipment. Pluto determines this value on December 31, 2024, Penny's last day as a partner. Thus, Pluto reports $40,000 of unrealized receivables to Penny ($160,000 unrealized receivables × Penny's 1/4 partnership interest). This amount represents her share of Pluto's unrealized receivables that she must treat as ordinary income on her tax return.

Penny can include this income with her other sources of QBI. Her QBID from unrealized receivables can be up to $8,000 ($40,000 QBI × 20% deduction).

> **Note.** For more information about the implications of QBID for partnerships, see the 2022 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 3: Partnership Basics. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

141. Treas. Reg. §1.199A-3(b); and IRC §199A.

142. Treas. Reg. §1.751-1(c).

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REPORTING THE TERMINATION OF A PARTNER'S INTEREST

A partner terminating their interest in a partnership should receive a Schedule K-1 (Form 1065) marked as final. The information on the Schedule K-1, in conjunction with the partner's basis, determines any gain or loss the partner must report on their personal income tax return.

A tax return for a partner ending their partnership interest may report the entity's activities similarly to the way they have reported the same activities in prior years.[143] Although Schedule K-1 (Form 1065) contains a checkbox marked "Final K-1," the instructions make no reference to it.[144] Designating a Schedule K-1 as final may allow a partner to recognize suspended losses,[145] providing the partner has sufficient outside basis to take them.[146] Several questions can arise when completing a final tax return.

DETERMINING THE YEAR OF THE FINAL RETURN

If a partnership files its tax returns on a calendar year basis, the date on the Schedule K-1 (Form 1065) showing the partnership's final date may not correspond to the entity's prior calendar year closing. For example, if a partnership has used a calendar year basis, but its operations end in February one year, the entity must file its Form 1065 with a mid-May filing deadline.[147] Thus, the partner in a partnership that terminates early in the year may have two Schedules K-1 (Form 1065) to address, both of which show the same year. However, its individual partners must report the income from one of those Schedules K-1 on the next calendar year's Form 1040.[148]

Practitioner Planning Tip

The taxpayer has most of the year to misplace the Schedule K-1 that is prepared for a partnership that terminates early in a calendar year. This timing may result in unreported income or suspended tax benefits that are lost. A tax practitioner may suspect that a final Schedule K-1 (Form 1065) is missing if the client brought in a Schedule K-1 (Form 1065) from an entity in the prior year but does not have one for the tax year being prepared. The partnership may have sent one outside of tax season that the client discarded, not realizing it contained important tax information to be included on their tax return.

---

143. 2023 Partner's Instructions for Schedule K-1 (Form 1065).

144. Ibid. The instructions for this Schedule contains no special instructions for the final Schedule K-1 that is sent to a partner.

145. IRC §469(g)(1)(A).

146. IRC §165(b), referring to IRC §1011.

147. IRC §6072(b).

148. Treas. Reg. §1.6031(a)-1(a)(1).

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PARTNER REPORTING TO THE PARTNERSHIP[149]

The partner must notify the partnership that they have sold their interest, assuming that the partnership is not redeeming their interest and is already aware of the transfer. Therefore, when a partner sells or exchanges their interest in the partnership, they must notify the partnership. If they fail to notify the partnership, the partner is subject to the penalties under IRC §6722(b). The selling partner must provide the following information.

- Their name, address, and social security number (SSN) or employer identification number (EIN)
- The buyer's name, address, and SSN or EIN
- The date on which the sale or exchange occurred

The partner's provision of this information to the partnership enables it to prepare Form 8308, *Report of a Sale or Exchange of Certain Partnership Interests,* and Schedule K-1 (Form 1065). The partner's deadline for reporting this information to the partnership is the earliest of the following.

- 30 days after the sale or exchange of their partnership interest
- January 15 of the succeeding year

The reporting requirement applies to exchanges defined in §751(a). Consequently, the donor of a gifted interest in a partnership does not have an obligation to report this information to the partnership.[150]

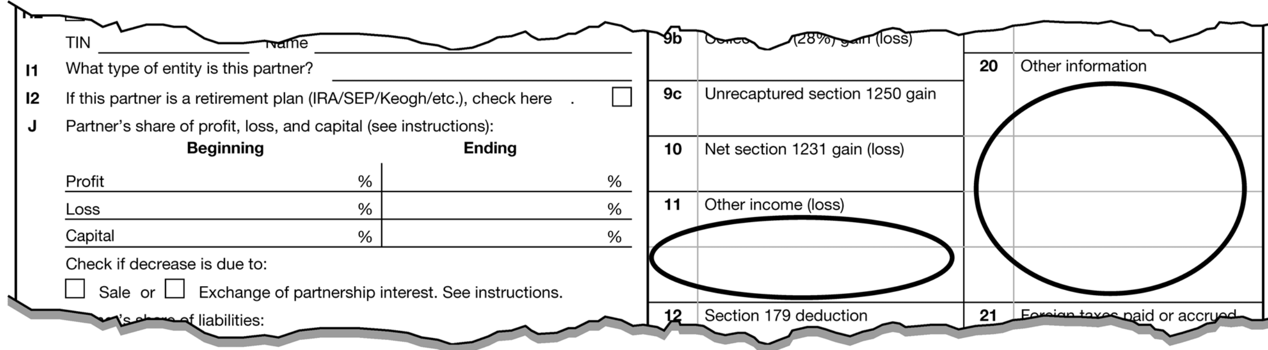
IRC §6045 contains an exception for transactions that are reported by a broker, thus relieving partners in many publicly traded partnerships from this reporting responsibility. However, the Code has no de minimis exception for small partnerships, leaving their partners and their tax practitioners with a critical responsibility.

If a partner fails to report the information associated with their sale or exchange of a partnership interest, they are subject to a $50 fine.[151]

PARTNER RECEIPT OF SCHEDULE K-1 (FORM 1065)

The partnership is responsible to report the sale of hot assets to the partner on their Schedule K-1 (Form 1065). The partner should receive a Schedule K-1 (Form 1065) that reports this information in multiple places.[152]

- Box 11, code L reports their share of the partnership's income, gain, or loss from a distribution under §751(b)
- Box 20, code AB reports the §751 gain or loss that is taxed at ordinary income rates
- Box 20, code AC reports the portion of the §751 gain or loss that is taxed at the rate for collectible assets under IRC §1(h)(5)
- Box 20, code AD reports the portion of the §751 gain that is taxed as §1250 unrecaptured gain



TIN ______ Name ______
I1 What type of entity is this partner?
I2 If this partner is a retirement plan (IRA/SEP/Keogh/etc.), check here ☐
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.

9b	(28%) gain (loss)
9c	Unrecaptured section 1250 gain
10	Net section 1231 gain (loss)
11	Other income (loss)
12	Section 179 deduction

20	Other information
21	Foreign taxes paid or accrued

149. IRC §6050K(c); Treas. Reg. §1.6050K-1(d), which provides requirements for information that the partner must provide.

150. Instructions for Form 8308.

151. IRC §6723.

152. 2023 Partner's Instructions for Schedule K-1 (Form 1065).

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The withdrawing partner should also receive a copy of Form 8308 that the partnership files with the IRS, showing that the partner has transferred their interest in the partnership. This form has been expanded for the reporting of partnership interests beginning with those occurring on January 1, 2023.[153]

REPORTING GAIN AND LOSSES

The final Schedule K-1 (Form 1065) a partner receives **likely** reports a variety of income, gains, losses, deductions, and possibly credits. Some of these items, particularly the capital gain or unrecaptured §1250 gains, appear in the boxes for:

- Net short-term capital gain or loss,
- Net long-term capital gain or loss, and
- Unrecaptured §1250 gain.

Capital Gains on Disposition of Partnership Interests

If a partner **exchanges their interest** in the partnership to a successor, any amount they receive may be a capital gain or loss, depending on their outside basis, their allocation of hot assets, and the consideration received.[154] Capital gains from the **sale of assets** appear on the partner's Schedule K-1 (Form 1065) if they had been held longer than a year. Thus, the partner may have two sources of capital gains to report.

Generally, individual partners report gains and losses from their interests in partnerships on Form 8949, *Sales and Other Dispositions of Capital Assets,* which flows to Schedule D (Form 1040), part II, where long-term capital gains and losses are reported.

Note. Nonresident aliens who sell an interest in a partnership doing business in the United States report the sale of their partnership interest on Form 8949. Additionally, nonresident aliens must attach a completed Schedule P (Form 1040-NR), *Foreign Partner's Interests in Certain Partnerships Transferred During Tax Year,* to their tax returns if they sold an interest in a partnership that conducted a U.S. trade or business.[155]

Example 25. Melody has been a $^{1}/_{5}$ partner of the TR partnership since January 1, 2020. On November 1, 2023, she received notification that Howard, another partner owning 50% of TR's capital, wished to purchase the interest of all other partners, paying $1,000 for each percentage interest held. Thus, Melody would receive $20,000 ($^{1}/_{5}$ × $100,000) on December 31, 2023, if she accepts the offer. The partnership would terminate on that date because Howard would be the last remaining individual with an equity interest. TR has no hot assets in December due to a seasonal lull in business and it owns no depreciable assets.

Melody accepts the offer, as do all the other partners. Because of large losses in 2020 and 2021 and distributions in 2022 and 2023, Melody has zero outside basis in the partnership. Thus, the $20,000 she received on December 31, 2023, represents a $20,000 capital gain ($20,000 received – $0 basis) because she has held the interest in TR for longer than one year. Melody reports the gain on Form 8949.

During 2023, TR also sold a small, undeveloped parcel of land for $50,000, having purchased it for $40,000. The land's sale in July created a $10,000 gain ($50,000 sales price – $40,000 cost) that must be allocated among the partners based on their ownership in July, following the provisions of the partnership agreement.

Because this land is a capital asset, Melody's Schedule K-1 (Form 1065) reports it as a $2,000 (($50,000 amount realized – $40,000 basis) × $^{1}/_{5}$ interest in the partnership) long-term capital gain on this form, which is marked final. The $2,000 long-term capital gain appears on her Schedule D (Form 1040), line 12.

---

153. *A look at revised Form 8308*. Kim, Grace and Graves, Emilie. Feb. 1, 2024. AICPA. [www.thetaxadviser.com/issues/2024/feb/a-look-at-revised-form-8308.html] Accessed on Mar. 27, 2024.

154. IRC §§741, 751, 1001, and 1011.

155. 2023 Instructions for Form 8949.

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Reporting the Disposition of Hot Assets

As mentioned previously, when a partner sells their interest in a **continuing partnership,** some portion of the gain or loss associated with the exchange of their interest in the partnership is actually attributed to hot assets. Under §751, a partner must report the sale of their proportionate share of hot assets separately from capital gain items because the sale of hot assets generates ordinary income. Similarly, when a partner reports income from their final Schedule K-1 (Form 1065) received from a **terminating partnership,** they may need to report a portion of their gain as ordinary income from the exchange of hot assets.

Partner Tax Return Reporting of Hot Asset Sales and Distributions. The partner's share of ordinary income from the exchange of hot assets appears in box 11 of their Schedule K-1 (Form 1065). Code L is associated with this ordinary income. This income passes to Form 4797, where it is reported with other ordinary gains in part II, line 10. Assuming a partner is a natural person, this income subsequently passes to Schedule 1 (Form 1040), *Additional Income and Adjustments to Income,* line 4, *Other gains or (losses),* where it is combined with other additions to income.

If some portion of the amount reported as ordinary income from hot assets arises from collectibles or §1250 unrecaptured income, this is reported on Schedule K-1 (Form 1065) in box 20 with code AC or code AD, respectively. Box 20 also reports gain from the exchange of hot assets. This amount is associated with code AB and may equal the amount reported in box 11 if the partnership had no collectibles or depreciable property among its assets.

Note. Treas. Reg. §1.751-1(b)(5) imposes the following notification requirements on partners **with their tax returns** when a distribution of hot assets takes place under other situations, including sales of partnership interests, their liquidation, or possibly even their abandonment if it involves hot assets.[156]

- Computation of any income, gain, or loss
- The gain or loss attributed to §751 property
- Any capital gain or loss on the sale of a partnership interest
- Date on which hot assets were distributed

Example 26. Sam is a 60% partner in P.E. On June 30, 2023, Sam sells his interest in P.E. to Dude. As compensation for his partnership interest, Sam receives $78,000 in cash. This represents the FMV of Sam's share of underlying partnership assets. The partnership assets consist of depreciable equipment (hot assets). Sam receives the following Schedule K-1 (Form 1065) from P.E. that allocates him 60% of the partnership's earnings for the first six months of the year.

156. Treas. Reg. §1.751-1(a)(3), as referenced by Treas. Reg. §1.751-1(b)(5).

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For Example 26

☒ Final K-1 ☐ Amended K-1 OMB No. 1545-0123

Schedule K-1 (Form 1065) **2023**
Department of the Treasury
Internal Revenue Service

For calendar year 2023, or tax year

beginning / / 2023 ending / /

Partner's Share of Income, Deductions, Credits, etc. See separate instructions.

Part I Information About the Partnership

A Partnership's employer identification number
12-1212121

B Partnership's name, address, city, state, and ZIP code
P.E.
1 Main, Anytown IL 61801

C IRS center where partnership filed return: e-file

D ☐ Check if this is a publicly traded partnership (PTP)

Part II Information About the Partner

E Partner's SSN or TIN (Do not use TIN of a disregarded entity. See instructions.)
***-**-1111

F Name, address, city, state, and ZIP code for partner entered in E. See instructions.
Sam Partner
100 Ave, Anytown, IL 61801

G ☒ General partner or LLC member-manager ☐ Limited partner or other LLC member

H1 ☒ Domestic partner ☐ Foreign partner

H2 ☐ If the partner is a disregarded entity (DE), enter the partner's:
TIN ______ Name ______

I1 What type of entity is this partner? Individual

I2 If this partner is a retirement plan (IRA/SEP/Keogh/etc.), check here ☐

J Partner's share of profit, loss, and capital (see instructions):

	Beginning	Ending
Profit	60 %	%
Loss	60 %	%
Capital	60 %	%

Check if decrease is due to:
☒ Sale or ☐ Exchange of partnership interest. See instructions.

K1 Partner's share of liabilities:

	Beginning	Ending
Nonrecourse	$	$
Qualified nonrecourse financing	$	$
Recourse	$ 120,000	$

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 ☐

L **Partner's Capital Account Analysis**

Beginning capital account	$ 0
Capital contributed during the year	$
Current year net income (loss)	$ 29,753
Other increase (decrease) (attach explanation)	$ (29,753)
Withdrawals and distributions	$ (78,000)
Ending capital account	$ 0

M Did the partner contribute property with a built-in gain (loss)?
☐ Yes ☒ No If "Yes," attach statement. See instructions.

N **Partner's Share of Net Unrecognized Section 704(c) Gain or (Loss)**
Beginning $
Ending $

Part III Partner's Share of Current Year Income, Deductions, Credits, and Other Items

Line	Item	Amount	Line	Item	Amount
1	Ordinary business income (loss)	29,753	14	Self-employment earnings (loss)	A 29,753
2	Net rental real estate income (loss)				
3	Other net rental income (loss)		15	Credits	
4a	Guaranteed payments for services				
4b	Guaranteed payments for capital		16	Schedule K-3 is attached if checked ☐	
4c	Total guaranteed payments		17	Alternative minimum tax (AMT) items	
5	Interest income				
6a	Ordinary dividends				
6b	Qualified dividends		18	Tax-exempt income and nondeductible expenses	
6c	Dividend equivalents				
7	Royalties				
8	Net short-term capital gain (loss)		19	Distributions	
9a	Net long-term capital gain (loss)				
9b	Collectibles (28%) gain (loss)		20	Other information	
9c	Unrecaptured section 1250 gain				AB 78,000
10	Net section 1231 gain (loss)				
11	Other income (loss)				
12	Section 179 deduction		21	Foreign taxes paid or accrued	
13	Other deductions				

22 ☐ More than one activity for at-risk purposes*
23 ☐ More than one activity for passive activity purposes*
*See attached statement for additional information.

For IRS Use Only

For Paperwork Reduction Act Notice, see the Instructions for Form 1065. www.irs.gov/Form1065 Cat. No. 11394R Schedule K-1 (Form 1065) 2023

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P.E. provides Sam with the following Form 8308 to report the sale of Sam's interest in the partnership to Dude.

Form **8308** (Rev. October 2023) Department of the Treasury Internal Revenue Service

Report of a Sale or Exchange of Certain Partnership Interests

Go to *www.irs.gov/Form8308* for the latest information.

OMB No. 1545-0123

Name of partnership	Phone number	Employer identification number
P.E.	217-217-2170	12-1212121

Number, street, and room or suite no. If a P.O. box, see instructions.
1 Main

City or town, state or province, country, and ZIP or foreign postal code
Anytown, IL 61801

Part I Transferor Information

Record holder of the partnership interest immediately before transferring that interest:

Name	Identifying number
Sam Partner	***-**-1111

Number and street (including apt. no.)
100 Ave

City or town, state or province, country, and ZIP or foreign postal code
Anytown, IL 61801

Check if the transferor is foreign: ☐

Beneficial owner of the partnership interest immediately before transferring that interest:

Name	Identifying number
Sam Partner	***-**-1111

Number and street (including apt. no.)
100 Ave

City or town, state or province, country, and ZIP or foreign postal code
Anytown, IL 61801

Notice to Transferors: The information on this form has been supplied to the IRS. The transferor in a section 751(a) exchange is required to treat a portion of the gain realized from the exchange as ordinary income. For more details, see Pub. 541, Partnerships.

Statement by Transferor: The transferor in a section 751(a) exchange is required under Regulations section 1.751-1(a)(3) to attach a statement relating to the sale or exchange to their return. See *Instructions to Transferors* on page 3 for more details.

Part II Transferee Information

Record holder of the partnership interest immediately after the transfer of that interest:

Name	Identifying number
Dude	***-**-4444

Number and street (including apt. no.)
18 Omaha

City or town, state or province, country, and ZIP or foreign postal code
Town, IL 61801

Beneficial owner of the partnership interest immediately after the transfer of that interest:

Name	Identifying number
Dude	***-**-4444

Number and street (including apt. no.)
18 Omaha

City or town, state or province, country, and ZIP or foreign postal code
Town, IL 61801

Part III Transfer of Partnership Interest

1 Date of sale or exchange of partnership interest: 06 / 30 / 23

2 Type of partnership interest transferred:

A Capital ☒

B Preferred ☐

C Profits ☐

D Other ☐

For Paperwork Reduction Act Notice, see instructions. Cat. No. 62503I Form **8308** (Rev. 10-2023)

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For Example 26

Form 8308 (Rev. 10-2023) Page **2**

Part IV **Partner's Share of Gain (Loss) Required by Sections 751(a) and 1(h)(5) and (6)**
The amounts in column (c) should be reported to the selling partner on their Schedule K-1 in box 20 using the relevant code.

		(a) Partnership-level deemed sale gain (loss)	**(b1)** Percentage interest in the partnership transferred	**(b2)** Number of units in the partnership transferred	**(c)** Partner-level deemed sale gain (loss)	K-1 box 20 code
1	Section 751(a) gain (loss) . . .	130,000	60		78,000	AB
2	Section 1(h)(5) gain					AC
3	Deemed section 1250 unrecaptured gain					AD

Sign here only if you are filing this form by itself and not with Form 1065.

Under penalties of perjury, I declare that I have examined this return, including accompanying attachments, and to the best of my knowledge and belief, it is true, correct, and complete.

Signature of partnership representative or partner or limited liability company member

Date / /

Sam and his wife, Sarah, file the following Form 1040 and associated schedules to report his allocated income from P.E. and the sale of his interest.

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For Example 26

Form **1040** Department of the Treasury—Internal Revenue Service
U.S. Individual Income Tax Return **2023** OMB No. 1545-0074 IRS Use Only—Do not write or staple in this space.

For the year Jan. 1–Dec. 31, 2023, or other tax year beginning ________, 2023, ending ________, 20____ See separate instructions.

Your first name and middle initial	Last name	Your social security number
Sam	Partner	*** ** 1111
If joint return, spouse's first name and middle initial	Last name	Spouse's social security number
Sarah	Partner	*** ** 3333

Home address (number and street). If you have a P.O. box, see instructions.	Apt. no.
1 Lane	

City, town, or post office. If you have a foreign address, also complete spaces below.	State	ZIP code
Anytown	IL	62338
Foreign country name	Foreign province/state/county	Foreign postal code

Presidential Election Campaign Check here if you, or your spouse if filing jointly, want $3 to go to this fund. Checking a box below will not change your tax or refund. ☐ You ☐ Spouse

Filing Status Check only one box.
☐ Single
☒ Married filing jointly (even if only one had income)
☐ Married filing separately (MFS)
☐ Head of household (HOH)
☐ Qualifying surviving spouse (QSS)
If you checked the MFS box, enter the name of your spouse. If you checked the HOH or QSS box, enter the child's name if the qualifying person is a child but not your dependent: ________

Digital Assets At any time during 2023, did you: (a) receive (as a reward, award, or payment for property or services); or (b) sell, exchange, or otherwise dispose of a digital asset (or a financial interest in a digital asset)? (See instructions.) ☐ Yes ☒ No

Standard Deduction **Someone can claim:** ☐ You as a dependent ☐ Your spouse as a dependent
☐ Spouse itemizes on a separate return or you were a dual-status alien

Age/Blindness **You:** ☐ Were born before January 2, 1959 ☐ Are blind **Spouse:** ☐ Was born before January 2, 1959 ☐ Is blind

Dependents (see instructions): If more than four dependents, see instructions and check here ☐

(1) First name Last name	(2) Social security number	(3) Relationship to you	(4) Child tax credit	Credit for other dependents
			☐	☐
			☐	☐
			☐	☐
			☐	☐

Income

Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld. If you did not get a Form W-2, see instructions.

Attach Sch. B if required.

Standard Deduction for—
- Single or Married filing separately, $13,850
- Married filing jointly or Qualifying surviving spouse, $27,700
- Head of household, $20,800
- If you checked any box under *Standard Deduction*, see instructions.

Line	Description			Line	Amount
1a	Total amount from Form(s) W-2, box 1 (see instructions)			1a	60,000
b	Household employee wages not reported on Form(s) W-2			1b	
c	Tip income not reported on line 1a (see instructions)			1c	
d	Medicaid waiver payments not reported on Form(s) W-2 (see instructions)			1d	
e	Taxable dependent care benefits from Form 2441, line 26			1e	
f	Employer-provided adoption benefits from Form 8839, line 29			1f	
g	Wages from Form 8919, line 6			1g	
h	Other earned income (see instructions)			1h	
i	Nontaxable combat pay election (see instructions)	1i			
z	Add lines 1a through 1h			1z	60,000
2a	Tax-exempt interest	2a	b Taxable interest	2b	
3a	Qualified dividends	3a	b Ordinary dividends	3b	
4a	IRA distributions	4a	b Taxable amount	4b	
5a	Pensions and annuities	5a	b Taxable amount	5b	
6a	Social security benefits	6a	b Taxable amount	6b	
c	If you elect to use the lump-sum election method, check here (see instructions) ☐				
7	Capital gain or (loss). Attach Schedule D if required. If not required, check here ☐			7	(3,000)
8	Additional income from Schedule 1, line 10			8	107,753
9	Add lines 1z, 2b, 3b, 4b, 5b, 6b, 7, and 8. This is your **total income**			9	164,753
10	Adjustments to income from Schedule 1, line 26			10	2,102
11	Subtract line 10 from line 9. This is your **adjusted gross income**			11	162,651
12	**Standard deduction or itemized deductions** (from Schedule A)			12	27,700
13	Qualified business income deduction from Form 8995 or Form 8995-A			13	21,130
14	Add lines 12 and 13			14	48,830
15	Subtract line 14 from line 11. If zero or less, enter -0-. This is your **taxable income**			15	113,821

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For Example 26

Tax and Credits	16	Tax (see instructions). Check if any from Form(s): 1 ☐ 8814 2 ☐ 4972 3 ☐			16	15,656
	17	Amount from Schedule 2, line 3			17	
	18	Add lines 16 and 17			18	15,656
	19	Child tax credit or credit for other dependents from Schedule 8812			19	
	20	Amount from Schedule 3, line 8			20	
	21	Add lines 19 and 20			21	0
	22	Subtract line 21 from line 18. If zero or less, enter -0-			22	15,656
	23	Other taxes, including self-employment tax, from Schedule 2, line 21			23	4,204
	24	Add lines 22 and 23. This is your **total tax**			24	19,860
Payments	25	Federal income tax withheld from:				
	a	Form(s) W-2	25a	8,000		
	b	Form(s) 1099	25b			
	c	Other forms (see instructions)	25c			
	d	Add lines 25a through 25c			25d	8,000
If you have a qualifying child, attach Sch. EIC.	26	2023 estimated tax payments and amount applied from 2022 return			26	
	27	Earned income credit (EIC)	27			
	28	Additional child tax credit from Schedule 8812	28			
	29	American opportunity credit from Form 8863, line 8	29			
	30	Reserved for future use	30			
	31	Amount from Schedule 3, line 15	31			
	32	Add lines 27, 28, 29, and 31. These are your **total other payments and refundable credits**			32	
	33	Add lines 25d, 26, and 32. These are your **total payments**			33	8,000
Refund	34	If line 33 is more than line 24, subtract line 24 from line 33. This is the amount you **overpaid**			34	
	35a	Amount of line 34 you want **refunded to you**. If Form 8888 is attached, check here ☐			35a	
Direct deposit? See instructions.	b	Routing number	c Type: ☐ Checking ☐ Savings			
	d	Account number				
	36	Amount of line 34 you want **applied to your 2024 estimated tax**	36			
Amount You Owe	37	Subtract line 33 from line 24. This is the **amount you owe**. For details on how to pay, go to *www.irs.gov/Payments* or see instructions			37	11,860
	38	Estimated tax penalty (see instructions)	38			

Do you want to allow another person to discuss this return with the IRS? See

Year Ending: December 31, 2023 ***-**-1111

Sam and Sarah Partner

Statement of Sale or Exchange of Interest in Partnership That Has Code Sec. 751 Property

Taxpayer submits the following information in accordance with Reg 1.751-1(a)(3) for the sale or exchange of an interest in (EIN 12-1212121) that had Code Sec. 751 property at the time of sale or exchange:

Date of sale or exchange:	6/30/23
Gain or (loss) attributable to Code Sec. 751 property:	$78,000
Gain or (loss) attributable to capital gain or loss on the sale of the partnership interest:	($29,753)

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For Example 26

SCHEDULE 1 (Form 1040)
Department of the Treasury
Internal Revenue Service

Additional Income and Adjustments to Income

Attach to Form 1040, 1040-SR, or 1040-NR.
Go to *www.irs.gov/Form1040* for instructions and the latest information.

OMB No. 1545-0074
2023
Attachment Sequence No. **01**

Name(s) shown on Form 1040, 1040-SR, or 1040-NR: **Sam and Sarah Partner**
Your social security number: ***-**-1111

Part I Additional Income

Line	Description	Sub-line	Sub-amount	Line	Amount
1	Taxable refunds, credits, or offsets of state and local income taxes			1	
2a	Alimony received			2a	
b	Date of original divorce or separation agreement (see instructions):				
3	Business income or (loss). Attach Schedule C			3	
4	Other gains or (losses). Attach Form 4797			4	78,000
5	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E			5	29,753
6	Farm income or (loss). Attach Schedule F			6	
7	Unemployment compensation			7	
8	Other income:				
a	Net operating loss	8a	( )		
b	Gambling	8b			
c	Cancellation of debt	8c			
d	Foreign earned income exclusion from Form 2555	8d	( )		
e	Income from Form 8853	8e			
f	Income from Form 8889	8f			
g	Alaska Permanent Fund dividends	8g			
h	Jury duty pay	8h			
i	Prizes and awards	8i			
j	Activity not engaged in for profit income	8j			
k	Stock options	8k			
l	Income from the rental of personal property if you engaged in the rental for profit but were not in the business of renting such property	8l			
m	Olympic and Paralympic medals and USOC prize money (see instructions)	8m			
n	Section 951(a) inclusion (see instructions)	8n			
o	Section 951A(a) inclusion (see instructions)	8o			
p	Section 461(l) excess business loss adjustment	8p			
q	Taxable distributions from an ABLE account (see instructions)	8q			
r	Scholarship and fellowship grants not reported on Form W-2	8r			
s	Nontaxable amount of Medicaid waiver payments included on Form 1040, line 1a or 1d	8s	( )		
t	Pension or annuity from a nonqualifed deferred compensation plan or a nongovernmental section 457 plan	8t			
u	Wages earned while incarcerated	8u			
z	Other income. List type and amount:	8z			
9	Total other income. Add lines 8a through 8z			9	
10	Combine lines 1 through 7 and 9. This is your **additional income**. Enter here and on Form 1040, 1040-SR, or 1040-NR, line 8			10	107,753

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 71479F **Schedule 1 (Form 1040) 2023**

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For Example 26

Schedule 1 (Form 1040) 2023 Page 2

Part II Adjustments to Income

Line	Description				Amount
11	Educator expenses			11	
12	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106			12	
13	Health savings account deduction. Attach Form 8889			13	
14	Moving expenses for members of the Armed Forces. Attach Form 3903			14	
15	Deductible part of self-employment tax. Attach Schedule SE			15	2,102
16	Self-employed SEP, SIMPLE, and qualified plans			16	
17	Self-employed health insurance deduction			17	
18	Penalty on early withdrawal of savings			18	
19a	Alimony paid			19a	
b	Recipient's SSN				
c	Date of original divorce or separation agreement (see instructions):				
20	IRA deduction			20	
21	Student loan interest deduction			21	
22	Reserved for future use			22	
23	Archer MSA deduction			23	
24	Other adjustments:				
a	Jury duty pay (see instructions)	24a			
b	Deductible expenses related to income reported on line 8l from the rental of personal property engaged in for profit	24b			
c	Nontaxable amount of the value of Olympic and Paralympic medals and USOC prize money reported on line 8m	24c			
d	Reforestation amortization and expenses	24d			
e	Repayment of supplemental unemployment benefits under the Trade Act of 1974	24e			
f	Contributions to section 501(c)(18)(D) pension plans	24f			
g	Contributions by certain chaplains to section 403(b) plans	24g			
h	Attorney fees and court costs for actions involving certain unlawful discrimination claims (see instructions)	24h			
i	Attorney fees and court costs you paid in connection with an award from the IRS for information you provided that helped the IRS detect tax law violations	24i			
j	Housing deduction from Form 2555	24j			
k	Excess deductions of section 67(e) expenses from Schedule K-1 (Form 1041)	24k			
z	Other adjustments. List type and amount:	24z			
25	Total other adjustments. Add lines 24a through 24z			25	
26	Add lines 11 through 23 and 25. These are your **adjustments to income**. Enter here and on Form 1040, 1040-SR, or 1040-NR, line 10			26	2,102

Schedule 1 (Form 1040) 2023

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For Example 26

SCHEDULE 2 (Form 1040) Department of the Treasury Internal Revenue Service	**Additional Taxes** Attach to Form 1040, 1040-SR, or 1040-NR. Go to *www.irs.gov/Form1040* for instructions and the latest information.	OMB No. 1545-0074 2023 Attachment Sequence No. 02
Name(s) shown on Form 1040, 1040-SR, or 1040-NR: Sam and Sarah Partner		Your social security number: ***-**-1111

Part I Tax

1	Alternative minimum tax. Attach Form 6251			1	0
2	Excess advance premium tax credit repayment. Attach Form 8962			2	
3	Add lines 1 and 2. Enter here and on Form 1040, 1040-SR, or 1040-NR, line 17			3	0

Part II Other Taxes

4	Self-employment tax. Attach Schedule SE			4	4,204
5	Social security and Medicare tax on unreported tip income. Attach Form 4137	5			
6	Uncollected social security and Medicare tax on wages. Attach Form 8919	6			
7	Total additional social security and Medicare tax. Add lines 5 and 6			7	
8	Additional tax on IRAs or other tax-favored accounts. Attach Form 5329 if required. If not required, check here ☐			8	
9	Household employment taxes. Attach Schedule H			9	
10	Repayment of first-time homebuyer credit. Attach Form 5405 if required			10	
11	Additional Medicare Tax. Attach Form 8959			11	
12	Net investment income tax. Attach Form 8960			12	
13	Uncollected social security and Medicare or RRTA tax on tips or group-term life insurance from Form W-2, box 12			13	
14	Interest on tax due on installment income from the sale of certain residential lots and timeshares			14	
15	Interest on the deferred tax on gain from certain installment sales with a sales price over $150,000			15	
16	Recapture of low-income housing credit. Attach Form 8611			16	

(continued on page 2)

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 71478U Schedule 2 (Form 1040) 2023

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For Example 26

SCHEDULE D (Form 1040)
Department of the Treasury
Internal Revenue Service

Capital Gains and Losses

Attach to Form 1040, 1040-SR, or 1040-NR.
Use Form 8949 to list your transactions for lines 1b, 2, 3, 8b, 9, and 10.
Go to *www.irs.gov/ScheduleD* for instructions and the latest information.

OMB No. 1545-0074
2023
Attachment Sequence No. **12**

Name(s) shown on return	Your social security number
Sam and Sarah Partner	***-**-1111

Did you dispose of any investment(s) in a qualified opportunity fund during the tax year? ☐ **Yes** ☒ **No**
If "Yes," attach Form 8949 and see its instructions for additional requirements for reporting your gain or loss.

Part I **Short-Term Capital Gains and Losses—Generally Assets Held One Year or Less** (see instructions)

See instructions for how to figure the amounts to enter on the lines below. This form may be easier to complete if you round off cents to whole dollars.	(d) Proceeds (sales price)	(e) Cost (or other basis)	(g) Adjustments to gain or loss from Form(s) 8949, Part I, line 2, column (g)	(h) Gain or (loss) Subtract column (e) from column (d) and combine the result with column (g)
1a Totals for all short-term transactions reported on Form 1099-B for which basis was reported to the IRS and for which you have no adjustments (see instructions). However, if you choose to report all these transactions on Form 8949, leave this line blank and go to line 1b .				
1b Totals for all transactions reported on Form(s) 8949 with **Box A** checked				
2 Totals for all transactions reported on Form(s) 8949 with **Box B** checked				
3 Totals for all transactions reported on Form(s) 8949 with **Box C** checked				

Line	Description	Line	Amount
4	Short-term gain from Form 6252 and short-term gain or (loss) from Forms 4684, 6781, and 8824 . .	4	
5	Net short-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1	5	
6	Short-term capital loss carryover. Enter the amount, if any, from line 8 of your **Capital Loss Carryover Worksheet** in the instructions	6	( )
7	**Net short-term capital gain or (loss).** Combine lines 1a through 6 in column (h). If you have any long-term capital gains or losses, go to Part II below. Otherwise, go to Part III on the back	7	

Part II **Long-Term Capital Gains and Losses—Generally Assets Held More Than One Year** (see instructions)

See instructions for how to figure the amounts to enter on the lines below. This form may be easier to complete if you round off cents to whole dollars.	(d) Proceeds (sales price)	(e) Cost (or other basis)	(g) Adjustments to gain or loss from Form(s) 8949, Part II, line 2, column (g)	(h) Gain or (loss) Subtract column (e) from column (d) and combine the result with column (g)
8a Totals for all long-term transactions reported on Form 1099-B for which basis was reported to the IRS and for which you have no adjustments (see instructions). However, if you choose to report all these transactions on Form 8949, leave this line blank and go to line 8b .				
8b Totals for all transactions reported on Form(s) 8949 with **Box D** checked				
9 Totals for all transactions reported on Form(s) 8949 with **Box E** checked				
10 Totals for all transactions reported on Form(s) 8949 with **Box F** checked.	78,000	107,753	0	(29,753)

Line	Description	Line	Amount
11	Gain from Form 4797, Part I; long-term gain from Forms 2439 and 6252; and long-term gain or (loss) from Forms 4684, 6781, and 8824	11	
12	Net long-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1	12	
13	Capital gain distributions. See the instructions	13	
14	Long-term capital loss carryover. Enter the amount, if any, from line 13 of your **Capital Loss Carryover Worksheet** in the instructions	14	( )
15	**Net long-term capital gain or (loss).** Combine lines 8a through 14 in column (h). Then, go to Part III on the back	15	(29,753)

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For Example 26

Form 8949 (2023) Attachment Sequence No. **12A** Page **2**

Name(s) shown on return. Name and SSN or taxpayer identification no. not required if shown on other side	Social security number or taxpayer identification number
Sam and Sarah Partnership	***-**-1111

Before you check Box D, E, or F below, see whether you received any Form(s) 1099-B or substitute statement(s) from your broker. A substitute statement will have the same information as Form 1099-B. Either will show whether your basis (usually your cost) was reported to the IRS by your broker and may even tell you which box to check.

Part II **Long-Term.** Transactions involving capital assets you held more than 1 year are generally long-term (see instructions). For short-term transactions, see page 1.

Note: You may aggregate all long-term transactions reported on Form(s) 1099-B showing basis was reported to the IRS and for which no adjustments or codes are required. Enter the totals directly on Schedule D, line 8a; you aren't required to report these transactions on Form 8949 (see instructions).

You *must* check Box D, E, *or* F below. Check only one box. If more than one box applies for your long-term transactions, complete a separate Form 8949, page 2, for each applicable box. If you have more long-term transactions than will fit on this page for one or more of the boxes, complete as many forms with the same box checked as you need.

☐ **(D)** Long-term transactions reported on Form(s) 1099-B showing basis was reported to the IRS (see **Note** above)
☐ **(E)** Long-term transactions reported on Form(s) 1099-B showing basis **wasn't** reported to the IRS
☒ **(F)** Long-term transactions not reported to you on Form 1099-B

1 (a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold or disposed of (Mo., day, yr.)	(d) Proceeds (sales price) (see instructions)	(e) Cost or other basis See the **Note** below and see *Column (e)* in the separate instructions.	Adjustment, if any, to gain or loss If you enter an amount in column (g), enter a code in column (f). **See the separate instructions.** (f) Code(s) from instructions	(g) Amount of adjustment	(h) Gain or (loss) Subtract column (e) from column (d) and combine the result with column (g).
Sale of Partnership Interest	6/30/19	6/30/23	78,000	107,753			(29,753)
2 Totals. Add the amounts in columns (d), (e), (g), and (h) (subtract negative amounts). Enter each total here and include on your Schedule D, **line 8b** (if **Box D** above is checked), **line 9** (if **Box E** above is checked), or **line 10** (if **Box F** above is checked)			78,000	107,753		0	(29,753)

Note: If you checked Box D above but the basis reported to the IRS was incorrect, enter in column (e) the basis as reported to the IRS, and enter an adjustment in column (g) to correct the basis. See *Column (g)* in the separate instructions for how to figure the amount of the adjustment.

Form **8949** (2023)

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For Example 26

Schedule E (Form 1040) 2023 Attachment Sequence No. 13 Page 2

Name(s) shown on return. Do not enter name and social security number if shown on other side.	Your social security number
Sam and Sarah Partnership	***-**-1111

Caution: The IRS compares amounts reported on your tax return with amounts shown on Schedule(s) K-1.

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 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	P.E.	P	☐	12-1212121	☐	☐
B			☐		☐	☐
C			☐		☐	☐
D			☐		☐	☐

	Passive Income and Loss		Nonpassive Income and Loss		
	(g) Passive loss allowed (attach Form 8582 if required)	(h) Passive income from Schedule K-1	(i) Nonpassive loss allowed (see Schedule K-1)	(j) Section 179 expense deduction from Form 4562	(k) Nonpassive income from Schedule K-1
A					29,753
B					
C					
D					
29a Totals					29,753
b Totals					

30	Add columns (h) and (k) of line 29a . . .	30	29,753
31	Add columns (g), (i), and (j) of line 29b . . .	31	( )
32	**Total partnership and S corporation income or (loss).** Combine lines 30 and 31 . . .	32	29,753

Part III Income or Loss From Estates and Trusts

33	(a) Name	(b) Employer identification number
A		
B		

	Passive Income and Loss		Nonpassive Income and Loss	
	(c) Passive deduction or loss allowed (attach Form 8582 if required)	(d) Passive income from Schedule K-1	(e) Deduction or loss from Schedule K-1	(f) Other income from Schedule K-1
A				
B				
34a Totals				
b Totals				

35	Add columns (d) and (f) of line 34a . . .	35	
36	Add columns (c) and (e) of line 34b . . .	36	( )
37	**Total estate and trust income or (loss).** Combine lines 35 and 36 . . .	37	

Part IV Income or Loss From Real Estate Mortgage Investment Conduits (REMICs)—Residual Holder

38 (a) Name	(b) Employer identification number	(c) Excess inclusion from Schedules Q, line 2c (see instructions)	(d) Taxable income (net loss) from Schedules Q, line 1b	(e) Income from Schedules Q, line 3b

39	Combine columns (d) and (e) only. Enter the result here and include in the total on line 41 below .	39	

Part V Summary

40	Net farm rental income or (loss) from **Form 4835**. Also, complete line 42 below . . .	40	
41	**Total income or (loss).** Combine lines 26, 32, 37, 39, and 40. Enter the result here and on Schedule 1 (Form 1040), line 5 . . .	41	29,753
42	**Reconciliation of farming and fishing income.** Enter your **gross** farming and fishing income reported on Form 4835, line 7; Schedule K-1 (Form 1065), box 14, code B; Schedule K-1 (Form 1120-S), box 17, code AN; and Schedule K-1 (Form 1041), box 14, code F. See instructions .	42	
43	**Reconciliation for real estate professionals.** If you were a real estate professional (see instructions), enter the net income or (loss) you reported anywhere on Form 1040, Form 1040-SR, or Form 1040-NR from all rental real estate activities in which you materially participated under the passive activity loss rules . . .	43	

Schedule E (Form 1040) 2023

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For Example 26

SCHEDULE SE (Form 1040) Department of the Treasury Internal Revenue Service	**Self-Employment Tax** Attach to Form 1040, 1040-SR, 1040-SS, or 1040-NR. Go to *www.irs.gov/ScheduleSE* for instructions and the latest information.	OMB No. 1545-0074 2023 Attachment Sequence No. **17**
Name of person with self-employment income (as shown on Form 1040, 1040-SR, 1040-SS, or 1040-NR) Sam Partner	Social security number of person with **self-employment** income	***-**-1111

Part I Self-Employment Tax

Note: If your only income subject to self-employment tax is **church employee income**, see instructions for how to report your income and the definition of church employee income.

A If you are a minister, member of a religious order, or Christian Science practitioner **and** you filed Form 4361, but you had $400 or more of **other** net earnings from self-employment, check here and continue with Part I ☐

Skip lines 1a and 1b if you use the farm optional method in Part II. See instructions.

Line	Description			Line	Amount
1a	Net farm profit or (loss) from Schedule F, line 34, and farm partnerships, Schedule K-1 (Form 1065), box 14, code A			1a	
b	If you received social security retirement or disability benefits, enter the amount of Conservation Reserve Program payments included on Schedule F, line 4b, or listed on Schedule K-1 (Form 1065), box 20, code AQ			1b	( )
	Skip line 2 if you use the nonfarm optional method in Part II. See instructions.				
2	Net profit or (loss) from Schedule C, line 31; and Schedule K-1 (Form 1065), box 14, code A (other than farming). See instructions for other income to report or if you are a minister or member of a religious order			2	29,753
3	Combine lines 1a, 1b, and 2			3	29,753
4a	If line 3 is more than zero, multiply line 3 by 92.35% (0.9235). Otherwise, enter amount from line 3			4a	27,477
	Note: If line 4a is less than $400 due to Conservation Reserve Program payments on line 1b, see instructions.				
b	If you elect one or both of the optional methods, enter the total of lines 15 and 17 here			4b	0
c	Combine lines 4a and 4b. If less than $400, **stop**; you don't owe self-employment tax. **Exception:** If less than $400 and you had **church employee income**, enter -0- and continue			4c	27,477
5a	Enter your **church employee income** from Form W-2. See instructions for definition of church employee income	5a			
b	Multiply line 5a by 92.35% (0.9235). If less than $100, enter -0-			5b	0
6	Add lines 4c and 5b			6	27,477
7	Maximum amount of combined wages and self-employment earnings subject to social security tax or the 6.2% portion of the 7.65% railroad retirement (tier 1) tax for 2023			7	160,200
8a	Total social security wages and tips (total of boxes 3 and 7 on Form(s) W-2) and railroad retirement (tier 1) compensation. If $160,200 or more, skip lines 8b through 10, and go to line 11	8a	60,000		
b	Unreported tips subject to social security tax from Form 4137, line 10	8b			
c	Wages subject to social security tax from Form 8919, line 10	8c			
d	Add lines 8a, 8b, and 8c			8d	60,000
9	Subtract line 8d from line 7. If zero or less, enter -0- here and on line 10 and go to line 11			9	100,200
10	Multiply the **smaller** of line 6 or line 9 by 12.4% (0.124)			10	3,407
11	Multiply line 6 by 2.9% (0.029)			11	797
12	**Self-employment tax.** Add lines 10 and 11. Enter here and on **Schedule 2 (Form 1040), line 4**, or **Form 1040-SS, Part I, line 3**			12	4,204
13	**Deduction for one-half of self-employment tax.** Multiply line 12 by 50% (0.50). Enter here and on **Schedule 1 (Form 1040), line 15**	13	2,102		

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 11358Z **Schedule SE (Form 1040) 2023**

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For Example 26

Form **4797**

Department of the Treasury
Internal Revenue Service

Sales of Business Property

(Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2))

Attach to your tax return.
Go to *www.irs.gov/Form4797* for instructions and the latest information.

OMB No. 1545-0184
2023
Attachment Sequence No. 27

Name(s) shown on return: **Sam and Sarah Partner**
Identifying number: *****-**-1111**

1a	Enter the gross proceeds from sales or exchanges reported to you for 2023 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20. See instructions	1a	
b	Enter the total amount of gain that you are including on lines 2, 10, and 24 due to the partial dispositions of MACRS assets	1b	
c	Enter the total amount of loss that you are including on lines 2 and 10 due to the partial dispositions of MACRS assets	1c	

Part I Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty or Theft—Most Property Held More Than 1 Year (see instructions)

2 (a) Description of property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis, plus improvements and expense of sale	(g) Gain or (loss) Subtract (f) from the sum of (d) and (e)

3	Gain, if any, from Form 4684, line 39	3	
4	Section 1231 gain from installment sales from Form 6252, line 26 or 37	4	
5	Section 1231 gain or (loss) from like-kind exchanges from Form 8824	5	
6	Gain, if any, from line 32, from other than casualty or theft	6	
7	Combine lines 2 through 6. Enter the gain or (loss) here and on the appropriate line as follows	7	
	Partnerships and S corporations. Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 10, or Form 1120-S, Schedule K, line 9. Skip lines 8, 9, 11, and 12 below.		
	Individuals, partners, S corporation shareholders, and all others. If line 7 is zero or a loss, enter the amount from line 7 on line 11 below and skip lines 8 and 9. If line 7 is a gain and you didn't have any prior year section 1231 losses, or they were recaptured in an earlier year, enter the gain from line 7 as a long-term capital gain on the Schedule D filed with your return and skip lines 8, 9, 11, and 12 below.		
8	Nonrecaptured net section 1231 losses from prior years. See instructions	8	
9	Subtract line 8 from line 7. If zero or less, enter -0-. If line 9 is zero, enter the gain from line 7 on line 12 below. If line 9 is more than zero, enter the amount from line 8 on line 12 below and enter the gain from line 9 as a long-term capital gain on the Schedule D filed with your return. See instructions	9	

Part II Ordinary Gains and Losses (see instructions)

10 Ordinary gains and losses not included on lines 11 through 16 (include property held 1 year or less):

(a)	(b)	(c)	(d)	(e)	(f)	(g)
From K-1						**78,000**

11	Loss, if any, from line 7	11	( )
12	Gain, if any, from line 7 or amount from line 8, if applicable	12	
13	Gain, if any, from line 31	13	
14	Net gain or (loss) from Form 4684, lines 31 and 38a	14	
15	Ordinary gain from installment sales from Form 6252, line 25 or 36	15	
16	Ordinary gain or (loss) from like-kind exchanges from Form 8824	16	
17	Combine lines 10 through 16	17	**78,000**
18	For all except individual returns, enter the amount from line 17 on the appropriate line of your return and skip lines a and b below. For individual returns, complete lines a and b below.		
a	If the loss on line 11 includes a loss from Form 4684, line 35, column (b)(ii), enter that part of the loss here. Enter the loss from income-producing property on Schedule A (Form 1040), line 16. (Do not include any loss on property used as an employee.) Identify as from "Form 4797, line 18a." See instructions	18a	
b	Redetermine the gain or (loss) on line 17 excluding the loss, if any, on line 18a. Enter here and on Schedule 1 (Form 1040), Part I, line 4	18b	**78,000**

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For Example 26

Form **8995**

Department of the Treasury
Internal Revenue Service

Qualified Business Income Deduction Simplified Computation

Attach to your tax return.

Go to *www.irs.gov/Form8995* for instructions and the latest information.

OMB No. 1545-2294

2023

Attachment Sequence No. **55**

Name(s) shown on return	Your taxpayer identification number
Sam and Sarah Partner	***-**-1111

Note. *You can claim the qualified business income deduction **only** if you have qualified business income from a qualified trade or business, real estate investment trust dividends, publicly traded partnership income, or a domestic production activities deduction passed through from an agricultural or horticultural cooperative. See instructions.*

Use this form if your taxable income, before your qualified business income deduction, is at or below $182,100 ($364,200 if married filing jointly), and you aren't a patron of an agricultural or horticultural cooperative.

1	**(a)** Trade, business, or aggregation name	**(b)** Taxpayer identification number	**(c)** Qualified business income or (loss)
i	P.E.	12-1212121	105,651
ii			
iii			
iv			
v			

Line	Description				
2	Total qualified business income or (loss). Combine lines 1i through 1v, column (c)	2	105,651		
3	Qualified business net (loss) carryforward from the prior year	3	(0)		
4	Total qualified business income. Combine lines 2 and 3. If zero or less, enter -0-	4	105,651		
5	Qualified business income component. Multiply line 4 by 20% (0.20)			5	21,130
6	Qualified REIT dividends and publicly traded partnership (PTP) income or (loss) (see instructions)	6			
7	Qualified REIT dividends and qualified PTP (loss) carryforward from the prior year	7	( )		
8	Total qualified REIT dividends and PTP income. Combine lines 6 and 7. If zero or less, enter -0-	8			
9	REIT and PTP component. Multiply line 8 by 20% (0.20)			9	
10	Qualified business income deduction before the income limitation. Add lines 5 and 9			10	21,130
11	Taxable income before qualified business income deduction (see instructions)	11	134,951		
12	Enter your net capital gain, if any, increased by any qualified dividends (see instructions)	12	0		
13	Subtract line 12 from line 11. If zero or less, enter -0-	13	134,951		
14	Income limitation. Multiply line 13 by 20% (0.20)			14	26,990
15	Qualified business income deduction. Enter the smaller of line 10 or line 14. Also enter this amount on the applicable line of your return (see instructions)			15	21,130
16	Total qualified business (loss) carryforward. Combine lines 2 and 3. If greater than zero, enter -0-			16	( )
17	Total qualified REIT dividends and PTP (loss) carryforward. Combine lines 6 and 7. If greater than zero, enter -0-			17	( )

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No Like-Kind Exchanges for Partnership Interests

The exchange of a partnership interest for another one does not satisfy the requirements for like-kind exchanges under IRC §1031, even if the partnership owns real estate. Thus, a partner in a terminating partnership cannot defer any gain in that partnership by exchanging it with another taxpayer.

TRANSFERS OF PARTNERSHIP INTERESTS AND FORM 8594 REQUIREMENTS

In some cases, the transfer or exchange of a partnership interest requires filing Form 8594, *Asset Acquisition Statement under Section 1060*. IRC §1060 requires the transfers of property associated with a **trade or business and subject to IRC §755** to be reported. Transactions need not be reported if the assets do not constitute a trade or business to either the former owner or the new owner.[157] A secondary exception exists for gifted or inherited property because the basis of that property is not "determined wholly by reference to the consideration paid for such assets."[158] Generally, the basis of gifted property is the donor's basis, and because the recipient did not pay for the gifted assets, they usually are not subject to the requirement to file Form 8594.[159] Because the basis of an inherited partnership interest is generally its FMV on the date of the decedent's passing, the transfer of a partnership interest by bequest also generally avoids the requirement to file Form 8594.[160]

Caution. Tax practitioners should consider whether the deemed sale provisions of Treas. Reg. §1.1001-2(a) may bring certain gifts under the jurisdiction of §1060.[161] A deemed sale occurs when a donor is relieved of debt greater than their basis in the property. The donor of the partnership interest recognizes gain to the extent that they are relieved of debt that exceeds their tax basis. The recipient accepts the gift with a basis equal to the donor's debt relief or the donor's adjusted outside basis, whichever is greater.[162] The recipient's basis is further increased for any gift tax paid by the donor.[163] Because it may have been adjusted for the partnership's losses, the donor's adjusted outside basis in the partnership could be very small.[164] In such circumstances, the deemed sale provisions may indirectly impose the requirement to file Form 8594 on the gift of a partnership interest.

157. Treas. Reg. §1.1060-1(b)(1).

158. Treas. Reg. §1.1060-1(c)(2).

159. IRC §§1015(a), 1060(c)(2), and 1060(d)(2).

160. IRC §1014(a)(1).

161. *Gifts of Partnership Interests.* Ellentuck, Albert. Apr. 1, 2016. AICPA. [www.thetaxadviser.com/issues/2016/apr/gifts-of-partnership-interests.html] Accessed on Mar. 28, 2024.

162. Treas. Reg. §1.1015-4(a).

163. Treas. Reg. §1.1015-5(a).

164. IRC §705.

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Chapter 6: Installment Sales

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Note. Corrections for all of the chapters are available at **TaxSchool.illinois.edu.** For clarification about terms used throughout this chapter, see the **Acronyms and Abbreviations** section following the index.

For your convenience, in-text website links are also provided as short URLs. Anywhere you see **uofi.tax/xxx**, the link points to the address immediately following in brackets.

About the Author

Peg Phillips, CPA, is a writer and editor for the University of Illinois Tax School. She has been with the program since 2003. Peg graduated from the University of Illinois with high honors in accounting and passed the CPA exam in 1989. She currently owns and operates Phillips Tax Service in Pekin, IL.

Other chapter contributors and reviewers are listed at the front of this book.

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INSTALLMENT SALE DEFINED[1]

An installment sale is a sale of property in which the taxpayer receives at least one payment after the year of sale. The year of sale is the one in which the taxpayer and another person enter into a binding agreement to transfer the property. To be legally binding, the agreement must include adequate consideration.[2]

> **Note.** Contract laws vary by state.[3] If there are any questions concerning the year that a contract became binding, practitioners may wish to contact a legal professional.

The rules for installment sales do **not** apply if the taxpayer **elects not** to use the installment method or the transaction is one for which the installment method is prohibited.

The installment sales method **cannot** be used to report the following.

- Sale **at a loss**
- Sale of inventory
- Sale of personal property by a person who regularly sells the same type of personal property on installment plans
- Sale of real property held for sale to customers in the ordinary course of a trade or business
- Sales of stocks or securities traded on an established securities market

> **Note.** Dealers of time-shares and residential lots may treat certain sales as installment sales and report them under the installment method if they elect to pay a special interest charge. For more information, see IRC §453(l).

The buyer's obligation to make future payments to the taxpayer may be documented in various ways. It may be in the form of a deed of trust, note, land contract, mortgage, or other evidence of the buyer's debt to the taxpayer.

> **Note.** Installment notes are an important tax-planning tool. Proper structuring can save taxpayers a significant amount of income tax, capital gains tax, alternative minimum tax, gift tax, generation-skipping tax, and estate tax. For information on using installment agreements as part of tax planning and other strategies, see the 2016 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 5: Wealth Accumulation and Preservation. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

> **Observation.** Before making the decision to use the installment method, taxpayers should consider the following disadvantages of this income deferral provision. These include the following.
>
> 1. An installment sales contract does not receive a stepped-up basis upon the death of the owner.
> 2. IRC §1245 depreciation recapture is reported in full in the year of sale.[4] This could result in the tax liability in the year of sale being greater than the installment payment received in the year of sale.
> 3. The requirement to report taxable income in future years increases adjusted gross income (AGI) and could reduce AGI-limited tax benefits in those years.
> 4. Converting real estate to an installment sale contract may have estate tax implications including the reduced ability to utilize special use valuation under IRC §2032A.

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1. IRC §453; IRS Pub. 537, *Installment Sales.*
2. *Contract.* Cornell Law School Legal Information Institute. [www.law.cornell.edu/wex/contract] Accessed on May 24, 2024.
3. Ibid.
4. IRC §453(i).

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GENERAL RULES[5]

For the year of the sale, the gain in an installment sale is calculated using Form 6252, *Installment Sale Income*. For each year in which the taxpayer receives a payment on the installment sale, Form 6252 is used to calculate the portion of the gain reported for that year. The taxable gain is referred to on the form as **installment sale income.**

The nature of the gain as short-term or long-term is **determined at the time of the sale,** not when the payments are received. The gain is long-term if the taxpayer owned the property for more than one year as of the property's sale date.

> **Caution.** The tax preparer must consult state tax rules regarding installment agreements. Some states have special rules, such as the requirement of a separate state-level election, or the pledging of adequate security to ensure the collection of tax paid in connection with the installment sale transaction.

The taxpayer reports the income attributable to **depreciation recapture** in the year of the sale regardless of the amount the taxpayer received in that year. Calculating depreciation recapture is discussed later.

CALCULATING INSTALLMENT SALE INCOME

Each payment on an installment sale usually consists of the following three parts.

1. Interest income
2. Return of the property's adjusted basis
3. Gain on the sale

In each year the taxpayer receives a payment, the taxpayer must include both the interest and the gain portions in income. The taxpayer does not include in income the portion that is the return of the property's basis.

> **Note.** Ideally, taxpayers should consult with their tax advisors before finalizing the terms of the sale. Practitioners should consider the impact of the net investment income tax (NIIT) and the brackets for capital gains rates when advising clients on the terms of the installment note. Stretching the length of the contract may result in significant tax savings if the taxpayer can avoid the NIIT and/or apply the lower capital gains rates to the gains. For more information about the NIIT, see the 2024 *University of Illinois Federal Tax Workbook*, Chapter 2: Individual Taxpayer Issues.

> **Caution.** Practitioners should also consider adverse tax consequences from stretching the length of the contract. For example, income from the installment contract may affect taxable social security benefits or the amount of allowable deductions that are subject to AGI limitations.

Interest Income

The taxpayer must report interest as **ordinary income.** Interest is generally not included in a down payment. However, the taxpayer may have to treat part of each subsequent payment as interest, even if it is not referred to as such in the agreement with the buyer. This type of interest is referred to as **unstated interest.** The interest rate provided in the agreement is referred to as **stated interest.**

---

5. IRC §453; IRS Pub. 537, *Installment Sales.*

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Adequate Interest Rate. If the agreement does not provide for an adequate interest rate, the taxpayer must recognize imputed interest income (unless certain exceptions apply, explained later). The imputed interest income may be unstated interest, original issue discount (OID), or a combination of both.

If the stated rate is not adequate, the selling price per the agreement is reduced by the unstated interest[6] or OID.[7] This is important because interest is subject to ordinary tax rates and gains may qualify for capital gain tax rates.

It is often easy to determine that a stated rate is **adequate** by comparing it to current market conditions. However, the rules and calculations necessary to determine that a contract's interest rate is **inadequate** are complex.

If the agreement's interest rate is at least as much as the prime rate, the interest rate is adequate. This is because the **adequacy** test is determined using **applicable federal rates (AFRs).** AFRs are based on the average market yield of U.S. marketable obligations (e.g., U.S. savings bonds).[8] The **prime rate** is the average lending rate posted by a majority of the top 25 U.S. commercial banks for short-term business loans.[9] The prime rate generally exceeds the rates for U.S. government securities.

If the agreement's interest rate is greater than 0% and less than the prime rate, the rate in the agreement must be compared to a **test rate** to determine if the rate is adequate. The appendix at the end of the chapter explains how to calculate the test rate for an installment agreement. If the agreement's stated interest rate is 0% or if the agreement does not call for interest, the interest rate is clearly inadequate.

When the agreement's interest rate is inadequate, the rate used to determine the imputed interest is the lowest 3-month AFR applicable to the sale or exchange,[10] compounded semiannually.[11] The **lowest 3-month rate** is the lowest AFR in effect for the calendar month in which there is a binding contract in writing for such sale or exchange or either of the two preceding months.[12]

Example 1. On April 19, 2024, Johan sold his tax practice to Gretta. Under the terms of the contract, Johan immediately received a vacation home in Hawaii worth $2 million and a note payable for $1 million. The $1 million payment is due on April 19, 2034 (a long-term contract). Neither the contract nor the note states an interest rate.

Because the contract does not call for interest, the interest must be imputed. The imputed interest rate is the lowest AFR in effect for long-term contracts at the semiannual compounding rate for the 3-calendar-month period ending April 2024. The AFRs for these periods are as follows.

February 2024	4.14% [13]
March 2024	4.35% [14]
April 2024	4.40% [15]

Accordingly, Johan's tax preparer will use 4.14% as the interest rate when making the necessary calculations to report the imputed interest on Johan's 2024 return.

---

6. IRC §483.
7. IRC §1274.
8. IRC §1274(d)(1)(C).
9. *Selected Interest Rates (Daily) — H.15.* Board of Governors of the Federal Reserve System. [www.federalreserve.gov/releases/h15/] Accessed on May 31, 2024.
10. For agreements subject to the imputed interest rules, both IRC §§1274 and 483(b)(2) require that the appropriate interest rate be determined using the method in §1274(d)(2). See appendix for more information.
11. IRC §1274(b)(2)(B).
12. IRC §1274(d)(2).
13. Rev. Rul. 2024-03, 2024-6 IRB 646.
14. Rev. Rul. 2024-04, 2024-10 IRB 686.
15. Rev. Rul. 2024-07, 2024-14 IRB 749.

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> **Note.** Imputed interest income may need to be calculated when the stated interest rate is less than market rates, or when the stated interest rate appears adequate but the sum of all principal payments due is different than the stated principal amount.[16]

Contract Term. There are three categories of federal rates that are determined by the weighted average maturity (WAM) term of the contract.[17]

- For a WAM term of three years or less, the AFR is the **short-term** rate.
- For a WAM term of over three years but not over nine years, the AFR is the **mid-term** rate.
- For a WAM term of over nine years, the AFR is the **long-term** rate.

The **WAM** is calculated by adding the weight of all payments. The weight of **each** principal payment is calculated using the following formula.[18]

$$\text{Weight of principal payment} = \frac{\text{Years from issue date until payment made} \times \text{Payment amount}}{\text{Debt instrument redemption price at maturity}}$$

If the **annual principal payments** are the **same each year,** the following table can be used to determine the weighted average term.[19] This table is **not** appropriate for contracts if the principal payments vary.

WAM for Equal Annual Payments

Contract Length	AFR Term
2-5 years	Short-term
6-17 years	Mid-term
Over 17 years	Long-term

Example 2. Edna has a note receivable of $500,000 dated February 14, 2023. Under the terms of the note, she is to receive $100,000 each year for the next five years. Her tax advisor determines that the WAM term of the note is three years. Using the preceding table, the advisor confirms that the short-term AFR is used to determine if the interest rate is adequate for a 5-year contract.

If the annual payments are not equal, the WAM formula must be used.

Example 3. Edith has a note receivable of $300,000 dated February 14, 2023. Under the conditions of the note, she is to receive $100,000 on February 15, 2024, and $200,000 on February 15, 2025. The WAM of each payment is as follows.

- Payment 1: **1 year × $100,000 payment ÷ $300,000 face value = .33 year**
- Payment 2: **2 years × $200,000 payment ÷ $300,000 face value = 1.33 years**

The WAM is the sum of the weights for the payments, or 1.66 years. Accordingly, the WAM **term** of the note is 1.66 years.

> **Note.** Options to renew or extend the installment agreement are taken into account when determining the contract term for these purposes.[20]

16. IRC §1274(c).
17. IRC §1274(d)(1).
18. Treas. Reg. §1.1273-1(e)(3).
19. Ibid.
20. IRC §1274(d)(3).

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Calculating Unstated Interest or OID. The unstated interest or OID is the excess of the contract's stated principal amount over the imputed principal amount. The imputed principal is equal to the net present value (PV) of all the payments under the contact when the PV of the payments is based on the AFR.[21] The formula to calculate PV is $\mathbf{PV = FV \div (1 + i)^n}$, where FV is the future value, i is the interest rate, and n is the number of periods.[22] Financial calculators, PV charts, and numerous online tools are available to make these calculations.

Adjusted Basis and Gain on Sale

As mentioned earlier, the taxpayer (or tax practitioner) must determine how much of each payment to treat as interest. After this is calculated, the taxpayer treats the rest of each payment as the selling price.

The gain on the sale is calculated using the following formula.

	Selling price
−	Tax-free return of the property's adjusted basis
	Gain on the sale

The gain divided by the **contract price** is the **gross profit percentage.** The reportable gain each year is the gross profit percentage multiplied by the principal payments received on the installment agreement. Additional key definitions and the mechanics of reporting the gain are explained in this section.

Selling Price. The selling price is the total cost to the buyer and includes the following.

- Any money the seller received or will receive
- The fair market value (FMV) of any property the seller received or will receive
- Any existing mortgage or other debt (such as unpaid property taxes) that the buyer pays or assumes
- Any of the selling expenses the buyer pays

The selling price does **not** include any of the following.

- Stated or unstated interest
- Any amount recalculated or recharacterized as interest
- OID

Example 4. Presley sold her vacation home on contract for deed to an unrelated party. The total sales price under the terms of the contract was $200,000. In the year of the sale, the buyer gave her $10,000, a motor home worth $30,000, and a $160,000 note payable. The note was payable in four installments of $40,000 each, beginning the following year. The note's stated interest rate was 0%.

The AFR was 1% at the time of the sale. The PV of $40,000 payable annually for four years at 1% interest is $156,079.[23] Therefore, the unstated interest is $3,921 ($160,000 original note − $156,079 PV of note).

For tax purposes, the selling price of the real estate is calculated as follows.

Cash received	$ 10,000
FMV of property received	30,000
Note payable	160,000
Less: unstated interest	(3,921)
Selling price	$196,079

21. IRC §1274.

22. *What Is Present Value? Formula and Calculation.* Fernando, Jason. Oct. 31, 2023. Investopedia. [www.investopedia.com/terms/p/presentvalue.asp] Accessed on May 31, 2024.

23. Calculated using *Present Value of Annuity Calculator.* Financial Mentor. [financialmentor.com/calculator/present-value-of-annuity-calculator] Accessed on May 30, 2024.

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Adjusted Basis. The property's adjusted basis **for installment sale purposes** is the sum of the following elements.

- Adjusted basis as normally defined for determining gain or loss
- Selling expenses, which include commissions, attorney fees, and any other expenses paid on the sale
- **Depreciation recapture** that must be included in income in the year of the sale (depreciation must be recaptured for **certain** IRC §1250 property and for **all** §1245 property, as discussed in depth later)

Gross Profit. Gross profit is the total gain the taxpayer recognizes using the installment method. The depreciation recapture taxed in the year of sale is not included in the gross profit. Gross profit equals the selling price less the adjusted basis as calculated for installment sale purposes.

Contract Price. The contract price is calculated as follows. Note that this formula and the formula for determining the gross profit percentage are both illustrated in **Example 5.**

	The selling price
−	Mortgages, debts, and other liabilities assumed by the buyer
+	Amount by which the mortgages, debts, and other liabilities assumed by the buyer exceed the adjusted basis for installment sale purposes
	Contract price

6

Gross Profit Percentage. The gross profit percentage is the portion of principal received that is reported as gain each year. As mentioned earlier, the gross profit percentage is calculated by dividing the gain by the contract price.

Example 5. Willie sold four acres of specialty cropland to Wayland for $100,000. In the sale agreement, Wayland assumed the mortgage of $80,000 and agreed to pay the remaining $20,000 over five years at $4,000 per year plus interest of 3%. Willie's adjusted basis in the land was $30,000. The excess of the assumed mortgage over Willie's basis was $50,000 ($80,000 mortgage – $30,000 adjusted basis). The contract price for the exchange was calculated as follows.

Selling price	$100,000
Less: mortgage assumed by Wayland	(80,000)
Plus: excess of mortgage over basis	50,000
Contract price	$ 70,000

Willie's gain was also $70,000 ($100,000 selling price – $30,000 adjusted basis). Accordingly, his gross profit percentage is 100%, and he will report each $4,000 payment as gain attributable to the sale. This is in addition to the $50,000 he reports in the year of the sale.

Amount to Report as Installment Sale Income. To calculate the annual amount reported as installment sale income for the tax year, the payments the seller receives each year (less interest) are multiplied by the gross profit percentage. In certain circumstances, the taxpayer may be treated as having received a payment, even though the taxpayer received nothing directly. A receipt of property or the assumption of a mortgage on the property sold may be treated as a payment to the seller. Payments received or considered received are covered later.

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Reporting Installment Sale Income

Form 6252 is used to calculate the gross profit percentage in the year of sale. It also is used to report the taxable portion of principal payments received each year. The taxable gain flows to Schedule D, *Capital Gains and Losses,* or Form 4797, *Sales of Business Property*, or both, depending on the taxpayer's use of the property.

Line 1 of Form 6252 is used to describe the property sold and must also include one of the following codes based on how the property was used at the time of the sale.[24]

1. As a timeshare or residential lot
2. By individual taxpayers for **personal purposes**
3. In the trade or business of farming[25]
4. For all other purposes, including in a trade or business, rental activity, or other income producing manner.

Example 6. On January 16, 2022, Jim sold 100 acres of swampland in Florida on an installment sale. He purchased the acres for $45,000 on March 2, 1974. He held the property as an investment and did not use it in any business ventures. Hattie, the buyer, built a custom home in the center of the acreage.

The selling price was $300,000. Jim's total selling expenses were $30,000, which consisted of $21,000 in commissions he paid to the realtor and $9,000 he paid an attorney to draw up the necessary legal documents.

Jim received a $100,000 down payment on the sale. According to the terms of the note, he will receive the remaining $200,000 in four annual installments of $50,000, plus interest, beginning in January 2023.

Jim's 2022 Form 6252 and page 1 of his Schedule D follow. As shown on Form 6252, Jim's gross profit on the sale was $225,000 (line 16) and his gross profit percentage was 75% (line 19).

24. Instructions for Form 6252 (2023). See also IRC §1275(b)(3) referencing IRC §212.

25. Farming for these purposes is defined within the meaning of IRC §§2032A(e)(4) or (5).

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For Example 6

Form **6252** | **Installment Sale Income** | OMB No. 1545-0228

Department of the Treasury
Internal Revenue Service

Attach to your tax return.
Use a separate form for each sale or other disposition of property on the installment method.
Go to *www.irs.gov/Form6252* for the latest information.

2022 Attachment Sequence No. **67**

Name(s) shown on return	Identifying number
Jim Stafford	***-**-9848

Line	Description				
1	Description of property 2 -100 Acres Investment Real Estate				
2a	Date acquired (mm/dd/yyyy) 03/02/1974 **b** Date sold (mm/dd/yyyy) 01/16/2022				
3	Was the property sold to a related party? See instructions. If "Yes," complete Part III for the year of sale and 2 years after the year of the sale unless you received the final payment during the tax year				☐ Yes ☒ No
4	Reserved for future use				☐ Yes ☐ No
Part I	**Gross Profit and Contract Price.** Complete this part for all years of the installment agreement.				
5	Selling price including mortgages and other debts. **Don't** include interest, whether stated or unstated			5	300,000
6	Mortgages, debts, and other liabilities the buyer assumed or took the property subject to (see instructions)	6			
7	Subtract line 6 from line 5	7	300,000		
8	Cost or other basis of property sold	8	45,000		
9	Depreciation allowed or allowable	9			
10	Adjusted basis. Subtract line 9 from line 8	10	45,000		
11	Commissions and other expenses of sale	11	30,000		
12	Income recapture from Form 4797, Part III (see instructions)	12			
13	Add lines 10, 11, and 12			13	75,000
14	Subtract line 13 from line 5. If zero or less, **don't** complete the rest of this form. See instructions			14	225,000
15	If the property described on line 1 above was your main home, enter the amount of your excluded gain. See instructions. Otherwise, enter -0-			15	
16	**Gross profit.** Subtract line 15 from line 14			16	225,000
17	Subtract line 13 from line 6. If zero or less, enter -0-			17	0
18	**Contract price.** Add line 7 and line 17			18	300,000
Part II	**Installment Sale Income.** Complete this part for all years of the installment agreement.				
19	Gross profit percentage (expressed as a decimal amount). Divide line 16 by line 18. (For years after the year of sale, see instructions.)			19	0.7500
20	If this is the year of sale, enter the amount from line 17. Otherwise, enter -0-			20	0
21	Payments received during year (see instructions). **Don't** include interest, whether stated or unstated			21	100,000
22	Add lines 20 and 21			22	100,000
23	Payments received in prior years (see instructions). **Don't** include interest, whether stated or unstated	23			
24	**Installment sale income.** Multiply line 22 by line 19			24	75,000
25	Enter the part of line 24 that is ordinary income under the recapture rules. See instructions			25	
26	Subtract line 25 from line 24. Enter here and on Schedule D or Form 4797. See instructions			26	75,000
Part III	**Related Party Installment Sale Income. Don't** complete if you received the final payment this tax year.				
27	Name, address, and taxpayer identifying number of related party				
28	Did the related party resell or dispose of the property ("second disposition") during this tax year?				☐ Yes ☐ No
29	**If the answer to question 28 is "Yes," complete lines 30 through 37 below unless one of the following conditions is met. Check the box that applies.**				
a	☐ The second disposition was more than 2 years after the first disposition (other than dispositions of marketable securities). If this box is checked, enter the date of disposition (mm/dd/yyyy)				
b	☐ The first disposition was a sale or exchange of stock to the issuing corporation.				
c	☐ The second disposition was an involuntary conversion and the threat of conversion occurred after the first disposition.				
d	☐ The second disposition occurred after the death of the original seller or buyer.				
e	☐ It can be established to the satisfaction of the IRS that tax avoidance wasn't a principal purpose for either of the dispositions. If this box is checked, attach an explanation. See instructions.				
30	Selling price of property sold by related party (see instructions)			30	
31	Enter contract price from line 18 for year of first sale			31	
32	Enter the **smaller** of line 30 or line 31			32	
33	Total payments received by the end of your 2022 tax year (see instructions)			33	
34	Subtract line 33 from line 32. If zero or less, enter -0-			34	
35	Multiply line 34 by the gross profit percentage on line 19 for year of first sale			35	
36	Enter the part of line 35 that is ordinary income under the recapture rules. See instructions			36	
37	Subtract line 36 from line 35. Enter here and on Schedule D or Form 4797. See instructions			37	

For Paperwork Reduction Act Notice, see page 4. Cat. No. 13601R Form **6252** (2022)

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For Example 6

SCHEDULE D (Form 1040)

Department of the Treasury Internal Revenue Service

Capital Gains and Losses

Attach to Form 1040, 1040-SR, or 1040-NR.
Go to *www.irs.gov/ScheduleD* for instructions and the latest information.
Use Form 8949 to list your transactions for lines 1b, 2, 3, 8b, 9, and 10.

OMB No. 1545-0074

2022

Attachment Sequence No. **12**

Name(s) shown on return: **Jim Stafford**

Your social security number: ***-**-9848

Did you dispose of any investment(s) in a qualified opportunity fund during the tax year? ☐ **Yes** ☒ **No**

If "Yes," attach Form 8949 and see its instructions for additional requirements for reporting your gain or loss.

Part I **Short-Term Capital Gains and Losses—Generally Assets Held One Year or Less** (see instructions)

See instructions for how to figure the amounts to enter on the lines below. This form may be easier to complete if you round off cents to whole dollars.	**(d)** Proceeds (sales price)	**(e)** Cost (or other basis)	**(g)** Adjustments to gain or loss from Form(s) 8949, Part I, line 2, column (g)	**(h) Gain or (loss)** Subtract column (e) from column (d) and combine the result with column (g)
1a Totals for all short-term transactions reported on Form 1099-B for which basis was reported to the IRS and for which you have no adjustments (see instructions). However, if you choose to report all these transactions on Form 8949, leave this line blank and go to line 1b				
1b Totals for all transactions reported on Form(s) 8949 with **Box A** checked				
2 Totals for all transactions reported on Form(s) 8949 with **Box B** checked				
3 Totals for all transactions reported on Form(s) 8949 with **Box C** checked				

Line	Description		Amount
4	Short-term gain from Form 6252 and short-term gain or (loss) from Forms 4684, 6781, and 8824	4	
5	Net short-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1	5	
6	Short-term capital loss carryover. Enter the amount, if any, from line 8 of your **Capital Loss Carryover Worksheet** in the instructions	6	( )
7	**Net short-term capital gain or (loss).** Combine lines 1a through 6 in column (h). If you have any long-term capital gains or losses, go to Part II below. Otherwise, go to Part III on the back	7	

Part II **Long-Term Capital Gains and Losses—Generally Assets Held More Than One Year** (see instructions)

See instructions for how to figure the amounts to enter on the lines below. This form may be easier to complete if you round off cents to whole dollars.	**(d)** Proceeds (sales price)	**(e)** Cost (or other basis)	**(g)** Adjustments to gain or loss from Form(s) 8949, Part II, line 2, column (g)	**(h) Gain or (loss)** Subtract column (e) from column (d) and combine the result with column (g)
8a Totals for all long-term transactions reported on Form 1099-B for which basis was reported to the IRS and for which you have no adjustments (see instructions). However, if you choose to report all these transactions on Form 8949, leave this line blank and go to line 8b				
8b Totals for all transactions reported on Form(s) 8949 with **Box D** checked				
9 Totals for all transactions reported on Form(s) 8949 with **Box E** checked				
10 Totals for all transactions reported on Form(s) 8949 with **Box F** checked				

Line	Description		Amount
11	Gain from Form 4797, Part I; long-term gain from Forms 2439 and 6252; and long-term gain or (loss) from Forms 4684, 6781, and 8824	11	75,000
12	Net long-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1	12	
13	Capital gain distributions. See the instructions	13	
14	Long-term capital loss carryover. Enter the amount, if any, from line 13 of your **Capital Loss Carryover Worksheet** in the instructions	14	( )
15	**Net long-term capital gain or (loss).** Combine lines 8a through 14 in column (h). Then, go to Part III on the back	15	75,000

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 11338H **Schedule D (Form 1040) 2022**

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In years after the year of sale, the taxpayer generally must complete Form 6252 each year that they receive principal payments. The taxpayer reports the interest received on Schedule B, *Interest and Ordinary Dividends.* If the seller holds a mortgage on the property and the buyer uses the property as a personal residence, the seller must provide their tax identification number to the buyer.[26] In addition, the seller must report the buyer's name, address, and tax identification number on Schedule B or as an attachment to the return.[27]

Note. Form 6252 must be filed each year of the installment agreement, even if no principal payments are received. In addition, part I must **now** be completed each **year.**[28]

Practitioner Planning Tip

The requirement to complete part I of Form 6252 every year after the year of sale only started in 2023. Therefore, practitioners should review all prior returns for new clients with installment sales that started prior to 2022.

Example 7. Use the same facts as **Example 6.** In 2023, Jim received $50,000 of principal and $20,000 of interest on the note. On his 2023 Form 6252, lines 1 to 4 and part I show the same information as shown on his 2022 Form 6252. In part II, he reports the $50,000 he received in 2023 and multiplies that by the 75% gross profit percentage to determine that $37,500 of the principal he received in 2023 is taxable. This flows to Schedule D (not shown). He reports the $20,000 of interest income on Schedule B.

Jim's 2023 Form 6252 and Schedule B follow.

26. Instructions for Schedule B.

27. Ibid.

28. Instructions for Form 6252.

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For Example 7

Form **6252** — Department of the Treasury, Internal Revenue Service

Installment Sale Income

Attach to your tax return.
Use a separate form for each sale or other disposition of property on the installment method.
Go to *www.irs.gov/Form6252* for the latest information.

OMB No. 1545-0228 — 2023 — Attachment Sequence No. 67

Name(s) shown on return: **Jim Stafford** — Identifying number: *****-**-9848**

1 Description of property **2 - 100 Acres Investment Real Estate**

2a Date acquired (mm/dd/yyyy) **03/02/1974** b Date sold (mm/dd/yyyy) **01/16/2022**

3 Was the property sold to a related party? See instructions. If "Yes," complete Part III for the year of sale and 2 years after the year of the sale unless you received the final payment during the tax year . . . ☐ Yes ☒ No

4 Reserved for future use . . . ☐ Yes ☐ No

Part I Gross Profit and Contract Price. Complete this part for all years of the installment agreement.

Line	Description	Box	Amount	Box	Amount
5	Selling price including mortgages and other debts. **Don't** include interest, whether stated or unstated			5	300,000
6	Mortgages, debts, and other liabilities the buyer assumed or took the property subject to (see instructions)	6			
7	Subtract line 6 from line 5	7	300,000		
8	Cost or other basis of property sold	8	45,000		
9	Depreciation allowed or allowable	9			
10	Adjusted basis. Subtract line 9 from line 8	10	45,000		
11	Commissions and other expenses of sale	11	30,000		
12	Income recapture from Form 4797, Part III (see instructions)	12			
13	Add lines 10, 11, and 12			13	75,000
14	Subtract line 13 from line 5. If zero or less, **don't** complete the rest of this form. See instructions			14	225,000
15	If the property described on line 1 above was your main home, enter the amount of your excluded gain. See instructions. Otherwise, enter -0-			15	
16	**Gross profit.** Subtract line 15 from line 14			16	225,000
17	Subtract line 13 from line 6. If zero or less, enter -0-			17	0
18	**Contract price.** Add line 7 and line 17			18	300,000

Part II Installment Sale Income. Complete this part for all years of the installment agreement.

Line	Description	Box	Amount	Box	Amount
19	Gross profit percentage (expressed as a decimal amount). Divide line 16 by line 18. (For years after the year of sale, see instructions.)			19	0.7500
20	If this is the year of sale, enter the amount from line 17. Otherwise, enter -0-			20	0
21	Payments received during year (see instructions). **Don't** include interest, whether stated or unstated			21	50,000
22	Add lines 20 and 21			22	50,000
23	Payments received in prior years (see instructions). **Don't** include interest, whether stated or unstated	23	100,000		
24	**Installment sale income.** Multiply line 22 by line 19			24	37,500
25	Enter the part of line 24 that is ordinary income under the recapture rules. See instructions			25	
26	Subtract line 25 from line 24. Enter here and on Schedule D or Form 4797. See instructions			26	37,500

Part III Related Party Installment Sale Income. Don't complete if you received the final payment this tax year.

27 Name, address, and taxpayer identifying number of related party

28 Did the related party resell or dispose of the property ("second disposition") during this tax year? . . . ☐ Yes ☐ No

29 **If the answer to question 28 is "Yes," complete lines 30 through 37 below unless one of the following conditions is met. Check the box that applies.**

a ☐ The second disposition was more than 2 years after the first disposition (other than dispositions of marketable securities). If this box is checked, enter the date of disposition (mm/dd/yyyy)

b ☐ The first disposition was a sale or exchange of stock to the issuing corporation.

c ☐ The second disposition was an involuntary conversion and the threat of conversion occurred after the first disposition.

d ☐ The second disposition occurred after the death of the original seller or buyer.

e ☐ It can be established to the satisfaction of the IRS that tax avoidance wasn't a principal purpose for either of the dispositions. If this box is checked, attach an explanation. See instructions.

Line	Description	Box	Amount
30	Selling price of property sold by related party (see instructions)	30	
31	Enter contract price from line 18 for year of first sale	31	
32	Enter the **smaller** of line 30 or line 31	32	
33	Total payments received by the end of your 2023 tax year (see instructions)	33	
34	Subtract line 33 from line 32. If zero or less, enter -0-	34	
35	Multiply line 34 by the gross profit percentage on line 19 for year of first sale	35	
36	Enter the part of line 35 that is ordinary income under the recapture rules. See instructions	36	
37	Subtract line 36 from line 35. Enter here and on Schedule D or Form 4797. See instructions	37	

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For Example 7

SCHEDULE B (Form 1040)
Department of the Treasury
Internal Revenue Service

Interest and Ordinary Dividends

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

OMB No. 1545-0074
2023
Attachment Sequence No. 08

Name(s) shown on return	Your social security number
Jim Stafford	***-**-9848

Part I Interest

(See instructions and the Instructions for Form 1040, line 2b.)

Note: If you received a Form 1099-INT, Form 1099-OID, or substitute statement from a brokerage firm, list the firm's name as the payer and enter the total interest shown on that form.

			Amount
1	List name of payer. If any interest is from a seller-financed mortgage and the buyer used the property as a personal residence, see the instructions and list this interest first. Also, show that buyer's social security number and address:		
	Seller-Financed Interest: Hattie Waters SSN ***-**-4321	1	20,000
	Address: 1225 Lyndall Dr., Kissimmee, FL 34741		
2	Add the amounts on line 1	2	20,000
3	Excludable interest on series EE and I U.S. savings bonds issued after 1989. Attach Form 8815	3	
4	Subtract line 3 from line 2. Enter the result here and on Form 1040 or 1040-SR, line 2b	4	20,000

Note: If line 4 is over $1,500, you must complete Part III.

Part II Ordinary Dividends

(See instructions and the Instructions for Form 1040, line 3b.)

Note: If you received a Form 1099-DIV or substitute statement from a brokerage firm, list the firm's name as the payer and enter the ordinary dividends shown on that form.

			Amount
5	List name of payer:	5	
6	Add the amounts on line 5. Enter the total here and on Form 1040 or 1040-SR, line 3b	6	

Note: If line 6 is over $1,500, you must complete Part III.

Part III Foreign Accounts and Trusts

Caution: If required, failure to file FinCEN Form 114 may result in substantial penalties. Additionally, you may be required to file Form 8938, Statement of Specified Foreign Financial Assets. See instructions.

You must complete this part if you (**a**) had over $1,500 of taxable interest or ordinary dividends; (**b**) had a foreign account; or (**c**) received a distribution from, or were a grantor of, or a transferor to, a foreign trust.

		Yes	No
7a	At any time during 2023, did you have a financial interest in or signature authority over a financial account (such as a bank account, securities account, or brokerage account) located in a foreign country? See instructions		
	If "Yes," are you required to file FinCEN Form 114, Report of Foreign Bank and Financial Accounts (FBAR), to report that financial interest or signature authority? See FinCEN Form 114 and its instructions for filing requirements and exceptions to those requirements		
b	If you are required to file FinCEN Form 114, list the name(s) of the foreign country(-ies) where the financial account(s) is (are) located:		
8	During 2023, did you receive a distribution from, or were you the grantor of, or transferor to, a foreign trust? If "Yes," you may have to file Form 3520. See instructions		

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 17146N **Schedule B (Form 1040) 2023**

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If the property sold was used in a trade, business, or rental activity, then the profit calculated on Form 6252 flows to Form 4797 instead of directly to Schedule D. Special rules (discussed later) apply to property for which depreciation was allowed or allowable. In addition, if the seller sold the property in the course of their trade or business and they receive mortgage interest during the year of $600 or more, the seller is required to report the interest they received on Form 1098, *Mortgage Interest Statement.*[29]

Example 8. Use the same facts as **Example 6,** except Jim received rental income from the property during the time he owned it. In 2023, the taxable gain flows to line 4 of Form 4797, which follows. Note that the Form 6252, line 1 description code is now "4" as shown next.

Note. If the taxpayer reports payments from an installment sale as income in respect of a decedent or as a beneficiary of a trust, including a partial interest in such a sale, then the taxpayer may not be able to provide all the information asked for on Form 6252. In this situation, the taxpayer should provide as many details as possible in a statement attached to Form 6252.

Form **4797** | **Sales of Business Property** | OMB No. 1545-0184

(Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2))

2023

Department of the Treasury
Internal Revenue Service

Attach to your tax return.
Go to *www.irs.gov/Form4797* for instructions and the latest information.

Attachment Sequence No. **27**

Name(s) shown on return	Identifying number
Jim Stafford	*****-**-9848**

1a	Enter the gross proceeds from sales or exchanges reported to you for 2023 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20. See instructions	1a	
b	Enter the total amount of gain that you are including on lines 2, 10, and 24 due to the partial dispositions of MACRS assets	1b	
c	Enter the total amount of loss that you are including on lines 2 and 10 due to the partial dispositions of MACRS assets	1c	

Part I Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty or Theft—Most Property Held More Than 1 Year (see instructions)

2	**(a)** Description of property	**(b)** Date acquired (mo., day, yr.)	**(c)** Date sold (mo., day, yr.)	**(d)** Gross sales price	**(e)** Depreciation allowed or allowable since acquisition	**(f)** Cost or other basis, plus improvements and expense of sale	**(g) Gain or (loss)** Subtract (f) from the sum of (d) and (e)

3	Gain, if any, from Form 4684, line 39	3	
4	Section 1231 gain from installment sales from Form 6252, line 26 or 37	4	**37,500**
5	Section 1231 gain or (loss) from like-kind exchanges from Form 8824	5	
6	Gain, if any, from line 32, from other than casualty or theft	6	
7	Combine lines 2 through 6. Enter the gain or (loss) here and on the appropriate line as follows	7	**37,500**
	Partnerships and S corporations. Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 10, or Form 1120-S, Schedule K, line 9. Skip lines 8, 9, 11, and 12 below.		
	Individuals, partners, S corporation shareholders, and all others. If line 7 is zero or a loss, enter the amount from line 7 on line 11 below and skip lines 8 and 9. If line 7 is a gain and you didn't have any prior year section 1231 losses, or they were recaptured in an earlier year, enter the gain from line 7 as a long-term capital gain on the Schedule D filed with your return and skip lines 8, 9, 11, and 12 below.		
8	Nonrecaptured net section 1231 losses from prior years. See instructions	8	
9	Subtract line 8 from line 7. If zero or less, enter -0-. If line 9 is zero, enter the gain from line 7 on line 12 below. If line 9 is more than zero, enter the amount from line 8 on line 12 below and enter the gain from line 9 as a long-term capital gain on the Schedule D filed with your return. See instructions	9	

Part II Ordinary Gains and Losses (see instructions)

[29]. Instructions for Form 1098.

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For Example 8

Form **6252** — **Installment Sale Income**

Attach to your tax return.
Use a separate form for each sale or other disposition of property on the installment method.
Go to *www.irs.gov/Form6252* for the latest information.

Department of the Treasury
Internal Revenue Service

OMB No. 1545-0228
2023
Attachment Sequence No. 67

Name(s) shown on return	Identifying number
Jim Stafford	***-**-9848

1 Description of property 4 - 100 Acres Rental Real Estate

2a Date acquired (mm/dd/yyyy) 03/02/1974 b Date sold (mm/dd/yyyy) 01/16/2022

3 Was the property sold to a related party? See instructions. If "Yes," complete Part III for the year of sale and 2 years after the year of the sale unless you received the final payment during the tax year . . . . ☐ Yes ☒ No

4 Reserved for future use . . . . ☐ Yes ☐ No

Part I **Gross Profit and Contract Price.** Complete this part for all years of the installment agreement.

5	Selling price including mortgages and other debts. **Don't** include interest, whether stated or unstated	5	300,000
	Mortgages, debts, and other liabilities the buyer assumed or took the property ...		

SELLING PRICE REDUCED

If the selling price is reduced after the year of sale, then the gross profit on the sale also changes. The taxpayer (or tax preparer) must recalculate the gross profit percentage for the remaining payments. The taxpayer's remaining gain is spread over future installments.

6

The new gross profit percentage is calculated using the following formula.

	Reduced selling price
−	Adjusted basis (as defined earlier)
−	Any installment sale income previously reported
	Remaining deferred gain
÷	Future installments
	New gross profit percentage

Example 9. In 2022, Milo sold land with a \$40,000 basis for \$100,000. The gross profit was \$60,000 (\$100,000 proceeds – \$40,000 basis). He received a \$20,000 down payment and a note for \$80,000. The note provides for four annual payments of \$20,000 each, plus 8% interest, beginning in 2023. The gross profit percentage is 60% (\$60,000 gross profit ÷ \$100,000 proceeds). Milo reported a gain of \$12,000 (\$20,000 annual payment × 60% gross profit percentage) on each payment received in 2022 and 2023.

In 2024, Milo and the buyer agree to reduce the purchase price to \$85,000. Accordingly, the remaining unpaid purchase price is \$45,000 (\$85,000 purchase price – \$20,000 paid in 2022 – \$20,000 paid in 2023), and the payments for 2024, 2025, and 2026 are reduced to \$15,000 each.

The new 46.67% gross profit percentage is calculated as follows.

Reduced selling price	\$85,000
Less: adjusted basis	(40,000)
Less: any installment sale income previously reported (\$12,000 in 2022 + \$12,000 in 2023)	(24,000)
Remaining deferred gain	\$21,000
Future installments	÷ 45,000
New gross profit percentage	46.67%

Milo will report a gain of \$7,000 (46.67% gross profit percentage × \$15,000 annual payment) on each of the \$15,000 installments due in 2024, 2025, and 2026.

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ELECTING OUT OF THE INSTALLMENT METHOD[30]

When taxpayers **elect not** to use the installment method, they must report the entire gain in the year of sale. To make the opt-out election, the taxpayer reports the sale on Form 4797 and/or Form 8949, *Sales and Other Dispositions of Capital Assets*, depending on the taxpayer's use of the asset. Form 6252 is not used.

> **Note.** For taxpayers filing Schedule F, *Profit or Loss From Farming,* this choice can be a very powerful tax planning tool. Farmers may have grain delivered, priced, sold, and held for payment in the following year using a valid deferred payment agreement. Farmers may either report the income under the installment method as income in the following year or elect out of the installment method and report the income in the current year. This opt-out election can be made for each contract and is accomplished by reporting the income on the current year Schedule F.[31] For more information on installment sales and farmers, see the 2024 *University of Illinois Federal Tax Workbook,* Chapter 11: Agricultural Issues and Rural Investments.

To calculate the amount of gain to report, the taxpayer adds the FMV of the buyer's installment obligation to the other consideration received during the year. The taxpayer must calculate the FMV of the buyer's installment obligation, regardless of whether the taxpayer would actually be able to sell it.

When the taxpayer uses the cash method of accounting, the FMV of the obligation is **never treated as less than the FMV of the property sold** minus any other consideration received. Thus, for most individual taxpayers, the FMV of the **obligation** is treated as equal to the note's stated principal amount.

A taxpayer using the accrual method of accounting treats the total amount payable under the installment obligation as the amount realized in the year of sale.[32] For this purpose, interest (whether stated or unstated) and OID are not considered part of the amount payable.

> **Note.** If the amount payable is otherwise fixed but the timing of the payments is contingent on outside factors, additional calculations are necessary. For more information, see Temp. Treas. Reg. §15a.453-1T(d)(2).

The election must be made by the due date, including extensions, for filing the tax return for the year the sale takes place. If the taxpayer timely files the tax return without making the election, the taxpayer may still make the election by filing an amended return within six months of the due date of the return (excluding extensions). To make the election out of the installment method with an amended return, the taxpayer writes "Filed pursuant to section 301.9100-2" at the top of the amended return and sends it to the IRS location at which the original return was filed.

Once made, the election can only be revoked with the IRS's approval. A revocation is retroactive. The election cannot be revoked if either of the following applies.

- One of the purposes is to avoid federal income tax.
- The tax year in which any payment was received has closed.

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30. IRS Pub. 537, *Installment Sales.*

31. IRS Pub. 225, *Farmer's Tax Guide.*

32. Temp. Treas. Reg. §15a.453-1T(d)(2)(ii)(A).

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PAYMENTS RECEIVED[33]

For each year an installment sale payment is received or treated as received, the taxpayer must calculate gain from the installment sale. In certain situations, the taxpayer is considered to have received a payment, even though the buyer does not pay the taxpayer directly. These situations occur when the buyer assumes or pays any of the taxpayer's debts (such as a loan) or pays any of the taxpayer's expenses (such as a sales commission). However, in many cases, the buyer's assumption of a debt is treated as a recovery of the basis rather than as a payment. This is discussed later.

BUYER PAYS SELLER'S EXPENSES

When the buyer pays any of the taxpayer's expenses related to the sale of the property, it is considered a payment to the taxpayer in the year of sale. These expenses are included in the selling and contract prices when calculating the gross profit percentage.

BUYER ASSUMES MORTGAGE

If the buyer assumes or pays off the taxpayer's mortgage or otherwise takes the property subject to the mortgage, the rules that apply depend on whether the mortgage is less than or equal to the basis, or more than the basis. Other rules apply if the mortgage is canceled.

Mortgage Less than or Equal to Basis

When the buyer assumes a mortgage that is not more than the installment sale basis in the property, it is not considered a payment to the taxpayer. Instead, it is considered a recovery of the taxpayer's basis. The contract price is the selling price minus the mortgage.

Example 10. In 2024, Billie sells property with an adjusted basis of $19,000. She incurs selling expenses of $1,000. Therefore, her installment sale basis is $20,000.

The buyer, Minnie, assumes the existing mortgage of $15,000 and makes a $2,000 down payment. In addition, Minnie agrees to pay Billie $8,000 over the next four years at $2,000 per year, plus 12% interest.

- The selling price is $25,000 ($15,000 mortgage + $2,000 down payment + $8,000 installment payments).
- The gross profit is $5,000 ($25,000 selling price – $20,000 installment sale basis).
- The contract price is $10,000 ($25,000 selling price – $15,000 mortgage).
- The gross profit percentage is 50% ($5,000 gross profit ÷ $10,000 contract price).

Billie reports 50% of each $2,000 payment she receives as gain from the sale. She also reports the interest as ordinary income.

Mortgage More than Basis

When a buyer assumes a mortgage that is more than the installment sale basis in the property, the seller recovers the entire basis in the year of the sale. The part of the mortgage greater than the seller's basis is treated as a payment received in the year of sale. The gross profit percentage is always 100% in this situation.

To calculate the contract price, the taxpayer subtracts the mortgage from the selling price. This is the total amount the taxpayer will receive directly from the buyer. The taxpayer adds this to the payment the taxpayer is considered to have received (the difference between the mortgage and the installment sale basis). The contract price is then the same as the gross profit from the sale.

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[33]. IRS Pub. 537, *Installment Sales.*

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Example 11. In 2023, William sells 10 acres of hunting ground for $9,000. His basis is $4,400 and he incurs $600 of selling expenses; therefore, his installment sale basis is $5,000. The buyer, Harry, assumes an existing mortgage of $6,000 and agrees to pay the remaining $3,000 in $750 annual installments, plus 8% interest, over the next four years.

The part of the mortgage that is more than the installment sale basis is $1,000 ($6,000 mortgage – $5,000 basis). This $1,000 is considered part of the installment contract. It is added to the $3,000 difference between the selling price and the mortgage. Therefore, $4,000 is the contract price.

On William's 2023 Form 6252, his gain of $4,000 ($9,000 selling price – $4,400 basis – $600 selling expenses) is reported on lines 14 and 16. The contract price reported on line 18 is $4,000 ($1,000 excess mortgage + $3,000 to be received in future years). His gross profit percentage is 100%. The entire $1,000 difference between the mortgage and the installment sale basis is treated as 2023 income.

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For Example 11

Form **6252** Department of the Treasury Internal Revenue Service

Installment Sale Income

Attach to your tax return.
Use a separate form for each sale or other disposition of property on the installment method.
Go to *www.irs.gov/Form6252* for the latest information.

OMB No. 1545-0228 **2023** Attachment Sequence No. **67**

Name(s) shown on return: **William Fits** | Identifying number: *****-**-4666**

1	Description of property **2 -10 Acres Recreational Woodland**				
2a	Date acquired (mm/dd/yyyy) **02/14/2014** **b** Date sold (mm/dd/yyyy) **02/14/2023**				
3	Was the property sold to a related party? See instructions. If "Yes," complete Part III for the year of sale and 2 years after the year of the sale unless you received the final payment during the tax year	☐ Yes ☒ No			
4	Reserved for future use	☐ Yes ☐ No			

Part I Gross Profit and Contract Price. Complete this part for all years of the installment agreement.

5	Selling price including mortgages and other debts. **Don't** include interest, whether stated or unstated			5	9,000
6	Mortgages, debts, and other liabilities the buyer assumed or took the property subject to (see instructions)	6	6,000		
7	Subtract line 6 from line 5	7	3,000		
8	Cost or other basis of property sold	8	4,400		
9	Depreciation allowed or allowable	9			
10	Adjusted basis. Subtract line 9 from line 8	10	4,400		
11	Commissions and other expenses of sale	11	600		
12	Income recapture from Form 4797, Part III (see instructions)	12			
13	Add lines 10, 11, and 12			13	5,000
14	Subtract line 13 from line 5. If zero or less, **don't** complete the rest of this form. See instructions			14	4,000
15	If the property described on line 1 above was your main home, enter the amount of your excluded gain. See instructions. Otherwise, enter -0-			15	
16	**Gross profit.** Subtract line 15 from line 14			16	4,000
17	Subtract line 13 from line 6. If zero or less, enter -0-			17	1,000
18	**Contract price.** Add line 7 and line 17			18	4,000

Part II Installment Sale Income. Complete this part for all years of the installment agreement.

19	Gross profit percentage (expressed as a decimal amount). Divide line 16 by line 18. (For years after the year of sale, see instructions.)			19	1.0000
20	If this is the year of sale, enter the amount from line 17. Otherwise, enter -0-			20	1,000
21	Payments received during year (see instructions). **Don't** include interest, whether stated or unstated			21	
22	Add lines 20 and 21			22	1,000
23	Payments received in prior years (see instructions). **Don't** include interest, whether stated or unstated	23			
24	**Installment sale income.** Multiply line 22 by line 19			24	1,000
25	Enter the part of line 24 that is ordinary income under the recapture rules. See instructions			25	
26	Subtract line 25 from line 24. Enter here and on Schedule D or Form 4797. See instructions			26	1,000

Part III Related Party Installment Sale Income. Don't complete if you received the final payment this tax year.

27 Name, address, and taxpayer identifying number of related party

28 Did the related party resell or dispose of the property ("second disposition") during this tax year? ☐ Yes ☐ No

29 **If the answer to question 28 is "Yes," complete lines 30 through 37 below unless one of the following conditions is met. Check the box that applies.**

- a ☐ The second disposition was more than 2 years after the first disposition (other than dispositions of marketable securities). If this box is checked, enter the date of disposition (mm/dd/yyyy)
- b ☐ The first disposition was a sale or exchange of stock to the issuing corporation.
- c ☐ The second disposition was an involuntary conversion and the threat of conversion occurred after the first disposition.
- d ☐ The second disposition occurred after the death of the original seller or buyer.
- e ☐ It can be established to the satisfaction of the IRS that tax avoidance wasn't a principal purpose for either of the dispositions. If this box is checked, attach an explanation. See instructions.

30	Selling price of property sold by related party (see instructions)	30	
31	Enter contract price from line 18 for year of first sale	31	
32	Enter the **smaller** of line 30 or line 31	32	
33	Total payments received by the end of your 2023 tax year (see instructions)	33	
34	Subtract line 33 from line 32. If zero or less, enter -0-	34	
35	Multiply line 34 by the gross profit percentage on line 19 for year of first sale	35	
36	Enter the part of line 35 that is ordinary income under the recapture rules. See instructions	36	
37	Subtract line 36 from line 35. Enter here and on Schedule D or Form 4797. See instructions	37	

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Mortgage Canceled

When the buyer of the property is the person who holds the mortgage, the debt is canceled, not assumed. The seller is considered to receive a payment equal to the outstanding canceled debt.

> **Example 12.** Mary loaned John $45,000 in 2018 in exchange for a note and a mortgage on a tract of land John owned. On April 1, 2024, she buys the land from him for $70,000. At that time, $30,000 of her loan to him is outstanding. She agrees to forgive this $30,000 debt and to pay him $20,000 plus interest on August 1, 2025, and $20,000 plus interest on August 1, 2026. Mary does not assume an existing mortgage; instead, she cancels the $30,000 debt John owed her. John must treat the $30,000 as a payment received at the time of the sale.

BUYER ASSUMES OTHER DEBTS

When the buyer assumes any other debts, such as a loan or back taxes, the assumption of debt **may be** considered a payment to the seller in the year of sale. The rules that apply to mortgages also apply to the following types of debt that the buyer assumes.

- Debts related to ownership of the property the taxpayer sold, such as a mortgage, lien, overdue interest, or back taxes
- Debts incurred in the ordinary course of a business, such as a balance due for inventory the taxpayer purchased

When the buyer assumes any other type of debt, such as a personal loan or the legal fees relating to the sale, it is treated as if the buyer paid off the debt at the time of the sale. The value of the assumed debt is then considered a payment to the taxpayer in the year of sale.

PROPERTY USED AS A PAYMENT

When the taxpayer receives property other than money from the buyer, it is considered a payment in the year received unless the like-kind exchange provisions apply. Like-kind exchanges are discussed later. Generally, the “payment” is equal to the property’s FMV on the date the taxpayer receives it.

When the property the buyer gives the taxpayer is **payable on demand (e.g., a third-party note) or readily tradable (e.g., publicly traded stocks),** the amount the taxpayer considers as payment in the year received is determined under the following rules.

1. If the taxpayer uses the **cash method of accounting,** then the payment is equal to the property’s FMV on the date the taxpayer receives it. If the property is third-party debt, then any payments the taxpayer later receives from the third party are not considered part of the installment sale. The excess of the note’s face value over its FMV is interest.
2. If the taxpayer uses the **accrual method of accounting,** then the payment is equal to the face amount of the obligation on the date the taxpayer receives it.
3. If the obligation includes OID or unstated interest, then the payment equals the stated redemption price at maturity appropriately adjusted to reflect OID or total unstated interest.

> **Observation.** If the seller is also the lender in an installment sale transaction and wants to avoid treating the note receivable as being fully taxable in the year of sale, the note payable must **not be payable on demand** and must **not be readily tradable.**[34] This prevents the note payable from being treated as a payment in the year of sale and allows income to be recognized as an installment obligation in future years.

---

34. IRC §453(f)(4).

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Any third-party debt that the taxpayer receives from the buyer that is **not payable on demand** is **not** considered a payment. This is true even if the debt is guaranteed by a third party, including a government agency.

Example 13. Barry owes Debbie $50,000 as evidenced by a note he gave her in 2021. Under the terms of the note, he pays 5% interest each year. Principal of $25,000 is due in 2026, and the balance of $25,000 is due in 2027. There are no provisions allowing Debbie to demand payment prior to the due dates.

In October 2024, Debbie buys a 2017 Luxury Fiesta motorhome from Ron. Debbie assigns the note from Barry to Ron. In addition, she gives Ron $2,000 and a note for $20,000 from her payable to Ron. Debbie's note is payable over four years beginning in 2025, plus 8% interest.

At the time of the sale, the **FMV of Barry's note is $30,000,** as determined by a valuation expert. This amount, not the $50,000 principal balance on the note, is considered a payment to Ron in the year of sale.

The sales price is $52,000 ($30,000 note FMV + $2,000 paid to Ron + $20,000 note from Debbie to Ron). Ron treats $32,000 ($30,000 + $2,000) as payments in 2024, the year of sale. The taxable portion of payments from Debbie to Ron in 2025 through 2028 will be determined under the installment sales rules.

At the time of the sale, Barry's note has an FMV equal to 60% of its face value ($30,000 ÷ $50,000). Therefore, 60% of each principal payment Ron receives from Barry is a nontaxable return of capital. The remaining 40% is interest income. If Barry pays Ron as scheduled in 2026 and 2027, then Ron will report $10,000 ($25,000 annual payment × 40% interest allocation) as interest income each year.

INSTALLMENT OBLIGATION USED AS SECURITY[35]

If the taxpayer uses an installment obligation to secure any of their debt, the net proceeds from the debt may be treated as a payment on the installment obligation. This is called the **pledge rule.** The purpose of the pledge rule is to keep taxpayers from extracting cash from an installment sale without incurring any immediate tax. The rule applies if the selling price of the property sold on installment is over $150,000. It does **not** apply to the following dispositions.

- Sales of property used or produced in farming
- Sales of personal-use property
- Qualifying sales of time-shares and residential lots

The net debt proceeds equal the gross debt minus the direct expenses of obtaining the debt. The amount treated as a payment is considered received on the **later** of the following dates.

- The date the debt becomes secured
- The date the taxpayer receives the debt proceeds

A debt is secured by an installment obligation to the extent that payment of principal or interest on the debt is directly secured (under the terms of the loan or any underlying arrangement) by any interest in the installment obligation.

Payment on a debt is treated as directly secured by an interest in an installment obligation to the extent an arrangement allows the taxpayer to satisfy all or part of the debt with the installment obligation.

[35] IRC §453A; IRS Pub. 537, *Installment Sales,* pp. 8–9 (2023).

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Limit

The net debt proceeds treated as a payment on the pledged installment obligation cannot be more than the excess of:

1. The total contract price on the installment sale, **minus**
2. Any payments received on the installment obligation before the date the net debt proceeds are treated as a payment.

Accelerated Reporting

The pledge rule accelerates the reporting of the installment obligation payments. Payments received on the obligation after it was pledged are not reported until the payments received exceed the amount reported under the pledge rule.

Example 14. Mary Jane received a $500,000 note from Conrad for the sale of her commercial building in 2022. The note is payable over 10 years, with interest. She did not receive any payments on the note from Conrad in 2022.

In January 2023, Mary Jane uses the note as collateral to borrow $200,000 from Nancy. Under the pledge rule, Mary Jane reports the $200,000 she borrowed from Nancy in 2023 as if it constituted principal payments from Conrad in 2023.

Mary Jane also receives $50,000 from Conrad in March 2023. Conrad's $50,000 payment is disregarded for installment reporting purposes. Conrad's payments will be disregarded until they total more than the $200,000 Mary Jane reports in 2023 under the pledge rule.

Example 15. Use the same facts as **Example 14,** except Mary Jane uses the note as collateral in 2023 after she has received a total of $350,000 of principal payments from Conrad. The limit in 2023 on the amount she must report under the pledge rule is $150,000 ($500,000 contract price – $350,000 payments). In this instance, she will not have any principal payments to report in the following years because she has already reported receiving the entire contract principal.

Exception

The pledge rule does not apply to pledges made after December 17, 1987, in order to refinance a debt, under the following circumstances.

- The debt was outstanding on December 17, 1987.
- The debt was secured by the installment sale obligation on that date and at all times thereafter until the refinancing occurred.

A refinancing as a result of the creditor's calling of the debt is treated as a continuation of the original debt as long as a person other than the creditor or a person related to the creditor provides the refinancing. This exception applies only to refinancing that does not exceed the principal of the original debt immediately before the refinancing. Any excess is treated as a payment on the installment obligation.

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MONETIZED INSTALLMENT SALES[36]

In 2023, the IRS and the Department of the Treasury identified certain monetized installment sale transactions and substantially similar transactions as **listed transactions.**[37] Material advisors and participants in these transactions are required to file disclosures with the IRS and are subject to penalties for failure to disclose. In 2024, the IRS identified monetized installment sales as one of the top schemes for the year in their list of Dirty Dozen scams.[38]

> **Note.** For more information on the 2024 Dirty Dozen list, see the 2024 *University of Illinois Federal Tax Workbook,* Chapter 7: IRS Update.

A listed transaction is a transaction that the IRS has:

1. Determined to be a tax avoidance arrangement, and
2. Identified by a notice, regulation, or other form of published guidance as a listed transaction.[39]

A **monetized installment sale transaction** generally includes the following characteristics.

- A seller of appreciated property, or their representative, finds a buyer willing to purchase the property for cash or other assets.
- The seller makes an agreement to sell the property to an intermediary in exchange for an installment obligation, wherein the intermediary pays interest to the seller.
- The seller then transfers the property to the intermediary, who either briefly holds the title or never takes it, before passing it to the buyer in exchange for the buyer's payment.
- Additionally, the seller secures a loan with an agreement for interest payments matching those received from the intermediary.
- Both the installment agreement and the loan involve interest payments over the same periods, with the principal due in a lump sum (balloon payment) towards the end of their terms.
- The intermediary forwards the sale proceeds, minus certain fees, to the lender to finance the seller's loan or holds them in an escrow account, with the lender as a beneficiary.
- The lender commits to repaying these amounts to the intermediary over the installment obligation's duration.
- The seller reports the sale as an installment under IRC §453 on their federal income tax return, deferring gain recognition until receiving the principal balloon payment.

36. *Treasury and IRS issue proposed regulations identifying certain monetized installment sales as listed transactions.* Aug. 3, 2023. IRS. [www.irs.gov/newsroom/treasury-and-irs-issue-proposed-regulations-identifying-certain-monetized-installment-sales-as-listed-transactions] Accessed on Jun. 10, 2024.

37. Prop. REG-109348-22, IR-2023-139 (Aug. 3, 2023).

38. See *Dirty Dozen: High-income filers vulnerable to illegal tax schemes; face risk from improper art donation deductions, charitable remainder annuity trusts, monetized installment sales.* Apr. 10, 2024. IRS. [www.irs.gov/newsroom/dirty-dozen-high-income-filers-vulnerable-to-illegal-tax-schemes-face-risk-from-improper-art-donation-deductions-charitable-remainder-annuity-trusts-monetized-installment-sales] Accessed on Jun. 10, 2024.

39. Treas. Reg. §1.6011-4(b)(2).

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In this scheme, the seller gets the majority of the proceeds, but improperly delays recognizing the gain on the appreciated property until the final payment on the installment note, which is often many years later. Unfortunately, promoters may look for taxpayers who are seeking to defer the recognition of gain once they sell the appreciated property by organizing an abusive shelter through selling monetized installment sales. Accordingly, the IRS targets the promoters by requiring material advisors (who profit from the scheme) to alert the Treasury Department about the arrangement.

Note. For issues specific to farmers, see the 2024 *University of Illinois Federal Tax Workbook,* Chapter 11: Agricultural Issues and Rural Investments.

MATERIAL ADVISOR

A **material advisor** is a person who:[40]

1. Provides any material aid, assistance, or advice with respect to organizing, managing, promoting, selling, implementing, insuring, or carrying out any reportable transaction, and
2. Directly or indirectly derives gross income in excess of the threshold amount for such aid, assistance, or advice.

For listed transactions, the threshold amount is $10,000 for a natural person and $25,000 for all other entities,[41] whereas for non-listed transactions, the threshold amount is $50,000 for a natural person and $250,000 for all other entities.

REPORTING REPORTABLE TRANSACTIONS[42]

Form 8886, *Reportable Transaction Disclosure Statement,* generally must be filed for each reportable transaction. The form must:

- Describe the expected tax treatment and all potential tax benefits expected from the transaction,
- Describe any tax result protection regarding the transaction, and
- Identify and describe the transaction in sufficient detail for the IRS to understand the tax structure of the transaction and identify all the parties involved in the transaction.

ESCROW ARRANGEMENTS[43]

Occasionally, a sales agreement or a later agreement may require the buyer to establish an irrevocable escrow account from which the remaining installment payments (including interest) are to be made. **These types of sales cannot be reported on the installment method.** The buyer's obligation is paid in full when the balance of the purchase price is deposited into the escrow account. When an escrow account is established, the taxpayer relies on the escrow arrangement for the rest of the payments, rather than on the buyer.

When the taxpayer makes an installment sale and in a later year establishes an irrevocable escrow account to pay the remaining installments plus interest, the amount placed in the escrow account represents payment of the balance of the installment obligation.

40. IRC §6111(b)(1).
41. Treas Reg. §301.6111–3(b)(3).
42. *Abusive tax shelters and transactions.* May 3, 2024. IRS. [www.irs.gov/businesses/corporations/abusive-tax-shelters-and-transactions] Accessed on Jun. 10, 2024; Instructions for Form 8886.
43. IRS Pub. 537, *Installment Sales.*

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However, if an escrow arrangement imposes a substantial restriction on the seller's right to receive the sale proceeds, the sale can be reported on the installment method if it otherwise qualifies. For an escrow arrangement to impose a substantial restriction, it must serve a bona fide purpose of the **buyer.**[44] This means that it must have a **real and definite restriction placed on the seller** or a specific economic benefit conferred on the buyer.

Example 16. Alba enters into an asset purchase and sale agreement with Benny, the seller, to purchase business assets. The total purchase price for the assets is $400,000. Alba and Benny agree that the $400,000 purchase price will be placed into an escrow account for a 2-year period. The escrow agreement is being used to protect Alba from any breach of representations made by Benny regarding the assets purchased by Alba, and to ensure the assets are free of any encumbrances. After two years, Benny will receive the funds. During the two years that the funds are in escrow, however, Benny will be entitled to quarterly interest payments for the interest earned on the $400,000 while in escrow.

Benny's access to the escrow funds is limited to quarterly interest payments, and the escrow arrangement is used to protect Alba, the purchaser. Benny's right to the trust funds is therefore subject to a substantial restriction or condition. Benny may use the installment sale rules for the sale transaction.[45]

Note. For the general rule that funds deposited in escrow are constructively received by the seller, disqualifying the transaction from installment sale treatment, see *Oden v. Comm'r*.[46] For the substantial restriction or condition exception to the *Oden* rule, see *Stiles v. Comm'r*.[47] For additional authority and details regarding the substantial restriction or condition exception, see also Rev. Rul. 77-294.

DEPRECIATION RECAPTURE AND UNRECAPTURED §1250 GAIN[48]

When the taxpayer sells property for which the taxpayer claimed or could have claimed a depreciation deduction, the taxpayer must report any depreciation **recapture** income in the **year of sale.** This is true regardless of whether an installment payment was received that year. Depreciation recapture is taxed as ordinary income.

Depreciation **recapture** is limited to the gain realized on the disposition and includes the following.

1. All depreciation **allowed or allowable** on §1245 property (personal property)
2. Depreciation in **excess of straight-line** on §1250 property (depreciable real estate)

Example 17. Darrel sold his concrete slab jacking equipment to Scott in December 2023 for a note payable of $15,000, plus interest. Under the terms of the note, Scott agreed to pay $500 per month beginning on January 31, 2024. These payments will continue until the note is paid in full.

Darrel originally purchased the equipment for $25,000. As of 2023, it was fully depreciated.

Darrel reported the entire $15,000 selling price as depreciation recapture on his 2023 Form 4797. He did not file Form 6252, because all of the profit was taxed in 2023. In subsequent years, Darrel will only report the interest received on the note.

Observation. The use of an installment sale may be impractical for businesses who made use of bonus depreciation or the IRC §179 deductions in prior years because the §1245 recapture rules apply. The tax liability may exceed the cash received in the year of sale.

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44. Rev. Rul. 79-91, 1979-1 CB 179.
45. This example is based on Ltr. Rul. 200521007 (Feb. 25, 2005).
46. *Oden v. Comm'r,* 56 TC 569 (1971).
47. *Stiles v. Comm'r,* 69 TC 558 (1978), *acq.* 1978-2 CB 3.
48. IRS Pub. 544, *Sales and Other Dispositions of Assets*.

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Essentially, only the gain in excess of the original purchase price qualifies for the lower long-term capital gains tax rates. Any portion of the gain that is a recovery of a deduction is generally taxed at ordinary income tax rates. However, there is a limit on the tax rate for recovery of straight-line depreciation on §1250 property.

Gain from the sale of §1250 property that is attributable to the accumulated depreciation allowed or allowable under the straight-line method is called **unrecaptured gain** and is **taxed as ordinary income up to the maximum rate of 25%.** The taxpayer enters the amount of unrecaptured gain on the "Unrecaptured Section 1250 Gain Worksheet," which is part of the Schedule D instructions.

The taxable gain on principal payments received on the installment basis is **first** allocated to the unrecaptured §1250 gain. This continues each year until the taxpayer claims the entire amount of unrecaptured gain.[49] The remainder of the gain is taxed as a short-term or long-term capital gain, depending on the holding period of the sold assets.

Example 18. Ursula sold residential rental property on contract for deed on September 9, 2023, for $200,000. The property was originally purchased for $145,000 in September 2008. The land value at the time of purchase was $10,000. Of the $135,000 depreciable basis, her accumulated allowed or allowable depreciation at the time of the sale was **$73,635.**[50]

Ursula's adjusted basis in the property was $71,365 ($145,000 cost – $73,635 accumulated depreciation). Her total gain was $128,635 ($200,000 sales price – $71,365 adjusted basis). This is also her gross profit under the installment agreement. The gain is composed of the following.

Unrecaptured gain	$ 73,635
Long-term capital gain	55,000
Total gain	$128,635

Under the terms of the contract, Ursula received a down payment of $20,000 in 2023. She will receive the remaining principal over 15 years beginning in January 2024.

Ursula's gross profit percentage is 64.32% ($128,635 gain ÷ $200,000 sales price). Her 2023 taxable gain is $12,864 ($20,000 principal received × 64.32% gross profit percentage). The entire $12,864 is taxed as unrecaptured §1250 gain. Ursula will not claim any of the gain as long-term capital gains until she has claimed the entire $73,635 of depreciation.

On her 2023 return, Ursula reported the sale in part III of Form 4797 and on Form 6252. Line 32 of Form 4797 is marked "N/A" in accordance with the instructions for Form 6252, line 12, about reporting the installment sale on Form 4797. The taxable portion of the sale flowed from Form 6252 to line 4 of Form 4797. Pages of Ursula's Forms 6252 and 4797 follow.

49. Treas. Reg. §1.453-12(a).

50. Calculated using MACRS, straight-line, mid-month convention, 27.5 years.

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For Example 18

Form **6252** Department of the Treasury Internal Revenue Service

Installment Sale Income

Attach to your tax return.
Use a separate form for each sale or other disposition of property on the installment method.
Go to *www.irs.gov/Form6252* for the latest information.

OMB No. 1545-0228 | 2023 | Attachment Sequence No. 67

Name(s) shown on return	Identifying number
Ursula Gwinn	***-**-2222

1 Description of property **4 - Residential Rental Property**

2a Date acquired (mm/dd/yyyy) **09/09/2008** b Date sold (mm/dd/yyyy) **09/09/2023**

3 Was the property sold to a related party? See instructions. If "Yes," complete Part III for the year of sale and 2 years after the year of the sale unless you received the final payment during the tax year ☐ Yes ☒ No

4 Reserved for future use ☐ Yes ☐ No

Part I Gross Profit and Contract Price. Complete this part for all years of the installment agreement.

Line	Description				
5	Selling price including mortgages and other debts. **Don't** include interest, whether stated or unstated			5	200,000
6	Mortgages, debts, and other liabilities the buyer assumed or took the property subject to (see instructions)	6			
7	Subtract line 6 from line 5	7	200,000		
8	Cost or other basis of property sold	8	145,000		
9	Depreciation allowed or allowable	9	73,635		
10	Adjusted basis. Subtract line 9 from line 8	10	71,365		
11	Commissions and other expenses of sale	11			
12	Income recapture from Form 4797, Part III (see instructions)	12	0		
13	Add lines 10, 11, and 12			13	71,365
14	Subtract line 13 from line 5. If zero or less, **don't** complete the rest of this form. See instructions			14	128,635
15	If the property described on line 1 above was your main home, enter the amount of your excluded gain. See instructions. Otherwise, enter -0-			15	
16	**Gross profit.** Subtract line 15 from line 14			16	128,635
17	Subtract line 13 from line 6. If zero or less, enter -0-			17	0
18	**Contract price.** Add line 7 and line 17			18	200,000

Part II Installment Sale Income. Complete this part for all years of the installment agreement.

Line	Description				
19	Gross profit percentage (expressed as a decimal amount). Divide line 16 by line 18. (For years after the year of sale, see instructions.)			19	0.6432
20	If this is the year of sale, enter the amount from line 17. Otherwise, enter -0-			20	0
21	Payments received during year (see instructions). **Don't** include interest, whether stated or unstated			21	20,000
22	Add lines 20 and 21			22	20,000
23	Payments received in prior years (see instructions). **Don't** include interest, whether stated or unstated	23			
24	**Installment sale income.** Multiply line 22 by line 19			24	12,864
25	Enter the part of line 24 that is ordinary income under the recapture rules. See instructions			25	
26	Subtract line 25 from line 24. Enter here and on Schedule D or Form 4797. See instructions			26	12,864

Part III Related Party Installment Sale Income. Don't complete if you received the final payment this tax year.

27 Name, address, and taxpayer identifying number of related party

28 Did the related party resell or dispose of the property ("second disposition") during this tax year? ☐ Yes ☐ No

29 **If the answer to question 28 is "Yes," complete lines 30 through 37 below unless one of the following conditions is met. Check the box that applies.**

a ☐ The second disposition was more than 2 years after the first disposition (other than dispositions of marketable securities). If this box is checked, enter the date of disposition (mm/dd/yyyy)

b ☐ The first disposition was a sale or exchange of stock to the issuing corporation.

c ☐ The second disposition was an involuntary conversion and the threat of conversion occurred after the first disposition.

d ☐ The second disposition occurred after the death of the original seller or buyer.

e ☐ It can be established to the satisfaction of the IRS that tax avoidance wasn't a principal purpose for either of the dispositions. If this box is checked, attach an explanation. See instructions.

Line	Description		
30	Selling price of property sold by related party (see instructions)	30	
31	Enter contract price from line 18 for year of first sale	31	
32	Enter the **smaller** of line 30 or line 31	32	
33	Total payments received by the end of your 2023 tax year (see instructions)	33	
34	Subtract line 33 from line 32. If zero or less, enter -0-	34	
35	Multiply line 34 by the gross profit percentage on line 19 for year of first sale	35	
36	Enter the part of line 35 that is ordinary income under the recapture rules. See instructions	36	
37	Subtract line 36 from line 35. Enter here and on Schedule D or Form 4797. See instructions	37	

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For Example 18

Form **4797** | **Sales of Business Property** (Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2)) | OMB No. 1545-0184 | 2023

Department of the Treasury
Internal Revenue Service

Attach to your tax return.
Go to *www.irs.gov/Form4797* for instructions and the latest information.

Attachment Sequence No. 27

Name(s) shown on return	Identifying number
Ursula Gwinn	***-**-2222

1a	Enter the gross proceeds from sales or exchanges reported to you for 2023 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20. See instructions	1a	
b	Enter the total amount of gain that you are including on lines 2, 10, and 24 due to the partial dispositions of MACRS assets	1b	
c	Enter the total amount of loss that you are including on lines 2 and 10 due to the partial dispositions of MACRS assets	1c	

Part I — Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty or Theft—Most Property Held More Than 1 Year (see instructions)

2 (a) Description of property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis, plus improvements and expense of sale	(g) Gain or (loss) Subtract (f) from the sum of (d) and (e)

3	Gain, if any, from Form 4684, line 39	3	
4	Section 1231 gain from installment sales from Form 6252, line 26 or 37	4	12,864
5	Section 1231 gain or (loss) from like-kind exchanges from Form 8824	5	
6	Gain, if any, from line 32, from other than casualty or theft	6	0
7	Combine lines 2 through 6. Enter the gain or (loss) here and on the appropriate line as follows	7	12,864

Partnerships and S corporations. Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 10, or Form 1120-S, Schedule K, line 9. Skip lines 8, 9, 11, and 12 below.

Individuals, partners, S corporation shareholders, and all others. If line 7 is zero or a loss, enter the amount from line 7 on line 11 below and skip lines 8 and 9. If line 7 is a gain and you didn't have any prior year section 1231 losses, or they were recaptured in an earlier year, enter the gain from line 7 as a long-term capital gain on the Schedule D filed with your return and skip lines 8, 9, 11, and 12 below.

8	Nonrecaptured net section 1231 losses from prior years. See instructions	8	
9	Subtract line 8 from line 7. If zero or less, enter -0-. If line 9 is zero, enter the gain from line 7 on line 12 below. If line 9 is more than zero, enter the amount from line 8 on line 12 below and enter the gain from line 9 as a long-term capital gain on the Schedule D filed with your return. See instructions	9	

Part II — Ordinary Gains and Losses (see instructions)

10 Ordinary gains and losses not included on lines 11 through 16 (include property held 1 year or less):

11	Loss, if any, from line 7	11	( )
12	Gain, if any, from line 7 or amount from line 8, if applicable	12	
13	Gain, if any, from line 31	13	0
14	Net gain or (loss) from Form 4684, lines 31 and 38a	14	
15	Ordinary gain from installment sales from Form 6252, line 25 or 36	15	
16	Ordinary gain or (loss) from like-kind exchanges from Form 8824	16	
17	Combine lines 10 through 16	17	0
18	For all except individual returns, enter the amount from line 17 on the appropriate line of your return and skip lines a and b below. For individual returns, complete lines a and b below.		
a	If the loss on line 11 includes a loss from Form 4684, line 35, column (b)(ii), enter that part of the loss here. Enter the loss from income-producing property on Schedule A (Form 1040), line 16. (Do not include any loss on property used as an employee.) Identify as from "Form 4797, line 18a." See instructions	18a	
b	Redetermine the gain or (loss) on line 17 excluding the loss, if any, on line 18a. Enter here and on Schedule 1 (Form 1040), Part I, line 4	18b	

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For Example 18

Form 4797 (2023) Page 2

Part III **Gain From Disposition of Property Under Sections 1245, 1250, 1252, 1254, and 1255** (see instructions)

19	(a) Description of section 1245, 1250, 1252, 1254, or 1255 property:	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)
A	**Residential Rental Property**	**09/09/2008**	**09/09/2023**
B			
C			
D			

	These columns relate to the properties on lines 19A through 19D.		Property A	Property B	Property C	Property D
20	Gross sales price (**Note:** *See line 1a before completing.*)	20	**200,000**			
21	Cost or other basis plus expense of sale	21	**145,000**			
22	Depreciation (or depletion) allowed or allowable	22	**73,635**			
23	Adjusted basis. Subtract line 22 from line 21	23	**71,365**			
24	Total gain. Subtract line 23 from line 20	24	**128,635**			
25	**If section 1245 property:**					
a	Depreciation allowed or allowable from line 22	25a				
b	Enter the **smaller** of line 24 or 25a	25b				
26	**If section 1250 property:** If straight line depreciation was used, enter -0- on line 26g, except for a corporation subject to section 291.					
a	Additional depreciation after 1975. See instructions	26a	**0**			
b	Applicable percentage multiplied by the **smaller** of line 24 or line 26a. See instructions	26b	**0**			
c	Subtract line 26a from line 24. If residential rental property **or** line 24 isn't more than line 26a, skip lines 26d and 26e	26c	**128,635**			
d	Additional depreciation after 1969 and before 1976	26d				
e	Enter the **smaller** of line 26c or 26d	26e				
f	Section 291 amount (corporations only)	26f				
g	Add lines 26b, 26e, and 26f	26g	**0**			
27	**If section 1252 property:** Skip this section if you didn't dispose of farmland or if this form is being completed for a partnership.					
a	Soil, water, and land clearing expenses	27a				
b	Line 27a multiplied by applicable percentage. See instructions	27b				
c	Enter the **smaller** of line 24 or 27b	27c				
28	**If section 1254 property:**					
a	Intangible drilling and development costs, expenditures for development of mines and other natural deposits, mining exploration costs, and depletion. See instructions	28a				
b	Enter the **smaller** of line 24 or 28a	28b				
29	**If section 1255 property:**					
a	Applicable percentage of payments excluded from income under section 126. See instructions	29a				
b	Enter the **smaller** of line 24 or 29a. See instructions	29b				

Summary of Part III Gains. Complete property columns A through D through line 29b before going to line 30.

30	Total gains for all properties. Add property columns A through D, line 24	30	**128,635**
31	Add property columns A through D, lines 25b, 26g, 27c, 28b, and 29b. Enter here and on line 13	31	**0**
32	Subtract line 31 from line 30. Enter the portion from casualty or theft on Form 4684, line 33. Enter the portion from other than casualty or theft on Form 4797, line 6	32	**N/A**

Part IV **Recapture Amounts Under Sections 179 and 280F(b)(2) When Business Use Drops to 50% or Less** (see instructions)

			(a) Section 179	(b) Section 280F(b)(2)
33	Section 179 expense deduction or depreciation allowable in prior years	33		
34	Recomputed depreciation. See instructions	34		
35	Recapture amount. Subtract line 34 from line 33. See the instructions for where to report	35		

Form **4797** (2023)

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Part I of Form 6252 is required to be completed each subsequent year that the installment agreement is in place. The total amount of unrecaptured §1250 gain from the sale is generally the lesser of line 9 or line 16 of Form 6252.

Line 23 in part II of Form 6252 reports the total of principal payments that the taxpayer received in prior years. Accordingly, if the prior years' Forms 6252 were completed correctly, it is possible to determine the portion of the gain that must be taxed under these rules in the current year by comparing lines 9 and 23.

Real property for which accelerated depreciation was taken may be subject to both depreciation recapture and tax on unrecaptured gain. The depreciation recapture portion of the gain is taxed in the year of sale.

As mentioned earlier, depreciable real estate is §1250 property and personal property is §1245 property. **However, any §179 deduction** or **bonus depreciation deduction taken on real property is considered §1245 property for depreciation recapture purposes.**[51] The amount of depreciation recapture for §1250 property treated as personal property under the §1245 rules is the excess of accelerated depreciation over straight-line depreciation, multiplied by the applicable percentage.

The applicable percentage is 100% for most real property. However, the applicable percentage for qualified low-income housing decreases when held for more than 100 full months.

Note. See IRS Pub. 544, *Sales and Other Dispositions of Assets*, for more information on qualified low-income housing. In addition, IRS Pub. 544 contains information about rules applicable to corporations other than S corporations under IRC §291, which is not covered in this material.

Example 19. On July 1, 2015, Quinn opened a nightclub in a leased facility in Juneau, Alaska. The facility is owned by Neeley, an unrelated party. Prior to opening night, Quinn invested $60,000 in improvements to the interior of the building.

On his 2015 tax return, Quinn claimed $30,000 of bonus depreciation on the leasehold improvements in addition to straight-line depreciation on the remaining $30,000.[52]

As part of his agreement with his landlord, if Quinn did not renew his lease, Neeley had to purchase the leasehold improvements at a price based on any appreciation attributable to the renovations made by Quinn. In 2023, Quinn closes the club and gives notice that he will not renew the lease effective December 1, 2023. He sells the equipment at auction and sells the leasehold improvements for $75,000 to Neeley in an installment sale. Quinn receives $5,000 in 2023 as a down payment. The remaining $70,000 is due over seven years, with interest at 10%.

Step 1. Quinn's total gain on the sale of the property is calculated on **page 2 of Form 4797,** as shown later. Line 20 represents the total sales price. Lines 21 through 23 show the calculation of his adjusted basis of $14,000 ($60,000 cost – $46,000 accumulated depreciation). Line 24 shows his total gain of $61,000 ($75,000 sales price – $14,000 adjusted basis).

Step 2. **The depreciation recapture is calculated on line 26 of Form 4797.** In this step, line 26a is calculated as follows.

Bonus depreciation taken in 2015	$30,000
Straight-line depreciation from July 2, 2015 through December 1, 2023	16,000
Total accumulated depreciation	$46,000
Straight-line depreciation allowable without bonus depreciation	(32,000)
Additional depreciation reported on line 26a	$14,000

51. IRC §1245(a)(3)(C) and Treas. Reg. §1.168(k)-1(f)(3).

52. Per the 2015 Instructions for Form 4562, *Depreciation and Amortization,* 50% bonus depreciation applied to qualified leasehold improvement property as defined in IRC §§168(e)(6) and (k)(3).

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Step 3. The additional depreciation on line 26a is multiplied by the applicable percentage of 100% to arrive at the $14,000 reported on lines 26b and 26g. (The applicable percentage is 100% because the leasehold improvements are not related to qualified low-income housing rental real estate.) Line 32 shows N/A, in accordance with the instructions for Form 6252 regarding line 31 of Form 4797, because the remaining balance of the gain is reported on Form 6252. After completing the mechanics of page 2 of Form 4797, the $14,000 flows to line 13 of page 1 of Form 4797 (shown later).

Step 4. The balance of Quinn's gain of $47,000 ($61,000 total gain – $14,000 depreciation recapture) is reported as an installment sale on **Form 6252** (shown later). The $14,000 adjusted basis is calculated on lines 7 through 10. Line 12 shows the depreciation recapture from Form 4797, page 2. The amounts on lines 10 and 12 are the same because the accelerated depreciation Quinn used in 2015 was 50% bonus depreciation.

Step 5. Because the depreciation recapture is taxed in 2023, it is added to the adjusted basis on Form 6252. The gross profit on line 14 is the remaining gain after taking into account the depreciation recapture. Line 18 shows the contract price of $75,000.

Step 6. Quinn's gross profit percentage is 62.67%, as shown on line 19. The $5,000 he receives on the contract sale in 2023 is reported on line 21 and multiplied by the gross profit percentage. This results in $3,133 of installment sale income, which is shown on line 24.

Note. Line 25 applies to IRC §§1252, 1254, and 1255 property, which are not discussed in this chapter.

Step 7. Line 26 of Form 6252 is carried to Form 4797, part I.

Step 8. The amount of Quinn's contract gain that represents unrecaptured §1250 depreciation **is not** shown anywhere on his return. His **unrecaptured gain** is equal to the $32,000, as calculated in Step 2 (the amount of depreciation calculated on the straight-line basis as if he had not used bonus depreciation). During the contract period, Quinn treats 100% of the taxable portion of the contract payments as unrecaptured gain until he claims the entire $32,000. Accordingly, in 2024, he will use $3,133 as the amount on line 4 of the Unrecaptured Section 1250 Gain Worksheet (shown later).

The remaining gain of $15,000 ($47,000 total gain − $32,000 unrecaptured gain) is taxed at the applicable long-term capital gains rates in effect for the years Quinn reports the payments received.

Quinn's Form 4797, Form 6252, and Unrecaptured Section 1250 Gain Worksheet follow.

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For Example 19

Form **4797**

Department of the Treasury
Internal Revenue Service

Sales of Business Property
(Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2))
Attach to your tax return.
Go to *www.irs.gov/Form4797* for instructions and the latest information.

OMB No. 1545-0184
2023
Attachment Sequence No. **27**

Name(s) shown on return	Identifying number
Quinn Phillips	***-**-7777

1a	Enter the gross proceeds from sales or exchanges reported to you for 2023 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20. See instructions	1a	
b	Enter the total amount of gain that you are including on lines 2, 10, and 24 due to the partial dispositions of MACRS assets	1b	
c	Enter the total amount of loss that you are including on lines 2 and 10 due to the partial dispositions of MACRS assets	1c	

Part I Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty or Theft—Most Property Held More Than 1 Year (see instructions)

2 (a) Description of property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis, plus improvements and expense of sale	(g) Gain or (loss) Subtract (f) from the sum of (d) and (e)

3	Gain, if any, from Form 4684, line 39	3	
4	Section 1231 gain from installment sales from Form 6252, line 26 or 37	4	3,133
5	Section 1231 gain or (loss) from like-kind exchanges from Form 8824	5	
6	Gain, if any, from line 32, from other than casualty or theft	6	0
7	Combine lines 2 through 6. Enter the gain or (loss) here and on the appropriate line as follows	7	3,133
	Partnerships and S corporations. Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 10, or Form 1120-S, Schedule K, line 9. Skip lines 8, 9, 11, and 12 below.		
	Individuals, partners, S corporation shareholders, and all others. If line 7 is zero or a loss, enter the amount from line 7 on line 11 below and skip lines 8 and 9. If line 7 is a gain and you didn't have any prior year section 1231 losses, or they were recaptured in an earlier year, enter the gain from line 7 as a long-term capital gain on the Schedule D filed with your return and skip lines 8, 9, 11, and 12 below.		
8	Nonrecaptured net section 1231 losses from prior years. See instructions	8	
9	Subtract line 8 from line 7. If zero or less, enter -0-. If line 9 is zero, enter the gain from line 7 on line 12 below. If line 9 is more than zero, enter the amount from line 8 on line 12 below and enter the gain from line 9 as a long-term capital gain on the Schedule D filed with your return. See instructions	9	

Part II Ordinary Gains and Losses (see instructions)

10 Ordinary gains and losses not included on lines 11 through 16 (include property held 1 year or less):

11	Loss, if any, from line 7	11	( )
12	Gain, if any, from line 7 or amount from line 8, if applicable	12	
13	Gain, if any, from line 31	13	14,000
14	Net gain or (loss) from Form 4684, lines 31 and 38a	14	
15	Ordinary gain from installment sales from Form 6252, line 25 or 36	15	
16	Ordinary gain or (loss) from like-kind exchanges from Form 8824	16	
17	Combine lines 10 through 16	17	14,000
18	For all except individual returns, enter the amount from line 17 on the appropriate line of your return and skip lines a and b below. For individual returns, complete lines a and b below.		
a	If the loss on line 11 includes a loss from Form 4684, line 35, column (b)(ii), enter that part of the loss here. Enter the loss from income-producing property on Schedule A (Form 1040), line 16. (Do not include any loss on property used as an employee.) Identify as from "Form 4797, line 18a." See instructions	18a	
b	Redetermine the gain or (loss) on line 17 excluding the loss, if any, on line 18a. Enter here and on Schedule 1 (Form 1040), Part I, line 4	18b	14,000

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For Example 19

Form 4797 (2023) Page 2

Part III **Gain From Disposition of Property Under Sections 1245, 1250, 1252, 1254, and 1255** (see instructions)

19	(a) Description of section 1245, 1250, 1252, 1254, or 1255 property:	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)
A	**Leasehold Improvements**	**07/01/2015**	**12/01/2023**
B			
C			
D			

	These columns relate to the properties on lines 19A through 19D.		Property A	Property B	Property C	Property D
20	Gross sales price (**Note:** *See line 1a before completing.*)	20	75,000			
21	Cost or other basis plus expense of sale	21	60,000			
22	Depreciation (or depletion) allowed or allowable	22	46,000			
23	Adjusted basis. Subtract line 22 from line 21	23	14,000			
24	Total gain. Subtract line 23 from line 20	24	61,000			
25	**If section 1245 property:**					
a	Depreciation allowed or allowable from line 22	25a				
b	Enter the **smaller** of line 24 or 25a	25b				
26	**If section 1250 property:** If straight line depreciation was used, enter -0- on line 26g, except for a corporation subject to section 291.					
a	Additional depreciation after 1975. See instructions	26a	14,000			
b	Applicable percentage multiplied by the **smaller** of line 24 or line 26a. See instructions	26b	14,000			
c	Subtract line 26a from line 24. If residential rental property **or** line 24 isn't more than line 26a, skip lines 26d and 26e	26c	47,000			
d	Additional depreciation after 1969 and before 1976	26d				
e	Enter the **smaller** of line 26c or 26d	26e				
f	Section 291 amount (corporations only)	26f				
g	Add lines 26b, 26e, and 26f	26g	14,000			
27	**If section 1252 property:** Skip this section if you didn't dispose of farmland or if this form is being completed for a partnership.					
a	Soil, water, and land clearing expenses	27a				
b	Line 27a multiplied by applicable percentage. See instructions	27b				
c	Enter the **smaller** of line 24 or 27b	27c				
28	**If section 1254 property:**					
a	Intangible drilling and development costs, expenditures for development of mines and other natural deposits, mining exploration costs, and depletion. See instructions	28a				
b	Enter the **smaller** of line 24 or 28a	28b				
29	**If section 1255 property:**					
a	Applicable percentage of payments excluded from income under section 126. See instructions	29a				
b	Enter the **smaller** of line 24 or 29a. See instructions	29b				

Summary of Part III Gains. Complete property columns A through D through line 29b before going to line 30.

30	Total gains for all properties. Add property columns A through D, line 24	30	61,000
31	Add property columns A through D, lines 25b, 26g, 27c, 28b, and 29b. Enter here and on line 13	31	14,000
32	Subtract line 31 from line 30. Enter the portion from casualty or theft on Form 4684, line 33. Enter the portion from other than casualty or theft on Form 4797, line 6	32	N/A

Part IV **Recapture Amounts Under Sections 179 and 280F(b)(2) When Business Use Drops to 50% or Less** (see instructions)

			(a) Section 179	(b) Section 280F(b)(2)
33	Section 179 expense deduction or depreciation allowable in prior years	33		
34	Recomputed depreciation. See instructions	34		
35	Recapture amount. Subtract line 34 from line 33. See the instructions for where to report	35		

Form **4797** (2023)

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For Example 19

Form **6252** — Department of the Treasury, Internal Revenue Service

Installment Sale Income

Attach to your tax return.
Use a separate form for each sale or other disposition of property on the installment method.
Go to *www.irs.gov/Form6252* for the latest information.

OMB No. 1545-0228 — **2023** — Attachment Sequence No. **67**

Name(s) shown on return	Identifying number
Quinn Phillips	***-**-7777

1 Description of property **4 - Leasehold Improvements**

2a Date acquired (mm/dd/yyyy) **07/01/2015** — **b** Date sold (mm/dd/yyyy) **12/01/2023**

3 Was the property sold to a related party? See instructions. If "Yes," complete Part III for the year of sale and 2 years after the year of the sale unless you received the final payment during the tax year . . . ☐ Yes ☒ No

4 Reserved for future use . . . ☐ Yes ☐ No

Part I Gross Profit and Contract Price. Complete this part for all years of the installment agreement.

Line	Description			Line	Amount
5	Selling price including mortgages and other debts. **Don't** include interest, whether stated or unstated			5	75,000
6	Mortgages, debts, and other liabilities the buyer assumed or took the property subject to (see instructions)	6			
7	Subtract line 6 from line 5	7	75,000		
8	Cost or other basis of property sold	8	60,000		
9	Depreciation allowed or allowable	9	46,000		
10	Adjusted basis. Subtract line 9 from line 8	10	14,000		
11	Commissions and other expenses of sale	11			
12	Income recapture from Form 4797, Part III (see instructions)	12	14,000		
13	Add lines 10, 11, and 12			13	28,000
14	Subtract line 13 from line 5. If zero or less, **don't** complete the rest of this form. See instructions			14	47,000
15	If the property described on line 1 above was your main home, enter the amount of your excluded gain. See instructions. Otherwise, enter -0-			15	
16	**Gross profit.** Subtract line 15 from line 14			16	47,000
17	Subtract line 13 from line 6. If zero or less, enter -0-			17	0
18	**Contract price.** Add line 7 and line 17			18	75,000

Part II Installment Sale Income. Complete this part for all years of the installment agreement.

Line	Description			Line	Amount
19	Gross profit percentage (expressed as a decimal amount). Divide line 16 by line 18. (For years after the year of sale, see instructions.)			19	0.6267
20	If this is the year of sale, enter the amount from line 17. Otherwise, enter -0-			20	0
21	Payments received during year (see instructions). **Don't** include interest, whether stated or unstated			21	5,000
22	Add lines 20 and 21			22	5,000
23	Payments received in prior years (see instructions). **Don't** include interest, whether stated or unstated	23			
24	**Installment sale income.** Multiply line 22 by line 19			24	3,133
25	Enter the part of line 24 that is ordinary income under the recapture rules. See instructions			25	
26	Subtract line 25 from line 24. Enter here and on Schedule D or Form 4797. See instructions			26	3,133

Part III Related Party Installment Sale Income. Don't complete if you received the final payment this tax year.

27 Name, address, and taxpayer identifying number of related party

28 Did the related party resell or dispose of the property ("second disposition") during this tax year? . . . ☐ Yes ☐ No

29 **If the answer to question 28 is "Yes," complete lines 30 through 37 below unless one of the following conditions is met. Check the box that applies.**

- a ☐ The second disposition was more than 2 years after the first disposition (other than dispositions of marketable securities). If this box is checked, enter the date of disposition (mm/dd/yyyy)
- b ☐ The first disposition was a sale or exchange of stock to the issuing corporation.
- c ☐ The second disposition was an involuntary conversion and the threat of conversion occurred after the first disposition.
- d ☐ The second disposition occurred after the death of the original seller or buyer.
- e ☐ It can be established to the satisfaction of the IRS that tax avoidance wasn't a principal purpose for either of the dispositions. If this box is checked, attach an explanation. See instructions.

Line	Description	Line	Amount
30	Selling price of property sold by related party (see instructions)	30	
31	Enter contract price from line 18 for year of first sale	31	
32	Enter the **smaller** of line 30 or line 31	32	
33	Total payments received by the end of your 2023 tax year (see instructions)	33	
34	Subtract line 33 from line 32. If zero or less, enter -0-	34	
35	Multiply line 34 by the gross profit percentage on line 19 for year of first sale	35	
36	Enter the part of line 35 that is ordinary income under the recapture rules. See instructions	36	
37	Subtract line 36 from line 35. Enter here and on Schedule D or Form 4797. See instructions	37	

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For Example 19

Unrecaptured Section 1250 Gain Worksheet—Line 19

Keep for Your Records

If you aren't reporting a gain on Form 4797, line 7, skip lines 1 through 9 and go to line 10.

1.	If you have a section 1250 property in Part III of Form 4797 for which you made an entry in Part I of Form 4797 (but not on Form 6252), enter the **smaller** of line 22 or line 24 of Form 4797 for that property. If you didn't have any such property, go to line 4. If you had more than one such property, see instructions			**1.**	
2.	Enter the amount from Form 4797, line 26g, for the property for which you made an entry on line 1			**2.**	
3.	Subtract line 2 from line 1			**3.**	
4.	Enter the total unrecaptured section 1250 gain included on line 26 or line 37 of Form(s) 6252 from installment sales of trade or business property held more than 1 year. See instructions			**4.**	3,133
5.	Enter the total of any amounts reported to you on a Schedule K-1 from a partnership or an S corporation as "unrecaptured section 1250 gain"			**5.**	
6.	Add lines 3 through 5			**6.**	3,133
7.	Enter the **smaller** of line 6 or the gain from Form 4797, line 7	**7.**	3,133		
8.	Enter the amount, if any, from Form 4797, line 8	**8.**			
9.	Subtract line 8 from line 7. If zero or less, enter -0-			**9.**	3,133
10.	Enter the amount of any gain from the sale or exchange of an interest in a partnership attributable to unrecaptured section 1250 gain. See instructions			**10.**	
11.	Enter the total of any amounts reported to you as "unrecaptured section 1250 gain" on a Schedule K-1, Form 1099-DIV, or Form 2439 from an estate, a trust, a real estate investment trust, or a mutual fund (or other regulated investment company) or in connection with a Form 1099-R			**11.**	
12.	Enter the total of any unrecaptured section 1250 gain from sales (including installment sales) or other dispositions of section 1250 property held more than 1 year for which you didn't make an entry in Part I of Form 4797 for the year of sale. See instructions			**12.**	
13.	Add lines 9 through 12			**13.**	3,133
14.	If you had any section 1202 gain or collectibles gain or (loss), enter the total of lines 1 through 4 of the **28% Rate Gain Worksheet**. Otherwise, enter -0-	**14.**	0		
15.	Enter the (loss), if any, from Schedule D, line 7. If Schedule D, line 7, is zero or a gain, enter -0-	**15.**	(0)		
16.	Enter your long-term capital loss carryovers from Schedule D, line 14; and Schedule K-1 (Form 1041), box 11, code D*	**16.**	(0)		
17.	Combine lines 14 through 16. If the result is a (loss), enter it as a positive amount. If the result is zero or a gain, enter -0-			**17.**	0
18.	**Unrecaptured section 1250 gain.** Subtract line 17 from line 13. If zero or less, enter -0-. If more than zero, enter the result here and on Schedule D, line 19			**18.**	3,133

* If you are filing Form 2555 (relating to foreign earned income), see the footnote in the Foreign Earned Income Tax Worksheet in the Instructions for Form 1040 before completing this line.

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SALES TO RELATED PERSONS AND LATER DISPOSITIONS[53]

A special rule applies to installment agreements with related persons if **both** of the following conditions apply.

- The related person resells or disposes of the property within **two years** of the purchase from the taxpayer.
- The disposition by the related person occurs before all of the payments are made under the installment agreement.

Related persons for these purposes include the following. The definition for these related parties is found in IRC §1239, rather than in IRC §§267 or 318.

1. Members of a family, including only brothers and sisters, spouses, ancestors, and lineal descendants of the taxpayer(s)
2. A partnership or estate, and a partner or beneficiary
3. A trust (other than an IRC §401(a) employees trust) and a beneficiary
4. A trust and an owner of the trust
5. Two corporations that are members of the same controlled group as defined in §267(f)
6. The fiduciaries of two different trusts, and the fiduciary and beneficiary of two different trusts, if the same person is the grantor of both trusts
7. A tax-exempt educational or charitable organization and a person (if an individual, including members of the individual's family) who directly or indirectly controls such an organization
8. An individual and a corporation when the individual owns, directly or indirectly, more than 50% of the value of the corporation's outstanding stock
9. A fiduciary of a trust and a corporation when the trust or the grantor of the trust owns, directly or indirectly, more than 50% in value of the corporation's outstanding stock
10. The grantor and fiduciary, and the fiduciary and beneficiary, of any trust
11. Any two S corporations if the same persons own more than 50% in value of each corporation's outstanding stock
12. An S corporation and a corporation that is not an S corporation if the same persons own more than 50% in value of each corporation's outstanding stock
13. A corporation and a partnership if the same persons own more than 50% in value of the corporation's outstanding stock and more than 50% of the capital or profits interest in the partnership
14. An executor and a beneficiary of an estate unless the sale is in satisfaction of a pecuniary bequest

Because of this special rule, when a taxpayer makes an installment sale to a related party, they must include Form 6252 with their return for the year of sale and for the two years after the year of sale.[54] For each year, the taxpayer must indicate if the related party sold or otherwise disposed of the property. This applies regardless of whether the taxpayer received any principal payments in those years.

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53. IRS Pub. 537, *Installment Sales.*

54. Instructions for Form 6252.

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Under the special rule, the taxpayer must treat at least a portion of the amount the related person realizes from the second disposition **as if the taxpayer received it** at the time of the second disposition. The amount recognized by the taxpayer is calculated as follows.

1. Determine the **lesser** of:
   a. The amount realized on the second disposition, or
   b. The contract price on the first disposition.
2. Subtract the sum of the payments received by the taxpayer on the contract through the end of the tax year.

An important exception applies to this rule when tax avoidance is not a principal purpose of the transaction. This is discussed later. If the amount received on the second disposition is more than the original contract price of the first disposition, the taxpayer must claim the entire deferred gain from the first disposition in the year of the second disposition.

Example 20. In 2022, Margaret sold farmland to her son, Brent, for $500,000. This was to be paid in five equal payments over five years, plus adequate stated interest on the balance due. Her installment sale basis for the farmland was $200,000, and the property was not subject to any outstanding liens or mortgages. Her gross profit is $300,000 ($500,000 sale price – $200,000 basis) and her gross profit percentage is 60% ($300,000 gross profit ÷ $500,000 contract price).

She received $100,000 in 2022 and included $60,000 in income for that year ($100,000 × 60%). On her 2022 Form 6252 (not shown), Margaret marked on line 3 that the property was sold to a related party. She provided Brent's name, address, and social security number on line 27 and indicated on line 28 that Brent did not resell the property in 2022.

Brent makes no improvements to the property and sells it to an unrelated party, Maryland Dreams, Inc., in 2023 for $600,000 after making the $100,000 payment due that year. He does not make any additional payments to her in 2023.

Margaret uses the following calculation to determine that she must report $300,000 as if it were received in 2023 because Brent sold the property.

A. Amount realized on second disposition	$600,000
B. Contract price on first disposition	500,000
Lesser of A or B	$500,000
Less: the sum of payments from Brent in 2022 and 2023	(200,000)
Amount treated as received because of the second disposition	$300,000

Margaret's Form 6252 for 2023 is shown next. Line 26 shows the $60,000 income from the 2023 installment payment of $100,000, and line 37 shows the installment sale income from the $300,000 treated as received.

In 2023, Margaret reported the entire remaining deferred profit on the sale. Therefore, she will not report any additional gain when she receives the subsequent installment payments from Brent.

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For Example 20

Form **6252** | **Installment Sale Income** | OMB No. 1545-0228
Department of the Treasury Internal Revenue Service
Attach to your tax return.
Use a separate form for each sale or other disposition of property on the installment method.
Go to *www.irs.gov/Form6252* for the latest information.
2023 Attachment Sequence No. **67**

Name(s) shown on return: Margaret Forrest | Identifying number: ***-**-8488

1	Description of property	3 - 40 Acres Farm Land	
2a	Date acquired (mm/dd/yyyy)	Various	
b	Date sold (mm/dd/yyyy)	03/01/2022	
3	Was the property sold to a related party? See instructions. If "Yes," complete Part III for the year of sale and 2 years after the year of the sale unless you received the final payment during the tax year	☒ Yes	☐ No
4	Reserved for future use	Yes	No

Part I Gross Profit and Contract Price. Complete this part for all years of the installment agreement.

5	Selling price including mortgages and other debts. **Don't** include interest, whether stated or unstated			5	500,000
6	Mortgages, debts, and other liabilities the buyer assumed or took the property subject to (see instructions)	6			
7	Subtract line 6 from line 5	7	500,000		
8	Cost or other basis of property sold	8	200,000		
9	Depreciation allowed or allowable	9			
10	Adjusted basis. Subtract line 9 from line 8	10	200,000		
11	Commissions and other expenses of sale	11			
12	Income recapture from Form 4797, Part III (see instructions)	12			
13	Add lines 10, 11, and 12			13	200,000
14	Subtract line 13 from line 5. If zero or less, **don't** complete the rest of this form. See instructions			14	300,000
15	If the property described on line 1 above was your main home, enter the amount of your excluded gain. See instructions. Otherwise, enter -0-			15	
16	**Gross profit.** Subtract line 15 from line 14			16	300,000
17	Subtract line 13 from line 6. If zero or less, enter -0-			17	0
18	**Contract price.** Add line 7 and line 17			18	500,000

Part II Installment Sale Income. Complete this part for all years of the installment agreement.

19	Gross profit percentage (expressed as a decimal amount). Divide line 16 by line 18. (For years after the year of sale, see instructions.)			19	0.6000
20	If this is the year of sale, enter the amount from line 17. Otherwise, enter -0-			20	0
21	Payments received during year (see instructions). **Don't** include interest, whether stated or unstated			21	100,000
22	Add lines 20 and 21			22	100,000
23	Payments received in prior years (see instructions). **Don't** include interest, whether stated or unstated	23	100,000		
24	**Installment sale income.** Multiply line 22 by line 19			24	60,000
25	Enter the part of line 24 that is ordinary income under the recapture rules. See instructions			25	
26	Subtract line 25 from line 24. Enter here and on Schedule D or Form 4797. See instructions			26	60,000

Part III Related Party Installment Sale Income. Don't complete if you received the final payment this tax year.

27 Name, address, and taxpayer identifying number of related party: Brent Atwood
16 Scion Way New Windsor MD 21776 ***-**-6788

28 Did the related party resell or dispose of the property ("second disposition") during this tax year? ☒ Yes ☐ No

29 **If the answer to question 28 is "Yes," complete lines 30 through 37 below unless one of the following conditions is met. Check the box that applies.**

- a ☐ The second disposition was more than 2 years after the first disposition (other than dispositions of marketable securities). If this box is checked, enter the date of disposition (mm/dd/yyyy)
- b ☐ The first disposition was a sale or exchange of stock to the issuing corporation.
- c ☐ The second disposition was an involuntary conversion and the threat of conversion occurred after the first disposition.
- d ☐ The second disposition occurred after the death of the original seller or buyer.
- e ☐ It can be established to the satisfaction of the IRS that tax avoidance wasn't a principal purpose for either of the dispositions. If this box is checked, attach an explanation. See instructions.

30	Selling price of property sold by related party (see instructions)	30	600,000
31	Enter contract price from line 18 for year of first sale	31	500,000
32	Enter the **smaller** of line 30 or line 31	32	500,000
33	Total payments received by the end of your 2023 tax year (see instructions)	33	200,000
34	Subtract line 33 from line 32. If zero or less, enter -0-	34	300,000
35	Multiply line 34 by the gross profit percentage on line 19 for year of first sale	35	180,000
36	Enter the part of line 35 that is ordinary income under the recapture rules. See instructions	36	
37	Subtract line 36 from line 35. Enter here and on Schedule D or Form 4797. See instructions	37	180,000

For Paperwork Reduction Act Notice, see page 4. Cat. No. 13601R Form **6252** (2023)

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If the amount realized on the second disposition is less than the contract price of the first disposition, the taxpayer will **not** have claimed the entire gain in the year of the second disposition. In this case, the taxpayer applies the gain attributable to future payments first to the previously recognized gain. The taxpayer does not recognize any of the remaining gain until after the gain received exceeds the previously taxed gain.

Example 21. Use the same facts as **Example 20,** except Brent sells the land for $300,000. The amount **treated** as received in 2023 is $100,000, which is calculated as follows.

A. Amount realized on second disposition	$300,000
B. Contract price on first disposition	500,000
Lesser of A or B	$300,000
Less: the sum of payments from Brent in 2022 and 2023	(200,000)
Amount treated as received because of the second disposition	$100,000

The $100,000 payment Margaret receives in 2024 is applied against the amount treated as received in 2023. The payments in 2025 and 2026 are not treated as received in 2023 and will be taxed accordingly.

This rule requiring current recognition of deferred gain does **not** apply to a second disposition if the taxpayer can show to the IRS's satisfaction that neither disposition had as one of its principal purposes the avoidance of federal income tax. The IRS automatically recognizes that there was no tax avoidance purpose in the following situations.

1. Involuntary dispositions including foreclosures on the property and bankruptcy of the related person
2. Involuntary conversions if the first disposition occurred before the threat of conversion
3. A second disposition that is also an installment sale if the payment terms under the installment resale are substantially equal to or longer than those for the first installment sale (this exception does not apply if the resale terms permit significant deferral of recognition of gain from the first sale)

Note. A transfer after the death of one of the parties (if this death occurs before the death of the other party) to the installment agreement is not treated as a second disposition.

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SALES OF DEPRECIABLE PROPERTY TO A CONTROLLED ENTITY[55]

If the taxpayer sells **depreciable property** to a **controlled entity** in an installment sale, the taxpayer is generally prohibited from reporting the sale using the installment method.[56] However, the installment method may be used if no significant tax deferral benefit is derived from the sale,[57] **and** the taxpayers can prove to the IRS's satisfaction that avoidance of federal income tax was not one of the principal purposes of the sale.[58] There is no prohibition against using the installment method for such sales if the assets are not depreciable by the purchaser.

Controlled entities for these purposes include the following related parties.

- A person and all controlled entities with respect to that person[59]
- A taxpayer and any trust in which such taxpayer (or their spouse) is a beneficiary, unless their interest in the trust is a remote contingent interest[60]
- An executor of an estate and a beneficiary of that estate except in the case of a sale or exchange in satisfaction of a pecuniary bequest[61]
- Two or more partnerships in which the same person owns, directly or indirectly, more than 50% of the capital interests or the profits interests[62]

If the taxpayers cannot prove that the sale of depreciable property among these related persons was not for the purpose of avoiding federal income tax, all noncontingent payments to be received are considered received in the year of sale. The FMV of any contingent payments is also considered received in the year of sale. If the FMV of the contingent payments cannot be reasonably determined, the basis in the property is recovered proportionately.[63] The purchaser cannot increase the basis of the property acquired in the sale before the seller includes a like amount in income.[64]

LIKE-KIND EXCHANGE[65]

When a taxpayer trades real estate used in business or as investment property in a like-kind exchange, reporting the gain can be postponed. The taxpayer treats the property received in a like-kind exchange as if it were a continuation of the relinquished property. The taxpayer is **not required to report any part of the gain** if they receive only like-kind property. However, if the taxpayer also receives money or other property (boot) in the exchange, they must report the gain to the extent of the money and the FMV of the other property received.

> **Note.** For more information about like-kind exchanges, see IRS Pub. 544.

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55. IRC §453(g).
56. IRC §453(g)(1).
57. IRS Pub. 537, *Installment Sales.*
58. IRC §453(g)(2). See also *Tecumseh Corrugated Box Co. v. Comm'r,* 94 TC 360 (1990).
59. As defined in IRC §1239(c).
60. As defined in IRC §1239(b).
61. Ibid.
62. As described in IRC §707(b)(1)(B).
63. IRC §453(g)(1)(B)(ii).
64. IRC §453(g)(1)(C).
65. IRS Pub. 537, *Installment Sales.*

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If the taxpayer receives an installment obligation in the exchange in addition to like-kind property, the following rules determine the installment sale income each year.

- The contract price is reduced by the FMV of the like-kind property received in the trade.
- The gross profit is reduced by any gain on the trade that can be postponed.
- Like-kind property received in the trade is not considered payment on the installment obligation.

Example 22. In 2023, Georgia trades real estate with an installment sale basis of $400,000 for like-kind property having a $200,000 FMV.[66] She also receives an installment note for $800,000 in the trade. Under the terms of the note, she receives $100,000 (plus interest) in 2024 and the balance of $700,000 (plus interest) in 2025.

Relevant calculations for the installment sale are shown in the following table.

Installment note	$ 800,000		
FMV of like-kind property received	200,000		
Selling price	$1,000,000	$1,000,000	
Installment sale basis	(400,000)		
Gross profit	$ 600,000		$600,000
Less: FMV of property received		(200,000)	
Contract price		$ 800,000	÷ 800,000
Gross profit percentage			75%
Payment received in 2024		(100,000)	× 100,000
Gain reported in 2024			$ 75,000
Balance on installment note		$ 700,000	
Gross profit percentage		× 75%	
Gain reported in 2025		$ 525,000	

Georgia did not report any gain in 2023 because the like-kind property she received was not treated as a payment for calculating gain. As shown in the table, she reports a $75,000 gain in 2024 and a $525,000 gain in 2025.

Note. A deferred exchange is one in which the taxpayer transfers business or investment property and later receives like-kind property. Under this type of exchange, the person receiving the property may be required to place funds in an escrow account or trust. If certain rules are met, these funds are not considered a payment until the taxpayer has the right to receive the funds or, if earlier, the end of the exchange period.[67]

66. Based on example in IRS Pub. 537, *Installment Sales,* p. 11.

67. See Treas. Reg. §1.1031(k)-1(j)(2).

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CONTINGENT PAYMENT SALE[68]

A contingent payment sale is one in which the total selling price cannot be determined by the end of the tax year of sale. This happens, for example, when the taxpayer sells a business and the selling price includes a percentage of the business's profits in future years.

If the selling price cannot be determined by the end of the tax year, the taxpayer must use different rules to calculate the contract price and the gross profit percentage than those the taxpayer uses for an installment sale with a fixed selling price.

Note. For rules on using the installment method for a contingent payment sale, see Treas. Reg. §15a.453-1(c). For unstated interest or OID related to a contingent sale, see Treas. Regs. §§1.1275-4(c) and 1.483-4.

SINGLE SALE OF SEVERAL ASSETS[69]

If the taxpayer sells **different types** of assets in a single sale, the taxpayer must identify each asset to determine whether they can use the installment method to report the sale of that asset. The taxpayer must also allocate part of the selling price to each asset. However, if the taxpayer sells assets that constitute a trade or business, different rules apply. This is discussed later.

Ideally, both parties in an arm's-length transaction have agreed to the allocation of the selling price. If not, the taxpayer must allocate the selling price to the assets based on their FMVs. If debt is assumed by the buyer, the FMV of the property is reduced by the debt amount.

A taxpayer reports the sale of separate and unrelated assets of the same type under a single contract as one transaction for the installment method. However, if an asset is sold at a loss, its disposition cannot be reported on the installment method. It must be reported separately. The remaining assets sold at a gain are reported together.

Example 23. In 2023, Albert sells three separate and unrelated parcels of real property (E, M, and C) under a single contract with a total selling price of $130,000. The total selling price consists of a cash payment of $20,000, the buyer's assumption of a $30,000 mortgage on parcel M, and an installment obligation of $80,000 payable in eight annual installments of $10,000, plus interest at 8% per year.

The installment sale basis for each parcel is $15,000. The net gain is $85,000 ($130,000 sales price – (3 properties × $15,000 basis)). Albert reports the gain using the installment method.

The sales contract does not allocate the selling price or the cash payment received in the year of sale among the individual parcels. According to the county assessor, the FMVs of parcels E, M, and C are $60,000, $60,000, and $10,000, respectively.

The installment sale basis for parcel C is more than its FMV. Consequently, it is sold at a loss and has to be treated separately. Albert allocates the total selling price and the amounts received in the year of sale between parcel C and the remaining parcels.

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68. IRS Pub. 537, *Installment Sales.*

69. Ibid.

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Of the total $130,000 selling price, Albert allocates $60,000 each to parcels E and M and $10,000 to parcel C. Because E and M are both sold at a gain, he reports them as one installment sale. He allocates the $20,000 received in 2023 based on the proportionate FMV, net of the mortgage assumed. The allocation is calculated as follows.

	Parcels E and M	Parcel C
FMV	$120,000	$10,000
Less: mortgage assumed	(30,000)	(0)
Net FMV	$ 90,000	$10,000
Allocated percentage of net FMV	90%	10%
Payments in 2023:		
$20,000 × allocated percentage	$ 18,000	$ 2,000
Plus: excess of parcel M mortgage over installment sale basis ($30,000 − $15,000)	15,000	0
Payments received and considered received	$ 33,000	$ 2,000

Albert does not report the sale of parcel C on the installment method because the sale results in a loss. He reports this loss of $5,000 ($10,000 selling price – $15,000 installment sale basis) in 2023. If the real estate parcels were used in Albert's trade or business, the $5,000 loss would be reported on Form 4797 and is fully deductible in the year of the sale. If the real estate parcels were Albert's investment property, the $5,000 loss would be reported on Form 8949, which flows to Schedule D, subject to capital loss limitations.

The installment note payments are applied to the parcels based on their allocated percentages in future years. Of the annual $10,000 payment, 90% is attributed to parcels E and M. **The 10% attributed to C is not reported on future returns.**

SALE OF A BUSINESS[70]

To determine whether any of the gain on the sale of the business is allowed to be reported on the installment method, the taxpayer must allocate the total selling price and the payments received in the year of sale between each of the following classes of assets.

1. Assets sold at a loss
2. Real and personal property eligible for the installment method
3. Real and personal property **ineligible** for the installment method, including:
    a. Inventory
    b. Dealer property
    c. Stocks and securities

The gain on the sale of property that is ineligible for the installment method **must be reported in the year of sale,** regardless of whether the taxpayer will receive payments in later years. The amount that the taxpayer receives (or will receive) for **inventory** is reported as ordinary business income. The basis in the inventory is included in the cost of goods sold. Any part of the selling expenses allocated to inventory is an ordinary business expense.

70. Ibid.

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RESIDUAL METHOD

To allocate the sales price, taxpayers must use **the residual method** for any transfer of a group of assets that constitutes a trade or business and for which the buyer's basis is determined only by the amount paid for the assets. This applies to both direct and indirect transfers, such as the sale of a business or the sale of a partnership interest in which the basis of the buyer's share of the partnership assets is adjusted for the amount paid under IRC §743(b).

A group of assets constitutes a trade or business if:

- Goodwill or going concern value could, under any circumstances, attach to the assets **or**
- The use of the assets would constitute an active trade or business under IRC §355.

The business's sales price is first reduced by any cash, checking, or savings accounts included in the sale. The sales price is then allocated among the following assets in proportion to (but not more than) their FMV on the purchase date in the following order.

1. **Certificates of deposit,** U.S. government securities, foreign currency, and actively traded personal property, including stock and securities
2. **Accounts receivable,** other debt instruments, and assets that the taxpayer marks to market at least annually for federal income tax purposes (see Treas. Reg. §1.338-6(b)(2)(iii) for exceptions that apply to debt instruments issued by persons related to a target corporation, contingent debt instruments, and debt instruments convertible into stock or other property)
3. Property of a kind that would properly be included in **inventory** if on hand at the end of the tax year or property held by the taxpayer primarily for sale to customers in the ordinary course of business
4. All other assets **except** IRC §197 **intangibles**
5. Other §197 intangibles **except goodwill and going concern** value
6. **Goodwill and going concern value** (regardless of whether they qualify as §197 intangibles)

If an asset is includable in more than one category, it should be included in the lower number category. For example, if an asset is described in both categories 4 and 6, include it in 4.

AGREEMENT

Ideally, the agreement will include the allocation of the sales price to the assets. This agreement is binding on both parties unless the IRS determines the amounts are not appropriate.

Example 24. Sebastian owned The Mermaid's Song, a music store that he operated as a sole proprietor. He sold the business on June 4, 2023. The sales price of $220,000 includes all inventory, furnishings, equipment, a delivery truck, the business name, and the building. Selling expenses are $11,000. Sebastian's adjusted basis in the property at the time of the sale follows (with the building depreciated using the straight-line method).

Asset	Original Purchase Price	Accumulated Depreciation	Adjusted Basis
Inventory	$ 8,000	$ 0	$ 8,000
Furnishings and equipment	126,000	40,160	85,840
Truck	24,000	18,624	5,376
Building	45,000	9,000	36,000
Land	15,000	0	15,000
Total	$218,000	$67,784	$150,216

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After consulting with their attorneys and accountants, Sebastian and the buyer agree that the FMV of the assets included in the purchase price are as shown in the following table. All of the selling costs are allocated proportionally.

Asset	Sales Price	Selling Expenses	Adjusted Basis	Gain
Inventory	$ 10,000	$ 500	$ 8,000	$ 1,500
Furnishings and equipment	95,000	4,750	85,840	4,410
Truck	6,500	325	5,376	799
Building	48,000	2,400	36,000	9,600
Land	42,000	2,100	15,000	24,900
Goodwill	18,500	925	0	17,575
Total	$220,000	$11,000	$150,216	$58,784

Not all of the assets qualify to be reported on the installment method. The following tables explain the breakdown of the sale for reporting purposes.

6

Asset	IRC Section	Lesser of Gain or Accumulated Depreciation	Depreciation Recapture	Unrecaptured §1250 Gain
Inventory	IRC §471	$ 0	$ 0	$ 0
Furnishings and equipment	IRC §1245	4,410	4,410	0
Truck	IRC §1245	799	799	0
Building	IRC §1250	9,000	0	9,000
Land	N/A	0	0	0
Goodwill (IRC §197)	IRC §1245	0	0	0
Totals			$5,209	$9,000

Asset	Qualified for Installment Method	Reported in Return on...
Inventory	No, sale must be reported as business income	Schedule C
Furnishings, equipment	No, entire gain is subject to depreciation recapture	Form 4797, part III
Truck	No, entire gain is subject to depreciation recapture	Form 4797, part III
Building	Yes	Form 4797, part III and Form 6252
Land	Yes	Form 4797, part I and Form 6252
Goodwill	Yes	Form 4797, part I and Form 6252

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In 2023, Sebastian receives a $100,000 down payment on the sale. A Form 6252 is required for each asset reported on the installment method. Sebastian must allocate the principal he receives each year to the assets according to their proportion of the selling price as shown in the following table.

Asset	Form 6252 Contract Price	Percentage of Total Sale of $220,000	Allocation of Principal Received
Building	$ 48,000	21.82%	$21,818
Land	42,000	19.09%	19,091
Goodwill	18,500	8.41%	8,409
Total	$108,500		

Each year, Sebastian multiplies the allocated principal by the gross profit percentage to determine the gain to report. The gross profit percentage for each asset equals the gross profit for that asset divided by the asset's contract price. The following table shows his gains reported in 2023 under the installment method.

Asset	Gross Profit	Gross Profit Percentage	2023 Principal	2023 Gain Reported
Building	$ 9,600	20.00%	$21,818	$ 4,364
Land	24,900	59.29%	19,091	11,318
Goodwill	17,575	95.00%	8,409	7,989
Total	$52,075			
Gross profit percentage of contract price		48.00%		

In 2023, Sebastian also reports the $1,500 in profit from inventory on his Schedule C, *Profit or Loss From Business,* and depreciation recapture of $5,209 ($4,410 furnishings and equipment + $799 truck) on his Form 4797. When he receives principal payments in later years, no part of the payment for the sale of these assets will be included in gross income.

REPORTING REQUIREMENT

If the sale of a business involves goodwill or going concern value, both the buyer and seller must report the allocation on Form 8594, *Asset Acquisition Statement under Section 1060.* The buyer and seller should each attach Form 8594 to their federal income tax return for the year in which the sale occurred.[71]

Note. A partner who sells a partnership interest at a gain may be able to report the sale on the installment method. The sale of a partnership interest is treated as the sale of a single capital asset. However, the taxpayer treats any part of any gain or loss from unrealized receivables, inventory, and depreciation recapture as ordinary income. These parts of the gain cannot be reported under the installment method. The gain allocated to the other assets can be reported under the installment method. For more information, see IRS Pub. 541, *Partnerships*. For corporate shareholders, a sale of shares may be treated as a sale of stock and reported under the installment method.

[71] Instructions for Form 8594.

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DISPOSITION OF AN INSTALLMENT OBLIGATION[72]

When the taxpayer uses the installment method and later disposes of the installment obligation, the taxpayer generally has a gain or loss to report. A disposition includes a sale, exchange, cancelation, bequest, distribution, or transmission of an installment obligation.[73]

The tax treatment of the disposition of the installment agreement is based on the original sale of the property for which the taxpayer received the installment obligation. For example, if the original installment sale produced ordinary income, the disposition of the obligation results in ordinary income or loss. Likewise, if the original sale resulted in a capital gain, the disposition of the obligation results in a capital gain.

The following rules are used to calculate the gain or loss from the disposition of an installment obligation.

1. If the taxpayer sells or exchanges the obligation or the taxpayer accepts less than face value in satisfaction of the obligation, the gain or loss is the difference between the basis in the obligation and the amount the taxpayer realizes.
2. If the taxpayer disposes of the obligation in any other way, the gain or loss is the difference between the basis in the obligation and its FMV at the time of the disposition. This rule applies, for example, when the taxpayer gives the installment obligation to someone else or cancels the buyer's debt to the taxpayer.

The basis in an installment obligation is calculated using the following formula.

Basis in installment obligation = Unpaid balance on obligation × (100% – Gross profit percentage)

Example 25. Ernie sold Olaf a building on contract for deed in 2019. The gross profit percentage on the sale was 60%. As of January 1, 2023, Olaf still owed Ernie $10,000 on the contract. Ernie's basis in the obligation on January 1, 2023, is $4,000 ($10,000 unpaid balance × (100% – 60%).

TRANSFER BETWEEN SPOUSES OR FORMER SPOUSES

No gain or loss is recognized on the transfer of an installment obligation between spouses or former spouses when the transfer is incident to a divorce. A transfer is incident to a divorce if it occurs within one year after the date on which the marriage ends or is related to the end of the marriage.

The same tax treatment of the transferred obligation applies to the recipient of the transfer as would have applied to the taxpayer who made the transfer. The basis of the obligation to the transferee is the adjusted basis of the transferor. This nonrecognition rule does not apply if the spouse or former spouse receiving the obligation is a nonresident alien.

GIFTS[74]

A gift of an installment obligation is a disposition. The gain or loss is the difference between the basis in the obligation and its FMV at the time the taxpayer makes the gift.

The IRS has not specified how to determine the FMV of the obligation at the time of the gift for these purposes. Determining an obligation's FMV requires knowing what the obligation could be sold for to an unrelated third party in an arm's-length transaction. Without a third party making an offer to buy the note, the FMV may not be readily available. In an open market, the FMV of an installment agreement is equal to the PV of the future cash flow using a discount rate that incorporates the debt instrument's underlying risk profile.[75]

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72. IRS Pub. 537, *Installment Sales.*

73. IRC §453B(a)(2).

74. Treas. Regs. §§25.2512-0 through 25.2512-8.

75. *What is the Fair Market Value of Your Promissory Note?* Aug. 2009. Mercer Capital. [mercercapital.com/article/what-is-the-fair-market-value-of-your-promissory-note] Accessed on Aug. 14, 2024.

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If the taxpayer is not able to determine the note's FMV by other means, the most conservative approach is to assume that the balance remaining on the note is the FMV of the note. This treatment is consistent with the principles of Temp. Treas. Reg. §15a.453-1T(d)(2), under which the FMV of the installment obligation is defined for purposes of electing out of the installment method.

Using those principles, the FMV of the installment agreement at the time of the gift is the FMV of the property sold minus any other consideration received. Other consideration includes principal previously reported. Using this approach, if the original transaction was conducted at arm's-length, the balance remaining on the note will be the FMV of the note. A taxpayer gifting the installment agreement would recognize a gain to the extent the remaining balance of the agreement exceeded the basis of the agreement.

Example 26. Use the same facts as **Example 25.** On January 1, 2023, Ernie gifts the installment contract to his daughter. The FMV of the obligation is the remaining $10,000 due. Ernie's basis in the installment agreement is $4,000. Ernie reports a $6,000 gain on the disposition of the installment contract on his 2023 return.

Note. If the gift amount exceeds the annual exclusion, a gift tax return may be required. For more information on gift tax returns, see the 2024 *University of Illinois Federal Tax Workbook,* Chapter 2: Individual Taxpayer Issues.

CANCELATION

If an installment obligation is canceled or otherwise becomes unenforceable, it is treated as a disposition other than a sale or exchange. The gain or loss is the difference between the taxpayer's basis in the obligation and its FMV at the time the taxpayer cancels it.

Example 27. Use the same facts as **Example 25.** In 2023, Olaf defaults on the agreement due to a series of unfortunate events that renders him insolvent. In addition, the real estate is declared an environmental hazard. Ernie decides that the costs of repossessing the property are prohibitive and the chances of collecting the balance of the obligation are nonexistent. Ernie cancels the remaining obligation.

Because the installment obligation is worthless at the time of cancelation, its FMV is zero. On his 2023 return, Ernie reports a loss from the cancelation equal to his remaining $4,000 basis in the contract.

Note. If the parties are related, the FMV of the obligation is considered to be no less than its full face value.

FORGIVING PART OF THE BUYER'S DEBT

If a taxpayer accepts partial payment on the balance of the buyer's installment debt to the taxpayer and forgives the rest of the debt, the taxpayer treats the settlement as a disposition of the installment obligation. The gain or loss is the difference between the basis in the obligation and the amount the taxpayer realizes on the settlement.

TRANSACTIONS THAT ARE NOT DISPOSITIONS

When the taxpayer **reduces the selling price** but does not cancel the rest of the buyer's debt to the taxpayer, it is not considered a disposition of the installment obligation. The taxpayer must recalculate the gross profit percentage and apply it to the payments the taxpayer receives after the reduction (see the "Selling Price Reduced" section earlier).

When the **buyer of the property sells it** to someone else and the taxpayer agrees to let the new buyer assume the original buyer's installment obligation, the taxpayer has not disposed of the installment obligation. This is true even if the new buyer pays the taxpayer a higher rate of interest than the original buyer.

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Death of the Seller

The **transfer of an installment obligation** (other than to a buyer) as a result of the **seller's death** is not a disposition.[76] The recipient of the debt obligation reports the installment payments in the same manner as the decedent would have if they had lived to receive the payments. The recipient does not receive a step up in basis in the installment obligation.

> **Example 28.** In 2009, Patricia sold her business to her daughter, Peggy, on installment. When Patricia died, her son, Larry, inherited the installment note. Larry reports the interest and principal payments he receives each year in the same manner that Patricia would have if she had not passed away.

However, if an installment obligation is canceled, becomes unenforceable, or is transferred **to the buyer because of the death of the holder** of the obligation, then **it is a disposition.** A transfer of the note under these conditions is considered to occur upon the earlier of the following events.[77]

1. The executor's assent to the distribution of the note under state statute
2. The cancelation of the note by the executors
3. When the note becomes unenforceable
4. Termination of the administration of the estate for federal income tax purposes

The estate must calculate its gain or loss on the disposition based on the note's FMV. If the deceased holder and the buyer were related, the installment obligation's FMV is considered to be no less than its full face value.

> **Example 29.** Use the same facts as **Example 28,** except Peggy inherites the note. Because Peggy is both related to the decedent and the obligor of the note, the FMV of the note is equal to the remaining principal due under the agreement. Accordingly, Patricia's estate must report the remaining unreported gain from the sale on its income tax return for the year the note is actually transferred to Peggy, the year the note is canceled by the executors, or the year the note becomes unenforceable.

REPOSSESSION[78]

If the taxpayer repossesses the property after making an installment sale, the taxpayer must calculate the following.

- The gain (or loss) on the repossession
- The basis in the repossessed property

The rules for repossessions of personal property differ from those for real property. In addition, special rules apply if the taxpayer repossesses property that was their main home before the sale.[79]

The repossession rules apply regardless of whether title to the property transfers to the buyer. It does not matter how the taxpayer repossesses the property, whether the taxpayer forecloses, or the buyer voluntarily surrenders the property to the taxpayer. However, the property is not considered repossessed when the buyer puts the property up for sale and the taxpayer repurchases it.

76. IRC §453B(c).
77. Ltr. Rul. 8552007 (Sep. 18, 1985).
78. IRS Pub. 537, *Installment Sales.*
79. See Treas. Reg. §1.1038-2 for further information.

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For the repossession rules to apply, the repossession must at least partially satisfy the buyer's installment obligation to the taxpayer. The discharged obligation must be secured by the property the taxpayer repossesses. This requirement is met if the property is auctioned off after the taxpayer forecloses and the taxpayer then applies the installment obligation to the bid price at the auction.

FMV OF REPOSSESSED PROPERTY

The repossessed property's FMV is a question of fact to be established in each case. If the taxpayer bids for the property at a lawful public auction or judicial sale, its FMV is presumed to be the price it sells for, unless there is clear and convincing evidence to the contrary.

PERSONAL PROPERTY

If the taxpayer repossesses personal property, they may have a gain or a loss on the repossession. In some cases, the taxpayer also may have a bad debt.

The gain or loss on the repossession is calculated using the following formula.

	FMV of property at time of repossession
+	FMV of additional property received at time of repossession
−	Total basis in the installment obligation
−	Repossession expenses
	Gain or loss on reposession

How the taxpayer calculates the basis in the installment obligation depends on whether the taxpayer reported the original sale on the installment method. The method the taxpayer used to report the original sale also affects the character of the gain or loss on the repossession.

Installment Method Not Used to Report Original Sale

If the taxpayer did **not** use the installment method to report the original sale, the basis of the installment obligation is the value of the obligation used to calculate the gain or loss in the year of the sale less the principal payments received prior to repossession. Accordingly, the following formula may be used to calculate the gain or loss on the repossession.

	FMV of property at time of repossession
+	FMV of additional property received at time of repossession
−	Value of the obligation used to calculate gain or loss in the year of the sale
+	All principal payment received prior to repossession
−	Repossession expenses
	Gain or loss on repossession

A gain on an installment obligation is taxed as ordinary income. If the repossession results in a loss, the loss is considered a bad debt. The manner in which the taxpayer deducts the bad debt depends on whether the taxpayer sold business or nonbusiness property in the original sale.

> **Note.** See IRS Pub. 550, *Investment Income and Expenses*, for information on nonbusiness bad debts. See IRS Pub. 334, *Tax Guide for Small Business (For Individuals Who Use Schedule C),* for information on business bad debts.

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Example 30. Tommy sold his custom 1965 Volkswagen van to Marian for $89,000 in 2019. On his 2019 return, Tommy elected out of the installment method. He reported the $10,000 cash he received and the $79,000 face value of the installment note as if he received the full $89,000 in 2019. Tommy received $9,000 principal payments, plus interest, in each year from 2020 to 2022.

In 2023, Marian's medical bills make it impossible for her to continue making the required payments, so she stops payments on the note. Tommy repossesses the van. Unfortunately, because Marian's glaucoma has interfered with her ability to drive, the van is only worth $20,000 when Tommy takes it back. As part of the negotiated settlement, Marian also gives Tommy her porcelain doll collection, which has an FMV of $25,000 at the time of the settlement. Tommy pays $2,000 in attorney's fees to negotiate the settlement.

Tommy's loss on the repossession is calculated as follows. He reports the nonbusiness bad debt on his 2023 return as a as a short-term capital loss.

FMV of property at time of repossession	$20,000
Plus: FMV of additional property received at time of repossession	25,000
Less: value of the obligation used to calculate gain or loss in the year of the sale	(79,000)
Plus: all principal payment received prior to repossession ($9,000 × 3)	27,000
Less: repossession expenses	(2,000)
Loss realized on repossession	($ 9,000)

Installment Method Used to Report Original Sale

If the taxpayer used the installment method to report the original sale, the basis in the installment obligation is the unpaid balance multiplied by the difference between 100% and the gross profit percentage. Accordingly, the gain or loss may be calculated using the following formula.

	FMV of property at time of repossession
+	FMV of additional property received at time of repossession
−	Unpaid balance on the obligation × (100% − gross profit percentage)
−	Repossession expenses
	Gain or loss on reposession

The gain or loss on the repossession is of the same character (capital or ordinary) as the gain on the original sale.

Example 31. Use the same facts as **Example 30,** except Tommy did not elect out of the installment method. On his 2019 return, he calculated his gross profit percentage to be 25%. The unpaid balance on the installment agreement at the time of the repossession is $52,000 ($79,000 installment note – ($9,000 annual principal payments × 3 years)). Tommy's 2023 gain is calculated as follows.

FMV of property at time of repossession	$20,000
Plus: FMV of additional property received at time of repossession	25,000
Less: Unpaid balance on the obligation of $52,000 × (100% − 25% gross profit percentage)	(39,000)
Less: repossession expenses	(2,000)
Gain realized on repossession	$ 4,000

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REAL PROPERTY

The rules for the repossession of real property allow the taxpayer to keep essentially the same adjusted basis in the repossessed property that the taxpayer had before the original sale. The taxpayer can recover this entire adjusted basis when they resell the property. In effect, this cancels out the tax treatment that applied to the taxpayer on the original sale and puts the taxpayer in the same tax position they were in before that sale.

As a result, the total payments the taxpayer received from the buyer on the original sale are considered income to the taxpayer. The taxpayer must report as gain on the repossession any part of the payments not yet included in income. These payments are amounts the taxpayer previously treated as a return of the adjusted basis and excluded from income. However, the total gain the taxpayer reports is limited, as explained later.

The rules concerning basis and gain on repossessed real property apply regardless of whether the taxpayer reported the sale on the installment method. However, they only apply if **all** the following conditions are met.

1. The repossession must occur to protect the taxpayer's security rights in the property.
2. The installment obligation satisfied by the repossession must have been received in the original sale.
3. The taxpayer cannot pay any additional consideration to the buyer to get the property back unless either of the following situations applies.
    a. The reacquisition and payment of the additional consideration were provided for in the original contract of sale.
    b. The buyer defaulted, or default is imminent.

Additional consideration includes money and other property the taxpayer pays or transfers to the buyer. For example, additional consideration is paid when the taxpayer reacquires the property subject to a debt that arose after the original sale.

If any of the three conditions above are not met, then the taxpayer must use the rules applicable to personal property instead of real property.

Gain on Repossession

The gain on repossession of real property is the difference between the following amounts.

- The total payments received, or considered received, on the sale
- The total gain already reported as income

Taxable gain is **limited** to the gross profit on the original sale minus the sum of the following amounts.

- The gain on the sale the taxpayer reported as income before the repossession
- The repossession costs

The limit on taxable gain does not apply if the selling price is indefinite and cannot be determined at the time of repossession. For example, a selling price stated as a percentage of the profits realized from the buyer's development of the property is an indefinite selling price.

If the taxpayer reported the sale on the installment method, the taxable gain on repossession is ordinary income or capital gain, the same as the gain on the original sale. However, if the taxpayer did not report the sale on the installment method, the gain is ordinary income.

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Example 32. Gloria sold a tract of land in January 2021 for $25,000. She received a $5,000 down payment, plus a $20,000 mortgage secured by the property and payable at the rate of $4,000 annually, plus 5% interest. The payments began on January 1, 2022. The adjusted basis in the property was $19,000, and she reported the transaction as an installment sale. The selling expenses were $1,000. On her 2021 return, she calculated the gross profit as follows.

Selling price	$25,000
Less: adjusted basis	(19,000)
Less: selling expenses	(1,000)
Gross profit	$ 5,000

The gross profit percentage is 20% ($5,000 gross profit ÷ $25,000 contract price).

In 2021, Gloria included $1,000 in income (20% × $5,000 down payment). In 2022, she reported a profit of $800 (20% × $4,000 annual installment). In 2023, the buyer defaults and Gloria repossesses the property. She pays $500 in legal fees to get the property back.

Gloria includes $2,700 as taxable gain from the repossession on her 2023 return. Her original profit limited her taxable gain, which is calculated as follows.

Total payments received before repossession ($5,000 + $4,000)	$9,000
Less: gain already reported as income ($1,000 + $800)	(1,800)
Gain on repossession	**$7,200**
Gross profit on original sale	$5,000
Less: gain already reported as income ($1,000 + $800)	(1,800)
Less: costs of repossession	(500)
Limit on taxable gain on repossession	**$2,700**

The lesser of the limit on gain on repossession or the taxable gain is $2,700.

Basis in Repossessed Property

The basis in the repossessed property is determined as of the date of repossession. It is the sum of the following amounts.

- The adjusted basis in the installment obligation (i.e., the unpaid balance on the obligation × (100% – gross profit percentage))
- The repossession costs
- The taxable gain on the repossession

Example 33. Use the same facts as **Example 32.** The unpaid balance of the installment obligation (the $20,000 note) is $16,000 at the time of repossession ($20,000 – 4,000 payment in 2022). The gross profit percentage on the original sale is 20%. Gloria's adjusted basis in the note is $12,800 ($16,000 × (100% – 20%)) at the time of the repossession. She calculates the basis in the repossessed property as follows.

Adjusted basis in the installment obligation	$12,800
Plus: repossession costs	500
Plus: taxable gain on the repossession	2,700
Basis in repossessed real property	$16,000

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Holding Period for Resales

If the taxpayer resells the repossessed property, the resale may result in a capital gain or loss. The holding period includes the period the taxpayer owned the property **before the original sale** plus the **period after the repossession.** It does not include the period the buyer owned the property. If the buyer made improvements to the reacquired property, the holding period for these improvements begins on the day after the date of repossession.

Bad Debt

If the taxpayer repossesses real property under these rules, the taxpayer cannot take a bad debt deduction for any part of the buyer's installment obligation. This is true regardless of whether the obligation is fully satisfied by the repossession.

If the taxpayer took a bad debt deduction before the tax year of repossession, the taxpayer is considered to have recovered the bad debt when they repossessed the property. The taxpayer must report the bad debt deduction taken in the earlier year as income in the year of repossession. However, if any part of the earlier deduction did not reduce the tax, the taxpayer does not have to report that portion as income. The taxpayer increases the adjusted basis in the installment obligation by the amount the taxpayer reports as income from recovering the bad debt.

INTEREST ON DEFERRED TAX[80]

Generally, the taxpayer must pay interest on the deferred tax related to any obligation that arises during a tax year from the disposition of property under the installment method if **both** of the following apply.

- The property had a sales price over $150,000. In determining the sales price, all sales that are part of the same transaction are treated as a single sale.
- The total balance of all nondealer installment obligations arising during, and outstanding at the close of, the tax year is **more than $5 million.**

The taxpayer must continue to pay this interest in subsequent years if installment obligations that originally required interest to be paid are still outstanding at the close of a tax year.

This interest rule does not apply to dispositions of the following types of property.

- Farm property
- Personal-use property by an individual
- Personal property sold before 1989
- Real property sold before 1988

> **Note.** For more information about the interest on deferred tax and how to report the interest on tax returns, see IRS Pub. 537, *Installment Sales*.

80. IRS Pub. 537, *Installment Sales.*

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SELF-CANCELING INSTALLMENT NOTES

A self-canceling installment note (SCIN) instantly cancels all future payments due when the holder of the note dies.[81] One purpose of a SCIN is to reduce the taxpayer's taxable estate without incurring gift taxes during the taxpayer's lifetime. A SCIN may also be part of a business succession plan.

Example 34. Jean has no children and no other family members who have an interest or ability to operate her business. Jean wants to retire, but she does not want to sell her tax practice to anyone incompetent or unethical. The only potential buyer that she trusts is her assistant, Tate.

Jean would give Tate the business outright, but she needs the income for support during her lifetime. Therefore, Jean sells the business at FMV to Tate on an installment contract that provides her the requisite annual income. However, because Tate is her chosen successor, the terms of the note provide that any balance on the installment contract will be forgiven upon her death.

Because the business was purchased at FMV, Jean does not have to file a gift tax return. Furthermore, the business is no longer part of her estate, so any future growth in its value will not be reflected in her estate's taxable value. The note has no value upon her death, so it is also not included in her estate.

CCA 201330033 outlines the IRS's position on SCINs. Based on that advisory, the preceding **Example 34** provides the "cleanest" fact pattern for passing IRS scrutiny.

1. The parties are not related, which makes it more likely to be an arm's-length transaction.
2. The cash flow from the note is appropriate to the situation because it is based on Jean's needs; therefore, there was a good reason, other than estate tax savings, to enter into the transaction.
3. The self-canceling feature will contribute to the business's odds of survival.

Based on these factors, it is easy to conclude that the transaction is a bona-fide sale and that tax avoidance is not its primary purpose. However, this type of situation is rare. The typical SCIN transactions involve related parties and multiple entities, such as revocable and irrevocable trusts. These complex transactions often employ many other features meant to preserve the tax benefits in the event of IRS scrutiny. Such intricacies are beyond the scope of this material.

Note. For background information on SCINs and a prelude to understanding the current climate, see "Self-Canceling Installment Notes (SCINs) – IRS Guidance and Pending Tax Court Case; CCA 201330033 and *Estate of William Davidson*" by Steve R. Akers. This article can be found at **uofi.tax/17b1x1** [www.bessemertrust.com/portal/binary/com.epicentric.contentmanagement.servlet.ContentDeliveryServlet/Advisor/Presentation/Print%20PDFs/Self-Canceling%20Installment%20Notes%20CCA%20 201330033 _10.18.13_FINAL.pdf].

The courts, not the IRS, have the ultimate authority to determine which fact patterns satisfy the requirements of the applicable tax laws and which do not. There have been a number of court cases involving SCINs.

81. CCA 201330033 (Feb. 24, 2012).

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Two high-profile cases illustrate how the courts could address these issues — *Estate of Woelbing v. Comm'r*[82] and *Estate of Davidson v. Comm'r*.[83] In these cases, the plaintiffs filed petitions with the Tax Court after the IRS assessed deficiencies. The IRS's position was based on the following arguments.

1. The notes had no value at the time of the transactions; therefore, gift tax was due on the transfers.
2. The sales were not bona-fide arm's-length transactions; therefore, the transferred assets should be included in the taxable estate.

Many interested parties hoped that the courts would weigh in on key issues, such as the following.

1. Which of the following measures are appropriate to use in determining the FMV of the note?[84]
   a. The rules applicable to installment debt instruments (the willing-buyer, willing-seller standard in Treas. Reg. §25.2512-8)
   b. The rules applicable to annuities under IRC §7520
2. What is the effectiveness of certain provisions, such as the "value adjustment clause," which were included in the SCIN documents to protect the transactions from being nullified by the IRS and the courts?[85]

Unfortunately, these cases were settled out of court, leaving observers to continue speculating on the issues. The *Woelbing* case settlement involved no additional gift or estate tax liabilities. However, compromises may have been reached in a related situation.[86] Therefore, any conclusions drawn from the settlement are speculative.

Note. For the *Estate of Marion Woelbing* case, a stipulated decision was entered on March 28, 2016, indicating that no additional gift tax is due related to the SCIN transaction in this and the related *Estate of Donald Woelbing* case. However, this case did not address estate tax. The statute of limitations was still open for the decedent's estate tax at the time of the settlement. Accordingly, the SCIN issues may have been part of undisclosed negotiations between the IRS and the decedent's estate regarding unassessed estate taxes.[87]

The *Davidson* case, in contrast, was settled for $338 million, which covered estate and gift tax liabilities. While the settlement does not disclose how the valuation issues were decided, it does provide a warning to practitioners on the riskiness of using SCINs as part of "cutting-edge" estate planning strategies. After settling with the IRS, the estate sued Deloitte Tax, LLP. The case was dismissed because of a clause in the engagement agreement that limited the time frame during which the client could sue for malpractice.[88]

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82. *Estate of Donald Woelbing v. Comm'r,* Tax Court Docket No. 30261-13 (Petition filed Dec. 26, 2013; stipulated decision Mar. 25, 2016).

83. *Estate of William Davidson v. Comm'r*, Tax Court Docket No. 13748-13 (Petition filed Jun. 14, 2013; stipulated decision Jul. 6, 2015).

84. *Ron Aucutt's "Top Ten" Estate Planning and Estate Tax Developments of 2015*. Aucutt, Ronald. Jan. 8, 2016. The American College of Trust and Estate Counsel. [www.actec.org/capital-letter/top-ten-estate-planning-and-estate-tax-developments-of-2015] Accessed on Jun. 7, 2024.

85. Ibid.; *IRS Grabs $388 Million From Billionaire Davidson Estate*. Ebeling, Ashlea. Jul. 8, 2015. Forbes. [www.forbes.com/sites/ashleaebeling/2015/07/08/irs-grabs-388-million-from-billionaire-davidson-estate] Accessed on Jun. 7, 2024.

86. *Estate of Marion Woelbing v. Comm'r*, Tax Court Docket No. 30260-13. See *Settlement of Woelbing Cases (Involving Sale to Grantor Trust with Defined Value Feature).* Akers, Steve. Apr. 2016. Bessemer Trust. [www.bessemertrust.com/insights/settlement-of-woelbing-cases-involving-sale-to-grantor-trust-with-defined-value-feature] Accessed on Jun. 7, 2024.

87. *Expert Analysis: IRS Settlement With Carmex Owners Is Surprising.* Aucutt, Ronald D. Apr. 14, 2016. Law 360. [www.law360.com/articles/783013?scroll=1] Accessed on Jun. 7, 2024.

88. *Protecting Yourself When Planning in Unsettled Waters: A Case Study on How to Structure Your Client Relationship to Protect Yourself from Malpractice Claims and Ethical Issues*. Snyder, Shawn. Jan. 25, 2018. Denver Estate Planning Council. [www.denverestateplanningcouncil. org/assets/Councils/Denver-CO/library/012518%20Handout.pdf] Accessed on Jun. 7, 2024.

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GIFT TAX[89]

The transfer of property by gift is subject to gift tax.[90] A transfer involves a gift if the transferor receives less than adequate consideration in exchange for the property.[91] The gifted portion of a transfer is the amount by which the FMV of the property given exceeds the FMV of the consideration received.

> **Example 35.** Aaron gave Margret a Triumph motorcycle in exchange for an antique teddy bear. The FMV of the Triumph was $20,000. The FMV of the teddy bear was $1,000. Aaron gave Margret a gift of $19,000.

In general, a transaction in which property is exchanged for a promissory note is not treated as a gift if the value of the property transferred is substantially equal to the value of the note.[92] The FMV of a note is presumed to be the amount of unpaid principal, plus accrued interest.[93] However, the note's face value and time period over which payments are due must be reasonable in light of the circumstances.

A note's FMV is worth less than its unpaid principal, plus interest, in the following circumstances.

1. The interest rate, maturity date, or other factors cause it to be worth less.
2. The full face value of the note is not collectible (due to the insolvency of the liable parties or for other reasons).
3. The FMV of the property pledged as security is insufficient to satisfy the debt.

> **Example 36.** Elvis gives his mother a Cadillac in exchange for an unsecured note payable. The FMV of the Cadillac is $20,000. The note payable is for $20,000. However, under the terms of the note, the principal is due in 500 years and the interest rate is 0%. Elvis gives his mother a gift of $20,000.

In *Estate of Costanza v. Comm'r,*[94] the appellate court set the standard for related party SCINs: **"a SCIN signed by family members is presumed to be a gift and not a bona fide transaction."** However, the appellate court also stated that this presumption may be rebutted by affirmative evidence that at the time of the transaction there was a real expectation of repayment and intent to enforce the collection of the indebtedness.

ESTATE TAX[95]

The FMV of a decedent's gross estate is subject to the estate tax. An estate includes the FMV of all property owned by the decedent at the time of their death, to the extent of the decedent's ownership interest in the property.[96] An estate also includes the value of **transferred** property in the following circumstances.[97]

1. The enjoyment of the property was under the decedent's control at the time of their death (in a grantor trust or otherwise). "Under the decedent's control" includes situations in which the control was shared with another party or parties.
2. During the 3-year period ending on the date of the decedent's death, the decedent surrendered the property or the rights to control the property for less than adequate consideration.

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89. CCA 201330033 (Feb. 24, 2012).
90. IRC §2501.
91. IRC §2512(b).
92. Treas. Reg. §25.2512-8.
93. Treas. Reg. §25.2512-4.
94. *Estate of Costanza v. Comm'r,* 320 F.3d 595 (6th Cir. 2003), *rev'g* TC Memo 2001-128.
95. CCA 201330033 (Feb. 24, 2012).
96. IRC §2033.
97. IRC §2038.

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Example 37. On his deathbed, Carl gave his mansion to Priscilla in exchange for a SCIN. The mansion was included in his estate because he clearly made the transfer in anticipation of his death without any intention that the SCIN would require any payments from Priscilla.

If a SCIN is not a valid debt instrument, the decedent may be considered to have retained enough control over the assets to include them in the decedent's estate. One significant factor in determining if a SCIN is a valid debt instrument is the debtor's ability to repay the note.

INCOME TAX

There are particular income tax consequences to canceling a note when the debt is between related parties. In such a case, the holder of the note must recognize income equal to the difference between the greater of the FMV or the **face** value of the note and the holder's basis in the obligation.[98] This also applies when the holder of the note is an estate.[99] The estate's basis in the note is not stepped up because the unpaid principal is income in respect of a decedent (IRD); the estate's basis is equal to the decedent's basis.[100]

The IRS's position is that the IRD related to the canceled note principal is reported on the estate's initial income tax return.[101] This position was upheld by the 8th Circuit Court in *Estate of Frane v. Comm'r*[102] in 1993.

Observation. It may be argued that the position taken by the dissenting justices in *Estate of Frane v. Comm'r* is the most legally sound.[103] In that dissent, the judge recharacterizes the transaction as a contingent payment sale. If a SCIN arrangement is a contingent payment sale, the life span of the decedent determines the selling price of the property. There is no debt canceled and there is no IRD to recognize. Practitioners taking such a stance are advised to disclose that the position is contrary to IRS published guidance.

It is unclear what the income tax consequences are of a SCIN's cancelation feature for the purchaser of the property. Exploring the following questions is outside the scope of this material, but the issues should be researched by anyone representing a client who has received property via a SCIN arrangement.

1. What is the purchaser's basis in the property? It may be equal to the principal payments actually made if SCINs are considered contingent payment instruments under Treas. Regs. §§1.483-4 and 1.1275-4(c)(5).
2. Are there cancelation-of-indebtedness issues under IRC §108(e)?

98. IRC §§453B(a) and (f).

99. IRC §§691(a)(2), (4), and (5).

100. IRC §691(a)(4).

101. Rev. Rul. 86-72, 1986-1 CB 253.

102. *Estate of Frane v. Comm'r*, 998 F.2d 567 (1993), *aff'g* 98 TC 341 (1992).

103. Ibid.

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APPENDIX

TEST RATES FOR UNSTATED INTEREST AND ORIGINAL ISSUE DISCOUNT[104]

An installment sale contract may provide that each deferred payment on the sale includes interest or that there will be an interest payment in addition to the principal payment. Interest provided under the contract is referred to as **stated interest.**

If an installment sale contract does not provide for **adequate** stated interest, part of the stated principal amount of the contract may be recharacterized as interest. When IRC §483 applies to the contract, this interest is called **unstated interest.** When IRC §1274 applies to the contract, this interest is called **OID.** Whether either of these sections applies to a particular installment sale contract depends on several factors, including the total selling price and the type of property sold. An installment sale contract does not provide for adequate stated interest if the stated interest rate is lower than the test rate (both of these Code sections and the test rate are discussed later).

To determine whether §§1274 or 483 applies to an installment sale contract, all sales or exchanges that are part of the same transaction (or related transactions) are treated as a single sale or exchange. In addition, all contracts arising from the same transaction (or a series of related transactions) are treated as a single contract. The total consideration due under an installment sale contract is determined at the time of the sale or exchange. Any payment (other than a debt instrument) is taken into account at its FMV.

When either §§1274 or 483 applies to the installment sale contract, the seller must treat part of the installment sale price as interest, even though interest is not called for in the sales agreement. If either section applies, the taxpayer must reduce the stated selling price of the property and increase the interest income by this unstated interest.

Note. The buyer reduces their basis in the assets by the unstated interest or OID. Their interest expense includes the unstated interest and/or OID. These rules do not apply to personal-use property.

IRC §§483 and 1274

IRC §§483 and 1274 both require that when the stated interest rate in an installment agreement is not adequate, the seller and the buyer must recharacterize a portion of the contract principal as interest. The reason it is important to know which Code section applies is because **unstated interest (§483)** is included in income based on the taxpayer's method of accounting and **OID (§1274)** is included in income over the term of the contract. The following example demonstrates how the interest is taxed under each of these Code sections.

Example 38. Rocky has an installment contract that calls for one payment of $500,000 five years following the agreement date. The agreement states that the interest rate is 0%. If the AFR is 2%, the PV of the contract is $452,865.[105] Accordingly, the imputed interest over the life of the contract is $47,135 ($500,000 payment – $452,865 PV).

If the contract falls under §483 and Rocky uses the cash basis of accounting, he will include the $47,135 interest in income in the year the payment is received. If the contract falls under §1274, he must recognize the interest income each year as it accrues regardless of his method of accounting.

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[104] IRS Pub. 537, *Installment Sales.*

[105] Calculated using *Present Value Calculator.* Financial Mentor. [financialmentor.com/calculator/ present-value-calculator] Accessed on Jun. 1, 2024.

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OID includable in income each year is based on the constant yield method described in IRC §1272 (this computation is beyond the scope of this chapter). In some cases, the OID on an installment sale contract may also include all or part of the stated interest, especially if the stated interest is not paid at least annually. Each Code provision exempts a number of transactions. Before determining whether the interest rate is adequate, it is important to ensure the transaction does not qualify for one of the exceptions applicable to both Code sections. **Both** §§483 and 1274 **exclude** debt instruments related to sales and exchanges under the following circumstances.

- All payments are due within six months after the date of the sale.
- The buyer assumes an existing debt on the exchanged property unless the terms or conditions of the debt instrument are modified in a manner that constitutes a deemed exchange under Treas. Reg. §1.1001-3.
- Either the debt instrument issued or the exchanged property is publicly traded.
- The sale or exchange involves all of the substantial rights to a patent, or an undivided interest in property that includes part or all substantial rights to a patent, or if any amount is contingent on the productivity, use, or disposition of the property transferred.[106]
- An annuity contract described in IRC §1275(a)(1)(B) and Treas. Reg. §1.1275-1(j) is issued as part of the exchange.
- The property is transferred between spouses or incident to a divorce.[107]
- A demand loan that is a below-market loan described in IRC §7872(c)(1) (e.g., gift loans and corporation-shareholder loans) is issued as part of the exchange.
- A below-market loan described in §7872(c)(1) (which applies only to the seller) is issued in connection with the sale or exchange of personal-use property. The exchanged property is personal-use property in the hands of the buyer.[108]

If both §§483 and 1274 apply to a transaction, then the rules of §1274 apply.[109] Thus, practitioners should first review the exceptions for §1274. Generally, §1274 applies to a debt instrument issued for the sale or exchange of property when **both** of the following conditions exist.

1. Any payment is due more than six months after the date of the sale or exchange.
2. The note does not provide for adequate stated interest.

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106. See IRS Pub. 544, *Sales and Other Dispositions of Assets.*

107. See IRC §1041.

108. IRC §1275(b).

109. IRC §483(d)(1).

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However, a number of exceptions apply in addition to those previously covered that apply to both Code sections. The first exception is for cash method debt instruments issued as part of property exchanges that do not involve new tangible personal property subject to depreciation.[110] A **cash method debt instrument** is any debt instrument given as payment for a sale or exchange if the debt's stated principal is $5,070,500[111] (in 2024) **or less** and the following conditions apply (this stated principal amount is indexed annually for inflation).[112]

1. The lender does not use an accrual method of accounting and is not a dealer in the type of property sold or exchanged.
2. Both the borrower and the lender jointly elect to account for interest under the cash method of accounting.
3. IRC §1274 would apply except for the election in (2) above.

IRC §1274 also does **not** apply to an installment sale contract that is a cash method debt instrument arising from the following types of sales and exchanges.

1. Total payments are $250,000 or less
2. Sale or exchange of the taxpayer's main home
3. Farms sold or exchanged for $1 million or less by an individual, an estate, a testamentary trust, an IRC §1244(c) small business corporation, or a domestic partnership that meets requirements similar to those of §1244(c)(3)
4. Certain land transfers between related persons (discussed later)

If an installment contract lacks adequate stated interest and meets one of the preceding §1274 exceptions, the rules of §483 must be used. However, there are additional exceptions to the application of §483. IRC §483 does **not** apply to an installment sale contract that arises from the following transactions.

1. A sale or exchange for which no payments are due more than one year after the date of the sale or exchange
2. A sale or exchange for $3,000 or less

> **Note.** If the debt is subject to the §483 rules and is also subject to the below-market loan rules, the below-market loan rules apply. Below-market loans include gift loans, compensation-related loans, and corporation-shareholder loans. For more information, see the 2017 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 1: Investments. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

110. IRC §1274A(b) defines the excluded property as "other than new section 38 property within the meaning of section 48(b), as in effect on the day before the date of enactment of the Revenue Reconciliation Act of 1990…"

111. Rev. Proc. 2023-34, 2023-48 IRB 1287.

112. IRC §1274A(d)(2)(A).

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Adequate Stated Interest Test Rate

In general, an installment sale contract provides for adequate stated interest if the stated interest rate (based on an appropriate compounding period) is at least equal to the test rate of interest. The test rate of interest for a contract is the "3-month rate." The 3-month rate is the **lower** of the following AFRs based on the appropriate compounding period (this 3-month rate is **not** the same as the 3-month rate used to calculate imputed interest).

1. The lowest AFR in effect during the 3-month period ending with the first month in which there is a **binding written contract** that substantially provides the terms under which the sale or exchange is ultimately completed.
2. The lowest AFR in effect during the 3-month period ending with the month in which **the sale or exchange occurs.**

> **Note.** AFRs are published monthly by the IRS and can be found at **uofi.tax/24x6x1** [apps.irs.gov/app/picklist/list/federalRates.html].

Example 39. On June 1, 2023, Archie entered into a binding written contract to sell his tavern. The contract called for the transfer of the property on contract for deed to the buyer on March 1, 2024. To determine if the contract for deed included adequate stated interest, his CPA used the lowest appropriate 3-month rate for April, May, and June of 2023 and January, February, and March of 2024.

For 2024, if the sale or exchange involves seller financing of $7,098,600[113] **or less,** the test rate of interest cannot be more than 9%, compounded semiannually. However, if the sale or exchange is over $7,098,600 or for new IRC §38 property, the test rate of interest is 100% of the AFR. For information on new IRC §38 property, see IRC §48(b), as in effect before the enactment of the Omnibus Budget Reconciliation Act of 1990.

Test Rate for Land Transfers Between Related Persons

For land transfers between related persons, the test rate used to determine if the interest rate is adequate cannot exceed 6%, compounded semiannually.[114] Related persons for this purpose include an individual and the members of the individual's family and their spouses. Members of an individual's family include the individual's spouse, brothers and sisters (whole or half), ancestors, and lineal descendants.

The §483 rules apply to debt instruments issued in a land sale between related persons to the extent the sum of the following amounts is **$500,000 or less.**

- The stated principal of the debt instrument issued in the sale or exchange
- The total stated principal of any other debt instruments for prior land sales between these individuals during the calendar year

The §1274 rules, if otherwise applicable, apply to debt instruments issued in a sale of land between related parties to the extent the stated principal amount **exceeds** $500,000. IRC §1274 is also used instead of §483 if any party to the sale is a nonresident alien.

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113. Rev. Proc. 2023-34, 2023-48 IRB 1287.

114. IRC §483(e)(1).

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Chapter 7: IRS Update

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Note. Corrections for all of the chapters are available at **TaxSchool.illinois.edu.** For clarification about terms used throughout this chapter, see the **Acronyms and Abbreviations** section following the index.

For your convenience, in-text website links are also provided as short URLs. Anywhere you see **uofi.tax/xxx**, the link points to the address immediately following in brackets.

About the Authors

Debbie Held, CPA, has worked for the University of Illinois Tax School since 2000 as an instructor, author, reviewer, and self-study course developer. She worked for the Internal Revenue Service for over 44 years as a revenue agent, appeals officer, project manager, and management analyst. She previously taught accounting courses at Lincoln Land Community College, and is a graduate of Sangamon State University (University of Illinois at Springfield). Debbie resides in Raymond, Illinois where her family farms.

Chris Korban, CPA, is a Tax Materials Specialist at the University of Illinois Tax School. He joined Tax School in 2023 with nine years of experience in public accounting. Chris earned both his Bachelor's Degree in Accounting and Master of Accounting Science from the University of Illinois.

John W. Richmann, EA, is a Tax Materials Specialist at the University of Illinois Tax School. Prior to joining Tax School in 2021, he owned a tax practice in St. Charles, Illinois, and held positions in private industry and consulting firms. John earned a Masters Degree in Business Administration from the University of Texas and an electrical engineering degree from the Massachusetts Institute of Technology.

Other chapter contributors and reviewers are listed at the front of this book.

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INFORMATION RETURNS INTAKE SYSTEM (IRIS)[1]

The Taxpayer First Act (TFA) required the IRS to develop an Internet portal by January 1, 2023, to allow taxpayers to electronically file **information returns.** Starting with the 2023 tax year, any entity that files a combination of 10 or more **information returns** must file them electronically. The IRS created the Information Returns Intake System (IRIS) to allow taxpayers a **free** option to electronically file certain information returns. Any entity that has an employer identification number (EIN) can electronically file via IRIS.

> **Note.** Taxpayers must file any corrected information electronically if the original return was required to be filed electronically.

There are two ways through IRIS to electronically file returns: through the IRIS portal and with software through IRIS Application to Application (A2A).

IRIS PORTAL

The IRIS portal allows taxpayers to enter data to create forms and conduct the following activities.

- Electronically prepare and file up to 100 returns at a time
- Download and print completed copies of information returns to distribute
- Keep a record of completed, filed, and distributed information forms
- Validate data before submission
- Participate in the Combined Federal/State Filing Program[2]
- Submit automatic extensions for information returns
- Make corrections to information returns filed with IRIS

> **Note.** Taxpayers who currently use the filing information returns electronically (FIRE) system or a third-party provider to prepare and submit information returns can continue to use these systems.

The IRIS portal accepts the following Forms 1099 and their automatic extensions for tax years 2022 and beyond.

- Form 1099-A, *Acquisition or Abandonment of Secured Property*
- Form 1099-B, *Proceeds from Broker and Barter Exchange Transactions*
- Form 1099-C, *Cancellation of Debt*
- Form 1099-CAP, *Changes in Corporate Control and Capital Structure*
- Form 1099-DIV, *Dividends and Distributions*
- Form 1099-G, *Certain Government Payments*
- Form 1099-H, *Health Coverage Tax Credit (HCTC) Advance Payments*
- Form 1099-INT, *Interest Income*

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1. *E-file forms 1099 with IRIS.* Feb. 8, 2024. IRS. [www.irs.gov/filing/e-file-forms-1099-with-iris] Accessed on Feb. 15, 2024; IRS Pub. 5717, *Information Returns Intake System (IRIS) Taxpayer Portal User Guide;* IRS Pub. 5718, *Information Returns Intake System (IRIS) Electronic Filing Application to Application (A2A) Specifications.*
2. Discussion of the Combined Federal/State Filing Program is beyond the scope of this chapter. Information on the program can be found in IRS Pub. 5717, *Information Returns Intake System (IRIS) Taxpayer Portal User Guide.*

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- Form 1099-K, *Payment Card and Third-Party Network Transactions*
- Form 1099-LS, *Reportable Life Insurance Sale*
- Form 1099-LTC, *Long-Term Care and Accelerated Death Benefits*
- Form 1099-MISC, *Miscellaneous Income*
- Form 1099-NEC, *Nonemployee Compensation*
- Form 1099-OID, *Original Issue Discount*
- Form 1099-PATR, *Taxable Distributions Received from Cooperatives*
- Form 1099-Q, *Payments from Qualified Education Programs (Under Section 529 and 530)*
- Form 1099-QA, *Distributions from ABLE Accounts*
- Form 1099-R, *Distributions from Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.*
- Form 1099-S, *Proceeds from Real Estate Transactions*
- Form 1099-SA, *Distributions From an HSA, Archer MSA, or Medicare Advantage MSA*
- Form 1099-SB, *Seller's Investment in Life Insurance Contract*

Note. Users should download IRS Pub. 5717, *IRS Information Returns Intake System (IRIS) Taxpayer Portal User Guide,* prior to beginning the registration. This publication contains a wealth of valuable information and screenshots. The publication also provides valuable information on making corrections, requesting automatic extensions, and downloading recipient copies.

Getting Started

To get started, the business will need an IRIS Transmitter Control Code (TCC), a 5-character alphanumeric TCC that begins with the letter "D," which identifies the business when forms are electronically filed. The TCC can only be used for IRIS.

Caution. It may take 45 days or longer to obtain the TCC.

Transmitters who file for multiple issuers should submit one application and use the assigned TCC for all issuers. The purpose of the TCC is to identify the business acting as the transmitter of the file. Transmitters may transmit files for as many companies as needed under one TCC.

A responsible official (RO) completes and submits the **application** for a TCC electronically. The RO must provide the following information to complete each application.

- Firm's business structure
- Firm's employer EIN (social security numbers (SSNs) and individual taxpayer identification numbers (ITINs) are not permitted)
- Firm's legal business name and business type
- Firm's doing business as name if different from the legal business name
- Business phone number
- Business address (must be a physical location, not a post office box)
- Mailing address if different than business address

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- For the RO and authorized delegate, if applicable, information must include the following.
  - SSN or ITIN
  - Date of birth
  - Contact information, including email address, position/title, and phone number
- Role: RO must select either issuer or transmitter (issuer is a person filing **only** for their business and transmitter is a person filing for their own business **and** other businesses or multiple businesses)
- Forms: select Form 1099
- Transmission Method: select the check box next to Portal

Each RO must sign the application with a self-selected 5-digit code and accept the terms of agreement.

To access the IRIS TCC application, users must complete the following steps.

1. Go to the IRIS TCC web page at **uofi.tax/24x7x1** [www.irs.gov/tax-professionals/iris-application-for-tcc].
2. Click on the Access Application for TCC button.
3. Sign in or create an account to begin the application process.
4. Select Individual on the Select Your Organization page.
5. Click on New Application and select IRIS Application for TCC.
6. Complete and submit an IRIS Application for TCC.
7. After the application is in Completed status and TCCs have been issued, users can access the IRIS portal at **uofi.tax/24x7x2** [www.irs.gov/filing/e-file-forms-1099-with-iris] to submit information returns.

Caution. Electronically filed returns **cannot** be transmitted through the IRIS portal until a TCC has been approved and assigned.

IRIS A2A

Companies that are developing software can use IRIS A2A to electronically file thousands of returns. A2A uses extensible markup language (XML) format and allows users to file volumes of information returns. IRS Pub. 5718, *Information Returns Intake System (IRIS) Electronic Filing Application to Application (A2A) Specifications,* provides additional information on the communication procedures, transmission formats, business rules and validation procedures for information returns transmitted electronically through the IRIS A2A system.

To start using IRIS A2A with software, users must follow these steps.

1. Apply for an IRIS A2A TCC.
2. Obtain an application program interfaces (API) client identification.[3]
3. Obtain a schema package.[4]
4. Submit IRIS Assurance Testing System (ATS) transmissions.[5]

After successfully submitting ATS transmissions, users can transmit return data through IRIS A2A.

3. For more information on the API client identification and the process of acquiring it, see [www.irs.gov/tax-professionals/get-an-api-client-id].
4. For a table listing XML schemas, business rules, and release memorandum for IRIS, see [www.irs.gov/e-file-providers/iris-schemas-and-business-rules].
5. For more information on ATS transmissions, see [www.irs.gov/e-file-providers/iris-assurance-testing-system-ats].

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RESUMPTION OF COLLECTION NOTICES[6]

In 2022, the IRS suspended mailing certain automated reminder notices to taxpayers with income tax balances due.[7] While the IRS continued to issue **initial** notices of balances due, it ceased to send subsequent reminders of unpaid balances due and accrued failure-to-pay tax penalties under IRC §6651. Recognizing the inequity of taxpayers accruing failure-to-pay tax penalties but receiving no correspondence from the IRS regarding the accruals, the IRS is granting relief from the failure-to-pay tax penalties for eligible taxpayers. In January 2024, the IRS resumed mailing reminder collection notices to individuals with tax liabilities before tax year 2022. It also resumed sending notices to businesses, tax-exempt organizations, trusts, and estates with tax liabilities before tax year 2023.[8]

> **Note.** Relief is provided only for failure to pay tax penalties and not for any accrued interest resulting from underpaying a tax liability.

ELIGIBLE TAXPAYERS

Relief from the failure to pay tax penalty is only applicable for the 2020 and 2021 tax years. Eligible taxpayers include individuals, businesses, trusts, estates, and tax-exempt organizations who filed an eligible income tax return for the 2020 or 2021 tax year. Such eligible income tax returns include, but are not limited to, the following.

- Form 1040, *U.S. Individual Income Tax Return*
- Form 1040-NR, *U.S. Nonresident Alien Income Tax Return*
- Form 1120-S, *U.S. Income Tax Return for an S Corporation*
- Form 1120, *U.S. Corporation Income Tax Return*
- Form 1041, *U.S. Income Tax Return for Estates and Trusts*
- Form 990-T, *Exempt Organization Business Income Tax Return*

To be eligible for relief, the taxpayer must meet **all** the following requirements.

- The taxpayer's tax liability (excluding applicable additions to tax, penalties, or interest) for the 2020 or 2021 tax year is less than $100,000 as of December 7, 2023.
- The IRS issued the taxpayer an initial balance-due notice for the 2020 or 2021 tax year on or before December 7, 2023.
- The taxpayer is otherwise liable for the failure-to-pay tax penalty for the 2020 or 2021 tax year during the period of February 5, 2022, through March 31, 2024.

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6. IRS Notice 2024-7, 2024-07 IRB 673.

7. IRS News Rel. IR-2022-31 (Feb. 9, 2022).

8. *IRS resumes issuing collection notices*. Jan. 4, 2024. IRS. [www.irs.gov/newsroom/irs-resumes-issuing-collection-notices] Accessed on Jun. 18, 2024.

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RELIEF

Taxpayers eligible for relief from the failure-to-pay tax penalty for the 2020 and 2021 tax years **do not need to take any action** to obtain such relief. Rather, the IRS will notify eligible taxpayers of their adjusted balances due, factoring relief from the failure to pay tax penalty in such balances. Eligible taxpayers who already paid tax balances that included failure-to-pay tax penalties will receive a refund or credit toward an outstanding tax liability.

> **Note.** The notice grants relief from failure-to-pay tax penalties incurred during the period beginning on the date of the IRS notice of initial balance due (or February 5, 2022, whichever is later) and ending on March 31, 2024. Failure-to-pay tax penalties are not eligible for relief if accrued before or after this period.

The IRS clarified that relief would **not** be granted from failure to pay tax penalties arising from a fraudulent failure to file, calculated and included in an offer in compromise (OIC), or settled in a closing agreement or judicial proceeding.

OFFER IN COMPROMISE[9]

Many taxpayers face financial challenges and cannot satisfy their tax obligations either by paying the full amount due or using installment options. Taxpayers may consider an OIC to settle the balance due for a reduced amount. This also allows an eligible taxpayer to start fresh with their IRS tax obligations. The objectives of the OIC program are as follows.[10]

- Obtain what can reasonably be collected at the earliest possible time with the least cost to the government.
- Resolve the taxpayer's delinquent tax liability in a manner that fits the best interests of both the taxpayer and the IRS.
- Provide the taxpayer with a fresh start toward future compliance with filing and payment requirements.
- Collect tax that may not otherwise be collected.

> **Caution.** Taxpayers should explore all other payment options before submitting an OIC.

ELIGIBILITY

Taxpayers applying for an OIC must meet the following preliminary requirements.

- Filed all required tax returns
- Made all required estimated payments for the current year
- Are not in an open bankruptcy proceeding
- Have a valid extension for a current year return
- Made all required federal tax deposits for the current quarter and past two quarters (if taxpayer is an employer)

9. *Offer in compromise*. May 15, 2024. IRS. [www.irs.gov/payments/offer-in-compromise] Accessed on Jun. 14, 2024; Form 656 Booklet, *Offer in Compromise.*

10. IRM 5.8.1.1 (2023).

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Prequalifier Tool

The IRS provides a prequalifier tool, which is useful in determining whether a taxpayer qualifies for an OIC. It also assists in determining a starting point for the preliminary offer amount. The online questionnaire gathers needed information to provide eligibility feedback. However, this preliminary offer amount does not guarantee acceptance by the IRS.

> **Note.** The OIC prequalifier tool can be found at **uofi.tax/24x7x3** [irs.treasury.gov/oic_pre_qualifier] along with other helpful information associated with the OIC application and OIC approval process. For a step-by-step guide through the OIC prequalifier status screens, see the 2015 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 3: IRS Update. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

The prequalifier tool **requires no personally identifiable information** (PII) about the taxpayer. It is a generic application that provides a guideline of the information required. Once the taxpayer's information is entered, the prequalifier tool makes basic calculations to determine whether the taxpayer's circumstances meet OIC criteria in a manner that will lead to acceptance of the OIC application by the IRS.

The OIC prequalifier has the following **six basic sections.**

1. **Status.** The status section asks questions about the preliminary requirements the taxpayer must meet in order to be eligible for an OIC. If the taxpayer does not meet these preliminary requirements as listed in the eligibility section, then an OIC is not an option for the taxpayer at this time.
2. **Basic information.** The basic information section requests general information about the tax liability, household size, most recent tax filing, and state of residence.
3. **Assets.** In the assets section, taxpayers enter information including bank balances, home value, home loan balance, vehicle equity, retirement account equity, other real property equity, any other asset's equity, and stocks, bonds, and other investments. There is also an entry for any miscellaneous assets.
4. **Income.** This section requests relevant income for the prequalifier, including gross wages (including social security, pensions, unemployment, etc.), interest and dividends, distributions from flow-through entities, net rental income, net business income, and any child support or alimony received. Taxpayers should also include any additional income.
5. **Expenses.** The expenses section reviews the taxpayer's typical household expenses for a month. These are in addition to expenses for food, clothing, miscellaneous items, and out-of-pocket medical expenses that the IRS estimates based on the taxpayer's location and number of family members. Pertinent expenses include rent or mortgage and utilities, information on vehicles the taxpayer owes, any public transportation costs, health insurance premiums, life insurance premiums, taxes, court-ordered payments, and child dependent care costs. For the standards used by the IRS, see Collection Financial Standards, discussed later.
6. **Proposal.** Based on the information the taxpayer provides, the prequalifier calculates whether the taxpayer is likely to qualify for an OIC **or does not appear** to meet the qualifications that may lead to an accepted OIC application.

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Practitioner Planning Tip

Tax practitioners should be realistic when reviewing a taxpayer's financial information. If the client has income or asset equity sufficient to satisfy the balance due, submitting an OIC is unlikely to be successful. As a part of considering offers that involve doubt as to collectability, the IRS undertakes financial analysis that examines the valuation of taxpayer assets.[11]

The IRS will investigate the taxpayer's income, assets, and liabilities to verify the financial data on the application. Therefore, tax practitioners should use due diligence to ensure the accuracy of the OIC. Tax practitioners should use a separate engagement letter to prepare a taxpayer's OIC and obtain a retainer, if possible.

Example 1. Archie meets with Howie, a CPA, to figure a way to pay his tax liabilities for the 2020 and 2021 tax years. Howie requests a list of Archie's income, assets, and liabilities. After reviewing the information provided, Howie discusses submitting an OIC with Archie. Using the prequalifier tool, Howie enters Archie's net monthly income and his equity in assets, among other financial data. Howie prepares an OIC proposing a cash settlement of $5,000 based on the prequalifier tool.

PREPARING THE OIC APPLICATION

Form 656, *Offer in Compromise,* is used to apply for an OIC if the application is based on doubt as to collectability or on the premise that the offer is in the best interest of effective tax administration. Form 656 is published in a booklet format that also contains the following information.

- Instructions (including information required, payment options, fee information, and how to apply)
- Form 433-A (OIC), *Collection Information Statement for Wage Earners and Self-Employed Individuals*
- Form 433-B (OIC), *Collection Information Statement for Businesses*
- Application checklist with mailing instruction

Form 656-B, *Offer in Compromise Booklet,* contains information regarding the application process and fees, payment options, completing the application, and submission.

Caution. The IRS released **revised** English versions of these forms in April and May **2024.** It released the Spanish versions of these forms in 2020 and 2023. Tax practitioners must use the most recent versions of the OIC forms. **Using the older forms will delay the acceptance of an OIC.**

11. IRM 5.8.5.1 (2021). See also IRM 8.23.3.2 (2023).

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Grounds for an OIC Application[12]

After a taxpayer applies for an OIC, the IRS reviews the taxpayer's ability to pay by analyzing their income, expenses, and asset equity. Acceptance of an OIC depends on meeting **one or more** of the following grounds.

- Doubt as to collectability
- Doubt as to liability
- The best interest of tax administration

The IRS may accept the OIC application on the basis of any of these three grounds. The taxpayer must submit appropriate documentation to establish that the grounds for application have been met.

Doubt as to Collectability. Doubt as to collectability exists in any case in which the taxpayer's assets and income are less than the full amount of the assessed liability. When doubt as to collectability has been established, an offer is generally considered acceptable if it closely approximates the amount that could reasonably be collected by other means, including through IRS administrative and judicial collection powers.

The following four components of collectability must be considered.

1. Net equity in assets
2. Present and future income
3. Amounts collectable from third parties
4. Amounts available to the taxpayer but beyond IRS reach

Doubt as to Liability. Doubt as to liability exists when there is a genuine dispute as to the existence or amount of the correct tax liability under the law. Doubt as to liability does not exist when the liability has been established by a final court decision concerning the existence or amount of the liability.

Taxpayers filing an OIC application based on doubt as to liability grounds use Form 656-L, *Offer in Compromise (Doubt as to Liability).*

Interest of Effective Tax Administration. In general, when there are no grounds for compromise on collectability or liability grounds, a compromise may be entered into in order to promote effective tax administration. This applies when collection of the full liability would create economic hardship within the meaning of Treas. Reg. §301.6343-1 or when compelling public policy or equity considerations identified by the taxpayer provide a sufficient basis for compromising the liability.

Note. Further details on each of these three grounds can be found in Treas. Reg. §301.7122-1.

12. IRM 33.3.2.3 (2004).

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Filing Fee

For the IRS to consider an OIC, the taxpayer generally must pay an application fee of $205. This fee must be paid separately from any other required payments.

Low-income taxpayers can request a waiver of the application fee and/or the initial payment using the low-income certification form found in Form 656-B. The low-income exemption applies if the taxpayer's monthly income is below 250% of the federal poverty level (as defined by Health and Human Services guidelines).[13] To qualify for this exemption, page 2 of the Form 656 must be completed.

> **Note.** The Health and Human Services federal poverty guidelines for 2024 may be found at **uofi.tax/24x7x4** [aspe.hhs.gov/topics/poverty-economic-mobility/poverty-guidelines/prior-hhs-poverty-guidelines-federal-register-references/2024-poverty-guidelines-computations].

If the IRS decides that a taxpayer has not filed all required forms, it returns the OIC application and the fee paid to the taxpayer.

Forms for Collection Information Statements

Taxpayers applying for an OIC must submit information that allows the IRS to evaluate their financial ability to make payments. With the OIC application form, individuals who report wages or self-employment income should also submit Form 433-A (OIC). They provide information about household size, location, assets, and earnings. The IRS uses location information to estimate reasonable living costs for their city or county.

The IRS allows some assets (such as vehicles and real estate) to be valued at the quick sale value (QSV). This is the amount the asset can be sold for immediately. To calculate the QSV, a taxpayer obtains the value of a vehicle by consulting a trade association guide (such as **kbb.com**) for the fair market value (FMV) and discounting the value by 20%. The FMV of real estate is obtained by an appraisal, the replacement cost, or the taxable value of the home.[14]

Businesses other than sole proprietors use Form 433-B (OIC) to provide financial information instead of Form 433-A (OIC). Form 433-B (OIC) provides information about the business's location, assets, whether it is a federal contractor, its gross monthly payroll, and whether it has a separate payroll processing or tax preparation service. The form also provides information about the business's expenses.

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13. IRC §7122(c)(3).

14. *Offer in Compromise (OIC) Disagreed Items.* Jan. 18, 2024. IRS. [www.irs.gov/appeals/offer-in-compromise-oic-disagreed-items] Accessed on Aug. 7, 2024.

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Final Checklist

The following checklist appears near the end of Form 656-B and can assist tax practitioners in ensuring that OICs are complete and the IRS can process them.

APPLICATION CHECKLIST

Review the entire application using the Application Checklist below. Include this checklist with your application.

Forms 433-A (OIC), 433-B (OIC), and 656

- ☐ Did you complete all fields and sign all forms
- ☐ Did you make an offer amount that is equal to the offer amount calculated on the Form 433-A (OIC) or Form 433-B (OIC)? If not, did you describe the special circumstances that are leading you to offer less than the minimum in Section 3, Reason for Offer, of Form 656, and did you provide supporting documentation of the special circumstances
- ☐ Have you filed all required tax returns and received a bill or notice of balance due
- ☐ Did you include a complete copy of any tax return filed within 12 weeks of this offer submission
- ☐ Did you select a payment option on Form 656
- ☐ Did you sign and attach the Form 433-A (OIC), if applicable
- ☐ Did you sign and attach the Form 433-B (OIC), if applicable
- ☐ Did you sign and attach the Form 656
- ☐ If you are making an offer that includes business and individual tax debts, did you prepare a separate Form 656 package (including separate financial statements, supporting documentation, application fee, and initial payment)

Supporting documentation and additional forms

- ☐ Did you include photocopies of all required supporting documentation
- ☐ If you want a third party to represent you and receive confidential information during the offer process, did you include a Form 2848? If you want a third party to only receive confidential information on your behalf, did you include a valid Form 8821? Does the authorization include the current tax year
- ☐ Did you provide a letter of testamentary or other verification of person(s) authorized to act on behalf of the estate or deceased individual

Payment

- ☐ Did you include a check or money order made payable to the “United States Treasury” for the initial payment? (Waived if you meet Low-Income Certification guidelines—see Form 656)
- ☐ Did you include a separate check or money order made payable to the “United States Treasury” for the application fee? (Waived if you meet Low-Income Certification guidelines—see Form 656)

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OIC PAYMENT OPTIONS

Payment can be made in either a lump sum or through periodic payments.

Lump Sum

Selection of the lump-sum option requires that a 20% down payment be included with the offer. Remaining payments are **due after the OIC is accepted** in five or fewer monthly payments.

Periodic Payments

For the periodic-payment option, an initial payment must accompany the offer. The remaining balance is due in six to 24 monthly installments, depending on the offer the taxpayer proposed. The total amount paid with periodic payments will be greater than the amount paid with the lump sum.

> **Note.** When using this option, monthly payments must be paid while the IRS is considering the offer. Failure to make the monthly payments will result in the offer being rejected. Interest and penalties will continue to accrue while the offer is being evaluated.

Interest **does not accrue** on the taxpayer's accepted OIC amount from the date of acceptance until the OIC is paid.

The amount of time a taxpayer requires to pay their offer will affect the amount of the minimum offer. Paying over a shorter period of time reduces the amount of the offer.

Example 2. Fred and Frieda, a married couple, owe $102,862 in delinquent taxes. Based on the information in their OIC application, a lump sum offer would be $49,228, and a periodic offer would be $61,156. These are the minimum amounts needed to apply for the OIC.

Benny, an EA, informs Fred and Frieda about the $205 application fee, which is sent with the application, and also advises them about their payment options. These options are summarized in the following table.[15]

Lump Sum Cash Option	Periodic Payment Option
Fred and Frieda must submit an initial payment of 20% of the calculated offer ($49,228 × 20% = $9,846) with the OIC application. If the IRS accepts the OIC, the remaining balance of $39,382 ($49,228 − $9,846) may be paid in five or fewer payments (made over a period of five or fewer months). If the offer is rejected, the IRS **retains** the $9,846 initial payment and will apply it against the tax liability.	The payments are made in six or more monthly installments, with the full amount of the offer paid within 24 months of acceptance of the offer. Fred and Frieda submit the initial periodic payment of $2,548 ($61,156 ÷ 24 months) with the OIC application and continue to make monthly payments in the same amount while the IRS considers the offer. If the offer is rejected, the IRS **retains** all periodic payments and will apply them against the tax liability.

> **Note.** To view Fred and Frieda's completed Form 433-A (OIC) that illustrates the periodic payment option, see the 2015 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 3: IRS Update. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

15. *Topic 204: Offers in Compromise.* Jan. 26, 2024. IRS. [www.irs.gov/taxtopics/tc204.html] Accessed on Jun. 16, 2024.

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If the OIC is not calculated correctly or the offer amount is not high enough, the IRS will figure the appropriate or revised amount. If this amount is higher than what the taxpayer offered, and they do not have any special circumstances, the taxpayer will be given the opportunity to accept the new amount. If the taxpayer does not accept, their offer will be rejected. The taxpayer should give due consideration to the new amount to avoid an appeals process or starting the OIC process again.[16]

> **Note.** OICs are reviewed for fraudulent intent. Submitting an OIC with false information or making fraudulent statements to an IRS employee is considered fraud and may be subject to civil or criminal penalties.

IRS INTERNAL VERIFICATION[17]

The taxpayer's OIC application should reflect current information. The IRS may request updated information if the information becomes older than one year and it appears that the taxpayer's financial circumstances have significantly changed. However, before contacting the taxpayer for updated information, the IRS will attempt to update information through available internal resources.

These internal resources include previous tax returns filed by the taxpayer. Some steps that the IRS takes to verify OIC application amounts include the following.

- Determine whether the taxpayer has disclosed all business activity in the OIC application by researching and cross-referencing the taxpayer's taxpayer identification number (TIN) with IRS business return information.
- Ensure that the taxpayer has filed previous returns and has complied with federal tax laws.
- Compare the income and expense amounts in the OIC application with those reported on tax returns.
- Compare real estate tax and mortgage-related amounts in the OIC application with those reported on tax returns.
- Identify any discrepancies between the OIC application and tax returns for investment accounts.
- Verify sources of income, including income from employers, banks, and retirement accounts.
- Determine if assets have been recently disposed of, including investment assets.

Moreover, the IRS may take steps to determine whether there are any vehicles or real estate registered to the taxpayer that were **not disclosed in the OIC application.** This may involve the use of public records and a search of business records (to identify any indirect ownership through an entity).

Ownership in additional assets may be determined through searches of Uniform Commercial Code (UCC) filings, court records, and other names used by the taxpayer in the past.

IRS verification may also include researching taxpayer information with credit bureaus. This may provide information about the taxpayer's past residences, employers, and payment history. As with UCC filing research, this provides information about the taxpayer's debts, any liens on taxpayer property, and any property that the taxpayer has not listed in the OIC application. There are several internal IRS rules regarding the acquisition of a taxpayer credit report in the course of verifying an OIC application. These rules can be found in IRM 5.8.5.3.1.2 (2024).

> **Caution.** Transferring assets from the taxpayer's name before submission of the OIC will result in rejection because the IRS thoroughly investigates applications before accepting the OIC. Such a transfer may result in allegations of fraud or perjury if intent to defraud is found.[18]

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16. *Offer in Compromise — Frequently Asked Questions.* May 6, 2024. IRS. [www.irs.gov/businesses/small-businesses-self-employed/offer-in-compromise-FAQs] Accessed on Aug. 6, 2024.

17. IRM 5.8.5.3 (2021).

18. IRC §7206(4).

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COLLECTION FINANCIAL STANDARDS

IRS collection financial standards (CFS) are used in the calculations to determine the taxpayer's ability to pay delinquent taxes. Generally, sources of income are added together; this amount is then reduced by expenses. However, these expenses generally must be those allowable under CFS rules. In addition, national standards are generally used for allowable expense amounts (instead of the actual expenditures made by the taxpayer).

Accordingly, national standards are used for expenses associated with food, clothing, and other items. These national standard amounts vary with family size. National standards also exist for out-of-pocket healthcare costs.

Many expenses disclosed by the taxpayer in an OIC application are associated with housing costs, including utilities. Because of the disparity in such expenses across the country, localized standards are used for housing and utility expenses. This ensures a standard that is more appropriate and fair to the taxpayer. Local standards are also used for transportation costs, which include the ownership costs of an automobile.

> **Note.** For further information on CFS and the amounts used for the various allowable expenses, see **uofi.tax/24x7x5** [www.irs.gov/businesses/small-businesses-self-employed/collection-financial-standards].

The IRS's authority to use national and local guidelines within the OIC process is provided by IRC §7122(d)(2). This Code section requires the IRS to determine whether the use of the national and local guidelines for each taxpayer is appropriate based on a facts and circumstances analysis. The IRS may not apply these standards if it would result in the taxpayer not having adequate means to provide for basic living expenses.

Generally, the taxpayer can use these allowable national and local standard expense amounts in their OIC application (even if their actual expenses are lower). However, if the taxpayer's actual expenses are higher, **the IRS may use the lower standard amounts.** Generally, in order for the IRS to agree to the higher amount instead of imposing a lower standard amount for a particular expense, substantial and clear documentation of the actual expense amount and its necessity must be provided.

The IRS's use of CFS in calculating the taxpayer's ability to pay delinquent taxes has been upheld by the Tax Court. In *Drakes and Taylor v. Comm'r,*[19] the taxpayers owed $75,157 for the 2006 and 2007 tax years. The taxpayer's OIC application offered the IRS payment of $12,000, and the IRS rejected the taxpayer's application. After the rejection, the taxpayer claimed undue financial hardship, and the case was assigned to the Appeals Division for reconsideration.

Upon reconsideration, the Appeals Division settlement officer determined that the taxpayers could pay $5,664 per month. However, the taxpayers were only willing to agree to a monthly installment of $1,650 per month. In calculating the monthly amount the taxpayer could afford, the settlement officer used CFS and applied the national and local standards to arrive at the monthly installment requirement of $5,664. Because the taxpayers had the ability to pay $5,664 under CFS guidelines, the Tax Court held that there was no hardship to the taxpayers and that it was proper for the IRS to reject the taxpayer's OIC application.

> **Note.** Taxpayers should designate in writing the tax period that each payment should be applied to when payments are made. In the absence of any written designation, the IRS applies the payments in the best interest of the government, typically the earliest period. By designating the payments, the taxpayer may apply the payments in a manner that is in their best interest.

19. *Drakes and Taylor v. Comm'r,* TC Memo 2012-189 (Jul. 11, 2012).

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REJECTED OIC APPLICATIONS

Taxpayers' OICs are **automatically accepted** if the taxpayer has received no notice for 24 months from the date the IRS received them.[20] As a practical matter, however, the IRS sends timely rejections to many taxpayers, and this automatic acceptance provision does not have an effect.

Appeals Process[21]

Taxpayers can appeal a rejected OIC within 30 days of the date on their rejection letter. Using Form 13711, *Request for Appeal of Offer in Compromise,* as shown later, taxpayers can request an administrative review of their offer in many cases. Taxpayers should send this form to the IRS office that originated the rejection letter.

Practitioner Planning Tip

Tax practitioners should consider submitting additional supporting documentation with their client's Form 13711. At the very least, taxpayers should provide a collection information statement, such as Form 433-A (OIC). For example, an individual may need to provide substantiation of health insurance premiums, utilities, rent, or dependent care expenses. A business may find additional information about expenses, such as vehicle expenses, utilities, and taxes, to be helpful.[22]

20. IRC §7122(f); Treas. Reg. §301-7122-1(f)(5).

21. *Taxpayers can appeal a rejected offer in compromise.* May 30, 2024. IRS. [www.irs.gov/newsroom/taxpayers-can-appeal-a-rejected-offer-in-compromise] Accessed on Jun. 4, 2024.

22. See sections 6 and 7 of Form 433-A (OIC), *Collection Information Statement of Wage Earners and Self-Employed Individuals*; See sections 2–4 of Form 433-B (OIC), *Collection Information Statement for Businesses*.

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Example 3. Use the same facts as **Example 1.** Archie's OIC application was rejected on April 1, 2024. On April 25, Archie filed the following Form 13711 to appeal the IRS's decision.

Form **13711** (December 2017)

Department of the Treasury - Internal Revenue Service

Request for Appeal of Offer in Compromise

Provide the information required in the spaces below. You must sign and date this form.

Taxpayer name	Taxpayer Identification Number
Archie Baker	*****-**-8877**

Taxpayer name	Taxpayer Identification Number

Mailing address			Tax form number
1500 Main St			**1040**
City	State	ZIP Code	Tax period(s) ended
Elizabeth	**IL**	**61028**	**2020, 2021**
Taxpayer's current daytime telephone number			
815-555-6644			

Name of authorized representative			
Howie Chandler			
Mailing address	City	State	ZIP Code
2000 Main St	**Elizabeth**	**IL**	**61028**

Telephone number of authorized representative	Best time to call *(during normal business hours)*
815-555-6655	**9:00 a.m. – 4:00 p.m.**

If you disagree with a specific item shown on the Income and Expense Table and Assets and Equity table you received with your rejection letter, identify the specific item(s). In the space next to the disagreed item, provide a brief statement indicating why you don't agree with our determination *(if the disagreed item is the value of future income, indicate that under "Disagreed Item," and provide an explanation under "Reason for Disagreement")*. There is room for more entries on the back of this form, and you may use additional pages, if necessary. Attach supporting documents for each disagreed item you identify and indicate on them which issue they apply to. If you disagree with a reason for the rejection stated in our letter but not discussed on the Table, identify what statement you disagree with, the reason you disagree and attach any supporting documentation. Additional pages may be attached. If you do not agree with the Service's analysis of economic hardship or Effective Tax Administration, please provide an explanation with documentation. If possible, attach a copy of the rejection letter to this form.

Disagreed item	Reason for disagreement *(attach supporting documentation)*
Medical expenses	**Taxpayer incurs signficant expenses for transportation to life-sustaining medical treatment for kidney dialysis. Doctor's prescription is attached with bill from dialysis center and transportation company. These expenses are not included in the IRS explanation of rejected offer.**

Certification of Taxpayer: Under penalties of perjury, I declare that to the best of my knowledge, the information contained herein is true, correct, and complete.

Signature of Taxpayer	Date signed	Signature of Taxpayer	Date signed

Certification for authorized representative: Check the box that applies depending on whether you have personal knowledge.

☒ I declare that I have submitted the protest and accompanying documents and to the best of my knowledge, the facts stated in the protest and accompanying documents are true, correct, and complete.

☐ I declare that I have submitted the protest and accompanying documents, but have no personal knowledge concerning the facts stated in the protest and the accompanying documents.

Signature of authorized representative *(Attach a copy of your completed Form 2848, Power of Attorney and Declaration of Representative.)*

Signature of authorized representative	Date signed

www.irs.gov/compliance/appeals

Scan this QR Code with your smartphone or other device with a QR reader, or go to the website url shown, to view more information about completing this form and other Appeals processes online.

Catalog Number 40992F www.irs.gov Form **13711** (Rev. 12-2017)

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Businesses that wish to appeal an adverse OIC decision also use Form 13711.

The IRS may decline an appeal of a rejected OIC in any of the following situations.[23]

- The taxpayer's offer was not processable.
- The taxpayer failed to provide the requested information.
- The taxpayer uses the OIC process to delay an IRS proceeding.

However, the return may not be processable because an IRS employee decides the taxpayer has failed to provide needed financial information. In this situation, the IRS does not return the taxpayer's paperwork until a managerial review has affirmed the decision.[24]

Caution. An appeal of a rejected OIC results in the **suspension of the statute of limitations.**[25]

ACCEPTED OIC APPLICATIONS

The taxpayer applying for an OIC **must agree to its offer terms,** as contained in section 7 of Form 656. This includes an obligation to file all required tax returns and make all payments. As with any legally binding agreement, taxpayers agree to comply with the terms of the agreement, and breaching them may cause the OIC agreement to be canceled. In this event, the taxpayer is again fully liable for the tax balance due. The IRS will not release federal tax liens until the offer terms are satisfied.

Although taxpayers should carefully review these terms themselves or with an attorney, tax professionals can call attention to the following provisions.

- The taxpayer is liable for the **unpaid amount of the full tax liability** until they have completely met the terms of the agreement. This provision means taxpayers still owe the entire tax amount while paying the OIC, perhaps longer.
- Interest and penalties accrue on the **unpaid amount** of the tax liability, even while the taxpayer is making payments under the OIC's terms.
- The taxpayer agrees not to file an amended tax return for the years stated on the OIC application, even before the offer is accepted. Violation of this provision may cause the OIC to be canceled.
- If the taxpayer files an amended return for a year **not** covered by the OIC application but ends before the IRS accepts the OIC, any refund associated with the amended return is applied to the tax liability.
- If the taxpayer pays the IRS more than the OIC requires, the IRS applies the extra amount to the tax liability and does not return it.
- The statute of limitations is suspended if the IRS cannot levy against the taxpayer's property. The IRS may require the taxpayer to agree to extend the statute of limitations on assessment.[26] The specific period during which the IRS cannot levy begins with submitting an OIC and continues for 30 days following a rejection.[27]

Caution. Taxpayers should be aware that certain offer information is available for public review by requesting a copy of a public inspection file.

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23. Treas. Reg. §301.7122-1(f)(5)(i).
24. Treas. Reg. §301.7122-1(f)(5)(ii).
25. Treas. Reg. §301.7122-1(g)(1).
26. Treas. Reg. §301.7122-1(i).
27. Treas. Reg. §301.7122-1(g)(1).

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OIC CONDITIONS AND CONSEQUENCES

The IRS may deem an OIC agreement to be in default if the taxpayer is **noncompliant** during the period in which an OIC is effective.

Defaulted OIC

An OIC can generally be deemed to be in default by the IRS if the taxpayer:[28]

- Fails to make timely payments in accordance with the terms of the accepted OIC agreement,
- Does not comply with other terms of the OIC agreement, or
- Received an erroneous refund and fails to return it to the IRS.

If the taxpayer engages in such conduct, the IRS will seek to obtain compliance from the taxpayer before deeming the OIC agreement in default. If the taxpayer fails to comply with any requests for delinquent returns or payments, the OIC will be deemed to be in default.[29] An OIC agreement in default is considered to be no longer in effect.

After default, the entire tax liability (less any payments made by the taxpayer under the OIC agreement while it was in effect), is directed back to the regular IRS collection system. The IRS may use any of the usual collection methods available to obtain payment of the tax liability remaining at the time of default.

> **Note.** For further information on the collection methods available to the IRS, see **uofi.tax/24x7x6** [www.irs.gov/taxtopics/tc201.html].

Rescinded OIC Agreements[30]

Once an OIC application has been accepted, the IRS expects the taxpayer to comply with tax laws and not have any further delinquencies. The IRS requires the taxpayer to abide by all the terms and conditions of the accepted OIC. These terms generally include a requirement to timely file all tax returns and pay all taxes for the 5-year period beginning with the OIC acceptance date. If the taxpayer does not adhere to these terms, the IRS **may rescind** the agreement.

IRS procedures for rescinding an OIC agreement include sending a letter to the taxpayer, identifying the particular OIC agreement, and indicating the grounds for its rescission. All rescission letters are reviewed and approved by IRS legal counsel before they are sent to the taxpayer.

Statute of Limitations and Impact on OIC

IRC §6502(a)(1) provides that the IRS has 10 years after the taxes are assessed to collect the tax due. An OIC extends the 10-year statute of limitations for collection of the tax assessment.

When an OIC is made, the statute of limitations is suspended during the following periods.[31]

- During the pending period (under IRS consideration to accept or reject)
- For 30 days following the rejection of the offer
- For the period the timely filed appeal is under consideration

IRC §7122 provides that the OIC amount includes the tax assessed, interest, and assessable penalty. From this total, the monthly payment amount or lump-sum payment can be calculated.

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28. IRM 5.8.9 (2022).
29. Ibid.
30. IRM 5.8.9.2 (2022).
31. Treas. Reg. §301.7122-1(g).

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Example 4. Kristoff applied for an OIC in January 2019. The tax years covered by the OIC application are 2013 through 2015. Kristoff's tax liability for these years is $51,000. However, his OIC application offered payment of $20,000. Part of his offer required him to make monthly payments for 24 months to pay the $20,000. The offer was approved, and Kristoff made the required payments, with the last payment made in December 2020.

In 2022, Kristoff started a small snow plowing business and failed to pay estimated tax payments, resulting in a balance due of $10,000 for the 2022 tax year. The IRS issued a letter requesting the 2022 return in June 2024. Kristoff initially ignored the notice. He eventually filed the 2022 return in January 2025, with the $10,000 balance due still remaining (along with applicable interest). **Because the failure to file the 2022 tax return and pay the $10,000 amount due is within five years of the date the OIC was accepted, the IRS sent Kristoff a letter rescinding the OIC agreement.**

As a result, the offer accepted for the 2013–2015 tax years is void. If these returns were timely filed, the 10-year collection limitations period would normally expire for the 2013 return in 2024. However, due to the suspension of the statute while the offer was processed, the collection limitation period will expire in 2025. The 2014 return's collection statute will expire in 2026, and the 2015 return's collection statute will expire in 2027.

Even though the OIC reduced Kristoff's tax liability from $51,000 to $20,000 for tax years 2013 through 2015, the IRS's rescission means that the **original balance due is reinstated.** This $51,000 balance is reduced by the $20,000 that Kristoff paid under the OIC agreement while it was effective, leaving $31,000 due. This $31,000 (plus applicable interest and penalties) is the amount the IRS may now collect after the rescission of the OIC agreement.

Observation. Many taxpayers who apply for an OIC or who have an accepted OIC agreement do not understand the grounds for rescission or the conduct that causes the agreement to be deemed in default. It is essential that practitioners advise clients of their obligations and the consequences for failure to adhere to those obligations during the OIC period and for the 5-year period after the OIC has been accepted.

TWO NEW REFUND POLICIES[32]

Effective **November 1, 2021,** the IRS does not reduce refunds to offset a prior tax liability in the calendar year it **accepts** a taxpayer's OIC. Previously, the IRS would retain the refund to offset the previous tax liability using a process called a "refund offset."[33]

Even with the new policy, the taxpayer's refund may be retained by the IRS and applied to the taxpayer's liability.[34] This policy does not apply to businesses; it only applies to individual taxpayers. Additionally, the taxpayer promises to repay any refund they receive that the IRS mistakenly sends them.[35]

Example 5. Annabelle's OIC covering the 2020 and 2021 tax years was accepted on December 15, 2022. The OIC provides for payments through December 2023. Even though the OIC has not been fully paid when she files her 2022 tax return, Annabelle receives a refund of her 2022 income tax overpayment. Prior to November 1, 2021, the IRS would have applied the refund to Annabelle's balance due for 2020 and 2021.

Example 6. Use the same facts as **Example 5,** except that the IRS accepted Annabelle's OIC on January 15, **2023**. Even though Annabelle had submitted her OIC in 2022, the IRS accepted it in calendar year 2023. Under the terms of the new OIC policy, the IRS applies Annabelle's 2022 refund to her tax liability for 2020 and 2021.

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32. *IRS Initiates New Favorable Offer in Compromise Policies.* Feb 8, 2024. National Taxpayer Advocate. [www.taxpayeradvocate.irs.gov/news/nta-blog/nta-blog-irs-initiates-new-favorable-offer-in-compromise-policies/2021/11] Accessed on Jun. 4, 2024.

33. IRC §6402(a); IRM 21.4.6 (2023).

34. Form 656 Booklet, *Offer in Compromise*.

35. Form 656, *Offer in Compromise.*

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A second new policy applies to certain taxpayers who submitted OICs before November 1, 2021, and, therefore, were ineligible for the first new policy. In some circumstances, the IRS's retention of a taxpayer's refund for the year an OIC is accepted causes financial hardship. These taxpayers are able to seek offset bypass refunds (OBRs) while their OICs are pending. Under the new rules, the IRS can forego the offset and issue the refund only if the taxpayer has a federal tax liability and is experiencing economic hardship. For example, the taxpayer may be facing disconnection of their electric service because they owe $1,000. In this case, the taxpayer may receive a $1,000 refund to alleviate the hardship. The IRS applies the remaining refund to outstanding liabilities.

Unfortunately, there is no specific form to request an OBR. To make the request, a client must contact the IRS at 800-829-1040 or the Taxpayer Advocate Service (TAS) **before** the IRS posts their refund to their tax liability.

TAXPAYER ADVOCATE SERVICE[36]

As an independent organization within the IRS, TAS assists taxpayers in resolving IRS disputes while protecting taxpayer rights. The functions of the TAS are as follows.

- Assist taxpayers in resolving problems with the IRS.
- Identify areas in which taxpayers have problems dealing with the IRS.
- To the extent possible, propose changes in the IRS's administrative practices to mitigate identified problems.
- Identify potential legislative changes that may be appropriate to mitigate such problems.

The National Taxpayer Advocate (NTA) leads the TAS, as established in IRC §7803(c). IRC §7803(c) outlines the administration, function, and responsibilities of the NTA. The NTA is not considered an IRS employee. The NTA reports semi-annually to Congress. These reports are not reviewed by the IRS Commissioner, the Secretary of the Treasury, or the Office of Management and Budget prior to their submission to Congress.

TAS has at least one local taxpayer advocate (LTA) office in every state, Puerto Rico, and the District of Columbia. Although it is not organized by congressional district, TAS reports statistics by district.[37]

Practitioner Planning Tip

Some states, such as Illinois, California, and Texas, have multiple local offices for TAS.[38] Practitioners who need to request assistance for taxpayers in these states should contact the local TAS office that corresponds to the taxpayer's congressional district, as TAS advocates may service taxpayer issues based on their congressional district. This is not necessarily the closest local TAS office.

36. IRC §7803(c).

37. *Research Studies and Congressional District Statistics*. Taxpayer Advocate Service. [www.taxpayeradvocate.irs.gov/research-studies/] Accessed on Apr. 11, 2024.

38. *Local Taxpayer Advocate.* Mar. 20, 2024. IRS. [www.irs.gov/advocate/local-taxpayer-advocate] Accessed on Apr. 11, 2024.

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CASE CRITERIA[39]

The primary responsibility of TAS is to assist taxpayers in resolving issues with the IRS. Most TAS cases fall into one of two general categories: **economic advocacy** and **systemic advocacy.**

A taxpayer qualifies for TAS assistance under **economic advocacy** if they have one of the following **economic hardship** situations.

- Suffers from or is about to suffer economic harm
- Faces an immediate threat of adverse IRS action
- Will likely incur significant costs if relief from IRS action is not granted
- Will likely suffer irreparable injury or long-term adverse impact if relief from IRS action is not granted

A taxpayer qualifies for TAS assistance under **systemic advocacy** if they have one of the following **systemic burdens.**

- Experiences a delay of more than 30 days to resolve a tax account problem
- Does not receive a response or resolution to the problem or inquiry by the date promised
- Suffers from a system or procedure that fails to operate as intended or fails to resolve the taxpayer's problem or dispute within the IRS

TAS also accepts cases that are in the best interest of the taxpayer. These cases ensure that taxpayers receive fair and equitable treatment and that their rights as taxpayers are protected. Additionally, TAS accepts cases of public policy that are determined by the NTA. These cases are generally based on a unique set of circumstances warranting assistance to certain taxpayers.

TAS PROCESS[40]

Practitioners should first attempt to resolve a taxpayer's IRS problem through telephone contact or mail correspondence with the IRS. If resolution is not achieved and the taxpayer's circumstances meet the qualifications previously listed, then they should contact TAS. The tax practitioner must have an active power of attorney (POA) and a centralized authorization file (CAF) number to advocate for a client.

To request TAS assistance, a taxpayer should call the phone number for the closest TAS office. A list of all the TAS offices is available on the IRS website at **uofi.tax/24x7x16** [www.irs.gov/advocate/local-taxpayer-advocate]. The taxpayer should then complete Form 911, *Request for Taxpayer Advocate Service Assistance.* This completed form, and/or any other correspondence, should be faxed or mailed to the appropriate TAS office.

Once TAS accepts the request, a case advocate is assigned. This person becomes the single point of IRS contact and works the case through to its conclusion. Taxpayers incur no fee to use TAS services.

TAS **does not have the power to stop or overturn IRS activity,** except in limited situations provided by IRC §7811 and its supporting regulations. For example, TAS cannot lift wage garnishments or remove liens. However, if TAS determines an erroneous lien has been placed on a taxpayer's property, TAS works with the IRS Collection Division to rectify the situation.[41] TAS can advocate the taxpayer's issue to key IRS personnel. The IRS will comply with an order from the TAS unless it is appealed and then modified or rescinded by the NTA, the IRS Commissioner, or the Deputy Commissioner.[42]

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39. IRM 13.1.7.3 (2023).

40. Instructions for Form 911.

41. *Resolving IRS hardships with the Taxpayer Advocate Service*. Stigile, Cory. Oct. 1, 2020. AICPA. [www.thetaxadviser.com/issues/2020/oct/taxpayer-advocate-service.html] Accessed on Apr. 11, 2024.

42. Treas. Reg. §301.7811-1.

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Form 911

A taxpayer or their representative must complete Form 911 in its entirety to ensure that it can be processed by TAS. A few key points for completing Form 911 follow.

- Section I, *Taxpayer Information*, should state the taxpayer's name **exactly** as shown on the tax return.
- Checkbox 7b authorizes the TAS advocate to leave confidential information on a voicemail. This checkbox should be marked if such a message would not create an unauthorized disclosure.
- In item 12a, taxpayers should describe the tax issue concisely. A bulleted list of the facts is easier for TAS to process, particularly if it includes dates and contacts at the IRS.
- In item 12b, taxpayers should describe the assistance they seek. This request should be specific, relevant, and concise. For example, a taxpayer should state that the IRS will remove funds from their bank account on December 24 if that is the case.
- Section II, *Third Party Information,* identifies the taxpayer's representative. Form 2848, *Power of Attorney and Declaration of Representative,* should be attached if it has not already been provided to the IRS or TAS.

A blank Form 911 follows.

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Form **911** (March 2024)	Department of the Treasury - Internal Revenue Service **Request for Taxpayer Advocate Service Assistance** **(And Application for Taxpayer Assistance Order)**	OMB Number 1545-1504

Section I – Taxpayer Information *(See Pages 3 and 4 for Form 911 Filing Requirements and Instructions for Completing this Form.)*

1a. Taxpayer name as shown on tax return

1b. Taxpayer Identifying Number *(SSN, ITIN, EIN)*

2a. Spouse's name as shown on tax return *(if joint return)*

2b. Spouse's Taxpayer Identifying Number *(SSN, ITIN)*

3a. Taxpayer current street address *(number, street, & apt. number)*

3b. City

3c. State *(or foreign country)*

3d. ZIP code

4. Fax number *(if applicable)*

5. Email address

6. Person to contact if no authorized third party

7a. Daytime phone number

☐ Check if Cell Phone

7b. ☐ Check here if you consent to have confidential information about your tax issue left on your answering machine or voice message at this number.

8. Best time to call

9. Preferred language *(if applicable)*

☐ TTY/TDD Line ☐ Interpreter needed - Specify language other than English *(including sign language)* ____________

☐ Other *(specify)*

10. Tax form number *(1040, 941, 720, etc.)*

11. Tax year(s) or period(s)

12a. Describe the tax issue you are experiencing and any difficulties it may be creating
(If more space is needed, attach additional sheets.) (See instructions for completing Lines 12a and 12b)

12b. Describe the relief/assistance you are requesting *(if more space is needed, attach additional sheets)*

I understand that Taxpayer Advocate Service employees may contact third parties in order to respond to this request and I authorize such contacts to be made. Further, by authorizing the Taxpayer Advocate Service to contact third parties, I understand that I will not receive notice, pursuant to section 7602(c) of the Internal Revenue Code, of third parties contacted in connection with this request.

13a. Signature of taxpayer or corporate officer, and title, if applicable

13b. Date signed

14a. Signature of spouse *(if joint assistance request)*

14b. Date signed

Section II – Third Party Information *(Attach Form 2848 or Form 8821 if not already on file with the IRS.)*

1. Name of authorized third party

2. Centralized Authorization File (CAF) number

3. Current mailing address

4. Daytime phone number ☐ Check if Cell Phone

5. Fax number

6. Signature of third party

7. Date signed

Catalog Number 16965S www.irs.gov Form **911** (Rev. 3-2024)

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Section III – Initiating Employee Information *(Section III is to be completed by the IRS only)*

Taxpayer name			Taxpayer Identifying Number *(TIN)*	
1. Name of employee	2. Phone number	3a. Function	3b. Operating division	4. Organization code no.

5. How identified and received *(check the appropriate box)*

IRS function identified issue as meeting Taxpayer Advocate Service (TAS) criteria

- ☐ (r) Functional referral *(function identified taxpayer issue as meeting TAS criteria)*
- ☐ (x) Congressional correspondence/inquiry not addressed to TAS but referred for TAS handling
  Name of senator/representative ______________________

Taxpayer or authorized third party requested TAS assistance

- ☐ (n) Taxpayer (or authorized third party) called into a National Taxpayer Advocate (NTA) toll-free site
- ☐ (s) Functional referral *(taxpayer or representative specifically requested TAS assistance)*

6. IRS received date

7. TAS criteria *(Check the appropriate box.* ***NOTE: Checkbox 9 is for TAS Use Only****)*

- ☐ (1) The taxpayer is experiencing economic harm or is about to suffer economic harm.
- ☐ (2) The taxpayer is facing an immediate threat of adverse action.
- ☐ (3) The taxpayer will incur significant costs if relief is not granted (including fees for professional representation).
- ☐ (4) The taxpayer will suffer irreparable injury or long-term adverse impact if relief is not granted.

(if any items 1-4 are checked, complete Question 9 below)

- ☐ (5) The taxpayer has experienced a delay of more than 30 days to resolve a tax account problem.
- ☐ (6) The taxpayer did not receive a response or resolution to their problem or inquiry by the date promised.
- ☐ (7) A system or procedure has either failed to operate as intended or failed to resolve the taxpayer's problem or dispute within the IRS.
- ☐ (8) The manner in which the tax laws are being administered raise considerations of equity or have impaired or will impair the taxpayer's rights.
- ☐ (9) The NTA determines compelling public policy warrants assistance to an individual or group of taxpayers **(TAS Use Only)**

8. What action(s) did you take to help resolve the issue? ***(This block MUST be completed by the initiating employee)***
If you were unable to resolve the issue, state the reason why (if applicable)

9. Provide a description of the Taxpayer's situation, and where appropriate, explain the circumstances that are creating the economic burden and how the Taxpayer could be adversely affected if the requested assistance is not provided
(This block MUST be completed by the initiating employee)

10. How did the taxpayer learn about the Taxpayer Advocate Service

☐ IRS forms or publications ☐ Media ☐ IRS employee ☐ Other *(specify)* ______________________

Catalog Number 16965S www.irs.gov Form **911** (Rev. 3-2024)

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TAS personnel complete section III, *Initiating Employee Information,* which appears on page 2. To accept the case, the TAS employee must identify at least one of the TAS criteria, as shown in Item 7. If the case does not meet one criterion, TAS rejects the case.

Note. Taxpayers and tax professionals may believe it is easier to file Form 911 than to work with the IRS. However, if the case does not meet the TAS criteria, TAS will likely reject Form 911.

Practitioner Planning Tip

If TAS accepts a case and the TAS case advocate does not respond reliably, noting the name and phone number of their supervisor may be useful. A contact log showing the dates, times, and the subject of intended conversations with the case advocate may prove useful in bringing the necessary focus to the case. Before a tax practitioner bypasses the case advocate and goes directly to their supervisor, they should prepare a document listing attempted contacts with the case advocate. The case advocate's manager will review what attempts have been made to resolve the case.

Taxpayer Assistance Orders.[43] A taxpayer facing a significant hardship may file an application for a taxpayer assistance order (TAO) on Form 911. The NTA can subsequently issue a TAO to assist the taxpayer. Alternatively, the NTA can issue a TAO on its own when it sees a taxpayer facing a significant hardship. IRC §7811 authorizes the NTA to issue TAOs to assist taxpayers who are suffering or about to suffer a significant hardship because of how the IRS is administering the tax laws or when the taxpayer meets other requirements. A TAO is a powerful statutory tool delegated by the NTA to LTAs to push the IRS to take **immediate** action. The TAO is used on a case-by-case determination. A taxpayer can suffer **significant hardship** from the following.

- Immediate threat of adverse action

  Example 7. The IRS serves notice of a levy on Alex's bank account. Alex needs the bank funds to pay for a medically necessary surgical procedure that is scheduled to take place in two weeks. If the levy is not released, Alex will lack the funds necessary to have the procedure. He is experiencing an immediate threat of adverse action.

- Delay in resolving account problems of more than 30 days or receiving a response by the date promised by the IRS

  Example 8. On April 1, Leo receives a notice from the IRS requesting additional information to process his return. He responds right away. Yet, every 60 days he receives a letter saying that the IRS needs 60 more days to process the return. He has received several of these letters. When he calls the IRS, no one is able to help.

43. Treas. Reg. §301.7811-1(a)(4)(ii); see IRM 13.1.20 (2023).

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- Significant costs, including professional representation costs, if relief is not granted

  Example 9. The IRS sends The Three Musketeers, Inc. (TTM) a notice demanding payment of outstanding employment taxes and penalties. The notice states that TTM has outstanding employment tax balances for 12 quarters totaling $25,000. TTM provides documentation to the IRS, which, it contends, shows that if all payments were applied to each quarter correctly, there would be no balance due. The IRS requests additional records and documentation. Because there are 12 quarters involved, to comply with this request, TTM must hire an accountant who estimates fees of at least $5,000 to organize all the records and provide a detailed analysis of the deposits and payments. Therefore, TTM faces significant costs.

- Irreparable injury to, or a long-term adverse impact on, the taxpayer if relief is not granted

  Example 10. Millie has arranged with a bank to refinance her mortgage to lower her monthly payment. She is unable to make the current monthly payment. Unless the monthly payment amount is lowered, she will lose her residence to foreclosure. The IRS refuses to subordinate the federal tax lien, as permitted by IRC §6325(d), or discharge the property subject to the lien, as permitted by §6325(b). As a result, the bank does not allow Millie to refinance. She faces an irreparable injury, the loss of her home, if relief is not granted.

If an IRS employee is not following published administrative guidance, the NTA can consider how to issue the TAO in a way that favors the taxpayer.[44]

OFFICE OF SYSTEMIC ADVOCACY[45]

The TAS Office of Systemic Advocacy studies, analyzes and recommends actions that address systemic issues affecting large groups of taxpayers. It recommends administrative changes to IRS policy, procedures, and processes. When appropriate, it suggests legislative remedies.

The Office of Systemic Advocacy focuses on big-picture issues rather than individual issues, such as processing original returns, rejected returns, returns that cannot be posted, processing amended returns, and injured spouse claims. TAS focuses its limited resources on economic burden cases and only those systemic burden cases in which it plays a more direct role in affecting the outcome. Examples of systemic cases that the TAS accepts include those referred by a congressional office and those that could be resolved if a taxpayer files an amended return, original return, or claim for refund.

The Office of Systemic Advocacy uses the Systemic Advocacy Management System (SAMS) database to receive, prioritize, and assign issues submitted by the public and IRS employees. Individuals, businesses, academic and research institutions, professional organizations, practitioners, and all other interested parties may submit issues.

Issues are submitted to SAMS at **uofi.tax/24x7x11** [www.irs.gov/advocate/systemic-advocacy-management-system-sams]. The practitioner briefly describes the issue and includes contact information. The information is transmitted over a non-secure channel, so specific tax account information should **not** be included.[46]

Additionally, an issue can be submitted by completing Form 14411, *Systemic Advocacy Issue Submission*, and faxing it to 855-813-7412 or emailing to **Systemic.Advocacy@irs.gov**.

After the issue is submitted, an acknowledgement is sent to the taxpayer via email. Based on the facts presented, a decision is made about whether the issue merits development as an advocacy project. If so, it is assigned. As the issue is reviewed and the status updated, additional email correspondence may be sent.[47]

An example of Form 14411 follows.

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44. IRC §7811(a)(3).

45. IRM 13.2.2 (2020); IRM 13.1.7 (2023).

46. *Systemic Advocacy: Report a systemic issue.* Jun. 17, 2024. IRS. [www.irs.gov/advocate/systemic-advocacy-management-system-sams] Accessed on Jun. 21, 2024.

47. *TAS Systemic Advocacy FAQ.* Aug. 9, 2023. IRS. [www.irs.gov/advocate/tas-systemic-advocacy-faq] Accessed on Jun. 21, 2024.

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Form **14411** (March 2022)	Department of the Treasury - Internal Revenue Service **Systemic Advocacy Issue Submission**	OMB Number 1545-1832

The purpose of Form 14411 is to report systemic issues to the Taxpayer Advocate Service (TAS). For questions about your tax account visit www.irs.gov or call the IRS at 800-829-1040. For information about your refund, visit "Where's My Refund" on www.irs.gov. If you have tried to resolve your tax problem with the IRS and were not successful, contact the Taxpayer Advocate Service at 877-777-4778.

The Form 14411 can be submitted by Fax: (855) 813-7412 or by email: Systemic.Advocacy@irs.gov.

To submit an issue via the web, visit www.irs.gov/advocate/systemic-advocacy-management-system-sams.

Originator's name	Daytime telephone number ☐ Cell phone	Best time to call

Address *(street, city, state, ZIP code)*

Email address *(TAS will contact you by email if you can't be reached by phone as a way to notify you that you should contact TAS to discuss your submission)*

☐ Practitioner ☐ Professional/Trade Group ☐ Academic/Research
☐ Taxpayer ☐ Attorney ☐ LITC
☐ Other

Before you begin:

Be sure the issue is systemic, meaning that it requires a change to an IRS administrative policy, procedure, or process, or a legislative recommendation. A systemic issue:

- Impacts multiple taxpayers;
- Involves an IRS system, policy, or procedure;
- Affects taxpayer rights, increases burden, causes disparate treatment, or involves essential taxpayer services.
- Is not exclusively a tax law issue; and
- Is not a specific taxpayer's account issue.

Describe the problem and how you think it is affecting other taxpayers. What group (or groups) of taxpayers is affected? Include any actions you have taken, if any, to resolve the problem. *Caution: Do not include your tax account information or any personally identifiable information (e.g., SSN, EIN, etc.)*

(Optional) Can you identify a possible cause of the problem? Can you recommend a possible solution to the problem? Include relevant authorities or guidance, such as sections of the Internal Revenue Code, Treasury Regulations, or Internal Revenue Manual (IRM), etc.

Privacy Act and Paperwork Reduction Act Notice

The Privacy Act of 1974 requires that when we ask you information about yourself, we state our legal right to do so, tell you why we are asking for it, and how it will be used. We must also tell you what could happen if we do not receive it, and whether your response is voluntary, required to obtain a benefit, or mandatory. This information is voluntary and may be used to study and analyze issues identified to help mitigate problems encountered by taxpayers. Your contact information will be used only to respond to you with our finding on the systemic advocacy issue you identified.

You are not required to provide the information requested on a form that is subject to the Paperwork Reduction unless the form displays a valid OMB control number.

Books or records relating to a form or its instructions must be retained as long as their contents are material in the administration of any Internal Revenue Law. Generally, tax returns and return information are confidential, per Internal Revenue Code section 6103.

The estimated average time to complete this form is 48 minutes. Send comments regarding this burden estimate or any other aspect of this collection of information, including suggestions for reducing the burden, to Internal Revenue Service, Tax Products Coordinating Committee, SE:W:CAR:MP:T:T:SP, 1111 Constitution Ave. NW, IR-6526, Washington, DC 20224.

Catalog Number 35591S www.irs.gov Form **14411** (Rev. 3-2022)

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ANNUAL REPORTS TO CONGRESS

The NTA submits two reports to Congress each year; an Annual Report in January and an Objectives Report in June.

Annual Report[48]

This report identifies the most serious problems that taxpayers encounter, analyzes those problems, and recommends solutions. According to the 2023 Annual Report, the **10 most serious problems** encountered by taxpayers are the following.[49]

1. Ongoing processing delays
2. IRS hiring, recruitment, and training
3. IRS transparency
4. Telephone and in-person service
5. Return preparer oversight
6. Identity theft
7. Online account access for both taxpayers and tax professionals
8. International information return penalties approach
9. Compliance challenges for taxpayers living abroad
10. The IRS Independent Office of Appeals is not perceived as independent, which ultimately prolongs dispute resolution

The Code requires the NTA to identify the **10 most litigated tax issues** in federal courts and to recommend ways to lessen these disputes.[50] In the 2023 Annual Report, the following litigated tax issues received the NTA's focus.

Ranking	Issue Category	Total Petitions to Tax Court
1	Gross income (IRC §61 and related IRC sections)	13,475
2	Statutory adjustment	5,409
3	Filing status and dependents	2,088
4	Family status related credits	1,772
5	Payments and credits	1,669
6	Earned income tax credit (EIC)	1,608
7	Federal income tax withholding	1,036
8	Schedule A itemized deductions under IRC §§211–224	916
9	Adjusted gross income exclusions and deductions	778
10	Taxes and other credits	617

The NTA must give this report to the House Ways and Means Committee and the Senate Finance Committee by December 31 of each year.

48. IRC §7803(c)(2)(b)(ii).

49. *National Taxpayer Advocate Annual Report to Congress: 2023*, pp. 5–142. Dec. 31, 2023. Taxpayer Advocate Service. [www.taxpayeradvocate.irs.gov/wp-content/uploads/2024/03/Pub-2104_2023_508Compliant.pdf] Accessed on Apr. 16, 2024.

50. IRC §7803(c)(2)(B)(ii)(XI).

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Objectives Report[51]

The *National Taxpayer Advocate Objectives Report to Congress* is delivered each June and contains the goals and objectives planned by TAS for the upcoming year. The Objectives Report to Congress reviews the filing season that has just ended. For example, the fiscal year 2024 *Taxpayer Advocate Service Objectives Report* was issued in June 2023 and provided Congress with a review of the **2023 filing** season. It reported that the 2023 filing season generally ran smoothly.

This report identifies key TAS objectives for the upcoming fiscal year. The fiscal year 2024 report indicated that:

- The IRS caught up in processing paper-filed original Forms 1040 and various business returns,
- Refunds were generally issued quickly, and
- Taxpayers calling the IRS were much more likely to get through with substantially shorter wait times.

The report also indicated that the IRS is still behind in processing amended tax returns and taxpayer correspondence. The major successes are:

- Eliminating the backlog of about 17 million paper-filed Forms 1040; and
- Answering a much higher percentage of taxpayer telephone calls.

The annual Objectives Report also identifies TAS's key objectives for the upcoming fiscal year, segregated as case advocacy objectives and other business objectives, research objectives, and systemic advocacy objectives. In its FY2024 Objectives Report, TAS expects to work with the IRS to improve the processing of tax returns and taxpayer service. The FY2024 report identifies the following objectives, among others.

- Protect taxpayer rights as the IRS implements its Strategic Operating Plan
- Improve correspondence audit processes, taxpayer participation, and agreement and default rates
- Implement systemic first-time penalty abatement but allow substitution of reasonable cause

The NTA must give this report to the House Ways and Means Committee and the Senate's Committee on Finance by June 30 of each year.

7

TAXPAYER ROADMAP[52]

TAS provides a taxpayer roadmap that illustrates the U.S. tax system and provides information about the processing of income tax information and issues. The roadmap is a graphic illustrating the path from tax preparation through processing, collections, appeals, and even litigation.

Note. The IRS provides an online, interactive version of this tool at **uofi.tax/24x7x12** [www. taxpayeradvocate. irs.gov/get-help/roadmap]. This graphic provides taxpayers and their tax practitioners with useful information about the sequence of steps needed to resolve a tax controversy.

51. IRC §7803(c)(2)(b)(i); *NTA Objectives Report to Congress: Fiscal Year 2024*. Taxpayer Advocate Service. [www.taxpayeradvocate.irs.gov/reports/2024-objectives-report-to-congress/full-report] Accessed on Apr. 12, 2024.

52. *Taxpayer Roadmap*. Apr. 27, 2022. Taxpayer Advocate Service. [www.taxpayeradvocate.irs.gov/get-help/roadmap] Accessed on Apr. 11, 2024; IRS Pub. 5341, *The Taxpayer Roadmap.*

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This online, interactive version allows tax professionals to input a notice number that their clients received. The system responds with an explanation of why the IRS sent the notice and how the client can resolve the issue. Currently, the taxpayer roadmap application contains commonly issued IRS notices and letters, **but not all of them.** The taxpayer roadmap can be used in a variety of ways.

- Enter an IRS notice number in the search field
- Use the 'View by map' section to navigate a "processing station" area within the map
- Manually click on different markers (stops) throughout the map

When a user enters an IRS notice or letter number, the taxpayer roadmap provides answers to the following questions.

- What does the notice or letter mean to the taxpayer?
- Where is the taxpayer in the tax system?
- How did the taxpayer get into the current situation?
- What are the taxpayer's next steps?
- Where can the taxpayer get more information?
- Where can the taxpayer get additional help?
- What are the taxpayer's rights?

For example, the explanation for Notice CP14, *Notice of Tax Due and Demand for Payment,* can be found using the roadmap. IRS Pub. 5341, *The Taxpayer Roadmap,* provides a paper version of the digital roadmap but is not interactive.

TAXPAYER BILL OF RIGHTS[53]

The Taxpayer Bill of Rights is closely connected to TAS. Both are creations of Congress that were designed to protect U.S. taxpayers' rights when they deal with the IRS. As presently written, the Taxpayer Bill of Rights assures taxpayers of the following rights when dealing with the IRS, as the right to:[54]

- Be informed,
- Receive quality service,
- Pay no more than the correct amount of tax,
- Challenge the IRS's position and be heard,
- Appeal an IRS decision in an independent forum,
- Finality,
- Privacy,
- Confidentiality,
- Retain representation, and
- A fair and just tax system.

---

53. *Taxpayer Bill of Rights 2*, PL 104-168, §101.

54. IRS Pub. 1, *Your Rights as a Taxpayer*.

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MANAGING CAF AUTHORIZATIONS WITH A TAX PRO ACCOUNT

The IRS Tax Pro Account is an online portal for tax practitioners that allows for virtual creation of a POA and tax information authorization (TIA). It permits access to individual taxpayer information once a taxpayer has created their own IRS online account and grants authorization to their tax professional.[55] The record is updated in the CAF immediately in most cases.[56] This electronic means of establishing client representation in the CAF system significantly improves the system, reducing dependence on outdated fax machines.

> **Note.** Tax practitioners can access their tax pro accounts at **uofi.tax/24x7x15** [www.irs.gov/tax-professionals/tax-pro-account]. For more information about IRS Tax Pro accounts, see the 2021 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 1: New Developments. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

In September 2023, the IRS unveiled a new feature that allows practitioners to link their Tax Pro Account with their CAF number.[57] This enables a tax practitioner to view the clients for whom they have authorizations in effect and manage the authorizations. More specifically, this new feature enables a tax practitioner to immediately withdraw a POA for a client they no longer represent. Previously, a tax practitioner had to file a Freedom of Information Act (FOIA) request to manage their active client authorizations, usually incurring a long turnaround time.

LINKING A CAF NUMBER WITH A TAX PRO ACCOUNT

The IRS uses a PIN to identify the tax practitioner and link a Tax Pro Account to a CAF number. Because this process must be very secure, it requires sending the PIN to the tax practitioner's mailing address as stored in the CAF system.

Tax practitioners must follow the following steps to link their CAF number and Tax Pro Account.

1. **Sign in or create a new Tax Pro account.** The linking process starts with the tax practitioner logging in to their Tax Pro Accounts with ID.me. If the tax practitioner does not already have an ID.me account with the IRS, they can create a new account. Before signing in, the tax practitioner should have their 9-digit CAF number handy. They should also expect to use the 2-factor authentication (2FA) code generator.

> **Caution.** Tax practitioners must already have a CAF number to link with their Tax Pro Account. Practitioners can obtain a CAF number by submitting a POA or a Form 8821, *Tax Information Authorization*, with "None" entered in the space on the form where the number is customarily entered.[58]
>
> While this method is still available, it is now possible for practitioners to obtain a CAF number online using their Tax Pro Account. The IRS web page describing these accounts states that a new CAF number is available to individual practitioners without a wait and without filing Form 2848 or 8821.[59]

> **Note.** For more information on setting up a Tax Pro Account, see the 2021 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 1: New Developments. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

55. IRS Pub. 5533-A, *How to Submit Authorizations Using Tax Pro Account and Online Account*.
56. IRS Pub. 5533-B, *Benefits of Tax Pro Account and Digital Authorizations.*
57. IRS News Rel. IR-2023-182 (Sep. 28, 2023).
58. Instructions for Form 2848.
59. *Tax Pro Account.* Jul. 1, 2024. IRS. [www.irs.gov/tax-professionals/tax-pro-account] Accessed on Jul. 9, 2024.

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2. **Request PIN to link CAF number.** Once signed in to their Tax Pro Account, the tax practitioner should click the button "link your CAF number" and then, on the next screen, click the button "request PIN." After the practitioner submits the required information, the IRS sends this PIN through the U.S. Postal Service via a CP310 Notice. The IRS advises that it may take 1–2 weeks to arrive. **This PIN is only good for 30 days.** If the PIN becomes invalid for any reason, the tax practitioner must repeat the process to request a new PIN, which means waiting another 1–2 weeks for a second PIN.

3. **Enter PIN to Link CAF Number.** Upon receipt of the PIN, the tax practitioner can finish linking their CAF numbers to their Tax Pro Accounts by navigating back to the "link your CAF number" screen and clicking the "enter PIN" button. After entering the PIN and CAF number, the tax practitioner can view client authorizations within their Tax Pro Account.

Caution. The process for linking a CAF account to a Tax Pro Account gives tax practitioners another reason to guard their CAF numbers. If an imposter can intercept a tax practitioner's information, they could gain access to the tax practitioner's client information by establishing the link before the tax practitioner does. Fortunately, the IRS has designed what seems like a secure process, and the tax practitioner may find that by linking their CAF numbers to their Tax Pro Accounts proactively, they have prevented an imposter from first establishing that link. Once a CAF number is linked, it cannot be unlinked.[60]

WITHDRAWING AUTHORIZATIONS USING A TAX PRO ACCOUNT

After the tax practitioner links their Tax Pro Account to their CAF number, they can manage their authorizations more effectively. The tax practitioner can see authorization details, such as the tax form, the periods covered by the authorization, and communications the IRS is authorized to undertake with the practitioner for all clients associated with their CAF number. It also lists which acts the tax practitioner is authorized to undertake on behalf of the client.

The tax practitioner can withdraw the authorization by enabling the check box near the bottom of the dialog box and clicking the white "WITHDRAW" button. This step immediately withdraws the POA or TIA.

60. *Tax Pro Account*. Feb. 6, 2024. IRS. [www.irs.gov/tax-professionals/tax-pro-account] Accessed on Apr. 4, 2024. See the CAF number/ Linking your CAF number dialogs.

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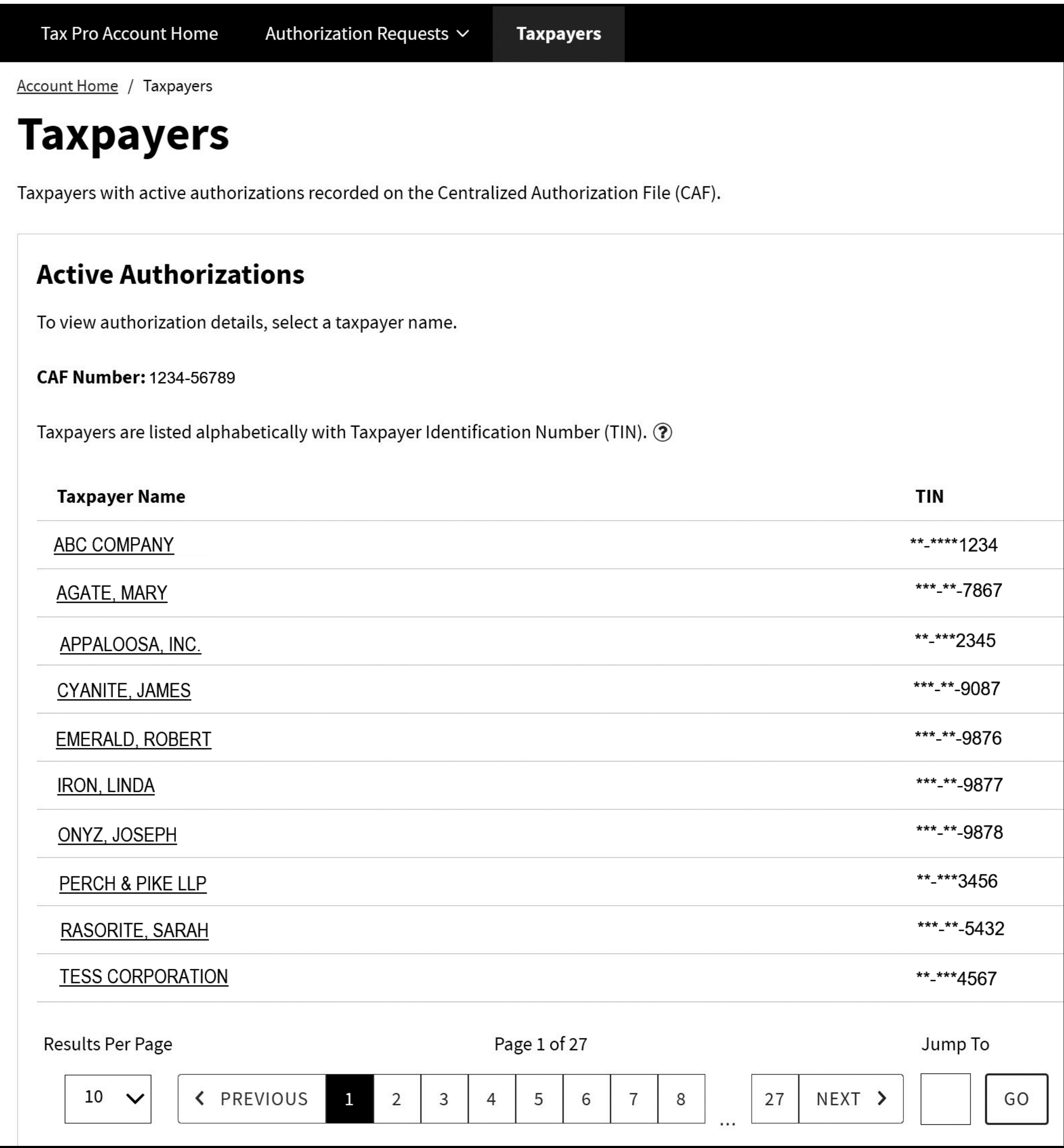
Example 11. John wants to check the validity of active POAs he has on file. To access them online, he needs to link his Tax Pro Account to his CAF number. He goes through the process of requesting a PIN to link his CAF number. Approximately a week later, he receives a CP310 notice in the mail with the PIN. John logs back into his Tax Pro Account and enters the PIN. His Tax Pro Account is now linked to his CAF number and he can see the following active authorizations.



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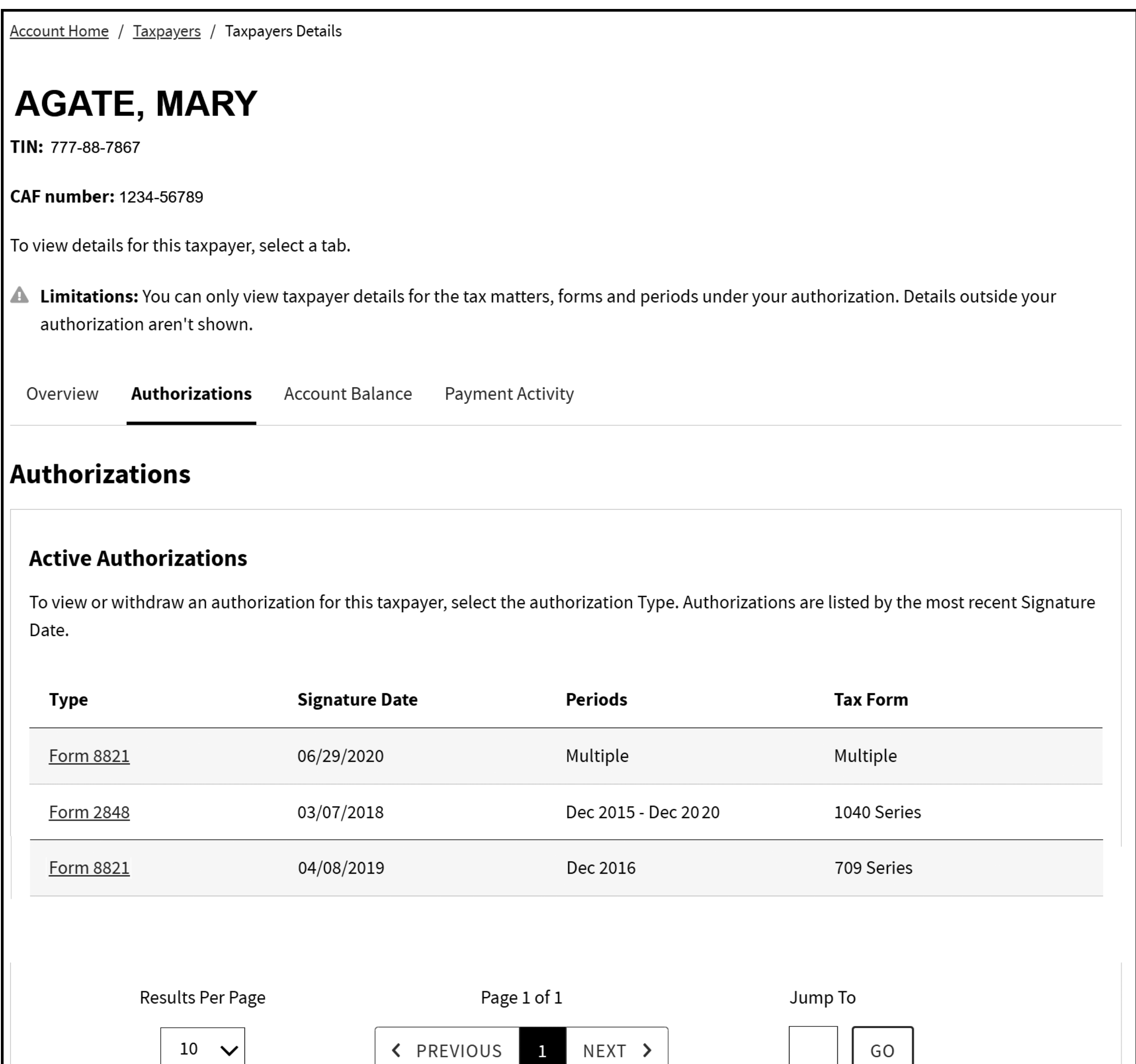
John remembers working on Mary Agate's return a couple of years ago but has not seen her since 2022. He clicks on her name and sees the following details.



Type	Signature Date	Periods	Tax Form
Form 8821	06/29/2020	Multiple	Multiple
Form 2848	03/07/2018	Dec 2015 - Dec 2020	1040 Series
Form 8821	04/08/2019	Dec 2016	709 Series

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John does not want the responsibility of having a POA for Mary because she is no longer a current client. He selects Form 2848 and sees the following dialog box.

Account Home / Taxpayers / Taxpayers Details / Authorization Details

Authorization Details

AGATE, MARY

TIN: 777-88-7867

Form 2848, Power of Attorney and Declaration of Representative

Signature Date: 07/29/2018

Form Details

Tax Form	**1040 Series**
Periods	Dec 2015 - Dec 2020

Authorization Information

Designation	Enrolled Agent
Communications	Authorized to receive copies of notices and other written communications
Acts Authorized	Substitute or Add Representatives

Back to Taxpayer Details

Withdraw this Authorization

You can withdraw an authorization at any time. Once you withdraw, the authorization is immediately and permanently removed from the CAF database.

To withdraw this authorization, provide your electronic signature.

Electronic Signature

All fields with an asterisk (*) are required.

☐ By checking this box, you are electronically signing your request to withdraw this authorization from the CAF database.*

WITHDRAW

John selects the box to withdraw the authorization. His POA with Mary is immediately terminated. The IRS will send Mary a notice informing her that John has withdrawn the authorization.

The IRS continues to enhance Tax Pro Accounts. For example, in July 2024, the IRS added the capability to obtain a new CAF number online, in addition to obtaining one by filing Form 2848 or Form 8821.

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IRS RELEASES "DIRTY DOZEN" LIST OF TAX SCAMS FOR 2024

The IRS issued its "dirty dozen" list of tax scams and reminded taxpayers to remain vigilant to these schemes throughout the year. Although these scams may peak during tax season, taxpayers may encounter them anytime.

A recap of this year's top scams follows.

1. **Phishing and smishing.**[61] Scammers pose as legitimate organizations and send unsolicited text messages (smishing) or emails (phishing) to entice unsuspecting victims into providing their personal and financial information. The thieves then use that information for identity theft. The IRS reminds everyone that it initiates most contact through regular mail rather than email, text, or social media.

2. **Questionable employee retention credit (ERC) claims.**[62] Scammers promote large refunds related to the ERC, attempting to con ineligible individuals and businesses to claim the credit. The scammers' promotions often base their sales claims on inaccurate information about a business's eligibility for the ERC and its credit computation. The scammers may collect personally PII and use that information to steal taxpayers' identities.

3. **Third-party scammers offering to set up free IRS online accounts.**[63] Taxpayers should not accept help from third parties offering to help taxpayers set up IRS online accounts. Such scammers can use that valuable information for fraudulent gains once the taxpayer provides the third party with their PII. Taxpayers should establish their online accounts without outside help other than from the IRS or their tax practitioners.

4. **False fuel tax credit claims.**[64] The fuel tax credit is available for off-highway and farming use. Most taxpayers are not eligible for the credit. Unscrupulous practitioners and promoters entice taxpayers to inflate their tax refunds by incorrectly claiming the credit on Form 4136, *Credit for Federal Tax Paid on Fuels*.

5. **OIC mills.**[65] OICs help individuals unable to pay their total tax liability to settle with the IRS. However, third-party OIC mills aggressively promote OICs to individuals who do not meet the qualifications, often costing the taxpayer thousands of dollars.

6. **Fake charities.**[66] Defrauders set up fake charitable organizations to exploit donors' generosity whenever a crisis or natural disaster strikes. The scammers acquire taxpayers' money and personal information to exploit them. Individuals can only claim itemized deductions if they donate to qualified tax-exempt IRS-approved organizations.

7. **Untrustworthy tax preparers.**[67] Common warning signs of a corrupt tax preparer include charging a contingency fee based on the size of the refund, refusing to sign the return as the preparer, or refusing to provide their preparer tax identification number (PTIN). They may even induce a taxpayer to have their refund deposited into the bogus tax preparer's bank account.

8. **Social media: fraudulent form filing and bad advice.**[68] The IRS has observed some individuals using social media to recommend fraudulent tax practices. Some social media postings recommend the fraudulent filing of Forms W-2, *Wage and Tax Statement,* or Forms 8944, *Preparer e-file Hardship Waiver Request*. The scheme encourages individuals to file these forms using false, inaccurate information to get a refund.

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61. IRS News Rel. IR-2024-84 (Mar. 28, 2024).
62. IRS News Rel. IR-2024-85 (Mar. 29, 2024).
63. IRS News Rel. IR-2024-87 (Apr. 1, 2024).
64. IRS News Rel. IR-2024-89 (Apr. 2, 2024).
65. IRS News Rel. IR-2024-91 (Apr. 3, 2024).
66. IRS News Rel. IR-2024-92 (Apr. 4, 2024).
67. IRS News Rel. IR-2024-96 (Apr. 5, 2024).
68. IRS News Rel. IR-2024-98 (Apr. 8, 2024).

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9. **Spearphishing and new client scams aimed at tax practitioners.**[69] Tax practitioners are common targets for data thieves because they extensively use clients' PII. The IRS warns tax practitioners that cybercriminals use spearphishing to gain access to clients' sensitive data, sometimes by embedding malware that maliciously sends this data to a remote computer. Sometimes, the cybercriminal pretends to be a potential tax client seeking help. Although these criminals take advantage of tax professionals' busy schedules during tax season, they may attack throughout the year. They may also attack nonrelated businesses if they anticipate gaining access to valuable information.

10. **Scams targeting high-income taxpayers.**[70] High-income taxpayers are attractive targets for tax-related schemes. The IRS has highlighted three scams that prey on high-income taxpayers and their desires to minimize their tax burdens.

    - **Monetized installment sales.** Promoters target people who want to delay recognizing capital gains from selling their property. These scammers offer a so-called "monetized installment sale" for a fee.

> **Note.** For more information on legitimate installment sales and monetized installment sales, see the 2024 *University of Illinois Federal Tax Workbook*, Chapter 6: Installment Sales and Chapter 11: Agricultural Issues and Rural Investments.

    - **Charitable remainder annuity trusts (CRATs).** CRATs are irrevocable trusts established to transfer assets to qualified charitable organizations. After individuals contribute appreciated assets to their CRATs, they draw annuity income for a specified period, sometimes even for life. Eventually, the assets pass to the charitable organization. However, some trusts are misused to eliminate ordinary income or capital gain on the sale of property.

> **Note.** The IRS has proposed that certain CRATs should be identified as listed transactions.[71] IRC §6707A(c) defines listed and reportable transactions as transactions designed for tax avoidance.

    - **Improper art donation deductions.** Art donation scams targeting high-income taxpayers are a new addition to the IRS's dirty dozen for 2024. Promoters encourage these taxpayers to purchase "art" from the promoter, hold it for one year, and then donate it to a charitable organization. The donation deduction may claim an exaggerated value for the art. To combat this, the IRS employs professionally trained art appraisers.

69. IRS News Rel. IR-2024-100 (Apr. 9, 2024).

70. IRS News Rel. IR-2024-104 (Apr. 10, 2024).

71. 89 Fed. Reg. 20,569 (Mar. 25, 2024). See IRC §6707A(c) for definitions of listed and reportable transactions.

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11. **Bogus tax avoidance schemes.**[72] The IRS has identified two specific tax avoidance schemes of which to be aware.

   - **Syndicated conservation easements.** Conservation easements restrict a taxpayer's right to use real property, typically rural land. Generally, the taxpayer claims a charitable contribution for the FMV of a conservation easement they contribute to a qualified charity. The transfer must meet the requirements of IRC §170. Promoters abuse the system by grossly inflating the associated tax deduction.

   - **Micro-captive insurance arrangements.** Micro-captive insurance companies are those whose owners are taxed only on the captive's investment income. These schemes lack many of the characteristics of legitimate insurance, yet the companies that establish them may take deductions for "insurance premiums" that they pay. These schemes may include improbable risks, the failure to match legitimate business needs, and the unnecessary duplication of insurance coverage for the taxpayer. In some cases, however, companies may establish micro-captive insurance companies because they cannot insure unusual business risks with publicly available insurance. The IRS has investigated at least one tax attorney who has provided legal services establishing micro-captive insurance companies.[73]

12. **Bogus schemes with international elements.**[74] The IRS has identified the following specific international schemes of which to be aware.

   - **Offshore accounts and digital assets.** The IRS continues to investigate individuals with offshore accounts. Recently, it has focused on accounts containing digital assets, such as cryptocurrency. Individuals who attempt to conceal their assets in offshore banks, brokerage accounts, digital asset accounts, and nominee entities are subject to IRS investigations. The IRS can identify and track seemingly anonymous transactions involving foreign financial accounts and digital assets.

   - **Maltese retirement arrangements.** This scheme involves U.S. residents and citizens contributing to individual retirement arrangements (IRAs) in Malta or other host countries to avoid U.S. taxes. However, they lack any connection to the host country. The individuals claim the foreign arrangement is a pension fund and, based on the tax treaty, qualifies for an exemption from U.S. income tax on gains and earnings in and distributions from the foreign IRA.

Note. More information on each of these scams can be found at **uofi.tax/24x7x9** [www.irs.gov/newsroom/dirty-dozen].

72. IRS News Rel. IR-2024-105 (Apr. 11, 2024).

73. *Celia R. Clark v. U.S. and Internal Revenue Service*, No. 21-cv-82056 (S.D. Fla. 2022).

74. IRS News Rel. IR-2024-105 (Apr. 11, 2024).

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IRS DATA BOOK STATISTICS

Each year in the spring, the IRS issues its data book containing statistical tables and organizational information for the most recently concluded fiscal year (FY). The FY 2023 IRS data book, covering October 2022 to September 2023, is available at **uofi.tax/24x7x7** [irs.gov/pub/irs-pdf/p55b.pdf]. The FY 2022 IRS data book is available at **uofi.tax/24x7x8** [www.irs.gov/pub/irs-prior/p55b--2023.pdf].

REVENUE COLLECTION AND RETURNS PROCESSING[75]

During FY 2023, the IRS collected more than $4.6 trillion (Figure 1, Figure 2), processed more than 271.5 million tax returns and other forms, and issued almost 121 million individual income tax refunds totaling over $461.2 million (Figure 3, Table 1). In FY 2023, the average cost of collecting $100 was $0.34, representing an increase over FY2022 ($0.29).[76]

Figure 1. Gross Collections by Type of Tax, Fiscal Years 2014–2023

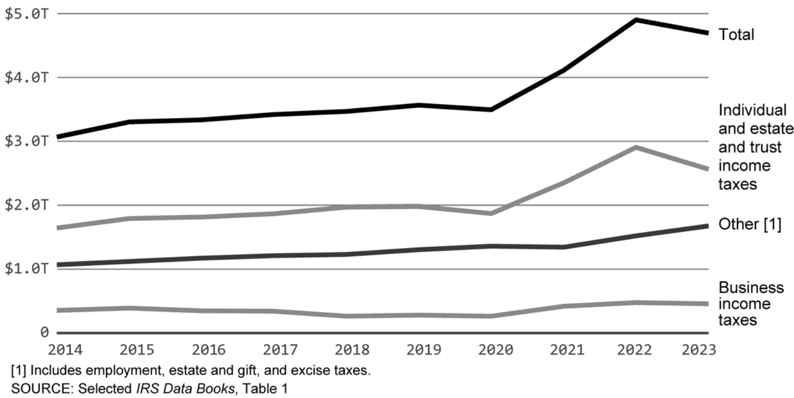
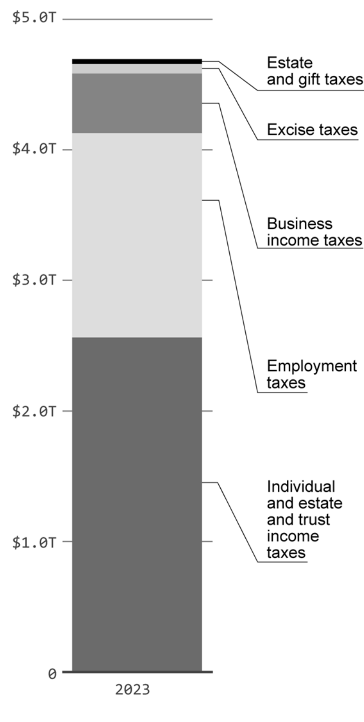


Figure 2. Gross Collections by Type of Tax, Fiscal Year 2023



75. *2023 IRS Data Book*. Apr. 2024. IRS. [www.irs.gov/pub/irs-pdf/p55b.pdf] Accessed on Jun. 11, 2024.

76. See Table 33, *Collections, Costs, Personnel, and U.S. Population, Fiscal Years 1994–2023.*

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Table 1. Collections and Refunds, by Type of Tax, Fiscal Years 2022 and 2023

[Money amounts are in thousands of dollars]

Type of tax	Gross collections [1]			Refunds [2]	Net collections	
	2022	2023	Percentage of 2023 total	2023	2023	Percentage of 2023 total
	(1)	(2)	(3)	(4)	(5)	(6)
United States, total	**4,901,514,194**	**4,694,335,168**	**100.0**	**659,051,685**	**4,035,283,483**	**100.0**
Business income taxes	**475,871,099**	**456,940,780**	**9.7**	**43,854,645**	**413,086,135**	**10.2**
Corporation income tax	474,468,574	454,962,812	9.7	n.a.	n.a.	n.a.
Tax-exempt organization unrelated business income tax	1,402,525	1,977,968	[3]	n.a.	n.a.	n.a.
Individual and estate and trust income taxes [4]	**2,903,798,899**	**2,561,601,596**	**54.6**	**466,447,613**	**2,095,153,983**	**51.9**
Individual income tax withheld	1,763,004,514	1,725,748,211	36.8	n.a.	n.a.	n.a.
Individual income tax payments [5]	1,055,634,292	783,602,938	16.7	n.a.	n.a.	n.a.
Estate and trust income tax [6]	85,160,093	52,250,447	1.1	5,235,503	47,014,944	1.2
Employment taxes	**1,417,809,803**	**1,566,109,766**	**33.4**	**144,723,954**	**1,421,385,812**	**35.2**
Old-Age, Survivors, Disability, and Hospital Insurance (OASDHI), total [4]	1,404,615,026	1,550,944,750	33.0	144,547,165	1,406,397,585	34.9
Federal Insurance Contributions Act (FICA)	1,326,252,997	1,473,833,500	31.4	n.a.	n.a.	n.a.
Self-Employment Insurance Contributions Act (SECA)	78,362,029	77,111,250	1.6	n.a.	n.a.	n.a.
Unemployment insurance	7,046,465	7,946,725	0.2	162,062	7,784,663	0.2
Railroad retirement	6,148,312	7,218,291	0.2	14,726	7,203,565	0.2
Estate and gift taxes	**33,355,276**	**35,434,261**	**0.8**	**1,850,749**	**33,583,512**	**0.8**
Estate	28,909,393	33,780,186	0.7	1,748,560	32,031,626	0.8
Gift	4,445,883	1,654,075	[3]	102,189	1,551,886	[3]
Excise taxes [7]	**70,679,117**	**74,248,765**	**1.6**	**2,174,724**	**72,074,041**	**1.8**

n.a.—Not available.

[1] Gross collections include penalties and interest in addition to taxes.

[2] Includes overpayment refunds, refunds resulting from examination activity, refundable tax credits, and other refunds required by law. Also includes $10.2 billion in interest, of which $1.1 billion was paid to corporations and $9.1 billion was paid to all others (related to individual, employment, estate, gift, and excise tax returns). Excludes refunds credited to taxpayer accounts for tax liability in a subsequent year.

[3] Less than 0.05 percent.

[4] Collections of withheld individual income tax are not reported by taxpayers separately from Old-Age, Survivors, Disability, and Hospital Insurance (OASDHI) taxes on salaries and wages (under the Federal Insurance Contributions Act or FICA) and individual income tax payments along with taxes on self-employment income (under the Self-Employment Insurance Contributions Act or SECA). The OASDHI tax collections and refunds shown in this table are based on estimates made by the Secretary of the Treasury pursuant to the provisions of Section 201(a) of the Social Security Act as amended and include all OASDHI taxes. Amounts shown for individual income tax withheld and individual income tax payments were derived by subtracting the FICA and SECA tax estimates from total individual income tax withheld and individual income tax payments. Refund estimates, and, therefore, net collection estimates, were not made for the components of income and OASDHI taxes.

[5] Includes collections of estimated income tax and payments made in conjunction with individual income tax return filings.

[6] Includes collections of estimated estate and trust income taxes and payments made in conjunction with estate and trust tax return filings.

[7] Excludes excise taxes collected by U.S. Customs and Border Protection and the Alcohol and Tobacco Tax and Trade Bureau.

NOTES:

Detail may not add to totals because of rounding.

All money amounts are in current dollars.

Collection and refund data may not be comparable for a given fiscal year because payments made in prior years may be refunded in the current fiscal year.

Partnership, S corporation, regulated investment company, and real estate investment trust data are not shown in this table since these entities generally do not have a tax liability. Instead, they pass any profits or losses to the underlying owners, who include these profits or losses on their income tax returns.

SOURCE: Chief Financial Officer, Financial Management, Corporate Accounting.

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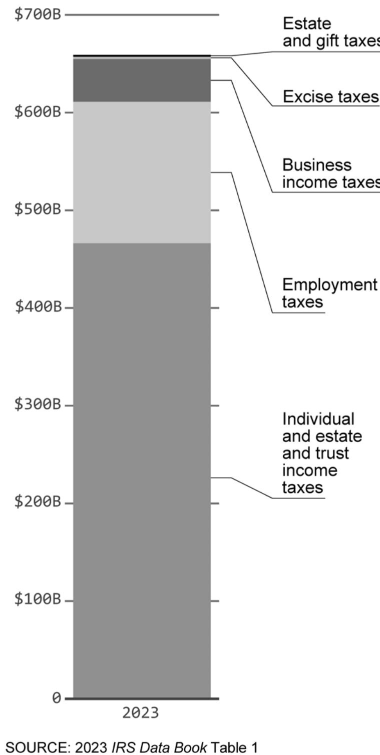
Figure 3. Refunds by Type of Tax, Fiscal Year 2023

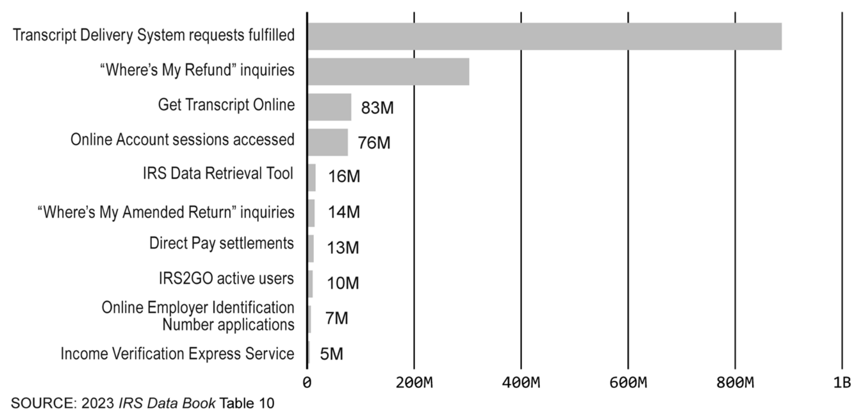


In FY 2023, more than 15.7 million tax refunds included a refundable child tax credit (CTC), and almost 22.4 million included a refundable EIC.[77]

TAXPAYER SERVICE AND ENFORCEMENT ACTIONS

The IRS provided taxpayer assistance through approximately 880.9 million visits to IRS.gov and helped almost 60.3 million taxpayers through correspondence, toll-free telephone helplines, or Taxpayer Assistance Centers. Taxpayers made approximately 303.1 million inquiries to the "Where's My Refund" application. The number of active IRS2GO mobile app users has almost doubled since 2017 to over 10.3 million. Taxpayers and tax practitioners downloaded over 538 million tax forms, their instructions, and other files from IRS.gov during the fiscal year. The IRS responded to almost 887 million transcript delivery requests during FY 2023, as shown in the following chart.

Figure 4. Selected Electronic Transactions, Fiscal Year 2023



77. See Table 7, *Number of Refunds Issued, by Type of Refund and State, Fiscal Year 2023.*

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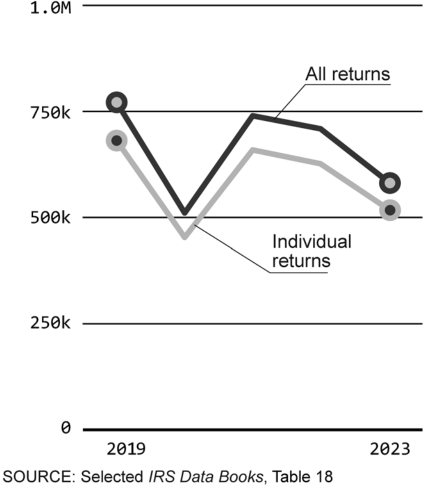
Enforcement Actions

The IRS closed fewer taxable return audits during FY 2023 (582,944) than the prior year (708,309).[78] The percentage covered by field examinations increased slightly from 21.4% in FY 2022 to 22.7% in 2023.[79] The IRS collected an additional $31.9 billion from the FY 2023 audits.

The IRS conducted fewer audits and collection actions during FY 2023 than in FY 2022, as shown in Figure 5. The IRS closed examinations of over 518,607 individual income tax returns during FY 2023, of which more than 84% were correspondence examinations.[80]

Figure 5. Number of Returns Examined, Fiscal Years 2019–2023



SOURCE: Selected *IRS Data Books*, Table 18

In FY 2023, the number of IRS-requested levies increased 4.8%.[81] However, the number of seizures decreased from 89 to 65. The IRS filed almost 13.8% more liens in FY 2023 than in FY 2022.[82]

Of the almost 271.5 million total federal tax returns and supplemental documents that the IRS processed, taxpayers filed 213.3 million returns electronically in FY 2023.[83] When other forms are included, this number represents 78.6% of all filings, an increase of over 8% since FY 2017.[84] Paid preparers filed more than 84 million **individual** tax returns.

During FY 2023, the IRS completed 2,584 criminal investigations and referred 1,838 for prosecution. The criminal investigation program resulted in 1,167 cases that involved some form of incarceration.

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78. See Table 18, *Examination Coverage: Recommended Additional Tax, and Returns with Unagreed Additional Tax, After Examination, by Type and Size of Return, Fiscal Year 2023; 2022 IRS Data Book*, p. 46. Mar. 2023. IRS. [www.irs.gov/pub/irs-pdf/p55b.pdf] Accessed on Jun. 12, 2024. See Table 18, *Recommended Additional Tax, and Returns with Unagreed Additional Tax, After Examination, by Type and Size of Return, Fiscal Year 2022.*

79. In 2022, the IRS closed 151,437 field examinations ÷ 708,309 total examinations closed, which equals 21.4%. In 2023, the IRS closed 132,587 field examinations ÷ 582,944 total examinations closed, which equals 22.7%.

80. In FY 2023, 437,566 correspondence closed individual examinations ÷ 518,607 closed total examinations, which equals 84.37%.

81. The increase is computed as (286,270 requested levies in FY 2023 – 273,286 requested levies in FY 2022) ÷ (273,286 requested levies in FY 2022), which equals 4.8%.

82. The increase is computed as (179,019 liens filed in FY 2023 – 157,323 liens filed in FY 2022) ÷ (157,323 liens filed in FY 2022), which equals 13.8%.

83. See Table 2, *Number of Returns and Other Forms File, by Type, Fiscal Years 2022 and 2023*, and Table 4, *Number of Returns and Other Forms Filed Electronically, by Type and State, Fiscal Year 2023*.

84. *2017 IRS Data Book*, pp. 4 and 8. Mar. 2018. IRS. [www.irs.gov/pub/irs-soi/17databk.pdf] Accessed Jun. 12, 2024. See Table 2, *Number of Returns and Other Forms File, by Type, Fiscal Years 2016 and 2017*, and Table 4, *Number of Returns and Other Forms Filed Electronically, by Type and State, Fiscal Year 2017*.

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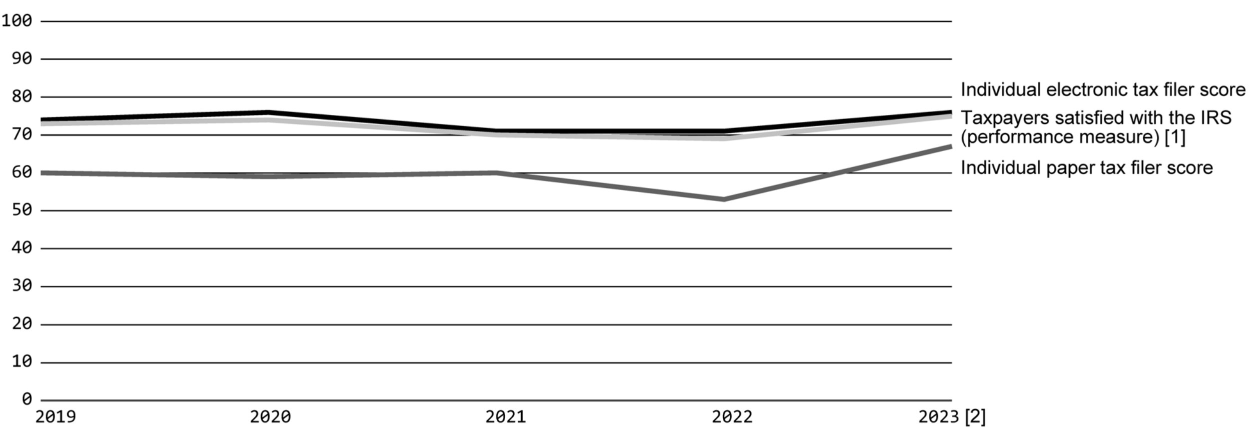
TAXPAYER ATTITUDES

The IRS developed a measure of customer satisfaction in 1994, still in use. The American Customer Satisfaction Index (ACSI) Index tracks taxpayer satisfaction with the IRS, generally based on their experience with Forms 1040 and 1040-SR, *U.S. Tax Return for Seniors*. The following graph shows trends over the last five years.

Figure 6. ACSI Customer Satisfaction



[1] The Taxpayers Satisfied with the IRS measure calculation weights the individual paper and electronic filer customer satisfaction scores by the percentage of paper and electronic individual tax returns filed, derived from IRS Publication 6187, *Calendar Year Projections of Individual Returns by Major Processing Categories*, Table 1A, and combines the results.

[2] In 2023, IRS changed the American Customer Satisfaction Index (ACSI) data collection methodology from telephone interviews to online panel surveys and made efforts to improve representation.

NOTE: The IRS ACSI survey is conducted by Claes Fornell International Group, founding partner of ACSI and sole company licensed in the United States to use the patented, customized ACSI methodology.

SOURCE: 2023 IRS ACSI Survey.

This measurement shows relatively stable satisfaction, although it increased in 2023 among taxpayers who paper-filed individual income tax returns.

In past years, the IRS has conducted a Comprehensive Taxpayer Attitude Survey, which has guided IRS decision-making. For the first time since 1999, this survey was not conducted in FY 2023, perhaps reflecting the increasing difficulty of reaching survey respondents for telephone interviews. Nevertheless, the IRS expects to resume its use.

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Chapter 8: Divorce

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8

Note. Corrections for all of the chapters are available at **TaxSchool.illinois.edu.** For clarification about terms used throughout this chapter, see the **Acronyms and Abbreviations** section following the index.

For your convenience, in-text website links are also provided as short URLs. Anywhere you see **uofi.tax/xxx**, the link points to the address immediately following in brackets.

About the Authors

Kelly Golish, CPA, is the Assistant Director, Tax Materials, at the University of Illinois Tax School. She was previously a manager at Crowder, CPAs in Danville, IL and worked for both public and private accounting firms in Decatur, IL, Cleveland, OH, and San Jose, CA. Kelly earned a Masters in Accounting with an emphasis in Taxation and a Bachelors in Accounting at the University of Notre Dame.

John W. Richmann, EA, is a Tax Materials Specialist at the University of Illinois Tax School. Prior to joining Tax School in 2021, he owned a tax practice in St. Charles, Illinois, and held positions in private industry and consulting firms. John earned a Masters Degree in Business Administration from the University of Texas and an electrical engineering degree from the Massachusetts Institute of Technology.

Other chapter contributors and reviewers are listed at the front of this book.

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While a divorce proceeding may involve several important issues, the impact of tax law on the parties to a divorce is an area that continuously evolves legislatively and judicially. **Tax professionals can help divorcing couples prevent unfavorable tax consequences when they are involved early in divorce planning discussions.** However, beware of the potential for conflicts of interest.

Caution. While there is the risk of a conflict of interest anytime a tax practitioner is representing a married couple, the heightened emotions that exist in a divorce create a minefield of potential conflicts of interest. Circular 230, §10.29 identifies situations that represent conflicts of interest, as well as if and when a tax practitioner may still represent such taxpayers. For a discussion on the ethical considerations of conflicts of interest, see the 2024 *University of Illinois Federal Tax Workbook,* Chapter 1: Ethics.

Practitioner Planning Tip

To avoid exposure to a conflict of interest when working with a divorcing couple, communication must be transparent to both parties. Tax practitioners must be willing to communicate with both parties, not just one. If that type of relationship is not attainable, the tax practitioner should consider resigning from the engagement.

TAX RETURN ISSUES

FILING STATUS

The IRS acknowledges that state law controls whether an individual is considered married.[1] Only persons considered married are allowed to file joint returns, **which is an election.[2]** Marital status is determined on the last day of the tax year.[3] Spouses must have the same tax year to qualify for filing a joint return.[4] If a divorce is not finalized by December 31 of the tax year, taxpayers have multiple filing status options.

- Married filing separately (MFS), which is the default status
- Married filing jointly (MFJ), which is at the option of the parties
- Head of household (HoH), with a qualifying child or qualifying dependent

Note. An MFS return can be amended within the statue of limitations and the filing status changed to MFJ. **However, once a joint return has been filed and the due date has passed, it cannot be undone.** See the innocent spouse relief discussion later for additional information.

1. Rev. Rul. 58-66, 1958-1 CB 60.
2. IRC §6013(a).
3. IRC §6013(d)(1)(A).
4. IRC §6013(a)(2).

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A joint return can be filed if a difference in tax years exists because one or both spouses died.[5] Therefore, a joint return can be filed if a spouse's death occurred prior to the time a divorce is finalized.

If a spouse dies, marital status on the date of death determines whether joint filing status is appropriate.[6] In the year a spouse dies, if the surviving spouse remarries before the end of that tax year, the surviving spouse can file jointly with the new spouse but cannot file jointly with the deceased former spouse. The deceased former spouse's filing status is MFS.[7] Generally, both spouses must be U.S. citizens or U.S. residents to file jointly.[8]

> **Note.** A couple in a common-law marriage is considered married under tax rules. As such, they can file jointly if their common-law marriage began in a state recognizing common-law marriages or if they live in one of these states at the end of the tax year.[9] Although common-law marriage is recognized in these states, there is no such thing as a "common-law divorce." Common-law couples must use the same formal divorce procedures in their state that married couples must use to obtain a divorce.[10]

Same-Sex Marriage

For federal tax purposes, same-sex marriages are treated the same as opposite-sex marriages. However, persons who have entered into a registered domestic partnership, civil union, or other similar relationship that is **not considered** a marriage under state laws are not considered married for federal tax purposes.[11]

Separation, Divorce, and Filing Status

A married couple can file jointly even though the spouses did not live together during part or all of the tax year. In addition, when a married couple lives apart for the last six months of the year, the custodial parent of a dependent child can file as HoH and the other spouse can file MFS. However, spouses legally separated under a decree of separate maintenance are not considered married and **cannot file jointly.**[12] Divorced spouses are no longer considered married once the divorce is final. If the divorce decree is interlocutory, the spouses are considered married until the decree is final.[13]

An "interlocutory" divorce decree (sometimes called a "judgment nisi") is a decree that is issued by the court but is considered incomplete or temporary until after the expiration of a period of time (such as 30, 60, or 90 days), when it automatically becomes final.[14] During the waiting (nisi) period after entry of the judgment for divorce, the spouses are still considered married and are officially divorced only after the expiration of the nisi period.

Example 1. Michael and Juanita, a married couple, have the same calendar tax year. They filed for divorce in January 2024. The court issued a final decree of divorce on December 15, 2024. On the last day of their respective tax years, December 31, 2024, Michael and Juanita were not married. They ceased being married on December 15, 2024. They cannot file a joint return for the 2024 tax year.

5. Ibid.

6. IRC §6013(d)(1)(B).

7. *Filing Status.* IRS. [apps.irs.gov/app/vita/content/globalmedia/4491_filing_status.pdf] Accessed on May 9, 2024.

8. IRC §6013(a)(1), but for exceptions see §§6013(g) and (h).

9. *Filing Status.* IRS. [apps.irs.gov/app/vita/content/globalmedia/4491_filing_status.pdf] Accessed on May 9, 2024.

10. *How do we end a common law marriage?* NOLO. [www.nolo.com/legal-encyclopedia/question-end-common-law-marriage-28053.html] Accessed on May 9, 2024.

11. IRS Pub. 504, *Divorced or Separated Individuals.*

12. IRC §7703(a)(2).

13. Ibid.

14. *Interlocutory Decree.* Encyclopedia Britannica. [www.britannica.com/topic/interlocutory-decree] Accessed on May 9, 2024.

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Example 2. Use the same facts as **Example 1,** except the final divorce decree was issued February 23, 2025. Because Michael and Juanita are considered married until the final decree and are therefore still married on December 31, 2024, they may file a joint return for the 2024 tax year.

Example 3. Use the same facts as **Example 1,** except the court order issued on December 15, 2024, is a judgment nisi with a 30-day nisi period. Michael and Juanita are considered married on December 31, 2024, and may file jointly for the 2024 tax year.

Invalid Divorce Judgment. If a state court later finds a final divorce judgment invalid, the IRS disregards the divorce.[15] However, there is a split of authority among tax cases in federal courts involving invalid divorce decrees. The Second Circuit decided it would not recognize a state court's determination that a divorce was invalid.[16] The Ninth Circuit, however, ruled that such a determination by a state court must be recognized.[17] The IRS indicated that a foreign jurisdiction divorce for the sole purpose of tax avoidance is not recognized. If a divorce becomes effective at the end of a tax year with a subsequent remarriage at the beginning of the following tax year, intent to avoid tax may be inferred.[18]

Appeal of Divorce Judgment. State law determines whether a divorce decree remains final if it is appealed. If an appeal makes the divorce judgment interlocutory, the spouses are considered married until the divorce judgment is final after the appeal is resolved. The Fourth Circuit held that a joint return could not be filed in a year in which a Maryland divorce was appealed because the divorce remained final despite the appeal.[19] However, in states where an appeal delays finality, a joint return may be permitted.

Annulment. A taxpayer who obtains a decree of annulment (which holds that no valid marriage ever existed) must file amended returns for all tax years affected by the annulment that are not closed by the statute of limitations. The taxpayer generally must use the single filing status on the amended returns, unless they meet the requirements to file as HoH.[20]

Itemized Deductions on Separate Returns. If spouses file MFS and one of them itemizes deductions, the other spouse **must** also itemize. In this situation, the standard deduction amount is zero for the non-itemizing spouse.

Taxpayers who file using the MFS status may be able to claim itemized deductions on their separate return for certain expenses they paid separately or jointly with their spouse. The following table from IRS Pub. 504, *Divorced or Separated Individuals,* shows which deductions can be claimed on a separate return.

Note. Beginning with the 2018 tax year, provisions in the Tax Cuts and Jobs Act (TCJA)[21] affect various categories of itemized deductions. For more information, see the 2018 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 1: New Legislation — Individual Concerns. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

For more information on tax planning ahead of the expiration of TCJA, see the 2024 *University of Illinois Federal Tax Workbook,* Chapter 12: Planning for the Sunset of the TCJA.

15. Rev. Rul. 67-442, 1967-2 CB 65.

16. *Est. of H. Borax v. Comm'r*, 349 F.2d 666 (2nd Cir. 1965); *H.E. Wondsel v. Comm'r,* 350 F.2d 339 (2nd Cir. 1965), *cert. denied,* 383 U.S. 935.

17. *H.K. Lee and Louise Geise v. Comm'r,* 550 F.2d 1201 (9th Cir. 1977).

18. Rev. Rul. 76-255, 1976-2 CB 40.

19. *K.T. Sullivan v. Comm'r,* 256 F.2d 664 (4th Cir. 1958).

20. IRS Pub. 504, *Divorced or Separated Individuals.*

21. *Tax Cuts and Jobs Act,* PL 115-97.

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IF you paid ...	AND you ...	THEN you can deduct on your separate federal return ...
medical expenses	paid with funds deposited in a joint checking account in which you and your spouse have an equal interest	half of the total medical expenses, subject to certain limits, unless you can show that you alone paid the expenses.
state income tax	file a separate state income tax return	the state income tax you alone paid during the year.
	file a joint state income tax return and you and your spouse are jointly and individually liable for the full amount of the state income tax	the state income tax you alone paid during the year.
	file a joint state income tax return and you are liable for only your own share of state income tax	the smaller of: • the state income tax you alone paid during the year; or • the total state income tax you and your spouse paid during the year multiplied by the following fraction. The numerator is your gross income and the denominator is your combined gross income.
property tax	paid the tax on property held as tenants by the entirety	the property tax you alone paid.
mortgage interest	paid the interest on a qualified home[1] held as tenants by the entirety	the mortgage interest you alone paid.
casualty loss	have a casualty loss[2] resulting from a federally declared disaster on a home you own as tenants by the entirety	half of the loss, subject to the deduction limits. Neither spouse may report the total casualty loss.

[1] For more information on a qualified home and deductible mortgage interest, see Pub. 936.

[2] For more information on casualty losses, see Pub. 547.

Other Issues Applicable to Separate Returns. The following special rules apply to married couples who file separate returns.[22]

- The tax rate is generally higher than it would be on a joint return.
- The exemption amount for calculating the alternative minimum tax (AMT) is half that allowed on a joint return.
- The taxpayer cannot take the credit for child and dependent care expenses in most cases. The amount excludable from income under an employer's dependent care assistance program is limited to $2,500.

> **Note.** If the taxpayer exceeds the $2,500 maximum exclusion on a separate return through dependent care benefits, the difference will be included in income.

- Generally, the taxpayer cannot take the earned income credit (EIC) unless they have a qualifying child.
- In most cases, the taxpayer cannot take the exclusion or credit for adoption expenses.
- The taxpayer cannot exclude the interest from qualified savings bonds used for higher education expenses.
- If the taxpayer lived with their spouse any day during the year:
  - They cannot claim the credit for the elderly or the disabled, and
  - They must include in income a higher percentage of any social security or equivalent railroad retirement benefits they received.

[22] IRS Pub. 504, *Divorced or Separated Individuals.*

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- The following credits and deductions are reduced at income levels that are half of those for a joint return.
  - Child tax credit
  - Retirement savings contributions credit
- The capital loss deduction limit is $1,500 (instead of $3,000 on a joint return).
- If the taxpayer's spouse itemizes deductions, the taxpayer cannot claim the standard deduction. If the taxpayer can claim the standard deduction, the basic standard deduction is half of the amount allowed on a joint return.
- The taxpayer cannot take the American opportunity credit, the lifetime learning credit, or the deduction for student loan interest.
- The taxpayer is not eligible for the premium tax credit unless they qualify for a special rule applicable to victims of domestic abuse and spousal abandonment under Treas. Reg. §1.36B-2(b)(2).[23]

Considerations for HoH. Taxpayers may be able to file HoH if they meet all of the following requirements.[24]

1. Are married or considered unmarried,
2. Provide over half of the costs of maintaining a household, and
3. Live with a qualifying person in the same household for over six months.

> **Note.** For more discussion on HoH filing status, see the 2011 *University of Illinois Federal Tax Fundamentals,* Chapter 3: Filing Status and Dependency Exemptions. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

Filing Status after Divorce. After a divorce is finalized, the taxpayer may have the option of choosing single or HoH status. However, if the divorced taxpayer remarries, that taxpayer may jointly file with the new spouse if the taxpayer and new spouse are married on or before December 31 of the tax year.[25]

> **Note.** A taxpayer may qualify to file as HoH even before the divorce is final. For more information on the requirements to file as HoH, see IRS Pub. 17, *Your Federal Income Tax (For Individuals)*, and IRS Pub. 504.

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23. *Questions and answers on the Premium Tax Credit.* Aug. 22, 2024. IRS. [www.irs.gov/affordable-care-act/individuals-and-families/questions-and-answers-on-the-premium-tax-credit] Accessed on Sep. 6, 2024.

24. IRS Pub. 504, *Divorced or Separated Individuals.*

25. *Filing Status.* IRS. [apps.irs.gov/app/vita/content/globalmedia/4491_filing_status.pdf] Accessed on May 9, 2024.

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Healthcare Insurance Considerations

A divorce or separation may impact an individual's responsibilities under the Affordable Care Act (ACA)[26] in the following ways.[27]

- **Special Marketplace enrollment period —** Losing coverage because of a divorce is considered a qualifying life event that allows the divorced individual to enroll in health coverage through the health insurance Marketplace during a special enrollment period.
- **Changes in circumstances —** Certain individuals who purchase health insurance coverage through the Marketplace may get advance payments of the premium tax credit. These individuals should report changes in circumstances to the Marketplace. Such changes include a change in marital status, a name change, and a change in income or family size. Reporting such changes helps ensure that the individual gets the proper type and amount of financial assistance.
- **Shared policy allocation —** An individual who obtains a divorce or legal separation during the year and is enrolled in the same qualified health plan must allocate policy amounts with the former spouse on their separate tax returns to calculate their premium tax credit and reconcile any advance payments of the credit. The instructions for Form 8962, *Premium Tax Credit (PTC),* contain instructions for making this allocation.

Note. Employee COBRA benefits can be extended to the former non-employee spouse for a maximum of 36 months. The employer can charge a 2% premium increase and the cost must be born by the former non-employee spouse.[28]

DEPENDENCY EXEMPTION

Custodial Parent

A custodial parent may claim a dependency exemption for a child. Under the TCJA, the personal exemption amount is reduced to zero for tax years beginning after December 31, 2017, and before January 1, 2026.[29] IRC §151(d)(5)(B) states that, "For purposes of any other provision of this title, the reduction of the exemption amount to zero… shall not be taken into account in determining whether a deduction is allowed or allowable, or whether a taxpayer is entitled to a deduction, under this section." This means that if a taxpayer is required to qualify for a child's dependency exemption for purposes of any other Code provision (e.g., the child tax credit), they are still required to do so, even though the dependency exemption is reduced to zero.[30]

Determining who is the custodial parent is a mathematical computation, not controlled by the divorce decree. The custodial parent is the parent in whose home the child resides for the greater number of nights during the year. This is the case even if that parent is not present in the home when the child is there. Overnight stays with the parent that occur outside that parent's home count as nights with that parent. If the child spends an equal number of nights with each parent during the year **(this can only happen in a leap year),** the custodial parent is the parent with the higher adjusted gross income. A child is treated as residing with neither parent if the child is emancipated under state law.[31]

Special Rule for Parents Working Nights. A child may spend days instead of nights with a parent due to the parent's nighttime work schedule. In this case, days are counted instead of nights. The parent with whom the child spends the greater number of days is the custodial parent. However, on school days, the child is deemed to reside at the primary residence that is registered with the child's school.[32]

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26. *Affordable Care Act,* PL 111-148.
27. IRS Pub. 504, *Divorced or Separated Individuals.*
28. *FAQs on COBRA Continuation Health Coverage for Workers.* U.S. Department of Labor. [www.dol.gov/sites/dolgov/files/ebsa/about-ebsa/our-activities/resource-center/faqs/cobra-continuation-health-coverage-consumer.pdf] Accessed on Jul. 31, 2024.
29. IRC §151(d)(5).
30. *Dependents.* IRS. [apps.irs.gov/app/vita/content/globalmedia/4491_dependency_exemptions.pdf] Accessed on May 10, 2024.
31. Treas. Reg. §1.152-4(d).
32. Treas. Reg. §1.152-4(d)(5).

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Practitioner Planning Tip

If a couple has more than one child, tax practitioners should advise that the parents keep a calendar documenting the number of nights each child is with them. By ensuring that at least one child is with each parent for a greater number of nights than the other parent, **both parents** will be able to file HoH status.

Transferring the Dependent Child Exemption

IRC §152(e) provides for the transfer of the dependent child exemption from the custodial to the noncustodial parent. This can only be accomplished if all four of the following requirements for §152(e) are satisfied.

1. The parents:
    a. Are either divorced or legally separated under a decree of divorce or separate maintenance,
    b. Are separated under a written separation agreement, or
    c. Lived apart at all times for the last six months of the year.
2. The parents provide over half of the child's support for the year.
3. One or both parents had custody of the child for more than half of the year.
4. The custodial parent provides **qualifying documentation** to waive the claim to the dependent child's exemption and transfer the right of that claim to the noncustodial parent.

Qualifying documentation includes one of the following.

1. The custodial parent's **written waiver** of the dependent child exemption satisfying all the following requirements[33]
    a. Is unconditional
    b. Is signed by the custodial parent
    c. Names the **noncustodial parent** to whom the exemption claim is being transferred
    d. Specifies the **tax year(s)** that it is effective
    e. Is provided on **Form 8332,** *Release/Revocation of Release of Claim to Exemption for Child by Custodial Parent* (A document similar to Form 8332 that provides the same information and is used for the same sole purpose is also sufficient. A court order, decree, or separation agreement generally **does not suffice** for this purpose.)
2. If the noncustodial parent provides at least $600 for the support of the child during the year, a **pre-1985** divorce decree, separate maintenance agreement, or other written agreement indicating that the noncustodial parent is entitled to claim the child dependency exemption[34]

33. Treas. Regs. §§1.152-4(b)(3)(i) and 1.152-4(e)(1)(i)–(ii).
34. Treas. Reg. §1.152-4(b)(3)(ii).

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The noncustodial parent must attach the qualifying documentation to their tax return each year that the noncustodial parent claims the dependent child exemption.[35]

Alternative Documentation. Although the regulations specifically indicate that a court order, decree, or separation agreement will not suffice as the written waiver,[36] IRS Pub. 504 states that under certain circumstances, such alternative documentation may be submitted which **will** suffice. This alternative documentation rule can only be used for parents having a **divorce decree or separation agreement that went into effect after 1984 and before 2009.** IRS Pub. 504 states that the noncustodial parent's tax return can be accompanied by the relevant pages of the decree or agreement stating the following.

- The noncustodial parent can claim the dependent child exemption without condition
- The custodial parent will not claim the exemption for the child
- The particular tax years that the noncustodial parent is entitled to claim the exemption

The relevant pages containing the previous information along with the following additional pages must be attached to the noncustodial parent's tax return to support the claim.

- The signature page showing the custodial parent's signature and the date of the decree or agreement
- The cover page showing the custodial parent's social security number (SSN)

Note. The following examples assume that the child in each example meets the requirements of a qualifying child for purposes of the dependency exemption. These requirements are found in §152(c). Moreover, these examples assume that the parents provide over half of the child's support unless otherwise specified.

Example 4. Jason and Lana are the divorced parents of their 3-year old daughter, Gia. Their divorce was final on November 29, 2023. They lived apart since March 15, 2023, when Jason moved into a new apartment. Gia stayed with Lana in the matrimonial home. Under the terms of the divorce decree, Lana's brother, Simon (Gia's uncle), has custody of Gia from January 1, 2024, to July 4, 2024.

During 2023, both parents had legal custody of Gia for more than half of the year and Jason and Lana provided over half of Gia's support. Because Gia spent nights solely with Lana since the March 15, 2023, separation date, Lana was the custodial parent for purposes of claiming the dependent child exemption for 2023. Lana invoked §152(e) and transferred her right to claim a 2023 dependency exemption for Gia to Jason. She accomplished this by completing and forwarding to Jason the following Form 8332 for 2023, which Jason attached to his tax return.

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35. Treas. Reg. §1.152-4(e)(2).

36. Treas. Reg. §1.152-4(e)(1)(ii).

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For Example 4

Form **8332** (Rev. October 2018) Department of the Treasury Internal Revenue Service

Release/Revocation of Release of Claim to Exemption for Child by Custodial Parent
▶ Attach a separate form for each child.
▶ Go to *www.irs.gov/Form8332* for the latest information.

OMB No. 1545-0074
Attachment Sequence No. **115**

Name of noncustodial parent	Noncustodial parent's social security number (SSN) ▶	
Jason Mills		***-**-7777

Note: This form also applies to some tax benefits, including the child tax credit, additional child tax credit, and credit for other dependents. It doesn't apply to other tax benefits, such as the earned income credit, dependent care credit, or head of household filing status. See the instructions and Pub. 501.

Part I Release of Claim to Exemption for Current Year

I agree not to claim an exemption for **Gia Mills**
Name of child

for the tax year 20 **23**.

Lana Mills — Signature of custodial parent releasing claim to exemption
*****-**-9999** — Custodial parent's SSN
January 9, 2024 — Date

Note: If you choose not to claim an exemption for this child for future tax years, also complete Part II.

Part II Release of Claim to Exemption for Future Years (If completed, see **Noncustodial Parent** on page 2.)

I agree not to claim an exemption for ______________________
Name of child

for the tax year(s) ______________________.
(Specify. See instructions.)

Signature of custodial parent releasing claim to exemption — Custodial parent's SSN — Date

Part III Revocation of Release of Claim to Exemption for Future Year(s)

I revoke the release of claim to an exemption for ______________________
Name of child

for the tax year(s) ______________________.
(Specify. See instructions.)

Signature of custodial parent revoking the release of claim to exemption — Custodial parent's SSN — Date

For 2024, because Gia was in the custody of her uncle Simon for more than half of the year, neither Jason nor Lana had custody of Gia for more than half the year. Therefore, the dependent child exemption **transfer provision of §152(e) cannot be used.** If Gia is a "qualifying child" under §152(c) or "qualifying relative" under §152(d) of Jason, Lana, or Simon, that person can claim the 2024 exemption for Gia. Jason or Lana may be able to claim an exemption for Gia as a qualifying relative or Simon may be able to claim Gia as a qualifying child for 2024.

> **Note.** Even though Lana released the exemption to Jason for 2023, she was still allowed to use the HoH filing status and claim the EIC and the dependent child care credit if otherwise qualified. However, Jason could claim the child tax and education credits, if applicable, because these credits are tied to the exemption.[37]

37. IRS Pub. 504, *Divorced or Separated Individuals; Education Credits — AOTC and LLC.* Dec. 12, 2023. IRS. [www.irs.gov/credits-deductions/individuals/education-credits-aotc-llc] Accessed on May 10, 2024.

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Note. Lana could also complete Form 8332, part II, and specify either particular tax years or indicate the form is for "all future years." Part III is used for the revocation of a previously completed Form 8332.[38] The custodial parent can revoke a release of claim to an exemption that they previously released to the noncustodial parent. **Revocation is a minimum of a 2-year process.** As an example, for the revocation to be effective for 2024, the custodial parent must have provided or reasonably attempted to provide written notice of the revocation to the noncustodial parent no later than in 2023. The custodial parent can use part III of Form 8332 as written notice. For each tax year they claim the child as a dependent resulting from the revocation, the custodial parent must attach a copy of the revocation to their tax return.[39]

Example 5. Felipe and Greta are the parents of Adam, who is 17. Felipe and Greta finalized their divorce on January 11, 2023, and have lived apart since the divorce. The court granted Felipe's mother, Marilee, custody of Adam for the first three months of 2023. From April 1 through December 31, Felipe and Greta had joint custody. Beginning April 1, Adam resided 190 nights with Felipe and 85 nights with Greta. Adam was a qualifying child, and Felipe and Greta provided over half his support. Because one or both parents had custody of Adam for more than half of the year (April 1 through December 31), the requirements of §152(e) are met. Adam lived with Felipe for the greater number of nights, which means Felipe was the custodial parent. Felipe could complete and sign a Form 8332 (or similar statement) releasing his right to claim an exemption for Adam, giving that right to Greta.

Example 6. Use the same facts as **Example 5.** In 2024, Adam lived with Felipe during the entire tax year. Adam attained age 18 on September 28, 2024. Under state law, Adam was emancipated as of September 28, 2024. After his 18th birthday, neither parent can be the custodial parent of Adam. However, because Felipe had custody of Adam for more than half of the year prior to Adam's 18th birthday, Felipe could use §152(e) to transfer the exemption to Greta if all the other requirements are met.

Example 7. Use the same facts as **Example 6,** except Adam's 18th birthday was on March 12, 2024. Felipe did not have custody of Adam for more than half of the year because Adam was emancipated on his birthday. Felipe was not considered a custodial parent and could not use §152(e).

Note. The emancipated child rules can have significant tax consequences, especially if the child is a student with qualified higher education expenses. It may be that Treas. Reg. §1.152-4, which established this rule, is inconsistent with congressional intent. For a detailed discussion of this issue, see the 2011 *University of Illinois Federal Tax Fundamentals,* Chapter 3: Filing Status and Dependency Exemptions. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

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38. Instructions for Form 8332.

39. IRS Pub. 504, *Divorced or Separated Individuals.*

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ALLOCATION OF TAX BENEFITS BETWEEN DIVORCED PARENTS

When the custodial parent transfers the right to claim the child's dependency exemption to the noncustodial parent, the right to claim the child tax credit is also transferred.[40] In addition, many other tax benefits (e.g., education credits) cannot be used unless the taxpayer claims the dependency exemption.[41] As mentioned earlier, the requirement for the parent to qualify for the dependency exemption to claim certain tax benefits still applies to tax years beginning after December 31, 2017, and before January 1, 2026, even though the dependency exemption is reduced to zero for those years.

A custodial parent who transfers the dependency exemption still meets the qualifying child requirement for purposes of filing as HoH and can still claim a dependent care credit. In addition, the EIC can be claimed only by the custodial parent, regardless of any transfer of the child's exemption to the noncustodial parent.[42]

Medical Expense Deduction by Either Parent[43]

If a noncustodial parent meets all the §152(e) requirements, they can claim the following medical items even if they have not been given the right to claim the child's exemption from the custodial parent.

- An IRC §105(b) income exclusion for medical expense reimbursement in connection with medical expenses incurred for the child
- An income exclusion for accident or health plan contributions for the child by an employer under IRC §106(a) and Treas. Reg. §1.106-1
- A fringe benefit income exclusion for no-additional-cost services or qualified employee discounts under IRC §132(a) when the child's use of these benefits is considered to be use by the taxpayer-parent under §132(h)(2)
- The deduction of the child's medical expenses under IRC §213(a)
- Income exclusions for Archer medical savings accounts and health savings accounts under IRC §§220(f)(1) and 223(f)(1) if the distribution is used to pay the child's qualified medical expenses

The child is considered a dependent of both parents in connection with the above claims.

TAX LIABILITY

MFJ taxpayers are jointly and severally liable for the taxes owed on a joint return.[44] The couple remains jointly and severally liable for all taxes on joint returns filed for all tax years ending before the finalization of a divorce. Pre-divorce returns filed separately and all post-divorce tax returns result in individual liability for each divorced spouse. To determine the extent of joint tax liability, it is essential to determine the extent of the tax liability that arises from any pre-divorce joint returns that were filed.

Example 8. Brett filed for divorce from Mandy in September 2023. In October 2023, Brett sold some stock at a gain, which resulted in a substantial tax liability of $17,400 for 2023. Brett and Mandy file MFJ for 2023 despite their pending divorce. Their divorce is finalized on November 6, 2024. They also have an unpaid joint tax liability of $6,000 for 2021 and $4,200 for 2022.

Because Brett and Mandy filed MFJ for the 2023 tax year, they are **both** jointly and severally liable for all three years. This means that both Brett and Mandy are liable for the entire $17,400 balance owed for 2023 and for the unpaid balances for 2021 and 2022 of $6,000 and $4,200, respectively.

Example 9. Use the same facts as **Example 8,** except Brett and Mandy decide to file MFS for the 2023 tax year. Brett reports the sale of stock on his return, and he is solely liable for the tax liability on the gain. For 2023, Mandy is liable only for the tax amount reported on her MFS return. She remains jointly and severally liable for the 2021 and 2022 unpaid balances because she filed MFJ with Brett for those years.

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40. IRS Notice 2006-86, 2006-41 IRB 680.

41. See IRS Pub. 970, *Tax Benefits for Education.*

42. IRS Notice 2006-86, 2006-41 IRB 680.

43. Rev. Proc. 2008-48, 2008-36 IRB 586.

44. IRC §6013(d)(3); Treas. Reg. §1.6013-4(b).

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Requirements of a Joint Tax Return

A divorced spouse cannot be held jointly and severally liable unless a joint return is filed with a former spouse. Regardless of whether both signatures are on a return as required by regulations for the filing of a joint return,[45] courts hold that intent to file jointly is a necessary aspect of a joint return. A signature on a joint return does not, by itself, conclusively establish the necessary intent. Consider the following cases.

- In *V.C. Payne,* a return signed by both spouses did not constitute a joint return. Because the wife helped complete the return, she believed she had to sign it. She did not intend for a joint return to be filed, her name was not indicated as spouse at the top of the return, and she gained no advantage from filing the return jointly.[46]
- In *R.A. Kiesling,* returns filed separately by a married couple because of poor accounting advice were treated as one joint return. The court held that the couple was not bound by an intentional election because the couple did not understand their choice to file separate or joint returns and they relied solely on the accountant's advice.[47]

If only one spouse signs the return or if one spouse signs for the other without their consent, courts may find that a joint return exists because of the tacit consent of the nonsigning spouse.[48] Tacit consent can be found in cases with a nonsigning spouse who did not file a separate return, knowing that the other spouse is filing a return.[49] A nonsigning spouse who is familiar with the obligation to file an annual return and who permits their own income to be reported on a joint return may also have tacitly consented to the filing of that return.[50]

IRS-Prepared Returns. The IRS can prepare a return for a taxpayer who fails to file a return but agrees to provide the information needed for its preparation.[51] An IRS-prepared document constitutes a joint return if it is based on information from a married couple who intended to file a joint return and signed the document under penalty of perjury.[52] However, if the IRS prepares the return based on information provided by third parties, the return is not considered a valid joint return because it is not signed under penalty of perjury.[53] A signature under penalty of perjury is a requirement for a valid joint return.[54]

If a taxpayer's name is signed to a return, the IRS presumes that the taxpayer in fact signed it.[55] However, this presumption is rebuttable.[56]

Duress.[57] A joint return does not exist if one spouse demonstrates to the IRS that they signed the return under duress. **Accordingly, a spouse who signs under duress is not jointly and severally liable for the tax shown on the return.** The IRS recomputes the return for the spouse who signed voluntarily by using the MFS status. This recomputed return reflects only the income and tax liability of that spouse.

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45. Treas. Reg. §1.6013-1(a)(2).
46. *V.C. Payne v. U.S.,* 247 F.2d 481 (8th Cir. 1957).
47. *R.A. Kiesling v. U.S.,* 171 F.Supp 314 (S.D. Tex. 1958).
48. See *M. Heim v. Comm'r,* 251 F.2d 44 (8th Cir. 1958); *M.S. Howell v. Comm'r,* 10 TC 859 (May 17, 1948), *aff'd per curiam* 175 F.2d 240 (6th Cir. 1949); *W.L. Kann v. Comm'r,* 210 F.2d 247 (3rd Cir. 1953).
49. *H. Klayman v. Comm'r,* TC Memo 1979-408 (Sep. 27, 1979).
50. *M.W. Streit v. Comm'r,* TC Memo 1989-265 (Jun. 1, 1989).
51. IRC §6020(a).
52. Ibid.
53. IRC §§6020(b) and 6065; Rev. Rul. 2005-59, 2005-37 IRB 505.
54. IRC §6065.
55. IRC §6064.
56. SCA 1998-021 (Sep. 9, 1998); *V. Hennen v. Comm'r,* 35 TC 747 (1961).
57. Treas. Reg. §1.6013-4(d).

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DIVISION OF PROPERTY

Many people involved in a divorce think of their assets merely in terms of value. However, many assets carry intrinsic tax consequences that should be considered when dividing the property. For example, the tax consequences are significantly different when selling depreciated rental property versus selling a main home. The tax effects are also profoundly different when redeeming certificates of deposit versus taking distributions from individual retirement arrangements (IRA).

NONRECOGNITION RULES

Three basic nonrecognition rules apply to the transfer of property between spouses or incident to a divorce. These nonrecognition rules apply to **outright transfers** or **transfers in trust** incident to a divorce.[58]

1. For transfers prior to the finalization of the divorce, generally, no gain or loss is recognized on the transfer of property between spouses.[59]
2. For transfers after the divorce is finalized, no gain or loss is recognized on the transfer of property between former spouses if the transfer is incident to the divorce.[60]
3. The transfer is treated as a gift for income tax purposes. The spouse receiving the property takes the same basis as the transferor spouse even if the property is business property for which the receiving spouse paid the transferor spouse.[61] The receiving spouse also acquires the transferring spouse's holding period in the property.[62]

A transfer is incident to the divorce if it occurs **within one year** after the ending date of the marriage or if it is made under a qualifying divorce or separation instrument and the transfer occurs not more than six years after the date on which the marriage ends.[63] Any transfer not made under a divorce or separation instrument and any transfer occurring more than six years after the end of the marriage is presumed to not be related to the end of the marriage. This presumption can be rebutted by showing that the transfer was made to effect the division of the property owned by the former spouses at the time the marriage ended.[64]

The transfer **must** be a transfer of property. Property generally includes **all** property, including real and personal property and tangible and intangible property.[65] In addition, these nonrecognition rules are applicable to property that was not owned by either spouse during the marriage.[66]

Example 10. Kendall and Zach finalized their divorce on December 31, 2023. Rather than selling their house and dividing the proceeds after the divorce, Zach decides to purchase a second house with a value of approximately half of the home and transfers it to Kendall before December 31, 2024. The nonrecognition rules prevent the triggering of any capital gain or loss to Zach upon the transfer and Zach receives a carryover basis from Kendall's half of the matrimonial home. Kendall's basis in the new house received from Zach also has a carryover basis equal to the amount Zach paid for the house.

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58. IRC §1041(a).
59. IRC §1041(a)(1).
60. IRC §1041(a)(2).
61. IRC §1041(b).
62. Treas. Reg. §1.1250-3(a)(3)(ii).
63. IRC §1041(c); Temp. Treas. Reg. §1.1041-1T(b).
64. Temp. Treas. Reg. §1.1041-1T(b).
65. IRC §1041(c); Temp. Treas. Reg. §1.1041-1T(a).
66. Temp. Treas. Reg. §1.1041-1T(a).

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Example 11. Alphonse and Jessica finalized their divorce in 2019. At the time of their divorce, Alphonse, an inventor, was involved in patent infringement litigation. Their divorce decree ordered Alphonse to pay Jessica a percentage of any damage award Alphonse receives from the litigation. Five years after the divorce, Alphonse wins his lawsuit and obtains a damage award. He immediately pays Jessica her portion. The transfer of funds to Jessica is considered a transfer of property incident to a divorce and is accorded **nonrecognition** treatment.[67]

Note. Under the **assignment of income doctrine** (discussed later), the nonrecognition rules apply to gains and losses but not income. Under the assignment of income doctrine, in **Example 11,** Alphonse pays any applicable income tax on the entire damage award because the income is attributable to him and is a result of his actions and efforts, not those of Jessica.

Community Property States

While living in a community property jurisdiction, all property acquired by either spouse during the marriage is considered community property.[68] Although some aspects of community property law differ between the community property states, each spouse generally has a one-half share in the community property marital estate upon divorce.

The nonrecognition rules apply regardless of whether the property transferred is separately owned by a spouse or is divided under a state's community property laws.[69]

Spouses living in community property states who file separately must report their respective half of income and deductions in connection with community property in addition to their own separate income and deductions.[70] A taxpayer may request relief from community property laws if community property treatment would be inequitable. This relief is requested under the innocent spouse provisions,[71] discussed later.

Nonrecognition Basis Rules

The nonrecognition rules treat a transfer of property incident to divorce as a **gift** for income tax purposes only. For subsequent dispositions, the carryover basis rule associated with the nonrecognition rules **differs** somewhat from that for gifting. For calculating a **gain,** divorce nonrecognition and gifting rules both use the transferor's basis. For calculating a **loss,** however, gifting rules use the **lesser of** the transferor's (donor's) basis or the fair market value (FMV) on the date of the transfer.[72] **The divorce nonrecognition rules use the transferor's basis for calculating a loss.[73]**

Example 12. Hannah received some Fordham Motor Company stock as a gift from her friend Joe in 2020. On the date the gift was made, the stock had an FMV of $70,000. Joe's basis in the stock was $100,000. Hannah sells the Fordham stock in 2024 for $60,000. The appropriate amount to use to calculate Hannah's loss on the sale of the stock is the lesser of Joe's basis or the FMV of the stock on the date the gift was made, which is $70,000. Therefore, Hannah uses the $70,000 FMV to calculate her loss. Hannah's loss is $10,000 ($60,000 sale price − $70,000 FMV).

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67. This example is based on Ltr. Rul. 9143050 (Jul. 26, 1991).

68. The community property states are Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin. See IRS Pub. 555, *Community Property.*

69. Temp. Treas. Reg. §1.1041-1T(d).

70. IRS Pub. 555, *Community Property*.

71. Ibid.

72. IRC §1015(a).

73. Temp. Treas. Reg. §1.1041-1T(d).

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Example 13. Use the same facts as **Example 12,** except Joe is Hannah's former husband and she receives the stock in accordance with the terms of their divorce decree. The appropriate basis to use in calculating Hannah's loss is $100,000, which is the carryover basis from Joe. Hannah's loss is therefore $40,000 ($60,000 sale price − $100,000 basis).

Debt in Excess of Basis

A property settlement may involve the transfer of property subject to a liability. As a general tax rule, if property with a cost basis less than its associated liabilities is transferred, the transferor must recognize gain in the amount of the excess of the liabilities over the basis in the property.[74] However, under the divorce nonrecognition rules, **no such gain or loss is recognized** on a transfer of property incident to a divorce.[75] The transferee spouse takes the transferor spouse's basis in the property with no step up in basis for the assumed liability.[76]

Example 14. Buddy owns a **rental home** on which he claimed depreciation. His adjusted basis in the building is $100,000. The property is subject to a $130,000 mortgage. He transfers this property to his wife Jennifer incident to their pending divorce. Buddy does not recognize $30,000 of gain on the transfer. Jennifer has a carryover basis of $100,000 in the property.

Example 15. Use the same facts as **Example 14.** Upon receiving the rental home from Buddy, Jennifer immediately sells the property. The sale price is $120,000. Jennifer recognizes gain of $20,000 ($120,000 − $100,000). Buddy's holding period for the rental home passes to Jennifer when he transfers the property to her.[77] If Buddy's holding period and Jennifer's holding period total more than one year, Jennifer's $20,000 gain is long term.

Jennifer uses the $120,000 sale proceeds to extinguish all but $10,000 of the mortgage, which she pays. She has no tax consequences as a result of the additional $10,000 payment.

Transfers in Trust. Property may be transferred to a spouse or former spouse incident to divorce outright or in trust. One or both spouses may prefer to use a trust if they have a desire to ensure the property or income from the property passes to children or other beneficiaries after the death of one or both divorced spouses.

Generally, transfers in trust fall under IRC §1041(e) and do not result in any recognition of gain or loss to the transferor. However, there are exceptions to this general rule.[78] Gain or loss is recognized with:

1. A transfer of an installment obligation to a trust, or
2. A transfer of property in trust with debt in excess of basis.[79]

For transfers in trust, if the liability to which the property is subject plus any additional liabilities assumed by the transferee exceeds the basis in the property, this excess is the amount of gain that the **transferor** must recognize. The trust's basis in the property is increased by the recognized gain.[80]

Example 16. Use the same facts as **Example 14,** except instead of Buddy transferring the property directly to Jennifer, the property is transferred to a trust for the benefit of Jennifer. Even though the transfer is still incident to a divorce, Buddy is required to recognize $30,000 of gain ($130,000 mortgage − $100,000 basis) on the transfer to the trust. The trust's basis in the property is the $100,000 carryover basis increased by the $30,000 gain that Buddy must recognize. Therefore, the trust's basis is $130,000.

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74. *Crane v. Comm'r*, 331 U.S. 1 (1947); *Comm'r v. Tufts*, 461 U.S. 300 (1983).
75. IRC §1041(a) and Temp. Treas. Reg. §1.1041-1T(d).
76. Temp. Treas. Reg. §1.1041-1T(d).
77. Treas. Reg. §1.1250-3(a)(3)(ii).
78. IRS Pub. 504, *Divorced or Separated Individuals.*
79. IRC §453B(g); IRS Pub. 504, *Divorced or Separated Individuals.*
80. IRS Pub. 504, *Divorced or Separated Individuals.*

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Additional Exceptions to Nonrecognition Treatment

There are some other areas in which the nonrecognition rules do not apply.

Income. Generally, the nonrecognition rules apply to gains and losses but not to **income.**[81] Most cases involving income are determined by the **assignment of income doctrine,** wherein income is taxed to the individual who either earns that income or who owns the property that generates the income. This doctrine prevents a taxpayer from assigning income to another person to avoid tax.[82]

Amounts that are specifically designated as interest income in property settlements between spouses are generally treated as interest income.

> **Example 17.** As part of Roderick and Lynnette's divorce settlement, Lynnette agrees to accept installment payments from Roderick to obtain her share of the value of the marital property. Roderick pays Lynnette her half of the value of the marital property in equal monthly installments over two years at an interest rate of 5%.
>
> Lynnette does not recognize income on the portion of each payment that represents Roderick's principal obligation. The principal amount is a transfer of property covered by the nonrecognition rules. However, the 5% interest Roderick pays on each installment is taxable interest income to Lynnette.[83]

Even though the nonrecognition rules do not apply to income, they generally **do** apply to the transfer of **rights to receive** income, such as a transfer of an interest in a trust or annuity, a nonqualified stock option, and deferred compensation.[84]

Moreover, the imputed interest rules do not apply to debt issued between spouses incident to their divorce.[85]

> **Note.** A detailed discussion of the imputed interest rules and the tax treatment of below market-rate loans can be found in the 2017 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 1: Investments. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].
>
> More information on installment sales can be found in the 2024 *University of Illinois Federal Tax Workbook,* Chapter 6: Installment Sales.

Deductibility of Interest. The IRS has argued that any interest paid in connection with a nonrecognition transfer incident to divorce constitutes nondeductible personal interest. However, the Tax Court held that the interest tracing rules[86] apply in determining the deductibility of interest by the transferor even in the case of transfers incident to divorce under §1041. Therefore, qualified residence interest, passive activity interest, or investment interest is deductible when the interest is pursuant to a nonrecognition transfer between spouses.[87]

Transfer of Services. Although the nonrecognition rules embrace a rather broad definition of property, services do not constitute property and are never included.[88]

> **Example 18.** Wallace and Nancy are divorced. For the year following the finalization of their divorce, Nancy continues to be Wallace's physician. Nancy is taxed on any fees she earns from Wallace because the performance of physician services is not a transfer of property. The nonrecognition rules do not apply.

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81. Rev. Rul. 87-112, 1987-2 CB 207.
82. See, e.g., *U.S. v. G.R. Shafto,* 246 F.2d 338 (1957).
83. Based on *L. Gibbs v. Comm'r,* TC Memo 1997-196 (Apr. 29, 1997).
84. Rev. Rul. 2002-22, 2002-1 CB 849.
85. Treas. Reg. §1.1274-1(b)(3)(iii).
86. Temp. Treas. Reg. §1.163-8T.
87. *J.L. Seymour v. Comm'r*, 109 TC 279 (1997).
88. Temp. Treas. Reg. §1.1041-1T(a).

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Nonresident Alien Spouse. The nonrecognition rules do not apply if the spouse or former spouse receiving the transferred property is a nonresident alien.[89] In such cases, gains and losses are recognized.

CARRYFORWARD RULES

Federal tax law determines who gets the future benefits of loss carryforwards after a divorce. The future tax savings related to loss carryforwards have a value that should be considered as part of the total value of marital assets. However, it may be difficult to value these losses, because the future tax consequences vary depending on the taxpayers' situation each year.

The following loss carryforwards should be included in this type of analysis.

- Capital loss carryforwards
- Net operating losses (NOLs)
- Charitable contribution carryforwards
- Passive activity losses
- S corporation losses
- Investment interest expense carryforward

Capital Loss Carryforward Amounts

For each tax year, capital losses are allowed to the extent of capital gains, plus up to $3,000 ($1,500 MFS).[90] To the extent that capital losses exceed the gains by more than $3,000, the taxpayer can carry the excess forward and use it in future years. Capital losses carry forward indefinitely until exhausted.

Treas. Reg. §1.1212-1 addresses the spousal allocation of capital losses when the spouses file jointly and thereafter file separate returns, such as in a divorce situation. The capital loss carryover is allocated to the spouses based on their individual net capital losses for the preceding year.[91] Short- and long-term capital losses are aggregated into separate categories, with allocations of each calculated separately. Short- and long-term losses retain their character once allocated to the appropriate spouse.

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89. IRC §1041(d).

90. IRC §1211(b)(1).

91. Treas. Reg. §1.1212-1(c)(1)(iv).

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Example 19. Hector and Andrea file **jointly** for the **2023** tax year. They own separate brokerage accounts. They divorce in 2024. The following amounts of capital gains and losses were incurred by the spouses in 2023 or carried forward to 2023 from prior years.

	Hector	+	Andrea	=	Joint Gains and Losses
Short-term gain	$6,000		$ 4,000		$10,000
Short-term loss	(9,000)		(3,000)		(12,000)
Net short-term gain/(loss)	($3,000)		$ 1,000		($ 2,000)
Long-term gain	$7,000		$10,000		$17,000
Long-term loss	(3,000)		(22,000)		(25,000)
Net long-term gain/(loss)	$4,000		($12,000)		($ 8,000)

On Hector and Andrea's 2023 joint return, they had net capital losses available to carry forward to 2024 of $10,000 ($2,000 short-term loss + $8,000 long-term loss).

Short-Term Carryover. Hector has $3,000 of short-term losses available after offsetting his $6,000 short-term gain. The short-term loss is used to offset the remaining $1,000 of short-term gain Andrea has after fully utilizing her $3,000 short-term loss against her $4,000 short-term gain. This leaves **Hector** with a **$2,000 short-term loss carryover** ($3,000 – $1,000) to 2024.

Long-Term Carryover. Andrea had $12,000 in net long-term losses for 2023, of which $4,000 was used to offset Hector's long-term gain after he used his $3,000 in long-term losses. This leaves **Andrea** with an **$8,000 long-term loss carryover** ($12,000 − $4,000) for 2024 on her separate return.

Note. Taxpayers frequently have joint brokerage accounts. When they do, the capital loss carryforward is split 50:50.

Net Operating Losses

When spouses file jointly, one or both spouses may have NOLs. When spouses file jointly, spousal incomes are combined and NOL amounts can be claimed collectively.[92] After a divorce, **each spouse's respective NOL** amounts, based on each spouse's separate business income and deductions that were reported on the joint return, **follow that spouse.** A divorced spouse can only use an NOL against their own income, whether the NOL is carried back to a year in which they filed a joint return with the former spouse or carried forward and used on their individual return or on a joint return with a new spouse.[93] Once the spouses cease filing jointly and begin filing separately, it is necessary to complete a separate income and deduction analysis to determine the NOL amount attributable to each spouse that they can claim on their respective separate returns.

Accordingly, only the spouse who had the loss can take the NOL deduction. An NOL carryback from a separate filing year to a joint filing year is limited to the income of that respective spouse.[94]

Caution. Practitioners should review IRS Pub. 536, *Net Operating Losses (NOLs) for Individuals, Estates, and Trusts,* for rules about handling NOLs for their client's specific situations.

92. Treas. Reg. §1.172-7(c).

93. IRS Pub. 536, *Net Operating Losses (NOLs) for Individuals, Estates, and Trusts*.

94. Ibid.

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The TCJA changed the rules for NOL deductions for tax years beginning after 2017. Under these rules, the NOL deduction for tax years beginning after December 31, 2017, is limited to 80% of taxable income determined without regard to the deduction.[95] Losses attributable to tax years beginning before January 1, 2018, are not subject to the 80% limitation. In addition, the TCJA generally repeals the 2-year carryback period and special carryback provisions for certain losses.[96]

Example 20. Garrett and Kara are spouses who each have their own separate businesses. Both businesses are operated as sole proprietorships. For the **2023** tax year, Garrett and Kara filed their **last joint tax return** before their divorce.

Garrett and Kara finalize their divorce in early 2024. During 2023, both businesses had losses for the first time. Their 2023 joint return and the accompanying Schedules C, *Profit or Loss From Business,* for each spouse's business indicates the following separate amounts applicable to each spouse.

	Garrett	Kara	Joint Return Amount
Wages	$40,000	$ 22,000	$ 62,000
Net business loss	(60,000)	(100,000)	(160,000)
NOLs carried forward to 2024	($20,000)	($ 78,000)	($ 98,000)

Post-divorce, each spouse retains their own respective NOL amount. Accordingly, after the divorce is finalized, Kara has a $78,000 NOL carryforward from 2023. Later in 2024, Kara remarries. In 2024, her business is profitable. She files jointly with her new husband, Mitch, and they take the standard deduction. Kara and Mitch have the following 2024 incomes.

	Kara	Mitch
Net business income	$48,000	$340,000
Wages	0	30,000

On the 2024 joint tax return, Kara's NOL deduction is limited to 80% of her taxable income, or $26,720 (($48,000 net business income[97] – $14,600 standard deduction) × 80%). She cannot use any of her remaining NOL carryforward to offset Mitch's 2024 income. Only losses generated by Kara while she is married to Mitch can be used against Mitch's income on their jointly filed returns.

Refund Limitation. When a divorced taxpayer carries back an NOL against a previous year's joint return that was filed with a former spouse, the divorced taxpayer's refund is limited to their own tax liability. The divorced taxpayer can claim a refund for the difference between their share of the recalculated tax and their contribution toward the tax paid on the joint return. The refund cannot be more than the joint overpayment. The divorced taxpayer's liability is calculated using MFS tax rates as follows.[98]

- Calculate the tax in the carryback year for each spouse as if they had filed MFS instead of MFJ.
- Compute each spouse's percentage of the total tax from the two MFS returns.
- Multiply the recomputed tax on the joint return after the NOL carryback by the taxpayer's percentage of the total MFS tax. The result is the taxpayer's share of the joint tax liability.

95. IRC §172(a), as amended by the TCJA.

96. IRC §172(b), as amended by the TCJA.

97. For simplicity, this example ignores implications from self-employment taxes or qualified business income deductions.

98. IRS Pub. 536, *Net Operating Losses (NOLs) for Individuals, Estates, and Trusts*.

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Only the amount of taxes attributable to the spouse who carries back the NOL (the NOL spouse) can be refunded.

Caution. For taxpayers in community property states, the IRS issued the following rulings that modify these calculations.

- Rev. Rul. 2004-71, 2004-2 CB 74 (Arizona and Wisconsin)
- Rev. Rul. 2004-72, 2004-2 CB 77 (California, Idaho, and Louisiana)
- Rev. Rul. 2004-73, 2004-2 CB 80 (Nevada, New Mexico, and Washington)
- Rev. Rul. 2004-74, 2004-2 CB 84 (Texas)

If any of the taxpayer's income or deduction is subject to AMT adjustments, the NOL must be first recomputed under AMT rules to arrive at the alternative tax NOL (ATNOL) before the carryback amount is calculated. ATNOL is only adjusted for tax preferences when the preferences increase the amount of the NOL for regular tax purposes.[99]

Note. For more information on the ATNOL, see the 2020 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 3: Net Operating and Excess Business Losses. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

Charitable Contribution Carryovers

Charitable contribution carryover amounts must be allocated between divorcing spouses who filed jointly while married.[100] The spouses must use the IRS allocation rules.[101] The charitable carryover amount is allocated based on the amount of carryover each spouse would have if they filed MFS returns instead of MFJ returns.[102]

Because charitable contributions are subject to a 5-year carryover period,[103] a carryover amount from a couple's final joint return may be composed of charitable contributions carried forward from up to four prior tax years. Therefore, joint returns must be recomputed as separate returns for each tax year going back to the earliest year within that 4-year period in which a carryover amount existed.

Passive Activity Losses

The transfer of a passive activity incident to a divorce is treated as a gift.[104] Any suspended passive activity losses of the donor spouse are added to the donee spouse's basis in the transferred property[105] and are not deductible as passive losses in any tax year.[106]

99. IRC §56(d)(2)(A).
100. Treas. Reg. §1.170A-10(d)(4)(i).
101. Rev. Rul. 76-267, 1976-2 CB 71.
102. Treas. Reg. §1.170A-10(d)(4)(i).
103. IRS Pub. 526, *Charitable Contributions.*
104. IRC §1041(b).
105. IRC §469(j)(6)(A).
106. IRC §469(j)(6)(B).

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Example 21. Seth and Brianne finalize their divorce on November 1, 2024. Seth is the sole owner of rental property that he inherited from his aunt. Because he inherited the property, it is not considered a marital asset. However, as part of their property settlement, Seth agrees to transfer the rental property to Brianne on December 31, 2024.

At the beginning of 2024, Seth had suspended passive activity losses of $42,000. The following details apply.

Brianne's transferred basis under gift rules (IRC §1015(a))	$150,000
Suspended losses transferred, January 1, 2024	42,000
Brianne's adjusted basis in the property	$192,000

Brianne must treat the $42,000 of suspended passive activity losses transferred to her as an increase to the property's basis. If Seth has positive rental income for 2024, he must report it with no allowance for suspended losses from previous years.

S Corporation Losses Limited by Basis

S corporation loss carryover amounts are personal to the shareholder and are generally not transferable to another person.[107] However, an **exception** to this rule applies when shares are transferred to a spouse or former spouse incident to a divorce. If a shareholder transfers S corporation stock to a spouse or former spouse incident to a divorce, any loss or deduction with respect to the transferred stock that is disallowed to the transferring shareholder because of insufficient basis is treated as incurred by the corporation in the following tax year with respect to the transferee spouse or former spouse. The amount of the loss or deduction relating to the transferred stock is determined by prorating the losses or deductions disallowed for the year of the transfer between the transferor and the spouse or former spouse based on their stock ownership at the beginning of the next tax year.[108]

Example 22. Jeffery owned all 100 shares in FreeFalling, Inc., a calendar-year S corporation. For 2022, FreeFalling had $400 in losses. Jeffery could not deduct any of the $400 loss in 2022 because he had no stock or debt basis. Therefore, the $400 loss carried forward to 2023.

On July 1, 2023, Jeffery transferred 50 of his shares to his spouse, Brandi, in connection with their pending divorce. In 2023, FreeFalling had $200 in losses. This 2023 loss amount is allocated to Jeffery and Brandi based on per-day, per-share ownership.[109] The amount of the $200 loss for 2023 allocable to the first half of the year is $100 ($200 × 50%). This $100 loss is allocable to Jeffery because he was the sole shareholder for the first half of the year.

The $100 loss allocable to the second half of the year was split equally between Jeffery and Brandi as equal shareholders. Therefore, for the second half of the year, Jeffery and Brandi were each entitled to half of that $100 loss (or $50).

Total losses for 2023 were allocated between Jeffery and Brandi as follows.

	Jeffery	+	Brandi	=	Total 2023 Loss
First half of 2023	$100				$100
Second half of 2023	50		$50		100
Total loss for 2023	$150		$50		$200

107. Treas. Reg. §1.1366-2(a)(6)(i).

108. Treas. Reg. §1.1366-2(a)(6)(ii).

109. IRC §1377(a); Treas. Reg. §1.1377-1(a)(1).

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On his 2023 return, Jeffery can use his carryover loss from 2022 ($400) and his pro-rata share of the 2023 loss ($150) to the extent he has basis. Brandi can use her pro-rata share of the 2023 loss ($50) to the extent she has any stock or debt basis at the end of 2023.

If Jeffery cannot use any of the 2022 loss of $400 in 2023, it is prorated between Jeffery and Brandi based on their stock ownership at the beginning of 2024. Because each spouse owned 50% of the shares in FreeFalling at the beginning of 2024, each spouse shares equally in the unused 2022 loss of $400. This provides an allocation of $200 to each spouse. Likewise, Jeffery's loss for the first half of 2023 with respect to the transferred stock that is disallowed because of insufficient basis is treated as incurred by the corporation at the beginning of 2024.

The loss amount is determined by prorating the losses or deductions disallowed for the year of the transfer between Jeffery and Brandi based on their stock ownership at the beginning of 2024. Therefore, Jeffery's disallowed loss for the first half of 2023 is prorated equally between Brandi and him based on their equal ownership at the beginning of 2024. The S corporation loss carryover available to each spouse at the beginning of 2024 is as follows.[110]

	Jeffery	+	Brandi	=	Total 2023 Loss
Prorated 2022 unused carryover	$200		$200		$400
Allocated 2023 loss amounts (1/1/2023–6/30/2023)	50		50		100
Allocated 2023 loss amounts (7/1/2023–12/31/2023)	50		50		100
Total available carryover, January 1, 2024	$300		$300		$600

Example 23. Use the same facts as **Example 22,** except Jeffery obtained $160 of basis from a capital contribution during 2023 and can therefore deduct $160 of the $400 loss carryover from 2022. He claims this $160 loss on his 2023 tax return. This leaves $240 of the 2022 carryover to be allocated between the spouses based on the relative share ownership they have at the beginning of 2024 (50% ownership for each spouse). Their revised available loss carryover amounts at the beginning of 2024 are as follows.

	Jeffery	+	Brandi	=	Total 2023 Loss
Prorated 2022 unused carryover	$120		$120		$240
Allocated 2023 loss amounts	100		100		200
Total available carryover, January 1, 2024	$220		$220		$440

Investment Interest Expense Carryovers

The IRS has not provided guidance on the allocation of investment interest expense carryover amounts incident to a divorce. Logically, the interest expense carryover should be allocated in the same manner between spouses as the underlying debt that generates the interest expense.

110. IRC §1366(d)(2).

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SALE OF HOME

Under IRC §121, single individuals can exclude up to $250,000 of gain if **all** of the following apply.[111]

- The taxpayer **owned** and **used** the home as a principal residence for at least two years during the 5-year period ending on the date of sale. The time of usage does not need to be continuous, nor does it have to occur at the same time as ownership.
- During the 2-year period ending on the date of sale, the taxpayer did not exclude a gain on the sale of another home.
- The taxpayer did not acquire the home through a like-kind exchange during the past five years.

Married couples filing MFJ can exclude up to $500,000 of gain, provided:[112]

- One spouse meets the ownership test and both spouses meet the use test, and
- Neither spouse claimed a §121 exclusion within the prior two years.

Special provisions relating to divorce allow the nonoccupant spouse who owns a home to meet the use test if the occupant spouse or former spouse is allowed to use the home under a divorce decree or separation instrument and uses the home as a principal residence. For property transferred from a spouse or former spouse, the ownership of the transferee includes the period of ownership of the transferor spouse.[113]

NONQUALIFIED PLANS

Nonqualified plans are not covered by the Employee Retirement Income Security Act of 1974 (ERISA).

Rev. Rul. 2002-22 provides that the nonrecognition provisions under §1041 apply to nonstatutory stock options and other nonqualified deferred compensation arrangements.[114] The revenue ruling also provides that the assignment of income doctrine does not apply to a nonqualified compensation transfer.[115]

Example 24. Wendell is employed by Graduated Plastics Incorporated (GPI).[116] Before Wendell's divorce from Barbara, GPI issued nonstatutory stock options to him that were not taxable to him at the time they were granted. In addition, Wendell has two unfunded, nonqualified deferred compensation plans that provide him with the right to post-employment payments. At the time of the divorce, one of these accounts had a $100,000 balance and the other account had a $50,000 balance. Both of these balances were vested.

Under the terms of their divorce settlement, Wendell transferred the following to Barbara.

- One-third of his stock options
- The right to receive some of the deferred compensation payments from the two nonqualified deferred compensation accounts

Four years after the divorce, Barbara exercised all the stock options she received. The FMV of the stock was greater than the exercise price. Wendell subsequently terminated his employment with GPI, and Barbara receives payments from both of the nonqualified deferred compensation accounts.

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111. IRS Pub. 523, *Selling Your Home.*

112. Ibid.; IRC §121(b).

113. IRS Pub. 523, *Selling Your Home;* IRC §121(d)(3).

114. Rev. Rul. 2002-22, 2002-1 CB 849.

115. Ibid.

116. This example is based on the facts in Rev. Rul. 2002-22, 2002-1 CB 849.

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The transfers of the nonstatutory stock options and the rights in the two deferred compensation accounts constitute **"property"** under §1041. **Nonrecognition** treatment applies to these transfers that were incident to the divorce.

Moreover, the **assignment of income doctrine** does not apply to Barbara's exercise of stock options. Wendell therefore does not include any amount in income as a result of Barbara's exercise of the options or from her receipt of funds from the deferred compensation plans. Rather, Barbara is taxed on the exercise of the stock option as if she were the individual who performed the employment services with GPI. Barbara also includes the amounts received from the deferred compensation accounts in her income.

The IRS noted that a result different from those obtained in the preceding example might occur if the nonstatutory stock options or deferred compensation accounts are unvested or subject to substantial contingencies at the time of the transfer.[117]

JOINT ESTIMATED TAX PAYMENTS[118]

Taxpayers filing MFS who made joint estimated tax payments can choose which spouse or former spouse claims all their payments or divide the payments between them in whichever way they agree. If unable to come to an agreement, the joint estimated tax payments must be allocated based on each person's tax as a percentage of the total tax between the spouses or former spouses.

If claiming any portion or all of the joint estimated tax payments, taxpayers should include their spouse's or former spouse's SSN in the spouse's SSN field on the first page of the return. For remarried taxpayers filing a joint return with their new spouse who claim any of the joint payments, they should write "DIV" to the left of the line item for estimated tax payments applied to their return (line 26 for Form 1040, *U.S. Individual Income Tax Return*).

Tax practitioners **must** specify how each joint estimated tax payment is to be allocated on **both** taxpayer's returns.

ALIMONY AND SEPARATE MAINTENANCE[119]

Generally, alimony and separate maintenance are payments received by an ex-spouse under the terms of a divorce or separation agreement. The TCJA **repeals the deduction** for alimony and separate maintenance payments by the payor spouse and the **inclusion in income** by the recipient spouse for the following situations.[120]

- Divorce or separation instruments executed after December 31, 2018
- Pre-January 1, 2019 agreements modified after December 31, 2018, **if the modification expressly provides that the repeal applies**

Note. This is a permanent change that will not revert when TCJA expires. The remainder of this section addresses divorces and separation agreements that occurred prior to 2019.

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117. Rev. Rul. 2002-22, 2002-1 CB 849.

118. IRS Pub. 504, *Divorced or Separated Individuals.*

119. *Topic no. 452, Alimony and Separate Maintenance.* Jan. 30, 2024. IRS. [www.irs.gov/taxtopics/tc452] Accessed on Jun. 25, 2024.

120. TCJA §11051.

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For divorce and separation agreements executed prior to 2019, **qualified** alimony or separate maintenance payments are included in the income of the recipient spouse and are deductible by the payor spouse.[121] Alimony or separate maintenance is "qualified" if it meets the following requirements.

1. The payment must be made in cash. Checks or money orders payable on demand meet this requirement. A transfer of property, no matter how easily the property can be converted to cash, does not qualify. Transferred services also do not qualify.[122]

2. The payment must be made to the spouse or former spouse. Additionally, payments made to a third party on behalf of the recipient spouse in accordance with the terms of the divorce decree or separation instrument also meet this requirement. Cash payments made to a third party at the written request, consent, or ratification of the recipient spouse qualify as alimony payments. The written request, consent, or ratification must state that the spouses intend to treat the payments as alimony. In addition, the request, consent, or ratification must be received by the payor spouse before the payor spouse's **first income tax return** is filed for the tax year in which the payment was made.[123]

Caution. The regulation's use of the word "first" appears to suggest that it may not be possible for the payor spouse to amend a filed return to deduct an amount that was ratified as alimony after the original return is filed.

Example 25. Following their 2017 divorce, Nelson makes regular alimony payments to Maisie. Maisie tells Nelson to send her December 2023 alimony check to the Save the Penguins Charitable Foundation. Nelson makes the alimony payment by check to the charity at Maisie's request. In January 2024, before Nelson files his tax return, Maisie confirms to Nelson in a written statement that she agrees to this arrangement for her December alimony payment.

The Save the Penguins payment for December 2023 is considered alimony. As long as it meets all the other requirements for qualified alimony, Nelson may deduct the December payment along with the other 2023 alimony payments. In addition, it is included in Maisie's income as taxable alimony for 2023. Maisie is entitled to a charitable deduction if the Save the Penguins Foundation is a qualified charity.

3. The payments must be made in accordance with a divorce or separation instrument.[124] To qualify as alimony, the payments must be made pursuant to a written instrument, even if only temporary.[125] The written instrument need not be part of an actual divorce decree to qualify, but it must create a legal obligation to make payments to the other spouse for support or maintenance.[126] Payments made pursuant to a judge's verbal order are not deductible because the required written instrument does not exist.[127]

4. The spouses are legally separated under a divorce decree or separate maintenance agreement and are not members of the same household when the payment is made.[128] However, if payments are made under a temporary support order or a written separation agreement, they qualify regardless of the spouses' living arrangements.

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121. IRC §§71 and 215; Temp. Treas. Reg. §1.71-1T(a).
122. IRC §71(b)(1); Temp. Treas. Reg. §1.71-1T(b).
123. Temp. Treas. Reg. §1.71-1T(b).
124. Ibid.
125. Treas. Reg. §1.71-1(b).
126. Ibid.
127. *S.W. Jachym v. Comm'r*, TC Memo 1984-181 (Apr. 10, 1984); *N.T. Semel v. Comm'r*, TC Memo 1965-232 (Aug. 27, 1965).
128. Temp. Treas. Reg. §1.71-1T(b); IRS Pub. 504, *Divorced or Separated Individuals.*

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5. There must be no requirement that the payments continue after the recipient spouse's death. If the payor spouse is required to make any payment in cash or property as a substitute for payments after the death of the recipient spouse, the payments made during the recipient spouse's lifetime do not constitute qualified alimony.[129] Continuation of payments after the death of the recipient spouse disqualifies all pre-death payments.[130] An obligation to make a substitute payment after the recipient spouse's death disqualifies the amount of alimony for which the payment was a substitute.[131]

   Example 26. Eric and Pattie have a divorce decree from 2015 that requires Eric to pay alimony of $20,000 per year to Pattie. The payments are required until the earlier of the end of 10 years or Pattie's death. However, in the event that Pattie dies before the end of the 10-year period, the divorce decree requires that Eric pay $10,000 annually to a trust for the benefit of a qualified charity after Pattie's death.

   The obligation to make the $10,000 trust payments disqualifies part of the $20,000 of annual alimony payments. Accordingly, $10,000 of the $20,000 annual alimony payments made to Pattie is disqualified. Eric cannot deduct $10,000 of the $20,000 alimony he pays to Pattie. This is true even if Eric does not actually make any substitute payments. Simply having the substitute provision in the divorce decree serves as a partial disqualification of the alimony paid.[132]

   Example 27. Janet's 2017 divorce decree requires her to make $40,000 of annual alimony payments to her former husband, René. The terms of the divorce decree require Janet to continue to make the same annual payments to a trust for the benefit of his brother if René passes away. All of Janet's alimony payments are disqualified.

6. The payments are not designated as something other than alimony. The spouses can designate that otherwise qualifying payments are not alimony. They do this by including a provision in the divorce or separation agreement that states the payments are not deductible as alimony by the payor spouse and are excludable from the payee spouse's income. The payee spouse can exclude the payments from income only if the payee attaches a copy of the instrument designating that the payments are not alimony to their return. The copy must be attached to the return each year that the designation applies.[133]

7. The amount intended as alimony in the divorce decree, separate maintenance agreement, or other relevant document must not be fixed as child support. An amount specified in the instrument is treated as "fixed as child support" if:

   a. It is specifically designated for the support of the payor spouse's child,

   b. It is reduced on the occurrence of a contingency relating to a child, or

   c. It is reduced at a time that can clearly be associated with a contingency relating to a child.[134]

   Any amount fixed as child support does not qualify as alimony.[135]

8. The spouses do not file joint returns with each other.[136]

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129. IRC §71(b)(1)(D).
130. *R.E. Hoover v. Comm'r,* 102 F.3d 842 (6th Cir. 1996).
131. IRC §71(b)(1)(D); Temp. Treas. Reg. §1.71-1T(b).
132. *J.R. Okerson v. Comm'r*, 123 TC 258 (2004).
133. IRS Pub. 504, *Divorced or Separated Individuals.*
134. Temp. Treas. Reg. §1.71-1T(c).
135. IRC §71(c)(1); Temp. Treas. Reg. §1.71-1T(c).
136. IRC §71(e).

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A payment associated with a pre-2019 divorce or separation agreement that meets all eight requirements automatically constitutes qualified alimony or separate maintenance and can be deducted by the payor spouse and must be included as income by the recipient spouse.

Note. The previous requirements for qualified alimony are applicable to payments made under a divorce or separation agreement made or modified **after 1984 and before 2019.** Different requirements apply to payments made under pre-1985 agreements. See Temp. Treas. Reg. §1.71-1T(e) for effective dates regarding the written instruments and modification issues and Treas. Reg. §1.71-1 for the pre-1985 rules.

Payments for Jointly Owned Home[137]

If a divorce or separation agreement states that one spouse must pay expenses for a home jointly owned with a spouse or former spouse, some of the payments may be alimony. The following table from IRS Pub. 504 shows how such payments are treated.

IF you must pay all of the ...	AND your home is ...	THEN you can deduct and your spouse (or former spouse) must include as alimony ...	AND you can claim as an itemized deduction ...
mortgage payments (principal and interest)	jointly owned	half of the total payments	half of the interest as interest expense (if the home is a qualified home).[1]
real estate taxes	held as tenants in common	half of the total payments	half of the real estate taxes.[2]
	held as tenants by the entirety or in joint tenancy	none of the payments	all of the real estate taxes.

[1] Your spouse (or former spouse) can deduct the other half of the interest if the home is a qualified home.
[2] Your spouse (or former spouse) can deduct the other half of the real estate taxes.

[137]. IRS Pub. 504, *Divorced or Separated Individuals.*

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DIVISION OF RETIREMENT ASSETS

The basic nonrecognition rules can also apply to retirement assets that are transferred incident to divorce. However, there are other specific rules and regulations associated with the division of retirement assets that must be followed if retirement accounts are part of the divided marital property.

> **Note.** Placing an appropriate **value** on retirement assets can be difficult. Depending on the type of retirement plan, actuarial calculations and various financial assumptions must be used.

IRA ACCOUNTS

The transfer of traditional IRA assets incident to divorce may be tax-free to the spouses if two requirements are met.[138]

1. The transfer is made under a divorce or separation instrument.
2. There is a transfer of the interest in the IRA and not a distribution.

Divorce or Separation Instrument

A tax-free transfer of IRA assets to a spouse or former spouse requires a divorce or separation instrument.[139] This is required for both individual retirement accounts and individual retirement annuities. A "divorce or separation instrument" is defined as:

- A divorce or separate maintenance decree or written instrument incident to such a decree,
- A written separation agreement, or
- A decree requiring a spouse to make support or maintenance payments to the other spouse.[140]

The IRA assets transferred are considered the IRA assets of the recipient spouse after the transfer.[141] This means that the recipient spouse is not required to take distributions from the IRA assets received even if the spouse who originally owned the IRA assets was taking distributions, unless they meet the required minimum distribution (RMD) rules. Moreover, the transfer itself is not considered an IRA distribution.[142]

> **Note.** For information on the RMD rules, see the 2023 *University of Illinois Federal Tax Workbook,* Chapter 8: Retirement Plan Issues for Individuals.

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138. Ibid.
139. IRC §408(d)(6).
140. IRC §71(b)(2).
141. IRC §408(d)(6).
142. Treas. Reg. §1.408-4(g)(1).

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Actual Transfer

The tax-exempt status of this type of IRA asset transaction between spouses or former spouses provided by the Code[143] requires a **transfer** of assets as opposed to a distribution or withdrawal.

According to the IRS, there are two commonly used methods to transfer IRA assets to a spouse or former spouse.[144]

1. Making a direct transfer of IRA assets
2. Changing the name on the IRA

Making a direct transfer or changing the name on the IRA accomplishes the valid transfer of IRA funds required by IRC §408(d)(6) for the transaction to be tax-free for both spouses.

Direct Transfer.[145] A direct transfer is accomplished when the transferor-spouse directs the trustee of the traditional IRA to transfer the affected assets directly to the trustee of a new or existing traditional IRA set up in the name of the transferee-spouse (or former spouse).

If the transferee-spouse is allowed to keep their portion of the IRA assets in the transferor-spouse's existing IRA, the transferor-spouse can direct the trustee to transfer the assets the transferor-spouse is permitted to keep directly to a new or existing traditional IRA set up in the transferor-spouse's name. The name on the IRA that holds the transferee-spouse's portion of the assets is changed to show the new ownership.

> **Example 28.** Under the terms of their divorce decree, David must transfer 100% of the funds in his IRA with Community Bank to Angie, his former wife. David forwards a copy of the divorce decree to Community Bank with instructions to transfer the IRA assets in his name to Angie. Community Bank establishes a new, temporary IRA in Angie's name and transfers all of David's IRA funds into Angie's account. Angie can choose to retain the account with Community Bank or transfer her new IRA to another custodian or trustee. A valid transfer of IRA assets incident to divorce has taken place. Neither David nor Angie faces any adverse tax ramifications from this transfer.

> **Example 29.** Use the same facts as **Example 28,** except David is only required to transfer 30% of his IRA balance to Angie. David forwards a copy of the divorce decree and instructions to transfer 30% of the account balance to Community Bank. Community Bank establishes a temporary IRA for Angie and transfers 30% into that temporary account. A valid transfer of IRA assets incident to the divorce has taken place. Angie can choose to continue to use Community Bank as custodian or transfer her new IRA to a different custodian.

Changing the Name on the IRA.[146] If all the IRA assets are to be transferred, the transfer can be accomplished by changing the name on the IRA from the transferor-spouse (or former spouse) to the name of the transferee-spouse.

> **Example 30.** Use the same facts as **Example 28,** except Community Bank simply changed the name on David's IRA to Angie as owner. David's IRA has been transferred to Angie.

Distribution. An individual's withdrawal and use of the funds for the benefit of the spouse or former spouse does not constitute the type of "transfer" required for tax-free treatment. Such a withdrawal results in a taxable distribution and penalties if the account owner has not attained age 59½.[147]

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143. IRC §408(d)(6).

144. IRS Pub. 590-A, *Contributions to Individual Retirement Arrangements (IRAs).*

145. Ibid.

146. Ibid.

147. See, e.g., *Summers v. Comm'r,* TC Memo 2017-125 (Jun. 26, 2017); *Bunney v. Comm'r,* 114 TC 259 (Apr. 10, 2000).

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Example 31. Maurice and Yvonne finalize their divorce in 2024. Their divorce decree requires Maurice to give Yvonne the funds in his IRA. Maurice cashed out his IRA and received a check for $68,000. He endorsed the check over to Yvonne. Even though Maurice never deposited the funds into his bank account and he endorsed the check directly to Yvonne, the endorsement of the check does not constitute a valid transfer of funds that qualifies for nonrecognition treatment. Maurice must include the $68,000 in income as a taxable IRA distribution.[148]

QUALIFIED RETIREMENT PLANS

A **qualified retirement plan** is a plan that is governed by the various requirements under IRC §401(a) and ERISA. Some examples of qualified plans include §401(k) plans, employee stock ownership plans (ESOPs), and profit-sharing plans.

Qualified Domestic Relations Order

ERISA created the term **qualified domestic relations order** (QDRO) to describe a court order that summarizes the division of retirement benefits under ERISA plans.[149] A QDRO is a judgment, decree, or court order issued under a state's domestic relations law that:[150]

- Recognizes the existence of an alternate payee's right, or assigns to an alternate payee the right, to receive all or part of the benefits of a qualified retirement plan or a tax-sheltered annuity;
- Relates to payment of child support, alimony, or marital property rights to a spouse, former spouse, child, or other dependent of the participant; and
- Specifies certain information, including the amount or part of the participant's benefits to be paid to the participant's spouse, former spouse, child, or other dependent.

A QDRO serves as the plan administrator's authorization to transfer benefits to the alternate payee.

8

Benefits Paid to a Child or Other Dependent.[151] For tax purposes, benefits paid under a QDRO to a child or other dependent are treated as paid to the participant.

Benefits Paid to a Spouse or Former Spouse.[152] Benefits paid under a QDRO to the plan participant's spouse or former spouse generally must be included in the spouse's or former spouse's income. If the participant contributed to the retirement plan, a prorated share of the participant's investment is used to calculate the taxable amount. There is no 10% early distribution penalty if the spouse is under age 59½.

If the benefits would have been treated as a lump-sum distribution if the participant received them, the spouse or former spouse can use the special rules for lump-sum distributions. The special rules for lump-sum distributions are explained in IRS Pub. 575, *Pension and Annuity Income.*

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148. This example is based on *Jones v. Comm'r*, TC Memo 2000-219 (Jul. 20, 2000).

149. *A Handbook for Attorneys on Court-Ordered Retirement, Health Benefits and Life Insurance Under the Civil Service Retirement Benefits, Federal Employees Retirement Benefits, Federal Employees Health Benefits, and Federal Employees Group Life Insurance Program.* Jul. 1997. OPM. [opm.gov/retirement-center/publications-forms/pamphlets/ri38-116.pdf] Accessed on Jun. 26, 2024.

150. IRS Pub. 504, *Divorced or Separated Individuals;* IRC §414(p).

151. IRS Pub. 504, *Divorced or Separated Individuals.*

152. Ibid.

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FEDERAL GOVERNMENT PENSIONS[153]

Most federal government employees participate in either the Civil Service Retirement System (CSRS) or the Federal Employees Retirement System (FERS). The CSRS covers most employees hired before 1984. The FERS generally covers employees hired after 1983 as well as employees who were hired earlier and elected to transfer their pension benefits from CSRS to FERS. These plans are administered by the U.S. Office of Personnel Management (OPM) and are not bound by the requirements of ERISA. Therefore, a QDRO cannot be used to divide federal pension plan benefits.

Any court order labeled as a QDRO or issued on a form for ERISA plans is not acceptable for processing unless the provisions within the court order expressly state that it applies to CSRS or FERS benefits and is drafted to conform to OPM's requirements. The court order must recognize that neither CSRS nor FERS are subject to the provisions of ERISA.

In addition, a state court order cannot be used to alter certain CSRS and FERS benefits, such as the eligibility for children's survivor benefits or the payment of accrued annuity amounts that exist at the participant's death. Federal law exclusively controls these benefits.

MILITARY PENSIONS

The Uniformed Services Former Spouses' Protection Act (USFSPA) permits, but does not require, state courts to divide military pensions when determining property rights in a divorce or separation proceeding.[154] In addition, it allows direct payments by the uniformed services of up to 50% of a military member's (or former member's) disposable retired pay to the former spouse if the settlement complies with the USFSPA.[155]

A traditional pension plan receives and invests contributions allocable to each participant. The participant has an actual sum of money within the pension plan and options available regarding that amount. However, this is not the case with a military pension for military members. Members receive military retired pay, which is a stream of income.[156]

The military member's retirement pay can be divided in two different ways.[157]

1. As a source of payment, such as a source of alimony and/or child support
2. As property, to be divided between spouses

To have military benefits used as a source of payment, generally the military pay center responsible for disbursing the military member's retirement pay must receive a certified court order that requires payments to be made to a spouse or former spouse.[158]

In the case of a property division, the USFSPA limits payments made on behalf of a military member to 50% of "disposable retired pay" for all payments that constitute a division of property.[159] More than 50% of disposable pay may be paid under certain circumstances, such as garnishments for child support arrears.[160]

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153. *A Handbook for Attorneys on Court-Ordered Retirement, Health Benefits and Life Insurance Under the Civil Service Retirement Benefits, Federal Employees Retirement Benefits, Federal Employees Health Benefits, and Federal Employees Group Life Insurance Program*. Jul. 1997. OPM. [opm.gov/retirement-center/publications-forms/pamphlets/ri38-116.pdf] Accessed on Jun. 26, 2024.

154. *Military Benefits for Former Spouses: Legislation and Policy Issues.* Kamarck, Kristy, N. Nov. 30, 2017. Congressional Research Service. [fas.org/sgp/crs/misc/RL31663.pdf] Accessed on Mar. 27, 2018.

155. Ibid.

156. Ibid.; 10 USC §1408(c).

157. 10 USC §1408(d).

158. Ibid.

159. 10 USC §1408(e)(1).

160. 10 USC §§1408(d)(5)–(6).

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INJURED SPOUSE

A tax overpayment is typically refunded to the taxpayer. However, the IRS has statutory authority to apply a tax overpayment to certain other debts and obligations of the taxpayer.[161] A spouse who would have obtained a refund but for the other spouse's debts is an **injured spouse.** The injured spouse can apply to obtain the refund to which they were entitled.[162] This may be useful for a divorced or divorcing spouse whose refund on a previous joint return was applied against the former spouse's debts. The debts against which a tax overpayment can be applied are as follows.[163]

- Unpaid federal taxes
- Debts owed to a federal agency
- Past-due child support or support of a child and the parent with whom the child is living
- Legally enforceable unpaid state income taxes
- Unpaid unemployment compensation obligations

When there is a tax overpayment on a joint return, the IRS generally applies the entire tax overpayment against any of the debts listed above.[164] Accordingly, the entire overpayment can be applied against the debts of one spouse, using an overpayment that would otherwise have been refunded to the other spouse that had no such debts to satisfy.

> **Note.** A couple does not have to be divorced or divorcing for a spouse to apply for injured spouse relief. A married person can also use this provision.

APPLYING FOR RELIEF

The apportioned share of an overpayment may be refunded to an injured spouse who applies for relief using Form 8379, *Injured Spouse Allocation.* This form may be filed:[165]

- With an original or amended joint tax return before the overpayment is applied to a debt, or
- On its own, after notification that an overpayment was applied to a debt.

If the form is sent with a joint tax return, the term "injured spouse" should be conspicuously noted at the top left corner of the first page of the tax return to alert the IRS that there is a Form 8379 attached. The IRS processes the injured spouse request before applying any overpayment shown on the return to an existing debt.

If the form is sent separately, the injured spouse must sign the form and both spouses' SSNs must appear on the form in the same order that they appeared on the income tax return. The requesting spouse should attach copies of all Forms W-2, *Wage and Tax Statement,* and W-2G, *Certain Gambling Winnings* for both spouses, as well as any Forms 1099 that show federal income tax withholding. The form is sent to the same IRS service center to which the original tax return was sent.[166]

> **Note.** The IRS calculates the injured spouse's share of the overpayment. For an injured spouse in a community property state, the IRS divides the joint overpayment in accordance with state law.[167]

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161. IRC §6402.
162. IRM 25.18.5.1 (2017).
163. Ibid; IRC §6402; *Social Security Act*, PL 74-271, §464(c).
164. IRM 25.18.5.1 (2017).
165. Instructions for Form 8379.
166. Ibid.; *Topic no. 203, Reduced Refund.* Jan. 26, 2024. IRS. [www.irs.gov/taxtopics/tc203.html] Accessed on May 10, 2024.
167. Instructions for Form 8379.

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APPORTIONMENT OF THE TAX OVERPAYMENT

The IRS established a method for apportioning the tax overpayment between spouses. This process is used to determine the amount of overpayment refundable to the injured spouse. The apportionment is based on the spouses' respective contributions to the payment of the taxes for the year, not on their respective incomes that gave rise to the tax liability.

The apportionment is accomplished in three steps.

Step 1. Determine each spouse's portion of the joint tax liability (JTL). Under the injured spouse rules, this is calculated using the following **separate tax formula.**[168]

$$\text{Spouse's portion of JTL} = \frac{\text{Spouse's MFS tax liability}}{\text{Both spouses' MFS tax liabilities}} \times \text{JTL}$$

Step 2. Calculate each spouse's contribution to the payment of the JTL. Each spouse's tax withholding on wages and other income counts as a contribution toward the payment of the JTL for that spouse. Estimated tax payments can be allocated in any way agreed to by both spouses. If the spouses cannot agree, the estimated payments are apportioned to each spouse using the following formula.[169]

$$\text{Spouse's contribution} = \frac{\text{Spouse's MFS tax liability}}{\text{Both spouses' tax liabilities}} \times \text{Estimated payment}$$

Step 3. Determine each spouse's share of the overpayment. This is calculated for each spouse by taking the amount calculated in Step 2 for that spouse and subtracting the amount calculated in Step 1 from it. This is reflected in the following formula.[170]

$$\text{Spouse's refund amount} = \text{Spouse's share of contribution to payment of JTL} - \text{Spouse's share of tax liability}$$

> **Note.** The instructions for Form 8379 contain more detailed instructions for allocating a tax overpayment.

[168] IRM 25.18.5.4 (2011).

[169] IRM 25.18.5.9 (2011); Instructions for Form 8379.

[170] IRM 25.18.5.3 (2017).

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Example 32. Marvin and Janis finalized their divorce in early 2024. Their 2023 tax return was their last joint tax return filed. Marvin has $15,000 of unpaid federal taxes from a prior year. The relevant figures in connection with their 2023 MFJ tax return, along with applicable MFS amounts for each spouse, are as follows.

	Marvin (MFS)	Janis (MFS)	Joint Return as Filed
Wages	$40,000	$50,000	$90,000
Standard deduction	(13,850)	(13,850)	(27,700)
Taxable income	$26,150	$36,150	$62,300
Tax liability (based on tax tables)	2,921	4,121	7,039
Federal tax withheld on wages	5,000	7,000	12,000

The 2023 joint tax return showed a total tax liability of $7,039 and an overpayment of $4,961 ($12,000 withholdings − $7,089 liability). The IRS applied the entire overpayment to Marvin's unpaid $15,000 tax liability. Marvin and Janis would have received a refund of the $4,961 overpayment had it not been for Marvin's unpaid taxes. Some of this overpayment is attributable to Janis. After the divorce in 2024, Janis applied for injured spouse relief to obtain a refund of the 2023 overpayment attributable to her.

To determine how much of the $4,961 overpayment is attributable to each spouse under the injured spouse rules, the following calculations must be made.

Step 1. Determine each spouse's portion of the JTL using the separate tax formula.

$$\begin{aligned}\text{Marvin's portion of JTL} &= \frac{\text{Marvin's MFS tax liability}}{\text{Both spouses' MFS tax liabilities}} \times \text{JTL} \\ &= \frac{\$2{,}921}{\$2{,}921 + \$4{,}121} \times \$7{,}039 \\ &= \frac{\$2{,}921}{\$7{,}042} \times \$7{,}039 \\ &= 0.415 \times \$7{,}039 \\ &= \$2{,}921\end{aligned}$$

$$\begin{aligned}\text{Janis's portion of JTL} &= \frac{\text{Janis's MFS tax liability}}{\text{Both spouses' MFS tax liabilities}} \times \text{JTL} \\ &= \frac{\$4{,}121}{\$2{,}921 + \$4{,}121} \times \$7{,}039 \\ &= \frac{\$4{,}121}{\$7{,}042} \times \$7{,}039 \\ &= 0.585 \times \$7{,}039 \\ &= \$4{,}118\end{aligned}$$

Each spouse's portion of the joint tax liability is therefore as follows.

Marvin	$2,921
Janis	4,118
Total joint tax liability	$7,039

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Step 2. Determine each spouse's contribution to the payment of the JTL. In this case, Marvin and Janis have each contributed the amount of federal tax that was withheld from their wages. Therefore, Marvin's contribution toward payment of the JTL is $5,000. Janis's contribution is $7,000.

Step 3. Determine each spouse's share of the overpayment. This amount for each spouse is calculated by taking each spouse's contribution toward payment of the JTL minus each spouse's respective share of the JTL. These calculations follow.

	Tax Payments Made	Apportioned Amount of JTL	Apportioned Amount of Overpayment
Marvin	$ 5,000	$2,921	$2,079
Janis	7,000	4,118	2,882
Total	$12,000	$7,039	$4,961

Janis's apportioned amount of the 2023 overpayment is $2,882, which will be refunded to her if injured spouse relief is granted. Marvin's $2,079 portion of the overpayment will be applied against his past tax debt.

Note. The outcome may be different for an injured spouse in a community property state. See the following revenue rulings for guidance in connection with community property states.

- Rev. Rul. 2004-71, 2004-2 CB 74 (Arizona and Wisconsin)
- Rev. Rul. 2004-72, 2004-2 CB 77 (California, Idaho, and Louisiana)
- Rev. Rul. 2004-73, 2004-2 CB 80 (Nevada, New Mexico, and Washington)
- Rev. Rul. 2004-74, 2004-2 CB 84 (Texas)

INNOCENT SPOUSE RELIEF

Statutory relief is available for spouses who have MFJ tax liability for amounts that are attributable to the other spouse. A spouse requesting relief (the "requesting spouse") has three available avenues for innocent spouse relief.[171] The following table outlines these three types of relief, the statutory provisions that created them, and the primary guidance that exists for each.

Type of Relief	Code Section	Applicable Regulation
General relief for joint filers (general relief)	IRC §6015(b)	Treas. Reg. §1.6015-2
Separate liability relief (separate relief)	IRC §6015(c)	Treas. Reg. §1.6015-3
Equitable relief	IRC §6015(f)	Treas. Reg. §1.6015-4, Rev. Proc. 2003-61

171. IRS Pub. 971, *Innocent Spouse Relief.*

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ELECTION PROCEDURE

To request relief from a tax liability under one or more of the three types of relief, the requesting spouse must have filed a joint return and must complete one of the following.[172]

- Form 8857, *Request for Innocent Spouse Relief*
- A written statement, signed under penalty of perjury, containing the same information as Form 8857

The election for **general relief** or **separate liability relief** must be filed no later than **two years** from the date of the **first collection activity** against the requesting spouse for the JTL. A request for **equitable relief** can be made any time within the limitation period for collection under IRC §6502 or for credit or refund of tax under IRC §6511.[173]

Although the election can be submitted before the commencement of collection activity[174] (such as in connection with an audit, examination, or demand for payment), the election cannot be made prematurely.[175] An election is **premature** if it is submitted for a tax year before the IRS sends notice of an audit or possible balance owed for that tax year.[176]

> **Note.** The definition of "collection activity" is found in Treas. Reg. §1.6015-5(b)(2).

After the requesting spouse makes the election, the nonrequesting spouse is notified.[177]

GENERAL RELIEF FOR JOINT FILERS

The IRS may grant relief to a requesting spouse who makes a proper election if the following conditions are satisfied.[178]

- A joint return was filed.
- The return has an understatement caused by erroneous items of the nonrequesting spouse.
- When the tax return was signed, the requesting spouse had neither actual knowledge nor any reason to know of the understatement.
- It is inequitable to hold the requesting spouse liable for the deficiency attributable to the understatement.

Actual Knowledge or Reason-to-Know Standard

The requesting spouse must establish that they lacked actual knowledge and had no **reason to know** of the understatement **when they signed the joint return.**[179]

Actual knowledge about omitted income exists if the requesting spouse knows that the nonrequesting spouse received the income. Actual knowledge about an erroneous deduction or credit exists if the requesting spouse knows the facts that make the particular expense not allowable as a deduction or credit. Actual knowledge about an inflated or fictitious deduction exists if the requesting spouse knows the expenditure was not incurred or not incurred to the extent claimed on the return. The IRS may rely on all the facts and circumstances in determining actual knowledge on the part of the requesting party.[180]

> **Note.** For further details about the definition of "actual knowledge," see Treas. Reg. §1.6015-3(c).

172. Ibid.; Treas. Reg. §1.6015-5(a).
173. IRS Pub. 971, *Innocent Spouse Relief.*
174. Treas. Reg. §1.6015-5(b)(3).
175. Treas. Reg. §1.6015-5(b)(5).
176. Ibid.
177. IRS Pub. 971, *Innocent Spouse Relief.*
178. Treas. Reg. §1.6015-2(a).
179. IRC §6015(b)(1)(C).
180. Treas. Regs. §§1.6015-2(c) and 1.6015-3(c)(2)(iv).

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The requesting spouse has **reason to know** if a reasonable person in similar circumstances would have known of the understatement, based on all the facts and circumstances, including the following.[181]

- The nature and amount of the understatement relative to other items on the return
- The financial circumstances of the spouses
- The requesting spouse's education, business experience, and participation in the activity that led to the understatement
- Whether the requesting spouse made reasonable inquiries about aspects of the return at the time of signature
- Whether the erroneous item on the return represented a divergence from the couple's past reporting practices

Example 33. Sharon and Otis filed jointly for 2023. Sharon knew that Otis inherited substantial funds from his deceased father. However, she did not know or have reason to know that Otis received and failed to report the taxable distributions from an inherited IRA. Sharon may be eligible for relief from the tax liability on the unreported IRA distributions.[182]

Obtaining knowledge of an understatement after the requesting spouse signs the joint return does not preclude relief from being granted.[183] Mere lack of knowledge of the tax consequences of a known error[184] or failure to read the return[185] before it is signed are not sufficient circumstances for relief.

Knowledge of Part of the Understatement

The requesting spouse may know or have reason to know about part of an understatement but not about the entire understatement. Relief can be granted only for the portion of the understatement of which there was no knowledge.[186]

Example 34. Gregg and Stacey file jointly each year. Gregg understated their tax liability by $50,000 for 2023. Stacey knew that Gregg underreported some income from his plumbing business, which resulted in $10,000 of the understated tax liability. However, Stacey did not know that Gregg also received and failed to report substantial income from a large contract that Gregg did not tell her about. Failure to report the contract income caused $40,000 of the understatement. Although Stacey is not eligible for relief for the $10,000 portion of the understatement of which she had knowledge, she may still be eligible for relief for the $40,000 portion for which she had no knowledge.

SEPARATE LIABILITY RELIEF

A requesting spouse can elect separate liability relief from a tax deficiency if the following conditions are satisfied.[187]

- At the time of the election, the spouses (or former spouses) who filed jointly are divorced, legally separated, or have not lived together for at least 12 months.
- The spouses have not transferred assets between them as part of a fraudulent scheme.
- The requesting spouse signed the return without actual knowledge of the other spouse's tax issues that caused the deficiency (unless the signature was under duress).

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181. Treas. Reg. §1.6015-2(c).
182. Based on *D.R. Braden v. Comm'r* , TC Memo 2001-69 (Mar. 22, 2001).
183. *B. Ianiello v. Comm'r*, TC Memo 1991-415 (Aug. 22, 1991).
184. *J. Hayman v. Comm'r*, 992 F.2d 1256 (2nd Cir. 1993); *H.L. Park v. Comm'r*, 25 F.3d 1289 (5th Cir. 1994).
185. *G. Erdahl v. Comm'r*, 930 F.2d 585 (8th Cir. 1991).
186. Treas. Reg. §1.6015-2(e)(1).
187. IRC §6015(c)(3).

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The requesting spouse has the burden of proof in showing initial eligibility for the election for relief. If the IRS denies the election on the grounds that the requesting spouse had **actual knowledge** of the other spouse's tax issues, the IRS bears the burden of proof.[188]

> **Note.** For a recent case demonstrating separate liability relief, see the *O'Nan* case in the 2024 *University of Illinois Federal Tax Workbook,* Chapter 10: Rulings and Cases.

Actual Knowledge Standard

Relief will not be granted if the IRS proves, by a preponderance of the evidence, that the requesting spouse had actual knowledge of the item causing a deficiency. The reason-to-know standard that also applies with a general joint relief election is inapplicable with an election for separate liability relief. Accordingly, what a reasonable person would have known is irrelevant under a separate relief election. However, the same actual knowledge standard that applies to general relief for joint filers also applies to separate relief.[189]

Example 35. Morrison's election for separate relief was successful for unreported income amounts that his former wife Alexa embezzled.[190] Even though Morrison should have known about the unreported income because Alexa deposited a substantial portion of the embezzled funds to their joint bank account and spent the money on household items, the IRS failed to show that Morrison had actual knowledge of the unreported income.

Example 36. Anthony failed to report restaurant income.[191] The IRS established that his former wife, Rachel, had actual knowledge of the unreported income because she was directly involved with daily restaurant operations along with her other family members. Additionally, Rachel studied accounting and earned a degree in business administration. She also signed two loan applications that showed restaurant income substantially in excess of the amount reported on the joint tax returns.

> **Observation.** To deny relief, the IRS must make a stronger showing under a separate relief election than for a general relief election. For a requesting spouse that had no actual knowledge but may have had reason to know about what caused the understatement, a separate relief election may provide a much stronger case because the IRS must show actual knowledge.

Allocating the Deficiency

If separate relief is granted, any item that caused the deficiency is allocated between the spouses as if separate returns had been filed.[192] The requesting spouse is only liable for that portion of the deficiency attributable to the requesting spouse.[193] However, the requesting spouse has the burden of proof in connection with the apportionment of liability for the deficiency.[194]

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188. IRC §6015(c)(2); Treas. Reg. §1.6015-3(d)(3).
189. Treas. Reg. §1.6015-3(c)(2); Treas. Reg. §1.6015-2(c).
190. This example is based on *M.G. Culver v. Comm'r*, 116 TC 189 (2001).
191. This example is based on *F. Entezam v. Comm'r*, TC Memo 2003-253 (Aug. 21, 2003).
192. IRC §6015(d)(3)(A).
193. IRC §6015(c)(1).
194. IRC §6015(c)(2).

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Example 37. Bruce and Julianne finalized their divorce in February 2023. They filed MFJ for the last time for 2022. Julianne received a substantial taxable IRA distribution in two payments — a smaller payment in April 2022 and a much larger payment in October 2022. In March 2024, Bruce and Julianne received a 30-day letter indicating a $100,000 deficiency for 2022 relating to Julianne's IRA distributions during that year. Twenty-five percent of the deficiency is attributable to the April payment, and 75% of the deficiency is attributable to the October payment.

In 2024, Bruce made an election under the separate liability relief provision. Bruce knew about the smaller April 2022 payment because Julianne deposited it in the joint bank account. Bruce used these funds to pay household expenses and received bank statements in connection with this account. However, he had no knowledge of the larger October payment because Julianne received and invested these funds without telling Bruce anything about this payment. Assuming Bruce is not eligible for further relief under another innocent spouse provision, he remains jointly and severally liable for 25% of the deficiency that is attributable to the April payment of which he had actual knowledge. He may obtain relief from joint and several liability for the other 75% of the deficiency related to the October payment.

Disqualified Asset Transfers

If a nonrequesting spouse transfers an asset to the requesting spouse with the principal purpose of avoiding tax or payment of tax, the transaction constitutes a disqualified asset transfer.[195] There is a **presumption** that any asset transferred during the 12-month period preceding the date of the first IRS letter regarding the proposed deficiency is the subject of a disqualified asset transfer. The presumption also applies to any asset transferred from the nonrequesting spouse to the requesting spouse after the first letter of proposed deficiency is mailed. This presumption is rebuttable by establishing that the principal purpose of the transfer was not the avoidance of tax or the payment of tax. The presumption does not apply if the requesting spouse establishes that the asset was transferred under a decree of divorce or separate maintenance or a written instrument incident to such a decree.[196]

The portion of the deficiency for which a requesting spouse is liable is increased (up to the total amount of the deficiency) by the value of a disqualified asset transferred to the requesting spouse.[197]

Example 38. Use the same facts as **Example 37,** except Julianne transferred $1,500 to Bruce in April 2023, shortly after the divorce was finalized. When Bruce elects relief from joint liability for the 2022 return, he indicates that the $1,500 transfer was not made for tax avoidance reasons. However, he does not provide the IRS with documentation for any alternative to explain the transfer of the $1,500 from Julianne. Because the $1,500 transfer took place within the year preceding the date of the 30-day letter, the presumption is that there was a tax avoidance purpose to the transfer. Bruce did not successfully rebut that presumption. Therefore, he remains liable for not only $25,000 ($100,000 × 25%) of the tax liability due to his knowledge of Julianne's April distribution, but also for an additional $1,500 of tax liability, for a total of $26,500. The $1,500 value of the transfer is added to the amount for which Bruce is otherwise liable.

Example 39. Use the same facts as **Example 38,** except Bruce explains to the IRS that Julianne always made a $1,500 payment each year to Bruce as a birthday gift. Despite the divorce, Julianne continued to make this payment to Bruce in 2023. Julianne is not required to make this payment under the divorce decree or related document. Bruce states these facts on his election for separate liability relief. He will likely have overcome the disqualified payment presumption, limiting his liability for the 2022 taxes to the $25,000 attributable to his knowledge of the April distribution received by Julianne.

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195. Treas. Reg. §1.6015-3(c)(3)(ii).

196. Treas. Reg. §1.6015-3(c)(3)(iii).

197. Treas. Reg. §1.6015-3(c)(3)(i).

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Example 40. Use the same facts as **Example 38,** except Julianne is required to make the $1,500 payment to Bruce under their divorce decree. The disqualified asset presumption therefore does not apply and Bruce's liability for tax is limited to the $25,000 attributable to his knowledge of the April distribution Julianne received.

EQUITABLE RELIEF[198]

Equitable innocent spouse relief requires the requesting spouse to meet **seven criteria.**

1. The tax liability from which the requesting spouse seeks relief is attributable to the nonrequesting spouse.
2. The requesting and nonrequesting spouses filed a joint return.
3. The requesting spouse did not knowingly participate in the filing of a fraudulent joint return.
4. The requesting spouse does not qualify for either general relief or separate liability relief.
5. No assets were transferred between the spouses as part of a fraudulent scheme.
6. The requesting spouse did not receive disqualified assets from the nonrequesting spouse.
7. The request for equitable relief is timely.

If the requesting spouse meets these seven criteria, they may qualify for a **streamlined decision** (discussed later).

Timely Request

A **timely** request for purposes of equitable relief is:

- Within the 10-year collections limitation period if the request is made for relief from an unpaid tax liability, or
- Within the 3-year limitation period for a credit or refund if the request is made for relief that would result in a credit or refund.

Determination of Relief

Upon receiving an application for equitable relief, the IRS makes a determination about whether to grant relief after reviewing all the relevant facts and circumstances of the case. These factors include the following.

- Existence of economic hardship for the requesting spouse
- The requesting spouse's knowledge of, or reason to know, the other spouse's deficiency or underpayment
- Any significant benefit the requesting spouse obtained from the deficiency or underpayment
- Whether either spouse has a legal obligation to pay the tax liability
- The requesting spouse's compliance with tax laws in years subsequent to the tax year for which relief is sought
- The requesting spouse's mental or physical health problems

Note. IRS Notice 2012-8 and IRS Pub. 971, *Innocent Spouse Relief,* provide additional guidance on these factors.

198. IRS Notice 2012-8, 2012-4 IRB 309.

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Streamlined Determination. If all seven equitable relief criteria are met, the IRS provides a streamlined determination if the requesting spouse can meet three additional requirements.

1. The spouses are legally separated, no longer married, or have not been members of the same household for the 12-month period preceding the request.
2. The requesting spouse did not know or have reason to know that the other spouse would not pay the underpaid tax reported on the joint return.
3. The requesting spouse will suffer economic hardship if relief is not granted.

LEGAL FEES AND DIVORCE

Legal fees associated with personal matters are not deductible.[199] However, for tax years beginning before January 1, 2018, legal fees in connection with an **income-producing activity or to establish or protect a source of taxable income** for the taxpayer were generally deductible as a miscellaneous itemized deduction subject to the 2% of adjusted gross income (AGI) limitation.[200] Legal costs incurred in the course of **recovering investment property or income from property** were also deductible as a miscellaneous itemized deduction subject to the 2% floor.[201] For legal costs to be deductible, they must be "ordinary and necessary." This means that the legal costs must bear a close relationship to the production of income and must be a reasonable amount.[202] The test of deductibility of legal fees is the origin and character of the claim with which the expense was incurred, not its potential consequences.[203]

The claim's origin and character is a factual determination made on the basis of the facts and circumstances of the litigation. The **most important factor** to consider is the **circumstances** from which the **lawsuit originated.** This includes an assessment of:

- The issues involved,
- The nature and objectives of the litigation,
- The defenses asserted,
- The purpose for which the claimed deductions were expended,
- The background of the litigation, and
- All facts pertaining to the controversy.[204]

199. IRC §262.
200. IRC §212; IRS Pub. 529, *Miscellaneous Deductions.*
201. Treas. Reg. §1.212-1(k); IRS Pub. 529, *Miscellaneous Deductions.*
202. Treas. Reg. §1.212-1(d).
203. U.S. v. *D. Gilmore et al.,* 372 U.S. 39 (1963).
204. *V. Boagni, Jr. v. Comm'r*, 59 TC 708 (1973).

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Under the TCJA, **all** miscellaneous itemized deductions **subject to the 2% of AGI floor** are suspended for years beginning after December 31, 2017, through December 31, 2025.[205] Therefore, during these years, no deductions are allowed for the following legal expenses.

- Legal fees in connection with an income-producing activity or to establish or protect a source of taxable income for the taxpayer
- Legal costs incurred in the course of recovering investment property or income from property
- The portion of the attorney's fees and other costs incurred in a divorce action that was related to the production or collection of taxable income
- The portion of legal fees allocable to tax counseling throughout a divorce proceeding
- The portion of divorce legal fees associated with **obtaining or collecting** alimony

LEGAL FEES ASSOCIATED WITH DIVORCE

Generally, legal fees and other costs associated with obtaining a divorce, separation, or decree for support are **not deductible** by either spouse.[206] Legal costs in connection with a divorce action are viewed as personal in nature. However, for tax years beginning before 2018, the portion of the attorney's fees and other costs that were related to the **production or collection of taxable** income was deductible as a miscellaneous itemized deduction subject to the 2% floor.[207]

Legal Fees and Child Support

Legal fees to obtain child support or to assert or defend the right to child support are nondeductible.[208] Such fees are considered personal in nature and are not incurred in the production of income because child support received is not taxable income.

Legal Fees to Protect Business Interests

In a 2009 case,[209] a married couple was not entitled to deduct fees related to the husband's divorce from his first wife but was allowed to deduct the portion of legal costs incurred to defend their interest in property and rental income held in the first wife's bankruptcy estate.

Legal Fees for Divorce Tax Counseling

The portion of legal fees allocable to tax counseling throughout a divorce proceeding was deductible as a miscellaneous itemized deduction subject to the 2% floor for tax years beginning prior to 2018. Accordingly, fees charged for determining the tax consequences of property settlements and alimony payments were deductible.[210] However, a spouse could only deduct their own expenses and not those paid on behalf of the other spouse.[211]

Note. The suspension of miscellaneous itemized deductions is scheduled to expire at the end of 2025. As such, some of these legal fees may be deductible again in the future. However, the change to alimony is permanent, so any legal fees associated with obtaining or collecting alimony will not be deductible. For more information on planning for the expiration of various TCJA provisions, see the 2024 *University of Illinois Federal Tax Workbook,* Chapter 12: Planning for the Sunset of the TCJA.

205. IRC §67(g).
206. Treas. Reg. §1.262-1(b)(7).
207. Ibid.; IRS Pub. 529, *Miscellaneous Deductions.*
208. *D.A. Swenson v. Comm'r,* 43 TC 897 (1965); *C.B. McClendon v. Comm'r,* TC Memo 1986-416 (Sep. 4, 1986).
209. *Estate of T.P. Melcher v. Comm'r*, TC Memo 2009-210 (Sep. 15, 2009).
210. *W.K. Carpenter v. U.S.*, 338 F.2d 366 (Cl. Ct. 1964).
211. *U.S. v. T.C. Davis*, 370 U.S. 65 (1962).

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DIVISIBILITY OF THE LEGAL FEES

Often, legal fees for divorce cover a variety of issues. Some of these issues may be in connection with the divorce decree or other items considered personal in nature and are therefore nondeductible. Some of the legal fees may be incurred for items related to the production or collection of income and therefore may be deductible as a miscellaneous itemized deduction subject to the 2% of AGI floor for tax years beginning before 2018 and potentially after 2025 again. It is therefore necessary to **allocate** the legal fees into deductible and nondeductible portions.

The IRS takes the position that the allocation between tax and nontax matters must be done on a reasonable basis.[212] A reasonable basis for this allocation exists in the following situations.[213]

- The taxpayer hires a firm that limits its practice to tax matters.
- Both tax and nontax matters are addressed, but the portion of the fee allocated to tax matters is based on the time spent on the tax issues, the difficulty of the tax issues, and the amount of tax involved.
- Both tax and nontax matters are addressed, but the portion of the fee allocated to tax matters is based on the time attributable to each, the fee customarily charged in the locality for similar services, and the results obtained in the divorce negotiations.

212. *W.K. Carpenter v. U.S.,* 338 F.2d 366 (Cl. Ct. 1964).

213. Rev. Rul. 72-545, 1972-2 CB 179.

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Note. Corrections for all of the chapters are available at **TaxSchool.illinois.edu.** For clarification about terms used throughout this chapter, see the **Acronyms and Abbreviations** section following the index.

For your convenience, in-text website links are also provided as short URLs. Anywhere you see **uofi.tax/xxx**, the link points to the address immediately following in brackets.

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About the Author

Ashley Akin is a Certified Public Accountant with over 8 years of experience. She started her career in public accounting working with a global mobility tax practice before switching to a private company specializing in individual crypto tax compliance. She started writing for the University of Illinois Tax School in June of 2023. She lives on Long Island with her husband and puppy.

Chris Korban, CPA, is a Tax Materials Specialist at the University of Illinois Tax School. He joined Tax School in 2023 with nine years of experience in public accounting. Chris earned both his Bachelor's Degree in Accounting and Master of Accounting Science from the University of Illinois.

Peg Phillips, CPA, is a writer and editor for the University of Illinois Tax School. She has been with the program since 2003. Peg graduated from the University of Illinois with high honors in accounting and passed the CPA exam in 1989. She currently owns and operates Phillips Tax Service in Pekin, IL.

John W. Richmann, EA, is a Tax Materials Specialist at the University of Illinois Tax School. Prior to joining Tax School in 2021, he owned a tax practice in St. Charles, Illinois, and held positions in private industry and consulting firms. John earned a Masters Degree in Business Administration from the University of Texas and an electrical engineering degree from the Massachusetts Institute of Technology.

Shane Smith, CPA, CMA, CFE, is a Tax Manager at AMG National Trust Bank and holds a Masters of Accountancy with an emphasis in Taxation from Gonzaga University.

Other chapter contributors and reviewers are listed at the front of this book.

RETIREMENT UPDATE

The Setting Every Community Up for Retirement Enhancement Act (SECURE) 2.0 Act of 2022 made many significant changes to retirement provisions at the taxpayer, plan, and business levels to incentivize taxpayers to save for retirement and make it easier for employers to offer retirement saving benefits. This section identifies key changes to retirement savings benefits at the **employer** level, highlighting provisions and key considerations that may benefit small businesses in their offerings of retirement plans and policies.

Note. For more information regarding changes resulting from the passing of the SECURE 2.0 Act at the **individual taxpayer** level, please see the 2023 *University of Illinois Federal Tax Workbook*, Chapter 8: Retirement Plan Issues for Individuals.

SMALL BUSINESS CREDITS FOR RETIREMENT PLANS

The SECURE 2.0 Act modified and introduced tax credits for small businesses to further incentivize establishing retirement plans for employees. Practitioners may be able to advise their small business clients to utilize these tax-saving opportunities in creating and implementing their retirement plan offerings.

Credit for Small Employer Pension Plan Startup Costs

Section 102 of the SECURE 2.0 Act makes modifications to the credit allowed under IRC §45E for small employer retirement plan startup costs. These changes are effective for tax years **beginning after December 31, 2022.**[1]

1. *SECURE 2.0 Act of 2022*, PL 117-328, §102; *SECURE 2.0 Act of 2022*. Dec. 19, 2022. United States Senate Committee on Finance. [www.finance.senate.gov/imo/media/doc/Secure 2.0_Section by Section Summary 12-19-22 FINAL.pdf] Accessed on Feb. 22, 2024.

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Plan Startup Cost Credit. The first modification of §102 increases the credit from 50% to 100% of qualified startup costs paid or incurred during the tax year. The credit is limited to the greater of $500 or the lesser of $250 for each employee of the eligible employer who is not a highly compensated employee or $5,000.[2] This credit is available for first three years of the plan. This can begin in the tax year the plan becomes effective or, if elected by the taxpayer, the tax year prior to the year the plan becomes effective.

The increased credit is only available for small businesses with up to 50 employees who are paid at least $5,000. Small businesses with up to 100 employees are still eligible for the 50% credit. The retirement plan must have at least one participant and at least one eligible employee who is not considered a highly compensated employee.[3]

Caution. The deduction for startup costs must be reduced by the plan startup cost credit amount on line 5 of Form 8881, *Credit for Small Employer Pension Plan Startup Costs, Auto Enrollment, and Military Spouse Participation*.[4]

Practitioner Planning Tip

Qualifying startup costs are generally higher when setting up IRC §401(k) plans, consequently resulting in a greater benefit from the credit for setting up such plans over simplified employee pension (SEP) and savings incentive match plan for Employees (SIMPLE) plans. However, SEP and SIMPLE plans may incur accounting fees, consulting fees, employee-training costs, and brokerage fees which may qualify for the credit.

Additional Credit for Employer Contributions by Certain Eligible Employers. The second modification of §102 created a credit for employer contributions to eligible retirement plans. The credit is a percentage of an employer's contributions to a plan on behalf of the employee, equaling 100% of contributions in the first and second year of the plan, 75% in the third year, 50% in the fourth year, and ending with 25% in the fifth year, with no credits allowed in any following years.[5] The credit has a cap of $1,000 per employee per tax year and does not allow a credit for employees with wages exceeding $100,000.[6]

The full credit is limited to employers with 50 or fewer employees, phasing out by 2% for every employee over 50. The credit completely phases out for employers with over 100 employees.[7] Taxpayers claim the credit on Form 8881.[8]

Note. Taxpayers can claim both the increased startup cost credit and the credit for employer contributions.[9]

---

2. Ibid.
3. IRC §45E.
4. Instructions for Form 8881.
5. An eligible employer plan is treated as being established on the date the plan becomes effective to the employer per IRS Notice 2024-2, 2024-02 IRB 316.
6. *SECURE 2.0 Act of 2022*, PL 117-328, §102; *SECURE 2.0 Act of 2022*. Dec. 19, 2022. United States Senate Committee on Finance. [www.finance.senate.gov/imo/media/doc/Secure 2.0_Section by Section Summary 12-19-22 FINAL.pdf] Accessed on Feb. 22, 2024.
7. Ibid.
8. IRS Pub. 560, *Retirement Plans for Small Business*.
9. IRS Notice 2024-2, 2024-02 IRB 316.

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Example 1. Janet Shift owns a small auto repair shop, called Shift Happens Automotive. She employs 30 employees, all of whom are paid at least $5,000 annually. She sets up a retirement plan for her employees starting January 1, 2023. Janet incurs $6,000 in qualifying startup costs for setting up the retirement plan and contributes $1,500 per employee to the retirement plan for all 30 employees.

In 2023, Shift can claim a startup cost credit of $5,000 and a small employer contribution credit of $30,000 (30 employees × $1,000 per employee credit cap) as shown on the following Form 8881.

Note. Janet must reduce the deduction for startup costs by the $5,000 startup cost credit. She must also reduce the deductions for the retirement plan contribution by $30,000 credit.

Form **8881** (Rev. December 2023) Department of the Treasury Internal Revenue Service

Credit for Small Employer Pension Plan Startup Costs, Auto-Enrollment, and Military Spouse Participation

Attach to your tax return.
Go to *www.irs.gov/Form8881* for instructions and the latest information.

OMB No. 1545-1810
Attachment Sequence No. **130**

Name(s) shown on return: **Janet Shift**
Identifying number: *****-**-6240**

Part I — Credit for Small Employer Pension Plan Startup Costs (Including Employer Contributions)

Line	Description		Amount
A	Enter the number of qualifying employees. See instructions: 30		
1	Qualified startup costs incurred during the tax year	1	6,000
2	Employers with 1-50 employees enter the amount from line 1. Employers with 51-100 employees enter 50% (0.50) of line 1	2	6,000
3	Enter the number of employees eligible to participate in the pension plan. See instructions. 30 X $250	3	7,500
4	Enter the greater of $500 or the amount from line 3 (Do not enter more than $5,000)	4	5,000
5	Enter the smaller of line 2 or line 4	5	5,000
6a	Enter the number of employees from the preceding tax year. See instructions	6a	30
b	Enter employer contributions made to the plan, but don't include (i) elective deferrals, (ii) contributions made to employees whose wages paid to the employee were in excess of $100,000 and (iii) any amount of contributions to an employee to whom you made contributions of more than $1,000	6b	0
c	For employees for whom you made matching and nonelective contributions of more than $1,000, (and who are not disqualified because they meet 6b(ii) above), see the instructions for information on how to determine the amount to enter on line 6c. If you did not make this type of contributions, enter -0-	6c	30,000
d	Add lines 6b and 6c	6d	30,000
	If the number of employees entered on line 6a is 50 or less, enter the amount from line 6d on line 6f. If the number of employees entered on line 6a is 51-100, continue to line 6e(1).		
e	**(1)** Subtract 50 (50.0) from the number of employees entered on line 6a	6e(1)	
	(2) Multiply line 6e(1) by 2% (0.02)	6e(2)	
	(3) Multiply line 6e(2) by line 6d	6e(3)	
	(4) Subtract line 6e(3) from line 6d	6e(4)	
f	If you did NOT complete line 6e, enter the amount from line 6d. If you completed line 6e, enter the amount from line 6e(4)	6f	30,000
g	Applicable percentages. See instructions • If this is treated as the first or second year of the plan, enter the amount from line 6f. • If this is treated as the third year of the plan, multiply line 6f by 75% (0.75). • If this is treated as the fourth year of the plan, multiply line 6f by 50% (0.50). • If this is treated as the fifth year of the plan, multiply the amount on line 6f by 25% (0.25).	6g	30,000
7	Credit for small employer pension plan startup costs from partnerships and S corporations	7	0
8	Add lines 5, 6g, and 7. Partnerships and S corporations, report this amount on Schedule K. All others, report this amount on Form 3800, Part III, line 1j	8	35,000

Small Employer Auto-Enrollment Credit

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EACA and QACA Tax Credits

A tax credit is available for employers who include an eligible automatic contribution arrangement (EACA) under their retirement plan. If automatic enrollment is either added to an existing plan or included in a new plan, the employer can receive a credit of up to $500 per year for the first three years.[10]

The automatic enrollment feature must meet EACA requirements. An EACA applies a default contribution percentage uniformly to all employees and allows employees to withdraw automatic enrollment contributions.[11]

A qualified automatic contribution arrangement (QACA) also meets EACA requirements and will qualify for this credit. A QACA is an arrangement with safe harbor provisions that allow the qualified plan[12] to automatically pass annual nondiscrimination testing. The safe harbor is a schedule of uniform minimum automatic contribution percentages starting at 3% with increases each year an employee participates.[13]

Qualified plans under a QACA must meet the following requirements.[14]

- Participants may elect to have their employer make contributions to the plan on their behalf or pay the contributions in cash to the participants.
- Participants are treated as having elected to have their employer make contributions of a uniform percentage of compensation to their plan until participants specifically elect not to have such contributions made.
- Plan administrators must provide plan participants notice of employees' rights and obligations.

Only **qualified employers** can use EACA and QACA tax credits. IRC §45T defines a **qualified employer** as having no more than 100 employees paid at least $5,000 in compensation in the preceding year.[15] Qualified employers claim the credits on Form 8881.[16]

> **Note.** This credit is allowed in addition to any startup costs plan tax credits and any deductions for employer contributions.[17]

CHANGES TO SIMPLE AND SEP IRAS[18]

The SECURE 2.0 Act made few but significant changes to SIMPLE and SEP plans, allowing for more options and flexibility than before the Act's adoption.

Prior to the SECURE 2.0 Act, a SIMPLE individual retirement arrangement (IRA) was not permitted to accept Roth employee contributions. Section 601 now allows an employee to designate a Roth IRA as the plan for the employee's SIMPLE IRA contributions. This change is effective for tax years beginning after December 31, 2022.

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10. IRC §45T.
11. *FAQs — Auto Enrollment - Are there different types of automatic contribution arrangements for retirement plans?* May 5, 2023. IRS. [www.irs.gov/retirement-plans/faqs-auto-enrollment-are-there-different-types-of-automatic-contribution-arrangements-for-retirement-plans] Accessed on Feb. 22, 2024.
12. IRC §414(w)(3).
13. *FAQs — Auto Enrollment - Are there different types of automatic contribution arrangements for retirement plans?* May 5, 2023. IRS. [www.irs.gov/retirement-plans/faqs-auto-enrollment-are-there-different-types-of-automatic-contribution-arrangements-for-retirement-plans] Accessed on Feb. 22, 2024.
14. IRC §§414(w)(3) and (4).
15. IRC §408(p)(2)(C)(i).
16. IRS Pub. 560, *Retirement Plans for Small Business*.
17. Instructions to Form 8881.
18. *SECURE 2.0 Act of 2022*, PL 117-328, §601; *SECURE 2.0 Act of 2022*. Dec. 19, 2022. United States Senate Committee on Finance. [www.finance.senate.gov/imo/media/doc/Secure 2.0_Section by Section Summary 12-19-22 FINAL.pdf] Accessed on Feb. 22, 2024; IRS Notice 2024-2, 2024-02 IRB 316.

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Section 601 also allows SEP plans to accept employer and employee Roth contributions. However, an employer is not required to offer an employee a Roth contribution election. Unless a salary reduction SEP (SARSEP) plan is in place, SEP contributions are employer contributions — not elective contributions. Previously, the contributions could not be Roth.

Any elective contribution under a SARSEP or SIMPLE plan which is made to a Roth IRA must be included in the employee's gross income. These amounts are withheld from the employee's paycheck but included in their wages because the amounts are going into a Roth IRA.

The employer reports employer contributions made to a Roth SEP or a Roth SIMPLE plan on Form 1099-R, *Distributions from Pensions, Annuities, Retirement or Profit Sharing Plans, IRAs, Insurance Contracts, etc.*, as code 2 or 7 in box 7. A Form 1099-R is issued for the year in which the employer makes the contribution, not the year to which the contribution relates.

The election to have a contribution made to a Roth IRA must be made by the employee before any contribution is made to the plan.

These changes are effective for tax years beginning after December 31, 2022.

Example 2. Mark owns a small landscaping business, GreenThumb Landscapes, LLC, which employs 15 people. He elects to be taxed as an S corporation. Mark sets up a retirement plan to provide savings opportunities for himself and his employees effective January 1, 2024. Mark contributes matching contributions to a SIMPLE plan of 3% of each employee's compensation. One of Mark's employees, Jane (age 40) has earnings of $60,000 and elects to contribute $13,500 in 2024 to her Roth SIMPLE IRA. Jane also requests Mark contribute his matching contributions to her Roth SIMPLE IRA.

Mark deducts the matching contribution of $1,800 as a retirement plan deduction on his Form 1120-S, *U.S. Income Tax Return for an S Corporation*. Jane's compensation of $60,000 is deducted as a wage expense on Form 1120-S. Jane's Form W-2 is as follows.

a Employee's social security number: ***-**-0000	OMB No. 1545-0008	Safe, accurate, FAST! Use IRS e-file	Visit the IRS website at *www.irs.gov/efile*.
b Employer identification number (EIN): 99-9999999		**1** Wages, tips, other compensation: 60000.00	**2** Federal income tax withheld: 8000.00
c Employer's name, address, and ZIP code: GreenThumb Landscapes, LLC, 24 Grass Road, Anywhere, USA 12345		**3** Social security wages: 60000.00	**4** Social security tax withheld: 3720.00
		5 Medicare wages and tips: 60000.00	**6** Medicare tax withheld: 870.00
		7 Social security tips	**8** Allocated tips
d Control number		**9**	**10** Dependent care benefits
e Employee's first name and initial / Last name / Suff.: Jane Doe, 123 Broadway, Anywhere, USA 12345		**11** Nonqualified plans	**12a** See instructions for box 12 — Code: S, 13500.00
		13 Statutory employee ☐ Retirement plan ☐ Third-party sick pay ☐	**12b** Code
		14 Other	**12c** Code
f Employee's address and ZIP code			**12d** Code

15 State	Employer's state ID number	16 State wages, tips, etc.	17 State income tax	18 Local wages, tips, etc.	19 Local income tax	20 Locality name
IL		60000.00	1500.00			

Form **W-2** Wage and Tax Statement 2024 — Department of the Treasury—Internal Revenue Service

Copy B—To Be Filed With Employee's FEDERAL Tax Return.
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Mark makes his matching contribution of $1,800 in December 2024, and issues the following 2024 Form 1099-R to Jane in addition to her Form W-2.

☐ CORRECTED (if checked)

PAYER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no. **GreenThumb Landscapes, LLC** **24 Grass Road** **Anywhere, USA 12345**		1 Gross distribution $ **1800.00** 2a Taxable amount $ **1800.00**	OMB No. 1545-0119 2024 Form **1099-R**	**Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.**
		2b Taxable amount not determined ☐	Total distribution ☐	**Copy B**
PAYER'S TIN **99-9999999**	RECIPIENT'S TIN *****-**-0000**	3 Capital gain (included in box 2a) $	4 Federal income tax withheld $	**Report this income on your federal tax return. If this form shows federal income tax withheld in box 4, attach this copy to your return.**
RECIPIENT'S name **Jane Doe**		5 Employee contributions/ Designated Roth contributions or insurance premiums $	6 Net unrealized appreciation in employer's securities $	
Street address (including apt. no.) **123 Broadway**		7 Distribution code(s) **2** — IRA/ SEP/ SIMPLE ☒	8 Other $ — %	This information is being furnished to the IRS.
City or town, state or province, country, and ZIP or foreign postal code **Anywhere, USA 12345**		9a Your percentage of total distribution %	9b Total employee contributions $	
10 Amount allocable to IRR within 5 years $	11 1st year of desig. Roth contrib. — 12 FATCA filing requirement ☐	14 State tax withheld $ $	15 State/Payer's state no.	16 State distribution $ $
Account number (see instructions)	13 Date of payment	17 Local tax withheld $ $	18 Name of locality	19 Local distribution $ $

Form **1099-R** www.irs.gov/Form1099R Department of the Treasury - Internal Revenue Service

9

Note. If Mark instead makes his matching contribution of $1,800 in January 2025, he will then issue a 2025 Form 1099-R to Jane.

CHANGES TO §401(K) EMPLOYER CONTRIBUTIONS[19]

The SECURE 2.0 Act made significant changes to employer contributions to Roth §401(k) plans and certain sole proprietor's first-year §401(k) plans that may be of interest to small businesses.

Employer Roth Contributions

Section 604 of the SECURE 2.0 Act allows employers to make matching contributions to an employee's Roth §401(k). To qualify, the employee must be 100% vested in their matching and nonelective contributions, and the Roth contributions are not considered compensation for the employee.[20]

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19. *Issue Snapshot — Deductibility of employer contributions to a 401(k) plan made after the end of the tax year.* Jul. 27, 2023. IRS. [www.irs.gov/retirement-plans/issue-snapshot-deductibility-of-employer-contributions-to-a-401k-plan-made-after-the-end-of-the-tax-year] Accessed on Feb. 22, 2024.

20. IRS Notice 2024-2, 2024-02 IRB 316.

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Deductible on Employer's Tax Return Subject to Limits

Prior to the original SECURE Act of 2019, employers were required to adopt a written retirement plan by the close of the plan's initial year. Section 201 of the SECURE Act of 2019 amends §401(b)(2), allowing employers to establish plans retroactively after the close of the plan year and fund the plans with contributions provided the funding occurs before the due date of the employer's tax return, including extensions.

Employers who make profit-sharing or matching contributions after the close of a tax year but prior to the due date of their tax return, including extensions, are allowed a deduction of the contributions subject to the limits of IRC §404. IRC §404 allows retroactive contributions if, for allocation purposes, the employer treats the contribution as having been made in the applicable tax year and pays the contribution on or before the due date of the employer's tax return, including extensions.

Example 3. Illuminating Solutions Corp., a C corporation, timely files an extension for its 2023 Form 1120, *U.S. Corporation Income Tax Return,* extending the due date to October 15, 2024. The corporation filed the return on July 16, 2024, with a $50,000 deduction for 2023 profit-sharing contributions which was less than the §404(a)(3) limit of 25% of eligible participant compensation. The $50,000 was then contributed to the plan on September 20, 2024. Because both the payment of the contribution and the deduction occurred prior to the October 15, 2024 due date, the deduction is allowed.

Retroactive First-Year Elective Deferrals Under §401(k) for Sole Proprietors

For plan years beginning after December 31, 2022, §317 of the SECURE 2.0 Act allows an individual who owns the entire interest of an unincorporated business **and** is the sole employee to **establish and make the elective deferral** portion of the contributions to a **new** §401(k) plan after the close of the tax year but before the due date of the individuals tax return, **without extensions.** Such contributions will be treated as having been made for the plan's first tax year.[21]

Note. This exception is only applicable for the first year of establishing the plan.

Contributions for self-employed individuals are reported on Schedule 1 (Form 1040), *Additional Income and Adjustments to Income*.[22]

Example 4. Gerald McCracken, a sole proprietor with no employees, wants to retroactively set up a new solo §401(k) plan for 2023 in March 2024. To accomplish this, he must open the plan by April 15, 2024, the due date of his 2023 tax return, without extensions, and fund the elective deferral portion of the §401(k) contribution. Gerald has until the extended due date of his individual return to make the employer portion of the contribution.

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21. *SECURE 2.0 Act of 2022*, PL 117-328, §317.

22. IRS Pub. 560, *Retirement Plans for Small Business*.

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BUSINESS PLAN PROVISIONS IN SECURE 2.0 ACT

Among the provisions in the SECURE 2.0 Act, Congress included additional incentive provisions, changes to plan procedures, and implementation of new retirement plans. Developing an understanding of these provisions is valuable in correctly applying retirement plan offerings.

Student Loan Matching[23]

Section 110 of the SECURE 2.0 Act allows employers to make contributions to a qualified retirement plan on behalf of employees who are making qualified student loan payments. Qualified student loan payments are payments made toward a qualified education loan the individual incurred to cover higher education expenses.

Employers sponsoring IRC §§401(k), 403(b), and SIMPLE IRA plans, as well as government employers offering IRC §457(b) or other plans, may make matching contributions to an individual's plan on account of qualified student loan payments. Student loan payments made after **December 31, 2023,** are eligible for matching contributions, and employers may rely on employee certification of payment of the student loan. In effect, this allows an employer to offer the benefit of retirement savings to an employee that is not actually making elective deferrals.

The amount of an individual employee's contribution and deemed contribution, comprised of both elective deferrals and student loan repayments, is limited to the lesser of the employee's compensation for the year or the applicable limitation on exclusion for elective deferrals under IRC §402(g). The applicable limitation is $15,000, adjusted for cost-of-living in multiples of $500.[24] For 2024, the applicable limitation is $23,000.[25] This limitation prevents an employer from making larger matching contributions associated with student loan repayments than would otherwise be allowed on elective deferrals.

Section 110 also addresses nondiscrimination testing rules, allowing plans to test separately for employees who receive matching contributions related to student loan repayments. Matching contributions will not fail to be treated as being available to an employee solely because the employee does not have student loan debt.

Practitioner Planning Tip

Practitioners may advise their business clients to utilize this student loan matching provision as an employee recruitment or retention incentive. The competitive landscape for hiring qualified employees requires attractive compensation and benefits packages, and the student loan matching program may be an alluring benefit to job candidates, particularly those who recently graduated from college with student loan debt.[26]

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23. *SECURE 2.0 Act of 2022,* PL 117-328, §110.

24. IRC §§402(g)(1)(B) and (4).

25. *Consequences to a Participant Who Makes Excess Annual Salary Deferrals*. Feb. 29, 2024. IRS. [www.irs.gov/retirement-plans/consequences-to-a-participant-who-makes-excess-annual-salary-deferrals] Accessed on Mar. 12, 2024.

26. *What Are the Rules for Making 401(k) Plan Matching Contributions on Student Loan Repayments?* Nov. 15, 2023. Thomson Reuters. [tax.thomsonreuters.com/news/what-are-the-rules-for-making-401k-plan-matching-contributions-on-student-loan-repayments] Accessed on Mar. 12, 2024.

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Changes to Auto-Enrollment Requirements[27]

Section 101 of the SECURE 2.0 Act requires automatic enrollment in the employer's retirement plan to increase participation and employee retirement savings. **Beginning January 1, 2025,** employers must enroll employees into their retirement plan when they meet plan eligibility requirements by contributing a portion of their wages into the plan on the employee's behalf. Initial enrollment contribution percentages into the plan can range from 3 to 10% with an automatic 1% increase each year until the contribution rate reaches 10%, but no more than 15%.

Employees can choose either to opt out of automatic enrollment or choose a contribution percentage and percent increase each year different from the default automatic enrollment rates. Wage deductions for retirement contributions are typically pre-tax, but employees may decide to make Roth contributions if their plan allows. Employees are always 100% vested in their automatic enrollment contributions.

> **Note.** Exceptions to automatic enrollment are allowed for plans established prior to December 29, 2022, small businesses with 10 or fewer employees, new businesses with less than three years of existence, church plans, and government plans.

Starter §401(k) Plans[28]

A starter §401(k) plan is a retirement plan option allowed under §121 of the SECURE 2.0 Act for eligible employers to offer employees beginning in plan years beginning after December 31, 2023. These plans are a lower-cost retirement plan option for employers to offer to their employees.[29] Eligible employers are those who do not already maintain a qualified retirement plan in the year of determination with limited exceptions. Such exceptions include employees covered by a collective bargaining agreement between employee representatives and one or more employers.[30]

The starter §401(k) plan, also referred to as safe harbor §403(b) plan, has the following compliance requirements.

- Enrollment into the plan must be automatic at a rate between 3 and 15% of compensation.
- **No employer contributions are permitted.**

> **Note.** Employers may set age and service requirements for employees to be eligible to contribute to the plan.[31]

Employee contributions are limited to $6,000 for calendar year 2024, with an additional $1,000 catch-up contribution for employees over the age of 50, resulting in a maximum of $7,000 an individual can contribute. These deferrals are significantly lower than a standard §401(k) plan. Cost of living adjustments may change the contribution limits starting after the close of the year ending December 31, 2024.

> **Note.** In addition to being a lower-cost option resulting from no employer matching contributions, starter §401(k) plans may be appealing to employers because there are fewer legal requirements (e.g., §401(k) plan compliance standards involving participation and nondiscrimination[32]) compared to other retirement plans. However, starter §401(k) plans may not be as appealing to employees because there are no employer matching contributions and lower employee contribution limits compared to other retirement plans. Small businesses should weigh these considerations when implementing retirement plan offerings, as lower financial and administrative costs could come at the price of a business being less desirable from an employee recruitment and retention perspective.

27. *SECURE 2.0 Act of 2022,* PL 117-328, §101.

28. *SECURE 2.0 Act of 2022*, PL 117-328, §121; *SECURE 2.0 Act of 2022*. Dec. 19, 2022. United States Senate Committee on Finance. [www.finance.senate.gov/imo/media/doc/Secure 2.0_Section by Section Summary 12-19-22 FINAL.pdf] Accessed on Feb. 22, 2024.

29. *What Are Starter 401(k) Plans?* Fontinelle, Amy. Jun. 20, 2023. Forbes Media LLC. [www.forbes.com/advisor/investing/what-are-starter-401k-plans/] Accessed on Feb. 22, 2024.

30. IRC §410(b)(3)(A).

31. Ibid.

32. Ibid.

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Additional Nonelective Employer Contributions to SIMPLE IRAs[33]

Employers are required to make **either** matching or nonelective contributions to an employee's SIMPLE IRAs each year. Qualified employees must be notified of the employer's intent **prior** to the 60-day period during which employees may make or modify their contribution elections.

Matching contributions apply only to employees who participate in the plan. The employer may match employee deferrals up to 3% of the employee's compensation.

Nonelective contributions apply to every employee who qualifies to participate in the plan, even those who do not elect to contribute. The default nonelective employer contribution rate is 2% of the employee's compensation. Effective for tax years beginning after December 31, 2023, employers may voluntarily make additional nonelective contributions.

Similar to the matching and 2% nonelective contributions, the **additional nonelective** contributions must be made by the due date of the employer's tax return, including extensions. This contribution is capped at 10% of the employee's compensation or $5,000 (indexed for inflation), whichever is less. Compensation for these purposes is subject to the same annual limit that applies to the 2% nonelective contribution, as adjusted for inflation each year (for 2024, the compensation limit is $345,000).[34]

Example 5. Bulgy Bros, Inc., has a SIMPLE plan that was established in 2019. In September 2023, the company notified its employees that it intended to make a 2% nonelective contribution to each qualified employee's SIMPLE IRA for 2024 instead of making matching contributions. As shown in the following table, the company **must** contribute $11,700 to its employees' SIMPLE IRAs for 2024 by the due date of its return.

When preparing the 2024 income tax return, Bulgy's accountant determined that its taxable income was higher than anticipated for the year. Accordingly, they recommended that the company make an additional nonelective contribution for 2024. They prepared the following table to show the maximum amount that could be contributed for each employee under the SIMPLE plan's provisions.

Qualified Employee	Compensation	Lesser of Compensation and Compensation Limit	Nonelective 2% Contribution	Additional Nonelective Contribution
Anthony	$400,000	$345,000	$ 6,900	$ 5,000
Amy	4,000	4,000	0	0
Rita	200,000	200,000	4,000	5,000
Paris	40,000	40,000	800	4,000
Total contributions			$11,700	$14,000

Higher Maximum Deferrals[35]

The maximum amount that an employee may elect to contribute to their SIMPLE IRA each year is capped by an amount specified in the Code as indexed for inflation. For 2024, the applicable limit is $16,000, plus $3,500 if the employee is age 50 or older.[36] However, if the **employer** meets certain requirements, these 2024 limits are increased by 10%[37] to $17,600 and $3,850, respectively.

33. IRC §408(p).

34. IRS Pub. 560 (2023), *Retirement Plans for Small Business.*

35. IRC §§408(p)(2)(E) and 414(v)(2).

36. IRS Pub. 560 (2023), *Retirement Plans for Small Business.*

37. IRC §408(p)(2)(E), as amended by PL 117-328 (SECURE Act of 2022), Act, §117(a). See also IRC §414(v)(2), as amended by SECURE 2.0 Act, §117(b).

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Generally, an employer may qualify its employees for these higher limits by being:[38]

- A small employer with no more than 25 employees who received at least $5,000 in compensation in the preceding year, **or**
- A large employer having between 26-100 employers **and** either providing
  - A 4% matching contribution, or
  - A 3% nonelective employer contribution.

Note. For small employers, the higher limit is effective automatically. However, large employers must take proactive measures for their employees to qualify. In addition to the increased percentages for matching and nonelective contributions, additional rules apply to larger employers that are beyond the scope of this material.[39]

BENEFICIAL OWNERSHIP INFORMATION REPORTING[40]

Congress was concerned that malign actors may use small corporations, limited liability companies (LLC), and other organized businesses to funnel money into criminal endeavors, such as drug trafficking, counterfeiting, securities fraud, and even the financing of terrorism. However, federal authorities had no access to beneficial ownership information (BOI) that could assist in their fight against these crimes.

Generally, taxpayers organize business organizations at the **state** level. Federal regulators have little insight into the ownership of organizations as states do not routinely collect information about the organizations' beneficial owners.[41] Congress acted on this significant security issue because taxpayers organize more than 2 million businesses annually. This high volume of newly registered businesses potentially makes it easier to hide criminal activity fronting as legitimate and registered businesses. The Corporate Transparency Act (CTA)[42] imposes a reporting requirement on large numbers of small businesses that they must satisfy by December 31, 2024.

Caution. Unlike the reporting requirements for foreign bank and financial accounts (FBAR), the CTA does not charge the IRS with responsibility for enforcement.[43] Thus, tax practitioners who prepare BOI forms on behalf of clients may be engaged in the practice of law, depending on how state statutes governing the practice of law are written. Practitioners should avoid such activities if they are not licensed to practice law in the governing state.

Note. For more information on the BOI reporting, see the 2023 *University of Illinois Federal Tax Workbook*, Chapter 10: Small Business Issues.

38. IRC §§408(p)(2)(C)(2)(iv) and 408(p)(2)(B)(iii).

39. IRC §408(p)(2)(E).

40. IRC §5336; *Beneficial Ownership Information*. Apr. 18, 2024. FinCEN. [www.fincen.gov/boi-faqs] Accessed on Aug. 1, 2024.

41. *Corporate Transparency Act,* §6402(2).

42. *Corporate Transparency Act*, §6402.

43. IRS Pub. 5569, *Report of Foreign Bank & Financial Accounts (FBAR) Accounts Reference Guide*, p.3 (2022).

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REPORTING COMPANIES AND INDIVIDUALS

The CTA imposes a filing requirement on **both** the small businesses that constitute the bulk of the reporting companies and on the individuals who must disclose their identities to the Financial Crimes Enforcement Network (FinCEN).

Companies

A reporting company is a corporation, LLC, or other entity created by **filing a document** with a secretary of state or similar office. The secretary of state may be one within any state, the District of Columbia, any Indian Tribe, or any commonwealth, territory, or possession of the United States.[44]

Organizations Exempt from Filing. The CTA exempts the following organizations from filing.

Exemption No.	Exemption Short Title
1	Securities reporting issuer
2	Governmental authority
3	Bank
4	Credit union
5	Depository institution holding company
6	Money services business
7	Broker or dealer in securities
8	Securities exchange or clearing agency
9	Other Exchange Act registered entity
10	Investment company or investment adviser
11	Venture capital fund adviser
12	Insurance company
13	State-licensed insurance producer
14	Commodity Exchange Act registered entity
15	Public accounting firm registered under the Sarbanes-Oxley Act of 2002 (15 USC §7212), §102[44])
16	Public utility
17	Financial market utility
18	Pooled investment vehicle
19	Tax-exempt entity if described in IRC §501(c) and exempt from tax under §501(a)[45]
20	Entity assisting a tax-exempt entity
21	Large operating company (having more than 20 employees)
22	Subsidiary of certain exempt entities
23	Inactive entity

A sole proprietorship does not need to file a BOI report unless it was **organized by filing a document** with their secretary of state.[47] Only filing a document for licensure or registering a fictitious “doing business as” (DBA) name does not require a sole proprietor to file a BOI report. However, the owner of a **single-member LLC** is required to file even if the LLC is a disregarded entity on their tax returns because the owner filed a document with their secretary of state to form the LLC.

44. 31 USC §5336(a)(12). See the *Federally Recognized Indian Tribe List Act of 1994*, PL 103-454, §102.

45. 31 USC §5336(a)(11)(B)(xv).

46. 31 USC §5336(a)(11)(B)(xix)(I).

47. *Is a sole proprietorship a reporting company?* Dec. 12, 2023. FinCEN. [www.fincen.gov/boi-faqs#C_6] Accessed on Jun. 25, 2024.

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Example 6. Lois owns and operates a tax practice that she organized as an S corporation by filing the necessary documents with her state's secretary of state and then the IRS. She is an enrolled agent who prepares tax returns for individuals and small businesses. Lois employs two individuals only during tax season. She must register with FinCEN to comply with the CTA.

Example 7. Marge operates a tax practice as a sole practitioner. Although she uses the DBA "Marge's Tax Service," she was not required to file any documents with her secretary of state. She employs 40 individuals throughout the year and another three during tax season. Marge does not have a requirement to file a BOI report because she never filed documents with her state's secretary of state, despite the fact that she has more than 20 employees.

Note. Entities employing **over 20 full-time employees** and more than **$5 million in gross receipts** for the previous year (including receipts for entities for which it owns or is owned by), and that have an operating presence at a **physical office located in the United States** fall under the large operating company exemption (exemption number 21 in the FinCEN list).[48]

Individuals

BOI reports must disclose the names and certain information about their beneficial owners. A beneficial owner meets either of the following criteria.[49]

1. Owns or controls 25% or more of the company's ownership interests
2. Exercises substantial control

The CTA broadly defines ownership interests and they can include forms of debt, equity options, or convertible securities.[50] Thus, an individual who has loaned money to a company but retains the right to exchange the debt for the company's equity may satisfy the second criterion in some cases.

Ownership is not required to exercise substantial control. Therefore, senior officers may be included among beneficial owners, regardless of whether they own company stock. Furthermore, BOI reports may disclose individuals who can appoint or remove senior officers, as this is an indication of substantial control.[51]

Company Applicants. Certain individuals may be required to report that they exercise substantial control of the business because they are involved in filing the business's documents. The guidelines specifically state that **individuals** must be listed, not legal entities. Company applicants fall into two categories.[52]

1. **Direct filers** who filed the document that created the corporation, LLC, or other business entity. BOI reports should identify these individuals within the corporation.
2. **Filers who direct or control the filing action** (i.e., primarily responsible for directing or controlling the filing of the creation or first registration document).

Observation. This requirement can put professionals who directly filed documents for a **former** client in a difficult situation. They are part of the business entity's filing requirement, yet they no longer have the client's consent to file documents.

48. *Are some companies exempt from the reporting requirement?* Apr. 18, 2024. FinCEN. [www.fincen.gov/boi-faqs#C_2] Accessed on Aug. 2, 2024.

49. 31 USC §5336(a)(3)(A).

50. *Small Entity Compliance Guide*, p. 25. Dec. 2023. FinCEN. [www.fincen.gov/sites/default/files/shared/BOI_Small_Compliance_Guide.v1.1-FINAL.pdf] Accessed on Jun. 25, 2024; *Reporting Deadline Looms — You May Not Be Prepared for The Corporate Transparency Act*. Polak, Andrew. Jun. 22, 2023. Rooney Law. [rooney.law/blog/reporting-deadline-looms-you-are-not-prepared-for-the-corporate-transparency-act/] Accessed on Jun. 25, 2024.

51. *Small Entity Compliance Guide*, p. 17. Dec. 2023. FinCEN. [www.fincen.gov/sites/default/files/shared/BOI_Small_Compliance_Guide.v1.1-FINAL.pdf] Accessed on Jun. 25, 2024.

52. Ibid., pp. 34–35.

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INFORMATION USAGE AND REPORTING

The CTA contains extensive requirements on the information that the reporting company must disclose.

Information Disclosure[53]

Federal agencies may retrieve BOI if they are responsible for national security or intelligence. The CTA also provides state and local law enforcement agencies access to the information. Financial institutions may also retrieve and use this information to fulfill their customer due diligence responsibilities.[54] Individuals who improperly disclose this information face potential civil and criminal penalties.[55]

Required Information

Reporting companies must include the following information in their BOI filings.[56]

- Full legal name
- Trade name or assumed name
- Complete address for its principal place of business in the United States
- State, tribal, or foreign jurisdiction under whose laws it was formed
- If formed originally under foreign jurisdiction, it must also list the state or tribal jurisdiction in which they first registered the entity in the United States
- Employer identification number (EIN)

An individual that is filing a BOI report must include the following information about any beneficial owner or company applicant.[57]

- Full legal name
- Date of birth
- Complete address information
  - Residential street address for beneficial owners
  - Business street address for company applicants
- Unique identifying number and issuing agency for one of the following:
  - U.S. passport
  - State driver's license
  - Identification document issued by a state or local government
  - Non-U.S. passport, but only if none of the previous documents exist

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53. 31 USC §5336(c)(2).

54. *William M. (Mac) Thornberry National Defense Authorization Act for Fiscal Year 2021*, PL 116-283, §6402(6)(B).

55. 31 USC §§5336(h)(2) and (3).

56. *Small Entity Compliance Guide*, p. 38. Dec. 2023. FinCEN. [www.fincen.gov/sites/default/files/shared/BOI_Small_Compliance_Guide.v1.1-FINAL.pdf] Accessed on Jun. 25, 2024.

57. Ibid.

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DEADLINES AND THE PENALTIES FOR NONCOMPLIANCE

BOI reports for entities formed on or after January 1, 2024, are due within 90 days of the entity's formation or a change in beneficial ownership of an existing company. As of January 1, 2025, these reports are required within 30 days. Reports for entities formed before January 1, 2024, are due by January 1, 2025.

> **Caution.** Practitioners should be aware that the above deadlines could change, as cases on the matter make their way through the courts. The American Institute of Certified Public Accountants and other state CPA societies have requested that enforcement of BOI reporting requirements be suspended in the meantime.

Individuals who willfully do not report BOI are subject to a $500 penalty for each **day** the required reports have not been filed. A maximum fine of $10,000 is possible. This individual is also subject to two years of imprisonment. The same penalties apply to individuals providing false or fraudulent information. For example, a fake identification card may constitute fraudulent information.

Practitioner Planning Tip

Tax practitioners should decide whether they plan to assist clients with BOI reporting. They may want to consult with their attorney and their errors and omissions (E&O) insurance company before deciding.

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FORM 7206

The IRS introduced Form 7206, *Self-Employed Health Insurance Deduction*, for taxpayers to calculate their self-employed health insurance deduction, starting with 2023 tax returns. Self-employed taxpayers can deduct health insurance premiums they paid up to their net earned income from self-employment.[58]

They claim the deduction as an adjustment to income on Form 1040, Schedule 1. The deduction does not appear on the originating schedule that reports the self-employment (SE) income, such as Schedule C, *Profit or Loss From Business*, Schedule F, *Profit or Loss From Farming*, or Schedule E, *Supplemental Income and Loss (From rental real estate, royalties, partnerships, S corporations, estates, trusts, REMICs, etc.)*. The deduction includes the costs incurred for accident and health insurance covering themselves, their spouse, dependents, and any child under the age of 27.[59]

The following self-employed taxpayers can claim the SE health insurance deduction.[60]

- Self-employed taxpayers reporting income on Schedules C or F
- Partners receiving SE earnings from a partnership
- Actively participating members in an LLC that elected partnership tax treatment
- Employees of an S corporation who own 2% or more of the corporation's stock

Historically, taxpayers have calculated the SE health insurance deduction using Worksheet 6-A, *Self-Employed Health Insurance Deduction Worksheet*, in IRS Pub. 535, *Business Expenses*.[61] The IRS clarified that beginning with tax year 2023, Worksheet 6A is replaced by Form 7206, and that IRS Pub. 535 is no longer being revised for years following tax year 2022.[62]

FILING REQUIREMENTS

Taxpayers claiming the SE health insurance deduction must prepare and file Form 7206 if any of the following apply.[63]

- The taxpayer has more than one source of SE income
- The taxpayer files Form 2555, *Foreign Earned Income*
- The taxpayer's insurance expenses for the deduction include long-term care insurance

Taxpayers who are not required to file Form 7206 use the SE health insurance deduction worksheet in the Form 1040 instructions to calculate their deduction.[64] However, taxpayers who acquired health insurance through the Marketplace and claim the premium tax credit must use Worksheet P, *Self-Employed Health Insurance Deduction for Nonspecified Premiums*, in IRS Pub. 974, *Premium Tax Credit (PTC)*, to calculate their SE health insurance deduction.[65]

The deduction is reported on line 17 of Form 1040, Schedule 1.

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58. See Form 7206.
59. IRC §162(l).
60. Instructions for Form 7206.
61. IRS Pub. 535, *Business Expenses* (2022).
62. *Publication 535 is no longer being revised.* Jan. 22, 2024. IRS. [www.irs.gov/forms-pubs/publication-535-is-no-longer-being-revised] Accessed on Jul. 12, 2024.
63. Instructions for Form 7206.
64. Instructions for Form 1040.
65. Instructions for Form 7206.

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Example 8. David Miller is a 35-year-old, single taxpayer in 2023. He earns $40,000 of net income from his Schedule C business and $10,000 of net income from farming activities, which he reports on Schedule F. Additionally, David is a 15% shareholder in Gurdlinger Industries, Inc. He receives a Schedule K-1 (Form 1120-S), *Shareholder's Share of Income, Deductions, Credits, etc.*, from Gurdlinger reporting $35,000 of ordinary business income, as well as a Form W-2*,* reporting $15,000 in wages (boxes 1, 3, and 5).

In 2023, David pays $18,000 in health insurance premiums and $2,500 in long-term care insurance premiums. David did not obtain insurance through the Marketplace. His insurance plan is established under his Schedule C business. David's Forms W-2 and 7206 follow.

a Employee's social security number: ***-**-6372	OMB No. 1545-0008	Safe, accurate, FAST! Use IRS e-file	Visit the IRS website at www.irs.gov/efile
b Employer identification number (EIN): 37-9182736		1 Wages, tips, other compensation: 15000.00	2 Federal income tax withheld: 1000.00
c Employer's name, address, and ZIP code: Gurdlinger Industries, Inc. 123 Main St. Denver, CO 80014		3 Social security wages: 15000.00	4 Social security tax withheld: 930.00
		5 Medicare wages and tips: 15000.00	6 Medicare tax withheld: 217.50
		7 Social security tips	8 Allocated tips
d Control number		9	10 Dependent care benefits
e Employee's first name and initial: David	Last name: Miller	Suff. 11 Nonqualified plans	12a See instructions for box 12 Code
201 N Front St. Cheyenne, WY 82001		13 Statutory employee ☐ Retirement plan ☐ Third-party sick pay ☐	12b Code
		14 Other	12c Code
f Employee's address and ZIP code			12d Code

15 State	Employer's state ID number	16 State wages, tips, etc.	17 State income tax	18 Local wages, tips, etc.	19 Local income tax	20 Locality name

Form **W-2** **Wage and Tax Statement** 2023 — Department of the Treasury—Internal Revenue Service

Copy B—To Be Filed With Employee's FEDERAL Tax Return.
This information is being furnished to the Internal Revenue Service.

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For Example 8

Form **7206** Department of the Treasury Internal Revenue Service

Self-Employed Health Insurance Deduction

Attach to Form 1040, 1040-SR, or 1040-NR.
Go to *www.irs.gov/Form7206* for instructions and the latest information.

OMB No. 1545-0074 | **2023** | Attachment Sequence No. **206**

Name(s) shown on return	Your taxpayer identification number
David Miller	**xxx-xx-6372**

Note: Use a separate Form 7206 for each trade or business under which an insurance plan is established.

1	Enter the total amount paid in 2023 for health insurance coverage established under your business (or the S corporation in which you were a more-than-2% shareholder) for 2023 for you, your spouse, and your dependents. But **don't** include the following. See instructions	1	**18,000**
	• Amounts for any month you were eligible to participate in a health plan subsidized by your employer or your spouse's employer or the employer of either your dependent or your child who was under the age of 27 at the end of 2023. • Any amounts paid, not to exceed $3,000, from retirement plan distributions that were **nontaxable** because you are a retired public safety officer. See instructions. • Any payments for qualified long-term care insurance (see line 2).		
2	For coverage under a qualified long-term care insurance contract, enter for each person covered the **smaller** of (a) or (b). **(a)** Total payments made for that person during the year. **(b)** The amount shown below. Use the person's age at the end of the tax year. $480— if that person is age 40 or younger $890— if age 41 to 50 $1,790— if age 51 to 60 $4,770— if age 61 to 70 $5,960— if age 71 or older **Note:** The amount of long-term care premiums that can be included as a medical expense is limited by the person's age. **Don't** include payments for any month you were eligible to participate in a long-term care insurance plan subsidized by your employer or your spouse's employer, or the employer of either your dependent or your child who was under the age of 27 at the end of 2023. If more than one person is covered, figure separately the amount to enter for each person. Then enter the total of those amounts	2	**480**
3	Add lines 1 and 2	3	**18,480**
4	Enter your net profit* and any other earned income** from the trade or business under which the insurance plan is established. Don't include Conservation Reserve Program payments exempt from self-employment tax. If the business is an S corporation, skip to line 11	4	**40,000**
5	Enter the total of all net profits* from Schedule C (Form 1040), line 31; Schedule F (Form 1040), line 34; or Schedule K-1 (Form 1065), box 14, code A, plus any other income allocable to the profitable businesses. Don't include Conservation Reserve Program payments exempt from self-employment tax. See the Instructions for Schedule SE (Form 1040). **Don't** include any net losses shown on these schedules	5	**50,000**
6	Divide line 4 by line 5	6	**0.80**
7	Multiply Schedule 1 (Form 1040), line 15, deductible part of self-employment tax, by the percentage on line 6	7	**2,826**
8	Subtract line 7 from line 4	8	**37,174**
9	Enter the amount, if any, from Schedule 1 (Form 1040), line 16, self-employed SEP, SIMPLE, and qualified plans, attributable to the same trade or business in which the insurance plan is established	9	**0**
10	Subtract line 9 from line 8	10	**37,174**
11	Enter your Medicare wages (box 5 of Form W-2) from an S corporation in which you are a more-than-2% shareholder and in which the insurance plan is established	11	
12	Enter any amount from Form 2555, line 45, attributable to the amount entered on line 4 or 11 above	12	
13	Subtract line 12 from line 10 or 11, whichever applies	13	**37,174**
14	**Self-employed health insurance deduction.** Enter the **smaller** of line 3 or line 13 here and on Schedule 1 (Form 1040), line 17. **Don't** include this amount when figuring any medical expense deduction on Schedule A (Form 1040)	14	**18,480**

* If you used either optional method to figure your net earnings from self-employment from any business, don't enter your net profit from the business. Instead, enter the amount attributable to that business from Schedule SE (Form 1040), Part I, line 4b.

** **Earned income** includes net earnings and gains from the sale, transfer, or licensing of property you created. However, it doesn't include capital gain income.

For Privacy Act and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 56399C Form **7206** (2023)

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Because David is under 40 years of age, he can potentially deduct only $480 of his $2,500 long-term care insurance premiums in 2023 under the long-term care premium limitations of IRC §213(d)(10). Therefore, the total premiums David may potentially deduct before any SE income limitations is $18,480 ($18,000 health insurance premiums + $480 allowed long-term care insurance premium deductions).

Next, David calculates the SE income limitation to determine the maximum amount of premiums he can deduct. David's non-S corporation SE income is $50,000 ($40,000 Schedule C income + $10,000 Schedule F income). Therefore, 80% of David's non-S corporation SE income is derived from his Schedule C business ($40,000 Schedule C income ÷ $50,000 total non-S corporation SE income).

David's deduction for half of the SE tax is $3,533, as calculated on his prepared Schedule SE, *Self-Employment Tax* (not shown). Of this amount, $2,826 is allocable to his Schedule C business ($3,533 SE tax deduction × 80% allocation to Schedule C). With no SEP, SIMPLE, or qualified contributions in 2023, nor any foreign income earned from his Schedule C business, David calculates his SE income limitation as $37,174 ($40,000 Schedule C income − $2,826 SE deduction attributed to Schedule C). Therefore, David can deduct $18,480 of the premiums he paid in 2023 on his Form 1040 for the year.

Example 9. Use the same facts as **Example 8,** except David's health insurance plan and long-term care plan are established under Gurdlinger Industries. Long-term care coverage is paid through Gurdlinger's flexible spending arrangement. Pursuant to IRS Notice 2008-1, these premiums are added to only Form W-2 box 1, not subject to withholding. David's Forms W-2 and 7206 follow.

a Employee's social security number: ***-**-6372	OMB No. 1545-0008	Safe, accurate, FAST! Use IRS e-file	Visit the IRS website at *www.irs.gov/efile*
b Employer identification number (EIN): 37-9182736		**1** Wages, tips, other compensation: 35500.00	**2** Federal income tax withheld: 1000.00
c Employer's name, address, and ZIP code: Gurdlinger Industries, Inc. 123 Main St. Denver, CO 80014		**3** Social security wages: 15000.00	**4** Social security tax withheld: 930.00
		5 Medicare wages and tips: 15000.00	**6** Medicare tax withheld: 217.50
		7 Social security tips	**8** Allocated tips
d Control number		**9**	**10** Dependent care benefits
e Employee's first name and initial: David / Last name: Miller / Suff. 201 N Front St. Cheyenne, WY 82001		**11** Nonqualified plans	**12a** See instructions for box 12 (Code)
		13 Statutory employee ☐ Retirement plan ☐ Third-party sick pay ☐	**12b** Code
		14 Other: SCorp MP 20500.00	**12c** Code
f Employee's address and ZIP code			**12d** Code

15 State	Employer's state ID number	16 State wages, tips, etc.	17 State income tax	18 Local wages, tips, etc.	19 Local income tax	20 Locality name

Form **W-2** Wage and Tax Statement **2023** Department of the Treasury—Internal Revenue Service

Copy B—To Be Filed With Employee's FEDERAL Tax Return.
This information is being furnished to the Internal Revenue Service.

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For Example 9

Form **7206**

Department of the Treasury
Internal Revenue Service

Self-Employed Health Insurance Deduction

Attach to Form 1040, 1040-SR, or 1040-NR.
Go to *www.irs.gov/Form7206* for instructions and the latest information.

OMB No. 1545-0074
2023
Attachment Sequence No. **206**

Name(s) shown on return	Your taxpayer identification number
David Miller	***-**-6372

Note: Use a separate Form 7206 for each trade or business under which an insurance plan is established.

		Line	Amount
1	Enter the total amount paid in 2023 for health insurance coverage established under your business (or the S corporation in which you were a more-than-2% shareholder) for 2023 for you, your spouse, and your dependents. But **don't** include the following. See instructions	1	18,000
	• Amounts for any month you were eligible to participate in a health plan subsidized by your employer or your spouse's employer or the employer of either your dependent or your child who was under the age of 27 at the end of 2023. • Any amounts paid, not to exceed $3,000, from retirement plan distributions that were **nontaxable** because you are a retired public safety officer. See instructions. • Any payments for qualified long-term care insurance (see line 2).		
2	For coverage under a qualified long-term care insurance contract, enter for each person covered the **smaller** of (a) or (b). **(a)** Total payments made for that person during the year. **(b)** The amount shown below. Use the person's age at the end of the tax year. $480— if that person is age 40 or younger $890— if age 41 to 50 $1,790— if age 51 to 60 $4,770— if age 61 to 70 $5,960— if age 71 or older **Note:** The amount of long-term care premiums that can be included as a medical expense is limited by the person's age. **Don't** include payments for any month you were eligible to participate in a long-term care insurance plan subsidized by your employer or your spouse's employer, or the employer of either your dependent or your child who was under the age of 27 at the end of 2023. If more than one person is covered, figure separately the amount to enter for each person. Then enter the total of those amounts	2	480
3	Add lines 1 and 2	3	18,480
4	Enter your net profit* and any other earned income** from the trade or business under which the insurance plan is established. Don't include Conservation Reserve Program payments exempt from self-employment tax. If the business is an S corporation, skip to line 11	4	
5	Enter the total of all net profits* from Schedule C (Form 1040), line 31; Schedule F (Form 1040), line 34; or Schedule K-1 (Form 1065), box 14, code A, plus any other income allocable to the profitable businesses. Don't include Conservation Reserve Program payments exempt from self-employment tax. See the Instructions for Schedule SE (Form 1040). **Don't** include any net losses shown on these schedules	5	
6	Divide line 4 by line 5	6	
7	Multiply Schedule 1 (Form 1040), line 15, deductible part of self-employment tax, by the percentage on line 6	7	
8	Subtract line 7 from line 4	8	
9	Enter the amount, if any, from Schedule 1 (Form 1040), line 16, self-employed SEP, SIMPLE, and qualified plans, attributable to the same trade or business in which the insurance plan is established	9	
10	Subtract line 9 from line 8	10	
11	Enter your Medicare wages (box 5 of Form W-2) from an S corporation in which you are a more-than-2% shareholder and in which the insurance plan is established	11	15,000
12	Enter any amount from Form 2555, line 45, attributable to the amount entered on line 4 or 11 above	12	0
13	Subtract line 12 from line 10 or 11, whichever applies	13	15,000
14	**Self-employed health insurance deduction.** Enter the **smaller** of line 3 or line 13 here and on Schedule 1 (Form 1040), line 17. **Don't** include this amount when figuring any medical expense deduction on Schedule A (Form 1040)	14	15,000

* If you used either optional method to figure your net earnings from self-employment from any business, don't enter your net profit from the business. Instead, enter the amount attributable to that business from Schedule SE (Form 1040), Part I, line 4b.

** **Earned income** includes net earnings and gains from the sale, transfer, or licensing of property you created. However, it doesn't include capital gain income.

For Privacy Act and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 56399C Form **7206** (2023)

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Because the business for which the health insurance plan is established is an S corporation, David's SE income limitation is his Medicare wages reported on the Form W-2 he received from Gurdlinger, less any foreign earned income allocable to income earned from the S corporation. Therefore, David's SE income limitation is $15,000 ($15,000 Medicare wages from − $0 foreign earned income). David may deduct only $15,000 as a SE health insurance deduction on his Form 1040 for 2023. The remaining $3,480 may be deductible on Schedule A (Form 1040), *Itemized Deductions,* subject to limitations.

If David had established the long-term care plan through his Schedule C business, then he would have prepared a second Form 7206 and the entire $480 would have been deductible.

Practitioner Planning Tip

As the prior example illustrates, taxpayers with multiple sources of SE income should try to establish health insurance plans under the business with the higher expected annual income or Medicare wages. By doing this, taxpayers may be able to increase the limit on their SE health insurance deduction.

VARIOUS ENERGY CREDITS

CLEAN VEHICLE TAX CREDITS[66]

There are two tax credits available for **new clean energy** vehicles purchased or leased for business use primarily in the United States. **Used vehicles do not qualify** for these credits.

- The **clean vehicle credit** under IRC §30D (sole proprietorships and other business entities)
- The **commercial clean vehicle credit** under IRC §45W (businesses and tax-exempt organizations)

Basis in the assets are reduced by the credits allowed under these provisions.[67] To the extent the vehicle is used for business, the credits are subject to general business credits provisions calculated on Form 3800, *General Business Credit*. The taxpayer must file Form 8936, *Clean Vehicle Credits,* with their tax return for the year they place the vehicle in service to claim these credits.

> **Note.** Schedule A (Form 8936), *Clean Vehicle Credit Amount*, is used to report specific vehicle information for each qualified vehicle purchased during the year. Consolidated information from each Schedule A is carried to Form 8936. Practitioners are advised to review the instructions carefully to ensure that credit limitations are applied properly.

66. *Clean vehicle tax credits.* May 29, 2024. IRS. [www.irs.gov/clean-vehicle-tax-credits] Accessed on Aug. 6, 2024.

67. IRC §§30D(f)(1) and 45W(d)(1).

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IRC §30D Clean Vehicle Credit

At the time of sale, the seller must give the purchaser information about the vehicle's qualifications, including the maximum amount of credit applicable to the vehicle.[68] Sellers must also report the same information to the IRS. If the seller fails to do so, the vehicle will not be eligible for the credit. Accordingly, the seller is also required to provide a copy of the confirmation the IRS provides when it accepts the time-of-sale report.[69] Although the IRS permits taxpayers to file Form 8936 without having a copy of the time-of-sale report, the IRS will reject the return if the vehicle identification number (VIN) on Form 8936 does not match its database.

> **Note.** For information on specific vehicle requirements, see IRS Pub. 5866, *New Clean Vehicle Tax Credit Checklist*. For more information on seller reporting requirements, see IRS Pub. 5905, *Information for Consumers Purchasing a New or Used Clean Vehicle*.

To qualify for the credit, the taxpayer's modified adjusted gross income (AGI) may not exceed:

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

Taxpayers may use their modified AGI from the year they take delivery of the vehicle **or the year before,** whichever is less, even if their modified AGI exceeds the threshold in one of those years. The credit is nonrefundable and does not carry forward.

For vehicles placed in service after April 17, 2023, the amount of the credit has two components based upon certain energy standards. The seller is responsible for determining whether the vehicle qualifies for a maximum credit of $3,750 or $7,500. This information must be included with the time-of-sale report.

Vehicles placed in service by S corporations and partnerships are reported on Form 8936 by the passthrough entity. The credit is allocated among the shareholders or partners on the applicable Schedule K-1.[70] For partnerships, the amount of the credit is reported on Schedule K-1 (Form 1065), *Partner's Share of Income, Deductions, Credits, etc.,* box 15 with the code AY.[71] For S corporations, the amount of the credit is reported on Schedule K-1 (Form 1120-S), box 13 with the code AY.[72] The partner or shareholder then claims their portion of the credit on their individual tax return, subject to the modified AGI thresholds.[73]

> **Note.** For more information on Form 8936, see the 2024 *University of Illinois Federal Tax Workbook,* Chapter 13: New Developments.

9

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68. *Credits for new clean vehicles purchased in 2023 or after.* Aug. 5, 2024. IRS. [www.irs.gov/credits-deductions/credits-for-new-clean-vehicles-purchased-in-2023-or-after] Accessed on Aug. 6, 2024.

69. *How to claim a clean vehicle tax credit.* Jun. 6, 2024. IRS. [www.irs.gov/credits-deductions/how-to-claim-a-clean-vehicle-tax-credit] Accessed on Aug. 6, 2024.

70. Treas. Reg. §1.30D-4(c)(2).

71. Instructions for Form 8936.

72. Ibid.

73. *Topic B — Frequently asked questions about income and price limitations for the New Clean Vehicle Credit — Q2. How do the income thresholds apply to my partnership's purchase and use of a new clean vehicle?* Mar. 31, 2023. IRS. [www.irs.gov/newsroom/topic-b-frequently-asked-questions-about-income-and-price-limitations-for-the-new-clean-vehicle-credit] Accessed on Aug. 20, 2024.

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IRC §45W Commercial Clean Vehicle Credit[74]

Businesses that buy a qualified commercial clean vehicle may qualify for a clean vehicle tax credit of up to $40,000 under §45W. The vehicle must qualify as a depreciable business asset and meet certain battery capacities. The credit is nonrefundable, but it can be carried forward as a general business credit. Form 8936 is used to calculate the applicable credit.

The credit is limited to the **smallest** of the following three amounts.

1. An amount based on the gross vehicle weight rating (GVWR) of the vehicle.
   a. **$7,500** for vehicles with a GVWR of less than 14,000 pounds (typically cars, vans, trucks, and similar passenger-sized vehicles)
   b. **$40,000** for vehicles with a GVWR of 14,000 pounds or more (typically larger vehicles like school buses and semi-trucks)
2. The applicable percentage of the taxpayer's basis in the vehicle based on engine type:
   a. **30% of basis** for a vehicle that **is not powered** by a gasoline or diesel internal combustion engine, such as an electric vehicle (EV) or fuel cell electric vehicle (FCEV).
   b. **15% of basis** for a vehicle that **is powered** (even partially) by a gasoline or diesel internal combustion engine, such as a plug-in-hybrid electric vehicles (PHEV).
3. The incremental cost of the vehicle as determined by the Department of Energy for the appropriate class of vehicle. For 2024, these costs are:
   a. **$7,000** for compact PHEVs with a GVWR of less than 14,000 pounds
   b. **$7,500** for all street electric vehicles, **other** than compact car PHEVs, with a GVWR of less than 14,000 pounds
   c. **$40,000** for all other vehicles with a GVWR of **14,000 pounds or more**

PHEVs with GVWR under 14,000 pounds must have a battery capacity of at least 7 kilowatt hours (kWh) to qualify for the credit. Those over 14,000 pounds GVWR must have a battery capacity of at least 15 kWh. EVs and FCEVs are not subject to battery capacity limitations.

IRC §179D COMMERCIAL BUILDINGS ENERGY-EFFICIENCY TAX DEDUCTION

IRC §179D allows a tax deduction for energy-efficient commercial building property (EECBP) or energy-efficient commercial building retrofit property (EEBRP) placed in service during the year. The deduction is available to both business owners and designers and incentivizes businesses to focus on environmental sustainability and energy efficiency efforts. The deduction was first available as of January 1, 2006, enacted by the Energy Policy Act of 2005, and was later amended and made permanent for tax years beginning after December 31, 2020, with the Consolidated Appropriations Act of 2021.[75] It was expanded in August 2022 with the Inflation Reduction Act of 2022 for which changes apply to qualifying property placed in service after December 31, 2022.[76]

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74. *Commercial Clean Vehicle Credit.* Aug. 5, 2024. [www.irs.gov/credits-deductions/commercial-clean-vehicle-credit] Accessed on Aug. 6, 2024.

75. *Energy Policy Act of 2005,* PL 109-58; *Consolidated Appropriations Act of 2021,* PL 116-260, §102(c)(2).

76. *Inflation Reduction Act of 2022*, PL 117-169, §13303.

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Practitioner Planning Tip

Prior to 2020, §179D was only temporarily extended for a few periods of time, making it more difficult for businesses to plan to utilize the deduction. However, since §179D was made permanent in 2020,[77] it is easier for businesses to plan ahead to qualify for the deduction, which can be a discussion point for clients with commercial buildings.

Additionally, some localities are starting to require commercial buildings meet certain emission standards or face potential penalties.[78] This presents a good planning opportunity for clients in these jurisdictions to ensure they qualify for the §179D deduction.

Although this appears to be a significant tax savings opportunity, there may be adverse tax consequences upon future disposition. The election under §179D converts IRC §1250 property to IRC §1245 (a)(3)(C) property.[79]

Eligibility[80]

Prior to the new rules enacted in 2022, the §179D deduction was available to owners of qualified commercial buildings as well as designers of energy property that were installed in government-owned buildings. Under §179D(d)(3), tax-exempt entities may have been allowed to allocate their deduction to the property designer. With the changes to the deduction, the list of tax-exempt entities that can allocate their deduction to designers expanded. Beginning January 1, 2023, the deduction is now available to the following.[81]

- Owners of qualified commercial buildings.
- Designers of EECBP/EEBRP installed in buildings owned by specified tax-exempt entities, including certain government entities, Indian tribal governments, Alaska Native Corporations, and other tax-exempt organizations. The deduction for designers is allocated from the entity.

Qualified Commercial Buildings[82]

To qualify for the deduction, EECBP must be depreciable or amortizable property installed on or in a building located in the United States and meet the standards of the specified Reference Standard 90.1 of the American Society of Heating, Refrigerating, and Air Conditioning Engineers (ASHRAE) and the Illuminating Engineering Society of North America. In addition, the property must also be installed as part of any of the following.

- Interior lighting systems
- Heating, cooling, ventilation, and hot water systems
- Building envelope

77. *Consolidated Appropriations Act of 2021,* PL 116-260, §102(c)(2).

78. New York City Local Law 97.

79. IRC §1245(a)(2)(C).

80. IRC §179D.

81. *Inflation Reduction Act of 2022*, PL 117-169, §13303; *Energy efficient commercial buildings deduction.* Jun. 6, 2024. IRS. [www.irs.gov/credits-deductions/energy-efficient-commercial-buildings-deduction#building] Accessed on Jun. 27, 2024.

82. IRC §179D(c).

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The property must be certified as installed as part of a plan to reduce the total annual energy and power costs for the requisite system by 25% or more when compared to a referential building that meets the minimal criteria of Reference Standard 90.1.

EEBRP must be installed in a qualified building located in the United States and originally placed in service for at least five years prior to establishing a qualified retrofit plan for the building. It must also be depreciable or amortizable property and certified as meeting certain energy-saving criteria. EEBRP must be installed on or in a qualified building as part of any of the following.[83]

- Interior lighting systems
- Heating, cooling, ventilation, and hot water systems
- Building envelope

Calculating the Deduction[84]

With the changes to the deduction made with the Inflation Reduction Act of 2022, the maximum deduction limit is different for property placed in service before January 1, 2023, and property placed in service after this date.

Deduction for 2023 and After. For property placed in service on or after January 1, 2023, the deduction for EECBP is the lesser of the following.

- The cost of the installed property or
- The savings per square foot, calculated as:
  - $0.50 per square foot for a building with 25% energy saving, indexed for inflation ($0.57 for 2024)[85]
  - Plus $0.02 per square foot for each percentage point of energy savings above 25%
  - Up to a maximum of $1.00 per square foot for a building with 50% energy savings, indexed for inflation ($1.13 for 2024)[86]

The maximum deduction **must be reduced by expenses under §179D** deducted in the prior three years (or four years for an allocated deduction) before the deduction for the current year is calculated.

83. IRC §179D(f).
84. IRC §179D(b).
85. Rev. Proc. 2023-34, 2023-48 IRB 1287.
86. Ibid.

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Additionally, starting in 2023, if local prevailing wages are paid and apprenticeship criteria are met, the maximum deduction amount increases to five times the savings per square foot. The maximum deductions amounts are shown next from the instructions for Form 7205, *Energy Efficient Commercial Buildings Deduction*.

Tax Year	Maximum Full Amount Allowed	Maximum Partial Amount Allowed
All years beginning before January 1, 2021	$1.80	$0.60
For tax years beginning on or after January 1, 2021	$1.82	$0.61
For tax years beginning on or after January 1, 2022	$1.88	$0.63
	Maximum Amount Allowed—Line 1(d) checked	**Maximum Amount Allowed—Line 1(d) not checked**
For tax years beginning on or after January 1, 2023	$5.36	$1.07
For tax years beginning on or after January 1, 2024	$5.65	$1.13

Note. Taxpayers are exempt from the local prevailing wage and apprenticeship requirements if construction began before January 30, 2023.[87]

Deduction for 2022 and Before. For properties placed in service before January 1, 2023, the maximum deduction is $1.80 per square foot (indexed for inflation) for buildings with 50% energy savings. A partial deduction is available for certain property. Additionally, all expenses deducted in previous years reduce the maximum deduction before calculating the current year's deduction.

Basis Reduction.[88] If a deduction is allowed for any energy efficient commercial building property, the basis of such property must be reduced by the allowed deduction.

ASHRAE Standards

The benchmark by which energy savings are measured are the latest ASHRAE standards affirmed at least four years before the property is placed in service. Accordingly, buildings beginning construction on or after January 1, 2023, with energy property placed in service on or after January 1, 2027, will be measured against ASHRAE Standard 90.1-2019, and buildings that began construction before January 1, 2023, or are placed in service before January 1, 2027, will use ASHRAE Standard 90.1-2007.[89] The IRS announced ASHRAE Standard 90.1-2022 will serve as the applicable reference standard for EECBP that began construction after December 31, 2022, and is placed in service after December 31, 2028.[90]

87. IRS Notice 2022-61, 2022-52 IRB 560.
88. IRC §179D(e).
89. Ibid.
90. IRS Ann. 2024-24, 2024-24 IRB 1675.

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Reporting

The deduction is reported on Form 7205, which was revised in December 2023 to account for the changes made by the Inflation Reduction Act of 2022 for property placed in service after December 31, 2022. For properties placed in service prior to December 31, 2022, the previous version of Form 7205 (the December 2022 version) should be used to report the deduction.[91]

The deduction is then reported on the taxpayer's appropriate business return as follows.

- Form 1040, *U.S. Individual Income Tax Return,* Schedule C, line 27b
- Form 1065, *U.S. Return of Partnership Income*, line 20
- Form 1120, line 25
- Form 1120-S, line 19

Practitioner Planning Tip

Taxpayers eligible to claim the §179D deduction must acquire a certification from a qualified licensed engineer or contractor. Information from the certification is included on Form 7205, part III, *Certification Information for Each Property Listed in Part I*. The certification should be retained for audit purposes.[92]

91. 2023 Instructions for Form 7205.

92. Ibid.

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Example 10. Sun Corporation constructed and placed in service an 80,000-square-foot office building with EECBP on July 15, 2023. The cost of the energy-efficient systems totaled $400,000 and resulted in 35% energy cost savings when compared to a reference building that meets the minimum requirements of ASHRAE 90.1. The prevailing wage and apprenticeship requirements for this project were met.

Using the following worksheet for Form 7205, Sun calculates a $3.78 deduction per square foot. The square foot rate ($3.78) is multiplied by the total square **footage** of the building (80,000) to calculate the potential §179D deduction of $302,400.

Worksheet for Form 7205, Line 1, Column (f) ***(Complete for each building)***

Keep for Your Records

Line	Instruction		
1.	Enter the percentage from Part I, line 1(c)		1. **35%**
2a.	If the % is less than 25%, STOP; you cannot claim the deduction for this building. If the % is 25% or greater, enter the percentage as a decimal, rounded to two decimal places (e.g. 26.22% enter as “0.26”)	2a. **.35**	
2b.	Subtract 0.25 from line 2a and enter the result here	2b. **.10**	
2c.	Multiply line 2b by 2	2c. **.20**	
2d.	Add 0.54 to line 2c and enter the result as a dollar amount (e.g. 1.04, enter as $1.04)	2d. **.74**	
3.	If the amount on line 2d is greater than $1.07, enter $1.07. Otherwise, enter the amount from line 2d		3. **.74**
4a.	If the box on Form 7205, line 1, column (d), is **checked**, enter the amount from line 2b of this worksheet here. If the box on Form 7205, line 1, column (d), is **not checked**, skip to line 5 and enter the amount from line 3 of this worksheet on line 5	4a. **.10**	
4b.	Multiply line 4a by 11	4b. **1.10**	
4c.	Add 2.68 to line 4b and enter the result as a dollar amount (e.g. 5.36, enter as $5.36)	4c. **3.78**	
4d.	If the amount on line 4c is greater than $5.36, enter $5.36. Otherwise, enter the amount from line 4c	4d. **3.78**	
5.	If the box on Form 7205, line 1, column (d), is **checked**, enter the amount from line 4d of this worksheet here. If the box on Form 7205, line 1, column (d), is **not checked**, enter the amount from line 3 of this worksheet here. Also enter the amount from line 5 on Form 7205, line 1, column (f)		5. **3.78**

Sun did not claim a deduction in a prior year and the deduction per square foot is less than the maximum amount per square foot allowed for 2023 ($5.36). Therefore, Sun does not need to make any adjustments to the current potential deduction.

The total cost of placing the EECBP in service ($400,000) is then compared to the potential deduction amount ($302,400). The balance of $97,600 ($400,000 – $302,400) is subject to depreciation as 39-year property. The lesser of the total cost and potential deduction amount ($302,400) is the total 2023 §179D deduction for the building owner. Sun’s Form 7205 follows.

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For Example 10

Form **7205** (Rev. December 2023) Department of the Treasury Internal Revenue Service

Energy Efficient Commercial Buildings Deduction

Attach to your tax return.
Go to *www.irs.gov/Form7205* for instructions and the latest information.

OMB No. 1545-2004

Name(s) shown on return	Identifying number
Sun Corporation	21-5436789

Claiming deduction as (check one): ☒ Building owner ☐ Designer of energy efficient property (EEP)

Part I Building and EEP Information (see instructions)

1	(a) Address of building	(b) Date EEP placed in service (see instructions)	(c) Energy efficient commercial building property (EECBP) system computed energy savings percentage, or energy efficient building retrofit property (EEBRP) energy use intensity reduction	(d) Check if Increased Deduction Amount criteria are met (see instructions)	(e) Check if EEBRP was installed under a Qualified Retrofit Plan	(f) Potential amount per square foot	(g) Building square footage	(h) Potential section 179D deduction amount (multiply column 1(f) by column 1(g))
A	123 Main Street New York, NY 10022	7/15/23	35%	☒	☐	3.78	90,000	302,400
B				☐	☐			
C				☐	☐			
D				☐	☐			

Part II Computation of Energy Efficient Commercial Buildings Deduction Amount (see instructions)

2	(a) Total per square foot amount claimed in prior years (see instructions)	(b) Subtract column 2(a) from the maximum amount allowed (see instructions)	(c) Check if the amount in column 2(b) is greater than or equal to column 1(f)	(d) If column 2(c) is checked, enter amount from column 1(h), skip column 2(e) and column 2(f) and go to column 2(g)	(e) Check if the amount from column 2(b) is less than the amount in column 1(f)	(f) If column 2(e) is checked, multiply column 2(b) by column 1(g)
A	0	5.36	☒	302,400	☐	
B			☐		☐	
C			☐		☐	
D			☐		☐	

	(g) Cost of EEP placed in service during the tax year (see instructions if building ownership percentage is less than 100%)	(h) Enter the greater of column 2(d) or column 2(f) (see instructions if building ownership percentage is less than 100%)	(i) Enter the lesser of column 2(g) or column 2(h)	(j) Designers enter the amount of the section 179D deduction allocated to you as the designer (see instructions)	(k) Section 179D deduction for the building (designers, enter the lesser of column 2(i) or column 2(j); building owners, enter the amount from column 2(i))
A	400,000	302,400	302,400		302,400
B					
C					
D					

3 **Total section 179D deduction.** Add amounts from column 2(k). Enter here and on the appropriate line of your return. See instructions 3 302,400

Part III Certification Information for Each Property Listed in Part I (see instructions)

4	(a) Name of Qualified Individual completing certification	(b) Date of certification	(c) Employer of Qualified Individual	(d) Address of Qualified Individual
A				
B				
C				
D				

Part IV Designer Allocation Information for Each Property Listed in Part I (to be completed by Designer only)

5	(a) Identified owner of building	(b) Date of allocation	(c) Name of building owner's authorized representative completing allocation	(d) Address of building owner's authorized representative
A				
B				
C				
D				

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 56398R Form **7205** (Rev.12-2023)

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IRC §§48 ENERGY CREDIT AND 48E CLEAN ELECTRICITY INVESTMENT CREDIT

The IRC §48 energy credit provides a tax incentive for businesses to invest in renewable eligible energy properties, including solar, wind, geothermal, and other renewable technologies. Businesses investing in eligible projects can receive a tax credit for a percentage of the project's eligible costs. The energy credit was originally enacted as a part of the Energy Tax Act of 1978 and was modified and expanded since then, including by the Energy Policy Act of 2005 and, most recently, as a part of the Inflation Reduction Act of 2022.[93]

The §48 energy credit will end December 31, 2024.[94] However, the §48 energy credit will be replaced with the IRC §48E tax credit.

IRC §48 Tax Credit

The §48 tax credit is a **business tax credit** available to taxpayers that install qualifying new energy property during the tax year.

To claim the credit, the energy property must be placed in service during the tax year and meet the performance and quality standards in place when the property was acquired. It must also be property for which depreciation or amortization is allowed and be either constructed or reconstructed by the taxpayer or acquired by the taxpayer for original use. Qualified energy property for purposes of this credit includes the following.

- Solar energy property which generates electricity or illuminates a structure
- Geothermal energy property
- Qualified fuel cell property or qualified microturbine property
- Combined heat and power system property
- Qualified small wind energy property
- Waste energy recovery property
- Geothermal heat pump system property
- Energy storage technology property
- Qualified biogas property
- Microgrid controller property
- Qualified investment credit facility treated as energy property under §48(a)(5)
- Clean hydrogen production facility treated as energy property under §48(a)(15)

> **Note.** Property that is part of a production credit allowed under IRC §45 for the taxable year or a prior taxable year is **not eligible** for the §48 tax credit.[95]

9

93. *Energy Tax Act of 1978,* PL 95-618; *Energy Policy Act of 2005*, PL 109-58; *Inflation Reduction Act of 2022,* PL 117-169, §13102.

94. Per the definitions of applicable energy property disclosed in IRC §§48(c)(6)(D), (c)(7)(C), and (c)(8)(C).

95. IRC §48(a)(3).

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Calculating the Credit. The §48 credit is somewhat complicated to calculate, so a 4-step synopsis is provided first, followed by additional context.

To receive the **increased credit** amount for each component of the calculation, the project must meet **any** of the following three conditions.

- Project meets the prevailing wage and apprenticeship requirements in §§48(a)(10)(A) and (11)[96]
- Project began construction after January 29, 2023
- Project has a maximum net output less than one megawatt of electrical or thermal energy

The credit calculation steps are as follows.

Step 1. Does the project meet any of the previous three conditions?

If **Yes,** the base credit is **30%**

If **No,** the base credit is **6%**

Step 2. Is the project placed in service in an energy community?

If **Yes,** and the project meets any of the three conditions, add **10%**

If **Yes,** and the project does **not** meet any of the three conditions, add **2%**

Step 3. Is the project a qualified solar and wind facility located in a low-income community or on Indian land?

If **Yes,** is the project also part of a qualified low-income residential building project **or** qualified low-income economic benefit project **and** have a maximum net output of less than five megawatts?

If **Yes,** and the project meets any of the three conditions, add **20%**

If **Yes,** and the project does **not** meet any of the three conditions, add **4%**

If **No,** and the project meets any of the three conditions, add **10%**

If **No,** and the project does **not** meet any of the three conditions, add **2%**

Step 4. Does the project meet domestic content requirements?

If **Yes,** and the project meets any of the three conditions, add **10%**

If **Yes,** and the project does **not** meet any of the three conditions, add **2%**

The maximum credit is **70%** if the project meets any of the three conditions, and **14%** if it does not meet any of the three conditions.

96. See IRS Notice 2022-61, 2022-52 IRB 560.

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The credit is generally calculated as 6% (base rate) of the basis for the qualified energy property. The Inflation Reduction Act of 2022 introduced an increased credit amount, multiplying the base credit for each energy property placed in service during the year by five if **any** of the following three conditions are met.[97]

1. Project meets the prevailing wage and apprenticeship requirements in §§48(a)(10)(A) and (11)[98]
2. Project began construction after January 29, 2023
3. Project has a maximum net output less than one megawatt of electrical or thermal energy

The credit can be increased by a bonus credit rate of 10% (2% if only qualifies for base rate) if the project is placed in service during the year in an energy community.[99] **An energy community** is defined as:[100]

- A brownfield site,
- A metropolitan statistical area or non-metropolitan statistical area which has (or had at any time after December 31, 2009) a 0.17% or greater direct employment or 25% or greater local tax revenues related to the extraction, processing, transport, or storage of coal, oil, or natural gas and has an unemployment rate at or above the national average rate for the previous year, or
- A census tract in which, after December 31, 1999, a coal mine closed, or after December 31, 2009, a coal-fired electric generating unit has been retired.

The credit can also be increased by another 10% (2% if only qualifying for the base rate) bonus credit rate for **qualified solar and wind facilities** located in a **low-income community or on Indian land.** Additionally, the credit can be increased to 20% (4% if only qualifying for the base rate) if the qualified solar and wind facilities are part of a **qualified low-income residential building project** or a qualified low-income economic benefit project and have a maximum net output of less than five megawatts.[101]

Practitioner Planning Tip

There are energy capacity limits based on categories and tax year.[102] Businesses looking to claim this bonus credit must apply online on the Department of Energy (DOE)'s website. Applicants are reviewed by the DOE and then approved or rejected by the IRS. Only individuals who can legally bind the organization are allowed to apply. Practitioners are not allowed to apply on behalf of their clients but should be aware of the submission windows for applications for clients applying for the bonus credit and remind clients to apply.

97. IRC §48(a)(9)(B).
98. See IRS Notice 2022-61, 2022-52 IRB 560.
99. IRC §48(a)(14).
100. IRC §45(b)(11)(B).
101. IRC §48(e)(2).
102. *Low-Income Communities Bonus Credit Program*. Office of Energy Justice and Equity. [www.energy.gov/justice/low-income-communities-bonus-credit-program] Accessed on May 20, 2024.

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IRC §48 also provides for another 10% (2% if only qualifying for the base rate) bonus credit if **domestic content requirements** are met. This bonus credit requires taxpayers to certify that any steel, iron, or manufactured product a part of the facility was produced in the United States.[103]

> **Note.** For a summary of the values of the investment tax credit and the production tax credit (discussed next), see the U.S. DOE's chart at **uofi.tax/24x9x1** [www.energy.gov/sites/default/files/2023-05/Summary-ITC-and-PTC-Values-Chart-2023.png].

Domestic Content Certification.[104] Taxpayers must submit a domestic content certification statement to the IRS for each applicable project for which they are claiming a §48 credit asserting that any steel or iron items or manufactured products that are subject to the Steel or Iron Requirement or Manufactured Product[105] were produced in the United States. The statement must be attached to Form 8835, *Renewable Electricity Production Credit,* or other applicable form along with the taxpayer's annual return for the first tax year in which the taxpayer reports the credit for the applicable project. Each subsequent tax year, the taxpayer must attach a copy of the original statement with their annual return.

The domestic content certificate statement must include the following information for each project.

- Whether the project is a qualified facility, energy project, or energy storage technology
- The specific type of project
- The geographic coordinates (and address if applicable) of the project
- The date the project was placed in service
- The credit amount in the first tax year for the project
- Any additional required information
- Signature by a person with legal authority to bind the taxpayer
- The statement, "Under penalties of perjury I declare that I have examined the information contained in this Domestic Content Certification Statement and to the best of my knowledge and belief, it is true, correct, and complete."

A taxpayer must certify that an applicable project meets the domestic content requirement as of the date the project is **placed in service** (i.e., placed in a condition or state of readiness and availability for a specifically assigned function, whether in a trade or business or in the production of income).

Reporting.[106] The credit is claimed on Form 3468, *Investment Credit,* which was revised to incorporate the changes to the credit included in the Inflation Reduction Act of 2022. This amount is then carried to Form 3800, part III, line 4a, and is eligible for a 3-year carryback.[107]

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103. IRC §45(b)(9)(B).
104. IRS Notice 2023-38, 2023-22 IRB 872.
105. See IRC §45(b)(9)(B).
106. 2023 Instructions for Form 3468.
107. IRC §39(a)(4).

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Example 11. A qualified solar facility with a basis of $50,000 is placed in service on May 12, 2023. The project does not meet the prevailing wage and apprenticeship requirements in §§48(a)(10)(A) and (11) and has a net output of more than one megawatt. It also is not located in an energy community, a low-income community, Indian land, or part of a low-income building project.

Because the project does not meet the requirements for any of the increased credit amounts, the credit is limited to the base rate of 6% of the basis of the property ($50,000). The §48 credit amount for this facility for tax year 2023 equals $3,000 ($50,000 basis × 6% base rate).

Example 12. Use the same facts as **Example 11,** except the project **does** meet the prevailing wage and apprenticeship requirements in §§48(a)(10)(A) and (11). Because the project meets the prevailing wage and apprenticeship requirements, the rate for the credit is 30%, making the §48 credit amount for this facility for tax year 2023 equal to $15,000 ($50,000 basis × 30% rate).

Example 13. ProzEnergy Corp. began construction of a qualified solar facility on March 1, 2023, with a basis of $50,000, and placed it in service on May 12, 2023. The project has a net output of 10 kWh (less than one megawatt) of energy which is equal to the nameplate capacity allocated to it. The project meets the prevailing wage and apprenticeship requirements in §§48(a)(10)(A) and (11) and domestic content requirements. It is located in an energy community as part of a low-income economic benefit project. ProzEnergy Corp. received certification from a qualified licensed engineer for the facility.

Because the project meets prevailing wage and apprenticeship requirements, it qualifies for the increased credit rate of 30%. The project also qualifies for the 20% bonus credit rate because it was part of a low-income economic benefit project and has a net output of energy equal to the nameplate capacity allocated to it. It also qualifies for both the domestic content requirement bonus and energy community bonus credits of 10% each. The total 2023 §48 credit amount for this $50,000 facility is equal to $35,000, as shown on the following Form 3468.

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For Example 13

Form **3468** — Department of the Treasury, Internal Revenue Service

Investment Credit

Attach to your tax return.
Go to *www.irs.gov/Form3468* for instructions and the latest information.

OMB No. 1545-0155 | **2023** | Attachment Sequence No. **174**

Name(s) shown on return: **ProzEnergy Corp.** | Identifying number: **44-3216789**

Part I **Facility Information** (see instructions)

A Check this box if you have petitioned for provisional emission rates and have also received written approval from a certified third-party verifier or a letter from the IRS . . . ☐

1 Description of the facility: **Solar facility**

2a IRS-issued registration number for the facility: **CM2YB12K2211**

b Type of facility (solar, geothermal, etc.): **Solar**

3 Location of facility, including coordinates (latitude and longitude).

a Address of the facility (if applicable): **127 Main Street, New York, NY 10022**

b Coordinates (if applicable). Latitude: **+ 40.714273** (Enter a "+" (plus) or "-" (minus) sign in the first box.) Longitude: **- 074.005970** (Enter a "+" (plus) or "-" (minus) sign in the first box.)

4 Date construction began (MM/DD/YYYY): **3/1/2023**

5 Date placed in service (MM/DD/YYYY): **5/12/2023**

6 Is the facility part of an expansion of an existing closed-loop biomass or open-loop biomass facility? ☐ Yes ☒ No

7 Does the project produce a net output of less than 1 megawatt (MW) alternating current (ac), or equivalent thermal energy?

- **a** ☒ Yes.
- **b** ☐ No.
- **c** ☐ Not applicable, the facility doesn't produce electricity.

8 Does the project satisfy the prevailing wage and apprenticeship requirements?

- **a** ☒ Yes, and sections 48C(e)(5) and (6) apply, and it was declared as provided per Notice 2023-18.
- **b** ☐ Yes, and either (i) section 48(a)(9)(B)(ii) applies if construction began before January 29, 2023; or (ii) sections 48(a)(10) and (11) apply.
- **c** ☐ No.
- **d** ☐ Not applicable.

9 Does the property qualify for a domestic content bonus credit per section 45(b)(9)(B)?

- **a** ☒ Yes, and section 48(a)(9)(B) is satisfied (10% bonus). Attach the required information.
- **b** ☐ Yes, and section 48(a)(9)(B) is **not** satisfied (2% bonus). Attach the required information.
- **c** ☐ No.

10 Does the project qualify for an energy community bonus credit per section 48(a)(14)?

- **a** ☒ Yes, and section 48(a)(9)(B) is satisfied (10% bonus).
- **b** ☐ Yes, and section 48(a)(9)(B) is **not** satisfied (2% bonus).
- **c** ☐ No.

11 Does the project qualify as a solar or wind facility in connection with low-income communities bonus credit per section 48(e)(2)?

- **a** ☐ Yes, and the facility is located in a low-income community per section 45D(e) (10% bonus).
- **b** ☐ Yes, and the facility is located on Indian land per section 2601(2) of P.L. 102-486 (10% bonus).
- **c** ☐ Yes, and the facility is part of a qualified low-income residential building project facility per section 48(e)(2)(B) (20% bonus).
- **d** ☒ Yes, and the facility is part of a qualified low-income economic benefit project facility per section 48(e)(2)(C) (20% bonus).
- **e** If "Yes" to 11a, 11b, 11c, or 11d, enter your 48(e) Control Number: **5478421**
- **f** ☐ No.

12 Enter the nameplate capacity or storage capacity.

- **a** ☒ Solar energy property or facility nameplate capacity: **10** kilowatt (kW) direct current (dc)
- **b** ☐ Small wind energy property or facility nameplate capacity: ______ kW
- **c** ☐ Wind energy property or facility nameplate capacity: ______ kW
- **d** ☐ Energy storage power capacity rating ______ kW, and energy storage capacity, if applicable, associated with the energy property or facility: ______ kWh (hour)
- **e** ☐ Solar or wind nameplate capacity is 5MW ac or more
- **f** ☐ Not applicable.

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For Example 13

Form 3468 (2023) Page **2**

Part I Facility Information (see instructions) *(continued)*

13 Enter the nameplate capacity, alternating current (ac) for all electricity generating energy properties or facilities in kW.

- a ☒ Solar energy property: 10
- b ☐ Wind energy property:
- c ☐ Other:
- d ☐ Not applicable.

14 Are you claiming the investment credit as a lessee based on a section 48(d) (as in effect on November 4, 1990) election? ☐ Yes ☒ No
If "Yes," complete lines 14a through 14e. If you acquired more than one property as a lessee, attach a statement showing the information below separately reported for each property.

- a Name of lessor:
- b Address of lessor:
- c Description of property:
- d Amount for which you were treated as having acquired the property . . . . $
- e Income inclusion amount reported for tax year under Regulations section 1.50-1 . . . . $

Part II Qualifying Advanced Coal Project Credit and Qualifying Gasification Project Credit

Section A—Qualifying Advanced Coal Project Credit Under Section 48A (see instructions)

...alified investment in integrated gasificati...

2	Add lines 1c, 1e, and 1g			2	

Section B—Solar Energy Credit (see instructions)

3a	Enter the basis of property using solar illumination (including electrochromic glass) or either solar energy property or solar facility placed in service during the tax year	3a	50,000		
b	If you checked the box in Part I, line 7a or 8b, enter 30%. If you checked the box in Part I, line 7b or 8c, enter 6%	3b	30 %		
c	Multiply line 3a by line 3b			3c	15,000

Caution: Property described under section 48(a)(3)(ii) does not qualify for the solar facility in connection with low-income community bonus credit under section 48(e). If completing Section B for a section 48(a)(3)(ii) property, skip lines 3d through 3j, and go to line 3k.

d	If you checked the box in Part I, line 11a or 11b, enter 10%. If you checked the box in Part I, line 11c or 11d, enter 20%. However, if you checked the box in Part I, line 11f; or Part I, line 12e (in relation to lines 11a, 11b, 11c, or 11d), you don't qualify for the bonus credit. In that situation, enter 0% here, go to line 3j and enter -0- (zero), and then go to line 3k	3d	20 %		
e	Enter the nameplate capacity you were allocated in the allocation letter	3e	10		
f	If the entry on Part I, line 12a, equals the entry on line 3e, multiply line 3a by line 3d and go to line 3j. Otherwise, continue to line 3g	3f	10,000		
g	If the entry on Part I, line 12a, is more than the entry on line 3e, divide line 3e by Part I, line 12a	3g			
h	Multiply line 3d by line 3g	3h			

Form **3468** (2023)

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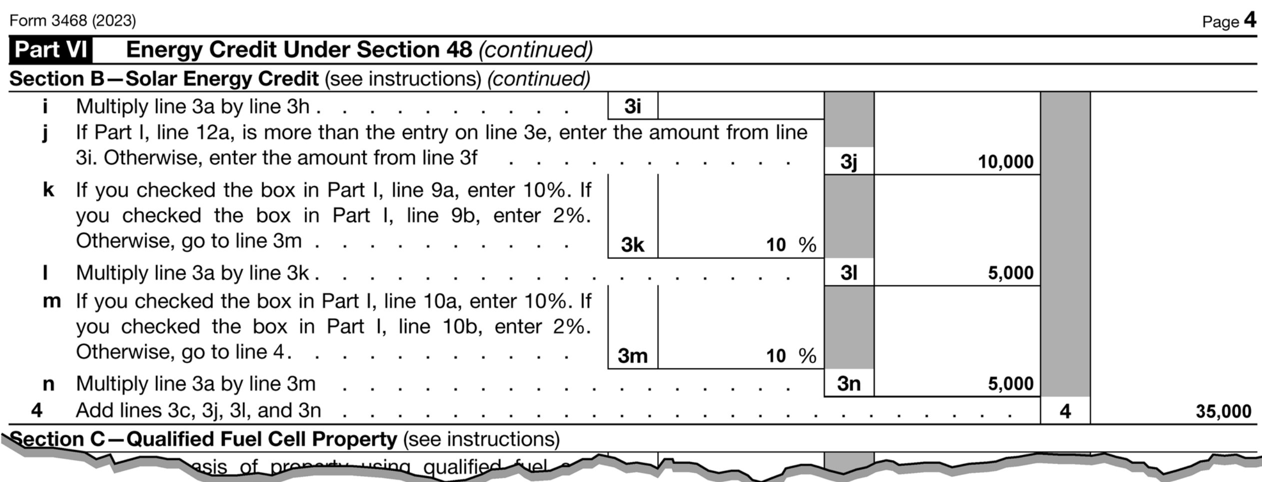
For Example 13



Form 3468 (2023) Page 4

Part VI **Energy Credit Under Section 48** *(continued)*

Section B—Solar Energy Credit (see instructions) *(continued)*

i	Multiply line 3a by line 3h	3i			
j	If Part I, line 12a, is more than the entry on line 3e, enter the amount from line 3i. Otherwise, enter the amount from line 3f			3j	10,000
k	If you checked the box in Part I, line 9a, enter 10%. If you checked the box in Part I, line 9b, enter 2%. Otherwise, go to line 3m	3k	10 %		
l	Multiply line 3a by line 3k			3l	5,000
m	If you checked the box in Part I, line 10a, enter 10%. If you checked the box in Part I, line 10b, enter 2%. Otherwise, go to line 4	3m	10 %		
n	Multiply line 3a by line 3m			3n	5,000
4	Add lines 3c, 3j, 3l, and 3n			4	35,000

Section C—Qualified Fuel Cell Property (see instructions)

IRC §48E

Replacing the §48 tax credit is the §48E tax credit, a new technology-neutral tax credit available to projects placed in service **after December 31, 2024.** The §48E investment tax credit is available to commercial taxpayers who place qualified energy property in service after December 31, 2024.

The new §48E eliminates the multiple categories of energy property outlined in the §48 credit requirements. The §48E credit will apply for the following.

- Any qualified facility which is defined as any facility which is used for the generation of electricity for which the greenhouse gas emissions rate is not greater than zero
- Any energy storage technology

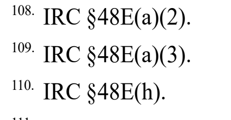
Calculating the Credit. The new credit will have the same 6% base rate that can be increased to five times the amount (30%) if the project meets the prevailing wage and apprenticeship requirements.[108]

Similar to the §48 bonus credit, the §48E credit can be increased by 10% (2% if only qualifies for base rate) if the project is located in an energy community and if it meets domestic content requirements.[109]

The credit can also be increased by 10% (2% if only qualify for base rate) if the qualified facility is located in a low-income community or on Indian land. Additionally, it can be increased by 20% (4% if only qualify for base rate) if the facility is part of a qualified low-income residential building project or a qualified low-income economic benefit project.[110]

> **Note.** These 10% bonus credits are for **commercial property** only, and not for residential homes.[111] For more information on the energy efficient home improvement credit and other individual energy credits, see the 2023 *University of Illinois Federal Tax Workbook,* Chapter 11: New Developments.

Taxpayers claiming credits under §48E generally must reduce the basis in the underlying property by 50% of the claimed credit.[112]



108. IRC §48E(a)(2).
109. IRC §48E(a)(3).
110. IRC §48E(h).
111. IRC §48E(b)(3).
112. IRC §50(c)(3).

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TRANSFERABILITY[113]

The Inflation Reduction Act of 2022 provides two ways for a taxpayer to monetize tax credits with the addition of IRC §§6417 and 6418. IRC §6417 offers a "direct pay" election whereby qualifying entities could receive a cash payment from the government in lieu of tax credits. IRC §6418 allows qualifying entities to sell the tax credits to unrelated third parties. In April of 2024, the IRS released final regulations under §6418.

The IRS uses elective pay as a means for making certain clean energy tax credits refundable and treats the elective payment amount as a tax payment. It is then counted as an overpayment and refunded to the entity filing the return. Certain entities that cannot use elective pay can transfer all or a portion of credits to an unrelated party in exchange for cash.

A taxpayer eligible for elective payments of energy credits is defined under §6417(d)(1)(A) and is generally tax-exempt organizations and government entities. For most other taxpayers, §6418 allows for transferability more like a sale of the credits.

If the applicable investment credit property is disposed of or no longer is investment credit property to the eligible taxpayer during the 5-year recapture period, the eligible taxpayer must provide notice of the credit recapture to the transferee taxpayer. The transferee taxpayer in turn must provide notice of the recapture amount to the eligible taxpayer.[114]

Eligible Credits

Eligible credits that can be transferred include the following.

- Energy credit[115]
- Clean electricity investment credit[116]
- Renewable electricity production credit[117]
- Clean electricity production credit[118]
- Zero-emission nuclear power production credit[119]
- Advanced manufacturing production credit[120]
- Clean hydrogen production credit[121]
- Clean fuel production credit[122]
- Carbon oxide sequestration credit[123]
- Credit for alternative fuel vehicle refueling/recharging property[124]
- Qualified advanced energy project credit[125]

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113. IRC §6418.
114. IRC §6418(g)(3)(B).
115. See IRC §48.
116. See IRC §48E.
117. See IRC §45.
118. See IRC §45Y.
119. See IRC §45U.
120. See IRC §45X.
121. See IRC §45V.
122. See IRC §45Z.
123. See IRC §45Q.
124. See IRC §30C.
125. See IRC §45C.

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Transfer Election Statement[126]

Both the eligible taxpayer and the transferee should attach a transfer election statement to their tax return for the tax year the entity is eligible for the credit. The statement should include a description of the type and amount of tax credit transferred, when the credit was transferred, the amount paid for the tax credit, and the registration number for the property qualifying for the credit.

PRODUCTION TAX CREDIT

The §45 renewable electricity production tax credit (PTC) is a tax credit available to taxpayers that generate electricity from qualified energy resources and sell the energy during the tax year.[127] The Inflation Reduction Act of 2022 broadened the credit as one way to incentivize taxpayers to build-out renewable energy. The §45 credit will end on December 31, 2024, and replacing it is the §45Y credit, the clean energy production tax credit.[128]

> **Note.** Taxpayers are not allowed to claim the PTC and an energy credit under §48 on the same facility. Project-specific factors can vary in determining whether claiming the PTC is more or less advantageous than claiming an energy credit under §48.[129]

IRC §45 Tax Credit

As mentioned previously, the §45 tax credit is a business tax credit available to taxpayers who produce electricity from qualified energy resources at a qualified facility and sell the energy generated to an unrelated person during the tax year.[130] The credit is available during the first 10 years the facility was originally placed in service. The facility owner is allowed to claim the credit, but in certain cases, the lessee or operator of the facility may claim the credit if the owner is not the producer of the electricity.[131]

The electricity must be generated by a qualified energy resource at a qualified facility located in the United States or U.S. territories.[132] The facility must be placed in service after December 31, 1993, and construction must have begun before January 1, 2025. For the changes made by the Inflation Reduction Act of 2022 to apply, the qualified facility must be placed in service after 2021. It must be owned by the taxpayer and used to produce electricity. Qualified facilities include any of the following.[133]

- Wind
- Closed-loop biomass
- Open-loop biomass
- Geothermal energy
- Solar energy
- Small irrigation power
- Municipal solid waste
- Qualified hydropower production
- Marine and hydrokinetic renewable energy

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126. *Elective pay and transferability frequently asked questions: Transferability*. May 7, 2024. IRS. [www.irs.gov/credits-deductions/elective-pay-and-transferability-frequently-asked-questions-transferability] Accessed on Jun. 25, 2024.

127. IRC §45(a).

128. *Inflation Reduction Act of 2022*, PL 117-169, §13101.

129. *Federal Solar Tax Credits for Businesses.* Aug. 2024. Office of Energy Efficiency & Renewable Energy. [www.energy.gov/eere/solar/federal-solar-tax-credits-businesses] Accessed on Aug. 20, 2024.

130. IRC §45(a).

131. IRC §45(d).

132. IRC §45(e).

133. IRC §45(d).

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Calculating the Credit. The credit for a qualified facility placed in service after December 31, 2021, is equal to 0.3 cents multiplied by the kWh of electricity produced by the qualified facility. For qualified facilities placed in service before January 1, 2022, the credit is 1.5 cents per kWh. These rates are adjusted for inflation.[134]

The 2023 credit rates for qualified facilities placed in service before January 1, 2022, are:

- 2.8 cents per kWh for qualified energy resources of wind, closed-loop biomass, and geothermal energy, and
- 1.4 cents per kWh for qualified energy resources of open-loop biomass, landfill gas, trash, qualified hydropower, and marine and hydrokinetic renewable energy.

The 2023 credit rates for qualified facilities placed in service after December 31, 2021, are:

- 0.55 cents per kWh for qualified energy resources of wind, closed-loop biomass, geothermal energy, and solar energy, and
- 0.3 cents per kWh for qualified energy resources of open-loop biomass, landfill gas, trash, qualified hydropower, and marine and hydrokinetic renewable energy.

The 2023 credit rate for qualified hydropower, marine, and hydrokinetic renewable energy resources placed in service after December 31, 2022, is 0.55 cents per kWh.

An increased credit of five times the credit rate is allowed if any of the following apply.[135]

- A facility with a maximum net output of less than one megawatt
- A facility for which the construction began before January 29, 2023
- A facility that meets the prevailing wage and apprenticeship requirements

A 10% bonus credit is allowed for qualified facilities placed in service after December 31, 2022, if the project meets domestic content requirements, as described previously.

An additional increased credit is allowed for qualified facilities located in an energy community (as described previously) and placed in service after December 31, 2022. When the reference price exceeds the 8-cent threshold price, the credit is phased out over a 3-cent range. If the reference price is equal to or less than the threshold price (adjusted for inflation), the credit is not reduced. The reference price is published each year in the Federal Register.[136]

Reporting.[137] The credit is reported on Form 8835.

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[134] 88 Fed. Reg. 40,400 (Jun. 21, 2023).

[135] IRC §45(b)(6).

[136] 2023 Instructions for Form 8835.

[137] Ibid.

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Example 14. A qualified geothermal facility owned by GeoRockz Corporation, a calendar year taxpayer, was placed in service on May 15, 2023. The facility produced and sold 12,000,000 kWh of electricity per day. Construction on the project began on March 10, 2021, and meets the prevailing wage and apprenticeship, and domestic content requirements. The facility is not located in an energy community.

The amount of kWh for the geothermal facility for the year is reported on line 1c, column (a). The kWh are then multiplied by the applicable rate of $0.0055 for geothermal facilities to calculate the potential credit of $15,246,000. There is no phaseout adjustment because GeoRockz is a calendar-year filer. Because the prevailing wage and apprenticeship requirements are met for this project, the increased credit amount applies, equaling $76,230,000 for this project. Additionally, the domestic bonus credit applies which amounts to an additional $7,623,000. The energy community bonus credit does not apply for this example. Accordingly, the total 2023 credit for the corporation is $83,853,000, as calculated on the following Form 8835.

Form **8835**

Department of the Treasury
Internal Revenue Service

Renewable Electricity Production Credit

Attach to your tax return.
Go to *www.irs.gov/Form8835* for instructions and the latest information.

OMB No. 1545-1362
2023
Attachment Sequence No. **835**

Name(s) shown on return: **GeoRockz Corporation**
Identifying number: **12-3457742**

Part I Facility Information

1 IRS-issued registration number for the facility: **PL2YB34K2233**

2 Type of facility you are claiming (see instructions):

a Description of facility: **Geothermal field with 8 geothermal power plants**

b Type of facility (wind, closed-loop biomass, geothermal, solar, open-loop biomass, landfill gas, etc.): **Geothermal**

3 Location of facility, including coordinates (latitude and longitude).

a Address of the facility (if applicable):

b Coordinates (if applicable). Latitude: **+ 38.7749** Longitude: **- 122.7553**
Enter a "+" (plus) or "-" (minus) sign in the first box. Enter a "+" (plus) or "-" (minus) sign in the first box.

4 Date construction began (MM/DD/YYYY): **03/10/2021**

5 Date placed in service (MM/DD/YYYY): **05/15/2023**

6 Is this facility part of an expansion of an existing closed-loop biomass or open-loop biomass facility? ☐ Yes ☒ No

7 Reserved for future use.
☐ Yes.
☐ No.

8 Does the project satisfy one of the qualified facility requirements? See instructions.

a ☐ Yes, the facility's maximum net output is less than 1 megawatt (as measured in alternating current).

b ☐ Yes, the facility's construction began before January 29, 2023.

c ☒ Yes, the facility meets the prevailing wage requirements of section 45(b)(7)(A) and the apprenticeship requirements of section 45(b)(8).

d ☐ No, the facility does not meet the qualified facility requirements.

9 Does the property qualify for the domestic bonus credit?

a ☒ Yes, and section 45(b)(9)(B) is satisfied (10% bonus). Attach the required information. See instructions.

b ☐ No.

10 Does the project qualify for an energy community bonus credit?

a ☐ Yes, and section 45(b)(11)(B) is satisfied (10% bonus). See instructions.

b ☒ No.

c ☐ Not applicable.

11 Enter the nameplate capacity direct current (dc) in kW for:

a ☐ Solar energy property facility: ____________

b ☒ Not applicable.

12 Enter the nameplate capacity, alternating current (ac) for all electricity generating energy properties or facilities in kW:

a ☐ Solar energy property or facility: ____________

b ☐ Wind energy property or facility: ____________

c ☐ Other: ____________

d ☒ Not applicable.

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 14954R Form **8835** (2023)

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For Example 14

Form 8835 (2023) Page **2**

Part II **Renewable Electricity Production**

Complete line 1 with respect to electricity produced at qualified facilities using:		(a) Kilowatt-hours produced and sold (see instructions)	(b) Rate (see inst.)*	(c) Column (a) × Column (b)
1a Wind	**1a**		$0.0055	
b Closed-loop biomass	**1b**		$0.0055	
c Geothermal	**1c**	**2,772,000,000**	$0.0055	**15,246,000**
d Solar	**1d**		$0.0055	
e Offshore wind facility	**1e**		$0.0055	
f Open-loop biomass	**1f**		$0.003	
g Landfill gas	**1g**		$0.003	
h Trash	**1h**		$0.003	
i Hydropower	**1i**		$0.003**	
j Marine and hydrokinetic renewables	**1j**		$0.003**	

Line	Description	Box	Amount
2	Add column (c) of lines 1a through 1j and enter here	**2**	**15,246,000**
3	Phaseout adjustment (see instructions) $______ × ______	**3**	**0**
4	Credit before reduction. Subtract line 3 from line 2	**4**	**15,246,000**

Credit reduction for tax-exempt bonds

If you used proceeds of tax-exempt bonds to finance your facility, continue to line 5a; otherwise, enter the amount from line 4 on line 6.

5a **Divide.** Sum, for the tax year and all prior tax years, of all proceeds of tax-exempt bonds (within the meaning of section 103), used to finance the qualified facility ÷ Aggregate amount of additions to the capital account for the qualified facility, for the tax year and all prior tax years, as of the close of the tax year = **5a**

Line	Description	Box	Amount
b	Multiply line 4 by line 5a	**5b**	
c	Multiply line 4 by 15% (0.15)	**5c**	
d	Enter the smaller of line 5b or line 5c	**5d**	
6	Subtract line 5d from line 4	**6**	**15,246,000**
7a	Enter the amount from line 6 applicable to wind facilities, the construction of which began during 2017 — **7a** ______		
b	For facilities placed in service after 2021, enter -0-; otherwise, multiply line 7a by 20% (0.20)	**7b**	**0**
c	Enter the amount from line 6 applicable to wind facilities, the construction of which began during 2018, 2020, or 2021 — **7c** ______		
d	For facilities placed in service after 2021, enter -0-; otherwise, multiply line 7c by 40% (0.40)	**7d**	**0**
e	Enter the amount from line 6 applicable to wind facilities, the construction of which began during 2019 — **7e** ______		
f	For facilities placed in service after 2021, enter -0-; otherwise, multiply line 7e by 60% (0.60)	**7f**	**0**
g	Add lines 7b, 7d, and 7f	**7g**	**0**
8	Subtract line 7g from line 6	**8**	**15,246,000**
9	Increased credit amount for qualified facilities. Did you check a “Yes” box in Part I, question 8? If so, multiply the amount in Part II, line 8, by 5.0. If not, enter the amount from Part II, line 8	**9**	**76,230,000**
10	Domestic content bonus credit. See instructions. If you qualify, multiply the amount on line 9 by 10% (0.10). Otherwise, enter -0-	**10**	**7,623,000**
11	Energy community bonus credit. See instructions. If you qualify, multiply the amount on line 9 by 10% (0.10). Otherwise, enter -0-	**11**	**0**
12	Add lines 9, 10, and 11	**12**	**83,853,000**
13	If you are making an elective payment election for a facility whose construction began in calendar year 2024, and the facility does not conform to section 45(b)(10)(B), or meet an exception under section 45(b)(10)(D), multiply line 12 by 90% (0.90). All others, enter the amount from line 12	**13**	**83,853,000**

* See instructions for rates to use for facilities placed in service before 2022.

** $0.0055 for qualified facilities related to hydropower and marine and hydrokinetic renewables placed in service after 2022. See instructions.

Form **8835** (2023)

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IRC §45Y

The IRC §45Y clean electricity production tax credit will replace the §45 tax credit for facilities placed in service on or after January 1, 2025. Just like the §45 tax credit, the §45Y tax credit is a business tax credit available to taxpayers who produce electricity at a qualified facility and sell the energy generated to an unrelated person during the tax year. The credit is available during the first 10 years the facility is originally placed in service. A qualified facility is one that is:

- Used for the generation of electricity,
- Placed in service after December 31, 2024, and
- For which the greenhouse gas emissions rate is not greater than zero.

For facilities placed in service before January 1, 2025, §45Y may apply to the extent the increased amount of electricity is produced at the facility due to a new unit placed in service after December 31, 2024, or any additions of capacity placed in service after December 31, 2024.

Calculating the Credit. The §45Y credit is calculated similarly to the §45 credit. The kWh are multiplied by the base rate of 0.3 cents per kWh. An increased credit amount of 1.5 cents per kWh is available for facilities with a maximum net output of less than one megawatt that meet certain construction deadlines and the prevailing wage and apprenticeship requirements.[138]

The 10% bonus credit for projects that meet certain domestic content requirements and the 10% bonus credit if the project is located in an energy community also apply for §45Y.[139]

The credit starts to phase out the later of 2032 or when U.S. greenhouse gas emissions from electricity reach 25% of 2022 emissions or less.[140]

EMPLOYER-PROVIDED CHILDCARE CREDIT[141]

The credit for employer-provided childcare has existed for over 20 years,[142] and although originally scheduled to expire, it was made permanent in 2012.[143] The employer-provided childcare credit is provided by IRC §45F and incentivizes employers to provide childcare services for their employees.

Employers can claim this credit for providing childcare facilities[144] or for providing resources[145] and referrals for childcare. These provisions allow a credit of up to $150,000 per year based on **25% of qualified childcare expenditures for childcare facilities and 10% of spending for qualified resource and referral expenditures.**[146]

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138. IRC §45(a)(2).

139. IRC §45Y(g); For additional guidance regarding the energy community bonus credit, see IRS Notice 2023-29, 2023-29 IRB 1, IRS Notice 2023-45, 2023-29 IRB 317, and IRS Notice 2023-47, 2023-29 IRB 318.

140. IRC §45Y(d).

141. *Employer-provided childcare credit*. Nov. 30, 2023. IRS. [www.irs.gov/businesses/small-businesses-self-employed/employer-provided-childcare-credit] Accessed on Apr. 23, 2024; IRS News Rel. IR 2024-34 (Feb. 7, 2024).

142. *Economic Growth and Tax Relief Reconciliation Act of 2001*, PL 107-16, §205; *The 45F Tax Credit for Employer-Provided Child Care.* Crandall-Hollick, Margot and Boyle, Conor. Apr. 12, 2023. Congressional Research Service. [crsreports.congress.gov/product/pdf/IF/IF12379] Accessed on Apr. 23, 2024.

143. *American Taxpayer Relief Act of 2012*, PL 112-240, as indicated in *The 45F Tax Credit for Employer-Provided Child Care*, p.2. Crandall-Hollick, Margot and Boyle, Conor. Apr. 12, 2023. Congressional Research Service. [crsreports.congress.gov/product/pdf/IF/IF12379] Accessed on Apr. 25, 2024.

144. IRC §45F(c)(2)(A).

145. IRC §45F(c)(3)(A).

146. IRC §§45F(a) and (b).

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The taxpayer can claim the credit in any year it makes **qualified expenditures.**[147] Qualified childcare expenditures include the following.

- Costs associated with acquiring, constructing, rehabilitating, or expanding property used as the taxpayer's **qualified childcare facility**
- Qualified childcare facility expenditures are operating expenses made by the taxpayer, including amounts paid to support childcare workers through training, scholarship programs, and providing increased compensation to employees with higher levels of childcare training
- Qualified resource and referral expenditures which include amounts paid or incurred under a contract with a qualified childcare facility to provide childcare services to employees of the taxpayer

Taxpayers may **deduct** any eligible expenditures that exceed the maximum credit.[148]

QUALIFIED CHILDCARE FACILITIES[149]

The employer-provided childcare credit provides small businesses with a nonrefundable credit for expenditures incurred for qualified childcare facilities. A **qualified childcare facility** must meet the following requirements.

1. The primary purpose of the facility must be childcare, and the facility must meet all local and state rules and regulations, including licensing as a childcare facility. The facility cannot be a part of the residence of the employer or any employee.[150] One exception is if the childcare facility is part of the contracted operator's home, provided it is not also the home of the employer or any employee.[151]
2. The employer-provided childcare facility must be open to employees throughout the taxable year. In addition, at least 30% of those attending must be employees' dependents. Childcare facilities must be available to the children of all company employees, not just those of highly compensated employees under IRC §414(g).

QUALIFIED CHILDCARE RESOURCE AND REFERRAL SERVICES[152]

The credit also provides employers with incentives to offer referrals and resources to employees who are seeking childcare. The credit for these services is a maximum of 10% of the qualifying expenditures. Like the childcare facility credit, this service must be available to all employees' dependents and not just to dependents of highly paid employees.

SPECIAL RULES[153]

In addition to the $150,000 annual limitation, the employer-provided childcare credit is constrained by the following rules and limitations.

Aggregation Rules

The $150,000 annual limit is applied at the entity level, and stretches across organizations that are part of the same controlled group or share common ownership. The controlled group limitation is applied by reference to IRC §§52(a) and (b). As a result, the $150,000 annual limit applies to multiple corporations and subsidiaries that share 50% ownership, as measured by the voting power of all classes of stock.

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147. IRC §45F(b).

148. IRC §45F(f)(2); *Employer-provided childcare credit*. Nov. 30, 2023. IRS. [www.irs.gov/businesses/small-businesses-self-employed/employer-provided-childcare-credit] Accessed on Apr. 25, 2024.

149. IRC §45F(c).

150. IRC §45F(c)(1)(A)(i)(iii).

151. IRC §45F(c)(3).

152. IRC §45F(c)(3).

153. IRC §45F(e).

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Limitations for Estates and Trusts

Estates and trusts that operate businesses may claim the credit. The credit is apportioned between the estate or trust and the beneficiaries on the basis of the income of the estate or trust.

Allocations for Partnerships

For partnerships, the credit is allocated among partners under regulations prescribed by the IRS.

Passive Activity Limits[154]

Businesses may have activities that are passive to some of its owners. Such an entity may have net active income that is less than the employer-provided childcare credit available to passive owners. In this case, the credit is suspended and carried over to the next year.

Basis Limits[155]

The depreciable basis of the property acquired, constructed, rehabilitated, or otherwise used for providing the childcare must be reduced by the amount of the credit.

CLAIMING THE CREDIT[156]

Employers organized as partnerships, S corporations, estates, and trusts claim the credit using Form 8882, *Credit for Employer-Provided Childcare Facilities and Services.* Partnerships report the credit on Schedule K, line 15f, *Other Credits*, of Form 1065. In turn, the credit is allocated among partners and reported on their Schedules K-1 (Form 1065), *Partner's Share of Income, Deductions, Credits, etc.*, box 15, *Credits*, with code AH.[157] S corporations report the credit on Schedule K, line 13g, *Other credits*, and it is then reported on shareholders' Schedules K-1 (Form 1120-S), in box 13, *Credits*, with code AH.[158]

An estate or trust must allocate the credit between the trust or estate and the beneficiaries in the same manner as income. Individual taxpayers, sole proprietors, C corporations, and other entity types (that are not partnerships, S corporations, trusts, or estates) claim the credit directly on Form 3800, if they:

- Received a Schedule K-1 from a pass-through entity that reported the income, and
- Have no other sources of employer-provided childcare credit.

Taxpayers may claim the credit any time within three years of the due date for their return on either an original or an amended return.

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154. IRC §§469(b) and (e)(2).
155. IRC §§45F(f)(1) and 1016(a).
156. Instructions for Form 8882.
157. Instructions for Form 1065.
158. Instructions for Form 1120-S.

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Example 15. GEX CO, an S corporation, provides childcare services for its employees. In 2024, GEX CO incurred $20,000 in childcare facility expenses and $4,000 in childcare resource expenses. GEX CO completed the following Form 8882 to calculate its 2024 credit for employer-provided childcare facilities and services.

Form **8882** (Rev. December 2017) Department of the Treasury Internal Revenue Service

Credit for Employer-Provided Childcare Facilities and Services

► Attach to your tax return.
► Go to *www.irs.gov/Form8882* for the latest information.

OMB No. 1545-1809 Attachment Sequence No. **131**

Name(s) shown on return	Identifying number
GEX CO	33-7654321

1	Qualified childcare facility expenditures paid or incurred	1	20,000		
2	Enter 25% (0.25) of line 1			2	5,000
3	Qualified childcare resource and referral expenditures paid or incurred	3	4,000		
4	Enter 10% (0.10) of line 3			4	400
5	Credit for employer-provided childcare facilities and services from partnerships, S corporations, estates, and trusts			5	0
6	Add lines 2, 4, and 5			6	5,400
7	Enter the **smaller** of line 6 or **$150,000.** Estates and trusts, go to line 8. Partnerships and S corporations, stop here and report this amount on Schedule K. All others, stop here and report this amount on Form 3800, Part III, line 1k			7	5,400
8	Amount allocated to beneficiaries of the estate or trust (see instructions)			8	
9	Estates and trusts. Subtract line 8 from line 7. Report this amount on Form 3800, Part III, line 1k			9	

No Double Benefit

Taxpayers claiming the employer-provided childcare credit are prevented from taking both a credit and a deduction for the same expenses. Consequently, the taxpayer must reduce the following.

- The basis of any qualified childcare facility by the amount of the credit that was generated by capital expenses of the facility
- Any otherwise allowable deduction for expenses used to calculate the credit by the amount of the credit allocable to those deductions

Reporting the Passive Activity Limitation on Credits[159]

Trusts or estates may be limited by the passive activity limitation on credits, as discussed previously. Form 8582-CR, *Passive Activity Credit Limitations*, is used to calculate any passive activity credit for the current year, including any prior year disallowed credits, and the allowed credit for the current year.[160] If the trust or estate is subject to the passive activity rules, it must include any credit for employer-provided childcare facilities and services from passive activities disallowed for prior years and carried forward to the current year. Form 8582-CR reports the allowed credit that must be allocated between the trust or estate and its beneficiaries.

159. Instructions for Form 8882.

160. Instructions for Form 8582-CR.

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CREDIT RECAPTURE[161]

If an employer ceases to operate a childcare facility within the first 10 years in which the qualified childcare facility is placed in service, they may have to recapture all or a portion of the credit. Additionally, a change in ownership may trigger recapture if the new owner does not agree in writing to accept the recapture liabilities of the seller.

The recapture is a declining percentage of the credit depending on the year the facility ceases to be a childcare facility. The following table shows the applicable recapture percentage of the employer-provided childcare credit.

Facility Stops Being Used for Qualified Childcare Activities in	Applicable Recapture Percentage
Years 1–3	100
Year 4	85
Year 5	70
Year 6	55
Year 7	40
Year 8	25
Years 9 and 10	10
Years 11 and thereafter	0

Year 1 starts on the day the qualified childcare facility is placed in service, rather than the calendar year in which it is opened. If the employer must pay back credits because the facility ceases to be a childcare facility, the recapture amount increases the basis of the property.

However, if the facility changes ownership, the new owners may continue the childcare facilities and avoid the recapture provisions. The new owner must assume the recapture liability from the employer who is disposing of the property.

Any recaptured tax is reported on the taxpayer's tax return where other recaptured taxes are reported (or, if the return does not have a line for recaptured taxes, reported on the "total tax" line). For example, individuals claim recapture taxes as income on their Form 1040, Schedule 2, *Additional Taxes*, line 17a, *Recapture of Other Credits*, with code **ECCFR** (stands for "Employer Childcare Facility Recapture").[162]

ERC FALLOUT

The employee retention credit (ERC) is a refundable tax credit for eligible businesses and tax-exempt organizations that paid qualified wages to employees after March 12, 2020, and before January 1, 2022. The credit was originally enacted as part of the 2020 Coronavirus Aid, Relief, and Economic Security (CARES) Act to help businesses impacted by the COVID-19 pandemic retain their employees during the period of economic uncertainty.[163] However, controversy has surrounded the credit, stemming from many businesses erroneously claiming it after being misled by aggressive marketing efforts by third-party credit promoters.[164]

Note. As a result of these unscrupulous promoters, the IRS listed ERC scams as one of the Dirty Dozen tax schemes for 2024. For more information on this and the other Dirty Dozen, see the 2024 *University of Illinois Federal Tax Workbook,* Chapter 13: New Developments.

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161. IRC §45F(d); Instructions for Form 8882.

162. Instructions for Form 1040.

163. *Consolidated Appropriations Act of 2021,* PL 116-260, §206.

164. IRS Ann. 2024-3, 2024-2 IRB 364.

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Additional legislation, including the American Rescue Plan Act of 2021 (ARP), modified the credit and relaxed eligibility guidelines.[165] This led to opportunistic promoters taking advantage of the loosened guidelines and running deceitful ads encouraging businesses to apply for the credit despite not meeting the eligibility requirements. Aware of these ERC marketing campaigns, the IRS is stepping up compliance efforts, warning of scam promotions, encouraging businesses to confirm eligibility before claiming the credit, and providing options for businesses that mistakenly claimed the credit.[166]

The IRS encourages businesses to carefully review the requirements for the ERC prior to filing a claim and to consult with a tax professional rather than a tax promoter or marketing firm for guidance on eligibility. Tax professionals should review each employer's eligibility and ensure there is a reasonable basis for filing a claim to avoid complications with the IRS.[167]

In response to the heightened concerns regarding improper claims for the credit, the IRS implemented a **processing moratorium on new claims for the ERC** submitted after September 14, 2023.[168] The moratorium has continued through June 2024 and is likely to continue for the foreseeable future. In those nine months, the IRS processed 28,000 claims worth $2.2 billion received prior to September 2023. Additionally, it disallowed more than 14,000 claims worth more than $1 billion.[169]

The IRS has analyzed a group of more than 1 million ERC claims representing more than $86 billion and found the following information.[170]

- 10-20% of claims are highest risk, showing clear signs of being erroneous claims
- 60-70% of claims have an unacceptable level of risk, causing the IRS to conduct additional analysis to gather more information
- 10-20% of claims are low risk

Despite the moratorium, business may have an option to amend or withdraw an ERC claim or participate in the voluntary disclosure program.

9

AMENDING ERC CLAIMS[171]

The ERC is a refundable credit that businesses could claim for certain quarters on their original 2020 or 2021 payroll tax returns. For employers that file on a quarterly basis, this form is Form 941, *Employer's Quarterly Federal Tax Return*. Businesses that are eligible for the ERC but did not claim it when they filed their original employment tax return could file an amended employment tax return to claim the credit. Employers filing on a quarterly basis use Form 941-X, *Adjusted Employer's Quarterly Federal Tax Return or Claim for Refund*, to amend their payroll tax return.

Businesses that need to adjust their employment tax return for the credit should utilize the return and applicable instructions for the tax period they need to adjust. If employers qualify for the credit for more than one quarter in 2020 or 2021, an amended payroll tax return must be filed for each applicable period.

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165. *American Rescue Plan Act of 2021,* PL 117-2, §9651.

166. IRS Ann. 2024-3, 2024-2 IRB 364.

167. IRS News Rel. IR-2023-169 (Sep. 14, 2023).

168. Ibid.

169. IRS News Rel. IR-2024-169 (Jun. 20, 2024).

170. Ibid.

171. Instructions for Form 941-X.

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Filing Deadline

The period of limitations for filing Form 941-X for overreported taxes is generally within three years of the date the Form 941 was filed or two years from the date the taxpayer paid the tax reported on Form 941, whichever is later. For purposes of determining the period of limitations, for Forms 941 due within a calendar year, the filing date is considered April 15 of the following year if the return was filed before that date. Accordingly, Forms 941-X for periods within tax year 2020 generally needed to be filed by April 15, 2024. For 2021, taxpayers have until April 15, 2025.[172]

> **Example 16.** Shady Tree Lawn Maintenance filed its 2021 fourth quarter Form 941 on January 25, 2022, claiming the ERC based on the advice from an ERC mill. The business made its liability payments for the quarter on time. On January 25, 2025, after discussing the matter with their accountant, Shady Tree decides to amend its 2021 fourth quarter Form 941 upon discovering the business did not originally qualify for the ERC. Shady Tree has until April 15, 2025, to prepare and file Form 941-X to correct the error.

Determine Eligibility

Prior to filing an amended return for an ERC claim, employers should determine if they meet the eligibility requirements. To claim the ERC employers must have either: [173]

- Sustained a full or partial suspension of operations due to an order from an appropriate governmental authority which limited commerce, travel, or group meetings because of COVID-19 during 2020 or the first three quarters of 2021, or
- Experienced a significant decline in gross receipts during 2020 or a decline in gross receipts during the first three quarters of 2021, or
- Qualified as a recovery startup business for the third or fourth quarters of 2021.

> **Note.** For more information on the eligibility and calculation of the ERC, see the 2023 *University of Illinois Federal Tax Workbook,* Chapter 11: New Developments.

In Notice 2021-20, the IRS published documents employers should retain to substantiate they qualify for the credit.[174] Prior to filing a claim, employers and preparers should review this list to ensure they have the proper documents.

Income Tax Considerations. If a business files a Form 941-X to claim the ERC, they must also reduce their wage deduction or salary expense on the income tax return for the total ERC credit claim.[175] Accordingly, an amended **income tax return** will need to be filed for the same tax year an amended Form 941 is filed. Depending on the entity's structure, this may mean a corporate and/or individual income tax return. Because the IRS issued a moratorium on processing new ERC claims, an employer may want to amend an income tax return prior to receiving the refund for the credit.

> **Note.** For more information on statute of limitations considerations when amending tax returns for an ERC credit claim, see the 2023 *University of Illinois Federal Tax Workbook*, Chapter 11: New Developments.

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172. Ibid.

173. *Consolidated Appropriations Act of 2021,* PL 116-260, §206.

174. IRS Notice 2021-20, 2021-11 IRB 922.

175. *Consolidated Appropriations Act of 2021,* PL 116-260, §206.

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Tax Practitioner Responsibilities.[176] The IRS Office of Professional Responsibility communicated that practitioners must follow Circular 230's standards when engaging with a client who claimed the ERC, wants to claim the ERC, or inquires about the possibility of claiming the ERC. Tax preparers need to exercise due diligence to ascertain if the client meets the eligibility criteria for claiming the ERC. While preparers can rely on the information provided by a taxpayer without verification, the preparer should make reasonable inquiries to confirm eligibility. Preparers cannot sign returns for positions that lack a reasonable basis for claiming the ERC. If the practitioner feels the claim for the ERC lacks a reasonable basis, the practitioner should discuss this with the client.

WITHDRAWING AN ERC CLAIM

With more than 1.4 million unprocessed ERC claims, the claim withdrawal process remains an important option for businesses who may have submitted an improper claim.[177] The IRS has a withdrawal process for employers who claim a refund for the ERC and would like to subsequently withdraw the claim. The IRS will consider withdrawal claims as if the ERC claim was never made and not charge employers interest or penalties. Businesses can withdraw their ERC claim if all of the following apply.[178]

- The claim was made on an adjusted employment tax return.
- The amended return was filed only to claim the ERC and made no other adjustments.
- The entire ERC claim is being withdrawn.
- The IRS has not paid the ERC claim or the claim has been paid but the check has not been cashed or deposited.

The IRS will notify employers if their withdrawal request is accepted or rejected by sending a letter. **An approved request is not effective until the IRS sends this letter.**[179]

Employers that made other changes on the amended employment tax return filed or only need to reduce the ERC claimed and not withdraw it entirely are instructed to file an amended employment tax return instead of using the withdrawal process.

The method of requesting an ERC withdrawal depends on whether the taxpayer has received and taken ownership of the ERC disbursal funds **and** whether the IRS has flagged the claim for an audit.

No Receipt of ERC Claim Funds nor Subject to an Audit

Taxpayers who have not received a refund or notification that their ERC claim is under audit must complete the following steps to withdraw from an ERC claim.

1. Make a copy of the adjusted return with the claim the taxpayer wishes to withdraw.
2. Write "Withdrawn" in the left margin of the first page of the adjusted return copy.
3. Have an **authorized person** sign and date the form in the right margin of the first page of the adjusted return copy.
4. Write the authorized person's name and title next to their signature in the right margin.
5. Fax the signed copy to 855-738-7609.

---

176. *Professional Responsibility and the Employee Retention Credit*. Mar. 7, 2023. IRS. [www.irs.gov/pub/opr-taxpros/2023-02-professional-responsibility-and-the-employee-retention-credit-R2-508-compliant.pdf] Accessed on Jun. 24, 2024.

177. IRS News Rel. IR-2024-169 (Jun. 20, 2024).

178. IRS News Rel. IR-2023-193 (Oct. 19, 2023).

179. *Withdraw an Employee Retention Credit (ERC) claim.* Dec. 21, 2023. IRS. [www.irs.gov/newsroom/withdraw-an-employee-retention-credit-erc-claim] Accessed on May 14, 2024.

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An authorized person for the purpose of withdrawing from an ERC claim depends on the taxpayer's entity type.[180]

- For sole proprietorships, an authorized person is the owner of the business.
- For corporations, including LLCs, an authorized person is the president, vice president, or other principal officer duly authorized to sign.
- For partnerships, including LLCs, an authorized person is a responsible and duly authorized member, partner, or officer having knowledge of the partnership's affairs.
- For single-member LLCs, an authorized person is the owner of the LLC or a principal officer duly authorized to sign.
- For trusts or estates, an authorized person is the fiduciary.

An authorized person may also be a duly authorized agent of the taxpayer, such as an individual with a valid power of attorney with Form 2848, *Power of Attorney and Declaration of Representative*, filed with the IRS. Additionally, an authorized agent of the taxpayer may include a reporting agent with Form 8655, *Reporting Agent Authorization*, filed with the IRS.[181]

Example 17. Malprave Industries, LLC, an S corporation, claimed an ERC for the second quarter of 2023 by filing Form 941-X. Due to the increased exposure of news articles and IRS announcements regarding the prevalence of non-qualifying and fraudulent ERC claims, the company reviewed their claim of the ERC. After considerable scrutiny, Malprave Industries finds that it did not qualify for the ERC and wishes to withdraw its ERC claim. **Because it has not received the funds from the ERC claim, Malprave Industries faxes a copy of the filed Form 941-X for the second quarter of 2023, writes "Withdrawn" in the left margin of the first page of the form, and has the company's president, Adrian Malprave, sign and date the form in the right margin.**

Form **941-X:** **Adjusted Employer's QUARTERLY Federal Tax Return or Claim for Refund**
(Rev. April 2023) Department of the Treasury — Internal Revenue Service OMB No. 1545-0029

Withdrawn

Employer identification number (EIN) 12 – 3456789

Name (*not your trade name*) Malprave Industries, LLC

Trade name (*if any*)

Address 2001 Poseidon Dr
Number Street Suite or room number
Los Angeles CA 90002
City State ZIP code
Foreign country name Foreign province/county Foreign postal code

Return You're Correcting...
Check the type of return you're correcting.
☒ 941
☐ 941-SS

Check the ONE quarter you're correcting.
☐ 1: January, February, March
☒ 2: April, May, June
☐ 3: July, August, September
☐ 4: October, November, December

Enter the calendar year of the quarter you're correcting.
2023 (YYYY)

Enter the date you discovered errors.
10 / 15 / 2023
(MM / DD / YYYY)

Adrian Malprave, President
Adrian Malprave
02/15/2024

Read the separate instructions before completing this form. Use this form to correct errors you made on Form 941 or 941-SS. Use a separate Form 941-X for each quarter that needs correction. Type or print within the boxes. You MUST complete all five pages. Don't attach this form to Form 941 or 941-SS unless you're reclassifying workers; see the instructions for line 42.

Part 1: **Select ONLY one process. See page 6 for additional guidance, including information on how to treat employment tax credits and social security tax deferrals.**

☐ 1. **Adjusted employment tax return.** Check this box if you underreported tax amounts. Also check this box if you overreported tax amounts and you would like to use the adjustment process to correct the errors. You must check this box if you're correcting both underreported and overreported tax amounts on this form. The amount shown on line 27, if less than zero, may only be applied as a credit to your Form 941, Form 941-SS, or Form 944 for the tax period in which you're filing this form.

☒ 2. **Claim.** Check this box if you overreported tax amounts only and you would like to use the claim process to ask for a refund or abatement of the amount shown on line 27. Don't check this box if you're correcting ANY underreported tax amounts on this form.

Part 2: **Complete the certifications.**

☒ 3. **I certify that I've filed or will file Forms W-2, Wage and Tax Statement, or Forms W-2c, Corrected Wage and Tax Statement, as required.**

Note: If you're correcting underreported tax amounts only, go to Part 3 on page 2 and skip lines 4 and 5. If you're correcting overreported tax amounts, for purposes of the certifications on lines 4 and 5, Medicare tax doesn't include Additional Medicare Tax. Form 941-X can't be used to correct overreported amounts of Additional Medicare Tax unless the amounts weren't withheld ... employee ...

[180] *Frequently asked questions about the Employee Retention Credit*. Mar. 25, 2024. IRS. [www.irs.gov/coronavirus/frequently-asked-questions-about-the-employee-retention-credit] Accessed on Apr. 29, 2024.

[181] Ibid.

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ERC Claim Funds Received but Not Cashed or Deposited

Taxpayers who **received an ERC refund check but neither cashed nor deposited it** must complete the following steps to withdraw from an ERC claim.

1. Make a copy of the adjusted return with the claim the taxpayer wishes to withdraw.
2. Write "Withdrawn" in the left margin of the first page of the adjusted return copy.
3. Have an authorized person sign and date the form in the right margin of the first page of the adjusted return copy.
4. Write the authorized person's name and title next to their signature in the right margin.
5. Write "Void" in the endorsement section on the back of the refund check.
6. Include a note titled "ERC Withdrawal" containing a brief explanation of the reason for returning the refund check.
7. Include the voided check (without stapling, paper clipping, or bending the check) with the claim withdrawal request and mail it to the IRS at the following address.

   Cincinnati Refund Inquiry Unit
   PO Box 145500
   Mail Stop 536G
   Cincinnati, OH 45250

Practitioner Planning Tip

Taxpayers should make a copy of the front and back of the voided check, the withdrawal request, and their explanation note for their records. Taxpayers should also track the mailing of their documents to confirm delivery and receipt by the IRS.

9

No Receipt of ERC Claim Funds but Subject to an Audit

If a taxpayer has been notified that the IRS is auditing the adjusted return including an ERC claim that the taxpayer wishes to withdraw from, the taxpayer should inquire of the IRS whether they have been assigned an examiner. If the taxpayer has been assigned an examiner, the taxpayer should communicate with the examiner about how to submit the withdrawal request directly to the examiner and what specific steps to take regarding documentation. If the taxpayer has not been assigned an examiner, the taxpayer should respond to the audit notice with their withdrawal request, using the instructions in the notice for responding.

Finalization of Claim[182]

The IRS will send a letter notifying a taxpayer of the acceptance or rejection of their ERC claim withdrawal request. The approved request is not effective until the taxpayer has received the acceptance letter from the IRS. If the withdrawal is accepted, the taxpayer may need to amend an affected income tax return accordingly.

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182. *Withdraw an Employee Retention Credit (ERC) claim*. Dec. 21, 2023. IRS. [www.irs.gov/newsroom/withdraw-an-employee-retention-credit-erc-claim] Accessed on Apr. 29, 2024.

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Income Tax Considerations[183]

If an employer's withdrawal of their ERC claim is accepted by the IRS, they may need to amend their income tax return if the employer adjusted the wage deduction for the ERC claim.

Caution. Practitioners who are working with their clients on amending their income tax returns due to withdrawing from an ERC claim should consider the time limitation for claiming a credit or refund, which is the later of three years from the date the tax return was filed or two years from the date the tax was paid.[184] If a client's amended return will not be able to be prepared and filed within this time period, practitioners may consider filing a protective refund claim.

For more information on filing protective refund claims, see the 2021 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 2: Individual Taxpayer Issues. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

VOLUNTARY DISCLOSURE PROGRAM[185]

In December 2023, the IRS announced a voluntary disclosure program as a part of its efforts to address erroneous ERC claims. The program started after discussions with tax professionals and employers revealed businesses wanted to rectify their erroneous claims. The program was available for employers who received an ERC refund but were not eligible for the credit and wanted to repay the amount they received. The program required employers to repay only 80% of the funds they received from the credit and will not be charged penalty or interest.

Businesses participating in this program were required to submit Form 15434, *Application for Employee Retention Credit Voluntary Disclosure Program*, by **March 22, 2024,** for the IRS to review. For tax periods ending in 2020, the employer was also required to complete ERC-VDP Form SS-10, *Consent to Extend the Time to Assess Employment Taxes.* The IRS mailed letters notifying employers if they were accepted into the program. Applications that were accepted were required to repay 80% of the credit received. If an employer was unable to repay 80%, an installment agreement could be arranged on a case-by-case basis. Installment agreements would incur interest and penalties.

Second Voluntary Disclosure Program[186]

The IRS reopened the voluntary disclosure program on August 15, 2024. As part of its second iteration, the voluntary disclosure program requires participants to repay **85%** of the funds they received from the credit (up 5% from the 80% required in the first program). Similar to before, participants will not be charged penalty or interest if timely repaying the 85% of the credit they received. This second program is only applicable for repaying credits received for **tax periods in 2021.** Employers have until 11:59 PM local time on **November 22, 2024,** to participate in this second voluntary disclosure program.

Participants elect to participate in the disclosure program by preparing and filing Form 15434. Participants must use the IRS's Document Upload Tool to electronically upload the form and any required attachments.[187] Payments can be made through the Electronic Federal Tax Payment System (EFTPS), with separate payments for each tax period covered under the submitted Form 15434. For participants unable to repay the full 85% of the credit they received, the IRS may consider them for an installment agreement on a case-by-case basis, with agreements incurring interest and penalties.

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183. Ibid.

184. *Time You Can Claim a Credit or Refund*. Sep. 6, 2023. IRS. [www.irs.gov/filing/time-you-can-claim-a-credit-or-refund] Accessed on Jun. 24, 2024.

185. IRS Ann. 2024-3, 2024-2 IRB 364.

186. IRS Ann. 2024-30, 2024-36 IRB 581.

187. The Document Upload Tool is accessible at irs.gov/DUT.

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Employers are eligible for the second voluntary disclosure program if the following are true.

- The employer is not currently under criminal investigation and has not been notified that they are under criminal investigation.
- The employer is not under an IRS employment tax examination for the tax period for which they are applying to the voluntary disclosure program.
- The employer has not received an IRS notice and demand for repayment of part or all of the ERC.
- The IRS has not received information from a third party that the taxpayer is not in compliance or has not acquired information directly related to the noncompliance from an enforcement action.
- The participant has not received notification from the IRS that the ERC the participant received is being recaptured for any tax period for which the participant is applying under the voluntary disclosure program.

Note. The IRS plans to mail up to 30,000 letters to taxpayers reversing or recapturing improper ERC claims. Because one of the eligibility requirements precludes taxpayers who already received such letters from participating in the program, taxpayers interested in the program should assess their situation and file Form 15434 as soon as possible.[188]

IRS AUDITS

As of March 2024, the IRS is still auditing thousands of ERC claims. The agency has sent over 12,000 letters to businesses recapturing the ERC claim and requiring **100%** repayment of the amount the business received, including penalties and interest charges. These letters are for ERC claims for tax year 2020 but the agency plans to send more letters for tax year 2021 as well. As of May 2024, the IRS has also opened 450 criminal cases regarding the ERC with 36 of them already resulting in federal charges. Of those, 16 investigations resulted in convictions and seven sentencings with an average sentence of 25 months.[189]

Employers selected for an ERC audit can expect a shorter examination period compared to an income tax return audit. The IRS will send an information document request (IDR) asking for information regarding the claim. Some of the documents the IRS may request include the following.[190]

- Details of employees paid wages for which the ERC was claimed
- Documentation that the employer was eligible to claim the ERC
- Supporting documentation for the calculation of the credit including copies of worksheets used to complete the Form 941-X
- Documentation of the full-time employees from 2019-2021
- Verification prohibited funds including a paycheck protection program (PPP) loan was not used to pay qualified ERC wages

9

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188. *IRS reopens Voluntary Disclosure Program to help businesses with problematic Employee Retention Credit claims; sending up to 30,000 letters to address more than $1 billion in errant claims.* Aug. 15, 2024. IRS. [www.irs.gov/newsroom/irs-reopens-voluntary-disclosure-program-to-help-businesses-with-problematic-employee-retention-credit-claims-sending-up-to-30000-letters-to-address-more-than-1-billion-in-errant-claims] Accessed on Aug. 20, 2024.

189. IRS News Rel. IR-2024-78 (Mar. 22, 2024); IRS News Rel. IR-2024-169 (Jun. 20, 2024).

190. *ERC Update: Tax Professional Responsibilities and IRS Examinations.* Apr. 6, 2023. Cherry Bekaert LLP. [www.cbh.com/guide/articles/erc-update-tax-professional-responsibilities-and-irs-examinations/] Accessed on May 14, 2024.

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After the IDR is submitted, the auditor will conduct an interview to collect more details about the claim. In more recent cases, the IRS is asking employers how they learned of the credit and who determined eligibility. A claim in which a credit promoter is involved may receive more scrutiny than one involving a tax preparer.[191]

Practitioner Planning Tip

Practitioners working with clients selected for an ERC claim audit should set client expectations for the audit and inform their clients that although they were selected for audit due to an ERC claim, the auditor will review the **entire Form 941** they filed, which may result in additional adjustments to the form besides the ERC.

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191. *So you've been selected for an ERC audit, here's what to expect.* Oct. 3, 2023. Baker Tilly US, LLP. [www.bakertilly.com/insights/so-youve-been-selected-for-an-erc-audit] Accessed on May 14, 2024.

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Note. Corrections for all of the chapters are available at **TaxSchool.illinois.edu.** For clarification about terms used throughout this chapter, see the **Acronyms and Abbreviations** section following the index.

For your convenience, in-text website links are also provided as short URLs. Anywhere you see **uofi.tax/xxx**, the link points to the address immediately following in brackets.

Note. This chapter contains selected cases, revenue rulings, revenue procedures, Treasury regulations, announcements, and letter rulings issued during the past year, through approximately July 31, 2024. Each appears as a condensed version and should not be relied on as a substitute for the full document. A full citation appears for each item. This chapter is not intended to be a comprehensive coverage of all tax law changes. Rather, it reports the rulings and cases most likely to be of interest to tax professionals.

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About the Authors

Rong Fu, JD, served as a legal assistant at the University of Illinois Tax School in Spring 2024 and graduated from the University of Illinois College of Law in the same year. Her academic focus was on tax law. Additionally, she was an editor for the law school journal.

Kelly Golish, CPA, is the Assistant Director, Tax Materials, at the University of Illinois Tax School. She was previously a manager at Crowder, CPAs in Danville, IL and worked for both public and private accounting firms in Decatur, IL, Cleveland, OH, and San Jose, CA. Kelly earned a Masters in Accounting with an emphasis in Taxation and a Bachelors in Accounting at the University of Notre Dame.

Debbie Held, CPA, has worked for the University of Illinois Tax School since 2000 as an instructor, author, reviewer, and self-study course developer. She worked for the Internal Revenue Service for over 44 years as a revenue agent, appeals officer, project manager, and management analyst. She previously taught accounting courses at Lincoln Land Community College, and is a graduate of Sangamon State University (University of Illinois at Springfield). Debbie resides in Raymond, Illinois, where her family farms.

Chris Korban, CPA, is a Tax Materials Specialist at the University of Illinois Tax School. He joined Tax School in 2023 with nine years of experience in public accounting. Chris earned both his Bachelor's Degree in Accounting and Master of Accounting Science from the University of Illinois.

Michael Lathwell served as a legal assistant and writer at the University of Illinois Tax School during 2024. Michael is a law student at the University of Illinois College of Law and will be graduating in 2025. Michael also serves as the Editor-in-Chief for the University of Illinois Law Review. He has also recently served as a staff writer for the Law Update Column in the Illinois Bar Journal. Michael worked in the insurance industry prior to law school, and has a Bachelor of Arts degree from Regent University.

Agnes Mung is a law student at the University of Illinois College of Law. She graduated with a history degree from California Polytechnic State University, San Luis Obispo.

John W. Richmann, EA, is a Tax Materials Specialist at the University of Illinois Tax School. Prior to joining Tax School in 2021, he owned a tax practice in St. Charles, Illinois, and held positions in private industry and consulting firms. John earned a Masters Degree in Business Administration from the University of Texas and an electrical engineering degree from the Massachusetts Institute of Technology.

Other chapter contributors and reviewers are listed at the front of this volume.

SUBSTANTIAL AUTHORITY

If there is substantial authority for a position taken on a tax return, neither the taxpayer nor the tax preparer will be subject to the penalty for underreporting income even if the IRS successfully challenges the position taken on the return. By contrast, if there is no substantial authority for a position taken on a tax return, the underreporting penalties may be imposed unless the position has been adequately disclosed and there is a reasonable basis for the position.

EVALUATION OF AUTHORITIES

There is substantial authority for the tax treatment of an item only if the weight of the authorities that support the treatment is substantial in relation to the weight of the authorities that support a contrary treatment.

- All the authorities relevant to the tax treatment of an item (including the authorities contrary to the treatment) are taken into account in determining whether substantial authority exists.
- The weight of the authorities is determined in light of the pertinent facts and circumstances. There may be substantial authority for more than one position with respect to the same item.
- Because the substantial authority standard is an objective one, the **taxpayer's belief** that there is substantial authority for the tax treatment of an item **is not relevant** in determining whether that is in fact true.

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NATURE OF ANALYSIS

The weight accorded to an authority depends on its relevance and persuasiveness, as well as the type of document providing the authority. For example, a case or revenue ruling that has some facts in common with the tax treatment at issue is not particularly relevant if the authority is materially distinguishable on its facts or otherwise inapplicable to the tax treatment. An authority that merely states a conclusion ordinarily is less persuasive than one that reaches its conclusion by cogently relating the applicable law to pertinent facts. The weight of an authority from which information has been deleted (such as a private letter ruling) is diminished to the extent that the deleted information may have affected the authority's conclusions.

The type of document also must be considered. For example, a revenue ruling is accorded greater weight than a private letter ruling addressing the same issue. Private rulings, technical advice memoranda (TAM), general counsel memoranda (GCM), revenue procedures, and/or actions on decisions issued prior to the Internal Revenue Code (IRC) of 1986 generally must be accorded less weight than more recent ones.

There may be substantial authority for the tax treatment of an item despite the absence of certain types of authority. Thus, a taxpayer may have substantial authority for a position that is supported only by a well-reasoned construction of the applicable statutory provision.

AUTHORITY HIERARCHY

The following factors are considered in determining whether there is substantial authority for the tax treatment of an item.[1]

- Applicable provisions of the IRC and other statutory provisions
- Temporary and final Treasury regulations construing such statutes

> **Note.** A proposed regulation presents a **tentative** IRS position that may be changed when a temporary and/or final regulation is issued.

- Revenue rulings
- Revenue procedures
- Tax treaties and regulations thereunder, and Treasury Department and other official explanations of such treaties
- Federal court cases interpreting such statutes
- Congressional intent, as reflected in committee reports
- Joint explanatory statements of managers included in congressional conference committee reports, and floor statements made prior to enactment by one of a bill's managers
- General explanations of tax legislation prepared by the Joint Committee on Taxation
- Letter rulings and TAM issued after October 31, 1976
- Actions on decisions and GCM issued after March 12, 1981
- IRS information or press releases, and notices, announcements, and other administrative pronouncements published by the IRS in the Internal Revenue Bulletin (IRB)

1. Treas. Reg. §1.6662-4(d)(3)(iii).

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Additional information on some of the preceding items follows.

IRC. Except where provisions violate the U.S. Constitution, IRC provisions are binding in all courts.

Treasury Regulations (Income Tax Regulations). The regulations are the Treasury Department's official interpretation and explanation of the IRC. Regulations have the force and effect of law unless they are in conflict with the statute they explain.

Revenue Rulings. The IRS is bound by the position taken in a revenue ruling. Revenue rulings that interpret Treasury regulations are entitled to substantial deference.

Letter Rulings and TAM. Private letter rulings and TAM are IRS rulings directed at particular taxpayers. A private letter ruling is issued for a fee. The IRS is bound to such a ruling only for the particular taxpayer who requested it. A TAM is issued in response to a request for a legal opinion.

Chief Counsel Advice (CCA). A CCA is an IRS ruling issued to IRS field operations by the Office of Chief Counsel. It may be directed at a particular taxpayer or a particular issue. Included in this category are various legal memoranda (e.g., Internal Legal Memoranda (ILM) and Litigation Guideline Memoranda (LGM)).

GCM. GCM detail the legal reasoning behind the issuance of a revenue ruling.

Service Center Advice (SCA). SCAs are issued by the IRS in response to a question coming from an IRS center. There are two types of SCAs: routine and significant. A **routine SCA** is answered by district counsel and not coordinated with the national office. A routine SCA is not issued to the public. A **significant SCA** (SSCA), on the other hand, is issued only with the approval of the national office. An SSCA is not legal advice and addresses only the interpretation or application of the Internal Revenue laws. SSCAs are made public, but any information identifying taxpayers is deleted.

Tax Court Summary Opinions. A case decided under the small-case procedures cannot be appealed by the taxpayer or the IRS. Without the appeals process, incorrect legal interpretations by the Tax Court cannot be challenged. Therefore, the Tax Court's decision is binding only on that particular case. However, reviewing the cases can still be useful; they explain the IRS's arguments, the taxpayer's arguments, and the Tax Court's reasoning.

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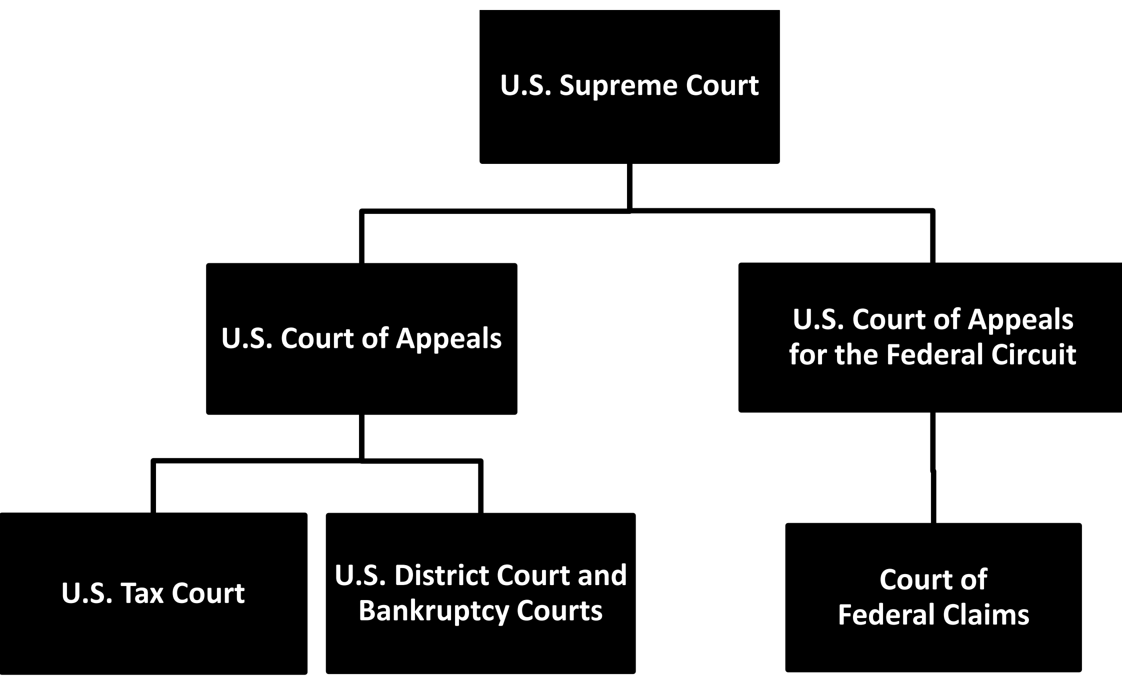
JUDICIAL SYSTEM FOR TAX DISPUTES

Three levels of federal courts have jurisdiction to hear tax cases. The following diagram illustrates the three levels. The diagram is followed by a brief description of each court.



> **Note.** Although tax liabilities are addressed by bankruptcy courts, they are generally addressed in a bankruptcy context under the terms of the Bankruptcy Code in a different manner than in the other courts noted in the above diagram.

CASE COMMENCEMENT

A taxpayer in a dispute with the IRS generally has two choices after they receive a statutory notice or notice of final determination (a 90-day letter).

1. File a petition in the Tax Court without paying the tax.
2. Pay the tax and file a claim of refund. If the IRS rejects the claim, the taxpayer can file suit in a U.S. District Court or the Court of Federal Claims.

> **Note.** U.S. District Courts also have jurisdiction to hear federal tax cases. However, these courts are generally used only for very substantial tax disputes because of the high costs and the complexities of using them to resolve tax issues. Consequently, these courts are rarely used by individual taxpayers to resolve tax disputes with the IRS.

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THE U.S. TAX COURT

The U.S. Tax Court is a federal court of record that was established in 1942 by Congress under Article I of the Constitution. It replaced the Board of Tax Appeals. Congress created the Tax Court to provide a judicial forum in which taxpayers could dispute tax deficiencies determined by the Commissioner of Internal Revenue prior to the payment of the disputed amounts.

The Tax Court is located at 400 Second Street, NW, Washington, DC 20217. Although the court is physically located in Washington, the judges travel nationwide to conduct trials in various designated cities.

As of July 2024, the Tax Court is composed of 19 judges (six currently vacant), 12 senior judges, and six special trial judges. The judges generally have expertise in tax law.

This is the only forum in which a taxpayer can contest a tax liability **without** first paying the tax. However, there is a $60 filing fee that may be paid online at **pay.gov**, or by check or money order made out to "Clerk, United States Tax Court."[2] Jury trials are not available in this forum.

The jurisdiction of the Tax Court was greatly expanded by the Revenue Reconciliation Act of 1998. The jurisdiction of the Tax Court includes the authority to hear tax disputes concerning the following.

- Notices of deficiency
- Notices of transferee liability
- Certain types of declaratory judgments
- Readjustment and adjustment of partnership items
- Review of the failure to abate interest
- Administrative costs
- Worker classification
- Relief from joint and several liability on joint returns
- Review of certain collection actions

The Tax Court also has limited jurisdiction under IRC §7428 to hear an appeal from an organization that is threatened with the loss of its tax-exempt status. Under IRC §7478, the Tax Court can also issue a declaratory judgment for a state or local government that has failed to get a tax exemption for a bond issue.

The IRS issues a statutory notice of deficiency in tax disputes in which the IRS has determined a deficiency. In cases in which a deficiency is not at issue, the IRS issues a notice of final determination. A notice of final determination is issued in the following types of tax disputes.

- Employee versus independent contractor treatments
- Innocent spouse claim determinations
- Collection due process cases

[2] *How to Pay the Filing Fee.* United States Tax Court. [ustaxcourt.gov/pay_filing_fee.html] Accessed on Jul. 16, 2024.

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To invoke the jurisdiction of the Tax Court, the taxpayer must file a petition in Tax Court within 90 days after the IRS notice of deficiency (or notice of final determination) is mailed.[3] **The 90-day date cannot be extended by the IRS.** Similarly, the Tax Court has no statutory authority to extend the 90-day period.[4] However, the Tax Court does have the discretion to accept a timely but nonconforming document as a petition and allow later amendments to that document that relate to the originally timely filed nonconforming petition.[5]

Observation. Taxpayers and practitioners should not rely on the Tax Court's discretion to extend the 90-day period by filing a nonconforming document that is not a valid Tax Court petition. There is no guarantee that the Tax Court will grant relief from the 90-day deadline.

Who May Practice in the U.S. Tax Court

A taxpayer may represent themselves in Tax Court, or they may be represented by a practitioner admitted to the bar of the Tax Court. Generally, an attorney who is a member of the bar of any state (or the District of Columbia) may be admitted to the bar of the U.S. Tax Court. The attorney must complete the required application for admission to practice (which must be notarized), attach the required proof of good standing in their state bar, and pay the required $50 fee.

A nonattorney may also be admitted to practice before the U.S. Tax Court. To do so, the nonattorney practitioner must pass a 4-hour examination consisting of the following four parts and pay the $150 examination fee.

- Tax Court rules of practice and procedure
- Federal taxation
- Federal rules of evidence
- Legal ethics

A score of at least 70% in each of the four parts is necessary to pass the examination. The examination is conducted at least once every two years. After passing the examination, the nonattorney practitioner must file the required application for admission.

The following resources for attorneys and nonattorneys provide information about admission to practice before the U.S. Tax Court (including the necessary forms, fee information, and mailing addresses).

- **Attorneys: uofi.tax/15b7x1** [www.ustaxcourt.gov/forms/Admission_Attorney_Form_30.pdf]
- **Nonattorneys: uofi.tax/15b7x2** [www.ustaxcourt.gov/resources/forms/Admission_Nonattorney_Info.pdf]

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3. IRC §6213(a).
4. *R. S. Schoenfeld v. Comm'r*, TC Memo 1993-303 (Jul. 13, 1993); *Schake v. Comm'r,* TC Memo 2002-262 (Oct. 10, 2002).
5. *R. M. Crandall v. Comm'r*, 650 F.2d 659 (5th Cir. 1981); *N. E. Carstenson v. Comm'r,* 57 TC 542 (1972).

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Tax Court Decisions

The Tax Court hears several types of cases and issues several types of opinions. Specifically, the court hears both regular cases and small tax cases (referred to as S cases).

An S case is generally one that involves less than $50,000 of unpaid tax. The $50,000 threshold includes penalties but does not include interest. S cases are heard using less formal procedures and do not provide the right of appeal to a higher court. For a case to be treated as an S case, the taxpayer must choose S case status and the Tax Court must agree that the case qualifies.

> **Note.** For more information about S cases, see IRC §7463 and **uofi.tax/15b7x3** [www.ustaxcourt.gov/petitioners_start.html].

A Tax Court **summary opinion** is an opinion rendered in an S case. It may **not** be relied on as precedent.

Regular opinions are opinions from cases that are not S cases, and a regular opinion may be a memorandum opinion or a Tax Court opinion. A **Tax Court opinion** is issued if the Tax Court believes the case involves a sufficiently important or novel legal or tax issue. All other regular cases result in **memorandum opinions.** Both memorandum opinions and Tax Court opinions may be appealed and may serve as precedents.

A **bench opinion** can be issued by the Tax Court in any regular or S case. A bench opinion occurs when the judge issues the opinion orally in court during the trial. The taxpayer receives a transcript of the bench opinion a few weeks after the trial. Bench opinions may **not** be relied on as precedents.

> **Observation.** Tax Court opinions may be viewed online. A search engine for finding cases is available at **uofi.tax/15b7x4** [www.dawson.ustaxcourt.gov].

> **Note.** Information about the Tax Court rules of practice and procedure are available at **uofi.tax/15b7x5** [www.ustaxcourt.gov/rules.html].

Tax Court Appeals

A Tax Court opinion or memorandum opinion may be appealed in a U.S. Court of Appeals. However, a taxpayer who commences their case in the U.S. Court of Federal Claims must appeal their case to the U.S. Court of Appeals for the Federal Circuit.

A final appeal can be made to the U.S. Supreme Court; but, because the Court's jurisdiction is discretionary, it hears relatively few tax cases. Many of the court transcripts from these cases can be accessed online at **uofi.tax/15b7x6** [www.uscourts.gov].

The taxpayer can file a refund suit in the Claims Court or the Federal District Court once they have paid the deficiency. In both of these courts, decisions of the Tax Court are not binding as precedents. A jury trial is available only in the Federal District Court. Many federal court opinions can be accessed online at **uofi.tax/15b7x6** [www.uscourts.gov].

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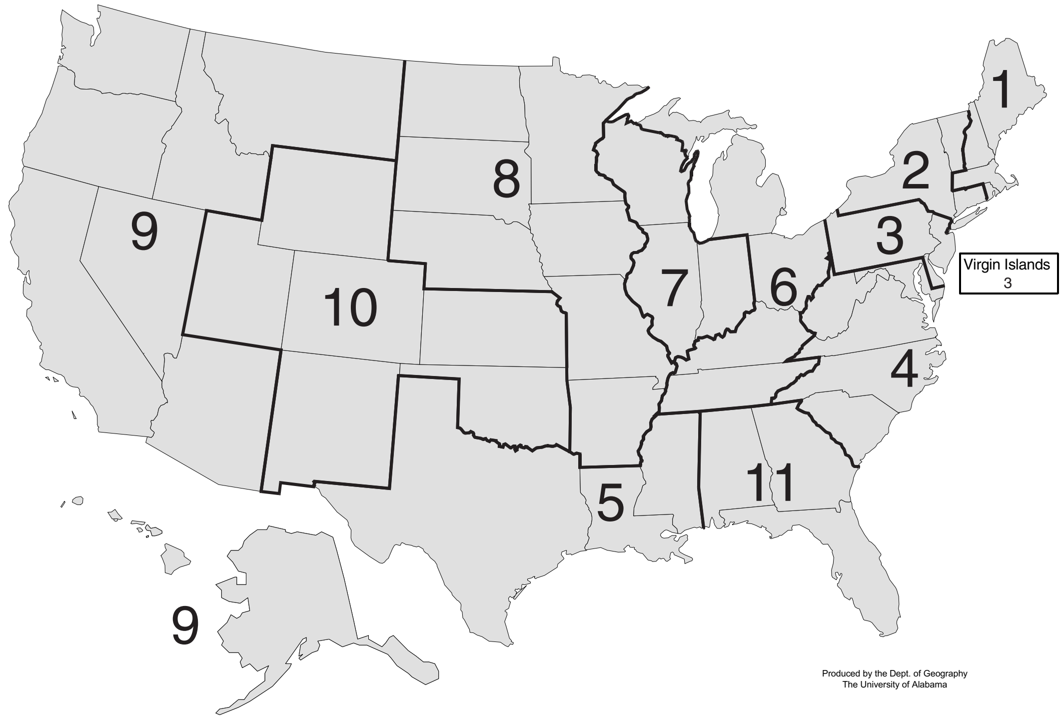
The 13 judicial circuits of the United States are constituted as follows.

Circuits	Hears Appeals from Federal District Courts and U.S. Tax Court Cases Originating in:
D.C.	U.S. Tax Court cases originating in D.C., Federal Administrative agencies, and Federal District Court cases for the District of Columbia
1st	Maine, Massachusetts, New Hampshire, Puerto Rico, Rhode Island
2d	Connecticut, New York, Vermont
3d	Delaware, New Jersey, Pennsylvania, Virgin Islands
4th	Maryland, North Carolina, South Carolina, Virginia, West Virginia
5th	Louisiana, Mississippi, Texas
6th	Kentucky, Michigan, Ohio, Tennessee
7th	Illinois, Indiana, Wisconsin
8th	Arkansas, Iowa, Minnesota, Missouri, Nebraska, North Dakota, South Dakota
9th	Alaska, Arizona, California, Hawaii, Idaho, Montana, Nevada, Oregon, Washington, Guam
10th	Colorado, Kansas, New Mexico, Oklahoma, Utah, Wyoming
11th	Alabama, Florida, Georgia
Fed.	Any federal case involving subject matter within its jurisdiction; U.S. Court of Federal Claims; U.S. Court of International Trade



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IRS ACTIONS ON DECISION [6]

The IRS has the ability to refuse to accept a court's legal reasoning in a tax case (unless the case was resolved by the U.S. Supreme Court). Generally, the IRS may issue an Action on Decision (AOD) for a case that it did not appeal but that decided issues that were adverse to it.

An AOD is a formal memorandum that alerts IRS officials and the public about the position the IRS will take in future litigation. An AOD is issued at the discretion of the IRS, and the IRS is not bound by it. An AOD does not have the force of a regulation or revenue ruling.

An AOD may take one of the following forms, depending on the position the IRS takes regarding the litigated case.

- **Acquiescence.** The IRS accepts the holding of a court in the case and will follow it in disposing of other cases in which the same facts are controlling.
- **Acquiescence in result only.** The IRS accepts the holding of a court in the case and will follow it in disposing of other cases in which the same facts are controlling. However, the IRS has general disagreement or concern with the court's reasoning in the case.
- **Nonacquiescence.** The IRS has decided against appealing the case but does not agree with the holding of the court and will not apply the court's decision in resolving similar cases with other taxpayers.

Observation. An AOD may provide a practitioner with insight on the stance the IRS will take on an issue that has been litigated. In this regard, an AOD may provide a useful source of information about taxpayers in the same or similar circumstances as those involved in the litigation.

The practitioner can view AODs online at **uofi.tax/15b7x7** [irs.gov/actions-on-decisions]. In addition, the Internal Revenue Manual provides information about when the IRS will consider issuing an AOD and the criteria used to determine when doing so is appropriate. This information can be found at **uofi.tax/15b7x8** [www.irs.gov/irm/part36/irm_36-003-001#d0e51].

Note. Although the IRS is bound by a particular Tax Court or federal court ruling with regard to the taxpayer(s) involved in that case, it is not bound to follow that decision in subsequent cases that have the same or similar facts. In addition, the IRS is not obligated to appeal a case from Tax Court or any other court.

6. *Actions on Decision (AOD)*. IRS. [irs.gov/actions-on-decisions] Accessed on Jul. 24, 2024; IRM 36.3.1 (2013).

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CORPORATIONS

Corporate Deductions

***Short Stop Electric, Inc. v. Comm'r*, TC Memo 2023-114 (Sep. 11, 2023)**
IRC §§162, 172, 179, and 6662

☞ Low-Voltage Argument Short Circuits Electrical Contractor's Day in Tax Court

Facts. Short Stop Electric, Inc. (Short Stop) provides residential and commercial electrical contracting services. Originally incorporated in 1989 by Bob Boyum and his wife, Michelle, it has always been a C corporation and has used the **cash method of accounting.**

Short Stop's 2015 and 2016 tax returns claimed deductions for interest payments it never made to Mr. Boyum, who owned almost all of Short Stop's stock. Short Stop recorded these interest payments as increases in what Mr. Boyum called a "revolving line of credit." Mr. Boyum recorded a loan made to Short Stop after determining how much interest he wanted Short Stop to owe him. Although Short Stop never paid the interest to Mr. Boyum, he did recognize income from the interest payments on his personal income tax return. The interest "payments" caused net operating losses (NOL) on Short Stop's returns.

The IRS examined Short Stop's 2006 return. The IRS's revenue agent explained to Mr. Boyum that the unpaid interest could not offset the business's income. Because the agent perceived Mr. Boyum as being receptive to their instruction and eager to learn, the IRS suspended the examination with a "no change" status, even though it effectively converted the retained earnings of the C corporation into deductible interest payments.

Nevertheless, Short Stop continued to record interest payments to Mr. Boyum despite the absence of any cash moving and the revenue agent's instructions. In 2016, Short Stop adopted a new accounting practice, "stranger still," to quote the Tax Court.

In 2012, Mr. Boyum acquired an interest in a cabin on a lake. Mr. Boyum formed a partnership with the property's original owners named Orfei's Landing, LLP, to own and operate the cabin. With $90,000 of personal funds, Mr. Boyum acquired a 25% interest in the partnership but put the interest in Short Stop's name. For a while, the original owners retained the 75% interest but did not transfer the title to the cabin and the associated real estate to the partnership. Mr. Boyum told the court he had wanted to develop the property into a 5-plex.

Claiming that he wanted Short Stop to develop the property, Mr. Boyum acquired another 50% interest in the cabin and an option to acquire the remaining 25%. Mr. Boyum again paid with personal funds, even though Short Stop technically owned the partnership's interest. Short Stop exercised the option, and it indirectly owned an interest in a cabin on a lake. The investment appeared on Short Stop's books in 2016, causing an additional payment of "interest" to Mr. Boyum.

Short Stop never developed the property but used it to entertain its clients and employees. It claimed a deduction for the boat stored on the property, a snowplow, and a forklift. Mr. Boyum later conceded that the boat's cost was not deductible but maintained that the forklift and the snowplow were legitimate business expenses.

For 2015, Short Stop claimed $45,000 of interest deductions, including over $30,000 associated with the new debt associated with the property. This interest expense offset the corporation's taxable income entirely, generating an NOL under IRC §172. For 2016, Short Stop reported over $115,000 in interest expense to Mr. Boyum but used the NOL carryforward to offset its taxable income for that year.

The IRS disallowed the interest deductions and the NOLs that the interest deductions caused. The IRS also disallowed the IRC §179 deductions for the boat, the forklift, and the snowplow because Short Stop did not use them in its business. The IRS added penalties for negligence and substantial underpayment.

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Issues. The issues in this case are the following.

- Whether Short Stop can claim interest deductions on its 2015 and 2016 tax returns
- Whether Short Stop is entitled to the NOL that it carried forward
- Whether Short Stop properly claimed deductions under §179
- Whether Short Stop is liable for accuracy-related penalties

Analysis. Cash-basis taxpayers must pay the interest claimed on their returns; the interest cannot be simply added to the debt's principal.[7] The court explained that this differs from capitalizing interest, summarizing the *Heyman* case.[8]

> *Capitalizing interest postpones an obligation to pay; it does not discharge that obligation.*

Observing that this conclusion is settled law, the tax court did not review whether a genuine debtor-creditor relationship existed between Mr. Boyum and Short Stop.

The court noted the "exceptional strangeness" with which Short Stop computed the interest due to Mr. Boyum. The revolving line of credit was associated with a written agreement dated December 31, 2009, between Mr. Boyum and Short Stop, permitting the company to borrow up to $1 million from Mr. Boyum. The agreement provided for **monthly** interest payments. This agreement authorized Mr. Boyum to determine a rate of interest each year and permitted Short Stop either to pay Mr. Boyum or add unpaid interest to the principal amount of the loan. But instead of collecting interest each month, Mr. Boyum calculated an interest rate and then added the unpaid interest on an **annual** basis.

Considering this practice, the court concluded that the loan agreement was fictional and that Mr. Boyum had made capital contributions to the company rather than extending loans. Because Mr. Boyum testified that he considered the financial condition of Short Stop when determining the interest percentage, the court concluded that any payments would amount to dividends rather than interest. Short Stop could not deduct unpaid "interest" amounts under IRC §162 as a C corporation, but its shareholder, Mr. Boyum, would still pay tax on them. Further, the court concluded the following.

> *The real surge that fries [Mr. Boyum's] argument is [his] intent in creating the loan... Boyum admitted that his goal for this "line of credit" was to convert as much of the balance as possible to principal.*

This action was Mr. Boyum's way of transforming Short Stop's retained earnings into the balance of a loan that would be repaid to him without tax effect when he sold Short Stop rather than being treated as a capital gain.

The court examined the legitimacy of the NOLs in light of denying the interest deductions. Because the interest deductions were not valid, the legitimate 2014 NOL reduced from $34,000 to $762. Additionally, because the company failed to elect on its 2014 return to carry the NOLs **forward,** this smaller amount would have to be carried **back** to its 2012 and 2013 returns, which showed positive income when the interest deductions were disallowed. Treas. Reg. §1.172-1(c) requires taxpayers to include a "concise statement setting forth the amount of the net operating loss deduction claimed." The omission of this statement from the 2015 and 2016 returns by itself disqualified the carryforward of the 2014 NOL.[9]

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7. Treas. Reg. §1.461-1(a)(1).
8. *Heyman v. Comm'r*, 70 TC 482 (1978), *aff'd* 652 F.2d 598 (6th Cir. 1980).
9. See *Amos v. Comm'r*, TC Memo 2022-109 (Nov. 10, 2022), in which the taxpayer provided inadequate substantiation for their NOL, resulting in the Tax Court disallowing it.

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The court also examined Short Stop's §179 deductions for its snowplow attachment and forklift. Before trial, Short Stop conceded that the boat was not deductible, and the court's opinion indicated that personal use of it made the company's deduction untenable. The court concluded that neither the forklift nor the snowplow was listed property, which would have subjected both assets to the heightened substantiation requirements of IRC §274(d)(4). The court concluded that its use was predominately business-related, meeting the 50% threshold requirement for §179.[10] The court followed the IRS's earlier finding that Short Stop used the plow 50% for business to arrive at this conclusion.

In examining the §179 deduction for the forklift, the court took judicial notice that Minnesota has "lovely seasons that are snow-free." This notice supported the court's acceptance of Mr. Boyum's testimony that Short Stop used the forklift for business purposes. The Tax Court concluded that Short Stop was entitled to claim it used the asset 70% for business.

Because the IRS had already told Mr. Boyum not to add the unpaid interest to the loan, the court applied accuracy-related penalties under IRC §6662.

Holding. The Tax Court held that Short Stop's claim for interest deductions was improper, as was the claim for the NOL. Although the Tax Court allowed the §179 deduction for a portion of its forklift purchase, it denied the deductions for the boat. Finally, the court held that Short Stop was liable for accuracy-related penalties.

Corporate Valuation

***Connelly v. U.S.*, No. 23-146 (Jun. 6, 2024)**
IRC §§2001, 2031, and 2033

☞ Supreme Court Puts a Price on Brotherly Love

Facts. Brothers Michael and Thomas Connelly owned a building supply company organized as a corporation. They entered into an agreement providing that if one brother died, the other brother had the option, but not the obligation, to purchase his deceased brother's shares. If he declined the option, the corporation was obliged to buy the decedent's shares and thereby redeem them. Accordingly, the corporation bought life insurance on each brother's life to pay for the share redemption. When Michael passed away, Thomas decided not to purchase the shares. Consequently, the corporation had to redeem them. Thomas was the executor of Michael's estate and filed a federal estate tax return for it.

This tax return valued Michael's shares at $3 million. The valuation said the company was worth $3.86 million but excluded $3 million in insurance proceeds used to redeem the shares. It assumed that the share redemption obligation offset the life insurance proceeds. The IRS, however, believed the redemption obligation did not offset the life insurance proceeds, implying the company was worth $6.86 million. Multiplying that by Michael's 77.18% interest meant his shares were worth $5.3 million. According to this calculation, the IRS determined the estate owed an additional $889,914 in taxes. The estate paid the deficiency, and Thomas sued for a refund.

Issue. The issue in this case is whether the corporation's obligation to redeem Michael's shares offsets the life insurance proceeds in the company's valuation.

[10] Treas. Reg. §1.179-1(d)(1).

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Analysis. Tax is owed on the transfer of the taxable estate of every U.S. citizen.[11] The taxable estate includes the value of all property owned by the decedent at the time of their death, minus applicable deductions.[12] The estate includes shares in a closely held private corporation.[13] The fair market value (FMV) of a corporation determines the values of its shares. The proceeds of life insurance policies must be considered when determining the FMV of a corporation.[14]

If a corporation buys a shareholder out, fewer shares remain outstanding because the company spent money to buy the shareholder out. Yet, the value of each outstanding share is unaffected. Therefore, a redemption obligation does not reduce share value; fewer shares are outstanding after the redemption. Also, the executor must assess the corporation's value at the time the shareholder died.

At the time of Michael's death, the company would have been worth the full $6.86 million, as the redemption would not yet have occurred.[15] Additionally, if the share redemption obligation offsets the insurance proceeds, Thomas would receive a larger stake in the company, which would have the same value as before Michael died. When a company spends its money to redeem shares, it reduces the company's value by the expenditure of its own assets rather than another shareholder's money.

Holding. The court held that the corporation's obligation to redeem Michael's shares does not decrease their value.

> **Note.** As a result of this ruling, business owners should review the structure of any buy-sell agreements and consider whether a cross-purchase agreement where shareholders purchase insurance on each other may better serve their estate needs. Additionally, owners should evaluate their life insurance policies and regularly obtain a professional valuation of their business to comply with current market values and relevant tax regulations.[16]
>
> For more information on cross-purchase agreements and estate planning with life insurance, see the 2024 *University of Illinois Federal Tax Workbook,* Chapter 11: Agricultural Issues and Rural Investments.

CREDITS

Credits

***Meyer, Borgman, & Johnson Inc. v. Comm'r,* No. 23-1523 (8th Cir. May 6, 2024), *aff'g* TC No. 7805-16 (Nov. 19, 2020)**
IRC §41

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☞ Structural Engineering Firm's Research Tax Credit Claim Does Not Hold Weight

Facts. The structural engineering firm Meyer, Borgman, & Johnson, Inc. (Meyer) claimed $190,000 in research tax credits for the tax years 2010, 2011, and 2013. The credits arose from contracts with architects for custom engineering and design. The IRS denied the tax credits, and at trial, the Tax Court's summary judgment upheld its determination.

The Tax Court reached its decision because Meyer would receive payments regardless of the outcome of the research. The court disregarded the provisions of the contracts that imposed guidelines on Meyer. Because Meyer received payment irrespective of the research's result, the court regarded the research as funded. Under IRC §41(d)(4)(H), only research that is **not funded** by an outside party qualifies for the research tax credit.

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11. IRC §2001(a).
12. IRC §2031(a).
13. IRC §2031(b).
14. Treas. Reg. §20.2031-2(f)(2).
15. IRC §2033.
16. *Supreme Court Upholds Connelly: What It Means For Business Owners.* Erskine, Matthew. Jun. 6, 2024. Forbes. [www.forbes.com/sites/matthewerskine/2024/06/06/supreme-court-upholds-connelly-what-it-means-for-business-owners] Accessed on Jul. 8, 2024.

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Issue. The issue in this case is whether the Tax Court's legal conclusion is correct that Meyer is **not** entitled to the research tax credits.

Analysis. Research credits are limited to qualified research expenses.[17] Qualified research is undertaken to discover technological information to develop business components.[18] Research funded by grants, contracts, or other persons is not considered qualified research.[19] A taxpayer can only claim the credit if payment for the research is not funded because it is "contingent on the success of the research."[20]

Meyer claimed its payments were contingent on its research success because it was required to create designs including everything the clients required, and Meyer had to comply with building codes. Contract provisions also allowed for termination if Meyer did not substantially perform. However, none of the contracts explicitly made payment contingent on Meyer's successful research. Additionally, requirements to abide by building codes did not require successful performance.

Meyer also claimed its contracts had quality assurance provisions, making payment contingent upon successful research. However, Meyer's contracts did not have the express terms that courts have identified as important to making payment contingent upon successful research.[21]

Holding. The appellate court affirmed the Tax Court's summary judgment. Meyer was not entitled to the research tax credit because payment from its clients was not contingent upon its successful research.

Low-Income Housing Credit

***23rd Chelsea Associates, LLC v. Comm'r*, 162 TC 3 (Feb. 20, 2024)**
IRC §§42 and 263A

☞ The Benefit of Financing Costs

Facts. Between June 2000 and March 2001, 23rd Chelsea Associates, LLC purchased real estate on West 23rd St. in New York City. Chelsea built an apartment building on the land called the Tate during 2001-2002. The construction was funded by a 31.5-year, $110 million loan from the New York State Housing Finance Agency (HFA). To finance the loan, HFA issued bonds, some of which were tax-exempt.

As a condition of the loan, HFA required Chelsea to agree to certain restrictions on the tenant mix as determined by income. The restrictions were designed to preserve the tax-exempt status of the bonds and qualify the Tate for the low-income housing credit (LIHC). Chelsea spent $107,444,441 out of the $110 million loan by December 2003. The $107 million figure included $5,745,837 that Chelsea spent in financing costs. Chelsea claimed an LIHC of $593,961 for each tax year from 2003-2009.

In 2004, Chelsea presented to the HFA an independently audited final cost certification and included an eligible basis calculation. The eligible basis calculation included a portion of the financing costs, which was $1,218,320. The HFA was responsible for allocating to the Tate an amount no greater than necessary for the project. The HFA did not dispute Chelsea's calculation of eligible basis, qualified basis, or LIHC amount. However, in 2019, the IRS issued a notice of final partnership administrative adjustment for the tax year 2009 to Chelsea, claiming the $1,218,320 should not be included in the eligible basis calculation.

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17. IRC §§41(a)(1) and (b).
18. IRC §41(d)(1)(B).
19. IRC §41(d)(4)(H).
20. Treas. Reg. §1.41-4A(d)(1).
21. *Dynetics, Inc. & Subsidiaries v. U.S.,* 121 Fed.Cl. 492, 505 (2015).

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Issues. The issues in this case are the following.

- Whether the eligible basis in a qualified low-income residential building includes financing costs
- If financing costs are not includible in eligible basis, whether IRC §42(j) requires credit recapture by the taxpayer

Analysis. The LIHC provides a tax credit for low-income restricted housing. The building must be residential rental property subject to income level restrictions for at least 15 years and must be eligible for the modified accelerated cost recovery system (MACRS). The credit is calculated as a **percentage** of the apartment building's **qualified basis.**

The qualified basis is computed by determining the building's **eligible basis,** which equals its **adjusted basis** at the end of the first year of the credit period. The adjusted basis is the total of the property's direct costs and properly allocable share of indirect costs. Then, the eligible basis is increased by 30% if the building is in an area with a large number of low-income residents, a high poverty rate, or high construction costs. The eligible basis is then multiplied by an **applicable fraction,** which is the lower of the fraction of rental units that are rent-restricted and occupied by low-income tenants or the fraction of residential rental floor space allocated to the low-income units.[22] IRC §42 also provides for recapturing some credits allowed for prior years. The credits are recaptured if, at the end of any year during the first 15 years of credit periods, the building's qualified basis is lower than at the end of the previous year.[23]

The IRS disputed Chelsea's eligible basis calculation, so the court looked to §42(d) to resolve the dispute. The Tate's eligible basis was the sum of Chelsea's direct construction costs and a properly allocable share of the indirect construction costs, minus costs allocable to portions of the building that were not "residential real property" at the end of the first year of the credit period.[24]

Direct costs are the sum of direct material and labor costs,[25] while indirect costs are all other properly allocable costs. Indirect costs must be a "but-for" cause of the taxpayer's production activities.[26] The $1,218,320 of financing costs were an indirect but-for cause of the Tate's construction because Chelsea decided to finance construction by borrowing from the HFA. Thus, the financing costs are part of the adjusted basis, which is part of the eligible basis.

The IRS also argued the LIHC requires a building to be subject to MACRS to be a qualified low-income building,[27] and the costs of obtaining bond proceeds should be capitalized into the underlying loan. The IRS argued further that if Chelsea capitalized the bond costs with the loan, they would be subject to depreciation but not MACRS. Consequently, Chelsea cannot include the bond costs in the eligible basis calculation. Nevertheless, the court ruled that the cost of bond proceeds does not need to be capitalized into an underlying loan as they were indirect costs "incurred by" the Tate's construction.[28] Additionally, the Tate is tangible business property and thus eligible for MACRS under IRC §168.

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The IRS also argued that the legislative history shows that the portion of the costs allocable to tax-exempt bonds is not included in the property's eligible basis, even if some of the financing costs are included. However, the IRS failed to allege any ambiguity in §42, which reads, "The adjusted basis of any building shall be determined without regard to the adjusted basis of any property which is not residential rental property." When the language of a statute is clear, the court does not consider legislative history.[29]

Holding. The court held that the $1,218,320 of financing costs were properly included in the eligible basis. Consequently, the court did not reach the issue of whether the recapture provisions of §42(j) would apply to Chelsea.

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22. IRC §§42(c)(1), (d)(1), (4), (6)(C), and (i)(3).
23. IRC §42(j)(1).
24. See IRC §42(d)(4)(A).
25. Treas. Reg. §1.263A-1(e)(2)(i).
26. *Robinson Knife Mfg. Co., Inc. & Sub. v. Comm'r,* 600 F.3d 121, 131–32 (2d Cir. 2010).
27. IRC §42(c)(2)(B).
28. See Treas. Reg. §1.263A-1(e)(3)(i).
29. *Hughes Aircraft Co. v. Jacobson,* 525 U.S. 432, 438 (1999).

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DEDUCTIONS

Taxable Income

***David and Juana Villa v. Comm'r*, TC Memo 2023-155 (Dec. 28, 2023)**
IRC §§61, 162, 274, 6001, 6662, 6751, and 7491

☞ On the Fence About "Costs of Goods Sold"

Facts. David Villa moved to the United States in 1998, entering the fence-building business with his father after they immigrated. Mr. Villa operates the business as a sole proprietorship. During the years in issue, Mr. Villa worked as a subcontractor for 10 Point, Inc., DBA All-Texas Fence (All-Texas), and as a direct contractor for other customers. All-Texas provided the wood for the subcontractor projects, but Mr. Villa had to provide all materials for his direct contracting projects.

All-Texas paid Mr. Villa $26,022 in 2016 and $28,314 in 2017, and it reported those amounts on Forms 1099-MISC, *Miscellaneous Income*. Mr. Villa received $20,817 in 2016 and $40,630 in 2017 for direct contracting work. He deposited the checks but took out cash, marked "less cash" on the bank deposit slips, to pay business and personal expenses. The "less cash" withdrawals were $8,996 in 2016 and $16,480 in 2017. Mr. Villa kept some receipts, but not all.

For each year at issue, Mr. Villa asked his cousin to prepare a joint income tax return for his wife and himself. Mr. Villa's cousin was not a licensed accountant but prepared the returns for free as a favor. For the years at issue, the Villas only reported the payments from All-Texas but not any payments from the direct contracting work. Mr. Villa deducted $8,750 as contract labor expenses for 2016 and $10,501 for 2017. Mr. Villa also deducted "other" expenses of $11,690 for 2016 and $12,096 for 2017.

The IRS analyzed bank deposits, determining that the gross income for both years should be increased by the payments received for direct contracting work. The IRS also adjusted expenses reported on Schedule C, *Profit or Loss from Business*. Contract labor expenses were decreased from $8,750 to $4,814. The "other" expenses were reduced from $11,690 to $2,860. For 2017, contract labor expenses were increased to $11,881, and "other" expenses were decreased from $12,096 to zero. The IRS imposed accuracy-related penalties under IRC §6662(a), including penalties attributable to disregarding the rules or regulations under §6662(b)(1), and a substantial understatement of income tax under §§6662(b)(2) and (d).

Based on receipts that Mr. Villa produced before trial, the IRS agreed to increase contract labor expenses for 2016 to $8,750 and "other" expenses to $4,108. For 2017, the IRS increased "other" expenses from zero to $10,837.

The Villas asked the court to reduce the Schedule C net profit by applying their "less cash" withdrawals, $8,996 for 2016 and $16,480 for 2017, as costs of goods sold. This was based on Mr. Villa's "less cash" withdrawals, as supported by an estimate of his average profit margin, as discussed later. The net profit amounts claimed by the Villas were $24,985 for 2016 and $29,746 for 2017.

Issues. The issues in this case are the following.

- Whether the net profit amounts claimed for the years at issue should be reduced for "costs of goods sold" that were a part of Mr. Villa's "less cash" withdrawals based on his estimated profit margin
- Whether the Villas should be subject to penalties under §6662

Analysis. A taxpayer must maintain sufficient permanent records to substantiate their business's cost of goods sold.[30] If a taxpayer shows they incurred a deductible expense but cannot substantiate the exact amount, the court can estimate it according to the *Cohan* rule.[31] This rule also applies to estimating the cost of goods sold. The rule, however, cannot be used to estimate expenses covered by the substantiation requirements of IRC §274(d), which for the years at issue applied to most expenses for transportation, lodging, meals, etc.

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30. IRC §6001.

31. *Cohan v. Comm'r*, 39 F.2d 540, 543-44 (2d Cir. 1930).

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Deductions from gross income are allowed only to the extent provided by law. However, the reduction of gross receipts by cost of goods sold is mandatory, as only **income** is taxable according to the 16th Amendment of the U.S. Constitution. The Code defines a taxpayer's income as gross receipts less the cost of goods sold.[32] Mr. Villa testified he used "less cash" withdrawals to pay for business needs and personal expenses but did not specify what proportion of withdrawals went to business needs and personal expenses.

Mr. Villa gave an example of a recent project where 73% of his payment from the client went to pay for materials and contract labor. The court found this to be an accurate representation of his direct contracting work. However, the ratio did not consider the portion of the "less cash" withdrawals that Mr. Villa used for personal expenses without proper substantiation. Nor did it consider the fact that Mr. Villa did not have to purchase materials that he used on subcontracting projects with All-Texas.

Because neither party explained the composition of the "other" expenses for 2016 and 2017, the court was unclear to what extent these amounts included materials from the direct contracting work. Nevertheless, the court was confident that Mr. Villa used a substantial portion of the withdrawals to purchase materials and allowed 50% of the "less cash" withdrawals as cost of goods sold. Thus, the court allowed $4,498 for 2016 and $8,240 for 2017 as cost of goods sold.

A penalty of 20% applies to any underpaid tax due to negligence, disregard of rules, or a substantial understatement of income tax.[33] An understatement is substantial if it exceeds the greater of $5,000 or 10% of the tax required to be shown on the return for the year in question.[34]

The IRS also established that the Villas failed to report any gross receipts from direct contracting work. This omission reflected reckless or intentional disregard for IRC §61, which provides that gross income includes income "from whatever source derived." Thus, the IRS made a prima facie case for a 20% penalty under §6662(a) and (b)(1).

There is an exception to §6662 under IRC §6664(c)(1) "if it is shown that there was a reasonable cause" for the underpayment and "the taxpayer acted in good faith by not reporting all of the income." This is determined on a case-by-case basis. Mr. Villa testified that he failed to report the receipts for direct contracting work because his customers did not send him Forms 1099-MISC and therefore, he "didn't know how to" report that income. Even if Mr. Villa truly believed that he needed to report only income appearing on Forms 1099-MISC, it would not have been a reasonable belief. Mr. Villa's reliance on his cousin to prepare the tax returns was also unreasonable under the circumstances because even if his cousin told him he did not need to report that income, he knew that his cousin was not a professional accountant.

Holding. The court held that there should be a deduction for the cost of goods sold that included a portion of the "less cash" withdrawals that Mr. Villa presumably used to purchase materials. It adjusted the total income amount on the Villas' tax returns to $29,483 for 2016 and $37,986 for 2017. The Villas were held liable for penalties under §6662(a) for both years at issue.

32. Treas. Reg. §1.61-3(a).

33. IRC §6662(a).

34. IRC §6662(d)(1)(A).

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Deductions

***Andrew and Katherine Harrell v. Comm'r,* TC Summ. Op. 2023-31 (Oct. 30, 2023)**
IRC §§162 and 274

☞ Taxpayers' Deductions Go Off the Record

Facts. In 2017, Andrew Harrell was employed by Goodwill, GPR Logistics, LLC, and Village Management Services, Inc. at different times during the year. While working for Goodwill and GPR, Mr. Harrell managed a fleet of buses that served a residential complex and managed maintenance of the roads, clubhouses, and assisted-living facilities in the complex. Mr. Harrell's employment responsibilities required frequent travel through southern California. Mr. Harrell **did not keep** track of the expenses he incurred during his business travels and **did not keep** a record of whether use of his personal vehicle was employment-related or for personal use. Village sometimes reimbursed Mr. Harrell for his business expenses. The Harrells did not provide the employee expense reimbursement policies of any of Mr. Harrell's employers.

Mr. and Mrs. Harrell filed a joint federal income tax return in 2017. The Harrells reported the amounts from their Forms W-2, *Wage and Tax Statement,* and they also claimed a miscellaneous itemized deduction for unreimbursed employee business expenses related to Mr. Harrell's employment. The deduction totaled approximately 50% of the income shown on the Forms W-2. The deductions included amounts for vehicle expenses, travel expenses, meals and entertainment expenses, and other business expenses.

The IRS disallowed the entire deduction because the Harrells did not establish that the business expense on their tax return was paid or incurred during the taxable year and that the expense was ordinary and necessary to Mr. Harrell's business.

Issue. The issue in this case is whether the Harrells are entitled to a miscellaneous itemized deduction for unreimbursed employee business expenses.

Analysis. In a notice of deficiency, the IRS's determination of the taxpayer's federal income tax liability is presumed correct, and the taxpayer bears the burden of proving the determination to be wrong. Deductions are a matter of legislative grace, and the taxpayer bears the burden of proving entitlement to any claimed deduction. A taxpayer is required to substantiate expenses underlying deductions and produce adequate records.

Taxpayers can deduct ordinary and necessary expenses paid in connection with operating a trade or business. The performance of services as an employee constitutes a trade or business. If an employee is required to incur certain expenses, as a condition of employment, the employee is entitled to deduct those expenses unless they are entitled to reimbursement from their employer. If there is sufficient evidence that the taxpayer has incurred a business or trade expense but is unable to provide the amount, the court may estimate the amount of the deduction. In this case, there is no basis in the record that allows the court to estimate the amount of any expense included in the deduction.

Deductible business expenses for travel, meals, entertainment, and vehicle expenses require strict substantiation. Taxpayers are required to substantiate these deductions either by adequate records or by sufficient evidence about the amount of the expense, the time and place the expense was incurred, the business purpose of the expense, and in the case of an entertainment or gift expense, the business relationship to the taxpayer of each expense incurred. Adequate records include keeping an account book, diary, log statement of expense, trip sheets, or other similar records. Substantiation by other evidence requires the production of corroborative evidence supporting the taxpayer's statement. The Harrells failed to establish whether the expenses were paid or incurred and whether the expenses were ordinary and necessary expenses related to Mr. Harrell's employment with any of his employers.

Holding. The court found that the Harrells are not entitled to deduct the expenses and entered judgment for the IRS with respect to the deficiency.

> **Note.** The Tax Cuts and Jobs Act (TCJA) suspended miscellaneous itemized expenses between 2018 and 2025.[35] Because this case related to the 2017 tax year, the TCJA rules did not apply. For more information on the sunsetting of TCJA legislation and associated planning opportunities, see the 2024 *University of Illinois Federal Tax Workbook,* Chapter 12: Planning for the Sunset of the TCJA.

35. *Tax Cuts and Jobs Act,* PL 115-97, §11045.

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EMPLOYMENT TAX

Trust Fund Recovery Penalty

***Taylor v. Comm'r,* TC Memo 2024-33 (Mar. 25, 2024)**
IRC §§6671 and 6672

☞ Delegating Tax Duties Did Not Exempt the CEO from Liability as a Responsible Person

Facts. Rodney A. Taylor, a seasoned management consulting and executive recruiting professional, founded and led Taylor & Co., Inc. ("the company") as its chief executive officer (CEO) and sole shareholder. Mr. Taylor delegated financial tasks to employees and accountants due to his self-reported math learning disability. Robert Gard, an accountant hired for bookkeeping, embezzled $1–2 million from the company over several years. This embezzlement, discovered after Mr. Gard's heart attack and subsequent confession in 2013, led to legal actions against him and the bank involved in the fraud.

However, Mr. Taylor did not use the settlements from these lawsuits to pay the company's unpaid employment taxes. Instead, in December 2013, he paid himself a significant bonus. In January 2014, he transferred company assets to a new entity he organized.

The IRS determined the company failed to remit employment taxes and attempted to notify Mr. Taylor of a trust fund recovery penalty (TFRP) assessment. During this period, Mr. Taylor updated his address on IRS records from 113 Sandy Shores to 99 Sandy Shores Court in Panama City, Florida, on an updated Form 433-A, *Collection Information Statement for Wage Earners and Self-Employed Individuals*, which also contained additional financial details not provided earlier. He eventually relocated to Atlanta, renting out the property. The IRS's efforts to notify Mr. Taylor via certified mail at the 99 Sandy Shores Court address were unsuccessful, as the residence was vacant. In response to the TFRP assessment, Mr. Taylor contested the tax liability at an administrative hearing, challenging the IRS's claim without seeking an alternative to the Notice of Federal Tax Lien (NFTL) filed against him.

Issues. The issues in this case are the following.

- Whether Mr. Taylor, as the sole shareholder and an officer of the company at the relevant time, was a responsible person as described in IRC §§6671 and 6672
- Whether the IRS properly notified Mr. Taylor of the proposed TFRP assessment under §6672(b)
- Whether the IRS's determination to proceed with collection of the TFRP is an abuse of discretion

Analysis. IRC §6672(a) imposes a penalty on any person responsible for collecting, accounting for, and paying over federal taxes but willfully fails to do so. To qualify as a responsible person in the corporate context, they should have had sufficient control over a corporation's affairs to ensure the payment of its employment taxes.[36]

Mr. Taylor contended that he was not a responsible person due to his mathematical incompetence and delegation of financial tasks to others, including the embezzling accountant, Mr. Gard. Nevertheless, considering Mr. Taylor's position as the CEO and sole shareholder of the company and his decisions to disburse the company's funds to pay for items other than its employment tax liabilities, the court determined that Mr. Taylor had sufficient control over the company's financial affairs to ensure the payment of employment taxes. Further, the court found that Mr. Taylor's delegation of tax responsibilities did not exempt him from liability as a responsible person. Moreover, the court determined that Mr. Taylor's failure to pay the company's employment taxes was willful, as he prioritized other payments over tax obligations even after being aware of the unpaid taxes.

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36. See IRC §6671(b); *Scott v. U.S.,* 825 F.3d 1275, 1279 (11th Cir. 2016).

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Next, the court addressed the procedural aspects of the TFRP assessment. A §6672(a) penalty may be assessed against a taxpayer only after the IRS provides written notice sent to the taxpayer at the taxpayer's **"last known address"** that the IRS intends to assess that penalty.[37] The IRS sent the notice to the address from the most recent communication received from Mr. Taylor, the updated Form 433-A. The court held that the IRS had fulfilled its notification obligations by sending the notice to Mr. Taylor's last known address. Mr. Taylor's argument for a reasonable cause defense, based on his delegation of tax duties, was rejected. Deliberate decisions to use corporate funds for non-tax obligations indicated willful neglect.

Finally, the court indicated that any disputes over the exact amount of the underlying tax liability should be settled through computations made under Tax Court rules. The decision to proceed with the collection of the underlying liability through an NFTL was not considered an abuse of discretion, given the IRS's compliance with procedural requirements and the settlement officer's verification of supervisory approval for the penalty assessment.

Holding. The court held that Mr. Taylor was a responsible person, that the IRS properly notified Mr. Taylor of the proposed TFRP assessment in accordance with §6672(b), and that the IRS's determination to proceed with collection of the TFRP is not an abuse of discretion.

EXCISE TAX

Excise Tax

***British Airways PLC v. U.S.*, No. 1:19-cv-01124 (Fed. Cl. Mar. 21, 2024)**

IRC §4261

☞ The IRS Has the Right to Tax Frequent-Flyer Miles Payments

Facts. IRC §4261(a) applies a 7.5% excise tax to "the amount paid for taxable transportation of any person." Taxable transportation mainly includes domestic air transportation that departs in the United States or in a 225-mile zone and ends in the United States or in the 225-mile zone. If the flight is international but begins or ends in the United States, the fares paid are subject to a $12 excise tax under §4261(c)(1). IRC §4261(e)(3)(A) states that excise taxes are imposed on amounts paid to an air carrier for the right to provide mileage awards for transportation of persons. The §4261 taxes are deposited into the Airport and Airway Trust Fund, which finances programs administered by the Federal Aviation Administration (FAA).

British Airways is an airline with headquarters in the United Kingdom. British Airways had reciprocal mileage agreements with three American domestic airlines where British Airways passengers could earn frequent-flyer miles (FFM) as members of the domestic airline's programs when they flew on British Airways flights. British Airways made payments to the domestic airlines on a per-mile basis for the FFMs awarded to passengers. The domestic airlines billed British Airlines for the FFMs and included the 7.5% excise tax in the bill. Between June 2011 and March 2015, the domestic airlines collected approximately $11.4 million in excise taxes from British Airways. British Airways filed administrative claims for a refund because the payments were not "for the right to provide" FFMs. British Airways also argued in the alternative that it was entitled to a refund of the excise taxes that were not redeemed for taxable air travel and instead redeemed for services and goods. The IRS refunded the taxes redeemed for services and goods but disallowed the remaining refund claims of approximately $5.6 million for the period between 2011 and 2015.

The U.S. government filed a motion to dismiss the complaint for lack of subject-matter jurisdiction and a motion for summary judgment as to all of British Airways' refund claims.

37. IRC §§6212(b) and 6672(b)(1).

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Issue. The issue in this case is whether British Airways' payments to the U.S. domestic airlines are subject to the 7.5% excise tax for transportation.

Analysis. The United States argues that the court lacks jurisdiction because the refund forms were not signed. The court has jurisdiction only over tax refund claims that are duly filed with the IRS. However, previous court decisions held that the "duly filed" requirement does not affect subject-matter jurisdiction.[38] Therefore, the Court of Federal Claims has jurisdiction to hear claims for the refund of taxes paid to the IRS under the Tucker Act.[39]

Statutory interpretation first looks at the language of the statute and the plain meaning.[40] British Airways argued that the payments were not made "for the right to provide mileage awards for the transportation of person by air." The court held that the amounts were for the right to provide mileage awards because the "right" is defined as a power or privilege. British Airways argued that §4261(c)(3)(A) does not apply to payments for FFMs that are earned from actual flight activity. However, the statute states that the application of the tax depends on whether the amounts are for the right to provide FFMs. British Airways made the payment to acquire the right to provide its passengers with FFMs in the domestic airlines' frequent-flyer programs to achieve their goal of receiving marketing advantages. The "right to provide" language is not superfluous because it indicates that payments for mileage awards that the payor provides to another carrier should also be taxed.

If the statutory language is clear, the meaning of the statute controls interpretation unless the legislative history demonstrates an "extraordinary showing of contrary intentions."[41] The legislative history, including the House bill reports and conference agreement, supports the government's interpretation of the statute. The statute's purpose was to finance the FAA programs that benefit airlines, and as a result, its interpretation aligns with that purpose. British Airways argued that it is unfair to be taxed under §4261(a) when domestic airlines can earn FFMs for international flights but only have to pay the §4261(c) tax. Despite this result, the interpretation does not frustrate the law's intent because Congress wanted to tax previously untaxed payments to generate revenue.

British Airways argues that two IRS documents should be given "considerable weight" under *Skidmore v. Swift & Co.* IRS Notice 2002-62 supports the government's interpretation that the British Airways' payments to domestic airlines are subject to the §4261(a) tax.[42] In Rev. Rul. 2002-60, the IRS held that amounts paid for mileage awards that can be redeemed for taxable transportation are subject to tax for miles that are not awarded in connection with the purchase of taxable transportation. This ruling involved similar facts of a foreign airline offering FFMs for flights that did not begin and end in the United States. Therefore, the FFMs were not awarded for the purchase of taxable transportation and are subject to the §4261(a) tax.

Rev. Rul. 55-534 is not analogous because, in that ruling, the transportation involved two or more carriers, but British Airways is the only carrier involved in this case.[43] The IRS issued that ruling more than forty years before §4261(e)(3)(A) was enacted. IRC §4261(a) indicates that the excise tax does not only apply to the customer's payment but also to the carrier's payment. Furthermore, the *Skidmore* case is also not applicable because the payments by British Airways to the domestic airlines fall within the plain language of §4261(e)(3)(A).

Holding. The court denied the United States's motions to dismiss for lack of jurisdiction but granted its motion for summary judgment against British Airways.

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38. *Brown v. U.S.*, 22 F.4th 1008 (Fed. Cir. 2022).
39. See *Ont. Power Generation v. U.S.*, 369 F.3d 1298, 1301 (Fed. Cir. 2004); 28 USC §1491.
40. See *Myore v. Nicholson*, 489 F.3d 1207, 1211 (Fed. Cir. 2007).
41. *Bank of Am. Corp. v. U.S.*, 964 F.3d 1099, 1103 (Fed. Cir. 2020).
42. Rev. Rul. 2002-60, 2002-2 CB 641.
43. Rev. Rul. 55-534, 1955-2 CB 655.

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FOREIGN INCOME

Foreign Corporation Taxation

***Charles and Kathleen Moore v. U.S.,* No. 22-800 (Jun. 20, 2024)**
IRC §965

☞ Taxpayer Must Pay Moore Taxes on Foreign Undistributed Income

Facts. Charles and Kathleen Moore invested in an American-controlled foreign corporation called KisanKraft in 2006. The Moores did not pay tax on their income because they did not receive income distributions from KisanKraft. In 2017, Congress passed the Mandatory Repatriation Tax (MRT). The MRT was a one-time, backward-looking, pass-through tax on American shareholders of American-controlled foreign corporations.[44] The MRT imposed an 8–15.5% pro rata tax on American-owned shares. The IRS determined that the Moores owed $14,729 in tax for 2006-2017 pursuant to the MRT. The Moores paid the tax, but then filed suit against the U.S. government, arguing the tax was unconstitutional.

Issue. The issue in this case is whether Congress may attribute an entity's realized and undistributed income to an entity's shareholders and partners, and then tax the shareholders or partners for the income.

Analysis. Congress can tax a corporation's shareholders or its partners rather than the corporation itself as passthrough income.[45] Alternatively, Congress can tax the business entity itself and then tax the shareholders when the entity distributes a dividend or when the shareholder sells their shares. Congress considers American-controlled foreign corporations to be passthrough entities per subpart F.

Direct taxes (those imposed on persons or property) must be apportioned among the states based on each state's population. Indirect taxes (those imposed on income) are not apportioned but must be uniform throughout the United States. The Moores argued the MRT was a tax on property and not apportioned, which is unconstitutional. The MRT, however, was not tax on property. The MRT was taxing income that had been realized by KisanKraft and was then attributed to KisanKraft's shareholders. Therefore, it did not need to be apportioned.

The Moores also argued the MRT was different from taxes that have been upheld by the U.S. Supreme Court in the past, such as taxation of partnerships, S corporations, and subpart F income.[46] But the MRT is not meaningfully different from any of those three types of taxes. The MRT attributes the income of American-controlled foreign corporations to their American shareholders, and then taxes the shareholders on that income. This is the same way that Congress taxes partnerships, S corporations, and subpart F income.

Holding. The Court affirmed that Congress has the authority to tax shareholders or partners for the undistributed income attributed to shareholders or partners of an American-controlled foreign corporation when the entity has not already been taxed for that income.

> **Caution.** The Court ruled on a very narrow issue in this case. It declined to rule on the issue of whether "realization" is a constitutional requirement. It seems likely that a similar case with slightly different facts and circumstances could be ruled in favor of the taxpayer.

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44. IRC §§951–952.
45. *Burnet v. Wells,* 289 U. S. 670, 678–79 (1933).
46. IRC §§1361–1362.

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Reporting Foreign Business Ownership

***Alon Farhy v. Comm'r,* No. 23-1179 (D.C. Cir. May 3, 2024), *rev'g and rem'g* 160 TC 6 (2023)**

IRC §§6038, 6201, and 6330

☞ **Nowhere to Hide Assets**

Facts. In 2004, Alon Farhy, a U.S. permanent resident, created a scheme to falsely underreport his income from exercising stock options by transferring over $2 million to a foreign corporation in Belize, which he owned. Mr. Farhy failed to report ownership of the Belizean corporation for eight years and consequently owed the IRS $500,000 in penalties. The IRS notified Mr. Farhy that it intended to levy his property to collect the penalties. Mr. Farhy conceded that he owed the penalties but disputed how the IRS sought to collect the sum. Mr. Farhy claimed the IRS must sue in federal court and cannot administratively collect the money.

Issue. The issue in this case is whether the IRS's method of collecting the IRC §6038 penalties was lawful.

Analysis. Congress amended IRC §6038(b) to provide a fixed-dollar penalty for failing to report foreign business ownership. The statutory change resulted in a flat $10,000 penalty for failure to file a return on a controlled foreign business, which increases by standard increments to $60,000 per year for knowing violations.[47] Mr. Farhy failed to report his income for years, and the penalties grew to approximately $500,000.

The Treasury Secretary has the power to assess this tax liability, and the assessment power is delegated to the IRS.[48] The assessment sets in motion the IRS's collection powers.[49] If a taxpayer fails to pay a tax assessed by the IRS, the IRS "can employ administrative enforcement methods to collect the tax."[50]

The IRS argued that IRC §6201(a) gave it power to assess the penalties. IRC §6201(a) lists several assessable penalties and associated charges but does not specifically include the §6038 penalties. The IRS, however, argued the §6201(a) list is non-exhaustive. Mr. Farhy countered that the fact that §6038 penalties were not explicitly listed meant they were not assessable. Ultimately, the fact that Congress amended the statute to allow a fixed-dollar penalty to make administrative collection easier indicates the penalties are assessable. Additionally, if the IRS had to sue in federal court rather than use an administrative process, the penalties would be harder to collect, not easier.

IRC §6038 also provides for specified defenses to penalties, such as a reasonable cause affirmative defense, which means the taxpayer must establish they exercised ordinary care in attempting to report obligations.[51] IRC §6038(c)(4)(B) grants the IRS, not a court, the power to grant or deny that defense. If the penalties were not assessable, there would be no post-assessment administrative process in which the taxpayer could show reasonable cause, and the IRS could make a ruling. To emphasize the point, the court discussed the role of collection due process hearings, in which taxpayers can converse with the IRS in a relatively informal setting.[52]

Additionally, Congress may revisit a statute with a longstanding administrative interpretation. The court reasoned that if Congress does not revise or repeal that interpretation, it is evident that Congress intends for the IRS and courts to follow it.[53]

Holding. The court held that the penalties imposed under §6038(b) are assessable, and the IRS may collect the penalties against Mr. Farhy using an administrative process.

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47. *Taxpayer Relief Act of 1997*, PL 105-34, Title XI, §1142(a).

48. IRC §§6201(a) and 6203.

49. *Phila. & Reading Corp. v. U.S.*, 944 F.2d 1063 (3d Cir. 1991).

50. *U.S. v. Galletti*, 541 U.S. 114, 122 (2004).

51. *U.S. v. Boyle*, 469 U.S. 241, 246 (1985).

52. In this discussion, the court quoted the opinion from *Our Country Home Enters., Inc. v. Comm'r,* 855 F.3d 773, 780 (7th Cir. 2017).

53. *NLRB v. Bell Aerospace Co.*, 416 U.S. 267, 274-75 (1974).

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Foreign Tax Credit

***Christensen v. U.S,* 1:20-cv-00935 (Fed.Cl. 2023)**

IRC §§27, 901, 904, 911, 1411, 6511

☞ Vive la Foreign Tax Credit Allowed Against NIIT

Facts. Matthew and Katherine Christensen are U.S. citizens who permanently reside in France. They sought a refund of the $3,851 they paid to the IRS because of the net investment income tax (NIIT) reported on their 2015 income tax return. This action was sought under the 1994 Tax Convention with the French Republic[54] (the "1994 Treaty"). The Christensens filed this return in mid-December 2016 on a timely basis and paid income taxes of $4,672. The return included Forms 1040, *U.S. Individual Income Tax Return*, 1116, *Foreign Tax Credit*, and 8960, *Net Investment Income Tax — Individuals, Estates, and Trusts,* as well as other forms the court found irrelevant to its consideration. In January 2020, Mr. and Mrs. Christensen filed an amended tax return, which included a Form 8833, *Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b)*, and a Form 8275, *Disclosure Statement*.

The Form 8833 indicated they were "disclosing a treaty-based position as required by [IRC] section 6114." "FRANCE" was entered as the treaty country on the form, indicating they relied on articles "2 & 24" of the treaty between the United States and France. The couple specified that they were seeking a refund based on their understanding that they could apply a foreign tax credit against the NIIT imposed by IRC §1411. Form 8275 indicated their dependence on TD 9644.[55]

In February 2020, the IRS disallowed the Christensens' refund claim because the Christensens filed it after the statute of limitations lapsed on October 15, 2019. Their amended return was postmarked on January 8, 2020. Rather than contesting this decision with the IRS, they filed with the Court of Federal Claims.

The litigation focused on applying the "three-bite" rule, each "bite" being the exaction of income tax by the United States or the French government, applying priority as shown below.

1. Treaty-authorized U.S. tax on certain U.S.-source income of a French resident
2. The French tax on income earned by French residents
3. The U.S. tax on worldwide income that the Code imposes based on U.S. citizenship

The three-bite rule implements the provisions of the treaty in the following manner. In the second "bite," France grants U.S. citizens a tax credit against its tax for the tax paid to the United States in the first bite, as provided by paragraph 2(a) of Article 24 of the 1994 Treaty. This paragraph provides French **residents** a credit against French taxes for U.S. tax paid. In the third bite, the United States grants its citizens who are French residents a tax credit for the tax they paid to France in the second bite, as provided by paragraph 2(b) of Article 24 of the 1994 Treaty. However, credits under the third bite do not apply against taxes imposed by the first bite or the second bite. The parties' arguments in court included a dispute about whether the Christensens' attorney provided the United States with the requested calculations of the three-bite foreign tax credits.

Through their attorney, the Christensens argued that the NIIT is identical to the taxes imposed in Chapter 1 of the Code. In opposition, the United States argued that the credit strictly applied to taxes imposed by Chapter 1 of the Code, and requested that the court defer to its interpretation of the Treaty, citing the Supreme Court's decision in *Sumitomo Shoji America, Inc. v. Avagliano*.[56] The Christensens' attorney argued that when a treaty can be interpreted in two manners, the court should prefer the more liberal interpretation, citing another Supreme Court case, *U.S. v. Stuart*.[57]

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54. Tax Convention with the French Republic, Fr.-U.S., Aug. 11, 1985, 1963 U.N.T.S. 67.

55. TD 9644, 2013-51 IRB 676.

56. *Sumitomo Shoji America, Inc. v. Avagliano*, 457 U.S. 176 (1982).

57. *U.S. v. Stuart*, 489 U.S. 353 (1989).

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Issue. The issue in this case is whether a U.S. citizen can claim income taxes paid to France as a credit against the NIIT.

Analysis. The IRS asserted that IRC §911 permits qualified individuals to exclude foreign-earned income from their U.S. taxable income.[58] The court found that IRC §27 provides for a **credit** against tax imposed by IRC chapter 1, which includes §§1–1400Z. However, the NIIT is imposed by IRC §1411, which is the sole section contained in Chapter 2A of the IRC.

The court decided it would defer to the interpretation of the treaty by the United States and France, but neither party in the case offered evidence that a shared understanding had been reached on this issue. The court decided against affording deference to the U.S. Treasury Department's technical explanations of the treaty because they are the opinions solely of the United States and not necessarily shared by France.

The court found that IRC §6511 establishes a clear distinction between foreign tax credits under IRC §901 and foreign tax credits allowed by a treaty. In the end, the court's decision hinged on the judicial principle that extends the most liberal interpretation based on *U.S. v. Stuart,* deciding the following.

> *[t]his liberal interpretation would "enlarge" the availability of foreign tax credit "which may be claimed thereunder," and … is applicable to the interpretation of tax treaties, including the 1994 Treaty, as amended.* [59]

Holding. The court held that paragraph 2(b) of Article 24 of the 1994 Treaty provides a foreign tax credit against the NIIT. The Christensens, therefore, prevailed in their attempt to recover the amount they claimed to have overpaid to the IRS. The court concluded it needed further proceedings regarding the Christensens' calculation of tax credits against other income taxes under the three-bite rule.

GIFT TAX

Impact of Goodwill on Gift Tax

***Cynthia L. Huffman et al. v. Comm'r*, TC Memo 2024-12 (Jan. 31, 2024)**
IRC §§2701, 2703, 6651, and 6662(a)

☞ The Cost of Keeping It in the Family

Facts. Dukes, Inc. manufactured and supplied engineering parts to the aerospace industry. Lloyd and Patricia Huffman were its employees. In 1970, Dukes made Lloyd president, and he acquired 113,365 company shares. In 1979, Lloyd and Patricia formed the Huffman Family Trust (Trust) and appointed themselves as trustees. Dukes reissued Lloyd's shares to the Trust, which acquired 5,000 more shares in 1990. Lloyd and Patricia's son, Chet, became the CEO in 1987 and received 5,000 Dukes shares.

Mr. Barneson was the majority shareholder of Dukes, with 322,241 shares, representing 43% of outstanding shares. He entered into an assignable agreement with Lloyd Huffman, giving Lloyd the right to purchase his shares upon his death or granting him a right of first refusal to acquire his shares for no more than $2 per share (the Lloyd-Barneson agreement). Lloyd assigned his rights under the agreement to Chet, who exercised the right to purchase all of Mr. Barneson's shares in August 1993. Thus, Chet became the majority shareholder of Dukes.

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58. IRC §911(b)(1)(B).

59. *U.S. v. Stuart*, 489 U.S. 353 (1989).

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Chet entered into two other right-to-purchase (RTP) agreements for the rest of the shares of Dukes with the entities owning them; Dukes Research and Manufacturing (DRM), owned by Patricia, his mother, and the Huffman Family Trust. The family's intent for the RTP agreements was to retain ownership within the Huffman family rather than for compensatory purposes, and therefore, restrictions limited their assignability. The RTP agreements allowed Chet to purchase DRM's shares for $3.6 million and the Huffman Family Trust's shares for $1.4 million, for a total of $5 million. Under Chet's leadership, Dukes expanded its customer base, increased its revenues, and improved its profitability. The Huffman family formed and acquired other companies to support Dukes, including a Nevada entity, CCC&B, LLC, which Chet and Cindy, his wife, formed to hold intellectual property assets.

In September 2007, Chet attempted to sell Dukes through a stock sale with a complex reorganization. Dukes-affiliated entities transferred their assets to a new entity, Dukes Group, LLC, to which all Dukes shares would be transferred. The next month, Chet exercised his rights under the RTP agreements, resulting in him owning or controlling all Dukes stock. This first attempt to sell Dukes failed. However, in 2009, a subsidiary of TransDigm, a publicly traded corporation, acquired the Dukes assets for $95.75 million. These assets included all of the goodwill associated with Dukes, including Chet's personal goodwill related to the assets and the business. The agreement between Dukes and TransDigm specified that it would be interpreted according to California law.

An appraiser hired by TransDigm valued goodwill at $50 million, attributing $21.8 million of that to Chet's personal goodwill. Chet entered into a noncompete agreement with TransDigm. The Huffman family relied on their accountants to prepare returns for the family and Dukes. In notices of deficiency, the IRS contested these valuations, and its appraiser valued DRM's and the Trust's shares in Dukes at $23.9 million and $9.3 million, respectively, and Chet's personal goodwill at $0.

During this period, Chet and Cindy Huffman filed several personal tax returns late. Late returns were also filed by CCC&B and by Dukes. The family changed accounting firms during this period, and ultimately their 2008 and 2009 Forms 1040, *U.S. Individual Income Tax Return*, were filed in 2011, as was Form 1065, *U.S. Return of Partnership Income*, for CCC&B, and Forms 1120, *U.S. Corporation Income Tax Return,* for years 2008 – 2010. Lloyd and Patricia Huffman timely filed their income tax returns but failed to file any gift tax returns because they were unaware of the responsibility to do so.

This case consolidated the following three cases that the Huffman family undertook to contest IRS notices of deficiency against them.

- Cynthia (Cindy) and Chet Huffman, and after Chet's death, *Cynthia Huffman and the Estate of Chet Huffman v. Comm'r*
- Patricia and Lloyd Huffman, parents of Chet, and after Lloyd's death, *Patricia Huffman and the Estate of Lloyd Huffman v. Comm'r*
- *Infinity Aerospace, Inc. v. Comm'r* (Dukes was renamed Infinity Aerospace after its assets were acquired by TransDigm)

Issues. The issues in this case are the following.

- Whether Patricia and the Estate of Lloyd Huffman made a taxable gift when Chet exercised his rights to buy DRM's and the Trust's shares in Dukes for $5 million
- Whether Cindy, the Estate of Chet Huffman, and Dukes properly reported the gain from the TransDigm acquisition related to Chet's personal goodwill and CCC&B's intellectual property assets

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Analysis. The value of any property is generally determined without considering options or agreements to acquire property for less than the fair market value.[60] The exception to using agreements for valuation purposes requires three components of an agreement.

1. It is a bona fide business arrangement.
2. It is not a device to transfer property to a decedent's family members for less than full consideration.
3. It has terms comparable to similar arrangements made in arms-length transactions.[61]

The RTP agreements fulfill the first two requirements because keeping a business asset within the family is a bona fide business arrangement, and there was full consideration when Chet negotiated the agreements and accepted a reduced salary as the CEO. However, the RTP agreements are not comparable to the Lloyd-Barneson agreement, which was an arms-length transaction, so the Huffmans did not satisfy the last requirement of IRC §2703(b). Therefore, the court concluded that the Dukes shares purchased by Chet in 2007 could not be valued based on the RTP agreements.

The IRS argued that Patricia made a taxable gift to Chet with a value of $8 million, and Patricia and Lloyd jointly made another taxable gift of $3.1 million on October 15, 2007, through the RTP agreements. Patricia and Lloyd argued that the Trust and DRM shares were worth $5 million, and therefore, they made no taxable gift on October 15. After evaluating the expert opinions of both parties, the court determined that the elder Huffmans failed to show why their expert's valuation was correct. Under IRC §2512(b), any value attached to the shares in excess of Chet's $5 million payment for them is considered a taxable gift from his parents.

The IRS argued that the sale of intellectual property assets should be attributed to Dukes, with a constructive dividend passing to Chet and Cindy. In response, the Huffmans argued that the CCC&B-Dukes transaction was never fulfilled, and therefore, CCC&B owned the intellectual property assets until the TransDigm acquisition in December 2009. The court concluded that the Huffmans had properly reported the gain, and CCC&B was the proper party to report the gain from the sale. Therefore, Chet and Cindy are not liable for dividend income related to the CCC&B sale.

Chet and Cindy reported $21.8 million as the sale price attributable to Chet's personal goodwill and reported $19.4 million of that amount as installment sale income. The IRS argued that this amount should not be reported by Chet and Cindy; instead, it should be reported by Dukes Group according to Nevada law. However, the asset purchase agreement with TransDigm specified that the transaction is governed by California law, and therefore, California law was used to determine whether goodwill can be attributed to an individual. Chet created personal goodwill through his relationships as Dukes's CEO, and under California law, personal goodwill can be owned by an individual.[62] However, the court reduced the valuation of Chet's personal goodwill, and the amount that was distributed to Chet and Cindy needs to be reclassified as a constructive dividend and taxed under IRC §301. The court also found that the IRS's initial valuation of Chet's goodwill at $0 was arbitrary, and the IRS thereby relinquished the presumption of correctness under IRC §7491(a) on this point.[63] Nevertheless, the court ultimately accepted a valuation offered by the IRS's expert, although with some modifications. This shifted some of the goodwill from being reported on Chet's 2009 Form 1040 as **personal** goodwill to being reported by Dukes on its Form 1120 as **enterprise** goodwill.

60. IRC §2703(a)(1).

61. IRC §2701(b).

62. See, e.g., *In re Marriage of Nichols*, 33 Cal. Rptr. 2d 13, 20 n.4 (Ct. App. 1994).

63. *Welch v. Helvering*, 290 U.S. 111,115 (1933); *Estate of Simplot v. Comm'r*, 249 F.3d 1191, 1193 (9th Cir 2001), *rev'g* 112 TC Memo 1997-461 (1997).

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The IRS determined accuracy-related penalties under IRC §6662 against Cindy and the Estate of Chet Huffman and Dukes. The IRS bears the burden of proving tax liability under an individual, but for nonindividual taxpayers, the burden of production remains with the corporation.[64] Under §6662, there is a penalty for underpayment attributable to "negligence or disregard of rules or regulations" or for underpayment attributable to any "substantial understatement of income tax." Cindy and Chet argue that they had reasonable cause, negating §6662(a) penalties because of reliance on their accountants. The Huffmans relied on their two licensed CPAs to determine how to report the TransDigm sale proceeds. They provided their accountants with as much accurate information as they could gather. Therefore, the Huffmans had reasonable cause and are not liable for the §6662(a) penalties attributable to underpayment. The court ruled that Patricia and Lloyd also had reasonable cause for failing to report gift tax liability because their accountant did not advise them of any potential gift tax liability. Therefore, Patricia and her late husband's estate do not have to pay the IRC §6651(a) penalty for failure to file timely gift tax returns.

Holding. The court held that Patricia and her late husband's estate are liable for tax on the gift given to Chet on October 7, 2007. Chet properly reported personal goodwill on his taxes; however, the amount of goodwill must be lowered. The court also found that Dukes understated the amount of **enterprise** goodwill reported on its 2009 Form 1120, resulting in an increase in 2009 corporate income tax.

Under §6662, Lloyd and Patricia Huffman had reasonable cause to avoid the accuracy-related penalties due to reliance on their accountants. However, the court sustained the late payment and late filing penalties assessed against Cindy and the Estate of Chet Huffman.

GROSS INCOME

Civil Fraud Penalties

***Khurram Gondal and Arooj Asmat v. Comm'r*, TC Memo 2024-36 (Mar. 27, 2024)**

IRC §§6662, 6663, 7454, and 7491

☞ The Highest-Paid Taxi Driver in New York City

Facts. Khurram Gondal and his business partner ran a car-for-hire business in New York during 2017 and 2018. They ran the business through the following C corporations (collectively, Gondal's Transportation Companies or GTC).

- All County Med Cab, Inc.;
- Four Way Taxi, Inc.;
- Green Mountain Medical Transportation, Inc.;
- Capital Cab Corporation; and
- All NY Taxi & Limo, Inc.

Mr. Gondal and his business partner contracted with the New York State Department of Health to provide medical transportation. However, they billed the State for trips that were not medical in nature. Mr. Gondal eventually pleaded guilty to one count of healthcare fraud. For the 2017 tax year, Mr. Gondal and Arooj Asmat filed a joint tax return with a reported income of $30,000. Four Way Taxi issued Mr. Gondal a Form W-2, *Wage and Tax Statement*, reporting $30,000 of wages in 2017. For 2018, Mr. Gondal received Forms W-2 from Capital Cab Corporation and Four Way Taxi, collectively reporting wages of $20,000. Mr. Gondal and Ms. Asmat's joint tax return for 2018 reported total income of $22,305. Also in 2018, Mr. Gondal filed a single Schedule C*, Profit or Loss From Business*, listing $20,659 of gross income and $6,464 of total expenses, resulting in net taxable income of $14,195.

[64] IRC §7491(c); See *NT, Inc. v. Comm'r*, 126 TC 191, 195 (2006).

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The IRS examined Mr. Gondal and Ms. Asmat's tax and bank records after Mr. Gondal's plea agreement in the healthcare fraud case. The examination agent found that Mr. Gondal paid personal expenses with money from GTC during the years at issue. The agent concluded that Mr. Gondal, fraudulently and with intent to evade tax, withdrew money from GTC to pay personal expenses. In total, Mr. Gondal withdrew $701,125 for 2017 and $715,365 for 2018 and failed to report it as income in the form of constructive dividends. None of the withdrawals were repaid. Mr. Gondal also underreported his tax due by $142,882 for 2017 and $138,311 for 2018.

In August 2021, the IRS agent and his supervisor asserted a civil fraud penalty against Mr. Gondal and an accuracy-related negligence penalty under IRC §6662(a) in the alternative. The IRS also assessed an accuracy-related negligence penalty under §§6662(a) and (c) against Ms. Asmat. The agent's supervisor timely approved the penalties in writing.

The IRS issued a notice of deficiency asserting these penalties in August 2022. In October 2022, Mr. Gondal and Ms. Asmat petitioned the Tax Court to dispute this notice of deficiency. They claimed the income mentioned in the notice of deficiency was business income, not personal income, but they failed to address the penalties in their petition.

Issues. The issues in this case are the following.

- Whether Mr. Gondal and Ms. Asmat understated and underpaid their income tax for 2017 and 2018
- Whether Mr. Gondal is liable for civil fraud penalties for 2017 and 2018

Analysis. Taxpayers are obligated to maintain books and records to establish income and expenses.[65] Otherwise, the IRS can reconstruct income by reviewing the taxpayer's bank deposits. After reviewing GTC's and Mr. Gondal's bank accounts, the IRS determined that Mr. Gondal withdrew $701,125 and $715,365 from GTC's accounts for 2017 and 2018 respectively, far more than Mr. Gondal's reported income. The court agreed with the IRS agent that these payments constituted "constructive dividends," as they were disbursements not intended to be repaid to the company. Mr. Gondal and Ms. Asmat failed to establish that the withdrawals were used for business purposes, treated as loans, or repaid. As they also failed to establish a nontaxable source for the unreported deposits into their personal accounts, Mr. Gondal and Ms. Asmat failed to include these constructive dividends in their income for 2017 and 2018, thus understating their tax for the two years.

The IRS bears the burden of proving taxpayer liability for any penalty.[66] The fraud must be proven by "clear and convincing evidence."[67] To satisfy this requirement, the IRS must prove both of the following.

1. Underpayment of tax for the year at issue, and
2. Some part of the underpayment is attributable to fraud.[68]

If the IRS successfully proves these things, it may impose a 75% penalty for underpayment of tax.[69] The first element was proven as the IRS showed Mr. Gondal underpaid the tax.

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65. IRC §6001.

66. IRC §7491(c).

67. IRC §7454(a).

68. *DiLeo v. Comm'r*, 96 TC 858, 873 (1991).

69. IRC §6663(a).

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Fraudulent intent may be shown by circumstantial evidence. A taxpayer's entire course of conduct can establish fraudulent intent.[70] Additionally, a court can infer fraudulent intent when a taxpayer files a document to conceal information that prevents the collection of tax. There are various indicators, or "badges," of fraud courts to consider.[71] The court found several badges of fraud present in this case, as Mr. Gondal understated his income and concealed it through cash withdrawals and payment of personal expenses from business accounts. He also failed to report constructive dividends received from GTC. Mr. Gondal also misreported his exemptions, net investment income tax, self-employment tax, earned income tax credit, additional child tax credit, and tax due. Additionally, he failed to maintain adequate records and submit them in connection with the examination.

Holding. Mr. Gondal and Ms. Asmat underreported their income for 2017 and 2018. Mr. Gondal is also liable for the civil fraud penalties imposed by the IRS.

Settlement Proceeds

***Estate of Finnegan et al. v. Comm'r,* TC Memo 2024-42 (Apr. 10, 2024)**

IRC §§61 and 104

☞ Taxpayers' Unsuccessful Exclusion Attempt for Settlement Proceeds

Facts. Roman J. Finnegan, a resident of Indiana, passed away, leading to legal actions involving his estate and family members, who resided in Indiana and Tennessee. Mr. Finnegan had been married to Lynnette since May 2004 and was the stepfather to her children, Katelynn, Johnathon, Tabitha, and J.S. The family faced tragedy when J.S. died at 14 due to several medical issues, leading to investigations by the Indiana Department of Child Services (DCS) and the Indiana State Police (ISP). They alleged neglect and abuse by Mr. and Mrs. Finnegan. Although the criminal charges were dismissed, DCS continued to scrutinize the family, resulting in Katelynn and Tabitha being placed in foster care temporarily.

Mr. and Mrs. Finnegan contested the DCS's allegations in Pulaski Circuit Court, which eventually ordered DCS to remove the substantiations against them. The family, including the children, then filed a lawsuit against various Indiana state employees under 42 USC §1983, alleging civil rights violations under the First, Fourth, Sixth, and Fourteenth Amendments. The lawsuit contended that state employees retaliated against the Finnegan family following Mr. Finnegan's complaints about DCS's handling of their case by falsely accusing the Finnegans of neglect and abuse, and wrongfully detaining their children.

In the litigation, Mr. Finnegan was the only one who mentioned suffering from post-traumatic stress disorder (PTSD), related to the stress and accusations faced during the ordeal. The court cases involved complex legal proceedings, including the dismissal of some claims and retention of others, focusing on the improper actions of the state employees, which allegedly violated the family's constitutional rights. The family sought and was awarded compensatory damages for these violations, but did not secure punitive damages. On April 4, 2017, the parties settled the litigation by executing a settlement agreement where the family received $25 million in compensation for the alleged violations of their civil and constitutional rights.

On June 18, 2018, the IRS initiated an examination of Mr. and Mrs. Finnegan's 2017 tax return. The IRS's contacts with Mr. and Mrs. Finnegan's representative revealed claims of tax exclusions for settlement proceeds, citing constitutional rights, but not PTSD. The IRS maintained that the settlement proceeds were taxable.

Issue. The issue in this case is whether the settlement proceeds Mr. Finnegan's estate and family members received should be excluded from their gross incomes under IRC §104(a)(2).

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70. *Niedringhaus v. Comm'r*, 99 TC 202, 210 (1992).

71. *Bradford v. Comm'r*, 796 F.2d 303, 307 (9th Cir. 1986).

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Analysis. The IRS's determinations in a notice of deficiency are presumed correct, and the taxpayers bear the burden of proving those determinations erroneous.[72] IRC §61(a) broadly defines gross income, and taxpayers must clearly show that an exclusion applies to their situation.[73]

IRC §104(a)(2) specifically excludes from gross income **damages** received due to personal physical injuries or sickness. Emotional distress damages are included in gross income unless they stem directly from a physical injury or sickness.[74] When damages are received pursuant to a settlement agreement, the nature of the claim that gave rise to the settlement controls whether the damages are excludable under §104(a)(2).[75] To determine the nature of the claim, the court looks first to the terms of the agreement and, if the terms are ambiguous, to the facts and circumstances surrounding the settlement.[76]

The Finnegans argued that the damages were awarded for PTSD, which they characterized as a physical injury to the brain. However, after examining the nature of the claim, the court found that the settlement agreement compensated the Finnegan family for alleged violations of federal laws, civil rights, and constitutional rights, without specific reference to PTSD or any physical injury or sickness. Further, the complaints, jury instructions, and voir dire questions focused on constitutional violations, not on physical injuries or illnesses. Moreover, the bulk of the evidence presented in court pertained to the emotional and civil rights impacts rather than physical health.

The court concluded that the evidence presented, including the handling of PTSD in the litigation, did not establish it as a direct cause linked to the claimed physical injuries or illnesses necessary to qualify for the tax exclusion under §104(a)(2).

Holding. The court held that settlement payments are not excludable from the Finnegans' gross income under §104(a)(2).

> **Note.** For more information about the taxation of legal settlements, see the 2024 *University of Illinois Federal Tax Workbook*, Chapter 2: Individual Taxpayer Issues.

> **Observation.** The short time between the Finnegans filing their 2017 tax return and the initiation of an audit suggests that the IRS was aware of the settlement and had flagged it for expedited review.

72. See Rule 142(a)(1).
73. IRC §61(a).
74. IRC §104(a)(2).
75. See *U.S.v. Burke,* 504 U.S. 229, 237 (1992).
76. *Rivera v. Baker W., Inc.,* 430 F.3d 1253, 1257 (9th Cir. 2005).

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Tax on Social Security Benefits

***Donald and Kristen Ecret v. Comm'r*, TC Memo 2024-23 (Feb. 14, 2024)**
IRC §86 and 42 USC §424a(a)

☞ Receipt of Social Security Benefits is Taxable Income

Facts. Donald and Kristen Ecret are a married couple. Mrs. Ecret became injured and medically disabled in 2014. She received workers' compensation starting in 2014 after she could not work as a registered nurse. In 2015, Mrs. Ecret applied for social security disability benefits. In 2017, the Social Security Administration (SSA) awarded her benefits beginning in 2015. However, 42 USC §424a(a) limits the total workers' compensation and social security benefits a person may receive in a year. The SSA found that Mrs. Ecret was over the statutory limit and refused to disburse benefits to her.

Mrs. Ecret requested the SSA reconsider and recalculate her workers' compensation offset amount. In January 2019, the SSA decided in her favor, stating it had miscalculated her monthly average current earnings (ACE). ACE is the figure used to estimate the monthly earnings a person would have received if they were not disabled, and SSA calculates the workers' compensation offset using a number equal to 80% of ACE. Effective January 2018, the SSA increased Mrs. Ecret's ACE to $5,074, increasing 80% of her ACE to $4,059. Additional relevant information is provided in the following table.

Year	Total Reported on Form SSA-1099	Attributable to Year Paid	Attributable to Prior Years	Paid to Mrs. Ecret	Withheld as Federal Tax or Attorney's Fees	Taxable Workers' Compensation Offset
2018	$71,918	$19,322	$52,596	$20,749	$5,375	$45,794
2019	55,248	19,866	35,382	6,120	1,080	48,048

For 2018 and 2019, Mrs. Ecret's Form SSA-1099, *Social Security Benefit Statement,* reported taxable income, some attributed to the year she received it and the balance attributable to prior years. In 2019, her Form SSA-1099 reported $55,248 of taxable income, with $19,866 attributable to 2019, while $35,382 was attributable to 2016 – 2018. Of the $55,248 of taxable income reported for 2019, Mrs. Ecret received only $6,120. However, her social security income also included the amount withheld for federal taxes and the amount of her workers' compensation payments deemed to have been paid by social security. Only $19,866 was potentially reportable income in 2019 because the $35,382 balance was attributable to prior years.

However, for 2019, Mr. and Mrs. Ecret reported only $5,202 in taxable social security benefits. The court speculated that this reflected 85% of Mrs. Ecret's payments for the year ($6,120 × 85%). The SSA withheld $1,080 for federal income tax. This amount ignores the tax withheld by the SSA and the amount of her workers' compensation that is taxable.

The IRS examined the Ecrets' joint 2019 return and determined they should have reported an additional $49,128 in social security benefits ($1,080 in federal tax withholding + $48,048 in taxable workers' compensation offset). The IRS sent the Ecrets a notice of deficiency, to which they responded promptly. The IRS asserted an accuracy-related penalty under IRC §6662(a).

The IRS also applied the same logic to examining the Ecrets' 2018 joint return and sent them a notice of deficiency for that year. However, the Ecrets' filed their response late, and the tax court accordingly dismissed the case with respect to that year.

Issue. The issue in this case is whether Mrs. Ecret underreported taxable social security benefits in 2019 under IRC §86(d)(3).

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Analysis. Gross income generally does not include workers' compensation,[77] but it includes social security benefits to the amount required by §86. Social security benefits include "any amount received by the taxpayer by reason of entitlement to a monthly benefit under the Social Security Act."[78] The statute directly addresses whether workers' compensation is considered to be social security benefits. If workers' compensation reduces the social security benefit, then the social security benefits include the reduction in workers' compensation benefits.[79] Congress enacted this law because it wanted to equalize the treatment of taxpayers who lived in states where receipt of social security benefits would reduce workers' compensation benefits.[80]

Taxpayers must consider the entire amount paid by the SSA as potentially taxable income, up to 85%, regardless of whether the SSA distributed it directly to the taxpayer. However, the portion attributable to prior years is not taxable in the year received. Consequently, Mr. and Mrs. Ecret's 2019 taxable social security benefits amount to $16,866 ($19,866 × 85%). The IRS conceded that it was incorrect to assert that Mrs. Ecret should have included the amount paid in 2019 for prior years in her taxable income. It also dropped its assessment of an accuracy-related penalty.

Holding. The court held that Mrs. Ecret properly reported $19,866 of social security benefits in 2019, of which 85% or $16,886 is taxable income.

Change in Accounting Method

***Hyatt Hotels Corporation & Subsidiaries v. Comm'r,* TC Memo 2023-122 (Oct. 2, 2023)**
IRC §§61 and 481

☞ No Points for Excluding Reward Program in Gross Income

Facts. Hyatt Hotels Corp. & Subsidiaries has operated a customer rewards program, known as the Gold Passport Program (the Program), since 1987. Participating members receive rewards points when they stay at Hyatt-branded hotels and can redeem them for a free stay at any Hyatt-branded hotel. Members cannot redeem their points for cash, but they can redeem rewards points for hotel stays, room upgrades, and other goods and services at Hyatt-branded hotels. The Program was highly successful and a central component of its marketing efforts.

Hyatt owned roughly 25% of all Hyatt-branded hotels. The rest were owned by third-party hotel owners (TPHOs), some who contracted Hyatt to manage their hotels, while others operated as a franchise, managing the hotel on their own or using a separate management company. Hyatt required all Hyatt-branded hotels to participate in the Program and did not allow TPHOs to request refunds of payments to the Fund (explained next).

When a Program member received reward points from a Hyatt-branded hotel, the hotel owner paid Hyatt 4% of the revenue from that member's stay. In 2011, Hyatt increased the assessment fee for full-service Hyatt-branded hotels to 4.5%. When a Program member received travel miles instead of rewards points, the hotel owner paid Hyatt the actual cost of the miles. Hyatt also sold rewards points directly to customers, hotel owners, car rental companies, and its timeshare business. These sales payments, 4% payments, and mile payments, known as the Fund, were deposited into bank accounts owned and operated by Hyatt.

Whenever a Program member redeemed rewards points at a Hyatt-branded hotel, Hyatt paid a compensation payment to the hotel owner out of the Fund. The compensation amount was calculated based on the hotel's forecasted monthly average rate for rooms and the hotel's occupancy rate during the award stay. In 2011, Hyatt changed the formula for compensation payments, decreasing annual amounts of payments and increasing the amount of the Fund. The TPHOs had no control over the compensation payments formula.

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77. IRC §104(a)(1).

78. IRC §86(d)(1)(A).

79. IRC §86(d)(3).

80. The court's opinion cites Charles T. Hall, *Social Security Disability Practice* §5:19 (2023).

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Hyatt invested portions of the Fund in marketable, fixed-income securities through third-party investment advisers. The Fund accrued interest and realized gains from investments. TPHOs had no input or control over the choice of advisers, or the investment strategy, and did not regularly receive communications about the performance of the Fund investments. Hyatt also used the Fund to pay advertising and administrative costs related to operating the Program including the costs of maintaining member call centers, the salaries and benefits of employees involved in operating the Program, and the cost of maintaining the Program's member database. The member database recorded extensive information related to individual members and their preferences. Hyatt's marketing department used the member database for targeted advertising to its customers. TPHOs had no control over how the Fund was spent on administrative costs or advertising.

Hyatt did not include any income or expense activity within the Fund on any of its income tax return filings. After auditing Hyatt's returns for tax years 2009 through 2011, the IRS determined the exclusion of the Fund's income and expenses was an improper tax treatment and that correctly including all prior-year activity from the Program in Hyatt's tax filings would constitute a change in accounting method. Accordingly, the IRS issued a notice of deficiency to Hyatt in March 2017, determining $71,056,669 of tax deficiency on an unreported net revenue of $240,081,335.

In response, Hyatt timely filed a petition with the Tax Court in June 2017. Hyatt argued its exclusion of the Fund's income and expenses was proper due to Hyatt holding the Fund as a trustee instead of an owner for federal income tax purposes. Hyatt also argued that even if improper, the IRS's determination that correcting the Fund's income and expense activity omissions did not constitute a change in accounting method. Furthermore, if Hyatt's exclusion of the Fund's income and expense activity from federal income taxation was improper, Hyatt argued it should be able to offset the Fund's income by the estimated cost of future compensation payments to hotel owners under regulatory provisions of the trading stamp method, explained later.

Issues. The issues in this case are the following.

- Whether Program payments received, accrued interest, and realized investment gains should be included in Hyatt's gross income for the tax years 2009, 2010, and 2011
- Whether a change in Hyatt's tax treatment of these receipts constitutes a change in the method of accounting subject to IRC §481 adjustment
- Whether Hyatt may adopt the trading stamp method to offset its gross receipts with the estimated future compensation payments to hotel owners for the tax years 2009, 2010, and 2011

Analysis. IRC §61 defines gross income as "all income from whatever source derived." Hyatt claimed it had two distinct roles: being the "agent" for the hotel owners and being the owner of 25% of the hotels. As the agent, Hyatt did not include any Program revenue in gross income or claim any deductions for Program expenses. However, as the owner of 25% of the hotels, Hyatt claimed deductions for its share of Program expenses and included in gross income the compensation payments made to it out of the Fund. The majority of domestic TPHOs deducted the 4% payments on their federal income tax returns. Hyatt claimed that the trust funds from gross income should be excluded under the trust fund doctrine, where the funds are legally restricted for a specific use for which the taxpayer does not gain, profit, or benefit from spending the funds for that purpose.[81] Hyatt argued it did not directly benefit from its use of the Fund and was restricted in its use of the Fund by the agreements and its fiduciary duties to the TPHOS.

[81] See *Ford Dealers Advertising Fund, Inc., Jacksonville Div. v. Comm'r*, 55 TC 761, 771 (1971).

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The trust fund doctrine disallows any benefit to the taxpayer that is more than incidental and secondary.[82] Hyatt mandated the TPHOs participate in the Program, controlled the amounts of Program payments and compensation payments, decided how to invest the Fund, and determined how to use the Fund to pay for advertising or administrative costs — all without insight or input from the TPHOS. Hyatt only provided a generalized Fund financial statement to the TPHOs and retained the right to reimburse itself out of the Fund at its own discretion. Hyatt directly benefited by paying less for advertising for the 25% of Hyatt-branded hotels that it owned by shifting the advertising costs to the Fund. Hyatt also directly benefited from the Program advertising, which maintained and enhanced the value of Hyatt's goodwill. Hyatt was more than a mere conduit passively holding funds with only an incidental benefit to itself. Hyatt directly benefited from the Fund and had a sufficient beneficial economic interest in the Fund. Therefore, the court found that the Program revenue was includible in Hyatt's gross income.

IRC §481(a) allows the IRS to make an adjustment by including omitted income that escaped taxation. The adjustments to include omitted income can only be made due to a change in the taxpayer's method of accounting.[83] IRC §481 applies to a change in the overall method of accounting for gross income or deductions, or a change in the treatment of a material item.[84] A **material item** is an item that concerns the timing of reporting income or deductions. The lifetime income test is used to determine whether something is a material item by assessing whether the existing treatment would permanently exclude reporting the income or simply postpone reporting the income. If reporting the item is only postponed, then the item is material. If the item is material, the next assessment concerns whether the change in the treatment of the material item would affect the taxpayer's lifetime income. If the item does not affect the lifetime income, the matter is a timing issue and constitutes a change in the method of accounting. Hyatt's previous return treatment permanently excluded Program revenue without claiming deductions. If the Program was ever discontinued, Hyatt planned to refund the remaining balance of the Fund without reporting income or deductions. Therefore, Hyatt's treatment of the Program revenue is not a material item and the issue of whether the proposed change would alter Hyatt's lifetime income is not reached. The court found that the IRS is not allowed to make a §481 adjustment to the Program revenue.

A liability is incurred after it has satisfied the all-events test for accrual method taxpayers. The exception to the all-events test is the **trading stamp method,** where a taxpayer issues trading stamps or premium coupons with sales and such stamps or coupons can be redeemed for merchandise, cash, or other property.[85] Under the exception, the amount of the cost to the taxpayer for the merchandise, cash, or other property used for redemption and the reasonably estimated number of trading stamps or coupons for future redemptions during the taxable year can offset the gross receipts from the sales and accelerate future year deductions. Hyatt argued that the reward points should be included as "other property" within the trading stamp exception. The court held that other property must be physical and tangible property. As such, reward points are not included in "other property" and Hyatt is not entitled to the trading stamp exception. Instead, Hyatt must defer the cost recovery to the year the compensation payments occurred and take the deductions at that time.

Holding. The court held that the Program revenue should be included in Hyatt's gross income for the tax years 2009, 2010, and 2011. The court further held that Hyatt's correction to include the Program's income and expenses did not constitute a change of accounting method subject to a §481 adjustment. Finally, the court held that Hyatt is not allowed to adopt the trading stamp method to offset its gross receipts with the estimated future compensation payments to hotel owners.

82. See *Angelus Funeral Home v. Comm'r* (9th Cir. 1969), *aff'g* 47 TC 391 (1967).

83. See *Rankin v. Comm'r*, 138 F.3d 1286, 1288 (9th Cir. 1998), *aff'g* TC Memo 1996-350 (Jul. 31, 1996).

84. Treas. Reg. §1.481-1(a)(1).

85. Treas. Reg. §1.451-4(a)(1).

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Unreported Income

***Victor Attisha et al. v. Comm'r*, TC Memo 2023-150 (Dec. 18, 2023)**
IRC §§446, 6001, and 6662

☞ Taxpayer's Unreported Income from Illegal Activities Included in Tax Liability

Facts. Victor Attisha operated several businesses during 2017.

1. Platinum Processing Services, LLC, a credit card processing company, was established under Michigan law, with Mr. Attisha and partner Sabah Ammouri each holding a 50% ownership.
2. A&S ATM was also established under Michigan law, with Mr. Attisha as the resident agent.
3. ATM of America, Inc., incorporated in Michigan, listed Mr. Ammouri as its resident agent and president, owned by Mr. Ammouri and two other individuals. Mr. Attisha engaged in sales for ATM of America, which shared a location with Platinum Processing.
4. Holy Moly Donut Distribution, LLC, and Holy Moly Donut Shop, Inc., were formed under Michigan law, with Mr. Attisha as the resident agent and an incorporator of Holy Moly Donut Shop. Holy Moly Donut Shop operated alongside Unified Collective, an unlicensed marijuana dispensary.

Mr. Attisha and his wife jointly filed the 2017 federal income tax return, reporting income from businesses including rental income, nonpassive partnership income, gross receipts from ATM and credit card sales businesses, and wages. The return did not report any income from the marijuana sale or business operation.

A federal search warrant executed at Mr. Attisha's residence by a Drug Enforcement Administration (DEA) Special Agent uncovered evidence of involvement in marijuana manufacturing and distribution. This led to further searches and seizures, uncovering significant amounts of U.S. currency and documents related to marijuana operations.

In October 2018, following these investigations, Mr. Attisha faced charges related to marijuana distribution and money laundering. In June 2019, Mr. Attisha ultimately pleaded guilty to a single count of conspiracy to manufacture, possess with intent to distribute, and distribute marijuana. This plea agreement required the forfeiture of substantial assets, totaling $512,777.

In August 2019, the IRS assigned a revenue agent to review Mr. Attisha's tax liabilities for 2017, leading to a jeopardy assessment based on unreported income from the sale of marijuana. In November 2019, the IRS issued a notice of deficiency of $211,451 and an IRC §6662(a) accuracy-related penalty of $42,290.

Issues. The issues in this case are as follows.

- Whether Mr. Attisha had unreported income of $512,777 for 2017 from the sale of marijuana
- Whether Mr. Attisha is liable for a §6662(a) accuracy-related penalty of $42,290

Analysis. Ordinarily, the statutory notice of deficiency carries with it a presumption of correctness which places the burden on the taxpayer to show that the IRS's determination is erroneous. In cases where the IRS alleges unreported income from illegal activities, for the presumption of correctness to attach to the notice of deficiency, the **burden of proof rests on the IRS** to demonstrate a minimal evidentiary foundation showing a nexus between the taxpayer and the illegal tax-generating activity.[86] Mr. Attisha contested the notice of deficiency, arguing it lacked substantial evidence linking him to any specific income-producing activity, particularly illegal marijuana sales. The court found that the IRS had met the burden to connect Mr. Attisha to the income-producing activity, namely illegal marijuana manufacturing and sales, by citing evidence such as items seized from his home, his criminal indictment, plea agreement, asset forfeiture, and statements made during his sentencing hearing. Therefore, the court upheld the IRS's presumption of correctness in determining unreported income, rejecting Mr. Attisha's argument that the notice of deficiency was unsupported by substantive evidence.

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[86] *Garavaglia v. Comm'r*, TC Memo 2011-228 (Sep. 26, 2011); *Solimene v. Comm'r*, TC Memo 1982-370 (Jun. 30, 1982).

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The burden thus shifted to Mr. Attisha to establish that, by preponderance of evidence, the IRS's determinations were arbitrary or erroneous. Mr. Attisha argued that he was disassociated from the seized assets and that the forfeited amounts were not indicative of income from illegal activities. The court held that the evidence, including DEA raids, Mr. Attisha's own admissions, and documentation related to his businesses and financial transactions, provided a clear and direct link to the illegal manufacture and sale of marijuana.

Mr. Attisha further argued that the IRS did not use an approved method of calculating the deficiency under IRC §446. The IRS contended that they had great latitude in reconstructing Mr. Attisha's income because he failed to keep books and records and refused to cooperate with the revenue agent's examination.

IRC §6001 requires all taxpayers to maintain sufficient records to determine their correct tax liabilities. Where a taxpayer fails to keep the required books and records, or if the records they maintain do not clearly reflect income, the IRS is authorized by §446 to determine income under such method as, in the opinion of the Secretary, does clearly reflect income.[87]

The Code does not have statutory guidelines specifying the nature and quality of evidence for which the tax administrator must gather to support deficiency determination, or form and contents of a notice of deficiency. Thus, the IRS has great latitude in reconstructing a taxpayer's income, and the reconstruction need only be reasonable in light of all surrounding facts and circumstances. The IRS has even greater latitude when the case involves an illegal enterprise and the taxpayer fails to keep records or cooperate in the ascertainment of their income. Mathematical precision is not required.[88]

The court held that given Mr. Attisha's failure to maintain proper records, refusal to answer IRS inquiries about his marijuana income, and failure to provide requested documents, the IRS had great latitude to reconstruct Mr. Attisha's income for 2017. Overall, it was reasonable for the IRS to reconstruct the income that Mr. Attisha generated from the illegal marijuana business in this manner and that the IRS's calculation of income was supported by substantive evidence.

Finally, regarding the accuracy-related penalty, §6662(a) imposes a 20% penalty on the portion of an underpayment of tax that is attributable to a substantial understatement of income tax. An understatement of income tax is substantial if it exceeds the greater of 10% of the tax required to be shown on the return or $5,000. The court concluded that Mr. and Mrs. Attisha failed to report income of $441,079 ($512,777 − $71,698 (returned property)), which was an underpayment of tax attributable to a substantial understatement of income tax. Mr. Attisha has not shown that he acted with reasonable cause and in good faith under §6664(c)(1) with respect to any portion of the underpayment.

Holding. The court held that Mr. Attisha failed to report income of $441,079. The court also held that Mr. Attisha is liable for a §6662(a) accuracy-related penalty to be computed in accordance with Rule 155.

87. See *Petzoldt v. Comm'r*, 92 TC 661, 693 (1989).

88. Ibid.

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Cancelation of Debt Income

***Michael and Julie Parker v. Comm'r,* TC Memo 2023-104 (Aug. 10, 2023)**
IRC §§108 and 1001

☞ Forgiven Nonrecourse Debt Results in Larger Capital Gain

Facts. In 2012, Michael Parker was the sole member of Exterra Realty Partners, LLC, which was a California real estate development company. From its inception, Exterra elected treatment as an S corporation. Exterra was the sole member of two other limited liability companies (LLCs), PLF-XIII, LLC and PLF-XIV, LLC. Mr. Parker personally was the sole member of an additional LLC, PLF-XI, LLC. The Tax Court documents identify these three entities as the "PLF entities." Each of the two PLF entities that Exterra owned, in turn, contributed capital to two other LLCs, Montevina Phase I, LLC, and Montevina Phase II, LLC. The Tax Court referred to them as the "Montevina entities." The PLF entities and the Montevina entities were disregarded entities as Exterra was the sole owner of the PLF entities.

During 2007, the PLF and the Montevina entities incurred over $32 million in debt to develop property in Livermore, California. The two Montevina entities were debtors for two loans with principal amounts totaling over $24.4 million. These two loans were **nonrecourse** as to Exterra. The two PLF entities borrowed another $7.8 million that was secured by the entities' ownership of the Montevina entities. The PLF entity owned directly by Mr. Parker individually received another $2 million loan. Real estate in Iowa secured this loan. Mr. Parker secured the five debts incurred by the LLCs he controlled with personal guarantees. The debts incurred by the PLF entities were **mezzanine loans**, a term referring to temporary loans secured by an equity interest in another entity.[89] The following table summarizes the loans.[90]

Loan Description	Debtor	Amount	Recourse or Nonrecourse	Security
Loan N709A (Phase I senior mortgage)	Montevina Phase I, LLC	$20,120,000	Nonrecourse as to Exterra	Montevina Phase I real estate
Loan N709B (Phase II senior mortgage)	Montevina Phase II, LLC	4,230,000	Nonrecourse as to Exterra	Montevina Phase II real estate
Loan N712A (Phase I mezzanine loan)	PLF-XIII, LLC	5,030,000	Nonrecourse as to Exterra, Mezzanine loan	PLF-XIII ownership of Montevina, Phase I, LLC
Loan N712B (Phase II mezzanine loan)	PLF-XIV, LLC	2,820,000	Nonrecourse as to Exterra, Mezzanine loan	PLF-XIV ownership of Montevina, Phase II, LLC
Loan N713 (Iowa mezzanine loan)	PLF-XI, LLC	2,000,000	Mezzanine loan	PLF-XI ownership of another LLC owning the Iowa real estate

In 2012, Exterra sold the Livermore property to three unrelated individual buyers. These buyers acquired the Montevina entities that held title to the real estate and agreed to pay $7.4 million on the mortgage. The buyers also assumed Mr. Parker's obligation on the debts. In the transaction, the lender agreed to cancel the unpaid balances. The buyers acquired not just the Montevina entities with the real estate the entities owned, but they also acquired over $40 million of debt, deferred interest, lender advances, and other liabilities. Exterra realized another $12.7 million from other canceled debts.

89. *Risks and Realities of Mezzanine Loans.* Bernman, Andrew. Fall 2007. Missouri Law Review. [scholarship.law.missouri.edu/mlr/vol72/iss4/3] Accessed on Sep. 4, 2024.

90. This table is compiled from a similar table in the Tax Court's opinion and information in the court's decision.

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On its 2012 original Form 1120-S, *U.S. Income Tax Return for an S Corporation*, Exterra reported gross receipts of over $53 million and $2.7 million in ordinary business income after expenses. It reported the cancelation of debt income in the same amount. It later amended this return to reduce its gross income by $2,741,399 to reflect the discharge of indebtedness. The amended return included Form 982, *Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment).* With this Form 982, Exterra excluded the cancelation of debt income based on insolvency. The insolvency exclusion eliminated Exterra's ordinary business income, which an amended Schedule K-1 (Form 1120-S), *Shareholder's Share of Income, Deductions, Credits, etc.* reflected. With this amended Schedule K-1, Mr. Parker filed an amended Form 1040, *U.S. Individual Income Tax Return*, that reported no income from his ownership of Exterra's stock.

In response, the IRS issued a notice of deficiency to Mr. and Mrs. Parker, asserting a tax deficiency of over $3.1 million for 2012, an addition to tax exceeding $157,000, and an IRC §6662(a) accuracy penalty of $622,327. These changes indicated an increase in the Parkers' taxable income that included the $2,741,399 that they had removed on their amended tax return.

Issue. The issue in the case is whether the release of Exterra's nonrecourse debt should be treated as cancelation of debt income or as an additional amount received upon the sale of the properties.

Analysis. Mr. Parker's attorneys argued that the forgiven loan should be considered cancelation of debt income to Exterra. Because this corporation was insolvent, the Schedule K-1 provided to Mr. Parker could exclude the cancelation of debt income.[91]

However, the court reasoned that another question had to be resolved before reaching this conclusion. This question concerned whether the loan could be forgiven and the property's tax attributes reduced, as Mr. Parker argued, or whether the loan forgiveness had first to be considered an amount realized in the sale of the property.

Making this argument, the IRS contended that invoking the insolvency exclusion for nonrecourse debt is premature when a property with nonrecourse debt is sold and the associated debt is forgiven. Instead, the forgiven amount of the debt canceled is considered an increase in the amount realized through the sale of the property. Thus, the forgiven debt increases the price **Exterra** received for the properties. The court's opinion cited Treas. Reg. §1.1001-2(a)(1), which requires the amount of liabilities forgiven to be included in the property's sale price.

This regulation creates an exception for **recourse** liabilities extinguished through a property sale. Debt forgiveness associated with recourse debt is not included in the amount realized for the property sold.[92] Mr. Parker argued that the debt forgiven was recourse to himself because he had personally guaranteed the loan and was the sole member of Exterra.

However, the court distinguished the debt owed by Exterra from the debt guarantee Mr. Parker provided. In this case, the canceled debt was an obligation owed by Exterra, for which the debt was nonrecourse. Although Mr. Parker was liable for the loan, the court decided the matter based on the fact that Exterra, as a corporation, had a distinct identity from Mr. Parker, even though he owned all shares of the corporation. It expressed its conclusion favoring the IRS with the following text.

> *In determining whether to sustain [the IRS's] upward adjustment to Exterra's gross receipts..., we respect Exterra's separate corporate existence... Accordingly, [Mr. Parker's] observation, for instance, that Loans N712A and N712B were recourse as to Mr. Parker personally, is simply irrelevant to the issue before us.*

Holding. The Tax Court held that Exterra's forgiven nonrecourse debt should be considered an additional amount received upon the sale of the property. Any cancelation of debt income, which could have been excluded if certain requirements were satisfied, was irrelevant to the court's decision. The court reached this decision because Mr. Parker was not personally a party to the sale; only the S corporation he controlled, Exterra, was involved in the transaction.

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91. IRC §108(a)(1)(B).

92. Treas. Reg. §1.1002-2(a)(2).

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Personal Injury Exclusion

***Kristen Quevy v. Comm'r,* TC Summ. Op. 2023-34 (Dec. 12, 2023)**
IRC §§104 and 111

☞ Severance Compensation Cannot Be Excluded from Income

Facts. Kristen Quevy worked for Acuity Brand Lighting (Acuity) during a period when she suffered from increasing physical illness and neurological issues. After starting work for the firm in 2009, her anxiety led to migraines and agoraphobia. Her condition worsened after suffering a workplace assault. Acuity allowed her to work from home when these ailments interfered with her work. Unfortunately, the conditions also led to alcoholism.

Before she could be treated for alcoholism, Ms. Quevy was diagnosed with cancer. After successful treatment for this, she started alcoholism treatment. She incurred medical expenses exceeding $125,000, which she deducted on her tax returns for 2016 and 2017.

During this time, Ms. Quevy's disability benefits expired and she shifted to COBRA health insurance coverage.[93] She suffered a relapse into alcoholism. After leaving treatment for this, she suffered spinal injuries in a car accident. When Ms. Quevy told Acuity she would not be able to return to work until November 2017, the company terminated her employment.

In response to a series of demand letters from her attorney, Acuity paid Ms. Quevy $75,000, which it reported on Form 1099-MISC, *Miscellaneous Income*, as nonemployee compensation. Ms. Quevy reported only $7,500 as income on her 2018 tax return, treating the balance as excludable damages under IRC §104(a)(2).

Issue. The issue in this case is whether Ms. Quevy can exclude from taxable income a settlement she received from a former employer for severing her employment.

Analysis. Ms. Quevy argued that Acuity's payments compensated her for physical injuries or sickness. The IRS argued that the payments compensated Ms. Quevy for wrongful termination, which is not excludable from taxable income.

The Tax Court noted that §104(a)(2) permits exclusion from taxable income the payments received for damages arising from "personal physical injuries or physical sickness." These two causes exclude emotional distress, although payments paid for personal injuries or sickness arising from emotional distress may be excludable in limited cases. The court noted that Congress specifically added the restriction to "physical" injuries in 1996.[94]

The court, however, placed greater weight on the claim that resulted in the settlement, which required the court's examination of the settlement agreement that resulted in the payments. This agreement stated that the payment was for "severance compensation" and was intended to "resolve all issues between them." It specified compensation for Ms. Quevy's "personal injuries" but failed to specify **physical** injuries, thereby missing the standard established by §104(a)(2). Although Ms. Quevy argued that Acuity was aware that she was assaulted on company premises, the settlement agreement did not state this.

Ms. Quevy argued in the alternative that she should be able to deduct the payments received as medical expenses. The court found that her 2016 and 2017 tax returns already deducted those expenses. The tax benefit rule of IRC §111 would require her to include the recovery of any amount she had deducted in a prior year unless it did not provide a tax benefit to her. Because Ms. Quevy did not prove the absence of a tax benefit, she also failed on this point to exclude the payments from her income.

Holding. The Tax Court found Ms. Quevy could not exclude compensatory compensation from her income because the settlement agreement with her former employer stated the amount was paid as "severance compensation."

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93. *Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA)*, PL 99-272.

94. *Small Business Job Protection Act of 1996*, PL 104-188, §1605(b).

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INDIVIDUAL ISSUES

Tax Return Definition

***Joselito E. Cortez v. IRS*, No. 2:21-CV-01598 (E.D. Cal. Jan. 12, 2024)**
IRC §§6020, 6201, and 6511

☞ Would a Return by Any Other Name Smell as Sweet?

Facts. Joselito Cortez failed to file his 2004 federal tax return or an extension. In December 2009, the IRS assessed a tax of $6,006 against Mr. Cotez under a substitute tax return for the 2004 tax year. In April 2011, Mr. Cortez filed a married filing joint 2004 Form 1040, *U.S. Individual Income Tax Return,* with his now-deceased wife. The Form 1040 reported $87,752 in income and claimed three exemptions for three Cortez children and a child tax credit for one of the children. Mr. and Mrs. Cortez signed their Form 1040 before submitting it, and the IRS assessed an additional $2,113 tax jointly against Mr. and Mrs. Cortez on October 31, 2011.

In 2012, Mr. Cortez submitted an offer in compromise (OIC) for the tax he owed for 2004, and the IRS rejected it. Subsequently, Mr. Cortez entered into an installment agreement with the IRS and made several voluntary payments from early 2017 through early 2018.

However, in January 2021, Mr. Cortez filed a claim for a refund under IRC §6511 for all the payments he made toward the October 2011 assessment for payments made within two years of the claim date. Mr. Cortez filed a lawsuit after the IRS did not respond to his claim for a refund.

In his pleadings, Mr. Cortez argued that submitting the joint Form 1040 in April 2011 to the IRS was "not an honest and reasonable attempt to comply with the Tax Code." Therefore, the filing was not a tax return, and he should be entitled to a refund because the filing is a nullity. Under established law, an assessment based upon a nullity is invalid, null, and void. Therefore, Mr. Cortez claimed that the assessment for the April 2011 filing was invalid, null, and void. Mr. Cortez and the IRS filed cross-motions for summary judgment.

Issue. The issue in this case is whether Mr. Cortez's late submission of Form 1040 qualifies as a "return" for tax purposes.

Analysis. The Code contains no definition of the term "return." The Bankruptcy Code also lacked a definition before 2005, but the Bankruptcy Court continues to use the *Beard* test, a 4-factor test, to determine whether a document is a "return."[95] This test requires the document to "purport to be a return, … be executed under penalty of perjury, …contain sufficient data to allow calculation of tax, and …represent an honest and reasonable attempt to satisfy the requirements of the tax law."[96] Under the Bankruptcy Code, a debtor cannot discharge a tax liability assessed for a required tax return if they did not file it.[97]

Mr. Cortez cited a case where a filing was not a "return" for bankruptcy discharge purposes. In that case, *In re Smith*, Mr. Smith, the plaintiff, filed a Form 1040 seven years after the tax return was due and after he was issued a tax assessment.[98] The IRS responded that this case only determined the issue of whether Form 1040 was a "return" under the Bankruptcy Code and **not whether it was a "return" for all tax purposes.**[99] Mr. Cortez argued for a precedent where, if a term is defined in one section of the federal code, federal courts must adopt that definition for another section of the federal code where the term is undefined. The Seventh Circuit and the Ninth Circuit have rejected this approach and have held that a "return" can have different definitions in separate parts of the Code.

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95. *Beard v. Comm'r*, 82 TC 766 (1984).
96. *In re Hatton,* 220 F.3d 1057, 1060 (9th Cir. 2000).
97. 11 USC §523(a)(B)(i).
98. *In re Smith*, 828 F.3d 1094, 1096 (9th Cir. 2016).
99. Ibid.

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Under IRC §6201(a), a Form 1040 turned in late can still be a "return," and the IRS is allowed to make an assessment based on that return. The court stated that it would continue to apply the *Beard* factors to determine whether a Form 1040 is a return, and that it would ignore Mr. Cortez's argument that the late submission is not an "honest and reasonable attempt to satisfy the requirements of the tax law."

Under the *Beard* factors, a Form 1040 was a "return" for the purpose of a tax assessment. The submission was on the proper form, and Mr. Cortez properly completed it. Mr. and Mrs. Cortez both signed the form, attesting that the return was accurate to the best of their knowledge, under penalty of perjury. Mr. Cortez's other actions, including submitting an OIC and signing the installment agreement, also indicate that their Form 1040 was a return.

Holding. The court granted the summary judgment motion for the IRS and denied Mr. Cortez's argument that his late-filed Form 1040 was not a return for tax purposes.

INNOCENT SPOUSE

IRA and Life Insurance Withdrawals

***Joseph Balint v. Comm'r,* TC Memo 2023-118 (Sep. 25, 2023)**
IRC §§61, 72, 408, and 6330

☞ Not My Withdrawal, Not My Problem

Facts. Joseph Balint was incarcerated from December 2013 to January 2015. In March 2014, while still in prison, Mr. Balint signed a power of attorney (POA) allowing his wife, Jacqueline, to handle his affairs. From April 2014 to October 2014, Mrs. Balint made numerous withdrawals from her husband's individual retirement arrangement (IRA) with Pershing, LLC, and his life insurance policy with Pruco Life Insurance Co. In total, Mrs. Balint withdrew $137,469.66 into their joint account, and then withdrew a total of $130,908.64 from the joint account into her personal accounts, leaving a difference of $6,561.02.

Mrs. Balint used the money to move from the Florida residence to Kentucky, to renovate a house in Kentucky, to care for her ailing mother, and to pay living expenses. She then filed for divorce in September 2014, while Mr. Balint was still in prison.

Mr. Balint was released from jail in January 2015, and filed his 2014 tax return in April 2015. His filing status was married filing separately. Mr. Balint reported his gross income as $223,191, which consisted of (1) $375 in taxable interest; (2) $154,477 in taxable IRA distributions; (3) $67,078 in taxable distributions from pensions and annuities; and (4) $1,261 in taxable social security benefits. Mr. Balint said although he did not believe the IRA and life insurance withdrawals were his income, he included them because he thought it might violate the terms of his parole otherwise. The return reported $34,614 as the balance due.

The IRS sent a notice of intent to levy on amounts due for 2013 and 2014. In response, Mr. Balint requested a collection due process (CDP), and timely submitted a Form 12153, *Request for a Collection Due Process or Equivalent Hearing,* concerning 2013, 2014, and 2015 taxable years. Mr. Balint attached a written attachment alleging his wife stole more than $240,000 from his IRA and pension accounts. Mr. Balint also made a claim for innocent spouse relief and submitted Form 8857, *Request for Innocent Spouse Relief.*

An Appeals settlement officer conducted a CDP hearing and sustained the proposed levy, finding that Mr. Balint was ineligible for innocent spouse relief because he and Mrs. Balint had not filed joint returns for the years at issue, and Mr. Balint provided insufficient information about the legal action he took regarding Mrs. Balint's withdrawals to warrant any adjustment of the tax liabilities. Mr. Balint timely filed a petition for review of the SO's determination.

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During the couple's divorce proceedings, the state court found Mr. Balint authorized Mrs. Balint to withdraw $10,800 from his IRA, for which he should be liable for the tax. The state court also found, however, that Mrs. Balint should be liable for tax on $179,296 of income consisting of $89,320 in IRA distributions and $89,976 of life insurance distributions, as Mr. Balint did not receive an economic benefit from those funds.

Issues. The issues in this case are the following.

- Whether the withdrawals Mrs. Balint took from the IRA, pension fund, and annuity must be included as taxable income on Mr. Balint's 2014 tax return
- Whether the IRS abused its discretion in sustaining the levy

Analysis. The definition of gross income is very broad under the Code. According to IRC §§61(a)(9), (10), and (11), a taxpayer's gross income encompasses "all income from whatever source derived." Additionally, IRA distributions are generally included in the gross income of the "payee" and "distributee."[100] Amounts "received" from a life insurance policy but not paid as an annuity are also included in the taxpayer's gross income if they exceed the amount invested in the contract.[101] Thus, the definition of gross income appears to include amounts received from IRAs and life insurance policies.

However, there is an exclusion for misappropriated funds. Funds misappropriated from the taxpayer's accounts are not included in the taxpayer's gross income if the taxpayer is not the payee, distributee, or recipient of the funds, and does not receive an economic benefit from the distributions.[102] In *Roberts v. Comm'r*, the taxpayer's wife withdrew money from an IRA account to establish a new household, and the court held the withdrawal should not be included in the taxpayer's gross income because the taxpayer received no economic benefit from the withdrawal.[103] Similarly to *Roberts*, Mrs. Balint misappropriated funds from an IRA account to establish a new household which did not economically benefit the taxpayer. Thus, the money should be included as taxable income on Mrs. Balint's tax return, not Mr. Balint's.

Mrs. Balint, however, argued that she was authorized to make the withdrawal by virtue of her POA. POAs are interpreted according to state law. The POA Mr. Balint signed was governed by Florida law. An agent acting pursuant to a POA has a fiduciary relationship to the principal. The agent "[m]ay not act contrary to a principal's reasonable expectations actually known by the agent," or "in a manner that is contrary to the principal's best interest."[104] Mrs. Balint should have known Mr. Balint did not reasonably expect her to use the money to move to Kentucky, as she did not even tell him about the withdrawals. Indeed, Mr. Balint did not find out until he was released from prison.

Additionally, "an agent may only exercise authority specifically granted to the agent in the power of attorney and any authority reasonably necessary to give effect to that express grant of specific authority,"[105] and "powers of attorney are strictly construed and will be closely examined in order to ascertain the intent of the principal."[106] Thus, in a POA, a more specific grant of authority takes precedent over a more general grant of authority.

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100. IRC §408(d)(1).

101. IRC §§72(e)(1)(A), (5)(A), and (C).

102. *Roberts v. Comm'r,* 141 TC 569 (2013).

103. Ibid.

104. Fla. Stat. §709.2114(1) (2013).

105. Fla. Stat. §709.2201(1) (2011).

106. *Manor Oaks, Inc. v. Campbell,* 276 So. 3d 830, 833 (Fla. Dist. Ct. App. 2019) (quoting *De Bueno v. Castro,* 543 So. 2d 393, 394 (Fla. Dist. Ct. App. 1989)).

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Although Mrs. Balint's POA generally allowed actions benefitting her, which might otherwise be construed as self-dealing, the POA limited this power by requiring the actions to be for Mr. Balint's benefit, when it said, "actions that might otherwise be considered prohibited as self-dealing are specifically authorized . . . for the purpose of tax, financial or estate planning, for [petitioner's] benefit." Mr. Balint did not receive an economic benefit from the withdrawals as the money was used to help Mrs. Balint establish a new life in Kentucky.

An appeals officer who issues a determination arbitrarily, capriciously, or without sound basis in fact or law is said to abuse their discretion. The court determined that the settlement officer did not error in her proposed levy.

Holding. The court held the withdrawals made by Mrs. Balint were not includable in Mr. Balint's taxable income because they were not made for his economic benefit, they were made without his knowledge, and they were made outside the scope of Mrs. Balint's authority under the POA.

Joint and Several Liability

Marisol Severance v. Comm'r, **TC Memo 2023-101 (Aug. 8, 2023)**
IRC §§6015(b) and (f)

☞ Joint and Several Results in Severance Pay

Facts. Marisol and Neil Severance filed joint tax returns for tax years 2010 and 2011. On their 2010 tax return, $91,500 of foreign earned income was excluded from taxable income under IRC §911 that was attributed to Mr. Severance's employment overseas. This amount was reported on the Severances' filed Form 2555, *Foreign Earned Income*. Likewise, on their filed 2011 return, $36,881 of foreign earned income was excluded from taxable income from the same employment and was reported on a filed Form 2555.

The IRS issued a notice of deficiency dated April 10, 2014, to the Severances for tax years 2010 and 2011, where after an examination the IRS disallowed the §911 exclusion of the reported foreign income for both tax years, as well as finding an underreporting of unemployment income for 2011. These errors resulted in deficiencies of federal income tax in the amounts of $20,958 for 2010 and $8,618 for 2011. In addition, the IRS assessed accuracy-related penalties of $4,192 and $1,713 for 2010 and 2011, respectively.

In April 2015, the IRS used a $1,000 overpayment from the Severances' 2014 income tax return to offset some of the outstanding 2010 tax liability. In August 2015, the IRS issued federal tax lien notices associated with the outstanding 2010 and 2011 income tax liabilities. In December 2015, Mr. Severance filed for Chapter 13 bankruptcy, where he listed the IRS as one of his creditors. That same month, the IRS filed a proof of claim with the Bankruptcy Court that included the amount of outstanding 2010 and 2011 income tax liability that the Severances still owed.

In March 2019, the IRS received a filed Form 8857, *Request for Innocent Spouse Relief*, from Mrs. Severance for the 2010 and 2011 tax years. In this filing, she asserted that neither she nor other family members were victims of abuse perpetrated by the spouse, and that she did not have a mental or physical health issue during the time the applicable returns were filed. Mrs. Severance stated that she had some college education at the time the returns were filed and that while she did not deal directly with the CPA who had assisted her and her husband with their 2010 and 2011 tax filings, she did provide tax documents to the CPA. While she signed the tax returns, she was not aware of any errors or omissions with the filings. Mrs. Severance went on to indicate that she was the decision-maker for the spending of the family's money during the applicable tax years when experiencing financial difficulties. Additionally, Mrs. Severance painted a picture of her current financial situation, where she divulged the household received a monthly income totaling $7,875 and monthly expenses totaling $6,219 to support a family of seven people (the taxpayers and their five children).

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In June 2019, while waiting for the IRS to process her filed Forms 8857, Mrs. Severance notified the IRS via letter that she would voluntarily pay the outstanding balance of income taxes owed, but she was not waiving her innocent spouse claim. The IRS received the payment the following month, where loan proceeds for the Severances' purchase of a house were used to fund the payment. In August, the IRS denied Mrs. Severance's innocent spouse claim, stating that there was no outstanding balance, no refundable payments were made, and that Mrs. Severance did not provide support showing the payments were made solely by her. Mrs. Severance's attorney responded to the letters, requesting that the IRS review the enclosed supporting documentation and update their records accordingly. In November, the IRS denied Mrs. Severance relief from joint and several liability through the innocent spouse claim. Mrs. Severance appealed the IRS's decision in Tax Court, seeking relief from joint and several liability under IRC §§6015(b) and (f) for the 2010 and 2011 tax years.

Issue. The issue in the case is whether Mrs. Severance is entitled to innocent spouse relief under §§6015(b) or (f).

Analysis. The court first assessed whether Mrs. Severance would be entitled to relief from joint and several liability for the 2010 and 2011 tax years under §6015(b). This requires the requesting taxpayer to meet the following conditions.

- A joint return was filed for the applicable year.
- An understatement of tax arose from errors made by the nonrequesting spouse.
- The requesting spouse did not and could not have known about the errors when signing the applicable tax return.
- It is inequitable to hold the requesting spouse liable for the outstanding tax due, and the requesting spouse elects relief within two years of the IRS beginning collection activities.

Not meeting any one of the required conditions would result in a taxpayer being unable to receive relief under §6015(b).

Mrs. Severance did not meet the timing criteria for requesting relief within two years of the IRS beginning collection activities. She filed Form 8857 in March 2019, which was over two years after the IRS had applied the Severances' 2014 income tax overpayment to the 2010 income tax liability in 2015. The IRS also filed a proof of claim when Mr. Severance filed for Chapter 13 bankruptcy in 2015. Treasury regulations support that both events constitute collection activities, and therefore, Mrs. Severance was not entitled to relief from joint and several liability under §6015(b).[107]

Next, the court assessed whether Mrs. Severance was entitled to relief under §6015(f), which provides relief to a taxpayer when none is available under §§6015(b) or (c), and it is inequitable to hold the requesting spouse liable for the outstanding tax. Because the court had already found that Mrs. Severance was not eligible for relief under §6015(b), and that due to her marital status, she would not be eligible for relief under §6015(c), it considered whether it would be inequitable to hold her liable for the 2010 and 2011 tax deficiency.

To determine whether equitable relief provisions applied, the court used Rev. Proc. 2013-34, which includes a streamlined process if the following three conditions apply to the requesting spouse.[108]

1. No longer married to the nonrequesting spouse
2. Would suffer economic hardship if relief were not granted
3. Was unaware of any errors or circumstances that resulted in the understatement or deficiency of the filed income tax return

Because Mrs. Severance remained married to Mr. Severance, the streamlined determination was not applicable to her case.

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107. Treas. Reg. §1.6015-5(b)(2)(i).

108. Rev. Proc. 2013-34, 2013-43 IRB 397.

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Rev. Proc. 2013-34, in addition to a streamlined determination, also provides seven nonexclusive general conditions under consideration for determining if a taxpayer is eligible for relief under §6015(f). The first threshold is marital status, which weighs in favor of the requesting spouse if they are no longer married to the nonrequesting spouse. As Mrs. Severance remained married to Mr. Severance, this factor was neutral in the court's assessment.

The second threshold is economic hardship, which weighs in favor of the requesting spouse if joint and several liability would result in the requesting spouse being unable to pay reasonable living expenses on their current income. The court found that Mrs. Severance, based on her testimony and other supporting evidence, could still adequately pay living expenses, and therefore the factor was neutral.

The third factor is knowledge or reason to know of the underlying cause of understatement or deficiency. The court found that Mrs. Severance's college education, as well as her management of family finances and providing supporting tax documents to her CPA, resulted in the knowledge factor weighing against her.

The fourth threshold is legal obligation, where a divorce or other binding agreement results in the nonrequesting spouse having the sole legal obligation to pay the tax liability. As Mrs. Severance remained married to Mr. Severance and no such agreement was in place, this factor was neutral.

The fifth threshold is significant benefit, where the factor weighs against relief if the requesting spouse significantly benefitted from the understatement or deficiency. The court found that because neither Mrs. nor Mr. Severance lived lavish lifestyles resulting from the understatement of the 2010 and 2011 tax years, the factor weighed in favor of Mrs. Severance.

The sixth factor is compliance with income tax laws, where nonncompliance weighs against the requesting spouse. Even though the Severances did not timely file their returns, all applicable and subsequent tax returns were filed before the IRS received Mrs. Severance's Form 8857, and therefore, the factor was neutral.

The seventh and final factor is the mental or physical health of the requesting spouse at the time of filing the applicable tax returns, where the factor weighs in favor in situations where the requesting spouse suffers from poor mental or physical health. Mrs. Severance did not indicate that she was in poor mental or physical health, resulting in the factor being neutral in her case.

After weighing all the factors, the court found that Mrs. Severance did not adequately establish that it would be inequitable for her to be held liable for the 2010 and 2011 understatement of tax liabilities and is therefore not entitled to relief under §6015(f).

Holding. The Tax Court held that Mrs. Severance was not eligible for innocent spouse relief from joint and several liability for the 2010 and 2011 tax years under either §§6015(b) or (f).

Innocent Spouse Relief

***O'Nan v. Comm'r*, TC Memo 2023-117 (Sep. 18, 2023)**
IRC §§6015 and 6321

☞ The Widow's Mite Is Mighty Large

Facts. Sarah O'Nan and her husband purchased an Ohio residence in 2012, possessing the real estate with a form of joint tenancy with the right of survivorship known in Ohio as "survivorship tenancy."[109] Not long after the home's purchase, Mr. O'Nan borrowed funds using the home as collateral, as evidenced by a promissory note. At some point later, an additional amount was borrowed against the home, creating a second promissory note with a second bank. Both Mr. and Mrs. O'Nan cosigned the two mortgage deeds, but only Mr. O'Nan's signature was present on the first promissory note.

109. Ohio Rev. Code Ann. §6302.20(A).

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At age 43, Mr. O'Nan died in 2014, leaving Mrs. O'Nan with no way to repay the mortgage loans or his substantial federal tax liabilities for 2012 and 2013. Although they timely filed their returns for these years, the O'Nans did not pay the balances due.

Now newly widowed, Mrs. O'Nan listed her home for sale in 2015, but one of the banks began foreclosure. She filed an IRC §6015 request for innocent spouse relief and dropped the home's listing price to accelerate its sale. Her Form 8857, *Request for Innocent Spouse Relief*, was received by the IRS on May 6, 2015. About a week earlier, on April 28, 2015, the IRS filed a notice of a federal tax lien under IRC §6321 against Mrs. O'Nan and her late husband, apparently unaware of his death.

The home sold for $895,000 in June 2015, enough to pay off the mortgages held by both banks. The IRS also received $123,200 in satisfaction of the lien it had placed on the home. After all liabilities were satisfied, Mrs. O'Nan received $76,535 from the sale.

On February 13, 2017, the IRS granted Mrs. O'Nan partial relief from her liability for 2012 taxes and full relief for the tax due from their 2013 return. The IRS still claimed that Mrs. O'Nan owed $3,340 for 2012 taxes, plus interest. However, according to the lien, the IRS denied Mrs. O'Nan's claim for a refund of the $123,200 that it had seized. Mrs. O'Nan subsequently filed a petition with the Tax Court to contest the IRS's refusal to refund the $123,200 lien payment.

Issue. The issue in this case is whether Mrs. O'Nan made overpayments of federal tax that would entitle her to a refund under the innocent spouse provisions of §6015(g)(1).

Analysis. As noted by the Tax Court, this case constitutes an unusual approach to the innocent spouse regulations. Although the innocent spouse usually contests the IRS's denial of relief under §§6015(b), (c), or (f), in this case, the IRS had already granted relief. Mrs. O'Nan disputed the denial of a refund for the funds seized by the IRS.

The Tax Court observed that federal law permits a refund to an innocent spouse only if the tax payment came from the innocent spouse's funds. The court cited a 2006 case denying a refund of payments from a couple's community property.[110] It also found that tax payments made from a deceased spouse's estate were similarly not eligible for a refund to an innocent spouse. The court referred to a principle that an innocent spouse can only trace funds to a joint account if they demonstrate that the funds originated with them.

However, the court distinguished the O'Nan case from these prior cases based on the nature of Ohio law. The joint tenancy with right of survivorship provisions of the state's laws provided that Mrs. O'Nan immediately inherited her husband's half interest in their property upon his passing.[111] This reasoning follows the precedent from a prior case in which a federal district court concluded the following.

> *When a cotenant in an Ohio survivorship tenancy dies subject to a[n IRC §6321] lien, the surviving cotenant takes the decedent's interest subject to the lien.*[112]

Therefore, Mrs. O'Nan inherited her husband's interest in the property subject to the lien.

The Tax Court determines the requesting spouse's tax liability as if the taxpayer and the spouse had used the married filing separately filing status. This filing status resulted in Mrs. O'Nan having a 2012 tax liability of $3,340 and a $0 liability for 2013.

Holding. The Tax Court held that because Mrs. O'Nan made the IRS payment with funds she had inherited from her late husband, she was entitled to a refund of the IRS lien payment of $123,200. From this amount, the IRS withheld $3,340 for her 2012 tax liability.

110. *Ordlock v. Comm'r*, 126 TC 47 (2006).

111. Ohio Rev. Code Ann. §5302.20(B).

112. *Paternoster v. U.S.*, 640 F.Supp.2d 983 (S.D.Ohio 2009).

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IRS PROCEDURES — MISCELLANEOUS

Timely Filed Return

***Madiodio Sall v. Comm'r*, 161 TC 13 (Nov. 30, 2023)**
IRC §§6213, 7451, and 7503

☞ An Early Christmas

Facts. The IRS mailed a notice of deficiency to Madiodio Sall on August 26, 2022. The notice said the last day to file a petition was November 25, 2022. Mr. Sall mailed a petition on November 28, 2022, and it was received and filed by the court on December 1, 2022. The IRS moved to dismiss on the basis that the Tax Court lacked jurisdiction because the petition was untimely.

Issue. The issue in this case is whether Mr. Sall's petition was timely filed.

Analysis. The party invoking the court's jurisdiction has the burden of proving the court has jurisdiction.[113] A taxpayer must file a petition within 90 days of the IRS's mailing of the notice.[114] If the filing deadline falls on a Saturday, Sunday, or legal holiday, the deadline is extended to the next business day.[115] Additionally, if the court is closed on the next business day, the deadline is extended for 14 days past that deadline.[116]

In this case, the 90-day deadline fell on Thanksgiving, a legal holiday. Thus, the deadline would have been moved to the next business day, Friday, November 25, 2022. But the court was closed that day, so the deadline would be extended an additional 14 days to December 10, 2022, according to IRC §7451(b)(1). Additionally, December 10 was a Saturday, so the deadline would be extended an additional two days to Monday, December 12, 2022.

Holding. The court held that the petition was timely filed because Mr. Sall's petition was filed on November 28, 2022, and the deadline was extended to December 12, 2022.

Reconstruction of Evidence

***R. J. Channels, Inc. v. Comm'r*, TC Memo 2023-109 (Aug. 28, 2023)**
IRC §6663

☞ IRS Attorneys Fall "Woefully Short" of Tax Court's Expectations

Facts. In February 2021, the IRS issued a notice of deficiency for the 2017 tax year to R. J. Channels, Inc. (RJ), a California corporation. RJ timely petitioned the Tax Court in May 2021, including a partial copy of the notice of deficiency with only the first page of Form 4549-A, *Report of Income Tax Examination Changes,* and Form 886-A, *Explanation of Items*. The first page was stamped "ORIGINAL" and included the IRS deficiency determination and IRC §6663 civil fraud penalty.

In September 2021, the IRS answered RJ's petition with a copy of a notice of deficiency that the IRS claimed was a "complete copy." The first page was stamped "ORIGINAL" and contained a continuation sheet with an "Interest on Deficiencies" section as well as a "Civil Fraud Penalty IRC section 6663" section.

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113. *David Dung Le, M.D., Inc. v. Comm'r,* 114 TC 268, 270 (2000).

114. IRC §6213(a).

115. IRC §7503.

116. IRC §7451(b)(1).

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A proposed stipulated decision was filed in October 2022, to which the parties supposedly agreed to an IRC §6662(a) accuracy-related penalty. However, the record contained no reference to a §6662(a) penalty. Just two weeks later, the court struck the proposed stipulated decision (PSD) and ordered revisions.

A month later, the court received a revised PSD along with a November status report. The PSD set forth a deficiency, a civil fraud penalty, and an accuracy-related penalty. The PSD explained that an accuracy-related penalty was **recommended as an alternative to the civil fraud penalty**. The notices presented information using a different font size and different margins, and one section was diagonal relative to the other sections. Noticing the differing appearances, the judge asked for an explanation of the status report.

The IRS responded that several discrepancies were noted between the complete copy attached to the IRS answer and the complete copy attached to the IRS November status report. At the time the IRS answer was filed, the IRS attorneys **did not have** the actual physical administrative file due to the COVID-19 pandemic and were unable to obtain the file prior to the answer deadline. Instead of requesting additional time to provide the court with the requested document, the IRS counsel attempted to reconstruct the notice of deficiency. The reconstruction resulted in the exclusion of the signed civil penalty approval form and Form 886-A along with Letter 531, *Notice of Deficiency*, which excluded the §6662 alternative penalty position. When it filed the document with the court, the IRS attorneys did not advise the court that they had reconstructed the document.

A status hearing was held on February 7, 2023, with IRS attorneys Gonzalez and Wight. Gonzalez explained the procedures the IRS followed due to COVID-19 to reconstruct the notice of deficiency when they did not have access to the administrative file. Wight did not have knowledge of the reconstruction at the time. When asked why the court was not informed about the discrepancies, Wight stated:

> *I was simply hoping that just by attaching a complete copy back with the [s]tatus [r]eport it would at least put the correct notice on record.*

The court ordered RJ to submit a complete copy of the notice of deficiency, but RJ provided a notice unrelated to the years at issue. The court repeated the request, and RJ submitted the IRS's petition notice to the court but not the notice of deficiency that the IRS claimed to have sent.

Issue. The issue in this case is whether the court should strike the PSD from the court's records.

Analysis. Instead of requesting more time to comply with the court's directive, the IRS created a **new** document. Even though the IRS claimed it to be a "complete copy," it was not. Both the answer notice and the status report notice were materially different from all other notices in the record.

The court was dismayed by the IRS not informing it of the document reconstruction process, stating the following.

> *Respondent's conduct falls woefully short of our expectations for practitioners who regularly appear before this [c]ourt... We have no confidence that the slipshod cut-and-paste Status Report Notice presented to the [c]ourt was the version of the notice of deficiency actually sent to the petitioner.*

Because the statutory notice of deficiency is critical to adjudicating and settling the case, the judge was uncertain that the IRS had actually sent the required notice of deficiency to RJ. The judge ordered the partners to file a revised decision document.

Holding. The court held that the PSD be stricken from the record. The court entered a decision against RJ for unpaid income taxes of $84,358 and refused to allow a §6663 penalty against RJ.

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Disaster Relief

***Mohamed Abdo and Fardowsa Farah v. Comm'r*, 162 TC 7 (Apr. 2, 2024)**
IRC §§6662 and 7508

☞ A Helpful Extension

Facts. The IRS issued a notice of deficiency dated December 2, 2019, to Mohamed Abdo and Fardowsa Farah. The notice stated that $9,634 was due in income tax and $166 was due as an accuracy-related penalty under IRC §6662(a) for the tax year 2018. The 90th day after December 2, 2019, was March 1, 2020, which was a Sunday. The notice of deficiency specified the following day, March 2, 2020, as the last day to file a petition. However, the couple did not mail their petition until March 17, 2020. The Tax Court did not receive mail between March 19 and July 9, 2020, as it was closed due to the COVID-19 pandemic. The court received and filed the couple's petition on July 10, 2020.

The President of the United States declared a national emergency on March 13, 2020. The IRS issued Notice 2020-23[117] on April 11, 2020, extending the deadline for filing a Tax Court petition to July 15, 2020, for taxpayers who had a petition due between April 1, 2020, and July 15, 2020. Accordingly, the IRS contended that the couple did not file their petition timely according to the notice. Mr. Abdo and Ms. Farah agreed that the deadline to file a petition was not extended under the **regulation**, but they argued the petition was timely filed under all reasonable constructions of IRC §7508A(d).

Issue. The issues in this case are the following.

- Whether §7508A(d) provides a mandatory 60-day extension when a disaster is declared
- Whether Treas. Regs. §§301.7508A-1(g)(1) and (2) are valid
- Whether Mr. Abdo and Ms. Farah's petition was valid because they filed it during the automatic postponement period

Analysis. IRC §7508A(a) provides that tax deadlines may be extended up to one year by the Secretary of the Treasury if there is a federally declared disaster. IRC §7508A(d) provides that tax deadlines shall be disregarded for the period beginning on the earliest incident date specified in the disaster declaration and ending on the date which is 60 days after the latest incident date specified.

The couple argued that the first incident date of the disaster was January 20, 2020, and so after applying the 60-day extension, the deadline would be March 21, 2020. However, Treas. Reg. §§301.7508A-1(g)(1) and (2) limit the acts subject to the mandatory postponement period of §7508A(d) to "the acts determined to be postponed by the Secretary's exercise of authority under §7508A(a) or (b)." The regulation appears to provide that the extension is not mandatory. But Mr. Abdo and Ms. Farah argued this regulation conflicts with §7508A(d), which provides an automatic extension, thereby making the regulations null and void under the 2-step statutory interpretation test articulated in *Chevron USA, Inc. v. Nat. Res. Def. Council, Inc.*[118]

The statutory interpretation test from *Chevron* is:

1. Whether Congress has spoken on the precise question at issue, and
2. If Congress has not spoken on it, the statute is ambiguous, and the question becomes whether the agency's answer is a permissible construction of the statute.[119]

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117. IRS Notice 2020-23, 2020-18 IRB 742.

118. See *Chevron, USA, Inc. v. Nat. Res. Def. Council, Inc.,* 467 U.S. 837 (1984).

119. Ibid.

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Here, the court first considered step 1, by looking at the plain and literal language of the statute, the context in which the language was used, and the broader context of the statute as a whole. The couple argued that the discretionary language of §7508A(a) compared to the later, mandatory language of §7508(d) indicated Congress wanted the 60-day extension to be mandatory when it added (d).

The IRS countered that §7508A(d) is ambiguous because Congress did not identify specifically what time-sensitive acts are subject to §7508A(d), and so deference to Treas. Regs. §§301.7508A-1(g)(1) and (2) is necessary. But §7508A(d) clearly provides that the defined time period "shall be disregarded." This extension is for the 60 days provided for in subsection (a) because subsection (d) says the extension shall be in the "same manner" as provided by (a), which is unambiguous. Headings can also be used to help resolve doubt about the meaning of the text.[120] The heading of subsection (d) is "mandatory 60-day extension" which is clear and unambiguous, and is not at odds with any of the statute's underlying text. Thus, the plain language of the statute indicates Congress clearly intended to provide mandatory postponement, and deference to the Treasury Regulation is unwarranted.

The IRS also contended §7508A is ambiguous because it did not specify how the mandatory postponement in §7508A(d) applies to a federal disaster declaration without an incident date, and the Nationwide Emergency Declaration did not specify an incident date. But the petitioners argued they were entitled to a postponement under the Ohio Disaster Declaration, which specified an incident date of January 20, 2020.

Holding. The court held that because §7508A is clear, an automatic, 60-day petition filing extension is granted in the event of a federally declared disaster to qualified taxpayers. Because this Code section unambiguously provides for a mandatory filing extension for qualified taxpayers, the IRS regulations in conflict with it are not entitled to the court's deference. Accordingly, Mr. Abdo and Ms. Farah timely filed their Tax Court petition in response to the IRS's notice of deficiency. Thus, the petition in this case was timely.

> **Observation.** Through their attorneys, Mr. Abdo and Ms. Farah successfully argued that the IRS could not impose a regulation in conflict with clear legislation. It is difficult to envision taxpayers making *pro se* appearances in Tax Court having the same success. Perhaps more importantly, if this case had been argued after the Supreme Court's *Loper Bright Enterprises* decision, it would be more difficult for the IRS to claim the Tax Court's deference to its positions.[121]

Third-Party Summons

***God's Storehouse Topeka Church v. U.S.*, 98 F.4th 990 (10th Cir. 2024)**

IRC §§7609 and 7611

☞ Validity of Third-Party Summons in Church Tax Investigation Affirmed

Facts. Richard and Pennie Kloos founded God's Storehouse Topeka Church (GSH) in 2009, a thrift store with an attached coffee shop in Kansas, with Mr. Kloos serving as a pastor. While GSH was registered as a Kansas not-for-profit corporation in the subsequent year, it opted not to pursue formal tax-exempt status under IRC §501(c)(3). Instead, it designated itself as a church under IRC §508(c)(1)(A), thus avoiding the need for IRS recognition. Despite this classification, GSH predominantly functioned as a thrift store, retailing donated items to the public, with the coffee shop serving patrons at cost. Mr. Kloos ran for the Kansas State Senate in 2020, displaying campaign yard signs referencing his connection to GSH.

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120. *Almendarez-Torres v. U.S., 523* U.S. 224, 234 (1998).

121. *Loper Bright Enterprises v. Raimondo*, 45 F.4th 359 (D.C. Cir. 2022), *vac'd and remanded* 603 U.S. _____ (2024).

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In February 2021, the IRS launched an investigation into GSH's tax-exempt status for the 2019 and 2020 tax years, alleging potential tax liabilities due to operating as a thrift store, political campaign intervention, coffee shop income, and unpaid employment taxes for the Klooses. Despite GSH's objections, the IRS initiated a church tax examination and issued a third-party summons to Kaw Valley Bank, which held GSH's bank accounts. The summons requested bank records spanning January 1, 2019, to December 31, 2020, seeking to gather financial information pertinent to GSH's tax status. GSH disputed the summons's validity and petitioned the district court to quash it, contending that the IRS failed to meet IRC §7611 requirements. In particular, GSH asserted the Tax Exempt and Government Entities Commissioner (TE/GE Commissioner), the IRS official who signed off on the GSH inquiry, is not an "appropriate high-level Treasury official" for purposes of §7611(a)(2).

In response, the IRS moved for summary denial, asserting that IRC §7609, not §7611, governed the summons's validity. The district court ruled in favor of the IRS, agreeing with its position regarding §7611 third-party summonses related to churches. Further, the district court affirmed the summons's validity under §7609, concluding that the IRS followed all requisite administrative steps under the *Powell* case.[122]

Issue. The issue in this case is whether the TE/GE Commissioner is an appropriate high-level Treasury official to approve church tax inquiries, examinations, and summonses under §7611.

Analysis. The court reasoned that the issue of whether the TE/GE Commissioner could authorize the summons was only relevant if §7609 depended on §7611. This issue, in turn, raises a question of statutory construction.[123] GSH contended that the validity of the IRS's §7609 third-party summons to Kaw Valley depends on the summons's compliance with §7611. This Code section would impose heightened procedural requirements before the IRS could undertake either a "church tax inquiry" or a "church tax examination," but only if the IRS must comply with it before issuing the summons. However, the court held that plain language in §7611 contradicts this argument, as it clarifies that §7609 third-party summonses are not church tax inquiries or examinations.[124]

Thus, the court affirmed that §7609 exclusively governs third-party summonses, even within the context of church tax inquiries and examinations.[125] Contrary to GSH's interpretation, §7611 procedural requirements do not apply to third-party summonses, as clarified by case law.[126] Therefore, IRS compliance with §7611 is irrelevant to the validity of third-party summonses, which are subject only to §7609 administrative steps as analyzed under the *Powell* case.

Holding. The court affirmed the district court's judgment denying GSH's petition to quash the third-party summons because the IRS summons needed to follow only the provisions of §7609, not §7611.

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122. IRC §7609, together with the decision in *U.S. v. Powell*, 379 U.S. 48 (1964), govern the validity of the third-party summons. To enforce the summons, the IRS must establish all four of the *Powell* factors. The fourth *Powell* prong requires that IRS shows it followed all requisite administrative steps. As relevant to the issues on appeal, the court discussed the fourth prong only.

123. *Standing Akimbo, LLC v. U.S.,* 955 F.3d 1146 (10th Cir. 2020).

124. See IRC §7611(h).

125. See, e.g., *U.S. v. C.E. Hobbs Found. for Religious Training & Educ., Inc.,* 7 F.3d 169, 173 (9th Cir. 1993).

126. *Bible Study Time, Inc. v. U.S.*, 240 F. Supp. 3d 409, 420–21 (D.S.C. 2017).

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Tax Preparer Fraud

***Stephanie Murrin v. Comm'r,* TC Memo 2024-10 (Jan. 24, 2024)**
IRC §6501(c)

☞ Tax Preparer's Fraud Catches Up with Taxpayer 20 Years Later

Facts. Stephanie Murrin and her then-husband employed the services of a tax return preparer, Duane Howell, to prepare their joint federal income tax returns and income tax returns for two partnerships in which Ms. Murrin was a general partner for tax years 1993 through 1999. Unbeknownst to the Murrins, Mr. Howell had previously had his CPA license revoked for preparing false tax returns but was continuing to prepare tax returns without listing his name as the preparer, instead listing various entity names with different addresses. Mr. Howell would later testify that nearly every return he prepared during a decade-long period included fraudulent entries, including the following.[127]

- Setting up false partnerships
- Deducting Keogh plan contributions without verifying the taxpayer made the contributions
- Deducting fabricated business expenses he made up without his clients' knowledge, often using the same amount of expenses across all the returns he prepared, which would result in reported net business income of exactly $2

Mr. Howell entered false and fraudulent information on the returns to evade tax without the knowledge of the Murrins. The Murrins did not enter any false or fraudulent information themselves and did not intend to evade tax. The IRS found the fraudulent information after the 3-year period of limitation had passed. In 2019, the IRS issued a notice of deficiency for the years at issue, utilizing the fraud exception for the statute of limitations.

Issues. The issue is whether IRC §6501(c) applies only when a taxpayer has personally filed a false or fraudulent return with the intent to evade tax.

Analysis. Under Rule 142(b), the IRS has the burden of proof to show fraud with the intent to evade tax. Although the IRS has the burden of proof to prove the issue of fraud, the Murrins claimed Mr. Howell committed fraud with the intent to evade tax. IRC §6501(a) states that there is a 3-year period for the IRS to assess tax after a federal income tax return is filed. Under §6501(c)(1), there is no time limit to assess tax if there is a "false or fraudulent return with the intent to evade tax." Under precedent, §6501(c)(1) applies even when it is the tax return preparer behind the false or fraudulent return with the intent to evade tax.[128] Ms. Murrin requested a reconsideration of this decision and to hold that §6501(c) applies solely to taxpayer fraud.

The court does not revisit the statutory analysis for a prior decision unless there is special justification. The case proposed by Ms. Murrin as special justification was not clear on the point of contention and the Federal Circuit does not have jurisdiction to appeal any Tax Court decision. Under §6501(c)(1), limitations statutes preventing the collection of taxes are also strictly construed in favor of the Government. When the language in the statute is clear and it aligns with Congress's intentions, that language is regarded as conclusive.[129]

IRC §6501(c)(1) states that "in the case of a false or fraudulent return with the intent to evade tax, the tax may be assessed, or a proceeding in court for collection of such tax may be begun without assessment, at any time." If there was intent to evade tax in a false return, it is irrelevant who possessed that intent. There is no requirement that the taxpayer must be the party with the intent to evade tax to qualify under the provision.

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127. *Limitation Period Extended Due to Preparer Fraud.* Beavers, James A. Sep. 1, 2016. AICPA. [www.thetaxadviser.com/issues/2016/sep/limitation-period-extended-due-to-preparer-fraud.html] Accessed on Aug. 6, 2024.

128. *Allen v. Comm'r*, 128 TC 37 (2007).

129. *Byrd v. Shannon*, 715 F.3d 117, 122 (3d Cir. 2013).

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Ms. Murrin argued that §6501(c)(1) should be interpreted similarly to IRC §6663(a). IRC §6663(a) imposes a penalty if there is fraud on a tax return leading to an underpayment of tax. There is an exception in IRC §6664(c)(1) where taxpayers are not penalized if they can show reasonable cause and good faith. Although §6663 was originally close in placement to §6501(c)(1) within the Revenue Act of 1918 (Act), identical terms or phrases in the Code do not have to be interpreted to have the same meaning if the statutes have different legislative purposes.[130] The purpose of §6501(c)(1) is to provide the IRS with adequate time to assess a tax liability in cases of false or fraudulent returns because of the associated higher difficulty in investigation. The purpose of §6663(a) is to impose a civil penalty to punish taxpayers who commit fraud and to reimburse the Government, and therefore, the statute is attached to the intent of a particular taxpayer.

Ms. Murrin also argued that §6501(c)(1) should be interpreted according to IRC §7453(a). IRC §7453(a) states that Congress considers the fraudulent intent of only the taxpayer when pursuing fraudulent actions. Congress included this language in one section of the same Act but did not include that language in §6501(c)(1). The court argued this omission shows Congress acted purposely and intentionally when deciding whether to include or exclude the language in different sections of the Act. The court found the language in §6501(c)(1) unambiguous and saw no need to turn to legislative history to interpret the statute.

Holding. The court held in favor of the IRS, finding Mr. Howell's preparation of false or fraudulent returns with the intent to evade tax qualifies for an indefinite statute of limitation to assess tax on Ms. Murrin.

Offer in Compromise

***Justin C. Cloar v. Comm'r*, TC Memo 2024-17 (Feb. 6, 2024)**
IRC §§6330 and 7122

☞ No Abuse of Discretion in Rejecting Lowball Offer

Facts. Justin Cloar timely filed income tax returns for the years at issue: 2008, 2009, 2010, and 2012. However, he failed to pay the full tax due and had income tax liabilities amounting to $107,410. In 2017, the IRS issued him a Notice LT11, *Notice of Intent to Levy and Notice of Your Right to a Hearing*. Mr. Cloar submitted a Collection Due Process (CDP) hearing request and a Form 9465, *Installment Agreement Request*. Mr. Cloar proposed an installment agreement where he would pay $25 a month. As an alternative, he proposed that the IRS place him in currently-not-collectible (CNC) status, accept an offer in compromise (OIC), and/or abate any penalty.

An IRS settlement officer sent a letter to Mr. Cloar scheduling a CDP hearing and requesting financial documentation. During the hearing, Mr. Cloar's representative stated that Mr. Cloar intended to submit an OIC and was no longer seeking an installment agreement or CNC status. Mr. Cloar submitted an OIC of $756 to settle his tax liability for the years at issue.

IRS's Centralized Offer in Compromise (COIC) unit found that Mr. Cloar had a reasonable collection potential (RCP) of $18,824 and recommended that the IRS Independent Office of Appeals (Appeals) reject his OIC. The COIC unit found that Mr. Cloar had $5,249 of monthly income, total monthly expenses of $4,358, and total assets of $8,132, the value of his state retirement account.

The settlement officer informed Mr. Cloar's representative that the OIC was rejected because he failed to disclose all income and expenses, and the OIC was not in the government's best interest. The settlement officer floated the option of placing Mr. Cloar's account into CNC status if he withdrew his OIC. Mr. Cloar refused this offer, and Appeals upheld the rejection of Mr. Cloar's OIC and issued him a notice of determination in November 2018.

130. *Yarish v. Comm'r*, 139 TC 290, 297 (2012).

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Mr. Cloar was terminated from his job at the Arkansas Public Defenders Commission in September 2019 after he filed his case in court. Mr. Cloar and the IRS jointly requested the remand of Mr. Cloar's case to Appeals in October 2020 because of his unemployment, and another CDP hearing was scheduled. Mr. Cloar liquidated his retirement account, and after state and federal tax deductions, Mr. Cloar transferred the remaining $8,829 to the IRS. Mr. Cloar submitted his OIC and offered $25 to resolve his remaining tax liabilities. He reported zero income and no equity in his retirement account.

However, in examining Mr. Cloar's reports, the COIC unit found that Mr. Cloar had an RCP of $23,155. It found Mr. Cloar had $8,132 in assets, $4,762 in monthly income, and $3,510 in monthly expenses, resulting in $1,252 monthly that could be paid towards his tax liabilities. The monthly income was calculated using the income from 2018 and 2019. At the time of the calculation, Mr. Cloar had been unemployed for two years. The COIC unit rejected the OIC of $25 because it was below the RCP of $23,155. Subsequently, Appeals affirmed the rejection and issued a supplemental notice of determination on May 16, 2022.

Issue. The issue in this case is whether the determination of Appeals to reject Mr. Cloar's OIC offer of $25 was arbitrary, capricious, or without sound basis in fact or law.

Analysis. The court determined whether Appeals abused its discretion using the following factors: whether the settlement officer verified that the requirements of the applicable law or administrative procedure were met, considered relevant issues raised by Mr. Cloar, and whether the proposed collection action balances the efficient collection of taxes with the concern that collection be no more intrusive than necessary.

The settlement officer satisfied the verification requirement, and Mr. Cloar did not claim otherwise or provide any facts to support another position. The IRS can reject an OIC when the taxpayer's RCP exceeds his offer.[131] The court's job is to review for abuse of discretion and determine whether the settlement officer's actions were arbitrary, capricious, or without sound basis in fact or law.[132] The court will not determine the RCP of the taxpayer or whether the COIC unit's determination was completely accurate. The settlement officer considered all the facts and circumstances and found that Mr. Cloar's RCP exceeded his OIC offer of $25. Therefore, the settlement officer did not act in an arbitrary and capricious manner when she rejected Mr. Cloar's OIC.

The IRC §6330(c)(3)(C) balancing test weighs the need for efficient collection of taxes against the objective of making collection action no more intrusive than necessary. The settlement officer balanced the competing interests and considered Mr. Cloar's unemployment when she decided to reject his OIC. The court noted that Mr. Cloar declined to be placed into CNC status. In light of this, the settlement officer did not abuse her discretion in determining that the balancing requirement was met.

Holding. The court upheld Appeal's supplemental determination because it found no abuse of discretion.

> **Note.** For more information on OICs, see the 2024 *University of Illinois Federal Tax Workbook,* Chapter 7: IRS Update.

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131. See *Johnson v. Comm'r*, 136 TC 475, 486 (2011).

132. See *Thompson v. Comm'r*, 140 TC 173, 179 (2013); *Murphy v. Comm'r*, 125 TC 301, 320 (2005).

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IRS PROCEDURES — PENALTIES

Underpayment Penalties

***Burt Kroner v. Comm'r*, TC Memo 2024-41 (Apr. 8, 2024)**
IRC §§6662(c), 6664(c), and 6751(b)

☞ Tax Court Assesses Penalties After IRS Appeal

Facts. Burt Kroner worked in the discounted cashflow industry and developed a relationship with David Haring, who provided emergency funding to Peachtree Settlement Funding. Mr. Kroner received from Mr. Haring $4,425,000 in 2005, $15,350,000 in 2006, and $5 million in 2007. Robert Bernstein, a lawyer who represented both Mr. Haring and Mr. Kroner, told Mr. Kroner that the transfers were excludable from income. Mr. Bernstein gave this advice based on a conversation with Mr. Kroner and a note Mr. Bernstein drafted with Mr. Mitchell, an associate of Mr. Haring. Mr. Kroner did not report any of the transfers as income. During this time, Peachtree investors received substantial payments when the company received an injection of private equity funding, went public on the London Stock Exchange, and eventually was acquired by Credit Suisse. The court used the term "liquidity events" to identify these payments to Peachtree investors.

In the Tax Court's original 2020 decision,[133] it rejected Mr. Kroner's version of events for the following reasons.

- A lack of evidence
- Doubts about the authenticity of the note from Mr. Haring stating he wanted to make Mr. Kroner a monetary gift
- The coincident timing of liquidity events by Mr. Haring as an investor in Peachtree
- Willingness by Mr. Kroner and Mr. Haring to enter into nominee arrangements and the nature of the relationship between the two

Mr. Kroner could not invest in Peachtree because he had signed a noncompete agreement. Peachtree had three liquidity events and shortly after each event, Mr. Haring transferred money to Mr. Kroner.

Mr. Bernstein became Mr. Kroner's tax attorney in 1996, and he also represented and provided Mr. Haring with tax advice for the transfers. Mr. Bernstein did not discuss with Mr. Haring his intentions for the transfers. Mr. Bernstein reviewed the note provided to Mr. Kroner and told Mr. Kroner the transfers would be tax-free. Mr. Kroner's accountant prepared his Form 1040, *U.S. Individual Income Tax Return,* without information about the transfers from Mr. Haring, and Mr. Bernstein prepared Mr. Kroner's Form 3520, *Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts.*

Although the court found Mr. Kroner liable for tax on the transfers he received, it decided that the IRS supervisor had not provided written approval before the first notice of potential penalties was sent on August 6, 2012. Thus, the Tax Court held in 2020 that the IRS had not complied with procedural requirements, so Mr. Kroner was not liable for accuracy-related penalties.[134]

On appeal, the U.S. Court of Appeals for the Eleventh Circuit did not agree with the Tax Court's conclusion that the IRS had not complied with IRC §6751(b) and reversed the lower court's decision concerning the penalties.[135] Thus, the Tax Court was required to impose the penalties requested by the IRS.

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133. *Burt Kroner v. Comm'r*, TC Memo 2020-73 (Jun. 1, 2020), *rev'd* 48 F.4th 1272 (11th Cir. 2022).

134. IRC §6662(a).

135. *Kroner v. Comm'r,* 48 F.4th 1272 (11th Cir. 2022), *rev'g* TC Memo 2020-73 (Jun.1, 2020).

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Issues. The issues in this case are the following.

- Whether Mr. Kroner is liable for IRC §6662 accuracy-related penalties for 2005, 2006, and 2007
- Whether the IRC §6664(c) reasonable cause exception applies to the penalties
- Whether the IRS complied with the supervisory approval requirements of §6751(b)

Analysis. Under §6662, there is a 20% penalty for the amount of underpaid tax if there is either of the following.

- Substantial understatement of income tax, or
- Negligence or disregard of rules or regulations

An understatement is **substantial** if it is at least 10% of the tax required to be reported for the year or $5,000, whichever is greater. As the understatements in this case are substantial, the court did not need to determine whether the underpayments were due to negligence or disregard. If there was reasonable cause for the underpayment and the taxpayer acted in good faith, §6664(c)(1) states that the §6662 penalty does not apply.

Mr. Kroner claimed that he relied on professional advice given by Mr. Bernstein, and therefore, he had reasonable cause and acted in good faith. A taxpayer needs to demonstrate three elements for reasonable cause.

1. The adviser was a competent professional who had sufficient expertise.
2. The taxpayer provided necessary and accurate information to the adviser.
3. The taxpayer indeed relied in good faith on the adviser's judgment.[136]

Mr. Kroner did not demonstrate that he provided Mr. Bernstein with the necessary and accurate information. Mr. Bernstein did not know about the large transfer amounts, the dates of the transfers, or to which accounts the transfers were made. Mr. Bernstein also did not know about the noncompete agreement preventing Mr. Kroner from investing in Peachtree, the Peachtree liquidity events, or details of Mr. Kroner's and Mr. Haring's business and personal relationship. Furthermore, Mr. Bernstein had no knowledge that the transfers were made shortly after liquidity events and distributions were made to Mr. Haring as a Peachtree investor.

The record indicates that Mr. Kroner did not provide Mr. Bernstein with the necessary information to properly advise him about the tax consequences of the transfers. Mr. Kroner also did not rely in good faith on Mr. Bernstein's advice because Mr. Kroner did not inform his accountant about the transfers from Mr. Haring. Therefore, Mr. Kroner has not proven that he had reasonable cause or acted in good faith for the tax underpayments.

The Appeals Court for the 11th Circuit decided that the IRS has satisfied the timing requirements of §6751(b)

> *[a]s long as a supervisor approves an initial determination of a penalty assessment before it* ***assesses*** *those penalties.* [emphasis added]

The appellate court concluded that the IRS had not assessed the penalties when it provided Mr. Kroner with its August 12, 2012, letter proposing penalties. On the contrary, the IRS made the formal assessment after the supervisor signed the approval document on October 31, 2012. Therefore, the appellate court reversed the Tax Court's prior decision that disallowed Mr. Kroner's penalties and remanded the case to the Tax Court to hold Mr. Kroner liable for the §6662(a) penalties.

Holding. The court held that Mr. Kroner is liable for taxes on the unreported income from liquidity events and accuracy-related penalties for the years at issue. The reasonable cause exception does not apply. The IRS correctly followed procedures for supervisory approval before it assessed penalties.

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136. See *Neonatology Assocs., P.A. v. Comm'r*, 115 TC 43, 99 (2000), *aff'd*, 299 F.3d 221 (3d Cir. 2002).

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Passport Revocation

***Daniel Olin Nye v. Comm'r,* TC Memo 2023-154 (Dec. 28, 2023)**
IRC §§6672 and 7345

☞ Court Grounds Taxpayer for Tax Deficiencies

Facts. Daniel Nye filed timely tax returns for 2011 to 2016 but failed to collect, account for, and pay social security and federal income taxes withheld from employees. Under IRC §6672, the IRS assessed civil trust fund recovery penalties against Mr. Nye for the years 2011 to 2016. For those years, the assessed deficiencies and civil penalties, including interest, totaled $99,222 (including interest of $19,685) as of February 27, 2023.

The IRS filed notices of federal tax lien, sending copies to Mr. Nye to inform him of his right to request a Collection Due Process (CDP) hearing. These notices were mailed between December 2014 and June 2018 for each year and period at issue. On January 11, 2017, Mr. Nye requested a CDP hearing concerning the 2016 notice associated with the 2015 income tax deficiency. The IRS Office of Appeals resolved the hearing in July 2017 and issued a notice of determination. Mr. Nye did not request a CDP hearing concerning any other notice and did not petition the court after the 2017 notice of determination.

On July 30, 2018, the IRS certified Mr. Nye as an individual owing a seriously delinquent tax debt arising from the years and periods at issue and for income tax deficiencies for 2008 and 2009. Mr. Nye entered into an installment agreement with the IRS on October 3, 2018, and established a monthly payment of $318. The installment agreement was conditional upon periodic reviews of Mr. Nye's financial condition. On November 12, 2018, the IRS reversed Mr. Nye's certification as an individual owing a seriously delinquent tax debt. The installment agreement payments were applied against Mr. Nye's tax liabilities for 2008 through 2010, in chronological order, until the remaining balance for each year was written off because the statute of limitations expired.

On November 7, 2022, the IRS mailed Mr. Nye a notice of intent to levy for each year and period at issue. The notice stated that Mr. Nye did not provide the required updated financial statements and that Mr. Nye could either provide the updated financial statements or request a Collection Appeals Program hearing. However, the notice stated that if Mr. Nye failed to do either, his installment agreement would be terminated. Mr. Nye did not request the hearing or provide the requested information.

The IRS terminated the installation agreement on January 9, 2023. On February 27, 2023, the IRS recertified Mr. Nye as an individual owing a seriously delinquent tax debt. The IRS also sent Mr. Nye a Notice CP508C, *Notice of Certification of Your Seriously Delinquent Federal Tax Debt to the State Department* (Passport Notice).

Issue. The issue in this case is whether the IRS erred in certifying Mr. Nye as having seriously delinquent tax debt related to income tax deficiencies for 2012 to 2015 and civil trust fund recovery penalties for 2011 to 2016.

Analysis. When the IRS certifies that a taxpayer has a seriously delinquent tax debt, IRC §7345 requires the certification to be transmitted to the Secretary of State for action concerning the denial, revocation, or limitation of the taxpayer's passport. A seriously delinquent tax debt is a federal tax liability that:

- Has been assessed,
- Exceeds $50,000, adjusted for inflation,
- Is unpaid and legally enforceable, and
- Is the subject of a completed levy or a filed lien notice with all administrative rights exhausted or lapsed.

IRC §7345(e)(1) permits a taxpayer who has been certified as having a seriously delinquent tax debt to petition the court to determine whether the certification was erroneous. If it was erroneous, the IRS must reverse the certification and notify the Secretary of State and the taxpayer.

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The IRS met the criteria to certify that Mr. Nye had a seriously delinquent tax debt and supplied the account transcripts and the notices of intent to levy for the years and periods at issue. All the notices (with all administrative rights exhausted or lapsed) had been filed. Mr. Nye did not request a Collection Appeals Program hearing or a CDP hearing for any of the tax liabilities other than the one for 2015. The record shows that at the time of certification, Mr. Nye's liabilities met the statutory definition of seriously delinquent tax debt.

Mr. Nye claimed that when the IRS issued the notices and requested additional documents, he provided the documents within the allowed timeframe. He further asserted that he had not defaulted on the installment agreement and continued making his monthly payments until petitioning the court. However, there was no evidence supporting Mr. Nye's claim from either party that he submitted documentation. Thus, Mr. Nye failed to establish this argument as a disputed material fact.

Holding. The court granted summary judgment to the IRS because the certification of seriously delinquent tax debt was not erroneous.

Importance of Proof of Mailing

***John Peter Zaimes v. Comm'r,* TC Memo 2023-121 (Sep. 26, 2023)**
IRC §6651, 6654, and 7502

☞ Refresher Course on the Mailbox Rule

Facts. Having extended his 2015 tax return before the due date of April 18, 2016, John Peter Zaimes thought he had filed his tax return on October 17, 2016. The return showed that Mr. Zaimes owed $118,145 for his 2015 tax liability. Mr. Zaimes included a check for $58,145 with his tax return, even though it was not the total amount due. His tax practitioner, a CPA, recommended that he send the return by regular U.S. mail. He claimed that he had placed his signed return in a manilla envelope with a postmark from a private meter, not a U.S. Postal Service (USPS) postmark. On his way to board a plane at Los Angeles International Airport later that evening, Mr. Zaimes deposited the envelope in a drive-up mailbox. However, he did not retain evidence of the IRS address to which he mailed the package or evidence of the postage.

At some point within the ensuing 13 months, Mr. Zaimes noticed that the IRS had not cashed his check. Accordingly, he electronically filed his 2015 tax return on November 13, 2017, more than a year after the extended due date. This return showed an unpaid balance of $110,693, including an estimated tax penalty. He did not submit a payment with the electronically filed return.

Within a month of receiving the electronically filed return, the IRS processed it and mailed Mr. Zaimes a notice of tax due and demand for payment on the same day. This notice assessed interest of $8,405, a $24,213 addition to tax for late filing his 2015 return, and a $10,761 addition to tax for not paying the balance due on time. He was also assessed a $3,078 estimated tax penalty.

In March 2018, Mr. Zaimes paid $100,000 toward the balance due. Although the IRS credited his account with that amount, six months later, it sent him a "Notice of Federal Tax Lien Filing and Your Right to a Hearing under IRC 6320." Mr. Zaimes mailed a request for a Collection Due Process (CDP) hearing on a timely basis, which the IRS did receive. In it, Mr. Zaimes claimed that he filed his 2015 return on time and should not be responsible for the penalties. He also claimed to have evidence that he had filed on time.

At the CDP hearing, Mr. Zaimes agreed that he owed the tax due but stated that the IRS should abate the penalties because he claimed he had filed the return on time and included a payment, even though it was not the full payment. He did not request a collection alternative.

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Roughly two months later, the settlement officer from the CDP hearing declined his invitation. She determined he did not establish that he had filed his 2015 return on time. Researching the possibility of first-time abatement, she found that he had late-filed and late-paid returns for the three previous years.

Mr. Zaimes filed a petition for review by the Tax Court but raised no additional issues.

Issues. The issues in this case are the following.

- Whether Mr. Zaimes is liable for the addition to tax under IRC §6651(a)(1) for failing to file his 2015 income tax return on time
- Whether Mr. Zaimes is liable for the addition to tax under §6651(a)(2) for failing to pay the amount shown on his 2015 tax return on time

Analysis. The court reviewed the requirements for mailing a tax return on time. It cited Treas. Reg. §301.7502-1(c)(1), which imposes three requirements for the "postbox" rule to apply.

1. The envelope is properly addressed to the IRS office where the IRS requires the return to be filed.
2. The envelope is timely deposited in U.S. mail.
3. The envelope has either a USPS postmark on the envelope **made by the U.S. Postal Service** or another postmark that clearly shows the date mailed and that the date is on or before the due date for the return.

The court concluded that Mr. Zaimes did not file his 2015 return on time, even though he mailed it on the due date. It reached this conclusion after determining that the return was never delivered to the IRS, which is one of the requirements for the mailbox rule.[137] Because Mr. Zaimes had no proof of the address on the envelope, he failed the test of Treas. Reg. §301.7502-1(c)(1)(i), which requires taxpayers to address the envelope to the correct IRS office. In Mr. Zaimes' case, the proper address was an IRS post office box listed in the 2015 Instructions for Form 1040, *U.S. Individual Income Tax Return,* but he could not prove that he had properly addressed the envelope.

The regulations impose another requirement that the envelope must have sufficient postage. However, Mr. Zaimes could provide no evidence that he had affixed adequate postage, although he told the court that he had applied "a postage strip on it covering the necessary postage." Although postage from private postage meters is allowed, Mr. Zaimes provided no evidence that he applied the proper postage. Similarly, he did not provide evidence that a timely and legible postmark had been applied to his envelope.

After rejecting Mr. Zaimes' reasons for failing to file the return on time, the court turned to his reasons for failing to pay the tax due on time. The court found no basis for his claim that paying by the extended due date was evidence of his attempt to pay his tax on time, noting that the tax was due six months earlier in April on the unextended due date. The court quoted a 2004 case stating that reasonable cause for failure to pay is established on the unextended due date.[138]

> *The reasonable cause standard is a one-time test to be passed or failed at the payment due date.*

Thus, Mr. Zaimes was also found liable for the failure-to-pay penalty of §6651(a)(2).

Holding. The Tax Court found Mr. Zaimes liable for the failure to file addition to tax and the failure to pay addition to tax.

Practitioner Planning Tip

When sending physical documents to the IRS, using certified mail (or other USPS methods with tracked proof of delivery) can avoid many of the issues that Mr. Zaimes unsuccessfully faced.

137. Treas. Reg. §301.7502-1(e)(1).

138. *Estate of Hartsell v. Comm'r*, TC Memo 2004-221 (Sep. 21, 2004).

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Multiple IRS Errors on Appeal

***Daniel and Christine Larkin v. Comm'r*, TC Memo 2023-106 (Aug. 16, 2023)**
IRC §§6211, 6651, 6662, and 7486

☞ Win, Lose, or Draw for UK Attorney and IRS

Facts. Previous Tax Court decisions found that Daniel Larkin, an attorney working in the United Kingdom, owed additional taxes and penalties for 2003–2006.[139] In his capacity as a partner in a large law firm, Mr. Larkin earned around $400,000 per year but paid no U.S. tax. Upon exam, the IRS determined he was liable for $524,140 of federal taxes, additions to tax under IRC §6651(a)(1), and penalties under IRC §6662(a) totaling $104,828.

On appeal, the U.S. Court of Appeals for the District of Columbia Circuit affirmed the Tax Court's opinion except for four errors acknowledged by the IRS. The court of appeals partly vacated the Tax Court's decision and remanded the cases to correct assessments involving the four years of tax returns. By this point, the IRS had twice revised its computations. The four errors involved the following matters.

1. Inclusion of self-employment tax in computing the tax liabilities for each year
2. A $27 increase in 2003 income
3. Inclusion of an excess $10,792 of §6662(a) penalty for 2004
4. An erroneous inclusion of $1,948 of income in 2006

Issue. The issue in this case is whether the IRS has corrected errors in assessing income tax, additions to tax, and penalties due from Mr. Larkin.

Analysis. On remand from the court of appeals, the Tax Court requested the IRS and Mr. Larkin revise their filings. The IRS obtained an extension of time to submit its filing and submitted a recalculation of the amounts due. Mr. Larkin, representing himself, did not respond to the Tax Court's request. Shortly after this, though, an attorney began representing the Larkins. This attorney requested additional time to comment on the IRS calculations. The Tax Court was unable to confirm the IRS calculation, finding discrepancies between the IRS amended calculation and the amounts that the Tax Court had previously determined.

The Larkins' attorney argued that the Tax Court could not find a deficiency in their tax liabilities if the IRS had made assessments that **had not been abated,** citing IRC §6211(a). Therefore, the Larkins' attorney requested that the Tax Court direct the IRS to prove that there were no existing assessments for 2003–2006.

In response, the Tax Court requested both sides do additional work. The court asked both parties to explain a "defaulted [automated underreporter] AUR notice" that caused assessments for tax related to 2004. In response, the Larkins told the Tax Court they never received the AUR notice. They also asserted the IRS should exclude the missing AUR notice amounts from its calculations. Further, the Larkins contended the IRS abated the Larkins' 2005 and 2006 tax liabilities. Finally, the Larkins argued, based on IRC §7486 and the *Estate of Smith* case, they should be able to apply their foreign tax credits to any tax liability they may have for 2004.

Because the IRS filed still more corrections, the Tax Court provided Mr. and Mrs. Larkin another opportunity to object to the agency's filings. The Larkins used this opportunity to remind the court that the IRS had abated their 2005 and 2006 tax liabilities. They claimed sufficient foreign tax credits to offset any remaining tax liability. Furthermore, they questioned whether the IRS had met the burden of proof that it had obtained a timely supervisory approval of the penalties it sought from the Larkins.

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[139]. *Larkin v. Comm'r*, TC Memo 2017-54 (Apr. 3, 2017).

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In response to the confusing volley of arguments, the Tax Court agreed with neither side. However, it found the IRS had provided enough information to allow the court to correct the four errors and comply with the court of appeals' instructions. However, the Tax Court could not reconsider issues raised in the initial trial that were accepted, yet not part of the court of appeals' remand. With this reasoning, the Tax Court refused to entertain the Larkins' arguments in response to the IRS's new calculations.

Examining the claims year-by-year, the Tax Court disagreed with the Larkins' claim that they did not receive the notice of deficiency. Instead, the Tax Court only corrected the penalty the IRS included twice. It took note of Mr. Larkin's experience as an attorney, noting that he should have been aware of the obligation to plead issues that he wanted the court to consider.

The Tax Court also rejected any notion that it should require the IRS to abate any assessments before entering revised decisions. The court clarified that §7486 is a "procedural device" irrelevant to the Larkins' case. Similarly, the court rejected the Larkins' claim that the IRS had abated the tax due for 2005 and 2006. This issue was not part of the remand instructions from the court of appeals. The Tax Court also refused to permit the Larkins to carry back any foreign tax credit to reduce their 2004 tax liability.

Citing the restricted scope of instructions from the appeals court, the Tax Court declined to pursue the Larkins' argument that the IRS personnel did not first obtain the appropriate supervisory approval under IRC §6751(b).

Holding. The Tax Court held that the IRS corrected errors in determining income tax, additions to tax, and penalties that Mr. and Mrs. Larkin owed the U.S. Treasury. The corrections reduced the Larkins' tax liability by more than $100,000, even though it found the Larkins' arguments to reduce it further without merit.

Reasonable Cause for Failure of Timely Filing

***Wayne Lee v. U. S.*, No. 8:21-cv-01579 (11th Cir. 2023)**
IRC §§6511 and 6651

☞ Reasonable Cause Argument for e-Filing Reaches Boyle-ing Point

Facts. Wayne Lee, a surgeon residing in Florida, engaged Kevin Walsh, a CPA, to prepare and file his individual income tax returns. For each tax year from 2014 through 2016, Dr. Lee reported over $1 million in gross receipts. In 2014, Dr. Lee had a significant overpayment that was applied to his 2015 tax return, which in turn resulted in an overpayment that was applied to the 2016 tax return. Dr. Lee reviewed the tax returns each year and signed Form 8879, *IRS e-file Signature Authorization*, to give Mr. Walsh authorization to electronically file his returns. However, while Mr. Walsh prepared the 2014, 2015, and 2016 income tax returns, he did not file them. Because the IRS had an incorrect address for him, Dr. Lee did not receive IRS notices advising him of the unfiled tax returns. It was not until an IRS agent visited Dr. Lee's office in December 2018 that Dr. Lee became aware of the issue. Shortly after, Dr. Lee filed his prepared 2014 through 2016 tax returns.

Because of the 3-year lookback period,[140] the IRS disallowed Dr. Lee's overpayment calculated on his 2014 tax return. Consequently, Dr. Lee owed income tax for the 2015 and 2016 tax years. Combined with failure-to-file and failure-to-pay penalties, Dr. Lee was liable for $289,183 owed to the IRS, which he paid in August 2019. Dr. Lee eventually filed a lawsuit against Mr. Walsh and his firm, and they settled in 2020. Dr. Lee subsequently filed a lawsuit against the United States for a refund of his taxes and fees, arguing that reliance on his CPA to file his tax returns was reasonable cause. The U.S. District Court for the Middle District of Florida did not rule in his favor, finding *U.S. v. Boyle*[141] was precedent for "reliance on an agent" alone being insufficient for "reasonable cause." In response, Dr. Lee appealed.

140. IRC §6511(b)(2)(A).

141. *U. S. v. Boyle*, 469 U.S. 241 (1985).

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Issues. The issues in the case are the following.

- Whether *Boyle* applies to e-filed tax returns
- Whether Dr. Lee demonstrated reasonable cause under IRC §6651 for filing his returns late
- Whether the IRS incorrectly assessed the failure-to-pay penalties

Analysis. The court first tackled the issue of whether *Boyle*, which found that the sole reliance on an agent to file tax returns is an insufficient defense for reasonable cause, applies to e-filed tax returns. Dr. Lee argued that Form 8879 exempts e-filing from the bright line rule that *Boyle* establishes for paper filing. He stated that the form demonstrates that e-filing fundamentally differs from paper filing. Specifically, Dr. Lee explained that the issue in *Boyle* pertains to the taxpayer delegating the task of **preparing** the return, while in his situation, the issue at hand was his delegating the task of **filing** the return. Through this delegation, Mr. Walsh's failure to file his returns was beyond his control. The court disagreed, stating that Form 8879 is an authorization form allowing an agent to submit a tax return and does not constitute an action of a taxpayer filing a tax return. Consequently, signing Form 8879 does not absolve the taxpayer from exercising ordinary business care and prudence when filing a return or paying any tax due. Dr. Lee is still responsible for ensuring the tax return was prepared and submitted.

Further, circumstances beyond the taxpayer's control in the context of *Boyle* include only instances such as postal delays and taxpayer disabilities or illnesses. Dr. Lee's situation differed from these criteria, and signing Form 8879 did not alter his duty to exercise ordinary business care and prudence. While *Boyle* dealt with the paper filing of a tax return and Dr. Lee's situation involves the electronic filing of a return, the issue at hand of a taxpayer relying on an agent remains the same: taxes and penalties under §6651 apply equally to e-filed returns and paper-filed returns.

Dr. Lee also argued that e-filing is a task undertaken by tax preparers and not ordinary taxpayers, using the mandated e-filing requirement for specified tax return preparers[142] as a demonstration of Congress's intent. Essentially, Dr. Lee argued that once he signed Form 8879 after reviewing the tax returns and verifying they were indeed prepared, it was the responsibility of Mr. Walsh and the CPA firm to file his tax returns. The court also disagreed with this argument, stating that Dr. Lee was not forced to work with Mr. Walsh and retained full control over the engagement. While the court acknowledged Mr. Walsh may have failed to fulfill his contractual and ethical obligations to Dr. Lee and could theoretically reimburse him for damages resulting from such negligence, the court found that Mr. Walsh did not assume Dr. Lee's obligation to file a tax return on time and pay any tax due.

The court next assessed Dr. Lee's argument that he demonstrated reasonable cause for both filing his returns late and paying the tax due late under §6651. The court found Dr. Lee did not demonstrate reasonable cause regarding his late filings or late payments, regardless of the applicability of *Boyle*. As indicated in its earlier analysis, the court did not find that the filing medium, whether paper-filing or e-filing, alters the reasonable cause analysis under §6651. In assessing the exercise of ordinary business care and prudence, the court pointed out that Dr. Lee did not confirm whether Mr. Walsh filed his income tax returns. Instead, he assumed Mr. Walsh had filed them. As such, Dr. Lee's reliance on Mr. Walsh for filing the tax returns did not meet the reasonable cause standards under §6651(a)(1) for filing a tax return late.

The same fact patterns also pertain to Dr. Lee's late payment of taxes. While the disallowance of Dr. Lee's overpayment on his 2014 income tax return to 2015 and 2016 resulted in income tax due, had Dr. Lee verified that his 2014 income tax return was timely filed, he would have applied his overpayment to his 2015 and 2016 income tax returns. Dr. Lee's failure to pay his taxes on time did not result from financial hardship, unavailable records, or other events outside of his control,[143] but rather solely from his assumption that he would not have to pay 2015 and 2016 income tax because his 2014 income tax overpayment was applied to any tax due in those years.

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142. TD 9518, 2011-17 IRB 710.

143. Treas. Reg. §301.6724-1(c).

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Finally, the court assessed Dr. Lee's argument that the IRS incorrectly assessed the failure-to-pay penalties. The court identified that Dr. Lee did not make this argument before the district court, only presenting his arguments that *Boyle* did not apply to e-filed returns, and he was excused from failure to file and failure to pay penalties under reasonable cause. Because Dr. Lee first presented the argument of the IRS incorrectly assessing the failure-to-pay penalties on appeal, the court refused to consider the argument.

Holding. The district court held that *Boyle* applies to e-filed tax returns, and as such, Dr. Lee's reliance on his CPA to timely file his tax returns is not due to reasonable cause. Thus, the failure-to-file and failure-to-pay penalties under §§6651 and 6656 cannot be abated. The district court did not address whether the IRS assessed the failure-to-pay penalties incorrectly. The 11th Circuit Court of Appeals affirmed the decision made by the U.S. District Court for the Middle District of Florida.

> **Note.** This case specifically applies *Boyle* to e-filed returns. It establishes that by signing Form 8879, taxpayers have not fulfilled their responsibility to timely file tax returns and pay taxes due. While practitioners should exercise diligence in ensuring they are timely e-filing their clients' tax returns when authorized, taxpayers should be aware they are not personally relieved of their responsibilities when working with tax preparers.

PASSIVE ACTIVITIES

Net Investment Income Tax

***James and Catherine Senty v. Comm'r,* No. 22-cv-283-wmc (W.D.Wis. Dec. 15, 2023)**

IRC §§469 and 1411

☞ Let Sleeping NIIT Refunds Lie

Facts. James Senty holds leadership roles at multiple companies, manages apartment buildings, and owns farms in Wisconsin and Minnesota. Mr. Senty was the president of Deerfield Finance Corporation (DFC), Reconyx, Inc., Park Capital, LLC, and several other companies in 2014 and 2015. During those two years, Mr. Senty worked 65–70 hours per week but **did not keep any record of his time.** He estimated he worked more than 100 but less than 500 hours for Deerfield, Reconyx, and Park Capital during 2014 and 2015.

Both Mr. Senty and his son Paul worked for DFC in 2014 and 2015. Mr. Senty claimed that in 2014 and 2015, he worked more than 255 hours for DFC, and worked as a consultant, reviewed financial statements, monitored the performance of the directors, met with bank regulators, attended bank director conferences, attended director and compliance training, and monitored major issues in loan examinations, among other things. Mr. Senty said that he relied solely on his and Paul's memories to develop the list. However, he failed to provide any documentation of these hours other than an employment agreement he signed in 2017.

Mr. Senty worked on the board of directors for Reconyx in 2014 and 2015 and claimed he spent more than 276 hours working for Reconyx each year. Mr. Senty claimed he worked as a consultant, attended board meetings, field-tested cameras, developed cell phone camera lines, assisted with the opening of the Australian market, and provided international connections for the possible use of Reconyx's cameras at the Rio 2016 Olympics. Mr. Senty signed an employment agreement with Reconyx in 2016, which obligated him to provide at least 276 hours of service.

In 2014 and 2015, Mr. Senty was the sole manager of Park Capital, for which he claimed he did succession planning and held discussions with the successor manager, his son Paul. He also developed, financed, and leased a building in Verona, Wisconsin, to Park Capital. Mr. Senty said he spent more than 500 hours in 2014 and 2015 working for Park Capital but did not provide documentation to substantiate his claims.

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Mr. Senty and his wife, Catherine, filed joint income tax returns for 2014 and 2015. The IRS audited the returns for both years and determined that the Sentys owed a 3.8% net investment income tax (NIIT) pursuant to IRC §1411. The Sentys paid the NIIT under protest in the amounts of $101,097 for 2014 and $105,354 in 2015. Then, in November 2021, the Sentys filed amended federal income tax returns for 2014 and 2015 to reduce the net investment income subject to NIIT for both years.

The IRS issued a $133,498 refund to the Sentys for the additional NIIT assessed and paid for 2014, plus interest. The IRS denied any refund for 2015. The Sentys filed suit over the 2015 return in May 2022, and the IRS counterclaimed for a return of their 2014 refund, putting at risk the money the Sentys were previously refunded. In July 2023, the Sentys filed a new set of amended federal tax returns for 2014 and 2015. The Sentys claimed the net investment income subject to NIIT should be further reduced as they argued that the rental income they received during 2014 and 2015 should not be subject to NIIT at all.

Issues. The issues in this case are the following.

- Whether Mr. Senty materially participated in the activities of DFC, Reconyx, and Park Capital
- Whether the Sentys can raise alternative theories a year after their initial lawsuit was filed

Analysis. Net investment income for purposes of determining NIIT is any excess sum of (1) gross income from interest, dividends, annuities, royalties, and rents, except as derived in the ordinary course of a trade or business and (2) other gross income derived from a trade or business through a passive activity.[144] A trade or business counts as a "passive activity" subject to NIIT if the taxpayer does not materially participate in the business.[145]

To show material participation, the Sentys relied on the significant participation test as defined by Treas. Reg. §1.469-5T(a)(4). Under this test, the taxpayer must prove that their significant participation activities exceed 100 hours but are less than 500 hours per year.[146] To prove participation, the taxpayer may show it by any reasonable means, such as daily time reports, logs, appointment books, calendars, or narrative summaries.[147]

The Sentys relied on four sources to show significant participation.

1. Post hoc employment agreements with Reconyx and DFC from 2016 and 2017
2. Board meeting minutes from a single 2014 DFC directors meeting, a 2015 Bank of Deerfield meeting, and a 2014 and 2015 Reconyx meeting
3. Mr. Senty's own deposition testimony
4. Deposition testimony from Mr. Senty's family and friends

The post-event employment agreements Mr. Senty signed in 2016 and 2017 requiring Mr. Senty to work hours of 276 and 255, respectively, consistent with "historical practice," do not prove hours worked from 2014 and 2015. The court found these agreements "self-serving." The headings, structure, and language of the agreements from two purportedly separate companies were also almost identical. The board meeting minutes from single meetings at each company also do not prove the number of hours worked throughout the year. Mr. Senty's testimony was too vague, as he did not give many details about how much time he spent doing any particular task, and he also conceded he had no documentation to substantiate his claimed hours. His other witnesses also failed to substantiate Mr. Senty's hours. His co-workers testified that Mr. Senty did a significant amount of work, but their testimony was vague, and they did not provide any documents substantiating the hours worked.

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144. IRC §1411(c)(1).

145. IRC §§469(c) and 1411(c)(2)(A).

146. *Brumbaugh v. Comm'r*, TC Memo 2018-40 (Apr. 3, 2018).

147. Treas. Reg. §1.469-5T(f)(4).

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The Sentys also raised two alternative theories. First, the Sentys contended that because Park Capital's only income came from the rental of a building to Park Bank, its income was not subject to NIIT as it was "rented to a nonpassive activity."[148] Second, the Sentys contended the IRS should consider the Park Bank entities to be an "appropriate economic unit" for tax purposes. Because Mr. Senty worked more than 500 hours for all the entities combined, he should be exempt under Treas. Reg. §1.469-4(c)(1). This regulation imposes a requirement to "participat[e] in the activity for more than 500 hours during such year."[149] However, the Sentys cannot raise these arguments without first presenting them in a refund request.[150] The "substantial variance" doctrine limits a taxpayer to the grounds raised in the refund claim.[151] Here, the Sentys raised these two additional theories in their new amended returns a year after filing the lawsuit. The substantial variance theory thus precludes the Sentys from raising these alternate theories.

Finally, the Sentys contended that the IRS waived its substantial variance defense because the Sentys gave the government notice of the new theories in July 2023. However, the "waiver doctrine" only applies if the IRS considers the taxpayer's claim during administrative proceedings, despite the taxpayer not raising the specific claim.[152] That did not occur in this case.

Holding. The court held that the Sentys failed to meet their burden of proof establishing that Mr. Senty significantly participated in any of the three companies he worked for during 2014 and 2015. The Sentys also failed to present their alternative theories in their original suit. Therefore, the Sentys' net investment income is not excluded from the NIIT for 2014 or 2015.

RETIREMENT

Rollover IRA Contributions and Rollover Period

***Estate of James Caan v. Comm'r*, 161 TC 6 (Oct. 18, 2023)**
IRC §408(d)

☞ Actor's Distribution Caan't Qualify for Nontaxable Rollover

Facts. James Caan was a successful actor before his passing in 2022. In 2014, while a resident of California, Mr. Caan had two individual retirement arrangements (IRAs) with the global firm UBS. In addition to cash and mutual funds, and other securities, one of the IRAs also contained a partnership interest in P&A Multi-Sector Fund, L.P. (P&A Interest), which required Mr. Caan to provide UBS with the interest's appraised fair market value (FMV) at yearend per U.S. Department of the Treasury requirements. However, Mr. Caan did not provide this requested information, and after several notices that UBS sent to Mr. Caan requesting the information for which no response was received, UBS resigned as the P&A Interest's custodian on November 25, 2015. UBS distributed the ownership interest as an in-kind distribution. In January 2016, UBS issued Mr. Caan a Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.*, using the 2013 FMV that Mr. Caan had provided a year earlier as the gross distribution of $1,910,903.

In October 2015, Mr. Caan transferred both IRA accounts from UBS to a single IRA at Merrill Lynch, apart from the P&A Interest, which still listed UBS as the custodian. In his timely filed 2015 individual tax return, Mr. Caan reported the P&A distribution but excluded the entire distribution from the taxable amount.

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148. Treas. Reg. §1.469-2(f)(6).
149. Temp. Treas. Reg. §1.469-5T(a)(4).
150. *Blakely v. U.S.*, 593 F.3d 1337, 1342 (Fed.Cir. 2010).
151. Ibid.
152. *Brown v. U.S.*, 22 F.4th 1008, 1013 (Fed.Cir. 2022).

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In 2017, Merrill Lynch liquidated the P&A Interest held by Mr. Caan from January through June, with the distributions totaling $1,532,605. In November of that year, the IRS issued a notice to Mr. Caan, proposing to change his 2015 tax return to include the $1,910,903 distribution of P&A Interest as taxable income. In April 2018, the IRS followed with a notice of deficiency, claiming a balance of $779,915 in unpaid tax for the taxable distribution of the P&A Interest. A $155,983 accuracy-related penalty was also assessed. In response, Mr. Caan requested a private letter ruling, in which he sought an IRS waiver of the 60-day rollover requirement for a distribution to be deemed rolled over, and thus nontaxable. The IRS denied this request in November 2018, stating that the liquidation of the P&A Interest and subsequent cash contribution to the Merrill Lynch IRA did not meet the "same property" requirements under IRC §§408(d)(3)(A)(i) and (D), and therefore they could not grant a waiver of the 60-day rollover period.

Issues. The issues in the case are the following.

- Whether UBS distributed the P&A Interest to Mr. Caan in tax year 2015
- Whether the UBS distribution is nontaxable under the 60-day rollover period
- Whether the reported value of the UBS distribution was correct
- Whether the court may review the IRS's refusal to issue a private letter ruling to waive the 60-day rollover period under §408(d)(3)(I)
- Whether the IRS abused its discretion in declining to waive the 60-day rollover period under §408(d)(3)(I)

Analysis. The court first looked at the issue of whether UBS distributed the P&A Interest to Mr. Caan, noting that UBS was within its rights to resign as custodian and distribute the P&A Interest in-kind. Mr. Caan's estate argued that the distribution was a "phantom distribution," where UBS resigned as custodian but did not notify Mr. Caan or other responsible parties, thereby leaving them to believe UBS was still the custodian of the P&A Interest. The court pointed out that even if the submitted communication from UBS was not received by Mr. Caan, there appeared to be no follow-up to UBS by Mr. Caan regarding the issued Form 1099-R or the subsequent cessation of mailed account statements.

Mr. Caan's estate also argued the lack of distribution due to Mr. Caan not having actual or constructive receipt of the P&A Interest. The court disagreed with this argument, noting that Mr. Caan had unfettered command of the P&A Interest as documented by his ability to re-register the P&A Interest in his name without the involvement of UBS. Finally, the estate argued that there was no distribution under California trust law. The court dismissed the argument on the grounds that the relationship between Mr. Caan and UBS was custodial and the stated agreement between the two parties was governed by New York law, not California law.

The court next assessed whether the UBS distribution was nontaxable under the 60-day rollover period. Looking at the facts, the court noted UBS distributed the P&A Interest on November 25, 2015. As 60 days from that date fell on a Sunday, the 60-day period ended on Monday, January 25, 2016. Merrill Lynch requested the liquidation of the P&A Interest in December 2016, where the court found three issues with how the distribution was handled. First, the character of the property was changed when liquidated to cash, where §408(d)(3)(A)(i) requires the character to be unchanged when contributed to preserve its tax-deferred status. Second, the actual distribution was made after January 25, 2016. Finally, the distribution was made in three separate transactions, whereas §408(d)(3)(B) allows only one rollover contribution in a 1-year period. Therefore, even if the other two issues were not present, only the first rollover contribution would have qualified as a tax-free rollover.

The court further assessed whether the reported value of the distribution of $1,910,903 on the Form 1099-R that UBS issued Mr. Caan was correct. The IRS agreed with Mr. Caan's estate that the reported value was erroneous, being based on FMV as of 2013. Therefore, the IRS requested that the value be assessed at $1,548,010, which was the ending capital balance per the P&A Fund's issued Schedule K-1 (Form 1065), *Partner's Share of Income, Deductions, Credits, etc.* The estate did not argue against this value and did not propose a different one. Therefore, the court held that the value of the P&A Interest was $1,548,010.

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Finally, the court reviewed whether it had jurisdiction in reviewing denials of waivers under §408(d)(3)(I), and if so, whether the IRS abused its discretion in declining to waive the 60-day rollover period. The court looked to a case with similar fact patterns, *Trimmer v. Comm'r,*[153] to provide guidance. Just as with that case, the court found that it does have jurisdiction to review the IRS's denial of a waiver under §408(d)(3)(I) and that it can review said denial for abuse of discretion. Because the IRS identified the noncompliant issue of changing the contributing property's character under §408(d)(3)(A)(i) as prohibiting the IRS from issuing a waiver of the 60-day rollover period, the court found that the IRS did not abuse its discretion in declining the waiver.

Holding. The Tax Court held that UBS did distribute the P&A interest to Mr. Caan in tax year 2015 and that the distribution was not nontaxable under the 60-day rollover period. The court also held that the reported value of the P&A interest was incorrect and the corrected value is $1,548,010. Finally, the court held that it had jurisdiction to review the IRS's refusal to issue a private letter ruling to waive the 60-day rollover period under §408(d)(3)(I), and in doing so, found that the IRS did not abuse its discretion in declining the waiver.

S CORPORATION

S Corporation Debt versus Equity

***Estate of Thomas Fry v. Comm'r,* TC Memo 2024-8 (Jan. 23, 2024)**

IRC §§385, 1366, 6651, and 6662

☞ Debt, and Equity, and Basis, Oh Fry!

Facts. Thomas H. Fry, the sole shareholder of two S corporations, Crown Disposal, Inc. and CR Maintenance Services, Inc., managed both companies in a highly integrated operation despite their organizational distinctions. Crown, which is engaged in waste collection, and CR Maintenance, which is focused on processing waste into saleable commodities, shared a facility in Sun Valley, California. They operated under a shared infrastructure, including personnel, maintenance, and accounting services.

From 2008 to 2015, Mr. Fry received compensation and rent from both corporations. Despite their collaborative operations, financial transactions between the two entities did not involve direct payment for services or shared revenues. Instead, Crown supported CR Maintenance financially, especially as the latter faced unprofitability from 2010 onwards. A significant contract loss with the City of Los Angeles in 2011, triggered by a tragic accident, led to continued financial losses for CR Maintenance. The losses necessitated substantial financial interventions from Crown to sustain operations.

This support was manifested through direct financial transfers and payments for CR Maintenance's operational expenses by Crown ("the transfers and payments"), totaling $36,255,141 by the end of 2013. These transactions were not formalized through promissory notes or interest payments. Both entities accounted for these transactions as liabilities, with the intent of repayment subject to CR Maintenance's profitability.

Mr. Fry and his wife did not report any distributions from Crown on their tax returns from 2008 to 2019. However, Crown reported significant shareholder distributions and loan repayments on Mr. Fry's behalf, especially following a lucrative asset sale in 2015, which netted about $70 million. This sale marked the culmination of Crown's financial distributions to Mr. Fry, with subsequent distributions being mere accounting adjustments rather than actual cash transactions.

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[153] *Trimmer v. Comm'r*, 148 TC 334, and 345–49 (2017).

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Notably, on November 10, 2014, Mr. and Mrs. Fry untimely filed their joint tax return for the 2013 tax year, which was due on October 15, 2014. CR Maintenance reported a loss of $5,650,651 for the same year, and Mr. and Mrs. Fry claimed a flowthrough loss deduction of $4,733,675 from CR Maintenance on their individual return. The IRS's scrutiny for the 2013 tax year led to a notice of deficiency, determining a deficiency in income tax, an addition to tax pursuant to IRC §6651(a)(1), and an accuracy-related penalty pursuant to IRC §6662(a). The IRS also disallowed flowthrough loss deductions from CR Maintenance due to insufficient basis.

Issues. The issues in this case are the following.

- Whether the transfers and payments from Crown to CR Maintenance are bona fide debt or equity
- Whether Mr. Fry had an adequate basis in order to claim the disallowed flowthrough loss from CR Maintenance of $3,455,006
- Whether the IRS is harmed by a finding that the transfers and payments are equity
- Whether Mr. and Mrs. Fry are liable for the late filing addition to tax pursuant to §6651(a)(1)
- Whether Mr. and Mrs. Fry are liable for the accuracy-related penalty pursuant to §§6662(a) and (b)(2) for a substantial understatement of income tax

Analysis. In determining whether a particular interest is characterized as debt or equity, the court considers various factors that indicate the economic substance of a transaction. IRC §385 allows for the reclassification of corporate interests based on their substance, aiming to discern whether transactions were genuinely debt-based, with expectations of repayment, or equity contributions, lacking formal obligations of return. The court found no formal issuance of debt or equity instruments, rendering §385 inapplicable based on a strict interpretation.

Case law factors prioritize the substance over the form of transactions. The Ninth Circuit has identified 11 factors that may be relevant in determining whether a transfer to a corporation by a shareholder is debt or a contribution of capital.[154]

1. The names given to the certificates evidencing the debt
2. The presence or absence of a fixed maturity date
3. The source of the payments
4. The right to enforce payments of principal and interest
5. Whether the advances increase participation in management
6. Whether the "lender" has a status equal or inferior to that of regular creditors
7. Objective indicators of the parties' intent
8. Whether the capital structure of the "borrower" is thin or adequate
9. The extent to which the funds advanced are proportional to the shareholder's capital interest
10. The extent to which interest payments come from "dividend" money
11. The ability of the "borrower" to obtain loans from outside lending institutions

Of the 11 factors, the court found that four are neutral, six favor equity, and one favors debt.[155] After weighing the factors, the court concluded that the transfers and payments did not constitute true indebtedness and should be viewed as equity.

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[154] See *Hardman v. U.S.*, 827 F.2d 1409, 1412 (9th Cir. 1987).

[155] The six factors that the court found favoring equity are: (2) presence or absence of a maturity date; (3) source of payments; (4) right to enforce payment of principal and interest; (6) status equal to or inferior to that of regular corporate creditors; (9) identity of interest between creditor and stockholder; (10) extent to which interest payments come from "dividend" money. The only factor that the court found favoring debt is (7) the intent of the parties. The court found the remaining factors neutral.

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The court next examined whether the transactions can be recharacterized as constructive distributions from Crown to its shareholder, Mr. Fry, followed by contributions of capital to CR Maintenance. According to Ninth Circuit caselaw, a constructive dividend occurs where a 2-part test is met.[156]

1. The expenditures do not give rise to a deduction on behalf of the distributing corporation.
2. The expenditures create **economic gain, benefit, or income** to the shareholder.

The court found both prongs are satisfied as the constructive distributions were made primarily for Mr. Fry's benefit. There was no discernable business reason for Crown to make the transfers and payments, which is in accordance with the finding of no true expectation of interest or timely repayment. Accordingly, the court concluded that the transfers and payments constituted constructive distributions from Crown to Mr. Fry, followed by constructive contributions from Mr. Fry to CR Maintenance.

Then, the court examined Mr. Fry's ability to deduct losses based on his basis in the corporations. IRC §1366(d)(1) limits the amount of losses and deductions a shareholder may deduct to the sum of their adjusted basis in their stock and in any indebtedness they have in the S corporation. The court found that there was insufficient information to recalculate Mr. Fry's adjusted bases in CR Maintenance and Crown. Consequently, the court directed the parties to recalculate Mr. Fry's bases in the companies from 2013 to 2020, as this calculation can determine the allowable loss amount for 2013.

The IRS contended that recharacterizing the transfers and payments as equity would unfairly harm the IRS. Despite claims of potential harm, including incorrect basis calculations leading to unmerited loss claims, the court found the IRS's argument unsubstantiated. Notably, the assertion that distributions exceeded Mr. Fry's basis, potentially leading to tax avoidance, was challenged. Testimony revealed these "distributions" were merely accounting adjustments, not actual economic transactions. The court dismissed concerns over inconsistency, whipsaw, and election doctrine applicability, emphasizing that the transfers and payments were interests in equity, ensuring Mr. and Mrs. Fry's entitlement to claimed losses.

Finally, the court found Mr. and Mrs. Fry liable for an addition to tax under §6651(a)(1) due to the late filing of their 2013 return and an accuracy-related penalty under §6662(a) for a substantial understatement of income tax. The IRS met its burden of proof, including obtaining necessary supervisory approval for the penalty, as mandated by §6751(b)(1). Although Mr. and Mrs. Fry conceded late filing, their attempt to invoke a reasonable cause defense based on reliance on professional advice for the penalty was rejected due to late assertion, causing potential prejudice to the IRS. Therefore, liability for the penalty depends on the outcome of Rule 155 computations to ascertain if there was a substantial understatement of tax.

Holding. The court held that the transfers and payments between the corporations did not constitute true indebtedness, but instead, they constituted constructive distributions from Crown to Mr. Fry, followed by constructive contributions from Mr. Fry to CR Maintenance. The court also held that Mr. Fry's bases from 2013 to 2020 should be recalculated to determine the allowable loss amount for 2013. Additionally, the IRS is not harmed by a finding that the transfers and payments are equity. Lastly, the court held that the Frys are liable for an addition to tax due to the late filing of their return and an accuracy-related penalty.

[156] See *P.R. Farms, Inc. v. Comm'r*, 820 F.2d 1084, 1088 (9th Cir. 1987).

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Business Expenses

***Gary and Melissa Sinopoli v. Comm'r*, TC Memo 2023-105 (Aug. 14, 2023)**

IRC §162

☞ Business Expense Deductions Don't "Work Out"

Facts. This case arose from the consolidation of three separate cases. The petitioners for the first case were Dr. Gary Sinopoli and Melissa Sinopoli; Dr. Robert Siragusa was the petitioner for the second case; and Michael and Angela Hurring were the petitioners for the third case. Dr. Sinopoli, Dr. Siragusa, and Mr. Hurring were members who owned a limited liability company (LLC) called Planet LA, LLC (Planet), which elected to be taxed as an S corporation. Planet owned five Planet Fitness franchise locations, which it sold in mid-2017. Each of the three LLC members reported their income on their individual tax returns using Schedule E, *Supplemental Income and Loss*. In 2020, the IRS sent notices of deficiency to Drs. Sinopoli and Siragusa, and in 2021 to Mr. Hurring.

Prior to 2015, the members held business meetings at either the hospital where they worked or Planet's fitness center in Gretna, LA. The Gretna location was far from where the petitioners lived, however, and they started meeting at their homes in 2015. For this, Planet started to pay them rent for the use of their homes in 2015. However, they did not obtain an appraisal for the rental value of their residences as meeting space. Dr. Sinopoli researched how much rental rates were in that area, which he claimed was $1.83 per square foot. Using this calculation, the petitioners charged over $30,000 in rent to the business for the years 2015–2017.

The IRS revenue agent assigned to examine Planet's S corporation returns and the LLC members' personal returns, determined that the rate should have been $500 per day after some research. After calculating $500 per day for each meeting that the members were able to substantiate with notes, the IRS disallowed the rent deduction for 2015 entirely and allowed rent expense deductions for 2016 and 2017 of only $6,000 and $4,500, respectively. The LLC members had no records of what business they conducted at their meetings, but they presented some evidence that they actually held meetings in 2016 and 2017.

Planet also engaged in advertising. When it first started advertising, it paid local advertisers directly. In 2014, Dr. Sinopoli, Dr. Siragusa, and Mr. Hurring each incorporated their own marketing companies, which they controlled. Planet paid the marketing companies, which then paid the local advertisers. The IRS examined the marketing companies' returns and found the fees far exceeded the amounts paid to local advertisers and accordingly disallowed the deduction for marketing fees in excess of the amount paid to local advertisers.

Issue. The issue in this case is whether Planet's expense deductions for rent and marketing are reasonable and necessary and, therefore, deductible.

Analysis. The petitioners bear the burden of proof to substantiate their claimed corporate expenses. IRC §162(a) allows a deduction for a business's ordinary and necessary expenses paid or incurred during the year. The expenses are deductible only to the extent the amount is reasonable.[157]

The petitioners failed to present any record of what business was discussed at their meetings during the years at issue. Nevertheless, the court allowed a $500 deduction for rent for 2015 based on the members' testimony, even though it found their testimony about the meetings vague and inconsistent. The court allowed rent deductions of $500 for each of 12 meetings for 2015, 2016, and nine for 2017.

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157. *Audano v. U.S.*, 428 F.2d 251, 256–57 (5th Cir. 1970).

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The court found the marketing fees that Planet paid the three LLC members' marketing companies excessive considering the much smaller amounts that were paid to the local advertisers. The members failed to present evidence substantiating the business purpose of the excess marketing fees. The court noted the marketing companies undertook no activities other than paying the local advertisers. Accordingly, the court limited Planet's marketing deductions to the amounts the marketing companies actually paid the advertising companies. The court's opinion noted that the members' marketing companies ceased their operations when Planet was sold. The judge did not dispute the IRS's argument that the excessive marketing fees were a mechanism to direct Planet's earnings to its members for personal use. In light of this, the excess marketing fees did not qualify as an ordinary and necessary business expense.

Holding. The court reduced the Planet's rent deductions to $500 per meeting. The amounts that Planet paid for marketing fees in excess of the amounts paid to local advertisers were disallowed.

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Note. Corrections for all of the chapters are available at **TaxSchool.illinois.edu.** For clarification about terms used throughout this chapter, see the **Acronyms and Abbreviations** section following the index.

For your convenience, in-text website links are also provided as short URLs. Anywhere you see **uofi.tax/xxx**, the link points to the address immediately following in brackets.

About the Author

Roger McEowen, JD, is Professor of Agricultural Law and Taxation at Washburn University School of Law in Topeka, Kansas. He is a published author and prominent speaker, conducting more than 80 seminars annually across the United States for farmers, agricultural business professionals, lawyers, and tax professionals. He can also be heard on WIBW radio, the Kansas State University radio network and is interviewed weekly on RFD-TV. His radio program, the "Agricultural Law and Tax Report," is heard by over 2 million listeners daily. His writing can be found in law reviews and journals, national agriculture publications, a monthly publication, *Kansas Farm and Estate Law,* his two books, *Principles of Agricultural Law* and *Agricultural Law in a Nutshell,* as well as on **www.washburnlaw.edu/waltr** and **mceowenaglawandtax.substack.com**. He is the editor of the two-volume Thomson-Reuters treatises, *Estate Planning for Farmers and Ranchers,* and *Farm Business Organizations.* He received a BS with distinction from Purdue University in Management in 1986, an MS in Agricultural Economics from Iowa State University in 1990, and a JD from the Drake University School of Law in 1991. He is a member of the Iowa and Kansas Bar Associations and is admitted to practice in Nebraska. He is also a past President of the American Agricultural Law Association.

Other chapter contributors and reviewers are listed at the front of this book.

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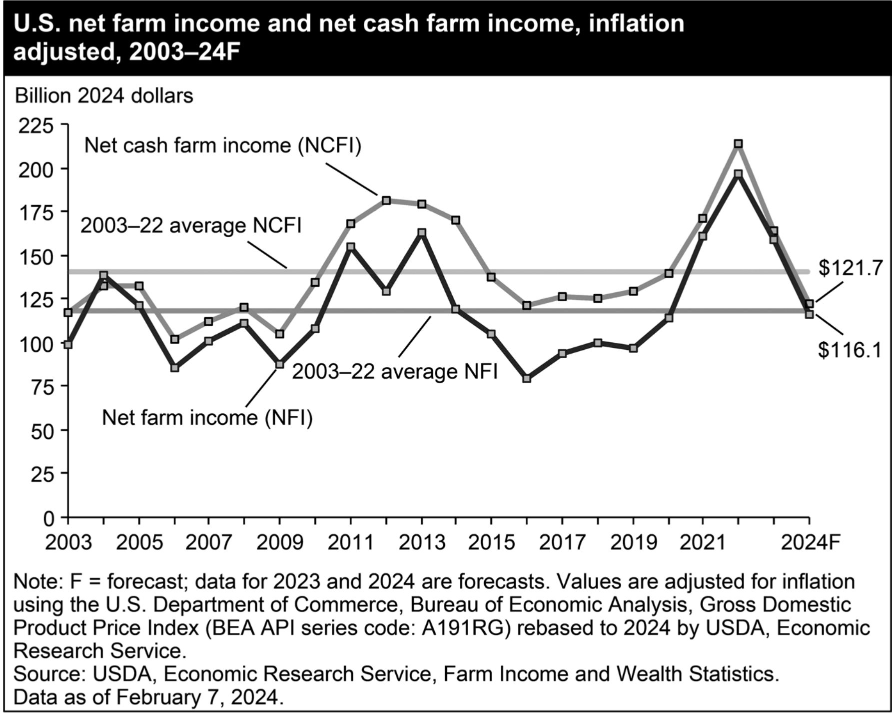
FINANCIAL DISTRESS-RELATED ISSUES

GENERAL ECONOMIC CONDITIONS[1]

According to the U.S. Department of Agriculture (USDA), farm sector income is forecasted to continue to fall in 2024 after reaching record highs in 2022. Net farm income reached $185.5 billion (in nominal dollars) in calendar year 2022. After decreasing by $29.7 billion (16.0%) from 2022 to an estimated $155.9 billion in 2023, net farm income in 2024 is forecasted to decrease further from the 2023 level by $39.8 billion (25.5%) to $116.1 billion.

In inflation-adjusted 2024 dollars, net farm income is forecasted to decrease by $43.1 billion (27.1%) from 2023 to 2024, and net cash farm income is forecasted to decrease by $42.2 billion (25.8%) compared with the previous year. If realized, both measures in 2024 would fall below their 2003-2022 averages (in inflation-adjusted dollars).

The following graph from the USDA shows the inflation-adjusted net farm income (NFI) and net cash farm income (NCFI).



Economic stress in agriculture can appear in numerous ways. Two of those that involve unique tax issues are losses on interests in cooperatives (co-ops) and repossessions (both voluntary and involuntary).

GENERAL RULES ON COOPERATIVE LOSS DEDUCTIBILITY

When the farm economy faces a downturn, it is often characterized by lower commodity prices. When lower commodity prices are coupled with higher input costs, many farming operations may generate losses. The same result can also occur for co-ops and businesses that provide production inputs. Co-ops are particularly vulnerable to an economic downturn in the agricultural economy because they tend to be highly leveraged.

1. *2024 Farm Sector Income Forecast.* Feb. 7, 2024. U.S. Department of Agriculture. [www.ers.usda.gov/topics/farm-economy/farm-sector-income-finances/farm-sector-income-forecast] Accessed on Jul. 2, 2024.

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Any resulting losses are governed by tax rules that are highly unique. For instance, a membership interest in a co-op may provide the owner with both an ordinary loss and a capital loss. No other organization structure allows this tax treatment for losses.

For a co-op interest that represents a retained patronage dividend held by a co-op, or redemption of qualified written notices of allocation at less than the stated amount on issuance, the holder of the interest may claim an ordinary loss for that portion of the total loss.[2] The facts of the applicable Revenue Ruling involved a chicken farmer who acquired supplies from a local co-op.[3] The IRS reasoned that the amount of the loss in question had already been subjected to income tax. Thus, **ordinary** loss treatment was appropriate. However, if allocated patronage dividends are not involved, and the transaction only involves the taxpayer's investment in co-op stock, gains and losses are **capital.**[4]

> **Note.** If a co-op's losses involve an asset,[5] the losses are not eligible for IRC §1231 treatment because such treatment is limited to "property used in a trade or business, of a character which is subject to the allowance for depreciation provided in section 167, held for more than one year, and real property used in the trade or business, held for more than one year…." That definition does not include an equity interest held in a co-op.

Timing Issue

Whether a loss attributable to a co-op membership interest is deductible depends on whether the loss is treated as associated with a worthless security[6] or a bad debt.[7]

Worthless Security. There is no guidance in either the Code or the Treasury Regulations on whether co-op stock losses are treated as a worthless security. However, the Board of Tax Appeals, the predecessor of the Tax Court, has applied the worthless security rules to co-op losses.[8] The IRS issued a non-acquiescence to the Board's opinion, but the Seventh Circuit affirmed on appeal.[9] For co-op stock treated as a worthless security, a deduction may be claimed up to cost (or other basis) **in the year the stock becomes totally worthless.**[10] No deduction is allowed for partially worthless stock.

> **Note.** Because of the requirement to be totally worthless, any losses a co-op sustains in a Chapter 11 (reorganization) bankruptcy are not deductible until there is a formal determination that the securities are worthless.[11] In addition, the IRS has taken the position that abandonment is not an indispensable requirement to establish worthlessness.[12] It is merely one of several factors.[13]

2. Rev. Rul. 70-64, 1970-1 CB 36.
3. Ibid.
4. IRC §§1211 and 1221. This would be the result, for example, for investors in a co-op that files bankruptcy who were not otherwise involved in the co-op's business activities.
5. For IRC §1231 assets, gains may be capital gains, but losses are ordinary losses.
6. IRC §165(g).
7. IRC §166(a).
8. *Morton v. Comm'r*, 38 BTA 1270 (1938), *nonacq.* 1939-1 CB 57, *aff'd* 112 F.2d 320 (7th Cir. 1940). The case involved a co-op apartment building that was formed as a syndicate.
9. Ibid.
10. IRC §165(g); Treas. Reg. §1.165-5(c). See also *Wagner v. U.S.*, No.: 6:01-cv-1218-Orl-18JGG (M.D. Fla. Jan. 21, 2003) and *Geddis v. Comm'r*, TC Memo 2005-191 (Aug. 4, 2005).
11. To be totally worthless, a loss must be evidenced by closed and completed transactions that are fixed by identifiable events and sustained during the taxable year. Treas. Reg. §§1.165-1 (b) and (d).
12. CCA 200851050 (Oct. 27, 2008).
13. Ibid.

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If the co-op stock is a capital asset, it is subject to the limitation on capital losses.[14] Otherwise, a security that becomes wholly worthless during the tax year gives rise to an ordinary loss.[15] Thus, stock in a co-op that was merely acquired as an investment and does not involve patronage is classified as a capital asset that would be subjected to treatment as a worthless security.[16] If the interest involves patronage in the co-op, treatment as a worthless security would arguably depend on whether the interest meets the definition of a "security."[17]

> **Note.** In Rev. Rul. 70-64,[18] the IRS allowed ordinary loss treatment on a co-op interest that represented retained patronage because the interest was not considered to be a capital asset. However, Rev. Rul. 70-64 was issued before the 1988 case of *Arkansas Best Corp. v. Comm'r,*[19] where the U.S. Supreme Court pointed out that everything is considered a capital asset unless a specific exclusion from the definition applies.

Bad Debt Deduction. If a co-op interest does not meet the definition of a worthless security on the basis that a co-op interest representing retained patronage is not a "security," any loss on the interest might be deductible as a bad debt.[20] A bad debt is deductible in the year the debt becomes worthless.[21] To be deductible, a bad debt need not be totally worthless — a deduction is allowed up to the amount "charged off" within the tax year.[22] That is the rule for a **business bad debt** — a debt incurred in the conduct of the taxpayer's trade or business. The rule is different for a nonbusiness bad debt. For a **nonbusiness bad debt,** the debt is not deductible until the year in which it becomes totally worthless.[23] A nonbusiness bad debt is incurred other than from the conduct of the taxpayer's trade or business.[24]

REPOSSESSION OF PROPERTY SOLD UNDER AN INSTALLMENT SALE

> **Note.** Installment sales are discussed in detail later in this chapter. Additionally, for more information on installment sales, see the 2024 *University of Illinois Federal Tax Workbook,* Chapter 6: Installment Sales.

Repossession of Land

A special exception exists under IRC §1038 that is favorable to sellers repossessing land under an installment sale. The gain on repossession of real property must be calculated and reported per §1038 if the transaction comes within the statute. In applying the rules, it is immaterial whether the seller realized a gain or sustained a loss on the sale of the real property or whether it can be ascertained at the time of sale whether a gain or loss occurred. It is also immaterial what method of accounting the seller used in reporting gain or loss from the sale or whether at the time of reacquisition the property has increased or decreased in value since the time of the original sale.

The rules **do not** apply if the disposition constitutes a tax-free exchange of the property. In addition, for the special rules to apply, the debt must be secured by the real property. Amounts of interest income received, stated or unstated, are excluded from the computation of gain.

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14. Treas. Reg. §1.165-5(c).
15. Treas. Reg. §1.165-5(b).
16. Treas. Reg. §1.165-5(c).
17. IRC §1221(a).
18. Rev. Rul. 70-64, 1970-1 CB 36.
19. *Arkansas Best Corp. v. Comm'r*, 485 U.S. 212 (1988).
20. IRC §§166(a) and (e). The bad debt and worthless security provisions are mutually exclusive.
21. IRC §166(a)(1).
22. IRC §166(a)(2). A formal declaration of a bankruptcy court declaring that a debt has been "charged off" would meet the test.
23. Treas. Reg. §1.166-5(a). See also *Scagliotta v. Comm'r*, TC Memo 1996-498 (Nov. 6, 1996) and *Powerstein v. Comm'r*, TC Memo 2011-271 (Nov. 16, 2011).
24. IRC §166(a)(2).

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Calculating Gain on Repossession of Real Property

On repossession, whether voluntary or involuntary, the amount of gain recognized is the lesser of the following.

1. The amount of cash and the fair market value (FMV) of other property received before the reacquisition (but only to the extent such money and other property exceeds the amount of gain reported before the reacquisition); or
2. The amount of gain realized on the original sale (adjusted sales price less adjusted income tax basis) in excess of the gain previously recognized before the reacquisition and the money or other property transferred by the seller in connection with the reacquisition.[25]

Because the provision is applicable only when the seller reacquires the property to satisfy the purchaser's debt, it is generally inapplicable where the seller repurchases the property by paying the buyer an extra sum in addition to canceling the debt. The rules generally are applicable, however, if the seller reacquires the property when the purchaser has defaulted or when default is imminent, even if the seller pays additional amounts. The provisions on repossession of real property do not apply except where the indebtedness was secured by the real property. Therefore, reconveyance of property by the obligor under a private annuity to the annuitant would appear not to come within the rules.[26]

Example 1. On December 31, 2022, Burt DuLapp sold farmland to Ernie Pyle for $150,000 on an installment basis. Burt originally acquired the land in 1985. The contract called for $15,000 down and payments of $15,000 per year for nine years. Burt's adjusted income tax basis in the property at the time of sale was $30,000.

Burt received the down payment and the first regular payment for the following year ($30,000 total), with all payments reported as income. Burt's gross profit is $120,000 ($150,000 contract price – $30,000 basis) and his gross profit percentage is 80% ($120,000 gross profit ÷ $150,000 contract price). By the end of 2023, Burt had reported $24,000 of the gain as income ($30,000 total payments × 80% gross profit percentage).

In 2024, Burt proceeds to repossess Ernie's interest in the property due to Ernie's request to be removed from the contract.

Burt completes the following Worksheet D from IRS Pub. 537, *Installment Sales,* to calculate the $6,000 gain on repossession.

Worksheet D. **Taxable Gain on Repossession of Real Property** *Keep for Your Records*

Note. Use this worksheet to determine taxable gain on the repossession of real property if you used the installment method to report the gain on the original sale.

1.	Enter the total of all payments received or treated as received before repossession	30,000
2.	Enter the total gain already reported as income	24,000
3.	Subtract line 2 from line 1. This is your gain on the repossession	6,000
4.	Enter your gross profit on the original sale	120,000
5.	Enter your costs of repossessing the property	0
6.	Add line 2 and line 5	24,000
7.	Subtract line 6 from line 4	96,000
8.	Enter the lesser of line 3 or line 7. This is your taxable gain on the repossession	6,000

25. IRS Pub. 537, *Installment Sales*.

26. Treas. Reg. §1.1038-1(a)(2)(i).

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> **Note.** If an installment sale involves a personal residence along with farmland, complications can arise if the seller reacquires the property and had excluded the gain attributable to the personal residence under IRC §121. Unless the personal residence is re-sold within a year of the reacquisition, the gain excluded under §121 is, essentially, recaptured in accordance with §1038.[27]

The character of the gain from reacquisition is determined by the character of the gain from the original sale.[28] For an original sale reported on the installment method, the character of the reacquisition gain is determined as though there had been a disposition of the installment obligation. If the sale was reported on the **deferred payment method,** and there was voluntary repossession of the property, the seller reports the gain as ordinary income.[29] If the debts satisfied were securities issued by a corporation, government, or political subdivision, the gain would be capital gain.[30]

Once the seller has reacquired the property, it is important to determine the seller's basis in the reacquired property. The adjusted income tax basis for the property in the hands of the reacquiring seller is the sum of the following three amounts.[31]

1. The adjusted tax basis to the seller of the indebtedness, determined as of the date of reacquisition;
2. The taxable gain resulting from reacquisition; and
3. The money and other property (at FMV) paid by the seller as reacquisition costs.

Example 2. Use the same facts as **Example 1.** Assuming Burt did not pay any reacquisition costs, his basis in the reacquired property is $30,000. His adjusted tax basis prior to the sale was $30,000 less $6,000 basis applied to the first two years of payments, plus $6,000 of taxable gain resulting from reacquisition.

> **Note.** The holding period of the reacquired property, for purposes of subsequent disposition, includes the holding period during which the seller held the property before the original sale plus the period after reacquisition.[32] However, the holding period does not include the time between the original sale and the date of reacquisition.

The provisions on reacquisition of property generally apply to residences or the residence part of the transaction. However, the repossession rules do not apply if:[33]

1. An election is in effect for an exclusion of gain on the residence, and
2. The property is resold within one year after the date of reacquisition.

If those conditions are met, the resale is essentially disregarded and is considered to constitute a sale of the property as of the original sale. In general, the resale is treated as occurring on the date of the original sale. An adjustment is made to the sales price of the old residence and the basis of the new residence. If not resolved within one year, gain is recognized under the rules for repossession of real property. An exclusion election is considered in effect if an election has been made and not revoked as of the last day for making such an election. The exclusion can, therefore, be made after reacquisition. An election can be made at any time within three years after the due date of the return.

27. See, e.g., *Debough v. Comm'r*, 142 TC 17 (2014).
28. IRS Pub. 537, *Installment Sales*.
29. Ibid.
30. Ibid.
31. IRC §§1038(b) and (c).
32. Ibid.
33. IRC §1038(e).

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A bad debt deduction is not permitted for a worthless or a partially worthless debt secured by a reacquired personal residence. The tax basis of any debt not discharged by repossession is zero.[34]

Losses are not deductible on the sale or repossession of a personal residence.[35] When gain is not deferred or excluded, the repossession of a personal residence is treated under the general rule as a repossession of real property. An adjustment is made to the tax basis of the reacquired residence.

In 1969, the IRS ruled that the special provisions on the income tax treatment of the reacquisition of property did not apply to reacquisition by the estate of a deceased taxpayer.[36] A decedent's estate was not permitted to succeed to the income treatment that would have been accorded a reacquisition by the decedent. The Installment Sales Revision Act of 1980[37] changed that result. The provision is effective for "acquisitions of real property by the taxpayer" after October 19, 1980. Presumably, that means acquisitions by the estate or beneficiary. Under the 1980 amendments, the estate or beneficiary of a deceased seller is entitled to the same nonrecognition treatment upon the acquisition of real property in partial or full satisfaction of secured purchase money debt as would have the deceased seller. The tax basis of the property acquired is the same as if the original seller had reacquired the property, except that the basis is increased by the amount of the deduction for federal estate tax which would have been allowable had the repossession been taxable.

The IRS ruled in 1986 that the nonrecognition provision on repossessions of land does not apply to a former shareholder of a corporation who receives an installment obligation from the corporation in a liquidation when that shareholder, upon default by the buyer, subsequently receives the real property used to secure the obligation.[38]

Repossession of Personal Property Under Installment Sale[39]

The tax consequences of repossession of **personal** property originally sold under an installment sale are more painful to the seller when compared to the rules applicable to repossession of **real** property. In these situations, the relief provisions of §1038 do not apply. Upon repossession, the seller realizes gain or loss in the year of repossession, the same as if the note or other obligation had been sold.

Voluntary Repossessions. Voluntary repossessions are those where the purchaser, upon being unable to make payment, voluntarily agrees to return the property to the seller in full satisfaction of the outstanding debt. The gain or loss is determined by the difference between the FMV of the repossessed personal property determined as of the date of repossession and the seller's tax basis in the purchaser's note or other obligation that is satisfied by the repossession.[40] The seller's basis in the obligation is the face value of the purchaser's note determined as the contract price less the principal payments made under the contract minus the unrealized profit, which is the percentage of profit times the unpaid principal balance.[41] The seller must adjust this basis figure for any other amounts collected or costs incurred in repossession.[42]

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34. IRC §1038(c)(2).
35. IRS Pub. 523, *Selling Your Home*, Worksheet 2.
36. Rev. Rul. 69-83, 1969-1 CB 202.
37. *Installment Sales Revision Act of 1980,* PL 96-471.
38. Rev. Rul. 86-120, 1986-2 CB 145.
39. IRC §§483 and 1274.
40. IRS Pub. 537, *Installment Sales*.
41. Ibid.
42. Ibid., See Worksheet C.

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Example 3. Bob Upp sold a tractor for $30,000 on an installment basis. Bob's tax basis in the tractor at the time of sale was $18,000. The gain of $12,000 was calculated with a 40% gross profit percentage. The buyer defaulted when the outstanding balance was $20,000 and the FMV of the tractor was $16,000.

Gain on an installment sale must be reported as income in the year of sale to the extent there is depreciation recapture. However, Bob claimed no depreciation on the tractor because it was not used in a trade or business. Bob offered to cancel the outstanding obligation if the buyer would return the tractor. The buyer agreed to return the tractor. The amount of gain that Bob must recognize upon repossession is calculated as follows.

FMV of property when repossessed		$16,000
Less: seller's basis in obligation given up:		
Original contract price	$30,000	
Less: payments received	(10,000)	
Balance of contract price	$20,000	
Less: unrealized profit ($20,000 × 40%)	(8,000)	
Nontaxable return of basis	$12,000	(12,000)
Gain on repossession		$ 4,000
Less: repossession costs		(1,200)
Recognized gain		$ 2,800

The character of the gain or loss is the same as on the original sale. If the obligation arose from a sale by a dealer to a customer, gain or loss on repossession is ordinary income, and the amount can be shown (on the dealer's income tax return and in the dealer's books) as an adjustment to the cost of goods sold. For a gain, purchase costs would be decreased. For a loss, purchase costs would be increased. If the original property was §1231 property (property used in the trade or business), it would be shown on Form 4797, *Sales of Business Property,* with a separate sheet showing the computation of the gain or loss. **If the original sale involved a capital asset and it was nonbusiness property,** it would be shown on Form 8949, *Sales and Other Dispositions of Capital Accounts,* flowing through to Schedule D, *Capital Gains or Losses,* with a separate sheet showing the computation of the gain or loss.[43]

Involuntary Repossessions. An involuntary repossession or foreclosure occurs when the purchaser is in default and is unwilling to return the property to the seller. The foreclosure sale or other action by the seller may involve bidding by the original seller or by a third party to reacquire the property. The original seller may buy back the property, or a third party may purchase the property and turn over the proceeds to the seller. If the original seller regains the property, it is assumed the seller paid the current FMV for the property. In either case, the FMV of the property at the time of sale may not be sufficient to cover the outstanding debt. In that event, the seller may obtain a deficiency judgment against the original purchaser for the remaining debt. If the seller receives only a partial payment of the debt, then the original purchaser remains liable for the balance as evidenced in the deficiency judgment.

The gain or loss is computed using the same procedure as in a voluntary repossession.

43. IRS Pub. 537, *Installment Sales*.

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Example 4. Use the same facts as **Example 3,** except that the property was not returned voluntarily. Bob took action under allowed legal remedies, and sold the property at a foreclosure sale. A third party purchased the property for $16,000 with the proceeds turned over to Bob in partial satisfaction of the $20,000 debt outstanding at the time of the obligation. Bob obtained a deficiency judgment for $4,000 in his favor for the remaining amount of the obligation.

The gain on the repossession is calculated as follows.

FMV upon repossession		$16,000
Less: seller's basis in obligation given up:		
Original contract price	$30,000	
Less: payments received	(10,000)	
Balance of contract price	$20,000	
Less: deficiency judgment	(4,000)	
Balance of installment note unpaid	$16,000	
Less: unrealized profit ($16,000 × 40%)	(6,400)	
Nontaxable return of basis	$ 9,600	(9,600)
Less: repossession costs		(1,200)
Recognized gain		$ 5,200

Bob receives $16,000 in cash. The tax basis of the amount received is $9,600 (60% of the $16,000 face value). The gain of $6,400 is adjusted downward by the costs of repossession which totaled $1,200. The result is $5,200 of recognized gain.

Note. When comparing the involuntary repossession situation with the voluntary repossession situation, the involuntary repossession produces a recognized gain of $5,200, whereas in the voluntary repossession, recognized gain is $2,800. The seller cancels the entire outstanding debt of $20,000 in the voluntary repossession but only cancels $16,000 of the outstanding debt in the involuntary repossession scenario. The buyer remains liable for the $4,000 balance of the outstanding obligation because of the deficiency judgment. If and when the entire deficiency judgment amount of $4,000 is paid, Bob, the seller, must report $1,600 of gain. Of the $4,000 received, 60%, or $2,400, is a tax-free return of basis and is deductible as a bad debt deduction when worthless.

The tax basis of the reacquired property in the hands of the seller for purposes of a subsequent disposition (or for depreciation) would be the FMV of the property at the time of the involuntary repossession adjusted for the interim period. The tax basis is the same whether repossession is voluntary or involuntary.

When an involuntary repossession occurs, a bad debt deduction is allowable if the outstanding debt is greater than the FMV of the item repossessed by the seller. The timing and nature of the bad debt deduction depend upon whether the excess debt over the FMV of the item received is uncollectible and whether the seller is a dealer in personal property. If the seller is not a dealer in personal property, a bad debt deduction is allowed in the year the remaining debt becomes completely worthless. A bad debt deduction is allowed to a dealer only if the property is not repossessed.[44]

Example 5. Use the same facts as **Example 4.** If the entire $4,000 is determined to be uncollectible, the $2,400 of Bob's basis in the obligation (60% × $4,000) would be allowable as a bad debt deduction. The bad debt deduction is the difference between the gain reported in the voluntary repossession scenarios ($2,800) and the gain reported in the involuntary scenario ($5,200). Thus, the final income tax consequences should be the same for voluntary and involuntary repossession if equal amounts of debt are discharged.

44. Ibid.

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LLCs AND SELF-EMPLOYMENT TAX

Farmers and ranchers often desire to manage self-employment (SE) tax. One way to structure a business to minimize SE tax might be as a limited liability company (LLC). For an LLC member that truly has a limited partnership interest, SE tax savings can be achieved. But truly being a limited partner is the key. The definition of a "limited partner" as an LLC member for SE tax purposes has been unclear and confusing for some time.

> **Note**. Farming operations that participate in the federal farm programs and are large enough to qualify for more than a single payment limit (currently $125,000 per person)[45] should have the operating entity structured as either a general partnership or joint venture under the current program payment limitation rules to be eligible for more than a single payment limit. The ownership interests in the operating entity can be owned in an LLC to potentially minimize SE tax and, perhaps, net investment income tax (NIIT).

NET EARNINGS FROM SELF-EMPLOYMENT

Net earnings from self-employment include the distributive share of income or loss from a trade or business carried on by a partnership.[46] Thus, the default rule is that all partnership income is included unless it is specifically excepted. However, under IRC §1402(a)(13), a limited partner does not have SE income except for any guaranteed payments paid for services rendered to the LLC. IRC §1402(a)(13) states the following.

> *there shall be excluded the distributive share of any item of income or loss of a limited partner, as such, other than guaranteed payments described in section 707(c) to that partner for services actually rendered to or on behalf of the partnership to the extent that those payments are established to be in the nature of remuneration for those services.*

The test of whether an ownership interest in an entity treated as a partnership for tax purposes is treated as a limited interest or a general interest, for the purpose of applying the SE tax, is stated at Prop. Treas. Reg. §1.1402(a)-2(h), issued in 1997.

> **Note.** Immediately after the Prop. Treas. Reg. was issued, Congress passed a statute prohibiting the IRS from finalizing the Reg. within one year. Nothing further has been forthcoming. Although still in proposed form, this regulation remains the best available authority.

The Prop. Treas. Reg. establishes a 3-part general rule, with two exceptions, that may permit limited partner treatment under certain conditions.

> **Note.** A third exception to limited partner treatment applies in the context of professional service businesses (e.g., law, accounting, health, engineering, etc.).[47] Such partners cannot be a limited partner under Prop. Treas. Reg. §1.1402(a)-2(h)(4) (or (2) or (3)).[48] Thus, for a professional services partnership, structuring as a manager-managed LLC would have no beneficial impact on SE tax liability. However, if a member of a services partnership (e.g., LLC) is merely an investor that is not involved in the operations of the LLC as a business **and is separately paid for services rendered,** any distributive share is not subject to SE tax.[49] However, if the distributive share is received from fees from the LLC's business, the distributive share is subject to SE tax.[50]

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45. This is the general payment limit. See *FSA Handbook: Payment Limitation, Payment Eligibility, and Average Adjusted Gross Income —* 6-PL. Jul. 12, 2023. FSA. [www.fsa.usda.gov/Internet/FSA_File/6-pl_r00_a03.pdf] Accessed on Jul. 16, 2024.

46. IRC §1402(a).

47. Prop. Treas. Reg. §1.1402(a)-2(h)(5).

48. Ibid.

49. See, e.g., *Hardy v. Comm'r*, TC Memo 2017-16 (Jan. 17, 2017).

50. See, e.g., *Renkemeyer, Campbell, & Weaver, LLP v. Comm'r*, 136 TC 137 (2011).

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Under the general rule, a member is **not** treated as a limited partner if they:

1. Have personal liability for the debts or claims against the LLC by reason of being a member;
2. Have authority under the state's LLC statute to enter into contracts on behalf of the LLC; or
3. Participated in the LLC's trade or business for more than 500 hours during the LLC's tax year.[51]

An exception applies only if the interest-holder owns a **single class of interest** regardless of whether there are multiple classes outstanding and failure of the 500-hour test is the sole reason for treatment of the interest as a general interest. In addition, the interest held must meet certain threshold requirements.

- There must be at least one member holding the same class of interest who meets all three of the requirements under the general rule, without application of any exceptions.
- The share of that class of interest held by those members must be "substantial" (with respect to the class of interest at issue and not with respect to the entity as a whole), based on the facts and circumstances (a safe harbor of 2%, in aggregate, is provided at Treas. Reg. §1.1402(a)-2(h)(6)(v)).
- The interests held by those members must be "continuing" (an undefined term).

Another exception to the general rule applies **only if the member owns at least two classes of interests** and the same threshold requirements are satisfied. This exception may permit a member to treat the distributive share attributable to at least one class as a limited interest if the three requirements of the general rule are met with respect to **any class** that the member holds. In that case, the distributive share attributable to that interest is not subject to SE tax. But the distributive share attributable to any interest held by a member that does not meet the three requirements of the general rule is subject to SE tax. Consequently, a portion of a member's total distributive share may be subject to SE tax, and some portion may not be subject.

Note. Under the general rule, it is likely that the entire distributive share of all members of a **member-managed** LLC will be subject to SE tax because state law likely gives all members the authority to contract. Likewise, limited liability partnership (LLP) statutes likely give management rights where the second requirement of the general rule cannot be satisfied. As a result, neither exception to the general rule can be met because both exceptions require at least one member to satisfy all three requirements of the general rule.

Thus, an LLC can be structured as a **manager-managed** LLC with two membership classes. With that approach, the income of a member holding a manager's interest is subject to SE tax, but if non-managers who participate less than 500 hours in the LLC's business hold at least 20% of the LLC interests, then any non-manager interests held by members that participate **more** than 500 hours in the LLC's business are **not** subject to SE tax on the pass-through income attributable to their LLC interest.[52] Such members, however, are subject to SE tax on any guaranteed payments.

For LLCs that are not a service partnership, such as a farming operation, it is possible to structure the business as a manager-managed LLC with a member holding both manager and non-manager interests that can be bifurcated. This results in a member holding both manager and non-manager interests that is not subject to SE tax on the pass-through income attributable to the non-manager interest, but is subject to SE tax on the pass-through income and a guaranteed payment attributable to the manager interest.

Note. The Treasury has included guidance under §1402(a)(13) in its 2023-2024 Priority Guidance Plan.[53]

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51. Prop. Treas. Reg. §1.1402(a)-2(h)(2).
52. Prop. Treas. Reg. §1.1402(a)-2(h)(4).
53. *2023–2024 Priority guidance plan,* p.6. Sep. 29, 2023. IRS. [www.irs.gov/pub/irs-counsel/2023-2024-priority-guidance-plan-initial-version.pdf] Accessed on Jul. 2, 2024.

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Example 6. A married couple operates a farming business as an LLC. The wife works full-time off the farm and does not participate in the farming operation. She holds a 49% non-manager ownership interest in the LLC. The husband conducts the farming operation full-time and also holds a 49% non-manager interest. He also holds a 2% manager interest. He receives a guaranteed payment for his manager's interest that equates to reasonable compensation for his services (labor and management) provided to the LLC. The result is that the LLC's income will be shared pro-rata according to the ownership percentages with the income attributable to the non-manager interests (98%) not subject to SE tax. The 2% manager interest is subject to SE tax along with the guaranteed payment that the husband receives. This produces a better SE tax result than if the farming operation were structured as a member-managed LLC.

MINIMIZATION OF NIIT

There is another potential benefit of utilizing the manager-managed LLC structure. The NIIT of IRC §1411 applies to a taxpayer's passive sources of income when adjusted gross income exceeds $250,000 on a joint return ($200,000 for a single return and $125,000 if married filing separately). While a non-manager's interest in a manager-managed LLC is typically considered passive with the income from the interest potentially subject to the 3.8% surtax, a spouse can take into account the material participation of a spouse who is the manager.[54] Thus, the material participation of the manager-spouse converts the passive income attributable to the non-manager spouse to active income that will not be subject to the 3.8% surtax.

Note. Returning to **Example 6,** the manager-managed LLC structure significantly reduces SE tax (it is limited to the SE tax rate of 15.3% of the husband's reasonable compensation paid in the form of a guaranteed payment and his 2% manager interest), and the NIIT is avoided on the income of both spouses.

RECENT CASES

In *Castigliola, et al. v. Comm'r,*[55] a group of lawyers structured their law practice as a member-managed professional LLC (PLLC). On the advice of a CPA, they tied each of their guaranteed payments to what reasonable compensation would be for a comparable attorney in their locale with similar experience. They paid SE tax on those amounts. However, the Schedule K-1 (Form 1065), *Partner's Share of Income, Deductions, Credits, etc.,* showed allocable income exceeding the member's guaranteed payment. They did not pay SE tax on the excess amounts. The IRS disagreed, assessing SE tax on all allocated amounts.

The Tax Court agreed with the IRS. Based on the Uniform Limited Partnership Act of 1916, the Revised Limited Partnership Act of 1976, and Mississippi law (the state in which the PLLC operated), the court determined that a limited partner is defined by limited liability and the inability to control the business. The members could not satisfy the second test. Because of the member-managed structure, each member had management power of the PLLC business. In addition, because there was no written operating agreement, the court had no other evidence of a limitation on a member's management authority. In addition, the evidence showed that the members actually did participate in management by determining their respective distributive shares, borrowing money, making employment-related decisions, supervising non-partner attorneys of the firm, and signing checks. The court also noted that a limited partnership must have at least one general partner and one limited partner, but the facts revealed that all members conducted themselves as general partners with identical rights and responsibilities. In addition, before becoming a PLLC, the law firm was a general partnership. After the change to the PLLC status, their management structure did not change.

Note. The Tax Court did not mention the Proposed Treasury Regulations, but even if they had been taken into account, the outcome of the case would have been the same. Member-managed LLCs are subject to SE tax because all members have management authority.

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54. IRC §469(h)(5).

55. *Castigliola et al. v. Comm'r,* TC Memo 2017-62 (Apr. 12, 2017).

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In *Soroban Capital Partners, LP v. Comm'r,*[56] the Tax Court issued a fully reported opinion (meaning it is of national significance in all jurisdictions) taking *Castigliola* one step further and holding that creating a limited partner interest under state law is not necessarily enough to have a limited partner interest for SE tax purposes. Soroban was a limited partnership that made guaranteed payments and distributed ordinary income to its limited partners. However, Soroban excluded distributions of ordinary income to its limited partners from its computation of net earnings from self-employment. Its basis for doing so was that the limited partners' interests conformed to state law. The IRS disagreed, asserting that was not enough and that the functions and roles of the limited partners also had to be analyzed for SE tax purposes. The Tax Court agreed with the IRS.

The Tax Court was faced with the definition of a limited partner for purpose of the exception from SE tax under §1402(a)(13). The Tax Court noted that the proposed treasury regulations provided a definition, that Congress froze the finalization of the regulation for six months and has said very little about the issue since the freeze was lifted, and has not provided a definition. The Tax Court noted that it applied a "functional analysis" test in *Renkemeyer*, but that this was the first time the Tax Court was asked to determine the SE tax status of a limited partner in a state law limited partnership (having passed on the issue in a 2020 case). The Tax Court determined that the functional analysis test applied was based largely on statutory construction of §1402(a)(13), which excludes from SE tax "the distributive share of any item of income or loss of a limited partner, as such." The court concluded that the "as such" language meant there was not a blanket exclusion for a limited partner. Instead, the statute only applies to a limited partner that is **acting** as a limited partner. If a limited partner is anything more than merely an investor, SE tax applies to the partner's distributive share.

Note. The court noted that Soroban cited legislative history in an attempt to support its position, but that the legislative history actually supported the position of the IRS. The Tax Court also noted that Soroban put forth numerous other arguments, none of which were persuasive. Soroban even cited language in the instructions for Form 1065, *U.S. Return of Partnership Income,* which it claimed defined a limited partner. In response, the Tax Court noted that the definition did not purport to define a limited partner.

The Tax Court held that a functional inquiry into the roles and activities of Soroban's individual partners under §1402(a)(13) "involves factual determinations that are necessary to determine Soroban's aggregate amount of net earnings from self-employment." Accordingly, the Tax Court denied Soroban's motion for summary judgment and set forth the rule going forward in evaluating the application of SE tax for limited partners in professional service businesses.

OBSERVATIONS AND TAX PLANNING CONSIDERATIONS

The manager-managed LLC provides a better result than the result produced by the member-managed LLC for LLCs that are not service partnerships. For service partnerships, such as the PLLC in *Castigliola,* an S corporation achieves a better SE tax result. For an S corporation, reasonable compensation will need to be paid subject to SE tax, but the balance drawn from the entity can be received free from SE tax. However, for farming operations with land rental income, the manager-managed LLC can provide a better overall tax result than the use of an S corporation because of the ability to eliminate the NIIT.

[56] *Soroban Capital Partners, LP v. Comm'r,* 161 TC 12 (2023).

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Practitioner Planning Tip

Practitioners should closely examine how involved limited partners are in the management of a partnership. Practitioners should also review limited partnership agreements to determine if the agreements contain provisions granting more power than what the caselaw and the IRS indicates is appropriate over managerial decisions. Such provisions can be amended by adding clauses that limit control. It is critical that a limited partner's conduct is consistent with that of a true limited partner.

Note. Presently, two additional limited partnership cases are docketed with the Tax Court on the same issue as discussed above.[57]

INFORMAL PARTNERSHIPS

A joint venture, or other contractual arrangement carried on for business purposes where the participants divide the profits, might create a separate entity for federal tax purposes.[58] But, a simple joint undertaking to share expenses does not create a separate entity for federal tax purposes.[59] Merely co-owning property that is maintained, kept in a state of repair, and rented out does not result in a separate tax entity.[60] Thus, if an owner or tenants in common of farmland lease it to a farmer under a cash rent or crop share lease, a separate entity is not necessarily created.[61]

A partnership is an association of two or more people to carry on as co-owners a business for profit.[62] Similarly, a business arrangement "may create a separate entity for federal tax purposes if the participants carry on a trade, business, financial operation, or venture and divide the profits therefrom."[63] The existence of a written partnership agreement usually settles the question of whether the arrangement is a partnership. Unfortunately, relatively few farm or ranch partnerships are based upon a written partnership agreement, or as it is expressed in some cases, a set of articles of partnership.

Note. As an estate planning device, the partnership is generally considered to be less complex and less costly to organize and maintain than a corporation. A general partnership is comprised of two or more partners. There is no such thing as a 1-person partnership, and there is no maximum number of partners that can be members of any particular general partnership.[64]

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57. *Denham Capital Management, LP v. Comm'r,* Docket No. 9973-23 (filed Jun. 22, 2023); *Point72 Asset Management, LP v. Comm'r,* Docket No. 12752-23 (filed Aug. 11, 2023).

58. See, e.g., Treas. Reg. §301.7701-1(a)(2).

59. Ibid.

60. Ibid.

61. Ibid.

62. Uniform Partnership Act, §6; *Uniform Partnership Act (1997) (Last Amended 2013),* p. 11. Aug. 19, 2015. National Conference of Commissioners on Uniform State Laws. [www.uniformlaws.org/viewdocument/final-act-98?CommunityKey=52456941-7883-47a5-91b6-d2f086d0bb44&tab=librarydocuments] Accessed on Jul. 5, 2024. See §102(11).

63. Treas. Reg. §301.7701-1(a)(2).

64. Ibid.

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Sometimes an interesting tax or legal issue arises as to whether a particular organization is, in fact, a partnership. Taxpayers may attempt to prove (or disprove) the existence of a partnership to split income and expense among several taxpayers in a more favorable manner[65] or establish separate ownership of interests for estate tax purposes. However, such strategies are not always successful.[66]

THE PROBLEMS OF AN ORAL ARRANGEMENT

Because a partnership is an agreement between two or more individuals to carry on as co-owners of a business for profit, a partnership generally exists when there is a sharing of net income and losses.[67] This agrees with the U.S. Supreme Court's definition of a partnership as the sharing of income and gains from the conduct of a business between two or more persons.[68] This rule has been loosely codified in IRC §761, which also includes a joint venture in the definition of a partnership.

Farm Leases

If there is no written partnership agreement, one of the questions that may arise is whether a landlord/tenant lease arrangement constitutes a partnership. Unfortunately, as mentioned previously, many farm partnerships and leases are based only on oral arrangements.

A **crop-share lease** shares gross income, but not net income because the tenant has some unique deductions that are handled differently than the landlord's.[69] For example, the landlord typically bears all of the expense for building maintenance and repair, but the tenant bears all the expense for machinery and labor. Thus, there is not a sharing of net income, and the typical crop-share lease is, therefore, not a partnership.

Likewise, a **livestock share lease** is usually not a partnership because both the landlord and the tenant have unique expenses. However, if a livestock share lease or a crop-share lease exists for some time and the landlord and tenant start pulling out an increased amount of expenses and deducting them before dividing the remaining income, then the arrangement will move closer to partnership status. When the arrangement arrives at the point where there is a sharing of net income, a partnership exists. With a general partnership, the partners have unlimited liability. Because of the fear of unlimited liability, landlords prefer to have written into crop-share and livestock-share leases a provision specifying that the arrangement is not to be construed as a partnership.[70]

Note. A partnership can exist in certain situations based on the parties' conduct rather than intent. State law can play a significant role and should be examined. In Kansas, for example, the form of property ownership generally does not, by itself, constitute a partnership.[71] Thus, forms of ownership of property (including joint ownership) do not by themselves establish a partnership "even if the co-owners share profits made by the use of the property."[72] Also, if a share of business income is received in payment of rent, a presumption that the parties would otherwise be in a partnership does not apply.[73]

65. See, e.g., *Holdner v. Comm'r*, 483 Fed.Appx. 383 (9th Cir. 2012), *aff'g* TC Memo 2010-175 (Aug. 4, 2010).

66. See, e.g., *Hohl v. Comm'r,* TC Memo 2021-5 (Jan. 13, 2021).

67. See, e.g., *In re Estate of Humphreys*, No. E2009-00114-COA-R3-CV (Tenn. Ct. App. Oct. 28, 2009).

68. *Comm'r v. Culbertson*, 337 U.S. 733 (1949).

69. See *Illinois Crop-Share Cash Farm Lease.* Farmdoc. [farmdoc.illinois.edu/assets/legal/form/Crop_Share_Lease.pdf] Accessed on Jul. 29, 2024.

70. See *Illinois Livestock Share Lease.* Farmdoc. [farmdoc.illinois.edu/assets/legal/form/Livestock_Share_Lease.pdf] Accessed on Jul. 29, 2024.

71. See, e.g., Kan. Stat. Ann. §56a-202.

72. See, e.g., Kan. Stat. Ann. §56a-202(c)(1).

73. See, e.g., Kan. Stat. Ann. §56a-202(c)(3)(iii).

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TAX CLASSIFICATION

While the circumstances of a particular arrangement are to be considered, the primary question is "whether the parties intended to, and did in fact, join together for the present conduct of an undertaking or enterprise."[74] If a business arrangement is properly classified as a partnership for tax purposes, a partner is taxed only on their distributive share of the partnership's income.

Luna Factors

The Tax Court, in *Luna v. Comm'r,*[75] set forth eight factors to consider in determining the existence of a partnership for tax purposes. In *Luna,* the Tax Court considered whether the parties in a business relationship had informally entered into a partnership under the Tax Code, allowing them to claim that a payment to one party was intended to buy a partnership interest. To determine whether the parties formed an informal partnership for tax purposes, the Tax Court asked, "whether the parties intended to, and did in fact, join together for the present conduct of an undertaking or enterprise." The Tax Court listed non-exclusive factors to determine whether the intent necessary to establish a partnership exists.

The eight factors set forth in *Luna* are the following.

1. The agreement of the parties and their conduct in executing its terms
2. The contributions, if any, which each party has made to the venture
3. The parties' control over income and capital and the right of each to make withdrawals
4. Whether each party was a principal and co-proprietor, sharing a mutual proprietary interest in the net profits and having an obligation to share losses, or whether one party was the agent or employee of the other who received contingent compensation in the form of a percentage of income in exchange for their rendered services
5. Whether business was conducted in the joint names of the parties
6. Whether the parties filed federal partnership returns or otherwise represented to the IRS or to persons with whom they dealt that they were joint ventures
7. Whether separate books of account were maintained for the venture
8. Whether the parties exercised mutual control over and assumed mutual responsibilities for the enterprise

The Tax Court applied the *Luna* factors in *White v. Comm'r,*[76] where Mr. White was approached by his ex-wife about forming a mortgage company and, along with their respective spouses, they orally agreed to work together in the real estate business in 2010 or 2011. The business was conducted informally and they did not consult any tax professionals. In 2011, Mr. White withdrew funds from his retirement account to support the business. His ex-wife and her new husband did not make similar financial contributions. Each of the "partners" handled various aspects of the business. Mr. White initially used his personal checking account for the business until business accounts could be opened. Some accounts listed Mr. White as "president" and his wife as treasurer, but other business accounts were designated as "sole proprietorship" with Mr. White's name on the account. Mr. White controlled the business funds and used business accounts to pay personal expenses and personal accounts to pay business expenses. Records were not kept of the payments. Business funds were also used to pay his ex-wife's personal expenses.

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[74] Ibid.

[75] *Luna v. Comm'r,* 42 TC 1067 (1964).

[76] *White v. Comm'r,* TC Memo 2018-102 (Jul. 3, 2018).

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The Tax Court applied the *Luna* factors and concluded that the business was **not a partnership** for tax purposes. The Tax Court determined that all but one of the *Luna* factors supported a finding that a partnership did not exist.

- The parties must have complied with the terms of a partnership agreement.
- There was no equal division of profits.
- The parties withdrew varying sums from the business.
- Mr. White claimed personal deductions for business payments.
- Mr. White's ex-wife and her new spouse could have received income from sources other than their share of the business income.
- There was no explanation for how payments shown on his ex-wife's return ended up being deposited into the business bank account.

Alternatively, the court concluded that even if a partnership existed, there was no reliable evidence of the partnership's total receipts to support an allocation of income different from the amounts that the IRS had determined by its bank deposits analysis.

When applying the *Luna* factors to typical farming/ranching arrangements, it is relevant to ask the following.

- Was a Form 1065 filed for any of the years at issue? Such filing is required for either a partnership or a joint venture.
- Did the parties commingle personal and business funds?
- Were any partnership bank accounts established?
- Was there any distinct treatment of income and expense between business and personal expenses?
- How do the parties refer to themselves to the public?
- How do the parties represent themselves to the Farm Service Agency?
- Are the business assets co-owned?

SE TAX

SE tax is imposed on a taxpayer's net earnings from a trade or business that the taxpayer conducts and are known as net earnings from self-employment.[77] Net earnings from self-employment includes a partnership member's distributive share of income or loss, whether distributed or not, from the partnership's trade or business that are not required to be separately stated.[78]

> **Note.** An individual who received a partnership interest by gift in a partnership where capital is not a material income-producing factor is not recognized as a partner for SE tax purposes.

When computing net earnings from self-employment, a partner must take into account that partner's distributive share of the partnership business earnings, regardless of the partner's lack of active participation in the business.[79]

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77. IRC §1402.

78. IRC §1402(a). For items that must be separately stated, see IRC §702(a)(8). The rule does not distinguish between the partnership's earned and unearned income. However, long-term capital gains, interest, rents, and royalties are separately stated items, and therefore, **are not** taken into account in computing the partners' net earnings from self-employment. See, e.g., *Pugh v. Comm'r*, TC Memo 1981-448 (Aug. 24, 1981).

79. See, e.g., *Estate of Ellsasser v. Comm'r*, 61 TC 241 (1973); *Norwood v. Comm'r*, TC Memo 2000-84 (Mar. 13, 2000).

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Example 7. Farmer Seth died, and his estate passed to his wife, Azura, and his son, Enosh. Azura and Enosh continued the farming operation together as an informal partnership for their joint profit, but Enosh made all the key managerial decisions. Even though Azura was not active in the farm business, her distributive share constitutes net earnings from self-employment.[80]

Other Situations

When computing net earnings from self-employment, a current-year partnership loss that is disallowed to a partner under the passive activity loss (PAL) rules is not taken into account in computing that partner's net earnings from self-employment. An earlier year's loss that was disallowed to a partner under the PAL rules and that was carried forward to another year is not taken into account in computing that partner's net earnings from self-employment until the tax year in which the earlier year's loss is allowed to that partner.[81]

For partnerships in a community property state, if a partner's share of partnership income or loss is community income, it is not net earnings from self-employment in the hands of the partner's spouse.[82]

Informal joint ventures can also result in a partnership for tax purposes. In *Methvin v. Comm'r*,[83] Mr. Methvin acquired a small percentage in the working interests of oil and gas activities that were not part of any business organization registered under state law. Instead, the activities were governed by an operating agreement Mr. Methvin entered into with an operating company. Under the agreement, Mr. Methvin had no right to participate in management and had no knowledge or expertise in the oil industry. He only had the right to enter the property to inspect the operations, get any information reasonably requested about development and operation, and inspect the operating company's records. Based on his lack of participation in the activity and the fact that he did not even know what the working interest owners were doing with the activity, Mr. Methvin did not report his income from the venture as net earnings from self-employment.

The Tax Court disagreed with Mr. Methvin, determining that the working interest owners and the operator created a joint venture for the operation of the wells meeting the definition of a partnership. Consequently, the net income Mr. Methvin received from his interests was SE income.

> **Note.** If a partner's tax year is different from the partnership's tax year, the partner includes in net earnings from self-employment their distributive share of income or loss of the partnership's tax year that ends with or within the partner's tax year.[84]

SMALL PARTNERSHIPS

If a business activity conducted by at least two persons is deemed to be a partnership, a return must be filed for each tax year that reports the items of gross income and allowable deductions.[85] If a partnership return is not timely filed in 2025 (including extensions) or is timely filed but is inadequate,[86] a monthly penalty is triggered that equals $245 multiplied by the number of partners during any part of the tax year for each month (or fraction thereof) for which the failure continues.[87] However, the penalty is capped at 12 months. The partnership is also potentially subject to IRS-specified audit procedures.

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80. See, e.g., Rev. Rul. 54-613, 1954-2 CB 269.
81. TAM 9750001 (Aug. 15, 1997).
82. IRC §1402(a)(5)(B).
83. *Methvin v. Comm'r,* TC Memo 2015-81 (Apr. 27, 2015), *aff'd* 653 Fed.Appx. 616 (10th Cir. 2016).
84. Treas. Reg. §1.1402(a)-2(e).
85. IRC §§761(a) and 6031(a).
86. Thus, the return does not contain the information required by IRC §6031.
87. IRC §6698(b); Rev. Proc. 2016-55, 2016-45 IRB 707, §3.49.

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Audit Procedures

The entity is also subject to the Bipartisan Budget Act of 2015[88] (BBA) audit rules for partnerships under which the partnership must designate a partnership representative to act on behalf of the partnership during an audit. However, IRC §6221(b) allows certain small partnerships to elect out of having the BBA apply on a timely filed partnership return for the tax year to which the election applies, including extensions.[89]

> **Note.** A partnership that fails to file a timely partnership return cannot make an election out for that tax year. The IRS did not prescribe the form or manner for this notification.

A partnership is eligible to elect out of the BBA if both of the following apply.

- All the partners are individuals, C corporations (including a foreign entity that would be treated as a C corporation, if domestic), S corporations, or the estate of a deceased partner. Partnerships with partners that are disregarded entities are not eligible to elect out of the BBA.
- The partnership is required to file 100 or fewer Schedules K-1.

If a partnership that elects out of the BBA (non-BBA partnership) is audited, each partner of the non-BBA partnership potentially is subject to a separate audit with respect to partnership-related items. If the partnership does not elect out of the BBA and instead elects to pay any additional tax determined from an audit, the tax will be assessed at the highest rate in effect for the reviewed year. This result may be simpler in form, but could generate a higher tax liability than if the additional tax is applied to each partner.

> **Note.** The election is made by checking the designated box on Form 1065, Schedule B, *Other Information,* and by completing Form 1065, Schedule B-2, *Election Out of the Centralized Partnership Audit Regime*.

Exception

An exception from the penalty for failing to **file** a partnership return and the BBA audit procedures could apply for many small business partnerships and farming operations. However, it is important to understand the scope of the exception, and what is still required of such entities even if a partnership return is not filed. In many instances, such entities may find that filing a partnership return in any event is a more practical approach.

If the entity is deemed to be a partnership and fails to file a partnership return, the penalty for failure to file is assessed against the partnership. While there is not a statutory exception to the penalty, it is not assessed if it can be shown that the failure to file was due to **reasonable cause.**[90] The taxpayer bears the burden to show reasonable cause based on the facts and circumstances of each situation.[91] On the reasonable cause issue, the IRS, in Rev. Proc. 84-35,[92] established an exception from the filing requirement for a **small partnership.** Under the Rev. Proc., an entity that satisfies the requirements to be a small partnership will be considered to meet the reasonable cause test and will not be subject to the penalty imposed by IRC §6698 for the failure to file a complete or timely partnership return. However, the Rev. Proc. noted that each partner of the small partnership must fully report their shares of the income, deductions, and credits of the partnership on their timely filed income tax returns.

88. *Bipartisan Budget Act of 2015,* PL 114-74.

89. If the partnership elects out of the BBA, it must disclose to the IRS the name and tax identification number of each partner and notify its partners that it made the election out of the BBA within 30 days of making the election.

90. IRC §6689(a).

91. See, e.g., SCA 200135029 (Aug. 31, 2001).

92. Rev. Proc. 84-35, 1984-1 CB 509.

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Under the BBA, a **small partnership** must satisfy the following five requirements.[93]

1. The partnership must elect out of the BBA for the tax year.
2. The partnership must have 100 or fewer partners.

> **Caution.** The definition of a **small partnership** was changed by BBA to "100 or fewer" but the penalty exception rules are contained in Rev. Proc. 84-35.

3. Each of the partners must be individuals, C corporations, foreign entities that would be treated as C corporations if they were domstic S corporations, or estates of deceased partners.
4. The election is made with a timely filed return for the tax year and includes the name and taxpayer identification number of each partner.
5. The partnership notifies each partner of the election.

Consequently, if a partner has transferred the partnership interest to a revocable living trust or owns the partnership interest through a single member LLC, the partnership does not qualify as a small partnership for purposes of §6698.[94]

Typically, the IRS will have asserted the §6698 penalty for the failure to file a partnership return. The penalty can be assessed **before** the partnership has an opportunity to assert reasonable cause or after the IRS has considered and rejected the taxpayer's claim.[95] When that happens, the partnership must request reconsideration of the penalty and establish that the small partnership exception applies so that reasonable cause exists to excuse the failure to file a partnership return.[96]

As noted previously, even though the failure to file penalties can be avoided via the small partnership exception, it is still necessary that all items of income, deductions, and credit, etc. from the partnership are properly reported on a timely basis on the partners' individual tax returns. In addition, the partnership allocation percentages must be the same for all partnership tax attributes. Furthermore, the tax preparer will have to split income and expenses into two or more separate Schedules F, *Profit and Loss From Farming,* and allocate depreciation and other tax items amongst the partners. Therefore, in most instances, it will be easier to report all of this information on a partnership tax return compared to making the same calculations and allocating individual items of income and expense to each partner.

Typically, the small partnership exception is limited in usefulness to those situations where the partners are unaware of the partnership return filing requirement or are unaware that they have a partnership for tax purposes and the IRS asserts a penalty for failing to file a partnership return. In those situations, the partnership can use the exception to show reasonable cause for the failure to file a partnership return. But, even if the exception is deemed to apply, the IRS can require that the individual partners prove that they have properly reported all tax items on their individual returns.

> **Note.** If the small partnership exception applies, it does **not** mean that the small partnership is not a partnership for tax purposes.[97] It only means that the small partnership is not subject to the penalty for failure to file a partnership return and the BBA audit procedures.[98]

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93. IRC §§6221(b)(1)(A)–(E).

94. The treatment of a grantor trust and single-member LLC as disregarded entities does not apply for the determination of whether the partnership interest is held by an individual. Treas. Reg. §301.6231(a)(1)–1(a)(2) treats a single-member LLC as a "pass-through" partner. See Rev. Rul. 2004-88, 2004-32 IRB 165.

95. See SCA 200135029 (Aug. 31, 2001).

96. The IRS has indicated that it could send a notice to a partnership that failed to file a return along with a questionnaire that could be completed and returned to the IRS so that the IRS could determine whether the penalty can be excused. See SCA 200135029 (Aug. 31, 2001).

97. This argument was tried by the Chapter 12 bankrupt debtor's expert witness in *In re Hemann*, No. 11-00261 (Bankr. N.D. Iowa Apr. 3, 2013). A Chapter 12 debtor sold an interest in a farm partnership which met the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) definition of a small partnership. The debtor's expert witness argued that, as a result, the debtor's partnership was to be treated as non-existent with the result that the debtor's income arose from the sale of a personal interest in a farm partnership rather than a capital interest in the partnership, and qualified as the sale of a "farm asset" for purposes of 11 USC §1222(A)(2)(a). The court rejected the expert's argument as irrelevant and stated, "...the decision here will not rely in any way on his testimony." The court noted there was a large amount of case law and legislative language contrary to the position of the debtor's expert.

98. See, e.g., *Cahill v. Comm'r*, TC Memo 2013-220 (Sep. 18, 2013).

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LIABILITY AND OTHER LEGAL CONCERNS

Much of the concern about whether an informal farming arrangement could be construed legally as a partnership is the fear of **unlimited liability.** Partners are **jointly and severally liable** for the debts of the partnership that arose out of partnership business. The fear of unlimited liability causes parties to have provisions specifying that the arrangement is **not** to be construed as a partnership written into crop-share and livestock-share leases.

There are many scenarios in which legal issues arise over the question of whether a partnership exists. For example, in *Farmers Grain Co., Inc. v. Irving,*[99] Farmers Grain extended credit to Mr. Foster who was a tenant under an oral livestock-share lease. Upon default of the loan, Mr. Foster filed for bankruptcy and Farmers Grain tried to bind the Irvings (the landlords) to the debt under a partnership theory. The court held that a partnership had not been formed where the landlord did not participate in the operation, no joint bank accounts were established, and gross returns were shared rather than net profits.

In *Tarnavsky v. Tarnavsky,*[100] the court determined that a partnership did exist where the farming operation was conducted for a profit, the evidence established that the parties involved intended to be partners and business assets were co-owned.

Oral business arrangements can also create unanticipated problems if one of the parties involved in the business dies. In *In re Estate of Palmer,*[101] the court determined that a partnership existed even though title to the real estate and the farm bank account were in joint tenancy. As such, the surviving spouse of the deceased "partner" was entitled to half of the farm assets instead of the land and bank account passing to the surviving joint tenant.

A tax issue that may arise is the determination of the properly allowed IRC §179 deduction. If multiple joint owners in separate sole proprietorships with multiple §179 deductions become classified as partners in a partnership, only one §179 deduction limit applies.[102]

SUSTAINABLE AVIATION FUEL TAX CREDIT

A new sustainable aviation fuel (SAF) credit was created under the Inflation Reduction Act of 2022.[103] The new credit is contained in IRC §40B. The Inflation Reduction Act also modified the existing credit contained in IRC §6426(k). The new credit has implications for corn and soybean farmers and biofuel plants, and will force a closer examination of the carbon intensity score of the production of corn and soybeans.

The SAF credit applies to a qualified fuel mixture containing sustainable aviation fuel for certain sales or uses in calendar years 2023 and 2024.[104] The SAF credit is $1.25 for each gallon of sustainable aviation fuel in a qualified mixture.[105] To qualify for the credit, the sustainable aviation fuel must have a minimum reduction of 50% in lifecycle greenhouse gas emissions.[106] Additionally, there is a supplemental credit of one cent for each percent that the reduction exceeds 50% until the credit is maximized at $1.75 per gallon.[107]

99. *Farmers Grain Co., Inc. v. Irving,* 401 N.W.2d 596 (Iowa Ct. App. 1986).

100. *Tarnavsky v. Tarnavsky*, 147 F.3d 674 (8th Cir. 1998).

101. *In re Estate of Palmer,* 708 P.2d 242 (Mont. 1985).

102. IRC §179(d)(8); Treas. Reg. §§1.179-2(c)(2)(i) and (3).

103. *Inflation Reduction Act of 2022,* PL 117-169, §§13203 and 40007, which introduced the "Fueling Aviation's Sustainable Transition (FAST)" grant program and provided $244.5 million in grants for SAF-related "production, transportation, blending, or storage."

104. IRC §§40B(f) and (h).

105. IRC §40B(a)(2)(A).

106. IRC §40B(d)(1)(D).

107. IRC §40B(b).

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IRS GUIDANCE

In late 2022, the IRS provided guidance on the related credit and payment rules under IRC §§34(a)(3), 38, 87, and 6427(e)(1), as well as the registration requirements contained in IRC §4101.[108] In the notice, the IRS provides a safe harbor for calculating the lifecycle greenhouse gas emissions reduction percentage, and also clarifies what constitutes sustainable aviation fuel and a qualified mixture. In addition, the notice explains that a claimant may choose to claim the SAF credit through the excise tax system or as a general business credit that is nonrefundable and must be included in income.

> **Note.** As noted, to qualify for the credit, SAF must have a minimum reduction of greenhouse gas emissions of 50% when compared to the production of petroleum-based jet fuel. Presently, the airline industry has committed to using three billion gallons of SAF annually by 2030 (10% of anticipated fuel needs).

> **Note.** The credit is claimed by a taxpayer that produces the fuel at a qualified facility, either an ethanol or biofuel plant.[109] These qualified facilities will pay farmers that adopt carbon-reducing farming practices that lead to the facility qualifying for the credit, and farmers can qualify for USDA grants to adopt practices that reduce carbon emissions (e.g., planting cover crops). The fuel producer must be registered with the IRS at the time the fuel is produced.[110]

USDA PILOT PROGRAM[111]

In early 2024, the IRS provided additional guidance and safe harbors. The notice specified the 40BSAF-GREET (Greenhouse gases, Regulated Emissions, and Energy use in Technologies) 2024 model as a qualifying method to calculate the emissions reduction percentage and for the corresponding unrelated party certification to qualify for SAF credits. The notice also specified the use of the USDA's Climate Smart Agriculture Pilot Program to further reduce the lifecycle greenhouse gas emissions reduction percentage calculated using 40BSAF-GREET 2024 for domestic soybean and domestic corn feedstocks, and for certifying the related requirements. This program establishes Climate Smart Agriculture (CSA) practices for cultivating domestic corn (CSA corn) and domestic soybeans (CSA soybeans) for use as sustainable aviation feedstocks.

> **Observation.** The bottom line is that the only way ethanol plants qualify for the SAF tax credit is that corn must be produced in a particular manner — no till, cover crop, and the precision placement of nitrogen. Corn cannot be "identity preserved" for the SAF credit in the current distribution system. Interestingly, the GREET model does not include the fuel usage necessary to plant the cover crop.

Only corn and soybeans are eligible for the program. To qualify for CSA practices, producers must engage in three activities for corn (no-till, cover crops, and enhanced efficiency nitrogen application). Soybean producers must only utilize no-till and cover crops. Practices are to be applied at the field scale. The definitional requirements are lengthy and specific.

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108. IRS Notice 2023-6, 2023-2 IRB 328. The IRS later issued Notice 2024-6, 2024-2 IRB 348 that superseded Notice 2023-6 in which it indicated that the GREET model at that time did not qualify for IRC §40B and indicated that a revised model would be issued. The automatic safe harbor qualifiers were biomass-diesel or advanced biofuel (eligible for a $1.25/gallon credit), and cellulosic biofuel or cellulosic diesel (eligible for a $1.35/gallon credit).

109. The optimal manner for an ethanol plant to reduce its carbon intensity score is to sequester CO2. That can be done either by direct capture or by pipeline. If by pipeline, the carbon intensity score drops by 30%. No pipeline will be in place before 2028 and the IRC §45Z credit expires at the end of 2027.

110. IRS Notice 2024-49, 2024-26 IRB 1781.

111. IRS Notice 2024-37, 2024-21 IRB 1191.

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Cover crops must meet the following requirements.

- Plant species, seedbed preparation, seeding rates, seeding dates, seeding depths, fertility requirements, and planting methods must be consistent with applicable local criteria and soil/site conditions.
- Select species must be compatible with other components of the cropping system.
- Herbicides used with crops must be compatible with cover crop selections and purpose(s).
- Cover crops may be established during the fallow season prior to planting the feedstock crop, or companion planted or relay-planted into production crops.
- Cover crop residue must not be burned.
- The method and timing of termination must be determined to meet the grower's objective and the current Natural Resource Conservation Service (NRCS) cover crop termination guidelines.
- Must ensure that the planned management of grazed or hayed cover crops will not compromise the soil health and organic matter content.
- Cover crops must not be harvested for seed.
- If the specific rhizobium bacteria for the selected legume are not present in the soil, treat the seed with the appropriate inoculum at the time of planting.

Records must be maintained for each CSA practice and a producer must attest to compliance in certification documents. Thus, an SAF producer (i.e., a "qualified facility") must:

- Have direct contact with the farmer;
- Collect and maintain the certificate for CSA crops from the farmer;
- Maintain records in accordance with Appendix A of Notice 2024-37; and
- Allow records to be available for certification and be subject to audits.

Observation. In essence, corn qualifies for a 10% emissions reduction if a farmer utilizes no-till or strip-till practices, plants cover crops, and uses enhanced low-carbon fertilizer. Soybeans qualify for a 5% emissions reduction if the farmer uses no-till and plants cover crops.

The USDA's goal is to sign-up at least 60,000 farmers and enroll 25 million acres that would sequester in excess of 60 million metric tons of carbon dioxide. Some states, such as Iowa, incentivize the planting of a cover crop at the rate of $30 per acre.[112] In addition, the USDA's Risk Management Agency offers crop insurance discounts of $5 per acre for planting fall cover crops in some states.

Note. Corn and soybean farmers must know their **carbon intensity score.** The current average corn carbon intensity score is 29. For every point below 29, the possible credit value is about $.054/bushel. If the carbon intensity is zero, the possible credit value is $1.57/bushel. It is possible that the carbon intensity score could be negative — which would increase the possible credit.[113]

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112. *Secretary Naig Announces Increased Cover Crop Cost-Share Incentives.* May 7, 2024. Iowa Department of Agriculture & Land Stewardship. [iowaagriculture.gov/news/cover-crop-CS-incentives-increase] Accessed on Aug. 8, 2024.

113. A professional agronomist can determine a farmer's carbon intensity score.

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DIFFERENT CREDIT POST-2024

As noted previously, the credit under §40B applies through the end of 2024. Subsequently, the credits under IRC §45Z apply to transportation fuel sold through 2027. To be eligible for the credit, the transportation fuel must be produced by the taxpayer at a qualified facility and sold by the taxpayer as required by §45Z. Beginning in 2025, the §45Z credit can be up to $1 per gallon for any biofuel with a carbon intensity score at least 50% lower than a petroleum-based fuel. The rate is increased to $1.75 per gallon for sustainable aviation fuel. Once the 50% level is attained, every point of carbon intensity reduction is worth $.02 per gallon.[114] In addition, qualifying for the §45Z credit requires the taxpayer to meet prevailing wage and be subject to apprenticeship programs to qualify for the maximum possible credit.

CUSTOMER LOYALTY PROGRAMS

Many companies, including agribusiness retailers, utilize customer loyalty programs as a means of attracting and keeping customers. Under the typical program, each time a customer or member buys a product or service, the customer earns reward points. The reward points accumulate and are computed as a percentage of the customer's purchases. When accumulated points reach a designated threshold, they can then be used to buy an item from the retailer or can be used as a discount on a subsequent purchase (e.g., cents per gallon off of a fuel purchase). Some programs are structured such that a reward card is given to the customer after purchases have reached the threshold amount. The reward card typically has no cash value and expires within a year of being issued.

A loyalty rewards program is a cost to the retailer and a benefit to the customer, triggering tax issues for both. This section focuses on the impact on retailers.

INCOME RECOGNITION

A retailer may receive an advanced payment for loyalty or reward points, discount vouchers, and the like. In general, an income item is included in gross income for tax purposes in the year in which the taxpayer receives it, unless the taxpayer's method of accounting dictates that it should be accounted for differently.[115] Generally, an accrual-method taxpayer recognizes income when all of the events occur that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy.[116] All of the events occur at the earliest of when:

- Payment is due;
- Payment is made; or
- The required performance takes place.[117]

However, IRC §451(c) requires an accrual-method taxpayer to take advance payments into income in the tax year of receipt with an election to defer inclusion to the next tax year if the income is also deferred for applicable financial statement purposes.[118] Prop. Treas. Reg. §1.451-8(b)(1) provides the definition of what an "advance payment" is for this deferral and includes gift cards as well as reward and loyalty programs. Thus, a retailer may treat these items as future revenue and not as an accrued expense.[119]

> **Note.** Under the proposed regulation, a taxpayer without an applicable financial statement that receives advance payments must include them in income in the tax year of receipt, to the extent earned, with the balance accounted for in the next succeeding tax year.

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114. For example, a 60% reduction compared with petroleum-based fuel garners a credit of $.20 per gallon, or $.35 per gallon for sustainable aviation fuel. A lower credit applies to biofuels and a higher credit for SAF. In addition, the taxpayer must have less than 50kg per million BTU of CO2 to qualify for any credit.

115. IRC §451.

116. Treas. Reg. §1.451-1.

117. See, e.g., Rev. Rul. 2003-10, 2003-1 CB 288.

118. See also Rev. Proc. 2004-34, 2004-22 IRB 991.

119. The preamble to the proposed regulation states that there is no corresponding offset for the cost of goods sold. Thus, it is possible that a taxpayer would recognize income in one year, but not recognize a corresponding offset for the cost of goods sold until a later year.

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Economic Performance

Treas. Reg. §1.461-4(g)(3) addresses the treatment of rebates and refunds and specifies that economic performance occurs when payment is made to the person to whom the liability is owed. The IRS's position is that a retailer cannot claim a deduction until the points are **actually redeemed** because the event fixing the retailer's liability occurs when a member reaches the minimum number of points for redemption **and** actually redeems the points.[120] However, for an accrual-method taxpayer, the taxpayer's liability becomes fixed (and a deduction can be claimed) when the customers **earn** the rewards.[121] A deduction is not deferred until the customer redeems the rewards.

> **Note.** The IRS does not agree on this point and only follows the Third Circuit's decision in cases appealable to the Third Circuit that cannot be distinguished.[122]

Two Requirements. Treas. Reg. §1.451-4 addresses trading stamps and premium coupons that are issued with sales and are redeemable in cash, merchandise, or other property. Most retailer customer loyalty programs likely satisfy both tests. The IRS, in a matter involving an accrual basis supermarket chain that had a rewards program allowing customers to receive a certain amount of gas for free depending on purchases of products, stated that the supermarket could take a current deduction for the value of the gas rewards.[123] The IRS concluded that the gas rewards were being redeemed for other property.[124] The rewards were issued on the basis of purchases.

Loyalty reward programs that might not satisfy the "redeemable in cash, merchandise or other property test" might be programs that provide customers with cents-off coupons. With these programs, the IRS could argue that a customer's right to redeem the coupon is conditioned on a future purchase and, as a result, the coupon liability should be matched to the later sale when the liability becomes fixed and determinable and economic performance occurs.[125]

Timing of Deduction. The regulation provides that the estimated redemption costs of premium coupons issued in connection with the sale of merchandise is deductible **in the year of the merchandise sale,** even though the reserves for future estimated redemption costs are not fixed and determinable and do not otherwise meet the economic performance rules of the all-events test.[126]

Retailers with loyalty programs that satisfy the two tests of Treas. Reg. §1.451-4 may find the use of this method preferential from a tax standpoint. For retailers that can qualify but are not presently using the Treas. Reg. §1.451-4 approach, a **method change** is required. The method change is achieved by using the advance consent procedures of Rev. Proc. 97-27.[127] If a loyalty program does not meet the requirements to use Treas. Reg. §1.451-4, the redemption liability is treated as a deduction and not as an exclusion from income. Thus, the redemption liability is taken into account in the tax year in which the liability becomes fixed and determinable and economic performance occurs under IRC §461. Generally, that is the year in which the customer redeems the loyalty rewards.

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120. Ltr. Rul. 200849015 (Dec. 5, 2008).

121. *Giant Eagle, Inc. v. Comm'r*, 822 F.3d 666 (3d Cir. 2016), *rev'g* TC Memo 2014-146 (Jul. 23, 2014).

122. AOD 201603 (Oct. 3, 2016).

123. FSA 20180101F (Nov. 7, 2017).

124. Treas. Reg. §1.451-4(a)(1).

125. IRC §461.

126. Treas. Reg. §1.451-4(a)(1).

127. Rev. Proc. 97-27, 1997-1 CB 680, modified by Rev. Proc. 2002-19, 2002-1 CB 696.

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Recent Case

In *Hyatt Hotels Corporation & Subsidiaries v. Comm'r*,[128] Hyatt established a "Gold Passport" rewards program in 1987 that provided its customers with reward points redeemable for free future stays at its hotels. Hyatt owns about 25% of its branded hotels with the balance owned by third parties who license Hyatt's intellectual property and/or management services. Under the program, Hyatt required hotel owners to make payments into an operating fund (Fund) when a customer earned points. Hyatt was the custodian of the Fund and compensated a hotel owner out of the Fund when a guest redeemed reward points for free stays. Hyatt determined the rate of compensation. Hyatt invested portions of the Fund's unused balance in marketable securities which generated gains and interest. In 2011, Hyatt changed the compensation formula to increase the amount it could hold for investment. Hyatt also used the Fund to pay administrative and advertising expenses that it determined were related to the rewards program.

The points could not be redeemed for cash and were not transferrable. In addition, any particular member hotel could not take back the payments made to the Fund except by providing free stays to members. The Fund allocated 46-61% of its amount to reward point redemptions. Fund statements described the funds as belonging to the hotel owners that paid into the Fund. Hyatt's Form 10-K, *Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934,* filed with the Securities and Exchange Commission (SEC), treated the Fund as a "variable interest entity" eligible for consolidated reporting. When Hyatt provided management services to member hotels, payments into the Fund were reported as "expenses."

Hyatt did not report the Fund's revenue as gross income with respect to the hotels it did not own. Additionally, it did not claim any deductions for expenses paid on the basis that Hyatt was a mere trustee, agent, or conduit for hotel owners rather than a true owner of the Fund. However, Hyatt did claim deductions for its share of program expenses associated with the 25% of hotels it owned. Hyatt reported Fund assets and liabilities on a consolidated basis on Schedule L, *Balance Sheets per Books*. Hyatt's Form 1120, *U.S. Corporation Income Tax Return,* did not state that it was using the trading stamp method or include any statement concerning Treas. Reg. §1.451-4. Hyatt's position was that third-party owners should make their own decision about the tax treatment of the money they paid to the Fund.

Note. Most third-party owners simply deducted payments to the Fund when paid regardless of whether economic performance would have occurred for expenses accrued for redemption, advertising, and operating costs.

The IRS audited Hyatt and took the position that Hyatt was using an improper accounting method. This triggered an IRC §481 adjustment requiring Hyatt to include the cumulative amounts from 1987 (Fund revenue less expenditures) in income. The IRS assessed an adjustment of $222.5 million and additional adjustments in 2010 and 2011. Hyatt disagreed and filed a Tax Court petition.

The Tax Court determined that the amounts Hyatt received related to the customer reward program (i.e., Fund revenue) were revenue includable in gross income because of Hyatt's significant control over the Fund. That control indicated that Hyatt had retained a beneficial interest in the Fund, and the exception under the **trust fund doctrine** established in *Seven-Up Co. v. Comm'r,*[129] did not apply. The trust fund doctrine allows a taxpayer to exclude from gross income funds received in trust, subject to a legally enforceable restriction that the funds be spent entirely for a specific purpose, where the taxpayer does not profit, gain, or benefit from spending the funds for that purpose. In *Hyatt,* the Tax Court determined that the trust fund doctrine did not apply because Hyatt:

- Mandated participation and payments into the Fund;
- Controlled the amounts of program payments to the Fund and the payments from the Fund;
- Made the decisions as to how Fund amounts were to be invested;
- Accrued interest and realized gains on investments in the Fund; and
- Decided whether Fund amounts would cover advertising and/or administrative costs.

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128. *Hyatt Hotels Corporation & Subsidiaries v. Comm'r,* TC Memo 2023-122 (Oct. 2, 2023).

129. *Seven-Up Co. v. Comm'r,* 14 TC 965 (1950), *acq.* 1950-2 CB 4.

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In other words, Hyatt received more than "incidental and secondary" benefits from the Fund.

In addition, the Tax Court pointed out that Hyatt benefited directly from the Fund based, in part, on the Fund generating goodwill among customers leading to increased bookings and royalties and fees. Indeed, Hyatt owned approximately 25% of the hotels that paid into the Fund, which indicated a clear benefit to Hyatt's own interests.

However, in a major win for Hyatt, the Tax Court also determined that Hyatt's treatment of Fund revenue and expenses did **not** amount to the adoption of a method of accounting. Thus, no §481 adjustment was required. Hyatt's consistent and total exclusion of Fund revenue and expense did not involve timing and, therefore, was not a method of accounting. Hyatt had simply excluded the Fund amounts from gross income and would have continued to do so if the Fund had ended and the amounts in the Fund were distributed to member hotels.

Note. The normal statute of limitation of IRC §6501 does not apply when an accounting method change has occurred. If Hyatt had adopted an impermissible accounting method, the IRS would not have been time-barred to make adjustments.

As for the application of the **trading stamp method** of reporting income and expense, Hyatt claimed that Fund gross receipts should be offset by both the current year reward redemptions and the estimated cost of future tax year reward redemptions (i.e., an acceleration of deduction beyond actual program costs). The Tax Court disagreed on the basis that a hotel stay, which is either characterized as a license or a leasehold, would not qualify as merchandise, cash, or other property as the trading stamp method required. The Tax Court also clarified that "other property" for purposes of Treas. Reg. §1.451-4 includes property like merchandise or cash. "Other property" is not a hotel stay. It is, rather, tangible property.

Note. *Hyatt* is a good case for tax advisers with clients that offer loyalty reward programs to customers. Retail businesses offering such programs will want to ensure that their program is structured in a manner fitting within the trust fund doctrine's exception for excluding program funds from gross income. *Hyatt* is basically a win for the taxpayer, because most of the adjustments the IRS proposed were time-barred once the Tax Court determined that a method of accounting had not been adopted.

Note. For more information on the *Hyatt* case, see the 2024 *University of Illinois Federal Tax Workbook,* Chapter 10: Rulings and Cases.

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BUY-SELL AGREEMENTS

A **buy-sell agreement** is a frequently used mechanism by a closely held farming or ranching business (as well as many non-farm businesses) to integrate the needs and capabilities of the business with the succession planning and transition objectives of the owners. A well-drafted buy-sell agreement can be a very useful document to assist in transitioning a family business from one generation to the next. It can also balance out inheritances among heirs by ensuring the heirs interested in running the family business end up with control of the business, and other heirs end up with non-control interests.

Common events that trigger buy-sell agreements are death, divorce, or bankruptcy. A buy-sell agreement can effectively provide a market for the ownership interests, limit transferability of those interests outside the immediate family, and establish a procedure for buying a deceased owner's interests which, in turn, can aid in establishing certainty as to the value of the shares for federal estate tax purposes. Likewise, when utilized properly, a buy-sell agreement may also provide estate tax valuation discounts.

Note. For more information on buy-sell agreements, including the issue with closely held corporations being named as a beneficiary of insurance policy proceeds to buy out a deceased shareholder, see the 2023 *University of Illinois Federal Tax Workbook,* Chapter 5: Agricultural Issues and Rural Investments.

VALUATION ISSUE

To be operational, the parties to a buy-sell agreement must have funds available to buy the stock at the time the agreement is triggered. Typically, life insurance is purchased for each business owner to cover the total purchase price (or at least the down payment of coverage). One approach is for each shareholder to buy, pay for, own, and be the beneficiary of a life insurance policy for each of the other shareholders. The surviving shareholders would then receive the proceeds when one shareholder dies and, if a cross-purchase (discussed later) is indicated and appropriate, use the proceeds as the necessary funds to carry out the buy-sell agreement. The surviving shareholders could also lend the proceeds to the corporation if a redemption agreement is utilized to enable the corporation to buy additional shares. Alternatively, the surviving shareholders could make capital contributions, which would have the effect of increasing each shareholder's stock basis.

There is a split of authority between the circuit courts of appeal on the issue of whether the policy proceeds are included in the corporate value as reflected in the stock base. If included, the enhanced value could trigger estate tax in the estate of the deceased shareholder and result in a decreased inheritance of the decedent's heirs. In essence, the issue is whether the redemption obligation of the corporation constitutes an offsetting corporate liability. The Eleventh Circuit has concluded the obligation is an offsetting liability that does not enhance the corporation's value.[130] The 9th Circuit had previously reached the same conclusion.[131]

However, in *Connelly v. U.S.,* the 8th Circuit reached a different conclusion.[132] The U.S. Supreme Court affirmed the decision and determined that the corporation's contractual obligation to redeem the deceased shareholder's shares at FMV was not a liability that decreased the value of those shares for purposes of the federal estate tax. The Supreme Court reasoned that the correct approach on valuation was to determine the value of the decedent's interest at the time of death, before the corporation spent $3 million on the redemption payment. The Court determined that a hypothetical buyer would treat the life insurance proceeds that would be used to redeem the decedent's shares as a net asset. This was the case because the redemption agreement specified that the insurance proceeds would be available to fund the redemption. This, in turn, indicated that the corporation would receive the proceeds and thereby increase the value of the deceased shareholder's shares.

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130. *Estate of Blount v. Comm'r*, 428 F.3d 1338 (11th Cir. 2005).

131. *Cartwright v. Comm'r*, 183 F.3d 1034 (9th Cir. 1999).

132. *Connelly v. U.S.*, 144 S. Ct. 1406, *aff'g* 70 F.4th 412 (8th Cir. 2023).

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> **Note.** In a footnote, the Court indicated that it was not holding that a redemption-style buy-sell agreement could never decrease corporate value. On this point, the Court stated that a redemption agreement could require a corporation to liquidate operating assets to pay for the shares, which would decrease the corporation's future earning capacity.[133]

> **Note.** For more information on the *Connelly* case, see the 2024 *University of Illinois Federal Tax Workbook,* Chapter 10: Rulings and Cases.

Alternative Approaches

In light of the Supreme Court's decision in *Connelly,* a redemption buy-sell agreement should be avoided in situations where the inclusion of the life insurance proceeds in the value of the corporation would result in estate tax issues for the deceased shareholder's estate. Alternatives include a cross-purchase buy-sell agreement, a cross-purchase buy-sell agreement with an insurance LLC, and a cross endorsement buy-sell agreement.

Cross-Purchase Buy-Sell Agreement. This type of agreement is a contract between or among the owners (the business is not necessarily a party to the agreement) whereby each owner agrees to sell their shares to the other owners on the occurrence of specified events. With a cross-purchase agreement, unless the shareholder is a dealer in stock, any gain on the sale is a capital gain regardless of the character of the corporation's underlying assets.[134] For an estate that sells the stock shortly after the shareholder's death, no gain is recognized if the agreement sets the sale price at the date of death value.[135] The purchasing shareholders increase their basis in their total holdings of corporate stock by the price paid for the shares purchased under the agreement, even if the shares are paid for with tax-free life insurance proceeds.

Cross-Purchase Buy-Sell Agreement with a Life Insurance LLC. This approach involves establishing a cross-purchase agreement under which the owners agree to create an LLC for the purpose of holding life insurance policies related to the business. The LLC's operating agreement includes a provision specifying that the insurance policies are to not be included in the insured's estate, with the allocation of the death benefit flowing to the surviving members of the business. The operating agreement should state that the business purpose of the LLC is to facilitate the ownership succession plan of the related entity.

> **Note.** A policy may be transferred to an LLC without triggering tax.[136] However, including other assets in the LLC in addition to the life insurance would help to support an argument, if challenged, that the LLC is a partnership under the transfer-for-value rules.[137]

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133. However, this would defeat the purpose of a buy-sell agreement for many closely held corporations, particularly farming and ranching corporations desiring to keep control of the corporation in the family for subsequent generations. The goal of a redemption-style buy-sell agreement is to utilize the life insurance proceeds to buy out the deceased shareholder's interest instead of (or at least before) liquidating corporate assets.

134. IRC §1221.

135. IRC §§1014 and 2032.

136. IRC §101(a)(2).

137. Ibid. Partnership tax status exempts transfers of interests in policies to the LLC or transfers of interests in the LLC to other members that would otherwise cause the death benefits to be taxable.

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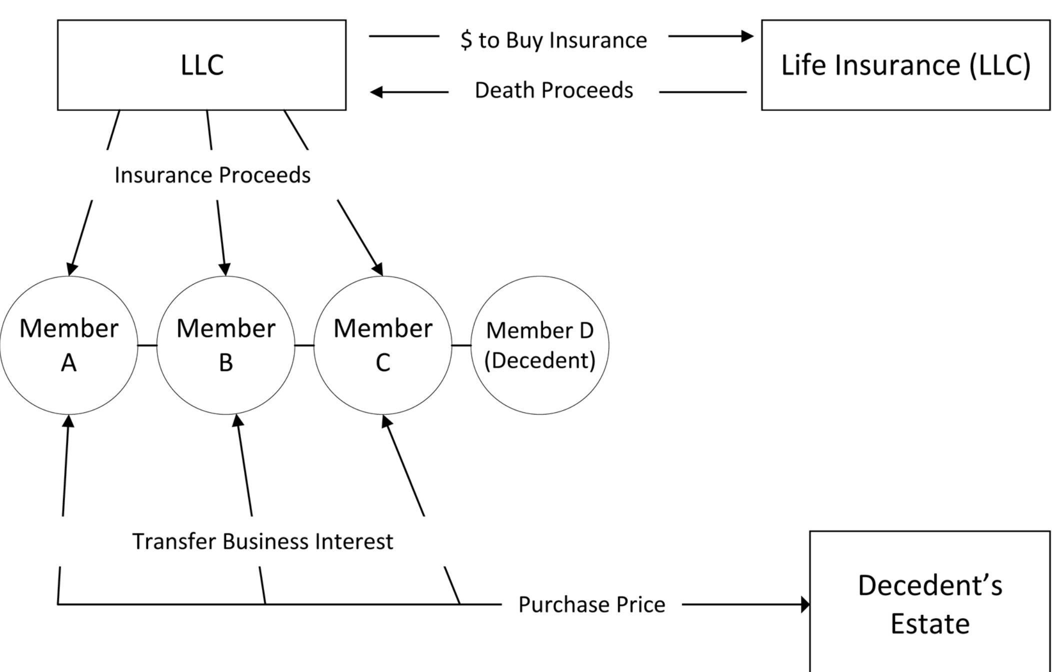
Another LLC should then be created, known as the "insurance LLC." The insurance LLC would name the other LLC as the beneficiary of the life insurance policies. The owners of the initial LLC should avoid being managers if the LLC is a manager-managed LLC. In addition, the insured should avoid having control over the policy or policies on the insured's life.[138] Member contributions to the LLC to pay policy premiums on the lives of other members are treated as contributions by non-insured members, which increases their respective tax capital accounts or a basis increase. Upon the insured's death, the insurer will divide the death benefits among the tax capital accounts of the surviving members in proportion to the premiums each respective member paid. The insurer also distributes the life insurance policy when a member dies. The remaining business owners buy the deceased member's interest in accordance with the terms of the buy-sell agreement. The decedent's ownership interest in the LLCs adjusts to FMV as of the date of death, and the death benefit to the beneficiaries increases their tax basis in the LLC. No income tax is triggered to the beneficiaries.

The following diagram illustrates the relationships among LLC members, the decedent's estate, the life insurance policy, and the flow of death proceeds.

Cross-Purchasing a Buy-Sell Agreement with a Life Insurance LLC



Note. With this approach as diagramed, the decedent's estate would still include one-fourth of the value of the insurance premiums for federal estate tax purposes.

Note. Generally, life insurance premiums are not deductible. They are tax-free unless the provisions of IRC §2042 are triggered.[139]

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[138] Likewise, the operating agreement should clearly bar members from acting with respect to insurance policies on their lives.

[139] IRC §246(a)(1).

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Cross Endorsement Buy-Sell Agreement.[140] With a cross-endorsement buy-sell agreement strategy, each business owner buys and is the owner of an insurance policy on their own life. Each owner then endorses a portion of the policy's death benefit to the other business owners, making them "renters" of the death benefit in proportion to the other business owners' ownership percentages in the business. Each policy owner pays the premiums while the other business owners pay the policy's owner an annual "rental charge" for the death benefit. This rental charge is equal to the economic benefit cost for the amount of death benefit endorsed to the "renter." The annual rental charge can be used to offset the premiums that the policy's owner must pay.

Upon a shareholder's death, the remaining owners buy the deceased owner's business interest from the estate with the death benefit paid to the remaining owners according to the amount endorsed to them.

Payment of the economic benefit amount under the "rental agreement" that accompanies a cross-endorsement agreement is taxable as ordinary income to the policy's owner. The economic benefit amount must be paid annually, in addition to the required premium payments, although the policy's owner can use the economic benefit amount received as an offset against the amount they have to pay as the premium.

Unless an exception is satisfied, a cross-endorsement arrangement can also trigger a violation of the transfer-for-value rule upon an insured's endorsement of the death benefit to another owner.

OPTIONS FOR RETIRING FARMERS (SELECTED TOPICS)

Retiring farmers have several options for succession planning and protecting their assets. This section compares charitable remainder trusts (CRTs) and cash balance plans, and installment sales as three such options.

CRTs VERSUS CASH BALANCE PLANS

Note. For more information on CRTs, see the 2023 *University of Illinois Federal Tax Workbook,* Chapter 5: Agricultural Issues and Rural Investments.

A common tax problem farmers encounter in their last few years of actively farming involves the practice of deferring grain sales from the prior year. When the last harvest occurs, the farmer faces the prospect of having the income from the sale of that last crop and the income from the deferred grain sales from the previous year being reported into income in the current year. Alternatively, the income from the sale of the last crop is deferred into the following year when very few deductions will exist to offset that income. This can cause a significant tax problem by pushing the farmer into a higher tax bracket and being subject to additional SE tax. It is possible the higher income may exceed the maximum earnings limit for SE tax and not be subject to the 12.4% social security tax.

CRT Strategy

One option to address the problem is for the farmer to transfer the grain from the last harvest to a CRT. A CRT must be irrevocable and may be either an annuity trust with level annual payments or a unit trust where the annuity is tied to a percentage of the trust assets on an annual basis per IRC §664. With a charitable remainder unitrust (CRUT), it is possible that annual payouts from the trust may increase if the trust assets grow in value. This structure makes it easier to keep pace with inflation. The farmer can be the trustee of the CRT. The IRS provides sample copies of pre-approved annuity trust instruments.[141] Likewise, the IRS has provided sample copies of pre-approved unitrust instruments.[142]

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140. *An Overview of Buy-Sell Arrangements.* Jun. 2020. NFP. [www.nfp.com/media/00bjwgsr/an-overview-of-buy-sell-arrangements.pdf] Accessed on Jul. 30, 2024.

141. See Rev. Procs. 2003-53 through 2003-60, 2003-31 IRB 230.

142. See Rev. Procs. 2005-52 through 2005-59, 2005-34 IRB 326.

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Utilizing such a strategy eliminates the SE tax on all of the contributed grain (as compared to the farmer selling the grain to a buyer, such as an elevator). While the farmer would not receive any charitable deduction due to the lack of income tax basis in the contributed grain,[143] the farmer would receive an annuity for life or a term certain not to exceed 20 years. Based on the required structure of the CRT rules, it is likely that at least 10% in present value will pass to a designated charity at the end of the annuity term.[144]

Example 8. Jerry harvests his last crop in 2024. Jerry sells this crop in 2025 for $160,000 and only has $10,000 of deductions to report on his 2025 Schedule F. His SE tax on his reported $150,000 of Schedule F income ($160,000 crop proceeds – $10,000 deductions) is $21,194 ($150,000 Schedule F income × 15.3% SE tax rate × 92.35% percentage of earnings subject to SE tax). If Jerry instead contributes his last crop to a CRT that subsequently sells the crop, Jerry does not owe SE tax, saving him $21,194. This is 13.25% of the crop value ($21,194 SE tax ÷ $160,000 crop proceeds).

A risk with a CRT is the untimely death of the farmer. A strategy to reduce that risk is to buy a life insurance policy to replace the assets in the CRT distributed to the charity and lost to the heir. Likewise, a spouse may be added as a successor income beneficiary to assure that the income stream remains within the family for a longer period of time (as long as the charitable remainder value remains at least 10%).[145] Alternatively, the risk of a premature death could, perhaps, be minimized by setting for the CRT a term certain of 20 years or less so the donor is more likely to outlive the term.

As the farmer collects annuity payments from the CRT over the term prescribed during their lifetime, the income from the last harvest is spread over multiple years instead of one year when the grain would otherwise have been sold. Collecting income over time may allow lower federal tax rates to be applied to the income from the last harvest. Large income amounts in one year can increase Medicare premiums in a later year. Spreading income over multiple years may also increase taxable social security benefits (SSB) in multiple years. These are among the many overall implications to be considered in a comprehensive tax management plan.

The **benefit of a CRT** is that it eliminates SE tax on contributed grain or livestock by a self-employed farmer. It may reduce income tax liability by spreading the income over a timeframe of up to 20 years, and it provides money to a charity at the end of the term. For a farmer that is charitably minded, this could have added value. The **drawbacks** include additional fees for reporting and trust administration, an annuity that locks the farmer in and eliminates flexibility, the inability to self-deal with the CRT, and the possibility of an untimely death of the beneficiary(ies) resulting in lost funds to the heirs with larger amounts passing to the charity. For some, the likelihood that 10% of the amount contributed to the CRT (in present value terms) will pass to a charity is not desirable.

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143. Ltr. Rul. 9413020 (Dec. 22, 1993).

144. Most farmers chose the term-certain annuity period to avoid the possibility of an untimely death causing the annuity payments to continue to the decedent's heirs.

145. IRC §664(d)(1)(D).

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Cash Balance Plans Strategy

A **cash balance plan** is a qualified retirement plan that allows eligible employees to receive tax-deferred retirement benefits exceeding those of an IRC §401(k) and other retirement plans.[146] In other words, a cash balance plan is a defined benefit retirement plan with an option of a lifetime annuity. The plan specifies the benefit to be received upon retirement in terms of a hypothetical account balance that is based on a formula considering the employee's salary and years of service.[147] The account grows tax-deferred with investment earnings and provides a guaranteed benefit upon retirement payable in a lump sum, regardless of investment performance. The account balance is also portable — the employee (which includes a self-employed farmer) takes it with them if they leave the job. As compared to a traditional defined benefit plan, a cash balance plan provides the employer with more predictable and manageable retirement benefit costs. Large annual tax deductions may be allowed to achieve the plan's objectives; this is a key reason cash balance plans may be attractive to farmers anticipating retirement in a few years.

Note. A traditional defined benefit plan can be converted to a cash balance plan.[148]

With a cash balance plan, the benefit calculation is simpler than for a typical defined contribution benefit plan (traditional pension plan) and, as a result, the administration costs are lower. A cash balance plan is similar to a defined benefit plan in that it provides for employer lump sum funding, subjects the employer to investment risks, and is subject to the same rules as defined benefit plans.[149]

Note. A cash balance plan also requires an actuary to calculate the benefits and funding based on employee demographics and years of service, and is sometimes insured by the Pension Benefit Guarantee Corporation.[150]

However, a cash balance plan differs from a defined benefit plan in that traditional defined benefit plans utilize benefits equal to a set percentage of future earnings that may be 30 or more years in the future. Conversely, a cash balance plan is simply a percentage of current earnings, plus a guaranteed interest rate on account balances.[151]

146. A cash balance plan satisfies IRC §401(a)(4) if it provides benefit accruals that are nondiscriminatory under the general test for defined benefit plans, or it is nondiscriminatory with respect to an equivalent amount of contributions under the cross-testing rules, or if it meets a special safe harbor for cash balance plans. See Treas. Reg. §1.401(a)(4)-8(c)(3)(i).

147. It is a "hypothetical" account balance because the participant really does not have a separate account. The account balance is merely a bookkeeping entry. The participant's hypothetical account balance is based on hypothetical pay credits (determined as a percentage of salary or compensation) and hypothetical interest credits not exceeding a market rate of return.

148. *Frequently Asked Questions on the Cash Balance Pension Plans Compliance.* U.S. Department of Labor. [www.dol.gov/sites/dolgov/files/EBSA/about-ebsa/our-activities/resource-center/faqs/cash-balance-pension-plans-for-employers.pdf] Accessed on Jul. 29, 2024.

149. IRC §411.

150. *Frequently Asked Questions on the Cash Balance Pension Plans Compliance.* U.S. Department of Labor. [www.dol.gov/sites/dolgov/files/EBSA/about-ebsa/our-activities/resource-center/faqs/cash-balance-pension-plans-for-employers.pdf] Accessed on Jul. 29, 2024.

151. Ibid.

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With a cash balance plan, the employer (which includes a self-employed farmer) credits the participant's account with a set percentage of the participant's annual earnings, plus a credit for interest earned on the participant's cash balance. The employer is responsible for funding limits and requirements, as well as investment risk. Changes in portfolio values do not increase or reduce payment owed to participants at retirement. A cash balance plan is maintained on an individual account basis similar to a defined contribution plan. Contribution amounts increase with the age of the participant. There is no contribution limit because the employer funds the plan to satisfy a specific account balance at the employee's planned retirement date. The maximum amount that can be contributed to a cash balance plan depends on age, earned income from wages, and Schedule F and prior earnings. This is the key provision allowing large annual tax deductions to the employer (also a self-employed farmer).[152]

Note. Cash balance plans also have specific regulatory requirements and limitations that apply for purposes of ensuring the plan's tax-qualified status.

Thus, because of the need to achieve the specific account balance at retirement date, an older employee can contribute more than a younger employee. For persons over age 60, contributions may exceed $300,000 annually. A sole proprietor farmer with a spouse can hire the spouse and include the spouse in the cash balance plan. Contributions to a cash balance plan are deductible. Thus, contributed amounts reduce federal income tax. But, while contributions reduce a sole proprietor's taxable income, they do not reduce SE tax.[153]

Example 9. Jed and Jethro are two brothers who each own 50% of a C corporation engaged in farming. Jed is age 75, Jethro is age 73, and each has been paid $55,000 average wages from the corporation over the past 10 years. There is no other retirement plan currently in place.

A third-party actuarial analysis indicated a deductible contribution of up to $183,000 for each Jed and Jethro into their cash balance plans. If utilized to the maximum level, the corporation could deduct $366,000 each year. This deduction would offset sales of grain and machinery in a retirement transition plan. The amounts in the cash balance plan are taxable to Jed and Jethro when they make withdrawals from the cash balance plan.

The corporation reported the following.

Corporation gross revenue from grain sales	$900,000
Corporation tax deductions before retirement plan contributions	150,000
Corporation taxable income	750,000
Federal income tax liability ($750,000 × 21% tax rate)	157,500

Adding a deductible cash balance plan retirement contribution of $366,000 lowers taxable income to $384,000 ($750,000 original taxable income – $366,000 contribution) and reduces federal income tax liability to $80,640 ($384,000 taxable income × 21% tax rate), a reduction of $76,860 ($157,500 original tax liability – $80,640 revised tax liability with contribution).

Note. Many financial/retirement planners recommend that a cash balance plan be financed for at least three years. Thus, for those that are looking to retire from farming immediately, it might be difficult to spread taxable gain over three years.

152. Ibid.

153. In this respect, the contributions function like a net operating loss or any other type of adjustment to income.

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Farmers often defer the income from the sale of crops into the following year and, as a result, maintain an inventory of grain from year-to-year as a tax management strategy to minimize the marginal tax rate. This strategy may allow a farmer to open a cash balance plan and fund it for several years before retirement by a gradual liquidation of grain or livestock inventory. The funding of the plan will be tax-deferred until amounts are withdrawn in later years. Funding may be as a level percentage of pay, a fixed dollar amount, or a hybrid of the two approaches. The approach taken will depend on the farmer's financial goals and cash flow needs.

Example 10. Jesse is 65 years old and wants to retire from active farming. He presently has two years' worth of grain inventory worth $1 million. Jesse also owns 1,000 acres of land that will net him over $250,000 in annual rental income. If he retires and sells the grain in one tax year, the sale will trigger ordinary income and be subject to SE tax. If Jesse lives in a state with a high state income tax, his combined federal and state income tax and SE tax could reach 50%.

For cash flow in retirement, Jesse determines that he does not need income from the sale of the crop because he has $250,000 in annual land rent. He also determines that having the land rent allows him to spread out the grain sales for three years and make deductible contributions into a cash balance plan with those proceeds. The grain sales will trigger SE tax, but the ordinary income that is also recognized will be offset by a deduction for the cash balance plan contribution.

Note. The grain sale income now invested inside the cash balance plan grows tax-free until Jesse takes a distribution. If Jesse does not withdraw any funds from the cash balance plan, the amount in the plan will continue to grow.

A cash balance plan can be combined with a §401(k) plan. A cash balance plan has both minimum and maximum annual limits. For 2024, the lifetime contribution limit per employee is $3.5 million. There is also a limit on compensation as part of the calculation. For 2024, the maximum employee compensation is $345,000.[154] Sole participant plans will max out at $275,000. A primary benefit of a cash balance plan for a farmer nearing retirement is the concept of **age-weighting.** A younger farmer will generally have more years to achieve their desired retirement income goal than will an older farmer. A cash balance plan allows greater contributions as the contributor gets older. Thus, annual contributions will increase with age and higher compensation.[155]

If a farming operation has employees, they may have to be included in the cash balance plan funding. This could result in a higher cost of contributions than anticipated.[156]

Example 11. John and Jeremiah are employees of Mount Hermon Farm where they each make $40,000 annually. John is 36 and Jeremiah is 56 and they each plan to retire at age 62. Mount Hermon Farm would have to make larger contributions for Jeremiah than it would for John for each of them to reach the same retirement income goal at age 62.

Contributions to a cash balance plan must be made for all **eligible** employees (which includes a self-employed farmer).[157] For most farm operations, this would only apply to full-time employees or permanent part-time employees. However, in many situations, the amount required to be contributed is much lower than the amount the farmer can contribute for their benefit. Indeed, it could be the case that a farm operation will need to fund about 5-10% of other employees' annual compensation unless most of these other employees are over age 50. In that situation, the percentage may be significantly higher.

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154. IRS Notice 2023-75, 2023-47 IRB 1256.

155. Treas. Reg. §§1.401(a)(4)-1(b)(2)(iii) and 401(a)(4)-8(c)(3)(i).

156. IRC §401(a)(5).

157. Ibid.

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Example 12. Sharon is a farmer, age 56, and has a grain inventory of $2 million. She is in her final year of farming and if she were to sell the grain, the sale would be subjected to income tax and SE tax during that final year. Felix, age 27, is Sharon's employee. Felix has a wage of $47,000 annually.

If Sharon uses a cash balance plan to defer the tax on the $2 million, she could fully fund the cash balance plan over six years with annual contributions of approximately $285,000. About $10,000 is required for Felix, with the remainder being credited to her account. When Sharon turns age 62, she will have about $1.8–2.0 million in the plan and none of it is subject to a required minimum distribution (RMD) until she turns 75.[158] However, Sharon will be subject to SE tax on the six years of grain sales to fund the full cash balance plan contributions — approximately $230,000 of SE tax over the six years.

Caution. Sharon should consider the risks associated with holding her grain for six years before selling.

Comparison of the Strategies

Both strategies (CRT and cash balance plan) have their own benefits and detriments as summarized in the following table.

	CRT	Cash Balance Plan
Advantages	• Eliminates SE tax on contributed grain or livestock. • Reduces income tax rates by spreading income over the term of the annuity (potentially up to 20 years). • Provides funds to a charity at the end of the term.	• A farmer aged 55 or older can make large contributions to reduce taxable income. • Most farmers are allowed to fully offset ordinary income or wages with contributions. • Defers income tax to age 73/75.
Disadvantages	• 10% of the funds in present value will likely pass to a charity. • The costs of administration and reporting. • The farmer is locked into the annuity with no flexibility. • No self-dealing is permitted. • An untimely death of the beneficiary(ies) can result in lost funds to heirs and remaining funds to charity. • Involves the element of a loss of control.	• The taxpayer is subject to full SE tax on earned income.[159] • Higher administrative costs for an actuary and Form 5500, *Annual Return/Report of Employee Benefit Plan,* filing requirements. • Must contribute for full-time and permanent part-time employees. • The plan must be maintained for five to ten years. • Creates larger RMDs beginning at age 73/75.[160]

158. Per *SECURE 2.0 Act of 2022,* PL 117-328, §107, the RMD for those born in 1960 or later is age 75. Sharon is age 56 in 2024, making her born in 1968 with an RMD of 75.

159. It is uncertain whether commodity wages qualify for cash balance funding. Also, it is likely that the SE cost will be close to the amount the passes to charity with a CRT.

160. The taxpayer could possibly be in the highest tax bracket at that time, or the larger RMDs may result in large Medicare income-related monthly adjustment amount (IRMAA) adjustments.

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Practitioner Planning Tip

There is no one-size-fits-all strategy, and practitioners should analyze their clients' particular situation to help them select the best strategy.

INSTALLMENT SALES

Note. For more information on installment sales, see the 2024 *University of Illinois Federal Tax Workbook,* Chapter 6: Installment Sales.

A common method for transferring a business interest to someone (such as a parent to a child in the case of a closely held business interest) is via a sale of that interest.[161] As opposed to an outright sale of the interest, a parent could structure the sale of the business interest as an **installment sale** — defined as the sale of an asset with at least one payment received after the tax year of sale.[162] Income tax and estate planning considerations are often the reasons for transferring interests in a business over time on an installment basis. For instance, an installment sale causes capital gains to be recognized when payments are made over the installment period which might keep the seller in lower tax brackets than would an outright sale. Additionally, it could minimize the potential for spikes in taxable income which, in turn, could reduce exposure to additional taxes, such as the NIIT.[163] The senior generation of a family business, for instance, may desire to transition out of ownership control, but would like the cash flow of funds from the sale of their business interests to be received over time rather than in a lump-sum. In addition, an installment sale can be used in an estate plan to "freeze" the value of an estate (typically that of a parent),[164] and simultaneously shift future appreciation in asset value caused by inflation or improvements to the next generation successor-operator.

Note. As an option, the sale of the business interest could be to an **irrevocable grantor trust** where the seller (typically a parent) is treated as the owner of the trust for income tax purposes — known as an **intentionally defective grantor trust (IDGT).** In general, the funding of the trust must be done via a seed gift of at least 10% of the FMV of the property sold to the trust. The seller receives a note in exchange with a face amount equal to the value of the assets with a minimum amount of interest charged and with the note secured by the property. The sale to the trust does not trigger capital gain tax and if the note is for adequate consideration, gift tax is not triggered. The value of the business interest sold to the trust is "frozen" in the form of the note. The cash flow from the interest (and, perhaps, appreciation in the interest's value) is structured to cover the loan with the balance passing to the trust beneficiaries.

For more information about IDGTs, see the 2016 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 5: Wealth Accumulation and Preservation. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

161. A sale, while effective for transferring a business interest to the next generation as part of an estate/transition plan, generates capital gain when the sale of a capital asset is involved.

162. IRC §453(b).

163. IRC §1411.

164. The "freeze" occurs by exchanging the interest for cash or a promissory note that cannot appreciate in value.

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Structured as an installment sale with an appropriate rate of interest, the transaction does not constitute a gift, and can provide a stream of income for the parents (as the sellers). In addition, if the value of the assets subject to the installment sale drop in value, the transaction can be renegotiated and the purchase price decreased while still maintaining installment sale tax treatment.

A part of each principal payment is treated as interest rather than sales price if interest of less than the prescribed "test rate" is specified.[165] Where the amount of seller financing in a transaction is $7,098,600 or less for 2024,[166] the test rate is the **lesser** of 9% or 100% of the applicable federal rate (AFR). When the amount of seller financing is more than $7,098,600 for 2024, the test rate is 100% of the AFR.[167] The threshold amount is indexed for inflation and the AFR is determined on a monthly basis.

> **Note.** The AFR is based on the average yield on federal debt obligations of similar maturity. The short-term rate is for obligations with a term not more than three years, the mid-term rate is for obligations with a term over three years but not more than nine years and the long-term rate is for a term of more than nine years. The federal rate used is the lowest of the rates in effect as of the first day on which there is a binding contract in writing for the sale or exchange, the rate for the preceding month or the rate for the second preceding month. The IRS issues monthly tables. For August 2024, for example, the long-term AFR is 4.52%.[168]

In general, both parties are required to account for the interest in seller-financed transactions under the accrual method of accounting. However, if the amount of seller financing is $5,070,500 or less for 2024,[169] both parties may elect to account for interest under the cash method of accounting.[170]

Installment Reporting of Gain

In general, gain or loss must be recognized at the time of sale. However, under the installment method, a seller can defer tax and recognize gain for any particular tax year in proportion to the amount of installments received.[171] This allows the seller to spread the income tax liability over the entire term. Installment contracts are also beneficial because the periodic payments can be available to the seller for retirement income, a security interest may be retained in the property, and the buyer has control and beneficial enjoyment of the property.

> **Caution.** If the seller outlives the term of the contract, cash flow problems could result if the payments are used for living expenses. Thus, the term of the contract (and associated note) should not exceed the seller's life expectancy. A backup plan should be in place to protect against the possibility of a premature death.

165. IRC §483.

166. Rev. Proc. 2023-34, 2023-48 IRB 1287.

167. The 9% test rate is not available for new property that would have been eligible for the investment tax credit, and any seller financing provided in connection with a sale-lease-back transaction must use a test rate of 110% of the AFR.

168. Rev. Rul. 2024-15, 2024-32 IRB 340.

169. Rev. Proc. 2023-34, 2023-48 IRB 1287.

170. IRC §1274A(b); The figure is indexed for inflation, and the election to report interest on the cash method of accounting is unavailable to dealers or those on the accrual method of accounting.

171. IRC §453.

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Installment reporting of gain is automatic for eligible property.[172] An election not to have installment reporting apply is made by reporting the income from the sale on or before the due date (including extensions of time) for filing the income tax return for the year in which the sale occurs.[173] Once an election is made, it can only be revoked with the consent of the IRS. In addition, installment reporting only applies to gain, and not to loss, upon sale of real property.

Note. Not all sales of property are eligible for installment sale treatment. One common property not eligible is the sale of farm equipment that includes the recapture of depreciation.[174]

When real property is sold on an installment basis, part of each payment received represents gain and part represents a nontaxable return of the taxpayer's basis in the property. The amount of principal reported as income for any year is determined by the **gross profit percentage,** which is based upon the gross profit on the entire transaction, the basis of the property, and the total contract price.[175] **Gross profit** is the selling price less the adjusted tax basis.[176] The selling price is computed without a reduction for any existing mortgage and/or selling expenses. The **total contract price** is the amount to be paid by the buyer and does not include a mortgage except to the extent the mortgage exceeds the income tax basis.[177] The remaining amount of each principal payment is a **nontaxable return of basis.** Interest received is taxable as ordinary income and may be subject to the NIIT even if business property is being sold.

The reporting of gain from an installment sale of real property involves a 4-step process, as follows.[178]

Step 1. Calculate gross profit (selling price – seller's adjusted basis in the property). In making this computation, expenses of sale are added to the basis of the property.

Step 2. Calculate total contract price (amount the buyer pays – indebtedness). The indebtedness must be **qualifying indebtedness** that is functionally related to the property. Debt incident to the sale, such as legal fees, does not qualify.

Step 3. Calculate gross profit percentage (gross profit ÷ total contract price).

Step 4. Calculate amount of gain to be reported for the year (each payment received × gross profit percentage).

Example 13. Wilbur Jones is retiring from farming, and has no heirs interested in continuing the operation. As a result, Wilbur decides to sell his farm to Tom Tiller in 2024 for $1,325,000. Wilbur sells the farm on an installment basis and agrees to take annual payments beginning in 2024 of $66,250 for 20 years with no down payment. Wilbur's basis in the farm is $360,000, and he owns the farm debt-free. The expenses of the sale are $26,500.

The computational process for reporting gain is as follows.

Step 1. Calculate gross profit.

Selling price	$1,325,000
Less: basis	(360,000)
Less: expenses of sale	(26,500)
Gross profit	$ 938,500

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172. IRC §453(d)(1).

173. IRC §453(d)(2).

174. IRC §453(1)(2)(A); See also *Thom v. U.S.,* 283 F.3d 939 (8th Cir. 2002).

175. Interest (actual or imputed) is taxed as ordinary income.

176. Treas. Reg. §1.453-1(b)(2)(v).

177. Treas. Reg. §1.453-1(b)(2)(iii).

178. IRS Pub. 537, *Installment Sales*.

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Step 2. Calculate total contract price.

Selling price	$1,325,000
Less: qualifying indebtedness	(0)
Total contract price	$1,325,000

Step 3. Calculate gross profit percentage.

$$\textbf{Gross profit percentage} = \frac{\textbf{Gross profit}}{\textbf{Total contract price}} = \frac{\$938,500}{\$1,325,000} = \textbf{70.83\%}$$

Step 4. Calculate amount of each payment received reportable as gain.

Amount received in 2024	$66,250	$66,250
Gross profit percentage	× 70.83%	
	$46,925	(46,925)
Amount representing nontaxable return of basis		$19,325

Depreciation[179]

The buyer may claim depreciation on qualifying property from the date of possession. Recaptured depreciation previously claimed by the seller is fully treated as taxable income to the seller in the year of sale. Depreciation recapture is involved when gain is realized on the disposition of depreciable property. The recapture of depreciation is instantaneous with no eligibility for deferral of income by installment sale. However, taxpayers can defer recognition of gain arising from unrecaptured IRC §1250 gain.[180]

Example 14. Hammond Beans acquired a tract of farmland and associated buildings on an installment basis in 2012. The purchase price was $1 million. Hammond sells the tract in 2024 for $1 million. During Hammond's period of ownership, Hammond took $400,000 of depreciation on the buildings subject to §1250 recapture ($100,000 in excess of what straight-line depreciation would have been).

Thus, upon the sale of the land and buildings in 2024, and even though the sale price did not exceed the purchase price, Hammond recognizes $400,000 of gain. Of that amount, $100,000 is reportable as depreciation recapture and $300,000 is unrecaptured §1250 gain, subject to a maximum tax rate of 25%. The unrecaptured §1250 gain is eligible for installment sale treatment. **The $100,000 of depreciation recapture is reported in the year of sale even if Hammond receives nothing under the contract in the year of sale.**

Example 15. Josh is retiring from farming and sells his machinery in 2024 to Jacob, his nephew, for $850,000. Jacob will make annual payments of $85,000 plus interest to be paid over 10 years beginning in 2025. Josh paid $1.2 million for the equipment and has fully depreciated that amount, leaving an adjusted tax basis of $0. **Due to the depreciation recapture rules, Josh must recognize the full $850,000 as taxable income in 2024 and only interest will be taxable in future years.**

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179. Ibid.

180. IRC §453(i)(1)(B).

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Practitioner Planning Tip

Because depreciation recapture is ineligible in an installment sale, taxpayers may not have cash available for year of sale taxes. Practitioners with clients nearing retirement who are planning on selling equipment and machinery need to have planning discussions before clients finalize transactions.

Payments in the year of sale include a down payment or other payment in a prior year. The **year of sale** is generally the year in which the benefits and burdens of ownership pass from seller to buyer. Usually this involves the transfer of possession unless title passes before any other transfer of benefit, in which case the year of title passage is the year of sale. If the seller's indebtedness taken over by the buyer exceeds the income tax basis of the property, the excess is considered a payment in the year of sale.[181]

Possible Gift Tax Treatment

When farmland is sold under an installment contract, it is often done to aid the farmer-buyer as an alternative to more traditional debt financing. Accordingly, the sale might be for less than FMV — known as a **bargain sale.[182]** In such a situation, the IRS could argue that the excess of FMV over the amount paid constitutes a gift. Also, if the buyer experiences financial trouble and cannot make the payments on the installment obligation and the seller forgives some of the principal on the contract, tax issues result. The same is true if the principal is forgiven as a means to pass wealth to the buyer as a family member and next generation farmer.

Given that the 2024 level of the present interest annual exclusion for gift tax purposes is $18,000,[183] an installment sale transaction could be established whereby farm assets could be conveyed to a child, for example, for an $18,000 principal amount interest-bearing note, payable semi-annually. This provides an income stream to the parents and does not trigger any gift tax.[184] But, if the parents desire to make a gift to the child, the payments could be forgiven as they become due. In that situation, it might be possible to discount the gift (for lack of control and lack of marketability, etc.) below the face value of the installment obligation. Also, if a gift is made within three years of death, any gift tax that the decedent (or the estate) pays on the gift is pulled back into the estate.[185] In addition, in an estate, an installment obligation is income in respect of a decedent (IRD).[186] It is not an item of property. That means that there is no basis step-up in accordance with IRC §1014 in the hands of the recipient of the obligation.[187]

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181. IRS Pub. 537, *Installment Sales*.

182. To deflect an IRS challenge, it is possible to use a "formula clause" that expresses the amount of the property being sold as a formula. See, e.g., *Wandry v. Comm'r*, TC Memo 2012-88 (Mar. 26, 2012), *nonacq.* AOD 2012-46 (Nov. 13, 2012).

183. Rev. Proc. 2023-24, 2023-48 IRB 1287; IRC §2503(a)(1), as adjusted for inflation.

184. This is because installment sales are not within the scope of IRC §2701.

185. IRC §2035.

186. IRC §691(a)(2).

187. IRC §691(a)(4).

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In *Deal v. Comm'r,*[188] a mother bought a tract of land at auction and transferred it in trust to her three sons-in-law for the benefit of her daughters. Simultaneously, the daughters executed non-interest-bearing demand notes payable to their mother. The notes were purportedly payment for remainder interests in the land. The mother canceled the notes in portions over the next four years. For the tax year in question, the mother filed a federal gift tax return, but did not report the value of the canceled notes on the basis that the notes the daughters gave made the transaction a purchase rather than a gift. The IRS disagreed, and the Tax Court agreed with the IRS. The Tax Court determined that the notes that the daughters executed were not really intended to be enforced and were not consideration for their mother's transfers. Instead, the transaction constituted a plan with donative intent to forgive payments. That meant that the transfers were gifts to the daughters. Even though the amount of the gifts was under the present interest annual exclusion amount each year, they were gifts of **future interests** such that the exclusion did not apply and the full value of the gifts was taxable.

In *Haygood v. Comm'r,*[189] the Tax Court upheld an arrangement where the parents transferred property to their children and took back vendor's lien (conceptually the same as a contractor's lien) notes which they then forgave as the notes became due. Each note was secured by a deed of trust or mortgage on the properties transferred. The Tax Court believed such facts contributed to the transaction appearing as a sale, with the periodic forgiveness of the payments under the obligation then constituting gifts.

> **Observation.** In *Deal*, the Tax Court noted that the property was transferred to a trust and **on the same day** the daughters (instead of the trust) gave notes to the mother. In addition, the notes did not bear interest and were unsecured. In *Haygood*, by contrast, the notes were secured, and the amount of the gift at the time of the initial transfer was reduced by the face value of the notes.

The Tax Court ruled likewise in *Estate of Kelley v. Comm'r.*[190] The case involved the transfer of a remainder interest in property and the notes received (non-interest-bearing vendor's lien notes) were secured by valid vendor's liens and constituted valuable consideration in return for the transfer of the property. The value of the transferred interests was reported as taxable gifts to the extent the value exceeded the face amount of the notes. The notes were forgiven as they became due. The IRS claimed that the notes lacked economic substance and were just a "façade for the principal purposes of tax avoidance."

The Tax Court disagreed with the IRS position. The Tax Court noted that the vendor's liens continued in effect as long as the balance was due on the notes. In addition, before forgiveness, the transferors could have demanded payment and could have foreclosed if there was a default. Also, the notes were subject to sale or assignment of any unpaid balance and the assignee could have enforced the liens. As a result, the transaction was upheld as a sale.

In Rev. Rul. 77-299,[191] the IRS said that an installment sale of land to grandchildren where the annual payments were forgiven constituted a gift of the full amount of the land in the year the parties entered into the transaction. The IRS came to this conclusion because the grandparent had been gifting property to his grandchildren in prior years and because the grandchildren did not have any other source of income. The courts, however, do not tend to agree with the IRS's position, particularly if the notes involved are legally enforceable, subject to sale to third parties or are assignable, and the property involved is subject to foreclosure if the buyer defaults.[192]

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188. *Deal v. Comm'r*, 29 TC 730 (1958).
189. *Haygood v. Comm'r,* 42 TC 936 (1964).
190. *Estate of Kelley,* 63 TC 321 (1974).
191. Rev. Rul. 77-299, 1977-2 CB 343.
192. See, e.g., *Estate of Kelley v. Comm'r,* 63 TC 321 (1974); *Haygood v. Comm'r*, 42 TC 936 (1964); *Hudspeth v. Comm'r,* 509 F.2d 1224 (9th Cir. 1975).

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The IRS reiterated its position taken in Rev. Rul. 77-299 in Field Service Advice (FSA) 1999-837.[193] In the FSA, two estates held farm real estate. The executors agreed to a partition and an IRC §1031 exchange of the land. After the exchange, the heirs made up the difference in value of the property they received by executing non-interest-bearing promissory notes payable to one of the estates. The executors sought a court order approving annual gifts of property to the heirs. They received that order which also provided that the notes represented valid, enforceable debt. The notes were not paid and gift tax returns were not filed. Tax returns did not report the annual cancelation of the notes. The IRS determined that a completed gift occurred at the time of the exchange and that each heir could claim a single present interest annual exclusion ($10,000 at the time). The IRS determined that the entire transaction was a prearranged plan to make a loan and have it forgiven — a sham transaction.[194]

Note. From a planning standpoint, the IRS's position makes it clear that loan transactions must be structured carefully in instances where the donor intends to forgive note payments. Written loan documents secured by notes where the borrower can and does make some payments may help minimize "sham" treatment.

It is also possible that a gift may occur on an installment sale of land if the interest rate is below a market rate of interest. The IRS, U.S. Tax Court, the Eighth and Tenth Circuit Courts of Appeals, and the U.S. District Court for the Northern District of New York agree that the use of an interest rate in an installment sale other than the market rate of interest results in a gift of the present value of the difference in interest rates (i.e., the market rate of interest and the interest actually charged).[195] For sales of land between family members, to the extent that the sales price does not exceed $500,000 during a calendar year, the minimum interest rate is the lower of 6% compounded semi-annually and the AFR.[196]

Observation. If an installment sale is an arm's length transaction where the parents are not legally obligated to forgive payments or make cash gifts to enable the buyer (child(ren)) to make the payments, the installment sale should be respected and would not trigger a gift in the year in which the transaction is entered. This is particularly the case if the value of the business interest involved is established with an appraisal, the parents actually receive payments in the early years of the installment sale, and an appropriate market rate of interest is utilized.

Sale-Leaseback

Parents who are not ready to retire from farming or ranching may consider a sale-leaseback transaction. Under this structure, the parents sell the property to their children and then lease it back. While this type of transaction results in the parents recognizing gain, that gain can at least be partially offset by a deduction for rent expense. In addition, the rental payment that the parents make to the children will help the children make the payments. A bona fide sale-leaseback transaction results in the children deducting interest on the installment obligation to the extent they use the rental payments they receive from their parents to repay the mortgage on the property purchased under the installment sale. However, no interest deduction is allowed for annual payments attributable to cash gifts. The sale-leaseback transaction works if ownership is completely transferred to the children, and the children have a non-contingent obligation to pay.[197]

193. Rev. Rul. 77-299, 1977-2 CB 343; FSA 1999-837 (Jun. 18, 1999).

194. See also Ltr. Rul. 200603002 (Oct. 24, 2005).

195. See, e.g., Ltr. Rul. 8804002, Sep. 3, 1987; *Frazee v. Comm'r*, 98 TC 554 (1992); *Krabbenhoft v. Comm'r*, 939 F.2d 529 (8th Cir. 1991), *cert. denied,* 502 U.S. 1072 (1992); *Schusterman v. Comm'r*, 63 F.3d 986 (10th Cir. 1995), *cert. denied,* 116 S. Ct. 1823 (1996); *Lundquist v. U.S.*, 99-1 U.S. Tax Cas. (CCH) ¶60,336 (N.D. N.Y. 1999). The 7th Circuit Court of Appeals disagrees, however. *Ballard v. Comm'r,* 854 F.2d 185 (7th Cir. 1988).

196. IRC §483(e). Under IRC §483(e)(2), spouses of children are not "members of the family."

197. See, e.g., *Hudspeth v. Comm'r,* 509 F.2d 1224 (9th Cir. 1975)*; Stiebling v. Comm'r,* TC Memo 1994-233 (May 26, 1994), *aff'd* without published opinion, 113 F.3d 1242 (9th Cir. 1997).

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C Corporation. For a sale-leaseback transaction involving a C corporation, it is imperative that the C corporation has sufficient earnings and profits. This means that distributions from the C corporation that a sole shareholder receives from a third party are not constructive dividends under IRC §316.[198]

IRC §1031 Exchange. Generally, an exchange of property for other property is treated as a sale. However, no gain or loss is recognized if property held for productive use in a trade or business or for investment is exchanged for property of a like-kind to be held either for productive use in a business or for investment.[199] The new property is treated as a continuation of the original property. Gain is recognized, however, to the extent of any **boot** (unlike property) received in the exchange.

There are four basic requirements to achieving tax-deferred treatment under §1031.[200]

1. There must be an **exchange** of property rather than a sale.
2. The property exchanged and the property received must be **like-kind** to the property relinquished.
3. The property exchanged and the property received must both be **held for productive use** in a trade or business or for investment.
4. The exchange of properties must be simultaneous, or the replacement property must be identified within 45 days of the exchange. Identified property must be received within 180 days of the identification or the due date of the transferor's return (including extensions), if earlier.[201]

If an exchange cannot be completed during the allotted timeframe, the funds held by a qualified intermediary (QI) are released to the seller, triggering taxation in the year of sale and defeating the purpose of the exchange.[202] However, language may be included in the sales contract directing the QI to send the funds to an assignment company which will then disperse the payments to the seller over a predetermined period of time through an **assignment trust.** This allows the seller to defer the income and associated taxes under the installment method by converting the transaction into one governed by the installment sale rules of IRC §453.

A sale-leaseback transaction may also be combined with a §1031 exchange. For example, in *Estate of Bartell v. Comm'r*,[203] the Tax Court upheld a non-safe-harbor reverse exchange that involved a sale-leaseback transaction. In the late 1990s, Bartell Drug Co. (Bartell) began utilizing §1031 exchanges in an attempt to relocate its stores as part of a change in its business model due to the growing obsolescence of its retail stores and a changing market structure. In August 2000, Bartell, an S corporation, arranged to buy another property (replacement property) to build a new drugstore. A QI facilitated the exchange.

An affiliate of the QI took title to the replacement property. The agreement specified that the affiliate was to lease the replacement property back to Bartell until Bartell acquired ownership upon completion of the exchange. Simultaneously, Bartell was in the process of finding a buyer for the property to be relinquished. Eventually a buyer was found, and the transaction was structured as a sale-leaseback with the buyer agreeing to cooperate if Bartell sold the property as part of a §1031 exchange.

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198. See, e.g., *Fabian v. Comm'r,* TC Memo 2022-94 (Sep. 13, 2022).

199. This rule does not cover stock in trade, or other property held primarily for sale, such as stocks or bonds.

200. IRC §1031(a)(1).

201. IRC §§1031(a)(3)(A)-(B)((ii). Generally, up to three properties can be exchanged. Treas. Reg. §1.1031(k)-1(c)(4)(i)(A). As an alternative, the taxpayer can identify any number of properties if their aggregate FMV (as of the end of the identification period) does not exceed 200% of the FMV of the relinquished property. Treas. Reg. §1.1031(k)-1(c)(4)(i)(B).

202. IRC §1031(a)(3)(B).

203. *Estate of Bartell v. Comm'r,* 147 TC 140 (2016).

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In late 2001, Bartell and the QI executed a §1031 exchange. The IRS denied §1031 treatment on the basis that Bartell owned the replacement property long before it had disposed of the relinquished property,[204] and that the QI did not have any of the benefits and burdens of ownership. The Tax Court held that a third-party facilitator (the QI) took title to the replacement property and did not need to assume the benefits and burdens of ownership in the replacement property under §1031. Thus, the transaction qualified for like-kind exchange treatment.[205]

Note. The transaction at issue in *Bartell* occurred before the issuance of Rev. Proc. 2000-37[206] which provides a safe harbor for placing replacement or relinquished property with a QI. Under the safe harbor, the QI cannot hold the property for more than 180 days to be considered the owner of the property, regardless of which party bears the burdens and benefits of ownership.

Related-Party Issues

For sales between closely related parties,[207] disposition of the property by the purchaser within two years of the original transaction may result in taxable gain to the original seller. The following exceptions may apply.

1. Transfers caused by involuntary conversion
2. Transfers after the death of the installment seller or purchaser
3. Sale or exchange of stock to the issuing corporation
4. Transfers where it is established to the satisfaction of the IRS that the disposition did not have, as one of its principal purposes, income tax avoidance[208]

Thus, if an exception does not apply, when a related party resells the property within two years of the original sale, gain is accelerated to the original seller.[209]

Note. A popular technique with some farm families is for a parent to transfer an installment contract to a child in exchange for annuity payments. This transaction is a taxable disposition because no provision in either §453 or §453B provides an exception from taxability.

Alternatively, a donor may recognize gain or loss on the gift of the installment contract. The donor's gain is equal to the amount that the FMV of the installment contract (at the time of the gift) exceeds the donor's basis.[210] The donee's tax basis in the contract is the FMV of the installment contract at the time of the gift.

For installment sales of depreciable property between related persons (limited to entities), the deferred payments are deemed received in the taxable year of sale.[211] Family members are **not** included in the definition of **related parties.** An exception is provided if income tax avoidance is not a principal purpose.

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204. The IRS based its position on *DeCleene v. Comm'r*, 115 TC 457 (2000).

205. The IRS has issued a nonacquiescence to the Tax Court's decision, AOD 201706 (Aug. 6, 2017). Thus, the IRS will continue to scrutinize arrangements that fall outside the safe harbor to determine whether the taxpayer has received the benefits and burdens of ownership before the transfer of legal title to the property.

206. Rev. Proc. 2000-37, 2000-2 CB 308.

207. For this purpose, "related party" is defined by the rules contained in IRC §267(b) per IRC §453(f)(1)(B).

208. IRC §§453(e)(6)–(7).

209. Disposition after the death of the seller or buyer to the original truncation is not treated as a second disposition per IRC §§453(g) and 1239(b). The same is likely true when there is a death of a joint tenant with respect to jointly owned property.

210. IRC §453B(a)(2).

211. IRC §§453(g) and 1239(b).

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When depreciable property is sold to a related party, ordinary income results.[212] In addition, the seller cannot use the installment method to report the income unless a principal purpose of the sale was something other than the avoidance of federal income tax.[213] A related party for this purpose is defined under IRC §1239(b).

Practitioner Planning Tip

Any installment sale contract should contain language that bars any disposition by the buyer within two years of the original sale unless the original seller consents. The same can be said with respect to pledging the property. In that instance, the original buyer should continue to bear any risk of loss associated with the property.

Principal Forgiveness

Cancelation of an installment obligation is treated as a taxable disposition of the obligation by the holder.[214] The amount of the gain is the difference between the FMV of the obligation and its basis, if the parties are not related.[215] Therefore, if the seller forgives or cancels the obligation to pay amounts due, the result is the same as a disposition of the obligation. If the parties are related, the gain is the difference between the face amount and the basis of the obligation.[216] FMV of the obligation is treated as not less than its face value. The IRS has ruled that cancelation of principal in a debt restructuring involving an installment sales contract does not result in income tax consequences to the seller.[217]

Other Dispositions

Sale, gift, or other disposition or satisfaction of an installment obligation results in recognition of gain.[218] In essence, almost anything the seller does triggers tax liability. A disposition or satisfaction of an installment obligation at other than face value results in recognized gain to the taxpayer, equalling the difference between the amount realized and the income tax basis of the obligation.[219] If the disposition takes the form of a "distribution, transmission, or disposition otherwise than by sale or exchange," the amount included in income is the difference between the FMV of the obligation and its income tax basis.[220] If related parties (in accordance with IRC §267(b)) are involved, the FMV of the obligation is considered to be not less than its full face value.[221]

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212. IRC §1239.

213. IRC §453(g)(2); See, e.g., Ltr. Rul. 9926045 (Apr. 2, 1999).

214. IRC §453B(f)(1).

215. IRC §453B(a)(2).

216. IRC §453B(f).

217. Ltr. Rul. 8739045 (Jun. 30, 1987).

218. IRC §453B(a). The privilege of income deferral by installment reporting is generally personal to the party electing the installment method and does not outlast the period during which the obligation is held.

219. IRC §453B(a)(1).

220. IRC §453B(a)(2).

221. IRC §453B(f)(2).

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There are two exceptions where transfer does not require gain recognition.[222]

1. **Disposition on account of death.** In the event the seller dies within the term of the contract, the tax is not immediately due, but the installment contract does not receive a new basis. Payments received after death are treated as IRD and the recipient reports the income in the same manner as if the decedent were still living. Disposition of an installment obligation to the obligor after death of the seller results in taxable gain for the deceased seller's estate to the extent of the obligor's ownership share. The impact of death on an installment sale is discussed next.

2. **Transfers by one spouse to another or a transfer between ex-spouses because of divorce.** In this case, the transferee is taxed on the installment obligation just as the transferor would have been taxed.[223]

Impact of Death

If the seller dies before the contract terminates, the value of the outstanding note will be included in the decedent's estate as of the date of death.[224] The cancelation of the remaining installments at death produces taxable gain.[225] In *Estate of Frane v. Comm'r*,[226] the Tax Court decided, based on §453B(f), that the installment obligations of the decedent's children were nullified where the decedent (transferor) died before two of the four could complete their payments. That meant that the deferred profit on the installment obligations had to be reflected on the **decedent's final tax return.** But, if cancelation is a result of a provision in the decedent's will, the canceled debt produces gain that is included in the **estate's gross income.[227]** In that instance, the obligor (the party under obligation to make payment) has no income to report.

If an installment obligation is transferred on account of death to someone **other than the obligor,** the transfer is not a disposition. Any unreported gain on the installment obligation is not treated as gross income to the decedent and no income is reported on the decedent's return due to the transfer. The party receiving the installment obligation as a result of the seller's death is taxed on the installment payments in the same manner as the seller would have been had the seller lived to receive the payments.

Upon the holder's death, the installment obligation is IRD.[228] This results in no basis adjustment at death. IRC §691(a)(4) states the following.

> *In the case of an installment obligation reportable by the decedent on the installment method under section 453, if such obligation is acquired by the decedent's estate from the decedent or by any person by reason of the death of the decedent or by bequest, devise, or inheritance from the decedent —*
>
> > *(A) an amount equal to the excess of the face amount of such obligation over the basis of the obligation in the hands of the decedent (determined under section 453B) shall… be considered as an item of gross income in respect of the decedent; and*
> >
> > *(B) such obligation shall… be considered a right to receive an item of gross income in respect of the decedent, but the amount includible in gross income… shall be reduced by an amount equal to the basis of the obligation in the hands of the decedent (determined under section 453B).*

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[222] IRS Pub. 537, *Installment Sales*.

[223] IRC §453B(g). One way to address this issue is for the seller to receive a self-canceling installment note (SCIN) in exchange for the asset(s) being sold. With a SCIN, the remaining note principal is canceled if the parent dies before the end of the note term. See, e.g., *Estate of Costanza v. Comm'r,* 320 F.3d 595 (6th Cir. 2003).

[224] Thus, the FMV of the note as of the date of the decedent's death (unpaid principal plus accrued interest) is potentially subject to federal (and, perhaps, state) estate tax.

[225] See, e.g., *Estate of Frane v. Comm'r*, 98 TC 341 (1992), *aff'd in part rev'd in part*, 998 F.2d 567 (8th Cir. 1993).

[226] Ibid.

[227] Ltr. Rul. 9108027 (Nov. 26, 1990).

[228] IRC §691.

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However, the disposition (sale) at death of the installment contract to the obligor is a taxable disposition.[229] Similarly, if the cancelation is triggered by the holder's death, the cancelation is treated as a transfer by the decedent's estate (or trust if the installment obligation is held by a trust).[230]

Modification of Contract Terms

If the holder of the obligation simply reduces the selling price but does not cancel the balance that the obligor owes, it is not a disposition.[231] Similarly, the modification of an installment obligation by changing the payment terms (such as reducing the purchase price and interest rate, and deferring or increasing the payment dates) is not a disposition of the installment obligation. The gross profit percentage must be recomputed and applied to subsequent payments. Also, where the original installment note was replaced, the substitution of a new promissory note without any other changes is not a disposition of the original note.[232]

> **Note.** There is also no disposition if the buyer under the installment obligation sells the property to a third party and the holder allows the third party to assume the original obligor's obligation. That is the case even if the third party pays a higher rate of interest than the original obligor.[233]

Unless agricultural property is involved, the tax consequences are also unfavorable if the seller takes the contract to a lender and pledges the contract on a new loan.[234] In that event, the entire amount of the loan proceeds is treated as a payment on the contract. This is a tremendous blow to a seller trying to dispose of an installment obligation.[235] Since December 17, 1987, pledging of installment obligations has resulted in the net proceeds of the secured indebtedness being treated as a payment received for installment obligations above $150,000, except for personal-use property and farm property.[236]

Structured Installment Sale

A **structured installment sale** is a variation of the standard installment sale technique. The concept involves the traditional installment sale with the buyer then assigning the buyer's obligation to an assignment company. The buyer transfers the discounted present value of the payment stream due under the installment sale agreement in a lump sum to the company in return for the company's assumption of the buyer's payment obligation. A life insurance company issues an annuity contract to the assignment company, which then becomes the source of the installment payments to the seller. The life insurance company then guarantees it will make all periodic payments due upon notice by the assignment company of the company being unable to make the required installment payments.[237]

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229. IRC §§691(a)(4)-(5).

230. IRC §691(a)(5)(A).

231. Ltr. Rul. 8739045 (Jun. 30, 1987).

232. See, e.g., Ltr. Ruls. 201144005 (Aug. 2, 2011) and 201248006 (Aug. 30, 2012).

233. Ibid.

234. CCA 20123401F (Jul. 18, 2012).

235. However, the result is different if the interest rates and maturity date differ, and the taxpayer does not part with a substantial portion of the ownership rights in the obligation.

236. IRC §453A(d).

237. *An Introduction to Structured Installment Sales.* Finn, Don. Dec. 2021. The CPA Journal. [cpajournal.com/2021/12/31/an-introduction-to-structured-installment-sales]. Accessed on Jul. 29, 2024.

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The transaction qualifies for installment reporting. In addition, the assignment does not accelerate income because it does not alter the original obligation.[238] Likewise, the buyer's transfer of the obligation to make periodic payments to the assignment company is not a disposition.[239] A disposition does not occur if the seller possesses substantially the same rights that the seller received in the original transaction.[240]

Observation. The perceived benefit of a structured installment sale is that the seller ends up as the beneficiary of an annuity that is backed by an insurance company.

IRC §721 Exchange[241]

Another mechanism for deferring capital gain tax that is conceptually similar to an installment sale is a §721 exchange. This transaction involves an exchange of real estate for interest in an operating partnership.

Note. While the concept has been widely used for commercial real estate, the concept also applies to farmland.

Under §721, property that is contributed to a partnership in exchange for an interest in the partnership does not trigger gain or loss.[242] The partnership maintains ownership of the farmland and distributes the income from the portfolio of investment properties that the partnership holds.[243] The partners retain the right to sell, gift, bequeath, or retain their interest. Tax is deferred until the farmland owner redeems or sells the interest, which can be planned to occur when the taxpayer is in a lower tax bracket.

An estate planning benefit of this technique is that the interest can be divided more easily than can fractional interest in real estate and, if necessary, be more easily liquidated upon the owner's death.

Caution. It is possible that the partnership would decide to liquidate some of its holdings, which could affect all partners. The partnership retains the right to return capital to the investor instead of reinvesting it in a new property. Such a return of capital is a taxable event and could occur in a year that is not tax efficient for the partners. In addition, such distributions are taxed as long-term capital gains.

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238. See, e.g., *Caldwell v. U. S.*, 114 F.2d 995 (3d Cir. 1940). The assignment is neither a disposition nor a deemed disposition under IRC §453(d). The buyer created the debt obligation, and the assignment company does not become directly contractually liable to the seller.

239. See, e.g., *Cunningham v. Comm'r*, 44 TC 103 (1965), *acq.* 1966-2 CB 4; *Wynne v. Comm'r*, 47 BTA 731 (1942), *nonacq.* 1943 CB 42; Rev. Rul. 75-457, 1975-2 CB 196; Rev. Rul. 82-122, 1982-1 CB 180.

240. GCM 36299 (Jun. 5, 1975). Thus, it is important that the payment terms of the underlying promissory note remain unchanged. On this point, see *Burrell Groves, Inc. v. Comm'r*, 223 F.2d 526 (5th Cir. 1955).

241. The concept is also known as an Umbrella Partnership Real Estate Investment Trust (UPREIT)

242. IRC §721(a).

243. The partnership provides commercial farm management of farms under its ownership. The shareholders are passive.

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From a legacy standpoint, it is possible to include in exchange documents controls on the sale of the farm, repurchase rights, and special usage rights.

> **Caution.** Eight states have anti-corporate farming laws that could impact the use of the §721 exchange technique involving farmland in those states. North Dakota and Oklahoma have statutory provisions that bar corporate investment in agricultural land.[244] The North Dakota provision requires an LLP, when registering with the state, to certify whether the entity plans to engage in farming or own farmland, and, if so, reveal the name and address of each partner in the LLP.[245] In Oklahoma, an LLP is barred from owning agricultural land.[246] The Missouri and Wisconsin provisions do not bar the ability of LLPs to hold farmland and do not explicitly restrict an LLC from indirectly owning farmland.[247] Thus, in these states, the operating partnership should be structured as an LLP whose partners are wholly owned LLCs. In Iowa, Kansas, Minnesota, and South Dakota, it may be possible to use a parallel LLP structure with only individuals as the partners.

Monetized Installment Sale

In Chief Counsel Advice (CCA) 202118016,[248] the IRS expressed its concern about **monetized installment sales** that, via an intermediary and an installment note, purport to defer gain recognition and income tax due on the sale of appreciated assets, despite the seller having effectively received substantially all of the cash proceeds. With a monetized installment sale, a promoter asserts that property can be sold with an installment agreement, with the seller then entering into an escrow agreement with funds being borrowed against a note and achieving gain deferral. The IRS noted that such transactions lack any genuine indebtedness, involve deemed payments that the seller does not report, and uses intermediaries that do not truly acquire the property in accordance with §453.

> **Note.** In the CCA, the IRS clearly stated that CCA 20123401F[249] did not support a monetized installment sale **unless the pledge involves the sale of agricultural property.**

The monetized installment sale technique has made the IRS "Dirty Dozen" tax scam list for 2021–2024, and the IRS has been pursuing promoters involved in such transactions.[250] In August 2023, the Treasury and IRS issued proposed regulations identifying monetized installment sale transactions and substantially similar transactions as listed transactions.[251]

> **Note.** For more information on monetized installment sales and the other scams that made the IRS's Dirty Dozen list, see the 2024 *University of Illinois Federal Tax Workbook,* Chapter 7: IRS Update.

> **Note.** Taxpayers use Form 8886, *Reportable Transaction Disclosure Statement*, to disclose information for each reportable transaction in which they participate. Material advisors must file Form 8918, *Material Advisor Disclosure Statement*, to disclose information about reportable transactions. Penalties apply to taxpayers and material advisors who fail to properly disclose their participation in reportable transactions.

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244. N.D. Cent. §§10-06.1-20, 24; Okla. St. tit. 18, §§952(F), 955(B).

245. See Office of the N.D. Sec. of State, *Limited Liability Partnership Registration,* at no. 11.

246. Okla. Stat. tit. 18 §955.

247. Mo. Rev. Stat. §§350.010, 350.15; Wis. Stat. Ann. §182.001.

248. CCA 202118016 (Oct. 31, 2019).

249. CCA 20123401F (Jul. 18, 2012).

250. See, e.g.*, Bishop v. U.S.*, No. 23-4020, 2023 U.S. App. LEXIS 31866 (10th Cir. Dec. 4, 2023), *cert. denied,* 144 S.Ct. 1460 (2024). The court upheld the denial of eight petitioners' motion to quash and ordered enforcement of IRS administrative summonses issued to financial institutions in a promoter investigation involving monetized installment sales.

251. 88 Fed. Reg. 51,756 (Aug. 4, 2023). The proposed regulations will apply as of the date of finalization.

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The Proposed Treasury Regulations[252] provide that a transaction is a monetized installment sale transaction if, in connection with the transaction, and regardless of the order of the steps or the presence of additional steps or parties, any of the following elements exist.

- A taxpayer (seller), or a person acting on the seller's behalf, identifies a potential buyer for appreciated property (gain property), who is willing to purchase the gain property for cash or other property (buyer cash).
- The seller enters into an agreement to sell the gain property to a person other than the buyer (intermediary), in exchange for an installment obligation.
- The seller purportedly transfers the gain property to the intermediary, although the intermediary either never takes title to the gain property or takes title only briefly before transferring it to the buyer.
- The intermediary purportedly transfers the gain property to the buyer in a sale of the gain property in exchange for the buyer cash.
- The seller obtains a loan, the terms of which are such that the amount of the intermediary's purported interest payments on the installment obligation correspond to the amount of the seller's purported interest payments on the loan during the period (with only interest due over identical periods, with balloon payments of all or a substantial portion of principal due at or near the end of the instruments' terms, on each installment obligation and loan).
- The sales proceeds from the buyer received by the intermediary (reduced by certain fees, including an amount set aside to fund purported interest payments on the purported installment obligation) are provided to the purported lender to fund the purported loan to the seller (or transferred to an escrow or investment account of which the purported lender is a beneficiary), and the lender agrees to repay these amounts to the intermediary over the course of the term of the installment obligation.
- On the seller's federal income tax return for the tax year of the purported installment sale, the seller treats the purported installment sale as an installment sale under §453.

The preamble to the Proposed Treasury Regulations states that the Treasury Department and IRS are aware that promoters are marketing transactions that purport to convert a cash sale of appreciated property into an installment sale to an intermediary (who may be the promoter), followed by a sale from the intermediary to the buyer. The promotional materials for these transactions assert that engaging in the transaction allows the seller to defer the gain under the installment method until the taxpayer receives the balloon principal payment in the year the installment obligation matures, even though the seller receives cash from the purported lender in an amount that approximates the amount paid by the buyer to the intermediary.

The IRS asserts that such transactions fail installment treatment based on the following.

- The intermediary is not a bona fide purchaser of the gain property that is the subject of the purported installment sale.
- The seller is appropriately treated as having already received the full payment at the time of the sale to the buyer because:
  - The purported installment obligation received by the seller is treated as the receipt of a payment by the seller under Treas. Reg. §15a.453-1(b)(3) because it is indirectly secured by the sales proceeds, or
  - The proceeds of the purported loan are appropriately treated as a payment to the seller because the purported loan is not a bona fide loan for federal income tax purposes, or
  - The pledging rule of §453A(d) deems the seller to receive full payment on the purported installment obligation in the year the seller receives the loan proceeds.
- The transaction may be disregarded or recharacterized under the economic substance rules codified under IRC §7701(o) or the substance over form doctrine. The step transaction doctrine and conduit theory may also apply to recharacterize monetized installment sale transactions.

[252.] Prop. Treas. Reg. §1.6011-13(a).

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One of the clear conditions of §453 is that the debt obligation be incurred by the buyer of the property. If someone other than the purchaser of the property is the obligor, the debt is treated as a payment on the sale.[253]

Example 16. Widget Collateral Company is a vendor of monetized installment sales. Its sales material purports that Widget is both the buyer and the obligor. However, in Widget's detailed summary of the transaction on its website, it states that the seller's deed is transferred directly to the actual buyer:

> *... there is only one transfer of title or ownership... the final buyer will receive the same instrument of transfer from the same party with the same representations and warranties, on the same day and for the same price as would have been the case if Widget had not been involved.*

At this point, the installment sale fails because Widget is the obligor. The actual buyer has paid cash which is held by Widget as agent for the seller. There is not an installment sale with a debt from the actual purchaser.

The buyer's funds cannot be escrowed for the benefit of the seller or to directly fund the installment obligation.[254]

Example 17. Use the same facts as **Example 16,** except that Widget's material represents that the installment note is not directly pledged or used to provide security. However, its website material states that:

> *... the lender does not require Widget to provide security because Widget agrees to invest the resale proceeds in accord with the lender's investment criteria.*

In addition, Widget's promotional material describes a 3-account escrow arrangement, in which an escrow company takes an automatic monthly payment from Widget, moves that money to an escrow account of the seller, and then automatically transfers the funds to the lender's "loan escrow" to pay the debt each month.

The result is that it is all pre-arranged with the funds automatically moving each month from Widget through a phantom account of the seller to then pay the lender. There are no economics in this for the seller, and the payments do not in any way provide income or loss to the seller, but are all pre-arranged to use the deposit of Widget from the land sale to fund the seller's bank debt in full. The transaction has no prospect of success with the IRS and is clearly within the scope of what the IRS is targeting in the proposed regulations.[255]

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253. Treas. Reg. §15a.453-1(b)(3)(i).

254. IRC §453A(d)-1; Treas. Reg. §15a.453-1(b)(3)(i); Rev. Ruls. 79-91, 79-1 CB 179; 77-294, 1977-2 CB 173; and 73-451, 1973-2 CB 158; Ltr. Rul. 200521007 (May 27, 2005).

255. Some monetized installment sale promoters point to CCA 20123401F (Jul. 18, 2012). However, the CCA involved a direct sale from a seller to a third party whose debt obligation was direct, and the subsequent pledging of the debt was only for a portion and to a third party with no connection to the buyer or the buyer's escrowed funds. As the IRS stated, each step had independent economic significance and was done for business reasons. An improper monetized arrangement has as its substance a cash sale, with the promoter inserting itself between buyer and seller, and using a loan arrangement with the promoter's escrowed funds used to cash out the seller.

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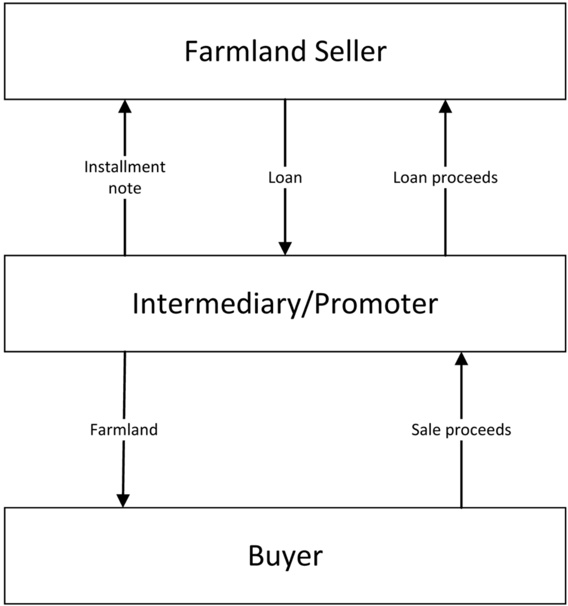
As noted, the pledge in a monetized installment sale can involve agricultural property.[256] Such a transaction can be diagrammed as follows.

Flow of Funds – Monetized Installment Sale of Farmland Transactions



Example 18. Nicholas sells $2 million worth of farmland on an installment basis to his son over 15 years with a note that will be amortized over the 15-year period. The note provides for 5% interest. Usurious State Bank loans Nicholas 95% of the face value of the note with an interest rate of 5% or higher. Scrooge Escrow Co. handles the collection of the proceeds from the sale and the offsetting loan payment to Usurious State Bank.

Nicholas receives 95% of his cash up front but will be able to spread the capital gain tax liability over 15 years.

Caution. If Nicholas spends the cash and has a large balloon payment, he may lack the funds to cover the taxes in later years. Also, if Nicholas were to die before the end of the 15-year term, his heirs would owe tax on the inherited note. If this occurs, the heirs will need cash available to pay the tax because cash is required to pay Usurious State Bank. The heirs will not receive a step up in basis.

Summary

The following table summarizes the pros and cons of installment sales for retiring farmers.

Pros	Cons
Defer recognition of income	No step up in basis
Cash flow to seller	Depreciation recapture not eligible
Can elect out of deferral	May cause taxable SSB in more years
May avoid NIIT	May not be best financing option for buyer
May avoid Medicare B surtax	
Allows renegotiation if prices fall	

256. CCA 20123401F (Jul. 18, 2012).

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SPLIT-INTEREST LAND ACQUISITIONS

A **split-interest purchase arrangement** involves the purchase of an asset by two parties. One party acquires an income interest in the asset for life and the other party acquires a remainder interest. Each party pays their respective proportionate share of the cost based on IRS actuarial tables for life estate and remainder interests based on their ages. Historically, the technique has been utilized to remove after-tax income from a family corporation, as well as brokering the cost of a farmland purchase to be covered by the corporation without trapping the asset inside the corporation.[257] The split-interest technique can, perhaps, be used as a mechanism to get farmland in the hands of a subsequent generation of the family.

> **Note.** For more information and additional background on the split-interest technique, see the 2016 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 7: Agricultural Issues and Rural Investments, pp. 325–331. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

The first step in the computations is to identify, for the month of the transaction, the rate that is 120% of the AFR for the midterm category and round to the nearest two-tenths of 1%. For July 2024, the 120% AFR midterm rate is 5.40%. This is rounded to 5.40% for the IRC §7520 rate.[258]

Example 19. Abe and his nephew Lot agree to acquire farmland they believe will appreciate in value. The land is presently valued at $200,000. If Abe is 55 years old, assuming a §7520 rate of 5.2%, his life income interest from IRS Table S[259] (shown next), is worth 70.42% ($140,840) of the full value of the property, and he pays that portion of the $200,000 purchase price.[260] Lot contributes the balance of $59,160 (29.58% from IRS Table S) as his share of the $200,000 purchase price.[261]

Table S - Based on Life Table 2010CM

Interest at 5.2 Percent

Age	Annuity	Life Estate	Remainder	Age	Annuity	Life Estate	Remainder
0	18.5724	0.96577	0.03423	**55**	13.5423	0.70420	0.29580
1	18.6565	0.97014	0.02986	**56**	13.3316	0.69324	0.30676
2	18.6346	0.96900	0.03100	**57**	13.1150	0.68198	0.31802
3	18.6089	0.96766	0.03234	**58**	12.8924	0.67040	0.32960
4	18.5806	0.96619	0.03381	**59**	12.6636	0.65851	0.34149
5	18.5499	0.96459	0.03541	**60**	12.4284	0.64628	0.35372
6	18.5173	0.96290	0.03710	**61**	12.1866	0.63370	0.36630
7	18.4828	0.96110	0.03890	**62**	11.9380	0.62078	0.37922
8	18.4461	0.95920	0.04080	**63**	11.6825	0.60749	0.39251
9	18.4073	0.95718	0.04282	**64**	11.4202	0.59385	0.40615
10	18.3662	0.95504	0.04496	**65**	11.1515	0.57988	0.42012
11	18.3228	0.95279	0.04721	**66**	10.8772	0.56561	0.43439
12	18.2773	0.95042	0.04958	**67**	10.5982	0.55110	0.44890
13	18.2299	0.94795	0.05205	**68**	10.3141	0.53633	0.46367
14	18.1812	0.94542	0.05458	**69**	10.0252	0.52131	0.47869
15	18.1313	0.94283	0.05717	**70**	9.7309	0.50601	0.49399
16	18.0804	0.94018	0.05982	**71**	9.4315	0.49044	0.50956
17	18.0283	0.93747	0.06253	**72**	9.1276	0.47463	0.52537
18	17.9750	0.93470	0.06530	**73**	8.8200	0.45864	0.54136
19	17.9203	0.93186	0.06814	**74**	8.5095	0.44250	0.55750

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[257] See generally, *Richard Hansen Land, Inc. v. Comm'r,* TC Memo 1993-248 (Jun. 2, 1993).

[258] Rev. Rul. 2024-13, 2024-28 IRB 18.

[259] *Table S.* IRS. [www.irs.gov/pub/irs-tege/table-s-2010cm-final.xlsx] Accessed on Jul. 29, 2024.

[260] See IRS Pub. 1457, *Actuarial Valuations Version 4A*.

[261] Ibid. It is important that the remainder holder furnish the consideration for the actuarial value of the remainder interest to avoid an IRS claim that, upon purchase of the property, the life tenant made a gift of a future interest to the remainder holder to the extent the value of the property exceeds the amount the remainder holder pays. IRC §2702. For purposes of §2702, a member of the family is defined by IRC §2704(c)(2) to include the individual's spouse, any ancestor or lineal descendant of the individual or the individual's spouse, any brother or sister of the individual, or any spouse of any individual that is an ancestor or lineal descendant of the individual or sibling of the individual.

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Assuming the arrangement is structured properly, Abe will receive the right to possess the farmland or enjoy any income it produces for his life.[262] If the property produces a 5% return, Abe will receive $10,000 annually, which exceeds 5% of $140,840. If Abe outlives the actuarial life expectancy built into the IRS assumptions of IRS Pub. 1457, *Actuarial Valuations Version 4A,* he will continue to enjoy the property (receive the income from it). Abe will be taxed on the income received from the property during his life.

Each year, the ownership value belonging to Abe decreases as his income interest declines in value. Lot's ownership value increases by the same amount. At age 70, Abe's ownership portion will be 50.601% and Lot's will have increased to 49.399%. This ownership transfer is not a taxable event. Lot becomes the outright owner of the land upon Abe's death. The property is not included in Abe's estate and, thus, Lot does not receive a basis step-up to FMV as of the date of Abe's death. Lot's tax basis will be $200,000.

Note. Rising interest rates make split-interest transactions more attractive for transition planning. If the applicable interest rate was 1%, at age 55, Abe would only have contributed 23.223% of the purchase price. With an interest rate of 5.2%, Abe must contribute 70.420% of the purchase price. Higher rates allow the senior owner to acquire a greater ownership interest up front and transfer a greater portion over time to the next generation. Higher rates also allow a much smaller contribution by the younger owner.

Caution. Each party to the transaction should pay the actuarial value of their respective interest, the property should be purchased from an unrelated third party, and the life tenant's control, rights, and duties should be consistent with those of a life tenant. Also, the life tenant should not provide financing to the remainder holder. If that occurs, the IRS could take the position that the life tenant acquired an interest in the entire property with a gift of the remainder interest and retained life income, resulting in the inclusion of the life interest in the life estate holder's estate at death, subject to estate tax.

If the parties to the split-interest transaction are **unrelated,** the transaction can be advantageous for income and transfer tax purposes.[263]

- The term interest holder's interest can be amortized on a straight-line basis over the number of years of the term.
- If the property is fairly valued by at least one independent and qualified appraiser, there is no gift tax on creation of the interest if the IRS Tables are used to determine the actuarial contributions of the life tenant and the holder of the remainder interest.
- The termination of the life tenancy upon the death of the life tenant is not a transfer by the life tenant. Thus, there is no estate tax implication and any appreciation in the asset's value is also not included in the life tenant's estate.
- The asset, upon the life tenant's death, is owned by the remainder holder and avoids probate in the life tenant's estate.

262. Based on his life expectancy, Abe may enjoy more income from the property than he would have received if he had invested the amount of his contribution to acquire another asset of the same type.

263. IRC §167(e)(1).

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If the parties to the split-interest transaction are **related,** there is an immediate gift tax consequence. Also, no amortization is allowed if the remainder portion is held, directly or indirectly, by a related party.[264] A related person is defined under §267(b) if they fall in any of the following categories.

- Brothers and sisters of the individual (whether by the whole or half-blood)
- Spouse of the individual
- Ancestors of the individual

Lineal descendants of the individual

> **Note.** Any attempt to create an amortizable split-interest land acquisition by structuring an arrangement between unrelated parties must be scrutinized in terms of analyzing the §267 related party rules and family attribution definitions.

TAX REPORTING OF FARM PROGRAM PAYMENTS

For farmers participating in the federal farm programs, payments received will have a corresponding Form 1099-G, *Certain Government Payments,* with the amount of the payments shown in Box 7. An exception to this is for market gain income, which is shown in Box 9.[265]

☐ CORRECTED (if checked)

PAYER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no.		1 Unemployment compensation $	OMB No. 1545-0120 Form **1099-G** (Rev. March 2024)	**Certain Government Payments**
		2 State or local income tax refunds, credits, or offsets $	For calendar year ______	
PAYER'S TIN	RECIPIENT'S TIN	3 Box 2 amount is for tax year	**4 Federal income tax withheld** $	**Copy B** **For Recipient**
RECIPIENT'S name		5 RTAA payments $	6 Taxable grants $	This is important tax information and is being furnished to the IRS. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported.
Street address (including apt. no.)		7 Agriculture payments $	8 If checked, box 2 is trade or business income ☐	
City or town, state or province, country, and ZIP or foreign postal code		9 Market gain $		
Account number (see instructions)		10a State	10b State identification no.	11 State income tax withheld $ $

Form **1099-G** (Rev. 3-2024) (keep for your records) www.irs.gov/Form1099G Department of the Treasury - Internal Revenue Service

264. IRC §167(e)(3).

265. A market gain payment is associated with a marketing assistance loan. Also, many state program payments are reported on Form 1099-G.

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TYPES OF PAYMENTS

Farmers receive several types of farm programs payments. Practitioners should be aware of the different types of payments and how to report them.

Agricultural Risk Coverage and Price Loss Coverage[266]

Agricultural risk coverage (ARC) and price loss coverage (PLC) payments are paid as the result of lower prices, yields, or both. As such, they provide a farmer with a safety net. The payments are reported to the IRS and the producer on Form 1099-G. These payments are issued at least one year after harvest of the associated crop, are reported in the year of receipt, and are not deferrable.

Supplement Coverage Option and Enhanced Coverage Option

Supplement coverage option (SCO) and enhanced coverage option (ECO) are types of crop insurance that provide additional area-based coverage for a portion of a farmer's underlying crop insurance policy that is purchased as an endorsement. These payments are not deferrable beyond the year of receipt because they are based on either county yield or the farmer's Schedule F income. Likewise, rainfall insurance proceeds are not deferrable because payment is based on rainfall amounts and not on actual physical damage to the farmer's crops.[267] These payments are reported on Form 1099-MISC, *Miscellaneous Information,* Box 9, *Crop Insurance Proceeds.*

☐ CORRECTED (if checked)

PAYER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no.		1 Rents $	OMB No. 1545-0115 Form **1099-MISC** (Rev. January 2024) For calendar year ____	**Miscellaneous Information**
		2 Royalties $		
		3 Other income $	**4 Federal income tax withheld $**	**Copy B For Recipient**
PAYER'S TIN	RECIPIENT'S TIN	5 Fishing boat proceeds $	6 Medical and health care payments $	
RECIPIENT'S name		7 Payer made direct sales totaling $5,000 or more of consumer products to recipient for resale ☐	8 Substitute payments in lieu of dividends or interest $	This is important tax information and is being furnished to the IRS. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported.
Street address (including apt. no.)		9 Crop insurance proceeds $	10 Gross proceeds paid to an attorney $	
City or town, state or province, country, and ZIP or foreign postal code		11 Fish purchased for resale $	12 Section 409A deferrals $	
	13 FATCA filing requirement ☐	14 Excess golden parachute payments $	15 Nonqualified deferred compensation $	
Account number (see instructions)		16 State tax withheld $ $	17 State/Payer's state no.	18 State income $ $

Form **1099-MISC** (Rev. 1-2024) (keep for your records) www.irs.gov/Form1099MISC Department of the Treasury - Internal Revenue Service

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266. *FSA Handbook: Agriculture Risk Coverage and Price Loss Coverage Program — 1-ARCPLC (Revision 1)*. Feb. 27, 2024. FSA. [www.fsa.usda.gov/Internet/FSA_File/1-arcplc_r01_a13.pdf] Accessed on Jul. 16, 2024.

267. IRS Pub. 225, *Farmer's Tax Guide,* p. 12 (2023).

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Emergency Relief Program[268]

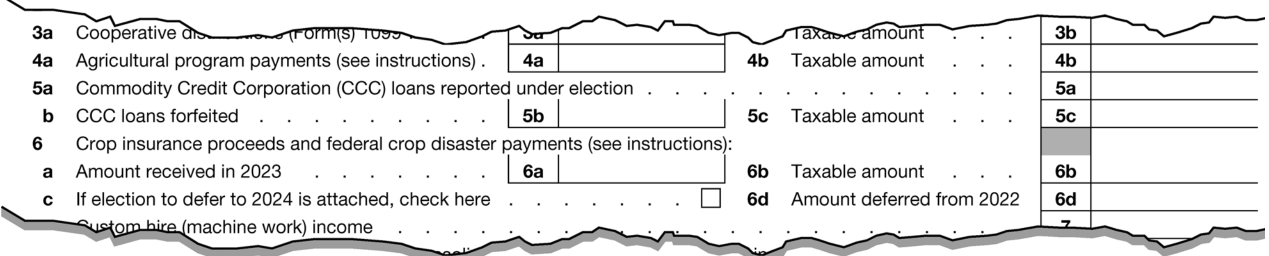
The USDA issued emergency relief program (ERP) payments related to crop losses on account of natural disasters for 2020-2022. The application deadline for "Track 2" was Aug. 14, 2024, and most of the 2022 "Track 2" payments will be received in 2024. ERP payments are not deferrable because the payments are attributable to crop damage that occurred in a prior year.

Commodity Credit Corporation Loans[269]

The Commodity Credit Corporation (CCC) is the USDA's financing institution. Among other things, the CCC makes commodity loans to farmers where the farmers' crops are pledged as collateral. These loans are part of the price and income support system of the federal farm programs. Upon repayment of the loan (known as **redemption**), the farmer can sell the grain, feed it to livestock, or store it. However, most CCC loans are nonrecourse so that, upon maturity, if the loan plus interest is not paid, the commodity may be forfeited to the CCC as full payment for the loan. That effectively establishes a minimum price insomuch as the farmer can forfeit the grain if prices drop below the loan value and still retain the ability to market the grain later if the commodity price increases.

Note. CCC loans are not reported on Form 1099-G.[270]

Farmers can report the loan proceeds under either the **loan method** or the **income method.** This option allows tax planning strategies to increase taxable income or to increase cash flow when the producer is not ready to sell the crop.[271] The following portion of Schedule F includes lines relevant to reporting income from agricultural program payments, CCC loans, and crop insurance proceeds.



Line	Description	Box		Line	Description	Box	
3a	Cooperative di... (Form(s) 1099 ...	3a			Taxable amount	3b	
4a	Agricultural program payments (see instructions)	4a		4b	Taxable amount	4b	
5a	Commodity Credit Corporation (CCC) loans reported under election					5a	
b	CCC loans forfeited	5b		5c	Taxable amount	5c	
6	Crop insurance proceeds and federal crop disaster payments (see instructions):						
a	Amount received in 2023	6a		6b	Taxable amount	6b	
c	If election to defer to 2024 is attached, check here ☐			6d	Amount deferred from 2022	6d	
	Custom hire (machine work) income					7	

It is presumed that every farm taxpayer treats CCC loans as loans for tax purposes. In this event, taxpayers on the cash method of accounting do not have taxable income until the year in which the commodity is sold or the crop is forfeited to CCC in full satisfaction of the loan. If grain is forfeited to the CCC in satisfaction of the loan, the taxpayer receives a Form 1099-A, *Acquisition or Abandonment of Secured Property,* from the USDA. The amount of the loan forfeited is reported on line 5b of Schedule F with the same amount entered as taxable income on line 5c if not previously reported as taxable income.[272]

Note. The loan method often creates large amounts of income with no cash flow in the year the grain is sold because the loan amount was received in the prior year.

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268. *FSA Handbook: Emergency Relief Programs — 1-ERP*. Oct. 2, 2023. FSA. [www.fsa.usda.gov/Internet/FSA_File/1-erp_r00_a06.pdf] Accessed on Jul. 16, 2024.

269. *Commodity Credit Corporation.* U.S. Department of Agriculture. [www.usda.gov/ccc] Accessed on Jul. 29, 2024.

270. IRS Pub. 225, *Farmer's Tax Guide*.

271. Treas. Regs. §§1.77-1 and 1.77-2.

272. Ibid.

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CCC loans may, by election, be treated as income in the year the proceeds of the loan are received.[273] If a farmer elects to treat CCC loans as income, it applies to all loans for all commodities that year.[274]

Observation. The CCC loan is not income. Rather, the amount reported as income is the cash proceeds of the CCC loan which then serves as the grain's tax basis.[275]

The amount of the income is entered on line 5a of Schedule F. The election is required to be made only once during a taxpayer's lifetime. A taxpayer may elect at any time to report CCC loans as income.[276] If the taxpayer does not elect to treat the loans as income, the income is reported in the year the commodity is sold or forfeited to the CCC.

Note. Effective for taxable years ending on or after December 31, 2001, IRS has ruled that a taxpayer reporting CCC loans as income can switch automatically to treating CCC loans as loans.[277]

The change is made on a cut-off basis.[278] In other words, when a taxpayer changes CCC loan reporting methods, the new method applies to current year and subsequent loans. Thus, a farmer could be reporting on both methods until prior loans are satisfied. In addition, even if a farmer had made the election to report the CCC loan as income within the past five years, the farmer is still eligible to switch to the loan method. The IRS waives that 5-year prohibition.[279] Form 3115, *Application for Change in Accounting Method,* must be attached to the return noting that the change is made under the automatic consent procedures of Rev. Proc. 2015-14. A copy of Form 3115 must be sent to the IRS in Washington, D.C.

The following table shows the income tax treatment of various dispositions of CCC loans and commodities.

	Treatment of CCC Loan When Received	
Disposition of the Loan or Commodity	**Treated as Income (Election Made)**	**Treated as Loan (No Election)**
1. Loan paid by forfeiting commodity	No income reported	Amount of loan reported as income
2. Commodity redeemed by paying off loan with cash	Farmer has basis in commodity equal to loan amount	Farmer has a zero basis in the commodity
3. Redeemed commodity is sold	Farmer has income (loss) equal to sale price less amount of loan, which is the basis in the commodity	Farmer has income equal to sales price
4. Redeemed commodity is fed	Farmer has a feed deduction equal to the amount of the loan, which is the basis in the feed commodity	Farmer has no deduction

273. IRC §77.

274. Treas. Reg. §1.77-1.

275. IRS Pub. 225, *Farmer's Tax Guide*.

276. IRC §77(a).

277. Rev. Proc. 2002-9, 2002-3 IRB 327, Appendix, §1.01(1). Loans taken out previously continue to be treated as if the election to report loans as income was still in effect.

278. Ibid.

279. Rev. Proc. 2015-13, 2015-5 IRB 419, Appendix §2.01(2).

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Normally, the repayment of a CCC loan is of no consequence, regardless of whether the taxpayer has made an election to treat the loans as income. However, if a farmer has elected to treat CCC loans as income, the courts are divided as to the outcome if loans are redeemed in the same year they are taken out. The Fifth Circuit Court of Appeals held that no income is realized from the loan on a crop redeemed in the same year.[280] Conversely, the Ninth Circuit Court of Appeals took the position that the loan triggers income even though redeemed.[281]

However, if the value of the crop subject to the CCC loan drops below the loan amount and the farmer elects to "pay" the loan at the lower value, the difference between the loan amount and the FMV of the crop is a **market gain.** In this situation, the CCC will issue a Form 1099-G. If the farmer elected to treat the loan as income in the year the loan was received, the market gain is not reported as income, however the farmer's basis in the crop associated with the loan will be reduced. Alternatively, if the farmer treated the loan as a loan, the amount shown on the Form 1099-G will be reported as income in the year the crop is forfeited. [282]

Caution. Often the commodity under a CCC loan is stored at a commercial elevator and when the crop is sold, the elevator pays off the CCC loan to remove the lien prior to completing the sale. The farmer then only receives a payment for the grain value exceeding the loan amount. Without proper accounting for the full sale price, farm taxpayers have a risk of omitting gross receipts from grain sales.

Example 20. Sarah Dippity is a corn farmer. In 2023, she places 10,000 bushels of corn under loan with the CCC and receives loan proceeds of $40,000 ($4 per bushel). In 2024, the price of corn drops to $3.75 per bushel. Sarah then redeems her corn by paying the CCC $37,500. She then later sells her corn for $42,500.

Sarah is on the loan method and did not include the loan as income when she received it. Therefore, she has a market gain of $2,500 ($40,000 loan proceeds – $37,500 CCC redemption) to report on Schedule F. When Sarah sells the corn for $42,500, she reports the sale on line 2. In 2024, Sarah reports $45,000 in income ($40,000 loan + ($42,500 sales proceeds – $37,500 price for 10,000 bushels at $3.75 per bushel)).

Example 21. Use the same facts as **Example 20,** except that Sarah is on the income method. She originally reported the $40,000 loan as income in 2023 which gave the crop a basis of $40,000. The market gain is not reported as income, but reduces the basis in the corn to $37,500. When the crop is sold for $42,500, Sarah reports the sale on line 1a and then report the cost of the sale on line 1b of $37,500, for a net gain of $5,000. The total amount of income reported in 2024 is $5,000 plus the $40,000 reported in 2023.

Feed Assistance[283]

Feed assistance payments may be made to a qualifying livestock producer upon the occurrence of a natural disaster or livestock emergency. The assistance is either in the form of lower feed cost or direct donations. The producer may include in income the amount of donated feed received based on the feed's FMV, the difference between the FMV of the feed and the amount the producer paid for the feed, or the cost reimbursement received. Any amounts will be reported on Schedule F, line 4a and 4b.[284]

Note. The amount of income reported is not deferrable under the provisions for weather-related sales of livestock because the payments are for feed, not livestock. However, the producer can deduct the income as additional feed cost with the net effect being zero (depending on the producer's method of accounting).

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280. *Thompson v. Comm'r*, 322 F.2d 122 (5th Cir. 1963), *aff'g and rev'g* 38 TC 153 (1962).

281. *U.S. v. Isaak*, 400 F.2d 869 (9th Cir. 1968).

282. IRS Pub. 225, Farmer's Tax Guide.

283. Ibid.

284. This is the case even though Form1099-G may not be received.

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Cost Share Exclusion

Under certain federal farm programs, especially those programs designed to provide environmental benefits (e.g., conservation, reclamation, or restoration), the USDA shares part of the expense associated with complying with the program. For example, under a particular USDA soil conservation program, a farmer may be encouraged to build terraces in crop fields to reduce or eliminate soil erosion. The farmer incurs an expense associated with building the terraces and the USDA pays the farmer a portion of that expense. The IRS permits some cost sharing amounts received by farmers and ranchers under several state and federal programs to be excluded from gross income.[285]

For amounts paid under eligible programs to be excludable, **three requirements** must be satisfied.

1. The Secretary of Agriculture must determine that the payments are made "primarily for the purpose of conserving soil and water resources, protecting or restoring the environment, improving forests, or providing a habitat for wildlife."[286]
2. The Treasury Secretary must determine the expenditures made under the program are not "increasing substantially" the annual income from the property.[287]

> **Note.** An increase in annual income is not substantial unless it exceeds the greater of $2.50 per acre or 10% of the average annual income derived from the property prior to the improvement.[288] Practitioners that have clients receiving these payments should consult Temp. Treas. Reg. §16A.126-1 for an example and the relevant formulas.

3. No part of a payment can be excluded if it is for an expense that is allowed to be deducted in the current tax year.

Example 22. Mindy owns a 640-acre farm in Indiana. She received gross income of $64,000 from crop production over each of the last three years. In 2024, Mindy installed a soil conservation terrace to comply with a soil and water conservation plan for the farm. The terrace cost $48,000, and increased the value of her farm by $27,000. Mindy received a $24,000 cost-share payment from the local FSA office, which she reported as a government payment. Mindy meets all of the tests for excludability. In determining how much of the $24,000 cost-sharing payment can she exclude from income, Mindy performs the following computations.

Computation of the 10%/$2.50-per-acre limit:

10% = $6,400

$2.50 × 640 = $1,600

Therefore, 10% of the rent ($6,400) is greater than $2.50 times 640 acres ($1,600). Part or all of the $24,000 cost-share amount is excludable if the annual income does not increase more than $6,400 because of the terrace.

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285. Cost-sharing payments received under the Wetlands Reserve Program (WRP), the Environmental Quality Incentives Program (EQIP), and the Wildlife Habitat Incentives Program (WHIP) are eligible for exclusion from gross income. Rev. Rul. 97-55, 1997-52 IRB 7 (WRP, EQIP, and WHIP are substantially similar to programs described in IRC §§126(a)(1)–(8)). The IRS has ruled similarly with respect to cost-share payments received under the Conservation Reserve Program, Rev. Rul. 2003-59, 2003-24 IRB 1014; the Forest Land Enhancement Program (FLEP), Rev. Rul. 2004-8, 2003-10 IRB 544; and the Conservation Security Program, Rev. Rul. 2006-46, 2006-2 IRB 511. IRS Pub. 225 lists the programs that qualify.

286. IRC §126(b)(1)(A).

287. IRC §126(b)(1)(B).

288. Temp. Treas. Reg. §16A.126-1.

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Computation of the excludable amount, based on the formula described in Temp. Treas. Reg. §16A.126-1(g):

1. Determine the value of the improvement.

$$\text{Value of improvement} = \text{Improvement FMV} \times \frac{\text{§126 cost}}{\text{Cost of improvement}}$$

$$= \$27{,}000 \times \frac{\$48{,}000}{\$48{,}000}$$

$$= \$27{,}000$$

2. Determine the excludable portion (the present FMV (PFMV) of the greater of 10% of annual income (or $2.50), times the number of acres affected).

$$\frac{\$6{,}400}{.06 \text{ (assumed PFMV discount factor)}} = \$106{,}667$$

3. Determine Mindy's cost associated with the improvement.

$24,000

4. Add the results of Steps 2 and 3.

$24,000 + $106,667 = $130,667

5. If the result of Step 4 exceeds the value of the improvement, the entire amount of cost-share payment can be excluded from income if annual income does not increase more than $6,400.

Value of improvement	$27,000
Less: Mindy's contribution	(24,000)
Amount includable in gross income	$ 3,000

If Mindy had **not** made an election to exclude the cost-share amount, she would have included $3,000 in gross income in addition to the $24,000 cost share program payment.[289] She also would have $51,000 of cost added to the depreciation schedule ($48,000 purchase price + $3,000 includable in gross income).

If Mindy made an election to exclude the cost share amount, she would have $24,000 of cost added to the depreciation schedule ($48,000 purchase price – $24,000 excluded income).

The excluded amount is reported by attaching a statement to the return for the tax year of receipt of the last government payment for the improvement. The statement must denote the dollar amount the government funded, the value of the improvement, and the amount being excluded. The total cost-share payment is reported on Schedule F, line 4a with the taxable amount on line 4b.[290]

> **Note.** If payments are reported on Form 1099-G in multiple years, the payment received should be reported on line 4a and nothing on line 4b, with an accompanying statement attached to the return.

[289] The election **not** to exclude the payment must be made on a timely filed return by simply reporting the income on line 4b of Schedule F.

[290] 2023 IRS Pub. 225, *Farmer's Tax Guide*, pp. 13–14.

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If property on which cost-sharing payments have been excluded from gross income is disposed of within 20 years, part or all of the excluded payments are taxed as ordinary income. The amount taxable as ordinary income is the lesser of the gain realized on sale of the property or the applicable percentage of the amount of the payment that had been excluded from income. The applicable percentage for the first 10 years after the date payments are received and excluded is 100%. Thereafter, the applicable percentage is reduced annually by 10%. After the 19th year, there is no recapture. However, the exclusion and recapture rules do not apply to government cost sharing payments to the extent a deduction is allowed in the year paid or incurred. Furthermore, if the exclusion is claimed, expenditures may neither be used to generate deductions or credits, nor be added to the income tax basis of property acquired. The exclusion for cost sharing payments is available to landlords also.[291]

AGRICULTURE-RELATED RULINGS AND CASES

The following are some agriculture-related rulings and cases from the past year.

Accounting Method

Impermissible Change to Amortize Base Acres Was a Change in Accounting Method

Conmac Investments, Inc. v. Comm'r, TC Memo 2023-40 (Mar. 27, 2023)

Conmac Investments was a corporation that owned and leased farmland to tenant farmers under oral leases. Conmac did not personally farm any of the land. The farmland contained **base acres** — such as wheat, corn, soybeans, cotton, rice, etc., from the USDA. The farm program payments (paid pursuant to the 2008 and 2014 Farm Bills) were paid to the tenants. Under the oral leases, the tenants received all of the payments attributable to the base acres and the annual rent payment was generally 25% of the gross income from the farmland, with gross income from the farmland including any farm subsidy payments received on account of the base acres.

Before 2009, Conmac did not claim any deductions for amortization or depreciation of the base acres. However, starting in 2009, Conmac began claiming an amortization or depreciation deduction for base acres acquired and placed in service in 2004 through 2013 (i.e., asserting an ownership interest in an intangible asset). To determine the claimed deductions, Conmac developed a methodology to calculate an average farm subsidy payment per base acre rented to tenant farmers. Conmac, selecting 2009 as the reference year, determined its average farm subsidy payment per rented-out base acre to be $39.62. Conmac then calculated the present value of its average farm subsidy payment over a 15-year period, which worked out to be $431.81. Using this present value, Conmac derived a proposed amount for the amortization or depreciation of its base acres each year, multiplying its total number of rented-out base acres by $431.81 and then dividing that amount by 15 to recognize the amortization or depreciation expense on a straight-line basis over 15 years. Using the methodology it devised, Conmac reported amortization or depreciation expenses for base acres rented to tenant farmers of $141,614 for 2009 through 2012, $48,373 for 2013, and $44,980 for 2014. By deducting its amortization expense, Conmac reduced its recognition of income paid by the tenant farmers. Changing the treatment of an asset from non-depreciable to depreciable or non-amortizable to amortizable (or vice-versa) is a change of accounting that results in a §481 adjustment.

> **Note.** It is unknown why Conmac decided to claim deductions against, essentially, cash rent. It was the tenants that were assuming the risk of production under the leases, not Conmac. In essence, Conmac started claiming deductions against guaranteed rental income without assuming any of the risk of the expenses under the leases.

[291] Ltr. Rul. 9014041 (Jan. 5, 1990).

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However, Conmac did not attach Form 3115 to its Form 1120 or otherwise seek IRS consent to change its accounting method. Conmac also did not file amended returns with an explanatory statement for all open years reclassifying the base acres as amortizable under IRC §197. Additionally, Conmac did not adopt the same accounting treatment for all bases acres that it owned.

The IRS determined that Conmac adopted an impermissible method of accounting and asserted deficiencies of approximately $116,000 for 2013 and $114,000 for 2014, and that a §481 adjustment of $141,614 for 2009–2012 was required. Conmac claimed that it had not changed its accounting method because of a change in underlying facts impacting its business. In addition, Conmac claimed that even if there was a change in the underlying facts that supported an accounting method change, the lack of IRS consent did not matter because the relevant tax years had closed. Conmac claimed that a §481 adjustment was not necessary because it should have been made for the year of change (e.g., 2009) and that the IRS could no longer require the adjustment because 2009 was a closed tax year.

The Tax Court (opinion by Judge Paris) agreed with the IRS noting that Conmac had changed an accounting method in violation of IRC §446(e) which requires IRS consent for such a change, and that a §481 adjustment was proper. The facts did not involve the application of an existing accounting method to a change in business practices. Indeed, there was no change in business practices — Conmac continued to serve as landlord to the tenant farmers and did not change the terms of the leases. Instead, the only economic consequence was the tax benefit that Conmac received on account of the change — there was no change in existing legal or economic relationships. In addition, Conmac continued to treat base acres acquired and placed in service in other years as non-amortizable or non-depreciable. The Tax Court determined that Conmac simply made a business decision in 2009 to start claiming amortization deductions on farmland that it had acquired and placed in service beginning in 2004. The corporation, the Tax Court pointed out, failed to identify the facts that had changed, causing it to change its tax treatment of the rented farmland.

Judge Paris referenced *Comm'r v. Brookshire Brothers Holding, Inc.,*[292] In that case, the appellate court, affirming the Tax Court, held that an IRS challenge to a method change for which consent was not given must be for the year of the improper change, and that failure to obtain prior consent did not serve as a basis to challenge the change for a closed year. In the present case, the Tax Court distinguished *Brookshire* on the basis that Conmac did not file amended returns with an explanatory statement for all open years reclassifying the base acres. In addition, based on the corporation's inconsistent treatment of the base acres depending on the year the farmland was placed in service, the Tax Court determined that finding an unauthorized change in accounting would promote consistency and would not offend basic fairness.

The Tax Court sustained the §481 adjustment. The Tax Court rejected Conmac's argument that the §481 adjustment was barred by the statute of limitations after finding that the year of the change was the oldest open tax year. The Tax Court explained that the only limitation on a §481(a) adjustment is that no pre-1954 adjustments may be made. As long as a change in an accounting method has occurred, the IRS may adjust a taxpayer's income in an open year to reflect amounts attributable to years for which the applicable statute of limitations has expired (i.e., time-barred years).[293]

Conservation Easements

Burden of Proof on Reasonable Cause for Substantiation Rules

Murfam Enterprises, LLC v. Comm'r, TC Memo 2023-73 (Jun. 15, 2023)

Murfam, a privately held company of a multi-generation hog farming family in North Carolina, obtained a 6,171-acre parcel of land named the "Rose Tract." The State of North Carolina granted hog-farming certificates that were attached to the Rose Tract. The certificates authorized a "feeder-to-finish" facility but it could be converted into an authorization for a "farrow-to-wean" facility.

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292. *Comm'r v. Brookshire Bros. Holding, Inc.,* 320 F.3d 507 (5th Cir. 2003), *aff'g* TC Memo 2001-150 (Jun. 22, 2001).

293. *Huffman v. Comm'r*, 518 F.3d 357 (6th Cir. 2008), *aff'g* 126 TC 322 (2006).

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In 2007, North Carolina imposed a moratorium on issuing new hog-farming certificates. In 2010, Murfam donated a conservation easement on the entire tract to a qualified land trust. The easement specified the Rose Tract could not be used for hog farming and Murfam claimed a charitable deduction of $5,744,600 (the value of the certificates) for the donation of the easement.

The IRS asserted that the value of the charitable deduction was $446,000. The Tax Court used the **highest and best use method** to determine the value of donated easement. In doing so, it relied heavily on the calculations of Murfam's expert, who determined that a farrow-to-wean facility was the most profitable use for the property before the easement. The IRS expert only examined the financials of building a feeder-to-finish facility and found that operation to be "financially unfeasible." In calculating the value of the easement, the court first took the value of the hog-farming facility plus the stipulated value of the remaining acreage to determine the initial value of the tract prior to the easement donation. It then subtracted the stipulated value of the land after the donation to determine that the value of the easement was $5,637,207.

However, when Murfam filed its pretrial memorandum, the IRS asserted that the deduction should be disallowed due to Murfam's failure to comply with IRC §170(f)(11). Under §170(f)(11), a taxpayer must substantiate charitable deductions associated with a donated conservation easement by attaching a fully completed appraisal summary that includes the basis of the property unless the taxpayer has reasonable cause for not doing so. This case presented the issue of which party bears the burden of proof on the reasonable cause defense when the IRS raises the issue of noncompliance as a "new matter" in litigation, and when reasonable cause for the noncompliance is at issue.

The Tax Court held that when the issue of noncompliance is a "new matter," the burden of proof shifts to the IRS. The Tax Court reasoned that the Final Partnership Administrative Adjustment (FPAA) issued to Murfam indicated that a deduction was allowable, but for much less than what Murfam was claiming, and that Murfam bore the burden of proof on the value of the charitable deduction. However, the Tax Court held that the IRS bore the burden of proof on the substantiation issue. Murfam based its reasonable cause argument on its reliance on a competent CPA who was provided necessary and sufficient tax information, and that Murfam relied on the CPA in good faith. No penalty resulted because the valuation of the donation was within 2% ($5,637,207 ÷ $5,744,600 = 98.13%) of the amount that the Tax Court determined to be correct.

Suit Barred by Anti-Injunction Act

Rocky Branch Timberlands, LLC v. U.S., No. 22-12646, 2023 U.S. App. LEXIS 23606 (11th Cir. Sep. 6, 2023), *cert. den.* 144 S. Ct. 812 (Feb. 20, 2024)

Rocky Branch Timberlands sued for an injunction and declaratory relief after the IRS issued an FPAA disallowing a $26.5 million charitable deduction for a conservation easement on land donated to a charity. The trial court dismissed the case on the basis that the Anti-Injunction Act (AIA) barred the relief sought. Rocky Branch claimed that IRC §7803(e)(4) gave it the right to seek administrative review with the IRS Independent Office of Appeals, but was denied a hearing before the IRS issued the FPAA denying the deduction. Rocky Branch claimed that the AIA did not bar suits challenging the IRS's conduct rather than collection of tax. The appellate court affirmed, finding that the FPAA disallowed the deduction that resulted in the underpayment of tax, which the IRS would not be able to collect even if the court granted the requested relief. The appellate court also noted that the AIA's equitable exception did not apply because Rocky Branch had another remedy available — filing suit in the U.S. Tax Court. The appellate court further noted that Rocky Branch had not shown that the IRS could not prevail on the merits of the case.

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Winning in Tax Court Does Not Mean You Are a "Prevailing Party"

Champion's Retreat Golf Founders, LLC v. Comm'r, TC Memo 2023-134 (Nov. 8, 2023)

IRC §7430 allows a court to award **reasonable administrative costs** and **reasonable litigation costs** to a taxpayer that is a **prevailing party** in a dispute with the IRS. Champions Retreat Golf Founders claimed a $10.8 million charitable deduction for a donated conservation easement on a 348-acre golf course and driving range. The IRS disallowed the deduction in its entirety, but also took a fallback position that the easement was worth $20,000. The Tax Court denied the deduction, but the Eleventh Circuit vacated the Tax Court's decision and remanded the case.[294] The Eleventh Circuit determined that the easement qualified as an open space easement under §170(h)(4)(A). On remand, the issue was the proper valuation of the easement. Ultimately, the Tax Court allowed a deduction of slightly under $8 million.[295]

In the present case, Champions sought to have the government pays its litigation costs because Champion was a prevailing party. The Tax Court disagreed. Under §7430(c)(4)(B), a taxpayer is not a prevailing party if the government can show that its position was **substantially justified** at the relevant time as to the issue or issues that the taxpayer won. The burden of proof is on the government.[296] The Tax Court determined that the government was substantially justified in its position that the easement was not a **qualified** easement because (as the IRS claimed) there was insufficient access to the property. On the valuation issue, the Tax Court noted that Champion was correct in claiming that the IRS had undervalued the easement, and that the IRS was correct that Champion had overvalued the easement. Thus, the IRS established that it was substantially justified in its position and Champion was not a prevailing party.

An Easement is Not Worth More than the Underlying Property

Oconee Landing Property, LLC, et al. v. Comm'r, TC Memo 2024-25 (Feb. 21, 2024)

IRS guidelines make it clear that a conservation easement's value is the value of the forfeited development rights based on the land's highest and best use. To qualify as a highest and best use, a use must satisfy the following four criteria.

1. The land must be able to accommodate the size and shape of the ideal improvement.
2. A property use must be either currently allowable or most probably allowable under applicable laws and regulations.
3. A property must be able to generate sufficient income to support the use for which it was designed.
4. The selected use must yield the highest value among the possible uses.

> **Note.** A tract's highest and best use is merely a factor in determining FMV. It does not override the standard IRS valuation approach — the FMV is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell, and both having reasonable knowledge of relevant facts.[297]

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294. *Champion's Retreat Golf Founders, LLC v. Comm'r*, 959 F.3d 1033 (11th Cir. 2020), *rev'g and rem'g* TC Memo 2018-146 (Sep. 18, 2018).

295. *Champion's Retreat Golf Founders, LLC v. Comm'r,* TC Memo 2022-106 (Oct. 17, 2022).

296. IRC §7430(c)(4)(B).

297. See, e.g., Treas. Reg. §1.170A-1(c)(2). See also *Boltar LLC v. Comm'r*, 136 TC 326 (2011).

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Oconee Landing Property donated 355 acres of undeveloped land to a land trust. The 355-acre tract was part of a larger tract that was a nationally recognized golf resort with associated developments. When the larger tract was not sold, Oconee became interested in the possibility of granting a conservation easement on the 355 acres. Ultimately, Oconee valued the 355 acres at about $60,000 per acre and claimed a charitable deduction for the entire amount — $20.67 million. The IRS disallowed the deduction due to **lack of donative intent** — the entire scheme involved a predetermined agreement to secure inflated appraisals so that investors would be able to deduct more than their respective investments.

Note. The amount of the deduction that can be claimed is subject to a limitation based on a percentage of the taxpayer's contribution base.[298] However, if the donor is a **qualified farmer or rancher** and the donated property is used in agricultural or livestock production, the deduction may be up to 100% of the donor's contribution base.[299]

While the Tax Court determined that the donated easement had value, it agreed with the IRS that the value of the tract was approximately $5 million. However, Oconee forfeited any associated deduction because it failed to attach a qualified appraisal to its return, as regulations require. An appraisal does not meet the standard of "qualified" if the taxpayer merely sets a target value for the appraiser to reach. This is especially true when Oconee is aware that the target value is overstated.

Note. Form 8283, *Noncash Charitable Contributions,* Section B, states an appraisal summary must be fully completed and attached to the return for noncash donations greater than $5,000.[300]

D				

Section B. Donated Property Over $5,000 (Except Publicly Traded Securities, Vehicles, Intellectual Property or Inventory Reportable in Section A)—Complete this section for one item (or a group of similar items) for which you claimed a deduction of more than $5,000 per item or group (except contributions reportable in Section A). Provide a separate form for each item donated unless it is part of a group of similar items. A qualified appraisal is required for items reportable in Section B and in certain cases must be attached. See instructions.

Part I Information on Donated Property

2 Check the box that describes the type of property donated. See instructions for definitions.

- a ☐ Art (contribution of $20,000 or more)
- b ☐ Qualified conservation contribution
- b(1) ☐ Certified historic structure
  NPS # ____________
- c ☐ Art (contribution of less than $20,000)
- d ☐ Other real estate
- e ☐ Equipment
- f ☐ Securities
- g ☐ Collectibles
- h ☐ Intellectual property
- i ☐ Vehicles
- j ☐ Clothing and household items
- k ☐ Digital assets
- l ☐ Other

3	**(a)** Description of donated property (if you need more space, attach a separate statement)	**(b)** If any tangible personal property or real property was donated, give a brief summary of the overall physical condition of the property at the time of the gift.	**(c)** Appraised fair market value
A			
B			
C			

	(d) Date acquired by donor (mo., yr.)	**(e)** How acquired by donor	**(f)** Donor's cost or adjusted basis	**(g)** For bargain sales, enter amount received	**(h)** Qualified conservation contribution relevant basis (see instructions)	**(i)** Amount claimed as a deduction (see instructions)
A						
B						
C						

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 62299J Form **8283** (Rev. 12-2023)

298. IRC §170(b)(1)(H).

299. IRC §170(b)(1)(E)(iv). For corporate farms and ranches, see IRC §170(b)(2)(B), and for the definition of a "qualified farmer or rancher," see IRC §170(b)(1)(E)(v) and *Rutkoske v. Comm'r*, 149 TC 133 (2017).

300. IRC §170(f)(11)(c).

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In addition, the Tax Court pointed out that the 355-acre tract had been transferred to a developer (a partnership) which then donated the easement. That meant that the donation was of ordinary income property which limited any deduction to the basis in the property. Because there was no evidence offered as to the basis of the property, the deduction was zero.[301]

The Tax Court added a gross overstatement penalty of 40%. In determining the penalty, the Tax Court agreed with the IRS's position that the highest and best use of the tract was as a "speculative hold for mixed-use development" and the easement was worth less than $5 million. The Tax Court also added a 20% penalty on the portion of the underpayment that was not associated with the erroneous valuation.

> **Note.** The rules associated with donated conservation easements are technical and must be followed precisely. While large tax savings can be achieved by donating a permanent conservation easement (especially for farmers and ranchers), carefully following all of the rules is critical. Predetermining a valuation is a big "no-no."

Conservation Easement Regulation Invalidated

Valley Park Ranch, LLC v. Comm'r, 162 TC No. 6 (Mar. 28, 2024)

Valley Park Ranch claimed a charitable deduction for a donated conservation easement. The easement deed stated that, if the conservation restriction ended, the donee would receive a certain monetary amount. This amount would be determined by a court unless prevented by state or federal law. If the government exercised eminent domain, the donee would receive its respective share of the proceeds based on a **qualified appraisal.** The IRS claimed that the deed language failed to satisfy the requirements of §170(h) and Treas. Reg. §1.170A-14(g)(6)(ii). Valley Park claimed that the regulation was invalid under the Administrative Procedure Act (APA). Following *Hewitt v. Comm'r,*[302] the Tax Court held that Treas. Reg. §1.170A-14(g)(6)(ii) is procedurally invalid under the APA and that the deed therefore need not comply with its requirements. The Tax Court also concluded that to the extent *Oakbrook Land Holdings, LLC,*[303] holds otherwise, the Tax Court will no longer follow it. The court also held the easement deed satisfies the **restriction (granted in perpetuity)** requirement under §170(h)(2)(C) and the **protected in perpetuity** requirement of §170(h)(5).

> **Note.** In *Cox Point Propco, LLC v. Comm'r*,[304] the Tax Court denied the IRS's motion for partial summary judgment that the petitioner's deed of easement regarding extinguishment proceeds failed to satisfy Treas. Reg. §1.170A-14(g)(6)(ii), because the regulation had previously been ruled invalid in *Valley Park Ranch*.

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301. IRC §170(e)(1)(A).

302. *Hewitt v. Comm'r,* 21 F.4th 1336 (11th Cir. 2021), *rev'g and rem'g,* TC Memo 2020-89 (Jun. 17, 2020).

303. *Oakbrook Land Holdings, LLC v. Comm'r,* 154 TC 180 (2020), *aff'd* 28 F.4th 700 (6th Cir. 2022).

304. *Cox Point Propco, LLC v. Comm'r,* No. 16731-19, 2024 U.S. Tax Ct. LEXIS 1009 (U.S Tax Ct. Apr. 22, 2024).

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> **Note.** In *Buckelew Farm, LLC v. Comm'r,*[305] the IRS disallowed the petitioner's charitable contribution deduction for a perpetual conservation easement based on the failure to meet the perpetuity requirement, and imposed penalties. The Tax Court allowed the deduction on the basis that the statutory requirements for a deduction had been satisfied and because the conservation purpose not being protected in perpetuity as required by Treas. Reg. §1.170A-14(g)(6)(ii) was not relevant. The court was bound to follow *Hewitt v. Comm'r,*[306] which invalidated the regulation in the Eleventh Circuit. However, the Tax Court held that the amount of the allowable charitable contribution deduction under §170 was the difference between the before and after value of the property, which was substantially less than the claimed deduction. The Tax Court determined that while a civil fraud penalty was not warranted, a penalty under IRC §6662 was warranted due to the gross valuation misstatement for the property.

Final Regulations on Donated Conservation Easements by Partnerships and Corporations

TD 9999 (Jun. 24, 2024), effective Jun. 28, 2022, for donations after Dec. 29, 2022

These final regulations implement provisions of the Setting Every Community Up for Retirement Enhancement (SECURE) 2.0 Act[307] that added §170(h)(7) which disallows a conservation contribution if the amount exceeds 2.5 times the sum of each partner's or shareholder's relevant basis in a partnership or S corporation. The final regulations provide guidance on the disallowance rule, including definitions, methods for calculating relevant basis, and reporting requirements. The final regulations also provide for reporting requirements for partners and shareholders that receive a distributive or pro rata share of any noncash charitable contribution made by a partnership or S corporation, regardless of whether the contribution is a qualified conservation contribution and whether or not the contribution involves real property.

SE Tax and Limited Partners

"Functional Analysis" Test

Soroban Capital Partners LP v. Comm'r, 161 TC No. 12 (Nov. 28, 2023)

A question in SE tax planning is whether an LLC member is a limited partner. In 1997, the Treasury issued a proposed treasury regulation[308] to address the issue, but it has never been finalized. The regulation establishes a fact-based analysis based on participation in management to determine limited partner status. **A limited partner does not participate in management.** For businesses other than those providing professional services, characterization of an LLC member's interest is determinative of whether the member has SE tax liability on amounts distributed to the member (other than guaranteed payments). That means that proper structuring of the entity matters, as does the drafting of the LLC operating agreement and the conduct of the members.

Here, the U.S. Tax Court issued a fully reported opinion confirming that state law classifications of a partner's interest is **not conclusive** on the SE tax issue. Soroban excluded distributions of ordinary income to its limited partners from its computation of net earnings from self-employment. Its basis for doing so was that the limited partners' interests conformed to state law. The IRS disagreed, asserting this was an insufficient reason, and that the functions and roles of the limited partners also had to be analyzed for SE tax purposes. The Tax Court agreed with the IRS.

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305. *Buckelew Farm, LLC v. Comm'r,* TC Memo 2024-52 (Apr. 25, 2024).

306. *Hewitt v. Comm'r,* 21 F.4th 1336 (11th Cir. 2021), *rev'g and rem'g,* TC Memo 2020-89 (Jun. 17, 2020).

307. *SECURE 2.0 Act,* PL 117-328.

308. Prop. Treas. Reg. §1.1402(a)-2.

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At issue was the definition of a **limited partner** for purpose of the exception from SE tax under §1402(a)(13). The Tax Court noted that the proposed regulations provided a definition and that Congress froze the finalization of the regulation for six months and has said very little about the issue since the freeze was lifted and has not provided a definition. The Tax Court noted that it had applied a **functional analysis test** in *Renkemeyer, Campbell, & Weaver, LLP,*[309] but this was the first time the Tax Court was asked to determine the SE tax status of limited partner in a state law limited partnership (having passed on the issue in a 2020 case).

The Tax Court determined that the functional analysis test applied based largely on statutory construction of §1402(a)(13), which excludes from SE tax "the distributive share of any item of income or loss of a limited partner, as such." The court concluded that the "as such" language meant that there was not a blanket exclusion for a limited partner. Instead, the statute only applies to a limited partner who is acting as a limited partner. If a limited partner is anything more than merely an investor, SE tax applies to the partner's distributive share.

Note. The Tax Court noted that Soroban cited legislative history to support its position, but that the legislative history actually supported the position of the IRS. The Tax Court also noted that Soroban put forth numerous additional arguments, none of which were persuasive. Soroban even cited language in the instructions for Form 1065 which it claimed defined a limited partner, but the Tax Court noted that the definition did not purport to define a limited partner.

The Tax Court held that a functional inquiry into the roles and activities of Soroban's individual partners under §1402(a)(13) "involves factual determinations that are necessary to determine Soroban's aggregate amount of net earnings from self-employment." Accordingly, the Tax Court denied Soroban's motion for summary judgment and set forth the rule going forward in evaluating the application of SE tax for limited partners in professional service businesses.

Note. The manager-managed LLC provides a better result than the result produced by the member-managed LLC for LLCs that are not service partnerships. For those that are, an S corporation is the most appropriate business form to achieve a better tax result. For an S corporation, reasonable compensation will need to be paid subject to SE tax, but the remaining taxable income from the entity can be received free from SE tax. However, for farming operations with land rental income, the manager-managed LLC can provide a better overall tax result than an S corporation because of the ability to eliminate the NIIT.

Observation. With this decision, the Tax Court has laid down the rule in a precedential opinion that it is not enough to simply hold a limited partnership interest under state law (in the context of a professional service business). A limited partner must truly be acting as an investor and no more. Based on *Soroban*, the parties in *Sirius Solutions, LLLP v. Comm'r,*[310] stipulated that the functional analysis test dictated that the taxpayer's "state-law" limited partners are not "limited partners, as such for purposes of IRC §1402(a)" and that their distributive shares of ordinary business income are part of net earnings from self-employment.

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309. *Renkemeyer, Campbell, & Weaver, LLP v. Comm'r,* 136 TC 137 (2011).

310. *Sirius Solutions, LLLP v. Comm'r,* No. 30118-21, 2024 U.S. Tax Ct. LEXIS 420 (Feb. 20, 2024).

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Hobby Loss

Horse Farm Not Operated for Profit

Skolnick v. Comm'r, 62 F.4th 95 (3d Cir. 2023), *aff'g* TC Memo 2021-139 (Dec. 16, 2021)

The Skolnicks jointly owned horse farms with others. Their company had between seven and 10 employees. Between 1998 and 2013, the Skolnicks lost more than $11.4 million, and for the years under examination (2010–2013), they lost $3.5 million. The Tax Court determined that the activity was not engaged in with a profit intent based on the nine factors in the regulations under IRC §183. Of those factors, the Tax Court determined that the magnitude of the losses was the strongest factor that favored the IRS and that only one factor favored the petitioners — their expertise about horses. The Skolnicks' company also spent funds on items that were personal, including a wedding for one of the owners. The appellate court affirmed.

Farming Activity not Engaged in for Profit, but No Accuracy-Related Penalty

Schwarz v. Comm'r, TC Memo 2024-55 (May 13, 2024)

The Schwarzes had a history of conducting real estate-related activities involving ranchland. Through their controlled entities, the Schwarzes bought 15,070 acres in 2005 with the intent to improve it and sell it. However, they later decided to establish an ecotourism activity on a portion of the land involving fee-based fishing and hunting and other outdoor events. That activity was conducted by a partnership that they owned, which leased the land from their other controlled entities. The partnership also conducted farming and construction operations on the land and other properties that they owned. The partnership filed a Schedule F for every year from 2005 to 2020, reporting income from both the ecotourism activity and the farming/construction operations. The Schedule F gross income reported for those years exceeded $14 million, but resulted in a reported net loss every year. The losses flowed through to the Schwarzes, which offset significant taxable income.

The IRS issued a notice of deficiency for tax years 2015–2017, determining that the partnership's activity was not engaged in with the requisite profit intent under §183. The IRS also applied a 20% accuracy-related penalty for each year. The Schwarzes claimed that they were engaged in the Schedule F activity with a profit intent and that the real estate and the partnership's (and related entities' activities) were engaged in a single activity.

The Tax Court determined that the Schedule F activity and the real estate activities were separate and that the Schedule F activity was not engaged in with the intent to make a profit. On whether the activities were separate or should be combined, the Tax Court noted that the factors of Treas. Reg. §1.183-1(d)(1) (which establishes a test for treating farming and the holding of land on which farming occurs as one activity) were relevant and that neither party "came even remotely close to adequately addressing the issue." The Tax Court rejected the Schwarzes' argument that the regulation was inapplicable because the farming expenses contributed to the appreciation of the real estate. The Tax Court held that no such exception applied and that the factors set forth in the regulation and caselaw favored the IRS.

On the profit intent issue, the Tax Court went through the factors of Treas. Reg. §1.183-2(b) and concluded that most of the factors favored the IRS, particularly noting the long history of losses and lack of profit only permissible by the Schwarzes' high non-farm income, particularly when the real estate market was strong. Accordingly, the Tax Court determined that the Schwarzes were not engaged in the farming activity with the intent to make a profit.

As for the accuracy-related penalties, the Tax Court noted that the Schwarzes' CPA advised them during the tax years in issue and they relied in good faith on him as an experienced CPA. As such, the Tax Court held that the accuracy-related penalties did not apply for the tax years at issue.

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Note. This case involved large-scale revenues and losses associated with activities regarding the petitioners' personal interests who also had high income derived from other sources. The petitioners' books and records were inadequate and their business plans were not well developed. The lawyering in the case was also deficient. Indeed, the Tax Court stated:

> *Many facts stipulated, alleged, argued, testified about, and otherwise presented to the Court in this case are, or appear to be, incorrect or misleading. The parties' work occasionally reflected an uninspired attitude toward developing, trying, and briefing this case. As a result, many potentially relevant facts and arguments were undeveloped, ignored, misrepresented, and/or missed.*

The Tax Court was also critical of the credibility of expert witness reports offered in the case, as well of the credibility of the petitioners. This case illustrates the responsibility of legal counsel to candidly assess credibility of both their clients and their expert witnesses.

Tax Litigation and Procedure

Damages Awarded for False Filing of Form 1099-Misc

Scot Thompson Farms, LLC v. Hap Holdings Trust, No 8:23CV25, 2023 U.S. Dist. LEXIS 107772 (D. Neb. Jun. 21, 2023), *appeal filed,* No. 23-2712 (8th Cir. Jul. 26, 2023)

Scot Thompson Farms received Forms 1099-MISC reporting more than $15 million in connection with land it had acquired from Hap Holdings Trust (a trust) in a court-ordered sale. The Hap Holdings Trust's trustee, Jan Mengedoht, apparently retaliated by submitting these false documents to the IRS. The stated amounts were based on "100 years' use of both wind and solar energy easements," "29 years of the settlor's wages," and "involuntary conversion of the land."

The court found a basis for relief under IRC §7434 that each of the four Forms 1099-MISC should reflect payments of $0 and imposed a statutory damage award of $5,000 for each of the four false Forms 1099-MISC. No attorney fee award was mentioned in the court's order.

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Chapter 12: Planning for the Sunset of the TCJA

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Note. Corrections for all of the chapters are available at **TaxSchool.illinois.edu.** For clarification about terms used throughout this chapter, see the **Acronyms and Abbreviations** section following the index.

For your convenience, in-text website links are also provided as short URLs. Anywhere you see **uofi.tax/xxx**, the link points to the address immediately following in brackets.

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About the Author

Chris Korban, CPA, is a Tax Materials Specialist at the University of Illinois Tax School. He joined Tax School in 2023 with nine years of experience in public accounting. Chris earned both his Bachelor's Degree in Accounting and Master of Accounting Science from the University of Illinois.

Other chapter contributors and reviewers are listed at the front of this book.

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The passage of the Tax Cuts and Jobs Act of 2017[1] (TCJA) brought widespread changes to the tax code, impacting tax provisions for individuals, businesses, and estates. Some of the TCJA changes are permanent, while others are set to expire **after** December 31, **2025.** Newer tax preparers may not have experience with pre-TCJA tax requirements. This chapter will help introduce these concepts to those preparers while also refamiliarizing experienced practitioners with these topics. This chapter will identify key expiring provisions, the impact of the potential expiration, and possible planning opportunities arising from the sunsetting provisions of the TCJA. The appendix contains permanent provisions that, although not impacted by the expiration of the TCJA, may still influence planning decisions.

Note. Unless otherwise noted, the following material is written with the assumption that Congress will not extend or alter the expiring TCJA provisions. Practitioners should consider the possibility some provisions may be extended and communicate that possibility when proposing or discussing tax planning strategies with their clients.

POTENTIAL IMPACT ON INDIVIDUAL TAX RETURNS

The TCJA contains provisions significantly impacting individual taxpayers and their income tax returns. The focus of the following discussion is a selection of **expiring provisions** and potential tax planning opportunities for the 2024 and 2025 tax years.

STANDARD AND ITEMIZED DEDUCTIONS

Taxpayers are allowed to deduct from their adjusted gross income (AGI) either a standard deduction[2] or the total of the allowable itemized expenses they incurred during the tax year.[3] Along with the qualified business income deduction (QBID), discussed later, the standard deduction and itemized deductions are key subtractions to arrive at taxable income and are consequently a focal point in tax planning discussions to help taxpayers achieve more favorable income tax outcomes. A taxpayer's filing status determines the amount of deduction a taxpayer claims, which includes filing as single, married filing separately (MFS), head of household (HoH), married filing jointly (MFJ), and qualifying surviving spouse (QSS).

Rules Under the TCJA

Among the more favorable changes made by the TCJA was the substantial increase in the amount of standard deduction available to taxpayers. Because these amounts are indexed for inflation, the deduction has grown considerably since the enactment of the TCJA as shown in the following table.

	Pre-TCJA[4]	As Amended[5]	As Adjusted for Inflation for 2024[6]
Single/MFS	$ 6,350	$12,000	$14,600
HoH	9,350	18,000	21,900
MFJ/QSS	12,700	24,000	29,200

1. *Tax Cuts and Jobs Act,* PL 115-97.
2. IRC §63(c).
3. IRC §63(d).
4. Rev. Proc. 2016-55, 2016-45 IRB 707.
5. IRC §63(c)(7)(A).
6. Rev. Proc. 2023-34, 2023-48 IRB 1287.

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The TCJA also suspended miscellaneous itemized deductions[7] and imposed a cap on the deduction for state and local taxes (SALT).[8] The SALT cap is $10,000 for all filers except for MFS taxpayers whose deduction is capped at $5,000. As an offset to these restrictions, the TCJA suspended the overall limitation on itemized deductions for taxpayers with higher AGIs, commonly referred to as the Pease limitation.[9] The Pease limitation reduces itemized deductions by the lesser of the following.[10]

- 3% of the amount of AGI that exceeds the threshold, or
- 80% of the total amount of itemized deductions that would otherwise be allowable.

Certain deductions are not subject to the Pease limitation. These include the following.[11]

- Medical and dental expenses
- Investment interest
- Casualty and theft losses
- Gambling losses

In calculating the reduction of itemized deductions, all other limitations are applied first (e.g., the 2% threshold for miscellaneous itemized deductions and the AGI threshold for medical expenses). The Pease limitation is then applied to the adjusted amount.[12]

Rules When the TCJA Expires

Unless modified by subsequent legislation, for 2026 the standard deduction will significantly decrease, reverting back to pre-TCJA levels. The following table shows the anticipated standard deductions after inflation adjustments for 2026.

	Pre-TCJA [13]	As Adjusted for Inflation for 2026
Single/MFS	$ 6,350	$ 8,300 [14]
HoH	9,350	12,300 [15]
MFJ/QSS	12,700	16,600 [16]

Miscellaneous itemized deductions will be allowed, and taxpayers will not be subject to the cap on SALT deductions.

7. IRC §67(g).
8. IRC §164(b)(6)(B).
9. IRC §68.
10. IRC §68(a).
11. IRC §68(c).
12. IRC §68(d).
13. Rev. Proc. 2016-55, 2016-45 IRB 707.
14. *Major tax changes in 2026*. Dec. 12, 2023. Cato Institute. [www.cato.org/sites/cato.org/files/2023-12/print-copy_amichel_2026-tax-changes_final.pdf] Accessed on Apr. 25, 2024.
15. IRC §67(b) as a percentage of §67(c) multiplied by the estimated inflated amount by the Cato Institute for Single/MFS and MFJ/QSS filers in 2026, rounded to nearest $100.
16. *Major tax changes in 2026*. Dec. 12, 2023. Cato Institute. [www.cato.org/sites/cato.org/files/2023-12/print-copy_amichel_2026-tax-changes_final.pdf] Accessed on Apr. 25, 2024.

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Individuals whose AGI exceeds the applicable thresholds will have to reduce their itemized deductions by the lesser of 3% of the excess or 80% of their total itemized deductions.[17] The thresholds will be indexed for inflation. The unadjusted and estimated 2026 thresholds follow.

	Unadjusted [18]	Adjusted for Inflation (Estimated) for 2026 [19]
Single	$250,000	$341,700
MFS	150,000	205,050
HoH	275,000	375,900
MFJ/QSS	300,000	410,100

The following example approximates a Pease limitation in 2026.

Example 1. Ted and Robin will file a joint tax return for 2026. Their AGI will be $500,000, and their itemized deductions before any limitations will total $89,250, which consists entirely of charitable contributions.

Ted and Robin's itemized deductions will be limited for regular tax purposes because their AGI will exceed the 2026 estimated threshold limitation of $410,100. The limitation is computed based on how the Pease limitation worked prior to the enactment of the TCJA.

Itemized deductions		$89,250
AGI	$500,000	
Less: threshold limitation	410,100	
AGI above threshold	$ 89,900	
	× 3%	
Reduction in itemized deductions (Pease Limitation)	$ 2,697	(2,697)
Allowed itemized deductions		$86,553

Planning Opportunities

After the enactment of the TCJA, the number of taxpayers taking the standard deduction significantly increased, resulting in fewer taxpayers itemizing deductions on their income tax returns.[20] After the expiration of the TCJA, more taxpayers may benefit from itemizing their deductions instead of claiming the standard deduction. Consequently, it may be beneficial for taxpayers to postpone payments of 2024 and 2025 deductions until 2026 to benefit from itemizing them in 2026. For example, taxpayers may consider delaying making large charitable contributions until 2026 to receive the benefit of an itemized deduction. Certain medical deductions may also be considered when planning on making such payments.

17. IRC §68(a).

18. IRC §68(b).

19. Rev. Proc. 2015-53, 2015-44 IRB 615; *Major tax changes in 2026*. Dec. 12, 2023. Cato Institute. [www.cato.org/sites/cato.org/files/2023-12/print-copy_amichel_2026-tax-changes_final.pdf] Accessed on Jun. 27, 2024; Estimated inflation by comparing the 2016 standard deductions for each filing status and the personal exemption with the 2026 estimated standard deductions and personal exemption estimated by the Cato Institute and multiplying the 2016 applicable thresholds by the increased percentage.

20. IRS Pub. 1304, *Individual Income Tax Returns Complete Report* (Rev. 09-2020), p. 22 (2018).

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Example 2. Kurt is unmarried with a single Form W-2, *Wage and Tax Statement*. He donates $10,000 a year to his synagogue, but he has no other itemizable deductions. In 2024 and 2025, Kurt claims the standard deduction. He receives no tax benefits from his contributions. In 2026, his annual $10,000 charitable donation will exceed the estimated $8,300 standard allowance, so he will itemize. If he postpones his 2025 $10,000 donation until the following year, thereby making total contributions of $0 in 2025 and $20,000 in 2026, he may take advantage of both the standard deduction in 2025 and the itemized contribution in 2026.

Discussion: What are some reasons Kurt should not double-up on contributions every other year? Are there other considerations he should take into account when utilizing this strategy? ________________________

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Discussion: What are some other strategies Kurt should consider regarding the standard and itemized deduction changes occurring in 2024, 2025, and 2026 as the TCJA sunsets? ________________________

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The following **miscellaneous itemized deductions,** subject to the 2% AGI limit,[21] are set to return after 2025.[22]

- Appraisal fees
- Casualty and theft losses
- Credit or debit card convenience fees
- Hobby expenses
- Legal expenses
- Safe deposit box rental fees
- Tax preparation fees
- Unreimbursed employee expenses, including traveling, union dues, job education, etc.

Practitioner Planning Tip

As these miscellaneous itemized deductions have not been deductible since 2016, taxpayers may need a reminder of the potential benefit of tracking such expenses and deducting them on their income tax returns. **Practitioners may wish to remind their clients of these deductions before they become active again.**

21. IRC §67.

22. IRS Pub. 529, *Miscellaneous Deductions*.

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The elimination of the SALT cap presents some tax planning opportunities. To maximize the benefit of the SALT deduction, taxpayers who are currently limited by the $10,000 cap may benefit from paying some or all of their state estimated tax payments in early 2026 as opposed to in 2025. Depending on the benefit from the full SALT deduction compared to the amount of late estimated tax payment penalty, some taxpayers may benefit from the larger deduction even when incurring late payment penalties. Practitioners should estimate such costs and benefits when discussing this planning strategy with their clients.

> **Note.** Should the SALT cap limitation expire, tax practitioners should understand the impact of their state's rules as a response to any current pass-through entity rules.

PERSONAL EXEMPTIONS

Taxpayers can claim a personal exemption for themselves, their spouse, and their dependents. The exemption amount changes annually.[23]

Rules Under the TCJA

The TCJA eliminated personal exemptions. During the TCJA period, taxpayers can no longer deduct such exemptions to arrive at taxable income.[24]

Rules When the TCJA Expires

For tax years after December 31, 2025, taxpayers can deduct personal exemptions to arrive at taxable income on their income tax returns. The amount of each personal exemption is estimated to be $5,300 in 2026.[25] Personal exemptions are subject to a phaseout based on the taxpayer's AGI and filing status as follows.

	Unadjusted[26]	Adjusted for Inflation (Estimated) for 2026[27]
Single	$250,000	$341,700
MFS	150,000	205,050
HoH	275,000	375,900
MFJ/QSS	300,000	410,100

Planning Opportunities

In planning for tax years after the expiration of the TCJA, practitioners should be mindful of the return of personal exemptions at arriving at taxable income. Taxpayers may need to adjust their withholding or estimated tax payments to reflect changes to anticipated taxable income resulting from exemption deductions.

23. IRC §151.

24. IRC §151(d)(5).

25. *Major tax changes in 2026.* Dec. 12, 2023. Cato Institute. [www.cato.org/sites/cato.org/files/2023-12/print-copy_amichel_2026-tax-changes_final.pdf] Accessed on Jun. 27, 2024.

26. IRC §68(b).

27. Rev. Proc. 2015-53, 2015-44 IRB 615; *Major tax changes in 2026*. Dec. 12, 2023. Cato Institute. [www.cato.org/sites/cato.org/files/2023-12/print-copy_amichel_2026-tax-changes_final.pdf] Accessed on Jun. 27, 2024; Inflation was estimated by comparing the 2016 standard deductions for each filing status and the personal exemption with the 2026 estimated standard deductions and personal exemption estimated by the Cato Institute and multiplying the 2016 applicable thresholds by the increased percentage.

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HOME MORTGAGE INTEREST DEDUCTION[28]

Qualified residence interest is allowed as an itemized deduction, subject to limitations. Qualified residence interest is defined as interest paid or accrued during the tax year on either acquisition indebtedness or home equity indebtedness secured by a qualified residence. A **qualified residence** is a taxpayer's principal residence and one other residence of the taxpayer selected to be a qualified residence.

Acquisition indebtedness is indebtedness incurred in acquiring, constructing, or substantially improving a qualified residence of the taxpayer and is secured by the residence. **Home equity indebtedness** is indebtedness other than acquisition indebtedness secured by a qualified residence.

Rules Under the TCJA

For tax years within the TCJA period, a taxpayer may treat no more than $750,000 as acquisition indebtedness ($375,000 for MFS taxpayers).

For acquisition indebtedness incurred **before December 15, 2017,** the limit is $1 million ($500,000 for MFS taxpayers). If a taxpayer entered into a written binding contract before December 15, 2017, to close on the purchase of a principal residence before January 1, 2018, and purchased the residence before April 1, 2018, the $1 million limit ($500,000 for MFS taxpayers) applies.

In addition, refinanced indebtedness is treated as incurred on the date that the original indebtedness was incurred to the extent that the amount of the debt resulting from the refinancing does not exceed the amount of the refinanced indebtedness. Therefore, acquisition debt incurred prior to December 15, 2017, retains its status, even if the debt is refinanced. The maximum dollar amount that can be treated as principal residence acquisition indebtedness does not decrease because of refinancing.

The TCJA suspends the deduction for interest on certain types of **home equity indebtedness.**[29] Interest paid on home equity loans and home equity lines of credit is **not deductible unless the loans are used to buy, build, or substantially improve the taxpayer's home that secures the loan.** This applies to tax years within the TCJA period. During these years, for example, interest on a home equity loan used to build an addition to an existing home is typically deductible, while interest on the same loan used to pay personal expenses is not. The $750,000 limit ($375,000 for MFS taxpayers) applies to the combined amount of loans used to buy, build, or substantially improve the taxpayer's principal residence and second home (if applicable).

During the TCJA period, certain types of home equity debt are no longer treated as qualified residence debt, as the deductibility of interest paid on such debt must now be determined under the interest-tracing rules.

Rules When the TCJA Expires

The maximum amount that can be treated as acquisition indebtedness is $1.1 million ($550,000 for MFS taxpayers).[30] The deduction for interest on certain types of home equity indebtedness is no longer restricted when the TCJA expires. Interest paid on home equity loans and home equity lines of credit is deductible regardless of whether the loans are used to buy, build, or substantially improve the taxpayer's home securing the loan. The $1.1 million limit ($550,000 for MFS taxpayers) applies to the combined amount of loans used to buy, build, or substantially improve the taxpayer's principal residence and second home (if applicable).

28. IRC §163(h).

29. IRS News Rel. IR-2018-32 (Feb. 21, 2018).

30. CCA 200940030 (Oct. 2, 2009).

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Planning Opportunities

Interest expense tracing rules may be relaxed and allow additional interest to qualify for a deduction. The purchase of a home with a debt of greater than $750,000 may lead to a larger interest deduction in 2026 and after. Depending on how the debt is acquired and for what purpose, interest deductions in 2026 could be increased compared to deductions during the TCJA period.

CASUALTY AND THEFT LOSSES[31]

A taxpayer can claim a deduction for a casualty or theft loss incurred during the tax year for which they were not compensated by insurance or otherwise. For individual taxpayers, deductible losses are those incurred in a trade or business, or that consist of property losses arising from casualty or theft. Personal casualty or theft losses are deductible only if they exceed $100 per casualty or theft and only to the extent that aggregate net casualty and theft losses exceed 10% of the taxpayer's AGI.

Rules Under the TCJA

The TCJA temporarily modified the deduction for personal casualty and theft losses. Under this provision, a taxpayer can claim a personal casualty loss only if the loss is attributable to a **federally declared disaster.**

However, a taxpayer can still offset personal casualty losses not attributable to a federally declared disaster against personal casualty gains to the extent that such losses do not exceed such gains.[32] When applying the 10% AGI threshold to personal casualty losses attributable to a federally declared disaster, the amount of casualty gains taken into account is reduced by the portion of gains offset against casualty losses not attributable to federally declared disasters.[33]

Rules When the TCJA Expires

A taxpayer can claim a personal casualty loss regardless of whether the loss is attributable to a federally declared disaster, subject to the limitations mentioned previously.

CHILD TAX CREDIT[34]

The child tax credit (CTC) is a reduction of tax based on the number of qualifying children the taxpayer has and the level of income the taxpayer earned in the tax year. Since the CTC was first enacted in 1997, the amount of the credit, its refundability, and various phase-outs have been modified several times based on congressional priorities at the time.

Rules Under the TCJA

The CTC is a $2,000 maximum tax credit per qualifying child under the age of 17. A portion of the credit, commonly referred to as the additional child tax credit (ACTC), may be refundable depending upon the taxpayer's earned income.[35] For 2024, the ACTC may refund eligible taxpayers up to $1,700.[36] The credit is phased out when modified adjusted gross income (MAGI) exceeds the following thresholds.

	MFJ	All Other Filers
MAGI	$400,000	$200,000

31. IRC §165(h).

32. IRC §165(h)(5)(B)(i).

33. IRC §165(h)(5)(B)(ii).

34. IRC §24.

35. IRC §24(d).

36. Rev. Proc. 2023-34, 2023-48 IRB 1287.

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Rules When the TCJA Expires

The CTC is reduced to $1,000 per qualifying child under the age of 17. The credit will be phased out when MAGI exceeds the following thresholds.

	MFJ	All Other Filers
MAGI	$110,000	$75,000

Note. The reinstatement of personal exemptions for dependents will offset some of the tax benefits lost from the change in the CTC amount.

Planning Opportunities

Depending on a taxpayer's number of dependents and their tax bracket, their tax liability may increase resulting from the reduction of the CTC, even considering the return of personal exemptions. Practitioners should identify such clients in their tax planning conversations with them. One strategy may include accelerating certain taxable income in 2025 while the CTC income phaseout thresholds are much higher, potentially allowing the taxpayer the opportunity to claim the credit in 2026 when the income threshold significantly drops. **Taxpayers may need to adjust their withholding or estimated tax payments for tax years after 2025** to account for any increase in tax liability due to the change in the CTC amount and income thresholds.

Example 3. Liam and his wife, Samantha, generally have MAGI of $160,000 each year. In 2025, they have two pre-teenage children who live with them. For 2025, Liam and Samantha are able to claim a CTC of $4,000 ($2,000 credit × 2 children). In 2026 when their MAGI is again $160,000, Liam and Samantha are unable to claim the CTC due to the credit being completely phased-out by their income exceeding the lower MAGI threshold.

Example 4. Use the same facts as **Example 3,** except Liam shifts $55,000 of income from his sole proprietor business from 2026 to 2025. Liam and Samantha have MAGI of $215,000 in 2025 ($160,000 base income + $55,000 shifted income from 2026) and claim a CTC of $4,000 ($2,000 credit × 2 children). In 2026, Liam and Samantha have MAGI of $105,000 ($160,000 base income − $55,000 shifted income to 2025) and claim a CTC of $2,000 ($1,000 credit × 2 children). By successfully shifting $55,000 of income, Liam and Samantha are able to increase their CTC in 2026 by $2,000.

OTHER DEPENDENTS CREDIT[37]

The other dependents credit (ODC) helps taxpayers address the costs associated with maintaining and providing for a household. To qualify:

- Taxpayers must provide over half of a **qualifying person's** support for the tax year,
- The qualifying person's income must be below the inflation adjusted exemption amount, and
- The person must meet certain relationship and residency requirements to be qualified.[38]

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37. IRC §24(h)(4).

38. IRC §152(d)(1).

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The qualifying person must bear one of the following relationships to the taxpayer.[39]

- A child or grandchild
- A sibling or stepsibling
- A father, mother, or ancestor of either
- A stepparent
- A niece or nephew
- An aunt or uncle
- A son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law
- An individual (other than a spouse) who lived with the taxpayer for the tax year and is a member of the taxpayer's household

Rules Under the TCJA

Taxpayers can claim a $500 maximum nonrefundable tax credit for each qualifying person. The credit begins to phase out when a taxpayer's MAGI exceeds the following thresholds, which are not subject to inflation.[40]

	MFJ	All Other Filers
MAGI	$400,000	$200,000

Rules When the TCJA Expires

The ODC is eliminated. However, dependent exemptions return, allowing taxpayers with dependents other than qualifying children to receive relief.[41]

Planning Opportunities

For most taxpayers, the tax savings from claiming a personal exemption for a dependent is greater than the $500 ODC. However, higher income taxpayers will lose the benefit of the dependent credit at lower income levels when the TCJA expires. Practitioners should identify such clients in their tax planning conversations with them, particularly those whose estimated tax payments may need adjusting to accommodate a higher projected tax liability in 2026. Additionally, practitioners may suggest additional strategies to mitigate impacted clients' tax burdens.

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39. IRC §152(d)(2).
40. IRC §24(h)(3).
41. IRC §§151(c) and (d)(5).

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Example 5. John and Sarah are married with two children, Emma (age 14) and Michael (age 9). They also financially support Sarah's mother, Mary (age 75), who lives with them. In 2025, in addition to taking the CTC for Emma and Michael, John and Sarah are eligible for the ODC for Mary, their dependent. The $500 credit directly reduces their tax liability.

In 2026, John and Sarah are not able to claim the ODC for Mary due to the expiration of the TCJA eliminating the credit. Instead, the couple claimed five personal exemptions on their return, consisting of two for each of them, two for their children, and one for Mary. Because they are in the 28% tax bracket in 2026, claiming the personal exemption for Mary results in a reduction in John and Sarah's income tax of $1,484 ($5,300 personal exemption × 28%). Therefore, in their specific situation, the personal exemption provided a greater tax benefit than the ODC of $500 to John and Sarah.

Discussion: How could John use a health savings account (HSA) contribution to reduce his post-TCJA taxable income? ______________________________

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Discussion: What other tax-saving tools could John and Sarah consider in their situation to take advantage of the ODC before it expires? ______________________________

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TAX BRACKETS

The U.S. federal income tax structure is based on a progressive tax system, where a tax progresses to a higher tax rate alongside an increase in income levels.[42] Consequently, understanding marginal rates and tax brackets is a critical component of tax planning.

Rules Under the TCJA

Seven income tax rates apply to individual taxpayers. For 2024, the following tax tables apply.[43]

Tax Rate	Single	MFJ/QSS	MFS	HoH
10%	$0 to $11,600	$0 to $23,200	$0 to $11,600	$0 to $16,550
12%	11,601 to 47,150	23,201 to 94,300	11,601 to 47,150	16,551 to 63,100
22%	47,151 to 100,525	94,301 to 201,050	47,151 to 100,525	63,101 to 100,500
24%	100,526 to 191,950	201,051 to 383,900	100,526 to 191,950	100,501 to 191,950
32%	191,951 to 243,725	383,901 to 487,450	191,951 to 243,725	191,951 to 243,700
35%	243,726 to 609,350	487,451 to 731,200	243,726 to 365,600	243,701 to 609,350
37%	Over 609,350	Over 731,200	Over 365,600	Over 609,350

42. IRC §1.
43. Rev. Proc. 2023-34, 2023-48 IRB 1287.

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Rules When the TCJA Expires

Tax rates will revert back to their pre-TCJA amounts of 10%, 15%, 25%, 28%, 33%, 35%, and 39.6%, and the higher rates will apply to lower brackets. Adjusted for inflation, estimated individual income tax brackets for 2026 follows.[44]

Tax Rate	Single	MFJ/QSS	MFS	HoH
10%	$0 to $9,325	$0 to $18,650	$0 to $9,325	$0 to $13,350
15%	9,326 to 37,950	18,651 to 75,900	9,326 to 37,950	13,351 to 50,800
25%	37,951 to 91,900	75,901 to 153,100	37,951 to 76,550	50,801 to 131,200
28%	91,901 to 191,650	153,101 to 233,350	76,551 to 116,675	131,201 to 212,500
33%	191,651 to 416,700	233,351 to 416,700	116,676 to 208,350	212,501 to 416,700
35%	416,701 to 418,400	416,701 to 470,700	208,351 to 235,350	416,701 to 444,550
39.6%	Over 418,400	Over 470,700	Over 235,350	Over 444,550

Planning Opportunities

Taxpayers should consider taking advantage of the lower tax rates in the TCJA tax years. For example, taxpayers wishing to convert from a traditional individual retirement arrangement (IRA) to a Roth IRA may benefit from making such conversions in 2024 and 2025. Taxpayers considering this strategy should keep in mind that they are not required to convert the entire balance of an IRA account.

> **Note.** For more information about Roth conversions, see the 2023 *University of Illinois Federal Tax Workbook*, Chapter 8: Retirement Plan Issues for Individuals.

Contrary to a traditional IRA strategy, a Roth IRA strategy provides no tax deduction for contributions and qualified withdrawals are not included in taxable income.

Example 6. Miguel is a single taxpayer with taxable income of $70,000 in 2026. He contributes $5,000 to a traditional IRA. The contribution is deductible on his 2026 tax return (assuming he meets the income eligibility criteria and is not covered by an employer-sponsored retirement plan), reducing his taxable income to $65,000 ($70,000 taxable income – $5,000 contribution). Assuming a 25% tax rate, Miguel saves $1,250 in taxes ($5,000 contribution × 25% tax rate).

Example 7. Use the same facts as **Example 6,** except Miguel has taxable income of $115,000. Miguel is now in the 28% tax bracket. The $5,000 IRA contribution saves him $1,400 in taxes ($5,000 contribution × 28% tax rate).

Discussion: What are some retirement considerations Miguel should consider when assessing options for contributions to traditional and Roth IRAs? ______________________________

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Discussion: What are some other strategies Miguel should consider when facing the tax bracket changes occurring in 2024, 2025, and 2026 as the TCJA sunsets? ______________________________

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[44] *2026 Tax Year Changes*. Sep. 27, 2023. eFile.com. [www.efile.com/2026-tax-year-changes-tcja] Accessed on Jun. 28, 2024.

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ALTERNATIVE MINIMUM TAX

The alternative minimum tax (AMT) was intended to prevent high income taxpayers from exploiting the income tax benefits available to lower income taxpayers. Alternative minimum taxable income (AMTI) is calculated by modifying regular taxable income for certain preferences and adjustments.

These adjustments include, but are not limited to, the following.[45]

- Itemized deductions for SALT are not allowed.
- The standard deduction is not allowed.

After subtracting the AMT exemption amount applicable to the filing status and income levels from AMTI, the tentative minimum tax is calculated based on the AMT brackets and applicable rates for capital gains and qualified dividends. The AMT is the amount by which the tentative minimum tax exceeds the regular income tax for the year.[46]

Rules Under the TCJA

The AMT exemption and income phase-out amounts are indexed for inflation. For tax years beginning in 2024, the amount of income exempt from AMT is the following for individual taxpayers.[47]

- $133,300 for MFJ taxpayers and QSS
- $85,700 for single taxpayers and HoH
- $66,650 for MFS taxpayers

For tax years beginning in 2024, the exemption amounts are phased out by 25% of the amount by which the individual's AMTI exceeds the following amounts.[48]

- $1,218,700 for MFJ taxpayers and QSS
- $609,350 for all other taxpayers

Note. For more information on the TCJA impact on AMT, see the 2018 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 2: Individual Taxpayer Issues. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

Rules When the TCJA Expires

For tax years beginning in 2026, the AMT exemption and phase-out will revert to pre-TCJA levels and then both will be adjusted for inflation. The 2026 amounts are estimated to be the following.[49]

- $110,400 for MFJ taxpayers and QSS
- $71,000 for single taxpayers and HoH
- $55,200 for MFS taxpayers

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45. IRC §56.
46. IRC §55.
47. IRS News Rel. IR-2023-208 (Nov. 9, 2023).
48. Ibid.
49. Rev. Proc. 2015-53, 2015-44 IRB 615; *Major tax changes in 2026*. Dec. 12, 2023. Cato Institute. [www.cato.org/sites/cato.org/files/2023-12/print-copy_amichel_2026-tax-changes_final.pdf] Accessed on Jun. 27, 2024; Estimated inflation by comparing the 2016 standard deductions for each filing status and the personal exemption with the 2026 estimated standard deductions and personal exemption estimated by the Cato Institute and multiplying the 2016 AMT and AMTI thresholds by the increased percentage.

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For tax years beginning in 2026, the exemption amounts are phased out by 25% of the amount by which the individual's AMTI exceeds the following estimated amounts.[50]

- $210,400 for MFJ taxpayers and QSS
- $157,700 for single taxpayers and HoH
- $105,200 for MFS taxpayers

Among the AMT adjustments modifying a taxpayer's AMTI includes miscellaneous itemized deductions. Because these deductions are disallowed by the TCJA,[51] taxpayers do not factor them as AMT adjustments in calculating AMTI during the TCJA period. With the return of these deductions in 2026, a taxpayer's AMTI must be modified to exclude miscellaneous itemized deductions the taxpayer claims on their Schedule A, *Itemized Deductions*.[52] Similarly, **personal exemptions** are an AMT adjustment that must be factored into calculating AMTI upon their return under the expiration of the TCJA.[53]

Planning Opportunities

If the AMT provisions return to pre-TCJA levels, **the number of affected taxpayers is expected to increase from 200,000 to over 5 million filers.[54] Long-term tax planning must include potential for exposure to this tax.**

During the years prior to the expiration of the TCJA, it may benefit taxpayers to realize income subject to an AMT adjustment while the exemptions and phase-outs are higher. For example, exercising an incentive stock option (ISO) creates AMTI to the extent the fair market value (FMV) at the time of exercise is greater than the exercise price.[55] Taxpayers may benefit from exercising ISOs during 2024 and 2025 instead of in 2026 or later.

Note. For more information on ISOs and associated AMT implications, see the 2016 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 1: Individual Taxpayer Issues and the 2019 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 3: Calculating Basis. These can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

QUALIFIED BUSINESS INCOME DEDUCTION

The QBID is among the most substantial changes arising from the enactment of the TCJA. The QBID is a tax deduction of 20% of qualified business income (QBI) from U.S. domestic business activities.[56] In addition to deriving from ownership of a sole proprietorship or interests in passthrough entities, discussed later, QBI may also derive from dividends and investment activity.

50. Ibid.
51. IRC §67(g).
52. IRC §56(b)(1)(A)(i).
53. IRC §56(b)(1)(D).
54. *Major tax changes in 2026*. Dec. 12, 2023. Cato Institute. [www.cato.org/sites/cato.org/files/2023-12/print-copy_amichel_2026-tax-changes_final.pdf] Accessed on Jun. 18, 2024.
55. IRC §56(b)(3).
56. IRC §199A.

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Rules Under the TCJA

Taxpayers may receive a 20% deduction of the aggregate amount of the taxpayer's qualified real estate investment trust (REIT) dividends and qualified publicly traded partnership (PTP) income for the tax year.[57] A qualified REIT dividend is any dividend from a REIT that meets **both** of the following criteria.[58]

1. The dividend is not a capital gain dividend under IRC §857(b)(3), and
2. The dividend is not qualified dividend income under IRC §1(h)(11).

REIT dividends are reported on Box 5, *Section 199A dividends*, of Form 1099-DIV, *Dividends and Distributions*.[59]

PTP income subject to the QBID is the sum of the following.[60]

1. The taxpayer's share of qualified income, deduction, gain, and loss from a PTP defined under IRC §7704(a), and
2. The taxpayer's recognized gain upon their disposition of their interest in the PTP if the interest is not a capital asset under IRC §751(a).

PTP income and other information related to IRC §199A and the QBID is reported on the partner's Schedule K-1 (Form 1065), *Partner's Share of Income, Deductions, Credits, etc.*, in Box 20, *Other information*, Code Z.[61] Shareholders report §199A information on Schedule K-1 (Form 1120-S), *Shareholder's Share of Income, Deductions, Credits, etc.,* in Box 17, *Other information,* using Code V.[62]

Rules When the TCJA Expires

The QBID will expire for tax years beginning in 2026. Consequently, taxpayers will not receive a 20% deduction for REIT dividends, PTP income, and QBI for 2026 and subsequent tax years.[63]

Planning Opportunities

Taxpayers may consider altering their investments appropriately, as REIT dividends and PTP income will not yield a deduction for QBI.

> **Example 8.** Jasper is a high-income taxpayer who has been investing in a REIT for several years. He has been benefiting from the QBID, which allows him to deduct up to 20% of QBI from his REIT investments each year since 2017. In anticipation of the TCJA expiring, Jasper meets with his tax advisor in 2024 to discuss the impact of the QBID phase-out on his overall tax liability. They review strategies to optimize Jasper's tax position, including potential adjustments to his investment portfolio.
>
> Based on advice from his tax advisor, Jasper explores alternative investment opportunities that may offer better after-tax returns given the impending QBID phase-out. This includes investments in assets with a different tax treatment. Jasper is instructed to be aware of timing considerations of any potential sales or purchases, such as ensuring capital gains do not place Jasper in a higher tax bracket while factoring in capital losses for AGI limitations to deductions and other non-tax, financial purposes, such as loan applications.

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57. IRC §199A(b)(1)(B).
58. IRC §199A(e)(3).
59. Instructions for Form 1099-DIV.
60. IRC §199A(e)(4).
61. Instructions for Schedule K-1 (Form 1065).
62. Instructions for Schedule K-1 (Form 1120-S).
63. IRC §199A(i).

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Discussion: What are some other strategies Jasper should consider for his individual tax return facing the QBID changes occurring in 2024, 2025, and 2026 as the TCJA sunsets? ______________________________

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POTENTIAL IMPACT ON BUSINESS TAX RETURNS

The TCJA made changes to the Code impacting business income tax returns, perhaps most notably the QBID. Other changes also arose from the enactment of the TCJA that taxpayers and their practitioners should consider in light of the possibility of these provisions expiring along with the sunset of the TCJA. This section addresses these considerations as well as associated potential planning opportunities.

QUALIFIED BUSINESS INCOME DEDUCTION

As described earlier, QBID is a tax deduction equal to 20% of QBI derived from U.S. domestic business activities.[64] QBID became a significant tax planning strategy during the TCJA period.

Rules Under the TCJA

QBID applies only for income tax purposes and is not a deduction for self-employment (SE) or net investment income tax (NIIT) purposes.[65] The deduction is taken after the standard or itemized deductions.[66]

Individual taxpayers with QBI from a partnership, S corporation, estate, trust, sole proprietorship and from certain rental activities can claim the QBID.[67] QBI comprises the net amount of qualified items of income, gain, deduction, and loss derived from a taxpayer's qualified trade or business.[68] QBI includes the taxpayer's deductible part of SE tax, self-employed health insurance, and contributions to qualified retirement plans, such as simplified employee pension (SEP) plans and savings incentive match plan for employees (SIMPLE).[69] **QBI does not include the following items.[70]**

- Items not properly included in taxable income
- Investment items including capital gains or losses
- Interest income not related to a trade or business
- Income from wages
- Income from business conducted outside the United States
- Commodities transactions or foreign currency gains or losses
- Certain dividends and payments in lieu of dividends

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64. IRC §199A.

65. *Tax Cuts and Jobs Act, Provision 11011 Section 199A - Qualified Business Income Deduction FAQs*. Dec. 01, 2023. IRS. [www.irs.gov/newsroom/tax-cuts-and-jobs-act-provision-11011-section-199a-qualified-business-income-deduction-faqs] Accessed on May 14, 2024.

66. IRC §63(b)(3).

67. IRC §§199A(d) and (f).

68. IRC §199A(c)(1).

69. *Qualified Business Income Deduction*. Apr. 26, 2024. IRS. [www.irs.gov/newsroom/qualified-business-income-deduction] Accessed on May 14, 2024.

70. Ibid.

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- Notional principal contract income, losses, or deductions
- Annuities not received in connection with a trade or business
- Reasonable compensation received from an S corporation
- Guaranteed payments received from a partnership
- Payments for services rendered outside the capacity of a partner
- Qualified REIT dividends, as described earlier
- PTP income, as described earlier

Taxpayers receive a total QBID from the combination of the following.[71]

1. The sum of the **initial QBIDs**, for each of the taxpayer's qualified businesses
2. 20% of the aggregate amount of the taxpayer's qualified REIT dividends and PTP income for the tax year, as described earlier

> **Note.** This formula only results in combined QBID if the taxpayer has net positive aggregate QBI from qualified businesses and/or positive aggregate income from REITs and PTPs.

Qualified Business Losses.[72] When the net QBI from all qualified businesses is less than zero, the combined QBID from qualified businesses is zero (item 1 of the combined QBID formula) for the tax year. The resulting qualified business loss (QBL) is treated as negative QBI from a separate trade or business in the taxpayer's succeeding tax year. This requirement does not affect the deductibility of the loss under other sections of the Code.

Taxpayers who have one or more businesses with QBLs but net positive overall QBI must apportion their QBLs among the businesses with positive QBI in proportion to the relative amounts of their positive QBI. The business's QBI less its allocation of losses from other businesses is its adjusted QBI, which becomes its QBI for the purposes of the initial QBID calculation.[73]

Specified Service Business. The QBID attributable to positive QBI from a specified service business (SSB) is reduced for taxpayers whose taxable income exceeds the following thresholds in 2024.[74]

- $383,900 for MFJ taxpayers
- $191,950 for all other filing statuses

The limitation is gradually phased in for MFJ taxpayers with taxable income between $383,900 and $483,900. The phase-in range is between $191,950 and $241,950 for other filing statuses. Taxpayers with SSBs that have taxable income above $483,900 (MFJ taxpayers) or $241,950 (all other taxpayers) are not entitled to a QBID.[75]

71. IRC §199A(b)(1).
72. Treas. Reg. §1.199A-1(c).
73. Treas. Reg. §1.199A-1(d)(2)(iii).
74. Rev. Proc. 2023-34, 2023-48 IRB 1287.
75. Ibid.

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An SSB is any trade or business involving the performance of services in the following areas.[76]

- Health
- Law
- Accounting
- Actuarial science
- Performing arts
- Consulting
- Athletics
- Financial service (including investing and investment management, and trading or dealing in securities or commodities)
- Brokerage services

An SSB also includes any trade or business in which **the principal asset is the reputation or skill of one or more of its employees or owners.**[77] This definition applies to any trade or business in which a person does one or more of the following.[78]

1. Receives fees, compensation, or other income for endorsing products or services
2. Licenses or receives fees, compensation, or other income for the use of an individual's image, likeness, name, signature, voice, trademark, or any other symbols associated with the individual's identity
3. Receives fees, compensation, or other income for appearing at an event or on radio, television, or another media format

Rules When the TCJA Expires

The QBID will expire for tax years beginning in 2026. Prior to the enactment of the TCJA, qualifying taxpayers could claim a domestic production activities deduction (DPAD) under IRC §199. However, the TCJA not only replaced the DPAD with the QBID, but it repealed the DPAD and §199 in its entirety.[79]

Planning Opportunities

Taxpayers with QBI may benefit from recognizing income in 2024 and 2025 to receive benefit from the QBID. Depending on their basis of accounting, taxpayers should consider accruing more income in 2024 and 2025 or collect payment in those years for services to be rendered in 2026 and later. One strategy may include selling items that potentially result in an ordinary IRC §1231 gain, which increases QBI. It may also benefit taxpayers to delay incurring or paying expenses until 2026 to recognize more income in prior years to benefit from the QBID.

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76. IRC §§199A(d)(2)(A) and 1202(e)(3)(A).
77. Ibid.
78. Treas. Reg. §1.199A-5(b)(2)(xiv).
79. *Tax Cuts and Jobs Act*, PL 115-97, §13305.

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Example 9. Clara operates a small consulting business as a sole proprietorship and files a Schedule C, *Profit or Loss from Business,* with her tax return. With the TCJA provisions set to expire, Clara plans for potential changes in tax law that could affect her business and personal taxes. She considers postponing as many deductible expenses into the 2026 and following tax years as possible to claim higher income eligible for the QBID in 2024 and 2025. Additionally, Clara keeps in mind that contributions to her SEP IRA would reduce the income eligible for the QBID and considers postponing those as well.

Discussion: What are some other strategies Clara should consider facing the QBID deduction changes occurring between 2024 and 2026 as the TCJA sunsets? ______________________________

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Discussion: Would there be a benefit to Clara waiting to make purchases of depreciable property until 2026?

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BONUS DEPRECIATION

Taxpayers can accelerate the depreciation of certain qualified property using a special allowance commonly referred to as bonus depreciation.[80] Bonus depreciation is in addition to regular depreciation and is automatic unless the taxpayer elects out.[81]

Bonus depreciation is applicable for the **first tax year** that qualifying property is placed in service. The adjusted basis of the property is first reduced by the bonus depreciation claimed and then regular depreciation deductions are computed on any remaining basis. Unlike IRC §179 expensing, there is no limit on the total amount of bonus depreciation a taxpayer can claim in any given tax year or short tax year.[82]

> **Note. For eligible property, §179 expensing is claimed first.** Then, bonus depreciation is claimed, and any remaining basis is subject to modified cost recovery system (MACRS). For comprehensive coverage of these options, see the 2023 *University of Illinois Federal Tax Workbook,* Chapter 7: Depreciation.

Only qualified property is eligible for bonus deprecation. **Qualified property** includes the following.[83]

- Property with a recovery period of 20 years or less
- Computer software depreciable over three years under IRC §167(f)
- MACRS water utility property
- Qualified film or television production as defined under IRC §181(d) that the aggregate cost exceeds $15 million and/or the production commences after December 31, 2025
- Qualified live theatrical production as defined under §181(e) that the aggregate cost exceeds $15 million and/or the production commences after December 31, 2025

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80. IRC §168(k).
81. IRC §168(k)(7).
82. *Additional First Year Depreciation Deduction (Bonus) – FAQ.* Jan. 30, 2024. IRS. [www.irs.gov/newsroom/additional-first-year-depreciation-deduction-bonus-faq] Accessed on May 15, 2024.
83. IRC §168(k)(2)(A)(i).

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Rules Under the TCJA

The TCJA altered provisions under IRC §168(k) impacting the amount and deductibility of bonus depreciation.

Qualified Property. Qualified property applies to new property. The TCJA allows qualified property to include used property if such property met the following two acquisition requirements.[84]

1. The taxpayer did not use the property at any time before acquiring it.
2. The taxpayer acquired the property by "purchase" within the meaning of §179(d)(2).

An acquisition is considered a **purchase** under §179(d)(2) unless the property meets any of the following criteria.

- Acquired from a close family member[85]
- Acquired by one member of a controlled group[86] of corporations from another member
- Has a basis in the hands of the acquirer determined wholly or partly by reference to the adjusted basis of the disposing party (e.g., a gift or IRC §1022 basis property)
- Has its basis determined under IRC §1014(a) (relating to inherited or bequeathed property)

The TCJA designated qualified improvement property (QIP) as being 15-year property, and **therefore qualifies for bonus depreciation.**[87] QIP does not include improvements for the enlargement of a building, elevator or escalator, or the internal structural framework of the building.[88]

Applicable Rate. The bonus depreciation rate was 100% for qualified property acquired and placed in service after September 27, 2017, and before January 1, 2023.[89] Longer production period property (LPPP) and certain noncommercial aircraft (NCA) are eligible if placed in service before January 1, 2025.[90] The 100% rate is phased down for years beginning after 2022. The applicable bonus depreciation rates are shown in the following table.[91]

Calendar Year Placed in Service		Bonus
LPPP and NCA	Other Qualifying Property	Depreciation Rate
After September 27, 2017, and before 2024	After September 27, 2017, and before 2023	100%
2024	2023	80%
2025	2024	60%
2026	2025	40%
2027	2026	20%
2028 and subsequent years	2027 and subsequent years	0%

84. IRC §§168(k)(2)(A)(ii) and (E)(ii).

85. As defined under IRC §§267 or 707(b) except as modified by IRC §179(d)(2)(A).

86. As defined under IRC §1563(a) except substituting 50% for the 80% stock ownership requirement under IRC §1563(a)(1).

87. IRC §168(e)(3)(E)(vii); Treas. Reg. §1.168(b)-1(a)(5).

88. IRC §168(e)(6)(B).

89. IRC §§168(k)(1)(A) and (6)(A).

90. IRC §§168(k)(1)(A) and (6)(B).

91. IRC §168(k)(6).

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Rules When the TCJA Expires

The bonus depreciation applicable rate is scheduled to phase down to 0% by January 1, 2028, for LPPP and NCA, and by January 1, 2027, for other qualifying property. This will result in taxpayers only being able to use bonus depreciation for a couple of years subsequent to the planned expiration of the TCJA.[92]

Planning Opportunities

Both bonus depreciation and the §179 deduction allow current year expensing of costs that otherwise would be deducted over multiple years. However, each provision operates somewhat differently in which assets qualify and what limits apply to the deductions.

One of the most significant differences between bonus depreciation and the §179 deduction is the dollar limitations on deductibility are only applicable to §179. For 2024, the following limitations apply to the §179 deduction.[93]

- The deduction cannot exceed $1,220,000
- The deduction is reduced dollar-for-dollar after the total cost of qualified assets exceeds $3,050,000

In addition to these limitations, the §179 deduction cannot create a loss from a taxpayer's trade or business.[94] Allowable §179 deductions in excess of income are carried forward.

When evaluating whether to elect §179 and/or elect out of bonus depreciation, practitioners may need to consider how these provisions carry forward to future years, especially if either of the following are true.

- The §179 deduction is limited by income, and
- **Bonus depreciation creates a net operating loss (NOL).**

Taxpayers who are considering making significant investments may benefit from purchasing the assets prior to the phase-out of the bonus depreciation deduction.

Example 10. In 2022, ABC, Co. is considering upgrading some of its equipment. The company has some flexibility in when they make the purchase. The desired replacement equipment costs $100,000, and its cost is not anticipated to increase in future years.

ABC purchases the $100,000 equipment in 2022 and elects 100% bonus on the purchase. ABC has income of $75,000 prior to the bonus deduction. The bonus depreciation creates an NOL of $25,000 ($75,000 income − $100,000 bonus deduction). Consequently, ABC does not have a tax liability for 2022.

Example 11. Use the same facts as **Example 10,** except ABC does not make the purchase until 2026. ABC takes the maximum 20% bonus depreciation in the first year of $20,000 ($100,000 equipment cost × 20% bonus depreciation rate) and takes §179 expense on the remaining $80,000 equipment cost ($100,000 equipment cost − $20,000 bonus depreciation). ABC has income of $75,000 prior to any depreciation deduction in 2026. Consequently, ABC has income of $55,000 after taking into account bonus depreciation ($75,000 income − $20,000 bonus depreciation). After applying §179 expense to its remaining income, ABC has a tax liability of $0 and a §179 expense carryover of $25,000 ($80,000 §179 expense − $55,000 income limitation).

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92. Ibid.

93. Rev. Proc. 2023-34, 2023-48 IRB 1287.

94. IRC §179(b)(3).

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Discussion: What are the advantages of ABC, Co. taking bonus depreciation over §179 expense? ________

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Discussion: What other strategies should ABC, Co. consider facing the phasing out of bonus depreciation in 2024, 2025, and 2026 as the TCJA sunsets? ____

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Congress has a long history of modifying and extending bonus depreciation provisions.[95] Because the provisions themselves do not expire, future legislation may reactivate the deduction simply by modifying §168(k)(6) to provide percentages applicable to later years.

> **Note.** For more comprehensive coverage of depreciation, including information regarding bonus depreciation and the §179 deduction, see the 2023 *University of Illinois Federal Tax Workbook*, Chapter 7: Depreciation.

POTENTIAL IMPACT ON ESTATE TAX RETURNS

Among the numerous changes resulting from the expiration of the TCJA, the estate tax implications primarily revolve around the reduction of the lifetime estate tax exclusion and the treatment of excess deductions. A discussion of these two planned changes and associated tax planning strategies follows.

REDUCTION OF THE LIFETIME ESTATE TAX EXCLUSION

The **unified credit** against the estate tax is a tax credit every decedent is entitled to use in offsetting both estate value and gift taxation.[96] The credit is applied to the potential estate tax after being reduced by the effect of taxable gifts the taxpayer made during their lifetime.

The credit is calculated based on the basic exclusion amount, also referred to as the **lifetime exemption.** The lifetime exemption changes annually. Normally, it is set at a specified dollar amount and adjusted for inflation each year.

> **Note.** The calculation of the unified credit and the amount of credit a taxpayer uses each year they make taxable gifts is reported on Form 709, *United States Gift (and Generation-Skipping Transfer) Tax Return*.[97] For more information on the unified credit, see the 2023 *University of Illinois Federal Tax Workbook,* Chapter 9: Individual Taxpayer Issues.

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95. *The Economic, Revenue, and Distributional Effects of Permanent 100 Percent Bonus Depreciation*. York, Erica et al. Aug. 30, 2022. Tax Foundation. [taxfoundation.org/research/all/federal/permanent-100-percent-bonus-depreciation-effects] Accessed on May 17, 2024.

96. IRC §2010(a).

97. Instructions for Form 709.

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Rules Under the TCJA

The TCJA changed the amount of the lifetime exemption, nearly doubling it from $5.6 million to $11.18 million.[98] For 2024, after adjustments for inflation, the lifetime exemption is $13.61 million.[99]

Rules When the TCJA Expires

The lifetime exemption drops to its lower pre-TCJA amount beginning January 1, 2026, under current law. One projection for the exclusion is estimated to be $7.15 million in 2026.[100]

Year	Basic Exclusion Amount
2017 (pre-TCJA)	$ 5.49 million
2024	13.61 million
2026 (projected)	7.15 million

Planning Opportunities

Taxpayers can use the 2024 and 2025 tax years to benefit from the larger lifetime exemption amount by gifting and transferring property in those two years and reducing their taxable estate by the higher exemption amounts. However, there are several considerations to make when gifting property before the sunset of the TCJA to ensure that such gifts and transfers successfully accomplish estate planning for tax advantageous positions. The following sections describe such considerations and illustrate the underlying concepts to aid tax practitioners advising their clients on estate planning issues before the sunset of the TCJA.

Anti-Clawback Provisions.[101] Historically, the basic exclusion amount increased over time, causing no issues when reconciling taxable gifts to the basic exclusion amount when an individual died. However, with a reduction in the basic exclusion amount after 2025, scenarios may arise where a taxpayer's lifetime taxable gifts exceeded the basic exclusion amount at the time of their death post-2025.

Example 12. Carolyn's net worth was just over $12 million in 2018 before she gave $11,015,000 to her friend, PJ. Carolyn filed Form 709 for 2018 showing that the gift exceeded the 2018 $15,000 annual gift tax exclusion by $11 million. This was the first gift tax return she ever filed. If Carolyn passes away in 2026, she will have already given away more than the exclusion during her lifetime, assuming the exclusion amount that year is $7.15 million.

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98. *Estate and Gift Tax FAQs*. Oct. 23, 2023. IRS. [www.irs.gov/newsroom/estate-and-gift-tax-faqs] Accessed on Apr. 10, 2024.

99. *IRS provides tax inflation adjustments for tax year 2024.* Nov. 27, 2023. IRS. [www.irs.gov/newsroom/irs-provides-tax-inflation-adjustments-for-tax-year-2024] Accessed on Jun. 18, 2024.

100. *Estate Tax.* Nov. 27, 2023. IRS. [www.irs.gov/businesses/small-businesses-self-employed/estate-tax] Accessed on Aug. 1, 2024; *Major tax changes in 2026*. Dec. 12, 2023. Cato Institute. [www.cato.org/sites/cato.org/files/2023-12/print-copy_amichel_2026-tax-changes_final.pdf] Accessed on Aug. 1, 2024.

101. Treas. Reg. §20.2010-1.

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Practitioner Planning Tip

Practitioners may want to advise taxpayers making gifts that they may benefit from **multiple** annual exclusion amounts. A person with three children, two of whom are married, five grandchildren, and two lifelong friends could gift $216,000 ($18,000 × 12) in 2024 with no gift tax liability and no requirement to file a gift tax return.

The **clawback** concept refers to a taxpayer who is subject to the estate tax because they used more than their basic exclusion amount available at death, even though their taxable gifts were under the annual basic exclusion amount at the time they gifted property. This treatment would render the benefits of the higher basic exclusion amount during the TCJA useless for taxpayers making gifts during that time who died after 2025.

To address the clawback issue, the IRS issued regulations providing a special rule for decedents whose basic exclusion amount for gifts in prior years exceeds the basic exclusion amount at the time of their deaths. This special rule only applies to taxpayers whose allowable basic exclusion amount for lifetime gifts exceeds the basic exclusion amount at their death. It prevents the estate from being taxed on taxpayer gifts that were free from gift tax in the year the taxpayer made the gift.

Example 13. Marcy, a single taxpayer, made a $4 million taxable gift of real estate in 2018 to her nephew Charlie. In 2019, Marcy made a $5 million taxable gift to Charlie. Both the 2018 and 2019 transactions were complete gifts when Charlie received the title to the property in 2018 and 2019. In 2019, the basic exclusion amount was $11.4 million. Marcy did not make any additional gifts during her lifetime before passing away in 2026.

Assuming the basic exclusion amount for taxpayers dying in 2026 is $7.15 million, Marcy's lifetime taxable gifts of $9 million ($4 million 2018 gift + $5 million 2019 gift) exceed the basic exclusion amount at the time of her passing. Therefore, the special anti-clawback rule applies to Marcy's estate. When filing Form 706, *United States Estate (and Generation-Skipping Transfer) Tax Return*, its **credit against the estate tax will be higher than that otherwise allowable to other estates.** Instead of a credit based on the $7.15 million exclusion amount, the estate's **credit will be based on Marcy's lifetime gifts of $9 million.**

Discussion: What additional estate planning opportunities exist for Marcy in 2024 and 2025? ___________

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The IRS provides guidance for gifts made after the decline in the basic exclusion amount. If the taxpayer previously claimed a credit higher than the maximum credit available currently, the credit remains that same amount for years subsequent to the decline in the basic exclusion amount.[102]

102. Treas. Reg. §20.2010-1(c).

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Example 14. Use the same facts as **Example 13,** except that Marcy does not pass away in 2026. She makes another taxable gift to Charlie of $1 million in 2026. Thus, she has given Charlie $10 million over her lifetime in taxable gifts ($4 million in 2018 + $5 million in 2019 + $1 million in 2026).

The estimated 2026 maximum credit will generally be capped based on the lifetime exclusion of $7.15 million. Because this is less than Marcy's lifetime gifts of $10 million, without the special rule, she would owe gift tax for 2026 on the gifts given in 2018 and 2019. However, under the anti-clawback rule, Marcy's 2026 maximum credit will be based on her prior gifts of $9 million. Thus, she will owe gift tax on only the 2026 gift of $1 million, less the annual exclusion. The tax rate applicable to her gift is 40%.

Observation. If Marcy gives Charlie the additional $1 million in 2024 or 2025 instead of 2026, the higher exclusions still apply. Thus, she could have saved $400,000 (40% of $1,000,000) with a little better planning.

Deceased Spouse's Unused Exclusion Considerations.[103] An executor for an estate can make an election to transfer a deceased spouse's unused exclusion (DSUE) to the surviving spouse to offset estate tax in a process known as "portability." Executors make this election by filing a Form 706. The DSUE is the difference between the maximum exclusion in the year of death and the amount used by the decedent at the time of their death. The surviving spouse may apply the DSUE to gifts they make after their spouse dies and to their estate before using their own exemption.[104]

Note. For more information on the DSUE, see the 2023 *University of Illinois Federal Tax Workbook,* Chapter 9: Individual Taxpayer Issues.

In determining how the anti-clawback provisions apply to a surviving spouse, the DSUE is applied to lifetime gifts **before** applying the basic exclusion amount.[105] A DSUE amount elected during the TCJA period is not reduced when a reduction in the basic exclusion amount occurs at the sunset of the TCJA. As such, taxpayers with a DSUE from a spouse who dies during a year in a higher basic exclusion amount are able to use the full DSUE amount against their taxable estate, even if such taxpayers die in a year where the basic exclusion amount is less than the DSUE available to them.

Practitioner Planning Tip

Taxpayers with large estates whose spouses passed away during 2018 through 2025 should consider electing **portability** and filing a Form 706, even if they are not required to file an estate tax form. Estates now have a 5-year window to make a DSUE election.[106] In doing so, the surviving spouse can lock-in a higher exemption amount by carrying over a DSUE originating during a year with a higher basic exclusion amount, even if the surviving spouse passes away after the TCJA sunsets when the basic exclusion amount significantly decreases.

103. IRC §2010(c)(4); Treas. Reg. §20.2010-2.

104. Treas. Reg. §20.2010-3(b)(ii).

105. Treas. Reg. §20.2010-1(c)(1)(ii)(A).

106. Rev. Proc. 2022-32, 2022-30 IRB 101.

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Example 15. Lola and Art were a married couple who lived on the family farm they inherited. After Art died in 2021, his DSUE was $4 million. In 2023, Lola sold the farm and gave her favorite nephew $9 million in taxable gifts; she had never been required to file a gift tax return before. When she filed her 2023 gift tax return, she applied the DSUE against the gift first.

Thus, in 2023, only the $5 million above the DSUE was potentially subject to gift tax ($9 million taxable gift − $4 million DSUE). Because this was less than the lifetime exclusion of $12.92 million in 2023, Lola was not required to pay gift tax. If she were required to file a gift tax return in 2026, her maximum credit would be the greater of her applicable credit amount used in prior periods or the available credit in the current period.

Treatment of Incomplete Gifts.[107] The IRS issued proposed regulations for treating incomplete gifts taxpayers made during 2017 through 2025, and who die after 2025. The regulations require these incomplete gifts to be included in the taxpayer's gross estate at the gifted property's FMV at the time of the taxpayer's death.

Because incomplete gifts are not taxable and do not have the offsetting basic exclusion amount in the year of the gift, **the special anti-clawback provisions do not apply to incomplete gifts.** Consequently, taxpayers do not receive an adjustment to their basic exclusion amount at the time of their death for incomplete gifts that exceeded the basic exclusion amount at the time of death but did not exceed the basic exclusion amount at the time the taxpayer initiated the gifts.

Practitioner Planning Tip

When advising clients to make gifts and transfers during 2024 and 2025 to take advantage of the higher basic exclusion amount under the TCJA, practitioners must communicate the importance of their clients making **completed** gifts. Failing to do so will result in the special anti-clawback provisions not applying to those gifts.

Example 16. Use the same facts as **Example 13,** except Marcy's 2019 gift to Charlie was incomplete because the property title did not transfer to Charlie until after Marcy's death. The special rules under Treas. Reg. §20.2010-1 do not apply, as the $4 million exclusion used against the completed gift in 2018 is less than the $7.15 million exclusion in 2026. Marcy's basic exclusion amount for estate tax purposes in 2026 is $7.15 million. If Marcy has no other assets at her death in 2026, $1.85 million of her estate is subject to estate tax ($9 million − $7.15 million).

Discussion: Are there any benefits or other reasons for Marcy to make an incomplete gift? What factors should she consider when comparing those benefits to the anti-clawback benefits in making gifts during her lifetime?

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107. Prop. Treas. Reg. §20.2010-1.

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EXCESS DEDUCTIONS

When the estate's final year administration expenses are greater than the estate's income, the pass-through deduction is called the **excess deductions on termination.** Generally, excess estate deductions do not pass through directly to beneficiaries. However, any losses arising in or carried to the termination year of the estate are subsequently passed through to beneficiaries succeeding to its property.[108] NOL and capital loss deductions and carryovers are passed through to beneficiaries and included in the beneficiaries' AGI.[109]

Excess deductions may be deducted in one of three ways.[110]

1. An adjustment to income on Schedule 1 (Form 1040), *Additional Income and Adjustments to Income* (e.g., estate administration expenses)
2. A non-miscellaneous itemized deduction (e.g., personal property taxes)
3. A miscellaneous itemized deduction (e.g., safety deposit box fees)

Rules Under the TCJA

Prior to the TCJA, excess deductions were always treated as miscellaneous itemized deductions. The TCJA and the subsequent regulations recharacterized trust and estate administration expenses as an adjustment to income.

Rules When the TCJA Expires

Even though other provisions of the TCJA suspended miscellaneous itemized deductions, the suspension did not prohibit beneficiaries from deducting excess administration costs. Consequently, the sunset of the TCJA itemized deduction provisions will not change the treatment of these deductions.

PERMANENT PROVISIONS

While numerous provisions of the TCJA are temporary and are set to expire at the end of 2025, many significant provisions of the TCJA are permanent. This section identifies several key provisions that do not expire.

LIKE-KIND EXCHANGES[111]

Taxpayers disposing property and receiving like-kind property in exchange can defer capital gain or loss arising from the transaction under IRC §1031. To qualify, the property must be held for productive use in a trade or business or for investment, and must be exchanged for like-kind property that will also be held for productive use in a trade or business or for investment. This results in no gain or loss being currently recognized.[112]

108. IRC §642(h).
109. Treas. Reg. §1.642(h)-1(b).
110. Treas. Reg. §1.67-4(a)(1)(ii); 85 Fed. Reg. 66,219 (Oct. 19, 2020).
111. IRC §1031.
112. IRC §1031(a)(1).

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Prior to the enactment of the TCJA, like-kind property eligible for gain or loss deferral included depreciable tangible personal property, intangible and nondepreciable personal property, and real property.[113] However, for exchanges completed after December 31, 2017, the like-kind exchange rules only apply to exchanges of **real property.[114]** As such, no gain or loss is recognized on the exchange of real property held for productive use in a trade or business or for investment to the extent that real property is exchanged for like-kind real property held either for productive use in a trade or business or for investment.[115]

> **Note.** For more information on like-kind exchanges, see the 2018 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 1: New Legislation — Business Concerns. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

In 2020, the IRS issued final regulations identifying real property eligible for like-kind exchanges.[116] Generally, such property includes the following (including intangible interests in such real property).[117]

- Land
- Improvements to land
- Unsevered natural products of land
- Water and air space superjacent to land
- Real property under state or local law

Improvements to land are defined as inherently permanent structures and their structural components. Inherently permanent structures include buildings or other structures that are distinct assets permanently affixed to real property for an indefinite period of time. Facts and circumstances determine whether separately identifiable items of property are **distinct assets** which must be separately analyzed from any other asset to identify if the property is real property eligible for a like-kind exchange. This is a critical concept when considering the treatment of different types of assets that make up one system where such interconnected assets should be analyzed together as a distinct asset possibly qualifying as a structural component of real property.[118]

Example 17. A restaurant business, Farmer Jack's Chicken Chicken Chicken, installs a gas line running into one of their restaurant buildings in 2020.[119] **The purpose of the gas line is to provide fuel to the building's heating system.** Accordingly, the gas line is a structural component of an inherently permanent structure, and therefore constitutes real property.

In 2024, when Farmer Jack's is planning on selling the restaurant building and purchasing another building in a different location, the business can include the gas line in a like-kind exchange of the two buildings and thereby receives preferential tax treatment.

Example 18. Use the same facts as **Example 17,** except the **purpose of the gas line is to provide fuel to the building's fryers and ovens.** Because the fryers and ovens are not inherently permanent structures, the gas line is not a component of real property and therefore is not eligible for preferential tax treatment under a like-kind exchange.[120]

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113. Treas. Reg. §1.1031(a)-2.
114. *Tax Cuts and Jobs Act*, PL 115-97, §13303.
115. IRC §1031(a)(1).
116. TD 9935, 2020-52 IRB 1746.
117. Treas. Reg. §1.1031(a)-3(a)(1).
118. Treas. Reg. §§1.1031(a)-3(a)(2) and (4).
119. Modified from an example from TD 9935, 2020-52 IRB 1746.
120. Ibid.

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Certain intangible assets are also treated as real property for purposes of a §1031 like-kind exchange. Such assets include the following.[121]

- Fee ownerships
- Co-ownerships
- Leaseholds
- Options to acquire real property
- Easements
- Stocks in cooperative housing corporations
- Shares in a mutual ditch, reservoir, or irrigation company[122]
- Land development rights

The regulations also identify intangible assets that are **not** considered real property for purposes of a §1031 like-kind exchange regardless of state or local law classification. Such assets include the following.[123]

- Stock (other than in cooperative housing corporations), bonds, or notes
- Other securities or evidence of indebtedness or interest
- Partnership interests (other than those with a valid IRC §761(a) election)
- Certificates of trust or beneficial interests
- Choses in action

CASH METHOD OF ACCOUNTING

Generally, the following entities **cannot** use the cash method unless they qualify as a **small business.**[124]

1. C corporations
2. Partnerships with one or more C corporations as a partner or partners
3. Certain trusts subject to tax on unrelated business income

The TCJA established a $25 million gross receipts test for determining whether activities qualify as small businesses eligible to use the cash method.[125] This test simplifies gross receipts determinations and increases the number of activities qualifying as small businesses.

> **Note.** Qualified personal service corporations, partnerships without C corporation partners, S corporations, and other pass-through entities may adopt the cash method of accounting regardless of whether they meet the gross receipts test if the cash method clearly reflects income and the entity is not a tax shelter.[126]

121. Treas. Reg. §1.1031(a)-3(a)(5).
122. As described in IRC §501(c)(12)(A).
123. Treas. Reg. §1.1031(a)-3(a)(5).
124. IRC §§448(a), (c)(1), and (d)(6).
125. IRC §448(c)(1).
126. *Joint Explanatory Statement of the Committee of Conference* (p. 220). Dec. 18, 2017. U.S. House of Representatives. [docs.house.gov/billsthisweek/20171218/Joint Explanatory Statement.pdf] Accessed on May 29, 2024; IRC §448(b)(2).

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The $25 million threshold is adjusted for inflation for tax years beginning after December 31, 2018.[127] For the 2024 tax year, the threshold for the gross receipts test is $30 million.[128] The gross receipts test is satisfied for a tax year if average annual gross receipts of the business for the 3-tax-year period that ends with the tax year preceding such tax year do not exceed the applicable threshold.[129]

> **Note.** For more information on the small business gross receipt test, see the 2018 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 1: New Legislation — Business Concerns. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

QUALIFIED IMPROVEMENT PROPERTY[130]

The TCJA expanded the definition of qualified real property eligible for §179 expensing to include improvements to the interior of any nonresidential real property (defined as QIP). The following improvements are specifically identified as qualified real property.[131]

- Roofs
- Heating, ventilation, and air conditioning property
- Fire protection and alarm systems
- Security systems

QIP does **not** include the enlargement of a building or improvements to elevators, escalators, or the internal structural framework of a building.[132]

Due to a drafting error, language providing a 15-year recovery period for QIP was inadvertently omitted from the TCJA. Consequently, QIP placed in service after December 31, 2017, was recoverable over 39 years, rather than the 15-year period that was intended. The Coronavirus Aid, Relief, and Economic Security (CARES) Act passed in 2020 and clarified that QIP is 15-year property under MACRS and 20-year property under alternative depreciation system (ADS). As a result, QIP is eligible for immediate expensing under §179.[133]

> **Note.** For more information regarding QIP, see the 2018 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 1: New Legislation — Business Concerns. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

127. IRC §448(c)(4).
128. Rev. Proc. 2023-34, 2023-48 IRB 1287.
129. IRC §448(c)(1).
130. *Tax Cuts and Jobs Act*, PL 115-97, §13101.
131. IRC §179(e)(2).
132. IRC §168(e)(6)(B).
133. *Coronavirus Aid, Relief, and Economic Security Act,* PL 116-136, §2307; IRC §179(d)(1)(B)(ii).

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CORPORATE INCOME TAX RATE

The TCJA eliminated the graduated corporate tax rate structure and imposed a flat 21% income tax.[134] This flat tax rate also applies to personal service corporations.[135]

CORPORATE ALTERNATIVE MINIMUM TAX

The TCJA repealed the corporate alternative minimum tax (CAMT) in 2017.[136] However, the Inflation Reduction Act introduced a new CAMT upon its enactment in 2022.[137] This new CAMT imposes a 15% minimum tax on an applicable corporation's adjusted financial statement income (AFSI) over the corporate AMT foreign tax credit.[138] Corporations subject to the CAMT are those with $1 billion or more of average AFSI in the previous three years.[139] The tax applies to tax years beginning after December 31, 2022.[140]

> **Note.** For more information on the CAMT, see the 2023 *University of Illinois Federal Tax Workbook,* Chapter 11: New Developments.

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134. IRC §11(b).
135. IRS Pub. 542, *Corporations*.
136. *Tax Cuts and Jobs Act*, PL 115-97, §12001.
137. *Inflation Reduction Act*, PL 117-169, §10101.
138. IRC §§55(b)(2) and 59(I).
139. IRC §59(k)(1)(B).
140. IRC §59(k)(1)(A).

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APPENDIX

The following tables summarize the provisions of the TCJA and identify whether they are permanent or temporary.[141]

TEMPORARY PROVISIONS OF THE TCJA

Section	Description	Expiration Date
§11028	Tax relief for 2016 declared disasters, including early IRA withdrawal penalties relief and personal casualty losses AGI limitation relief	Expired after December 31, 2017
§11027	AGI threshold for itemized medical expenses decreased from 10% AGI to 7.5% AGI	Expired after December 31, 2018
§13804	Reduces the rate of excise tax on certain wine	Expired after December 31, 2019
§13805	Modifies the alcohol content level to 16% from 14% for application of excise tax rates	Expired after December 31, 2019
§13807	Reduces the excise tax rate for certain distilled spirits	Expired after December 31, 2019
§13808	Allows distillers to transfer spirits in approved containers that are not bulk containers without paying tax	Expired after December 31, 2019
§13201	Allows 100% bonus depreciation for property placed in service from September 27, 2017, to December 31, 2022, and phases down the deduction by 20% for most property placed in service each subsequent year, with the schedule for property with longer production periods extending another year	100% bonus expired after December 31, 2022, and completely phases out to zero after December 31, 2026
§11001	Modification of individual taxpayer income tax rates	Expires after December 31, 2025
§11011	QBID	Expires after December 31, 2025
§11021	Standard deduction increase	Expires after December 31, 2025
§11022	CTC increased to $2,000 and nonrefundable credit of $500 is created	Expires after December 31, 2025
§11023	Cash charitable contributions limit increased to 60% from 50%	Expires after December 31, 2025
§11024	Increase in contributions to Achieving a Better Life Experience (ABLE) accounts	Expires after December 31, 2025
§11025	Rollovers to ABLE accounts from IRC §529 qualified tuition programs without penalty	Expires after December 31, 2025
§11026	Tax benefits for certain members of the armed forces in the Sinai Peninsula of Egypt	Expires after December 31, 2025

141. *Tax Cuts and Jobs Act*, PL 115-97.

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Section	Description	Expiration Date
§11031	Gross income excludes student loan discharges due to death or total and permanent disability	Expires after December 31, 2025
§11041	Eliminates personal exemption deductions and accordingly modifies wage withholding rules and requirements for filing a tax return	Expires after December 31, 2025
§11042	Limits the itemized deduction for SALT to $10,000	Expires after December 31, 2025
§11043	Limits home mortgage interest to apply only to mortgages for principal residences, to apply to mortgages up to $750,000, and to no longer apply to home equity loans	Expires after December 31, 2025
§11044	Limits personal casualty and left losses to apply only to federally declared disasters	Expires after December 31, 2025
§11045	Suspends miscellaneous itemized deductions subject to the 2% AGI limitation	Expires after December 31, 2025
§11046	Suspends overall limitation on itemized deductions	Expires after December 31, 2025
§11047	Suspends exclusion for qualified bicycle commuting reimbursement	Expires after December 31, 2025
§11048	Suspends exclusion for qualified moving expense reimbursement	Expires after December 31, 2025
§11049	Suspends the moving expenses deduction	Expires after December 31, 2025
§11050	Limits the deduction for wagering losses to the extent of gain arising from such transactions	Expires after December 31, 2025
§11061	Doubles the estate and gift tax exemption	Expires after December 31, 2025
§12003	Increases the individual AMT exemption thresholds	Expires after December 31, 2025
§20003	Mandates the Department of Energy draw down and sell crude oil during fiscal year 2026 and 2027 until deposits from such activity reaches $600 million	Expires after December 31, 2027
§11012	Limitation on excess business losses for noncorporate taxpayers	Expires after December 31, 2028[142]
§20002	Limits the amount of distributed qualified outer continental shelf revenues	Expires after December 31, 2055

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[142.] The expiration was extended from January 1, 2025, to January 1, 2029, by the *Inflation Reduction Act,* PL 117-169, §13903(b).

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PERMANENT PROVISIONS OF THE TCJA

Section	Description
§11001	Paid preparer due diligence requirements and penalties
§11002	Inflation adjustments are based on chained consumer price index (CPI)
§11032	IRC §529 plan funds may be used for tuition at elementary or secondary public, private, or religious schools
§11051	Repeals alimony and maintenance payments as deductions for payors and income for recipients for divorces occurring after December 31, 2018
§11071	Increases the time limit for contesting an IRS levy from nine months to two years
§11081	Repeals penalties for failure to maintain minimum essential health coverage under the Affordable Care Act
§12001	Repeals the CAMT (permanent, but reinstated by the passage of the Inflation Reduction Act)[143]
§12002	Modifies the AMT credit for corporations allowing the credit to offset regular tax liability and creating a refundable portion for tax years after 2017 and before 2022
§13001	Removes the graduated income tax rates for corporations for replacement with a flat 21% tax rate for tax years beginning after 2017
§13002	Reduces the 70% dividends received deduction to 50% and the 80% dividends received deduction to 65% for corporations
§13101	Modifies §179 expensing to increase the maximum amount to expense in a tax year, increase the phase-out thresholds, revise eligible qualified real property, and allow expensing for certain depreciable tangible personal property
§13102	Modifies small business accounting method rules, including expansion of which businesses can use the cash method of accounting, exempts certain taxpayers from being required to account for inventories, expands criteria for the exception to the uniform capitalization rules, and expands the exception from the requirement of using the percentage-of-completion method for small construction contracts
§13202	Increases the depreciation limits applying to luxury automobiles and personal-use property
§13203	Shortens recovery period for farm machinery or equipment (other than grain bins, cotton ginning assets, fences, or other land improvements) from seven to five years and repeals the requirement to use the 150% declining balance method for farm business property
§13204	Eliminates qualified leasehold improvement, qualified restaurant, and qualified retail improvement property definitions, and defines and applies the straight-line method to QIP
§13205	Requires farming businesses electing out of the limitation on the deduction for interest to use ADS for property with recovery periods of 10 or more years
§13206	Adjusts amortization rules and schedules for certain research and experimentation expenditures
§13207	Allows expensing of certain costs for replacing lost or damaged citrus plants by reason of casualty
§13221	Revises certain special rules for taxable years of inclusion
§13301	Limits the deduction for business interest
§13302	Modifies the NOL deduction by limiting it to 80% of taxable income, repealing carryback provisions, allowing indefinite carryforward of such losses, and allowing 2-year carryback for farming businesses (the CARES Act subsequently reinstated carryback provisions, albeit with modifications)[144]

143. *Inflation Reduction Act,* PL 117-169, §10101.

144. *CARES Act*, PL 116-136, §2303.

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Section	Description
§13303	Limits like-kind exchange income deferral to qualified real property not held primarily for sale
§13304	Limits an employer's deduction of employee fringe benefits
§13305	Repeals the DPAD
§13306	Prohibits deductions for certain fines, penalties, and other amounts incurred in violation of any law
§13307	Prohibits deductions for settlements and related attorney fees subject to nondisclosure agreements paid in connection with sexual harassment or sexual abuse
§13308	Prohibits deductions for local lobbying expenditures
§13309	Requires a 3-year holding period for certain net long-term capital gains for partnership interests in connection with performance of services
§13310	Prohibits the deduction of cash, gift cards, and other non-tangible personal property paid for an employee achievement award
§13311	Prohibits the deduction for living expenses incurred by members of Congress
§13312	Modifies the exclusion from income of certain contributions by governmental entities that are not treated as contributions to capital
§13313	Repeals the rollover of publicly traded securities gain into specialized small business investment companies
§13314	Excludes certain patents, inventories, models, designs, secret formulas, or taxpayer-created processes from the definition of a "capital asset"
§13401	Reduces the tax credit for clinical testing expenses incurred in certain drug and rare disease testing from 50% to 25%
§13402	Limits the 10% rehabilitated buildings credit to apply only to certified historic structures
§13403	Creates an employer credit for paid family and medical leave under IRC §45S
§13404	Repeals the authority to issue tax-credit bonds and direct-pay bonds
§13501	Establishes the treatment of gains or losses of foreign persons from selling or exchanging interests in partnerships engaged in trade or business within the United States
§13502	Modifies the definition of "substantial built-in loss" arising from transfers of partnership interests to include losses of more than $250,000 if the partnership assets were sold for cash equal to their FMV immediately after the transfer
§13503	Modifies the basis limitation on a partner's distributive share of a partnership loss to include such share of partnership charitable contributions and taxes paid or accrued to foreign countries
§13504	Repeals the technical termination of partnerships rule
§13511	Repeals the operation loss deduction for life insurance companies and allows NOL deduction under IRC §172
§13512	Repeals the small life insurance company deduction
§13513	Revises the tax treatment of income or losses from a change in method of computing life insurance company reserves
§13514	Repeals the special rule for distributions to shareholders of a stock life insurance company from a pre-1984 policyholders surplus account

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Section	Description
§13515	Modifies the proration rules for property and casualty insurance companies by replacing the 15% reduction with a 5.25% dividend of the highest corporate tax rate in effect
§13516	Repeals the special estimated tax payment rules for insurance companies
§13517	Modifies the rules for computing life insurance tax reserves for determining the taxable income of life insurance companies
§13518	Modifies the proration rule for reducing dividends received deductions with respect to untaxed income for life insurance companies
§13519	Extends the amortization period of policy acquisition expenses from 120 months to 180 months for insurance companies
§13520	Establishes reporting requirements for life insurance contract acquisitions
§13521	Establishes basis determination requirements of a life insurance or annuity contract
§13522	Eliminates from the transfer for valuable consideration rule reportable policy sales of life insurance contracts
§13523	Modifies discounting rules for property and casualty insurance companies by altering the interest rate used to discount unpaid losses, alters the computational rules for loss payment patterns, and repeals the election to use a historical loss payment pattern
§13531	Limits the deduction for Federal Deposit Insurance Corporation (FDIC) premiums for financial institutions with consolidated assets exceeding $10 billion
§13532	Repeals the exclusion for advance refunding bonds
§13541	Expands qualifying beneficiaries of an electing small business trust (ESBT) to include nonresident aliens
§13542	Modifies the charitable contribution deduction rules for ESBTs to follow rules applicable to individuals as opposed to trusts except for including trust administration expenses in determining AGI for such purposes
§13543	Modifies the tax treatment for S corporation to C corporation conversions
§13601	Repeals the performance-based compensation and commission exceptions, modifies the definition of "covered employee" and expands the definition of "publicly held corporation" for purposes of the deduction for covered employee compensation of a publicly held corporation of salaries not exceeding $1 million per year
§13602	Imposes an excise tax on excess tax-exempt organization executive compensation
§13603	Allows qualified employees to elect to defer income attributable to certain stock transferred to the employee by an employer for income tax purposes
§13604	Increases the excise tax imposed on the value of stock compensation held by insiders of an expatriated corporation from 15% to 20%
§13611	Repeals the rule allowing IRA contributions to one type of IRA to be recharacterized as a contribution to the other type of IRA
§13612	Modifies rules applicable for length of service award plans (LOSAP) by increasing the limit on accruals required for such plans for volunteers to be exempt from deferred compensation plan treatment, increasing the limit on plan accruals from $3,000 to $6,000, and providing a cost-of-living adjustment to such limits after 2017

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Section	Description
§13613	Extends the rollover period for certain plan loan offset amounts to be contributed to an eligible retirement plan
§13701	Imposes a 1.4% excise tax on certain private colleges' and universities' NII
§13702	Requires tax-exempt organizations with two or more unrelated trades or businesses to calculate unrelated business taxable income separately for each activity
§13703	Increases unrelated business taxable income by certain fringe benefit expenses that are not deductible
§13704	Repeals the deduction for expenditures for college athletic event seating rights
§13705	Repeals the substantiation requirements exception for certain contributions reported by the donee organization
§13801	Excludes the aging periods for beer, wine, and distilled spirits from the production period for purposes of the uniform interest capitalization rules
§13802	Lowers the excise tax rate on beer to $16 per barrel on the first six million barrels brewed or imported
§13803	Allows the transfer of beer between bonded facilities without payment of tax if specified requirements are met
§13806	Specifies the definition for "mead" and "low alcohol by volume wine" eligible to be taxed at the lowest applicable rate for still wine
§13821	Modifies the tax treatment of Alaska Native Settlement Trusts
§13822	Exempts certain payments for management of private aircraft from excise tax imposed on taxable transportation by air
§13823	Authorizes the designation of opportunity zones in low-income communities for tax incentives for investments in such communities
§14101	Establishes a deduction for a foreign-source portion of dividends received by domestic corporations from specified 10% owned foreign corporations
§14102	Establishes special rules for sales or transfers involving specified 10% owned foreign corporations
§14103	Establishes special rules for the tax treatment of deferred foreign income upon transition to participation exemption system of taxation
§14201	Requires the inclusion in gross income of global intangible low-taxed income for shareholders of any controlled foreign corporation (CFC)
§14202	Establishes a deduction for domestic corporations for specified portions of the corporation's foreign-derived intangible income and global intangible low-taxed income
§14211	Repeals provisions that treat foreign base company oil related income as subpart F income
§14212	Repeals the requirement for United States shareholders of CFCs to include a pro rata share of previously excluded subpart F income in their reported income for the tax year
§14213	Modifies the stock attribution rules in determining the status as a CFC

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Section	Description
§14214	Modifies the definition of a U.S. shareholder under subpart F to include any U.S. person who owns 10% or more of the total value of shares of stock of a foreign corporation
§14215	Eliminates the requirement that a corporation must be controlled for 30 days before subpart F inclusions apply
§14221	Modifies terms and valuation methods applying to transfers of foreign intangible property, thus limiting income shifting
§14222	Disqualifies deductions for any disqualified related party amount paid or accrued in hybrid transactions or with hybrid entities
§14223	Denies reduced rates for qualified dividends for shareholders who receive dividends from a surrogate foreign corporation
§14301	Repeals the deemed-paid credit with respect to dividends received by a domestic corporation owning 10% or more of the voting stock of a foreign corporation, while allowing a limited credit for certain foreign taxes paid
§14302	Requires foreign branch income to be allocated to a specific foreign tax credit basket
§14303	Requires the allocation of income partly earned outside of the United States between production activities in and outside of the United States
§14304	Establishes an election to increase the percentage of domestic taxable income offset by any pre-2018 unused overall domestic loss treated as foreign source income
§14401	Establishes a base erosion and anti-abuse tax to which certain large corporations are subject
§14501	Modifies the exception from passive foreign investment company rules for insurance businesses by focusing on its insurance liabilities for determining whether it is predominantly engaged in an insurance business
§14502	Repeals the FMV method in allocating and apportioning interest expense and replaces with it with using the adjusted bases of assets to determine such allocations and apportionment
§20001	States the Secretary of the Interior must establish and administer an oil and gas program in and from the Coastal Plain of the Arctic National Wildlife Refuge in Alaska

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Note. Corrections for all of the chapters are available at **TaxSchool.illinois.edu.** For clarification about terms used throughout this chapter, see the **Acronyms and Abbreviations** section following the index.

For your convenience, in-text website links are also provided as short URLs. Anywhere you see **uofi.tax/xxx**, the link points to the address immediately following in brackets.

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About the Author

Ashley Akin is a Certified Public Accountant with over 8 years of experience. She started her career in public accounting working with a global mobility tax practice before switching to a private company specializing in individual crypto tax compliance. She started writing for the University of Illinois Tax School in June of 2023. She lives on Long Island with her husband and puppy.

Kelly Golish, CPA, is the Assistant Director, Tax Materials, at the University of Illinois Tax School. She was previously a manager at Crowder, CPAs in Danville, IL and worked for both public and private accounting firms in Decatur, IL, Cleveland, OH, and San Jose, CA. Kelly earned a Masters in Accounting with an emphasis in Taxation and a Bachelors in Accounting at the University of Notre Dame.

Chris Korban, CPA, is a Tax Materials Specialist at the University of Illinois Tax School. He joined Tax School in 2023 with nine years of experience in public accounting. Chris earned both his Bachelor's Degree in Accounting and Master of Accounting Science from the University of Illinois.

John W. Richmann, EA, is a Tax Materials Specialist at the University of Illinois Tax School. Prior to joining Tax School in 2021, he owned a tax practice in St. Charles, Illinois, and held positions in private industry and consulting firms. John earned a Masters Degree in Business Administration from the University of Texas and an electrical engineering degree from the Massachusetts Institute of Technology.

Catherine Riddick, JD, CPA, has been with the University of Illinois Tax School since 2008 as an instructor, and as an author and reviewer for the University of Illinois Federal Tax Workbook. She is a CPA and licensed attorney. She worked for one of the large CPA firms in the Chicago area for 10 years and has had her own CPA firm, now in Westchester, Illinois, since 1994. Catherine received a bachelor's degree from Old Dominion University in Norfolk, Virginia and a law degree from Washington and Lee University in Lexington, Virginia.

Shane Smith, CPA, CMA, CFE, is a Tax Manager at AMG National Trust Bank and holds a Masters of Accountancy with an emphasis in Taxation from Gonzaga University.

Other chapter contributors and reviewers are listed at the front of this book.

FINAL REGULATIONS FOR INHERITED RETIREMENT PLANS

The Setting Every Community Up for Retirement Enhancement (SECURE) Act[1] significantly changed the distribution rules related to inherited employer plans and individual retirement arrangements (IRAs) for many beneficiaries. The Act is effective for defined contribution plans where the account owner dies after December 31, 2019.[2] For taxpayers who inherited retirement plans and IRAs on or before December 31, 2019, the rules were not changed by SECURE. The Act established three tiers of beneficiaries: designated beneficiaries (DB), eligible designated beneficiaries (EDB), and nondesignated beneficiaries. EDBs include surviving spouses and certain other protected individuals. EDBs are still able to use the prior rules relative to inherited plans during their lifetime.[3] This discussion focuses on the changes to the proposed regulations originally issued in February of 2022.[4] The final regulations[5] are generally effective on September 17, 2024.[6] However, the regulations related to determining required minimum distributions (RMDs) apply to calendar years beginning on or after January 1, 2025.[7] IRS Notice 2024-35, issued on April 16, 2024, provides relief from the excise tax due under IRC §4974 when a DB of an inherited plan fails to take an RMD for 2024.

1. *SECURE Act of 2019*, PL 116-94.
2. Treas. Reg. §1.401(a)(9)-1(b)(2).
3. IRC §401(a)(9).
4. 87 Fed. Reg. 10504 (Feb. 24, 2022).
5. Treas. Regs. §§1.401(a)(9)-1, 1.401(a)(9)-2, and 1.401(a)(9)-5.
6. TD 10001, 2024-33 IRB 412.
7. IRS Notice 2024-35, 2024-19 IRB 1051.

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SECURE ACT CHANGES

The SECURE Act sharply curtailed the use of stretch IRAs in planning for inherited IRAs. For a DB, the period for distributions is reduced from their life expectancy to 10 years. Except for surviving spouses and other EDBs, the law requires DBs of IRAs to withdraw all remaining funds within 10 calendar years from the calendar year of the account owner's death.

IRS Final Regulations[8]

In July 2024, the IRS finalized the regulations that require DBs to receive **annual** distributions from inherited plans and IRAs. Waiting until the end of the 10-year period will not be adequate for some beneficiaries.

Death After RBD.[9] In the final regulations, the IRS states that if an account owner dies **after their required beginning date (RBD),** then a DB that is not an EDB is responsible for taking distributions in the following years until the conclusion of the calendar year that includes the **9th anniversary** of the account owner's death. The remaining balance of the account owner's interest in the IRA or qualified plan must be distributed entirely in the following year.

Calculating RMD for DBs. DBs inheriting plans from an individual who dies after their RBD must consider factors such as life expectancy, the value of the retirement plan, and whether there are multiple beneficiaries when calculating their RMD. Initial RMDs are determined using the following equation.

$$\text{RMD} = \frac{\text{Account value at the end of the valuation year}}{\text{Beneficiary's life expectancy}}$$

The final regulations clarify that a DB inheriting from an individual who had reached their RBD must calculate their initial RMD by using the greater of the remaining life expectancy of the deceased account holder or the DB.[10] For this purpose, the DB's life expectancy (as determined using the single life table in Treas. Reg. §1.401(a)(9)-9(b)) is calculated based on their age in the year following the death of the account owner.[11] For calculating subsequent RMDs, the remaining life expectancy used in determining the initial RMD is subtracted by one for each year after the initial RMD.[12]

Example 1. Faith, age 91, died in May 2021 after receiving her RMD from her traditional IRA for 2021. Her daughter, Hope, is the only beneficiary of her IRA. She was born in March 1956 and celebrated her 65th birthday in 2021 before her mother passed away.

Because Hope had her 65th birthday in the year her mother died, she turns 66 in the year immediately after the year of her mother's death. Therefore, she determines that her life expectancy, for RMD purposes, is 22.0 years, as shown in the following table, excerpted from IRS Pub. 590-B. Presumably, 22.0 is greater than Faith's life expectancy, so Hope uses 22.0 as the denominator for computing her RMD in 2022 should she choose to take an RMD in 2022.

13

8. 89 Fed. Reg. 58886 (Jul. 19, 2024).

9. Treas. Reg. §1.401(a)(9)-5.

10. Treas. Reg. §§1.401(a)(9)-5(d)(1)(ii) and (3)(i).

11. Treas. Reg. §1.401(a)(9)-5(d)(3)(iii).

12. Ibid.

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For Example 1

Table I (Single Life Expectancy) (For Use by Beneficiaries)			
Age	**Life Expectancy**	**Age**	**Life Expectancy**
60	27.1	91	5.3
61	26.2	92	4.9
62	25.4	93	4.6
63	24.5	94	4.3
64	23.7	95	4.0
65	22.9	96	3.7
66	22.0	97	3.4
67	21.2	98	3.2
68	20.4	99	3.0

The life expectancy is significant even after Hope receives the first RMD. The denominator she uses in 2023 is **not** the value corresponding to age 67, her age in 2023, but one less than the value in the year after her mother's death (i.e., 21.0 years.) Thus, if Hope did not receive an RMD in 2022, she cannot use her life expectancy based on her age of 67 in the year of her first RMD (21.2 years). Hope is required to continue RMDs for years 2025 through 2031 and any remaining balance must be distributed in 2031.

Death Before RBD. The final regulations provide different rules for the beneficiaries depending upon whether the original account owner died before or after their RBD. The IRS clarifies the rules related to RMDs when the **account owner dies before the RBD.**[13] The IRS also affirms that either a 5-year rule, a 10-year rule, or life expectancy payments will determine the distributions.[14] If the account owner does not have a DB, then distributions must satisfy the 5-year rule. If the account owner has a DB who is not an EDB, then distributions must satisfy the 10-year rule and for EDBs, distributions must satisfy the life expectancy rule.[15]

The Code specifies the RMD rules, which numerous Treasury Regulations amplify.[16] For a DB of an **account owner who died before the RBD,** an annual distribution is only required if the life expectancy rule applies. For most DBs, the 10-year rule will be the applicable distribution requirement and therefore no annual distribution is required.[17]

Example 2. Charity dies in May 2023 when she is 60 years old. Her son, Henry, is 40. Charity had not reached her RBD when she died, so Henry, the only DB, has until 2033 to empty the inherited retirement account and is not required to take any RMDs.

13. Treas. Reg. §1.401(a)(9)-3.
14. Treas. Reg. §1.401(a)(9)-3(c).
15. Treas. Reg. §1.401(a)(9)-3(c)(5).
16. Treas. Reg. §1.401(a)(9)-5.
17. See Treas. Reg. §1.401(a)(9)-5(a)(2)(iii).

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Practitioner Planning Tip

Knowing that the money must all come out by the end of the 10th year, taxpayers may prefer to take larger distributions if they have lower tax years. Tax practitioners should consider multiple year projections for taxpayers with inherited IRA accounts.

Calculating RMDs for EDBs

The SECURE Act's changes **did not affect all beneficiaries** in the same way. Congress chose to establish a new class of beneficiaries with special rules related to inherited retirement accounts. These beneficiaries are known as EDBs, and include the following.[18]

- The surviving spouse of the retirement plan owner
- Minor children of the retirement plan owner
- Disabled individuals[19]
- A chronically ill individual provided that a doctor has certified that the illness is expected to be lengthy[20]
- Another individual who does not meet any of the previous four conditions and is not more than 10 years younger than the deceased retirement plan owner[21]

In general, these individuals are not subject to the requirement that all retirement plan funds be distributed by the end of the 10th year following the original owner's passing.[22] However, a minor child is exempt from the rules only for as long as they are minors.

Surviving Spouses. Treatment for surviving spouses has undergone changes both under the SECURE Act and the SECURE 2.0 Act.[23]

From the SECURE Act. Surviving spouses can elect to treat their deceased spouse's IRA as their own assuming that the surviving spouse is the sole beneficiary.[24] By doing so, the surviving spouse becomes the account owner, and RMDs are determined based on the surviving spouse's age. They can accomplish this by either of the following.[25]

- Retitling the account as their own rather than as a beneficiary
- **Not** receiving a distribution from the inherited IRA within the required time, generally the end of the next year, if the deceased had received their RMD prior to, but in the year of, their death
- Making a contribution of their own to the inherited IRA

18. IRC §401(a)(9)(E)(ii).
19. IRC §72(m)(7).
20. IRC §7702B(c)(2).
21. IRC §401(a)(9)(E)(ii)(v).
22. IRC §401(a)(9)(H)(ii).
23. *SECURE 2.0 Act of 2022,* PL 117-328.
24. Treas. Reg. §1.408-8(c).
25. Treas. Reg. §1.408-8(c)(2).

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They may only make this election if there are no other beneficiaries of the IRA and there are no restrictions on their ability to receive distributions from the IRA.[26]

Although they are not subject to the rule requiring total distribution of the retirement account by the end of 10 years following their spouse's passing, the amount must be distributed according to the surviving spouse's life expectancy.

From the SECURE 2.0 Act.[27] Taking effect in 2024, this legislation gives surviving spouses more flexibility to treat the inherited IRA as their own. They do not need to receive RMDs until the date the deceased spouse would have been required to receive RMDs had they lived to that age. The legislation directs the IRS to amend regulations to permit surviving spouses to use the uniform lifetime table.[28]

This limit is significant if the spouse who died was younger than the surviving spouse.

> **Example 3.** Henry, age 66, and Wendy, age 61, married, both have IRAs naming the other spouse as the sole beneficiary. Wendy was born in December 1962. Sadly, Wendy passes away suddenly in January 2024. Henry can delay receipt of his first RMD until Wendy would have reached her RBD. Because Wendy would have turned 73 in 2035, her applicable age is 74. Thus, were it not for her premature death, Wendy would have reached her applicable age in 2036. This provision allows Henry to delay the receipt of RMDs from Wendy's IRA until April 1, 2037, after he reaches the beginning date for his own RMDs.

> **Note.** Before this provision of the SECURE 2.0 Act went into effect on January 1, 2024, surviving spouses could treat IRAs inherited from their spouses as their own, using their own RBD. This provision of the SECURE 2.0 Act requires them to start using their deceased spouses' RBD, likely requiring earlier RMDs if the deceased spouse was older.

Minor Children.[29] Under the final regulations, children are minors until they attain the age of 21. At that time, the 10-year mandatory distribution rule begins. In the case of multiple minor children, the final regulations state that the 10-year mandatory distribution begins when the **youngest** of the minor children attains age 21.[30]

Disabled Individuals.[31] Provided the beneficiary was disabled when the retirement plan owner died, an individual is considered an EDB, and thereby exempt from the 10-year mandatory distribution rule. For a person who is at least 18 years old, disabled is defined as a condition preventing an individual from partaking in "substantial gainful activity" because of a physical or mental condition.[32]

An individual younger than 18 is considered disabled if they have a physical or mental impairment that results in "marked and severe functional limitations."

The final regulations provide a safe harbor indicating that a disability determination by the Social Security Administration can be used to satisfy the requirement.[33]

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26. Treas. Reg. §1.408-8(c)(1)(ii).
27. *SECURE 2.0 Act of 2022,* PL 117-328, §327.
28. IRS Pub. 590-B, *Distributions from Individual Retirement Arrangements (IRAs)*, p. 65 (2022).
29. Treas. Reg. §1.401(a)(9)-4(e)(3).
30. Treas. Reg. §1.401(a)(9)-5(f)(2)(ii)(C).
31. Treas. Reg. §1.401(a)(9)-4(e)(4).
32. IRC §72(m)(7).
33. Treas. Reg. §1.401(a)(9)-4(e)(4)(iv).

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Chronically Ill Individuals.[34] Chronically ill individuals are also exempt from the 10-year distribution requirement. The designation must be supported by a certification from a licensed health care practitioner that the individual cannot perform two activities of daily living.[35] This illness should be indefinite and explicitly longer than 90 days.

Multi-Beneficiary Trusts.[36] Trusts may be established for individuals who are either disabled or chronically ill under the definitions provided by the SECURE Act. If **at least one** beneficiary of a trust is either disabled or chronically ill, then the provisions for EDBs apply to any disabled or chronically ill beneficiary.[37] This treatment is contingent on the trust containing terms that:[38]

- Provide for its immediate separation into separate trusts for each beneficiary as soon as the retirement plan owner dies,
- No beneficiary who is not disabled or chronically ill can receive a benefit under the trust until the death of the last disabled or chronically ill individual, and
- Any individual who is not disabled or chronically ill is a DB of the trust.

Individuals Younger than the Retirement Plan Owner by 10 Years or Less.[39] Unless there is impairment or chronic illness, an individual who is within 10 years of the retirement plan owner's age is also exempt from the 10-year distribution requirement.

REBATES ON ENERGY EFFICIENT PROPERTY

Enacted as part of the Inflation Reduction Act of 2022, amounts paid toward the purchase of energy efficient property and improvements under the Department of Energy Home Energy Rebate Programs allow certain taxpayers to partially offset the cost of installing high-efficiency home improvements. These two programs are the Home Owner Managing Energy Savings (HOMES) Program and the High-Efficiency Electric Home Rebate Act (HEEHRA).[40] Although funded by the Department of Energy, both programs will be **administered by individual states.**

On April 4, 2024, the IRS released Announcement 2024-19[41] to address federal tax treatment for these rebates. A rebate paid to or on behalf of a purchaser under either of the programs referenced previously is treated as a **purchase price adjustment** for the purchaser for federal income tax purposes. Any such rebate is **not includable** in the purchaser's gross income. Instead, any rebate received by the qualifying taxpayer reduces the basis in the qualifying property.

> **Note.** A taxpayer's basis in an asset generally includes the purchase cost, plus capital improvements, less casualty losses and other decreases.[42] For a detailed discussion on basis in property, see the 2023 *University of Illinois Federal Tax Workbook*, Chapter 7: Depreciation.

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34. Treas. Reg. §1.401(a)(9)-4(e)(5).
35. IRC §7702B(c)(2).
36. IRC §401(a)(9)(H)(iv).
37. IRC §§401(a)(9)(H)(iv) and (v).
38. IRC §401(a)(9)(H)(iv).
39. Treas. Reg. §1.401(a)(9)-4(e)(6).
40. *Inflation Reduction Act*, PL 117-169, §§50121 and 50122.
41. IRS Ann. 2024-19, 2024-17 IRB 950.
42. *Property (basis, sale of home, etc.)*. Apr. 9, 2024. IRS. [www.irs.gov/faqs/capital-gains-losses-and-sale-of-home/property-basis-sale-of-home-etc] Accessed on May 26, 2024.

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If a rebate is provided at the time of sale, the rebated amount is excluded from the purchaser's cost basis under IRC §1012. If a lag occurs between the original purchase date and receipt of the rebate, the cost basis of the improvement is adjusted at the time the rebate has been received under IRC §1016.

> **Example 4.** In 2023, Jimmy purchased a single-family home. Due to the often-clear skies in winter, Jimmy adds solar panels to the roof in 2024 to offset some heating costs. The solar panels cost $30,000 and Jimmy receives a qualifying rebate of $4,000 at the time he purchases the solar panels. Jimmy's basis in the solar panels is $26,000 ($30,000 cost − $4,000 rebate).

A rebate payment treated as a basis adjustment, made directly to a purchaser, is not subject to informational reporting.

> **Note.** Payments of $600 or more generally require informational return filings with the IRS and the person paid, such as Form 1099-MISC, *Miscellaneous Information*, and Form 1099-NEC, *Nonemployee Compensation*.[43]

Payments made to **business taxpayers,** such as a contractor, on behalf of a purchaser are includable in taxable income of that business. Further, if the rebate paid to the business equals or exceeds $600 and is not solely attributable to the business's gross receipts from the sale of goods, informational reporting requirements may apply.[44]

HOMES PROGRAM

The HOMES program provides rebates for whole-house and retrofit energy construction savings through **various state energy offices.**[45]

Rebates awarded to upgrades of **single-family homes** shall not exceed the following.[46]

- The lesser of $2,000 and 50% of the project costs for retrofits achieving at least 20% but less than 35% of energy system savings
- The lesser of $4,000 and 50% of the project costs for retrofits achieving 35% or more of energy system savings
- Rate per kilowatt hour (kWh) saved of $2,000 per 20% reduction of energy use for the average home in the state, or 50% of the project costs for measured energy savings achieving at least 15% of energy system savings

Rebates under the program awarded to upgrades of **multifamily buildings** shall not exceed the following.[47]

- $2,000 per dwelling unit (with a maximum of $200,000 per multifamily building) for retrofits achieving at least 20% but less than 35% of energy system savings
- $4,000 per dwelling unit (with a maximum of $400,000 per multifamily building) for retrofits achieving 35% or more of energy system savings
- Rate per kWh saved of $2,000 per 20% reduction of energy use per dwelling unit for the average multifamily building in the state, or 50% of the project costs for measured energy savings achieving at least 15% of energy system savings

While the rebate programs will have different rebate caps per project, the rebate may be larger for **low- or moderate-income households** whose total annual income is less than 80% of the median income of the area in which the taxpayer resides.[48]

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43. Instructions for Forms 1099-MISC and 1099-NEC.
44. See Treas. Regs. §§1.6041-1(b)(1), 1.6014-1(i), and 1.6041-3(p).
45. *Inflation Reduction Act*, PL 117-169, §50121(c)(1).
46. *Inflation Reduction Act*, PL 117-169, §50121(c)(2)(A).
47. *Inflation Reduction Act*, PL 117-169, §50121(c)(2)(B).
48. *Inflation Reduction Act*, PL 117-169, §50121(c)(2)(C).

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Rebates under the program for such taxpayers shall not exceed the following.[49]

- The lesser of $4,000 per single-family home or dwelling unit and 80% of the project costs for retrofits achieving at least 20% but less than 35% of energy system savings
- The lesser of $8,000 per single-family home or dwelling unit and 80% of the project costs for retrofits achieving 35% or more of energy system savings
- Rate per kWh saved of $4,000 per 20% reduction of energy use per single-family home or dwelling unit of the average single-family home or multifamily building in the state, or 80% of the project costs for measured energy savings achieving at least 15% of energy system savings

The funds appropriated shall remain available until September 30, 2031. As of August 15, 2024:[50]

- 51 states and territories have applied for early administrative or full program funding
- 26 states have applied for full funding to launch their programs
- These states and territories have applied for a total of $3.6 billion in funding

HEEHRA PROGRAM

The HEEHRA program provides rebates for qualified electrification projects, including those with appliance and nonappliance upgrades.

Rebates under the program awarded to taxpayers for **appliance upgrades** do not exceed the following.[51]

- $1,750 for heat pump water heaters
- $8,000 for heat pumps for space heating or cooling
- $840 for electric stove, cooktop range, or oven, **or** electric heat pump clothes dryers

Rebates awarded to taxpayers for **nonappliance upgrades** do not exceed the following.[52]

- $4,000 for electric load service center upgrades
- $1,600 for insulation, air sealing, and ventilation
- $2,500 for electric wiring

Similar to the HOMES program, the HEEHRA program is applied to and directed through state energy offices.[53] This rebate may not be combined with other rebates on the same property and will only be provided to taxpayers defined as low- or moderate-income households, including an individual or entity that owns a multifamily building whose residents meet the income threshold.[54] The funds appropriated shall remain available until September 30, 2031.

Rebates will be provided at the time of sale in participating stores if taxpayers purchase directly from or through project contractors. Consequently, the total payment cost is reduced by the rebate amount upfront.

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49. Ibid.

50. *Power your home — and save money — with Home Energy Rebates*. Aug. 26, 2024. U.S. Department of Energy. [www.energy.gov/save/rebates] Accessed on Aug. 26, 2024.

51. *Inflation Reduction Act*, PL 117-169, §50122(c)(3)(A).

52. *Inflation Reduction Act*, PL 117-169, §50122(c)(3)(B).

53. *Inflation Reduction Act*, PL 117-169, §50122.

54. *Home Energy Rebates Frequently Asked Questions.* 2024. U.S. Department of Energy. [www.energy.gov/scep/home-energy-rebates-frequently-asked-questions] Accessed on Jul. 1, 2024.

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For the HEEHRA program, states may choose to provide a way for taxpayers to receive an upfront discount at the time of purchase. Taxpayers should check for additional information on when rebates may become available for their state.[55]

COORDINATION OF REBATES WITH ENERGY CREDITS[56]

Taxpayers may be able to claim the energy efficient home improvement credit per IRC §25C and receive energy efficient property rebates on the same qualifying property. For purposes of calculating their energy credit, such taxpayers must reduce the amount of qualifying expenditures by the rebates received.

Example 5. In 2024, Nestor spent $4,000 on qualifying exterior windows. Nestor received a $2,000 HOMES rebate shortly after he purchased the windows. In calculating the energy efficient home improvement credit, Nestor's qualifying expenses for the credit equal $2,000 ($4,000 cost − $2,000 rebate).

Taxpayers receiving energy efficient property rebates for projects allocate the rebate pro rata to individually itemized expenses of the project for purposes of calculating energy efficient home improvement credits for such property.

Example 6. In 2024, Sally Jo spent $5,000 on a heat pump and $3,500 on new insulation. Sally Jo received a $2,500 rebate for the project. For purposes of calculating the energy efficient home improvement **credit** for the heat pump and insulation, Sally Jo allocates the rebate proportionally. The heat pump will be allocated 59% ($5,000 cost of the heat pump ÷ ($5,000 cost of the heat pump + $3,500 cost of the new insulation)) of the rebate and the new insulation will be allocated 41% ($3,500 cost of the new insulation ÷ ($5,000 cost of the heat pump + $3,500 cost of the new insulation)) of the rebate. Therefore, Sally Jo reduces the cost of the heat pump by $1,475 ($2,500 rebate × 59%), resulting in $3,525 of the cost of the heat pump qualifying for the energy credit ($5,000 total cost − $1,475 allocated rebate). Similarly, Sally Jo reduces the cost of the new insulation by $1,025 ($2,500 rebate × 41%), resulting in $2,475 of the cost of the new insulation qualifying for the energy credit ($3,500 total cost − $1,025 allocated rebate).

Note. For more detailed information about the energy efficient home improvement credit, see the 2023 *University of Illinois Federal Tax Workbook*, Chapter 11: New Developments.

55. *Home Energy Rebates Frequently Asked Questions, #13.* Sep. 14, 2023. U.S. Department of Energy. [www.energy.gov/scep/home-energy-rebates-frequently-asked-questions] Accessed on Aug. 1, 2024.

56. IRS Ann. 2024-19, 2024-17 IRB 950.

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UPDATES ON DIGITAL ASSET REPORTING

The IRS is increasingly focusing on how taxpayers, both individuals and businesses, are reporting digital asset activity.[57] Digital assets refer to "any digital representation of value which is recorded on a cryptographically secured distributed ledger or any similar technology as specified by the Secretary."[58] Examples of digital assets include cryptocurrencies, such as Ethereum and Bitcoin, stablecoins, such as USDC, and non-fungible tokens (NFTs). Taxpayers can engage in a variety of transactions with digital assets, including trading (buying or selling), paying for services, making purchases, staking (supporting the blockchain), or derivative trading (options or futures).

Digital asset users generally have two options for storing their assets. Users may use a self-custodial digital wallet such as Metamask or Rainbow, or a centralized exchange such as Coinbase or Kraken. The self-custody wallet options give the holder control and domain over their assets.[59] Conversely, third parties manage exchanges, allowing users to access and make decisions with their assets. However, the exchange generally retains ownership of the assets.[60] Other than non-custodial wallets and centralized exchanges, there are a variety of decentralized platforms available that taxpayers can use to engage in transactions with their assets.

> **Note.** For more information on digital assets, see the 2023 *University of Illinois Federal Tax Workbook,* Chapter 11: New Developments.

FINAL REGULATIONS[61]

On June 28, 2024, the IRS and the Treasury finalized regulations[62] relating to digital asset transactions that should be reported by brokers, expanded the categories of assets for which basis reporting is required to include all digital assets, and provided a definition for the term digital assets. The goal of the regulations is that by standardizing broker information reporting on digital assets, there will be an increase in taxpayer compliance because taxpayers will have the necessary information from brokers to prepare their income tax returns. These regulations are effective on September 9, 2024.

The regulations mandate custodial brokers report certain sales and exchanges of digital assets starting in **calendar year 2025 (reporting in 2026).** The sales and exchanges will be reported on Form 1099-DA, *Digital Asset Proceeds From Broker Transactions.* A draft of that form follows.

> **Note.** These regulations mostly address **custodial** broker reporting requirements. The Treasury and the IRS still plan to issue additional guidance before the end of the year addressing **noncustodial** brokers. A custodial broker generally acts as a principal or agent to effect digital asset transactions on behalf of their customers. The IRS focused on custodial brokers first because this captures the majority of brokers.

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57. *Taxpayers should continue to report all cryptocurrency, digital asset income*. Jan. 22, 2024. IRS. [www.irs.gov/newsroom/taxpayers-should-continue-to-report-all-cryptocurrency-digital-asset-income] Accessed on Mar. 1, 2024.

58. *Digital Assets*. Feb. 28, 2024. IRS. [www.irs.gov/businesses/small-businesses-self-employed/digital-assets] Accessed on Mar. 1, 2024.

59. *A Guide to Crypto Custody*. 2019. Gemini Trust Company, LLC. [www.gemini.com/static/documents/guide-to-crypto-custody.pdf] Accessed on Mar. 1, 2024.

60. *What is a Centralized Cryptocurrency Exchange (CEX)?* Roy, Gaurav. Jun. 16, 2023. Ledger SAS. [www.ledger.com/academy/topics/crypto/what-is-a-centralized-cryptocurrency-exchange-cex] Accessed on Mar. 1, 2024.

61. IRS News Rel. IR-2024-178 (Jun. 28, 2024).

62. 89 CFR §56480; TD 10000 2024-31 IRB 185.

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☐ CORRECTED (if checked)

FILER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no.	Applicable checkbox on Form 8949	OMB No. 1545-XXXX 2025 Form 1099-DA	Digital Asset Proceeds From Broker Transactions
	1a Code for digital asset		Copy B For Recipient
FILER'S TIN / RECIPIENT'S TIN	1b Name of digital asset		
RECIPIENT'S name	1c Number of units		
Street address (including apt. no.)	1d Date acquired	1e Date sold or disposed	
City or town, state or province, country, and ZIP or foreign postal code	1f Proceeds $	1g Cost or other basis $	This is important tax information and is being furnished to the IRS. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported.
	1h Accrued market discount $	1i Wash sales loss disallowed $	
	2 Check if basis reported to IRS ☐	3a Reported to IRS: ☐ Gross proceeds ☐ Net proceeds	
Account number			
CUSIP number	3b Check if proceeds from: ☐ Reserved for future use ☐ QOF	4 Federal income tax withheld $	

5 Check if loss is not allowed based on amount in 1f ☐	6 Gross gain or loss: ☐ Short-term ☐ Ordinary ☐ Long-term	7 Check if 1f is only cash ☐	8 Check if broker relied on customer-provided acquisition information ☐
9 Check if digital asset is a noncovered security ☐	10 Digital asset is a noncovered security because: ☐ Broker did not provide custodial services for it ☐ Broker provided custodial services and it was transferred in to broker ☐ Broker provided custodial services and it was acquired prior to 2026		11a Check if gross proceeds reported in 1f is an aggregate amount for: ☐ Qualifying stablecoins ☐ Specified NFTs

11b If 11a checked, number of transactions	11c For aggregate reporting of specified NFTs, aggregate gross proceeds reported in 1f that are attributable to first sales by creator or minter $	12a Number of units transferred in	12b If transferred in, provide transfer-in date	13

14 State name	15 State identification no.	16 State tax withheld
		$
		$

Form **1099-DA** (Keep for your records) www.irs.gov/Form1099DA Department of the Treasury - Internal Revenue Service

TREASURY/IRS AND OMB USE ONLY DRAFT August 8, 2024 DO NOT FILE

The brokers impacted by the final regulations are those who take possession of the digital assets their customers sell. This includes the following.

- Operators of custodial digital asset trading platforms
- Certain digital asset hosted wallet providers
- Digital asset kiosks
- Certain processors of digital asset payments (PDAPs)

Transitional Relief

Along with the final regulations, the IRS issued the following guidance to provide transitional relief as the rules are put in place over the next several years.

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IRS Notice 2024-56.[63] Brokers who fail to report sales of digital assets on Form 1099-DA or fail to provide payee statements for transactions occurring in 2025 (reported in 2026), will not be subject to reporting penalties and backup withholding. However, the broker must have acted with a good faith effort to comply with the regulations.

IRS Notice 2024-57.[64] Brokers are not required to file information returns and provide payee statements regarding the following transactions and the IRS will not assess failure-to-file penalties.

1. Wrapping and unwrapping transactions
2. Liquidity provider transactions
3. Staking transactions
4. Transactions described as "lending of digital assets"
5. Transactions described as "short sales of digital assets"
6. Notional principal contract transactions

Rev. Proc. 2024-28.[65] Taxpayers can generally rely on any reasonable allocation of units of unused basis to wallets or accounts that hold the same number of remaining digital asset units based on the taxpayers' records of unused basis and remaining units in those wallets or accounts.

DIGITAL ASSET QUESTION ON ADDITIONAL FORMS

The IRS expanded digital asset questions to the 2023 versions of many tax forms to reflect the service's increased focus on reminding all taxpayers that income from digital assets is taxable.[66] In 2022, digital asset questions appeared on Form 1040, *U.S. Individual Income Tax Return,* Form 1040-SR, *U.S. Tax Return for Seniors,* and Form 1040-NR, *U.S. Nonresident Alien Income Tax Return*. For 2023, digital asset questions appear on the following forms as well.

- Form 1041, *U.S. Income Tax Return for Estates and Trusts*
- Form 1065, *U.S. Return of Partnership Income*
- Form 1120, *U.S. Corporation Income Tax Return*
- Form 1120-S, *U.S. Income Tax Return for an S Corporation*

For 2023, the wording for the question on these forms is a variation on the following.

> *At any time during 2023, did you: (a) receive (as a reward, award, or payment for property or services); or (b) sell, exchange, or otherwise dispose of a digital asset (or a financial interest in a digital asset)? (See instructions.)*

Taxpayers should answer "yes" if they sold, exchanged, transferred, or gifted digital assets. They may answer "no" if their activities were limited to the following.[67]

- **Held** digital assets in their own wallet or account
- **Transferred** digital assets between their own wallets or accounts
- **Purchased** digital assets using real currency
- Engaged in a combination of the aforementioned activities

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63. IRS Notice 2024-56, 2024-29 IRB 64.
64. IRS Notice 2024-57, 2024-29 IRB 67.
65. Rev. Proc. 2024-28, 2024-31 IRB 326.
66. *Digital asset question added to more forms for 2023 tax returns*. Waggoner, Martha. Jan. 26, 2024. AICPA. [www.journalofaccountancy.com/news/2024/jan/digital-asset-question-added-to-more-forms-for-2023-tax-returns.html] Accessed on Mar. 1, 2024.
67. Ibid.

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Additionally, the draft version of Schedule 1 (Form 1040), *Additional Income and Adjustments to Income,* includes a new line 8v to report "digital assets received as ordinary income not reported elsewhere."

SCHEDULE 1 (Form 1040)
Department of the Treasury Internal Revenue Service

Additional Income and Adjustments to Income

Attach to Form 1040, 1040-SR, or 1040-NR.
Go to *www.irs.gov/Form1040* for instructions and the latest information.

OMB No. 1545-0074
2024
Attachment Sequence No. **01**

Name(s) shown on Form 1040, 1040-SR, or 1040-NR | **Your social security number**

For 2024, enter the amount reported to you on Form(s) 1099-K that was included in error or for personal items sold at a loss . . . . .

Note: The remaining amounts reported to you on Form(s) 1099-K should be reported elsewhere on your return depending on the nature of the transaction. See *www.irs.gov/1099k*.

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Part I Additional Income

Line	Description	Sub-line	Amount	Line	Amount
1	Taxable refunds, credits, or offsets of state and local income taxes			1	
2a	Alimony received			2a	
b	Date of original divorce or separation agreement (see instructions):				
3	Business income or (loss). Attach Schedule C			3	
4	Other gains or (losses). Attach Form 4797			4	
5	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E			5	
6	Farm income or (loss). Attach Schedule F			6	
7	Unemployment compensation			7	
8	Other income:				
a	Net operating loss	8a	( )		
b	Gambling	8b			
c	Cancellation of debt	8c			
d	Foreign earned income exclusion from Form 2555	8d	( )		
e	Income from Form 8853	8e			
f	Income from Form 8889	8f			
g	Alaska Permanent Fund dividends	8g			
h	Jury duty pay	8h			
i	Prizes and awards	8i			
j	Activity not engaged in for profit income	8j			
k	Stock options	8k			
l	Income from the rental of personal property if you engaged in the rental for profit but were not in the business of renting such property	8l			
m	Olympic and Paralympic medals and USOC prize money (see instructions)	8m			
n	Section 951(a) inclusion (see instructions)	8n			
o	Section 951A(a) inclusion (see instructions)	8o			
p	Section 461(l) excess business loss adjustment	8p			
q	Taxable distributions from an ABLE account (see instructions)	8q			
r	Scholarship and fellowship grants not reported on Form W-2	8r			
s	Nontaxable amount of Medicaid waiver payments included on Form 1040, line 1a or 1d	8s	( )		
t	Pension or annuity from a nonqualifed deferred compensation plan or a nongovernmental section 457 plan	8t			
u	Wages earned while incarcerated	8u			
v	Digital assets received as ordinary income not reported elsewhere. See instructions	8v			
z	Other income. List type and amount:	8z			
9	Total other income. Add lines 8a through 8z			9	
10	Combine lines 1 through 7 and 9. This is your **additional income**. Enter here and on Form 1040, 1040-SR, or 1040-NR, line 8			10	

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 71479F **Schedule 1 (Form 1040) 2024**

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PTIN FEES FINALIZED[68]

On May 15, 2024, the IRS published a final regulation to set the fees associated with preparer tax identification numbers (PTINs). For new PTIN applications, the regulation set the fee at $21, plus third-party payment fees paid to a third-party contractor, such as a payment processor. For renewal of existing PTINs, the regulation set the fee at $11, plus the fee paid to a third-party contractor. As this fee is effective June 14, 2024, tax practitioners should expect to pay it when they renew their PTINs for the 2025 filing season.

The May regulations finalize the interim final regulations,[69] which estimated the third-party contractor fees at $8.75. Thus, tax practitioners paid $19.75 to renew their PTINs during the last several months of 2023, reflecting the $11 **renewal** charge, plus the $8.75 payment processing fee.[70] In 2023, the IRS charged individuals the same amount for a first-time application fee. Because of the higher application fee that the IRS now charges for new PTIN applications, the **application** fee in the final months of 2024 should be $10 higher, or $29.75 ($21 new application fee + $8.75 third-party fee). The IRS may adjust the fee for changes in payment processing costs.

Federal agencies, including the IRS, are authorized to charge user fees for services "provided by [the] agency."[71] Generally, an agency may charge a user fee that enables it to recover the full cost of providing the service, which for PTINs is the registration of tax return preparers. Agencies are authorized to review these fees every other year.[72] The purpose of the review is to enable the IRS to adjust the fee to reflect changes in costs or market values.[73] Because the next biennial review should be conducted for the renewal of PTINs in autumn 2025, practitioners may then see a different fee to renew their PTINs.

MEDICAL EXPENSE MISREPRESENTATION[74]

In response to increased misrepresentations claiming that certain medical expenses qualify for tax deductions or reimbursement, the IRS issued clarification for both taxpayers and health spending plan administrators to explain which expenses are considered medical under tax law and which are not.

MEDICAL VS. PERSONAL EXPENSES

Qualifying medical expenses exclude personal expenses for **general health and wellness.** Valid medical expenses qualify for deductions or reimbursements under health flexible spending arrangements (FSAs), health savings accounts (HSAs), health reimbursement arrangements (HRAs), or medical savings accounts (MSAs). Qualifying medical expenses must be for **medical care**, which the Code defines as payments for the following.[75]

- Diagnosing, curing, mitigating, treating, or preventing disease or for the purpose of affecting any structure or function of the body
- Transportation necessary for obtaining medical care
- Qualified long-term care services
- Insurance for medical care

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68. 89 Fed. Reg. 42,362 (May 15, 2024).

69. TD 9980, 2023-43 IRB 1087.

70. *PTIN Requirements for Tax Return Preparers*. Oct. 19, 2023. IRS. [www.irs.gov/tax-professionals/ptin-requirements-for-tax-return-preparers] Accessed on Jun. 26, 2024.

71. 31 USC §9701.

72. *Circular No. A-25 Revised*, p.8. The White House. [www.whitehouse.gov/wp-content/uploads/2017/11/Circular-025.pdf] Accessed on Jun. 26, 2024; 58 Fed. Reg. 38,142 (Jul. 15, 1993). See §8(e), page 38,146.

73. Ibid.

74. IRS News Rel. IR-2024-65 (Mar. 6, 2024).

75. IRC §213(d)(1).

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As a general rule, the IRS differentiates medical expenses from personal and general health expenses by specifying that medical expenses must be for a targeted diagnosis-specific activity or treatment.[76] Consequently, a doctor's note of recommendation alone does not convert nonmedical food, exercise, or general wellness expenses into qualifying medical expenses.

Example 7. Wilford has diabetes and tries to eat low-carbohydrate foods to manage his blood sugar levels better. He notices an ad from a company claiming they can help people use pre-tax dollars from their FSA to purchase healthy food. Interested, Wilford calls the company. The representative Wilford spoke to stated that for a fee, the company could provide Wilford with a doctor's note to provide as supporting documentation for charges against his FSA for healthy food. Before committing to the fee, Wilford asks his FSA administrator about this strategy, who, in turn, politely informs Wilford that such expenses for food do not qualify for reimbursement under the plan.[77]

IRC §6055 FILINGS AND THE NEW ELECTRONIC FILING THRESHOLD

On February 21, 2023, the IRS finalized a regulation that broadened the scope of the electronic filing requirement for information forms.[78] As a result of TD 9972, businesses must electronically file information returns if they have at least 10 of any information return to file.

Before the Taxpayer First Act went into effect, the threshold for the mandatory **electronic** filing of information returns was 250 or more returns of a specific form.[79] For example, a business that was required to file 225 Forms 1099-NEC could file them on paper, even if it also had another 50 Forms 1099-MISC to file.

Per TD 9972, a taxpayer must count all forms using the new method of determining the electronic filing requirement, regardless of their form number. Thus, a business can reach the lower threshold if it has just a few instances of different information returns to file.

Example 8. The Harrogate Mortgage Company is a small mortgage lender that started business in 2021. In its first year, it received mortgage interest from eight borrowers and, therefore, could file Forms 1098, *Mortgage Interest Statement*, on paper with the IRS.

In 2024, Harrogate worked with 10 mortgagors, but only nine paid interest over $600. Harrogate has a filing requirement associated with interest received on these nine mortgages. Additionally, two other mortgagors abandoned their property, and Harrogate issued them Forms 1099-A, *Acquisition or Abandonment of Secured Property*.

Harrogate must file these 11 information forms electronically.

Note. With the reduced threshold, virtually every business must file their information forms electronically. Fortunately, numerous private filing agencies and the IRS's Information Returns Intake System (IRIS) provide this service to file most information returns.[80]

For more information about IRIS, see the 2024 *University of Illinois Federal Tax Workbook*, Chapter 7: IRS Update.

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76. See IRS Pub. 502, *Medical and Dental Expenses*, for examples of qualifying medical expenses.

77. Modified example from IRS News Rel. IR-2024-65 (Mar. 6, 2024).

78. IRS News Rel. IR-2023-31 (Feb. 21, 2023).

79. *Taxpayer First Act*, PL 116-25, §2301.

80. Pub. 5717, *Information Returns Intake System (IRIS): Taxpayer Portal User Guide*, p.5 (2024).

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If a taxpayer files their information returns on paper when required to file them electronically, the taxpayer "is deemed to have failed to file the return." If a taxpayer has less than 10 forms to file so they are eligible to file on paper, but the paper form is not machine-readable, the taxpayer is also deemed to have failed to file the form, even if it is in the IRS's physical possession.[81]

ELECTRONICALLY FILING ACA FORMS

The final regulation also affects businesses that file information returns for the Affordable Care Act (ACA), including the following.[82]

- Form 1094-B, *Transmittal of Health Coverage Information*
- Form 1095-B, *Health Coverage*
- Form 1094-C, *Transmittal of Employer-Provided Health Insurance Offer and Coverage Information Returns*
- Form 1095-C, *Employer-Provided Health Insurance Offer and Coverage*

Third-Party Transmitters

Most employers must file these forms electronically if they provide their employees with health insurance.[83] Employers can meet the electronic filing requirement using a third-party transmitter, perhaps even their tax preparation firm.

IRS INITIATIVES TO CURB ABUSIVE PARTNERSHIPS

Partnerships are not new targets under IRS scrutiny. With the National Taxpayer Advocate mentioning the IRS's work to restore fairness in tax compliance with partnerships and high-income earners, it is unsurprising that the IRS has proposed regulations to address what it sees as abuses at the intersection of these two issues.[84]

In June 2024 guidance, the IRS identified partnerships that alter their assets' bases to reduce partners' tax liabilities as **potentially abusive.** The proposed regulations require the disclosure of basis-shifting transactions among related parties. In conjunction with the guidance released, they allow the IRS to deny deductions and assess penalties under IRC §6662(i).

Not all partnerships are subject to the new rules, as a proposed $5 million threshold applies. However, in light of the restrictions placed on partners and partnerships, tax practitioners must understand their underlying principles.

UNDERSTANDING BASIS SHIFTING AND BASIS STRIPPING

Basis stripping and basis shifting, two complex tax strategies, present unique challenges and opportunities for tax professionals. While partnerships may use both with tax-motivated related-party transactions, their mechanisms and implications differ significantly.

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81. Treas. Reg. §301.6011-2(f).

82. IRS Pub. 5165, *Guide for Electronically Filing Affordable Care Act (ACA) Information Returns*, p.2 (2023).

83. Treas. Reg. §1.6055-1(c)(1)(iv).

84. *National Taxpayer Advocate Annual Report to Congress: 2023,* p. xvi. Dec. 31, 2023. Taxpayer Advocate Service. [www.taxpayeradvocate.irs.gov/reports/2023-annual-report-to-congress/full-report/] Accessed on Jul. 19, 2024.

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Explanation of Basis Shifting[85]

Basis shifting in partnership taxation refers to strategies employed by partnerships to reallocate the tax basis of assets among partners, often to achieve a tax advantage without a corresponding economic transaction. The IRS considers this practice abusive when it manipulates the tax rules to create **artificial** losses or **unduly defer** income recognition.

At its core, basis shifting involves altering a partnership's inside basis in assets through distributions, transfers, or liquidations. Some partners may receive tax benefits from increased depreciation deductions by shifting basis from one asset to another. In other situations, partners may be able to reduce the gain on the sale of assets that were once held by the partnership.

One common form of basis shifting occurs when a partnership distributes high-basis property to a partner with a low **outside** basis. The partnership then increases the basis of its remaining assets, while the distributee-partner reduces the basis of the distributed asset. The related partners can structure the transaction so that the asset with the lower basis does not adversely affect some related partners. The increased basis in other partnership assets produces tax advantages for the other partners.

Another form of basis shifting occurs when a partner with a significant outside basis transfers their interest in the partnership to a related person. When the partner initiating the transfer has a relatively small inside basis but a high outside basis, a tax-free basis increase may occur for the partner receiving the partnership interest.

A third form of basis shifting arises from the liquidation of a partnership where low-basis assets are distributed to a partner with a high outside basis, and high-basis assets are distributed to a partner with a low outside basis. An acceleration of tax benefits can result, as the first partner can increase the basis of the property with a shorter life or intended for sale. In contrast, the second partner decreases the basis of the long-lived or non-depreciable property.

Explanation of Basis Stripping[86]

While basis shifting reallocates basis among partnership assets without reducing their overall basis, **basis stripping** involves reducing or eliminating the tax basis in a partnership's assets. Thus, the composite basis of partnership assets is lower than their economic principles would justify. Partnerships that consist of two corporate partners may use this tactic. Because the economic substance doctrine comes into play, Rev. Rul. 2024-14 plays an important role. Although this tactic has legitimate applications, its use may become abusive if it distorts income or gain.

Partnerships may engage in basis stripping by deliberately reducing the **inside** basis of assets through distributions, sales, or contributions. Basis stripping aims to create a disparity between assets' inside basis and their fair market value (FMV). When partners sell the disposed asset, their taxable gain is reduced, possibly to the extent that it becomes a loss.

IRS RESPONSE TO ABUSIVE PARTNERSHIPS

The basis adjustment rules are not new to the IRS, and neither is the way that some partnerships use the rules to shift basis or to strip basis to the tax benefit of some wealthy partners. This activity caught the attention of the Taxpayer Advocate Service, which described it in its annual report issued at the end of 2023. As such, the IRS developed initiatives to curb tax benefits from basis-shifting transactions in partnerships, ensuring accurate tax liability representation for related parties and consolidated groups.[87]

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85. *New IRS, Treasury guidance focuses on "basis shifting" transactions used by partnerships*. Jun. 17, 2024. IRS [www.irs.gov/newsroom/new-irs-treasury-guidance-focuses-on-basis-shifting-transactions-used-by-partnerships] Accessed on Jul. 22, 2024.

86. Rev. Rul. 2024-14, 2024-28 IRB 18; *News Analysis: Partnership Basis Stripping Inside a Consolidated Return.*Sheppard, Lee. Jul. 24, 2017. Tax Notes. [www.taxnotes.com/tax-notes-today-federal/partnerships-and-other-passthrough-entities/news-analysis-partnership-basis-stripping-inside-consolidated-return/2017/07/24/1vx13] Accessed on Jul. 19, 2024.

87. *Treasury and IRS release guidance on partnership "basis shifting" transactions.* Jun. 17, 2024. KPMG. [kpmg.com/us/en/home/insights/2024/06/tnf-treasury-and-irs-release-guidance-on-partnership-basis-shifting-transactions.html] Accessed on Jul. 19, 2024.

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IRS Notice 2024-54[88]

IRS Notice 2024-54 announces forthcoming regulations targeting certain basis-shifting transactions involving partnerships and related parties. These transactions, classified as "covered transactions," involve partners and their related parties attempting to increase asset bases under IRC §§732, 734(b), or 743(b) with the goal of enhancing cost recovery allowances or reducing gain upon the sale or disposition of the adjusted property.

To prevent inappropriate tax benefits, the Treasury and IRS are proposing regulations under §§732, 734(b), 743(b), and 755, as discussed later, that require a specific method for **recovering adjustments** to the bases of property held or distributed by a partnership. Additionally, proposed regulations under IRC §1502 will ensure the single-entity treatment of consolidated group members owning partnership interests, preventing basis shifting that distorts group income.

Notice 2024-54 outlines the need for these regulations, describing the covered transactions and their implications. The proposed regulations clarify the appropriate recovery method for basis adjustments and method to determine gain or loss on the disposition of adjusted property, including transactions involving tax-indifferent parties.

The anticipated regulations affect partnerships with related partners, defined by relationships described in IRC §§267(b) or 707(b)(1). The guidance also impacts certain transactions not involving related parties, such as those with tax-exempt or foreign entities or parties with tax attributes that preclude any gain recognition.

IRS News Release IR-2024-166[89]

With this communication, the IRS sharpens its focus on high-income compliance issues, announcing measures to combat abusive partnership transactions. The release announces specialized IRS teams and the development of guidance to close loopholes exploited by wealthy taxpayers through partnerships.

The IRS is forming a dedicated group within the Office of Chief Counsel and a pass-through work group in the Large Business and International division. These teams will create regulations to prevent basis-shifting transactions, where taxpayers manipulate asset bases to generate tax benefits without economic substance.

This initiative follows the Inflation Reduction Act of 2022 funding, which enables the IRS to increase audits on complex partnerships. The guidance targets transactions involving related-party partnerships, aiming to halt tax avoidance strategies that shift basis from non-beneficial assets to those yielding tax advantages.

Revenue Ruling 2024-14[90]

Revenue Ruling 2024-14 provides critical clarification on applying the economic substance doctrine to certain partnership transactions. This ruling addresses scenarios where related-party partnerships engage in transactions that create a disparity between the inside and outside bases of partnership assets. Subsequently, these transactions trigger basis adjustments under §§732(b), 734(b), or 743(b), as discussed earlier.

The ruling confirms that the economic substance doctrine applies to disallow tax benefits from such transactions, emphasizing that tax benefits must align with the economic realities of the transactions. This doctrine serves as a tool to combat tax avoidance strategies that lack a substantial purpose other than to produce tax benefits.

One of the issues raised in this revenue ruling is whether the IRS can use the economic substance doctrine in IRC §7701(o) to deny basis adjustments that otherwise would increase taxpayers' deductions for depreciation, depletion, and other forms of cost recovery. The IRS not only expects to deny these adjustments, it also plans to assess 20% penalties for nondisclosed noneconomic substance transactions.[91] The potential tax and penalties are substantial, given the $5 million threshold.

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88. IRS Notice 2024-54, 2024-28 IRB 24.
89. IRS News Rel. IR-2024-166 (Jun. 17, 2024).
90. Rev. Rul. 2024-14, 2024-18 IRB 18.
91. IRC §6662(i)

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Proposed Regulations[92]

Proposed regulations would require partnerships to identify certain basis adjustment transactions as **transactions of interest.** This regulation has the effect of making them reportable transactions that carry heavy fines if not reported. Treas. Reg. §1.6011-4(c)(4) contains "catch-all" provisions that make "substantially similar" transactions reportable, as well.

If taxpayers miss disclosing a transaction, significant penalties apply under IRC §6707A. This Code section provides a **penalty equal to 75%** of the decreased tax shown on the return. The **minimum** penalty is $5,000 for a natural person and $10,000 for any other taxpayer. Taxpayers may also be liable for additional accuracy-related penalties under IRC §6662A.

Not all transactions would apply in the currently proposed version of the regulations. The proposed regulations apply to related-party transactions with a $5 million minimum threshold requirement.[93]

The reporting requirement would apply to partners or a person related to a partner. They must disclose the transaction to the IRS on Form 8886, *Reportable Transaction Disclosure Statement.* Persons who assist them as material advisors must report the transactions using Form 8918, *Material Advisor Disclosure Statement.*

TAX PLANNING CONSIDERATIONS FOR PARTNERSHIPS

Implementing these provisions adds complexity to partnership transactions that could involve related parties. Therefore, partnerships may consider operational changes that preclude or at least make it unlikely that they run afoul of the new guidance. The following steps may serve as a starting point to ensure compliance.

1. **Review of Transactions.** Partnerships should thoroughly review all transactions, especially those involving related parties, to identify any that the IRS may consider abusive under the new rules. This review should include transactions that result in basis shifting or lack economic substance.
2. **Bookkeeping Practices.** Partnerships should implement robust bookkeeping practices that document the economic purpose of each transaction. They should ensure that the partnership's books reflect the substance of its transactions.
3. **Operating Agreement Amendments.** Working with their attorneys, partnerships should consider amending their partnership operating agreement to prohibit transactions lacking economic substance or those that the IRS could construe as abusive under IRS Notice 2024-54.[94]
4. **Tax Basis Documentation.** Partnerships must maintain detailed records of the tax basis of partnership assets and any adjustments. As outlined in the notice, this step is crucial for demonstrating compliance with IRC §§732, 734, 743, 755, and 1502.[95]
5. **Consultation with Tax Professionals.** Partnerships should work with tax professionals specializing in partnership taxation to review and advise on complex transactions. Their expertise can be invaluable in navigating the new regulations and ensuring the partnership's activities remain within legal boundaries.
6. **Training and Education.** Partnerships may need to provide additional training for partners and staff on the new rules and the importance of complying with them. Because the guidance may disallow some 2024 transactions, certain partnerships may wish to undertake training on the rules very soon.[96]
7. **Regular Audits.** Schedule regular internal or external audits to assess the partnership's compliance with the new rules. Audits can uncover potential issues before they come to the attention of the IRS.

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92. REG-124593-23, 2024-28 IRB 40.

93. Prop. Treas. Reg. §1.6011-18(c).

94. IRS Notice 2024-54, 2024-28 IRB 24.

95. Ibid.

96. *The IRS Takes Aim at Basis Adjustments in Partnership Transactions*. Allen, Trevor, et al. Jun. 25, 2024. Skadden, Arps, Slate, Meagher, & Flom LLP and Affiliates. [www.skadden.com/insights/publications/2024/06/the-irs-takes-aim] Accessed on Jul. 19, 2024.

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IMPLICATIONS FOR TAX PROFESSIONALS

IRS Notice 2024-54, IR-2024-166, and Rev. Rul. 2024-14 introduce significant changes affecting tax practitioners in preparing partnership and individual partner returns and those representing clients in tax controversies.

Tax Practitioners Preparing Partnership Returns[97]

These professionals must now navigate complex regulations targeting basis-shifting transactions. The new rules require careful and consistent documentation of partnership transactions to ensure they reflect economic reality and not merely serve to inflate basis without justification. Practitioners must adapt their practices to incorporate the special rules for cost recovery of positive basis adjustments and the ability to take these adjustments into account when computing gain or loss on the disposition of property with an adjusted basis. This adaptation requires a deep understanding of §§732, 734(b), 743(b), 755, and 1502, as the proposed regulations under these sections significantly affect partnership taxation.

Tax Practitioners Preparing Individual Partner Returns[98]

For those preparing returns for individual partners, the focus shifts to ensuring that the partnership accurately reports the partner's share of any basis adjustments. Practitioners must ensure that individual partners' returns are consistent with the partnership's reporting and comply with the new anti-abuse provisions. This practice includes verifying that any basis increase reported by the partner aligns with "legitimate nontax economic transactions of the partnership."[99]

Tax Practitioners Representing Clients in Tax Controversies

The anti-abuse provisions mean that attorneys, enrolled agents, and CPAs representing clients before the IRS may face additional challenges in defending partnership transactions. They must prepare to demonstrate the economic substance of transactions that cause basis adjustments. Because the IRS indicates it will aggressively challenge abusive partnership transactions, representatives must prepare to argue the partnership's position by invoking the economic substance doctrine.[100]

FORM 7217

Form 7217, *Partner's Report of Property Distributed by a Partnership,* arises from IRS attempts to restrain inappropriate basis shifting among related partners. The partnership files this form to identify partners who receive property that could result in recognition of a gain. Partnerships prepare Form 7217 when a distribution triggers a basis adjustment under one of §§732(d), 734(b), or 743(b).

Part I of Form 7217 summarizes the aggregate basis of property distributed. Part II of the form collects details of the property distributed, such as the FMV for each property and the partner's basis in the property after applying the related Code section.

Previously, §743(b) basis adjustments have been reported on Schedule K-1 (Form 1065), *Partner's Share of Income, Deductions, Credits, etc.,* in box 11 with code F if positive, in box 13 with code V if negative, and, generally, in box 20 with code U. Before 2024, this information was not reported on any form other than Schedule K-1 (Form 1065). A draft 2024 Form 7217 follows.

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97. Rev. Rul. 2024-54, 2024-28 IRB 18.

98. Ibid.

99. Ibid. See p. 22.

100. *IRS, Treasury Crack Down on Abusive Partnership Transactions in New Initiative.* Shaw, Tim. Jun. 18, 2024. Thomson Reuters Tax & Accounting. [tax.thomsonreuters.com/news/irs-treasury-crack-down-on-abusive-partnership-transactions-in-new-initiative] Accessed on Jul. 19, 2024.

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Form **7217** (December 2024) Department of the Treasury Internal Revenue Service

Partner's Report of Property Distributed by a Partnership

Attach to your tax return.
Go to *www.irs.gov/Form7217* for instructions and the latest information.

OMB No. 1545-0123
Attachment Sequence No. **217**

Partner's name | Partner's TIN

Distributing partnership's name | Distributing partnership's EIN

Date property was distributed to partner

TREASURY/IRS AND OMB USE ONLY DRAFT August 28, 2024

Part I **Aggregate Basis of Distributed Property on Distribution Date.** File a separate form for each date a partner received distributed property.

1 Was this distribution in complete liquidation of the partner's entire interest in the partnership? ☐ Yes ☐ No
2 Was any part of the distribution treated as a sale or exchange under section 751(b)? ☐ Yes ☐ No
3 Partnership's aggregate basis in distributed property (taking into account any basis adjustments under section 732(d), 734(b), or 743(b)) immediately before the distribution. This line should equal the total of Part II, line B, column (b) $
4 Adjusted basis of the partner's interest in the partnership immediately before the distribution $
5 Cash and marketable securities (as defined in section 731(c)) received in the distribution $
6 Enter the smaller of line 4 or line 5 $
7 Gain recognized. Subtract line 6 from line 5. If zero, enter -0- and go to line 9 $
8 Is U.S. tax required to be paid on the gain entered on line 7? ☐ Yes ☐ No
9 Partner's basis in partnership interest reduced by cash and marketable securities (as defined in section 731(c)) received in the distribution. Subtract line 6 from line 4 $
10 Aggregate basis to be allocated to the distributed property. For a non-liquidating distribution, enter the smaller of line 3 or line 9. For a liquidating distribution, enter the amount from line 9. Line 10 should equal the total of Part II, line B, column (e) $

For Paperwork Reduction Act Notice, see the Instructions for Form 1065. Cat. No. 94479B Form **7217** (12-2024)

Form 7217 (12-2024) Page **2**

TREASURY/IRS AND OMB USE ONLY DRAFT August 28, 2024 DO NOT FILE

Part II **Allocation of Basis of Distributed Property**

	(a) Description of distributed property (If applicable, include property code. See Pub. 946, Appendix B.)	(b) Partnership's basis in distributed property immediately before the distribution	(c) Check applicable box(es) below. See instructions.					(d) FMV of distributed property	(e) Partner's basis in distributed property after application of section 732
			(i) 732(d)	(ii) 732(f)	(iii) 734(b)	(iv) 743(b)	(v) Reserved for future use		
1		$	☐	☐	☐	☐	☐	$	$
2		$	☐	☐	☐	☐	☐	$	$
3		$	☐	☐	☐	☐	☐	$	$
4		$	☐	☐	☐	☐	☐	$	$
5		$	☐	☐	☐	☐	☐	$	$
6		$	☐	☐	☐	☐	☐	$	$
7		$	☐	☐	☐	☐	☐	$	$
8		$	☐	☐	☐	☐	☐	$	$
9		$	☐	☐	☐	☐	☐	$	$
10		$	☐	☐	☐	☐	☐	$	$
11		$	☐	☐	☐	☐	☐	$	$
12		$	☐	☐	☐	☐	☐	$	$
13		$	☐	☐	☐	☐	☐	$	$
14		$	☐	☐	☐	☐	☐	$	$
15		$	☐	☐	☐	☐	☐	$	$
16		$	☐	☐	☐	☐	☐	$	$
17		$	☐	☐	☐	☐	☐	$	$
18		$	☐	☐	☐	☐	☐	$	$
19		$	☐	☐	☐	☐	☐	$	$
20		$	☐	☐	☐	☐	☐	$	$
21		$	☐	☐	☐	☐	☐	$	$
22		$	☐	☐	☐	☐	☐	$	$
23		$	☐	☐	☐	☐	☐	$	$
24		$	☐	☐	☐	☐	☐	$	$
25		$	☐	☐	☐	☐	☐	$	$
26		$	☐	☐	☐	☐	☐	$	$
27		$	☐	☐	☐	☐	☐	$	$
28		$	☐	☐	☐	☐	☐	$	$
29		$	☐	☐	☐	☐	☐	$	$
30		$	☐	☐	☐	☐	☐	$	$
A	If applicable, enter any totals from any attached Parts II. See instructions	$						$	$
B	Totals for all items	$						$	$

Form **7217** (12-2024)

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Information about a partner's basis in the property distributed to them affects their return when they sell the property. At that time, the adjusted basis is reflected on their Form 4797, *Sales of Business Property,* or Form 8949, *Sales and Other Dispositions of Capital Assets*, depending on how they used the property after distribution to them.

RETIREMENT PLAN DISTRIBUTIONS FOR DISASTER RELIEF[101]

In passing the SECURE 2.0 Act in 2022, Congress made **permanent** the ability of retirement plan participants to use their retirement funds to recover from federally declared disasters.[102] The IRS issued frequently asked questions (FAQs) to provide guidance regarding such retirement plan distributions for disaster relief. This section summarizes and illustrates the IRS FAQs.

TAX-FAVORED WITHDRAWALS

A retirement plan participant can withdraw up to **an aggregate of $22,000** from their retirement plans without incurring a 10% additional tax on the distribution[103] if the participant meets the following criteria.

- Maintains a principal residence located in a qualified disaster area when the disaster occurred
- Incurs an **economic loss** caused by the qualified disaster, including but not limited to:
  - Losses, damages, and the destruction of real or personal property
  - Losses from the displacement from the participant's principal residence
  - Loss of livelihood attributed to temporary or permanent layoffs

For purposes of preferential tax treatment for such distributions, a qualified disaster is **any disaster the President declares as a major disaster after December 27, 2020.** The IRS advises plan participants to use the Federal Emergency Management Agency (FEMA) disaster declaration search tool[104] to verify if a specific disaster qualifies for tax-favored withdrawals. Additionally, plan participants can confirm the duration (a single day or multiple days) of the disaster using this tool.

> **Note.** FEMA may change a disaster's declaration type based on new information, such as first declaring a disaster to be an "emergency" and subsequently a "major disaster."

For a distribution to qualify as a disaster recovery distribution, the timing of the distribution must fall within a specified period. The plan participant must take the distribution on or after the first day of the disaster; a plan participant may **not** take a distribution before the disaster occurs and claim it as a qualified disaster recovery distribution. However, a plan participant must take the distribution before the date that is 180 days after the latest of the following.

- December 29, 2022
- The first day of the disaster's occurrence
- The day the disaster was declared as a qualifying disaster

---

101. *Disaster relief frequently asked questions: Retirement plans and IRAs under the SECURE 2.0 Act of 2022*. May 6, 2024. IRS. [www.irs.gov/newsroom/disaster-relief-frequent-asked-questions-retirement-plans-and-iras-under-the-secure-20-act-of-2022] Accessed on Jul. 15, 2024.

102. *SECURE 2.0 Act of 2022*, PL 117-328, §331.

103. IRC §72(t)(11).

104. *Disasters and Other Declarations*. 2024. FEMA. [www.fema.gov/disaster/declarations] Accessed on Jul. 18, 2024.

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Adherence to Plan Provisions

Plan participants must comply with specific provisions of their retirement plans regarding qualified disaster recovery distributions. The IRS clarifies that employers sponsoring retirement plans have the **option** of amending their plans to provide for qualified disaster recovery distributions. The SECURE 2.0 Act does not **require** plan sponsors to make such changes, including amending plan loan provisions or repayment schedules. Furthermore, the legislation does not provide additional distribution rights to participants or change the rules applying to plan distributions. Participants cannot withdraw funds as qualified disaster recovery distributions if the distributions do not satisfy the plan's provisions. The distributions must meet the criteria for distributable events.

Plan sponsors or plan administrators can generally rely on a participant's reasonable representation that they qualify for special treatment under qualifying major disaster relief for distributions and loans. However, if they know that a participant does not qualify, such reliance is invalid. Regardless of whether an employer treats a distribution as a qualified disaster recovery distribution, participants can treat the distribution as qualified on their income tax returns as long as they satisfy the applicable SECURE 2.0 Act provisions.

Income Tax Reporting and Consequences

Plan participants taking a qualified disaster recovery distribution receive a Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.*, from the retirement plan's trustee or custodian. Participants report the distributions on Forms 1040, and Forms 8915-F, *Qualified Disaster Retirement Plan Distributions and Repayments*. Participants must include the taxable portion of the distributions in income in equal amounts over three years, beginning with the year the participant received the distribution. Alternatively, participants may elect to include all qualified distributions as income in the year they received the distribution. Participants make this election on Form 8915-F.

Example 9. Garth's primary residence is in Montgomery, Texas, where he lived for all 2024. On July 8, Garth's residence incurs severe damage from Hurricane Beryl, a federally declared disaster. Garth takes $21,000 from his traditional IRA as a qualified disaster recovery distribution on July 16. The entire distribution is **taxable** but is not subject to the 10% **additional tax** on early distributions. Garth does not elect to claim the entire distribution as income in 2024. He prepares the Form 8915-F for 2024 shown on the following pages.

Garth reports $7,000 of income from IRA distributions on his 2024, 2025, and 2026 income tax returns.

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For Example 9

Form **8915-F** (Rev. January 2024) Department of the Treasury Internal Revenue Service

Qualified Disaster Retirement Plan Distributions and Repayments
Attach to Form 1040, 1040-SR, or 1040-NR.
Go to *www.irs.gov/Form8915F* for instructions and the latest information.

OMB No. 1545-0074
Attachment Sequence No. **915**

Name. If married, file a separate form for each spouse required to file Form 8915-F. See instructions.: **Garth Ellis**
Your social security number: ***-**-6642

Before you begin (see instructions for details):

- Use Form 8915-F for 2021 and later disasters. Also, use it after 2020 for coronavirus-related and other 2020 disasters instead of Form 8915-E.
- Major Disaster Declarations at *www.FEMA.gov/disaster/declarations* provides the only qualified disasters and their FEMA numbers for item C.
- "This year" (as used on this form) is the year of the form you check in item A next. For example, if you check 2022, "this year" is 2022.

Complete items A and B below. Complete item C and check the box in item D for the coronavirus, as applicable.

A Tax year for which you are filing form (check only one box): ☐ 2021 ☐ 2022 ☐ 2023 ☒ 2024 ☐ Other ______

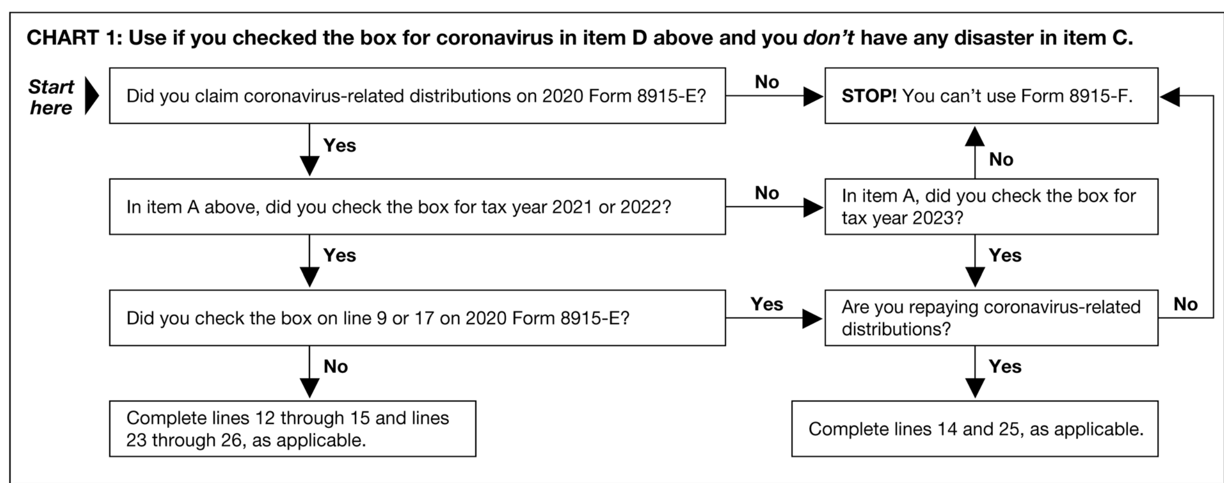
B Calendar year in which qualified disaster(s) began (check only one box): ☐ 2020 ☐ 2021 ☐ 2022 ☐ 2023 ☒ Other **2024**

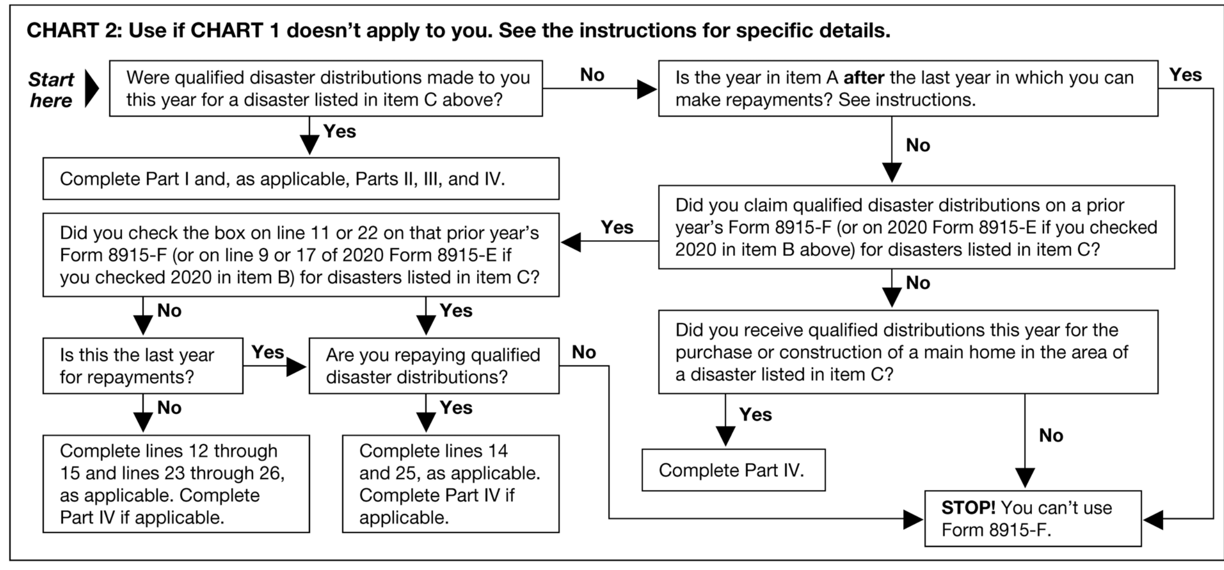
C FEMA number for each of your qualified disasters for the year checked in item B above. Use item D, **not** item C, for the coronavirus.

(1) **DR-4798-TX** (2) ______ (3) ______ (4) ______ (5) ______ (6) ______

D If your only disaster, or one of your disasters, is the coronavirus, check this box ☐ Don't list the coronavirus in item C.

Which lines on this form should I use? See CHARTS 1 and 2 below.





For Privacy Act and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 75585Y Form **8915-F** (Rev. 1-2024)

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For Example 9

Form 8915-F (Rev. 1-2024) Page **2**

Part I **Total Distributions From All Retirement Plans (Including IRAs)** (see instructions)

Caution: Complete Part I if, this year, you have qualified disaster distributions (see instructions) for disasters listed in item C earlier.

Part I Disaster Table. Provide the information requested below for the disaster(s) in item C earlier for which you are reporting qualified disaster distributions in this part.

Disaster FEMA number*	Disaster declaration date*	Disaster beginning date*
DR-4798-TX	**7/09/2024**	**7/05/2024**

* Major Disaster Declarations at *www.FEMA.gov/disaster/declarations* provides the FEMA number, Disaster declaration date, and Disaster beginning date for the disaster(s) listed in the Part I Disaster Table. If more than two disasters, see instructions and check this box . . . . ☐

Date(s) of distribution(s) made this year **7/16/2024**

If you completed Part I of two or more Forms 8915-F on which you checked the same year in item A but different years in item B, see *Part I* in the instructions to figure the amount for lines 2, 3, and 4 in column (a).

			(a) Available distributions for this year (see instructions)	(b) Qualified disaster distributions for the disasters in the Part I Disaster Table (see instructions)
1	See line 1a below to determine whether you need to complete lines 1a through 1e. You must use Worksheet 1B in the instructions **if** you are directed to do so in line 1a. However, you can always choose to use Worksheet 1B.			
a	**(i) If you checked 2021 in item A and 2020 in item B, do one of the following.** • If either you didn't file 2020 Form 8915-E or, on 2020 Form 8915-E, you only reported disasters other than those listed in the Part I Disaster Table earlier, skip lines 1a through 1d, and on line 1e enter $100,000 times the number of disasters you entered in the Part I Disaster Table. • Otherwise, complete lines 1a through 1e, entering on line 1a $100,000 times the number of disasters you entered in the Part I Disaster Table that were also reported on 2020 Form 8915-E, but do not include the coronavirus. **(ii) If you checked 2021 or later in both item A and item B, do one of the following.** (For 2021 and later disasters, the limit is $22,000, not $100,000, per disaster.) • If you listed only one disaster in the Part I Disaster Table and a prior year's Form 8915-F doesn't list that disaster in item C, skip to line 1e and enter $22,000 there. • If you listed only one disaster in the Part I Disaster Table and a prior year's Form 8915-F lists that disaster in item C, complete lines 1a through 1e, entering $22,000 on line 1a. • If all of the distributions for this year occurred within the qualified disaster distribution period (see *Qualified disaster distribution period* in instructions) for each of the disasters listed in the Part I Disaster Table, complete lines 1a through 1e, entering on line 1a $22,000 times the number of disasters you entered in the Part I Disaster Table that were also entered in item C on a prior year's Form 8915-F. • Otherwise, for lines 1a through 5, you must use Worksheet 1B in the instructions .	1a		
b	Enter the total qualified disaster distributions made to you in prior year(s) for all disasters in the Part I Disaster Table. See *Part I* in the instructions	1b		
c	Subtract line 1b from line 1a	1c		
d	Enter $22,000 ($100,000 if you checked 2020 in item B) times the number of qualified disasters that you entered in the Part I Disaster Table but didn't enter in item C on a prior year's Form 8915-F, or in Part I of 2020 Form 8915-E if you checked 2020 in item B . .	1d		
e	**Total available qualified disaster distribution amount for this year.** Enter the sum of lines 1c and 1d. **If the amount on line 1e is zero**, complete lines 2 through 4 in column (a), skip line 5, enter -0- on line 6, and do NOT include, in Part II or III later, amounts for disasters listed in the Part I Disaster Table	1e		**22,000**
2	Enter, in column (a), distributions from retirement plans (other than IRAs) made this year	2	**0**	**0**
3	Enter, in column (a), distributions from traditional, traditional SEP, and traditional SIMPLE IRAs made this year	3	**21,000**	**21,000**
4	Enter, in column (a), distributions from Roth, Roth SEP, and Roth SIMPLE IRAs made this year	4	**0**	**0**
5	Do (1) through (3) below in the order indicated. **(1)** Enter on line 5, column (a), the sum of lines 2 through 4 in column (a) reduced by the total distributions from lines 2 through 4 in column (a) that aren't qualified disaster distributions. **(2)** Enter on line 5, column (b), the smaller of the amount on line 5, column (a), or line 1e. **(3)** Enter on lines 2 through 4 in column (b) the amounts from lines 2 through 4, respectively, in column (a) **allocated, if needed**, by any reasonable method so that the sum of lines 2 through 4 in column (b) equals the amount on line 5, column (b)	5	**21,000**	**21,000**

6	**Total qualified disaster distributions.** Enter the amount from line 5, column (b). The additional tax for early withdrawals is waived for this amount (see instructions). See Parts II and III, later, for the tax on this amount	6	**21,000**
7	**Taxable amount.** Enter the excess of the sum of lines 2 through 4 in column (a) over the amount on line 6. Report this excess as IRA and/or pension and annuity distributions, as applicable, in accordance with the instructions for your tax return. All or part of the amount on line 7 may be eligible for the tax benefits in Part IV. See instructions	7	**0**

Form **8915-F** (Rev. 1-2024)

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For Example 9

Form 8915-F (Rev. 1-2024) Page 3

Part II **Qualified Disaster Distributions From Retirement Plans (Other Than IRAs) for the Coronavirus and Disaster(s) Listed in Item C**

Line	Description	Box	Amount
8	Did you enter an amount on line 2, column (b)? ☐ **No.** Skip lines 8 through 11, and go to line 12. ☐ **Yes.** Enter the amount from line 2, column (b)	8	
9	Enter the applicable cost of distributions, if any. See instructions	9	
10	Subtract line 9 from line 8. This is the taxable amount of your other-than-IRA retirement plan qualified disaster distributions	10	
11	The entire taxable amount on line 10 will be spread over 3 years unless you elect to have it taxed in this year. **If you elect NOT to spread the taxable amount over 3 years, check this box** ☐ **and enter the amount from line 10 (see instructions). Otherwise, enter the amount from line 10 divided by 3.0.** You must check the box on this line if you check the box on line 22	11	
12	Enter the amount, if any, from Worksheet 2 in the instructions. This is your income for prior years from other-than-IRA retirement plan qualified disaster distributions	12	
13	Add lines 11 and 12. This is your total income this year from other-than-IRA retirement plan qualified disaster distributions	13	
14	**Total repayment.** Enter the amount, if any, from Worksheet 3. This is your total repayment for this year of other-than-IRA retirement plan qualified disaster distributions	14	
15	**Amount subject to tax this year.** Subtract line 14 from line 13. If zero or less, enter -0-. Include this amount in the total on line 5b of this year's Form 1040, 1040-SR, or 1040-NR. See instructions	15	

Part III **Qualified Disaster Distributions From IRAs for the Coronavirus and Disaster(s) Listed in Item C**

Before you begin: Complete this year's Form 8606, Nondeductible IRAs, if required.

Line	Description	Box	Amount
16	Did you enter an amount on line 3, column (b), or line 4, column (b)? ☒ **Yes.** Go to line 17. ☐ **No.** Skip lines 17 through 22, and go to line 23.		
17	Did you receive a qualified disaster distribution from an IRA that is required to be reported on this year's Form 8606? ☐ **Yes.** Go to line 18. ☒ **No.** Skip lines 18 and 19, and go to line 20.		
18	Enter the amount, if any, from this year's Form 8606, line 15b. But if you are entering amounts here and on other Forms 8915-F for this year, only enter on line 18 the amount on Form 8606, line 15b, attributable to Form 8915-F distributions for this form. See the instructions for Form 8606, line 15b	18	
19	Enter the amount, if any, from this year's Form 8606, line 25b. But if you are entering amounts here and on other Forms 8915-F for this year, only enter on line 19 the amount on Form 8606, line 25b, attributable to Form 8915-F distributions for this form. See the instructions for Form 8606, line 25b	19	
20	Enter the amount from line 3, column (b), if any. Don't include on line 20 any amounts reported on Form 8606	20	21,000
21	Add lines 18, 19, and 20. This is the taxable amount of your IRA qualified disaster distributions	21	21,000
22	The entire taxable amount on line 21 will be spread over 3 years unless you elect to have it taxed in this year. **If you elect NOT to spread the taxable amount over 3 years, check this box** ☐ **and enter the amount from line 21 (see instructions). Otherwise, enter the amount from line 21 divided by 3.0.** You must check the box on this line if you check the box on line 11	22	7,000
23	Enter the amount, if any, from Worksheet 4 in the instructions. This is your income for prior years from IRA qualified disaster distributions	23	0
24	Add lines 22 and 23. This is your total income this year from IRA qualified disaster distributions	24	7,000
25	**Total repayment.** Enter the amount, if any, from Worksheet 5. This is your total repayment for this year of IRA qualified disaster distributions	25	0
26	**Amount subject to tax.** Subtract line 25 from line 24. If zero or less, enter -0-. Include this amount in the total on line 4b of this year's Form 1040, 1040-SR, or 1040-NR. See instructions	26	7,000

Form **8915-F** (Rev. 1-2024)

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Example 10. Use the same facts as **Example 9,** except Garth elects to include the entire distribution in 2024 income. Garth's Form 8915-F for 2024 looks identical to the prepared form in **Example 9,** except he prepares part III, *Qualified Disaster Distributions From IRAs for the Coronavirus and Disaster(s) Listed in Item C*, as follows.

	amount in the total on line 5b of this year's Form 1040, 1040-SR, or 1040-NR. See instructions	15	
Part III	**Qualified Disaster Distributions From IRAs for the Coronavirus and Disaster(s) Listed in Item C**		
	Before you begin: Complete this year's Form 8606, Nondeductible IRAs, if required.		
16	Did you enter an amount on line 3, column (b), or line 4, column (b)? ☒ **Yes.** Go to line 17. ☐ **No.** Skip lines 17 through 22, and go to line 23.		
17	Did you receive a qualified disaster distribution from an IRA that is required to be reported on this year's Form 8606? ☐ **Yes.** Go to line 18. ☒ **No.** Skip lines 18 and 19, and go to line 20.		
18	Enter the amount, if any, from this year's Form 8606, line 15b. But if you are entering amounts here and on other Forms 8915-F for this year, only enter on line 18 the amount on Form 8606, line 15b, attributable to Form 8915-F distributions for this form. See the instructions for Form 8606, line 15b	18	
19	Enter the amount, if any, from this year's Form 8606, line 25b. But if you are entering amounts here and on other Forms 8915-F for this year, only enter on line 19 the amount on Form 8606, line 25b, attributable to Form 8915-F distributions for this form. See the instructions for Form 8606, line 25b	19	
20	Enter the amount from line 3, column (b), if any. Don't include on line 20 any amounts reported on Form 8606	20	21,000
21	Add lines 18, 19, and 20. This is the taxable amount of your IRA qualified disaster distributions	21	21,000
22	The entire taxable amount on line 21 will be spread over 3 years unless you elect to have it taxed in this year. **If you elect NOT to spread the taxable amount over 3 years, check this box ☒ and enter the amount from line 21 (see instructions). Otherwise, enter the amount from line 21 divided by 3.0.** You must check the box on this line if you check the box on line 11	22	21,000
23	Enter the amount, if any, from Worksheet 4 in the instructions. This is your income for prior years from IRA qualified disaster distributions	23	0
24	Add lines 22 and 23. This is your total income this year from IRA qualified disaster distributions	24	21,000
25	**Total repayment.** Enter the amount, if any, from Worksheet 5. This is your total repayment for this year of IRA qualified disaster distributions	25	0
26	**Amount subject to tax.** Subtract line 25 from line 24. If zero or less, enter -0-. Include this amount in the total on line 4b of this year's Form 1040, 1040-SR, or 1040-NR. See instructions	26	21,000

Form **8915-F** (Rev. 1-2024)

Garth reports $21,000 of income from IRA distributions on his 2024 income tax return. He does not report any income from the qualified disaster recovery distribution on his 2025 and 2026 tax returns.

Note. If Garth had waited until 2026 to repay any part of the $21,000, pursuant to IRS Notice 2005-92,[105] he could choose which return(s) to amend subject to the statute of limitations.

Repayment of Qualified Disaster Recovery Distributions

For retirement plans that accept rollover contributions, plan participants may repay all or part of the qualified disaster recovery distributions they received. The plan participant must make repayment within the 3-year period beginning on the day after the participant receives the distribution. The IRS treats the repayment as a direct trustee-to-trustee transfer, making the portion of the distribution repaid not subject to income tax.

Caution. The SECURE 2.0 Act does not require retirement plans to change rollover terms or procedures to accept qualified disaster recovery distributions repayments. Plan participants must familiarize themselves with their plan provisions for rollover contributions **before** taking qualified disaster recovery distributions if they plan to repay all or a portion of the distribution to avoid incurring income tax.

Participants can amend previously filed tax returns to request refunds if they repay disaster recovery distributions after reporting them as income.

[105] IRS Notice 2005-92, 2005-51 IRB 1165.

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Example 11. Use the same facts as **Example 10,** except Garth does not elect to include his entire distribution in 2024 income. Because his retirement plan allows him to repay qualified disaster recovery distributions, Garth decides to repay the $21,000 distribution evenly at the end of each year from 2024 through 2026, starting with $7,000 repaid to his retirement plan on December 31, 2024. He prepares the following Form 8915-F, part III, and associated worksheet from the Form instructions for 2024.

15	amount in the total on line 5b of this year's Form 1040, 1040-SR, or 1040-NR. See instructions	15	
Part III	**Qualified Disaster Distributions From IRAs for the Coronavirus and Disaster(s) Listed in Item C**		
	Before you begin: Complete this year's Form 8606, Nondeductible IRAs, if required.		
16	Did you enter an amount on line 3, column (b), or line 4, column (b)? ☒ **Yes.** Go to line 17. ☐ **No.** Skip lines 17 through 22, and go to line 23.		
17	Did you receive a qualified disaster distribution from an IRA that is required to be reported on this year's Form 8606? ☐ **Yes.** Go to line 18. ☒ **No.** Skip lines 18 and 19, and go to line 20.		
18	Enter the amount, if any, from this year's Form 8606, line 15b. But if you are entering amounts here and on other Forms 8915-F for this year, only enter on line 18 the amount on Form 8606, line 15b, attributable to Form 8915-F distributions for this form. See the instructions for Form 8606, line 15b	18	
19	Enter the amount, if any, from this year's Form 8606, line 25b. But if you are entering amounts here and on other Forms 8915-F for this year, only enter on line 19 the amount on Form 8606, line 25b, attributable to Form 8915-F distributions for this form. See the instructions for Form 8606, line 25b	19	
20	Enter the amount from line 3, column (b), if any. Don't include on line 20 any amounts reported on Form 8606	20	21,000
21	Add lines 18, 19, and 20. This is the taxable amount of your IRA qualified disaster distributions	21	21,000
22	The entire taxable amount on line 21 will be spread over 3 years unless you elect to have it taxed in this year. **If you elect NOT to spread the taxable amount over 3 years, check this box** ☐ **and enter the amount from line 21 (see instructions). Otherwise, enter the amount from line 21 divided by 3.0.** You must check the box on this line if you check the box on line 11	22	7,000
23	Enter the amount, if any, from Worksheet 4 in the instructions. This is your income for prior years from IRA qualified disaster distributions	23	0
24	Add lines 22 and 23. This is your total income this year from IRA qualified disaster distributions	24	7,000
25	**Total repayment.** Enter the amount, if any, from Worksheet 5. This is your total repayment for this year of IRA qualified disaster distributions	25	7,000
26	**Amount subject to tax.** Subtract line 25 from line 24. If zero or less, enter -0-. Include this amount in the total on line 4b of this year's Form 1040, 1040-SR, or 1040-NR. See instructions	26	0

Form **8915-F** (Rev. 1-2024)

Worksheet 5

1.	Enter the amount, if any, from last year's Form 8915-F, line 25, except as follows. If you are completing 2021 Form 8915-F (2020 disasters), enter the amount, if any, from your 2020 Form 8915-E, line 18. If you are completing 2023 Form 8915-F (2021 disasters), enter the amount, if any, from your 2022 Form 8915-F (2021 disasters), line 25, if you completed that form. If you didn't complete that form, enter the amount, if any, from your 2021 Form 8915-F (2021 disasters), line 25.	1.	
2.	Enter the amount, if any, from last year's Form 8915-F, line 24, except as follows. If you are completing 2021 Form 8915-F (2020 disasters), enter the amount, if any, from your 2020 Form 8915-E, line 17. If you are completing 2023 Form 8915-F (2021 disasters), enter the amount, if any, from your 2022 Form 8915-F (2021 disasters), line 24, if you completed that form. If you didn't complete that form, enter the amount, if any, from your 2021 Form 8915-F (2021 disasters), line 24.	2.	
3a.	Subtract line 2 from line 1. If zero or less, enter -0-	3a.	0
b.	Enter the amount from line 3a that you have already carried back to a prior year	b.	0
c.	Subtract line 3b from line 3a	c.	0
4.	Enter the total amount of any repayments you made, with respect to this year's Form 8915-F, before filing this year's tax return	4.	7,000
5.	Enter the total of lines 3c and 4 here and on line 25 of this year's Form 8915-F	5.	7,000

Because Garth made the $7,000 payment before timely filing his tax return, the $7,000 repayment can offset the $7,000 of income from IRA distributions. Consequently, Garth reports $0 of income from IRA distributions on his 2024 Form 1040. Garth follows the same practice for his 2025 and 2026 repayments.

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LOAN REPAYMENTS FOR PRINCIPAL RESIDENCE PURCHASE

Taxpayers can exclude up to $10,000 of distributions from the 10% additional tax on early distributions from IRAs, provided the distribution qualifies as a qualified first-time homebuyer distribution.[106] Taxpayers may also avoid the 10% additional tax on early distributions by making **hardship withdrawals** from their IRC §§401(k) or §403(b) plans to purchase or construct their first home.[107] Taxpayers who plan to use these funds to purchase their first home, but fail to do so because the home was located in a qualified disaster area, may qualify for relief by repaying the distributions to the plan.

To qualify for relief, taxpayers must have received the distribution no earlier than 180 days before the disaster's first day and no later than 30 days after the disaster ended. Taxpayers must make such repayment during the period beginning on the day the disaster first occurred and ending 180 days after the latest of the following dates.

- December 29, 2022
- The first day of the disaster's occurrence
- The day the disaster was declared a qualifying disaster

Guidelines for Repayments

Taxpayers' repayments must not exceed the amount they received as a distribution. They must make repayments only to plans of which they are beneficiaries and accept rollover contributions. The IRS treats the repayment as a direct trustee-to-trustee transfer, making the portion of the distribution repaid not subject to income tax. Regardless of whether they made repayments during the tax year they received the distribution, taxpayers report qualified distributions on Form 8915-F, part IV, *Qualified Distributions for the Purchase or Construction of a Main Home in the Area of Disaster(s) Listed in Item C*. If they make repayments in a subsequent tax year, taxpayers may file an amended return to claim a refund for the tax they paid on the distribution.

Example 12. In 2024, Dolores planned to purchase her first home in Cherokee, Kansas. She withdrew $10,000 from her IRA as a qualified first-time homebuyer distribution on March 25. In April, the property Dolores was about to close on incurred severe damage from a federally declared disaster of severe storms and tornadoes. Due to the extensive damage, Dolores was unable to purchase the home. Consequently, Dolores repaid the $10,000 to her retirement plan on July 30. Portions of the Form 8915-F for 2024 that Dolores prepared are shown on the following page.

Because Dolores repaid the $10,000 distribution within the specified time, her contribution is treated as a direct trustee-to-trustee transfer. Consequently, Dolores does not incur any income tax or the 10% additional tax for early distributions on the $10,000 withdrawal she made in 2024.

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106. IRC §72(t)(8)(F).

107. IRC §§401(k)(14), 402(c)(13), and 403(b)(11)(B).

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For Example 12

Form **8915-F** (Rev. January 2024) Department of the Treasury Internal Revenue Service

Qualified Disaster Retirement Plan Distributions and Repayments

Attach to Form 1040, 1040-SR, or 1040-NR.
Go to *www.irs.gov/Form8915F* for instructions and the latest information.

OMB No. 1545-0074
Attachment Sequence No. **915**

Name. If married, file a separate form for each spouse required to file Form 8915-F. See instructions.	Your social security number
Dolores Abernathy	***-**-3016

Before you begin (see instructions for details):

- Use Form 8915-F for 2021 and later disasters. Also, use it after 2020 for coronavirus-related and other 2020 disasters instead of Form 8915-E.
- Major Disaster Declarations at *www.FEMA.gov/disaster/declarations* provides the only qualified disasters and their FEMA numbers for item C.
- "This year" (as used on this form) is the year of the form you check in item A next. For example, if you check 2022, "this year" is 2022.

Complete items A and B below. Complete item C and check the box in item D for the coronavirus, as applicable.

A Tax year for which you are filing form (check only one box): ☐ 2021 ☐ 2022 ☐ 2023 ☒ 2024 ☐ Other ______

B Calendar year in which qualified disaster(s) began (check only one box): ☐ 2020 ☐ 2021 ☐ 2022 ☐ 2023 ☒ Other 2024

C FEMA number for each of your qualified disasters for the year checked in item B above. Use item D, **not** item C, for the coronavirus.

(1) DR-4800-KS (2) ______ (3) ______ (4) ______ (5) ______ (6) ______

D If your only disaster, or one of your disasters, is the coronavirus, check this box ☐ Don't list the coronavirus in item C.

Form 8915-F (Rev. 1-2024) Page **4**

Part IV Qualified Distributions for the Purchase or Construction of a Main Home in the Area of Disaster(s) Listed in Item C

Before you begin: Complete this year's Form 8606, Nondeductible IRAs, if required.

Caution: Complete Part IV if, this year, you received a qualified distribution (as defined in the instructions) for the purchase or construction of a main home in the area of a disaster listed in item C earlier. You can only repay the distribution during the disaster's qualified distribution repayment period (see *Qualified distribution repayment period* in the instructions). If you are allowed to repay the distribution, in whole or in part, after this year, see the instructions. For the applicability of Part IV to other years for disasters listed in item C, see the instructions.

Part IV Disaster Table. Provide the information requested below for the disaster(s) in item C earlier for which you are reporting qualified distributions in this part.

Disaster FEMA number*	Disaster declaration date*	Disaster beginning date*	Disaster ending date*
DR-4800-KS	7/15/2024	4/25/2024	4/30/2024

* Major Disaster Declarations at *www.FEMA.gov/disaster/declarations* provides the FEMA number, Disaster declaration date, Disaster beginning date, and Disaster ending date for the disaster(s) listed in the Part IV Disaster Table.

Date(s) of qualified distribution(s) received this year 3/25/2024

27 Did you receive a qualified distribution, for the purchase or construction of a main home in the area of a disaster listed in the Part IV Disaster Table earlier, that is from an IRA and that is required to be reported on this year's Form 8606?

☐ **Yes.** Complete lines 28 through 32 only if you also had qualified distributions not required to be reported on this year's Form 8606; otherwise, stop here.

☒ **No.** Go to line 28.

		Line	Amount
28	Enter the total amount of qualified distributions you received this year for the purchase or construction of a main home in the area of disaster(s) listed in the Part IV Disaster Table. Don't include any amounts reported on this year's Form 8606. Also, don't include any distributions you reported on line 8 or 20, or on other Forms 8915 for this year, if any	28	10,000
29	Enter the applicable cost of distributions, if any. See instructions	29	0
30	Subtract line 29 from line 28	30	10,000
31	Enter the total amount of any repayments you made. See instructions for allowable repayments. Don't include any repayments treated as rollovers on this year's Form 8606. See instructions	31	10,000
32	**Taxable amount.** Subtract line 31 from line 30. If the distribution is: • From an IRA, include this amount in the total on line 4b of this year's Form 1040, 1040-SR, or 1040-NR. • From a retirement plan (other than an IRA), include this amount in the total on line 5b of this year's Form 1040, 1040-SR, or 1040-NR. **Note:** You may be subject to an additional tax on the amount on line 32. See instructions.	32	0

Form **8915-F** (Rev. 1-2024)

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CERTAIN QUALIFIED PLAN LOANS[108]

The SECURE 2.0 Act contains certain retirement plan loan relief for taxpayers sustaining an economic loss from a federally declared major disaster in which they reside. The legislation allows employers to provide additional time, not to exceed one year, for participants to repay certain plan loans. Such loans must be outstanding on or after the latest of the following dates.

- December 29, 2022
- The first day of the disaster's occurrence
- The day the disaster was declared a qualifying disaster

A loan payment due during the period beginning on the first day of the disaster's occurrence and ending on the date 180 days after the disaster ended may be extended up to one year.[109]

Additionally, the SECURE 2.0 Act increased the maximum loan amount employers can make from a retirement plan to federally declared major disaster victims. For plan loans made during a specified period following the disaster, employers can increase the plan loan limit up to the individual's vested benefit under the plan, not to exceed $100,000 (less any outstanding plan loans).

SELECTED NEW AND MODIFIED FORMS IN 2024

The IRS released several new and modified forms for 2024. This section discusses several of these forms and shows draft examples of affected sections.

FORM 172 (NEW)

In 2024, the IRS introduced Form 172, *Net Operating Losses (NOLs),* to make reporting net operating losses (NOLs) more systemic. In the past, worksheets within IRS Pub. 536, *Net Operating Losses (NOLs) for Individuals, Trusts, and Trusts*, provided information to guide taxpayers in reporting NOLs. However, taxpayers did not include those worksheets in their tax returns.

> **Note.** For information on calculating an NOL, see the 2020 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 3: Net Operating and Excess Business Losses. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

Form 172 presents the information from those worksheets in a form that accompanies an individual's, a trust's, or an estate's income tax return, starting with 2024 tax returns. An individual's NOL most commonly originates in their sole proprietorship, S corporation, or partnership.[110] A draft Form 172 follows.

108. IRC §72(p)(6).

109. IRC §72(p)(6)(B)(i).

110. IRS Pub. 536, *Net Operating Losses (NOLs) for Individuals, Estates, and Trusts*.

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Form **172** (January 2025) Department of the Treasury Internal Revenue Service

Net Operating Losses (NOLs)

For Individuals, Estates, and Trusts.
Go to *www.irs.gov/Form172* for instructions and the latest information.

OMB No. 1545-0074

TREASURY/IRS AND OMB USE ONLY DRAFT August 8, 2024 DO NOT FILE

For calendar year ________ , or other tax year beginning ____________________ and ending ____________

Name(s) shown on return			Social security or employer identification number
Address (number and street). If you have a P.O. box, see instructions.		Apt. or suite no.	Spouse's social security number (SSN)
City, town, or post office. If you have a foreign address, also complete spaces below.	State	ZIP code	Daytime phone number
Foreign country name	Foreign province/county		Foreign postal code

Part I **NOL** (see instructions)

1	For individuals, subtract your standard deduction or itemized deductions from your adjusted gross income (AGI) and enter it here. For estates and trusts, enter taxable income increased by the total of the charitable deduction, income distribution deduction, and exemption amount			1	
2	Nonbusiness capital losses before limitation. Enter as a positive number		2		
3	Nonbusiness capital gains (without regard to any section 1202 exclusion)		3		
4	If line 2 is more than line 3, enter the difference. Otherwise, enter -0-		4		
5	If line 3 is more than line 2, enter the difference. Otherwise, enter -0-	5			
6	Nonbusiness deductions (see instructions). Enter as a positive number		6		
7	Nonbusiness income other than capital gains (see instructions)	7			
8	Add lines 5 and 7		8		
9	If line 6 is more than line 8, enter the difference. Otherwise, enter -0-			9	
10	If line 8 is more than line 6, enter the difference. Otherwise, enter -0-. **But don't enter more than line 5**	10			
11	Business capital losses before limitation. Enter as a positive number		11		
12	Business capital gains (without regard to any section 1202 exclusion)	12			
13	Add lines 10 and 12		13		
14	Subtract line 13 from line 11. If zero or less, enter -0-		14		
15	Add lines 4 and 14		15		
16	Enter, if any, the combined net short-term and long-term capital loss from your Schedule D (Form 1040). Estates and trusts, enter, if any, the total net short-term and long-term loss from Schedule D (Form 1041). Enter as a positive number. If you don't have a loss on that line (and don't have a section 1202 exclusion), skip lines 16 through 21 and enter on line 22 the amount from line 15		16		
17	Section 1202 exclusion. Enter as a positive number			17	
18	Subtract line 17 from line 16. If zero or less, enter -0-		18		
19	If line 16 is a loss, enter, as a positive number, the smaller of: • The loss on line 16; or • $3,000 (If filing Form 1040, $1,500 when married filing separately)		19		
20	If line 18 is more than line 19, enter the difference. Otherwise, enter -0-		20		
21	If line 19 is more than line 18, enter the difference. Otherwise, enter -0-			21	
22	Subtract line 20 from line 15. If zero or less, enter -0-			22	
23	NOL deduction for losses from other years. Enter as a positive number			23	
24	**NOL. Combine lines 1, 9, 17, and 21 through 23. If the result is less than zero, enter it here. If the result is zero or more, you don't have an NOL**			24	

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Part II **NOL Carryover** (see instructions)

	Complete one column before going to the next column. Start with the earliest carryback year.	2nd preceding tax year ended: ________		1st preceding tax year ended: ________	
1	**NOL deduction.** Enter as a positive number .				
2	Taxable income before the current year NOL carryback. For estates and trusts, increase this amount by the sum of the charitable deduction (see instructions)				
3	Net capital loss deduction (see instructions) .				
4	Section 1202 exclusion. Enter as a positive number (see instructions)				
5	Qualified business income deduction (see instructions)				
6	Adjustment to adjusted gross income (AGI) (see instructions)				
7	Adjustment to itemized deductions from line 33 below (see instructions)				
8	**Estates and trusts**, enter exemption amount .				
9	**Modified taxable income.** Add lines 2 through 8. If zero or less, enter -0-				
10	**NOL carryover to the subsequent year.** Subtract line 9 from line 1. Enter the result from the first preceding tax year here and on the net operating loss line of Schedule 1 (Form 1040) or Form 1040-NR or the net operating loss deduction line of Form 1041. If zero or less, enter -0- (see instructions)				
	Adjustment to Itemized Deductions (Individuals Only). Complete lines 11 through 33 for the carryback year(s) for which you itemized deductions **only** if line 3, 4, or 5 above is more than zero.				
11	AGI before the current year NOL carryback . .				
12	Add lines 3 through 6 above				
13	**Modified AGI.** Add lines 11 and 12				
14	Medical and dental expenses after AGI limitation from Sch. A (Form 1040), or as previously adjusted				
15	Medical and dental expenses before AGI limitation from Sch. A (Form 1040), or as previously adjusted				
16	Multiply line 13 by 7.5% (0.075)				
17	Subtract line 16 from line 15. If zero or less, enter -0-				
18	Subtract line 17 from line 14				
19	Mortgage insurance premiums from Sch. A (Form 1040), for tax years before 2022, or as previously adjusted				
20	Refigured mortgage insurance premiums (see instructions)				
21	Subtract line 20 from line 19				

Form **172** (1-2025)

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Form 172 (1-2025) Page **3**

Part II **NOL Carryover** (see instructions) *(continued)*

Complete one column before going to the next column. Start with the earliest carryback year.	2nd preceding tax year ended:		1st preceding tax year ended:	
22 Modified AGI from line 13				
23 Enter as a positive number any NOL carryback from a prior year that was deducted to figure line 11				
24 Add lines 22 and 23				
25 Total charitable contributions for Sch. A (Form 1040 or Form 1040-NR), or as previously adjusted (see instructions)				
26 Refigured charitable contributions (see instructions)				
27 Subtract line 26 from line 25				
28 Casualty and theft losses deduction from Form 4684				
29 Casualty and theft losses before AGI limitation from Form 4684				
30 Multiply line 22 by 10% (0.10)				
31 Subtract line 30 from line 29. If zero or less, enter -0-				
32 Subtract line 31 from line 28				
33 Combine lines 18, 21, 27, and 32; enter the result here and on line 7				

Form **172** (1-2025)

TREASURY/IRS AND OMB USE ONLY DRAFT August 8, 2024

> **Observation.** Form 172 is one of the few forms where the associated Code section (IRC §172) corresponds to the form number.

Individuals report NOL carryforwards from prior years on Form 1040, Schedule 1, line 8a, *Net operating loss,* as negative numbers that reduce additional income. Estates and trusts report the NOL carryforward on line 15b, *Net operating loss deduction,* of Form 1041.

Status

The IRS posted a draft of Form 172 on August 8, 2024, and announced a tentative release date of January 2025. As of July 15, 2024, the agency has not released a draft of the proposed form's instructions.

FORM 3800 (REVISED)

Individuals, C corporations, S corporations, partnerships, trusts, and estates have used Form 3800, *General Business Credit*, to tabulate business credits since at least 1991, when it consisted of two pages. By 2023, the form had expanded to eight pages.

The draft 2024 version of the form presents taxpayers with changes in terms, new reporting requirements, and new credits they must report with it.

Part I — *Credits Not Allowed Against Tentative Minimum Tax (TMT)*

Part I contains terminology changes that generally involve passive activities.

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Form **3800**
Department of the Treasury
Internal Revenue Service

General Business Credit

Go to *www.irs.gov/Form3800* for instructions and the latest information.
You must include all pages of Form 3800 with your return.

OMB No. 1545-0895
2024
Attachment Sequence No. 22

Name(s) shown on return | Identifying number

TREASURY/IRS AND OMB USE ONLY DRAFT

A **Corporate Alternative Minimum Tax (CAMT) and Base Erosion Anti-Abuse Tax (BEAT).** Are you both (a) an "applicable corporation" within the meaning of section 59(k)(1) for the CAMT, and (b) an "applicable taxpayer" within the meaning of section 59A(e) for the BEAT? See instructions . . . . ☐ Yes ☐ No

Part I **Credits Not Allowed Against Tentative Minimum Tax (TMT)**
Complete applicable portions of Parts III and IV before Parts I and II. See instructions.

1	Credits not subject to the passive activity limit from Part III, line 2: combine column (e) with non-passive amounts from column (f)	1	
2	Credits subject to the passive activity limit. Combine Part III, line 2, column (d), and passive amounts included on line 2, column (f); and Part IV, line 6, column (d) — 2		
3	Enter the portion of line 2 allowed for 2024	3	
4	Enter the portion of Part IV, column (f), line 6, that is from carryforwards to 2024	4	
	Check this box if the carryforward was changed or revised from the original reported amount ☐		
5	Enter the portion of Part IV, column (f), line 6, that is from carrybacks from 2025	5	
6	Add lines 1, 3, 4, and 5	6	

Part II — *Figuring Credit Allowed After Limitations*

Part II is renamed *Figuring Credit Allowed After Limitations*, and is broken into four sections.

- **Section A** — *Figuring Credit Allowed After Section 38(c)(1) Limitation Based on Amount of Tax*
- **Section B** — *Figuring Section 38(c)(2) Empowerment Zone and Community Renewal Employment Credit Allowed*
- **Section C** — *Figuring the Specified Credit Amount Allowed Under Section 38(c)(4)*
- **Section D** — *Credits Allowed After Limitations*

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6	Add lines 1, 3, 4, and 5	6	

Part II **Figuring Credit Allowed After Limitations**

Section A—Figuring Credit Allowed After Section 38(c)(1) Limitation Based on Amount of Tax

7	Regular tax before credits: • Individuals. Enter the sum of the amounts from Form 1040, 1040-SR, or 1040-NR, line 16; and Schedule 2 (Form 1040), line 1z. • Corporations. Enter the amount from Form 1120, Schedule J, Part I, line 2 (excluding the base erosion minimum tax entered on line 1f); or the applicable line of your return. • Estates and trusts. Enter the sum of the amounts from Form 1041, Schedule G, lines 1a, 1b, and 1d, plus any Form 8978 amount included on line 1e; or the amount from the applicable line of your return.			7	
8	Alternative minimum tax: • Individuals. Enter the amount from Form 6251, line 11. • Corporations. Enter the amount from Form 4626, Part II, line 13. • Estates and trusts. Enter the amount from Schedule I (Form 1041), line 54.			8	
9	Add lines 7 and 8			9	
10a	Foreign tax credit	10a			
b	Certain allowable credits (see instructions)	10b			
c	Add lines 10a and 10b			10c	
11	**Net income tax.** Subtract line 10c from line 9. If zero, skip lines 12 through 15 and enter -0- on line 16			11	
12	**Net regular tax.** Subtract line 10c from line 7. If zero or less, enter -0-	12			
13	Enter 25% (0.25) of the excess, if any, of line 12 (line 11 for corporations) over $25,000. See instructions	13			
14	Tentative minimum tax: • Individuals. Enter the amount from Form 6251, line 9. • Corporations. Enter -0-. • Estates and trusts. Enter the amount from Schedule I (Form 1041), line 52.	14			
15	Enter the greater of line 13 or line 14			15	
16	Subtract line 15 from line 11. If zero or less, enter -0-			16	
17	Enter the **smaller** of line 6 or line 16. This is the amount of your credit allowed after the limitation of section 38(c)(1) **C corporations:** See the line 17 instructions if there has been an ownership change, acquisition, or reorganization.			17	

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Form 3800 (2024) Page **2**

Part II **Figuring Credit Allowed After Limitations** *(continued)*

Section B—Figuring Section 38(c)(2) Empowerment Zone and Community Renewal Employment Credit Allowed

Note: If you are not required to report any amounts on line 22 or line 24 below, skip lines 18 through 25 and enter -0- on line 26.

18	Multiply line 14 by 75% (0.75). See instructions	**18**	
19	Enter the greater of line 13 or line 18	**19**	
20	Subtract line 19 from line 11. If zero or less, enter -0-	**20**	
21	Subtract line 17 from line 20. If zero or less, enter -0-	**21**	
22	Combine the amounts from line 3 of Part III, column (e), with the amount from line 3 of Part IV, column (f)	**22**	
23	Passive activity credit from line 3 of Part III, column (d), plus the amount from line 3 of Part IV, column (d) . . . **23**		
24	Enter the applicable passive activity credit allowed for 2024. See instructions	**24**	
25	Add lines 22 and 24	**25**	
26	Empowerment zone and renewal community employment credit allowed. Enter the smaller of line 21 or line 25	**26**	

Section C—Figuring the Specified Credit Amount Allowed Under Section 38(c)(4)

27	Subtract line 13 from line 11. If zero or less, enter -0-	**27**	
28	Add lines 17 and 26	**28**	
29	Subtract line 28 from line 27. If zero or less, enter -0-	**29**	
30	Enter the general business credit from line 5 of Part III: combine column (e) with non-passive amounts in column (f). See instructions	**30**	
31	Reserved	**31**	
32	Passive activity credits from line 5 of Part III: combine column (d) with passive amounts in column (f). See instructions . . . **32**		
33	Enter the applicable passive activity credits allowed for 2024. See instructions	**33**	
34	Carryforward of business credit to 2024. Enter the amount of carryforwards from line 7 of Part IV, column (g). See instructions for statement to attach	**34**	
	Check this box if the carryforward was changed or revised from the original reported amount ☐		
35	Carryback of business credit from 2025. Enter the amount of carrybacks from line 7 of Part IV, column (g). See instructions	**35**	
36	Add lines 30, 33, 34, and 35	**36**	
37	Enter the **smaller** of line 29 or line 36. This is the amount allowed for specified credits	**37**	

Section D—Credits Allowed After Limitations

38	**Credit allowed for the current year.** Add lines 28 and 37. Report the amount from line 38 (if smaller than the sum of Part I, line 6, and Part II, lines 25 and 36; see instructions) as indicated below or on the applicable line of your return. • Individuals. Schedule 3 (Form 1040), line 6a. • Corporations. Form 1120, Schedule J, Part I, line 5c. • Estates and trusts. Form 1041, Schedule G, line 2b.	**38**	

Form **3800** (2024)

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The credits allowed that are reported on line 38 then carry to the following forms.

- **Individuals.** Schedule 3 (Form 1040), *Additional Credits and Payments,* line 6a
- **Corporations.** Form 1120, Schedule J, *Tax Computation and Payment,* part I, line 5c
- **Estates and trusts.** Form 1041, Schedule G, *Tax Computation and Payment,* line 2b

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Part III — *Current Year General Business Credits (GBCs)*

Part III adds the following lines for the credits introduced by the Inflation Reduction Act of 2022 and the Creating Helpful Incentives to Produce Semiconductors (CHIPS) 2022 Act.[111]

Line Number	Action	Code Section	Form
1q	Added	§45Z	Form 7218, *Clean Fuel Production Credit,* Part II
1r	Removed	§30B	Form 8910, *Alternative Motor Vehicle Credit*
1s	Replaced	§45D(e)	Form 8911, *Alternative Fuel Vehicle Refueling Property Credit,* Part I (formerly Part II of the same form)
1gg	Added	§45Y	Form 7211, *Clean Electricity Production Credit*

Form 3800 (2024) Page **3**

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Part III **Current Year General Business Credits (GBCs)** (see instructions). If there is more than one number applicable for column (b) or (c) for a line in Part III, enter the number of such items in column (a), complete Part V, and see instructions for what to report on that line in Part III.

	Current year credits from:	(a) No. of items	(b) Elective payment or transferor registration number	(c) Pass-through or transferor credit entity EIN	(d) Credits subject to the passive activity limit, before application of the limit	(e) Credits not subject to the passive activity limits	(f) Credit transfer election amount (enter amounts transferred out as a negative amount)	(g) Combine columns (e) and (f) with the credit from column (d) allowed after the passive activity limit	(h) Gross elective payment election (EPE) amount	(i) Amount of column (g) applied against tax in Part II	(j) Net EPE amount. Enter the smaller of column (h) **or** column (g) minus column (i)
1a	Form 3468, Part II										
b	Form 7207										
c	Form 6765										
d	Form 3468, Part III										
e	Form 8826										
f	Form 8835, Part II										
g	Form 7210										
h	Form 8820										
i	Form 8874										
j	Form 8881, Part I										
k	Form 8882										
l	Form 8864 (diesel)										
m	Form 8896										
n	Form 8906										
o	Form 3468, Part IV										
p	Form 8908										
q	Form 7218, Part II										
r	Reserved										
s	Form 8911, Part I										
t	Form 8830										
u	Form 7213, Part II										
v	Form 3468, Part V										
w	Form 8932										
x	Form 8933										
y	Form 8936, Part II										
z	Reserved										
aa	Form 8936, Part V										
bb	Form 8904										
cc	Form 7213, Part I										
dd	Form 8881, Part II										
ee	Form 8881, Part III										
ff	Form 8864, line 8										
gg	Form 7211, Part II										
hh	Reserved										
ii	Reserved										
zz	Other credits										
2	Add lines 1a–1zz										

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111. *Inflation Reduction Act of 2022*, PL 117-169; *CHIPS and Science Act*, PL 117-167.

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Part III **Current Year General Business Credits (GBCs)** (see instructions). If there is more than one number applicable for column (b) or (c) for a line in Part III, enter the number of such items in column (a), complete Part V, and see instructions for what to report on that line in Part III. *(continued)*

	Current year credits from:	(a) No. of items	(b) Elective payment or transferor registration number	(c) Pass-through or transferor credit entity EIN	(d) Credits subject to the passive activity limit, before application of the limit	(e) Credits not subject to the passive activity limits	(f) Credit transfer election amount (enter amounts transferred out as a negative amount)	(g) Combine columns (e) and (f) with the credit from column (d) allowed after the passive activity limit	(h) Gross elective payment election (EPE) amount	(i) Amount of column (g) applied against tax in Part II	(j) Net EPE amount. Enter the smaller of column (h) **or** column (g) minus column (i)
3	Form 8844										
4	**Specified credits:**										
a	Form 3468, Part VI										
b	Form 5884										
c	Form 6478										
d	Form 8586										
e	Form 8835, Part II										
f	Form 8846										
g	Form 8900										
h	Form 8941										
i	Form 6765 (ESB)										
j	Form 8994										
k	Form 3468, Part VII										
l	Reserved										
m	Reserved										
z	Other specified credits										
5	Add lines 4a–4z										
6	Add lines 2, 3, and 5										

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Part IV — *Carryovers of General Business Credits (GBCs)*

Part IV drops the reference to eligible small business credits (ESBCs) in its title. Additional changes include the following.

- The reference to Form 8910 in the 2023 version on line 1r is removed and not replaced with a reference to another form.
- New columns request a pass-through entity's employer identification number (EIN) and more detailed information about the effect of passive activity limitations.
- Taxpayers must provide the effect of the passive activity limitations on each credit based on the **form used**, not just the checkbox indicating that passive activity limitations pertained to the form and the underlying activity.

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Part IV **Carryovers of General Business Credits (GBCs)** (see instructions)

	Credits carried over to tax year 2024	**(a)** No. of items	**(b)** Originating tax year	**(c)** Pass-through entity EIN	Carryover — Subject to the passive activity limits — **(d)** **Before** the passive activity limitations	Carryover — Subject to the passive activity limits — **(e)** **After** the passive activity limitations	Carryover — **(f)** Not subject to passive activity limits	**(g)** Amount of columns (e) and (f) applied against tax in Part II	**(h)** Amount of columns (e) and (f) recaptured or otherwise adjusted	**(i)** Carryforward to 2025. Subtract the sum of columns (g) and (h) from the sum of columns (e) and (f)
1a	Form 3468, Part II									
b	Form 7207									
c	Form 6765									
d	Form 3468, Part III									
e	Form 8826									
f	Form 8835, Part II									
g	Form 7210									
h	Form 8820									
i	Form 8874									
j	Form 8881, Part I									
k	Form 8882									
l	Form 8864									
m	Form 8896									
n	Form 8906									
o	Form 3468, Part IV									
p	Form 8908									
q	Reserved									
r	Reserved									
s	Form 8911									
t	Form 8830									
u	Form 7213, Part II									
v	Form 3468, Part V									
w	Form 8932									
x	Form 8933									
y	Form 8936, Part II									
z	Reserved									
aa	Form 8936, Part V									
bb	Form 8904									
cc	Form 7213, Part I									
dd	Form 8881, Part II									
ee	Form 8881, Part III									
ff	Form 8864									
gg	Reserved									
hh	Reserved									
ii	Reserved									
jj	Reserved									
zz	Other									

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Part IV Carryovers of General Business Credits (GBCs) (see instructions) *(continued)*

	Credits carried over to tax year 2024 **Note:** Credits on lines 2a through 2x are expired. Only carryforwards are allowed.	**(a)** No. of items	**(b)** Originating tax year	**(c)** Pass-through entity EIN	Carryover — Subject to the passive activity limits: **(d)** **Before** the passive activity limitations	**(e)** **After** the passive activity limitations	**(f)** Not subject to passive activity limits	**(g)** Amount of columns (e) and (f) applied against tax in Part II	**(h)** Amount of columns (e) and (f) recaptured or otherwise adjusted	**(i)** Carryforward to 2025. Subtract the sum of columns (g) and (h) from the sum of columns (e) and (f)
2a	Form 5884-A									
b	Form 8586 (pre-2008)									
c	Form 8845									
d	Form 8907									
e	Form 8909									
f	Form 8923									
g	Form 8834									
h	Form 8931									
i	Form 1065-B									
j	Form 5884 (pre-2007)									
k	Form 6478 (pre-2005)									
l	Form 8846 (pre-2007)									
m	Form 8900 (pre-2008)									
n	Trans-Alaska pipeline liability									
o	Form 5884-A, Section A									
p	Form 5884-A, Section B									
q	Form 5884-A, Section A									
r	Form 5884-A, Section B									
s	Form 5884-B									
t	Form 8847									
u	Form 8861									
v	Form 8884									
w	Form 8942									
x	Form 8910									
y	Reserved									
z	Reserved									
zz	Other credits (see inst.)									
3	Form 8844									

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Part IV Carryovers of General Business Credits (GBCs) (see instructions) *(continued)*

	Credits carried over to tax year 2024	**(a)** No. of items	**(b)** Originating tax year	**(c)** Pass-through entity EIN	Carryover — Subject to the passive activity limits: **(d)** **Before** the passive activity limitations	**(e)** **After** the passive activity limitations	**(f)** Not subject to passive activity limits	**(g)** Amount of columns (e) and (f) applied against tax in Part II	**(h)** Amount of columns (e) and (f) recaptured or otherwise adjusted	**(i)** Carryforward to 2025. Subtract the sum of columns (g) and (h) from the sum of columns (e) and (f)
4	**Specified credits:**									
a	Form 3468, Part VI									
b	Form 5884									
c	Form 6478									
d	Form 8586 (post-2007)									
e	Form 8835									
f	Form 8846									
g	Form 8900									
h	Form 8941									
i	Form 6765 ESB credit									
j	Form 8994									
k	Form 3468, Part VII (post-2007)									
l	Reserved									
m	Reserved									
y	ESBC (see inst.)									
z	Other specified credits									
5	Add lines 4a–4z									
6	Add lines 1a through 2zz									
7	Add lines 3, 5, and 6									

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Part V — *Breakdown of Aggregate Amounts on Part III for Facility-by-Facility, Multiple Pass-Through Entities, etc.*

Part V requests more details than 2023 to complete for each facility or pass-through entity they identified in part III.

> **Observation.** Because part III reports business credit information based on the form used, and part V reports the information based on the **facility or pass-through entity** used, the same form number may appear multiple times in Part V if different facilities or pass-through entities generate the same credit.

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Part V Breakdown of Aggregate Amounts on Part III for Facility-by-Facility, Multiple Pass-Through Entities, etc.

					Credits subject to the passive activity limit				Not subject to the limit	
			EIN		Before applying the limit					
	(a) Part III line number	**(b)** Elective payment or transfer registration number	**(c)(1)** Pass-through entity EIN	**(c)(2)** Transferor entity EIN	**(d)(1)** Credits other than credit transfer election credits	**(d)(2)** Credit transfer election credits sold	**(d)(3)** Credit transfer election credits purchased	**(d)(4)** Credits from columns (d)(1) (less column (d)(2)) and (d)(3) allowed after limit	**(e)** Credits other than transfer election credits	**(f)(1)** Transfer election credits sold
1						( )				( )
2						( )				( )
3						( )				( )
4						( )				( )
5						( )				( )
6						( )				( )
7						( )				( )
8						( )				( )
9						( )				( )
10						( )				( )
11						( )				( )
12						( )				( )
13						( )				( )
14						( )				( )
15						( )				( )

	(f)(2) Purchased transfer election credits not subject to passive activity limit	**(g)** Combine columns (d)(4), (e), (f)(1), and (f)(2)	**(h)(1)** Gross EPE amount. Portion of column (g) eligible for the section 6417 EPE election	**(h)(2)** Subtract column (h)(1) from column (g) (credit excluding EPE)	**(i)(1)** Amount of column (h)(2) applied against tax in Part II	**(i)(2)** Amount of EPE eligible credit in column (h)(1) applied against tax in Part II	**(j)** Net EPE amount. Subtract column (i)(2) from column (h)(1)	**(k)** Carryforward to 2025. Subtract column (i)(1) from column (h)(2)
1								
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Part VI — *Breakdown of Aggregate Amounts in Part IV*

Part VI has increased information reporting from 2023. While part IV provides information based on the **form used,** part VI requires entries only for the rows containing data in part IV. For each form used in part IV, the taxpayer must use part VI to apply the passive activity limits to each **credit**.

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Part VI **Breakdown of Aggregate Amounts in Part IV** (see instructions)

				Carryover					
				Subject to the passive activity limits					
	(a) Line number from Part IV	**(b)** Originating tax year	**(c)** Pass-through entity EIN	**(d)** **Before** the passive activity limitations	**(e)** **After** the passive activity limitations	**(f)** Not subject to passive activity limits	**(g)** Amount of columns (e) and (f) applied against tax in Part II	**(h)** Amount of columns (e) and (f) recaptured or otherwise adjusted	**(i)** Carryforward to 2025. Subtract the sum of columns (g) and (h) from the sum of columns (e) and (f)
1									
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34									
35									

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Status[112]

The information about the 2024 Form 3800 is based on the draft form posted by the IRS on July 2, 2024. The IRS has not indicated the release date for the final 2024 form.

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112. *Draft Tax Forms*, Aug. 14, 2023. IRS. [www.irs.gov/draft-tax-forms] Accessed on Jul. 15, 2024.

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FORM 4626 (REVISED)[113]

Corporations use Form 4626, *Alternative Minimum Tax — Corporations*, to determine if they are **applicable corporations** under IRC §59(k) subject to the alternative minimum tax (AMT) under IRC §55. They also use it to calculate their AMT for the tax year.

For tax years starting after December 31, 2022, C corporations are responsible for the corporate alternative minimum tax (CAMT). Large C corporations file Form 4626 if they have adjusted financial statement income for a 3-year period exceeding $1 billion.[114]

During the IRS Nationwide Forum in Chicago during July 2024, the IRS referenced the following changes to the 2024 version of Form 4626.

- Part IV, Section I
- Part IV, Section II
- Create new Schedule A
- Incorporate Worksheet B into the form as part VI
- Part VI has two sections

Note. In addition to the changes the IRS has identified, the American Institute of Certified Public Accountants (AICPA) is requesting the IRS clarify the instructions for part V.[115] The AICPA would like the instructions to exempt organizations that already know they are applicable corporations from completing that section. It is currently unknown whether the IRS will incorporate these comments in the final version of the Form 4626.

The CAMT computation appears in part II, line 13, *Alternative Minimum Tax.* The CAMT amount is then reported on Form 1120, Schedule J, line 3.

Status

The IRS has not indicated the release date for the finalized Form 4626 or its instructions.

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113. *Tax Law Changes for Tax Year 2024,* p. 5. Jun. 28, 2024. IRS. [Released for the 2024 IRS Tax Forum].

114. IRC §56A.

115. *AICPA Requests Clarification on Form 4626, Part V.* Jul. 9, 2024. AICPA. [www.aicpa-cima.com/news/article/aicpa-requests-clarification-on-form-4626-part-v] Accessed on Jul. 19, 2024.

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Part II Corporate Alternative Minimum Tax (CAMT)

1	Net income or loss per AFS (see instructions):		
a	Consolidated net income or loss per the AFS of the corporation	1a	
b	Include AFS net income or loss of other includible entities (add net income and subtract net loss)	1b	
c	Exclude AFS net income or loss of excludible entities (add net loss and subtract net income)	1c	
d	Adjustment for certain consolidating entries (see instructions)	1d	
e	Specified additional net income or loss item D. Reserved for future use	1e	
f	AFS net income or loss before adjustments. Combine lines 1a through 1d	1f	
2	Adjustments (see instructions):		
a	Financial statements covering different tax years	2a	
b	Reserved for future use—Adjustment 2b	2b	
c	Corporations that are not included on the taxpayer's consolidated return (see instructions)	2c	
d	The corporation's distributive share of adjusted financial statement income of partnerships	2d	
e	Aggregate pro-rata share of adjusted net income from CFCs for which the corporation is a U.S. shareholder. Enter the amount from Part VI, Section II, line 3	2e	
f	Amounts that are not effectively connected to a U.S. trade or business	2f	
g	Certain taxes. Enter the amount from Part III, line 7	2g	
h	Patronage dividends and per-unit retain allocations (cooperatives only)	2h	
i	Alaska native corporations	2i	
j	Certain credits	2j	
k	Mortgage servicing income	2k	
l	Covered benefit plans described in section 56A(c)(11)(B)	2l	
m	Tax-exempt entities (organizations subject to tax under section 511)	2m	
n	Depreciation	2n	
o	Qualified wireless spectrum	2o	
p	Covered transactions	2p	
q	Adjustments related to bankruptcy and insolvency	2q	
r	Certain insurance company adjustments	2r	
s	AFSI adjustment S—Reserved for future use	2s	
t	AFSI adjustment T—Reserved for future use	2t	
u	AFSI adjustment U—Reserved for future use	2u	
z	Other	2z	
3	Total adjustments. Combine lines 2a through 2z	3	
4	AFSI before financial statement net operating loss carryover. Combine lines 1f and 3	4	
5	Financial statement net operating loss (FSNOL) (see instructions)	5	
6	AFSI. Subtract line 5 from line 4. If zero or less, enter -0-	6	
7	Multiply line 6 by 15% (0.15)	7	
8	Corporate alternative minimum tax foreign tax credit (CAMT FTC). Enter amount from Part IV, Section I, line 6 (see instructions)	8	
9	Tentative minimum tax. Subtract line 8 from line 7. If zero or less, enter -0-	9	
10	Regular tax liability (see instructions)	10	
11	Base erosion minimum tax (see instructions)	11	
12	Combine lines 10 and 11	12	
13	Alternative minimum tax. Subtract line 12 from line 9. If zero or less, enter -0-. Enter here and on Form 1120, Schedule J, line 3, or the appropriate line of the corporation's income tax return	13	

Part III Adjustment for Certain Taxes Under Section 56A(c)(5)

1	Current income tax provision—Foreign	1	
2	Current income tax provision—Federal	2	
3	Deferred income tax provision—Foreign	3	
4	Deferred income tax provision—Federal	4	
5	Income taxes included in equity method investment income	5	
6a	Adjustment A—Reserved for future use	6a	
b	Adjustment B—Reserved for future use	6b	
c	Adjustment C—Reserved for future use	6c	
d	Adjustment D—Reserved for future use	6d	
e	Adjustment E—Reserved for future use	6e	
f	Adjustment F—Reserved for future use	6f	
g	Adjustment G—Reserved for future use	6g	
h	Adjustment H—Reserved for future use	6h	
z	Income taxes in other places	6z	
7	Total. Combine lines 1 through 6z. Enter here and on Part II, line 2g	7	

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Part IV Corporate Alternative Minimum Tax—Foreign Tax Credit

Section I—CAMT Foreign Tax Credit

1	Domestic corporation CAMT foreign income taxes:				
a	Total foreign taxes paid or accrued as reported on Form 1118, Schedule B, Part I, column 2(j)	1a			
b	Adjustment	1b			
c	Adjustment	1c			
d	Adjustment	1d			
e	Adjustment	1e			
f	Adjustment	1f			
g	Adjustment	1g			
2	Total domestic corporation CAMT foreign income taxes. Combine lines 1a through 1g			2	
3	Allowable CFC CAMT foreign income taxes:				
a	Pro-rata share of CFC CAMT foreign income taxes from Part IV, Section II, line 11, column (n)	3a			
b	Other	3b			
c	Carryover of excess foreign taxes (from Part IV, Section III, line 4, column (vii))	3c			
d	Total CFC CAMT foreign income taxes. Add lines 3a, 3b, and 3c			3d	
e	Percentage specified in section 55(b)(2)(A)(i)	3e	15%		
f	Aggregate pro-rata share of adjusted net income from CFCs for which the corporation is a U.S. shareholder. Enter the amount from Part VI, Section II, line 3 (see instructions)	3f			
g	CFC CAMT FTC limitation (multiply line 3e by line 3f)			3g	
h	Allowable CFC CAMT foreign income taxes (lesser of line 3d or line 3g)			3h	
4	CAMT FTC Line 4—Reserved for future use			4	
5	CAMT FTC Line 5—Reserved for future use			5	
6	Total CAMT foreign income taxes. Combine lines 2 and 3h. Enter this amount on Part II, line 8			6	

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Part IV Corporate Alternative Minimum Tax—Foreign Tax Credit *(continued)*

Section II—Allowable CFC CAMT Foreign Income Taxes

	(a) Name of CFC	(b) EIN or reference ID number of CFC	(c) CFC income	(d) Foreign taxes for which credit is allowed	(e) Adjustment	(f) Adjustment
1						
2						
3						
4						
5						
6						
7						
8						
9						
10						
11	Total. Combine lines 1 through 10					

	(g) Adjustment	(h) Adjustment	(i) Adjustment	(j) Adjustment	(k) Adjustment	(l) Total (combine columns (d) through (k))	(m) Reserved for future use	(n) Pro-rata share of CFC CAMT foreign income taxes (see instructions)
1								
2								
3								
4								
5								
6								
7								
8								
9								
10								
11								

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Part IV Corporate Alternative Minimum Tax—Foreign Tax Credit *(continued)*

Section III—CAMT Foreign Tax Credit Carryover for CFCs (Report all amounts in U.S. dollars.)

	Foreign Tax Carryover Reconciliation	(i) 5th Preceding Tax Year	(ii) 4th Preceding Tax Year	(iii) 3rd Preceding Tax Year	(iv) 2nd Preceding Tax Year	(v) 1st Preceding Tax Year	(vi) Current Tax Year	(vii) Total (add columns (i) through (vi))
1	Foreign tax carryover from the prior tax year (enter amounts from the appropriate columns of line 8 of the prior year Form 4626, Part IV, Section III (see instructions))							
2	Adjustments to line 1 (enter description—see instructions):							
a								
b								
c								
d								
e								
f								
g								
3	Total. Combine lines 2a through 2g							
4	Adjusted foreign tax carryover from prior tax year (combine lines 1 and 3). If zero or less, enter -0-							
5	Foreign tax carryover used in current tax year (see instructions)	( )	( )	( )	( )	( )		( )
6	Foreign tax carryover expired and unused in current tax year (see instructions)	( )						( )
7	Foreign tax carryover generated in current tax year (see instructions)							
8	Foreign tax carryover to the following tax year. Combine lines 4 through 7. If zero or less, enter -0-							

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Part V Members of a Controlled Group Treated as a Single Employer and FPMG Members Taken Into Account in "Applicable Corporation" Determination

	(a) Name of member	(b) EIN of member	(c) Check if the entity is a member of a 59(k)(1)(D) group	(d) Check if the entity is a member of a 59(k)(2)(B) group	(e) EIN/FTIN of the U.S. return (if any) on which the majority of the member's income is reported	(f) Member's financial statement income/(loss)
1			☐	☐		
2			☐	☐		
3			☐	☐		
4			☐	☐		
5			☐	☐		
6			☐	☐		
7			☐	☐		
8			☐	☐		
9			☐	☐		
10			☐	☐		
11			☐	☐		
12			☐	☐		
13			☐	☐		
14			☐	☐		
15			☐	☐		
16			☐	☐		
17			☐	☐		
18			☐	☐		
19			☐	☐		
20			☐	☐		
21			☐	☐		
22			☐	☐		
23			☐	☐		
24			☐	☐		

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Part VI Aggregate Pro-Rata Share of Adjusted Net Income or Loss of CFCs Described in Section 56A(c)(3)

Section I—Pro-Rata Share of Adjusted Net Income or Loss of CFCs Described in Section 56A(c)(3)

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	(a) Name of CFC	(b) EIN or reference ID number of the CFC	(c) Country of incorporation (enter country code)	(d) Pro-rata share of adjusted net income or (loss) of the CFC described in section 56A(c)(3)
1				
2				
3				
4				
5				
6				
7				
8				
9				
10				
11				
12				
13				
14				
15				
16				
17				
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36				
37				
38				
39				
40				
41				
42	**Total** 42			

Section II—Section 56A(c)(3)(B) Negative Adjustment

1	Aggregate pro-rata share of CFCs' adjusted net income or (loss) from the total of Part VI, Section I	1			
2	Available section 56A(c)(3)(B) negative adjustment from preceding year . . .	2			
3	Aggregate pro-rata share of adjusted net income from CFCs for which the corporation is a U.S. shareholder, taking available section 56A(c)(3)(B) negative adjustment into account. Combine line 1 and line 2. If more than zero, enter here and on Part II, line 2e, and Part IV, Section I, line 3f. If zero or less, enter -0- and go to line 4			3	
4	Section 56A(c)(3)(B) negative adjustment to carry over to succeeding year. Combine line 1 and line 2. If less than zero, enter the combined total as a negative number. If zero or more, enter -0-			4	

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SCHEDULE A (Form 4626)
December 2024
Department of the Treasury
Internal Revenue Service

Pro-Rata Share of Adjusted Net Income or Loss of CFCs Described in Section 56A(c)(3)

Attach to Form 4626.

Go to *www.irs.gov/Form4626* for instructions and the latest information.

OMB No. 1545-0123

For tax year ended / /

TREASURY/IRS AND OMB USE ONLY DRAF July 23, 202 DO NOT FIL

Name of corporation

Employer identification number (EIN)

	(a) Name of controlled foreign corporation (CFC)	(b) EIN or reference ID number of the CFC	(c) Country of incorporation (enter country code)	(d) CFC current year net income or (loss) (in U.S. dollars)	(e) Section 56A(c)(3) adjustments (in U.S. dollars)	(f) Combine column (d) and column (e)	(g) Reserved for future use	(h) Reserved for future use	(i) Pro-rata share of adjusted net income or (loss) of the CFC, described in section 56A(c)(3) (in U.S. dollars)
1									
2									
3									
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10									
11									
12									
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25									
26									
27									
28									
29									
30									
31	Total								

For Privacy Act and Paperwork Reduction Act Notice, see the Instructions for Form 4626. Cat. No. 94588N **Schedule A (Form 4626)** (12-2024)

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FORM 6765 (REVISED)

The IRS has released a 2024 draft of Form 6765, *Credit for Increasing Research Activities.* The credit has been extended on a year-to-year basis since 2021.

The 2024 version has the following changes.

- **Section E.** Taxpayers use Section E, *Other Information,* to report officers' wages, the number of business components that generate the qualified research expenditures, whether the business disposed (or acquired) any portion of its operations, and if the current year's qualified research expenditures (QRE) included any new categories.
- **Section F.** The 2024 version consolidates lines of the prior versions of the form common to Sections A and B. Consolidating these questions in a new section shortens these two sections.
- **Section G.** A new section, Section G, *Business Component Information,* reports detailed information about the business's components that it researches. The section reports 13 attributes of the business components involved in the research. This section requires reporting detailed wage information and detailed information about the research performed and the part of the business conducting it.

Note. If payroll was reported under a different EIN from the EIN electing the payroll tax credit, the form must report that EIN in Section D, *Qualified Small Business Payroll Tax Election and Payroll Tax Credit*, question 33.

that must be 36

Section E—Other Information. See instructions.

37	Enter the number of business components generating the QRE on line 5 or line 20	37	
38	Enter the amount of officers' wages included on line 42	38	
39	Did you acquire or dispose of any major portion of a trade or business in the tax year? ☐ Yes ☐ No		
40	Did you include any new categories of expenditures as current year QRE? ☐ Yes ☐ No		
41	Did you determine any of the QRE on line 5 or line 20 following the ASC 730 Directive? ☐ Yes ☐ No		
	If "Yes," enter the amount from Appendix C Line 19 (you may attach your Appendices A, B, C, and D here)	41	
	This ASC 730 Directive only applies to taxpayers with assets equal to or greater than $10,000,000 who follow U.S. GAAP to prepare their Certified Audited Financial Statements showing the amount of currently expensed Financial Statement R&D. See instructions.		

Section F—Qualified Research Expenses Summary. See instructions.

A Are you required to complete Section G? See instructions to determine if you are required to complete Section G, and how to complete Section F if you are not required to complete Section G ☐ Yes ☐ No

42	Total wages for qualified services for all business components (do not include any wages used in figuring the work opportunity credit)			42	
43	Total costs of supplies for all business components			43	
44	Total rental or lease cost of computers for all business components			44	
45	Total applicable amount of contract research for all business components (do not include basic research payments)	45			
46	Enter the applicable amount of all basic research payments. See instructions	46			
47	Add line 45 and line 46			47	
48	Add lines 42, 43, 44, and 47, then enter line 48 on either line 5 or line 20, whichever is appropriate			48	

Form **6765** (Rev. 12-2024)

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Section G—Business Component Information. Complete lines 49(a) through 49(f) for each business component you are required to report. See instructions. Attach additional sheets if necessary to capture all business components.

BC	**49(a)** EIN of the controlled group member conducting the research activities on this business component	**49(b)** Controlled group member's principal business activity code	**49(c)** Business component's name or unique alphanumeric identifier (see instructions)	**49(d)** Business component type (select one from available options)
1				
2				
3				
4				
5				
6				
7				
8				
9				
10				
11				
12				
13				
14				
15				

BC	**49(e)** Software (if applicable, select from the available options)	**49(f)** Describe the information sought to be discovered. Use the space provided.
1		
2		
3		
4		
5		
6		
7		
8		
9		
10		
11		
12		
13		
14		
15		

Form **6765** (Rev. 12-2024)

TREASURY/IRS AND OMB USE ONLY DRAFT June 20, 2024 DO NOT FILE

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Form 6765 (Rev. 12-2024) Page **4**

Section G—Business Component Information *(continued)*. Complete lines 50 through 56 for each business component. If you have more than fifteen business components, see instructions.

BC	50 Direct research wages for qualified services	51 Direct supervision wages for qualified services	52 Direct support wages for qualified services	53 Total qualified wages (add line 50, line 51, and line 52)
1				
2				
3				
4				
5				
6				
7				
8				
9				
10				
11				
12				
13				
14				
15				
Total from attachments				
Total				

BC	54 Cost of supplies	55 Rental or lease cost of computers	56 Applicable amount of contract research expenses (see instructions for reporting basic research payments)
1			
2			
3			
4			
5			
6			
7			
8			
9			
10			
11			
12			
13			
14			
15			
Total from attachments			
Total			

TREASURY/IRS AND OMB USE ONLY DRAFT June 20, 2024 DO NOT FILE

Form **6765** (Rev. 12-2024)

Individual taxpayers with sole proprietorships report the tax on Form 3800, part III, line 4i, *Form 6765 (ESB).* Because it is nonrefundable, they must report the credit for increasing research activities on Schedule 3 (Form 1040) on line 6a, *General business credit.*

Estates and trusts do not use Form 3800 because the entire amount of the credit must be allocated to beneficiaries.[116]

Status

The IRS posted a draft of 2024 Form 6765 on June 20, 2024, and provided an anticipated final release in December 2024. The agency has not yet published draft instructions for the 2024 version of the form.

116. IRC §41(f)(2).

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FORM 7211 (NEW)

Form 7211, *Clean Electricity Production Credit,* enables taxpayers to claim a credit for producing clean electricity, usually through entities in which they own an ownership interest. The Inflation Reduction Act, §13701, which authorized IRC §45Y, provides that the credit applies only to facilities that taxpayers place in service after December 31, 2024.[117] Consequently, the form should receive little or no use during the 2025 tax return season.

When eligible facilities start producing clean energy, the business entities owning them will either report the credit themselves or pass it through to their equity owners. Thus, taxpayers claiming the credit may be individuals, partnerships, C corporations, and S corporations. Estates and trusts must pass the credit to beneficiaries.[118]

Form 7211 collects information on the facility used to generate electricity, including its latitude and longitude. The form collects information about when construction on the facility started and when its owner placed it in production. Part II of the draft form collects information about the power of clean electricity produced. Part III of the draft form calculates the credit reduction if the facility's owner used tax-exempt bonds to finance the facility.

117. IRC §45Y(b)(1)(A)(ii).

118. IRC §45Y(g)(5).

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Form **7211** (December 2024) Department of the Treasury Internal Revenue Service

Clean Electricity Production Credit

Attach to your tax return.
Go to *www.irs.gov/Form7211* for instructions and the latest information.

OMB No. 1545-XXXX
Attachment Sequence No. **211**

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

TREASURY/IRS AND OMB USE ONLY DRAFT July 9, 2024 DO NOT FILE

Part I Information on Qualified Facility

1 If making an elective payment election or transfer election, enter the IRS-issued registration number of the facility: ____________

2a If different than filer, enter the (i) owner's name ____________ and (ii) owner's TIN ____________.

b Address and description of the facility: ____________

c Coordinates.

(i) Latitude: ☐ ☐☐.☐☐☐☐☐☐☐ Enter a "+" (plus) or "-" (minus) sign in the first box. (ii) Longitude: ☐ ☐☐☐.☐☐☐☐☐☐☐ Enter a "+" (plus) or "-" (minus) sign in the first box.

3 Date construction began (MM/DD/YYYY): ____________

4 Date placed in service (MM/DD/YYYY): ____________

5 If you petitioned for a provisional emissions rate (PER), check the applicable box below:
(i) ☐ An emissions value was received from the Department of Energy (DOE).
(ii) ☐ A designated Lifecycle Analysis (LCA) model was used to recommend an emissions value.

6 Enter the DOE control number, if applicable: ____________

7 Does the facility qualify to claim the credit at the alternative amount? See instructions.
a ☐ Yes, the facility's maximum net output is less than 1 megawatt (as measured in alternating current).
b ☐ Yes, the facility's construction began before January 29, 2023.
c ☐ Yes, the facility meets the prevailing wage requirements of section 45(b)(7)(A) and the apprenticeship requirements of section 45(b)(8).
d ☐ No.

8 Does the facility qualify for an energy community bonus credit?
☐ Yes, the facility qualifies for the energy community bonus credit under section 45Y(g)(7).
☐ No.

9 Does the facility qualify for the domestic content bonus credit?
☐ Yes, the facility qualifies for the domestic content bonus credit under section 45Y(g)(11).
☐ No.

Part II Clean Electricity Production

The rate you enter in (b) will depend on how you answered Part I, question 7, and the calendar year in which you sold, consumed, or stored the kWh of qualified clean electricity. See instructions for information on calculating the rate.		**(a)** Kilowatt-hours of qualified clean electricity	**(b)** Applicable amount	**(c)** Column (a) x Column (b)
1 Calendar year: ________	1			
2 Calendar year: ________	2			

3 Enter the total amount of lines 1(c) and 2(c). See instructions	3	
4 Reserved for future use	4	
5a Energy community bonus credit. See instructions. If you qualify, multiply the amount on line 3 by 10% (0.10). Otherwise, enter -0-	5a	
b Add lines 3 and 5a	5b	

For Paperwork Reduction Act Notice, see the separate instructions. Cat. No. 56405V Form **7211** (12-2024)

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Form 7211 (12-2024) Page 2

Part II **Clean Electricity Production** *(continued)*

TREASURY/IRS AND OMB USE ONLY DRAFT July 9, 2024 DO NOT FILE

Credit Reduction for Tax-Exempt Bonds

If you used proceeds of tax-exempt bonds to finance your facility, continue to line 6a; otherwise, enter the amount from line 5b on line 7.

Line	Description	Box	Amount
6a	**Divide.** Sum, for the tax year and all prior tax years, of all proceeds of tax-exempt bonds (within the meaning of section 103) used to finance the qualified facility ÷ Aggregate amount of additions to the capital account for the qualified facility, for the tax year and all prior tax years, as of the close of the tax year = ...	6a	
b	Multiply line 5b by line 6a	6b	
c	Multiply line 5b by 15% (0.15)	6c	
d	Enter the smaller of line 6b or line 6c	6d	
7	Subtract line 6d from line 5b	7	
8a	Domestic content bonus credit. If you qualify, multiply the amount on line 7 by 10% (0.10). Otherwise, enter -0-. See instructions for reductions you may need to make when calculating this credit	8a	
b	Add lines 7 and 8a	8b	
9	Phase-out for elective payment. If you are making an elective payment election under section 6417, for a facility whose construction began in 2024 and the facility does not conform to section 45Y(g)(12)(B)(i) or meet the exception under section 45Y(g)(12)(B)(ii), multiply line 8b by 90% (0.90). If you are making an elective payment election, for a facility whose construction began in 2025 and the facility does not conform to section 45Y(g)(12)(B)(i) or meet the exception under section 45Y(g)(12)(B)(ii), multiply line 8b by 85% (0.85). All others, enter the amount from line 8b	9	
10	Clean electricity production credit from partnerships and S corporations, cooperatives, estates, and trusts (see instructions)	10	
11	Add lines 9 and 10. Cooperatives, estates, and trusts, go to line 12. Partnerships, and S corporations not electing transfer, stop here and report this amount on Schedule K. All others, stop here and report this amount on Form 3800, Part III, line 1gg	11	
12	Amount allocated to patrons of the cooperative or beneficiaries of the estate or trust (see instructions)	12	
13	Cooperatives, estates, and trusts, subtract line 12 from line 11. Report this amount on Form 3800, Part III, line 1gg	13	

Form **7211** (12-2024)

Taxpayers compute the credit on Form 7211, part II, *Clean Electricity Production*, line 11, and individuals receiving the credit must carry the number from this line to Form 3800, part III from which it is carried to Schedule 3 (Form 1040).

Estates and trusts must allocate the entire amount of the credit to beneficiaries on their Schedule K-1 (Form 1041), *Beneficiary's Share of Income, Deductions, Credits, etc*.

Status

The IRS released a draft of Form 7211 on July 9, 2024, but has not released draft instructions for this form as of mid-July 2024.

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FORM 7218 (NEW)

Taxpayers claim the tax credit authorized by IRC §45Z on Form 7218, *Clean Fuel Production Credit*. The form collects information about the amount of clean **transportation fuel** produced and the facility that produces it. The fuel produced may qualify for a production credit. This credit provides for the production of fuels used in transportation, in contrast to the credit authorized by §45Y, which is for clean electricity.

Generally, taxpayers who have invested in facilities and entities producing clean transportation fuels can claim this credit with Form 7218 for fuel produced after December 31, 2024, and before January 1, 2028.[119] However, estates and trusts entitled to this credit must pass it to their beneficiaries. It is currently uncertain whether the estates or trusts must file Form 7218 to pass the credit to their beneficiaries.

Form 7218 reports the following.

- Information on the facility used to generate electricity, including its latitude and longitude
- Information about when construction on the facility started and when it was placed in production
- Summary of the quantity of clean transportation fuel produced
- Calculation of the energy produced by the clean fuel

119. IRC §45Z(g).

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Form **7218**

(December 2024)

Department of the Treasury
Internal Revenue Service

Clean Fuel Production Credit

Attach to your tax return.
Go to *www.irs.gov/Form7218* for instructions and the latest information.

OMB No. 1545-XXXX

Attachment Sequence No. **218**

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

TREASURY/IRS AND OMB USE ONLY DRAFT July 8, 2024 DO NOT FILE

Part I Facility and Other Information (see instructions)

Caution: The facility must be a qualified facility under section 45Z(d)(4). Your eligibility to claim this credit is restricted if you have taken credits for this facility related to section 45V, section 46 (to the extent such credit is attributable to a section 48(a)(15) election), or section 45Q. See instructions.

1 If making an elective payment election or transfer election, enter the IRS-issued registration number for the facility:

2a Description of facility:

b If different than filer, enter (i) owner's name: and (ii) owner's TIN:

c Address of the facility (if applicable):

d Coordinates. (i) Latitude: ☐ ☐☐.☐☐☐☐☐☐ (ii) Longitude: ☐ ☐☐☐.☐☐☐☐☐☐

Enter a "+" (plus) or "-" (minus) sign in the first box. Enter a "+" (plus) or "-" (minus) sign in the first box.

3 Date construction began (MM/DD/YYYY):

4 Date placed in service (MM/DD/YYYY):

5a Enter the producer registration number:

b Date of registration approval for activity letter "CA" and/or "CN":

6 Check this box if you are using provisional emissions rate(s) (PER) to determine your amount of credit . . . . ☐

7 Does the facility satisfy IRC 45Z(f)(6) prevailing wage requirements and IRC 45Z(f)(7) apprenticeship requirements?

a ☐ Yes.

b ☐ No.

Part II Clean Aviation and Non-Aviation Transportation Fuel Production Credit

1	Enter the amount from Part III, line 25(h)	**1**	
2	Clean fuel production credit from partnerships, S corporations, cooperatives, estates, and trusts .	**2**	
3	Add lines 1 and 2. Cooperatives, estates, and trusts, go to line 4. Partnerships and S corporations not electing transfer, stop here and report on Schedule K. All others, stop here and report this amount on Form 3800, Part III, line 1q. See instructions	**3**	
4	Amount allocated to patrons of the cooperative or beneficiaries of the estate or trust	**4**	
5	Cooperatives, estates, and trusts, subtract line 4 from line 3. Report this amount on Form 3800, Part III, line 1q	**5**	

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 94754J Form **7218** (12-2024)

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Form 7218 (12-2024) Page 2

Part III Clean Aviation and Non-Aviation Transportation Fuel Produced and Sold After 2024 (see instructions)

TREASURY/IRS AND OMB USE ONLY DRAFT July 8, 2024 DO NOT FILE

	(a) Type of fuel	(b) Type of feedstock	(c) Calendar year sold	(d) Emissions Rate or PER Value in kg of CO_{2e} per mmBTU	(e) Subtract (d) from 50 kg of CO_{2e} per mmBTU and divide the result by 50 kg of CO_{2e} per mmBTU	(f) Gallons or gallon equivalents	(g) Inflation-adjusted applicable amount for fuel sold	(h) Multiply columns (e) x (f) x (g)
1								
2								
3								
4								
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12								
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18								
19								
20								
21								
22								
23								
24								
25	Total of column (h)						25	

Form **7218** (12-2024)

Form 7218 presents the computed credit in part II, line 3, and individuals receiving it must carry the credit from this line to Form 3800, part III, line 1q, *Form 7218, Part II*. From Form 3800, the credit transfers to Schedule 3 (Form 1040) for individual taxpayers.

Estates and trusts must allocate the entire amount of the credit to beneficiaries, who are notified of its availability on the Schedule K-1 (Form 1041) they receive.

Status

A draft of Form 7218 was released on July 8, 2024. The projected date of the form's release is December 2024.

FORM 8936 (REVISED)[120]

Taxpayers use Form 8936, *Clean Vehicle Credits,* to claim tax credits for vehicles they acquire for business or personal use. Beginning with 2024 vehicle purchases, the form is also used to transfer the credit to the dealer that sells the new or used clean vehicle. A clean vehicle is propelled by electricity stored in a battery or by a fuel cell. Numerous restrictions apply to the vehicles, and the form collects relevant information.

Form 8936 can be used by individuals, partnerships, and corporations, as the governing Code sections place no restrictions on the type of taxpayers eligible for the credit.[121] The form's instructions discuss its use by tax-exempt entities and government agencies to offset income tax.[122] However, the clean vehicle credit for previously owned vehicles can only be claimed by individuals.[123]

If the taxpayer transfers the credit to the dealer, they will also need to file Schedule A (Form 8936), *Clean Vehicle Credit Amount*.

120. 2024 Draft Instructions for Form 8936.

121. IRC §§25 and 30D.

122. 2023 Instructions for Form 8936.

123. IRC §25E(c)(3)(A).

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Form **8936**

Department of the Treasury
Internal Revenue Service

Clean Vehicle Credits

Attach to your tax return.
Go to *www.irs.gov/Form8936* for instructions and the latest information.

OMB No. 1545-2137
2024
Attachment Sequence No. 69

Name(s) shown on return | Identifying number

Notes:
- Complete a separate Schedule A (Form 8936) for each clean vehicle placed in service during the tax year.
- Individuals who transferred the credit to the dealer at the time of sale must file this form and Schedule A (Form 8936).

TREASURY/IRS AND OMB USE ONLY DRAFT July 16, 2024 DO NOT FILE

Part I Modified Adjusted Gross Income (MAGI) Amount

Line	Description		
1a	Enter the amount from line 11 of your 2024 Form 1040, 1040-SR, or 1040-NR. Estates and trusts, Form 1041, see instructions	1a	
b	Enter any income from Puerto Rico you excluded	1b	
c	Enter any amount from Form 2555, line 45	1c	
d	Enter any amount from Form 2555, line 50	1d	
e	Enter any amount from Form 4563, line 15	1e	
2	Add lines 1a through 1e		2
3a	Enter the amount from line 11 of your 2023 Form 1040, 1040-SR, or 1040-NR. Estates and trusts, Form 1041, see instructions	3a	
b	Enter any income from Puerto Rico you excluded	3b	
c	Enter any amount from Form 2555, line 45	3c	
d	Enter any amount from Form 2555, line 50	3d	
e	Enter any amount from Form 4563, line 15	3e	
4	Add lines 3a through 3e		4
5	Enter your 2023 filing status (S, MFS, etc., see chart below)		5

Individuals, estates, or trusts exceeding the following MAGI limits for both 2023 and 2024 can't claim the applicable credit.

Filing Status	Part II/III Limits	Part IV Limits
Single (S)	$150,000	$75,000
Married filing separately (MFS)	$150,000	$75,000
Head of household (HOH)	$225,000	$112,500
Married filing jointly (MFJ)	$300,000	$150,000
Qualifying surviving spouse (QSS)	$300,000	$150,000
Estates and trusts	$150,000	N/A

Part II Credit for Business/Investment Use Part of New Clean Vehicles

Line	Description	
6	Enter the total credit amount figured in Part II of Schedule(s) A (Form 8936)	6
7	New clean vehicle credit from partnerships and S corporations (see instructions)	7
8	**Business/investment use part of credit.** Add lines 6 and 7. Partnerships and S corporations, stop here and report this amount on Schedule K. All others, report this amount on Form 3800, Part III, line 1y	8

Part III Credit for Personal Use Part of New Clean Vehicles

Line	Description	
9	Enter the total credit amount figured in Part III of Schedule(s) A (Form 8936)	9
10	Enter the amount from Form 1040, 1040-SR, or 1040-NR, line 18	10
11	Personal credits from Form 1040, 1040-SR, or 1040-NR (see instructions)	11
12	Subtract line 11 from line 10. If zero or less, enter -0- and stop here. You can't claim the personal use part of the credit	12
13	**Personal use part of credit.** Enter the **smaller** of line 9 or line 12 here and on Schedule 3 (Form 1040), line 6f. If line 12 is smaller than line 9, see instructions	13

Part IV Credit for Previously Owned Clean Vehicles

Line	Description	
14	Enter the total credit amount figured in Part IV of Schedule(s) A (Form 8936)	14
15	Enter the amount from Form 1040, 1040-SR, or 1040-NR, line 18	15
16	Personal credits from Form 1040, 1040-SR, or 1040-NR (see instructions)	16
17	Subtract line 16 from line 15. If zero or less, enter -0- and stop here. You can't claim the Part IV credit	17
18	Enter the **smaller** of line 14 or line 17 here and on Schedule 3 (Form 1040), line 6m. If line 17 is smaller than line 14, see instructions	18

Part V Credit for Qualified Commercial Clean Vehicles

Line	Description	
19	Enter the total credit amount figured in Part V of Schedule(s) A (Form 8936)	19
20	Qualified commercial clean vehicle credit from partnerships and S corporations (see instructions)	20
21	Add lines 19 and 20. Partnerships and S corporations, stop here and report this amount on Schedule K. All others, report this amount on Form 3800, Part III, line 1aa	21

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 37751E Form **8936** (2024)

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SCHEDULE A
(Form 8936)

Department of the Treasury
Internal Revenue Service

Clean Vehicle Credit Amount

Attach to your tax return.
Go to *www.irs.gov/Form8936* for instructions and the latest information.

OMB No. 1545-2137

2024

Attachment Sequence No. **69A**

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

TREASURY/IRS AND OMB USE ONLY DRAFT July 16, 2024 DO NOT FILE

Notes:
- Complete a separate Schedule A (Form 8936) for each clean vehicle placed in service during the tax year.
- Individuals who transferred the credit to the dealer at the time of sale must file this schedule and Form 8936.

Part I Vehicle Details

1a Year . . . . ______

b Make . . . . ______

c Model . . . . ______

2 Vehicle identification number (VIN) (see instructions) . . ☐☐☐☐☐☐☐☐☐☐☐☐☐☐☐☐☐

3 Enter date vehicle was placed in service (MM/DD/YYYY) . . . . ______

4a Did you transfer the credit to the dealer at the time of sale?
☐ **Yes.** Enter the transferred amount shown on the seller's report . . . . ______
☐ **No.** Go to line 5.

b If line 4a is "Yes," complete line 8 or line 13, as applicable, and check here if directed to do so by line 8a, 8d, 13a, or 13c . ☐

5 Does the VIN entered on line 2 belong to a **new clean vehicle** placed in service during the tax year? See instructions for definitions.
☐ **Yes.** Go to Part II.
☐ **No.** Go to line 6.

6 Does the VIN entered on line 2 belong to a **previously owned clean vehicle** acquired after 2022 and placed in service during the tax year? See instructions for definitions.
☐ **Yes.** Go to Part IV.
☐ **No.** Go to line 7.

7 Does the VIN entered on line 2 belong to a **qualified commercial clean vehicle** acquired after 2022 and placed in service during the tax year? See instructions for definitions.
☐ **Yes.** Go to Part V.
☐ **No. Stop here.** You can't use this schedule to figure a credit amount for a vehicle not described on line 5, 6, or 7.

Part II Credit Amount for Business/Investment Use Part of New Clean Vehicle

8a Did you resell the vehicle within 30 days of the placed-in-service date shown on line 3?
☐ **Yes. Stop here.** You can't claim a clean vehicle credit for this vehicle. If line 4a is "Yes," check the box on line 4b and report the amount from line 4a on Schedule 2 (Form 1040), line 1b.
☐ **No.** Go to line 8b.

8b Are you filing this form with an individual income tax return?
☐ **Yes.** Go to line 8c.
☐ **No.** Skip lines 8c and 8d and go to line 8e.

8c Complete Form 8936, lines 1 and 2. Is line 2 more than the "Part II/III limits" amount shown on the chart below line 5, Form 8936 for your 2024 filing status?
☐ **Yes.** Go to line 8d.
☐ **No.** If you transferred the credit amount to the dealer at the time of sale, stop here and see instructions. Otherwise, skip line 8d and go to line 8e.

8d Complete Form 8936, lines 3, 4, and 5. Is line 4 more than the "Part II/III limits" amount shown on the chart below line 5, Form 8936 for your 2023 filing status? See instructions if your 2024 return is a joint return.
☐ **Yes. Stop here.** You can't claim a clean vehicle credit for this vehicle. If line 4a is "Yes," check the box on line 4b and report the amount from line 4a on Schedule 2 (Form 1040), line 1b.
☐ **No.** If you transferred the credit amount to the dealer at the time of sale, stop here and see instructions. Otherwise, go to line 8e.

For Paperwork Reduction Act Notice, see the Form 8936 instructions. Cat. No. 93602W **Schedule A (Form 8936) 2024**

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Part II **Credit Amount for Business/Investment Use Part of New Clean Vehicle** *(continued)*

8e Did you acquire the vehicle for use or to lease to others, and not for resale? Answer "No" if you are leasing the vehicle from another person.

☐ **Yes.**

☐ **No. Stop here.** You can't claim a credit amount for a vehicle you didn't acquire for use or to lease to others, or acquired for resale.

9	Tentative credit amount (see instructions)	**9**	
10	Business/investment use percentage (see instructions)	**10**	%
11	Multiply line 9 by line 10. Include this credit amount on line 6 in Part II of Form 8936. If you entered 100% on line 10, stop here. Otherwise, go to Part III below	**11**	

Part III **Credit Amount for Personal Use Part of New Clean Vehicle**

12	Subtract line 11 from line 9 in Part II. Stop here and include this credit amount on line 9 in Part III of Form 8936	**12**	

Part IV **Credit Amount for Previously Owned Clean Vehicle**

13a Did you resell the vehicle within 30 days of the placed-in-service date shown on line 3?

☐ **Yes. Stop here.** You can't claim a clean vehicle credit for this vehicle. If line 4a is "Yes," check the box on line 4b and report the amount from line 4a on Schedule 2 (Form 1040), line 1c.

☐ **No.** Go to line 13b.

b Complete Form 8936, lines 1 and 2. Is line 2 more than the "Part IV limits" amount shown on the chart below line 5, Form 8936 for your 2024 filing status?

☐ **Yes.** Go to line 13c.

☐ **No.** If you transferred the credit amount to the dealer at the time of sale, stop here and see instructions. Otherwise, skip line 13c and go to line 13d.

c Complete Form 8936, lines 3, 4, and 5. Is line 4 more than the "Part IV limits" amount shown on the chart below line 5, Form 8936 for your 2023 filing status? See instructions if your 2024 return is a joint return.

☐ **Yes. Stop here.** You can't claim a clean vehicle credit for this vehicle. If line 4a is "Yes," check the box on line 4b and report the amount from line 4a on Schedule 2 (Form 1040), line 1c.

☐ **No.** If you transferred the credit amount to the dealer at the time of sale, stop here and see instructions. Otherwise, go to line 13d.

d Have you claimed a previously owned clean vehicle credit for another vehicle purchased in the 3-year period ending on the date you purchased the vehicle identified in Part I? See instructions if you are filing a joint return.

☐ **Yes. Stop here.** You can't claim a credit for this vehicle if you have already claimed the previously owned vehicle credit for another vehicle purchased during this 3-year period.

☐ **No.** Go to line 13e.

e Is the sales price of the vehicle more than $25,000?

☐ **Yes. Stop here.** The vehicle doesn't qualify for the Part IV credit.

☐ **No.**

f Did you acquire the vehicle for use and not for resale? Answer "No" if you are leasing the vehicle from another person.

☐ **Yes.**

☐ **No. Stop here.** You can't claim a credit amount for a vehicle you didn't acquire for use or acquired for resale.

g Can you be claimed as a dependent on another person's tax return, such as your parent's return?

☐ **Yes. Stop here.** You can't claim a credit amount if you can be claimed as a dependent.

☐ **No.**

14	Enter the sales price of the vehicle	**14**	
15	Multiply line 14 by 30% (0.30)	**15**	
16	Maximum vehicle credit amount	**16**	*$4,000*
17	Enter the smaller of line 15 or line 16. Stop here and include this credit amount on line 14 in Part IV of Form 8936	**17**	

Schedule A (Form 8936) 2024

TREASURY/IRS AND OMB USE ONLY DRAFT July 16, 2024 DO NOT FILE

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Schedule A (Form 8936) 2024 Page 3

Part V **Credit Amount for Qualified Commercial Clean Vehicle**

18a If making an elective payment election, enter the IRS-issued registration number for the vehicle ________________

b Is the vehicle of a character subject to the allowance for depreciation? Answer "Yes" if the exception for certain tax-exempt entities discussed in the instructions applies.

☐ **Yes.**

☐ **No. Stop here.** The vehicle is not a qualified commercial clean vehicle unless the exception applies.

c Did you acquire the vehicle for use or to lease to others, and not for resale? Answer "No" if you are leasing the vehicle from another person.

☐ **Yes.**

☐ **No. Stop here.** You can't claim a credit amount for a vehicle you didn't acquire for use or to lease to others, or acquired for resale.

d Is the vehicle also powered in part by gas or diesel? See instructions.

☐ **Yes.**

☐ **No.**

e Enter the vehicle's gross vehicle weight rating (GVWR) . . . . ________________

Line	Description	Line	Amount
19	Enter the cost or other basis of the vehicle. See instructions	**19**	
20	Section 179 expense deduction (see instructions)	**20**	
21	Subtract line 20 from line 19	**21**	
22	Multiply line 21 by 15% (0.15) (30% (0.30) if the answer on line 18d above is "No")	**22**	
23	Enter the incremental cost of the vehicle. See instructions	**23**	
24	Enter the smaller of line 22 or line 23	**24**	
25	**Maximum credit.** Enter $7,500 ($40,000 if the vehicle's gross vehicle weight rating (see line 18e) is 14,000 pounds or more)	**25**	
26	Enter the smaller of line 24 or line 25. Include this credit amount on line 19 in Part V of Form 8936	**26**	

Schedule A (Form 8936) 2024

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Status

Taxpayers have used Form 8936 for some years without provisions to accommodate credit transfers. The IRS released a draft of Form 8936 and Schedule A (Form 8936) on July 16, 2024.

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EXPIRING PROVISIONS

The following are some expiring provisions for which taxpayers may want to plan.

December 31, 2024

Code Sections	Description
40(b)(6)(J)	Second generation biofuel producer credit
40A(g)	Various income tax credits for biodiesel fuel, biodiesel used to produce a qualified mixture, and small agribiodiesel producers (also renewable diesel)
40B(h)	Credit for sustainable aviation fuel
45(d), 48(a)(5)	Beginning-of-construction date for renewable power facilities eligible to claim the renewable electricity production credit or investment credit in lieu of the production credit
48(a)(2)(A)(i)(II), 48(a)(3)(A)(ii) and (vii), 48(c)(1)(E), 48(c)(2)(D), 48(c)(3)(A)(iv), 48(c)(4)(C)	Beginning-of-construction date for increased credit for business solar energy property and credit for fiber optic solar lighting system property, qualified fuel cell and stationary microturbine power plant property, combined heat and power property, small wind property, and waste energy recovery property
48(a)(3)(A), 168(e)(3)(B)	5-year recovery period for certain energy property
48(e)(4)(C)	Increase in energy credit for solar and wind facilities placed in service in connection with low-income communities
223(c)(2)(E)	Safe harbor for absence of deductible for telehealth
6426(c)(6)	Excise tax credits and outlay payments for (renewable) diesel fuel mixtures
6426(d)(5)	Excise tax credits and outlay payments for alternative fuel
6426(e)(3)	Excise tax credits for alternative fuel mixtures
6426(k)	Excise tax credits and outlay payments for sustainable aviation fuel
6427(e)(6)(B), (C), and (E)	Excise tax credits and outlay payments for (renewable) diesel fuel mixtures

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December 31, 2025

Code Sections	Description
1(j)	Modification of individual income tax rates
24(h)	Child tax credit amounts
25B(d)(1)(D), 529(c)(3)(C)(i)(III), 529A(b)(2)(B)	Achieving a Better Life Experience (ABLE) accounts: Contributions eligible for saver's credit; rollovers from qualified tuition plans permitted, and increased contribution amounts
36B	Premium assistance credit enhancements
45D(f)(1)	New markets tax credit
45S(i)	Employer credit for paid family and medical leave
51(c)(4)	Work opportunity tax credit
55	Modifications of exemption amount and phaseout threshold of individual AMT
59A(b)(2)	Rate on modified taxable income and treatment of credits in the calculation of base erosion minimum tax amount
63(c)(7)	Increase in standard deduction of individuals
67(g)	Suspension of miscellaneous itemized deduction
68(f)	Suspension of limitation on itemized deductions
108(a)(1)(E)	Exclusion from gross income of discharge of indebtedness on principal residence
108(f)(5)	Certain discharges of student loans
127(c)(1)(B)	Exclusion for certain employer payments of student loans
132(f)(8)	Suspension of exclusion for reimbursement of bicycle commuting
132(g)(2)	Suspension of exclusion for moving expense reimbursement
151(d)(5)	Suspension of deduction for personal exemptions
163(h)(3)(F)	Limitation on deduction for qualified residence interest, suspension of deduction for home equity interest
164(b)(6)	Limitation on deduction for state, local, etc., taxes
165(d)	Modification of rules relating to computation of wagering losses
165(h)(5)	Personal casualty losses limited to federally declared disaster areas
168(e)(3)(C)(ii), 168(i)(15)(D)	7-year recovery period for motorsports entertainment complexes
170(b)(1)(G)	Increase in percentage limitation on cash contributions to public charities
181(g)	Special expensing rules for certain film, television, and live theatrical productions
199A(i)	QBID
217(k)	Suspension of deduction for moving expenses
250(a)(3)	Deduction percentages for foreign-derived intangible income and global intangible low-taxed income
274(o)	Deductibility of employer de minimis meals and related eating facility, and meals for the convenience of the employer
954(c)(6)(C)	Look-through treatment of payments between related controlled foreign corporations under the foreign personal holding company rules

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December 31, 2025 *(continued)*

Code Sections	Description
1391(d), (h), 1394, 1396	Empowerment zones: Designation of an empowerment zone, tax-exempt bonds, employment credit
2010(c)(3)(C)	Increased estate and gift tax exemption
4611(f)(2)	Oil Spill Liability Trust Fund financing rate

December 31, 2026

Code Sections	Description
25B	Elective deferrals and IRA contributions by certain individuals
48D(e)	Credit for advanced manufacturing investment
168(k) and 460(c)	Various additional first-year depreciation elections
1400Z-2(a)(2)(B)	Election to invest capital gains in an opportunity zone

December 31, 2027, unless noted

Code Sections	Description
45Z(g)	Credit for clean fuel production
263A(d)(2)(C)	Expensing of certain costs of replanting citrus (expires December 22, 2027)

September 30, 2028

Code Sections	Description
4041(a) and (m), 4051(c), 4071(d), 4081(d)(1)	Highway Trust Fund excise taxes
4041(d)(4), 4042(b)(4), 4081(d)(3)	Leaking Underground Storage Tank Trust Fund financing rate
4043(d), 4081(d)(2)(B), 4083(b), 4261(j) and (k), 4271(d)	Various Airport and Airway Trust Fund excise taxes

December 31, 2028

Code Sections	Description
461(l)	Limitation on excess business losses incurred by noncorporate taxpayers

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Acronyms and Abbreviations

2FA	2-factor authentication
A2A	Application to application
AA	Acceptance agent
ABLE	Achieving a Better Life Experience Act of 2014
ACA	Affordable Care Act of 2010
ACE	Average current earnings
ACSI	American Customer Satisfaction Index
ACTC	Additional child tax credit
ADS	Alternative depreciation system
AFR	Applicable federal rate
AFSI	Adjusted financial statement income
AGI	Adjusted gross income
AI	Artificial intelligence
AIA	Anti-Injunction Act
AICPA	American Institute of Certified Public Accountants
AMT	Alternative minimum tax
AMTI	Alternative minimum taxable income
AOD	Action on Decision
APA	Administrative Procedure Act
API	Application program interfaces
ARC	Agricultural risk coverage
ARP	American Rescue Plan Act of 2021
ASHRAE	American Society of Heating, Refrigerating, and Air Conditioning Engineers
ATS	Assurance Testing System
ATNOL	Alternative tax net operating losses
BBA	Bipartisan Budget Act of 2015
BOI	Beneficial ownership information
CAA	Certified acceptance agent
CAF	Centralized Authorization File
CAMT	Corporate alternative minimum tax
CARES	Coronavirus Aid, Relief, and Economic Stimulus Act
CCA	Chief Counsel Advice
CCC	Commodity Credit Corporation
CDP	Collection due process
CEO	Chief executive officer
CFC	Controlled foreign corporation
CFS	Collection financial standards
CHIPS	Creating Helpful Incentives for Produce Semiconductors 2022 Act
CISA	Cybersecurity and Infrastructure Security Agency
COA	Certificate of accuracy
COBRA	Consolidated Omnibus Budget Reconciliation Act
CODI	Cancellation of debt income
CPA	Certified public accountant
CPI	Consumer price index
CRT	Charitable remainder trust
CRAT	Charitable remainder annuity trust
CRUT	Charitable remainer unitrust
CSA	Climate Smart Agriculture
CSRS	Civil Service Retirement System
CTA	Corporate Transparency Act
CTC	Child tax credit
CUSIP	Committee on Uniform Securities Identification Procedures
DB	Designated beneficiary
DBA	Doing business as
DEA	Drug Enforcement Administration
DISC	Domestic international sales corporation
DOE	U.S. Department of Energy
DPAD	Domestic production activities deduction
DRO	Deficit restoration obligation
DSUE	Deceased spousal unused exclusion

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EACA	Eligible automatic contribution arrangement
ECO	Enhanced coverage option
EDB	Eligible designated beneficiary
EECBP	Energy-efficient commercial building property
EEBRP	Energy-efficient commercial building retrofit property
EFL	Excess front-loading
EFTPS	Electronic Federal Tax Payment System
EIC	Earned income credit
EIN	Employer identification number
ERC	Employee retention credit
ERISA	Employee Retirement Income Security Act of 1974
ERP	Emergency relief program
ESBC	Eligible small business credit
ESBT	Electing small business trust
ESOP	Employee stock ownership plan
ETIP	Estate tax inclusion period
EV	Electric vehicle
EQIP	Environmental Quality Incentives Program
FAA	Federal Aviation Administration
FAFSA	Free Application for Federal Student Aid
FAQ	Frequently asked question
FBAR	Report of Foreign Bank and Financial Accounts
FCEV	Fuel cell electric vehicle
FDIC	Federal Deposit Insurance Corporation
FEMA	Federal Emergency Management Agency
FERS	Federal Employees Retirement System
FFM	Frequent flyer miles
FinCEN	Financial Crimes Enforcement Network
FIRE	Filing information returns electronically
FLP	Family limited partnerships
FMV	Fair market value
FOIA	Freedom of Information Act
FPAA	Final Partnership Administrative Adjustment
FSA	Field Service Advice
FTC	Federal Trade Commission
FUTA	Federal Unemployment Tax Act
FY	Fiscal year
GAAP	Generally accepted accounting principles
GBC	General business credits
GCM	General counsel memoranda
GST	Generation-skipping transfer
GSTT	Generation-skipping transfer tax
GVWR	Gross vehicle weight rating
HCTC	Health Coverage Tax Credit
HEEHRA	High-Efficiency Electric Home Rebate Act
HoH	Head of household
HOMES	Home Owner Managing Energy Savings Program
HRA	Health reimbursement arrangement
HSA	Health savings account
IDGT	Intentionally defective grantor trust
IDR	Information document request
ILM	Internal Legal Memorandum
IRA	Individual retirement arrangement
IRB	Internal Revenue Bulletin
IRC	Internal Revenue Code
IRD	Income in respect of a decedent
IRIS	Information Returns Intake System
IRMAA	Medicare income-related monthly adjustment amount
IRS	Internal Revenue Service
ISO	Incentive stock option
ITIN	Individual taxpayer identification number
JTL	Joint tax liability
kWh	Kilowatt hour
LGM	Litigation Guideline Memorandum
LIHC	Low-income housing credit

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LLC	Limited liability company
LLP	Limited liability partnership
LOSAP	Length of service award plan
LPPP	Longer production period property
LTA	Local taxpayer advocate
MACRS	Modified accelerated cost recovery system
MAGI	Modified adjusted gross income
MCC	Merchant category code
MFJ	Married filing jointly
MFS	Married filing separately
MMLLC	Multi-member limited liability company
MRT	Mandatory Repatriation Tax
MSA	Medical savings account
NATP	National Association of Tax Professionals
NCA	Noncommercial aircraft
NCAA	National Collegiate Athletic Association
NCFI	Net cash farm income
NFI	Net farm income
NFT	Nonfungible token
NFTL	Notice of Federal Tax Lien
NII	Net investment income
NIIT	Net investment income tax
NIL	Name, image, and likeness
NOL	Net operating loss
NRA	Nonresident alien
NRCS	Natural Resource Conservation Service
NTA	National Taxpayer Advocate
OBR	Offset bypass refund
ODC	Other dependents credit
OIC	Offer in compromise
OID	Original issue discount
OPM	Office of Personnel Management
PAL	Passive activity loss
PDAP	Processor of digital asset payments
PFMV	Present fair market value
PHEV	Plug-in-hybrid electric vehicles
PII	Personally identifiable information
PIN	Personal identification number
PLC	Price loss coverage
PLLC	Professional limited liability corporation
POA	Power of attorney
PPP	Paycheck Protection Program
PSD	Proposed stipulated decision
PSE	Payment settlement entity
PTC	Premium tax credit
PTC	Production tax credit
PTIN	Preparer tax identification number
PTP	Publicly traded partnership
PTSD	Post-traumatic stress disorder
PV	Present value
QACA	Qualified automatic contribution arrangement
QBI	Qualified business income
QBID	Qualified business income deduction
QBL	Qualified business loss
QDRO	Qualified domestic relations order
QEF	Qualified electing fund
QI	Qualified intermediary
QIO	Qualified income offset
QIP	Qualified improvement property
QJV	Qualified joint venture
QRE	Qualified research expenditures
QSS	Qualifying surviving spouse
QSV	Quick sale value
RBD	Required beginning date
REIT	Real estate investment trust
RMD	Required minimum distribution
RO	Responsible official
RTP	Right-to-purchase
SAF	Sustainable aviation fuel
SALT	State and local tax

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SAMS	Systemic Advocacy Management System
SARSEP	Salary reduction simplified employee pension
SCA	Service Center Advice
SCIN	Self-canceling installment note
SCO	Supplement coverage option
SE	Self-employment
SEC	Securities and Exchange Commission
SECURE	Setting Every Community Up for Retirement Enhancement Act
SEP	Simplified employee pension
SIMPLE	Savings Incentive Match Plan for Employees
SMLLC	Single-member limited liability company
SMS	Short message service
SSA	Social Security Administration
SSB	Specified service business
SSCA	Significant Service Center Advice
SSN	Social security number
TAC	Taxpayer Assistance Center
TAM	Technical Advice Memorandum
TAO	Taxpayer assistance order
TAS	Taxpayer Advocate Service
TCC	Transmitter control code
TCJA	Tax Cuts and Jobs Act of 2017
TD	Treasury Decision
TFA	Taxpayer First Act
TFRP	Trust fund recovery penalty
TIA	Tax information authorization
TIGTA	Treasury Inspector General for Tax Administration
TIN	Tax identification number
TMT	Tentative minimum tax
TPSO	Third-party settlement organization
UCC	Uniform Commercial Code
UPREIT	Umbrella Partnership Real Estate Investment Trust
URL	Uniform resource locator
USFSPA	Uniformed Services Former Spouses' Protection Act
USB	Universal serial bus
USDA	United States Department of Agriculture
USPS	United States Postal Service
VIN	Vehicle identification number
WAM	Weighted average maturity
WISP	Written information security plan
XML	Extensible markup language

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Quick Tips for Deciphering Citations

When reading cases and other legal materials, you will often encounter citations to other materials. While it may look overwhelming, it is really quite simple with the help of these tips.

Some examples of the types of citations you might see:

- Statute: **7 USC 1308** or **7 USC §1308**
- Case: ***Bush v. Gore,*** **121 S.Ct. 525 (2000)**

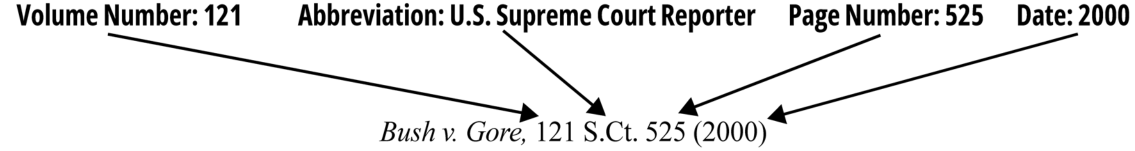
Here are some tips for finding these types of citations:

- To determine what the abbreviation stands for, please reference the following table:

Abbreviation	Meaning
USC	United States Code
CFR	Code of Federal Regulations
AFTR	American Federal Tax Reporter
U.S. or **S.Ct.**	U.S. Supreme Court Reporter
F.2d or **F.3d**	Federal Reporter (Circuit Court of Appeals Opinions)
Fed.Appx.	Federal Appendix (Circuit Court Rulings)
F.Supp or **F.Supp.2d**	Federal Supplement (U.S. District Courts)
TC	U.S. Tax Court (Opinions)
TC Memo	U.S. Tax Court (Memorandum opinions)
TC Summ. Op.	U.S. Tax Court Summary Opinion
Fed.Cl. or **Cl.Ct.**	U.S. Court of Federal Claims
Bankr. or **B.R.**	Bankruptcy Court Reports
Aff'd	Decision affirmed by appellate court
Rev'd	Decision overturned by appellate court
Cert. denied	Appeal refused by U.S. Supreme Court

- The **number preceding** the abbreviation is:
  - Case: volume number
  - Statute: title number
- The **number following** the abbreviation is:
  - Case: page number where case or law review article starts
  - Statute: section number (may include a § symbol)
- Often, the **date** of the article or case decision is included in parentheses.

Using the examples above, they break down as follows:



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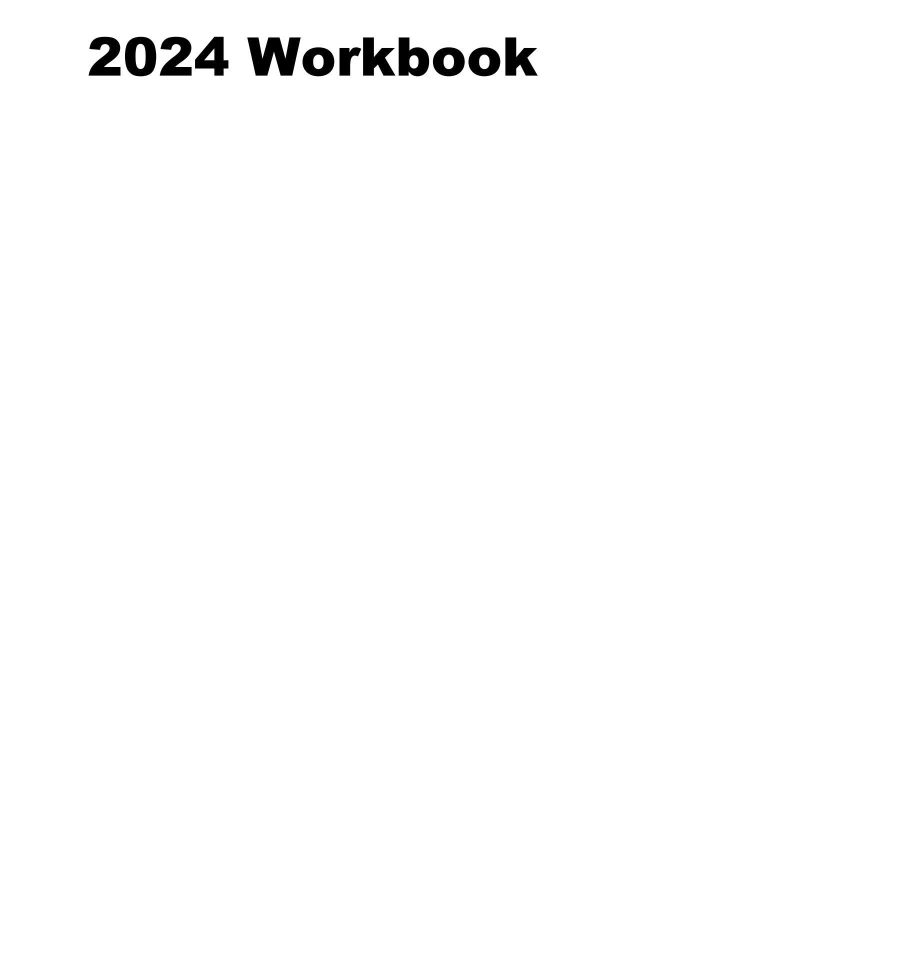

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